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AICGSPOLICY**REPORT**

THE EU SERVICES DIRECTIVE: NIGHTMARE OR OPPORTUNITY? IMPLICATIONS FOR TRANSATLANTIC BUSINESS

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FOREWORD

The EU Services Directive is likely to become Community law by the end of 2006, promising that, by the end of the decade, the EU will have a more deeply integrated market for services industries, allowing easier market access for companies, benefiting consumers, and enhancing economic growth. Many view the Directive as the litmus test of economic integration in an enlarged EU. Once implemented, the Directive should have a positive impact on transatlantic business, creating new trade and investment opportunities for U.S. firms and their EU-based subsidiaries.

The path leading up to the Services Directive proposal was anything but smooth, however. The evolution of the Directive is also an instructive case study in how policy is shaped in an enlarged European Union. The politics surrounding the proposal involved a complex interplay between the Commission, the Council, and the European Parliament, and with the individual EU member states, the media, and interest groups.

In their Policy Report, *The EU Services Directive: Nightmare or Opportunity? Implications for Transatlantic Business*, Klaus Deutsch, Björn Frank, and Martin Gornig analyze the politics that shaped the EU Services Directive, and assess its economic impact. They provide an overview of the services industries subject to the regulation, discuss the Commission's liberalization strategy in detail, and chart the political process to date. Finally, the authors explore the economic and business implications on the German economy, the lessons that can be drawn from the integration of North American services markets, as well as the implications for U.S. firms doing business in the EU.

The study is a significant contribution to our understanding of the complicated dynamics that shape regulatory approaches in an EU of twenty-five members. Such an understanding is particularly important for those outside the EU, who may have difficulty assessing the relative influence of EU institutions and of the national capitals on EU policy and directives.

This report is part of a series of analyses examining the historical/cultural, institutional, political, and economic context of transatlantic economic, regulatory, and policy approaches and the way that these factors shape our respective responses to the challenges of remaining competitive in a global market. The study was made possible through the generous support of the DaimlerChrysler-Fonds im Stifterverband für die Deutsche Wissenschaft. We are grateful to DaimlerChrysler for its support of this larger project and the Institute's work.

We are grateful to Klaus Deutsch, Björn Frank, and Martin Gornig for their comprehensive analysis and for illuminating an aspect of EU policymaking that often is little understood on this side of the Atlantic. I would also like to express my gratitude to Dr. John Starrels, Senior Fellow-in-Residence, who has helped immeasurably to shape and guide this series of reports, and to Ilonka Oszvald for her expert assistance in the editing and preparation of the manuscript.

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MARTIN GORNIG is currently Deputy Head of Department Innovation Manufacturing Services at German Institute for Economic Research (DIW Berlin) and Lecturer at the Technical University Berlin. After studies in economics and regional planning he joined the DIW Berlin in 1988. His main areas of research are analyses of the services sector, long-term economic forecasts, and regional economics.

EXECUTIVE SUMMARY

The EU Services Directive was proposed by the European Commission in January 2004. It will likely become Community law by the end of 2006 and will have to be implemented into member state law within two or three years after coming into force. By the end of the decade, the EU will create a more deeply integrated market for certain services industries such as retail and wholesale trade, business services, and tourism covering at least one-third of EU output. Companies in these services markets will benefit from easier market access in terms of both establishing a subsidiary in another member state and providing a service temporarily across the border.

The Directive will create a more deeply integrated market, strengthen services industries economically, benefit consumers and users of services, and contribute to economic growth. The bulk of the benefits will be concentrated in a small range of services in which both direct investment and cross-border provision are attractive. Typically, these industries employ skilled labor. In the study, we show that in the case of Germany computer services, R&D services and other high-quality, easy to trade services will benefit the most, while risks to low-skill services industries are mostly theoretical in nature.

In European politics, reality was often turned upside down, as timely analysis was not available and media activists and clever politicians set the agenda based on faulty assumptions. The politics of the Services Directive was highly complex. A radical Commission proposal was sharply rejected by a minority of member states (Germany and France) while it was generally supported by the vast majority of member states. The Parliament brokered a deal in which certain commercially less important service industries were removed from the scope of the Directive while the creation of the single market for key services was safeguarded. Politics followed the classic line of the conservatives adopting a pro-business position and the political left emphasizing the potential risks and costs of adjustment in particular for low-skilled services workers, and risks to the welfare state systems from liberalization. In the end, the EU of 25 member states is likely to reach agreement on a fairly deep integration project. This clearly demonstrates that European market integration can still work and even be deepened in an enlarged European Union.

U.S. and EU markets for services are more similar than most observers think. Since 1995, business services have grown in a similar fashion. Consumer services have been more dynamic in the United States due to stronger domestic demand. However, employment trends have been similar as well. Productivity developments have perhaps displayed the largest difference between the United States and the EU-15 in the period from 1995 to 2003: the United States recorded 1.8 percent productivity growth per annum in consumer and business services, whereas the EU only achieved 0.5 percent, less than one-third. The most significant difference exists in wholesale and retail trade, and to a lesser extent in the professions (architects and engineers, law and accounting firms) and in low-skill business services. There is a clear indication that regional specialization in the EU has not gone far enough yet and, by implication, a more deeply integrated market will provide incentives to specialize and change to more efficient and bigger business models.

Transatlantic business integration in services within the scope of the Directive is already quite substantial. Sales of U.S. foreign affiliates in related services industries alone exceeded $65 billion in 2000. The implications of the Services Directive for transatlantic business prospects are largely positive. Trade and investment opportunities for U.S. firms and their EU-domiciled subsidiaries will increase, fixed costs of doing business due to administrative burdens will be lower and productivity in those industries may well increase noticeably over time. Both EU companies and U.S. foreign affiliates in Europe will likely benefit more from the new opportunities across the border than U.S. firms selling at arms' length to European consumers or businesses. The eventual advent of the single market for services in the European Union by the end of the decade might be the ultimate inducement for those U.S. services providers who have not yet developed a full-fledged strategy for selling to the EU market to seize on the opportunity and enter the EU market.

01

CHAPTER ONE

INTRODUCTION

The existence of a properly functioning single European market has been taken for granted by the vast majority of citizens in Europe for at least a decade. "1992," as the project of Jacques Delors in the mid-1980s came to be known, was by and large completed on schedule with regard to the markets for goods. Later on, European Economic and Monetary Union gave another push to monetary and financial integration within the Eurozone's twelve member states. The liberalization of big infrastructure and services sectors in the 1990s and this decade has brought the third wave of single market, deregulation, and privatization exercises, with particularly high welfare benefits for citizens in the realm of telecommunications services. The recent enlargement of the EU increased the size of the single market once again. However, in many services industries, labor markets, and many other areas, a properly working single European market has yet to become a reality.

This verdict applies in particular to many commercial services activities in Europe, in which the legal framework of the Treaty of Rome, various waves of sectoral, vertical regulation of services industries or professions, and the jurisdiction of the European Court of Justice in effect failed to create the material conditions of a properly functioning single European market. As the OECD recently concluded, the services sector has lagged behind the market for goods. As a result, productivity growth remained sluggish, prices remained high and employment below potential.[1]

The services industries are of very considerable importance in terms of production, value added, and employment in the member states of the European Union.[2] Non-governmental services make up more than half the domestic product, roughly two-thirds of the labor force is employed in enterprises from these sectors, and more than four-fifths of businesses in the EU belong to the services industries. Major services sectors such as telecommunications, financial services, and public utilities have been regulated EU-wide in recent years. This is not, however, the case in all sectors. In particular, business services,[3] the wholesale and retail trade, construction, communications services, and restaurants and catering have not yet been covered by the last wave of internal market framework legislation, even though they are economically important; value added by these sectors in 2000 aggregated roughly €3 trillion and they employed more than 60 million workers. According to the OECD, roughly half of the output of the EU is produced by services sectors not functioning under effective single market conditions. And aside from these sectors statistically classified as services, in industry, too, a substantial part of value added is no longer generated by the production of goods but instead by related services provided by the company. These days, for example, complex mechanical engineering equipment is often sold together with a whole package of services.

At the height of the dotcom and economic boom in 1999/2000, the European Council adopted the Lisbon strategy. In the difficult economic times that followed, not much progress could be achieved. However, the Barroso Commission, which came into office in 2005, established a new action plan for fulfilling the Lisbon Agenda's unfinished business. In our view, the Services Directive, already proposed by the former Commission in January 2004, is still the cornerstone of market integration activities in this framework. Given its relative political and economic importance, it is no wonder that it did not sail through unnoticed waters in the legislative machinery of the EU.

The policy proposal quickly turned into a hot potato. It was attacked by France's President Chirac and German Chancellor Schröder and became a symbol of Anglo-American capitalism of a variety not liked in French public opinion. It was politically linked to the referenda on the EU's draft constitution. It was blamed for dubious practices in German slaughterhouses, in which East European workers were employed at well below German wage rates. It was dubbed the "Frankenstein directive," playing on Commissioner Frits Bolkestein's name. Despite the fact that a single market objective should hardly be controversial, the Commission's particular approach towards achieving this objective ignited a very lively debate in a few member states, the European Parliament, and among lawyers on the pros and cons of various legal integration alternatives and on the proper scope of the Directive.

In spring 2006, the proposal's prospects have brightened again, as the policy process has entered into a more normal phase of deliberation, argument, and compromise. Even though the proposal faced seemingly insurmountable opposition for months, our best guess is that the proposed legislation will be passed by the end of 2006.

In this study, we present the politics and the economics of the EU services sector. In chapter two, we provide an overview of EU services industries subject to regulation as proposed by the Commission. In chapter three, we discuss the Commission strategy for the liberalization of the various services industries that will be subject to the Directive. In chapter four, we analyze the political process that has unfolded to date. This chapter also includes an overview of the state of play on the draft legislation as it has emerged from the European Parliament's first reading on 16 February 2006 and the subsequently revised proposal of the Commission of early April 2006. In chapter five, we look at the economic and business implications of an implementation of the Directive on the German services economy, drawing on earlier research by DIW and the Ifo Institute. This serves as an example of what would happen in other countries as well, even though modified by their economic characteristics. In chapter six, we briefly explore what lessons might be drawn from North American services market integration. In chapter 7, we discuss the potential implications for U.S. business providing or using services in the EU.

We conclude that the EU's new policy approach towards those hitherto not integrated services industries may yield considerable aggregate benefits for the European economy in general and for European consumers and services users in particular. However, the opportunities and risks for certain segments of workers and companies in the services sectors will be unevenly spread. While many new opportunities will arise in high wage countries in easy-to-trade high-skill services and new jobs will be created in many fields, some, but by no means major, adjustment pressures will increase for firms and workers especially in low-skill activities, exacerbating existing labor market problems in continental European countries. However, there are only a few industries in which services that are provided in particular with the use of low-skilled labor can be traded well across borders. In these areas, firms and workers mainly from Southern and eastern European countries might seize on some of those opportunities. On balance, the benefits are as difficult to quantify in a meaningful way as the costs, but it seems safe to argue that the impact will clearly be beneficial.

The Services Directive is the first test of how and whether real economic integration will proceed politically and in economic terms in the much more diverse and heterogeneous economic environment of the enlarged European Union, in which both the benefits of deeper integration and the associated adjustment costs are higher than in the EU-15.

02 CHAPTER TWO

THE EUROPEAN SERVICES INDUSTRIES SUBJECT TO THE PROPOSED REGULATION

Our knowledge of the extent to which services are provided or received across member state borders is very limited. Services make up about 20 percent of intra-Community trade (€380 billion in 2001). Nowadays, direct investment related to the establishment of companies of this kind plays a more important part in absolute terms than in manufacturing industry (€180 billion in comparison to €50 billion in 2001). Research commissioned by the European Commission has at least conveyed the impression that these markets in the member states operate under very little competition from providers from other EU member states. Roughly half the suppliers of typical business services are active in foreign markets, but only slightly less than one-third of clients use foreign offers. Typically, foreign business accounts for less than 10 percent of sales.[4] From other research, we know that the UK, France, and the Netherlands in particular possess highly competitive services sectors, also registering export successes outside the EU precisely with business services.[5] In any case, we can analyze the major economic characteristics of the services industries in Europe in a comparative perspective.

Trends: Output, Employment, and Productivity

EVALUATION CONCEPT

For analyzing development trends in the services sector, extensive studies are available for all the larger European countries. There are also a number of major studies covering Europe and the EU as a whole.[6] In these studies the United States plays a central role as benchmark for the development of the services sector at both the national and European levels.

The objective of the Services Directive is to enhance the efficiency of services provision by harmonizing the framework conditions. In our interpretation of the development trends in the services sector we will, therefore, also take the United States as a benchmark, especially regarding assessments of the development in the EU as a whole, whereby we will be looking first of all at the development in the old EU-15. Further, we will seek to identify differences between the EU member states which, beyond regional economic differences,[7] could indicate a special need for harmonization. For this purpose we examine developments in Germany and the Netherlands as examples (a large and a small founding member of the EU). To capture the developments in the new member states that joined the EU in 2005, we look at Poland and the Czech Republic, again taking one large and one small country as examples.

The empirical research is focused on those services that are affected by the Services Directive. For the analyses we distinguish between the two segments of consumer services and business services. Here, consumer services include wholesale and retail trade, hotels and catering, and social and other personal services. Business services cover the areas of computer and related activities, research and development, business and technical consulting, and other business-related services (e.g. cleaning and courier services, etc.). Explicitly excluded are, therefore, those services that are largely unaffected by the Directive, such as construction, transport and logistics, finance, education and health care, public services, and housing.

In academic studies, labor productivity is regarded as a key economic measure of efficiency. However, a comparison of the productivity levels of different countries raises major conceptual problems that make it impossible to simply equate efficiency with productivity.[8] International comparisons of productivity in services industries are further aggravated by serious measurement problems caused by the different bases, e.g. administered prices or market prices, used for different services.[9] However, the more similar the institutional framework and the greater the harmonization in the statistical coverage, the smaller the measurement problems are also in the services sector.[10] Comparisons between the EU-15 should, therefore, tend to be less distorted from a statistical point of view. The statistical framework for comparing productivity levels between the EU and North America has also improved.[11]

For these reasons, in the following analyses we will not focus on the development of productivity on its own but will first look at the development of output and employment separately. We present the development of real output as percentage changes in the volume indices, as has been customary practice at the macroeconomic level for some time. For employment, we take the changes in labor input in terms of the volume based on annual hours worked. International comparisons based on headcounts of persons employed in the industry often produce misleading results, as working hours per employee vary considerably from country to country and the regional trends also differ widely.

Our data set is based on OECD and EUROSTAT statistics. For the years 1995 and 2003 we used data

Table 1: Output growth from 1995-2003 (Value added volume indices)

	USA	EU (15)	GER	NED	POL	CZE
	percentage change per year					
ALL INDUSTRIES	3.5	2.3	1.6	2.6	3.5	-4.5
Consumer Services	4.6	2.3	1.3	3.1	4.5	1.6
Wholesale trade and commission trade	6.9	3.1	2.3	5.2	6.6	6.8
Retail trade, repair of household goods	5.8	2.3	1.6	1.9	3.6	4.1
Hotels & catering	2.2	1.6	-0.4	0.7	6.5	-5.6
Other social and personal services	1.9	2.3	0.5	2.3	1.6	-3.9
Business Services	4.5	4.4	1.8	3.8	1.7	1.9
Computer and related activities	9.2	9.2	10.0	10.2	8.4	8.3
Research and development	1.8	1.4	4.5	-0.5	-32.1	-4.1
Legal, technical and advertising	3.3	3.0	0.0	2.9	-0.6	5.6
Other business activities	4.3	4.6	2.5	3.2	12.9	-5.4

Sources: Groningen Growth and Development Center; own calculations

compiled by the University of Groningen's Growth and Development Center. The service industries are defined on the basis of the ISIC Rev.3 classification. The figures are calculated as of October 2005, for Germany as of March 2006.

OUTPUT

In the EU-15 the pace of macroeconomic growth between 1995 and 2003 was generally much weaker than in the United States (Table 1). The growth in real output in consumer services in Europe is a good deal weaker. In the United States, growth is stimulated primarily by wholesale and retail trade. Business services, on the other hand, show a very positive development in both regions. The average annual growth rates do not differ much either in the sector as a whole or in the individual segments.

Looking at the individual EU countries, the underlying trends towards increasing services intensity are similar. However, there are big differences in the pace of development. In Germany, the growth in real output is below average in almost all of the service industries, one reason being that purchasing power in Germany has also developed unfavorably on regional comparison. Growth is high only in the computer and related activities and the research and development segments, where export ratios tend to be higher. Strong changes in output structure are visible in the two new EU member states as a result of the transformation process. Wholesale and retail trade is expanding strongly, while the relative weight of social services is on the decline. Research and development has also lost ground, mainly as a result of the closure of state research establishments.

There is little difference in the level of services intensity reached in 2003 in the EU-15 and the United States for the service industries covered here (Table 2). Consumer services account for 12 percent of output in Europe and for just less than 13 percent of output in the United States. In the case of business services, the levels are almost identical at 7.5 percent.

However, there are still big differences in output structures within the EU. In Germany and Poland, for instance, social and other personal services have an above-average share of output. In the Netherlands, the European logistics center of the old EU, the wholesale trade plays an important role. This segment also has a high share of output in eastern Europe. A certain specialization in technical and business consulting is visible in Germany and the Czech Republic. The above-average shares of output compared with the EU and United States are probably connected with the tendency toward technology-intensive production in these two countries.

Table 2: Output structure in 2003 (Value added in current prices)

	USA	EU (15)	GER	NED	POL	CZE
	percentage share					
ALL INDUSTRIES	100.0	100.0	100.0	100.0	100.0	100.0
Consumer Services	12.8	11.9	12.6	13.4	18.2	14.0
Wholesale trade and commission trade	3.2	2.6	3.4	5.3	7.9	6.1
Retail trade, repair of household goods	5.2	4.5	4.4	3.7	6.2	3.8
Hotels & catering	1.7	1.8	1.1	1.4	0.8	1.8
Other social and personal services	2.6	3.0	3.7	3.0	3.2	2.3
Business Services	7.3	7.5	7.5	7.4	7.5	10.2
Computer and related activities	1.4	1.4	1.1	1.2	1.4	2.2
Research and development	0.3	0.3	0.3	0.3	0.1	0.2
Legal, technical and advertising	3.4	3.6	4.3	3.4	3.5	5.3
Other business activities	2.1	2.2	1.8	2.5	2.6	2.5

Sources: Groningen Growth and Development Center; own calculations

EMPLOYMENT

In the development of employment in terms of annual hours worked, there is little difference between the EU-15 and the United States (Table 3). In the period 1995 to 2003 total employment in all industries increased by about 15 percent in both regions. The differences in the consumer services segment are also small. In the business services segment, however, employment growth in the EU-15 is almost twice as high as in the United States. Still, this is due entirely to the growth in employment in the low-skill, other business services segment. In the high-skill computer and related activities, research and development, and technical and business consulting segments, the growth rates in Europe and the United States are similar.

There are big differences in the development of employment levels within western Europe. In Germany, employment growth in all industries is only half the EU-15 average. In the Netherlands, growth is even static. There are also opposing trends in some cases in the individual service segments covered. Employment levels in the wholesale and retail trade are on the decline in Germany but are rising sharply in the Netherlands. In Germany, there is a strong shift towards low-skill, other business services, which is mainly at the expense of high-skill consulting services. In the Netherlands, the growth rates in these two services segments do not differ much.

In the new eastern European EU member states, total employment has fallen sharply in the course of the transformation process, with an overall decline of 14 percent in Poland and nearly 10 percent in the Czech Republic in the period 1995 to 2003. At the same time, employment has risen, in some cases substantially, in the services analyzed here. This is mainly in business services, with the exception of research and development. In Poland, strong employment growth is also seen in the retail trade and in hotels and catering.

However, if we look at the structure of employment in 2003, the differences among the European countries analyzed and between the EU-15 and the United States are not so large (Table 4). This is true especially in the case of business services. The only striking difference is the high share of low-skill, other business services in the Netherlands. In Germany and the EU-15 the percentage shares are not all that different from those in the United States. The Netherlands, Poland, and the Czech Republic show a stronger bias towards wholesale and retail trade.

Table 3: Employment growth from 1995-2003 (Total annual hours worked)	USA	EU (15)	GER	NED	POL	CZE
	percentage change per year					
ALL INDUSTRIES	14.1	15.8	8.0	-0.5	-13.8	-9.4
Consumer Services	10.3	11.3	0.0	11.7	12.1	-8.6
Wholesale trade and commission trade	1.0	5.4	-12.1	10.1	7.6	-17.9
Retail trade, repair of household goods	7.4	6.2	-1.7	8.1	14.5	-6.5
Hotels & catering	15.3	18.7	11.3	13.3	14.7	1.5
Other social and personal services	19.3	19.8	6.5	19.6	10.9	-8.8
Business Services	24.1	41.8	42.9	31.8	84.9	14.6
Computer and related activities	75.0	78.2	82.2	109.8	114.3	37.4
Research and development	14.8	12.9	21.1	11.4	-95.7	-35.7
Legal, technical and advertising	19.7	21.3	6.8	23.7	80.1	13.1
Other business activities	19.7	57.2	110.7	27.6	172.4	14.6

Sources: Groningen Growth and Development Center; own calculations

Table 4: Employment structure in 2003 (Total annual hours worked)	USA	EU (15)	GER	NED	POL	CZE
	percentage share					
ALL INDUSTRIES	100.0	100.0	100.0	100.0	100.0	100.0
Consumer Services	17.6	18.1	17.0	24.2	21.6	21.8
Wholesale trade and commission trade	2.7	2.9	2.8	7.0	5.9	4.9
Retail trade, repair of household goods	7.3	7.5	7.5	9.1	11.1	10.0
Hotels & catering	3.9	3.3	2.7	2.9	1.8	3.4
Other social and personal services	3.7	4.5	3.9	5.3	2.8	3.5
Business Services	7.6	7.5	7.8	14.6	6.0	8.5
Computer and related activities	0.9	1.0	0.9	1.8	0.5	1.0
Research and development	0.3	0.2	0.3	0.4	0.0	0.2
Legal, technical and advertising	2.7	2.8	3.5	5.1	2.4	4.1
Other business activities	3.7	3.4	3.2	7.3	3.1	3.3

Sources: Groningen Growth and Development Center; own calculations

PRODUCTIVITY

The lead of the United States over the EU in terms of productivity growth has been a central topic of economic debate in Europe in recent years. This discussion process ultimately was reflected in the Lisbon Accord, which made the promotion of faster productivity growth a key development goal in Europe. We cannot, and do not intend to go into this discussion process in detail here. Rather, our concern, in connection with the opportunities presented by the Services Directive, is to point once again to the potential deriving from past differences in productivity growth in the services affected.

The development of real output per hours worked in the EU-15 has lagged well behind that of the United States in almost all consumer and business-related services (Table 5). Only in the area of social and other personal services has productivity in the EU-15 remained constant, while declining slightly in the United States. The gap in productivity growth in the EU-15 is particularly pronounced in wholesale and retail trade. Also striking are the differentials in the other business services segment, where the United States achieved growth above the all-industries average, with average annual growth of 2 percent, while value added per hours worked declined in Europe (-1.2 percent).

The figure for western Europe is impacted by developments in large individual member states such as Germany, where value added per hours worked in the other business services segment declined by over 6 percent on an annual average. By contrast, in the smaller segments of computer and related activities and research and development, strong productivity growth, even higher than in the United States, was achieved. A big factor here, both in low and high-skill services, is likely to have been the outsourcing of these activities by the manufacturing industry.

The development of productivity in the two new eastern European member states–Poland and the Czech Republic–is difficult to interpret, due to the changes in the pricing systems in the course of the transformation process. All the same, the results suggest that considerable improvements have been achieved in productivity in the distributive trade. In contrast, the eastern European countries, too, show marked deficits versus the United States in terms of productivity growth in business services.

Nonetheless, when the levels of productivity in the services sector are related to the sectoral productivity structures the differences between the EU-15 and the United States are not all that large (Table 6). In 2003 productivity in consumer services was about two-thirds of the all-industries productivity level in the

Table 5: Productivity growth from 1995-2003 (Value added volume indices per hours worked)	USA	EU (15)	GER	NED	POL	CZE
	percentage change per year					
ALL INDUSTRIES	1.8	0.5	0.7	2.7	5.4	-3.3
Consumer Services	3.3	1.0	1.3	1.7	3.1	2.7
Wholesale trade and commission trade	6.8	2.4	3.9	3.9	5.7	9.4
Retail trade, repair of household goods	4.8	1.5	1.8	0.9	1.9	5.0
Hotels & catering	0.4	-0.6	-1.7	-0.9	4.7	-5.7
Other social and personal services	-0.3	0.0	-0.3	0.0	0.3	-2.8
Business Services	1.7	-0.1	-2.6	0.3	-5.8	0.2
Computer and related activities	1.8	1.6	2.1	0.5	-1.5	4.0
Research and development	0.1	-0.2	2.0	-1.8	0.8	1.3
Legal, technical and advertising	1.0	0.6	-0.8	0.2	-7.7	4.0
Other business activities	2.0	-1.2	-6.6	0.1	-0.4	-7.0

Sources: Groningen Growth and Development Center; own calculations

Table 6: Productivity structure in 2003 (Value added volume indices per hours worked)	USA	EU (15)	GER	NED	POL	CZE
	All industries = 100					
ALL INDUSTRIES	100	100	100	100	100	100
Consumer Services	73	66	74	56	84	64
Wholesale trade and commission trade	118	92	121	77	133	124
Retail trade, repair of household goods	72	61	58	41	56	38
Hotels & catering	44	54	39	48	45	52
Other social and personal services	72	66	95	57	117	66
Business Services	96	100	96	51	125	120
Computer and related activities	159	142	127	71	298	213
Research and development	116	114	96	66	232	131
Legal, technical and advertising	128	129	124	66	143	130
Other business activities	57	63	57	35	84	77

Sources: Groningen Growth and Development Center; own calculations

EU-15. In the United States it was just under three-fourths. The key factors in the United States are the better productivity ratios in the distributive trade. However, individual countries in Europe such as Germany also achieve similar ratios in some segments.

In the business services segment as a whole, there is virtually no difference between the EU-15 and the United States. In each case, value added per hours worked is more or less on a par with the all-industries average. However, in the United States, the differences in productivity between the individual business services segments are much more pronounced than in Europe. Productivity in the computer and related activities segment is about 40 percent above the average in the EU-15; in the United States it is 60 percent. In the low-skill other business services segment productivity in Europe is 37 percent below the all-industries average as compared with 43 percent in the United States.

CONCLUSIONS

The developments in consumer and business services are largely responsible for the deficits in Europe versus the United States in terms of growth and productivity. Taking the example of the retail trade, the main factors cited in the discussion to date are the differences in institutional framework conditions such as shop opening hours or labor market regulations.

One possible reason for the poorer productivity, especially in the services sector, might be that there is too little regional specialization in the EU compared to the United States. Here, the empirical evidence indicates growth potential above all in business services. Firstly, Europe as a whole has performed poorly so far in terms of productivity growth on intercontinental comparison. Secondly, trends from country to country are very heterogeneous, suggesting that higher productivity paths in the business services segment would be entirely possible.

Thanks to the improvements, for instance, in the freedom of establishment, the Services Directive could increase cross-border trade especially in business services and thus open the way for stronger specialization. This could help overcome the weak—and in some cases negative—productivity growth both in high-skill business services such as legal and business consulting, architectural services, engineering, and advertising as well as in low-skill business services like cleaning and courier services etc.

03

CHAPTER THREE

THE COMMISSION STRATEGY FOR LIBERALIZATION

According to the Treaty of Rome, services form part of internal market law. The freedom of establishment and the free movement of services are just as much a legal Community instrument as the freedom of movement for workers and the mutual recognition of diplomas, certificates, and other evidence of formal qualifications (Art. 39-55 EC Treaty). In principle this covers all forms of cross-border provision or use of services–trade, direct investment and temporary activity, the posting of workers, and customer mobility.

From the outset, the European Community was required to put in place Community regulations to realize these freedoms at the sectoral level. To a certain extent, this has been done over the last decades, although–and this is the general consensus–with limited success. In practice, the freedom of movement of workers, the recognition of professional qualifications, or the freedom to provide services are far from perfect; considerable barriers to a true internal market are still present, a situation that neither sectoral liberalization with directives for the individual services industries and regulated professions, nor any of the rulings handed down by the European Court of Justice on the freedom to provide services, the freedom of establishment, and the free movement of persons have been able to alter in any material way.

The EC Treaty does define as services activities of an industrial and commercial character and activities of craftsmen and the professions provided for remuneration, and it does ban restrictions on their free movement within the Community. There is also a large body of secondary sectoral legislation in these areas. However, the conceptual basis for an internal market policy for services has also lagged behind the integration of product markets. Full harmonization has stuttered and the hoped-for liberalization has failed to materialize. Mutual recognition has regularly fallen short of the mark; what is more, its legal enforcement has been pursued far less forcefully by the European Court of Justice than in the case of goods, even though, following rulings on two cases dating from the early 1990s, restrictions on the free movement of services may be imposed only to safeguard "key public interests" and then only on a reasonable scale. However, since not all relevant provisions of the Treaty are directly operative, the way was never open for market integration through the jurisdiction of the European Court of Justice anyway.

As the Commission recognized in an extensive assessment, the markets for these services are still fragmented.[12] In consequence, value added and employment presumably fail to achieve their potential. The choices effectively open to users and private consumers are thus restricted, and prices are excessively high. Moreover, the entire structure of these sectors falls far short of its possibilities in terms of company sizes, business models, and productivity. In

2002, the Commission adopted a policy approach committed to closing the obvious gap in its internal market strategy by the end of the decade.[13]

At the beginning of 2004, following a period of stocktaking and extensive consultation with industry representatives, the Commission, with the general backing of the Council of Ministers and the European Parliament, proposed removing the barriers in the internal market by the end of the decade in the form of a horizontal Directive.[14] The draft Directive did not apply in the field of taxation, nor to activities performed by the state as part of its social, cultural, educational, and judicial functions, nor to numerous other sectors or services regulated by other Community instruments or currently under negotiation.[15]

The Commission chose a horizontal, pragmatic, and innovative approach to the removal of barriers. It did not primarily seek EU-wide harmonization, aiming instead to launch a process of deregulation over a period of years, beginning with administrative simplification, the abolition of discriminatory national regulations, and the evaluation of remaining liberalization requirements by the member states themselves. For this purpose the Commission proposed applying the Country of Origin (CoO) principle for the supervision and monitoring of service providers. In addition, legislation to safeguard the general interest on vital issues such as consumer protection was to be fully harmonized. Matters pertaining purely to coordination, though, were to be addressed through self-regulation by the relevant providers in the form of voluntary codes of conduct from European bodies of professional associations.

Drawing on the experience in establishing the single market for goods, the Commission did not choose the principle of mutual recognition as the core strategy. Rather, it picked the CoO principle for the cross-border provision of services and a simple deregulation framework stressing member state responsibility for abolishing restrictions on the establishment of service providers. This strategic choice, in turn, ignited political controversy, as member states felt uneasy about the constraints on intervention by host states into the economic activity of services providers domiciled in other EU member states. Despite the flexible approach to liberalization of establishment, the strong CoO principle would have established a level playing field based on trust among member states despite divergent standards.

THE MAIN PROVISIONS OF THE COMMISSION PROPOSAL

The text provided for changes in three main areas. Member states are obliged to agree on principles for authorization schemes for firms. Typical requirements for setting up or conducting business abroad will be abolished, and other legal rules and regulations will be examined more closely. A single point of contact (“One Stop Shop”) is to be established in each member state for the completion of all administrative formalities.

Second, obstacles to the cross-border provision of services are to be eliminated. The main road for achieving this objective is the application of the CoO principle to the supervision of providers, with a few general and specific exceptions and transitional derogations. In addition, users of a service will have a right to the use of a service supplied by a provider established in another member state. The country of origin must ensure that workers posted on its territory satisfy the residence and working requirements in the country of origin upon posting.

Third, the text contained specific procedures designed to strengthen mutual trust between the member states: in some selected areas, the EU will harmonize rules and regulations of a general legal nature of relevance to the freedom of establishment and the free movement of services; member states are to offer each other support in monitoring service providers; in some areas, professional associations and their professional bodies in the EU will be required to develop codes of conduct.

04

CHAPTER FOUR

THE POLITICAL PROCESS

At times European market integration assumes irrational dimensions in political terms. In a rare instance of political demagogy, the whole approach of the Commission was sharply criticized in public and blamed for having the potential to destroy the European social and economic model. In domestic debates in Germany and France, in particular, a lack of knowledge about the state of affairs in the services trade, about the proposal itself and about its potential implications, was the spawning ground for a strident debate in which reality gave way to fantasy. It took more than a year for most political players to adopt a serious policy stance on the proposal, and it took another year to cope with the difficult consequences that the politicized approach to the matter in the media and in politics had created in the meantime. Despite several years of preparation and general support from the Council and the Parliament to tackle the matter, the Commission proposal hit a political audience in key member states that was simply not prepared for discussing serious deficits in the internal market in areas covering one-third to almost half of Community GDP. There was a heavy price to be paid later for the lack of communication between governments and domestic audiences.

Essentially, the Commission's approach has been very soft and modern, not prescribing a certain level of liberalization to be achieved but setting in motion a process of lowering barriers to trade by the member states themselves. The proposal for a Directive did not contain a specific road map for the liberalization of market access in the relevant sectors, nor did it specify a minimum of market opening or deregulation. It also left open the question as to what indicators the Commission would apply in its proposed ex post assessment of the member states' progress on implementation and how, indeed, twenty-five or more member states were supposed to be monitored, given the shortage of staff at the Commission. The Commission left leeway for the Directive's transposition into national law which, as it is, would be a complex technical administrative act of deregulation, calling for a host of amendments to laws and regulations, or their repeal.

Despite the fairly open framework for liberalizing those services in Europe, the Commission encountered very strong resistance from a few member states, in particular from Germany and France, and from many members of the European Parliament. It created much media and political heat in Germany, where it was related to the problem of controlling illegal or gray-area foreign workers in the meat business that arose, however, under the current legal framework and not in a liberalized setting as foreseen by the Directive.

Then German Chancellor Gerhard Schröder as well as French President Jacques Chirac made a number of public statements in the months through to spring 2005 declaring that the proposal was unacceptable and needed to be changed. However, it took the German government many more months to establish a list of problems, particularly with regard to the application of the CoO principle, while—at least on part of the Ministry of Economics and Labor, which was then formally responsible[16]—supporting the objective and the basic method of liberalizing those markets. Even months after the elections in September 2005, the German government was still struggling internally with the matter. By March 2006, it finally supported the compromise lines of the European Parliament.

The French government, quite distinct from the German government's opposition, objected to the actual method of liberalization and called for full harmonization as the better course of action. In the French debate, the supposed weakening of rights of supervision of the authorities in the country of destination was perceived as opening the doors to low-wage, low-standard competition in all kinds of services. This perception contrasts quite strongly with the excellence of the French retail trade and its highly competitive professional services that would be potential beneficiaries of an opening of markets in Europe. This difference between the French government's policy stance and the business interests of major French services providers did not matter too much in the French debate.

In most other member states of the EU-15 (and later the EU-25), the proposal of a Directive did not lead to similarly sharp reactions. In Belgium, concerns about the implications for the Belgian retail trade were widespread. In the UK and in several Scandinavian countries, the emphasis and perception was on the opportunities rather than the risks involved. In most other member states, there was not much political debate at all and a mostly positive approach to the proposal, criticism on detail notwithstanding. In the new eastern European member states, policy preferences did not evolve that quickly. In the end, those countries preferred a more open market.

In the midst of this political turmoil, a new Commission took office in November 2004. The new Commissioner for the Internal Market, Charlie McGreevy, found himself in an awkward position following in the footsteps of Frits Bolkestein, and essentially adopted a wait-and-see approach. He showed neither a will to withdraw or water down the proposal nor a particular zeal to achieve adoption by the Council and the Parliament of a largely unchanged text. At a plenary session of the European Parliament in Strassbourg on 9 March 2005,[17] he stated that something needed to be done to galvanize the European economy and that the proposal was a noble attempt to do so but would not have "a snowball's chance in hell of getting through either the Council or the Parliament." He would be ready to accept changes to the text. In a statement a day earlier,[18] McGreevy mentioned three points: first, clear wording on conditions and standards for workers, which are not to be touched; second, the exclusion of sectors such as health and publicly funded services from the scope of the Directive; third, clarification of the operation of the CoO principle. The Commission then took a fairly passive stance and waited for the European Parliament to debate changes to the text.

In the European Parliament, it took almost one and a half years for the major political players to sort out what to do about the issue. Initial statements coming out of the Committee on Legal Affairs and the Internal Market and the Committee on Employment and Social Affairs in 2004 and before the elections to the European Parliament reflected two major reservations. First, there was a concern that member states with a high regulatory level would lose control over foreign service providers' compliance with standards. Second, negative implications were feared for employment and social security as a result of possible regulatory arbitrage by service providers. Also, implementation problems with the Directive on the posting of workers were related directly to the Directive on services, and problems with the forthcoming EU-wide regulation of temporary employment agencies were cited as an impediment to new rules and regulations in the services sector.[19]

After the elections on 6 July 2004, and another several months of deliberation, two major policy positions emerged in the Parliament. The first position was shaped by MEP Evelyne Gephardt (SPD, Germany), rapporteur of the Internal Market and Consumer Protection Committee (IMCO) on the Directive, and presented an alternative road to services liberalization. She issued a first paper in May 2005 suggesting a radically different path for dealing with services in the EU. Rather than embarking on the CoO principle, she favored a combination of mutual recognition and targeted full harmonization. She favored the full exclusion of services of public interest and public economic interest from the liberalization of temporary service provision, which is one of the two major elements of the Directive. In her draft, she also called for the exemption of various services from the scope of the Directive: gambling, notary services, health care, public transportation, and others. She also called for much stronger rights of countries of destination to regulate, supervise, and restrict firms operating on their home territory.

The alternative position was not clearly stated right from the start, as many in the conservative camp felt uneasy with the Commission proposal as well, in particular with the CoO principle and the scope of the Directive. However, liberals and conservatives shared more widely the objective and the approach of the Commission to dismantle restrictions to trade. By June 2005, the conservative European People's Party, as the majority faction in the Parliament, had made up its mind and had put forward 1,154 suggested draft amendments to the Commission text. The EPP's approach was based on the Commission approach but favored a narrower scope of the Directive and a less comprehensive application of the CoO principle. The key change was the introduction of an internal market criterion for the application of the CoO principle which was thought to allow a distinction for market access and supervisory and control rights. The EPP also preferred to exempt services of general public interest from the scope of the Directive. It was felt that the decision on those services should be made by member states rather than at the EU level. The EPP also preferred to exclude gambling services, some audiovisual services, publicly funded health care, social services and certain public monopoly services such as notaries. Further, the EPP argued for strengthening the rights of supervision over service providers by the country of destination and the country of origin's obligations to supervise providers in its territory. Many of the amendments proposed, however, were designed to clarify the legal text.

In November 2005, MEP Evelyne Gephardt then issued a draft compromise report of the Committee. The drafters favored the exclusion of all services of general economic interest (usually water, electricity, waste etc.) from the application of the CoO and of services of public interest (education, social services etc.) generally, and the exemption of private health care services, gambling, audiovisuals, temporary work agencies, and notaries from the scope of the Directive. According to the proposal, member states would retain much leeway in imposing restrictions on the provision of services by foreign firms on grounds of public interest, on which it proposed a very broad definition. The drafters rejected the inclusion of any provisions on the posting of workers. Also, they proposed that the country of destination should have a strong hand in controlling services firms on their territory.

In a fine hour of parliamentary democracy, the Committee spent many hours on 22 November 2005 on a compromise vote whose outcome was more in line with the EPP's majority position than with the Socialist group's position. In essence, the scope of the Directive was restricted, but not as much as the Socialist camp would have liked. Also, the key governing principle of the Directive, the CoO principle, was renamed but upheld for all but control and supervisory rights of countries of destination. Also, the deal entailed the inclusion of services of general economic interest in the scope of the Directive in regard to freedom of establishment but not temporary provision. Member states would decide which activities would be subject to the Directive. Health care and audiovisual services were removed from the scope, as were gambling services and notaries. Regarding gambling, considerable differences in taxation were cited as a de facto barrier to fair competition in the industry. Importantly, however, urban transport, port services, taxis, and ambulances were voted to remain within the scope, as were temporary work agencies. However, both Socialists and conservatives preferred to exclude temporary agencies but could not agree in time how to achieve this in legal terms. The Committee also preferred a removal of sections on labor law and social security law from the scope of the Directive altogether. Almost unchanged in legal and economic substance was the whole section on the freedom of establishment, which, for a number of industries, would provide most of the beef of this Directive. On various specific issues, the Committee also adopted a more explicit legal wording than in the Commission proposal, suggesting for instance that international private law would not be changed and that negotiations on the harmonization of contractual law (Rome I) and extra-contractual law (Rome II) would not be affected, which created some problems, for instance, regarding a liberalization of cross-border marketing. However, the text also called for the abolition of restrictions on "commercial communication," read: marketing, in the regulated professions. The Committee also called on the Commission to assess whether two services–cash-in-transit and judicial recovery of debt–could be fully harmonized. The Committee also suggested various ways of dealing with the cooperation among member states, administrative issues such as the establishment of a single point of contact at the national and the EU level, and other matters. The Committee decided to delete the articles of the Commission draft relating to labor and employment rules of countries of destination which foreign service providers have to comply with. Also, the country of destination was assigned the right to control and supervise firms in order to assure that those firms comply with the laws of the state they are operating in; in the Commission draft there was no such provision.

The political drama reached its high point in the run-up to the plenary vote scheduled for 16 February 2006. A core group of four conservative and five Socialist MEPs reached the final compromise a few days in advance of the plenary session. The compromise was adopted by 394 in favor to 215 against, with thirty-three abstentions.[20] It is likely to survive the subsequent proceedings of the Commission, the Council and again the Parliament in its core substance. Regarding the scope of the Directive, most exemptions favored by one of the two major players were finally agreed: services of general interest as defined by the member states; services of general economic interest, mostly utilities such as electricity, gas, water and waste disposal, and postal services, were exempted from liberalization requirements in respect of cross-border provision; fully exempted are also gambling services, notaries and law firms, temporary work agencies, private health care service providers, several transportation services (urban transport, taxis and ambulances), audiovisuals, certain social services, and private security services. Also, provisions concerning workers' rights were dropped altogether. On private security services and temporary work agencies, the Commission was asked to propose measures for full harmonization.

The compromise further entailed a codification of the case law of the European Court of Justice and established that member states will have the right to intervene in the free provision of services on their territory on grounds of "overriding reasons related to the public interest" such as public order, public security and safety, environmental protection, public health, rules on employment conditions, and other highly specific public policy grounds, if all those measures are necessary, applied in a non-discriminatory and reasonable fashion. Concerns related to social policy or consumer protection were finally not included in the list of reasons on which member states might base restrictions of the provision of services across borders, despite a preference of some Socialist MEPs to do so. Moreover, certain well-known protectionist practices were explicitly prohibited, such as nationality requirements for staff, economic needs tests, the involvement of competitors in the granting of permissions for the provision of services, or obligatory financial guarantees.[21] Last but not least, the compromise entailed a new wording: the CoO principle will be replaced in the legislation by the "free provision of services." The Commission will report on the implementation of the free provision of services five years after implementation of the new rulebook. Also, member states have been assigned the duty to come up with workable solutions for single points of contact three years after the Directive comes into force.

On balance, the European Parliament upheld much of the liberalization drive of the Commission proposal. Despite the broad range of services industries which will not be within the scope of the Directive, the commercially relevant large services industries such as retail and wholesale trade, construction, crafts, business services, commercial communication, tourism, computer services, and much of the professional services will continue to fall under the full scope of liberalization. Regarding the scope of the Directive, services of general economic interest and private health care services are the most important exemptions. The former may be included if member states wish to do so. This could, however, pose problems of political reciprocity, in particular if the cross-border provision of services were to be perceived as a one-way street in a large member state. It would be preferable to agree on a common list of services that are to be included in the Directive. Whether this will become politically possible remains to be seen. The latter exemption, private health care, is a controversial one as this type of service will likely become a strongly growing sector in an ageing Europe if member states reform health care systems and strengthen private providers of services in this area. If these services are not covered by this Directive, a similar approach should be used to deal with them on a sectoral basis later on, a point which the Commission also made in its revised position of April 2006.

Member states were sidelined for most of 2005. Partly this was due to the fact that the whole objective of liberalizing services in the EU galvanized much opposition, in particular in Germany, France, and Belgium, from the political left, unions, and many business associations in which specific protectionist interests often gained the upper hand over supporters of liberalization. Through the course of 2004, industry associations, representing the services industry subject to regulation as well as users, worked hard to figure out what it might mean for business. Numerous position papers emerged, usually with larger and more trade-oriented groupings broadly supporting the approach while criticizing details and interest groups representing small and medium-sized firms, particularly those in labor-intensive and construction-related industries, quite often taking a more cautious stance but less often one of rejection.

At the spring European Council meeting on 23-24 March 2006, the Council signalled support for the compromise and its intention to adopt legislation in the course of 2006.[22] The UK and several eastern European members expressed their concern about the compromise, stressing the need to enhance liberalization, but the majority position was clearly behind the compromise.

The Commission reacted swiftly to the compromise reached in the Parliament and the Council statement and tabled a provisional amended proposal for a Directive on 4 April 2006. The Commission by and large accepted the main thrust of the amendments and suggested numerous changes in order to produce a legally coherent text. However, the Commission rejected a few important amendments on grounds of principle. The Commission rejected the call for full harmonization for temporary work agencies and security services while accepting the removal of those services from the scope. Similarly, the Commission did not accept the exclusion from the scope of whole professions such as notaries but only of certain activities which involve participation in the exercise of public authority. With regard to administrative simplification provisions, the Commission also rejected the call for the establishment of a European point of single contact, stressing subsidiarity considerations. Most importantly, perhaps, the Commission accepted the Parliament's position regarding the freedom to provide services. Also, it accepted excluding the provisions on the posting of workers. On one last important point, the Commission rejected the position of the European Parliament: rather than agreeing to a three-year deadline for translating the Directive into member state law, the Commission argued that the two-year deadline should be preserved. All in all, Commissioner McCreevy argued that the basic objectives of the Commission proposal were still contained in the revised proposal and that consumers and users of services would benefit from the improved market access both in terms of establishing businesses in other member states and of providing services across borders. And, indeed, if the Council adopts a Common Position along those lines, by the end of 2008 (or 2009) the EU markets for services covered by the Directive will have much lower barriers to entry and competition.

Interpreting the Policy Process

The policy process came as a surprise to many observers, as the staunch opposition of Germany and France to the initial Commission proposal led many observers to conclude that the proposal was "dead on arrival." The complexities of policymaking in the European Community were difficult to gauge, no doubt. However, a large majority of member states, key forces in the European Parliament and the Commission itself showed a strong interest in rescuing the substance of the proposed policy, engaged in helpful tactics to overcome protectionist leanings and in the end reached a compromise with those politicians in Europe, who were very concerned about the supposed, potential, or real harshness of economic and social adjustment that might ensue in the wake of an opening of EU services markets. The compromise safeguarded the bare essentials of market opening in almost all of the commercially weighty services sectors and industries initially targeted by the Commission, placed severe strings on future protectionist measures, committed member states much more strongly than before to an open market for services, and put the burden of implementation of market opening on the member states themselves.

The price that had to be paid was an exclusion of services of general interest and services of general economic interest from much more open cross-border provision and of private health care from a reinforced liberal market framework throughout Europe. The choice of whether to open up the utilities to cross-border competition is a decision that will have to be made in the national capitals. It remains to be seen whether, without binding multilateral reciprocity at the EU level, bilateral, or regional reciprocity will in fact be required or whether the more liberally inclined member states will open up their markets unilaterally on the basis of national welfare considerations. The potential dynamics of this process will be interesting to watch if and once it unfolds, but it is very hard to forecast. Recent government activism against takeovers of domestic energy firms by foreign bidders indicates that at least those firms considered to operate in strategically sensitive sectors such as energy will not be exposed to much greater external competition but instead will receive greater government protection, which is most likely an inappropriate policy approach.

The politics of policymaking in the EU on this matter is interesting in a number of other respects as well. The first issue is the preferred method of liberalization which the Commission revealed in tabling its proposal. The Commission pursued a principled approach towards liberalization. This approach emphasized member state responsibility for shaping the range and the scope of market opening rather than prescribing a certain target level of liberalization. Flexibility in reach and scope coupled with a strong principle, however, generated considerable political resistance from certain member states, members of parliament, social partners, and associations affected by the pending legislation. Risk-averse political actors opted for discretion and specificity rather than for principles in their attempt to control and micromanage liberalization and therefore chose to stonewall and, indeed, to block the project for fear of far-reaching material liberalization, a prospect which could not be ruled out for almost two years. The politics of certainty regarding market outcomes became intertwined with the debate about safeguarding high standards even in an enhanced competitive environment, with problems of controlling illegal or gray-area foreign self-employed workers in countries such as Germany, with doubts about the legal implications of the CoO principle in a variety of legal and other issues, and with a profound mistrust among member states regarding the supervision and control of firms domiciled on the territory of other EU member states. As the likely outcome indicates, the EU is by no means ready for a principled approach to integration but is very much inclined to micro-manage the scope, range, and extent of liberalization as in the past. In that sense the Commission approach failed to a great extent.

The second profound lesson on politics is the contingent power of the European Parliament in an instance in which the Commission proposal encountered staunch resistance in Germany and France. With two countries diverging from the preferences of the Council majority and the Commission proposal, the Commission refrained from brokering a compromise and essentially kept out of politics for a while. The politics in the European Parliament evolved essentially along classic European lines of conservatives and business-oriented arguments versus labor. The Parliament emerged as the power broker which mediated key concerns of labor, business groups, and even member states. Governments were reluctant to settle the many important issues in the Council working groups. The quintessential bargaining first in the Internal Market and Legal Affairs Committee of the European Parliament and later in the EPP/Socialist broker group of nine MEPs[23] in advance of the European Parliament plenary vote led not only to agreement on the controversial scope of the Directive, but also to a highly intelligent way of maintaining the spirit of liberalization, of "de-poisoning" the wording of the Directive (mainly by omitting reference to the CoO principle), of ruling out protectionist measures widely used so far by establishing a list of "don'ts" and of codifying European Court of Justice jurisprudence on acceptable reasons for state intervention.

In addition, some points raised in the academic literature on the contingent power of the European Parliament seem to have been validated. It is to be highlighted that the highly successful political play of MEP Evelyne Gephardt, who acted from a minority position in the respective Committee and the European Parliament itself, shaped the agenda by objecting to the very method chosen by the Commission and demanding full harmonization, with the conservatives struggling to balance concerns about the Commission proposal which they partly shared with the Socialist camp or governments such as Germany, France, and Belgium regarding the method on the one hand while maintaining the liberalization drive of the Commission on the other. In the end, the two parties came close enough together, with many small victories for the Socialists regarding the scope of the Directive and a final, if not complete, victory for the conservatives on the legal road to free services markets.

If the scenario described above unfolds, it may well teach a lesson about the shift of power from the Commission and the Council to the Parliament as the body able to provide the legitimacy, to marshall the interest aggregation of business, labor, social groups, and states in a highly divergent EU-25 and to deliver a deal on the final policy, with the Commission and the Council essentially ratifying the European Parliament's decision. In that sense, the Services Directive may well constitute the first instance of a more full-fledged EU political system at play in the realm of market integration.

The third point concerns the shaping of state preferences on this topic in the context of widespread fear of market forces, sensationalist media reporting, and profound uncertainty of governments about the probable benefits and risks of action regarding jobs, profits, business models, import competition, and other elementary economic variables. Judgment on those matters was in great demand but was in extremely short supply, from academic and other sources, despite several attempts by the Commission to buy in expertise and to pay for independent research. It became evident almost right from the start of the policy process in Germany and France that the media and interest groups were driving the politics of the issue, not the governments. Rational arguments that would have had to be based on sound empirical judgments and standard single market reasoning gave way to scandal reporting, wild accusations directed at the Commission by lobbies, member states, and others, and fuzzy thinking on internal market matters. Germany and France found themselves essentially unprepared to publicly explain their initial support for market opening; the pressure of domestic lobby groups to kill the draft Directive remained weak, but the media and union activism regarding potentially negative job implications of market opening and ideological political statements, which could only flourish in an environment of low empirical information on who would benefit or be at risk, pushed the governments within weeks into a corner of rejection. There seemed no way out of the corner for a period of more than a year. Only by shifting the responsibility to the European Parliament as a quintessential political institution were those two member states able to find ways to limit their exposure to the issue again. Hiding behind the parliament worked.

Fourth, politics in the EU-25 did not turn out to be much more difficult than in the EU-15. Despite the strong increase in economic and social heterogeneity, the new East-West split of poor vs. rich member states did not play a big role. The offensive interest of eastern European states in gaining better access for their firms to western markets was balanced by a defensive concern about the sheer competitiveness of western European firms in a more liberal environment of market access in eastern Europe itself. The implication of enlargement played a more indirect role, with some unions and political players emphasizing the potential threat of low-wage competition for jobs in Germany and other western European states. This shows how little public acceptance the enlarged EU now can safely bank on.

Finally, consumers and consumer groups, industry users of services, and other services industries likely to be beneficiaries of a more open EU market in those industries first considered within the scope of the Directive, tended to play a fairly marginal role in the public debate. While the associations of big firms at the national level as well as UNICE at the EU level favored market opening on balance, they did demand many changes to the draft text as well and had to cope internally with forces less inclined to market opening. Associations of small and medium-sized industries were even more circumspect in their support, not to mention craft or construction industry associations or those of the free professions, many of which were quite hostile to the method of liberalization. From an economic point of view, this is rather strange, as consumers, users of cheaper and better services among firms and their associations should have supported the policy proposal, but the politics of firms facing tougher adjustment risks in a liberal market place outweighed the politics of beneficiaries quite substantially.

On balance, the politics of the EU Services Directive was quite hot. The European Parliament, rather than the Commission and the Council, called the shots and established itself as the ultimate source of authority in policymaking–indeed quite a new role for the Parliament! Lobbying was even more biased towards protectionism than usual, and media reporting aggravated the fears of adjustment rather than pointing to the benefits of market opening. Interest aggregation by some large member states fell short of the mark. In the end, the EU resorted once again to micromanaging liberalization processes, as potential losers, or those who perceive themselves as such, have sufficient clout to be reassured by a high degree of political control over market opening and by the exclusion of those industries in which adjustments would have been the highest or benefits the greatest.

05

CHAPTER FIVE

IMPLICATIONS FOR THE GERMAN SERVICES INDUSTRY

Previous Studies on the Macroeconomic Effects

In the discussions on the Directive, one figure from one study was often quoted: 600,000 new jobs were expected to be created according to a study by Copenhagen Economics, with 100,000 of these in Germany.[24] While the quantification is tricky, the basic logic underlying the study is economic common sense.

- Step 1: The Directive reduces the discrimination faced by foreign service providers;
- Step 2: Reducing discrimination leads to direct cost reductions for foreign firms. Domestic firms are forced to increase their efficiency, and hence reduce costs, if possible;
- Step 3: Cost reductions lead to economic growth.

Generally, when economists estimate the size of expected effects, they make extensive use of past data that provide information about the relationship between variables. Such a direct comparison is not possible here, as there is no comparable past liberalization of the international services trade. The solution chosen by Copenhagen Economics is: For Step 1, data provided by the OECD and others are available for listing barriers to entry for all services firms and barriers to entry for foreign firms only, and hence for discrimination. The reduction of discrimination due to the Directive can then be assessed, though some intuitive judgment concerning the weighting of the items is necessary. For Step 2, corporate data on price-cost margins and other variables are regressed on entry barriers observed so far, resulting in "tariff equivalents." The effects of the Services Directive, which reduces non-tariff barriers to trade, are then treated as though simple tariffs were reduced. This is necessary as input for Step 3, a computable general equilibrium model, which also includes sectors that are not directly addressed by the Directive but benefit from decreased prices for inputs from service sectors.

It is not quite clear how some well-known determinants of international trade are treated in this study. For example, the role of distance and language barriers. Here, the study by the Dutch CPB is much more transparent.[25] In the study, CPB develops a measure for barriers to entry similar to that used by Copenhagen Economics. It then regresses international service trade flows on country distance, language dissimilarity, GDPs, and difference in entry barriers as the most important variables. The estimated equation then makes it possible to predict what happens when the Services Directive brings differences in regulation down. In our opinion, the resulting prediction underestimates the positive effects of the Directive.[26]

The original CPB study received much less public attention than the Copenhagen Economics study, one reason being that it only predicted trade and direct investment flows. Another reason might be that no point estimate was given—only a wide range of possible outcomes; in the revised draft of September 2005 that range was a 30 to 60 percent increase in intra-European services trade. The CPB researchers have to be applauded for having sacrificed publicity for seriousness. Furthermore, there have been a number of notable follow-up studies.

First, Breuss and Badinger[27] combine the CPB results on trade increase due to the Services Directive with their own estimates of the impact of trade on competition (measured as price-cost margin).[28] With the help of another set of estimates, the size of the positive effects of increased competition on productivity, investment, and employment is predicted. The employment increase is similar to the Copenhagen Economics result; for Germany it is in the range of between 77,000 and 153,000 people.[29]

Second, in a follow-up study by the CPB itself,[30] the welfare effects from trade increases are analyzed with CPB's applied general equilibrium model WorldScan. The interesting thing about this study is that the authors try to isolate the welfare effects that are achieved only if the Services Directive embodies the CoO principle. Their result is that a GDP increase of 0.2 to 0.4 percent is to be expected if the CoO principle is excluded, while the GDP increase would be 0.3 to 0.7 percent with the CoO principle. (While some countries would benefit more than others from the Services Directive, Germany is close to the EU average in this respect.) A total employment increase is not calculated due to technical restrictions–employment increases in the services sector are automatically offset by employment changes in the manufacturing sector. The authors note that:

> In reality extra labor demand in other commercial services and the corresponding wages change could affect labor supply or the unemployment rate. This could induce extra labor supply, increase employment and offset the real wage increase to some extent.[31]

However, they presume that any increase of labor demand that might be caused by the Services Directive would not change the dominant impact of national labor market policy and social policy on structural unemployment and labor supply.

Third, a gravity model has also been estimated for Canada, a large and nearly perfect "internal market" for services, providing an interesting benchmark for EU-internal trade. We will discuss this study in the section below.

Another combination of a gravity model and a CGE model is provided by O'Toole,[32] enormously burdened with assumptions. The starting point is the difference in trade between the United States and Europe, on the one hand, and trade between the United States and the "free trade benchmarks," Hong Kong and Singapore, on the other. Where these differences cannot be explained by factors such as GDP, Francois[33] had assumed that they must be due to trade barriers in Europe. O'Toole then assumes that the Services Directive decreases these barriers by 50 percent, leading to a 5 percent price decrease in internationally traded services. The GDP increase that finally results (+0.5 percent) is within the range of the CPB estimates. It should be noted, however, that O'Toole points out that he is conducting comparative statics and that adjustment processes and costs are disregarded.[34] This leads us on nicely to the next section, where we take a closer look at the possible impact of the Services Directive on the German service industries.

A Sectoral Differentiation

If institutional trade barriers fall, then competitive pressure due to competition from abroad does not increase in the same way for all industries. Some might simply not be suitable for trading over longer distances, whether a border is crossed or not. We cannot identify these services from past international trade data, because they are contaminated due to institutional trade barriers, and because the sectoral classification of international trade statistics is not differentiated enough. The answer is to investigate internal spatial concentration by sector within a perfect "internal market for services," i.e. a national market. The idea is this: If we find that suppliers of a certain service are distributed roughly like the general population, then we can presume that this service is typically not traded over long distances. On the other hand, if services are spatially concentrated, then this is typically not due mainly to spatial concentration of demand, but is due to the fact that the service can be supplied over longer distances.

Investigating German data, we can sort service industries into three categories: Services that can be traded inter-regionally, services that can be traded over shorter distances, and services which are typically supplied locally. We calculate a modified Ellison-Glaeser or modified Hirschman-Herfindahl Index[35] scaled between 0 and 100. The index is 0 in the case of no concentration of the industry, i.e. employment in the given service industry (as captured by the social security statistics) is distributed in space exactly like overall employment. The index approximates 100 if all firms of this industry are located in the same region. To begin with, we identify those sectors which display a clearly stronger regional concentration than others, suggesting that they can be traded supra-regionally (Table 7). This represents the most highly concentrated third of the services; in this group even the least concentrated boast a concentration index twice that of the "median sector," which has a concentration of 0.61. For comparison: the retail trade, which is the spatially most evenly distributed sector, has a regional concentration index of only 0.025, while that for healthcare, which obviously has a distribution similar to that of the population at large, is 0.056. The spatial units are based on Germany's 97 planning regions.

If we compare the spatial concentration measured at the planning region level with that measured at the level of Germany's 440 administrative districts, we find that there are some sectors which, considering that they are relatively evenly distributed at the planning region level, are relatively strongly concentrated within these planning regions. For all service sectors, we calculate the quotient of the level of concentration at the district level and that at the planning region level. If this value is high, it suggests that the services can be traded regionally beyond the boundaries of the district. Table 8 shows the 15 sectors with the highest values based on this quotient but which were not rated as being supra-regionally tradable.

The information reproduced in Tables 7 and 8 is supplemented by calculations based on a similar data set, where employees are not assigned to their employers' industries but to their own profession (e.g. an electrical engineer working in the motion picture industry is assigned to motion picture production in the first method, and to electrical engineering in the second). Here, we indicate only those professions for which there is evidence of interregional tradability (Table 9).

Many service sectors and professions are so evenly distributed spatially that they clearly suggest only local tradability. This includes, for instance, canteens and caterers; retail trade; private investigation agencies and security services; travel agencies/tour operators; healthcare; schools; pharmacies; office services and office staff; commercial/trade professions.

The method used here to identify services that can be traded regionally and supra-regionally produces results which, to begin with, are plausible for the most part. The list of the most highly regionally concentrated services (Table 7) contains services that can be traded since distances are immaterial to the rendering of the service owing to the possibility of electronic transmission (freelance journalists, news agencies, databases, data processing services, etc.). Other services listed typically require a physical presence at the user's or client's premises but only at longish intervals and without the transaction costs being unreasonably high in proportion to the value of the service (notably hardware consulting). The list also includes services where the user has to go to the service provider, but this is typically done only seldomly and there are no perfect substitution alternatives in the user's locality (archives, museums, zoos, tourism). The list of regionally (or, if close to the border, inter-regionally) tradable services is plausible as well. All the same, one cannot ignore the fact that the attempt to derive *quantitative* evidence on the basis of the given data raises a number of problems:

In many sectors, a range of services are rendered with quite different inter-regional tradability. For instance, some law firms typically advise private individuals in matters before local courts involving smallish sums, while others are highly specialized, for instance in cases of bankruptcy or media law, and can offer their services supra-regionally as they cannot be substituted easily and the distance-related costs are low in proportion (to the sum in litigation for instance). Advertising is another industry in which there is a similar differentiation between regional and supra-regional service providers.

It is therefore quite possible that any of the industries or professions not included in the list of (supra-regionally or regionally) tradable services might be affected to some extent—although the respective segments of those industries affected are likely to be of relatively minor importance.

As it is, regional sectoral concentration cannot be interpreted as a watertight measure of tradability. It

Table 7: Services sectors for which there are indications derived from regional concentration to suggest that they can be traded supra-regionally	
Sector	Index
Computers: Hardware consulting	4.88
Freelance journalists, news agencies	4.71
Databases	4.33
R&D in law, social sciences	4.32
Computer-related activities	3.39
Repair of data processing/office equipment	3.32
Construction equipment/personnel hiring	1.57
Other hotel/accommodation services	1.51
R&D in natural sciences, engineering, medicine	1.45
Data processing services	1.43
Advertising	1.32
Software firms	1.07
Libraries, archives, museums, zoos	1.07
Other catering services	1.07
For info: Legally not affected or mostly not affected by the Services Directive	
Other transport activities Credit business-related activities Long-distance pipelines Shipping Aviation Motion pictures and cinema (not copying/duplication) Radio and television Insurance Freight handling, warehousing	19.67 12.85 9.56 7.90 6.39 5.92 5.24 2.46 1.08
Average [a] Median [a]	1.86 0.61
[a] based on all industries	
Source: calculated on the basis of the statistics on persons employed subject to social security contributions (German Federal Employment Agency).	

merely serves to compare sectors, and if this is done—as above—in more specific form by making a classification on this basis, then there is necessarily a certain element of arbitrariness in the choice of the dividing lines between the groups of services.

In certain circumstances, wage and other cost differentials can give rise to a supra-regional specialization where this has not taken place at the national level (given that conditions in the respective regions are more similar). However, this is unlikely to be the typical case, since there are also other advantages of regional sectoral concentration if trading is possible.

Table 8: Services sectors for which there are indications to suggest that they can be traded regionally (inter-regionally close to borders)

Sector	Index (district level) relative to index at planning region level
Other cultural services	1.01
Other leisure and recreational services	0.97
Technical, physical, chemical analysis	0.94
Social insurance, job promotion	0.90
Auto (parts) trade, filling stations	0.89
Cleaning Firms	0.87
For info: Legally not affected or mostly not affected by the Services Directive	
Employment agencies	1.44
Postal/courier services	1.38
Universities	1.21
Telecommunications services	1.17
Business/professional organizations	1.12
Railroads	1.11
Insurance-related activities	1.10
Forwarding agents, other transport brokering services	1.06
Energy/water supply	1.03
Median[a]	0.82
Average[a]	0.82
[a] based on all industries	

Source: calculated on the basis of the statistics on persons employed subject to social security contributions (German Federal Employment Agency).

In any case, there definitely are industries where tradability can be presumed. For the representative firm in such an industry in a given country, the Service Directive increases competitive pressure from abroad as well as providing the firm opportunities for exporting its services. But do the opportunities increase more than the risks? A classification of services into four types[36] is useful for an a priori judgment as to which of a country's services might benefit more than suffer:

- Type 1: Services produced with a high intensity of human capital, low-skilled workers only playing a minor role (example: software engineering)
- Type 2: Services produced with a high intensity of human capital, with a more important role for low-skilled workers, however (example: accounting)
- Type 3: Low intensity of human capital, high capital intensity (example: auto dealing)
- Type 4: Low intensity of human capital, labor intensive (example: cleaning services)

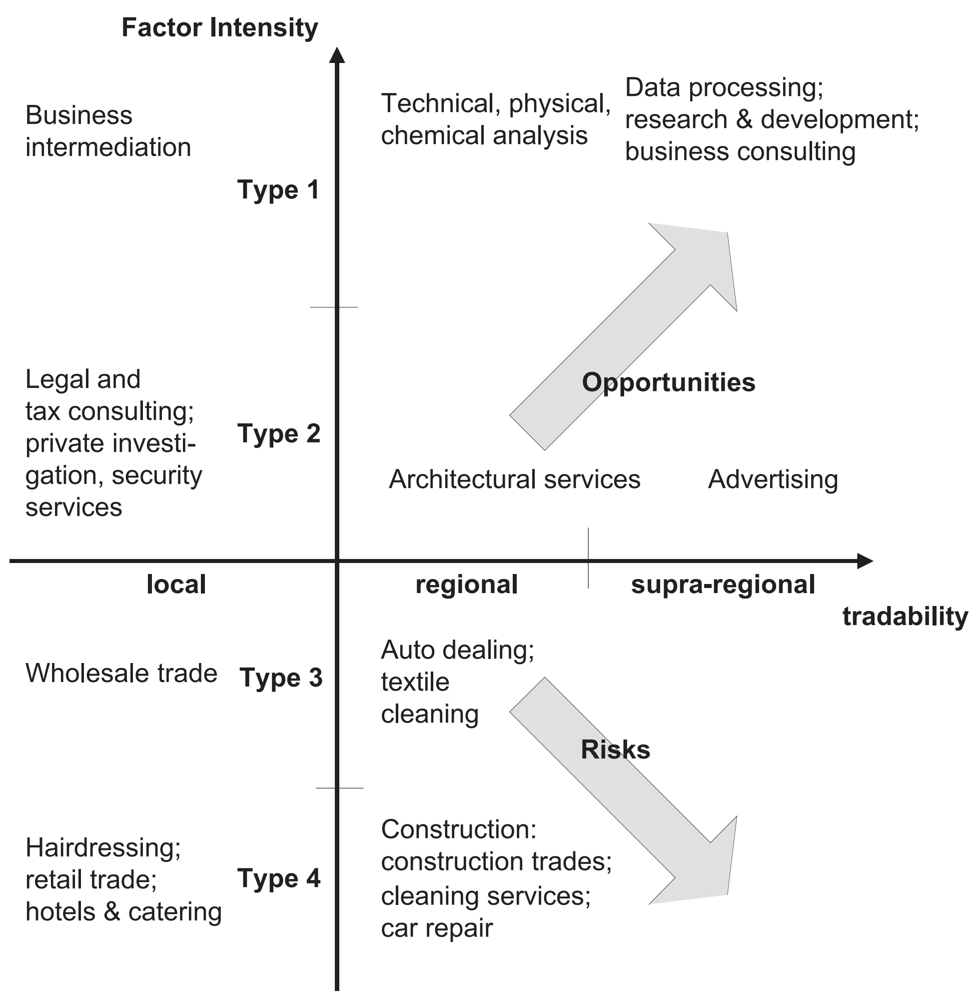
Table 9: Service professions for which there are indications derived from regional concentration to suggest that they can be traded supra-regionally	
Profession	Index
Creative and related stage, camera and sound engineering professions	2.76
Liberal arts	1.87
Electrical engineers	1.86
Business consultants	1.66
Writers, journalists	1.61
Advertising	1.52
Natural Scientists	1.32
Travel/Tourism	1.19
Brokers	1.07
Actors, entertainers	1.01
Mechanical engineers	0.89
Legal consultants	0.77
Data processors	0.72
Agricultural engineers	0.72
Social scientists	0.66
Fine arts	0.65
Chemists and physicists	0.62
For info: Legally not affected or mostly not affected by the Services Directive	
Water/aviation-related professions Insurance specialists Shipping/transport specialists	2.84 1.60 0.92
Average[a] Median[a]	0.56 0.24
[a] based on all professions	
Source: calculated on the basis of the statistics on persons employed subject to social security contributions (German Federal Employment Agency).	

Human capital, i.e. the accumulated skills of employees, is important because services needing a high input of human capital are typically differentiated, hence various dimensions of quality are very important parameters in competition with other firms, while cost (or wage) competition plays a smaller role, at least compared to types 3 and 4.

The labor characteristics and the tradability measures can be combined into one diagram (see Figure 1), which shows only selected service industries. On the left of the y-axis, we find service industries with different human capital characteristics, but all of them are typically not traded over longer distances. Moving to the right along the x-axis, we first find industries that we do not expect to be traded over such long distances, hence the Services Directive's presumed impact is on regions at the international borders. Finally, on the far right, we find services that can be traded over longer distances, none of which are type 3 or type 4 services with a high risk for German suppliers of being overrun by cheaper foreign competitors.

In conclusion, the Directive will have the most significant positive impact in those German services industries in which tradability is high and which employ highly-skilled workers. In these industries, opportunities of better market access abroad can be expected to be more important than the risks from higher import competition in the German market. For these economic reasons, the public perception of grave risks to low-skilled workers from a more liberal environment is most likely confined to very special circumstances and a few small services industries or areas.

Figure 1: Opportunities and risks for services sectors according to selected criteria



Risks and Opportunities as Perceived by German Firms

This section examines the chances that German services firms perceive for themselves. We present the most revealing results from a survey of 817 services firms conducted in spring 2005.[37] A key positive point to be derived from this survey is that optimism about the likely consequences of the Services Directive increases when respondents know the firm (whose opportunities are at stake) well, or if they know the market well from their own experience. The bare facts behind this interpretation are these: For their own firm, 25 percent of the respondents see more opportunities than risks arising from the Directive, and 48 percent of the respondents see more risks than opportunities.[38] For Germany as a whole, however, only 17 percent see more opportunities than risks, and 55 percent see more risks. While these figures might also be partly due to the sample not being adequately representative, it is quite typical that those who are already active in foreign markets are much more likely to have high hopes for the Services Directive than those who have less experience in selling abroad: 37 percent of the former see more opportunities than risks, compared to only 17 percent of the latter.

The countries thought to present the most additional competition as a consequence of the Directive are Poland, the Czech Republic, and France, in that order. All three states are large, direct neighbors of Germany, with the first and the second having much lower wage levels. Altogether, 73.2 percent of the respondents expect price competition to increase.

Country Size Effects

One final point concerns the possible effects of unequal country sizes. Are large countries like Germany likely to benefit more or less from the Services Directive? Overcoming the current institutional barriers to entering foreign EU markets means incurring fixed costs, which are largely independent of the size of the country of destination and the prospective earnings in that national market. When fixed costs can be distributed over more clients, these costs become less of a deterrent—in other words, exporters from smaller countries have had more incentives so far to try to penetrate the German market than vice versa. Now the Services Directive markedly lowers the fixed costs of market entry. This should cause less new foreign competition in Germany (as relatively more firms are already present) compared to *new* competition from German firms in smaller countries.[39]

06

CHAPTER SIX

LESSONS FROM THE NORTH AMERICAN MARKETS FOR SERVICES

Not surprisingly, the United States also shows a pattern of regional sectoral specialization. For example, Drennan[40] reports on advanced corporate services (producer services) in the United States and found that four cities (New York, Los Angeles, Chicago, and San Francisco) had a share of all U.S. earnings in these services industries that was almost twice as high as their share of total U.S. earnings. Yet to the best of our knowledge, there are no official data on interregional services trade flows within the United States. However, we will briefly sketch the most important results (for our purposes) from two studies whose authors found a way to solve the data problem. The first used Canadian data, the second used survey results from the United States.

Lejour and de Paiva Verheijden[41] use trade between Canadian provinces as a benchmark for European trade in services. The question, “If trade between European countries were as frictionless as trade between Canadian provinces, how much larger would the trade volumes be?” turns out to be too ambitious, given the many differences between Canada and Europe, the effects of which are hard to isolate. The authors’ result is an increase by about factor five, but they emphasize that a large number of assumptions had to be used to arrive at this number and that it should not be taken too seriously. The merely qualitative interpretation would be that even after the Services Directive, trade in services within Europe is very unlike trade within one country. While this is no surprise, some details from the gravity model of interprovincial Canadian trade and its comparison to the one discussed above are instructive. First, in Canada the effect of distance on trade is as strong for services as for goods. In Europe, distance is currently less important for services than for goods. This is probably due to the fact that current barriers to trade are more relevant for services trade requiring the presence of the supplier, e.g. services where personnel of the supplier moves across the border for a few days, incurring transportation costs. After the implementation of the Services Directive, the intensity of trade will increase more for this type of service than for services that are produced in the country of origin and are then transported (electronically, for example) across borders at costs that do not depend on distance very much. As a result, we should expect distance, ceteris paribus, to become a more important determinant of trade flows due to the Services Directive, i.e., it is trade between neighboring countries that will show the strongest relative increase.

Furthermore, while almost all types of barriers are absent within Canada, there is a language barrier, as French is spoken in the province of Quebec. This does not have a significant negative impact on the volume of goods traded with English-speaking provinces, but it does have a significant negative impact in the case of services (with the sole exception of health services). The straightforward interpretation offered by Lejour and de Paiva Verheijden is that “communication between provider and consumer is more important for services trade than for goods trade. A reason could be that many traded services are often less standardised than goods.”[42]

Let us turn to the United States now. Esparza and Krmenec[43] use data from a telephone survey of business services firms in Chicago to investigate the geographical pattern of sales that do not have the Chicago metropolitan region as destination (between 10 percent for accounting and 40 percent for computer and data processing and management/public relations). It turns out that the intensity of services trade between regions in the United States strongly depends on the distance between them,[44] confirming (albeit by a different method) the results from the gravity models discussed above. Esparza and Krmenec do not explicitly aim at the amount of "intra-industry" services trade.[45] However, the data they report at least gives an impression. The share of computer-related firms that buy data-processing services (10 percent) is not markedly smaller than that of firms whose business is less related to data processing. Roughly the same holds true for advertising and management/public relations firms, of which 21 and 24 percent respectively buy advertising/marketing services. However crude these bits of information may be, they do show that intra-industry trade is important, especially as we conjecture that it will be even more important in Europe than in the United States. While the Services Directive removes many institutional barriers to international services trade, language and cultural barriers will remain, and these are more important for services trade than for normal goods trade. In order to overcome these barriers, exporters will often seek help from partners in the destination countries,[46] resulting in extra intra-industry trade. This effect will become even stronger if cultural barriers have a larger impact on inter-industry than on intra-industry trade in services.

07

CHAPTER SEVEN

POTENTIAL IMPLICATIONS FOR TRANSATLANTIC BUSINESS

The Importance of Transatlantic Trade

U.S. business and the U.S. government have been strong supporters of a liberalization of EU services markets as proposed by the Commission. Given the sheer depth and extent of transatlantic integration through trade and foreign investment, it is easy to understand why most big U.S. corporations with subsidiaries in Europe had a keen interest in a more integrated market in the EU services industries. Providers as well as users of services would benefit from such a development. The U.S. government also supported the move towards a more integrated EU services market.

The extent of transatlantic business integration is usually underestimated. In fact, it is quite high. Quinlan reports that U.S. foreign affiliates earn about half of their total global earnings in Europe. In 2000, sales of those firms in EU markets exceeded one trillion dollars and output $300 billion while employment in those firms was above four million and R&D activities were widespread.[47] In services alone, U.S. foreign affiliates recorded sales in 2002 of $212 billion, almost twice as much as exports of those services from the United States to the EU in the same year. The UK accounts for almost half of the share of U.S. foreign affiliate sales in Europe, followed by Germany and France, with a share of roughly twelve percent each, the Netherlands with seven, and Italy with four percent. By industry, sales of IT services accounted for more than $40 billion, real estate for about ten billion, and wholesale trade for about $15 billion. In other words, those industries subject to the Directive represented at least $65 billion of sales of U.S. foreign affiliates. Hamilton and Quinlan note that barriers to trade are particularly high on the European side in accounting, maritime, and legal services, with two out of those three industries falling under the scope of the Directive.

The trend in sales of foreign affiliates has been very strong and is likely to remain so. To be sure: trade and sales growth in the other direction has also been very strong. EU affiliates' services sales in the United States and U.S. services imports from Europe are just as substantial. Affiliate sales exceeded $250 billion in 2001, with imports of around $100 billion. British firms held a share of 25 percent of sales of $269 billion in 2002, while German and French firms each accounted for some 16 percent. Again, more than $60 billion of sales originated in industries subject to the Directive.

Not surprisingly, the American Chamber of Commerce to the EU became the focal point of U.S. business interests in the policy issue. Obviously, U.S. companies with commercial activities in the services industries falling within the scope of the Directive would benefit like their "European" competitors (i.e. firms domiciled in the EU) from a better operating environment in Europe. In addition, liberalization of establishment would make life much easier for U.S. firms setting foot on EU soil. Even though a more liberal European services market might ultimately also increase the competitiveness of the EU services industry, and perhaps enhance trading and sales opportunities in the United States (and thus create some import competition in U.S. markets), this did not play a noticeable role at all. In a rare moment, the United States both government and business) was much more concerned with "making Europe work properly" than with keeping a potential competitor strapped in its own internal failings. "Europe 1992" had ignited some debate about trade diversion, but not this time. AmCham EU, for example, thus proved to be a strong supporter of the Commission's approach to services liberalization in the EU, essentially fully adopting the integrationist economic and political reasoning. It raised some issues of particular interest to U.S. firms operating in Europe, such as costs related to the posting of workers or the desirability of establishing single points of contact for handling administrative matters upon establishment or cross-border provision. It also cooperated with other pro-trade and pro-investment European business lobby groups. In the run-up to the plenary vote in February 2006, it voiced strong concerns about Parliament's many derogations from the original Commission draft and argued that it might create too many legal uncertainties for business. In the end, however, the U.S. business community remained on the political sidelines of the EU debate.

The Effects of the Services Directive

There are a number of different ways in which the Services Directive might make an impact on transatlantic trade; some of these effects might offset each other, hence the net effects are subject to some intuitive judgment ex ante.

While the Directive, taken literally, aims (only) at facilitating market entry for firms from other European countries, a discriminatory implementation is hard to imagine for most parts of the Directive. For example, cross-border trade of services will be facilitated in any European country for U.S. as well as for European suppliers. However, new market entrants from Europe will enjoy the additional advantage of cultural and geographical proximity. This is even more important if temporary presence of the supplier's personnel is required.

Yet this is also a reason why incentives for direct investment by U.S. service firms in Europe should increase markedly. Benefits from having at least one establishment in Europe are much higher after implementation of the Directive, as the market that can be served through one subsidiary will increase from one country to Europe as a whole, allowing the exploitation of economies of scale. However, for the same reason, incentives to serve the European market(s) through different subsidiaries in different countries will become lower for some services, but we do not expect this to be the dominant effect of the Directive on foreign direct investment. Quite the contrary, we fully agree with Hamilton and Quinlan who stress that implementation of the Services Directive would likely boost transatlantic foreign direct investment, in particular from the United States to Europe, and enhance competition, which would lead to lower prices and higher productivity, better jobs, and higher pay.

If the Services Directive becomes law in the EU roughly along the lines of the compromise in the Parliament, rules for establishment will become more in line with the spirit and the wording of the Treaty of Rome. This would be highly beneficial for U.S. companies planning to expand their affiliate business in Europe or setting up businesses there for the first time. It will also be beneficial for the cross-border provision of services in those industries subject to the new freedom provisions. U.S. firms will also benefit right from the start from the improved business conditions in Europe, whereas it might take some years before the more competitive and liberal environment in Europe induces lasting changes in business models, productivity levels, and other performance indicators in the EU services sectors subject to the Directive. In other words, the pro-competitive, trade-diverting implications that might improve the position both of EU-domiciled firms and foreign affiliates operating in Europe compared to firms exporting into the EU and firms operating in third markets such as the United States will occur much later than the direct trade-creating implications of lower barriers to trade in the internal market. In our view, the numerous instances of interventionist language in the Parliament's first reading of the Directive will not amount to much real intervention, given the tight limits set by ECJ jurisprudence in the past. The perception of persistent contingent market barriers may differ from this judgment, however. U.S. firms might well be at the forefront in testing those limits by aggressively entering new markets on the old continent. In that sense, they could spearhead the integration of the hitherto protected markets for retail and wholesale trade, IT, construction, and tourism services. Customers and users in the EU might get by with a little help from their U.S. friends. Today's economic realities provide ample opportunities for these paradoxical effects.

08

CHAPTER EIGHT

CONCLUSIONS

The EU Services Directive has been one of several highly controversial internal policies of the European Union in recent years; other hot topics were REACH, a Directive on testing chemical substances, the EU financial framework, and the Draft Constitution. The Services Directive has perhaps been the one most relevant for the Lisbon Agenda, as it has been designed to close a gap in internal market legislation. In a way, the Directive was the last piece needed to cover most of manufacturing and services by a modern legal framework establishing a single market. The services industries that should fall within the scope of the Directive initially, as conceived by the Commission, had been left behind since the mid-1990s when the EU tackled network industries and utilities, banking and financial markets, and other more clearly defined sectors and activities. The services "left-overs" subject to the Directive were, however, not economically marginal. Rather, those services had a large share in GDP and employment but lacked a coherent set of common characteristics. In a sense, the Services Directive covered too much in one piece of legislation.

The Commission's radical and comprehensive approach—based on a clear Council mandate dating from the early years of the decade—was perhaps the one and only realistic one. A differentiated, sector-by-sector approach to this hodge-podge of services would not have galvanized policymaking in Brussels sufficiently. And in the end, it worked.

However, the argument for rewriting the rules in order to establish a single market in these services industries should have been developed more clearly right from the start. Perhaps, EU institutions and politicians first underestimated the risk of populism and demagogy associated with legislation aimed at integrating markets and then jumped onto the bandwagon once the media started banging the drums and raising awareness of the potential implications of intra-European competition in an enlarged European Union. In this period (mainly from spring 2004 to summer 2005), many member states and the Commission navigated difficult waters. Sufficient academic advice was not available, and the economic complexities of what might happen in this or that services industry given a further opening of markets to cross-border competition through either trade or direct investment were difficult to explain in a thirty-second TV commercial. A key lesson from this episode seems to be that even those economic policies whose underlying rationale is thought to be agreeable, tried before, and tested well perhaps need a comprehensive theoretical treatment provided both by the Commission and by governments. Otherwise, agenda-setting might shift to the media, lobbyists, and populist politicians, seriously undermining a decent policy approach.

Last but not least, in today's world of deep transatlantic economic interdependence policy developments in one market do not leave the other untouched. The sheer amount of trade and direct investment between the United States and Europe is staggering, and is more important today than ever before. For U.S. firms, a single European market is much less of a threat of a rising global player increasing its economic power through internal unity but rather a bigger opportunity for increasing exposure, deepening the ties and serving consumers and businesses from European soil. U.S. business has become a supportive force of integration for that simple reason. A better regulatory framework in Europe will, in the end, help the EU to overcome its relative weakness and underperformance in certain services industries in which the U.S. markets are more developed. The Services Directive will contribute significantly to this objective of the Lisbon Agenda, as will U.S. services firms exporting management skills to Europe.

NOTES

1 OECD, “The EU Services Market: At your service?”, Economics Department Working Paper No. 449, Paris 2005, report by Line Vogt.

2 See European Commission, “Extended Impact Assessment of Proposal for a Directive on Services in the Internal Market,” Brussels 2003; Eurostat, European Business – Facts and Figures, Part 6: Business Services, Luxembourg, 2003.

3 The most important business services in economic terms are renting and leasing, research and development, legal, accountancy and management services, advertising and market research, architectural and engineering services, labor agencies services, and industrial cleaning and security services.

4 Centre for Strategy & Evaluation Services, “Barriers to Trade in Business Services,” Brussels, January 2001, available on the DG Internal Market website.

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15 Sectors not covered include postal services, electricity, gas, and water distribution services.

16 The Ministry of Economics and Labor was split up after the elections in September 2005. The Ministry of Economics and Technology remained in charge of the dossier.

17 Charlie McGreevy, “Verbatim of discussion in the European Parliament Plenary – Commissioner McGreevy on the Services Directive,” Strasbourg, 9 March 2005, available on http://europa.eu.int/.

18 Charlie McGreevy, “Statement to the European Parliament on Services Directive,” Strasbourg, 8 March 2005, available on http://europa.eu.int/.

19 EP, Working Document 26 March 2004, PE 343.503 (Rapporteur E. Gebhardt) and Working Document 25 March 2004, PE 341.862 (Rapporteur A.E.M. Van Lancker).

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21 See OECD, “The EU Services Market: At your service?” Economics Department Working Paper No. 449, Paris 2005, report by Line Vogt, 17.

22 See “Conclusions of the Council Presidency 7775/06,” 24 March 2006, para 57, available on the Council homepage.

23 Involved in the broker group were Marianne Thyssen (Belgium), Malcolm Harbour (UK), Othmar Karas (Austria), and Jacques Toubon (France) on behalf of the conservative EPP-ED Group and Evelyne Gephardt (Germany), Anne Van Lancker (Belgium), Robert Goebbels (Luxembourg), Johannes Swoboda (Austria), and Harlem Désir (France) on behalf of the Socialists (PSE Group).

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26 The reason is this: If one type of entry barrier exists in a pair of countries, then the difference in this respect is 0. If the Services Directive removes these barriers, we again have a symmetric situation with zero difference. The CPB model does not count this as something which has an effect, although more services should be traded in this new situation.

27 Fritz Breuss, Harald Badinger, “The European Single Market for Services in the Context of the Lisbon Agenda: Macroeconomic Effects.” Study commissioned by the Federal Ministry of Economics and Labor of the Republic of Austria, Final Report, December 2005, abridged report in: Austrian Federal Ministry of Economics and Labor (ed.), *Deepening the Lisbon Agenda: Studies on Productivity, Services and Technologies*, mimeo 2006.

28 Breuss and Badinger (2005), 97, note that not only actual trade, but also the mere increased threat of entry will enhance efficiency; this effect is disregarded in their estimates.

29 Breuss and Badinger, *The European Single Market*, 100.

30 Roland de Bruijn, Henk Kox, Arjan Lejour, “The Trade-induced Effects of the Services Directive and the Country of Origin Principle,” CPB Document No 108, February, 2006.

31 *Ibid*., 35.

32 Ronnie O'Toole, "The Services Directive - An Initial Estimate of the Economic Impact on Ireland," Forfás, 2005, mimeo: http://www.entemp.ie/trade/marketaccess/singlemarket/05serv099.doc.

33 Joseph Francois, "The Next WTO Round: North-South Stakes in New Access Negotiations," Adelaide: Centre for International Economic Studies und Rotterdam: Tinbergen Institute, 2001.

34 O'Toole, "The Services Directive," 18.

35 On regional concentration measures see e.g. L. Bertinelli, J. Decrop, "Geographical Agglomeration: The Case of Belgian Manufacturing Industry, Brussels," Federal Planning Bureau Working Paper 14-2002, http://www.plan.fgov.be/en/pub/WP/WP0214/WP0214en.pdf.

36 Following W. Gerstenberger et al., "Auswirkungen der EU-Osterweiterung auf Wirtschaft und Arbeitsmarkt in Sachsen," ifo Dresden Studien 35, Munich 2004.

37 The complete results are to be found in the joint study of the German Institute for Economic Research (DIW Berlin) and ifo Munich, "Chancen und Risiken veränderter Rahmenbedingungen für die Dienstleistungsunternehmen durch die EU-Dienstleistungsrichtlinie."

38 For the purpose of comparability, these are percentages not of all firms, but of all who see some relevance of the Services Directive for themselves.

39 For services sharing certain characteristics of media products, there are further market mechanisms favoring exporters from large countries if institutional barriers are sufficiently low, see Björn Frank, "A Note on the International Dominance of the US in the Trade in Movies and Television Fiction," *Journal of Media Economics* 5, 31-38, 1992.

40 Matthew P. Drennan, "Gateway cities: the metropolitan sources of US producer services exports," *Urban Studies* 29, 1992, 217-235.

41 Arjan Lejour, Jan-Willem de Paiva Verheijden, "Services trade within Canada and the European Union. What do they have in common?", CPB Discussion Paper No. 42, December 2004.

42 *Ibid*., 21.

43 Adrian X. Esparza, Andrew J. Krmenec, "Producer Services Trade in City Systems: Evidence from Chicago," *Urban Studies* 31, 1994, 29-46.

44 See also Adrian X. Esparza, Andrew J. Krmenec, "Large City Interaction in the US Urban System," *Urban Studies* 37, 2000, 691-709.

45 Esparza and Krmenec, "Producer Services." Their purpose is the comparison of interregional sales linkages and purchase linkages, which bears no importance for our study.

46 According to the survey described in the previous section, 27.5 percent of the responding service firms plan to cooperate with foreign service suppliers following the implementation of the Services Directive.

47 Joseph P. Quinlan, *Drifting Apart or Growing Together? The Primacy of the Transatlantic Economy*, Washington, D.C.: Center for Transatlantic Relations, The Johns Hopkins University, 2003; see also Daniel S. Hamilton, Joseph P. Quinlan, *Partners in Prosperity. The Changing Geography of the Transatlantic Economy*, Washington, D.C.: Center for Transatlantic Relations, The Johns Hopkins University, 2004; Hamilton and Quinlan, "The Sleeping Giant: Services in the Transatlantic Economy", in Hamilton and Quinlan, eds., *Deep Integration: How Transatlantic Markets are Leading Globalization*, Washington, D.C.: Center for Transatlantic Relations, The Johns Hopkins University, 2005, 39-49; and The Atlantic Council, *The Transatlantic Economy in 2020: A Partnership for the Future?*, Washington, D.C., 2004.

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