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PUBLIC HEARING ON THE PROPOSAL
FOR A DIRECTIVE ON SERVICES IN THE INTERNAL MARKET

Problems of transposition and Members States "screening" process and timetable

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As requested by the Committee on the Internal Market and Consumer Protection, this note focuses on Articles 14 and 15 of the proposed Directive on services. These two provisions are crucial: they define the "screening" process and the timetable which will make operational the "country of origin" principle (Article 16) on which the Directive crucially relies. As these two provisions raise economic more than legal questions, this note focuses on the economics of the Directive.

The Single Market: an elusive target

The objective of the proposed Directive is the creation of a functioning Single Market in services. This goal may seem strange, since it is often claimed that the Single Market has already been achieved. But, the past fifty years of the European Union (EU) shows that creating a Single Market has proven to be much more difficult and slow than expected.

This is true for the Single Market in goods. The remaining barriers between the markets of the Members States are still high: their *lowest* average estimate is roughly 8 percent (ad valorem equivalent) [de Serres, Hoeller and de la Maisonneuve, 2001]. This estimate is surprising all the more because it concerns only goods *highly* tradable (that is, goods for which barriers should be expected to be insignificant) and because "cross-border" trade in goods was liberalized in the very early years of the EU, forty years ago. Hence, it underlines the crucial importance for a functioning Single Market in services of the proposed Directive which precisely focuses on the liberalisation of cross-border trade of services.

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The three main reasons for such an imperfect Single Market in goods are important to mention because they underline the crucial role that the proposed Directive will have for creating a functioning Single Market in services. First, European consumers may have different tastes. These differences can be expected to persist for a long time, and little can - or indeed should - be done to change this situation. Second, despite elaborate EU mechanisms, the potential barriers generated by norms, standards and similar public or private regulations are hard to discipline, if only because it is difficult to distinguish between the legitimate needs that such regulations may fulfil and their use as trade impediments.

Last but not least, trade in goods requires complementary services, and the Single Market in services is still in an embryonic stage. Estimates do not exist of the impact of remaining internal barriers in services comparable to those mentioned above for trade in goods. But, there are indicators showing the very limited impact of the existing Directives in services. As Table 1 shows, the dispersion of the barriers to entry in the seven services examined is as wide among Member States as among all OECD countries, and it is as large in the services already covered by EU Directives than in the one not yet covered (retail distribution).

The even more limited Single Market in services flows from two specific reasons. Only infrastructure services (banking, telecoms, transport, energy, etc.) are covered by the existing Directives—a deliberate choice made by the Member States when designing the 1992 Programme in the late 1980s and early 1990s. Second, in accordance with the prevailing views of this time, the existing Directives focus much more on establishment than on cross-border trade (the main exception being the Directive "Televisions without Borders"). But, there are robust economic arguments suggesting that competitive pressures based on freer establishment tend to be weak—a conclusion consistent with the information provided by Table 1.

This brief description suggests two lessons. First, if one really wants to create a functioning Single Market in services, the insistence of the proposed Directive on cross-border aspects is very much needed for boosting competitive pressures. Second, the three forces which have made progressive the emergence of the Single Market in goods will also play a role in the rise of a Single Market in services. This is an essential point missed by the "doomsday" critics of the proposed Directive: the Directive will not eradicate all the barriers on trade in services in one stroke and it will not instantly expose Member State services markets to cut-throat

European competition. Rather, its impact will be progressive, allowing everybody to adjust to more competitive markets.

Two lists of requirements

A functioning Single Market requires the elimination of all the artificial barriers to entry which allow incumbent (generally powerful) firms to keep or create artificial dominant positions, and hence to extract unjustified rents. These rents hurt consumers – businesses as well as households - and they are large enough (in the case of goods, they represent 30 to 40 percent of the costs of European protection [Messerlin 2001]) to impose a severe drag on the growth that Europe needs so much in order to more smoothly resolve its serious problems of unemployment and demographic trends.

Articles 14 and 15 aim to eliminate these artificial barriers by providing two lists of "requirements" (in the Directive parlance) that Member States impose on market access to the services covered by the Directive: the requirements to be eliminated because they constitute undisputable barriers to entry (Article 14) and those to be "evaluated" for possible elimination or adaptation to the extent that they have a trade barrier component (Article 15). These lists give a clear, predictable description of the requirements to be examined. But, what about the requirements not listed, but of equivalent effects, which could then escape adequate disciplines (ban or evaluation)? In its explanatory memorandum of the proposed Directive, the Commission makes clear that the requirements not included in the two lists but having equivalent effects will be investigated under Article 43 of the Treaty.

This flexible approach in three tiers (ban under Article 14 of the Directive, evaluation under Article 15 of the Directive, and infringement procedures under Article 43 of the Treaty) deserves two remarks.

First, the proposed Directive largely "systemizes" the case law of the Court of Justice on Article 49 of the Treaty (prohibition of restrictions on freedom to provide services). This strong link with the case law of the Court of Justice has led some observers to criticize the proposed Directive on the basis that it would reflect the "government of the judges," not a democratic decision. This criticism misses the key point that the Court of Justice interprets the Treaties which have been democratically decided by the political bodies of the Member States—Parliaments and governments.

Second, effective competitors are often slow to emerge, as abundantly illustrated by available evidence. For instance, the three "packages" of EU Directives on air transport have had little impact during 15 years—until a few "low-cost carriers" emerged as serious rivals in certain markets which were often unexploited by incumbents. (The same story happened in the case of U.S. air transport liberalisation.) Once again, such evidence shows that the proposed Directive is unlikely to generate a *brutal* shift to competitive markets, but rather that its impact will be progressive.

That said, the current draft of the proposed Directive raises two concerns. First, the requirements listed in Articles 14 and 15 consist mostly in quantitative restrictions: maximum number of establishments, territorial restrictions, conditions on the shareholding, etc. The Directive does not mention subsidy-based requirements, with the exception of the indirect (and elliptic) Article 14(7) on financial guarantees and Article 15(2h) on below cost pricing. Devoting more attention to subsidies is desirable, even if the anti-subsidy rules under the Treaty may often be sufficient to cope with them. Monitoring subsidies in services will be particularly difficult because the scope for creating different "varieties" is almost endless in services—competition in services markets relies on "varieties" much more than on prices. For instance, let us assume that a government subsidises the consumption of the domestic variety of a service. Although such a subsidy is non discriminatory (all the firms selling on the domestic market in question benefit from it) it may provide a strategic advantage to the domestic firms selling this variety of services to the other European markets if these firms have a large share of the domestic market in question (and hence receive the largest share of the subsidy in question) and if the non-domestic firms are initially not very active in this variety of the service in question.

The second source of concerns flows from the fact that Articles 14 and 15 do not evoke a crucial difficulty which may occur when liberalising markets shaped by decades of inadequate regulations: their long-lasting anti-competitive effects. For instance, regulations restricting access to land for retail use have been adopted for protecting small domestic shopkeepers in some Member States. These regulations have been quite unsuccessful in achieving this goal - a point that emphasises the pivotal role of the "evaluation" concept included in the proposed

Directive (see below). Rather, over two decades, these regulations have favoured the emergence of a very concentrated retail industry behind high barriers to entry for foreign competitors, and they have generated a distorted environment in which politicians and civil servants operate. Article 15(2a) which lists this restriction does not recognize the serious problem of the long-lasting anti-competitive consequences of such an inadequate regulation.

The "screening" process

The Directive provides some procedural guidelines that Member States shall follow when undertaking the review of their requirements to be eliminated and evaluated. It should be more explicit in three respects.

First, Article 14 relies on the implicit assumption that spotting prohibited requirements will be neither difficult nor controversial. This assumption is unlikely to be verified. In a non-negligible number of cases, one should expect opposing views between the imposing Member State and the other Member States on whether a given regulation constitutes a requirement under Article 14, or not. Of course, such problems could be addressed by resorting to the Court of Justice. But it would be wise to pre-empt such a costly legal approach by imposing some form of collective action during the transposition period. The simplest one would be to expand the procedure of "mutual evaluation" enounced in Articles 15(4) and 41 (in which each Member State provides a report justifying its position, see below) to the litigious cases under Article 14.

Second, Article 15(3) states three criteria for the "screening process" to be implemented for evaluating the requirements listed: non-discrimination, necessity and proportionality. The use of the first criterion is unlikely to generate much debate, although it might be the source of litigious cases, as illustrated in the consumption subsidy case evoked above. But, the second and third criteria are almost certain to generate conflicts because they are expressed in very general terms. The necessity criterion states that "*requirements must be objectively justified by an overriding reason relating to the public interest*" whereas the proportionality criterion imposes that the "*requirements should not go beyond what is necessary to attain*" the objective pursued. As illustrated by the past debates on the infrastructures services already subjected to Directives, there is a very wide set of views among Europeans on necessity and proportionality (reflected in the Court of Justice rulings which do not offer stable references beyond the broad principles). For instance, some Europeans still argue that public interest can be only be achieved by public monopolies, and dismiss alternative regulatory structures which would potentially enable the public interest to be achieved more efficiently or at lower cost.

Last but not least, the procedure of "mutual evaluation" sketched in Article 15 and developed in Article 41 (Member States report, the Commission consults, the Committee monitoring the Directive enforcement debates) is much too bureaucratic and centralised—hence inadequate. The review procedure (Article 43) suffers from the same weaknesses, and it is much too infrequent (every three years) to be expected to do an adequate job. Lastly, the crucial (see below) procedure of "administrative cooperation" is mentioned in the explanatory memorandum of the Commission, in the Directive Preamble, and in the legislative financial statement attached to the Directive—but it does not appear in the Directive text itself, and it is never explained in detail.

A "culture of evaluation"

All these problems are serious, and they all point in the same direction: the Directive is too elusive on the role of the Member States – remarkable given the extent to which it is based on the country of origin principle. The Directive is sometimes criticized for being market-oriented, and it is. But, these criticisms miss a crucial point in regulatory matters: more efficient markets require better governments—that is, markets and governments can be complementary—and this is valid at both the EU *and* Member State level.

Too often, current European governments are content with loosely defined goals, and they rarely check whether the regulations they adopt fit the proclaimed goals. A first illustration was provided above, regarding the land restrictions for retail use. Another example is the requirement of a minimum distance between pharmacies. What is the desired objective of such a requirement? If loosening competition between pharmacists has been the price paid in order to get better health services, has this goal been achieved? What are the (unintended or not) costs of using such instruments to try to ensure better services (monopolistic behaviour of pharmacists, higher costs of running this essential retail activity for the people health, etc.)? Is there no other, more direct, regulation(s) for getting the best services possible from pharmacists? Such examples abound in every Member State.

In sum, "good governance" requires better definition of the goals of regulations and better monitoring of the implementation in order to assess their real effects. Despite its limits, the evaluation process included in the Directive is intimately based on such a dynamic view of better governance: more efficient markets require better governments, and better governments nurture more efficient markets. But, it is clear from the above examples that a full enforcement of the proposed Directive requires more than a short reference to mutual evaluation. It requires a more robust "culture of evaluation" in every Member State, and the development of procedures of administrative cooperation.

However, in most Member States, such a culture of evaluation is very weak today and the necessary institutions are embryonic [Hahn and Litan 2004]. The main weakness of the proposed Directive is its silence on this crucial aspect. In every Member State, there are bodies which are natural candidates for a key role in the national evaluation process, such as the Courts of Accounts (possibly after some reshuffling of their activities and procedures). "Mutual evaluation" should thus take a quite different dimension. Far to be limited to a bureaucratic and centralized structure (with the Commission being the "hub", and the Member States the "spokes") it should be rooted in an EU-wide collective peer review among the national regulatory bodies.

The Directive does not insist on this crucial phase (perhaps because it is a domestic problem of the Member States). But this discretion will be costly for a functioning Single Market in services because the introduction of a culture of evaluation in every Member State level is a <u>*necessary*</u> condition for the success of the Directive - and because it is intimately consistent with the country of origin principle which makes the Member States the key source of regulatory initiatives.

Reinforcing Member States' capacities to address the issues raised by the enforcement of the proposed Directive does not mean weakening the European level if one draws the appropriate lessons from the U.S. Office of Management and Budget (OMB) [Hahn and Litan 2004]. At this early stage, it would be premature to ask where the equivalent of a European OMB should be located (it may not necessarily be in the Commission, for reason of conflict of interest).

Additional advantages of this more decentralized procedure are to better ensure that the screening process will be permanent, and that it could involve regional bodies (a point left aside by the Directive, despite the crucial role of these bodies in the services regulations in many Member States).

In sum, a serious enforcement of the proposed Directive requires substantial preliminary work at the Member State level. It thus seems that the time schedule suggested by the proposed Directive would require one (maybe two) additional years at the very early stage—for every Member State to be ready

Regulatory convergence?

Often, the proposed Directive leaves a sense that Member States' regulations will "converge" after some time. This "harmonisation nostalgia" seems inconsistent with the country of origin principle and the culture of evaluation generated by the Directive. This point deserves attention all the more because it is related to the fears that the proposed Directive would trigger a "race to the bottom" in regulatory matters among Member States.

If there is one lesson to be drawn from the experience of the last thirty years in regulatory reforms, it is that there is not one instrument or set of instruments for reaching a given objective. For instance, public interest in telecoms is generally defined as the fact that every citizen gets an easy access to a telephone. For years, this objective has been understood as requiring a public firm to cross-subsidize rural and urban lines, short and long distance calls. But, competition between providers of mobile telephony in the 1990s was instrumental to provide phones to the <u>*poorest*</u> Europeans—those who were *de facto* largely excluded from the service of public fixed lines because they did not have a stable home. This competition was also instrumental for a much more intensive use of the fixed lines built by the public firms (in the mid 1990s, the French Railways used only a fraction of their line capacity), and hence for a better utilisation of and return on past public investments.

This basic lesson suggests that competition between Member States for offering the best "regulations" they can design, taking into account their strengths and weaknesses, is desirable for growth and welfare purposes, and it justifies the culture of evaluation. Such a regulatory competition makes unlikely the "regulatory convergence" floated by the Directive (except in the narrow sense of requirements to be eliminated or evaluated) if only because competition in services is so subtle (it has many more dimensions than prices).

The perspective of regulatory competition among Member States raises fears in Europe because it is associated to the risks of a "race to the bottom"—that is, to the risks that countries would adopt ever weaker social, environmental, etc., regulations.

Before examining this question, it is important to have two sets of facts in mind. First, the last decade or so has witnessed a race to the top in the industrial countries. For instance, less regulations on the day-to-day functioning of the markets of goods has been clearly accompanied by more regulations in environmental matters. Similarly, firms—with their home countries—have been involved in a severe and continuous "race to the top" in terms of product quality. Second, consumer contracts, the posting of workers and social security are largely excluded from the field of application of the proposed Directive (and the marginal relevance of the Directive may rather provide incentives for higher standards).

That said, the concept of a race to the bottom assumes that low standards are associated with higher and/or better growth. There is no evidence of such a correlation. On the contrary, growth and welfare require a substantial threshold in terms of standards, as documented in the key case of labour regulations [OECD 2000]. Above the threshold, things become more complex because of the many trade-offs that people may envisage (for instance, more leisure versus higher income). These complex trade-offs offer the possibility for different regulatory standards to coexist with no need to engage in a race to the bottom. Indeed, the many possible trade-offs are the fundamental reason for a permanent regulatory competition between Member States in their search for the "magic regulatory formula" nurturing the many conceivable varieties of a given service.

In regulatory matters, countries have a common feature with firms: they have to take into account their "reputation"—a particularly crucial point in the context of the country of origin principle which fundamentally requires "trust" between Member States. Firms based in a Member State having chosen to race to the bottom will rapidly run the risk of losing consumers, and paying a high price for such a choice. This may be true even if a Member State races to the bottom in one service (and not in the others) since reputation has often strong spill-over effects. Last but not least, democracy generates powerful barriers against a race to the bottom, and strong incentives for a race to the top.

Three concluding remarks

First, the very wide coverage of services is a precious feature of the Directive: it ensures that investments will go to the different sectors on a sound basis. Reducing this coverage would introduce distortions: the services out of the Directive coverage would become attractive to investors *because* they remain protected from competition, and generate unjustified rents. Such distortions generate stagnation in the long run and impose massive costs of re-adjustment in case of liberalization at a later stage.

That said, one can deal with "sensitive" services in two ways. First, requests for longer transition periods could be examined. This solution is acceptable if delays are not too long—that is, if they do not give enough time to the Member States and firms concerned to find devices limiting competition in the future in the services in question. Second, requests for definitive exemptions should be subjected to the "culture of evaluation." There is a strong case for arguing that such requests do not exempt the services in question from the thorough *analysis* imposed on the services to be covered by the Directive.

Second, the Directive raises some "border" issues with existing or forthcoming legal instruments. On the one hand, the focus on cross-border trade of the proposed Directive—and its related positive elements—should be applied to the previously "liberalized" infrastructure services, in order to make a better functioning Single Market in these services. On the other hand, the potential (limited) conflicts between the Directive and the proposed Rome II Regulation should be settled by giving precedence to the Directive which has a pro-growth potential that the Regulation does not have.

Lastly, the proposed Directive is unlikely to have any impact on the current negotiations on services at the World Trade Organization. The proposed Directive adheres to quite a different logic than that of WTO negotiations. It can be seen as a joint unilateral liberalization—with 25 countries recognizing simultaneously the trust they have in each other, in accordance with the country of origin principle. There is no place in the Directive for balanced concessions which are the mark of WTO negotiations, and there is little room in the WTO for the trust on which the Directive relies. Moreover, the country of origin principle recognizes the key role of Member States in regulating their services, in full accordance with the current devolution of power between the EU and its Member States in the WTO forum.

References

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Table 1. Barriers to entry in selected services, 1998
(the scale of indicators is 0 to 6, from least to most restrictive)

Air passenger transport		Road freight		Mobile telephony		Fixed telephony	
United States	**2.0**	**Britain**	**0.6**	**Britain**	**0.0**	**Austria**	**0.0**
New Zealand	2.2	**New Zealand**	**0.6**	**Finland**	**0.0**	**Belgium**	**0.0**
Netherlands	**2.6**	Finland	0.6	**France**	**0.0**	**Britain**	**0.0**
Norway	3.1	Korea	1.4	**Italy**	**0.0**	**Denmark**	**0.0**
Austria	3.1	United States	1.5	**Netherlands**	**0.0**	**Finland**	**0.0**
Ireland	3.1	Canada	1.6	**Sweden**	**0.0**	**France**	**0.0**
Britain	3.3	Norway	1.8	**Australia**	**0.0**	**Germany**	**0.0**
Belgium	3.3	Sweden	2.0	**Japan**	**0.0**	**Ireland**	**0.0**
Germany	3.4	Portugal	2.4	**Korea**	**0.0**	**Italy**	**0.0**
Sweden	3.4	**Mexico**	**2.6**	**New Zealand**	**0.0**	**Netherlands**	**0.0**
Australia	3.5	France	2.6	Austria	3.0	**Spain**	**0.0**
Denmark	3.6	Austria	2.8	Belgium	3.0	**Sweden**	**0.0**
Italy	3.8	Germany	3.2	Denmark	3.0	**Australia**	**0.0**
Finland	3.8	Belgium	3.3	Germany	3.0	**Canada**	**0.0**
Spain	3.9	Spain	3.4	Greece	3.0	**Japan**	**0.0**
France	4.1	Greece	3.4	Ireland	3.0	**Korea**	**0.0**
Canada	4.1	**Italy**	**4.9**	Portugal	3.0	**Mexico**	**0.0**
Korea	4.4	Denmark		**Mexico**	**3.0**	**New Zealand**	**0.0**
Japan	4.7	Ireland		**Norway**	**3.0**	**Norway**	**0.0**
Mexico	4.7	Netherlands		**Switzerland**	**3.0**	**Switzerland**	**0.0**
Portugal	**5.1**	Australia		**Spain**	**4.5**	**United States**	**0.0**
Switzerland	**5.1**	Japan		Canada		**Greece**	**6.0**
Greece	**5.1**	Switzerland		United States		**Portugal**	**6.0**

Electricity		Railways		Retail distribution	
Britain	**0.0**	**Germany**	**0.0**	**Canada**	**0.6**
Finland	**0.0**	**United States**	**0.0**	Australia	0.7
Sweden	**0.0**	Britain	3.0	**Netherlands**	**0.8**
New Zealand	**0.0**	Sweden	3.0	Switzerland	1.0
Norway	**0.0**	Canada	3.0	Ireland	1.0
Australia	0.3	Japan	3.0	Norway	1.1
Germany	2.7	**Belgium**	**6.0**	Germany	1.2
Denmark	4.0	**Finland**	**6.0**	Sweden	1.6
Japan	4.0	**France**	**6.0**	Mexico	1.7
United States	4.0	**Ireland**	**6.0**	**Korea**	**1.9**
Spain	4.7	**Italy**	**6.0**	Spain	2.0
Belgium	5.0	**Spain**	**6.0**	Britain	2.1
Portugal	5.3	**Korea**	**6.0**	Belgium	2.3
France	**6.0**	**Mexico**	**6.0**	Italy	2.8
Greece	**6.0**	**Norway**	**6.0**	Portugal	2.8
Ireland	**6.0**	**Switzerland**	**6.0**	Finland	3.0
Italy	**6.0**	Austria		France	5.0
Netherlands	**6.0**	Denmark		**Austria**	**5.5**
Canada	**6.0**	Greece		Denmark	
Austria		Netherlands		Greece	
Korea		Portugal		Japan	
Mexico		Australia		New Zealand	
Switzerland		New Zealand		United States	

Source : Nicoletti, Scarpetta and Boylaud (2000).