

***The Single Market:
Yesterday and Tomorrow***

Marcel Canoy, Roger Liddle and Peter Smith

**Bureau of European Policy Advisers (BEPA)
European Commission**

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Corresponding author: Peter Smith, peter-martin.smith@ec.europa.eu

Executive Summary

The Single Market Programme has *created benefits for both citizens and enterprises*. For enterprises the benefits are direct and stem from the possibility to develop through easier market access to other EU countries. For citizens the benefits are often indirect and vary from product safety and minimum standards, to lower air fares and mobile telephony. Some of the citizens' benefits are not generally recognised by the public such as allowing patients to travel abroad to seek health treatment or the Schengen Convention.

Nevertheless, *large potential benefits remain unrealised* and the Single Market, even complemented by the Euro, has not led Europe to outperform other OECD members. Nor is there a guarantee that the Single Market Programme as presently framed will unleash the untapped potential benefits in the future.

The reason for the Single Market's unfulfilled potential is *the fundamental changes in the context in which the Single Market operates* compared with when it was first conceived. The Single Market was conceived in terms of an economy based around mass manufacturing of standardised products benefiting from large economies of scale in production rather than a knowledge and service based one with much greater product differentiation. Enlargement has changed the nature of the Single Market. The market itself will no longer be 'single' but more diverse, culturally, linguistically, in levels of development and administrative capacity. The nature of competition puts a premium on innovation, adaptability and speed to market. The scope of the game has changed from national to European to global. This *changes the focus of the Single Market Program from removing internal borders to showing how the European dimension can be used to compete with the rest of the world*. Since the Single Market is operating in a very different environment, a different

approach to the way that the Single Market will be conceived and applied in future is required.

This is the *right time to reflect on the future* of the Single Market. The next multi-annual Single Market strategy is scheduled for adoption in 2007. Since its conception by the Commission in 1985, the Single Market programme has essentially moved along a single trajectory. More areas have been added to the initial list. Implementation has continued to pose problems with more and more attention paid to the issue. The concentration on legal and regulatory barriers has been maintained to the exclusion of other barriers of an economic, physical (infrastructure), cultural or linguistic nature.

For the next Single Market strategy, the choice is to continue in the line of the previous ones or more fundamentally to revise the strategy that has been followed up until now. There are *five reasons why continuing the same way as before will not bring the required benefits*.

First, the notion of the Single Market as a static and once and for all construct that only needs to be completed misses the point. Completing the Single Market is frequently seen in terms of either the absence of adequate legislation, often in particular sectors, or imperfect transposition and enforcement. And indeed progress can be made in these areas. BEPA would like to stress that the Single Market can never be complete. Markets are dynamic not static, and ever new non-tariff barriers are being created within the Single Market.

Second, adding new areas to the Single Market will become more difficult, as evidenced by the political and legal difficulties in trying to extend the Single Market into areas such as health care. Deep integration means that the Single Market enters more and more into areas of life that affect citizens directly and for which economic efficiency is only one criteria. As a result resistance grows.

Third, because the EU relies heavily on primary legislation and a lengthy legislative process is required for a Commission proposal to be adopted, it is

difficult to change Single Market legislation when circumstances warrant it. Much of the original Single Market legislation is now over ten years old, while markets have become much faster moving and new challenges have emerged. The directive as the principal legislative instrument for the Single Market suffers from the requirement of transposition into Member States' own legal order.

Fourth, trying to get Member States to transpose directives faster will not yield the expected benefits if the legislation itself is incorrectly conceived. Early directives had a tendency to harmonise EU regulations on the basis of existing national rules and with the help of trade associations representing the interests of incumbents. As a result, entry barriers were inadvertently built into the legislation, thereby stifling possibilities for innovation and greater competition.

Fifth, growing diversity and lack of administrative capacity implies that comprehensive harmonisation becomes both more difficult to apply and less attuned to the needs of the market. Certain Member States may even have to apply legislation that is both cumbersome and not very suited to their specific situation. Ease of implementation has not been a criteria for developing Single Market legislation in the past, but in large part the success of such legislation depends on the way it is applied.

Taken together, the five reasons imply above all that continuing as before ***threatens to miss the innovation boat***. All available evidence points at innovation driven productivity growth as the main source of future economic prosperity. A new Single Market strategy should take that as a primer and develop from there. Which elements are more likely to yield success? ***We identify four elements of a new strategy***.

1. prioritization

The approach adopted from the beginning identified existing legal obstacles to doing business across borders and sought to remove them. It did not seek to prioritise different measures. However, not all barriers for doing business are of

the same importance. Innovation thrives by opening up market opportunities for new products. Only by eliminating the major obstacles to placing new products on the market, whatever their source, will the Single Market be able to contribute effectively to raising Europe's growth potential.

2. delegalization

Growing diversity and lack of administrative capacity implies a different regulatory approach based around simpler legislation that deals only with the principal obstacles to economic integration rather than comprehensive harmonisation. To ease applicability, to minimise complexity and to get as close as possible to what drives innovation, the EU should adopt framework regulations in the place of detailed directives wherever possible with greater reliance on decentralised and flexible bodies responsible for implementing decisions.

3. differentiation

The changed nature and scope of many markets implies greater differentiation between sectors to enhance competition. The Single Market of the future requires a sectoral approach, such that justice can be done to both the realities of diversity and the requirement for coherence between different EU and national policies. Energy is a prime example of an area where the objective of creating competitive markets needs to take centre stage instead of necessarily creating legislative uniformity.

4. coordination

However important, a single policy instrument is unlikely to meet the challenges posed by the changing environment. Instead, much better co-ordination with other EU policies, in particular competition, trade, environment and consumer policies will be required. The Single Market also needs to be made coherent

with national policies, particularly the functioning of labour markets, for its full benefits to be reaped.

In place of a political objective for the Single Market, to create an integrated Europe based around a homogeneous legal order, the Single Market needs an economic objective, to stimulate competition and encourage innovation. This implies far-reaching changes in the outlook of the Commission and the way it organises itself. The skills required to analyse a market, to break down barriers to entry, to stimulate competition are different from those required for the harmonisation of existing national rules.

In order to provide the opportunity for a forward looking Single Market strategy, capable of replying to the needs for European integration in the years to come, strong political direction by the college to individual departments would be required. Such an initiative implies in turn that the Commission has at its disposition a realistic diagnostic of the current situation and future needs and the different policy options available. It also implies that the Commission should reject proposals that seek to build the future Single Market strategy around 'better implementation' or 'filling in the remaining gaps'.

Introduction

The core proposition of economic theory is that competitive markets promote welfare and dynamism. There are of course instances of market failure, but these can be identified and in most cases, addressed. The concept of the Single Market programme, which is aimed at enhancing competition, has therefore the vast bulk of economic theory on its side.

But economic commentators recognise that a gulf between theory and practice has emerged that needs some explaining. The Single Market has brought real benefits, but it has not led to a transformation of European economic performance. There have been a number of major reports by the Commission on

the Single Market over the years that have all indicated the very large potential gains from the project (Cecchini Report 1988; 1996 evaluation of the Single Market; Ten year review). However, the actual gains in terms of growth and jobs, without being negligible, have not reached their full potential. What then should the EU do differently to realise these gains? Have there been flaws in design and implementation? Or are the problems not attributable to weaknesses in the programme at all but to different factors?

In relative terms by comparison with the rest of the world, the EU's economic performance has deteriorated. There are of course explanations for this that have precious little to do with the Single Market. Some commentators stress the consequences of the macro policies that were pursued in order to make the Euro feasible. Others lay emphasis on the burdens of German unification, which given the importance of Germany to the European economy as a whole, have had an unfavourable impact throughout the EU. Some perceive an increasing preference on the part of European citizens for leisure in a post-materialist age. However the overwhelming majority of professional economic opinion, expressed through institutions like the IMF and the OECD, puts most weight on the absence of sufficient structural reform and weaknesses in the functioning of product, capital and labour markets. In this, the perceived strengths and weaknesses of the Single Market programme are not the only factor, but they are undoubtedly a significant one. This paper summarises the main conclusions which BEPA draws from its reading of outside analysis of the Single Market and studies of Europe's disappointing growth performance (Sapir et al 2004, Bailey and Kirkegaard 2004, Van Ark 2005).

The functioning of the Single Market cannot be analysed in a static way. The environment for doing business in Europe is changing. Major developments relate to the structure of the economy, the enlargement of the EU and world wide economic integration. The continued relevance of the Single Market in

enabling Europe to adapt to these new challenges needs to be addressed and where necessary, the Single Market programme reformulated.

In particular, it will be important to analyse each of the following distinct issues:

- The degree to which traditional Single Market measures must be accompanied by other policies in order for its potential to be realised, particularly in terms of growth and jobs;
- The manner in which the Single Market will be implemented in a diverse Europe of 27 and the adequacy of the regulatory regime for a new economy of globalisation and rapid technological change where the nature of economic competition has been transformed since Single Market was first conceived;
- New sectors and issues that the Single Market will need to tackle in order to promote economic integration.

The virtues of the existing Single Market Programme cannot be taken as self-evident. In a period where market liberalisation is a world-wide phenomenon, the EU must either do substantially more, or do things substantially better, in order to derive comparative advantage from its efforts. Equally, the social adjustment costs of more rapid economic change and how to deal with them should not be ignored.

A successful Single Market is also one that is accepted politically. The Single Market Programme as originally conceived was only made possible by the adoption of majority voting. However as the Single Market pushes deep into territory such as ways in which corporate governance is organised, public services provided or direct taxes levied, the degree of political consensus required becomes greater. Ultimately, closer political integration will need to go hand in hand with deeper economic integration for the Single Market Programme as presently conceived to be realised in its entirety.

If closer political integration seems unrealistic, the alternative is to seek other ways of achieving the economic benefits of market integration combining different policy levers as well as regulatory and economic forces to open markets.

The paper is structured as follows.

The *first* section asks how far on various different measures of both internal performance and external comparison the Single Market has led to economic integration.

The *second* section assesses the benefits of the programme to the citizen.

The *third* section considers the success of the Single Market in promoting the “new economy” and its appropriateness in an age of new technology for a new type of competition.

The *fourth* section asks whether enlargement and globalisation require a change of focus in the Single Market programme.

The *fifth* section reflects on the importance of the complementarity between the Single Market programme and other policies at EU and national level

The *sixth* section discusses how the regulatory challenge is changing.

The *seventh* section examines the proposition that “services” should be the main focus of future action.

The *eighth* section considers how best a sectoral approach might be made effective.

This then leads into the conclusions for the Single Market of the future.

1. How successfully has the Single Market advanced economic integration?

In terms of economic integration – the Single Market’s achievements are impressive, but its record is nevertheless patchy, the international comparisons are not as good as some might think, and the pace has slowed in recent times.

Although the Single Market programme has led undeniably to a legal construct of considerable sophistication, the extent to which this has led to economic integration between Member States is subject to a wide degree of interpretation (Aghion, Cohen and Pisani-Ferry 2006). The main indicators of integration are trade flows and price convergence. The evidence is mixed.

Mayer and Zignago (2006) used gravity models to compare the actual and theoretical level of trade integration within the EU and between the EU and North America. They find that over a long period, economic integration has progressed substantially. At the end of the seventies, crossing an internal border within Europe reduced trade by a factor of twenty while at the end of the nineties this had fallen to a factor of thirteen. This has to be compared to a theoretical minimum of three times for the US. Nevertheless the share of intra-EU trade has stagnated since 1993 while that within North America has increased significantly. This can in part be attributed to the success of NAFTA. However from an EU perspective, the comparison is partial because NAFTA merely reduced tariff barriers that were eliminated by the original six Member States as long ago as 1968, well before the genesis of the Single Market.

Nevertheless, the qualitatively superior Single Market Programme, reinforced by monetary union, should have led to an upsurge of trade for those areas that free trade agreements do not touch (essentially non-tariff barriers). It has not done so. It is striking that Canada remains significantly more integrated with the US than Member States are with each other within the EU.

Mergers and acquisitions (M&A) activity can also be an indication of the functioning of the Single Market. In general M&As tend to follow the business cycle, so that one has to treat the issue with some caution, but cross border mergers can indeed point at the effectiveness of the Single Market. In some markets, such as the banking and energy markets, cross border mergers could even lead to crucial breakthroughs from incumbency dominated national markets. There is evidence of increased cross-border M&A activity.

DG ECFIN's M&A NOTE of April 2006 points to the fact that the lion's share of M&A activity is still domestic, but cross-border activities are on the rise. For new Member States however the picture is very different, since firms in these countries are attractive investment opportunities for EU-15 firms. On the other hand the fact that most European firms are still acquired by other European firms, is open to different interpretations. It can be seen as a success of the Single Market that European firms find it easier than non-European firms to buy other firms in Europe. Alternatively it can be interpreted as a failure to open up to the outside world.

In terms of price convergence, Thévenot (2006), demonstrates that prices, even within the euro zone, remain dispersed. In 1985, the standard deviation of price level indexes of the future euro zone stood at 21% compared with 14% in 2003. After a period of rapid convergence at the beginning of the nineties, prices continued to converge more slowly until 1999, when convergence stalled, in spite of the positive effect that would have been expected from the introduction of the euro. Price convergence began with and has gone further in tradable goods than services.

An alternative way of looking at the extent of integration has been adopted by the OECD (1999 and 2005). This changes perspective from output measures of integration (like price convergence) to an evaluation of the extent of input measures of policy liberalisation. They find that with regard to regulatory

reforms, the EU did not do better on average than other developed countries. In the early period (up to 1998), when the general move towards liberalisation gathered speed, the degree of regulatory dispersion within the EU actually increased relative to the average. This arose because some countries within the EU liberalised much faster than others. By 2003, this situation had reversed with product market regulation typically more homogeneous than in the rest of the OECD. Both within the EU and outside the EU, the fall in dispersion of regulatory practices came from convergence towards those of the most liberal countries. With regard to the OECD findings, the most surprising element is that the Single Market did not appear to have a strong impact on regulatory convergence in the earlier period. This can be attributed in part to the fact that implementation sometimes preceded liberalisation for certain countries while it followed for others, sometimes with a considerable transposition and implementation lag.

2. What have been the benefits to the citizen?

It is not true that the Single Market has only benefited large firms. Citizens have benefited – but not visibly across the board; some benefits go unrecognised by the public.

It is often said that the Single Market delivered benefits for (large) firms but not for the citizens. The literature reveals that this argument is overstated: the Single Market has led to some clear benefits for consumers. R. Davidson et al (2002) perform a thorough empirical study in an attempt to measure the impact of the Single Market on price levels, price dispersion and price/cost margins. The objective was to test the theoretical argument according to which a reduction in price dispersion is expected to arise from greater integration. They also test how price transparency affects price/cost margins. Simulation results show increased output as a result of increased price transparency for producers and consumers in a great number of manufacturing sectors and lower mark-ups (3.6% to 3.9%) in

almost all of them (see also Allen et al 1998). A more recent empirical study (Griffith and Harrison 2004), focusing on product reform in general, confirmed substantial gains from lower mark-ups, higher employment, investment and productivity.

Apart from these empirically tested results there are also other types of relatively undisputed consumer benefits. For instance consumers enjoy greater protection thanks to the Single Market, are better informed about the products they buy and those products are safer. The products meet certain minimum standards, regardless of where they were produced. In addition, Single Market laws require that degradable products, such as food and medicines are labelled with “best before” dates and that they carry a list of ingredients, colourings and additives. Finally, the EU also ensures that the internal market is not undermined by rogue traders operating across borders. It is of course not entirely clear which of these benefits would still have been realized in the absence of the Single Market.

A few sectors where the Single Market made a critical difference for consumers are (EU 2002):

(i) **product liability** - consumers who are injured by defective products have the right to sue for compensation provided that they can prove that the product was defective and the defect in the product caused the injury;

(ii) **air transport** - liberalisation has increased the number of carriers from 119 in 1992 to a peak of 140 in 2000. The number of routes linking Single Market countries has risen by 46% since 1992. Fares at the lower end of the market fell by 41% between 1992 and 2000. In addition, passengers denied a seat because the airline has overbooked can demand compensation and have the right to a refund or else a seat on the next appropriate flight;

(iii) **cars** - there is greater choice for consumers as to where they get their cars serviced and more effective competition between garages and in the supply of spare parts.

BEPA (2006) provided a further number of examples where the Single Market contributed to consumer benefits. For instance in **mobile telephony**, the existence of a common European standard enabled manufacturers to benefit from economies of scale by supplying a product Europe wide and thereby to provide the handset at an affordable price for consumers. It also stimulated new market entry with the result that the dominant mobile equipment suppliers are not identical to those for fixed line networks. The main contribution of the EU was to insist on competition between operators at a time when fixed telephony was still under the control of national monopoly providers. This competition provided consumers with an element of choice, brought down prices and stimulated innovation, for instance the introduction of pre-paid cards and a wide variety of different service packages tailored to the different needs of individuals. There have been significant reductions in prices to consumers for national calls in the majority of Member States.

It is less well understood that some examples of consumer benefits relate to the Single Market (BEPA 2006). **Medical services** provide a relatively unknown example of how the Single Market can provide benefits to citizens. Freedom to supply services interacts with public provision in the field of health. The EU has succeeded in combining the maintenance of comprehensive national systems for health care with the freedom to provide services by allowing patients to travel abroad to seek treatment and have that treatment reimbursed by their home authorities when the domestic system is unable to provide treatment within an adequate time framework. This has created a new right for citizens while enabling more efficient use of the existing capacity of health systems. Similarly, the new health card gives access to emergency treatment throughout the EU extending the free movement of persons that is one of the four fundamental freedoms in a new and unique way.

The **Schengen** Convention abolished internal borders and created a single external border where immigration checks for the whole Schengen area are carried out with a single set of rules. This required the implementation of common rules regarding visas, asylum rights and checks at external borders. The original inter-governmental agreement has been successfully brought within the institutional framework, providing legal stability and ensuring that it can be extended to new members without delay. It could of course be argued that from the start Schengen should have been part of the Single Market programme, linked to the fundamental freedom of free movement of persons, and that all Member States should participate.

These examples qualify false perceptions that the Single Market has not delivered benefits to the citizens, but one cannot be too optimistic or complacent. For instance a Commission working paper (European Commission 2005a) showed that in network industries important results have been achieved, but there are still many obstacles to competition. Recent sector inquiries by the Commission (European Commission 2006a and b) confirmed major competition deficiencies in both energy market and financial markets. The same applies to many other services markets.

Lejour and de Paiva Verheiden (2004) show that differences in language and regulation hamper services and goods trade in Europe significantly. Trade in services is also hampered by regulation in the importing country, but this is not true for goods. Services trade within Canada is twice as high as within Europe measured as a share of GDP.

Lack of competition in the financial services sector leads to bad deals for consumers: higher prices, and less access to credit. It is estimated that pre-2000, barriers to foreign firms in the banking sector raised prices by roughly 5.3%. Integrating financial services could raise EU GDP by an estimated €130 billion (in 2002 prices) and business investment by 6.0%.

But the identification of benefits – both potential and realised - should be treated with some caution. It is not always clear what would have happened in the absence of the Single Market and Single Market policies are clearly not the only policies influencing product and labour market regulation. But it should nevertheless be clear that the internal market has generated significant benefits to the citizens already, that it could generate still more in the future and that new benefits are no longer flowing at the rate of the past.

3. What difference should the emergence of the “new economy” make?

The assumptions and policy remedies of the original Single Market programme need to be rethought in the light of the emergence of the “new economy”. Possibilities of new entry by innovative firms assume more importance in driving productivity and growth; incremental product improvement by established market incumbents will matter less. Labour mobility becomes even more important.

The Single Market is an on-going process rather than an event. While a backward looking evaluation of the extent to which it fulfilled original expectations is enlightening, a forward looking perspective of the degree to which it will be able to respond to current economic challenges is more relevant to the Commission’s current task.

The Sapir report charted the fundamental way in which the economy has changed over the last thirty years and why many of the policies that were so successful in the post-war period no longer generate results in a way that they once did. The Single Market Programme was conceived as a response to Eurosclerosis and was an early attempt to come to grips with that problem. However, the economic reasoning behind the initial programme was still largely based on an industrial economy with economies of scale in the manufacture of standardised products seen as one of the key benefits of the Single Market.

Shapiro and Varian (1999) argue that the industrial economy was populated with oligopolies which acquired considerable stability in the marketplace, mirrored by lifetime employment of managers. In contrast, the information economy is populated by temporary monopolies in which firms vie for dominance in the knowledge that today's leading technology will be replaced by an upstart with superior technology. Oligopolies were based on supply side economies of scale, while the information economy is driven by the economics of networks and demand side economies of scale, in which the winner often takes all. Success in such markets is often achieved through the imposition of standards, which may be proprietary or non-proprietary, closed or open. Windows is a proprietary open standard while OS Tiger is a closed proprietary one. Non-proprietary standards, such as GSM, tend by definition to be open.

Van Ark et al (2003) attempted to measure the contribution of the "new economy" to labour productivity and employment growth in the EU and the US. The relative contribution of an individual sector to overall growth depends on a combination of the share of that sector and its rate of growth. ICT producing industries saw accelerating productivity on both sides of the Atlantic, but faster in the US where the sector is also considerably larger. ICT using industries also witnessed a big improvement in productivity in the US, concentrated in a number of services (securities, wholesale and retail trade). As far as employment is concerned, growth rates improved during the nineties in all industry groups and for the EU and the US alike. While both ICT producing and using industries showed strong employment growth, the difference in employment growth in the "non-ICT" sector remained strongly in favour of the US.

It appears therefore that the boost to growth by the "new economy" was both greater and occurred in a more balanced way in the US than in Europe. However, the new economy was not alone in explaining differences in

performance: structural problems not related to technology also held back productivity and employment growth in Europe.

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

The over-riding importance of SMEs for employment growth has been well documented since the 1980s (OECD 2002). More recently their contribution to radical innovation has also been explored. Overall, new firm creation in Europe is comparable to that in the US as are firms that exit economic activity.

However, the growth profile is very different, with much faster growth in the US of the minority of start ups that have real growth potential.

Innovation, which is not necessarily technology based, is the main driver of high growth. It is the speed of diffusion that dictates the impact that an

innovation will ultimately have on the economy. Take two rather similar innovations in concept, Starbucks coffee in the US and the Pain Quotidien in Belgium. Both relied on a new business concept, how to supply an existing product in superior form to a market that was looking for higher quality combined with a better environment in which the products could be consumed base around conviviality. The degree of diffusion of the two chains is instructive. From its origins as a vendor of coffee (beans and ground), Starbucks was taken over in 1987 and converted to a coffee bar chain and opened its first locations outside Seattle in Vancouver and Chicago the same year. By the time of its initial public offering in 1992, Starbucks had grown to 165 outlets. It opened its first outlet outside North America in Tokyo in 1996 and is now present in 30 additional countries with more than 10,800 Starbucks world-wide. Pain Quotidien was founded by Belgian chef Alain Coumont at the end of the 1980s who had decided to bake his own sourdough loaves after his source in Paris failed. Today Pain Quotidien has over 60 branches worldwide, mainly in Belgium, France in and around New York and Los Angeles but with a nascent franchise in the UK and Turkey and openings to follow shortly in Kuwait, Lebanon and Dubai. It plans to open 15 new shops in 2006. Both Starbucks and Pain Quotidien are successful applications of a similar concept, but one is much bigger than the other.

Dantas, Machado and Rosas (2006) provide corroboration for the difference in high growth potential in their study of the profitability of venture capital investment in Europe and the United States. They find that the difference is particularly marked for early stage investment, with five and ten year investment horizon internal rates of return as low as -1.8% and 1.3% compared with IRRs of 54.9% and 37% for similar types of investment in the US. The returns for development stage investments are higher, but still substantially below those realised in the US. These low returns on what should be high risk but also high

growth investments could indicate that in Europe growth potential is blocked and this could be a major reason behind our poor overall growth performance.

From this brief review of the literature on economic performance and its sources, BEPA considers a number of consequences follow. An EU in which economic structures are changing fast implies much greater labour mobility, both geographically and sectorally. Skill bottlenecks at present coincide with high unemployment. Widening wage differentials are a symptom of these bottlenecks. In the past, such differentials did drive mobility, both within countries and between European countries. However, mobility has since declined to a low level. Wage bargaining systems that effectively set a common wage across different regions and across sectors seriously diminish the incentive for mobility. Experience with successive waves of enlargement has shown that expectations also play a role. Where there is an expectation that national labour conditions are likely to improve, people are more reluctant to move across borders. Achieving greater mobility turns on a wide variety of factors both positive (such as incentives) and negative. Geographical mobility is hindered by the state of the housing market, with affordable property for rent often unavailable, and lack of facilities for child care. For cross-border mobility transferability of pensions, recognition of qualifications as well as linguistic and cultural barriers remain formidable.

Economies of scale still play a role as demonstrated by the introduction of second generation mobile telecommunications where the single European standard certainly enabled firms to exploit such advantages. However, network externalities and accompanying demand side economies of scale along with the trend towards customisation and differentiation will likely become more important than supply side scale economies. Speed to market and innovation have become key factors for ensuring success along with the ability to use

technology successfully. These require different skills from those of replying to the undifferentiated demand that characterised the industrial era.

4. How do enlargement and globalisation change the context?

Globalisation and enlargement are rapidly changing the context in which the Single Market operates. Enlargement makes the EU more diverse and at the same time makes it more difficult to ensure adequate and uniform implementation of the Single Market. It also strengthens European competitiveness and so far there is no sign of an inability on the part of the EU-27 to compete in world markets. But the Single Market will have to facilitate and promote in future a more rapid pace of economic change.

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

On both government effectiveness and the rule of law, the ten new Member States score much lower on average than EU-15. In addition there is less variance between Member States of the EU-15 on these two measures than between the ten new Member States. The two applicants scheduled for accession in 2007 score even lower than the EU-10. Sverdrup concludes that this increases the administrative heterogeneity in the EU to such an extent that it is likely to challenge the notion of homogeneous implementation and application of rules and regulations. Whether or not the data warrant this rather extreme conclusion,

the regulatory environment that will be necessary to manage the Single Market of EU-27 will be different from that of the EU-12 under which the bulk of the programme was conceived. The market itself will no longer be 'single' but more diverse, culturally, linguistically, in levels of development and administrative capacity.

Globalisation, particularly the emergence of China and India, changes the context in which the Single Market operates. Yet we should not exaggerate. WTO figures for total world trade in manufactures demonstrate a very steady rate of increase over a long period (1950-2004), with large year-on-year swings but without any sudden leap as a result of globalisation. Between 1973 and 2003, the share of Europe (EU and non-EU) of world trade in merchandise has been essentially stable at around 45% (including intra-EU), of which intra-EU trade represents about two-thirds. Since 1999, EU-25 shares of world trade in goods (excluding intra-EU trade) have been stable at around 19%. For services the share is considerably higher at 26%. In extra-EU trade, the EU remains the leading exporter for both goods and commercial services, the leading importer for commercial services and the second most important importer of goods.

According to the Commission's Annual Economic Review (2005b), perhaps the most striking development over the last decade is the rapidly growing role of China in world trade. In 2003, Chinese exports accounted for 6.2% of world exports, up by almost 4 percentage points from 1992. However, as imports rose almost in parallel, China's trade surplus increased only moderately, to 1.6% of GDP in 2003. India's share in world exports and imports is still relatively small at about 1% each.

The Review points out that global financial market integration has progressed rapidly. Cross-border holdings of assets began to increase steadily from the mid-1970s on, with the accumulation of foreign assets accelerating sharply in the 1990s. In global terms, foreign direct investment (FDI) flows rose from 5% of

world GDP in 1985 to over 15% by the late 1990s. The most remarkable feature in foreign direct investment in recent years was the acceleration of mergers and acquisitions activity from the mid-1990s, which drove global FDI inflows to a peak in 2000, but FDI flows slumped sharply after the dot-com bubble burst.

The development of FDI is particularly important for the break-up of previously integrated production chains into their component parts, a phenomenon known as outsourcing. Outsourcing began with enterprises outsourcing part of their value chain to local companies but then spread to overseas suppliers and now to global outsourcing. Such outsourcing is in addition to market seeking foreign direct investment. The extent and impact of outsourcing is still somewhat controversial. Whether source countries benefit from outsourcing depends very much on the extent to which their economies are able to adjust (McKinsey 2004).

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

In view of their importance in the knowledge economy, standards, particularly standards for network industries are an important commercial instrument for market development and conquest. Europe has had relatively little success compared with the US and Japan in imposing proprietary standards on the rest of the world. It has had more success with non-proprietary standards for which the official industry-led standards setting process is well equipped. The ability to develop successfully and have adopted widely such standards could represent an important lever for the EU in a globalised world. However, the ability to develop a standard is not sufficient. It must be done in a time-frame that is compatible with fast-moving technologies and its adoption in Europe must lead other countries to follow suit. When other countries fail to adopt European standards, producers can be cut off from the markets they wish to serve. The

advantage that Europe has over its major competitors resides in the more open standards setting procedure that ensures that third countries will be able to license the relevant patents easily.

EU enlargement has already enabled firms to restructure to meet competitive challenges from low cost producers. Products are developed usually for the national EU markets first so that a well-functioning Single Market has become a necessary condition for competing successfully internationally. The change of scope from European to global does not therefore make the Single Market irrelevant. Even in areas in which the global level is the appropriate one, for instance the WTO or climate change, the EU still plays a crucial role as a major player on the international stage. Nevertheless, globalisation is sufficiently important to warrant a detailed evaluation of how it changes the way the Single Market should be conceived and managed and the appropriate level and form of governance in the economic field.

5. How to make the Single Market coherent with other EU and national policies?

Single Market regulation has not been sufficient to secure effective competition and the possibility of new market entry. Labour markets and product markets must become more flexible in tandem.

A first possibility to improve the functioning of the Single Market is to develop the interrelations with other policies. Sapir et al (2004) already stressed the importance of better coordination between Single Market policies and other policies. Similarly, the OECD analyzed the gains that can be achieved from coordinating labour market and product market reforms (OECD 2001, 2005). In an empirical study, the IMF finds sizeable positive employment effects of deregulation in OECD countries (Berger and Danninger, 2005). Reviewing the literature reveals that there are two different ways in which the Single Market interrelates with other policies. The first one acknowledges that enhancing

competition requires a whole array of policies, of which the Single Market is just one. The second one deals with the relation with interrelationship with the labour market.

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

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

Take for example the energy market. The recent sector inquiry launched by the Commission concluded that there are still a variety of obstacles for an effective internal energy market. Lack of transparency, insufficient market based pricing and inadequate regulatory action at Member State level leads to dependency of entrants on vertically integrated incumbents, such that most incumbents remain dominant on their home markets. Cross-border sales exert little competitive pressure, while integration is hampered by insufficient interconnector capacity

and long-term capacity reservations predate the liberalisation. There is also a lack of adequate incentives to invest in additional capacity to eliminate long-established bottlenecks. Such a broad range of problems can surely not be solved with a single policy. The Commission suggested combining competition law with remedies of a regulatory and structural nature and concluded that it might be unavoidable to fully unbundle the sector to achieve a well functioning common market.

The energy sector is by no means unique in its complexity and its need for Single Market regulation to interact with other policies. The initiation of detailed studies of the functioning of markets, with an open mind as to the best policy responses, such as the recent sector inquiries by the Commission (see http://ec.europa.eu/comm/competition/antitrust/others/sector_inquiries.html) are good examples of how the Commission should proceed in future.

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

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

government and trade unions agreed on a drastic change in 1996 (OECD 2005), while collective bargaining and tight restrictions basically prevented Sweden and Germany to take advantage of the opportunity offered by longer opening hours (McKinsey, 2002 and 2006).

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

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

This appears to be the lesson from the recent OECD country study of Germany, which charts the success of German enterprises in restructuring their activities and gaining competitiveness on which Germany's formidable export resurgence has been built (OECD 2006). However, the job losses associated with restructuring are not compensated by gains in other sectors of the activity so that the net gain to the German economy is diminished. In addition, consumer confidence is undermined as a result of job losses. A McKinsey study of offshoring confirms this picture in more detail (McKinsey 2004). While the US

gains \$1.12-1.14 from each dollar spent abroad in offshoring, Germany loses €0.2 from each euro spent abroad, because the value of German labour re-employed is so much less than that of the US.

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

While flexible labour markets make product market reforms more beneficial, it is more important to have labour market arrangements that are tailored to change than flexible labour markets per se. It is important to equip people with the tools that give them opportunities after restructurings and provide incentives to invest in human capital. These ideas fit into a deeper and more philosophical focus among European researchers on transitional labour markets (see e.g. G. Schmidt 2004).

Single market policies can only be effective if labour markets are sufficiently flexible. But for labour market reform to be successful open market policies should be in place. Labour and product markets are communicating vessels. Successful countries design policies that make vessels communicate, policies

that combine flexibility on the labour market with security for the individual affected (protecting the person not the job).

The fact that the Single Market will only achieve its full potential if other policies work in harmony has a number of important implications. Those policies that are set at EU level, particularly competition and trade policies, should be co-ordinated with the Single Market regulation. However, many competition related issues remain a national responsibility as does most labour market regulation. As a result, there is a co-ordination problem between action at EU and Member State level that remains unresolved, but which affects materially the functioning of the Single Market. This has both a technical and a political dimension with poorly functioning national regimes making it more difficult to adopt also regulation at EU level (as the debate on the Services Directive demonstrated).

6. How is the regulatory challenge changing?

A new approach to Single Market regulation will need to be adopted. The inflexibility of the existing acquis in face of globalisation and changing technology is a major potential problem for the future unless new, more rapid decision making procedures can be adopted. Enlargement requires an acceptance both of more diversity and regulation that is easier to apply.

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

There are four reasons why a forward looking approach to the Single Market should revisit the adequacy of the regulatory choices made in the past. The *first* as mentioned is that these choices do not seem to deliver adequately in terms of their economic results. The extent to which regulations affect new entry, the cost of compliance with a regulation and complexity are all relevant issues with this regard. Small businesses in general and new entrants and high growth firms in particular are likely to be the victims of a regulatory regime built around pre-existing national regulations rather than economically optimal ones. While these costs were an understandable price to pay in the past, this no longer holds true for the future.

The *second* is that regulatory techniques and choices have moved on and the first round of regulation may no longer represent best practice. As has been seen in telecommunications, while very heavy regulation may be necessary in an initial phase to allow competition, once competition starts to become effective competition policy becomes increasingly important compared to regulatory policies. Separation of regulation, ownership and financing of public services has now become well established. Issues such as the maintenance of vertical integration in previous monopoly industries such as electricity now come to the fore. Recourse to competition policy in combination with a lighter, more market oriented form of regulation may yield better results than regulation alone.

The *third* is where the Single Market has been successful in integrating markets, a purely national approach may no longer be valid. Areas such as securities markets and increasingly telecommunications have seen substantial integration across borders. National regulators may therefore no longer be adequate. The issue of where and how European regulatory authorities are required needs to be tackled. This does not necessarily imply a centralised authority. Networks of national regulators are able to take decisions applicable to parts or all of the EU. Mixed systems on the line of the ECB governing body are also possible.

The *fourth*, and potentially the most far reaching, is that of enlargement. The regulatory environment that will be necessary to manage the Single Market of EU-27 will be different from that of the EU-12 under which the bulk of the programme was conceived. The market itself will no longer be ‘single’ but more diverse, culturally, linguistically, in levels of development and administrative capacity.

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

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

These problems will be magnified in an EU of 27 by the relatively underdeveloped administrative capacity of several new Member States to apply complex regulations and the increased difficulty in reaching agreement on new

measures in an EU that has doubled its membership since 1995. Moreover, as the Single Market extends to public services, public procurement and the freedom to provide services, it starts to affect national social, regulatory and cultural models in ways that were not always originally envisaged. There is a latent opposition between the need for deep integration to achieve a single set of homogeneous rules of the game and a fragmented European space characterised by national idiosyncrasies and heterogeneous preferences (Aghion et al 2006).

The diverse nature of the EU today also calls into question the validity of a “one size fits all” approach. Either regulation will need to gravitate towards a “lowest common denominator” implying that Member States will go beyond this with national regulations, thereby fragmenting the market, or groups of countries with more homogeneous preferences must be allowed to proceed together in an “Europe à la carte”. Since neither of these solutions can be considered satisfactory, a third way would assess how to regulate more efficiently in the interest of all and which regulations are both economically worthwhile and politically feasible at the current stage of European integration – leaving to a later stage those that require a much higher level of political union.

A good example of where the existing regulatory approach may need rethinking is in relation to the environment. When it comes to integrating environmental concerns into the EU's internal market policy one needs to find a balance between the free movement of goods and environmental protection. The increasing openness of the market is sometimes perceived as a threat to the quality of Europe's environment. By the same token, environmental standards are often seen as barriers to market access or a danger to competitiveness of European companies.

On the impact of single market policies on competitiveness there is a fair bit of literature. There are three different views on this (see Hitchens, (2001) and the references therein). The first and obvious is ventilated often from the business

world where a loss of competitiveness as a result of environmental regulation is claimed, but little academic evidence supports this view. Whether one measures the effect on productivity or something else (see OECD, 1993) one finds no losses as a result of environmental policies.

The second quite opposite view is associated with Michael Porter, who claims (Porter and Van der Linde 1995) that environmental regulation drives innovation and competitiveness, since firms are forced to invest in clean technologies.

There is empirical evidence that most competitive countries are also frontrunners on environmental standards, but the causality is not clear. There is ample case study evidence of innovative successes (US EPA 1996) but it is not that clear which general lessons to draw from that.

The third and perhaps dominant view is that the economic impact depends on the type of environmental regulation. Some regulations can be particularly harmful for SME's while not contributing much to the environment. Yet it is likely that in the future a firm's environmental performance will become a key determinant of its economic performance. The reverse is also true: China will have huge problems with coping with the environmental consequences of their growth. Investing in efficient environmental technology can be cheaper than facing the consequences afterwards.

Another link between environmental policy and Single Market policy relates to different standards of implementation. If environmental directives are weakly implemented in Member States (and implementation indeed varies wildly across Member States), this can in itself distort the Single Market. While this may be true and problematic for specific cases, from above it follows that differences in environmental standards do not lead to problematic situations for competitiveness.

7. Should “services” be the main focus of future Single Market actions?

One cannot generalise about services, except to recognise their economic importance. It is crucial not simply to analyse different sectors, but to consider how policies can be coordinated at different levels to open service markets.

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

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

More to the point, it is hazardous to make generalisations about services. Services are extremely heterogeneous and defy description. For instance, it is not true that services are in general labour intensive. Some services are labour intensive but others are very capital intensive, for instance telecommunications, energy or transportation. Nor is it true that services are low productive ones.

Very high labour productivity is observed not only in the capital intensive services, but also many high level labour intensive ones such as professional services. Nor is it true that services differ from goods by their degree of regulation. While many services are highly regulated through differing methods (qualifications, sector specific regulators ...) some are not (for instance management consultancy). Nor has the Single Market passed services by. The Single Market has already had a significant effect on certain services, which have been the subject of extensive liberalisation, especially telecommunications and air transport.

The tradability of services is a subject of some dispute. The most heavily traded of all sectors are services (air and maritime transport). However, many services have been little traded, at least until recently. The extent to which services are potentially tradable is important for the Single Market in the light of their dominant place in economic life.

A recent US study by Jensen and Kletzer (2005) uses the geographic concentration of service activities within the United States to identify which service activities are traded domestically. On this basis they find that a third of services are tradable as against two-fifths for the economy as a whole. Their estimates find more workers in tradable professional and business service industries than in tradable manufacturing industries. Workers in tradable sectors have higher skills and significantly higher wages than those in non-tradable activities. Their estimates in practice relate to the three forms of direct cross-border trade in services. Since the Single Market definition of trade in services also includes trade by permanent establishment, in theory all services are tradeable in one form or another under the Single Market. The issue is not therefore whether the Single Market is relevant for services but the relative importance of cross-border provision and right of establishment in Single Market legislation.

In Kox and Lejour (2005) simulations for the EU show that if countries make more use of mutual recognition, bilateral trade in commercial services among EU countries could increase by 30% to 60%.

In order to make sense of the unfulfilled potential of the Single Market for services, the best way is to descend to the level of the individual service (sector or market), to analyse at that level the obstacles to integration (whether regulatory, economic or cultural) and the practical possibilities to remove these barriers to doing business. Very few studies look at individual services in this way. Although not designed with this in mind, the numerous national studies by the McKinsey Global Institute come closest to this purpose (McKinsey 2005, 2003, 2002, 2000, 1998, 1997). In addition they look on a disaggregated basis at certain goods producing sectors, facilitating comparisons across sectors of the economy. They conclude that lack of competition is always an important factor in poor performance but that lack of competition takes many different forms according to the sector and - to a lesser extent - the country concerned.

On specific examples the Commission (2005c) mentions that in accountancy national regulations mean that a firm looking to do business in another Member State faces, on average, business costs 23% higher than a domestic competitor. Eliminating such barriers would boost productivity, thus increasing wages throughout the EU economy by an average 0.4% and employment 0.3%.

8. How to make a sectoral approach effective?

The Single Market is only one of several levers to advance competition. Other levers are global competitive pressures and domestic reforms.

A potential disadvantage of looking at sectors is that one reduces a coherent and mutually supporting programme such as the Single Market to an amorphous case by case approach. One way to avoid this would be to look at the different

policy levers available to enhance competition and how they can be used in different situations. The McKinsey studies provide examples of this.

First, markets with weak competition can be shaken up as a result of pressure from world markets. For example, the fastest Swedish productivity growth of 8% per annum between 1992 and 2003 occurred in the automobile industry, largely export and world market oriented. During the nineties, the French automobile industry posted even higher annual rates of productivity growth of 15% against only 1.5% for Germany. The removal of restrictions on Japanese imports and resultant competitive threat forced French automobile producers to become more productive. At the start of the 1990s, the German automobile industry was in a stronger competitive position and felt less need to change.

The components sector is less directly exposed to international competition and currently productivity is well below that of assembly. For example, in 2000 productivity in the component sector was only 66% of automobile assembly in France, 77% in Germany, 76% in Spain and 29% in Portugal. Productivity in assembly is much more equal across countries as would be expected from the higher degree of competition. Portugal's assembly productivity is 70% that of France (with the highest productivity) and only 31% in components.

Although global market competition forced change in these cases, it would be incorrect to say that the Single Market was irrelevant to the ability of automobile producers to compete. The introduction of Community type approval meant that producers no longer had to modify vehicles for each national market. Possibly of even greater importance, the abolition of controls at frontier made it feasible to adopt just-in-time practices for the supply of components from other EU countries and to rationalise that part of the industry. Enlargement has provided manufacturers with a low cost base both to procure components and to assemble vehicles, which enhances the value of the Single Market to them.

Global competition has driven change in services as well as goods producing industries. Wholesale financial services are highly integrated globally and the City of London has been driven in reaction to fundamentally overhaul its working practices and organisation, often through the establishment of companies from abroad. Liberalisation of financial markets preceded Single Market legislation and regulatory developments outside Europe remain of major importance. For instance, regulatory overkill with the Sarbanes-Oxley legislation in the US is claimed to have led international companies to list recently with the London Stock Exchange rather than the New York Stock Exchange.

Second, European integration can be the required policy leverage. The impact of the Single Market is best illustrated by the experience of previous enlargements, whereby the impact comes in one go rather than gradually. Two Swedish sectors achieved very high productivity growth subsequent to accession and application of Single Market rules, retail banking (4.6%) and food processing (3.1%). Sweden suffered bank crises in the early 1990s which led to recognition of the need for reform. Regulatory changes associated with the Single Market made it possible for both domestic and foreign players to establish new banks in Sweden. New entry has been effective and their market share has increased significantly leading to higher competitive pressure. Similarly, the food processing sector, previously highly protected, was restructured to respond to entry. In addition, foreign companies established in Sweden, helping to spread best practice, and retailers put pressure on processed food producers to raise their game.

Third, domestic policy change can be the main driver for enhanced competition. Domestic regulatory developments largely drove improvements in productivity in the Swedish retail sector (4.6% per annum). Zoning laws were changed in 1992 to take into consideration competition issues. This enabled

supermarkets and specialised outlets to replace less efficient units, which in turn allowed IT-use to be deployed more effectively for supply chain management. Several McKinsey studies point to untapped potential in retail. The main barriers are zoning restrictions sometimes supplemented with restrictive conditions for opening large stores, shop opening times and labour market regulations that make it difficult or very expensive to employ labour outside standard hours.

In France, hypermarkets established a very strong position and are effectively protected from innovative competitors by zoning laws (McKinsey 2002).

Traditional, less productive stores are also protected so that changes have to occur within the existing store framework. While still leading international comparisons of productivity, French food retailing started to lose ground in the course of the 1990s. In Germany, according to McKinsey, the barrier is less related to the regulatory environment and more to the privately controlled ownership structure which accepts lower returns on investment that publicly traded new entrants would be willing to do. In the UK retail sector, the impact of planning restrictions is even more stark on labour productivity as the average store size is just two-thirds that of France, while in Portugal a 1997 law allowed large retail formats such as supermarkets and hypermarkets to control no more than 35% of the market. By contrast, in Poland, where new hypermarkets have entered the market since 1995, labour productivity reached 75% of the US level – three times the level of traditional domestic formats (McKinsey 2003).

Productivity growth in retail (and in wholesale) trade is important since this has been one of the drivers of productivity growth in the US both in the nineties and during the current decade (McKinsey 2006). Since most goods and an increasing number of services are sold through retail outlets, the impact of a poor performing retail sector on the Single Market is quite large. However, apart from encouraging e-commerce, the EU has relatively few levers that it can pull to encourage competition in that sector.

Conclusion: The Single Market of tomorrow

It is not enough to think in terms of making the Single Market complete. A new policy for the Single Market has to recognise the need to work better in tandem with complementary market opening policies; for a more flexible and faster acting approach to regulation; and to put the emphasis on facilitating new entry in the knowledge economy.

The Single Market programme has yielded substantial benefits. Yet there remains an equally substantial untapped potential, which can be measured by looking at the differences between European progress and other OECD countries or other trade unions such as NAFTA (Aghion et al 2006). Benefits have not always reached consumers. Developing the Single Market in this direction is not only a natural follow-up but also enhances the acceptance of the programme of the citizens. International comparisons are insightful but do not reveal in which way the untapped potential can be released.

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

One typical response in the literature is to look to the deficiencies of the Single Market programme itself. It is often said that the Single Market remains “incomplete”. This is frequently seen in terms of either the absence of adequate legislation or if there is legislation, its imperfect transposition and enforcement. In the first category would come issues relating to the robustness of the

compromise recently agreed over the Services Directive and the legislative gaps that arguably remain in sectors such as retail financial services, pharmaceuticals, and the defence industry (where the EU's competence is restricted). In the second category might come problems of enforcement and regulatory inadequacy across the EU in sectors such as wholesale financial services and the network industries, such as energy, posts and railways. For instance, one might want to analyse why EU- driven liberalisation appears to have been “more complete” in a sector such as telecoms, but much less so in energy, so far at least. The Commission's Services are well placed to flesh out this analysis of “incompleteness”.

BEPA would merely stress the points that the Single Market can never be “complete”. This is true not only in the obvious sense that markets are dynamic not static. But it is also the case that in the real world there are many factors that will ensure a permanence of diversity and legitimate non-tariff barriers within the Single Market as a result of such factors as differences of language, culture, consumer preference and the costs of doing business.

The literature review reveals that reaping the full potential of the Single Market requires simultaneous improvements in three different areas. ***First, the coordination between Single Market policies and other policies needs to be improved.*** Single Market policies were effective initially to open up markets and enhance competition in manufacturing, but after that initial stage more is needed now. In particular coherence between opening up markets, competition policy and regulation is needed to enhance competition in markets where that is complicated, such as oligopolistic markets. Policy coherence is also needed between labour market and product markets to make sure that the changes that product market reform creates are appropriately managed.

Second, the shift from EU-12, under which the bulk of the programme was conceived, towards EU-27 has important ramifications. A Europe of 27 is

more diverse both in its levels of development, in the composition of the sectors, in its regulatory capacity and the level of competition. This diversity implies that detailed directives are likely to be replaced by more general regulations or guidelines.

One approach would be to apply only basic regulations with more recourse to market and non-regulatory measures to ensure integration. Replacing directives by regulations and using more flexible implementation implementing bodies such as national regulators in place of legislation may prove necessary.

Application of the 80-20 rule by which 80% of the intended effects of a legislation are achieved at 20% of the cost could be a good principle. It implies however that the remaining 20% will still be subject to obstacles to doing business or that other means will need to be found to circumvent those obstacles.

Less burdensome regulation also has a trade-off in terms of lesser ability to open markets.

Third, the shift towards a service economy driven by knowledge and innovation also has consequences for the Single Market programme. Services are notoriously heterogeneous. What works for one service may not work for the other. The Services Directive should be seen as a first step, as laying the foundation to further improvements to the functioning of the services market in Europe. If the full potential of the Single Market for services is to be realised, a much better understanding of the obstacles to integration will be required. Barriers of a non-regulatory nature evidently will need a different, albeit complementary approach. Some of these barriers will be general barriers to setting up a business or in labour market regulation. Others will be more specific relating to differing consumer preferences or information deficiencies about the availability or performance of a specific service or a specific supplier. Innovation must be seen as a process for which competition is an effective driver provided that the underlying conditions are favourable.

These issues are strongly interlinked. It is much easier to make labour market and product market regulation coherent if regulations are tailored to specific sectors. The same applies for coherence between competition policy and Single Market policies. Framework regulations that are more general than detailed directives enable Member States to implement policy in a way that does justice to the specific situation of their economy. This will also help the acceptance of Single Market policies by the citizens.

All three conclusions point in a common direction: to reap the fruits of the Single Market in the future, differentiation is needed. The scope of the European Union is becoming more global and diversity increases. The way the economy works changes as well. Initial benefits could be realized under a uniform based approach, but that will not deliver anymore in the future. In that sense there is much to say for a change in terminology. A Single Market sounds like one size fits all. The ‘European Market’ seems a more appropriate term.

The logical step towards understanding how the Single Market can deliver in the future is to look at the sectoral level. Looking at the sectoral level improves effectiveness of policies. The energy market in Poland is more similar to the Spanish energy market than the Polish beverages market. Trade and entry takes place across borders in a sector. Finally, it is easier to streamline Single Market policies with other policies at the sectoral level.

A reorientation of the Single Market along these lines will require first an identification of what can be the most effective policy lever in each sector. In some cases, global competition shakes up European firms. The Single Market can then be used to give the European firms the best chance to be competitive. Sometimes, it is the Single Market programme itself that drives competitiveness. This occurs often in markets where international standards are needed to shift the scope from a national to an international scale. It is there that the European level can be particularly effective in achieving direct gains.

Finally, there are cases where domestic policies need to be modified to achieve gains. Given this gradual recourse to the market, the role of the EU can be to push domestic policies down the desired path by opening up public procurement to competition and state aid policies. Such policies are not without dangers since it is easy for national governments to blame ‘Brussels’ for changes that are required anyway. Making the case for domestic reform remains the sine qua non here.

The analysis of the literature has suggested a number of avenues for further work and a number of conclusions that have been presented above. In view of the short time to complete this first assessment, the correspondingly limited base on which it draws, the conclusions can at best be tentative. They are presented as hypotheses to be explored and tested in the second phase.

To drive innovation and productivity in Europe requires a new approach to the Single Market and then use every lever, including competition and trade policies and national reforms to make that a reality. The Single Market of the future will need to be easier to maintain and update, allow for more differentiation within the EU and be simpler to apply. To obtain citizens’ support, a revamped Single Market needs to be completed by effective social policies to deal with the human consequences of rapid economic adjustment. Only under these conditions will it be possible to make a fundamental policy choice in favour of an Open Europe.

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