

# The services directive

Can Europe deliver?

# The Services Directive - can Europe deliver?

## Contents

Executive summary	2
Is the Services Directive needed?	4
The aim of the directive and how it has changed	7
How big a bang? - estimating the benefits	14
Could the directive now lead to harmonisation?	16

## Executive summary

### What is the directive for?

- The Services Directive was intended to allow companies to temporarily provide services in other EU member states in which they are not yet established, by allowing them to operate abroad under the same regulations they face at home. It was hoped that this would make it easier for companies to “test the water” and see whether there is a market for their services in another country, before setting up a costly shop or office there. It was also intended to encourage member states to make it simpler to establish a business.
- An economic study by Copenhagen Economics suggests that removing all legal barriers to internal services trade would boost EU GDP by €37 billion, or 0.4%.
- The directive was originally proposed by the liberal former Commissioner Frits Bolkestein. The Commission’s initial proposal proved controversial, with opponents arguing that it will lead to a “race to the bottom” in social standards, because companies will headquarter themselves in low regulation member states and thus undermine higher levels of regulation.

### The debate so far - exaggerating the impact?

- For all the controversy, the directive, even in its original form, would affect relatively little economic activity. While the fact that services account for 70% of the economy is frequently cited in the debate, services *trade* (within the EU) is a relatively small part of the economy. Furthermore, the directive does not apply to some of the main services industries - like financial services, transport and telecoms - which have already been regulated by the EU. In total the directive would affect just over 1% of the economy.
- Nor would the directive (even in its original form) allow a reduction of employees rights. Employees posted to another country are already covered by the 1996 Posted Workers Directive, which gives them the same rights as employees in the country they are posted to. The EU itself also has a substantial body of social and health and safety regulation which applies to everyone in the EU.
- Crucially, the directive would not lead to a race to the bottom because it only applies temporarily - as soon as a company establishes itself in another member state it becomes bound by the regulations of that country.

"The Country of Origin Principle in the draft Directive relates only to operators providing cross border services on a temporary basis. Once a service provider becomes established in a Member State, the company must comply with all the rules of that country. Under the Country of Origin Principle a company which provides services in one country is automatically qualified to provide services in any other Member State on the basis of home-country regulation."

House of Lords Report July 2005

## Watering down the directive

- The European Parliament's rapporteur on the directive is Evelyn Gebhardt, a German Socialist hostile to many of the principles in the directive. She initially tried to steer it away from mutual recognition, and towards an attempt to harmonise regulations on a sector-by-sector basis. Until recently this attempt to invert the directive appeared to have been seen off.
- However, the Parliament did propose a raft of amendments which would water down the directive further, excluding more industries from its scope (like legal services, healthcare and the audiovisual industry) and also giving member states' loopholes allowing them not to apply the directive for all kinds of reasons ranging from "consumer protection" to "cultural policy objectives" - significantly blunting the impact of the directive.

## The European Parliament's new draft - Not just watering down, but a damaging proposal

- Alarmingly, the most recent draft, (8 February) which appears to be the subject of a cross party agreement in the European Parliament between the Socialists (PES) and Conservatives (EPP), would effectively dismantle the country of origin principle meaning that most of the benefits that the directive might have brought for small businesses would be lost.
- Worse still it would also introduce a clause allowing the Commission to begin harmonising service sector regulation after five years. This would mean the worst of both worlds - not just the loss of the economic gains the Services Directive was supposed to bring but the prospect of more costly regulation later.
- Although there will be a process of negotiation between the European Parliament and the Council of Ministers, French Prime Minister Dominique de Villepin has said that France will oppose the country of origin principle, claiming that it would "lead to social and legal dumping and call into question our labour laws and our public services." Other member states have also made it clear they will also oppose the country of origin principle. The German coalition government is split over the issue.
- If the EU can't even agree on such a limited reform then the outlook is not good. As Jean-Philippe Cotis, the OECD's Chief Economist, has noted, "at current trends...the average U.S. citizen will be twice as rich as a Frenchman or a German in 20 years." If the "country of origin" principle is finally excluded, most of the benefits that the directive would have brought for small businesses will be lost.
- Indeed, if the proposal to allow harmonisation later is adopted the benefits could be cancelled out by increased regulation later (the fate of a number of previous EU initiatives intended to lead to liberalisation). If the EU can only pass the directive in this mangled form - given that the freedom to provide services is a principle supposedly enshrined *in the Treaty of Rome in 1957* - then the directive will mark a milestone in the history of the EU.

## (1) Is the Services Directive needed? What is it supposed to do?

Since its inception with the Treaty of Rome in March 1957 the EU has been committed in theory to “the abolition, as between Member States, of obstacles to freedom of movement for persons, services and capital”.

Jacque Delors’ 1992 programme to create a single market has largely achieved its aim of eliminating non-tariff barriers to trade in goods, but there is still substantial progress which needs to be made if services are to be traded freely across borders.

The draft service directive builds on Articles 43 and 48 of the Treaty of the European Community, which concern the “freedom of establishment”, and Article 49, which sets out the “freedom to provide services within the Community”. While these freedoms are established in the treaties they are currently only applied on a practical basis if they are taken before the European Court of Justice (ECJ) on a case-by-case basis. But these ECJ rulings only establish single areas and only in the member state of jurisdiction. The Services Directive aims to enable all businesses to access these freedoms without having to rely on case law and court proceedings.

### **The basic rationale**

In 2002 the EU Commission produced a study which looked at the plethora of barriers to cross-border trade in services in Europe. The Commission found that the barriers to internal trade made it almost impossible for some businesses to set up in other member states. These barriers included legal restrictions, difficulties in obtaining the required authorisation from local authorities, and the length and complexity of procedures.

For example, the report cites a case where a lawyer wishing to establish a law firm in another member state found that he had to dissolve his existing company because lawyers are only allowed to operate limited liability companies.

Many companies found it easier to establish new enterprises in the accession states rather than in the EU-15. Spain for example has a total of 700 national and local regulations which countries have to adhere to when opening a new store.

Companies found it particularly difficult when there were questions of interpreting national laws resulting from unclear or unpredictable national jurisprudence. For example, in one member state, seven different local and national licenses are needed to open a hotel or restaurant; while in another a company wishing to open a retail outlet needs a building permit, an environmental permit and a socio-economic permit, as well as having to comply with zoning regulations which can sometimes be highly complex.<sup>1</sup>

The lack of recognition of qualifications across borders also creates barriers - despite a substantial body of existing EU legislation intended to ensure mutual recognition of qualifications.

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<sup>1</sup> The EU’s Single Market at Your Service? Line Vogt, OECD, October 2005.  
[http://www.oilis.oecd.org/oilis/2005doc.nsf/43bb6130e5e86e5fc12569fa005d004c/a7ce5a97ea540230c1257099002cc1dc/\\$FILE/JT00191215.PDF](http://www.oilis.oecd.org/oilis/2005doc.nsf/43bb6130e5e86e5fc12569fa005d004c/a7ce5a97ea540230c1257099002cc1dc/$FILE/JT00191215.PDF)

**Areas where mutual recognition of qualifications already exists include**

- Doctors
- Dentists
- Nurses
- Midwives
- Pharmacists
- Vets
- Architects

Nonetheless a qualification in one member state may not be recognised in another and their field of activity may also differ. For example, to be able to become a hairdresser in Germany it is necessary to go through several years worth of training.

There are also substantial accreditation barriers. The Commission gives the example that an electrician may have to join two different trade associations which can cost around 700 euros a year if he is to operate in two different countries.

These high barriers to services trade obviously hit the providers and consumers of services hardest but they also have knock on effects because services are often inextricably linked to other players in the wider economy. For example, a car manufacturer will often use other companies to deliver parts, provide insurance cover, to provide credit for hire purchases and so on, all of which are integral to delivering its primary product. Obviously the less competitive and therefore expensive these services are, the higher the final cost to the consumer will be.

**A relatively narrow focus - will effect just over 1% of the UK economy**

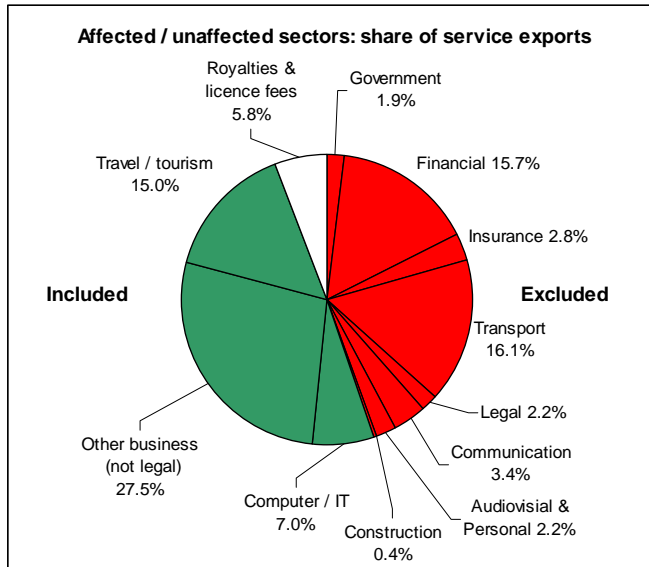
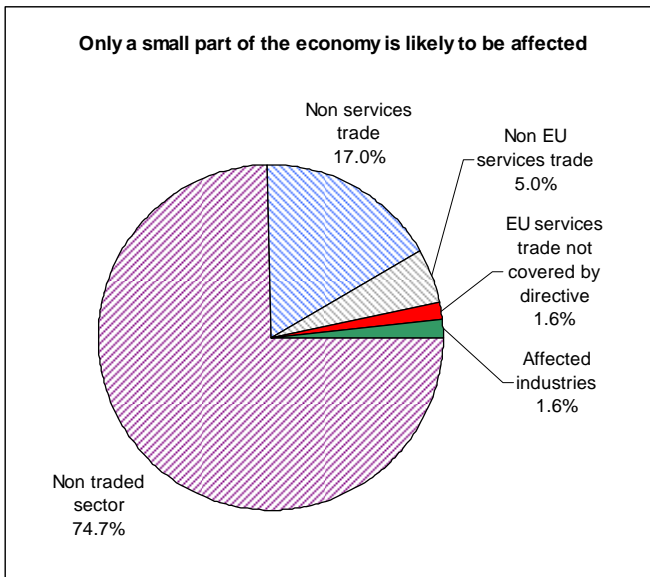
Given the fierce debate sparked by the directive, it has a surprisingly narrow focus. Speakers on the subject often note that services account for 70% of the EU economy. However, services account for a lower proportion of trade, which is itself only part of the economy. Many services (like hairdressing) are not likely to be internationally traded. So while a quarter of UK GDP is exported, only 8% of GDP is services exports, and only 3% involves services exports to the EU.

The focus of the directive is further limited because much of the services sector is not covered by the directive as it is already regulated at the EU level - particularly the largest and most tradable industries like financial services, transport and telecommunications.

Large public service industries like healthcare are likely to be excluded from the directive, which also excludes services which are not provided for remuneration, such as cultural or judicial services. Many other industries are not excluded from the directive, but were excluded from the key country of origin principle.

The Services Directive is addressed to the remainder of the services industry. For the UK this would essentially apply to one and a half percent of the economy.

Only a small part of the economy is affected -  
 Many service industries are excluded



Source: National Statistics, UK trade in services

## (2) The aim of the directive and how it has changed

### The original directive

The directive was originally proposed by the Commission at the beginning of 2004. The liberal Internal Market Commissioner, Frits Bolkestein, is largely credited with being the author of the directive, hence it often being referred to as the 'Bolkestein Directive'. Bolkestein's aim was to put into practice a concept which all EU members had signed up to in the EU's treaties.

However the proposals immediately met with fierce resistance. Trade unions and the left denounced it as an attack on the "European social model". The TUC General Secretary Brendan Barber said "It would create flags of convenience across the whole of Europe, in every part of the service sector." He argued that "It would undermine the very point of the European social model."<sup>2</sup>

The Commission's proposal has been the subject of a heated debate across much of Europe, (although much less so in the UK). This debate has been echoed in the European Parliament and has also been the subject of interventions from EU leaders, particularly Jacques Chirac and Gerhard Schröder.

### Two main strands

Essentially there are two key 'freedoms' at the heart of the proposed directive - the freedom to provide services in another member state and the freedom to establish a services business in another member state. In order to allow businesses to trade cross border, the EU Commission envisioned enshrining the "country of origin" principle in the legislation. The freedom to establish was intended to be addressed by simplifying authorisation procedures.

The country of origin principle was by far the most controversial part of the draft directive and has now effectively been scrapped by negotiators in the European Parliament. In this section we look at what was originally proposed by the EU Commission, and then look at how it has been adapted by the European Parliament - and what effect this would have if the directive is adopted as it now stands.

### The watering down of the directive

The European Parliament's Internal Market Committee (IMCO), led by German Socialist Evelyne Gebhardt (the committee *rapporteur*), has been reviewing and amending the directive since 2004 and voted on its final report in November 2005.

This report - effectively a list of amendments to the original directive will be voted on by the full European Parliament in plenary on 16 February 2006.

Broadly speaking, Ms Gebhardt is a critic of the liberalising aspects of the directive and has tried to press for (i) limitations in the scope of areas it applies to, (ii) general principles which would allow member states to suspend its operation on particular occasions and (iii) provisions which would accompany the directive with measures to harmonise (upwards) the level of regulation on a sector by sector basis across the EU.

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<sup>2</sup> <http://www.tuc.org.uk/international/tuc-9578-f0.cfm>

Until recently, it appeared that the Parliament would water down the directive, but leave its basic thrust intact. It also appeared that attempts to use the directive to open the way to harmonise service sector regulation had been seen off. However, the final European Parliament proposal:

- Abolishes the country of origin principle
- Calls for harmonisation of business establishment procedures
- Opens the way to harmonisation of service sector regulation across the board five years after the entry into force of the directive

And indeed the plenary may throw up further amendments (particularly from the Greens) which would limit it even further.

### The detail of the directive

#### (a) The country of origin principle

*"The CBI is very strongly supportive of the country of origin principle, so supportive that we believe without it the proposal makes little sense... We cannot support this directive if the Country of Origin principle is effectively gutted."*

John Cridland, CBI Deputy Director General, 19 January 2005, Evidence to the House of Lords EU Select Committee.

The country of origin principle has so far proved to be the most controversial part of the draft directive. In essence, the principle would allow service providers to operate across borders under the regulation of their home country *if they are not established in the country in which they want to supply their services.*

The principle was originally developed as a concept by the European Court of Justice in order to facilitate goods trade in the single market in 1978 in the Cassis de Dijon ruling. A product made in the UK can be sold across the EU without the need for authorisation or supervision in any other member state. The country of origin principle is also enshrined in the television without frontiers directive, the e-commerce directive, the directive on the electronic signature and the data protection directive. Admittedly its inclusion in the Services Directive is perhaps its most ambitious use to date.

Critics argue that if operators are able to operate across the EU relying on their home country's legislation this would lead to businesses effectively 'regulation shopping' - looking for the EU country with the most relaxed regulations. This they argue would lead to a 'race to the bottom' to ever lower regulation.

For example, UNISON commented that "This will simply lead to a race to the bottom as companies move their headquarters to the EU country with the lowest levels of regulation, with serious implications for health and safety, environmental and other forms of public protection."<sup>3</sup>

However, the directive would apply to those businesses that are not "established" in the member state in which they want to sell services. The definition of establishment as amended by the European Parliament is quite tight:

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<sup>3</sup> [www.unison.org.uk/eu/pages\\_view.asp?did=2456](http://www.unison.org.uk/eu/pages_view.asp?did=2456)

“establishment means the actual pursuit of an economic activity, as referred to in Article 43 of the Treaty, through a fixed establishment of the provider for an indefinite period in a Member State from where the business of providing services is effectively carried out”.

In that regard it would mainly be utilised by small self-employed businesses who are looking to break into new markets. This would be particularly useful because it would allow firms to “dip their toes in” and test the new market, to see if the new enterprise is viable without having to go through costly registration and adaptation procedures.

The EU Committee in the House of Lords argued in a recent report that, “firms wishing to provide a service in another Member State may not wish, at least in the first instance, to establish there. For example, a firm may want to bid for a construction contract, but will not establish unless it wins the contract. Or it may establish only if, after working on that contract for some time, it decides to set up in business more permanently. An architect may journey to another state to supervise construction of a building for which he/she has won an open design competition. A firm may be very uncertain as to demand for its service in the other Member State, and therefore may go there on a temporary basis to test the market.”<sup>4</sup>

As well as helping self-employed business people to ‘test the water’ in other member states, the country of origin principle will also be heavily utilised in business to business sales. For example a large scale UK retailer who is planning to expand in to a number of other member states would, in most cases, be unable at present to use the numerous service providers it relies on to help set up new shops in Britain. There would normally be too many barriers to using the services of the same real estate agents, shop designers, architects, engineers, construction companies, banks and insurance companies with whom the company works in the UK. These barriers could include holding the correct authorisations, qualifications or being a member of the applicable trade association.

The OECD argues “The impossibility of using the same business model in all member states prevents companies from taking advantage of economies of scale and competition is hampered. In the absence of international competition, firms are sheltered from market pressures and have little incentive to innovate. The result may be excess rents to capital or labour, or both, so that profits and/or wages, and ultimately prices, are higher than they would be under competitive conditions.”<sup>5</sup>

However, the country of origin principle has now effectively been dropped from the directive, replacing the key article with a vague provision saying that “The member state into which the service is provided shall ensure free access to and free exercise of a service activity within its territory”.

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<sup>4</sup> Completing the Internal Market in Services, House of Lords, European Union committee, July 2005

<sup>5</sup> The EU’s Single Market at Your Service? Line Vogt, OECD, October 2005  
[http://www.oilis.oecd.org/olis/2005doc.nsf/43bb6130e5e86e5fc12569fa005d004c/a7ce5a97ea540230c1257099002cc1dc/\\$FILE/JT00191215.PDF](http://www.oilis.oecd.org/olis/2005doc.nsf/43bb6130e5e86e5fc12569fa005d004c/a7ce5a97ea540230c1257099002cc1dc/$FILE/JT00191215.PDF)

As well as dropping the liberalising country of origin principle, the Parliament's new draft would open the way to substantial harmonisation of business regulations. The TUC and the socialist European Parliament *rapporteur* Evelyn Gebhardt favour harmonisation of regulation in each sector across Europe, leading to a large-scale increase in regulation even for service providers which do not operate across border. This idea has now been inserted into the directive by the European Parliament, in the form of a provision which would allow the Commission to start harmonising regulations five years after the entry into force of the directive.

#### (b) Freedom to establish and regulatory simplification

*"Some of the national restrictions are archaic, overly burdensome and break EU law. Those have simply got to go."*

Former EU Commissioner Frits Bolkestein, Press release, 13 January 2004

The second main strand of the directive is an attempt to cut the amount of red tape businesses currently have to wade through when attempting to set up in another member state. It outlines measures to set up 'single points of contact' in each member state, mutual recognition of certificates which show requirements have been satisfied, and requirements to ensure that authorisations are objectively necessary, proportionate, and non-discriminatory.

The single point of contact would essentially be a one-stop-shop for businesses looking to expand into a member state which could provide "all necessary declarations, notifications or applications for authorisation from the competent authorities, including applications for inclusion in a register, a roll or a database, or for registration with a professional body or association".<sup>6</sup> Crucially the directive requires that all relevant information should be kept electronically so that it can be accessible over the internet. The CBI has argued that it will "greatly assist businesses across the EU".

The directive also gives a black list of types of regulations which are banned, for example those that discriminate on the basis of the nationality of a company. There is also a grey list of regulations that may not be compatible with the directive.

While these proposals for regulatory simplification should ease the cost of establishing across border for all businesses, they will be of particular benefit to small and medium sized enterprises (SMEs) which spend disproportionately more than their larger competitors on complying with regulation. For example a study by the Federation of Small Businesses found that small businesses spend proportionately five times more than their larger rivals on complying with EU regulation.<sup>7</sup> This is particularly important as up to 90% of service providers are SMEs.

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<sup>6</sup> Chapter 2 Article 6

<sup>7</sup> Evidence to House of Lords EU Committee, 17 February 2005

A group of small and medium sized business organisations have said that the new directive will be a “step forward in reducing red tape.” Having to deal with various forms and legal prerequisites which vary across EU countries is, they argue, “time consuming and causes SMEs severe delays and costs in the running of their activities”.<sup>8</sup>

While this EU drive to deregulate the services market should be welcomed by UK businesses more accustomed to the EU Commission increasing rather than reducing the regulatory burden, there are still concerns, and the detail of the implementation will be crucial. For example the General Osteopathic Council has warned that the single points of contact “may in fact complicate rather than simplify administrative procedures through added red tape”. For example - if harmonisation of procedures leads to a more complex procedure than exists in the UK at present.

A study by Price Water-House Coopers (PWC) commissioned by the Department of Trade and Industry (DTI) found that some firms were unsure as to whether single points of contact on their own “would deliver tangible benefits. In particular, firms appeared to see considerably greater benefit from a system which accelerated the process of establishing in other Member States than from one which simply provided information on the process which needed to be followed, which many firms said they had little trouble accessing at present.”

The European Parliament’s proposals have also toned down the language instructing member states to simplify their procedures and cutting red tape which blocks businesses being able to authorise in other member states.

The current draft which has been approved by the European Parliament committee will also introduce “harmonised European forms” concerning establishment and proof that requirements have been satisfied. This could mean further paperwork for businesses than if the Commissions proposal for mutual recognition is accepted. The process of harmonising establishment procedures could easily lead to greater complexity and bureaucracy for member states (like the UK) which currently have minimal regulation in these areas.

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<sup>8</sup> The group consists of the SME Union of the EPP, European Small Business Alliance, EuroCommerce and EUROCHAMBRES  
<http://www.sme-union.org/viewdoc.php?LAN=en&FILE=doc&ID=19>

In summary, as it currently stands the European Parliament's draft would:

**1) Effectively abolish the country of origin Principle.** When IMCO voted on its final report on the directive it left the country of origin principle largely intact but renamed it as the "Freedom to Provide Services" principle. However this was further amended in a deal between the Conservative grouping (EPP) and the Socialists (PES) on 8 February. The article now reads, "Member states shall respect services providers' rights to provide a service in another member state than where they are established. The member state into which the service is provided shall ensure free access to and free exercise of a service activity within its territory." It also allows the host member state, the country where the service is provided, to ignore this principle "where they are justified for reasons of public policy or public security or social security or for the protection of the health or the environment."

**2) Narrow the focus of the directive further,** excluding transport, services connected to public authorities, and a range of specific industries including education, gambling and audiovisual services.

**3) Create an extremely broad set of exemptions from the directive as a whole** (i.e. not just the country of origin idea but also the right to establish) - which would cover all "overriding reasons relating to the public interest" which it says can include "the protection of public policy, public security, public safety, public health, the protection of consumers, recipients of services, workers and the environment including the urban environment, the health of animals, intellectual property, the conservation of the national historic and artistic heritage, social policy objectives and cultural policy objectives"

**4) Open the way to upward harmonisation of regulations.** The amendments call on the Commission to present a report 5 years after the directive comes into force which will "consider the need for proposing harmonisation measures regarding service activities covered by this Directive."

#### Next steps - negotiation between the Parliament and Council

The Council of Ministers has also debated the topic and produced a report. The Commission will take account of both these opinions before presenting a new draft at the European Council meeting in March.

Under the so-called "co-decision" procedure, both the Parliament and the Council have an effective right of veto over the directive.

However, it seems unlikely that the Council will take a strong united line in calling for the directive to be put back into its original liberal form. Indeed the current protectionist mood suggests that member states are unlikely to take a stand against the Parliament's proposed deal.

After the European Parliament proposal to axe the country of origin principle *only 6 of the 25 member states*, including the UK, the Netherlands, Poland and Hungary signed a letter calling for the principle to be re-established.

**Europe now: Liberal ideas on the defensive**

*"We will not accept a Services Directive which leads to social and legal dumping and calls into question our labour laws and our public services."*

Dominique de Villepin, AP, 6 February 2006

*"The services market we wish to introduce must preserve... respect for the European social model in accordance with the motto: Yes to the liberalisation of services, no to social dumping."*

Jean Claude-Juncker, press release, 23 March 2005

*"The content of the directive puts fear and horror into the hearts of people. In no circumstances should it go through."*

Gerhard Schroder, -The Times, 23 March 2005

*"If the law is adopted in its current form, far from creating a level-playing field for service providers and raising standards across EU member states, it will encourage unfair competition and undermine existing workers' rights and conditions."*

John Monks, ETUC Secretary-General, FT, 7 December 2005

*"Discussions on the Services Directive have become caught up in wider political debates to the detriment of the belief in an open, single market in the European Union."*

House of Lords report, July 2005

## (4) How big a bang? - estimating the benefits

### Overview studies

There have been various studies into the impact that the introduction of the Services Directive will make. The European Commission's own Extended Impact Assessment concluded that the gains from removing the barriers to services trade would be similar to the gains made from the improvements made in the single market in goods. The Commission estimates that this is equivalent to an increase in GDP of 1.8% or €164.5 billion and the creation of an extra 2.5 million jobs.<sup>9</sup>

However, independent research suggests more limited gains. Working on the assumption that the directive would be passed as it originally stood a study carried out by Copenhagen Economics (CE), predicted an increase in trade, leading to a substantial increase in employment, in the region 600,000 extra jobs. They argue that an increase in employment will intensify competition for "limited resources labour and capital". This combined with the higher levels of productivity generated by a more efficient allocation of resources will lead to higher real wages. The report concludes that "European consumers, firms and governments will benefit from enhanced higher wages, lower prices and increased quality of services."<sup>10</sup> In total this would mean an increase of 0.4% of EU GDP.

In a study at the start of 2005 CPB Netherlands Bureau for Economic Policy Analysis argued that the country of origin principle, the single points of contact and the outlawing of discrimination against foreign service providers will "substantially reduce" the difference in services regulation across the EU. They predict that the effect of this will be an increase in commercial service trade of 30 to 60% within the EU and an increase of 20 to 35% of intra-EU flows of Foreign Direct Investment.<sup>11</sup>

Some are not convinced by this body of economic analysis. The UK Trades Union Congress (TUC) argues that the directive will bring very few substantial economic benefits and it will make only a small contribution to the competitiveness of the EU. They suggest that "Europe does not have a general economic problem with excessive market regulation" and there will be few innovation or productivity gains from the service directive. The TUC argue that the directive will not help the EU achieve the Lisbon Agenda goals, because it already has the most competitive service industry in the world. From 1997-2003, the EU has increased its share of the world trade in services (from 24-25.8%), whereas Asia has fallen from 17.1-13.9%.

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<sup>9</sup>Extended Impact Assessment of Proposal for a Directive in on Services in the Internal Market, EU Commission, January 2004  
[http://europa.eu.int/comm/internal\\_market/services/docs/services-dir/impact/2004-impact-assessment\\_en.pdf](http://europa.eu.int/comm/internal_market/services/docs/services-dir/impact/2004-impact-assessment_en.pdf)

<sup>10</sup>Economic assessment of the Barriers to the Internal Market for Services, Copenhagen Economics, January 2005

<sup>11</sup>The Free Movement of Services within the EU, September 2005, CPB Netherlands Bureau for Economic Policy Analysis

## Studies of different aspects of the directive

A report by PWC for the DTI suggests that the impact of the draft directive might not be as large as that predicted by some of the economic analysis. PWC used 38 UK firms as case studies, in an attempt to assess what benefits the directive would bring. The report found that a free market in services would still not overcome the most significant barriers to trade which were cultural. The report argues that "natural barriers, particularly those related to culture, [are] the most significant barriers faced by firms seeking to provide services elsewhere in the EU... Nevertheless, approximately 40% of the barriers to establishment cited by case study firms would be addressed by the Services Directive."

However it did find that there would be some significant savings for firms wishing to establish in another EU member state. Estimates of this saving varied from between £10,000 of one-off costs to £50,000 of ongoing costs. Obviously any reduction in costs would benefit smaller firms, as they would save a greater proportion of their overall budget.<sup>12</sup>

An updated study by the Netherlands Bureau for Economic Policy Analysis in February 2006 looked at how the benefits of the directive broke down. It found that the introduction of the Directive could increase European GDP growth by 0.3 to 0.7% in the long run. However, the report concludes that the country of origin principle accounts for about 40% of the expected growth in GDP and consumption, so that a watered-down version would substantially reduce the projected economic gains to 0.2 to 0.4 % of GDP.

## Conclusion - still worth having?

While clearly there should be benefits beyond the country of origin principle, none of the studies so far have acknowledged the extent to which even these have been watered down in the most recent drafts (indeed all of the studies start from the assumption that the directive will lead to a substantial reduction in existing barriers). In reality the gains are likely to be smaller still.

With the potential benefits now dwindling into very small magnitude, the question of whether the directive is still worth having depends on the risk of the directive leading to substantial upward harmonisation of regulations later.

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<sup>12</sup> Impact of the proposed EU Directive on Services in the Internal Market: case studies of UK businesses, DTI/PWC, August 2005

## (5) Could the directive now lead to harmonisation?

From the European Parliament draft of the directive

Article 5 (1b)

*Member States, in conjunction with the Commission, shall introduce, where appropriate and feasible, harmonised European forms. Those forms shall be equivalent to certificates, attestations and any other documents concerning establishment which demonstrate that a requirement has been met in the Member State of destination.*

Article 16 (4)

*By five years after the entry into force of this Directive at the latest, the Commission shall, after consultation of the Member States and the Social Partners at European level, submit to the European Parliament and the Council a report on the application of this article, in which it shall consider the need for proposing harmonization measures regarding service activities covered by this Directive.*

One of the historic tensions in the European Union is between mutual recognition and harmonisation. In all kinds of projects - from the internal market for goods in the 1980s, to the justice and home affairs programme in recent years, a recurring dynamic is for attempts to get member states to recognise *each others'* rules to lead quickly for demands for *harmonised* rules.

The process of harmonising rules often leads to an increase in the level of regulation, not just because bargaining between rules tends to lead to a mid-point outcome, but also because of what economists describe as the incentive to raise rivals' costs.

### History repeating itself?

At the start of the attempt to create a single market in goods, the EU's Services Directive at first attempted to reduce barriers to trade through the process of mutual recognition. If a company's goods met the safety requirements in member state A, that was sufficient for it to be sold in member state B. This was intended to minimise the amount of harmonised standards that would be needed on an EU level, thus reducing the regulatory burden on EU businesses.

Unfortunately, since the single market was created, an increasing number of harmonising measures have been introduced, raising costs for European businesses. Some 250 sector-by-sector measures of harmonisation were introduced in total over a period of 10 years.<sup>13</sup>

Some have argued that this increase in regulation has even outweighed the benefits the single market has brought. On 9 November 2004, the *Financial Times* reported: "Peter Mandelson... said the cost of EU red tape was roughly double the economic benefits generated by the single market. Regulation amounted to about 4 per cent of the EU's gross domestic product."

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<sup>13</sup> Completing the Internal Market in Services, House of Lords, July 2005, Q441.

## From mutual recognition to harmonisation

In creating an internal services market, the country of origin principle would have established a principle of mutual acceptance of the standards employed in different member states. Now that it is likely to be removed from the final text, the possibility of greater central harmonisation of European service sectors increases. Without the country of origin principle barriers to services trade will remain high, and there will be calls from some to create standardised rules for all EU service providers.

Unfortunately, the latest amendments to the directive (8 February), not only remove the country of origin principle they also call on the Commission to present a report 5 years after the directive comes into force to "consider the need for proposing harmonisation measures regarding service activities covered by this Directive."

Business groups have expressed fears that sectoral harmonisation will lead to an increase in regulation especially for smaller services providers. Crucially, sectoral harmonisation would apply to businesses even if they had no intention of selling their services across border. The FSB's Chairman of International Affairs, Tina Sommers, has argued that harmonisation would be "very, very damaging" to British businesses.<sup>14</sup>

Harmonisation presents a particular risk to British business which traditionally applies a *laissez-faire* attitude to most service sectors. In countries such as Germany, France and the Netherlands businesses have to qualify in order to be able to trade, so, for example, a hairdresser or a book seller needs to train for several years before they are allowed to operate. In the UK, service providers will differ in quality, but if they do not provide a good enough service they will eventually go out of business. It is unimaginable that harmonisation would lead to a lowering of requirements in countries such as Germany, especially in the context of the current debate about "social dumping".

Harmonisation would almost certainly mean an increase in regulation in the UK, which would have severe repercussions for the UK's dynamic service industry. An increase in training requirements would also hit the UK's flexible job market, and could lead to UK unemployment levels rising up to those currently experienced in the eurozone. Harmonisation wouldn't just be felt in the UK though, a process of harmonisation would mean that all service businesses throughout Europe would have to adapt to new regulations, incurring costs, which would ultimately be passed on to European consumers.

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<sup>14</sup> Completing the Internal Market in Services, House of Lords, July 2005, Q161.