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## **New Challenges of the EU Single Market**

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In 1985 the European Commission proposed a large-scale agenda aiming at abolishing existing barriers to intra-EU trade, and removing obstacles to mobility of capital and labour within the EU which was known as the Single Market Programme (SMP). The final aim of the SMP was to promote European growth and competitiveness by promoting further integration. The mechanisms through which the removal of barriers to trade would enhance welfare and growth were mainly related to decreasing costs and prices via:

- the reduction of trade costs themselves due to the dismantling of trade barriers and custom formalities;
- the reduction of costs due to economies of scale and scope achieved in a larger market place;
- reductions in price/cost margins due to more intense competition; and,
- other non-price welfare gains such as enhanced innovation or a wider product variety.

The SMP placed special efforts in removing non-tariff trade barriers and harmonizing product regulations and technical standards. In parallel the EU also adopted measures aiming to strengthen the role of market mechanisms in highly regulated sectors (such as telecoms, energy and transport) and to enhance horizontal competition policies across the EU.

The implementation of the SMP focused mainly on manufacturing industries and capital markets while services and labour market reforms have been limited despite the fact that they were part of the initial reform agenda.

Twenty years later, despite the different progress across Europe (Delgado, 2006), there is no controversy on the positive achievements of the SMP (European Commission, 2006). However, there are concerns on whether

integration policies as understood in the SMP are appropriate in the current economic context.

The world has changed substantially in the last twenty years and “traditional” integration policies might not be as effective as before. The world economy is nowadays much more global than in the 80s and internal market policies cannot be designed in isolation of the changing global environment. Moreover, technological developments have allowed for radical changes in production processes and for an increase in the tradability of goods and services. This has had important consequences on the pattern of trade and on the industry structure.

Services play nowadays a much more important role in the economy than twenty years ago. The share of the services sector in the economy is meant to continue increasing so the Single Market becomes increasingly a question of how to achieve more integrated services markets. In addition, innovation has become the main driver for productivity growth so it becomes crucial to facilitate the generation and diffusion of innovation across Europe.

A review of the policies leading to further market integration seems necessary in order to meet the new challenges and to strengthen the link between market integration and growth. This note identifies ten areas which are crucial to the design of the Single Market policies of the future.

## **1. Well-functioning markets: Competition, entry and exit.**

The SMP aimed fundamentally at the removal of barriers to goods and services trade. This, together with the guarantee of the right of establishment (i.e. the right to enter a market “under the conditions laid down for its own nationals by the law of the country where such establishment is effected”<sup>1</sup>), would increase competition, favour industrial restructuring and facilitate the reallocation of economic activities.

The Treaty guarantees the right of establishment by applying the non-discrimination principle but does not prevent Member States from developing their own entry (and exit) regulations as far as they apply equally to national and foreign firms. The existence of high barriers to entry (and exit) and the different regimes in place in the different member states makes cross-border industry dynamics a difficult exercise.

Recent economic research (Bartelsman et al, 2003) shows that firm churning in Europe and in the United States does not substantially differ. However, the main difference between the United States and most European countries lays in post-entry employment growth amongst surviving firms. Indeed, firms in the United States are smaller at the initial stages than their European counterparts but, if

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<sup>1</sup> Article 43 of the Treaty.

successful, they grow much faster in the initial years. The reasons for this phenomenon are the different financial market structure which makes access to financing easier in the US, the generally higher administrative entry costs in the EU which make entry difficult for small firms and the product and labour market rigidities which make post-entry adjustments more costly.

The entry of new firms and the exit of inefficient ones imply a reallocation of resources to more efficient firms increasing average productivity and welfare. Market entry is also an important source of innovation and productivity gains since new potentially more innovative and competitive firms will come into the market field.

Ensuring the well-functioning of markets is crucial to increase growth, productivity, innovation and consumer welfare. Competition policies should aim at ensuring a well-functioning market playing field rather than at regulating market outcomes (through, for example, price regulation). The regulation of market outcomes without supporting measures to increase competition will not result in sustainable competitive markets.

## **2. Global production chains**

In the last twenty years production processes have become increasingly more global due mainly to technological progress, which allowed for a better organisation of production processes and drastic decreases in communication and transportation costs. This process has had obvious consequences for trade patterns and industry structure. Offshoring and outsourcing have become increasingly common. Trade nowadays is composed mainly of intermediate goods that are used for the production of other goods. Firms participating at different stages of the production chain are not necessarily located close to each other.

Trade is no longer about products but about “tasks”. Firms decide where to perform each task of the production chain according to efficiency criteria. Trade policies inspired by traditional trade theories need rethinking since the mechanisms through which trade affects the economy have changed (Grossman and Rossi Hansbergh, 2006). New trade theories provide insight on how trade affects industry structure and the reallocation of resources within firms in an industry (Melitz, 2003) and on the effects of intra-firm trade on firms’ internal reorganisation (Antras, 2003).

New trade and investment developments derived from the globalisation of production chains should be incorporated in the design of integration and trade policies. Moreover, special focus should be placed in the well functioning of those

industries that reduce trade frictions such as communications, transportation, retailing and banking and financial services.

### **3. Innovation and R&D**

The SMP focused specially on exploiting economies of scale and the benefits of increasing competition. By having access to a larger market firms could take advantage of economies of scale reducing their costs and increasing their productivity. However, economies of scale, although important in manufacturing sectors, are not such an important source of productivity gains in a services dominated economy. The production and diffusion of innovation and new technologies are increasingly more important as sources of growth (see Aghion, 2006, for an overview).

The low level of innovation in Europe is often blamed for the productivity gap between the EU and the US. In recognising this fact, the Lisbon European Council of March 2000 established that investment in European research and development (R&D) must be increased with the aim of approaching 3 % of GDP by 2010.

Investment in R&D is not only lower in Europe but also is concentrated in a smaller number of firms (DTI, 2006). Moreover, the system of intellectual property protection in the EU is highly fragmented and more expensive than in the US and Japan (van Pottelsberghe and Francois, 2006).

Innovation policies in the form of increasing public spending in R&D, support to innovation by private firms and intellectual property policies have become essential to increase productivity.

Innovation policies are also closely linked to the promotion of competition (so firms have incentives to innovate in order to develop new products) and to the existence of efficient financial markets (in order to facilitate innovators' access to capital).

Integration policies in the field of innovation should aim at removing barriers to the circulation of innovation guaranteeing an appropriate balance between competition and innovation protection.

### **4. A Services economy**

Services nowadays constitute more than two thirds of EU value added and employment. Although the lack of market integration in services was already recognised in the SMP, most of the efforts of integration policies were placed in goods markets. Integration policies cannot be fully effective if they ignore the

services sector which is responsible for most of the growth and job creation in the European economies nowadays.

Regulation of services is much more complex and heterogeneous than manufacturing goods regulation. Not only is the existence of excessive regulation a barrier to entry and trade (Conway et al, 2005) but also the heterogeneity of such regulation (Lejour and Kox, 2005).

Moreover, the services sector includes a wide range of industries with different problems and market structures. Addressing further opening in the services sector is not therefore a trivial process. The recently adopted Services Directive (which aimed to establish a general framework for further liberalization of services in Europe) will play an important role in setting a common liberalizing framework for services but its broad scope and abstract nature might not be sufficient to address the specificities of some services.

Technological progress allows for increasing possibilities of trade in services therefore it is important to ensure that such increased tradability is not constrained by regulatory barriers.

## **5. Global capital markets**

Financial market integration has made substantial progress in recent year not only due to integration policies but also to the process of globalisation of financial markets. Financial markets have extended beyond domestic borders providing investors and firms with more possibilities to access capital and enabling them to better manage potential risks through the diversification of their portfolios. A well-functioning capital market is crucial for the well-functioning of the rest of the economy.

The lack of a European common regulatory framework and a common supervisory authority creates difficulties for the creation of effective European capital markets. Progress towards a more market-based financial system should provide more funding opportunities for firms and should enable firms and investors to make a more efficient use of capital.

## **6. The sequence of reforms.**

Sectors and markets in the economy are interdependent on each other. Reforming product markets reduces the rents enjoyed by firms and therefore creates pressure for the introduction of more flexibility in labour markets (Blanchard and Giavazzi, 2003). Equally, more competition in product markets makes profits more volatile and increases the need for a better sharing and diversification of risks (Obstfeld and Rogoff, 2000).

Market reform policies therefore need to acknowledge such interdependence in order to be more effective. Lack of reforms in some markets might constrain

reforms in other markets (as it was for instance the case to some extent of the Services Directive where lack of integration of labour markets constrained the extent to which services markets could be liberalised).

It is therefore important not only to implement specific reforms but to take into account the synergies between reforms and coordinate their timing.

## **7. Political economy of reforms**

Reforms are not innocuous processes and although their objective is to increase total welfare they might also involve redistribution of rents. For example, market entry and exit are turbulent processes that imply the closing of firms and the firing of workers that might not easily relocate.

In a global context the EU has created the European Globalisation Fund in order “to help those who experience the negative consequences of globalisation through job losses”<sup>2</sup>. As shown by the recent debate on the Services Directive, the remaining obstacles to integration are not easy to tackle. Reform policies must increasingly take into account their redistribution effects and design the appropriate transition mechanisms to diminish frictions derived from reform and reduce opposition to reform.

## **8. Better, more consistent and more effective regulation.**

Effective regulation must not only deal in an appropriate way with the relevant substance but also must be easy to implement and monitor. The design of a regulatory strategy is fundamental for the effectiveness of regulation. This is even more crucial in the case of internal market policies since they cover a broad range of sectors and topics and their implementation often corresponds to different layers of administration. Regulation should be simple, consistent across sectors and easily enforceable.

Where possible regulatory designs should evolve towards performance-based regulatory systems where the required outcomes are specified but there is flexibility on the means of achieving such outcomes. Under this scenario, monitoring is easier since it only requires the control of the outcomes. Also governments and companies have more flexibility on the way to achieve the required outcomes. Other decentralized approaches to regulation such as co-

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<sup>2</sup> See

<http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/06/99&format=HTML&aged=0&language=EN&guiLanguage=en>

regulation and self regulation should also be considered in order to reduce the regulatory burden, the workload of regulators and to allow for more flexibility in reaching the desired outcome.

## **9. Towards an enlarged Europe**

The EU nowadays is not only larger than twenty years ago but also much more diverse. This poses two types of difficulties: First, “one-size fits-all” policies might not be appropriate for all member states given their different starting points and second, the implementation and monitoring becomes more complex in a more heterogeneous group of countries which reinforces the need for better regulation highlighted in the previous point.

In a world where borders are becoming less relevant it is also important that Single Market policies are closely linked to neighbourhood policies. Irrespective of the perspectives of enlargement, there is no economic reason to restrict Single Market policies to the EU territory.

## **10. The Single Market and the world economy**

Finally, the current world is far more global and interdependent than twenty years ago. EU policies do not have just an impact within the EU but also have consequences over the rest of the world and are also in some way determined by the evolution of the global economy. In this sense, internal market policies can be used as a tool to prepare the EU economies to better face globalisation before reforms become unavoidable due to pressures from the external world. Moreover, through a more integrated policy approach, the EU could also play a more important role in shaping up the process the globalisation.

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