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Economic performance and competition in services in the euro area: Policy lessons in times of crisis

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EXECUTIVE SUMMARY

Background and aim

Services have become the largest sector in euro area economies, providing the bulk of employment and income. Over the past decade rising demand has led to net job creation in most euro area services sectors. Nevertheless, the economic performance of the euro area in these sectors has been somewhat disappointing. Productivity growth in key services sectors, such as transport, wholesale and retail trade, tourism, sale and maintenance of motor vehicles and business services, lags growth in other countries. This may have been caused by various factors including inappropriate regulation and lack of competition, which tend to slow down the diffusion of new technologies and the pace of innovation.

A lack of competition and an inappropriate regulatory environment may also be reflected in the observed downward rigidities of prices in the services sector. Services generally show a higher inflation rate than goods and a relatively low frequency of price changes. Although inflationary pressures may not be a threat in the short-run, the downward rigidity of services prices is a main source of inflation over the medium-term. This is an important consideration when conducting monetary policy.

The services sector is also a key element in the adjustment mechanism within the euro area: in the absence of nominal exchange rate movements, appropriate responses to shocks need smooth internal prices adjustments. However price rigidities in services markets may hinder the necessary adjustment. Over the past couple of years, significant external competitiveness imbalances have built up, leading to diverging current account positions which have increased the exposure of some Member States to the financial turmoil. While some of the divergence has been driven by benign factors, underlying domestic imbalances in some Member States, inappropriate price and wage developments appear to have played an important role as well. In particular, there are indications that regulatory and other obstacles to an efficiently functioning services market in the euro area are larger than elsewhere in the EU and that less progress has been achieved in addressing these problems during the past decade. In particular, regulatory indicators measuring entry barriers in services show that some of the countries suffering most from competitiveness imbalances have the most restrictive regulatory environment.

Against the background of the weak growth triggered by the financial crisis and the recorded strong contraction in the manufacturing sector, a more dynamic and labour intensive service sector could help sustain growth. However, services in the euro area seem to have been hit harder by the crisis than in the European Union as a whole, which can at least in part be ascribed to a lower resilience to shocks due to insufficient reforms in the euro area. In fact an analysis of selected indicators of regulation, competition, market integration and innovation shows that poorly performing sectors make up one third of total value added in services in the euro area as opposed to only one fourth in the non-euro EU Member States. Moreover, some of the services sectors most affected by the crisis, such as logistics and telecommunications, are particularly important for adjustment in the euro area, as they have large interactions with other sectors of the economy. A poor performance of these sectors can therefore create negative spill-overs to the euro area economy as a whole.

This occasional paper analyses the main causes behind the poor performance of services sectors and evaluates the appropriate policy responses. It subsequently places this long run reform agenda in the context of the global present crisis and asks which measures should be prioritised to help fight the crisis while advancing the long run agenda.

Key factors explaining the poor performance of services in the euro area

The analysis in this paper identifies a number of explanatory factors for somewhat disappointing performance of services sectors in the euro area:

- The Single Market in services is still incomplete and therefore, many of the services sectors continue to be fragmented. Economies of scale and scope are inhibited and consolidation at a European level is thwarted. This is borne out by the fact that there are strong indications that it is as easy to trade in services with non-EU countries as with EU countries. Similarly, the price dispersion across countries has fallen in the goods' sector while it has not changed substantially in services. This is the case even though price dispersion in services is well above that in goods.

- There are many regulatory obstacles at national level in many services markets that act as barriers to entry, limiting the pressures of competition and reducing the possibilities for firms to achieve economies of scale. The euro area scores more poorly, both in terms of the level of regulatory barriers and in terms of progress achieved, than the EU on average.

- Linked to this, it is less easy to do business, particularly for new companies, in the euro area than on average in EU-27. Start-up conditions are more restrictive and there are many licensing provisions. Given that there are many small and medium sized companies in the services who are particularly sensitive to these barriers, these conditions disproportionally affect this sector.

The Lisbon strategy already maps out an ambitious agenda to improve the functioning of services markets, with a specific focus on the euro area

To address these challenges, the EU has developed an ambitious reform agenda under the Lisbon strategy combining measures at EU and national level. Implementation of this agenda has, however, been uneven and more progress is needed.

A key challenge is to ensure the timely and full transposition of the Services Directive by Member States. This should make it easier to establish and provide cross-border services and it should eliminate the restrictions currently making it more difficult for consumers and businesses to use services offered in Member States others than their own. Successful implementation could, therefore, be key to promoting new economic activity and employment opportunities as well as being an important driver of the recovery.

Regulatory obstacles and barriers to competition have been removed in many euro area countries in energy and telecommunication markets. However, the pace of reforms was more intense over the period 1998–2003 than over the period 2003-2008 and there is still a significant potential for further reforms aimed at improving business conditions, in particular in sectors such as professional services (where there are still restrictive access requirements and constraints on business conduct) and retail trade where spatial planning restrictions limit the setting up of retail outlets. Similarly, the pursuit of the “Better Regulation agenda”, including the removal of administrative burdens, has been uneven and more progress could be made in many countries.

The relatively poor performance of services in euro area Member States, as well as their importance for the functioning of the euro area, is already recognised in the Lisbon strategy. Since 2006, specific recommendations have been addressed to Member States in the euro area as a complement to recommendations addressed to specific countries: they focus on those aspects of reforms which are especially relevant for facilitating smooth adjustment in the absence of national monetary and exchange rate policies. From the outset, they have included a recommendation to euro area Member States to improve the functioning of services markets, and the Spring European Council of 2009 once again called on euro area countries to "…step up reforms that increase flexibility and competition in goods and services markets and contribute to deepen the internal market".

Improving economic performance of services is also essential in response to the economic crisis

Improving the economic performance of services is not only important for long-term term growth, but this is also essential in a period of economic crisis.

- First, as services account for a large share of household's expenditures, lower prices of services can contribute to preserve the purchasing power of consumers and to cushion the impact of the crisis on the most vulnerable segment of the population.

- Second, services contribute to a large extent to the adjustment capacity of the euro area economy because they have large interactions with manufacturing as suppliers (utilities) or users (tourism) of intermediate inputs and because they are a vector of technology diffusion (computer services).

- Third, as many services are labour intensive, well functioning services can more easily absorb workers affected by restructuring.

- Finally, most reforms needed to improve the functioning of services' markets do not involve an upfront budgetary cost. With fiscal space having disappeared or diminishing fast in most Member States, such reforms can help demonstrate a credible commitment of authorities to fiscal sustainability and the achievement of the growth potential.

While, on average, services have been less affected by the economic crisis than manufacturing there are notable exceptions: the sale and maintenance of motor vehicles, post and telecommunications, air transport, hotels and restaurants. Some of these sectors seem to have been particularly hard hit, also in relation to past performance relative to overall services, and may therefore have been “overshooting” on account of the specific features of the crisis, which was characterised by strongly negative confidence effects and restrictions in access to credit.

Main principles for services markets as part of recovery efforts

The European Economic Recovery Plan (EERP), endorsed by the European Council, recognised that measures to fight the crisis should support household incomes, stimulate aggregate demand, reduce regulatory costs and be consistent with long run policy objectives. Applying these principles to the services sectors, leads to the following policy of do's and don'ts for policy making:

- The full and ambitious implementation of the Services Directive could make a major contribution to integrating the internal market for services in the EU, improve productivity and competition and provide an important stimulus.

- The active pursuit of the "Better Regulation" agenda, notably the reduction of administrative burdens and obstacles to the "ease of doing business", could reduce costs and facilitate adjustment and reallocation of activity and should therefore be prioritised. These measures also have the important advantage that they do not come at a (significant) budgetary cost.

- The removal of entry and other regulatory barriers in sectors characterised by significant inefficiencies such as retail trade and liberal professions, could help to facilitate the reallocation of workers made redundant by the crisis and speed up their absorption in the services economy, thereby supporting employment. By reducing the costs of the provision of these services it would also prop up real disposable income and contribute to aggregate demand.

- Investment in ICT public infrastructure such as broadband and other high speed internet connections could help the diffusion of ICT and facilitate innovation in the services sector in addition to providing an important short term stimulus. It is obviously important that these measures are properly programmed and planned.

- Finally, it is important not to lose sight of the longer term economic policy objectives. The necessary reallocation of production factors may suffer if economic recovery plans lock in factors in low productivity sectors and activities. This is why it is essential to avoid direct support to enterprises in sectors characterised by significant overcapacity unless this is accompanied by measures to avoid locking in production (for example by limiting such support to sectors showing clear signs of "overshooting").

- For the same reason the reintroduction of protectionist measures and entry barriers should be discouraged.

1. INTRODUCTION

In the context of the current crisis, developments in the services sector are of vital importance. Efficient, well functioning services are essential for several reasons. First, efficiency gains in services may contribute to lower inflation rates, which in turn will help preserve the purchasing power of households. Second, since services are increasingly used as inputs in manufacturing and other non-service sectors, properly functioning services markets will have a positive impact on the economic performance of other sectors. Third, because most services are relatively labour intensive, a strong growth performance of these sectors will absorb unemployed workers hit by restructuring.

Developments in services are particularly important for the prospects of the economy as a whole, both because of their size and because of their interactions with the rest of the economy. Well functioning services markets are even more important for euro-area countries where efficient product markets are essential to facilitate adjustment to shocks. However, services markets continue to be less integrated and competitive than markets for goods. The specific characteristics of services (less tradable, lower scope for standardisation) partly explain this phenomenon. Nonetheless, with ICT being increasingly used in services and the ever finer slicing of value added chains, the tradability of services has increased significantly.

In reality, although services markets are becoming more open and integrated in the EU, there is not yet a Single Market for services. The lack of competition and market fragmentation that characterises some segments of the market can be associated with unnecessary and diverging regulatory national measures. These structural weaknesses of services are reflected in the challenges identified and measures proposed in the Lisbon reform agenda. With a heterogeneous and fragmented market, the reform agenda for services is still relatively large. Ongoing and planned reforms aimed at improving efficiency will have a significant impact on the evolution of prices and productivity in the sector. Further market integration in the services sectors could also speed up the process of structural reforms in the economies involved, initiating a virtuous circle of integration, competition and reforms. A larger market facilitates changes in specialisation. This is important for the transition to a “smarter” economic structure, particularly in times of crisis.

This paper is organised as follows. Section 2 reviews the economic performance of the euro area services sectors. It assesses their performance in terms of value added, productivity and price developments and analyses the impact of the crisis. Section 3 focuses on the structural characteristics of market services and reviews the functioning of markets along four dimensions: regulation, integration, competition and innovation. Finally, section 4 discusses possible policy responses to improve the functioning of services markets. It does so by proposing general principles and by attempting to identify best practices on the basis of the measures taken at Community and Member State level. The note concludes with some practical, operational suggestions in terms of how to move the reform agenda forward in times of crisis.

2. ECONOMIC PERFORMANCE OF THE SERVICES IN THE EURO AREA

2.1 Main economic characteristics of services

Services sectors are amongst the most dynamic in the euro area economy. While in the manufacturing industry production rose at an annual rate of 0.3% over the period 2000-2008, in services the annual turnover growth rate varied from 1.7% in 'hotels and restaurants' to 6.7% in 'water transport'. In construction, on the other hand, production growth rate was 0.1% only (see Table 1). Since the beginning of the decade, job losses in manufacturing have been quite substantial but jobs have been created in both the construction and most of the services sectors. Exceptions are the 'air transport' and the 'post and telecommunications' sectors. In these two sectors, structural reforms appear to have gone hand in hand with job losses. In most services sectors, however, rising demand has led to employment growth, particularly in ICT and knowledge-intensive sectors such as 'computer and related activities' and 'other business activities'.

Table 1: Development of economic importance of sectors over time – Average annual growth rate, 2000 to 2008

Code	Sector	Production	Employment
C_D_E	Total industry (excl. construction)	0.3%	-0.8%
F	Construction	0.1%	1.1%
Code	**Sector**	**Turnover**	**Employment**
G to N	Total Services	1.2%	n.a.
50	Sale, maintenance and repair of motor vehicles and motorcycles; retail sale of automotive fuel	1.9%	0.7%
51	Wholesale trade and commission trade, except of motor vehicles and motorcycles	3.3%	0.7%
52	Retail trade	2.5%	1.9%
H	Hotels and restaurants	1.7%	2.1%
60	Land transport	4.1%	1.0%
61	Water transport	6.7%	1.5%
62	Air transport	4.1%	-0.4%
63	Supporting and auxiliary transport activities; activities of travel agencies	4.7%	2.0%
64	Post and telecommunications	4.8%	-1.6%
72	Computer and related activities	4.8%	3.6%
74	Other business activities	6.6%	3.2%

Source: Commission services based on Eurostat.

As a consequence of its dynamism, the importance of the service sector in the euro area economy has significantly increased over time. Services (including network industries and non-market services) now account for around three quarters of the euro area's total value added and employment. Table 2 shows the contribution of different services sectors (at the two-digit NACE level) to total employment and value added. While some sectors such as 'whole sale and retail trade' and 'hotels and restaurants' are particularly important in terms of their employment share, others such as 'financial intermediation' and 'real estate activities' contribute significantly to overall value added. Moreover, services sectors merit ever greater attention because they are becoming increasingly integrated in overall production systems. In this respect, ICT and other knowledge-intensive service activities are often considered as having a strategic role in manufacturing production given their role as intermediate inputs.

Table 2 also shows labour productivity developments in the different services sectors over the period 1995-2005. The table illustrates that annual labour productivity growth rates in most services sectors fall below that in the manufacturing sector. This difference may be explained in part by the personal nature of many services, which holds back the labour-capital substitution often associated with technical progress. The figures, however, should be interpreted with caution: first, because there are problems in defining and measuring productivity in services; second, because of the positive impact on productivity that the use of some services as intermediates has on other sectors; and third, because of the substantial heterogeneity across services sectors. Indeed there are important differences in labour productivity growth rates between sectors. Relatively good performing sectors were 'water transport', 'post and telecommunications' and 'financial intermediation excluding insurance and pension funds'. On the contrary, negative productivity growth figures were recorded in 'insurance and pension funds', 'research and development', 'other business activities', 'hotels and restaurants' and marginally 'real estate activities'.

Table 2: Economic importance and performance in the euro area

	Value added share (1)	Employment share (2)	Productivity growth (3)	Interlinkages with the economy (4)
Wholesale and retail trade				
Sale, repair of motor vehicles	1.7	2.2	0.5	B
Wholesale trade	3.8	4.3	2.1	B-F ; U
Retail trade	4.4	8.5	1.1	B-F; U
Transport and communications				
Inland transport	2.5	2.5	2.0	F
Water transport	0.4	0.1	9.4	
Air transport	0.4	0.2	0.8	
Supporting transport activities	1.9	1.4	0.1	F
Post and telecommunications	2.7	1.5	7.3	F ; P
Financial intermediation				
Financial intermediation, excl. insurance, pension funds	4.3	1.7	4.2	
Insurance and pension funds	1.1	0.5	-2.8	
Activities related to financial intermediation	0.8	0.7	1.4	

Business services				
Renting machinery and equipment	1.3	0.3	2.3	F ; U
Computer and related activities	1.9	1.6	1.0	F ; U ; I
Research and development	0.4	0.4	-0.8	U
Other business activities	7.7	9.6	-2.0	F ; U
Other market services				
Hotels and restaurants	2.4	4.9	-0.4	B
Real estate activities	10.6	1.0	-0.01	
Non-services sectors				
Manufacturing	17.6	15.9	2.3	
Construction	6.2	7.3	-0.2	I
Motor vehicles	1.4	1.1	2.5	B;I
Basic metals	0.8	0.5	1.0	F
Chemicals	3.1	1.8	3.3	B-F
Machinery	2.1	1.8	1.4	B;I

Source: Commission services based on EUKLEMS database, release March 2008.

(1) Share of Gross value added Total Industries, at current basic prices, 2005.
(2) Share of total hours worked by employees, 2005.
(3) Gross value added per hour worked, average annual growth 1995-2005.
(4) B: Backward oriented (sectors, being large purchasers of intermediate inputs from the rest of the economy); F: forward oriented (sector being large suppliers of intermediate inputs to the rest of the economy; I: sectors having a share above 10% of gross capital formation in total commodity output; U: ICT user; P: ICT producer.

Inflation in market-related services over the last two decades has been generally higher than inflation in (non-energy) goods in the euro area (with a gap of around 2 percentage points for the period 1991-2008). The persistent gap may be explained by a number of factors: demand factors related to increasing real incomes, sectoral productivity growth differentials in favour of goods, rising mark-ups induced by a lack of competition in services (see discussion in next section), price competitiveness pressures from low-cost countries affecting tradable goods, etc. Although all explanations seem to have played a role, the most important factors from a policy perspective are a (poor) productivity performance and rising mark-ups (see ECB, 2009).[2] Policies aimed at increasing productivity and competition in services would have an impact in reducing inflationary pressures over the medium term.

Generally, the frequency of price changes is lower in services compared to manufacturing, although price changes are mostly upward (40% of price changes in manufactures are price decreases, while for services the figure only reaches 20%).[3] As the degree of services price rigidity differs from country to country, persistent cross-country differences in services inflation emerge. The lower frequency of price changes for services could be traced back to a number of factors: i) the low level of competition in the sector; ii) the pursuit of long-term relationships with customers and explicit contracts that are costly to renegotiate; iii) the fact that the costs of providing services are relatively stable (and most of the services costs are

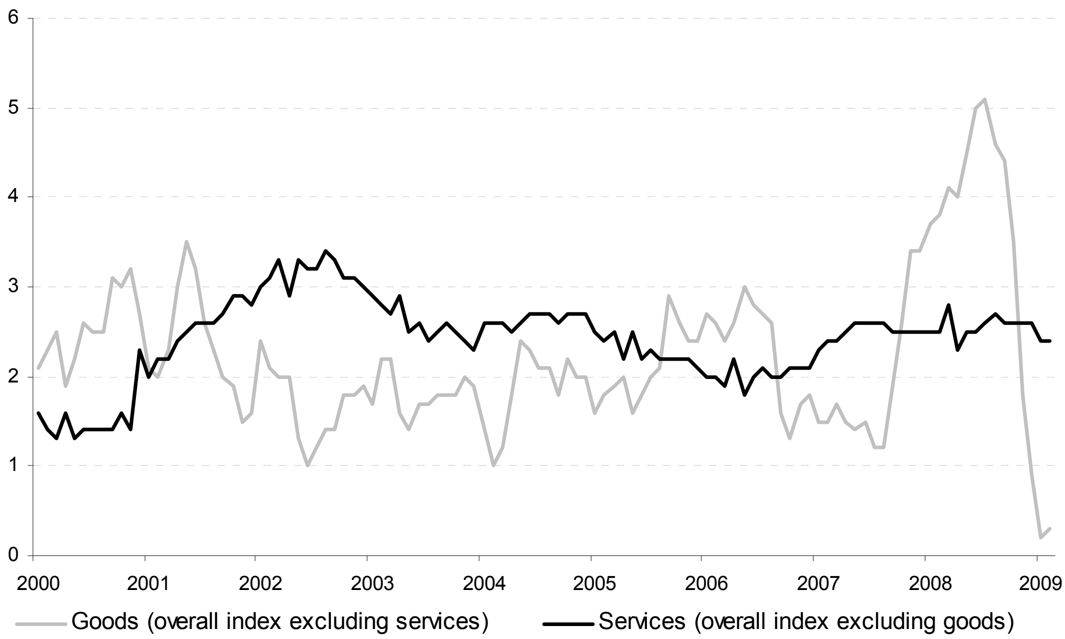
[2] According to ECB (2009), the labour productivity gap between manufactures and services was 1.3 percentage points during the period 1996-2005. During the same period, the profit mark-up was 37.3% for market services and 9.8% for manufactures.

[3] 40% of price changes in manufactures are price decreases, while for services the figure falls to 20% (see ECB (2007)).

labour costs and wages which change infrequently).[4] Empirical studies have found that in general prices change more frequently in services having high energy content and less frequently in services with high labour content. Based on these findings, prices are expected to change more frequently in inland transport, water transport and air transport which are energy intensive sectors, and less frequently in wholesale and retail sectors which are more labour intensive. Moreover, an examination of the degree of pass through of price changes from producer prices to consumer prices has shown that the retail sector generally adds a significant degree of price rigidity to consumer prices relative to producer prices.[5]

Figure 1A shows inflation developments in the euro area. Services inflation appears to be much less affected by the business cycle than goods inflation. The most recent up- and downswing in goods inflation has left little trace so far in services inflation.

Figure 1A: Harmonized indices of consumer prices (2005=100) - Monthly data (annual rate of change)



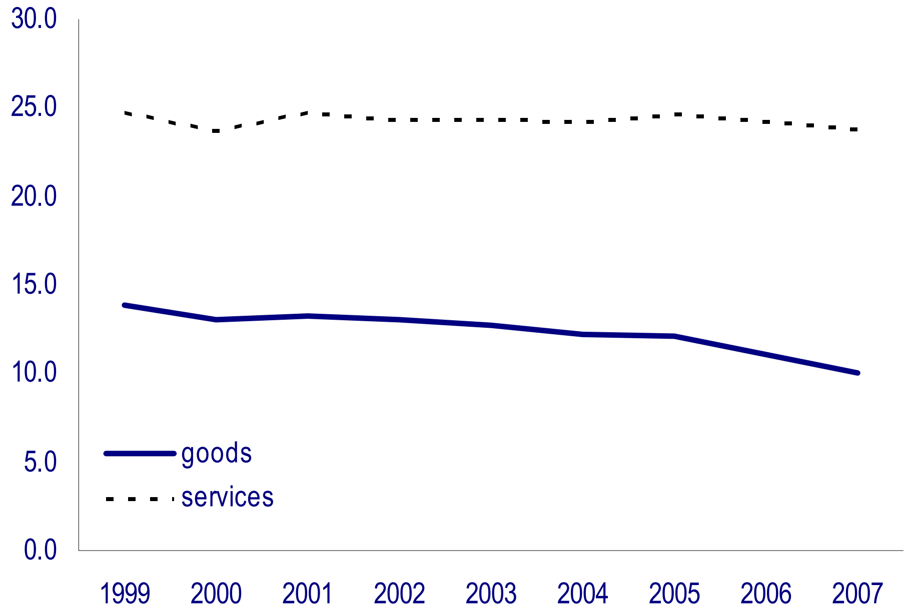
Source: Eurostat.

As shown in Figure 1B, while a clear trend towards convergence in the price level is evident for goods, convergence in price levels of services in the euro-area shows a flat path. The dispersion in price levels of services (as measured by the coefficient of variation) decreased only slightly from 25% in 1999 to 24% in 2007. On the contrary, price levels of goods showed a clear convergence with a decline in the coefficient of variation from 14% in 1999 to 10% in 2007. This result is an indication of the lower degree of integration across the euro area of services compared with goods (see next section).

4 See ECB (2007).

5 See Dhyne et al. (2009).

Figure 1B: Convergence in the price levels of goods and services, euro area (in % - 1999 – 2007)



Source: European Commission, DG ECFIN.
Note: Standard deviation of price levels of euro area countries compared to the euro area average.

Price rigidities, inflationary pressures and persistent cross-country differences in services inflation across countries have consequences for the conduct of monetary policy within the euro-area and could have an impact on the competitiveness positions of individual euro area Member States. In the absence of nominal exchange rate fluctuations as a shock-absorber, a smooth adjustment to economic shocks will require relative prices changes and thus flexible prices and wages. The issue is important given the existence of large competitive divergences within the euro area and the persistent deterioration of competitiveness in some Member States.

The heterogeneity of the regulatory environment contributes to explain the cross-country variation in services inflation and plays an important role in the adjustment mechanism within the monetary union. Indeed, as shown recently by Ruscher and Wolff (2009), the non-tradable component of the real effective exchange rate accounts for a significant and increasing contribution to change in intra-euro area competitive positions. Similarly, Burstein et al. (2005) also find, for a sample of OECD countries, that changes in the relative price on non-tradables could explain up to half of REER cyclical variations.

Focussing only on the Member States that adopted the euro in 1999 and 2000[6], there is an increasing divergence in competitiveness and current accounts positions within the euro-area

6 Movements in the competitiveness position of Malta, Cyprus, Slovakia and Slovenia are likely mainly driven by catching-up effects.

(see Table 3). Some Member States have steadily improved price competitiveness vis-à-vis the rest of the euro group (e.g. DE, FR), while others have experienced sharp losses in competitiveness (ES, IE, GR, PT). The later countries also show large external imbalances as measured by their high negative current account over GDP level. These countries are also the countries with the highest inflation in services (Spain, Greece, Ireland and Portugal). Looking forward, the unwinding of these intra-euro-area external imbalances will require large adjustments in relative prices and the reallocation of resources between sectors, in particular between tradable and non-tradable (mostly services) sectors. Efficient and flexible service sectors will be necessary to make sure that these adjustment processes run smoothly.

Table 3: International competitiveness and inflation in services

	Changes in REER(1)	**Current account balance (2)**	**Inflation in services (3)**
	cummulative change 1999-2008	2008	average 1999-2008
ea16		-0,8	2,2
Belgium	1,5	-1,7	1,9
Germany	-5,9	6,6	1,4
Ireland	13,3	-5,3	4,4
Greece	6,4	-12,6	3,3
Spain	10,2	-9,5	3,5
France	-2,8	-3,8	2,0
Italy	2,6	-3,0	2,3
Cyprus	5,9	-15,2	2,9
Luxembourg	1,5	8,3	2,6
Malta	10,2	-7,1	3,0
Netherlands	3,1	8,4	2,5
Austria	-1,8	3,3	2,0
Portugal	5,6	-12,2	3,4
Slovenia	6,7	-5,9	5,0
Slovakia	100,5	-6,8	6,9
Finland	-2,6	2,1	2,4

(1) Monthly real effective exchange rates (HICP deflator) against other ea countries, in %. *Source*: Commission services.
(2) Balance on current transactions with the rest of the world (National accounts), in % of GDP at market prices. *Source*: AMECO.
(3) HICP Annual rate of change. Overall index excluding goods (base year SI: 2000), in %. *Source*: Commission services.

2.2 Services and the crisis[7]

Services sectors are very heterogeneous and show different responses to economic downturns. Turnover growth rates summarised in Table 4 show that although not all sectors have been affected with the same intensity by the crisis, practically all sectors exhibit some deceleration in growth rates. The sectors which have been particularly hard hit are air transport, hotels and restaurants, post and communications, retail trade and motor trades.

However, output continued to grow in many services activities such as land and water transport, and some business services. Table 4 also reports data for the euro area (in brackets) and shows that for the majority of sectors with available data, the decline has been larger than for non euro area, the only exception being other business activities.

Compared to manufacturing industries, the effect of the crisis on the services sectors is more moderate. However, even though the largest declines in euro area activity appear to have been concentrated among the manufacturing activities, sectoral interrelations, measured using output multipliers, play an important role in the way crises spreads over the economy. In this sense, some of the most affected manufacturing sectors have large output multipliers and changes in final demand for those sectors can quickly spread to other sectors and, ultimately, to the economy as a whole. For example, manufacturing sectors such as motor vehicles, basic metals, wood and wood products, that have showed significant contraction, have important multiplier effects on services activities, mainly on other business activities, and wholesale trade.[8] In addition, the sharp decline in exchanges of goods in times of crisis has negative repercussions on freight transport (maritime, but also inland transport).

Table 4: The sectoral impact of the crisis in the EU

	Annual Turnover Index Growth (1)		Spread minus average spread (2)	Share in total value added (Eurozone, 2005)
	2008 Q2	2008 Q3		
Sale, repair of motor vehicles	n.a.	-8.0 *	**-10.5**	1.68%
Wholesale trade	n.a.	4.5*	2.0	3.81%
Retail trade	-0.1 (-1.1)	-1.6 (-2.4)	n.a.	4.42%
Inland transport	13.5 (5.1)	9.2 (4.2)	2.1	2.48%
Water transport	6.4 (4.7)	9.0 (7.2)	0.4	0.41%
Air transport	10.9 (8.5)	2.4	**-5.3**	0.41%
Supporting transport activities	5.0 (5.5)	4.6 (4.5)	**-3.2**	1.95%
Post and communications	1.4 (1.2)	0.5 (-0.2)	**-7.3**	2.71%

7 At the time of preparing this section the crisis is not yet over and thus the sectoral data presented and analysis carried out is a snapshot of the effects of the crisis in the second quarter of 2008. The results presented here are therefore not necessarily representative of the whole crisis period.

8 See European Commission (2009a).

Financial intermediation				
Business services				
Renting machinery and equipment	n.a.	n.a.	n.a.	1.26%
Computer and related activities	6.4 (6.0)	4.5 (4.1)	**-3.8**	1.84%
Research and development	n.a.	n.a.	n.a.	0.37%
Other business activities	10.1 (11)	7.8 (11.2)	**-0.6**	7.71%
Hotels and restaurants	2.4 (1.2)	1.1 (-0.8)	**-6.1**	2.37%
Real estate activities	n.a.	n.a.	n.a.	10.58%
Construction	n.a.	-4.5*	n.a.	6.2%
Motor vehicles	n.a.	-20*	**-13.1**	1.3%
Basic metals	n.a.	-15*	**-7.6**	0.8%
Chemicals	n.a.	-6.0*	**-0.5**	1.9%

Source: European Commission, DG ECFIN.

(1) In brackets data for euro area. Annual growth over the same quarter of the year before (Q2 and Q3 for all sectors, Q3 and Q4 for retail sector). (*) Data refer to November 2008 over November 2007. *Source*: Eurostat.

(2) The spread is the difference between sectoral growth in services turnover and other services turnover (in pp). For services, turnover growth in Q3 2008 by sector minus overall services turnover growth compared to long term trend (i.e., compared to the difference of the average services turnover growth by sector and the overall services turnover growth over 2000-2008). For manufacturing, industrial production (IP) growth in Q4 2008 by sector minus overall manufacturing growth compared to long term trend (i.e., compared to the difference of the average IP growth by sector and the overall manufacturing growth over 1996-2008).

A related question concerns the extent to which the current crisis is producing an overshooting or overreaction in some sectors. The identification of 'overshooting' sectors, i.e. sectors where a fall in production has been particularly acute, is done by comparing the difference between sectoral turnover growth of sector *i* and overall services growth during the crisis period to the same difference over 1990-2008.[9] Table 4 presents the results for non financial service sectors and reveals that motor vehicles trade, telecommunications and hotels and restaurants show clear signs of disproportionate adjustment. These sectors are also important for the EU economy in terms of their share in total value added and interlinkages with the rest of economy (see Table 5). Table 4 also displays the results for the manufacturing sectors displaying a high degree of overshooting. Although the numbers are not directly comparable (for services the spread is calculated using turnover while for manufacturing goods production is used as a basis for the calculation) the information they convey is still useful, and reinforces the result that the crisis has hit manufacturing sectors harder than services sectors.

9 Compared to manufacturing, data on services are not available for all sectors (data are not available for real estate activities, financial intermediation, renting of machinery and equipment). Therefore, the identification of overshooting sectors might be overestimated or underestimated and should be taken as an indication of possible overreaction.

Table 5: Service sectors and overshooting

	No overshooting**	Overshooting
Service sectors with a high share in total value added*	**Land transport** **Wholesale trade** **Other business activities**	**Computer and related activities** **Supporting transport activities** **Hotels and restaurants** **Post and telecommunications** **Trade of motor vehicles**
Service sectors with a low share in total value added	Water transport	Air transport

* High share sectors are those with a value added share above the median of all services (1.6).
** Overshooting corresponds to overshooting vis-à-vis overall services.
See footnote 9 for the limitations due to the availability of data.
In bold, sectors important for the adjustment of the economy (having many interlinkages with the rest of the economy).

3. STRUCTURAL CARACTERISTICS OF SERVICES

3.1. Market functioning in services

This section analyses the functioning of market services in the euro area along four dimensions. First, it looks at the regulatory environment of services. Second, it examines the extent to which services are well integrated in the Single Market. Third, it discusses the intensity of competition. Finally, it assesses the innovation performance of services. These findings should be considered with caution: first because of the high degree of heterogeneity that characterises the service sectors; second, because the analysis is carried out at a relatively aggregated level on the basis of a battery of relatively simple publicly available data; third, because there are significant data limitations in services both in terms of availability and quality.

The section shows that some of the euro-area countries having the most restrictive regulatory environment are those suffering most from external competitiveness imbalances and showing the highest inflation rate in services. Existing empirical literature has found that stronger competition leads to more frequent price changes, while price regulation has been identified as a major factor in slowing nominal adjustment.[10] Therefore, the enactment of reforms leading to reductions in or the elimination of price controls in sectors such as retail trade and road transport over the 1998-2008 period is expected to have improved price adjustment in these sectors.[11] Furthermore, reforms aimed at increasing competition in services such as the reduction in barriers to entry in services or the reduction of the amount of regulatory restrictions is expected to contribute to a rise in the frequency of price changes, reduce the degree of price stickiness and facilitate the adjustment process within the euro-area.

[10] ECB (2006, 2007), Dhyne et al. (2009).

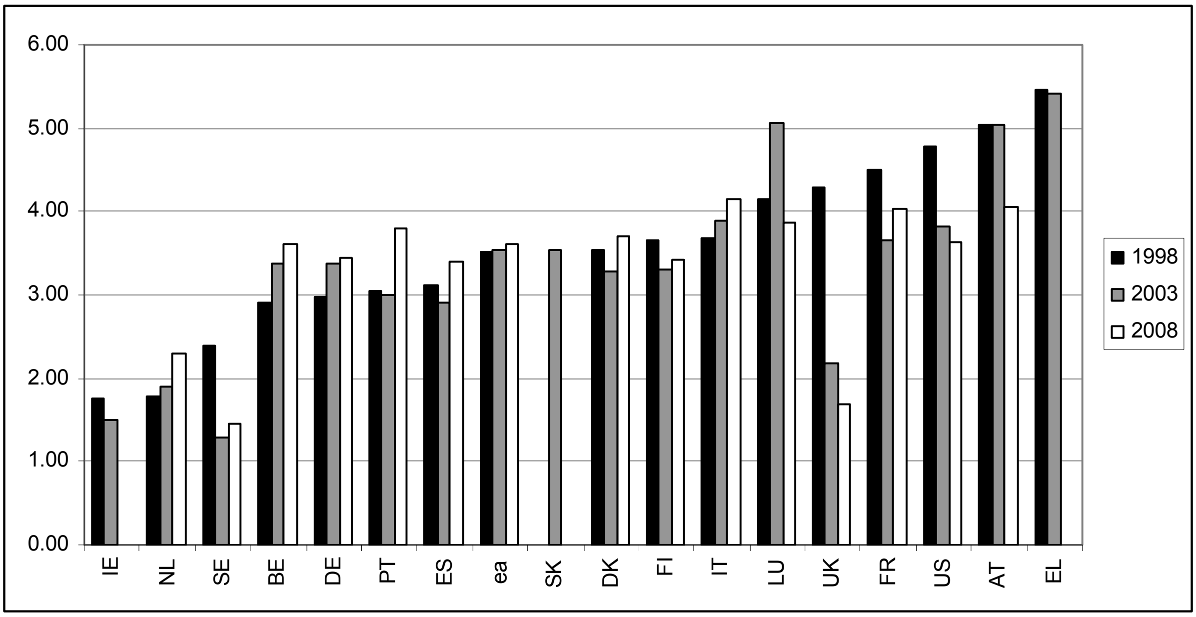
[11] See OECD (2009).

3.1.1 Regulation

The dynamism of the business environment in the euro area remains hampered by the difficulties of starting and making new businesses grow. Market entry rates continue to be higher in the US than in most euro area countries and the UK.[12] Moreover, the growth performance of new entrants is better in the US.[13] Firm's entry and exit is part of Schumpeter's creative destruction process that promotes productivity-enhancing strategies of incumbents. Evidence suggests that firm turnover rates are higher in the US than in the EU and as a result the EU is less likely to benefit from growth-enhancing effects coming from this churning process. In a study for the US retail trade business sector, Foster et al. (2002) found that almost all productivity gains have come from this source.

In 2008, entry barriers in services were substantially higher in many euro area countries than in non euro area countries, such as the UK and Sweden (see Figure 3A). Furthermore, while over the period 1998-2008, entry barriers in services decreased in the US and in non euro area countries, such as the UK and Sweden, they continued to increase in nearly half of the euro area countries over the same period, including those countries with persistent competitiveness losses over the past years and high inflation in services (e.g. Spain, Portugal, see previous section).

Figure 3A: Entry barriers in services



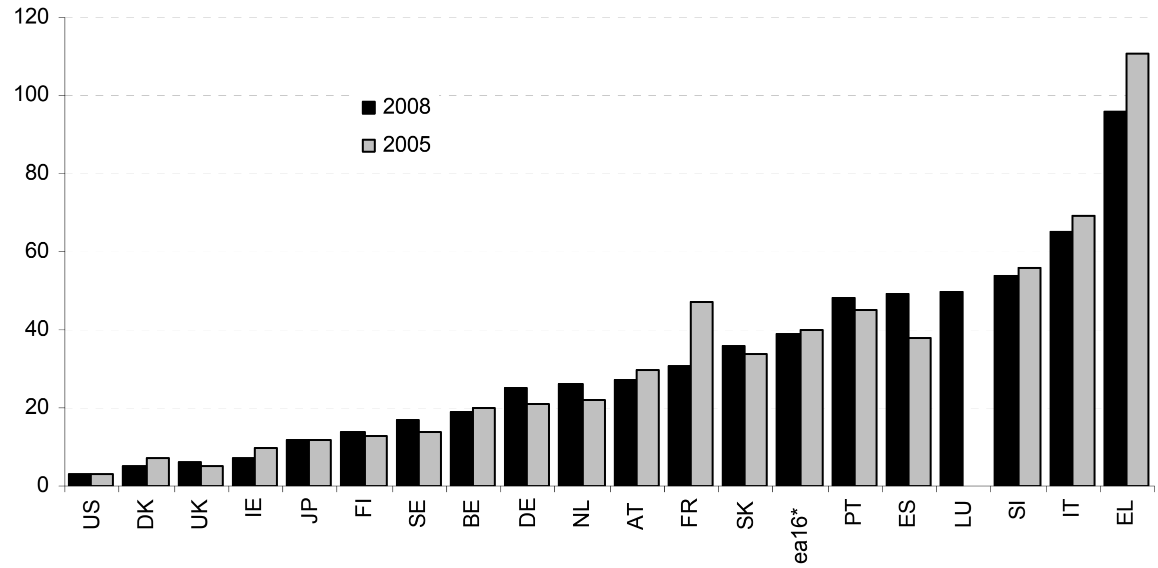
Source: Wölfl et al. (2009).

[12] Cincera and Galgau (2005).

[13] Bartelsman et al. (2005), European Commission (2007).

The ease of doing business index also shows that although the business environment has generally improved in many euro area countries, it is still significantly harder to do business in the euro area compared to the US, but also to some non-euro area countries such as the UK and Denmark (see Figure 3B).[14] Such lack of business dynamism reflects, amongst other factors, the remaining rigidities caused by EU product market regulations which, according to OECD, remained relatively burdensome in 2008, despite the several programmes of reforms put in place over the past fifteen years.

Figure 3B: Ease of Doing Business Index (rank)



Source: Doing Business 2009, 2006, World Bank and International Finance Corporation.

* ea16: Simple average, excluding Cyprus, Luxembourg (2005) and Malta.

Given that for most services, FDI is the main channel through which firms enter new markets, it is also interesting to examine the extent to which barriers to FDI are still present in euro area countries. The OECD's PMR sub-indicator on barriers to FDI show that while, in 2008, barriers to FDI in euro area countries are generally slightly higher than in the US, the UK or Denmark, they have come down considerably since 1998 in nearly all of the euro area countries.

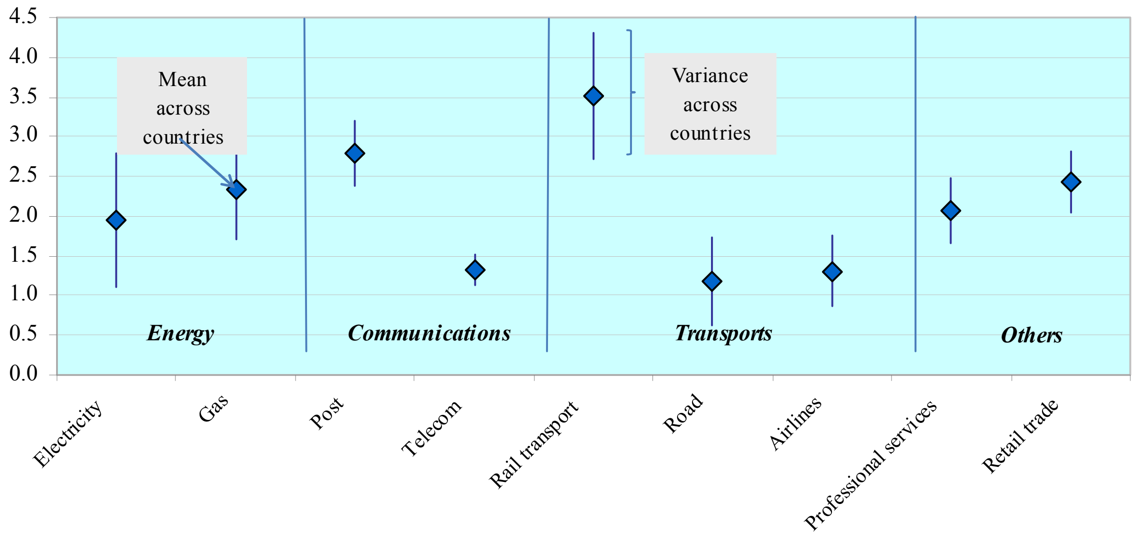
A different picture emerges for network industries where a significant effort of opening up has been made in the EU. In these services, entry barriers have decreased dramatically in the euro area countries between 1998 and 2008 and, in 2008, they are substantially lower in all euro area countries than in the US. However, in two non euro area countries, namely the UK

[14] The ease of doing business index is presented by the World Bank in its publication on "Doing Business 2009". The index ranks economies from 1 to 181 on the basis of the 10 following criteria: starting a business, dealing with construction permits, employing workers, registering property, getting credit, protecting investors, paying taxes, trading across borders, enforcing contracts and closing a business. It provides information on top reformer countries. The calculation of the index is based on the ranking of the simple average of its percentile rankings on each of the 10 topics covered in Doing Business 2009.

and Denmark, entry barriers in network industries have decreased even further over the 1998-2008 period and, as a result, they are lower than in euro area countries in 2008.

By contrast, it appears that there is still substantial scope to improve the regulatory environment in services sectors such as postal services, retail trade and professional services. In postal services, restrictive regulations are largely due to an important share of public ownership in incumbent firms as well as to relatively slow liberalisation of competitive activities. In professional services, restrictive regulation is due to access requirements and constraints on business conduct and in retail trade, to persistently restrictive licensing for setting up retail outlets (see Figure 3C).

Figure 3C: Distance from best practice regulation by sector, 2008



Source: OECD, Product Market Regulation Database.

The data available on regulation indicators seems to clearly show that regulation remains a cross-cutting issue which affects market functioning in many services industries in euro area countries. The regulatory framework is particularly stringent when it comes to creating barriers to entrepreneurship that limit the entry of new firms in sheltered sectors. Therefore, in many cases, the heavy regulatory framework is closely intertwined with integration and competition problems.

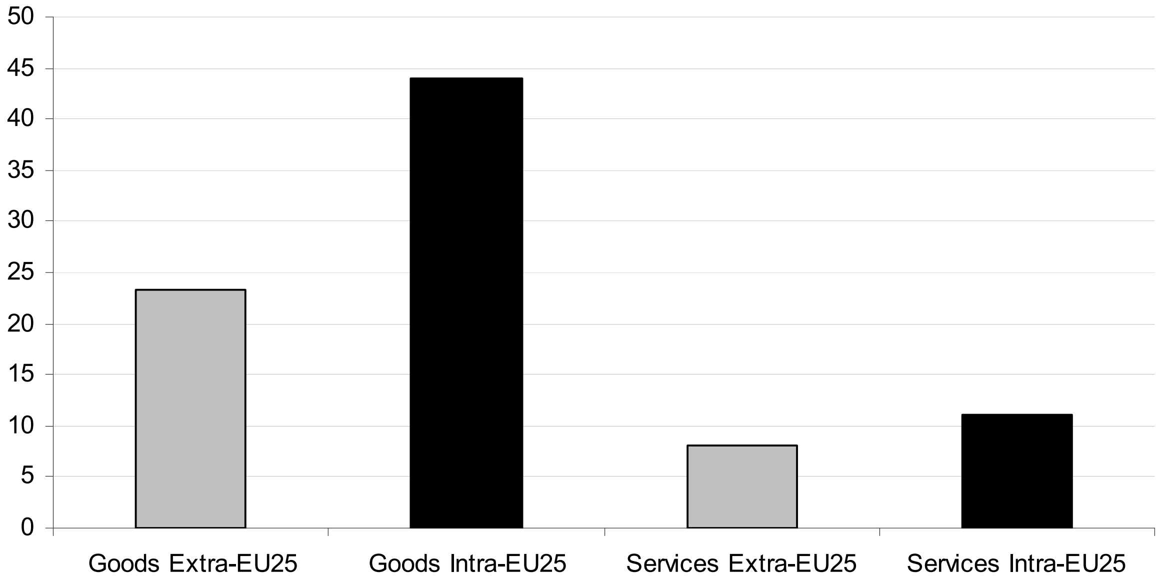
3.1.2 Market integration

The level of integration, meaning the extent to which international trade and foreign investment flows have been liberalised and prices of goods and services have converged across borders, is a crucial element to take into account when analysing the functioning of markets. The effect of removing tariffs and non-tariff barriers to cross border transactions is equivalent to increasing the size of the market, giving firms an opportunity to capture the benefits of increasing returns to scale both in production as well as in distribution and marketing activities. Integration is also a powerful device for disciplining firms, forcing them to behave in a more competitive way, to seek new ways of doing business and to innovate while driving out the least efficient players of the market. Over time, assuming competitive pressure is sustained, this process of industrial restructuring will also result in dynamic efficiency gains.

The Single Market, together with the single currency, has promoted economic integration within the European Union and the euro area, through increased intra-EU trade and FDI. However, while trade barriers have come down in manufacturing, the progress of trade in services has been much slower. The implementation of the Services Directive by the end of 2009 should help remedy this weakness. Nevertheless, it is likely that in the foreseeable future cross-border trade in services will remain well below that of manufacturing goods. While services amount to 70% of employment and value added in the EU, they account only for 20% of intra-EU trade.

Moreover, while the ratio of intra-EU trade over GDP is significantly above that of extra-EU trade, indicating that there is a Single Market effect for goods, this does not seem to be the case for services where the two ratios are very close (see Figure 3D). Completing the Single Market for services could contribute to improve the competitiveness of the euro in these sectors. This is particularly important because the increasing tradability of services, triggered mainly by the wider diffusion of information and communication technologies (ICT), has increased competition in world markets in many services sectors.

Figure 3D: Services and manufactured goods trade in 2007 as a % of GDP



Source: European Commission (2009c).

One way for companies to overcome international trade barriers is to establish subsidiaries abroad and service foreign markets via such subsidiaries. Such a strategy involving either takeovers or other forms of direct investments might seem particularly promising in the services sector. However, the level of protection and barriers to entry in the service sectors continues to act as a strong deterrent to cross-border mergers and acquisitions across countries.[15] Over the period 2002-2006, the average share of cross-border M&A deals over total deals is lower in services sectors than in manufacturing. Among services, the retail trade and hotels and restaurants sectors stand out as having a particularly low share of cross-border M&A deals (see table A1 in Annex 3 for more details).

15 Baldwin et al. (2008).

Another indicator of market fragmentation is the degree of price dispersion. Over the period 1999-2007, price dispersion is generally higher in services than in manufacturing. The energy sector as well as the financial intermediation, insurance and other business activities sectors show especially high levels of price dispersion.

Based on these indicators, it seems that the following services sectors suffer from particularly serious problems in terms of market integration: electricity, gas and water supply, retail trade, hotels and restaurants, financial intermediation, insurance and other business activities sectors.

3.1.3. Competition

Competition problems also seem to be far more frequent in service sectors than in manufacturing. Mark-ups in services tend to be significantly higher in the euro area than in the US and this is particularly the case in sale and repair of motor vehicles, recreational activities, retail trade and other service activities. Furthermore, services sectors tend to have a lower market turbulence indicator[16] compared to the US, indicating that there are a lower number of firms entering and exiting the top eight firms in service industries in the euro area compared with the US. The most problematic sectors according to the turbulence indicator are: electricity, gas and water supply, post and telecommunications and other service activities.

In addition to the mark-up and market turbulence indicators, data on market concentration as measured by the C8 indicator[17] point to particularly significant competition problems in the post and telecom sector, as well as in inland transport and hotels and restaurants. Finally the services sectors with the largest number of antitrust cases reported over the 1999-2006 period are: post and telecommunications, electricity, gas and water supply and recreational activities.

Based on these indicators, it appears that weak competition is a cross-cutting issue affecting many services industries in the euro area. The most problematic sectors in terms of competition are: post and telecommunications, electricity, gas and water supply and other service activities (see table A2 in Annex 3).

3.1.4 Innovation

The growing structural specialisation of industrialised economies towards service sectors implies that their innovative performance will be a crucial determinant of long run growth in Europe. Service sectors are perceived as being less innovative than manufacturing because R&D spending and the number of patents obtained by service firms are relatively low.

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16 The indicator of market turbulence is the "total number of different firms index" which is defined as the ratio of the number of firms that have belonged to the group of the 8 largest firms in the years between 2002 and 2005 over the maximum number of firms (32) that could have potentially been included in this group over this period. See Ilzkovitz et al. (2008).

17 The C8 ratio measures the cumulative market share of the eight largest firms in a sector.

However, these two indicators are somewhat misleading since innovation in services tends to take the form of incremental changes introduced to processes and procedures.

The examination of innovation inputs, outputs and outcomes (see table A3 in Annex 3) shows that the euro area performs less well in terms of innovation performance compared to the US, which suggests that there is room for improvement both in terms of research, based on the analysis of R&D investments and patent applications, as well as in terms of technological uptake and diffusion. However, this poor innovation performance is a cross-cutting issue affecting both manufacturing industries and services to similar degrees.

3.1.5 An overview of the market functioning in services

Overall, many services sectors show signs of problems in all four domains analysed above. Among the services sectors, electricity, gas and water supply, retail trade, hotel and restaurants, and other business activities show indications of problems in three out of four policy domains. Furthermore, a significant number of services sectors show signs of serious problems in two out of four policy domains: sale and repair of motor vehicles, wholesale trade, water transport, supporting transport activities, recreational activities (see Table 6).

Table 6: Summary overview of the causes for market malfunctioning

SECTORS	Regulation[1]	Integration	Competition	Innovation
E – Electricity, gas and water supply	**	**	**	*
F – Construction	-	n.a.	-	-
50 – Sale, maint. and repair of motor vehicles	**	-	*	**
51 – Wholesale trade	**	-	*	**
52 – Retail trade	**	**	*	**
H – Hotels and restaurants	*	**	**	**
60 – Inland transport	*	*	*	*
61 – Water transport	**	-	**	*
62 – Air transport	*	*	**	*
63- Supporting and aux. transport activities	**	-	**	*
64 – Post and telecoms	*	-	**	*
65 – Financial intermediation	*	*	**	*
66 – Insurance and pension funding	*	**	*	*
67 – Activities related to financial intermediation	*	n.a.	-	n.a.
71 – Renting of machinery and equipment	-	n.a.	-	**
72 – Computer and related activities	-	n.a.	*	**
73 – Research and development	-	n.a.	**	*
74 – Other business activities	**	**	*	**
90 – Sewage and refuse disposal	n.a.	n.a.	*	**
91 – Activities of membership organisations	n.a.	n.a.	**	-
92 – Recreational, cultural and sporting activites	n.a.	*	**	**
93 – Other service activities	n.a.	n.a.	**	-

Note: ** means that there are indications of potentially serious problems in the policy domain concerned.
* means that the presumption of problems cannot be rejected.
\- means that there is no evidence of potential problems on the basis of the indicators used.
[1] The column on regulation is based on the 2003 OECD REGREF indicators, updated with information on regulation provided in OECD (2009).

3.2 A screening of services presenting potential signs of market malfunctioning

The European Council has adopted country-specific recommendations prioritising service sectors in many euro area countries because these sectors are more fragmented than manufacturing industries. In this section a preliminary screening of services sectors allows identifying those sectors which are important (i) for growth and (ii) for adjustment in the euro area countries, and (iii) show signs of potential market malfunctioning (see Annex 4). The results should be complemented by an analysis of the causes of malfunctioning as a further robustness check.

Table 7: Comparison of the euro-area versus the non-euro area

GDP benchmark	Total number of selected sectors	SUM Value added selected sectors		
EURO		Total	Manufacturing	Services
AT	17	40%	5%	36%
BE	21	37%	10%	27%
CY	27	46%	7%	39%
DE	18	41%	11%	30%
EL	22	37%	5%	32%
ES	24	53%	12%	41%
FI	22	43%	15%	28%
FR	12	20%	2%	18%
IE	14	28%	4%	23%
IT	30	61%	15%	46%
LU	18	48%	4%	45%
MT	23	47%	7%	40%
NL	16	28%	6%	22%
PT	27	52%	10%	42%
SI	13	26%	4%	21%
SK	23	46%	9%	37%
Average	**20.4**	**40.8%**	**7.9%**	**32.9%**
Non EURO		Total	Manufacturing	Services
CZ	17	37%	8%	29%
DK	28	47%	12%	35%
EE	25	39%	16%	23%
HU	24	52%	13%	40%
LT	13	29%	4%	25%
LV	20	41%	7%	34%
PL	21	40%	10%	30%
SE	16	26%	9%	17%
UK	11	15%	3%	12%
Average	**19.4**	**36.2%**	**9.0%**	**27.2%**

The analysis shows that, on average, the services sectors presenting potential problems of market malfunctioning[18] accounted for a large share of value added in euro area countries

[18] The differentials in the productivity growth rate over the period 1995-2005 (Source: EU KLEMS March 2008, gross value added per hour worked, volume indices, 1995=100) compared to a benchmark is used as an indication of market malfunctioning. This has a number of limitations, as sluggish productivity performance gives only a first indication of potential market malfunctioning and there can be other legitimate reasons for productivity growth to vary such as different starting positions or variations over the business cycle.

than in non euro area countries.[19] The share in total value added of services presenting indications of potential malfunctioning ranges from 18% in France to 46% in Italy (see Table 7). Four euro area countries, namely Spain, Italy, Luxembourg, and Portugal stand out as having the highest share of services sectors (expressed in % of total value added) presenting signs of possible malfunctioning.

Moreover, a number of services are selected in most euro area countries, such as energy, transport, post and telecommunications, wholesale and retail trade, hotels and restaurants, and business services. This is an indication of problems in the whole euro area and this may require coordinated action across the euro area or even at the EU level as a whole.

4. POLICY RESPONSE

4.1 General policy principles

With the launch of the Lisbon strategy for growth and jobs in 2000 and its re-launch in 2005 the EU Member States agreed on a joint long-term agenda of structural reforms. While there have been ups and downs the Lisbon strategy has created a greater awareness of the need for a stronger reform effort. The economic crisis has made clear to everyone that problems continue to hamper the functioning of European labour, capital and product markets. The resilience of the euro area economy to what was initially an external shock has been disappointing.

The previous sections have illustrated the relatively poor economic performance of the different services sectors over the past decade. While not all services sectors have been affected equally by the crisis, a review of the structural characteristics of the sector as a whole clearly indicates weaknesses requiring a continuation of the policy initiatives initiated under the Lisbon strategy, such as reforms aimed at increasing the ease of doing business, encouraging market entry and competition, and stimulating the introduction and use of innovative technologies. Given the observation that many services sectors are closely linked with other sectors of the economy, an effort should be made to better integrate the services dimension into horizontal policies. R&D and innovation is a good example of an area where policies are perhaps too much targeted to address the needs of the manufacturing industry while underplaying the needs of the services sectors. ICT services in particular are at the heart of the high productivity growth experienced by some manufacturing industries and have an impact on the competitiveness of industry. O'Mahony and van Ark (2003), and McMorrow et al. (2009), among others have found that the delay in introducing ICT and process innovations in the sector (almost a decade later than in the US) is a main reason behind the relative poor productivity performance in the EU. Investment in ICT public infrastructure could help the diffusion of ICT and facilitate innovation in the services sector and beyond.

At the same time, it is impossible to ignore the more immediate needs associated with the economic crisis. As many services sectors (including 'retail trade', 'hotels and restaurants' and 'other business services') are labour intensive, output declines in these sectors have a disproportionate effect on the number of jobs lost. When devising a strategy to deal with the short-term impact of the crisis, the argument could be made to focus on these sectors first as

[19] This result is robust if we use alternative benchmarks to assess labour productivity growth in the euro area and in the non euro area. This result can be explained by the very good performance of the UK.

this will limit the number of jobs lost and help sustain consumer demand. The recently introduced possibility to reduce VAT rates in restaurants is an example of a policy initiative in this direction.

On the other hand, one should avoid undermining long-term, supply-side efforts aimed at improving the functioning of services markets with short-term measures that are in the end counterproductive. Sector or country specific measures may at a time of crisis be justified by 'overshooting' as explained before. However, the danger that such measures lead to market barriers and distortions is too serious to simply overlook. Community Single Market and competition policies have an important role to play in this respect. Moreover, given the scarcity of budgetary resources available, there is a need to ensure the efficiency and effectiveness of public fund spending, be it from Community or national sources.

4.2 What is being done at EU level

The performance of the services sector in the euro area continues to be affected by problems of market malfunctioning. These problems have already been addressed to some extent by the Lisbon strategy for growth and jobs. This long-term reform agenda is now being complemented by short-term policy actions aimed at addressing the impact of the economic crisis. Member States and the European Union have taken policy action in the face of the crisis severity. The European Economic Recovery Plan (EERP), endorsed by the European Council, recognised that measures to fight the crisis should support household incomes, stimulate aggregate demand, reduce regulatory costs and be consistent with long run policy objectives.

4.2.1 Long-term measures

The main ongoing Community initiative for services sector is the **Services Directive**. It aims at knocking down obstacles to a real Single Market for services and at releasing its unexploited potential. The Directive takes a horizontal approach and the same principles apply to a wide range of different EU services: it applies to all services that are not explicitly excluded from it.[20] The key challenge in 2009 is to ensure the timely and full transposition of this Directive by Member States. This should make it easier to establish and provide cross-border services and it should eliminate restrictions making more difficult for consumers and businesses to use services offered in Member States others than their own. Successful implementation could, therefore, be key to promote new economic activity and employment opportunities and it could be an important driver of the recovery.

From an operational perspective, the transposition into national legislation means that Member States will have to:

i) Review and adapt national legislation to make it consistent with the Directive. The Directive requires Member States to have a critical look at their existing regulatory framework and to get rid of red tape. Some observers have suggested that the absence of common guidelines in EU legislation, to perform the required screening, could lead to a

[20] Explicitly excluded are financial services, electronic communications networks, transport services, health services, audiovisual services, gambling activities and certain social services.

situation where the present fragmentation of the Single Market would not be fully eliminated as a result of remaining differences in regulatory approaches across the Single Market.

ii) Set up 'Points of Single Contact' (PSC) destined to become the single interlocutors through which service providers can easily obtained all relevant information and complete all necessary procedures. The possibility to complete all the procedures through PSC has to be available by electronic means and it should be possible to use these electronic procedures across the border. Eurochambres[21] have voiced some concern about progress with this objective and the Commission is, of course, monitoring these issues carefully.

iii) Reinforce their administrative cooperation.

As discussed above, the euro area is characterised by a relatively poorly performing services sector whilst it needs efficient and flexibly adjusting markets more than other EU countries. A timely and effective transposition of the Service Directive is therefore even more important for the euro area.

The **Better Regulation Strategy** is part of the regulatory reform process aimed at "better legislation for growth and jobs in the EU". Since in spite of the efforts done so far[22] regulation affecting the services sector is still relatively high, there is a need to continue making progress in the regulatory rationalisation of the sector. Although the "better regulation" agenda, defined jointly by the EU and Member States, is not focused on services, it appears particularly relevant given the over-regulation and inappropriate regulation that despite progress still characterises some segments of the services sectors. Currently, most EU countries have implemented programs intended to improve regulation and an institutional structure in place to support it. Following the Commission's target to reduce administrative burdens arising from EU legislation by 25% by 2012, most Member States have now also set their own national targets. There is room however for improvement: i) some countries still need to develop comprehensive simplification programs (instead, ad-hoc initiatives have being launched); ii) not all countries systematically carry out assessments of economic, social and environmental impact for new legislative proposals and the results are often not available to outside scrutiny.

Apart from the horizontal policies, relevant sectoral initiatives at Community level have been taken in a number of services sectors. The reform impulse in network-related services at Community level has focused on deregulation and liberalisation of the sectors, on fostering competition, and strengthening the power and independence of sectoral regulators. Community initiatives aiming at improving the Single Market are also relevant. For example, the currently most significant long-term ongoing initiative in air transport is the *Single European Sky.* This initiative attempts to overcome the fragmentation of the market by

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21 4[Th] Eurochambres survey on the implementation of the Services Directive. Eurochambres is the Association of European Chambers of Commerce and Industry.

22 Thanks to the simplification process around 10 % of the *acquis* or 7800 pages of the Official Journal, have been proposed for removal so far. The administrative burden reduction measures already presented (or foreseen) represent possible savings in excess of €30billion.

structuring airspace and air navigation services at a pan-European level rather than at a national one.

4.2.2 Specific measures to face the crisis

The stimulus packages of Member States in the framework of the EERP are complemented by actions at the EU level. Further funding (of the order of € 30 billion or 0.3% of GDP) has been made available from EU sources. The Commission has proposed a targeted investment to address the challenge of energy security and to bring high-speed internet to rural communities.

Of particular interest for services are some of the measures announced: i) Raising the *de minimis* threshold for state aid to € 500,000. Countries have been active in notifying public support schemes for SMEs or for sectors considered to be endangered by insufficient access to finance; ii) Creating the possibility of reduced VAT rates on labour-intensive services, including restaurants, homecare, repair businesses. Under the previous arrangement, 11 Member States were allowed to apply such reduced rates, while the remaining 16 were not allowed to do so.

In conclusion, Community level long-term initiatives with an impact on services markets, such as the Services Directive and the Better Regulation agenda, are also a good response to the current crisis. There are good reasons to accelerate their implementation and announced short-term measures on services clearly do not conflict with the long-term view.

4.3. Policies by MS

4.3.1 Long-term measures

Long-term measures adopted by Member States to deal with their structural problems cover a broad number of areas. Figure 4A shows the distribution of structural reforms adopted during the period 2004-2008 by euro area countries over various policy domains. The data come from the MICREF database[23].

Only a relatively low number of measures are services-specific. Network-type services sectors appear to be particularly affected by the reform effort (e.g. telecommunications with over 50% of the measures aimed at increasing effective competition). Only 8% of the total measures (15 measures) concern professional services, while countries do no report much reform activity in the retail sector. Examples of specific measures for a number of sectors can be found in the Annex 5. Figure 4C shows the breakdown by country and sector.

[23] The MICroeconomic REForms (MICREF) database has been developed to track and evaluate microeconomic reforms in Member States. It records the number of reform measures as well as qualitative information on those reforms, summarised by a set of descriptive features. The database, a user guide and more details are available at:http://ec.europa.eu/economy_finance/db_indicators/db_indicators10938_en.htm

Figure 4A: Euro area reform measures in MICREF (2004 to 2008)

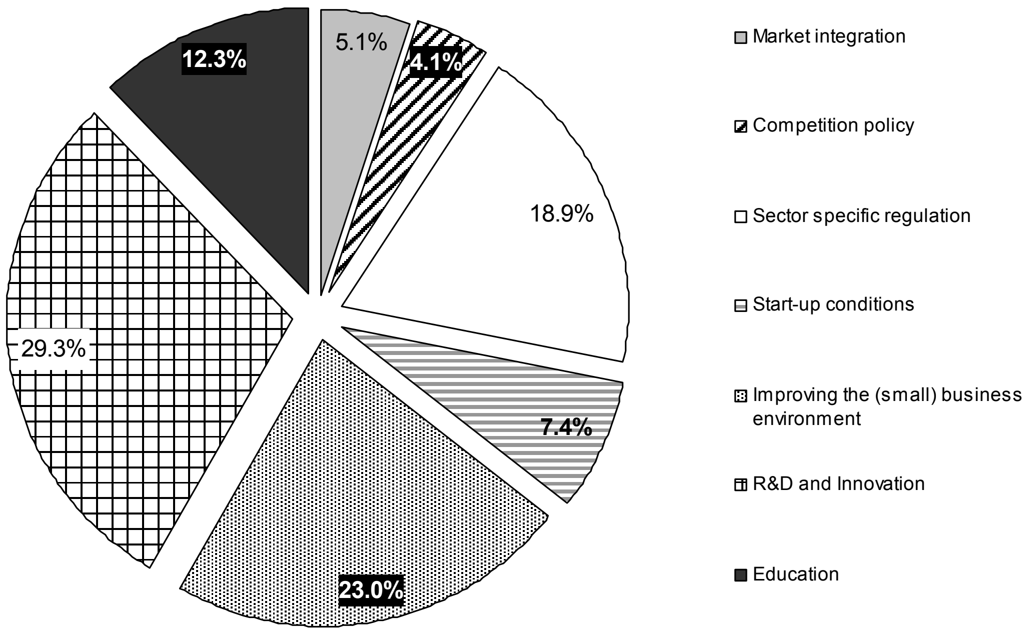


Figure 4B: Euro area reform measures in MICREF (2004 to 2008) – sector specific measures

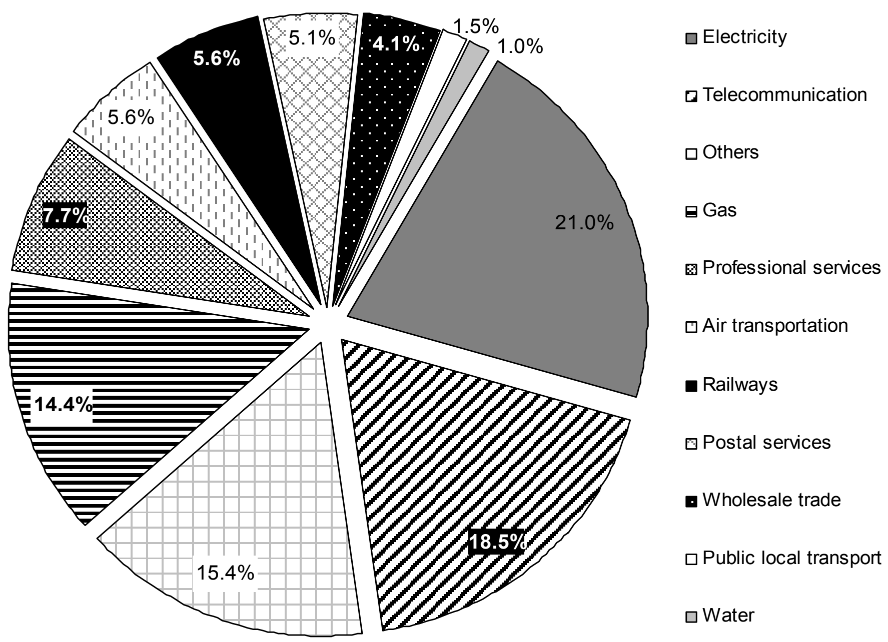
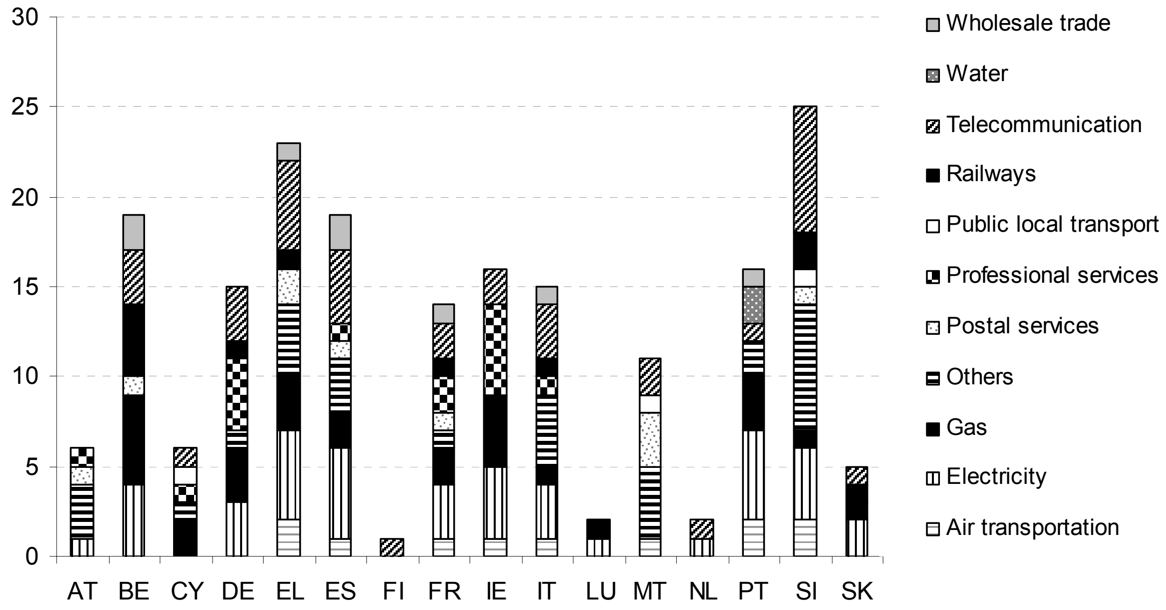


Figure 4C: Reform measures in MICREF, by country and sector (2004 to 2008)



In addition to the services-specific measures described above there a number of more general, long-term measures with a significant potential impact on services. This may be the case for measures furthering the knowledge-based economy (around 30% of the total measures taken during the period 2004-2008) and for measures encouraging market integration and competition (10% of the total), and for measures aimed at improving the business environment and entrepreneurship (30% of the total).

General reform efforts in the knowledge-based economy area will have an impact on innovation in services and, given their role in the economy, on productivity and long run growth in Europe. However, a better integration of the services dimension into R&D and innovation policy across EU may be needed to further exploit the innovation potential of the services sectors. Of particular relevance for a re-launch of economic growth are the measures focusing on improving start-ups conditions: access to finance (43 measures), reducing administrative burdens (27), and rules for a second start (bankruptcy rules, 6). Measures that make entry and exit easier are going to have an important effect on the restructuring of sectors hit by the crisis. Table A6 in annex 5 presents examples of measures taken in this field by Member States.

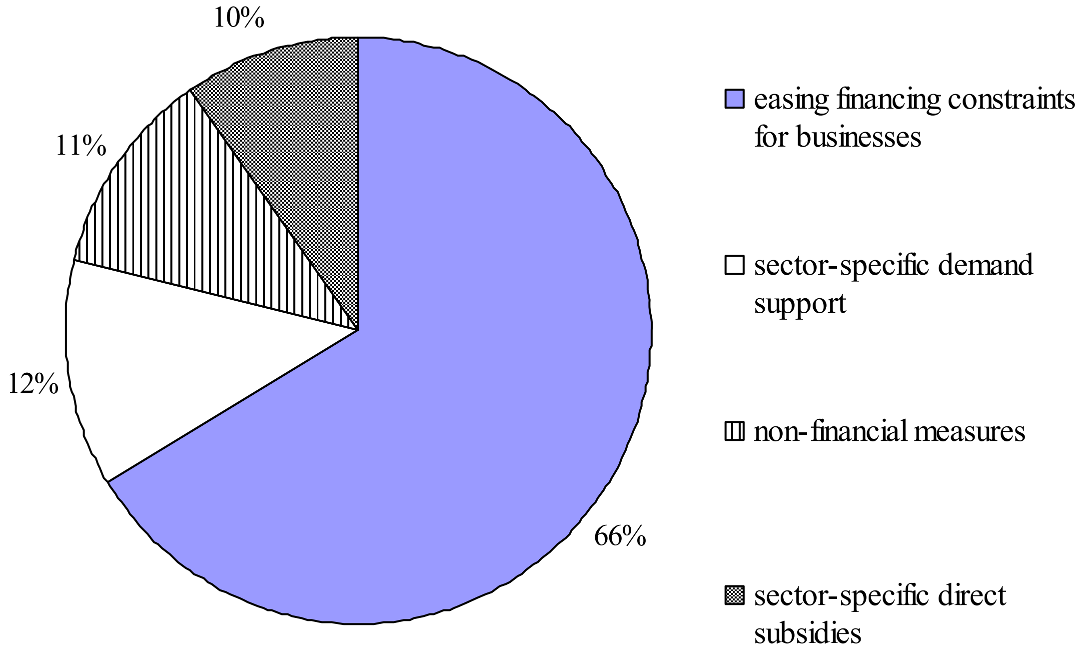
4.3.2 Specific measures to face the crisis

Compared to the manufacturing sector, there are not many services-specific measures undertaken by Member States in response to the crisis.[24] This might be expected given that, in general, services sectors have been less hit by the crisis. Measures to support specific services sectors have focused in the main on tourism, as it have been among the hardest hit by the fallout from the financial and economic crisis.

[24] Some examples are: reduced VAT rate on hotel accommodation (CY); reduction in the duty paid to local authorities by tourism enterprises (GR); handing out vouchers to consumers (SK, EL); constraints on opening new shops lifted (FR).

Figure 4D shows the distribution of crisis measures in support of industrial sectors, business and companies in euro area countries. These measures make up the largest part of Member States' efforts to respond to the crisis in the context of the EERP in terms of the number of actions pursued (29% of total measures). They also represent a considerable share (about 16%) of the overall discretionary stimulus provided in 2009/10. As shown in the figure, most countries are supporting business through easing their financing constraints and by accelerating the implementation of non-financial measures such as reduction of administrative burdens.

Figure 4D: Business support measures



5. Conclusion

To conclude, this paper has argued that services sector performance (mainly high inflation) is an important driver of Member States' divergent competitiveness positions. Indeed, changes in the relative prices of non-tradables (mostly services) between euro area Member States help explain a significant (and increasing) part of changes observed in intra-area competitive positions. Given that regulatory barriers affecting competition and integration still characterise services sector activities, reforms in services will deliver important gains in terms of the adjustment capacity within the euro-area.

Against the background of the crisis, countries are not doing a lot in terms of short-term measures specifically targeting services sectors. But the long-term strategy is broadly a fine response to the crisis and should be pursued. Pursuing the long-term view will facilitate adjustment and make the restructuring of sectors less painful. However, the pace of implementation has to be accelerated if the short-term problems and the more persistent long-term problems are to be resolved.

Some general principles for reforms of services sectors in times of crisis have emerged from the analysis:

- The regulatory indicators have shown that the business environment in the EU remains troubled by many difficulties in starting and growing new businesses. The crisis has increased the need for easy entry and exit and a restructuring of businesses and firms. In this context, the implementation of the Services Directive and of the Better Regulation agenda remains a priority. Given the expected heterogeneous implementation degree of the Service Directive across Member States, it may be necessary to develop a general framework for identification of best practices as well as specific indicators to monitor implementation.

- Investment in ICT public infrastructure such as broadband and other high speed internet connections could help the diffusion of ICT and facilitate innovation in the services sector in addition to providing an important short term stimulus.

- Although temporary rescue measures have focused on manufacturing industries, some services activities important for growth and adjustment already hit by the crisis or with the potential for being hit (through second-round effects from manufacturing), may need short-term temporary assistance. These sectors are candidates for close scrutiny.

- It is important not to lose sight of the longer term economic policy objectives. The necessary reallocation of production factors may suffer if economic recovery plans lock in factors in low productivity sectors and activities. This is why it is essential to avoid giving direct support to sectors characterised by significant overcapacity and steer clear of protectionist measures.

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ANNEX 1: SPECIFIC CHARACTERISTICS OF SERVICES

Services are at the heart of the transformation process that has changed the productive structure of developed countries. They are however frequently associated with “problems”, with some traditionally accepted stylised facts that do not reflect the changing reality for services, its heterogeneity and dynamism.

Fact: "services are characterised by low relative productivity". One of the more conventional stylised facts about services refers to its lower productivity performance compare to manufacturing. The fact finds its roots in the personal nature of many services (making it difficult the substitution of capital and incorporation if technical progress). However there are significant considerations to bear in mind when discussing productivity performance in services. First, the problems in defining and measuring productivity in services; second, the heterogeneity of service activities with some of them registering the productivity performance of high productive manufacturing sectors (e.g. telecommunications, financial services..); third, ICT are at the heart of the high productivity growth experienced by some manufacturing industries

Fact: "services are non/less tradable". However, the role ICT is increasingly being applied to services with consequences for the slicing of value added chains. The increasing tradability of services has important consequences in terms of outsourcing and externalisation.

Fact: "services and goods can be studied separately". However, the disaggregation of previously integrated vertical value chains implies that service sectors have an impact on the competitiveness of industry. Increasingly, developed economies use "soft" factors to improve their industry's comparative advantages (e.g. creation, design, marketing strategies).

Fact: "services are less innovative than goods”. However, in Europe, business services and financial services present higher density level (percentage of firms innovating) than manufactures (CIS III data). Besides, there are important problems concerning the measurement of innovation (product and process innovation) that affect particularly the services sector.

Fact: "services are labour intensive". However, many services such as telecommunications, transport services are capital intensive. In any case, to the extent to which many services are relatively low capital-intensive (and with low entry barriers) they enhance the flexibility of the economy by allowing reallocation of workers hit by restructuring and global competition. Services are different from goods in many aspects and these differences, that justify some type of public intervention, have to be kept in mind when efficiently designing policy actions. Next some main characteristics about services are presented:

i. Probably the most distinctive features of service activities are their *intangibility* and high involvement of clients as co-producers in some sub-sectors.

ii. *Productivity measures* have to be adapted as measurement in services is concerned not only with the quantity of resources utilised to produce a unit of output (i.e. traditional efficiency measures of productivity), but is also linked to the effectiveness of the service provided (i.e. the degree to which the required end result is achieved).

iii. *Economies of scale and scope* play a crucial role in some sub-sectors (e.g. telecommunications) in shaping its market structure as the number of firms (and thus degree of concentration) depends on these technology parameters. *Imperfect competition* prevails in most services: natural monopolies (e.g railroads) and oligopolistic structures (e.g. banking).

iv. There is a great deal of *product differentiation* as there is relatively lower scope for standardisation. Markets for non-standardised services can be non-transparent, particularly where price plays a relatively limited role in determining competition.

v. There is a problem of *asymmetric information* between service provider and client, and the client has to rely to a large extend on the regulator or other means (reputation and personal experience) to gather information. Since quality is difficult to measure (often of technical nature) an accreditation of provider is used in many cases (e.g. . To solve the asymmetric information problem, firms might have to invest in intangible costs in terms of building up reputation. In some sub-sectors reputation costs are sunk costs that work as barriers to entry (e.g. insurance).

vi. Existence of "*services of general interest*", for which the market does not provide the most appropriate allocation from an equity point of view. In these cases the state is (partly or totally) responsible for the provision of such goods. The scope of this analysis is on "market services" and thus excludes energy and water services, services activities typically associated with public sector provision, and other community, social and personal services activities.

Asymmetric information and imperfect competition have justified some form of public intervention in services. Many service markets, traditionally protected by public monopolies and protectionist regulations, are now opening up to competition. The (new) role of the public sector has to be interpreted in the context of a regulatory reform at the heart of the changing scenario faced by many services sectors.

ANNEX 2: METHODOLOGY AND DATA TO IDENTIFY SECTORS AFFECTED BY THE CRISIS

Data:

The analysis of overshooting sectors relies on seasonally adjusted quarterly industrial production indices (IP) for manufacturing sectors and turnover indices for services. Data is disaggregated at NACE 2 level.

Time frame*:* Q1 1996-Q4 2008 for real GDP data and Q1 2000 - Q3 2008 for services turnover data. For each indicator, the longest available time series were used.

Methods to measure "overshooting":

- The indicator is computed by comparing the **difference between the growth rate of turnover by sector and services' turnover growth** ($g_{sectori} - g_{total\_services}$) **with the average spread over** 2000-2008.

$$(g_{\sec tori} - g_{total\_services}) - (\bar{g}_{\sec tori} - \bar{g}totalservices)$$

where g refers to year-on-year growth of services turnover in Q3 2008 and $\bar{g}$ to average year-on-year growth over Q1 2000-Q3 2008:

Interpretation: This gap between the sectoral and total-service spread helps to identify the unusual or cyclical spread (after removing its long-term trend). The more negative the gap, the higher the overshooting.

The indicator of overshooting in services is computed by comparing the difference between the growth rate of turnover by sector and overall services turnover growth with the average spread over 1990-2008:

$$(g_{\sec tori} - g_{GDP}) - (\bar{g}_{\sec tori} - \bar{g}_{GDP}),$$

where g refers to year-on-year growth of services turnover in Q3 2008 and $\bar{g}$ to average year-on-year growth over Q1 2000-Q3 2008:.

Interpretation: The gap between the sector and total-economy spread helps to identify the unusual or cyclical spread (after removing its long-term trend). The more negative the gap, the higher the overshooting.

ANNEX 3: DATA ON MARKET FUNCTIONING IN SERVICES

Table A1: Signs of integration problems in services sectors

SECTORS	Share of cross-border M&A deals over total deals (average 2002-2006)	Price dispersion (average 1999-2007)	Signs of integration problems
E – Electricity, gas and water supply	23.50	0.49	**
F – Construction	n.a.	n.a.	n.a.
50 – Sale, maintenance and repair of motor vehicles	26.20	0.21	-
51 – Wholesale trade	25.50	0.22	-
52 – Retail trade	15.20	0.22	**
H – Hotels and restaurants	15.30	0.34	**
60 – Inland transport	28.80	0.26	*
61 – Water transport	26.67	n.a.	-
62 – Air transport	28.62	0.26	*
63 – Supporting and auxiliary transport activities	27.70	0.23	-
64 – Post and telecoms	29.30	0.21	-
65 – Financial intermediation	23.43	0.39	*
66 – Insurance and pension funding	22.40	0.39	**
67 – Activities related to financial intermediation	n.a.	n.a.	n.a.
71 – Renting of machinery and equipment	18.60	n.a.	*
72 – Computer and related activities	n.a.	n.a.	n.a.
73 – Research and development	n.a.	n.a.	n.a.
74 – Other business activities	22.50	0.39	**
90 – Sewage and refuse disposal	n.a.	n.a.	n.a.
91 – Activities of membership organisations	n.a.	n.a.	n.a.
92 – Recreational, cultural and sporting activites	n.a.	0.31	*
93 – Other service activities	n.a.	n.a.	n.a.

Table A2: Signs of competition problems among services sectors

SECTORS	EU-US markup differential (1981-2004)	Market concentration (2006)	Turbulence (2002-2005)	Number of antitrust cases (1999-2006)	Signs of competition problems
E – Electricity, gas and water supply	-0.13	27.97	-0.13	10	**
F – Construction	-0.10	19.12	0.03	1	-
50 – Sale, maintenance and repair of motor vehicles	0.39	8.92	0.03	4	*
51 – Wholesale trade	0.04	18.12	0.25	3	*
52 – Retail trade	0.23	23.13	0.13	2	*
H – Hotels and restaurants	0.11	28.78	0.06	0	**
60 – Inland transport	-0.08	28.62	0.03	2	*
61 – Water transport	0.49	27.72	0.13	7	**
62 – Air transport	0.48	56.45	0.03	8	**
63 – Supporting and auxiliary transport activities	0.11	22.20	0.09	6	**
64 – Post and telecoms	0.10	45.24	-0.03	15	**
65 – Financial intermediation	0.17	15.26	0.06	8	**
66 – Insurance and pension funding	0.19	21.97	0.25	2	*
67 – Activities related to financial intermediation	n.a.	23.61	0.00	0	-
71 – Renting of machinery and equipment	-0.76	18.35	0.00	0	-
72 – Computer and related activities	0.08	19.51	0.06	2	*
73 – Research and development	0.49	51.27	0.03	1	**
74 – Other business activities	0.18	24.00	0.19	3	*
90 – Sewage and refuse disposal	0.48	19.11	0.06	1	*
91 – Activities of membership organisations	0.58	44.96	n.a.	0	**
92 – Recreational, cultural and sporting activities	0.25	23.93	0.09	9	**
93 – Other service activities	0.60	27.07	-0.03	0	**

Table A3: Signs of innovation problems among services sectors

SECTORS	Quality of labour (1996-2004)	ICT (1996-2004)	TFP (1996-2004)	Signs of innovation problems
E – Electricity, gas and water supply	-0.12	-0.06	2.10	*
F – Construction	-0.01	-0.09	3.06	-
50 – Sale, maintenance and repair of motor vehicles	0.02	-0.31	-5.76	**
51 – Wholesale trade	-0.48	-1.03	-0.82	**
52 – Retail trade	-0.23	-0.12	-4.09	**
H – Hotels and restaurants	0.07	-0.32	-1.21	**
60 – Inland transport	-0.35	-0.34	0.46	*
61 – Water transport	2.01	3.48	-10.15	*
62 – Air transport	0.33	-0.11	-2.00	*
63- Supporting and auxiliary transport activities	-0.64	-2.45	7.18	*
64 – Post and telecoms	0.04	-0.85	4.84	*
65 – Financial intermediation	0.18	1.03	-3.80	*
66 – Insurance and pension funding	-0.67	-2.35	0.88	*
67 – Activities related to financial intermediation				
71 – Renting of machinery and equipment	-1.67	-0.34	-2.16	**
72 – Computer and related activities	-0.64	0.50	-3.85	**
73 – Research and development	-1.31	-3.53	2.57	*
74 – Other business activities	-0.34	-0.46	-1.27	**
90 – Sewage and refuse disposal	-0.26	0.18	-3.59	**
91 – Activities of membership organisations	0.34	-0.27	2.78	-
92 – Recreational, cultural and sporting activities	-1.08	0.56	-5.63	**
93 – Other service activities	1.25	-1.46	10.93	-

ANNEX 4: SCREENING SERVICES SECTORS

A sector is identified as showing signs of potential market malfunctioning if its average labour productivity growth[25] over the period 1995-2005 is below a given benchmark. Since the choice of a benchmark against which productivity performance is measured can affect significantly the results, two different benchmarks are compared:

- The US benchmark where the productivity growth rate is compared to the US productivity growth rate in the corresponding sector. Whenever the growth rate is lower than that of the US, the sector is selected as showing signs of potential market malfunctioning.

- To better take account of the different income groups to which countries belong, a GDP-level benchmark is constructed. To construct this alternative benchmark, the EU25 countries have been split into four groups of countries according to their GDP per capita in PPS (see table A4). The GDP benchmark is a more rigorous attempt at filtering out the catching-up effect because the groups of countries are defined using a quantitative indicator rather than the ad-hoc institutional grouping of the EU15/NMS benchmark. Four groups of countries have been identified: group 1 includes the small EU15 countries; group 2 contains the large EU15 countries; group 3 includes the NMS with a higher income plus Greece and Portugal; and group 4 contains the lower-income NMS. If a sector is below the simple average, in terms of productivity growth of the GDP group to which it belongs, it is selected as potentially malfunctioning. If a sector is below the simple average, in terms of productivity growth of the GDP group to which it belongs, it is selected as potentially malfunctioning.

Table A4: The GDP benchmark

	Member States (**Euro Area**)	2007 Gross domestic product at current market prices per head of population (1000 PPS)
Group 1	**LU**	**276,29**
	IE	**146,27**
	NL	**132,59**
	AT	**127,26**
	SE	126,12
	DK	**122,79**
	BE	**118,05**
	FI	**116,76**
Group 2	UK	115,83
	DE	**113,14**
	FR	**111,22**
	ES	**106,89**
	IT	**101,38**
Group 3	**EL**	**97,85**
	CY	93,13
	SI	**88,71**
	CZ	81,91
	MT	77,31
	PT	**74,77**
Group 4	EE	70,79
	SK	**68,55**
	HU	63,46
	LT	60,32
	LV	57,96
	PL	53,79
Source: AMECO		

[25] Gross value added per hour worked, volume indices, 1995=100 (Source: EU KLEMS March 2008).

ANNEX 5: MORE DETAILED INFORMATION ON MEASURES TAKEN BY THE MEMBER STATES IN THE AREA OF SERVICES

Table A5: Examples of sector specific measures (selected sectors) from MICREF

Air transport		
Obligation to state full price of air ticket	IT	2007
Act to Facilitate Market Access in Aviation	DE	2002
Aid scheme for the development of new and underserved air routes	MT	2006
Privatisation of the handling business	PT	2004
Distributives		
Alterations in competition limiting rules (Food, Restaurant and Hotel Act)	DK	2005
Amending shop opening hours	BE	2006
New Commercial Licensing Regime	PT	2004
Regional measures to increase competition in retail trade	ES	2006
Shop Opening Hours Act	AT	2003
Facilitating the entry of new operators in the network of wholesale markets	ES	2005
New opening hours	EL	2005
Reform of the Galland Act to boost price competition between retailers	FR	2005
Extension of the weekly shop opening hours	AT	2007
Professional services		
Altering the principles regulating the professions of public trust	PL	2005
Simplification of the conditions to perform certain professional activities	FR	2004
The Citizen-Consumer law eliminates a number of restrictions on competition	IT	2006
Liberalisation of medical advertisement law	AT	2006
Act to Reform the law on Legal Advice	DE	2007
Implemented recommendations for reform of architect profession	IE	2007
New Notaries Regulation	ES	2007
New Rules related to Dentists	IE	2007
Removal of barriers to entry to pharmacy market	IE	2007
Revision of fees for advocates	CY	2006
Telecommunication		
Abolition of fixed costs of prepaid cards for mobile telephone services	IT	2007
Abolition of mobile telephony top-up charges	IT	2007
Agreement on the rules for operators holding UMTS licenses	ES	2004
Enforcing powers of the Commission for Communication Regulation	IE	2007
Establishment of the National Authority for Communications (ANC)	RO	2008
Extended competences of the telecommunications regulatory agency	SI	2004
Imposing specific obligations on operators with significant market power	RO	2008
Introduction of number portability	SI	2006
Liberalization of radio frequencies for RFID technologies	IT	2007
Regulation of IP bitstream access	DE	2008
Ruling against high interconnection charges	FI	2004
State-owned Telecommunication Company Maltacom sold to private investor	MT	2006

Table A6: Examples of measures on entry and exit, from MICREF

Exit		
Amendments to the insolvency legislation	FI	2007
Draft Act on Bankruptcy and Reorganisation and the related draft Act on Trustees	SK	2004
Insolvency Act (Loi de Sauvegarde des Entreprises)	FR	2005
Insolvency Law 22/2003	ES	2003
New Bankruptcy Code	EL	2007
New bankruptcy legislation	FI	2003
Wide-ranging reform of bankruptcy procedures	IT	2006
Start-ups		
Abolishment of registration fees for start-ups	AT	2001
Formalities involved in starting a business will be simplified (Economic Modernisation Act)	FR	2008
Electronic exchange between notaries and the administration of the data required to start a bu:	BE	2002
Reduction of administrative burden of the health at work regulation	SK	2006
Reduction of the period for the issue of unregulated licences	SK	2004
Simplified start-up framework for limited liability companies (Law 3661/2008)	EL	2008
Single notification to set up new businesses	IT	2007
Symplifying process of starting up a business (Kontakt-N)	SE	2002
E-filing application system (pilot project)	BE	2007
Enabling start-up declarations via Internet (to be accepted at one-stop contact points)	FR	2006
Establishing single contact points (Flemish Community)	BE	2005
Extension of the scope and expansion of the network of the one stop contact points (PAIT)	ES	2006
Interactive internet site for business registration	LU	2004
Introduction of the e-VEM project for companies (One-Stop-Shop system for companies)	SI	2008
New business activity can be initiated through Single Points of Access	IT	2008
One-stop shops for foreign enterprises	DK	2007
Portal Single-window interface for companies (Portail Entreprise)	LU	2005
Setting up one-stop-shop systems to facilitate the opening of a business	SI	2005
Upgrading of the operations of the one stop shop	CY	2006
Development of the Companies Registration System (eFiling)	CY	2008