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## Dynamic effects of European services liberalisation: more to be gained

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## SUMMARY

Europe's market for services is fragmented by many regulatory barriers. The Services directive proposed by the European Commission aims to integrate national services markets by reducing these barriers. Several studies indicate that bilateral trade and foreign direct investment in services could boost substantially. GDP and consumption could increase by 0.5% to about 1% on average in Europe. The effects for the Member States vary depending on the size of the barriers in their services markets and specialization. These results take account of scale effects, and forward and backward linkages in the economy, but ignore the effects of more competition on productivity and innovation in the long term. This paper assesses the channels through which an integrated European services market may generate these dynamic gains. Improved market access will stimulate competitive selection and productivity growth. Through trade and investment, knowledge spillovers will increase and innovation will be fostered. These channels are illustrated with scarce quantitative evidence.



# 1 INTRODUCTION

The EC Treaty mentions 'the freedom to provide services within the Community' (art. 49) as one of its main objectives. Its realisation is still a far cry from present-day practice. Twenty years ago the Single Market Programme (SMP) was launched, meant to effectuate a free circulation of goods, services, capital and labour in an integrated European market. The services sector now accounts for almost 70 per cent of the European GDP and employment. But until 2004 it was kept in the waiting room for implementation of the SMP, and European services markets – including financial markets – remain highly fragmented. The European Commission then launched its proposals for a Directive on Services in the Internal Market (EC 2004). The topic sparked a remarkably intensive political debate in many of the 'old' EU countries. Unfortunately the SMP for services often appeared to be regarded as a zero-sum game, where countries either win or lose. The rejection of the Commission proposals by the European Council, in March 2005, was a painful setback for the SMP process. A factor may have been that the proposed Services Directive and the accession of ten new Member States approximately coincided in time, giving rise to labour immigration fears. In 2006, a political compromise was reached on a 'light' version of the original Services Directive proposals.

The amended version of the Services Directive is to be implemented from 2010 onwards (EC 2006). 2010 is also the benchmark year for the Lisbon targets, formulated to strengthen the competitiveness, productivity and innovation performance of the European economy. The Sapir Report (Sapir *et al.* 2004) singled out the extension of SMP to services as a top priority for raising the EU's growth performance and international competitiveness. Labour productivity growth in the European services sector decreased in the 1990s relative to the 1980s, and even more so in comparison with the USA (European Central Bank 2006). O'Mahony *et al.* (2003) found that one of the main causes of the relative productivity slowdown in Europe compared to the United States is that European ICT-using services, like wholesale and retail, have a slower productivity growth than comparable sectors in the USA.

The question is whether an open market for services in Europe could foster competition and productivity growth such that the productivity gap with the US can be diminished. This paper focuses on the relation between service market liberalisation, innovation and competitiveness. We single out the channels through which a more liberalised and intensive intra-European services trade can bolster productivity and innovation in the European economy. Up to now, most empirical studies –including our own– have quantified the static effects of services liberalisation, i.e. the shift effects that may occur as a result of a more integrated EU services market. What may even be more important are the

dynamic effects of liberalisation, because they may be a sustainable source of future productivity growth and innovation. This contribution is based on recent theoretical insights from trade theory, innovation theory, and on recent empirical findings on the European services economy.

The structure of this chapter is as follows. Section 2 presents some key statistics on the European services market. It also briefly discusses the regulatory obstacles that up to now constitute barriers to a more intensive intra-European services trade. Section 3 presents the main estimates of the static gains from services liberalisation. In Section 4 we assess the channels through which an integrated European services market in the future may generate dynamic welfare benefits for the Member States through more productivity and innovation. Valuable insights are derived from recent theory on trade with heterogeneous firms, and from the literature on competition and innovation. We present some of the still scarce quantitative evidence in this area. Section 5 draws conclusions and singles out some policies that may support the attainment of dynamic welfare gains from more liberal services trade.

## 2 A SINGLE EUROPEAN MARKET FOR SERVICES?

Commercial services represent some two-thirds of European economies and about 70 per cent of total employment. Despite press headlines on globalisation and offshoring of services jobs, services markets are still rather closed to foreign competition. Trade in commercial services is at most one-fifth of total world trade in goods and services. In value terms, world services exports now amounts to 2.4 trillion US dollars (WTO 2006). In 2005, world exports of commercial services rose by 11 per cent, while goods (merchandise) exports rose by 13 per cent. The gap between both is widening in recent years.

**Table 2.1** The position of the internal EU market in the system of services trade between developed countries, 1999–2003.

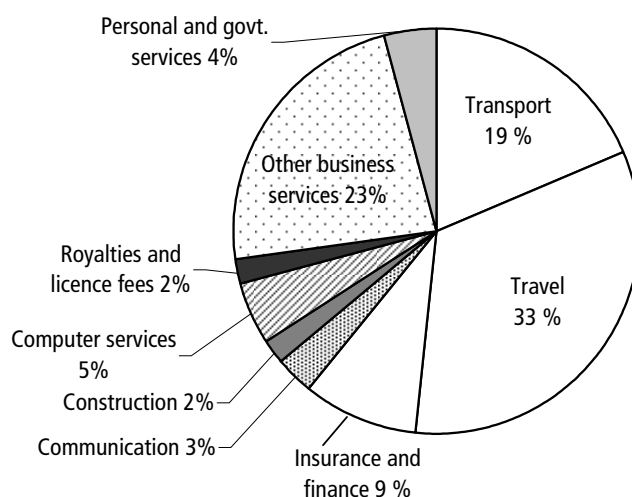
	EU services exports as % of OECD services exports		Intra-EU services exports as % of total OECD services exports	
	1999	2003	1999	2003
Total services	57	64	38	47
of which:				
Royalties for technical services	31	28 <sup>a)</sup>	19	14 <sup>a)</sup>
Other business services	56	64 <sup>a)</sup>	32	42 <sup>a)</sup>
Commercial services without travel and transport	53	54 <sup>a)</sup>	35	42 <sup>a)</sup>

Note: a) 2002 data.

Source: CPB consistent bilateral services trade matrices, developed on the basis of OECD data and the GTAP method for consistency of bilateral trade flows. Annual data in current US dollars. EU data have been calculated for EU25.

The EU services exports have grown faster than the average for all developed countries. This holds for the EU's external services exports and for exports in the internal EU services market. Table 2.1 shows that the shares of both in total OECD services exports have grown in recent years. This does not hold for the EU's share in total royalty and license-fee receipts, used as a measure for exports of specific technical and high-valued-added services. Here, the EU seems to be losing ground. Figure 2.1 shows the composition of intra-EU services trade. Travel is the largest category in services exports, before transport and business services. External and intra-EU services trade have a comparable sectoral composition.

**Figure 2.1** Share of services sectors in intra-EU services trade, 2003



Source: CPB consistent bilateral services trade matrices. The shaded components are most affected by the European Commission's amended Services Directive (2006).

Compared to manufacturing and agriculture, services sectors are less open to international trade (details in Kox *et al.* 2004). This difference with the goods-producing sectors has two basic causes.

1. Services production and delivery often needs the proximity of producer and consumer, so that the services supplier has to move abroad.<sup>2</sup> This makes cross-border trade relatively difficult compared to manufacturing where normally only the product is shipped abroad. If firms are large enough, they can choose between exporting and setting up a local establishment in the destination country. The share of foreign affiliates in services value added ranges from 7% in Denmark to nearly 40% in Ireland (OECD 2005). In the larger EU countries it is about 10% and in the accession countries it is much higher. Although recent FDI flows in services exceed those in manufacturing, the production share of foreign subsidiaries in manufacturing is still higher than in services.
2. Regulation-caused non-tariff barriers form a further cause for the limited international integration of services markets. The European Commission (EC 2002a) found a wide array of domestic measures that hamper service firms in supplying a foreign market through cross-border trade or foreign establishments. Regulations for service suppliers, for foreign investors and for the service products themselves often are primarily established for domestic purposes without taking account of the interests of foreign service providers.

The fact that a national service market *is* regulated need not in itself be a barrier to international services trade.<sup>3</sup> This can be shown by a little thought experiment. Suppose that all countries have the same type of regulation, for instance, a qualification requirement for providers producing a particular service product. Since qualification costs are mainly fixed costs, it would cost an exporting firm a one-off effort to comply with the qualification criteria. Once having incurred these fixed qualification costs, the firm would even have an incentive to export more. By enlarging its production through exports into other countries, the firm could reap economies of scale. However, such a uniform system of regulation for service markets does not exist. Countries often have little interest in each other's regulatory regimes or have little confidence in its quality. Hence, they are reluctant to adapt their own regimes where necessary to facilitate cross-border activities. If each country has different regulations in place and does not recognise qualifications in a foreign firm's home country, then the national qualification costs become cumulative fixed costs. Because the

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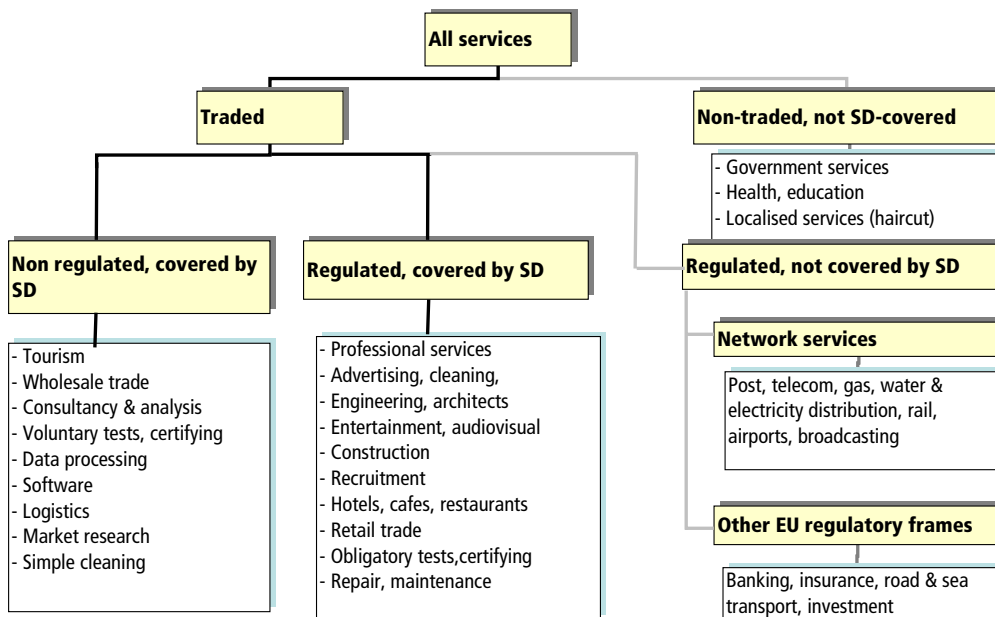
<sup>2</sup> In the case of tourism and travel, the consumers moves abroad.

<sup>3</sup> Even though regulations may have a negative bearing on competition and domestic market entry. The European Central Bank (2006) found that services prices rose more in those EU countries that have stricter regulations (barriers to entrepreneurship).

costs are country-specific, they are in fact sunk market-entry cost for a country market. This hampers exports and investment.

The Services Directive introduced by the European Commission intends to make headway with Single European Market for Services, by reducing the negative impact of policy heterogeneity, by ruling out national measures that explicitly or implicitly discriminate against foreign service supplies, and by calling for measures facilitating trade and investment in services. Figure 2.2 tentatively shows the sectoral coverage of the Services Directive. The regulated services sectors are the ones which are most affected by the directive. Combining the information of figures 2.1 and 2.2 we may conclude that from a quantitative perspective the SD first and foremost covers the intra-European trade in business-to-business services. These services correspond in particular to what Baldwin (2006) calls the 'second wave of unbundling'.

**Figure 2.2** Sectoral coverage of Services Directive (SD), as amended in 2006.



### 3 STATIC EFFECTS OF EU SERVICES MARKET LIBERALISATION

Until shortly, very few studies were available that quantify the potential impact of lower service-trade barriers in the EU internal market. An early study by Buigues *et al.* (1990) simulated strong effects of the European Single Market programme, but hardly paid attention to services. With its ambitious and far-reaching 2004 proposals for a Services Directive (EC 2004), the European Commission wants to accomplish a European Single Market for a large part of the services sector. The proposals would eliminate important obstacles to the freedom of establishment and the free movement of services, while strengthening mutual trust between the EU countries on their regulatory regimes. Using the 2004 Commission proposals for a Services Directive (SD) as a point of departure, several studies have quantified the potential effects of the proposed measures. Here we just summarise their main results.

Kox and Lejour (2005, 2006) approach the issue by quantifying the sunk market-entry costs of country-specific regulations, accounting for differences in product-market regulations between each EU country pair.<sup>4</sup> The degree of bilateral policy heterogeneity between countries is used as a proxy for sunk export costs; it may differ between each pair of countries. Applied in gravity equations for bilateral services trade in the EU, regulatory heterogeneity in policy areas like competition and trade regulation appears to have a robustly negative trade impact. At detailed level they subsequently estimate to what extent the Commission's SD would affect bilateral policy heterogeneity. The results are combined to simulate the effects of the SD:

- trade in commercial services (excluding transport and travel) could increase by 30 to 62 per cent;
- intra-EU FDI in services could increase by 18 to 36 per cent.

In order to estimate the macro-economic importance of the SD, De Bruijn *et al.* (2006) have fed the estimated trade impacts (not the FDI effects) into a large CGE model WorldScan which distinguishes most of the EU countries:

- average European consumption could increase by between 0.5 and 1.2 per cent;
- the mutual-recognition element in the Service Directive, i.e. the country-of-origin principle (or shortly: CoOP) accounts for about one-third of the effects.

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<sup>4</sup> Using country-wise data on some 200 different items in product-market regulations from the OECD International Regulation database. The indicator is decomposed into 5 different areas of product-market regulation.

If also the effects of more FDI are added (derived from Lejour *et al.* 2006) consumption could increase by 0.5 to 1.5 per cent. Frame 3.1 explains why these macro-economic effects seem relatively modest. However, expressed in terms of the 2004 European GDP, the measures would add 35 to 95 billion Euros. This still ignores the productivity and innovation impacts of more trade and FDI.

**Frame 3.1** Putting services-liberalisation in the size perspective of the EU economy

The Services Directive may increase the intra-EU volume of trade in *other commercial services* by 30 to 62 per cent (De Bruijn *et al.* 2006). This is a very strong increase for the services sectors involved. But a backside-of-envelop calculation shows that the effect at a macroeconomic level is much more modest. Intra-EU trade in *other commercial services* represents only about seven per cent of total EU trade. The 2004 Services Directive would thus increase total EU trade by some 2 to 5 per cent. Detailed simulation results at country level support this intuition. Given the small effects on total trade, it is not surprising that the static GDP effects are modest, on average ranging from 0.3 per cent to 0.7 per cent in the EU.

Breuss and Badinger (2005) use CPB's quantitative estimates of the SD's services-trade effects as input for their research. They estimate how much the additional trade will erode profit mark-ups in EU services markets. They find that more entry does not directly affect productivity, but for the sample of service industries covered by SD, they find significant effects of trade on more competition. And the latter has significant positive impacts on productivity, employment and investment in EU services.

Copenhagen Economics (2005a, 2005b) analyses the welfare effects of the EU proposals with a CGE model which also considers the FDI effects. They assess that overall consumption in the European Union would increase by 0.6 per cent. This estimate corresponds to the minimum estimate by De Bruijn *et al.* (2006). According to their analysis the CoOP contributes only about 10 per cent to the total welfare effects (including the FDI-induced effects). This is not surprising, since their concept of non-tariff barriers in services is more limited: they look at domestic regulation within a country, but do not consider the impacts of inter-country differences in the form and content of the regulations.

Vogt (2005) considers the estimates of Copenhagen Economics to be conservative, because all dynamic effects of extra competition on productivity and innovation are left unconsidered. It is however fair to say that this criticism also holds for the CPB studies. Both studies concentrate on the static (one-off) effects of opening up European services markets: economies of scale, efficiency gains through inter-sector supply linkages.

The estimates of the static gains of opening up services market are comparable to the effects of the SMP in 1992. In 2002 the European Commission (EC, 2002b) has estimated that GDP in the EU is about 1.4% higher due to SMP. The GDP increase mostly derives from the increased allocative efficiency in manufacturing. Moreover the liberalisation of network industries increases GDP by another 0.4%. The dynamic effects and integration of services sectors are not estimated.

## 4 DYNAMIC EFFECTS OF LIBERALISATION

What can we say about the dynamic welfare gains of more intra-European trade and FDI in services, i.e. their impact on productivity growth and innovation, the basic sources of future economic growth? These dynamic effects are certainly more difficult to quantify than the static effects. The main channels for long-term dynamic impacts are: (a) more competitive selection; (b) knowledge spill-overs; and (c) market entry as incentive for innovation. We discuss each of these channels and present relevant pieces of empirical evidence.

### 4.1 Competitive selection

Theory and empirics on the relation between (foreign) competition, innovation and productivity growth are still in their early stages. Some clues on the dynamic impact of SD on productivity and growth can be found in the literature on the relation between trade openness and income growth. The empirical relationship between openness and income is subject to debate.<sup>5</sup> Some influential papers estimate that 1 percentage point more trade openness causes income to grow by 0.6 per cent in the short term, and 1.1 per cent when also long-term effects are counted (Frankel and Rose; 2002). Applying the latter estimate, the 2004 Services Directive could increase European GDP by 2 to 5 per cent. These long-run effects incorporate the effects of extra competition, productivity spill-overs, extra innovation and productivity growth. Nicoletti and Scarpetta (2003) estimate that entry liberalisation in services could boost productivity growth by 0.1 to 0.2 per cent in some European countries. Less product market regulation may stimulate firm entry, investment and the growth of firms.

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<sup>5</sup> Cf. Feenstra (2003: Ch. 10) for a review.

Aghion and Griffith (2005) attempt to provide a unified and coherent account of the effects that competition and deregulated entry have on economic growth.<sup>6</sup> They sketch two opposing forces that are at work. One factor is that more competition may reduce the monopoly rents that reward successful innovators; too much competition would then be bad for innovation and growth. The other force is that more competition generates incentives for firms to work more efficiently, and thus generate – as is corroborated by some empirical studies – a higher productivity growth. Aghion and Griffith propose a distinction between 'competition for markets' (capturing market entry and the ability of escaping current markets by creating new market opportunities) from 'competition in markets' (traditional cost competition in product markets). After increased or imminent competitive entry *in* their market, incumbent firms will innovate again to escape competition. The incentive to innovate for new firms may become lower, however, because the potential rewards from successful innovation get smaller.

This insight can be applied to European services markets. The foreign firms that enter the domestic markets of other EU Member States are not new firms, but incumbents in their home market. Due to liberalisation, these incumbents do not leave their home markets but create new, additional market opportunities in other countries. The overall effect is that in all EU countries cost competition between incumbents increases in existing product markets.<sup>7</sup> It will raise the average productivity level. The incumbent firms will react by innovating into new product markets or by carving out niche markets. More foreign presence means that buyers have a larger choice variety to choose from. The entry hurdle and innovation incentive for *new* domestic firms may however become higher. Accompanying policies may be required to address this potential problem.

Griffith *et al.* (2006) analyse the impact that the Single Market Programme had on competition and subsequently innovation and productivity growth. They find that the programme had effects that are statistically and economically significant. In manufacturing, competition increased, as measured by profit mark-ups. This stimulated productivity growth, and it also fostered investment in R&D by existing firms. For services, they find that more competition goes along with more productivity growth, but due to statistical deficiencies they cannot establish the causality direction between both.

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<sup>6</sup> Earlier work by Aghion *et al.* (2003) includes some empirical support derived from manufacturing industries, but overall the empirics on the subject still are limited. For manufacturing, more and better statistical data on competition, innovation and productivity are available than for services. More European support for this type of research seems warranted, therefore.

<sup>7</sup> The extent to which competition will increase depends partly on the substitution between exports and FDI. Recent theory predicts that exports will increase more than FDI when liberalisation causes fixed market-entry costs to fall. Evidence from manufacturing industry supports this (Helpman *et al.* 2004).

**Frame 4.1** Fixed-cost impact of exports and local establishment in business services

A survey study commissioned by the European Commission provides some information on the magnitude of fixed market-entry costs (CSES 2001). Among a large number of business-services firms in the EU, 78 per cent of the firms mention that setup costs of selling services in other EU states are "significant" or "very significant" trading barriers. Of those firms that were able to estimate the size of the setup costs, 30 per cent estimated that these are in the order of 3–6 months sales proceeds, and 43 per cent estimated that the cost are more than 6 months of sales proceeds. The setup-cost effects are largest for small and medium-sized enterprises (SME): "*Evidence collected from SMEs and SME-supporting organisations suggests that many SMEs back off after initial inquiries about administrative requirements and procedures because they feel they do not have the necessary resources to deal with the current complexity*".

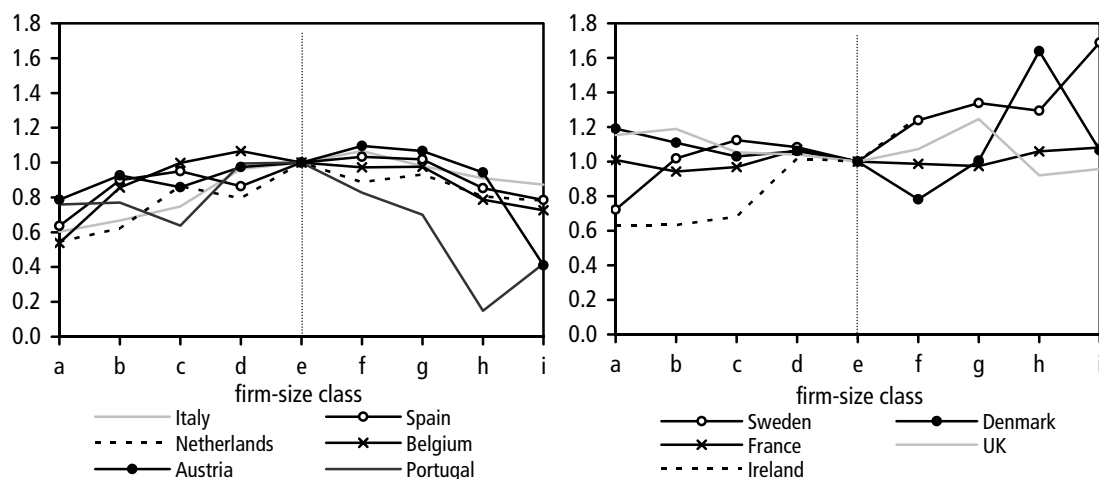
Scarpetta *et al.* (2002) conclude that stringent regulatory settings in the product market have a negative bearing on productivity and on market access. The largest impact of national product market regulations is on small and medium-sized enterprises. Only firms with sufficient size are able to overcome the fixed market-entry costs caused by national regulation (cf. Frame 4.1). Because of the country-specific character of most regulations, regulation-caused qualification costs for individual firms are sunk costs, specific for each export market. In a situation with fragmented services markets and high sunk export cost, only the largest or the most productive service firms can be expected to export.

The newest trade theory explicitly models and explains the impact of trade liberalisation in the case of heterogeneous firms (e.g. Melitz 2003; Baldwin 2005; Yeaple 2005; Helpman *et al.* 2006). These models explain a well-documented fact, namely that only the most productive firms are active in exports. They put particular emphasis on the role of sunk export costs. They also show that liberalisation causes exports of firms in all size classes to increase, but that the firms that newly embark on exports are smaller than before. If liberalisation (or mutual recognition) lowers entry costs, more and smaller firms will be able to export profitably. Especially firms from the ranks of the medium-sized services firms will start exporting. A further finding is that the average productivity level will increase due to the liberalisation, because relatively productive foreign firms gain market share at the expense of those domestic firms that are less efficient.

These findings may have a direct relevance for intra-European services trade. Looking to the relation between firm size and labour productivity among a very large sample of European business-services firms, Kox *et al.* (2007) find that medium-sized firms tend to have a higher than average labour productivity. The left panel of Figure 4.1 shows a hump-shape relation (inverted-U) between size

and productivity in six out of eleven EU countries.<sup>8</sup> While sunk export costs resulting from country-specific regulation requirements give large firms an advantage in intra-European exports, Figure 4.1 shows that these are not necessarily the most productive ones. If liberalisation lowers regulation-caused export costs, it is likely to cause more export by medium-sized firms. This may have a positive impact on overall productivity in services. Expanding the foreign markets opportunities for SMEs may thus generate welfare-enhancing scale and productivity effects. Empirical research finds firms that newly enter a market (like the newly exporting SME firms) to be more likely than incumbent firms to pass on productivity advantages through lower prices (Foster *et al.* 2005).

**Figure 4.1** Relative labour productivity in business services by size class, 11 EU countries, 1999 (Benchmark: productivity in size class of 50–99 employees).



Note: labour productivity is measured as value added (in 1000 Euros) per employed person. Legends for firm-size classes, based on employed persons per firm: a) 1-4; b) 5-9; c) 10-19; d) 20-49; e) 50-99; f) 100-249; g) 250-499; h) 500-999; and i) over 1000 employed persons. The value added of the size class with 50-99 employed persons is the benchmark (=1).

Data source: Eurostat, New Cronos, Figure from Kox *et al.* (2007).

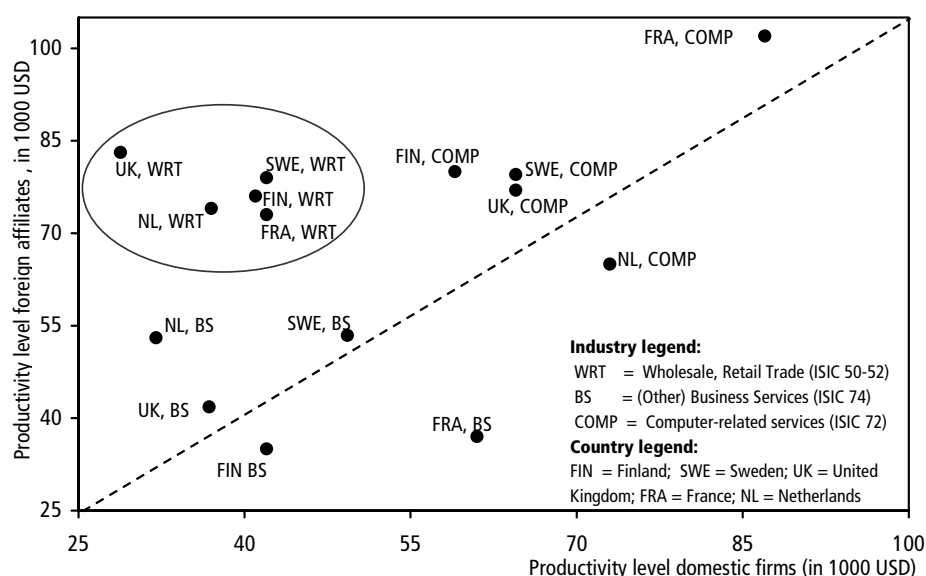
We estimated that the EU Services Directive could increase intra-EU FDI in services by 20 to 35 per cent (Kox and Lejour 2006). This will also raise average productivity and GDP growth. Several studies show that establishments of multinational service firms are often more productive than domestic services firms.<sup>9</sup> In Figure 4.2 we specifically look at the productivity gap in those sectors

<sup>8</sup> The right panel moreover indicates that in two more Member States (Sweden and Ireland), average labour productivity increases with size.

<sup>9</sup> E.g. Griffith *et al.* (2004); Hoekman and Javorcik (2005); OECD (2005) shows that foreign affiliates in services are on average more (labour) productive than the average firm in the host country.

that are central in the Services Directive, namely business services, computer-related services and the trade/distribution sector. The oval shape in Figure 4.2 indicates that the productivity advantage of foreign affiliates is largest in the distribution sector that often still is strongly dominated by domestic firms. Note that O'Mahony *et al.* (2003) found this sector to account for a large part of the EU-USA gap in productivity growth. Due to the Services Directive, foreign affiliates will gain market share at the expense of those domestic firms that are less productive, which will lift average productivity.

**Figure 4.2** Productivity gap between domestic firms and foreign affiliates in selected services sectors, 5 EU countries, 1997–1998.



Note: If the dots are above the line foreign affiliates have a higher labour productivity than domestic firms in that industry. Productivity is measured as value added per employed person.

Source: calculated from OECD STAN and OECD FATS databases.

## 4.2 Knowledge spill-overs

Deeper services market integration facilitates knowledge spill-overs. International trade contacts stimulate the exchange of ideas and knowledge. As was noted before, business services is the main sector affected by the EU Services Directive. It is a services sector that plays a crucial role in both knowledge diffusion and in innovation (Rubalcaba *et al.* 2007). An IMF study by Guerrieri *et al.* (2005) stresses the important role of business services in knowledge accumulation and growth. They find a strong statistical relation between international knowledge spillovers –as measured by bilateral patent

citations– and trade in knowledge-intensive business services. They use an econometric model that can accommodate dynamic effects of service-trade liberalisation. Their simulations suggest that output growth could become about 1 per cent higher due to liberalisation over a period of ten years.

From a vast amount of literature, Hoekman and Javorcik (2005) infer that services providers could be important in transferring knowledge, and that trade and FDI could be important in services sectors as source of knowledge. UNCTAD (2004) concludes that systematic evidence on the extent of transfer and dissemination of knowledge, expertise and skills by services multinationals is limited. There is proof that these firms train their employees, and that consultancy firms improve management practices in client firms. However, the empirical literature has largely ignored the services sectors so far.

### 4.3 Market entry as incentive for innovation

As mentioned before, several studies indicate that a tougher competitive selection process due to liberalisation could trigger services firms to innovate more rapidly, in order to distinguish themselves from competitors. So, apart from strengthening the spill-overs of existing knowledge, liberalisation may also induce new, original innovations, thereby stimulating productivity growth *and* future welfare (Nickell 1996; Aghion *ret al.* 2005). Innovation can be a way to escape competition for service firms if the post-innovation rents (with new market opportunities) exceed the pre-innovation rents (imminent erosion of profits due to strong market entry). However, the empirical evidence on the innovation effects of more market entry in services is still under-researched.

## 5 CONCLUSION AND POSSIBLE POLICY IMPLICATIONS

Services markets in Europe are fragmented and labour productivity performance is relatively weak. The available studies on the impact of the European Services Directive have shown that the measures will generate more intra-European trade in services, more foreign direct investment in services sectors, and lower prices of services. As a consequence, consumption and income will increase, and possibly also employment in Europe. These effects are static gains, in the sense that they represent a one-off shift in economic performance. Most of these static gains will probably materialise in the medium term –say five to seven years after implementation.

These static gains are considerable in themselves. For the economic future of the EU it is even more important what the accomplishment of the Internal Market for Services implies for future welfare. What does the integration of the

EU services markets mean for labour productivity growth, for innovation, and for the European capacity to adjust in a world where –with or without Internal Services Market– manufacturing *and* services activities will increasingly be sourced globally rather than regionally or nationally? These dynamic effects potentially have a larger and longer-lasting impact on the European economy, although they will materialise less quickly than the static gains of service-market liberalisation.

The upshot from the available evidence that we reviewed in this paper is that the prime dynamic gains from services liberalisation will come from more new market entry by firms based in other EU countries. Improved market access will subsequently stimulate competitive selection and productivity growth. Competitive selection will lift average productivity, bolster the role of SME firms in exports, intensify knowledge spill-overs, and strengthen innovation by incumbent firms. Moreover, increased FDI in liberalised services markets will also increase average productivity. This can be expected to be beneficial for the number of available service varieties, for service quality, and for the price of services. Domestic firms will have more choice options with regard to their service providers. This also includes their freedom to choose for cheaper foreign supply options. As a general result, the international competitiveness of non-service industries will be strengthened.<sup>10</sup>

The overall welfare gains will be positive for the EU, and it may go along with a reallocation process in which countries specialise in the products where they have the largest advantages. This is illustrated in Frame 5.1. It is normal that industry reallocations go along with 'local pains'. Those that stand to lose are those domestic firms that have a low efficiency, and that fail to innovate into new market opportunities.

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<sup>10</sup> According a study by the European Central Bank (2006): "a higher level of competition in the services sector would tend to support more efficient and flexible services markets, facilitate adjustment processes and increase the resilience of the euro area to economic shocks".

**Frame 5.1** Industry reallocations between Member States due to Services Directive

According to the CPB study (De Bruijn *et al.* 2006), industry reallocation will follow after implementing the Services Directive. We concluded that the Member States in Central and Eastern Europe will see a relatively large increase in services imports, but will be more than compensated by a relatively large export in manufacturing products. Countries like Germany and the UK will lose terrain in manufacturing value added, but gain in services exports. For a country like Poland it is the other way around. Their domestic value added in *other commercial services* diminishes due to more imports, because the country is not competitive enough in this area, but their gains are in manufacturing where they have the largest comparative advantage. The total gains, both in value added and in exports, are positive for all EU countries. It shows that a complex operation as the Internal Market for Services cannot adequately be interpreted as a simple zero-sum game.

Lowering national regulatory differences between Member States means that the sunk export costs for individual services firms will fall. This will attract new layers of particularly the more productive medium-sized firms to embark on exporting to other EU Member States. An integrated market for services will benefit SMEs. The burden of red tape is also more ponderous for SMEs than big firms, because many of the related costs are fixed costs and therefore hardly related to firm size.

Even with the 2006 Services Directive, the Single Market Programme (SMP) for services is still far from accomplished. First, the directive covers only a fraction of the services industries. European markets for financial services are still highly fragmented along national borders. Also in network services (telecom, utilities, rail, airlines) and transport national markets are only partially integrated. Second, the present Services Directive can only be considered as a first step for those service sectors that are covered by the directive.

The EU can reduce the costs that internationally operating firms experience due to national policy differences in the EU through two mechanisms: harmonisation or mutual recognition. In the latter case foreign firms are allowed to operate under regulatory standards of their home country. Harmonisation is a very long and complex process, and it may not even be efficient because countries may have different market preconditions or different regulatory preferences. A wider application of the mutual-recognition principle may be the most auspicious policy track. This approach was originally chosen by the European Commission in its 2004 proposals, with the country-of origin principle as the fundamental instrument. In the amended 2006 version this principle has been watered down to a vague and redundant formula (*'the freedom to provide services'*) that was already laid down in the EC Treaty. Many national exemptions are allowed, thus undermining transparency for individual services firms. At the time, given the heavy debate in some countries, this was perhaps the maximum feasible political compromise. Our studies suggest that from the perspective of the SMP

the watered-down Services Directive is just a first step that still leaves -so to speak- many 50 Euro notes lying on the sidewalk for being picked up later. Further steps come in reach as soon as there is enough mutual trust and stability in the relations between Member States, because this is essential for adopting the mutual recognition approach. Our results further suggest that trade and foreign direct investment in services could be boosted, if also the level of regulation is limited.

Meanwhile, more trade openness in European service markets will increase competition, it may in some service sectors go along with the exit of the less efficient national services firms. Rather than putting a brake on this reallocation process, it may be useful to strengthen the role of accompanying policies that address and mollify the transitional costs of adapting domestic sectors to these side effects of liberalisation. Such policies may include areas like social insurance against involuntary loss of jobs, a bankruptcy law that enables more exit flexibility, and re-education (cf. Andersen 2006; Davidson *et al.* 2006). Another type of policies that may accompany services liberalisation concerns the incentive for innovation by new services firms. The entry hurdle and innovation incentive for *new* domestic firms may however become higher. The failure rate and also self-selection for small domestic firms will increase. Though this effect will not be catastrophic, EU governments could opt for start-up premiums in order to compensate for the reduced start-up incentive for potential innovators. Finally, improved accessibility of venture capital for small and medium-sized firms may also work out beneficial for the number of start-ups.

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