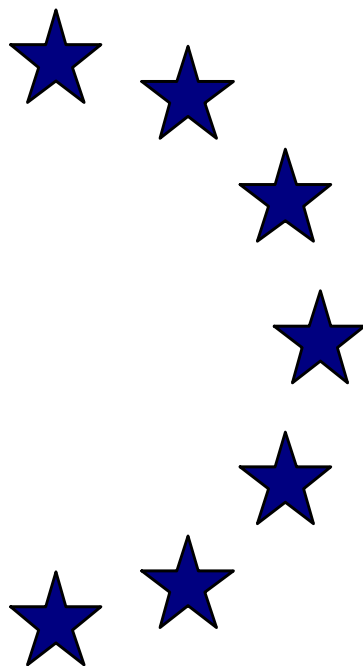


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**Steps towards a deeper economic integration:
the Internal Market in the 21st century
A contribution to the Single Market Review**

by

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Directorate-General for Economic and Financial Affairs

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**STEPS TOWARDS A DEEPER ECONOMIC INTEGRATION:
THE INTERNAL MARKET IN THE 21ST CENTURY
A contribution to the Single Market Review**

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ABSTRACT

The aim of this paper is to analyse the effects of the implementation of the Internal Market Programme and to propose ideas on how its potential can be better exploited. First, the paper offers a broader perspective to the analysis of the Internal Market by exploring its close links to the rapidly changing economic environment. Second, it puts together a comprehensive body of empirical evidence, based on the analysis of trade, FDI, M&A, prices and regulation data, which allows for a thorough stock taking exercise of what has been achieved in terms of European economic integration. Thirdly, it analyses the remaining barriers to the completion of the Internal Market while presenting a critical review of the adequacy of the instruments that have been used so far.

Overall the paper concludes that the Internal Market is a powerful instrument to promote economic integration and to increase competition within the EU and that it has been the source of large macro-economic benefits. However, these gains could have been substantially larger if the removal of most of the remaining cross-border barriers was achieved. In particular, the initial expectations that the Internal Market would serve as a catalyst for creating a more dynamic, innovative and competitive economy at the world level have not been met. Various reasons for this are identified, namely: the slow and sometimes incomplete implementation of directives, the inadequacy of some instruments, the persistence of barriers to cross-border trade and investment particularly in services and the slow development of an Internal Market for knowledge. Building on the evidence and analysis provided, the paper concludes with eight suggestions to guide the design of policymaking for the Internal Market in the 21st century.

JEL classification: F15, L16, L50

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EXECUTIVE SUMMARY

1. BACKGROUND AND OBJECTIVES

Internal Market aims at integration, competition and innovation, but ...

The European Internal Market project, which was initiated in the mid-1980s with the publication of the White Paper on the Single Market Programme, signalled the end of a period of euro-pessimism associated with the political, economic and monetary crises of the 1970s and the early 1980s. It opened up perspectives for restoring confidence of European business and for improving the performance of European companies through the formation of a better integrated, more competitive and innovative market place. The removal of non-tariff barriers was targeted at creating a large integrated market for goods and services, allowing the realisation of economies of scale. The fiercer competition in this integrated market was expected to result in (allocative and productive) efficiency gains. It was also aimed at providing increased incentives for European producers to invest in product and process innovations, thereby improving the dynamic efficiency of the European economy. For European consumers, the Internal Market was also seen as a source of benefits through wider choice and lower prices.

... its potential has not been fully exploited.

While the Internal Market has contributed to promote integration and, to a certain extent, competition within the EU, its potential has not been fully exploited. Initial expectations that the Internal Market would be a launching pad for a more dynamic, innovative and competitive economy at world level have not been met. In the early 1980s, the convergence in the EU level of GDP per capita towards that of the US came to an end. Over the past ten years, the average annual per capita growth rate of the European Union has been even below that of the US. The Single Market Review provides an opportunity to redefine the strategy for the Internal Market and to give it new impetus.

Paper addresses three main issues and suggests eight areas that could be further developed into a new Internal Market strategy.

The aim of this paper is to shed light on the economic principles underlying the Internal Market and to offer ideas on how its potential can be better exploited. This paper should be seen as a contribution to the on-going Single Market Review. From this perspective, the paper addresses three main issues. Section 2 explores to what extent the environment in which the Internal Market operates today is different from that of the late 1980s-early 1990s. Section 3 presents the latest empirical evidence on the economic impact of the Internal Market. Section 4 investigates why the Internal Market has failed to live up to early expectations. On the basis of these investigations, section 5 suggests eight ideas that could be further developed within the context of the Single Market Review.

2. THE CHANGING ENVIRONMENT OF THE INTERNAL MARKET

The environment of the Internal Market has been changed by the growing importance of services and the fast development of technologies, ...

The environment in which the Internal Market operates in the 21st century is very different from the context of the Internal Market at the beginning of the 1990s. First, this environment has been modified by the growing importance of services and the fast development of information and communication technologies (ICT). Services account for 70% of employment and value added but only for 20% of intra-EU trade, indicating their low tradability within the EU. Labour productivity growth in services is generally lower than in the US, except in sectors such as telecommunications which have been opened up to competition. With the increased tradability of services, competition at world level has increased and improvements in the competitive performance of the European services sectors have become more urgent. Moreover, as some of these sectors, such as telecommunications, transport, energy and financial services, provide inputs to a large number of other economic activities their performance has implications for the competitiveness of the European economy as a whole.

... by EMU,...

Second, the creation of the EMU has reinforced the integration and the competition effects of the Internal Market by reducing the costs of cross-border activities (elimination of the costs of managing multiple currencies and of exchange rate risks) and by increasing the transparency of prices. However, the relations between EMU and the Single Market go in both directions. A well functioning and flexible Internal Market which allows for a rapid market based adjustment in the case of shocks is essential for a smooth functioning of EMU. More competitive product markets are essential in ensuring price and wage flexibility in EMU. Labour mobility can also contribute to facilitate adjustment in EMU but it has remained rather low in the EU.

... by EU enlargement ...

Third, since the early 1990s, several rounds of enlargement have taken place leading to the expansion of the Internal Market. In particular, the recent accession of ten new Member States substantially increased the size of the Internal Market, while constituting at the same time a challenge to its proper functioning. On the one hand, the accession of the central and eastern European countries has increased the pool of consumers and has provided firms with additional opportunities to draw on a wider range of comparative advantages characterising the different Member States. This is a source of further dynamism and efficiency in the Internal Market. On the other hand, while the economic changes induced by this enlargement have been absorbed quite smoothly and there is no evidence of disruptive impacts on the product and labour markets, the increased divergence among the EU25 members has augmented the risks of tensions within the Internal Market, such as in the areas

of the opening up of services markets, tax competition and migration flows.

... by ageing ...

The EU will undergo unprecedented demographic change in coming decades. The population of working-age in Europe will start to shrink from 2010 and is projected to decline by 17% between 2010 and 2050. While net inflows to immigrants can partially offset demographic developments, immigration could not on its own solve the problems linked to ageing. However, immigration may have positive effects on the functioning of the labour market by relieving the labour shortages in certain areas.

... and by the forces of globalisation.

Finally, rising international economic integration has increased the competitive pressures faced by European companies. On the one hand, the EU is confronted by the dominance of the US in sectors with high knowledge content. On the other hand, strong competitors also emerge in Asia. China, industrialising with a large and growing stock of foreign direct investment together with its own scientific base, has begun to compete not only in low but also in high value-added manufacturing goods. India's challenge is no less real — notably in the service sector where it is a big beneficiary of the 'offshoring' or 'outsourcing' of service sector functions with an enormous pool of educated, cheap, English speaking workers. The potential rapid growth of the Chinese and Indian economies creates not only new competitors to Europe, but also offer new opportunities with their vast and growing markets. A large and competitive Internal Market is a necessary prerequisite for Europe to fully seize these opportunities because it contributes to create a business environment providing incentives for firms to improve efficiency and invest in innovation.

3. EMPIRICAL EVIDENCE ON THE EFFECTS OF THE INTERNAL MARKET

The Internal Market has resulted in a 2.2% increase of the EU GDP in 2006 and the creation of 2.75 million additional jobs.

The enlarged Internal Market (including liberalisation of network industries) is an important source of growth and jobs. As a result of the progress made over the period 1992-2006 in achieving an enlarged Internal Market of 25 Member States, GDP and employment levels have increased significantly. The estimated 'gains' from the Internal Market amount to 2.2% of EU value added and 1.4% of total employment (or 2.75 million jobs). Moreover, these gains could be doubled with the removal of most of the remaining Internal Market barriers.

Integration

The Internal Market, but also EMU and enlargement, have contributed to reinforce the integration of European product

***Increasing trend
but slowdown
since 2000...***

markets. However, the pace of European market integration appears to have slowed down over the recent period. The intra-EU trade to GDP ratio increased strongly during the second half of the 1990s but stabilised in 2000. Similarly, there is evidence showing that in the years following the implementation of the 1992 Single Market Programme, FDI activity in the EU increased. The convergence of price levels between the 25 Member States has also progressed substantially but within the EU15 price dispersion has remained more or less stable in recent years. The introduction of the euro appears to have boosted trade, FDI activity and cross-border mergers within the euro area. The level of price dispersion in the euro area is half that observed in the EU25. While, the increased transparency of prices associated with EMU has had little effect on the pace of price convergence amongst euro area members, price dispersion across the EMU was in 2001 already similar to that observed among the main US cities.

***... and the
potential not
completely
exhausted.***

It is quite natural to observe a slowing down over time in the process of European product market integration as remaining barriers are increasingly difficult to remove. Nevertheless, the potential for further progress does not appear to be completely exhausted: the US still is a more integrated trade area than the EU. This argument is staved by the observation that the ratio of intra-US States exports to GDP is around 70% higher than the ratio of intra-EU15 exports to GDP.

Competition

***Reduction in
profit margins
offset by
efficiency gains
...***

The Internal Market and EMU have changed the conditions of competition in the EU by facilitating market entry by new firms and by reducing the ability of European firms to segment national markets geographically. Empirical evidence shows that on average, price-cost margins of the sectors most affected by the Single Market Programme declined. European companies reacted to this decline in profit margins by reducing their costs, which indicates that the SMP was a source of efficiency gains. These efficiency gains have been obtained through an increased presence on the markets of other Member States (increased multinationality) and a concentration of activities on the core businesses of companies (reduced sectoral diversification).

***... considerable
turbulence in
market
leadership...***

The sharper competition in the Internal Market contributed to the elimination or take-over of the least efficient firms. As a result, production concentration at the level of the EU as a whole increased somewhat on average. However, this average hides a rich diversity across industries with highly concentrated sectors in particular having witnessed a decline in concentration. At the same time, there was considerable turbulence in market leadership in EU manufacturing industries, which would seem to suggest that the level of competition on EU product markets has increased.

... but a lack of

Despite the improvement in the competitive environment, rules and

*business
dynamism...*

regulations in Europe appear to act as a constraint on the mobility of economic resources to more productive activities. Regulatory requirements have their origin in local, national and EU level legislation. However, costs generated by EU legislation (including Internal market rules and regulations) will often be lower than those flowing from different pieces of national legislation. Nevertheless, unnecessary regulation is a serious issue that risks holding back business with negative consequences for EU competitiveness. In the retail sector, for example, restrictions emanating from spatial planning regulations work as an impediment to the introduction of new production technologies (including ICT) and hinder the reallocation of labour to more productive shopping outlets. Business dynamism, as measured by entry and exit, is essential for growth to the extent that less efficient firms are eliminated from the market and that new entrants innovate more. Progress has been made in facilitating business start-ups. Nevertheless, in most EU countries it is still more difficult to start a new business than in the US. Not only entry per se but also the growth performance of enterprises in the years after entry is important. In this respect, the US seem to be better able to reallocate resources towards more productive firms, as post entry growth performance among surviving firms is markedly higher in the US than in Europe. This is an indication of remaining barriers to firm growth, such as imperfect financial markets leading to lower financing possibilities for entrepreneurs with small or innovative projects.

*...and price
rigidities persist.*

The results of recent surveys on price-setting behaviour also point to lack of flexibility on product markets. They show that consumer prices are less flexible in the euro area than in the US. In particular, prices of services are less flexible downwards and this might be related to the remaining regulatory barriers in these sectors. The existence of price rigidities tends to complicate the conduct of monetary policy. The above mentioned surveys also indicate that euro area firms do not set competitive prices and that around 80% of euro area firms continue to price discriminate. Therefore, despite the positive effects of integration, there is still room for improving the conditions of competition within the Internal Market. The openness of the Internal Market can play a key role in this respect.

**External
dimension**

The Internal Market appeared to have lost its attractiveness for foreign investors and it did not provide an environment conducive to the expansion of activities in fast growing markets and sectors...

Over the recent period, the Internal Market seems to have lost its attractiveness for foreign investors, especially in comparison with fast growing markets. While this geographical shift may be partly explained by the evolution of the international division of labour, a more worrying evolution is that the EU market has also become less attractive in high-tech industries and for R&D international investments. A more integrated and efficient Internal Market should also help European companies to expand their activities in fast growing markets and sectors. However, since 2000, EU firms have been less active than the US ones in fast growing Asian markets. Finally, while the Internal Market and EMU have been associated with trade boosting effects and the EU25 has managed to maintain its share of world exports and imports over the last decade, the EU25 continues to reveal a comparative disadvantage in high tech sectors including ICT. The lag of the EU in developing ICT industries can be partly explained by a lack of progress in the creation of a competitive Internal Market for services and to a European innovation deficit.

Innovation

....and has been an insufficient driver for innovation.

According to the last Innovation Scoreboard, most EU countries lag behind the top performers like the US and Japan in terms of innovation. The EU innovation environment remains weak in a number of key "input "indicators, such as the amount of public and private R&D and the stock of science and technology researchers, as well as weaknesses of the higher education system. However, in addition to input deficiencies, market conditions and knowledge networks are key areas of EU weakness. European companies are not sufficiently encouraged to innovate and, in this respect, the Internal Market has been an insufficient driver of innovation: some markets, in particular in services, remain too fragmented, a clearer and more efficient Intellectual Property Rights system is lacking, the potential of public procurement has been insufficiently exploited and the European Research area is still fragmented, leading to duplication and waste of resources. All these elements can also contribute to explain why the Internal Market is losing its attractiveness for international R&D investments compared to the US and China.

4. WHY HAS THE POTENTIAL OF THE INTERNAL MARKET NOT BEEN FULLY EXPLOITED?

The Internal Market is still incomplete because ...

There are various reasons why the Internal Market has not lived up to its full potential. Clearly the Internal Market was an enormous challenge right from the start. Freeing up the movement of goods, services, capital and persons across Europe cannot be achieved from one day to the next. Nevertheless, it is somewhat disappointing that fifteen years after the so-called "completion of the Single Market" multiple barriers continue to hinder cross-border activities within the EU. Moreover, from an economic growth perspective it is quite disappointing that the gains from the Internal Market have been mostly static in nature, resulting in a one-off increase in living standards and that dynamic gains reflected in higher economic growth rates have been more difficult to achieve. On the other hand, it has to be acknowledged that in a changing environment the Internal Market will never be truly complete. The Single Market has always been somewhat of a moving target. This section offers some more specific explanations for the "incompleteness" of the Internal Market.

... implementation is slow and sometimes incorrect, ...

First, the speed with which Internal Market Directives are agreed, transposed into national legislation and actually implemented has been rather slow. In light of the need to consider the interests of all parties involved it may be difficult to speed up the decision making process. This is why the focus has been on improving transposition and implementation. Targets agreed within the context of the Lisbon Strategy for Growth and Jobs and peer pressure exerted through the reporting on Member States' performance in the Internal Market Scoreboard have had a positive effect. Nevertheless, in June 2006 the transposition deficit of the 25 Member States equalled 1.9% on average, which is still above the agreed target of 1.5%. In the view of the prominent role of the Internal Market as an adjustment mechanism in EMU, the poor performance of many euro area Member States in this respect is a special source of concern. Nine percent of outstanding Directives have not been transposed into national legislation in at least one Member State. Moreover, Internal Market rules are not always correctly applied as illustrated by the high number of infringement cases the Commission has had to launch.

... policy instruments are not fully operational ...

Second, other instruments that ensure the smooth functioning of the Internal Market are not fully operational. The application of the principle of mutual recognition leaves much to be desired. It is hampered by legal uncertainty and a lack of awareness of companies' rights both from the side of the companies themselves and that of the national authorities. The adoption of agreed standards is an alternative tool to remove trade barriers. It offers the

further benefit of ensuring a minimum degree of compatibility and interoperability of traded products. However, agreeing on such standards is a very time consuming process, which can be problematic in times of rapid technological change. The "New Approach" to standardisation is a more flexible and simplified regulatory tool. It leaves manufacturers the freedom to decide on technical detail within the context of agreed common principles. The Internal Market could profit from a more effective use of the "New Approach". It would also benefit from a more rapid opening up of public procurement. Currently only 22% of public procurement is published and thus open to competition. Some activities, notably in the defence sector, are exempted from the obligations spelled out in EU public procurement directives.

*... barriers persist
in certain sectors
...*

Third, the defence sector is not the only one in which barriers to cross-border trade and investment refuse to go away. Barriers in services are more prevalent than in manufacturing. Cross-border transactions in services often require the presence of the service provider in both countries, creating uncertainty about which country's rules to apply. The Services Directive aims to overcome such regulatory obstacles. While EMU and the introduction of the euro have provided a major impetus to financial integration in the EU, the financial sectors in the Member States continue to reflect specific national conditions and preferences. At the EU level, a divergence has emerged between the real sector which increasingly operates on a cross-border basis and a still fragmented financial sector. The on-going process of liberalisation in the network industries, while taking account of the need to provide services of general economic interest, implies a stepwise opening up of the telecommunications, postal services, energy and transport sectors to competition. Differences between countries in the pace of liberalisation and in the role of regulators in liberalised markets, as well as insufficient cross-border interconnection infrastructure have contributed to sustain existing barriers between national markets. Finally, the existence of 25 different tax systems creates barriers to the mobility of factors and thus to the full implementation of the Internal Market.

*... and an
Internal Market
for knowledge is
still missing.*

Fourth, the Single Market Programme never truly addressed the need to create in Internal Market for knowledge. The presumption was that knowledge spillovers would be a by-product of increased trade and investment. There is evidence however that only a quarter of innovative companies launch their new product in countries other than their own. Other means of knowledge diffusion, such as patent disclosure and licensing, are therefore essential to stimulate technological progress and productivity growth across the Community territory. The European system for the protection of intellectual property rights has struggled with finding the right balance between encouraging the creation of knowledge (by rewarding innovators) and stimulating its diffusion (through the prevention of strategic use of patents aimed at blocking market

entry of competitors). Moreover, it would benefit from a clarification and simplification of applicable rules; a reduction in the costs of obtaining patent protection; and a predictable, cost effective and accessible resolution of disputes.

5. REFLECTIONS ON THE INTERNAL MARKET IN THE 21ST CENTURY

Eight ideas to be further developed within the context of the Single Market Review.

This paper has analysed the underlying factors explaining why the potential of the Internal Market has not been fully exploited: (i) existing instruments to remove non-tariff barriers to cross-border transactions and factor movements are not fully adequate (ii) some markets remain fragmented and (iii) the Internal Market has failed to fully adapt to a changing environment. Based on this analysis, it is possible to sketch a new vision for the Internal Market in the 21st century. This section puts forward eight ideas that could be further developed within the context of the Single Market Review.

Internal Markets for services and knowledge are essential for productivity growth.

Due to the development of information and communication technologies in particular, services have become increasingly tradable. As a result, services producers in the EU are becoming more and more exposed to competition from third countries. An integrated and competitive home market is essential to face this challenge and raise productivity levels in the services sector. If the EU wants to replicate the spurt in productivity growth that the US has experienced, it will need to stimulate the use of new technologies in services such as wholesale and retail trade, financial services and professional business services. A more rapid diffusion of cost-effective production technologies supported by better developed Internal Market for knowledge is essential in this respect. Reforms in the European system of Intellectual Property Rights and better exploitation of the public procurement tool can also contribute to this objective.

The Internal Market can contribute to the smooth functioning of EMU.

The Internal Market is essential for a smooth functioning of EMU because it speeds up the process of adjustment to shocks by creating a more competitive business environment. More in particular, it increases incentives for firms to adapt prices, wages and quantities to changing market conditions. A better functioning Internal Market also eases the reallocation of resources across the EU territory. Therefore, facilitating such adjustment processes in EMU by promoting competition should be an essential component of the Internal Market in the 21st century. More flexible wage and price setting behaviour, more integrated and developed financial markets, a better functioning single market for services, as well as more flexible labour markets emerge as having a very important influence

in this respect.

Enlargement has increased the heterogeneity within the Internal Market.

Enlargement has increased the opportunities to be reaped from the Internal Market but it has also increased the heterogeneity among its members, increasing the risks of tensions between Member States. Differences in industrial structure and the stage of economic development tend to be reflected in different economic priorities. This diversity might be resolved naturally as the new Member States catch up with the EU average and differences in industrial structure gradually disappear. This however might take some time and tensions in areas such as corporate taxation and migration might have to be addressed in the meantime.

The Internal Market rules should be considered within a global context.

The radical reduction in international communication and coordination costs imply that EU firms can offshore specific tasks within the production process, leading to a new paradigm of globalisation. This task-level off-shoring implies that building-up the ability of individual workers to respond to different tasks and ensuring sufficient flexibility in the economic system to allow workers to move around are crucially important to seize the opportunities and minimise the adjustment costs of globalisation. Lessons can also be drawn from the policy used by our trading partners to enhance their competitiveness. For example, the dominance of US in certain fields such as ICT may be linked to state support in early development of technologies in these fields. In Europe, there is no defence equipment market and Member States concentrate too much on supporting weak companies and sectors. Finally, when drawing up Internal Market rules, it is important to agree at the EU level on standards that neither compromise the ability of EU exporters to sell abroad, nor limit the entry of imports in the EU market. A wider use internationally of Europe's high standards in terms of consumer and environmental protection would be beneficial in this respect.

Well designed Internal Market and external trade policies are mutually supportive.

The Internal Market is necessary to improve the competitiveness of European companies at world level. However, it is not sufficient to ensure that EU firms thrive in the global economy. Well designed external policies aimed foremost at ensuring that fair-trade rules are observed are complementary to internal policies. Only if EU firms are granted non-discriminatory access to markets across the world can the benefits from the Internal Market be fully reaped. This illustrates the benefits of ensuring consistency between internal and external policies.

Potential synergies between

The Internal Market policies may be integrated into a systemic approach combining various policy instruments and creating the

the Internal Market policies and competition and innovation policies can be better exploited.

appropriate framework conditions for European firms to be competitive at world level. For example, the Internal Market integration policies could be linked to competition (state aids, merger control and anti-trust) and innovation (R&D, education, ICT) policies, the other two economic mechanisms through which efficiency on product markets can be improved. For example, efficiency and innovation considerations could be better taken into account when designing competition policy. Steps in this direction have been taken in the new Merger Regulation and in the new framework for State Aid for R&D and Innovation. Similarly, a more efficient regulation of electronic communications and a better system of IPRs could contribute to the development of new technologies in Europe. There are strong spillovers between national and Community policies, as well. All Member States contribute to the well-functioning of the Internal Market, which can be considered as a common good. In areas where achieving a critical mass justify Community actions, an increased exploitation of synergies between Community and national policies can help to ensure that available resources are used more efficiently.

Adjustment costs associated with market integration need to be considered. This would involve a close monitoring of the impact of reforms undertaken.

Deepening the Internal Market implies the opening up to competition of sectors (such as the services sector) that are politically sensitive, because it directly affects the employment of a large number of people. Unless an effort is made to increase the public acceptability of market opening and liberalisation it will be very difficult to enact these reforms. In order to increase acceptability, it is crucial to provide evidence illustrating the overall benefits of reforms proposed; to consider the most appropriate sequencing of reforms; and to facilitate the process of adjustment particularly for those most directly affected. From this, it should be clear that reform proposals should be carefully prepared, necessitating theoretical analysis and diagnosis to guide the policy design ex ante. Moreover, once the reforms have been implemented it will be important to ensure a close monitoring of the effects of the reforms undertaken.

A move from a legalistic approach to a more economic approach based on the monitoring of markets offers potential benefits.

Better Internal Market regulation depends on a better understanding of the obstacles preventing markets from functioning well. This would imply moving from a largely legalistic approach to a more economic approach, based on the monitoring of markets. This more economic approach has started to be implemented in the area of competition policy, where sector enquiries, such as those undertaken in the energy and retail banking sectors, have proven to be a valuable tool for identifying the nature and scope of competition problems within the Internal Market. However, the market monitoring to be developed should be wider in scope and analyse also barriers to market integration and market access, technological developments and innovation and price and wage adjustments to changing market conditions. Internal Market monitoring would benefit from increased transparency and priority setting.

STEPS TOWARDS A DEEPER ECONOMIC INTEGRATION:

THE INTERNAL MARKET IN THE 21ST CENTURY

1. INTRODUCTION

The European Union and its Member States have been engaged in a process of market integration over a long period. A key objective of economic integration has been the removal or elimination of barriers between Member States' markets. A cornerstone of this process was the adoption and implementation of a major legislative programme, the Single Market Program, resulting in the elimination of non-tariff trade barriers by 1st January 1993. The removal of these barriers was targeted at creating a large integrated market for goods and services, allowing the realisation of economies of scale. The fiercer competition in this integrated market was expected to result in (allocative and productive) efficiency gains. It was also aimed at providing increased incentives for European producers to invest in product and process innovations, thereby improving the dynamic efficiency of the European economy. For European consumers, the Internal Market was also seen as a source of benefits through wider choice and lower prices.

While the Internal Market has contributed to promote integration and, to a certain extent, competition within the EU, its potential has not been fully exploited. Initial expectations that the Internal Market would be a launching pad for a more dynamic, innovative and competitive economy at world level have not been met. In the early 1980s, the convergence in the EU level of GDP per capita towards that of the US came to an end. Over the past ten years, the average annual per capita growth rate of the European Union has been even below that of the US. The on-going Single Market Review provides an opportunity to redefine the strategy for the Internal Market and to give it new impetus. This paper offers an economic perspective on the different issues currently under discussion within the context of the Review.

This paper addresses the three following questions. First, to what extent is the environment in which the Internal Market operates today different from that of the late 1980s-early 1990s? Second, what is the latest empirical evidence on the economic impact of the Internal Market? Third, why has the Internal Market failed to live up to early expectations? The answers to these three questions should help to shed light on the economic principles underlying the Internal Market and offer ideas on how its potential can be further exploited.

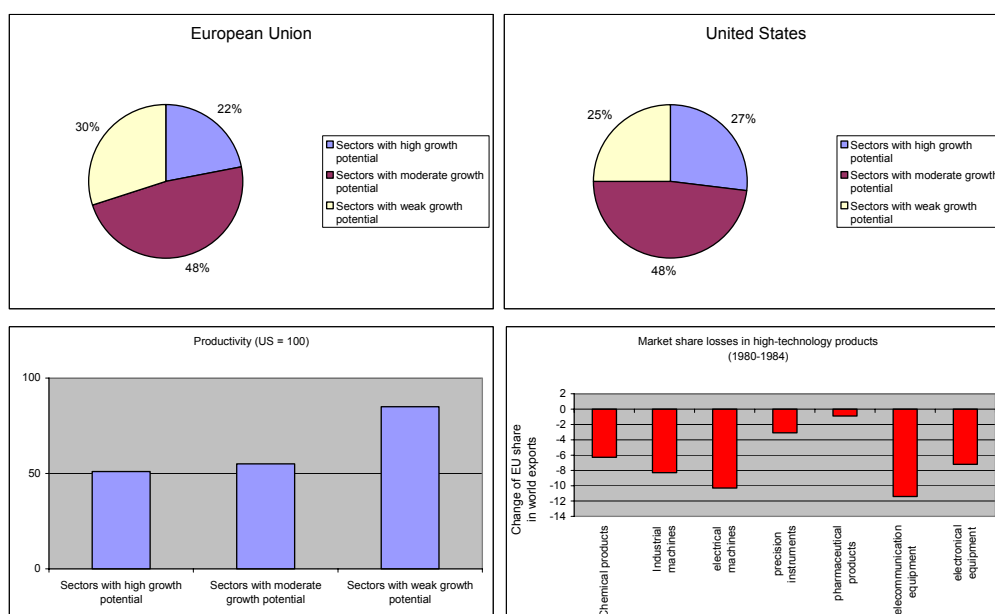
2. THE CHANGING ENVIRONMENT OF THE INTERNAL MARKET

This chapter explains the context in which the Internal Market operates since the completion of the Single Market Programme in 1992. It analyses the impact of subsequent policy initiatives that have led to further market integration, notably the use of a common currency in a large area within the Internal Market and the widening of the Internal Market through EU enlargement. It also considers the increased economic importance of the services sectors from an Internal Market perspective. The final section of this chapter discusses the role of the Internal Market in ensuring EU competitiveness in an increasingly global economy.

2.1. Single Market Programme

The publication of the White Paper on the Single Market Programme (SMP) in 1985 signalled the end of a period of euro-pessimism associated with the political, economic and monetary crises of the 1970s and early 1980s. The 1988 Cecchini Report delved into the structural weaknesses underlying the poor performance of the European economy¹. It highlighted the fact that European industry had a relatively weak specialisation in sectors with high growth potential, which was associated with especially low productivity levels in those sectors and resulted in substantial losses in world market export shares (see Figure 2-1), problems that must not sound unfamiliar to current policy makers. At the time, the SMP initiative opened up perspectives for restoring confidence, increasing competition and improving the competitiveness of European enterprises.

Figure 2-1: Weak EU performance in sectors with high growth potential, 1985



Source: European Commission - Cecchini Report (1988)
If not indicated data refer to the year 1985

The SMP presented a comprehensive list of measures intended to eliminate physical, technical and fiscal non-tariff barriers to the movement of goods, services, capital and persons inside the Community. To this end, it planned to remove border controls, standardise industrial regulations, open up government procurement, liberalise financial markets and establish the right to free establishment in other services, harmonize VAT rates, and generally remove barriers to competition among EC firms. The deadline for achieving the Single Market was set for end 1992.

Since that time, the definitions of the Internal Market and the expectations towards it have been constantly changing, taking into account the newly arising opportunities and challenges of the global environment. While initially the measures foreseen in the SMP mainly concerned manufacturing industries, over time there has been a gradual widening of the SMP's scope. In following years precedents were set that liberalised cross-border delivery of services and freedom of establishment, culminating in the much discussed services directive. This development reflected the increased economic importance and tradability of services. The success of the liberalisation process in the network industries

¹ See: Cecchini (1988).

largely depended on market entry, including by competitors from abroad. These broader needs for market integration were reflected in the Internal Market Strategy, which set out the main policy objectives in the years following the completion of the SMP in 1992².

Box 2.1: STRATEGIES FOR THE INTERNAL MARKET AFTER THE PUBLICATION OF THE 1985 WHITE PAPER

Action Plan of June 1997

This Action Plan aimed at removing the remaining obstacles in order to improve the performance of the Internal Market. It included four strategic targets:

- Tighter enforcement of existing Internal Market rules (e.g., in the area of public procurement) ;
- Dealing with key market distortions (e. g ., rigorous application of State aid control) ;
- Elimination of sectoral obstacles to market integration, especially in services ;
- Delivering an Internal Market for all citizens.

An Internal Market Scoreboard is published to record the progress made in these areas.

New strategy for the Internal Market of 1999

In 1999, the Commission has presented a new framework defining 4 strategic objectives for the Internal Market:

- To improve the quality of life of citizens ;
- To enhance efficiency of Community product and capital markets ;
- To improve business environment ;
- To exploit the achievements of the Internal Market in a changing world.

The actions necessary to achieve these strategic objectives were defined and adapted every year to take into account the reactions of markets, business and citizens.

Strategy for the Internal Market: priorities 2003-2006

In 2003, the Commission presented a ten point action plan defining the priorities to improve the operation of the Internal Market over the period 2003-2006. This new strategy has been put in place to take into account the Lisbon objective, the challenges of enlargement and ageing.

The ten priorities were:

- Facilitate the free movement of goods (e.g., by improving the implementation of the mutual recognition principle);
- Integrating services markets ;
- Ensuring high quality network industries
- Reducing the impact of tax obstacles ;
- Expanding procurement opportunities ;
- Improving conditions for business (e. g., by adopting a Community patent) ;
- Meeting the demographic challenge (e. g., by improving the portability of pension rights) ;
- Simplifying the regulatory environment ;
- Enforcing the rules;
- Providing more and better information.

2.2. Economic and Monetary Union

The next major step in European economic integration was the creation of an Economic and Monetary Union (EMU) in 1999 and the introduction of euro coins and bills in 2002. The remainder of this section explains that not only the EMU complements the Internal Market but also the Internal Market is essential for a smooth functioning of EMU.

² See: Ilzkovitz (2006).

2.2.1. How the EMU complements and enforces the mechanisms of the Internal Market

The creation of the single currency implies a direct reduction in trade barriers through the elimination of the cost of exchange rate transactions themselves and the elimination of the risks associated with exchange rate movements. In addition, it facilitates cross-border comparisons of prices, thereby enhancing market transparency and increasing competitive pressures.

The creation of the EMU has reinforced the integration and the competition effects of the Internal Market by reducing the costs of cross-border activities (elimination of the costs of managing multiple currencies and of exchange rate risks) and by increasing the transparency of prices (see Box 2.2). However, the relations between EMU and the Single Market go in both directions. A well functioning and flexible Internal Market which allows for a rapid market based adjustment in the case of shocks is essential for a smooth functioning of EMU. More competitive product markets are essential in ensuring price and wage flexibility in EMU.

Box 2.2: THE INTEGRATION EFFECTS OF THE EURO

Reduction of transaction costs: A single currency allows exporters or customers to save on the transaction costs associated with the management of multiple currencies. Transaction costs include conversion charges on the spot exchange rate market, the cost of hedging against currency fluctuations, in-house costs associated with the management of multiple currencies and banking charges on cross-border payments.

Elimination of exchange rate risks: The competitive positions of companies can no longer be overturned by exchange-rate movements but will reflect productivity, cost and inflation differentials. This makes a big difference with the past, where hedging was the mean to reduce exchange rate risks. In practice, exporters cannot insure themselves adequately against all forms of exchange rate risks. In particular, hedging can be more costly for currencies which are not traded intensively on world financial markets. In addition, available hedging instruments are essentially of a short-term nature. Trade is mainly affected by medium to long-term fluctuations in real exchange rates against which hedging is difficult.

Increased market transparency: The elimination of the national currencies and the introduction of a single currency make the prices of the participating Member States directly comparable. It thereby enhances cross-border competition and increases trade flows. This greater price transparency should allow (i) a reduction in information cost and facilitated cross-border arbitrage; (ii) a better allocation of capital and of available resources; (iii) a better exposure of the costs of structural rigidities as reflected in relative prices international; and (iv) a more effective comparison of balance sheets, mergers, acquisitions and alliances at Union level.

2.2.2. The Internal Market as an instrument for rapid adjustment in the EMU

For euro area countries the instruments of an independent monetary policy and exchange rate realignments are no longer available and the use of their fiscal policy is limited by the Stability and Growth Pact. In the absence of national monetary policy, or the use of other instruments, the adjustment process that brings cyclical conditions back in line with the euro area average uses the so-called "competitiveness channel"³. As the national economy enters a boom phase relative to the euro area average, for example, the pressures on resources causes costs to increase; the real effective exchange rate appreciates; and this in turn slows activity until cyclical conditions move back in line with the euro area average.

³ See: European Commission (2006h).

There is significant scope for policies to influence the adjustment process through the fiscal stance and, over the medium-term, structural policies. The main role of structural reforms is to speed up this often slow adjustment process. Wage and price setting behaviour exerts an important influence on the speed and efficiency of adjustment. Recent surveys show that prices in the euro area change relatively infrequently. Prices of services are especially sticky, which is an indication of a lack of competition in services markets. Further structural reforms therefore appear to be needed to increase the responsiveness of domestic prices and wages to shocks. Even though the gap with the US has narrowed, euro area product and labour markets remain highly regulated. The creation of a more integrated and competitive Internal Market, particularly in services, should help ensure that prices adjust more rapidly to changing supply and demand conditions. More integrated markets also allow a more rapid dissipation of asymmetric shocks, as excess demand (or supply) for goods and services in one region within the euro area can be satisfied by supply (or demand) from another region. A more ambitious reform programme aimed at speeding up the process of adjustment via changes in prices, wages and production quantities in the euro area would therefore seem essential.

From a longer term perspective, the adjustment to shocks requires moving production factors from declining sectors to sectors where the economy has a comparative advantage and where the factors can be used more efficiently. A more integrated Internal Market facilitates the reallocation of such factors, particularly in the case of more permanent supply shocks (such as technology shocks). This reallocation of resources can take place within industries via a process of entry and exit resulting in a shift in market shares towards most efficient firms. Alternatively it may occur via a process of industrial specialisation and geographic concentration reflecting the competitive advantages of countries or regions.

A well functioning and flexible Internal Market which allows for a rapid market based adjustment to correct asymmetric shocks has, thus, gained in importance with the establishment of the EMU.

Box 2.3: THE LISBON STRATEGY FOR GROWTH AND JOBS

Despite the incontestable achievements of economic integration, the EU has failed to catch-up with the US in terms of economic performance. This is why in 2000 the EU heads of state and government decided to launch the Lisbon Strategy for Growth and Jobs. In comparison with the Internal Market, the Lisbon strategy was much wider in scope, foreseeing reforms in product, capital and labour markets as well as measures aimed at stimulating R&D and innovation. It encouraged Member States to accelerate the reform effort and valued a better co-ordination of the Member States' national reform agendas. In addition, it aimed to exploit the synergies between the different structural policy areas (the traditional areas such as labour and product markets, but also new areas like the knowledge-based economy, improvement of social conditions and the protection of the environment), and synergies between structural and macroeconomic policies. The Internal Market strategy was seen as an important element of the Lisbon Strategy. The breadth of its scope, however, clearly differentiated the Lisbon strategy from the earlier Community initiatives such as the SMP and EMU, which had more precisely defined objectives..

2.2.3. Labour mobility as a tool of adjustment in EMU

As explained above, the adjustment of a region or a country to asymmetric shocks can occur through a change in price competitiveness or through resource mobility. The latter requires moving production factors to firms, sectors or regions where the factors can be put to more efficient use. This is how labour mobility can help unwinding imbalances across countries, promoting the efficient allocation of labour while at the same time reducing labour shortages in high-employment regions.

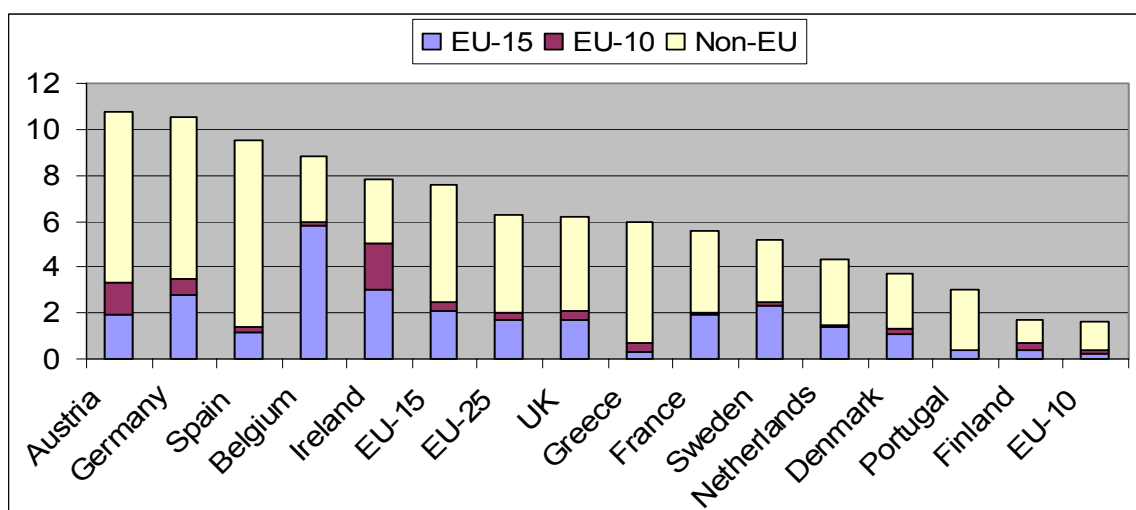
In the US, labour mobility was the most important adjustment channel⁴. Labour mobility accounted for the bulk of adjustment (after an initial increase in unemployment) while capital mobility and price and wage adjustments played a relatively minor role. In contrast, in Western Europe, a shock on employment was mainly absorbed by changes in labour force participation rather than labour mobility⁵.

Because of the limited role played by labour mobility in the EU, and especially in the euro area, enhancing the adjustment through migration is desirable. There is persistent dispersion of unemployment rates across countries and regions within them. European regions with skill shortages and low unemployment are often next to regions with skill or general labour surplus and high unemployment.

The free movement of labour between Member States of the European Community was introduced in 1968 and was one of the principles underlying the 1992 Single Market Programme. Nevertheless, labour mobility has remained rather low. In the EU15, only 0.1% of the working-age population change their country of residence in a given year. In the US, about 3 per cent of the working-age population moves to a different state every year. Labour mobility between the euro area Member States however, has slowed down considerably following the first oil price shock in 1973. It was much higher during the 1950s and 1960s when northern European countries actively recruited workers from southern Europe and Ireland. Labour markets remain segmented, country by country. Within countries, regional mobility rates are around 1% of the total working-age population in 2005, with rates below 0.3% in several Member States.

Compared to international migration from third countries, labour mobility within the EU is a limited phenomenon. The share of nationals from other Member States does not exceed 20 per cent of the total foreign working-age population and in general, a minority is from the EU10 Member States, see Figure 2-2.

Figure 2-2: Share of foreign nationals in percentage of resident working-age population, 2005



Source: Eurostat

The free movement of people and workers was probably the most significant dimension of economic integration to change after the EU enlargement in 2004, given that barriers

⁴ See: Blanchard and Katz (1992).

⁵ See: Decressin and Fatas (1995).

to trade, foreign direct investment and other capital movements had already been largely removed. Large gaps in per capita income and wages across the enlarged EU provide high incentives for east-west mobility, which are likely to persist for quite some time; furthermore, geographical proximity and established historical and cultural ties may ease migration flows. As in previous enlargements, temporary arrangements for the free movement of workers have been agreed upon and included in the accession treaties to ensure a smooth process of integration. Since enlargement, there has been an increase in the number of EU8⁶ workers in EU15 Member States. Overall, the percentage of EU8 nationals in the resident population of each EU15 Member State was relatively stable before and after enlargement, with the exception of the UK and, more strikingly, Austria and Ireland where there was an increase. In EU15 countries maintaining transitory restrictions, typically, labour market access for workers from the new Member States has been governed by quota systems.

2.3. EU enlargement

In parallel with the integration processes described above, several rounds of enlargement have taken place, leading to the expansion of the Single Market. The recent accession of ten new Member States substantially increased the size of the Internal Market, while constituting at the same time a challenge to its proper functioning. On the one hand, the accession of the central and eastern European countries has increased the pool of consumers and has provided firms with additional opportunities to draw on a wider range of comparative advantages characterising the different Member States. This is a source of further dynamism and efficiency in the Internal Market. On the other hand, while the economic changes induced by this enlargement have been absorbed quite smoothly and there is no evidence of disruptive impacts on the product and labour markets, the increased divergence among the EU25 members has augmented the risks of tensions within the Internal Market, such as in the areas of the opening up of services markets, tax competition and migration flows.

A Commission study⁷ reviewed the economic dimension of the 2004 enlargement. It concluded that the enlarged Internal Market has become, despite the increased economic divergence among its current members, more integrated and dynamic. In particular, the accession of the central and eastern European countries has increased the potential benefits of the Internal Market. It has increased the pool of consumers but it also provides firms with additional opportunities to draw on the wider range of comparative advantages that characterise the different Member States. Hence, enlargement contributes to a more dynamic and efficient Internal Market leading to a stronger European economy that is better equipped to face the increasing global competition.

2.4. Demographic change

The EU will undergo unprecedented demographic change in coming decades: over the period 2004 to 2050, fertility rates are expected to remain well below the natural replacement rate of 2.1 children per woman, and life expectancy is projected to continue to increase by about one year and a half per decade⁸. Demographic changes under way also mean that the working-age population in Europe will start to shrink from 2010

⁶ These Member States are: Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia and Slovenia.

⁷ See: European Commission (2006a).

⁸ See: Eurostat (2005).

onwards. The Commission projects that the working-age population (15 to 64) will decline by 16% (or 48 million) by 2050 while the elderly population (aged 65 and +) will rise sharply by 77% (or 58 million).⁹ In order to maintain and further improve the living standards of its ageing population Europe will have to use its human resources more efficiently. Achieving the benefits from an optimal allocation of workers across jobs, sectors and regions is becoming increasingly important. The Internal Market can contribute to this by giving workers the freedom to move between EU Member States.

The effects of ageing populations can also be offset to some extent by immigration from third countries. Net immigration flows are projected to hover around 0.2% of the total EU population which on its own will not solve the problems linked to ageing. Moreover, population ageing affects migrants themselves, as they get older and their fertility patterns tend to resemble those in their host country. Nevertheless, immigration may have positive effects on the functioning of the Internal Market by relieving the labour shortages in certain areas. New jobs can be created, for example in the construction sector, domestic services and hotels and restaurants. Highly skilled immigrants can bring scientific, technical and innovative skills that expand the production capabilities of the economy¹⁰, thereby contributing to the creation of new industries and the increase in long term growth through human capital accumulation. Market efficiency may also increase with immigration¹¹. Indeed, immigrants are very responsive to regional differences in economic opportunities. New immigrants in the US are found more likely to be clustered in the states where wages are the highest for the type of skills they offer, thus "greasing the wheels of the labour market". Immigration could have a potential role in improving the market efficiency by compensating, at least partially, for the low mobility of natives.

2.5. Increased importance of services

The character of the Internal Market has also been changed by an increased focus in policy development on services and network industries. The broadening of the scope of the Internal Market (which under the Single Market Programme was rather more narrowly focused on manufacturing industries) reflects the growing economic importance of the services sectors. Services now account for around 70% of employment and value added in the EU. However, they are responsible for only 20% of intra-EU trade. This relatively low figure reflects the low tradability of services in general but also the continued existence of regulatory barriers within the Internal Market.

Due to their intangibility services tend to be affected by more complex regulatory barriers than trade. Unlike goods, they often require business processes and the presence of the provider in both Member States: in that of the service provider and in that of the delivery. This double presence can result in the duplication of regulatory requirements and burdens (national social security schemes for the staff, different administrative and tax procedures, etc.). In addition, foreign firms often face additional costs due to the non-acknowledgement of their compliance with their home country regulation¹², and there is often a lack of clarity on the regulations and their effective implementation, resulting in

⁹ See: European Commission (2006j).

¹⁰ See: Freeman (2006).

¹¹ As suggested by Borjas (2001).

¹² Companies might have to provide professional (re-) qualifications, meet economic tests, and sometimes need to have the residence or even nationality of the owner or manager of the firm in the member state where the service is delivered, or for some branches geographical or quantitative limitations of establishment still exist.

legal and economic uncertainty for foreign service providers. This regulation heterogeneity severely restricts the realisation of economies of scale in complying with regulations within the EU.

From a competition perspective, the negative consequences of the low tradability of services can to a certain extent be offset by ensuring the freedom of establishment for service providers and by a simplification and harmonisation of regulatory requirements. The Services Directive, which was adopted towards the end of 2006, aims to enhance competition and growth by encouraging the cross-border provision of services, either via trade or the local establishment of competing service providers. At the same time tradability and competition in services is increasing at world level, mostly as a result of a fragmentation of production processes made possible by the development of new Information and Communication Technologies (ICT).

Improving effective competition in network industries has wider benefits, as these sectors provide inputs to a large number of other economic activities. While significant progress has been made in terms of market liberalisation (particularly in the air transport and telecom sectors and to a lesser extent in postal services, energy and rail transport) the goal of full market integration is still a long way off for all these sectors. This is reflected in the still significant price differences between Member States. The first step in fostering market integration in network industries is to ensure that the physical infrastructure for integration is in place. This is for example the case in air travel, telecommunications and postal services where a well established Europe-wide network already exists. This contrasts sharply with the electricity and gas sectors, where the necessary interconnection capacity between countries is still insufficient. Until the physical infrastructure is in place, the scope for a well functioning Internal Market remains severely restricted.

2.6. Globalisation

A number of large and rapidly growing markets, particularly in Asia, have started to be opened up to European companies. In order to be competitive in these new markets EU firms need to have a sound home base, which provides incentives for firms to improve efficiency and innovative performance. The enlarged Internal Market has the potential to develop into such a home base. Already it offers a number of benefits. First, as a source of sophisticated and innovation-driven demand, the Internal Market provides the incentive for EU producers to become increasingly specialised in high-value added production. Second, the Internal Market offers the opportunity to exploit economies of scale in R&D, innovation, production and advertising. The adoption of common standards within the EU and worldwide is also important in this respect. Third, the Internal Market makes the EU a more attractive location to do business. By attracting inward FDI, the Internal Market encourages the diffusion of new technologies developed elsewhere. Finally, as increasing trade openness puts added downward pressure on the prices of imported products, only a well functioning Internal Market will ensure that this will be translated into lower retail prices across all EU markets, leading eventually to benefits to EU consumers and higher economic growth.

Not only will a well functioning and open Internal Market increase economic growth and employment levels inside the EU, but it also helps European business to compete successfully in the global marketplace. First, as indicated above, the competitive position of EU business improves as a result of the learning process involved in competing in the Internal Market, allowing EU firms to more successfully exploit opportunities and

compete in markets abroad. Secondly, globalisation is providing an opportunity to export and promote Internal Market standards abroad for example in the field of environmental protection. This is taking place whilst the EU is simultaneously seeking convergence upon high quality regulatory standards from abroad. Thirdly, as the pace of global economic change increases, with the emergence of China, India and other emerging markets, the consolidation of the Internal Market will give EU Member States the possibility to present a common position in global economic forums based on shared economic goals.

3. EMPIRICAL EVIDENCE ON THE EFFECTS OF THE INTERNAL MARKET

This chapter describes the expected economic effects of deepening EU economic integration associated with the removal of non-tariff barriers to trade and cross-border activities and with the introduction of a single currency. Section 3.1 presents the expected microeconomic effects and compares these expectations with the available empirical evidence on the results achieved so far. Section 3.2 provides an updated estimate of the macroeconomic effects of product market integration taking into account the most recent enlargement.

3.1. Microeconomic effects

The consolidation of the Internal Market and the introduction of the euro are expected to deliver welfare gains that result from associated profound micro-economic changes, notably in terms of competition pressure, price setting behaviour of firms and changes in specialisation patterns (see Box 3.1).

The reduced barriers to cross-border flows of products and factors and the associated increase in price transparency across Member States reinforce competition pressures within the EU and contribute to higher productivity levels and greater competitiveness via three main channels: (i) increased allocative efficiency, which results from forcing firms to set prices lower and closer to marginal costs, reducing monopoly rents and distortions in the allocation of resources while pushing total output closer to the social optimum level; (ii) increased productive efficiency, due to the fact that inefficiencies are more strongly penalised in the marketplace; (iii) enhanced dynamic efficiency, which results from the greater incentives to invest in the adoption and development of product and process innovations.

Box 3.1: THE IMPACT OF PRODUCT MARKET INTEGRATION ON MICRO-ECONOMIC PERFORMANCE

To better understand the full impact of integration on economic performance, a distinction is made between short-term effects on the permeability of markets, medium-term effects on the behaviour of firms and longer-term effect on the organisation of industry, the structure of the economy and innovation performance¹³.

(1) Competition effects

The removal of barriers to intra-EU product and factor flows facilitates firm entry and the introduction of new brands in the various national markets, leading to an increase in inter-brand competition. This results in an increase in allocative efficiency and declining prices and profit margins. The EMU by increasing cross border price transparency and increasing intra-brand competition has further reduced firms' ability to exploit market power via price discrimination strategies. This effect is further reinforced by the growing importance of electronic commerce that minimises cross border search costs.

(2) Firms' behaviour

In reaction to the increased competition pressure and to restore their profit margins firms may decide to modify their strategy in different ways: *i*) by reducing production costs, which can be achieved by concentrating on the activities where their competitive position is strongest ('core business') or/and by exploiting further economies of scale by expanding in new geographical markets; *ii*) by regaining market power via increasing product differentiation.¹⁴ As this requires costly investments, the latter strategy is also likely to lead firms to concentrate resources on core business activities.¹⁵

(3) Effects on the structure of industry

The longer-run implications of the changes in the behaviour of firms are not straightforward:

- **Industrial concentration** levels, within each Member State, are likely to decline as firms from other Member States enter the market¹⁶. However, at EU level, concentration may increase because mutual entry does not lead to an increase in the total number of firms. Nevertheless, firms are expected to compete more intensely across borders.
- The impact on **industrial specialisation** results from two forces working in opposite directions. The reduction in cross-border transaction costs allows for greater exploitation of scale economies and therefore promotes inter-industry specialisation among Member States.¹⁷ However, since integration promotes convergence in income levels and factor endowments among Member States and the elimination of exchange rate fluctuations reduces uncertainty associated with cross-border transactions, intra-industry trade (hence reducing industrial specialisation) could rise.^{18,19}
- The **location** of production is also affected as firms expand activities beyond their home markets. "New Economic Geography" arguments claim that due to the exploitation of agglomeration economies production would become more concentrated in core regions which are closest to the largest markets²⁰. However, the concentration in the core leads to an increase in the prices of immobile production factors

¹³ See: Dierx, Ilzkovitz and Sekkat (2004).

¹⁴ Another option, facilitated by the increased price transparency, would be to come to a tacit agreement amongst producers and distributors to set high prices. However, the increased risks of collusion can be counteracted by an effective application of competition policy.

¹⁵ In the medium-term we will then expect to observe a decline in sectoral diversification at the firm level.

¹⁶ Assuming that, it is not offset by market exit or takeover of national firms.

¹⁷ Making them in the process more vulnerable to asymmetric shocks, see Krugman (1991a and 1991b).

¹⁸ See: Frankel and Rose (1997), Fontagné and Freudenberg (1999) and European Commission (1996 and 1997).

¹⁹ The empirical evidence available supports both claims. While production specialisation has risen since the early 1980s, export specialisation has remained more or less unchanged and there has been a notable increase in the relative importance of intra-industry trade.

²⁰ See: Krugman (1991a and 1991b).

and congestion costs are pushed up. As intra-EU trade barriers are reduced further, a re-dispersion of economic activity across the EU may occur, changing the specialisation patterns of countries and regions.

(4) Innovation effects

Product market integration can also lead to dynamic gains by stimulating innovation and the diffusion of innovation: first, the pressures of competition stimulate innovation because the risks of being eliminated from the market are higher; second, the creation of an Internal Market allows writing off the fixed R&D costs over a larger volume of production; and third, technology transfer and diffusion are stimulated via the increased FDI flows.

While it is still too early to draw definite conclusions about longer-term effects, existing empirical evidence allows a first investigation of the short and medium term changes triggered by the integration process. What emerges from the available evidence is somewhat of a mixed picture: while the Internal Market has helped to promote integration and, to a certain extent, competition within the EU, it has been relatively ineffective as a driver of innovation. The potential of the Internal Market has therefore not yet been fully exploited.

3.1.1. Market Integration

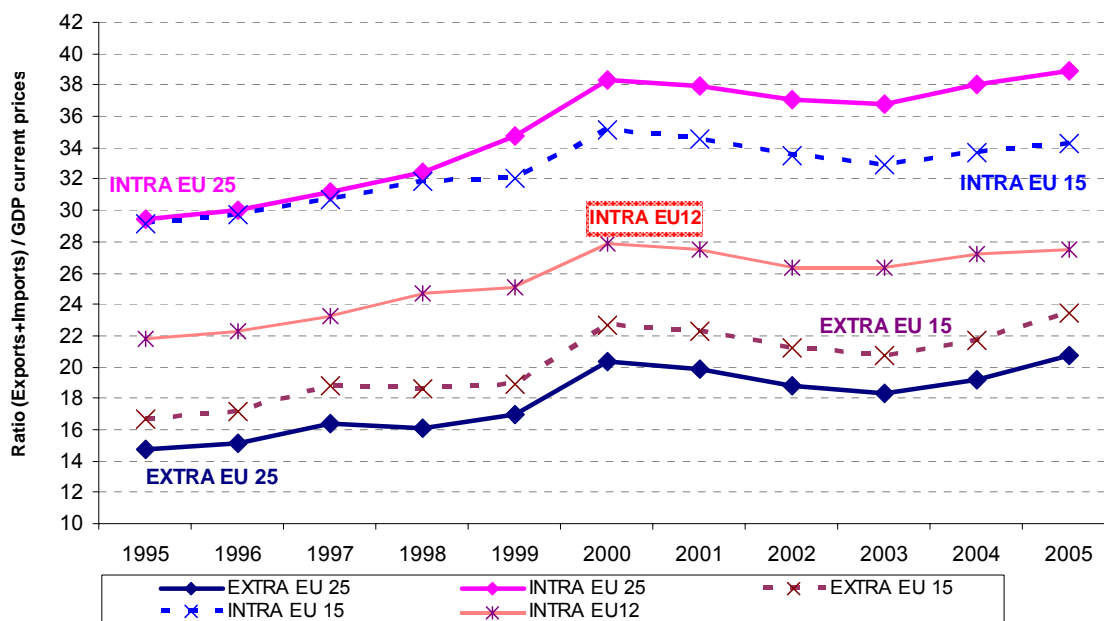
The Internal Market, but also EMU and enlargement, have helped to reinforce the integration of European product markets. However, the empirical evidence gathered in this section shows that the pace of European market integration appears to have slowed down in recent years.

3.1.1.1. Trade flows

Despite the ongoing efforts to eliminate all remaining barriers to cross-border transactions within the EU, integration as measured by the ratio of intra-EU trade flows of goods to GDP seems to have lost momentum since 2000, particularly among the EU15, after increasing noticeably in the late 1990s.

The ratio of intra-EU25 manufacturing trade to GDP increased strongly in the second half of the 1990s (particularly from 1998 onwards) fuelled by trade growth between the EU15 and the Central and Eastern European countries during the run up to the EU accession of the latter. An increase of intra EU15 trade as a share of GDP was also observed until 2000, which can be interpreted as an effect of the gradual implementation of the Internal Market *acquis* (see Figure 3-1).

Figure 3-1: Ratio of intra and extra-EU manufacturing trade to GDP (%)



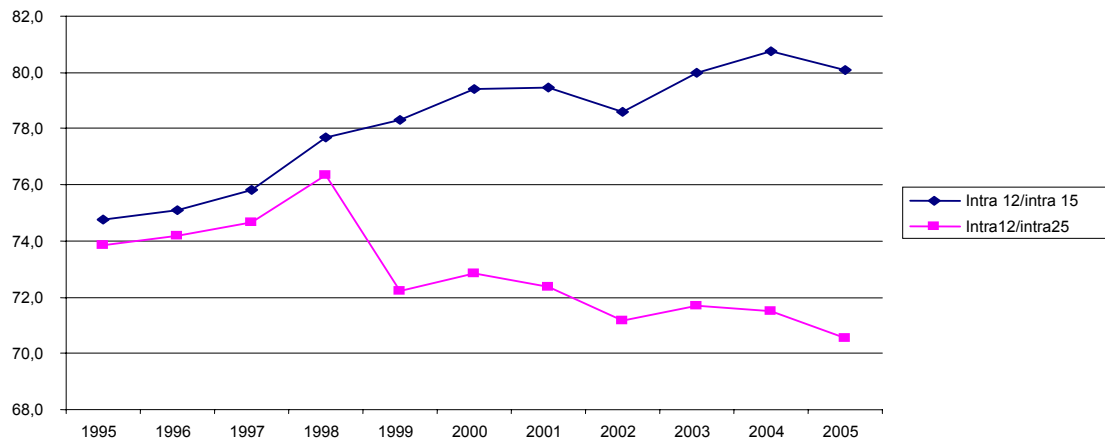
Source: Eurostat

However, since 2000 the trade effect of the enlargement process and particularly intra-EU15 trade integration, seem to have stalled. While, by 2005, the GDP share of intra-EU25 trade had bounced back from the slump observed in 2002-2003 it was nonetheless only marginally above the peak level of 2000. The ratio of intra-EU15 trade to GDP in 2005 still remained below the 2000 peak.

This period of slowdown in trade integration coincided with the introduction of the single currency. While it is still too early for a definite evaluation, there is wide agreement that the euro nevertheless has had a positive impact on trade integration. Estimates point to an increase in intra-euro-zone trade of 5% to 10% that can be attributed the introduction of the euro²¹. In fact, it is possible to observe an increasing trend in the share of intra-euro-zone trade in total intra EU15 trade, confirming the importance of the euro as an instrument to push forward the ongoing process of deepening economic integration within the EU (see Figure 3-2). The trade boosting effect of the introduction of the euro has however been far less pronounced than the trade effect of enlargement as illustrated by the decreasing ratio of intra euro-zone trade to intra-EU25 trade since 1998.

²¹ See: Baldwin (2006).

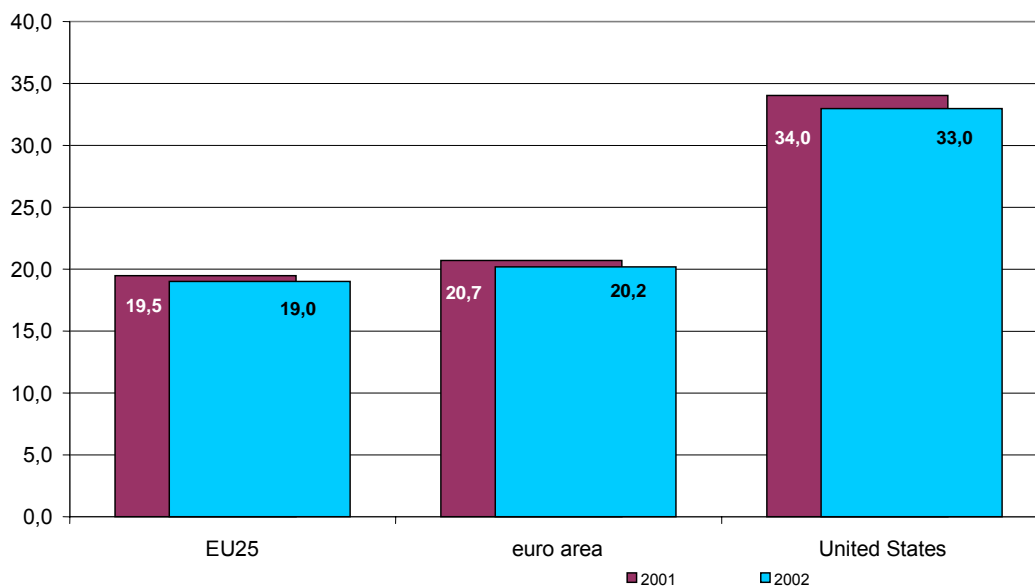
Figure 3-2: Ratio of intra euro-zone trade over intra EU15 and intra EU25 manufacturing trade (%)



Source: Eurostat

Despite the evidence pointing to a trade boosting effect associated with the introduction of the euro, in 2005 trade among euro-area members (as a ratio of GDP) was still below the level of 2000. This suggests that the trade boosting effect of the single currency has not been able to offset the dampening effect of the relatively subdued economic growth in the euro-zone *vis-à-vis* other economies since 2000.

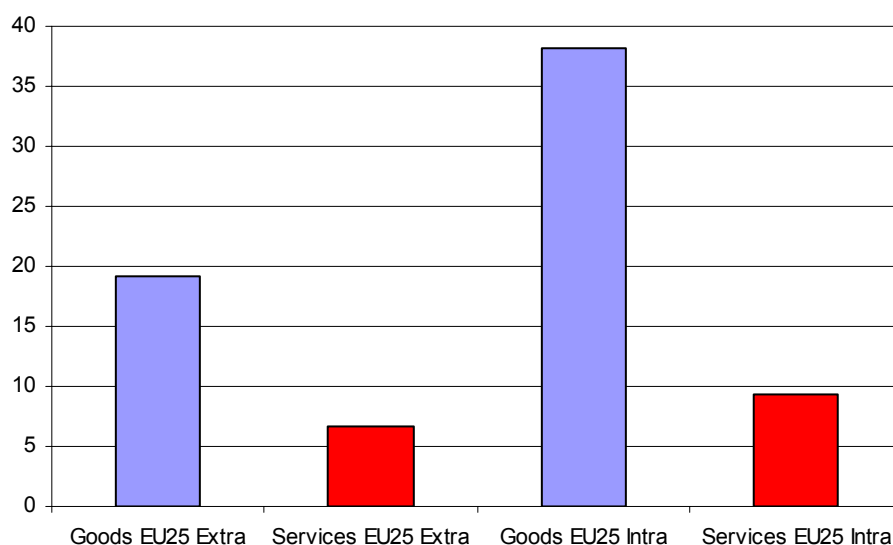
Figure 3-3: Intra trade in manufactured products (intra exports as % of GDP)



Source: own calculations using data from Eurostat (COMEXT) and the US Census Bureau.

The slowdown of trade growth within the EU15 and euro-zone relative to trade growth with third partners is unsurprising given the already very intense trade flows within the EU15 and the large untapped opportunities for trade gains with third partners. However the potential for trade integration in the euro-zone is far from exhausted. A comparison with the US clearly shows that there is room for further progress (see Figure 3-3). Using the latest data available (2001/2002), we find that the ratio of manufacturing exports among US states to GDP (33%) was more than a third higher than the corresponding ratio for the euro-area (20%).

Figure 3-4: Services and manufactured goods trade in 2004 (as a % of GDP)



Source: Eurostat

Particularly in services there is still plenty of scope for further trade integration. The available data (see Figure 3-4) clearly show that the Internal Market does not yet fully play its role in the services sectors. While services are less tradable by nature, there is little difference between trade between EU25 Member States and trade between the EU and third countries. This clearly contrasts with manufacturing where intra EU trade clearly dominates.

3.1.1.2. FDI flows

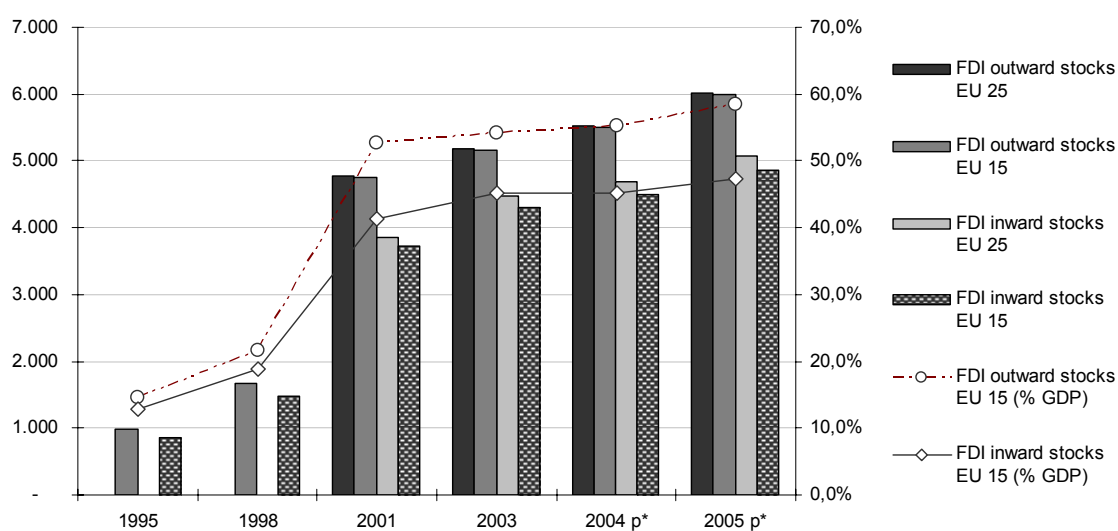
The link between EU economic integration and FDI flows is not straightforward. A priori the absence of substantial differences in factor endowments across Member States prevents large scale shifts in the location of industries associated with inter-industrial specialisation and intermediate trade based on differences in terms of comparative advantages²². Hence, the Internal Market can be expected to have a stronger impact in terms of promoting cross-border trade rather than intra-EU FDI flows associated with multi-plant production. However as the Internal Market Programme and the EMU reduce trade costs, the existing site-specific location advantages and agglomeration economies may lead to higher geographic concentration of production in certain industries. This can

²² While phenomena of outsourcing of labour intensive parts of the production process to lower wage Member States have been identified, they remain relatively small. For example, European Restructuring Monitor's survey data show that since 2002 only around 9% of restructuring cases were associated with the relocation of activities. For a more detailed overview of available evidence, see: European Commission (2005a).

lead to temporary a boost in intra-EU FDI activity as firms concentrate previously dispersed activities in the location that they find to be the most suitable. In services, particularly in the non-tradable sectors, FDI oriented towards serving local markets is expected to increase as cross-border investments become the main option of market entry across the EU following opening of these sectors to cross-border competition²³.

Overall, in the years following the implementation of the Internal Market Programme FDI activity in the EU15 has increased. Consequently, the accumulated stocks of inward and outward FDI have expanded spectacularly over the past decade (see Figure 3-5). However, the total stocks of inward and outward FDI increased only marginally with the EU enlargement from 15 to 25 Member States, as FDI in the new Member States is responsible for only a small share of total FDI in the EU25. Nonetheless, inward FDI accounts for an increasing share of GDP in the new Member States (around 40% in 2004/5), playing an important role in their process of economic modernisation²⁴.

Figure 3-5: FDI Outward and Inward Stocks in the EU15 and EU25²⁵



Source: Eurostat

It is difficult to disentangle the effects of the Internal Market (associated with the consolidation of many European industries and in particular with the deregulation and liberalisation of network industries) from broader phenomena like globalisation and factors of a cyclical nature like the stock market boom of the nineties, the subsequent burst of the dot com bubble and the weakness of the exchange rate of the euro in the early 1990s. However, the increasing share of intra-EU FDI flows in total EU FDI activity suggests that the Internal Market had a role to play. In 1995 50% of total FDI outflows and 53% of total FDI inflows in the EU15 originated from other EU15 countries. Ten years later these shares had grown to 66% and 78% respectively²⁶. Further Internal Market reforms, namely aimed at deregulating and removing barriers to entry in the services are likely to foster additional intra-EU FDI activity as EU firms are given the incentive to reorganise in order to better serve the integrated market.

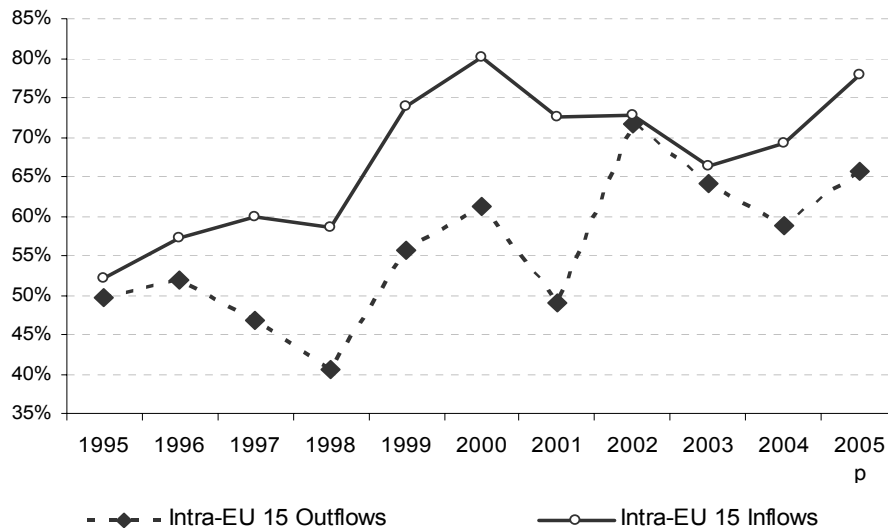
²³ As well as in sectors where trade costs are relatively important in total production costs.

²⁴ For more detailed analysis see: European Commission (2006a).

²⁵ FDI stocks in bn Euro.

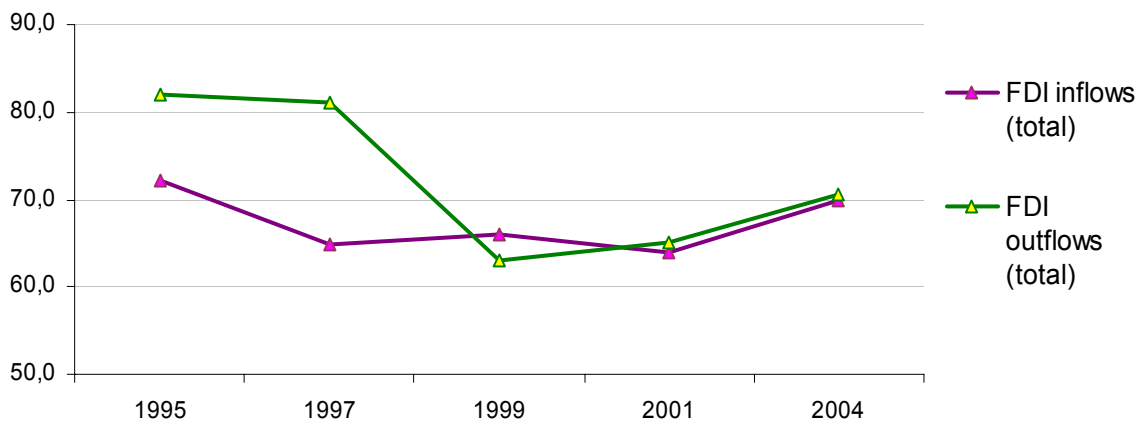
²⁶ In 2005, intra-EU25 FDI represented 70% and 82% of total outflows and inflows respectively.

Figure 3-6: Share of EU15 in total FDI outflows and inflows (1995-2005)



The FDI effect of the EMU is difficult to separate from that of the Internal Market. Since 1999 the declining trend of the share of the euro-zone economies in the total EU15 inward and outflows FDI flows seems to have been halted. This suggests that the common currency may have triggered some additional dynamism in FDI activity. While this confirms the findings of existing academic research, the quantified estimates of this effect remain uncertain²⁷. Some studies conducted so far find evidence of considerable positive effects of the EMU on FDI activity. Some empirical evidence points to increases in intra euro-area FDI inflows as high as 42% directly attributable to the EMU. Furthermore, there is evidence of positive effects on FDI flows from and to non-EMU economies.

Figure 3-7: Share of the euro-zone in EU15 flows (%)²⁸



Source: Eurostat

²⁷ For a summary of results, see: Petroulas (2004), de Sousa and Lochard (2004), Economist Intelligence Unit (2004) and Machin (2004), European Commission (2004a).

²⁸ In 1995 and 1997 no data are available for Greece and Ireland. In 1999 no data are available for Greece.

3.1.1.3. Mergers and Acquisitions

The Internal Market is expected to be associated with increased Mergers and Acquisitions (M&A) activity as the process of consolidation and restructuring in many industries is triggered by the increased pressure of competition²⁹. M&A are therefore expected to increase both within and between Member States as firms reorganise activities in order to restore profit margins. The added opportunities to do business abroad may also trigger cross-border M&A as firms seek to expand their markets³⁰.

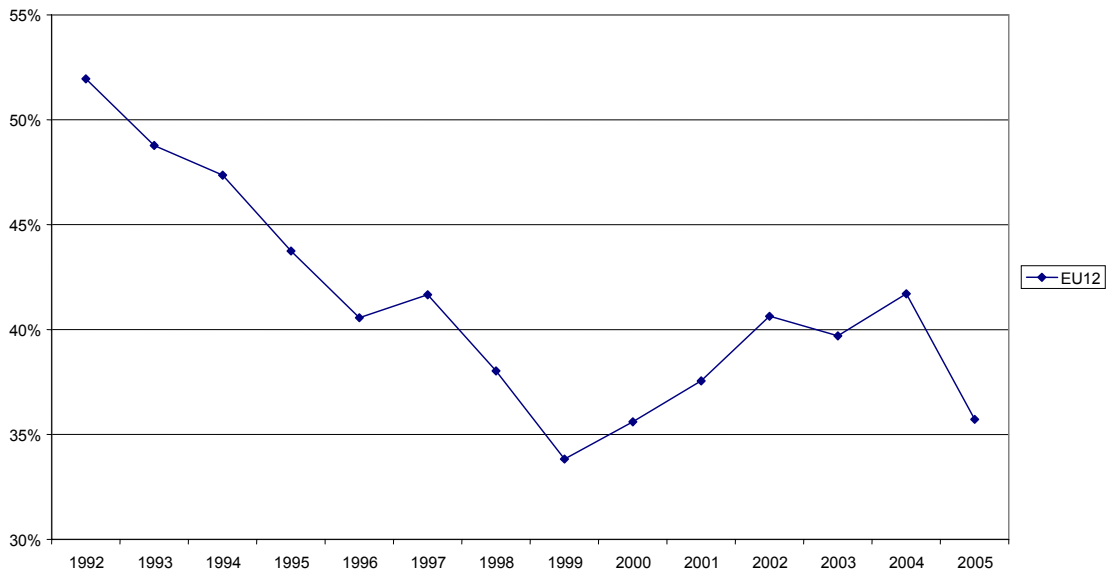
These claims are supported by the available evidence showing that in the late 1980s the introduction of the Internal Market Programme coincided with a M&A wave, largely fuelled by cross-border acquisitions of EU firms (both intra-EU deals and acquisitions by non-EU companies). The fact that in this period cross-border M&A increased at a much faster rate than domestic M&A suggests that they were increasingly used as a channel for market access rather than as a means for domestic restructuring. The data also suggest that the EMU provided added incentives for M&A operations within the euro-area. The share of the euro-area in the total number of cross-border acquisitions by euro zone firms increased from 34% in 1999 to 42% in 2004 despite the sluggish economic growth in the euro-area; this increase in M&A activity reversed the downward trend observed since the early 1990s (see Figure 3-8). However, the latest data suggest that this might have been a temporary phenomenon as this ratio declined in 2005 to the 2000 level. Meanwhile the 2004 enlargement triggered an increase of M&A operations in the new Member States. The share of M&A involving firms in the new Member States and the EU15 in total M&A involving EU15 firms increased from 6% in 1992 to 17% in 2003³¹.

²⁹ 85% of FDI flows worldwide were M&A which illustrates well their importance as channels for market integration.

³⁰ As an indicator for market integration cross-border M&A activity is however imperfect, as it overlooks the possibility of anti-competitive motives behind cross-border mergers, some of which may aim to keep markets segmented and to eliminate potential or actual competitors.

³¹ See: Garnier, G. (2006).

Figure 3-8: Intra euro-zone cross-border M&A as a share the total number of the cross-border acquisitions by euro-zone companies



Source: Own calculation based on Thomson Financial Services

Cross-border M&A are especially important to boost market integration in deregulated network industries as they give firms the possibility to expand beyond their traditional domestic markets by acquiring or merging with local firms. Two effects in the M&A activity in EU network industries can be expected. First, following the break-up or privatisation of former monopolies, an increase in (absolute and relative) M&A activity is expected. Second, the reduction in market barriers may lead to an increase in the share of cross-border M&A in total EU deals.

An analysis of the data between 1993 and 2005 confirms both effects to some extent, even after allowance is made for the effect of the merger wave of the late 1990s³². The share of the network industries in the overall number of EU25 M&A deals grew considerably – from 4.3% in 1993 to 9.2% in 2005, while their share in terms of value rose from 20% to 27%³³ (see Figure 3.9). The share of intra-EU cross-border deals in the total number of M&A in these sectors has increased from 15-20% of all M&A in the mid-1990s to over 25% more recently. Despite this positive evolution, the integration of markets in these sectors remains still limited and incumbents continue to dominate domestic markets.

³² See: European Commission (2006b).

³³ While the majority of deals covered in this analysis are of a small size, the aggregated values are typically dominated by very few large-scale deals, often involving incumbents or major firms. For instance, about 60% of the value of M&A deals in network industries recorded in 2000 can be attributed to two cross-border deals only. These large deals also explain the year-on-year fluctuations in aggregate values.

Figure 3-9: Evolution of the share of cross-border (intra EU) deals in network industries

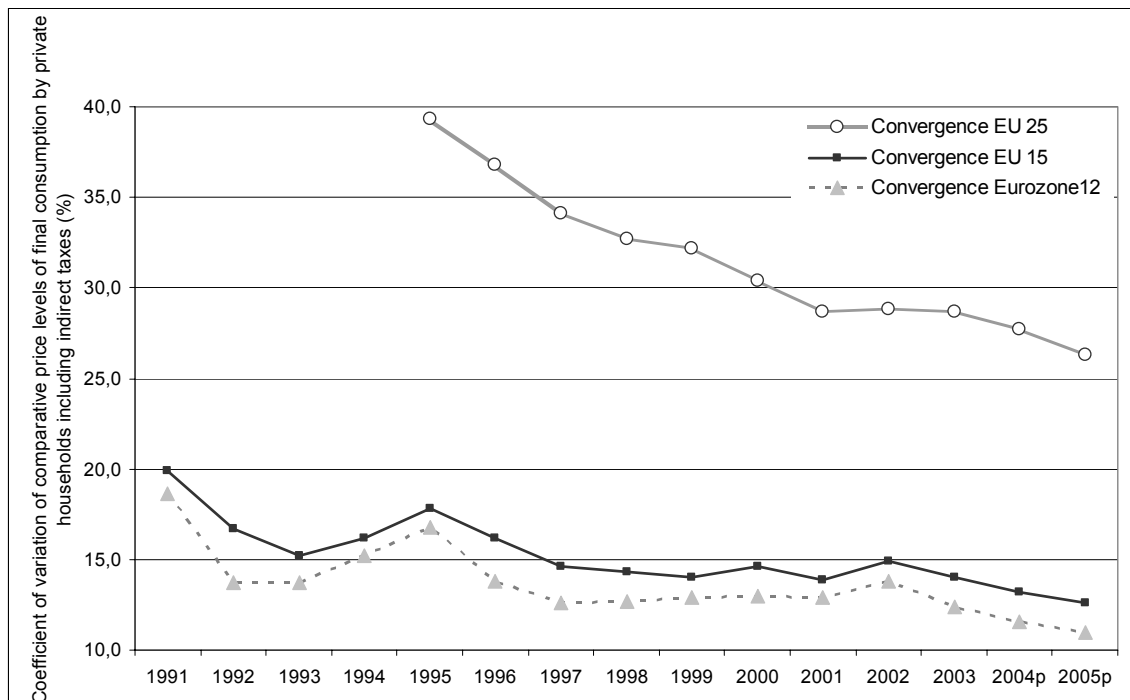


Source: European Commission (2006b)

3.1.2. Price dispersion and price levels

The increased market integration has accelerated price convergence among EU Member States. The coefficient of variation of comparative price levels of final consumption (including indirect taxes) across the EU15 has decreased from 20% in 1991 (before the launch of the Single Act) to 13% in 2005 (see Figure 3-10). In the EU25 progress has been even more remarkable as the new Member States become increasingly integrated with the rest of the EU and progressively adopt the Internal Market *acquis*. For the EU25 the coefficient of price variation dropped from 39% in 1995 to 26% in 2005. While this coefficient dropped by 4.8 percentage points between 1995 and 2005 in the EU15, it decreased by 13.3 percentage points in the EU25 as a whole over the same period.

Figure 3-10: Price convergence between EU Member States



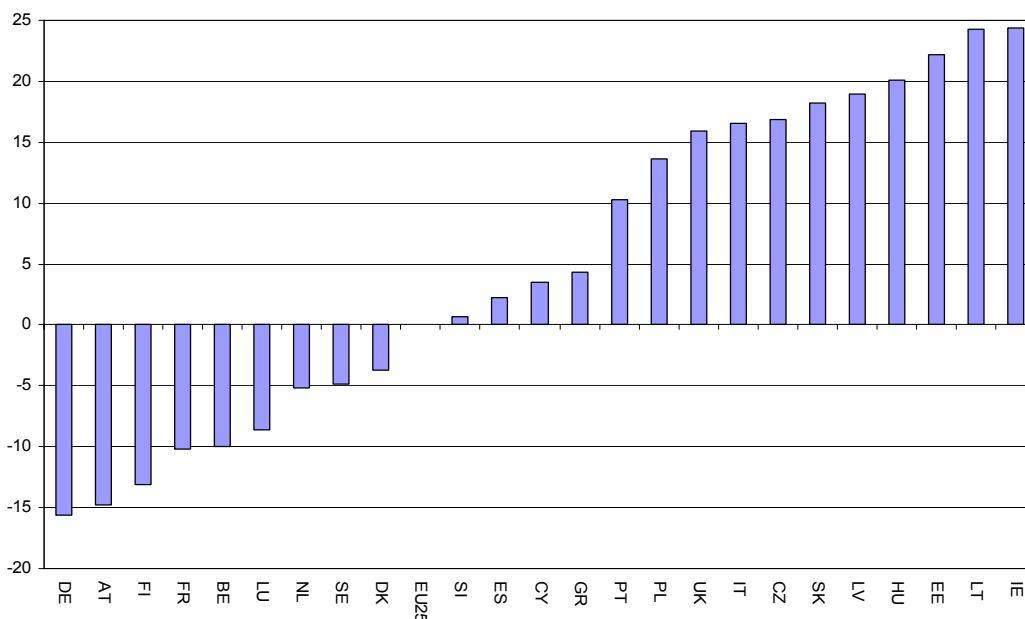
Source: Eurostat Structural Indicators

Within the EU two opposite trends underlie this process of price convergence (see Figure 3-11). First, across most high income EU15 Member States inflation levels have declined and price levels converged downwards towards the EU25 average. This can be partially attributed to the ECB monetary policy, the increased access to cheaper imports from across the world, and the higher price transparency associated with the introduction of the euro. The Internal Market has also had an important role in adding to the downward pressure on prices as it allowed for tougher competition in product and factor markets across the EU.

Second, in the new Member States and in the lower income EU15 Member States price levels have converged upwards towards the EU25 average³⁴. While integration and competition enhancing reforms have had disciplinary effect on firms' pricing strategies, the increased trade with higher income economies, improved production quality and the Balassa-Samuelson effect associated with the income convergence have pushed price levels up.

³⁴ Some high income Member States like Ireland, Italy and the UK, have also experienced noticeable price level increases. Their price levels at the start of the period under analysis were the lowest among the higher income Member States.

Figure 3-11: Variation in price levels 1995-2005 (EU25=100)



Source: Eurostat

Despite the positive evidence indicating that EU market integration has been accompanied by a process of price level convergence, it is clear from the available evidence that this process, particularly within the EU15, has slowed down in recent years. The coefficient of variation of comparative price levels of final consumption (including indirect taxes) decreased by 1.6 points between 2000 and 2005 while it had fallen by 3.8 points in the period 1995-1999. While the EMU has been a crucial step to increase in transparency, it does not seem to have added much dynamism to price convergence. In 2005 the coefficient of price variation across the euro-zone equalled 11%, which was only slightly below the coefficient for the EU15³⁵.

The slowdown in price convergence among the EU15 and the euro-zone is not unexpected. Following the completion of the Single Market Programme, a significant price convergence was visible for the core EU countries, that is, countries with relatively stable exchange rates³⁶. In addition, price levels in the euro-zone (and in the EU15) are already much more harmonised than across the EU25 and much of the remaining dispersion is associated with differences in indirect taxation and structural factors including factors such as transport costs and differences in tastes.

A comparison with the US (a large integrated market of comparable size to the EU which can be used as a benchmark) on the basis of price data for individual products confirms that overall the process of price convergence particularly within the EMU is close to being exhausted. In 2001, the level of traded goods price dispersion in the euro-area was already very close to that of the US (while remaining clearly higher in "Europe")³⁷.

³⁵ Since 1995 the euro-zone coefficient of price variation has declined by 5.8 percentage points, which is roughly comparable to the evolution within the EU15.

³⁶ See: Gasoriek et al. (2004).

³⁷ See Rogers (2002). In the study non-tradeable products broadly match services. Data for EMU excludes Greece and data for "Europe" include observation in cities located in the EU15 but also the Swiss cities of Geneva and Zurich and Oslo. No city data from the new Member States is included in the sample.

Furthermore, price dispersion among non-tradeables, while higher than for tradeables, was already lower than in the US (where dispersion driven by heterogeneous housing price developments across US metropolitan areas increased).

However, some further progress in terms of price convergence can be still expected due to deregulation and ICT development, which have greatly increased the scope for tradability and arbitrage in services³⁸. Despite some convergence observed since 1999, price dispersion in services remains relatively high (see Table 3-1). In non-durable goods (characterised by low scope for long-distance trading like services), the coefficient of variation of comparative price levels also remains higher than that of durable and semi-durable goods.

Table 3-1: Price convergence between EU25 Member States: breakdown by product categories³⁹

	1999	2000	2001	2002	2003	2004p
Non-durable goods	27.3%	25.3%	24.4%	24.0%	25.4%	23.8%
Semi-durable goods	18.2%	15.9%	14.5%	14.9%	11.8%	11.8%
Durable goods	15.6%	14.0%	13.0%	13.8%	13.8%	14.4%
Consumer services	42.2%	40.4%	38.0%	38.0%	37.0%	36.2%

Source: Own calculations based on Eurostat data

While the intrinsic characteristics of production remain important obstacles to further progress in price convergence across the EU, the relatively slow pace of market integration also play an important role, namely in the case of network industries (telecommunications, postal services, electricity, gas, airlines and public transport)⁴⁰. Market integration in these sectors which were formerly sheltered from domestic and foreign competition should, as a result of arbitrage activities, lead to price convergence or at least to parallel price movements across Member States⁴¹. However, despite the ongoing efforts towards market integration prices in network industries still vary greatly across Member States, reflecting to some extent their different degree of market deregulation.

In the telecommunications sector the coefficients of variation of price levels, notably for international and European calls are the highest among the network industries. Between 2000 and 2005 prices seem to have converged for local calls. For international calls and calls within the EU there has been some progress towards convergence after 2003 while for national calls price level dispersion across the EU has increased over the same period⁴². In the electricity and gas sectors intra-EU price differences are much lower but not much progress towards convergence has been achieved since 2000.⁴³

³⁸ See: European Commission (2001a).

³⁹ Coefficient of variation using comparative price levels for ESA95 aggregates.

⁴⁰ See: European Commission (2006b).

⁴¹ Price (net of transport costs) differences are likely to persist even in completely integrated markets – for example due to different production structures (including the content of local services) or the cost of supplying services of general interest, which will generally be higher in less densely populated countries.

⁴² This result is highly influenced by the very sharp price increase in Latvia in 2005. Telecommunications price disparity in general during this period can be greatly affected by since they may be seriously

Table 3-2: Price dispersion (coefficient of variation) in different network industries in the EU25⁴⁴

	2000	2001	2002	2003	2004	2005	2006
<i>Electricity</i>							
<i>Industry (annual consumption: 2000 Mwh)</i>	n.a.	20.3%	15.0%	17.0%	19.9%	18.1%	18.3%
<i>Households (annual consumption: 3500 kWh)</i>	n.a.	25.6%	21.0%	22.3%	23.3%	23.5%	22.9%
<i>Gas</i>							
<i>Industry (annual consumption :41860GJ)</i>	n.a.	22.4%	16.8%	13.4%	13.7%	16.8%	19.5%
<i>Households (annual consumption: 83.70 GJ)</i>	n.a.	24.4%	18.3%	18.3%	17.3%	17.4%	17.9%
<i>Telecommunications</i>							
<i>Local calls</i>	28.9%	29.2%	27.9%	28.1%	21.5%	24.4%	n.a.
<i>National calls</i>	28.8%	28.5%	26.7%	26.3%	35.1%	39.4%	n.a.
<i>International calls (to near EU country)</i>	50.3%	63.7%	69.7%	70.7%	61.6%	66.2%	n.a.
<i>International calls (US)</i>	51.7%	64.1%	69.4%	70.6%	37.3%	38.0%	n.a.

Source: European Commission (2006b)

While the speed of price convergence in these sectors is not straightforward to explain due to the interaction of many explanatory factors, the insufficient market integration across Member States can be identified as contributing to the slow progress observed until now⁴⁵. Even when all legal barriers to trade are removed, market access remains hampered by insufficient cross border interconnecting infrastructures. This factor also adds to cross border price differences as it leads to congestion costs which are passed on to consumers.

distorted by tariff-rebalancing, which is a necessary step towards the restructuring of the sector but that cannot be directly attributed to the progress achieved in terms of market integration.

⁴³ The recent rise in oil and gas prices is a factor that must be taken into account when interpreting these results. While in principle such price rises constitute a common external shock, their effects are asymmetric due to differences in the production structures across Member States namely the degree of reliance on those products as inputs. Nevertheless they might also reflect insufficient progress in market integration as they also point different the ability of Member States to pass external price shocks through to customers.

⁴⁴ Data refers to the period 2001-2006 in the case of electricity and gas and to the period 2000-2005 in the case of the telecommunication industries. Prices are indicated in €cent/kWh excl. taxes (electricity), €GJ excl. taxes (gas) and in €per 10 min call, VAT incl. (telecommunications). The average and the coefficient of variation are weighted by HICP-weights. Gas prices are not available for Greece, Cyprus, Malta and Finland (households). Source: Eurostat (Electricity and Gas), Teligen Ltd. (Telecommunications).

⁴⁵ Co-movements of prices (i.e. convergence in inflation rates), could be also used as indicators of price convergence. The available evidence given by the patterns of sectoral HICP-indices in Member States suggest that these do not seem to be occurring either.

3.1.3. Competition

Despite the recent slowdown in market integration and price convergence there is clear evidence that the Internal Market and the EMU have changed the conditions of competition in the EU by facilitating market entry by new firms and by reducing the ability of European firms to segment national markets geographically. The resulting increase in competition pressure is reflected in the observed greater instability in market leadership, contributed to market entry on national markets and led to change in the pricing strategies of firms. However, the EU product markets remain heavily regulated, business dynamism is insufficient and prices rigidities are persistent.

3.1.3.1. Turbulence in market leadership, reduction in price-cost margins and increased efficiency

The increased market integration has modified market conditions in many industries across the EU. Considerable turbulence in market leadership in EU manufacturing was observed between 1987 and 2000; by 2000 the leading top five companies had lost more than half of their production share to other firms and in many sectors a new market leader had emerged⁴⁶. The changed market conditions have led to reductions in mark-ups, particularly in the sectors most affected by the Single Market Programme⁴⁷. There is evidence pointing to an average reduction of 3.9 percentage points in price-cost margins in these sectors in the 1990s⁴⁸.

Box 3.2: PRICE REDUCTIONS IN SOME NETWORK INDUSTRIES

An empirical study⁴⁹, carried out by Copenhagen Economics for the Commission, examined the link between market opening and price performance. For most network industries the study finds a negative relationship, implying that market opening has led to a reduction in prices, holding other variables constant. Indeed, the results suggest that telecommunications and rail transport prices in the EU15 were more than 20% lower in 2001 than they would have been without the market opening that took place between 1993 and 2000. For electricity the equivalent figure is 8%, while only a modest price reduction is attributed to market opening in the gas industry (1%). For air transport, no statistically significant relationship was found and the results for urban passenger transport and postal services suggest that the reforms actually led to slight increases in prices. However, according to the authors of that study, the results for the two latter sectors can partly be attributed to poor data quality.

A study carried out by the ECB⁵⁰ postulates that further regulatory reforms in network industries could have a significant downward influence on telecommunications, electricity and gas prices. In a first stage the authors estimate the effect of a set of regulatory variables on price levels faced by different customers (e.g. households and industrial customers). In a second stage they assume a scenario in which all EU15 Member States align their regulatory conditions on those of the 'best practice' country. In the telecommunications sector prices would fall substantially (about 27-28%) for local and international calls, and only slightly for long distance calls and calls to mobile phones (0.05-0.2%). In the electricity and gas sectors, price falls calculated by this method would lie between 16% and 25% for households and between 22% and 35% for industrial users.

Furthermore there is evidence suggesting that European companies reacted to this decline in profit margins in terms of pricing but also by increasing their efficiency and reducing

⁴⁶ See: Veugelers (2004).

⁴⁷ For more details see: Griffith et al. (2006).

⁴⁸ See: Allen et al. (1998).

⁴⁹ See: Market Opening in Network Industries, Copenhagen Economics, September 2005, http://ec.europa.eu/internal_market/economic-reports/index_en.htm.

⁵⁰ See: Martin R., M. Roma, I. Vansteenkiste (2005).

their costs, which has allowed profit margins to be restored to some extent. A study⁵¹ showed that two phases can be distinguished in the evolution of price-cost margins in European manufacturing industry. Over the period 1989-1992, the fall in price-cost margins was mainly due to a decrease in prices greater than the decrease in costs while over the period 1992-1999, price-cost margins recovered mainly thanks to efficiency gains.

These efficiency gains have been obtained through an increased presence on the markets of other Member States (increased multinationality) and a concentration of activities on the core businesses of companies (reduced sectoral diversification). Evidence shows that, between 1987 and 2000, firms in the Internal Market have expanded in size and increased their presence beyond national borders (see Figure 3-12), often via cross-border mergers and acquisitions involving firms from different Member States and from outside the EU. Whereas in 1987, EU leading firms were on average active in three countries, this number increased to an average of five countries. Simultaneously EU firms concentrated their activities in their core business. The number of sectors in which leading firms were active declined from an average of 4.9 in 1987 to 3.3 in 2000. This increased sectoral concentration freed up funds for further investment in R&D and advertising⁵².

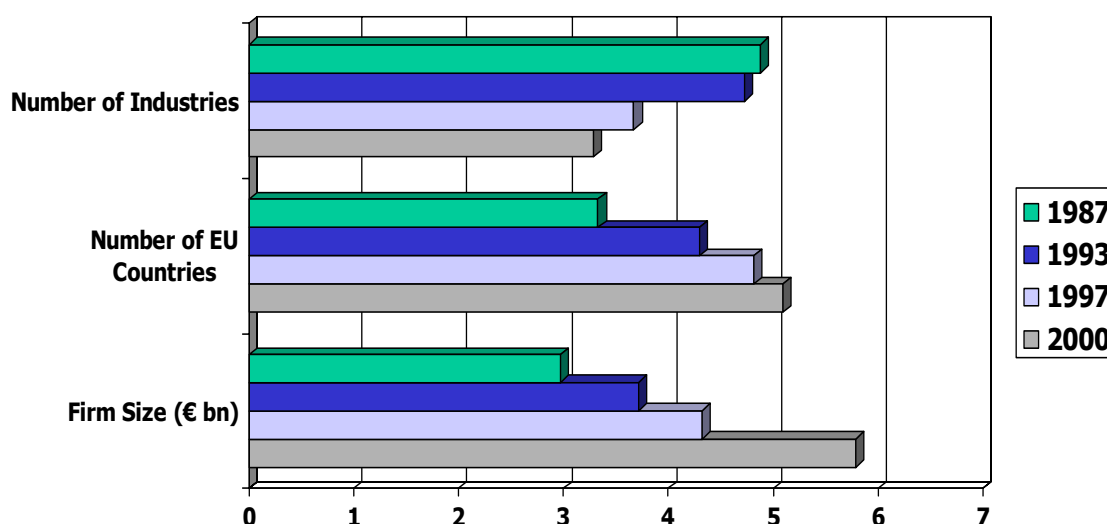
The sharper competition in the Internal Market can also contribute to the elimination or take-over of the least efficient firms, leaving fewer producers (bigger and more efficient) in the market. This should result in an increase in production concentration at the EU level. However, available studies suggest that while production concentration as a whole increased somewhat on average, there is wide diversity across industries with highly concentrated sectors in particular having witnessed a decline in concentration⁵³.

⁵¹ See: Sauner-Leroy (2003).

⁵² See: Rondi et al. (2004) and Veugelers (2004).

⁵³ See: Veugelers (2004).

Figure 3-12: Diversification, multinationality and firm size



3.1.3.2. Business dynamism

Despite the observed changes in the competitive environment, rules and regulations in Europe appear to act as a constraint on the mobility of economic activity to more productive sectors and regions. In the retail sector, for example, restrictions emanating from spatial planning regulations work as an impediment to the introduction of new technologies and hinder organisational improvements (see section 4.4.2). More generally, the still relatively high levels of product market regulations in many EU Member States contribute to hinder business dynamism, preventing them from taking full advantage of the integrated EU market. Recent estimates show that administrative costs to the private sector represent 3.5% of GDP in the EU25.⁵⁴ However, this varies widely across Members States from 1.5% in the United Kingdom, Finland and Sweden to 6.8% of GDP in Greece for example.

Regulatory requirements have their origin in local, national and EU level legislation. It would be fair to assume that in the absence of regulation at the EU level, there would exist, in most instances, a corresponding legislation at national level that would be equally, if not more burdensome. A situation in which 25 countries acted individually would most probably lead to higher administrative costs by creating huge inefficiencies. Also, one needs to bear in mind that market regulations help achieve valid policy goals, most notably in the area of consumer, health and environmental protection.

Business dynamism, as measured by entry and exit, is essential for growth and progress has been made to facilitate business start-ups in Europe. However, in most EU countries, it is still more difficult to start a new business than in the US and according to the World Bank “Ease of Doing Business indicator”, most euro-euro countries underperformed relative to the US. Entry and exit rates continue to differ significantly between countries

⁵⁴ See: Kox (2005). The estimated costs result directly from compliance to the requirements laid out in national and EU regulation, including time and effort of procedures such as filling in forms.

and industries. Recent figures show⁵⁵ that the average entry rate over the period 1997-2003 was twice as large in the US than in most euro-area countries and the UK. The US-EU gap in exit rates is even wider, reflecting the stigma associated with going bankrupt as well as the more onerous bankruptcy legislation in Europe. Entry rates in EU Member States were relatively high in sectors like post and telecommunications, electricity, gas and water supply and business activities and real estate, but lower in sectors like wood, textile and paper. Deregulation policies and the rapid pace of technological change in computer services can contribute to explain this discrepancy. A comparison of regulatory change in different domains show that the overall decline in the level of product market regulation in euro area countries over the period 1998-2003 is mostly due to a decline in state control (via a reduction in price controls and in direct government control over businesses) and to the elimination of barriers to trade and investment (via lower tariffs and fewer restrictions on foreign investment). Barriers to entrepreneurship have decreased less (see Box 3.3).

Not only entry and exit per se but also the growth performance of enterprises in the years after entry is important. In this respect, a recent OECD study using firm level data reveals that while firms' turnover are similar in the Europe and the US, their post entry performance differs markedly⁵⁶. Firms in the US are smaller than EU firms when they enter the market but, if they survive, they grow much faster and reach higher average sizes in terms of employment. This is an indication of EU remaining barriers affecting firm growth, such as imperfect financial markets leading to lower financial possibilities⁵⁷, higher administrative costs at entry that affect the expansion of firms in their initial years and tight firing and hiring restrictions.

Box 3.3: EVOLUTION OF PRODUCT MARKET REGULATION

The OECD product market regulation database⁵⁸ contains indicators on product market regulation for 19 EU Member States⁵⁹. Objective information is collected using questionnaires completed by the countries themselves to construct sub-indices that are then aggregated up to using weights derived from principal component analysis. Product market regulations are grouped around three domains: state control, barriers to entrepreneurship and barriers to trade and investment.

The World Bank 'Ease of Doing Business' indicator covers a wide range of market regulations, namely in terms of (i) starting a business; (ii) getting licences; (iii) hiring and firing workers; (iv) registering property; (v) getting credit; (vi) protecting investors; (vii) paying taxes; (viii) trading across borders; (ix) enforcing contracts; and (x) closing a business. The 2006 composite indicator showed that most euro-area Member States underperformed relative to the US. Within the EU, the front runner is the UK, while Italy and Greece are lagging well behind. Member States like Belgium, Germany, the Netherlands and especially Ireland and Finland have made good progress particularly in facilitating business operations.

⁵⁵ See: Cincera and Galgau (2005).

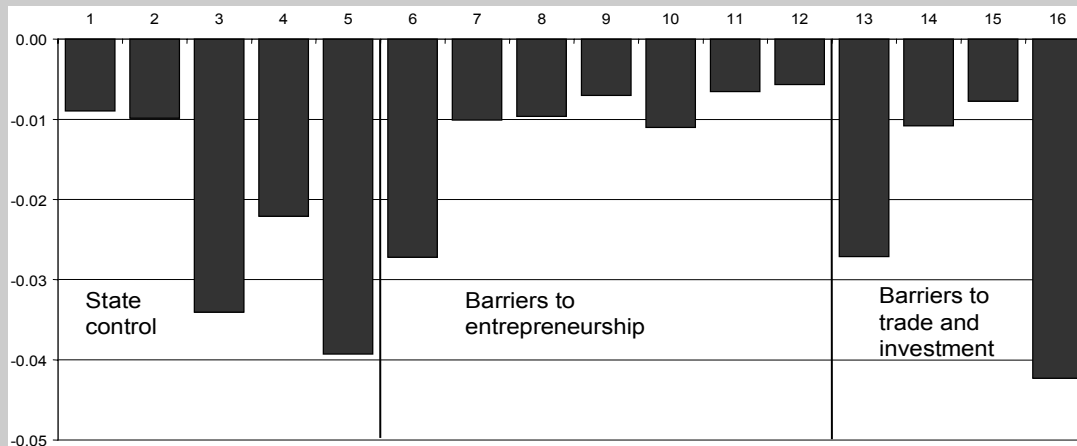
⁵⁶ See: Bartelsman et al. (2006). This study is based on firm level data for 1989 to 1994 for Canada, Denmark, Finland, Germany; France, Italy, the Netherlands, Portugal, United Kingdom, and US.

⁵⁷ The greater predominance of market-based financial systems in the US may lead to a lower risk aversion in project financing and to greater financing possibilities for entrepreneurs with small or innovative projects often characterised by limited cash flows and lack of collateral.

⁵⁸ See: Conway *et al.* (2005).

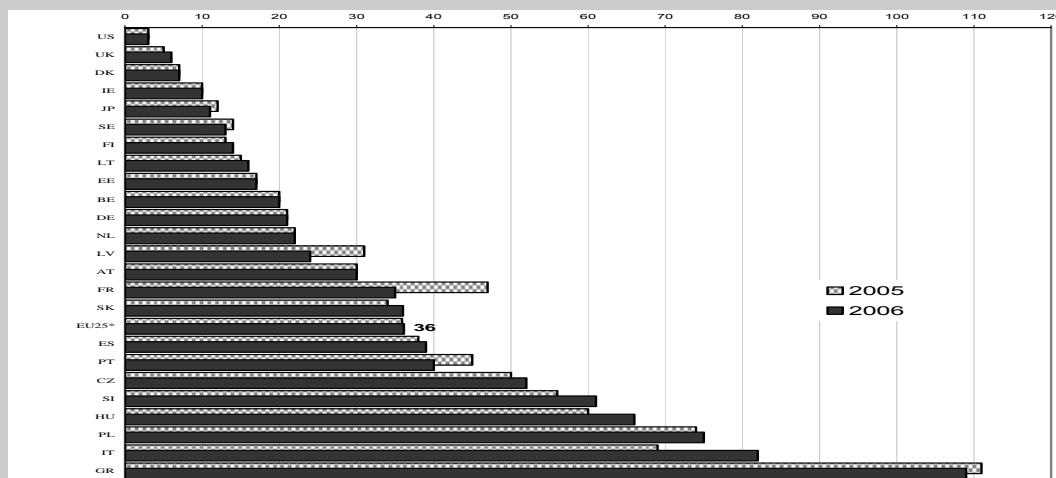
⁵⁹ Excludes Cyprus, Estonia, Malta, Latvia, Lithuania and Slovenia.

Figure 3-13: Sources of change in EU18⁶⁰ product market regulation, 1998 to 2003



- | | |
|--|--|
| 1 Scope of public enterprise sector | 9 Administrative burdens for sole proprietor firms |
| 2 Size of public enterprise sector | 10 Sector specific administrative burdens |
| 3 Direct control over business enterprise | 11 Legal barriers |
| 4 Use of command & control regulation | 12 Antitrust exemptions |
| 5 Price controls | 13 Ownership barriers |
| 6 Licence and permits system | 14 Discriminatory procedures |
| 7 Communication and simplification of rules and procedures | 15 Regulatory barriers |
| 8 Administrative burdens for corporation | 16 Tariffs |

Figure 3-14: Ease of doing Business 2005-2006



* EU25: Simple average, excl. CY,LU,MT
 Source: World Bank, Doing Business in 2005/2006

3.1.3.3. Price rigidities

The results of recent surveys on price-setting behaviour also point to a lack of flexibility on product markets (see Box 3.4). They show that consumer prices are less flexible in the euro area than in the US and that in Europe price stickiness is particularly high in services. In particular, prices of services are less flexible downwards. While this

⁶⁰ AT,BE,CZ,DE,DK,ES,FI,FR,GR,HU,IE,IT,LU,NL,PL,PT,SE,UK

downward price rigidity in services can be attributed to the higher labour intensity of the sector (and typically lower productivity growth), an insufficient degree of market integration (and competition pressure) due to the still low tradability of many service, the remaining regulatory distortions namely in network industries, retail trade, and professional services also play an important role⁶¹.

Box 3.4: THE PRICE SETTING BEHAVIOUR IN THE EURO AREA

Recent surveys on euro-area price-setting behaviour, conducted by the Eurosystem of Central Banks, show that firms continue to have considerable market power. Prices change infrequently in the euro-area; on average, only 15% of consumer prices and 20% of producer prices change every month. While these patterns are similar to the US in relation to producer prices, for consumer prices the US is considerably more flexible (26% of prices change every month). Consumer prices change on average every two quarters in the US against four to five quarters in the euro area⁶². In addition the frequency of price changes is more heterogeneous across sectors than across euro area countries. Prices change more frequently in sectors where demand, supply or input costs fluctuate more substantially, such as energy products (78% of consumer prices changing every month) and unprocessed foods (28%). Prices changes are the least frequent (6%) in services.

Price decreases dominate all recorded price changes in the euro-area (around 40%), except in services. This confirms that in services barriers hampering competition and downward price flexibility persist⁶³. Since 1999 services average inflation (2.3 percent) has substantially exceeded non-energy industrial goods inflation (0.7 percent). While real convergence can partly explain some cross country differences in this regard policy reforms (e.g. healthcare reforms) and changes in administered prices still play an important role⁶⁴. In network industries, retail trade, and professional services, where regulatory distortions remain important downward price rigidities are the strongest.

The most prominent factors preventing immediate price adjustments in the euro-area are implicit and explicit contracts with customers (that firms use to seek to make sales more predictable) and the still widespread use of "cost-based pricing" strategies that imply that prices are not changed unless costs change, and "competitors' prices" strategies when firms prefer not to change their price unless one of their competitors moves first. In fact, mark-up pricing remains the dominant price setting behaviour in the euro-area (54%) and 30% of euro-area firms reveal that their prices are shaped according to those of their competitors. Moreover, it is observed that the lower the competition pressure, the more frequent is the mark-up pricing methods used by the firm in the market. Furthermore, price discrimination remains a common practice; around 80% of euro-area firms set prices on a case-by-case basis or depending on the quantity of product sold.

The survey provides empirical evidence that price dynamics in the euro-area are determined by the intensity of competition pressure and barriers to market access and corroborates the claim that promoting competition pressure is important for price adjustment within the euro-area⁶⁵. Firms in highly competitive markets are more likely to react more strongly to price-reducing and price-increasing shocks. However, this effect is stronger in the case of price-decreasing factors, especially those resulting from the demand side.

⁶¹ See: European Commission (2006c).

⁶² See: Fabiani *et al.* (2005) and European Central Bank (2005).

⁶³ See: European Commission (2006c).

⁶⁴ Amongst euro-area Member States, services inflation has been highest in fast growing or catching-up countries such as Ireland, Portugal, Spain and Greece, but it has also been well above average in Italy, Luxembourg and the Netherlands.

⁶⁵ For producer prices, the more competitive the environment, the more frequently prices change. For consumer prices, there is substantial evidence that the frequency of price changes depends on the outlet type and is higher in super/hyper markets than in traditional corner shops.

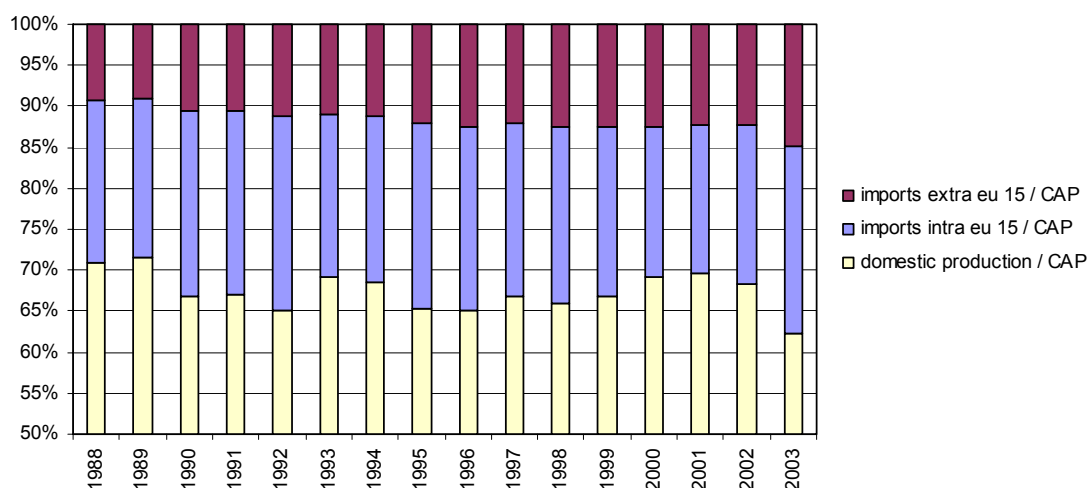
3.1.4 International dimension

While the Internal Market aims at increasing economic integration among EU Member States it is not meant to be inward looking. It is a necessary step towards a more successful integration of the EU economy in world markets.

Hence the trade boosting effect of the Internal Market is not limited to the promotion of intra-EU trade. As further integration boosts the dynamism of the EU business environment and the competitiveness of EU businesses, trade flows with the rest of the world are expected to grow. Available data confirms the increasing openness of the EU economy as the share of extra-EU25 trade to GDP - despite the slowdown observed in the last years - has increased since the mid-nineties (see Figure 3-1).

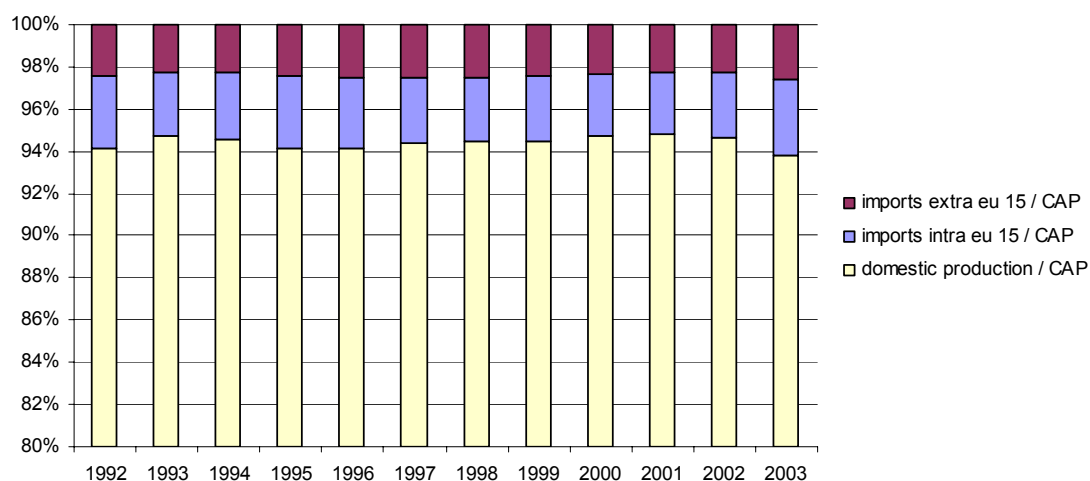
However, the EU integration process could lead to the substitution of imports from cheaper extra EU suppliers by suppliers in other Member States flows if barriers to extra-EU trade were high. This has not been the case in the EU where the extra-EU exporters have also benefited from the suppression of intra EU trade barriers and from the application of the principle of mutual recognition. In manufacturing since 1988 and until 2003 (latest available data) the share of extra EU suppliers in apparent consumption (AC) has gradually increased at the expense of domestic production (see Figure 3-15). However in services, the relative importance of imports (both from within the EU and from outside) remained relatively subdued confirming the claim that in these sectors the process of integration is still in the early stages (see Figure 3-16).

Figure 3-15: Shares in apparent goods consumption (AC) of domestic production, intra-EU imports and extra-EU imports during the period 1988-2003 (in %)



Source: Commission services

Figure 3-16: Shares in apparent services consumption (AC) of domestic production, intra EU-imports and extra-EU imports during the period 1992-2003 (in %)



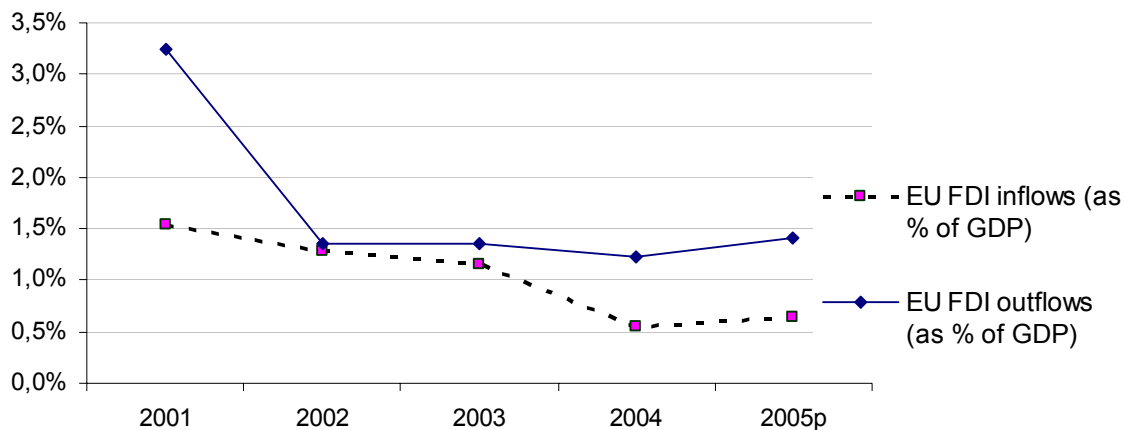
Source: Commission services

Overall, the enlargement process and the consolidation of the Internal Market have not crowded out trade relations with third countries. This point is crucial for the future of the EU economy given the rapid economic growth experienced by economies like the US and Asia and their growing importance in world markets.

As the European Internal Market becomes more integrated and efficient, it is expected to become more attractive for foreign firms. Moreover as it increases competition pressures within the EU and improves the business environment, it should also help EU firms to expand their activities beyond EU borders to fully benefit from the opportunities of globalisation. However, the empirical evidence on these issues is mixed.

While European integration seems to be associated with an increase of intra-EU FDI activity, the available evidence suggests that the Internal Market has not been able to deliver in terms of promoting further the role of the EU with respect to global investment flows. Two effects can play a role in explaining this evolution: either, the prospects of growth offered by the Internal Market are not any more sufficiently attractive for foreign investors, especially by comparison with fast growing economies like India and China, or the integration of the European markets has rendered unnecessary foreign presence in several Member States. Since 2001 the volume of FDI from the rest of the world into the EU25 has gradually declined (see Figure 3-17). The trend is only reversed in 2005. Between 2001 and 2002 the volume of FDI flows from the EU25 to the rest of the world dropped sharply. Thereafter it remained flat until 2005, when it recovered slightly. The Internal Market two-fold objective of making the EU a more attractive place for foreign investors and of boosting the presence and competitive position of EU firms in world markets seems far from being achieved.

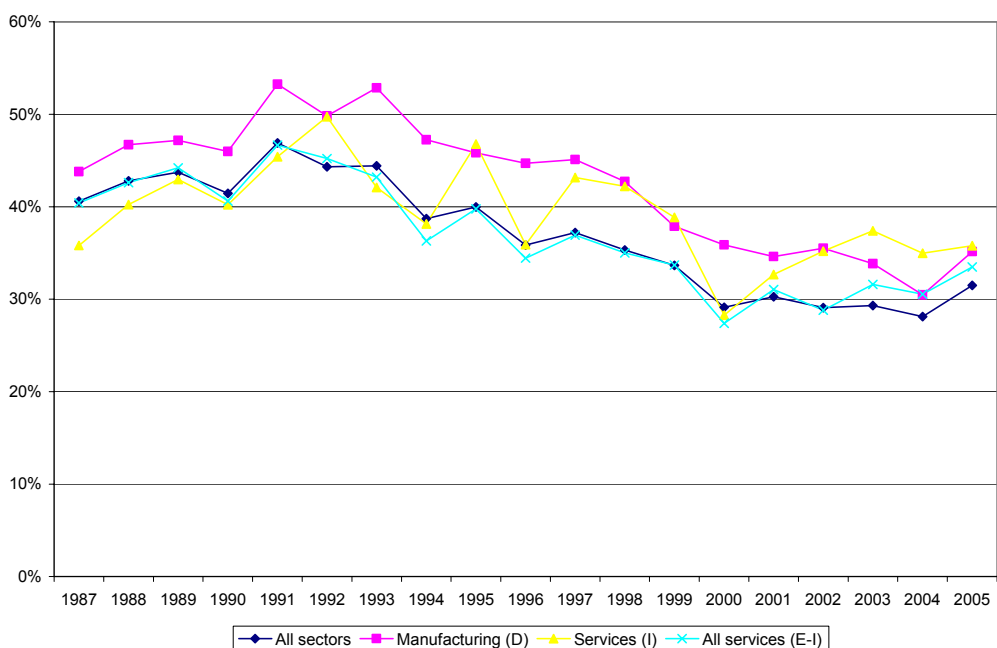
Figure 3-17: FDI flows between the EU25 and the rest of the world



Source: Eurostat

The same picture emerges from M&A data which show that the share of the EU in the number of targeted firms in M&A operations has continuously decreased since the 1990s. In 1991, almost 50% of M&A operations by non-EU firms targeted EU firms. In 2005 this share had fallen to slightly above 30% (see Figure 3-18).

Figure 3-18: EU share of total number of worldwide acquisitions by non-EU firms



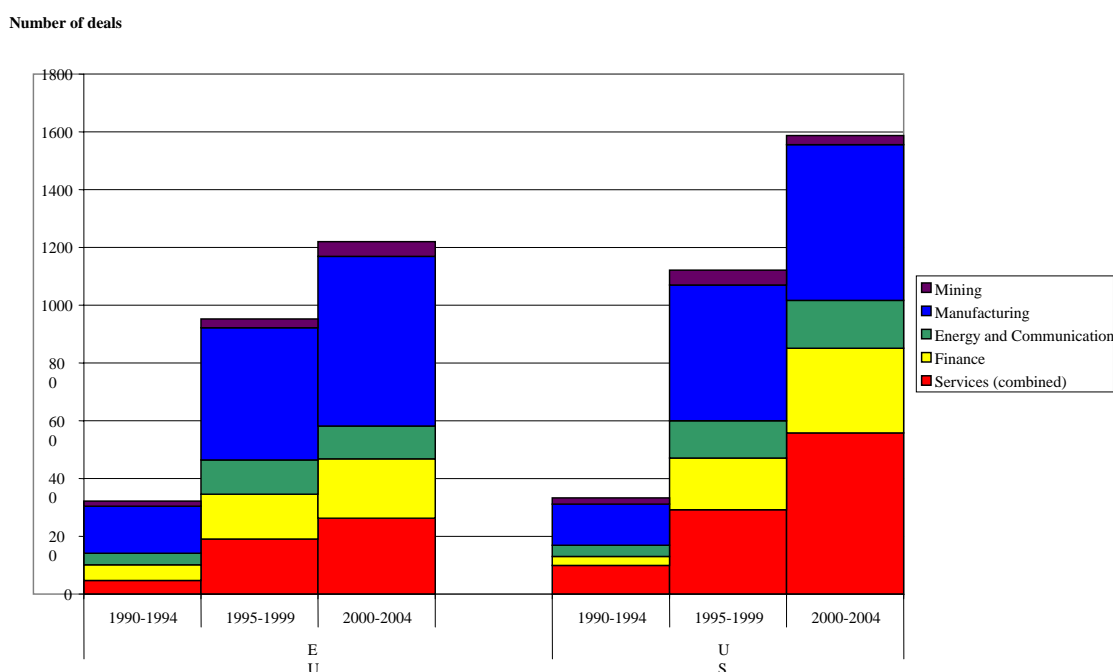
Source: Own calculations based on Thomson Financial Services

This geographical shift may first be explained by globalisation, which has allowed access to markets with higher growth potential and higher returns on investment. European firms themselves have increasingly acquired non-EU firms in all sectors. Second, this development mirror technology changes of recent years which have greatly expanded the possibilities for exploiting further the international division of labour. This has affected in particular the worldwide location of manufacturing, the sector where the reduction of

the EU share in terms of targeted firms was the largest over the period 1990- 2005 (compared with other sectors). This reduction was particularly felt in the low-tech and medium low-tech segments⁶⁶. In contrast, in services, notably in business services, the share of the total number of targeted firms has clearly increased after 2000, breaking with the decreasing trend of the previous years.

The evidence regarding EU firms as bidders in foreign markets also suggest subdued dynamism. Since 2000 EU firms have been less active in world markets relatively to firms from the rest of the world, particularly in the fast growing Asian service sectors⁶⁷. The difference *vis-à-vis* the US is striking; between 2000 and 2004 the number of acquisitions by US firms was twice that of EU firms.

Figure 3-19: EU and US M&A in Asia (1990-2004)



Source: Own calculations based on Thomson Financial Services

3.1.5 International specialisation

Not only are EU firms less active in fast growing markets but also they have not managed to improve their performance in fast growing sectors at world level although this was one of the main goals of the 1992 Single Market Programme. By mid 1980s, the observation was made that the EU was insufficiently specialised in high-tech sectors and that in these sectors, the EU was losing market share at world level. This situation has not changed dramatically since.

The Internal Market and the EMU have been associated with trade boosting effects and the EU25 has managed to maintain its share of total world exports and imports (18.7% and 18.9% respectively in 2003) over the last decade despite the emergence of developing countries, namely China, as major trading partners. The accession of the

⁶⁶ However, this reduction was observed in all segments of the EU15 manufacturing sector including the high-tech and medium-tech segments. This seems to indicate that EU firms have become less attractive in technology-driven segments. For more details see: Garnier (2006).

⁶⁷ The combined service sectors comprise wholesale trade; retail trade; and other services (which include hotels, personal services, business services, health services, legal services, etc.).

Central and Eastern economies provided firms with the additional opportunities to reallocate factors within the Internal Market and implement EU wide production sharing strategies to boost their international competitiveness. The decomposition of trade according to the nature of the exchanged goods confirms that the EU new Members States have become net importers from the EU15 of intermediate goods and capital goods to become assembly platforms for manufacturing and net exporters of consumer goods.

Nonetheless, while the overall evidence points to the conclusion that the Internal Market triggered efficiency seeking intra-EU reallocation of resources it has not led to a sufficient shift of the specialisation of the production sector towards the more technology intensive sectors where EU competitiveness can be more sustainable in the long-run. Recent evidence suggests that the structure of EU trade remains less than ideally suited to fully realise the potential gains from deeper international economic integration⁶⁸.

The EU trade balance in high-tech sectors is improving but a significant part of EU trade is concentrated in intermediate skills sectors whereas other high-income regions, like the US and some Southeast Asian economies, are more specialised in products requiring high to high-intermediate skills. EU exports of medium-high and medium-low tech industries accounted for over 40% of world exports in the period 1998-2003 (see Table 3-3). In contrast, in ICT-related industries, the EU accounted only for 11.4 % of world exports while the US and Japan accounted for considerably larger shares, 16.6% and 12.8% respectively. 16.6% of world exports of low technology goods originated in the EU 25 while only 8.4% and 1.6% came from the US and Japan. Furthermore, contrary to Japan and the US, the EU25 reveals a comparative disadvantage in high technology sectors including ICT (see Table 3-3).⁶⁹

Table 3-3: World export market shares by skill intensity of sectors (in%)

	High Technology	ICT ⁷⁰	Medium Technology	Low Technology
	1998-2003	1998-2003	1998-2003	1998-2003
EU15 (Extra)	13.1	10.4	37.2	14.0
EU10	0.8	1.0	4.3	2.6
US	19.9	16.6	23.8	8.4
Japan	11.8	12.8	18.2	1.6
China	2.8	3.0	4.5	7.4
S.E. Asia (excl China)	22.8	26.8	19.1	17.4
India	0.1	0.1	0.7	1.9

Source: Commission services

⁶⁸ For a more detailed analysis see: European Commission (2005a).

⁶⁹ See also: European Commission (2005).

⁷⁰ Part of the "High Technology" sectors.

Table 3-4: Revealed comparative advantage according to skill intensity categories⁷¹

	Skill Intensity				
	High Technology	ICT	Medium-High Technology	Medium-Low Technology	Low Technology
EU15	-26.1	-30.1	95.9	13.8	-13.1
EU10	-19.0	-13.1	-20.1	23.3	44.0
US	39.6	8.8	21.3	-6.9	-33.5
Japan	56.7	53.8	159.9	12.7	-114.4
China	-18.0	-8.1	-94.9	-15.8	135.7

Source: Commission services

In those sectors where most of the growth in world exports is realised like (semiconductors, passenger cars, telecommunications, computers, computer parts and pharmaceuticals) the EU was only able to keep its market position but not to improve it. Notably, in the more ICT-intensive industries like semiconductors, computers and parts and accessories for computers the export share of the EU is well below its overall share in the world's total exports. In services, in spite of the concerns about growing offshoring opportunities the EU remains a net exporter, particularly of other business services and financial services⁷².

This present specialisation pattern raises concerns as it leaves the EU economy greatly exposed to greater pressure from competition from emerging economies, namely China and India. These countries are upgrading the skill intensity of their exports and are rapidly catching up in terms of the non-price factors that often underlie the EU competitive edge in global markets particularly in upmarket products. Thus, stronger employment growth in the EU in services and high-tech manufacturing sectors – a move up the value chain – is desirable for sustaining and increasing EU living standards. The Internal Market has an important role to play. The noticeable lag of the EU with respect to ICT industries can be attributed to the lack of progress so far in the creation of a competitive Internal Market for services (which are the main consumers of ICT) and to a European innovation deficit.

3.1.6 Innovation

The Internal Market does not seem to have been a sufficient catalyst for innovation and resource reallocation towards technology intensive activities despite the observed reduction in mark-ups and evidence pointing to a reorganisation of production activities. Recent empirical findings show that the Single Market Programme (SMP) has contributed to a reduction in price-costs mark-ups, particularly in the manufacturing sectors that were most affected by the SMP. The increase in competition (as measured by the mark-ups) has helped to foster investments in R&D in manufacturing across the EU⁷³. While the effect of the Internal Market on R&D and innovation has been positive, it has not been strong enough to significantly improve the innovation and productivity growth performance of the EU. On a more positive note, these results show that a better

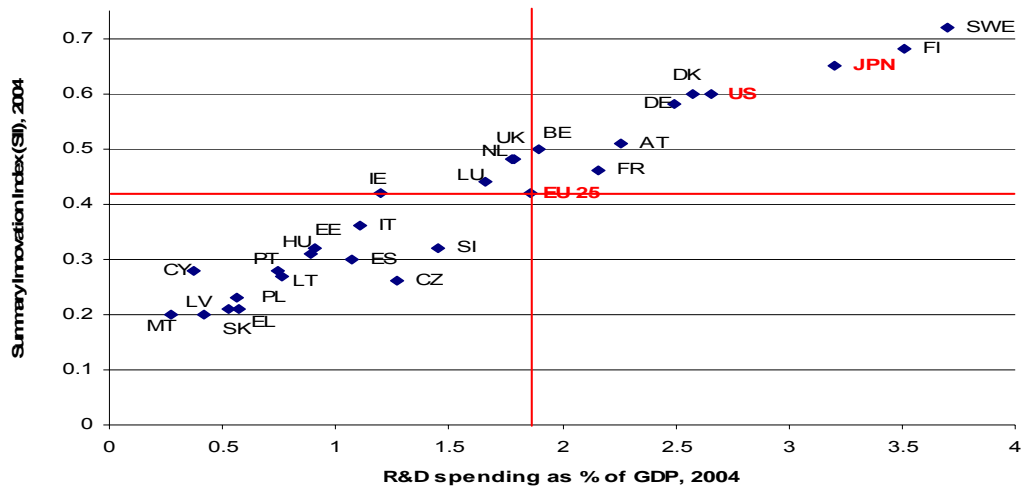
⁷¹ This indicator gives the contribution of different products or product groupings to the cyclically adjusted trade balance of the particular country or country grouping, see European Commission (2005) for more details on formulas used and calculations. A positive value means that the considered economy has a comparative advantage in the analysed sector.

⁷² For a more detailed analysis see: European Commission (2005).

⁷³ See: Griffith R., R. Harrison R. and H. Simpson H. (2006).

functioning and more integrated Internal Market can make a valuable contribution to improve the innovation performance of the EU economy. In this respect, the experience of the US illustrates that a more competitive and integrated market is essential to better exploit the innovative potential of the European economy as it moves closer to the technology frontier.

Figure 3-20: Innovation index and R&D spending as % of GDP



Source: Commission services based on Eurostat data

However, the innovative performance of the EU as a whole and of most EU countries lags significantly behind that of top performers such as the US and Japan (see Figure 3-20). There are some clear exceptions, notably the Nordic economies, which outperform the US and Japan.

Such intra-EU disparity is not a cause for concern per se, as in an integrated market the emergence of front-runners building on specific location of advantages is expected. What is more worrying is the widening gap between the laggards and front-runners and between the EU and other developed economies. This reflects the fact that the EU innovation environment remains weak in a number of key "input" indicators, such as the amount of public and private R&D and the stock of science and technology researchers, as well as weaknesses in the higher education system. In addition market conditions and knowledge networks are key areas of EU weakness. European companies are not sufficiently encouraged to innovate and, in this respect, the Internal Market has been an insufficient driver of innovation: some markets, in particular in services, remain too fragmented: a clearer and more efficient Intellectual Property Rights system is lacking; the potential of public procurement as innovation-driver is insufficiently exploited; and, the European Research area is still too much fragmented, leading to duplication and waste of resources (see also section 4.7)⁷⁴. All these elements contribute to the difficulties of the EU in developing ICT industries and to the EU's deteriorating attractiveness for international R&D investments compared to the US.

⁷⁴ The Internal Market is also losing its attractiveness for international R&D investment. Multinational companies prefer to carry out their R&D activities in the US - and more recently in China and India - rather than in the EU. The Asian share of overseas R&D expenditures by US-based companies is rising, while the European share is declining: US outward R&D investment in China has increased by 25% per year since the mid-1990s against 8% per year in EU15, see: Garnier (2006).

* * *

Concluding this section on the micro economic effects of the Internal Market, the overall picture that emerges is that integration seems to have lost momentum over the recent years. It is quite natural to observe a slowing down over time in the process of European product market integration as remaining barriers are increasingly difficult to remove. Nevertheless, while much has already been achieved the potential for further progress does not appear to be completely exhausted: the US still is a more integrated trade area than the EU as the ratio of intra-US States exports to GDP remains around a third higher than the ratio of intra-EU15 exports to GDP. The scope for further trade integration and price convergence in services still remains important. Moreover, the EU continues to have comparative disadvantage in high tech sectors including ICT. This disappointing result confirms that despite the good trade performance of the EU over the last years the necessary specialisation shift towards higher technology intensive sectors has failed to occur. The EU has not yet managed to establish itself as an innovation driven technology leader which is crucial to successfully reap the fruits of the changing and increasingly integrated global economy.

3.2. Macroeconomic effects

While there is evidence pointing to the conclusion that more can still be achieved in terms of promoting economic integration, efficiency and innovation, it is interesting to assess what has been the macroeconomic impact of the Internal Market Programme, particularly taking into account the more recent progress made in terms of liberalisation of network industries and the accession of 10 new Member States. Before presenting the results of the macroeconomic simulations a word of caution is necessary. The Internal Market is essentially a series of microeconomic reforms which together have a potentially significant macroeconomic impact. It is not straightforward however to derive the aggregate impact of a series of reforms which are spread out over time and affect sectors with quite different characteristics. The work presented below consists of three strands of analysis. First, macroeconomic impact of EU-15 market integration in manufacturing is estimated by simulating the competition and innovation effects as described in the already well-established literature on the impact of the Single Market Programme. Second, a more targeted simulation of the macroeconomic impact of the opening up to competition of the electricity and telecommunication markets has been carried out. Third, the competition and innovation effects of the increased trade in the enlarged EU of 25 Member States has been simulated.

The Commission's QUEST model has been used to carry out simulations ex-post of the macroeconomic impact of the Internal Market over the period 1992-2006. The simulations for the manufacturing industry are based on parameter estimates found in the empirical literature on the impact of the Single Market Programme (SMP) on price-cost mark-ups and total factor productivity⁷⁵. The simulations presented in Tables 3-5 through 3-7 assume that the SMP has resulted in a 0.9 percentage point decline in the aggregate price-cost mark-up and an increase in total factor productivity of 0.5%.

⁷⁵ See: Allen *et al.* (1998), Buigues *et al.* (1990), Bottasso and Sembenelli (2001), Notaro (2002) and Salgado (2002).

For network industries, the reduction in aggregate price-cost mark-ups associated with the liberalisation of network industries (electricity and telecommunication) is assumed to be 0.5 percentage points. This parameter estimate is based on preliminary evidence for the electricity sector suggesting a decline in price-cost margins of up to 25%⁷⁶. A somewhat larger decline in price-cost margins in telecommunications is assumed in light of the faster pace of liberalisation in that sector⁷⁷. The 0.5% aggregate mark-up shock reflects these sectoral declines in price-cost margins plus the weight of the electricity and telecommunication sectors in GDP. The introduction of this shock in QUEST results in an increase in GDP and employment of 0.4% and 0.6% respectively after 4 years; GDP is estimated to increase by 0.6% after 10 years⁷⁸.

These intra-EU15 simulations have been combined with simulations capturing the effects of EU enlargement. The enlargement simulations consist of three steps: (1) isolating the trade effect of the enlargement; (2) computing the resulting effect on mark-ups and total factor productivity; and finally (3) introducing the estimated mark-up and total factor productivity shocks into the QUEST model. The mark-up reductions over the period 2002-2006 add up to 0.05 and 1.75 percentage points for the old and new Member States respectively, while the gains in total factor productivity build up to 0.15% and 1.15% in 2006. According to the simulations, the magnitude of the enlargement effects varied substantially between the old and new Member States as the latter faced much higher mark-up and total factor productivity shocks during the early years of the enlargement. For the EU15 the simulations showed a 0.27% GDP increase in 2006⁷⁹ (relative to the baseline level) as a result of enlargement. This was accompanied by a slight increase in employment (see Table 3-5 and Table 3-6). In contrast the simulations for the new Member States showed a GDP increase of 2.9% on average, while employment increased by 0.5% in 2006 (relative to the baseline).

To compute the combined effect of EU15 integration and the enlargement, the corresponding yearly mark-up and total factor productivity shocks have been added up.

Table 3-7 presents the results for the EU25. These results show that the enlarged Internal Market (including liberalisation of network industries) is an important source of growth and jobs. As a result of the progress made over the period 1992-2006 in achieving an enlarged Internal Market of 25 Member States, GDP and employment levels have increased significantly. The estimated "gains" from the Internal Market in 2006 amount to 2.2% of EU GDP (or 223 billion euro)⁸⁰ and 1.4% of total employment (or 2.75 million jobs). These gains could have been substantially larger if services market had been fully opened up to cross-border competition (see section 4.4).

⁷⁶ See: Roeger and Warzynski (2002).

⁷⁷ The (cautious) assumption has been made that mark-ups in the telecommunications sector have decreased by 50% more than in electricity. This assumption is also consistent with the more advanced state of liberalisation in telecommunications.

These effects are somewhat stronger than the Internal Market effects, because in these simulations it is assumed that deregulation also has an effect on rent sharing between workers and firms. The decline in price-cost mark-ups is therefore associated with a decline in the mark-up of wages over the reservation wage.

⁷⁹ The enlargement trade effect is identifiable already in the years before enlargement took place in 2004.

⁸⁰ In 2002 prices.

Table 3-5: GDP effects of the Internal Market (SMP), the liberalisation of network industries and enlargement (deviation from baseline level), 2002-2006

Years	EU15						EU10	
	Network+SMP ^a		Enlargement		Network+SMP+Enlargement		Enlargement ^b	
	mrd EUR	%	mrd EUR	%	mrd EUR	%	mrd EUR	%
2002	164,5	1,79%	15,9	0,17%	180,4	1,96%	8,8	1,96%
2003	168,4	1,81%	18,9	0,20%	187,3	2,01%	11,4	2,45%
2004	172,2	1,81%	21,2	0,22%	193,4	2,03%	12,8	2,62%
2005	176,1	1,83%	24,5	0,25%	200,6	2,08%	14,8	2,90%
2006	179,9	1,83%	27,1	0,27%	207,0	2,10%	15,6	2,91%

Table 3-6: Employment effects of the Internal Market (SMP), the liberalisation of network industries and enlargement (deviation from baseline level), 2002-2006

Years	EU15						EU10	
	Network+SMP ^a		Enlargement		Network+SMP+Enlargement		Enlargement ^b	
	1000 p.	%	1000 p.	%	1000 p.	%	1000 p.	%
2002	2450,6	1,47%	67,9	0,04%	2518,5	1,51%	118,9	0,41%
2003	2454,5	1,46%	85,4	0,05%	2539,9	1,51%	104,2	0,36%
2004	2458,3	1,45%	86,0	0,05%	2544,3	1,50%	116,5	0,40%
2005	2462,2	1,44%	104,1	0,06%	2566,3	1,50%	145,0	0,49%
2006	2466,0	1,43%	122,4	0,07%	2588,4	1,50%	162,1	0,54%

Table 3-7: Total GDP and employment effects of the Internal Market (SMP), the liberalisation of network industries and enlargement (deviation from baseline level), 2002-2006

Years	EU25			
	Total GDP effect		Total employment effect	
	mrd EUR	%	1000 p.	%
2002	189,2	1,96%	2637,4	1,35%
2003	198,7	2,05%	2644,1	1,34%
2004	206,2	2,08%	2660,8	1,34%
2005	215,4	2,15%	2711,2	1,35%
2006	222,6	2,18%	2750,5	1,36%

Sources:

* **EU15 Internal Market and network liberalization effect:** W. Röger and K. Sekkat (2002), 'Request from DG MARKT to Assess the Macroeconomic Effects of the Single Market Program after 10 years.'

** **Effect of enlargement on EU15 and EU10:** J. Varga (2006): 'Ex-post Simulation of the Early Enlargement Process with QUEST II.' The impact of enlargement is based on manufacturing data only, see p. 8. "Table 1: Ex-post enlargement effects (deviation from baseline-level), EU12-EU15"

GDP: AMECO, Gross domestic product at constant prices in mrd EUR in 2002 prices.

EMPLOYMENT: Employment, 1000 persons; total economy (National accounts)

Note: The EU15 network + SMP effect (column A) is calculated by linear interpolation from the results of Roeger and Sekkat (2002).

4. WHY HAS THE POTENTIAL OF THE INTERNAL MARKET NOT BEEN FULLY EXPLOITED?

The creation of the Internal Market based on the Single Market Programme and successive legislative programmes is a necessary, but not a sufficient condition for European companies to successfully face the challenges of globalisation. This chapter considers various factors preventing the full exploitation of the potential of the Internal Market. Section 4.1 considers problems of insufficient implementation and application of existing legislation and instruments by the Member States. Section 4.2 recounts the difficulties of agreeing on common product standards and of applying the mutual recognition principle. Section 4.3 discusses the failure to fully open up public procurement markets. Section 4.4 treats barriers preventing the free provision of services across borders, while section 4.5 focuses on fiscal barriers. Section 4.6 looks at barriers hindering the free movement of people and the final section 4.7 investigates barriers to the diffusion of knowledge and innovation.

The results of simulations quantifying the potential effects of the removal of some remaining barriers show that the macroeconomic gains resulting from the Internal Market (2.1% of GDP in 2006, as indicated in section 3.2) could have been substantially larger if services markets had been fully opened up to cross border competition and fiscal barriers reduced. The implementation of the Services Directive could stimulate trade and foreign direct investment in services, resulting in a further 0.5 to 1% increase in GDP (see box 4.1). Fully integrated financial markets could – in the medium to long term - lower the cost of capital for EU companies by about 0.5 percentage points, and this could bring about a rise in the level of GDP of 1.1% in the long run (see box 4.3). The further opening up of energy would lead to an increase in GDP by about 0.6-0.8 % (see box 4.5). Finally, the potential gains from increased tax cooperation could represent 0.2% of GDP (see box 4.6)

4.1. Slow transposition and incorrect application of Internal Market Directives

The adoption and implementation of Internal Market Directives is the main policy tool specifically targeted at creating a better functioning Internal Market. Over the period 1999-2006 a number of important Directives with a direct effect on the EU economy have been proposed by the Commission, agreed with Council and Parliament, and started to be implemented by the Member States. Prominent examples are the legal framework for electronic commerce; modernising legislation in public procurement; consolidation and modernisation of rules regulating the recognition of professional qualifications; and, the recent political agreement within the Council on a draft services directive. However, all these new Directives need to be efficiently implemented by the Member States in order to be effective.

Member States have the primary responsibility for transposing Community directives into domestic legislation and for ensuring a correct implementation. However, there are important differences between Member States in terms of speed and efficiency of transposition. Two times a year the Commission publishes an Internal Market Scoreboard, which reports on progress made by the Member States in bringing down their transposition deficit. According to the latest 2006 Scoreboard⁸¹, the global

⁸¹ See: European Commission (2006d).

transposition deficit for Internal Market directives finally achieved the 1.5% target originally set by the Member States for the Spring of 2002.

In the view of the prominent role of the Internal Market as an adjustment mechanism in the euro area, the improved performance of many euro area Member States in transposing and applying Internal Market legislation is a positive sign. Nevertheless, it is a cause for concern that in four euro area countries (Greece, Luxemburg, Italy and Portugal) the transposition deficit remains well above the 1.5% target. In addition, the large number of infringements of Internal Market legislation illustrates that frequently Internal Market rules are disregarded or incorrectly applied.

The adoption and transposition into domestic law of EU Directives is a necessary but insufficient condition for the well-functioning of the Internal Market. Although the SMP and successive Internal Market strategies have been aimed at creating a level playing field by providing a set of rules to be applied across the Community territory, some provisions have lacked clarity and precision. The result is divergent, occasionally even conflicting interpretations by different Member States, which often result in the distortion of competition. Problems resulting from an uneven application and weak enforcement of EU regulation have been highlighted by many respondents of a recent public consultation carried out by the Commission on the future Single Market policy⁸². Concrete examples came for example from the music and high-tech industry, pointing at the incorrect implementation of the e-commerce and copyright directive or the food and beverages industry criticising Member States' compliance with the Packaging Directive. The often incorrect application of Internal Market rules can also be illustrated by the high number of infringement cases that the Commission has had to launch. According to the latest Internal Market Scoreboard none of the Member States has kept its promise to reduce infringement proceedings by 50% in 3 years.

4.2. Inadequate standards and insufficient mutual recognition

4.2.1. Product standards

The adoption of agreed standards and the application of the mutual recognition principle are two main tools for bringing down technical barriers to trade between Member States. The economic benefits of standards for producers are compatibility and interoperability of the traded products, reducing trade costs and allowing a better exploitation of economies of scale. For consumers, standards reduce uncertainty and costs of purchase decisions by facilitating comparisons. They can, furthermore, take into account broader policy objectives regarding consumer welfare, environmental protection, etc. Finally, standards may be viewed as a tool to promote the dissemination of know-how.

Nevertheless, there are some important outstanding issues: (i) industry is insufficiently aware of the strategic advantages of standardisation, which is often still seen as a cost factor; (ii) there is still room for improving the efficiency of the standards development process; and (iii) the speed of transposition of European standards into national standards is rather slow. Alternatives to the present, partly diversified system based on many competing National Standards Bodies may have to be considered. Moreover, the Commission has identified⁸³ a number of new challenges that European standardisation

⁸² See: European Commission (2006e).

⁸³ See: European Commission (2006f).

system is facing against the background of EU enlargement, the increased use of ICT and globalisation:

- **Enlargement:** European legislation and policies supported by standards can only work properly when they are complemented by a sound and well functioning European standards system including all of the Member States' National Standards Bodies. Due to the structure and size of enterprises in the new Member States, the involvement of Small and Medium-sized enterprises (SMEs) in standardisation work and the use of European standards present a particular problem in the sense that access to standards must be improved.
- **ICT:** The rapid development of technologies and processes in some sectors, in particular in the information and communication technology (ICT) sector, has led to an industry need for the equally rapid creation of specifications which do not have the status of a formal standard. In order to respond to this need, there has been a mushrooming of industrial fora and consortia developing such specifications. While the increased flexibility of this approach is welcome, one should avoid that it leads to the development of multiple specifications lacking interoperability.
- **Globalisation:** At the time of the establishment of the Single Market, there were some fears that the Internal Market would become a "Fortress Europe" by throwing up protectionist barriers (in the form of rather restrictive product standards, e.g.) and trading only with itself. In fact, as the evidence presented in the previous chapter showed, the opposite has happened. Over the past ten years, extra-EU imports into the EU have grown steadily. This is a clear sign that EU-wide product standards have contributed to the creation of a large homogeneous market, which has facilitated market access for firms from third countries. With increased globalisation and world trade, however, the question of standards has gone beyond that of the removal of trade barriers within the EU: an increased recourse to common standards within and outside the EU would open wider export possibilities. Accordingly, the Commission is supporting activities at international level which recommend the use of voluntary international standards. Based on international agreements, around 40% of all European standards are already direct transpositions of international ones and this percentage is increasing steadily. In particular, in the electro-technical field, the majority of European standards, around 75%, are either identical to IEC⁸⁴ standards (70%) or based on them (5%).

4.2.2. *New Approach*

The "New Approach" restricts product legislation to only those essential requirements necessary to make products safe. It was developed as a tool to offer a more flexible and simple approach towards standardisation. It foresees the adoption of less stringent forms of legislation in areas where, otherwise, any detail would have to be determined by the legislative act itself. The technical transposition of common principles is left to the producers. New Approach Directives are special in that they do not contain technical detail but broad safety and other basic requirements that have to be translated by manufacturers into technical solutions. With the New Approach standards can be updated much faster than via legislation. In particular technological developments can be more

⁸⁴ International Electrotechnical Commission.

easily incorporated into regulatory requirements, thereby encouraging the diffusion of new technologies.

Together, the trading volume of products covered by the new approach is estimated to exceed €1500 billion per year. While in this sense the New Approach has proved to be very successful, experience of implementation and identification of shortcomings have called for revisions of the principle in order to enhance its effectiveness, e.g. in the fields of market surveillance (enforcement of legislation at national level) and to ensure coherence of rules for the operation of Notified Bodies for conformity assessment. The New Approach is seen to be very dependent on the efficiency of the European standards bodies. It also suffers from the “industry” image of standardisation activities, making it often less attractive for the protection of the environment, protection of the consumer or of the worker at the work place. In June 2006 the Commission launched a public consultation⁸⁵ seeking the views from all interested parties on improving the New Approach, in particular in the areas of conformity assessment, CE marking and market surveillance. A legislative proposal addressing above mentioned problems is planned for the end of 2006 and it should put into place complementary tools for a better and more effective operation of existing and future legislation.

4.2.3. *Mutual recognition*

While the New Approach to standardisation is increasingly popular, in areas where no common standards have been agreed the principle of mutual recognition continues to apply. This principle allows goods that have been legally manufactured and/or sold in one country to be sold elsewhere without further formalities⁸⁶. Mutual recognition has been one of the main Community instruments for eliminating regulatory non-fiscal barriers to the free movement of goods within the EU. About 20% of industrial production and about 26% of intra-EU manufacturing trade are covered by mutual recognition⁸⁷. However, the practical implementation of the mutual recognition principle is often hampered by legal uncertainty, administrative hassle and a lack of awareness both from the side of the companies and that of the Member States` authorities.

The costs for enterprises of product conformity assessment can be substantial. Estimates vary depending on the type of product, its technical specifications, the size of the market of the receiving Member State, the size of the enterprise, etc. For companies offering several product types on a national market of a receiving Member State, these costs have been estimated to amount to approximately 2% of their entire annual turnover on that market. These costs are relatively higher for companies specialised in one specific product type because they do not benefit from economies of scale and learning in complying with these regulations. For these companies, the compliance and redundancy costs are reported to amount to approximately 10% to 15% of their entire annual turnover on a larger foreign market. These percentages increase fast for smaller national markets. In 2003, the Commission published a Communication clarifying this principle and aiming to help businesses and national administrations make it work better.

Nevertheless, problems with the practical application of the mutual recognition principle remain. It is estimated that around one quarter of enterprises relying on mutual

⁸⁵ For more information, see: http://ec.europa.eu/enterprise/newapproach/review_en.htm

⁸⁶ Under the mutual recognition principle, Member States cannot forbid the sale of such goods except for justified cause as described in Article 30 of the EC Treaty or on the basis of overriding requirements of general public importance recognised by the Court of Justice's case law.

⁸⁷ See inter alia: European Commission (2001b and 2001c).

recognition when selling goods in another Member State have problems⁸⁸. As a result, many companies have come to the conclusion that it is less costly to adapt their products to the regulations in place in the country of destination rather than to rely on the application of the mutual recognition principle.

An impact assessment⁸⁹ is being carried out by Commission services examining policy options to improve the functioning of the mutual recognition principle. Based on preliminary results the adoption of a legislative instrument, clarifying the burden of proof and reducing the regulatory risk in the receiving Member State, would help to improve the application of the mutual recognition principle. This legislative measure would have to be accompanied by non-legislative actions (such as improved administrative cooperation and the better provision of information on mutual recognition via a common website) addressing the lack of awareness of enterprises and national authorities about the existence of the mutual recognition principle

4.3. Public procurement

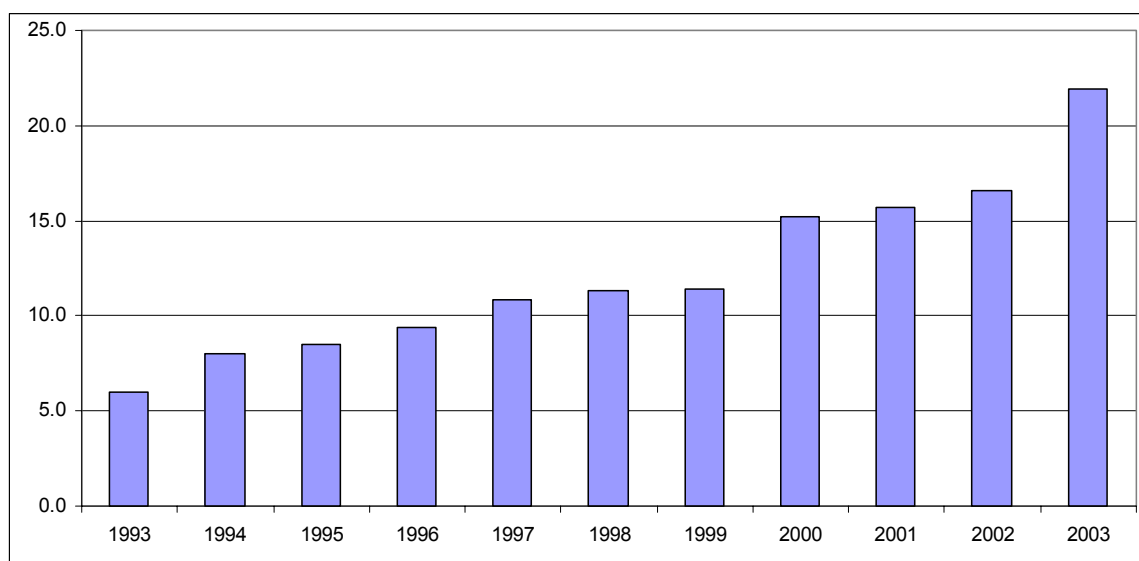
Public procurement accounts for around 16% of EU GDP. Therefore, improvements in public procurement practices have the potential to generate significant economic benefits. While the opening up of public procurement within the Internal Market has increased cross-border competition, direct cross-border procurement remains very low, accounting for only 3% of the total number of bids. However, the rate of indirect public procurement made by foreign firms' local subsidiaries is significantly higher (30%)⁹⁰. Not all public procurement is subject to the obligations established by EU directives. Some activities, notably in the defence sector are subject to special rules. Overall, only about 22% of public procurement is published and thus open to competition.

⁸⁸ See: European Commission (2004b).

⁸⁹ European Commission, Options to eliminate technical obstacles in the non-harmonised field of goods: impact assessment, forthcoming.

⁹⁰ See: European Commission (2004c).

Figure 4-1: Value of public procurement which is openly advertised as a % of total public procurement (EU15)



While defence procurement expenditure accounts for 0.8% of GDP (including spending on equipment, which is equivalent to 0.3% of GDP), these markets are not open to competition because of the specific characteristics that distinguish defence procurement from other procurement. Defence products are often very sensitive and connected with sovereignty and national security; the programmes tend to be complex, have a long lifetime, and involve high development costs and major commercial risks. The exclusion of the defence sector from EU-wide public procurement rules has some negative consequences: (i) the lack of effectiveness of acquisition systems and procedures increases the costs of military equipment; (ii) even though a small number of Member States (DE, ES, FR, IT, SE, UK) is responsible for 90% of EU spending on defence equipment, the competitiveness of the European defence industry is affected by the relatively small size of the national markets; (iii) the dispersion of product development in the defence sector acts as an obstacle to knowledge diffusion in the high-tech sector more generally. These difficulties contrast with the experience of the US, where defence-related government (R&D) spending has played a crucial role in the development of internationally competitive general-purpose technologies. This is especially true for a number of high-tech industries such as aircraft, nuclear power, computer, semiconductor, Internet and satellite communication, and Earth-observing systems developed in the US⁹¹.

Protecting large areas of economic activity from competition involves significant costs. The additional costs arising from sheltering sectors from cross-border competition have to be financed by the Member States' governments. The efficiency gains from a further opening up of the public procurement markets could, thus, result in important savings for the national budgets.

⁹¹ See: Ruttan (2006).

4.4. Barriers remaining in services sectors

4.4.1. Services in general

Trade and cross-border activity in services remains relatively limited. While the share of services in EU-15 value added is close to 70%, services account for only one-fifth of intra-EU trade. Cross border transactions in services between two countries takes place mainly through (i) the international trade of services, such as road freight transport, telecommunications or consultancy and financial services; (ii) the establishment of production units in another country (for example banking or accountancy services); and (iii) the consumption of foreign non-traded services, such as tourism. Due to the rapid development and increased use of information and communication technologies, services have become increasingly tradable and exposed to international competition.

Due to their specific nature and intangibility services are affected by more complex regulatory barriers than trade. Unlike goods, they often require business processes and the presence of the provider in both the country of origin of the service provider and in the country where the service is being delivered. This double presence can result in the duplication of regulatory requirements and burdens (national social security schemes for the staff, different administrative and tax procedures, etc.). In addition, foreign firms often face additional costs due to the non-acknowledgement of their compliance with their home country regulations⁹². In this respect, there is often a lack of clarity on the regulations and their effective implementation, resulting in legal and economic uncertainty for foreign service providers. This regulatory heterogeneity severely restricts the realisation of economies of scale in complying with regulations within the EU. As already mentioned in chapter 3, another undesired effect of Internal Market barriers in the services sector are downwards price rigidities and the persistence of higher than average headline inflation in the services sector.

In order to address and eliminate regulative distortions, the Commission approved in 2004 a draft Services Directive. It intended the simplification of administrative rules, the identification of typical restrictions in the regulation of services, and (with exemptions) a shift from the prevailing system of mutual recognition to general application of the country-of-origin principle. The latter would allow service providers of residents of other Member States direct access to all national markets of the EU without any scrutiny by national authorities. The responsibility of supervising the service providers would remain with the Member State of origin. The amended Commission proposal of the Services Directive of early April 2006, took to a large extent on board amendments voted by the European Parliament. It is narrowing the original proposal through: (a) restrictions on the use of the country-of-origin principle; (b) the deletion of a provision outlawing anticompetitive practices; and (c) a narrowing of the scope of the Directive through the exclusion of sectors such as gambling, audiovisual services, health care and notaries.

⁹² Companies might have to provide professional (re-) qualifications, meet economic tests, and sometimes need to have the residence or even nationality of the owner or manager of the firm in the member state where the service is delivered, or for some branches geographical or quantitative limitations of establishment still exist.

Box 4.1: QUANTIFYING THE MACROECONOMIC IMPACT OF THE LIBERALISATION OF SERVICES

The available studies show that the implementation of the European Services Directive will generate more intra-EU trade, more foreign investment in services sectors and lower prices of services. GDP could go up by 0.5% to around 1% on average in Europe:

Copenhagen Economics⁹³ quantified the impact of the Services Directive as it was when first submitted by the Commission to European Parliament. The results found pointed to an increase in aggregate employment of 0.3% (in the services industries employment would increase by 0.5%) and 1.1% in value added. Copenhagen Economics also considered the effect of the exclusion of the country of origin principle (CoOP) from the service directive in a study commissioned by the UK Department of Trade and Industry⁹⁴. The study found that the provisions relating to the CoOP account for around 10% of the total welfare gains (€2-4 billion per annum) from the service directive. This figure should however be viewed as the lower bound of the potential impact of withdrawing the CoOP.

Kox and Lejour (2006), find a similar result. They estimate that the trade and FDI effects of the EU services market liberalisation could lead to an increase in GDP by 0.5 to 1.5%. The CoOP would account for about one-third of these effects. However, these estimates do not take into account the dynamic effects of this liberalisation. Improved market access could stimulate competitive selection and productivity growth. In addition, through trade and investment, knowledge spillovers could increase and innovation could be fostered. These dynamic effects are harder to estimate. Back on the envelope calculations based on the relation between trade openness and growth suggest a further GDP increase by 2 to 5 % if the analysis incorporates these dynamic effects.

Some services sectors, such as the network industries, retail trade, and professional services, suffer particularly from regulatory distortions, downward price rigidities and insufficient competition. The following sections take a closer look at developments in some of these sectors.

4.4.2. Retail trade

The lack of a truly integrated European market in retail trade and the prevalence of national and local restrictions on the freedom of establishment have contributed to the relatively (in comparison with the US) slow diffusion of new technologies and organisational improvements in European retail services. This has limited productivity growth in the sector (see Box 4.2) and has contributed to a greater price stickiness overall. While retail prices are sticky on both sides of the Atlantic Ocean, price changes in Europe are less frequent than those in the US. According to a recent study⁹⁵, there are two main assumed reasons for this difference: firstly the higher ICT intensity of this sector, the larger share of modern superstores and the greater diffusion of e-commerce in the US resulted into a greater automation of retail transactions and therefore into lower menu costs. Secondly, in the US the competitive pressure of Wal-Mart and other large retailers encouraged other stores to adopt its technological and organisational best. Problems with the cross-border transactions of retail markets have also been highlighted by many respondents of the recent public consultation on the future of the Internal Market.

⁹³ Copenhagen Economics (2005b)

⁹⁴ See Copenhagen Economics (2005c).

⁹⁵ See: Dhyne *et al.* (2006).

Box 4.2: LAGGING EU RETAIL AND WHOLESALE PRODUCTIVITY COMPARED TO THE US

Wholesale and retail trade account for over 50% of the economy-wide productivity growth in the US after 1995. These two sectors have experienced a significant acceleration in productivity growth around the mid-1990s, almost doubling the trend growth rate of the previous twenty years. The average contribution of wholesale (retail) trade to total productivity growth was 27% (26%) in the US compared with 10% (7%) in the EU between 1994 and 2003. A recent study⁹⁶ compared the US and EU retail and wholesale sectors productivity effectiveness. It explains why Europe is lagging behind the US by two main factors:

- (1) **The early start of the US in using ICT:** over the last thirty years, the US retailing trade was transformed from a low-technology sector to one of the most intense users of ICT. The technologies used in this sector reward scale and scope, enabling large centralised chains and “big box” stores to expand rapidly. Europe has not changed as rapidly. In addition, unlike in the US, it has a heavy regulatory environment.
- (2) **Remaining regulatory obstacles within and between individual EU countries.** While progressing, the process of deregulation and harmonisation between Member States has been much slower than in the US, leading to the expansion of retailers across Europe. For example there is by now a strong presence of Western European companies in the markets of the ten new Member States. However, there are still significant barriers within Member States. The three major categories of regulation affecting productivity growth within EU Member States are store opening hours, land usage restrictions (especially on large stores), and labour laws. Store opening-hour regulation has become critically important for the retail sector as lifestyles and working patterns have changed over the past 25 years. Similarly, a retailer’s survival is dependent on getting a convenient, visible location. There are two major channels by which land usage impacts productivity. Firstly, the limitation of entry and exit: restrictions on retail land usage cut back on both the creation of new stores and the elimination of old ones. Building new stores might become very expensive (resulting in fewer entrants) and artificially inflates the value of old stores based on the land they occupy. Secondly, land rule regulations usually hamper the establishment of large stores, reducing the ability to exploit economies of scale.

4.4.3. Financial services

Financial services account for about 6% of the EU's GDP. Financial development can contribute to economic growth and welfare via several channels, notably lower transaction costs, wider opportunities for risk sharing and, thus, more efficient resource allocation. To the extent that the financial sector is constrained in the performance of these various functions, there is a consequent cost in terms of sub-optimal economic performance and welfare loss.

Box 4.3: QUANTIFYING THE ECONOMIC BENEFITS OF EU FINANCIAL INTEGRATION

While the link between financial integration, financial development and economic performance is complex, two independent studies undertaken on behalf of the Commission services have attempted to quantify the benefits of EU financial integration in terms of GDP.

A study by London Economics⁹⁷ (LE) adopts a macroeconomic approach to quantifying the economic effect of financial integration in the EU. The study focuses on the benefits of integrating the set of fragmented national systems into a pan-EU system by estimating the *static* efficiency gains from deeper and more liquid equity and bond markets. These gains are supplemented by improvements in the functioning of market infrastructure and greater competition between sources of direct and indirect financing. The study concludes that fully integrated markets could – in the medium to long term - lower

⁹⁶ See: McGuckin et al. (2005).

⁹⁷ London Economics (2002).

the cost of capital for EU companies by about 0.5 percentage points, and that this could bring about (i) a rise in the level of GDP of 1.1% in the long run; (ii) a 6% increase in the level of investment; (iii) a 0.8% increase in the level of private consumption; and (iv) a rise of 0.5% in the level of employment. The authors suggest that introducing *dynamic* adjustments would greatly increase the output and employment gains. The study also presents the results of a survey of market participants, which is used to confirm the assumptions underlying the empirical analysis.

The second study by a group of CEPR⁹⁸ researchers adopts a more microeconomic approach and focuses on the relationship between financial-market integration and corporate growth. A three-stage approach is used. First, the authors screen the available measures of financial development – related for instance to efficiency or the size of the financial system. Second, they examine the impact of financial integration on financial development, which is expected to be positive, both quantitatively (larger market and access to foreign markets and lenders) and qualitatively (importing better institutions, e.g. relating to creditor rights and investor protection). Third, an econometric analysis, at both industry sector and firm level, provides estimates of the output growth effects of greater financial development due to integration. In a scenario in which EU manufacturing companies would have the same access to finance as US companies, value-added growth in EU manufacturing is estimated to increase by 0.75–0.94 percent on a durable basis.

Quantifying the costs and benefits of financial integration is subject to significant data, statistical and model uncertainty. Accordingly, the results of these two studies can be considered only as indicative of the potential benefits of EU financial integration. In addition, exploiting these benefits fully will require flanking policies in the fields of competition, market transparency/integrity and financial stability. Nevertheless, the results of the studies tend to validate the rationale underlying EU policy on financial integration.

EMU and the introduction of the euro have provided a major impetus to financial integration in the EU, by creating the potential for large and liquid financial markets and scale and scope economies among financial intermediaries. By eliminating currency risk within the euro area, the euro has stimulated demand for cross-border financial services more generally in the EU and has brought into sharper focus the opportunity costs of remaining sources of fragmentation in the financial system, notably in the field of market regulation. The costs and risks associated with cross-border financial transactions are unnecessarily high, thereby discouraging the conduct of financial activity on a pan-EU basis. The result is an inefficient allocation of economic resources due to unexploited scale/scope economies, sub-optimal risk management, inefficient pricing and reduced opportunities for investment/consumption smoothing.

The process of EU financial integration is well underway in a range of areas and particularly in wholesale markets. However, as indicated below, progress has varied across the different sectors of the financial system, with unsecured segments (where there is no transfer of collateral involved) very much in the lead.

The *euro-area derivatives market* is highly integrated with a sharp expansion of euro interest swap activity and the rise of pan-European equity based index trading. As regards the integration of money markets, the market for interbank deposits is fully integrated, as witnessed by the acceptance of market participants of EONIA (Euro Overnight Index Average) and EURIBOR (Euro Inter-Bank Offered Rate) as uniform price references. On the other hand, various obstacles (i.e. technical, regulatory, fiscal and legal) related to the clearing and settlement are holding back the integration of the secured market segments, (e.g. commercial paper and treasury bills) which involve the exchange of liquidity against collateral.

In *bond markets*, the launch of the euro created a much more homogenous EU market, with largely convergent prices among euro-area member states and evidence of cross-

⁹⁸ See Giannetti M., L.Guiso, T. Jappelli, M. Padula and M. Pagano (2002).

border portfolio diversification. A deeper and more liquid euro-denominated bond market has resulted in higher net and gross issuance volumes for the market as a whole, when compared to the combined issuance in the legacy currencies.

In *equity trading*, the impact of the euro has so far been strongest at the level of the investor, with an overall reduction in “home bias” and a re-orientation of asset managers’ investment strategies towards a European-based approach. In consequence, a number of studies have found increased correlation among the performance of national stock markets. In contrast, with cross-border listings still exceptional, there is little evidence of a euro impact on the behaviour of issuers. Integration in the equity market is also particularly impeded by inefficiencies in the clearing and settlement process.

There has been a significant amount of M&As in the *banking sector* – still the dominant sector in providing euro area financing - although consolidation has mainly occurred along national lines due to a number of still existing legal and political barriers. The lack of cross-border banking integration is also reflected in the dispersion of national retail interest rates (for example for consumer credits or mortgages). A recent study by the ECB⁹⁹ explains such dispersion by structural differences among Member States in the retail banking sector, including different consumer protection rules, differing tax treatments of income from deposits as well as structural factors such as levels of technology and the degree of integration and competition in the financial sector. Three initiatives of the Commission are underway to address these differences: (a) a white paper on mortgage credit based on extensive consultations with stakeholders to be published in 2007, (b) a modified consumer credit directive, and (c) a proposal on payment services directive to enhance the competition and to facilitate the creation of a single EU payment area (SEPA) by 2010. Consolidation in euro area market infrastructure can be witnessed in Europe’s stock exchanges, where notable examples would include the merger of exchanges in Amsterdam, Brussels, Paris, and Lisbon in Euronext, and the integrated Nordic-Baltic market, which includes the stock exchanges of Copenhagen, Stockholm, Helsinki, Tallinn, Riga and Vilnius. Some progress has been made in the integration of payment systems, such as through TARGET and in clearing and settlement systems.

In order to address the main barriers in this sector, the Commission White Paper on Financial Services Policy in 2005-2010 has set the agenda for EU-level financial-sector reform in the coming five years. However, there are areas where there may be a need for further efforts, such as clearing and settlement, where cross-border clearing and settlement transaction are far more costly than domestic transactions, retail sector, where initiatives are underway in the areas of mortgage credit, consumer credit directive and payment services, EU supervisory arrangements, where greater clarity and transparency is needed from the perspective of financial-system efficiency and stability and investment fund industry. Looking globally beyond the EU, is the need for international dialogues on financial markets and their regulation with the United States and Japan, but also with the growing new economies in China and India.

4.4.4. *Network industries*

The on-going process of liberalisation in the network industries implies a stepwise opening up of the telecommunications, postal services, energy and transport sectors to

⁹⁹ See: ECB (2006).

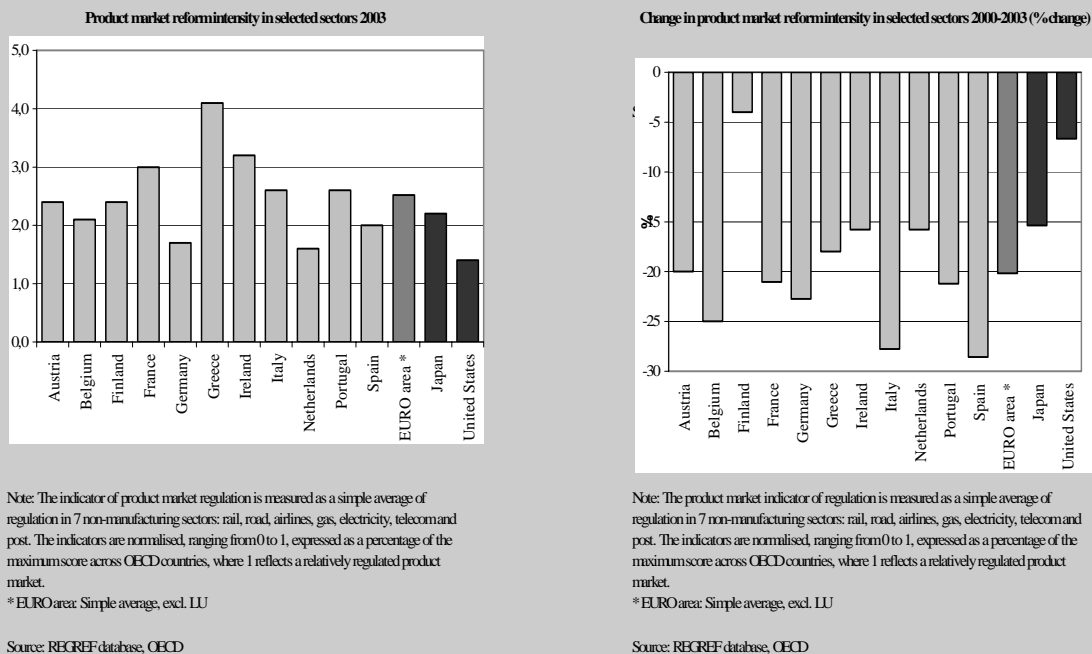
competition. Since the early 1990s, these efforts have accelerated, with the aim to open up the network industries to competition while at the same time promoting effective regulatory structures for those aspects of the networks requiring public policy intervention. Network industries contributed in 2003 with about 7.5% to the total value added of the EU-15. This compares with the much higher share in the new Member States ranging from 9.8% in Hungary to 14.3% in Slovakia.

Often the integration of markets is conditional on the physical integration of the respective national networks. Indeed, since most networks have originally been built for national (or even regional) markets, network service providers' access to national markets other than their own – and thus the development of cross-border competition – may often be impeded by insufficient interconnection. In some cases this can be overcome by increased investments in cross-border infrastructure, while in others it requires improvements in the interoperability of networks (e.g. harmonisation of technical norms and standards). This time consuming process should be accelerated by a number of ongoing measures, such as the recent creation of the European Railway Agency.

BOX 4.4: REGULATORY CONDITIONS

The OECD has calculated an indicator to track regulatory conditions in seven network industries. This indicator is based on different industry characteristics including entry regulation, public ownership, market structure, vertical integration and price controls. It shows a relatively high level of regulation in France, Greece and Ireland and lower levels in Germany, the Netherlands (see figure 4.3). While in 2003 network industries in the euro area were still more heavily regulated than in the US (except for electricity), the process of deregulation (over the period 2000-2003) was more rapid in the EU, especially in electricity and postal services.

Figure 4-2: Product market regulation in network industries



The rationale behind the liberalisation of network industries is to improve their sectoral performance and thereby to generate wider-reaching macro-economic benefits. A defining structural characteristic of most network industries is the presence of

bottlenecks separating producers and customers, notably the grid itself – e.g. transmission lines, pipes, railway tracks. These industries are also exceptional in that they provide essential inputs for virtually all of the rest of the economy. The importance of the proper functioning of these industries is further reinforced by their role as providers of services of general economic interest.

Most network industries were traditionally organised as vertically-integrated state-owned monopolies. Therefore, the separation (unbundling) of the bottleneck segments, which generally have inherent natural monopoly features from the potentially competitive segments (such as production, supply and maintenance), is a cornerstone of the market opening process. The resulting increase in competitive pressure should entail higher productivity (and productivity growth) and a downward pressure on prices, ultimately translating into higher economic growth.

BOX 4.5: QUANTIFYING THE EFFECTS OF FURTHER LIBERALISATION OF THE ENERGY SECTORS

To assess the macro-economic impact of liberalisation, one has to distinguish between direct effects on the network industries, effects on customers and indirect economy-wide effects. Some direct effects on the industries themselves are likely to be negative as the competitive pressure and the drive for more efficient production are likely to exert downward pressure on employment levels and mark-ups in incumbent firms. Nonetheless, lower prices and product innovation ensuing from the competitive pressures may lead to higher demand and output and thus mitigate the adverse employment effects. Although the effects of liberalisation on customers are expected to be positive and much larger than the effects on the incumbent firms and their employees, they are by and large more dispersed and less tractable. Indeed, lower prices of network industry services would enhance welfare by raising real household incomes and lowering the costs for those industries which rely heavily on inputs from network industries. Furthermore, given the considerable weight of network industries in the Harmonised Index for Consumer Prices, price developments in network industries may also have important consequences for the efficient conduct of monetary policy¹⁰⁰. In contrast to the direct effects on firms and employees in the sector, the indirect effects are far less visible and thus hard to measure and quantify. Moreover, in terms of timing, one can expect the incumbent firms and their employees to feel the effects of liberalisation rather abruptly while customers reap benefits somewhat later. The indirect effects would normally take much longer to materialise. In section 3.2, an estimation of the ex-post effect of the liberalisation of telecommunications and electricity is discussed. In this box, an attempt is made to quantify the effects of a further liberalisation of the energy (electricity and gas) sector. This quantification is subject to significant data, statistical and model uncertainty. Accordingly, the results of this quantification can be considered only as indicative of the potential benefits of these regulatory reforms.

The starting point of this simulation is the ECB estimate that further regulatory reforms in the EU electricity sector could lead to price reductions of about 20%. This result is based on the assumption that all EU 15 Member States align their regulatory conditions to those of the 'best practice' country and that prices adjust accordingly. Given the share of the EU electricity industry in value added (1.9%) and the size of the non tradable sector (2/3 of value added), a price reduction of 20% would be associated with a price decline of 0.6% in the non tradable sector. This reduction in prices has been translated into a total factor productivity (TFP) and a mark-up shock in the European Commission QUEST model. The shocks associated to the 20% price fall in the electricity sector were thus assumed to correspond to a TFP increase of 25% or to a decline in mark ups by 15 percentage points. In reality the reforms are likely to affect both mark-ups and efficiency and therefore, the observed price decline is the result of a combination of a mark-up reduction and of efficiency gains. The shocks to TFP and to mark ups are calibrated in such a way that

¹⁰⁰ For a further discussion of this link see Martin R., M. Roma, I. Vansteenkiste, (2005).

¹⁰¹ Though the total GDP effect is similar, both channels have different effects on employment. With the efficiency (TFP) channel, the reform is associated with an increase in investment in the non tradable sector but a decline in employment and a shift of employment to the tradable sector. The net employment effect is slightly negative. With the mark up channel, the investment and employment effects are stronger. In the first case more output is produced with a more efficient use of resources while in the second case, increased competition shifts the demand for factors of production in an upward direction.

the full price decline is spread over a period of five years. The results for electricity on the real GDP are presented in Table 4-1. The respective effects of a TFP and a mark-up shock are different. Over a period of five years, the GDP effect generated with the two channels is quite similar and amounts to about 0.5% of GDP. In the longer run, however, the effect from a reduction in mark ups seems somewhat stronger¹⁰¹. A similar analysis for the gas would lead to effects equal to roughly 30% of those observed for electricity.

Table 4-1: Effects on real GDP of a further opening up in the electricity sector

	GDP effect of a 25% increase in TFP in the electricity sector	GDP effect of a 15 percentage point mark-up reduction in the electricity sector
After 1 Year	+0.02	+0.03
After 5 Years	+0.51	+0.57
After 10 Years	+0.51	+0.62

Note: figures are % deviation from the base year. Investment refers to the non-tradable sector.

Source: Quest-model, run with adapted ECB estimates.

However effective competition does not follow automatically from legal market opening. As the recent Commission sectoral inquiry on distortions to competition in the electricity and gas sectors points out, a lack of liquidity in wholesale markets, insufficient unbundling of network and supply activities, and a lack of transparency benefits incumbents and undermines the position of new entrants. Direct competition remains difficult in network industries such as electricity or gas because the pipelines and electricity grids are well established and excessive switching costs may discourage customers to change their provider. Indirectly these markets become subject to competition as soon as less efficient players are acquired by more efficient ones.

However, such restructuring processes – in particular in cases of foreign acquirers or new entrants – often encounter the resistance of some Member States' governments. This can be in response to lobbying by vested interests, through reluctance to lose influence over major sectors of the economy or through fear that the public interest may not be adequately served in a liberalised environment. This resistance may take the form of slowness in transposing EU directives into national law, weak enforcement of the provisions relating to market opening or the introduction of unnecessarily cumbersome and time-consuming procedures that discourage new entrants. Some Member State governments also seem to pursue a policy of promoting incumbent enterprises as "national champions". On one hand, these governments may encourage incumbents to engage in some mergers and acquisitions to strengthen their market positions. On the other hand, governments sometimes intervene to discourage or block mergers which would result in a change of nationality of ownership of the domestic enterprise. However, this logic of artificially sheltering national firms from competition and maintaining domestic monopoly seems counter-productive, and might hamper the long-term international competitiveness of the companies. The similar example of the approach of successful Asian countries relates to catch-up strategies by developing economies.

4.5. Fiscal barriers

Member States are free to design their tax systems according to their preferences and there is no across the board harmonisation of the national tax regimes. The existence of 25 different tax systems, however, creates barriers to the mobility of factors and thus, to the full implementation of the Internal Market. The main barriers are constituted by different corporate, personal and value-added taxes.

The need for companies involved into cross-border activities to deal with 25 different accounting and **corporate** tax systems results in high compliance costs. In a 2004 comprehensive survey covering more than 700 EU companies, the European Commission found that these costs represent 1.9% of tax collected for large companies and 30.9% of tax collected for SMEs. In addition, Companies with subsidiaries or permanent establishment in another Member State have larger compliance costs than companies having domestic subsidiaries only. This is an indication of tax obstacles to cross-border activities. Among compliances costs, four out of five large companies see issues related to transfer pricing and double taxation as a major problem¹⁰².

Part of the remedy would be the agenda proposed by the Commission in 2001 to work out an optional common consolidated corporate tax base for companies doing business in Europe. The project presents several important technical difficulties that are currently dealt with by a working group of national and European experts. It carries nevertheless a substantial potential welfare gain for the European Union, both thanks to the coordination of corporate tax policies and the reduced tax compliance costs that a common tax base would bring. Provided it is well-designed, it would also bring additional benefits via cross-border fiscal consolidation and better transfer pricing resolutions, two aspects that are costly for both businesses and tax authorities.

Another tax obstacle concerns the **VAT**. In the 2004 survey, a substantial percentage of large companies (86.1%) also quote cross-border repayment or refund of VAT as a major difficulty. 53.5% of large companies have not requested refunding at some point because of the complexity or the length of the procedures under the 8th VAT Directive.

There are no rules at Community level regarding **personal taxation** of cross-border workers. Member States agree special rules for cross-border workers in their bilateral double taxation conventions. Since these rules reflect the special situation between two Member States, they vary from one double taxation convention to another.

More generally, the absence of an **EU multilateral tax treaty** is a major hurdle to capital and labour mobility. Currently, cross-border taxation issues are dealt with by ways of bilateral tax treaties (if existing) between Member States. The rules differ from treaty to treaty, creating confusion and uncertainty. Furthermore, cases involving more than two Member States imply triangular situations and may potentially lead to differences in rules and/or interpretations between tax authorities. This is for example the case of workers who are hired in one Member State but are posted in other Member States during the year. There are frequent situations where some workers do not spend more

¹⁰² A Commission report estimates that "medium sized multinational enterprises spend approximately EUR 1 to EUR 2 million a year on complying with transfer pricing rules" and that "large multinational enterprises incur compliance costs related to transfer pricing of approximately EUR 4 up to EUR 5.5 million a year. These figures do not include the costs and risks of double taxation due to transfer pricing disputes" (European Commission, 2001a. p.343).

than half a year in any country, creating confusion on their tax (and social security) situation.

BOX 4.6: QUANTIFYING POTENTIAL TAX COOPERATION BENEFITS¹⁰³

Various attempts have been made to assess the potential gains from increased tax cooperation:

- The European Commission used in its 2001 Communication¹⁰⁴ the Tax Analyser Model to assess the effects of a harmonisation of tax rates and/or bases on the dispersion of effective tax rates and found that a significant decrease in this dispersion is only achieved in the tax rate harmonisation scenario.
- Mendoza and Tesar¹⁰⁵ simulate capital tax competition that triggers an adjustment of either labour or consumption taxes to adjust the budgets. The respective net welfare gains of tax coordination in their simulations are respectively equal to 0.26% and 0.04% of lifetime consumption.
- Sørensen¹⁰⁶ shows EU-average welfare gains from tax coordination that are ranging from 0.18% to 0.94% of GDP. This potential gain from coordinating corporate taxes in Europe increases to 1.42% of GDP for the scenario where the marginal public revenue is spent on public goods and not on transfers.
- Parry¹⁰⁷ uses a model to assess the welfare losses of tax competition and introduces, as additional scenarios - possibilities of capital flights outside of the EU, a Leviathan behaviour with large states capable of influencing the after-tax rate of return on capital, and non-competitive governments (that is governments are less likely to cut taxes, knowing that others may imitate them). These scenarios respectively reduce the welfare gains of coordination by about 25% and 50%. The 'Leviathan' scenario unsurprisingly reduces the welfare gains (although capital taxation may be too low or too high depending on the parameters of the model). The same goes with the scenario of non-competitive governments.
- The magnitude of these results is broadly confirmed by a study of Copenhagen Economics¹⁰⁸ in which various tax harmonisation scenarios yield welfare gains between 0.02% and 0.21% of GDP.

4.6. Free movement of people

The free movement of labour between Member States of the European Community is possible since 1968. However, overall labour mobility in Europe has remained rather low. In the EU-15, only 0.1% of the working-age population change their country of residence in a given year. In comparison, in the US, about 3% of the working-age population moves to a different State every year. Also labour markets remain segmented, country by country. Within countries, regional mobility rates are around 1% of the total working-age population in 2005, with rates below 0.3% in several Member States.

Language is one of the main barriers to geographical mobility. Across the EU, only every second person speaks another language than his or her mother tongue. In addition, there are large differences between Member States¹⁰⁹. Other discouraging factors¹¹⁰ for individuals are the expected transaction costs and/or the lack or insufficient information

¹⁰³ See: Nicodeme (2006).

¹⁰⁴ See: European Commission (2001d).

¹⁰⁵ See: Mendoza and Tesar (2005).

¹⁰⁶ See: Sørensen (2000, 2001, 2004a, 2004b).

¹⁰⁷ See: Parry (2003).

¹⁰⁸ See: Copenhagen Economics (2004).

¹⁰⁹ See: European Commission (2005b).

¹¹⁰ See: ECAS report (2006).

about administrative and financial burdens associated with mobility; economic ties to the home country (e.g. home-ownership); about the society and job prospects, legal requirements of the destination country; family concerns (disruption of family life, difficulties for the spouse, or children who want to join the migrant), etc. Another major difficulty is the lack of convergence between national regulations. The EU has 25 different social security, taxation and pension systems. Every Member State determines how to operate its own social security system, the benefits and conditions.

There have been a number of initiatives to address these problems¹¹¹. This includes a variety of Community language learning programmes; a European health insurance card; the coordination of social security schemes; a proposal for a directive on the portability of pension; and a vast information network to provide targeted information and personally tailored assistance to workers and their families. However, these initiatives have not succeeded in establishing a genuine policy of mobility at European labour-market level. This was also reflected in the recent public consultation on the future of the Internal Market. Respondents mainly mentioned the lack of portability of pension rights, differences in social security systems and delays in the free movement of workers from the new Member States.

4.7. Barriers to the diffusion of knowledge and innovation

Market integration has a twofold impact on the incentives to innovate. First, greater market size increases profits and allows writing off the costs of innovation and invention over a larger volume of sales.¹¹² Second, firms operating in a more integrated market, and therefore exposed to higher competition, have stronger incentives to innovate in order to retain their market positions and stay ahead of the competitors¹¹³. Moreover, the creation of a single market should lead to increased knowledge spillovers because of more intensified trade and investments. Contrary to these expectations, current Member States differ quite substantially in terms of their innovative performance and most of them are lagging significantly behind the US and Japan in this respect (see section 3.1.6). Evidence also suggests that EU companies do not fully exploit the opportunities given by the Internal Market – about 60% of the innovative companies tend to launch their new products on national markets while only 25% do it in other Member States¹¹⁴ (see Figure 4.4).

As indicated in section 3.1.6, the reasons why the Internal Market has been an insufficient driver of innovation are that markets are still too fragmented, in particular, in services, that the potential of public procurement is insufficiently exploited and that a clear and more efficient Intellectual Property Right (IPR) system is lacking. As the two first issues have already been discussed above, this section focuses on the last one.

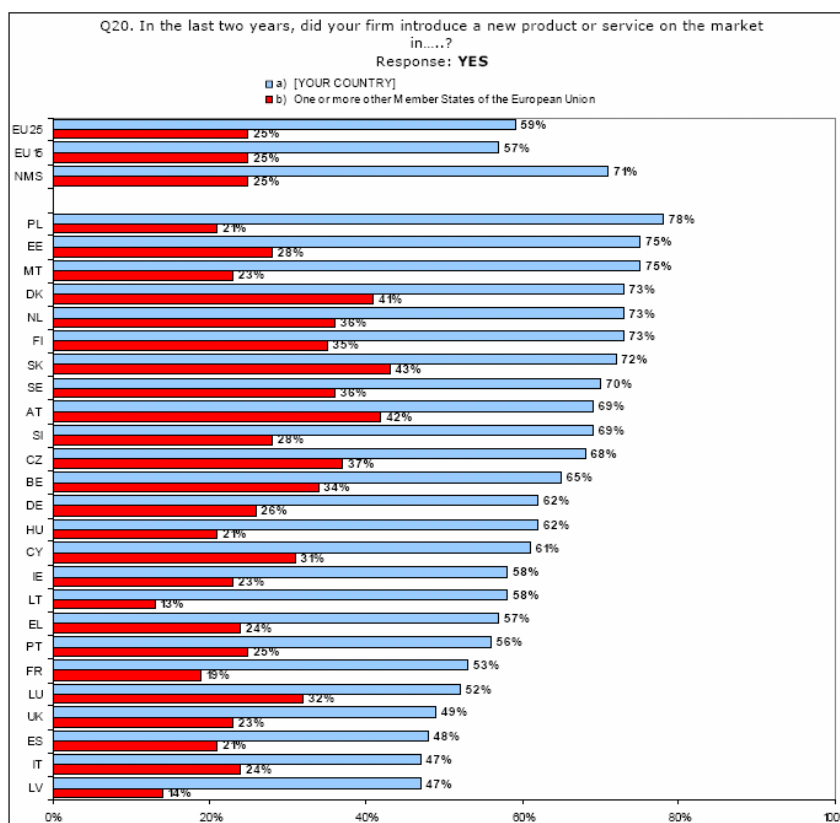
¹¹¹ See: European Commission (2006g).

¹¹² See: Schmookler (1966 b).

¹¹³ See: Aghion *et al.* (2005), Griffith *et al.* (2006).

¹¹⁴ See: European Commission (2004d).

Figure 4-3: Cross-border provision of innovative goods and services



Source: Innobarometer 2004

It is now generally accepted that IPRs can play an important role in fostering innovation but the design of an effective IPR system remains a difficult challenge. In particular, achieving the right degree of intellectual property protection is difficult in practice. First, the role of Intellectual Property Rights varies considerably across industry sectors and types of inventions. Over the past decades, the domains covered by patents have been extended in many countries to include biotechnology, software and business methods. The question arising here is whether the incentives provided by competitive markets mechanisms need to be always supplemented by IPR and in which cases it is necessary. Second, granting protection over commercially interesting invention must not stifle diffusion of innovation or obstruct innovative activities. In case of cumulative innovation, excessive intellectual property protection may hinder development of new products and processes that build on previous technology advancements. In this respect, it is important to encourage the diffusion of innovative technologies through licensing agreements. Third, incumbents may use patents strategically to block their competitors from developing new products¹¹⁵. The issue here is to prevent strategic patenting as it distorts competition and hampers development and circulation of new technologies. Finally, the effectiveness of patents as a tool to stimulate innovation and technology diffusion will also depend on the capacity of patent offices and their ability to select genuinely new and non-trivial inventions.

SMEs, especially start-ups, have specific needs for patents, as their business is generally focused on one activity and the protection of a competitive advantage based on technology may be crucial for their survival. A well-functioning IPR system would offer SMEs in particular the opportunity to assemble a valuable patent portfolio. Such a

¹¹⁵ See: Shapiro (2002).

portfolio could then be used as collateral to obtain the necessary financing of the research required to transform to patent into a marketable product. However, evidence shows that EU based SMEs tend to file fewer patents than large companies, since they do not benefit from the same economies of scale, bargaining power, etc as large firms¹¹⁶. Moreover, SMEs are less able to detect and track down infringements of the patents that they own. Finally, EU based companies are also faced with far greater patenting costs than in the US, which is a problem for SMEs in particular. This is largely due to high translation and maintenance costs and the cost of having to defend a European patent separately in the courts of each Member State, in the event of litigation, with the risk of conflicting decisions.

The EU Member States are currently characterised by different multi-layered patent systems. The establishment of a European patent system aiming at harmonising national administrative and legal practices would, thus, be an important contribution to better knowledge diffusion. It could create clear rules and provide access to simple and inexpensive procedures for obtaining patent protection for inventions as well as predictable, cost effective and accessible resolution of disputes. There are presently two major international proposals to harmonise the European patent systems: the London Protocol¹¹⁷ and the European Patent Litigation Agreement (EPLA)¹¹⁸. In addition, there is one Community initiative, the Community Patent which adoption failed due to unsolved dispute on the question whether the validated patent documents need to be translated into the different national languages¹¹⁹.

5. REFLECTIONS ON THE INTERNAL MARKET IN THE 21ST CENTURY

The European Internal Market project, which was initiated in the mid-1980s with the publication of the White Paper on the Single Market Programme, opened up perspectives for restoring confidence of European business and for improving the performance of European companies through the formation of a better integrated, more competitive and innovative market place. While the Internal Market has contributed to promote integration and to a lesser extent competition within the EU, its potential has not been fully exploited. The contribution of the Internal Market to the transformation of the EU into a more dynamic, innovative and competitive economy at world level was insufficient because: (i) existing instrument to remove non-tariff barriers to cross-border transactions and factor movements are not fully adequate; (ii) some markets remain fragmented; and (iii) the Internal Market has failed to fully adapt to a changing environment. The Single Market Review provides an opportunity to sketch a new vision for the Internal Market in the 21st century and to give it new impetus. This chapter suggests eight ideas that could be further developed within the context of the Single Market Review.

¹¹⁶ See: L  veque and M  nieri (2006).

¹¹⁷ London Agreement of 2000 proposes provisions aimed at reducing the costs of translation of patents granted under European Patent Convention of 1963.

¹¹⁸ The European Patent Litigation Agreement (EPLA) proposes an integrated judicial system based on uniform rules of procedures with a common appeal court.

¹¹⁹ For more detail see: Dietmar (2006).

(1) Internal Markets for services and knowledge are essential for productivity growth.

Due to the development of information and communication technologies in particular, services have become increasingly tradable. As a result, services producers in the EU are becoming more and more exposed to competition from third countries. An integrated and competitive home market is essential to face this challenge and raise productivity levels in the services sector. If the European Union wants to replicate the spurt in productivity growth that the US has experienced, it needs to offer service providers the freedom to introduce new technologies and business practices. While progress has been made in network industries and financial services, the **retail and wholesale trade sector** remains heavily regulated, which has retarded technological and organisational improvements in this sector.

More generally, the European Union would benefit from a faster diffusion of cost-effective production technologies supported by better developed Internal Market for knowledge. Such an EU market for knowledge would have to be based on a common system of **Intellectual Property Rights**. If Europe is to become a region in which innovation and ideas can circulate without being impeded by national barriers, there is a clear need for harmonisation of European administrative and legal practices in this area. At the same time a better balance between the need to provide incentives to innovators and the goal to encourage the diffusion of innovative technologies and business practices would have to be achieved. This implies to develop transparent, inexpensive and uncomplicated Intellectual Property Rights system. This system would aim at (i) developing markets for technological assets which enable transactions for the use, diffusion and creation of know-how, for example, by expanding patent licensing; (ii) improving the quality of patents to strike a better balance between the protection of owners versus users and prevent strategic patenting; (iii) ensuring a better coordination between the IPR policy and other policies crucial for innovation, such as R&D, education and competition.

The diffusion of innovation is also affected by **public procurement** practices. In certain sectors, like construction, defence, aerospace, ICT or public services (education and health), the joint purchasing power of public bodies constitutes a substantial share of demand, which can significantly affect innovation and technology adoption. Industry tends to react strongly to demand impulses generated by the government, particularly for new technologies¹²⁰, because governments tend to be more willing or able to incur the high start-up costs associated with the development of innovative products or processes. Considering the fact that public procurement is responsible for around one-sixth of the EU GDP, it would be fair to say that its potential to promote innovation has not been fully exploited.

Therefore, the role of public procurement as a tool to foster corporate investment in new technologies and innovation could be better exploited. In this context, three questions are of particular interest: (i) the role of the pre-commercial public procurement (i.e. promoting the role of the State as a “first buyer” of new goods and services) for fostering

¹²⁰ The costs associated with technology adoption are typically incurred at the beginning of the adoption process and cannot be recovered (*sunk* costs) while the benefits from adopting new technology are mostly flow benefits which occur throughout the life of the acquired innovation.

innovation; (ii) the potential of "second-sourcing" (creating the possibility to oust the incumbent producer in case of poor performance replacing it by an entrant) and "dual-sourcing" (launching bidding competitions which are split between two different firms), to improve procurement practices; and (iii) the role of the State as a "lead user" to test innovative solutions and promote their adoption by private users.

(2) The Internal Market can contribute to the smooth functioning of EMU.

The Internal Market is essential for a smooth functioning of EMU because it speeds up the process of adjustment to shocks. By creating a more **competitive business environment** it increases incentives for firms to adapt prices and quantities to changing market conditions. More integrated and competitive product markets help ensure that wage moderation and productivity gains are reflected more rapidly in lower price levels. Moreover, they contribute to amplify the beneficial effects of labour market reforms. For example, if prices are flexible, productivity gains from technological progress will be translated into lower prices, which will drive up demand and limit the negative impact of technological progress on employment in the short term. A better functioning Internal Market also eases the reallocation of resources across the EU territory.

Therefore, facilitating the adjustment processes in EMU would be an essential component of the Internal Market in the 21st century. More flexible **wage and price setting** behaviour, more integrated and developed **financial markets**, a better functioning **single market for services**, as well as **more flexible labour markets** clearly emerge as having a very important influence in this respect.

(3) Enlargement has increased the heterogeneity with the Internal Market.

Enlargement has increased the opportunities to be reaped from the Internal Market but it has also increased the heterogeneity among its members, increasing the risks of tensions between Member States. Differences in industrial structure and the stage of economic development tend to be reflected in different economic priorities. This diversity might be resolved naturally as the new Member States catch up with the EU average and differences in industrial structure gradually disappear. This however might take some time and tensions in areas such as corporate taxation and migration might have to be addressed in the meantime.

Regarding **corporate taxation**, the issue of corporate tax harmonisation/competition has received much attention although there is no clear evidence regarding both the existence and the effects of tax competition in Europe. This does not mean that there is no need for EU initiatives in this area. Several tax obstacles to the implementation of a truly integrated European market can be identified. Moreover, there is evidence that firms try to avoid paying taxes by relocating (part of) their activities abroad. The proposition made by the European Commission to have a common consolidated corporate tax base for companies doing business in Europe offers substantial benefits, in particular by reducing tax compliance costs associated with the existence of different national taxation systems.

Regarding **migration**, the fear of massive flows of people moving from the new Member States to the old Member States did not materialise, partly due to temporary arrangements restricting the free movement of workers. Migration inflows were concentrated in countries such as Ireland, Sweden and the UK that did not impose such restrictions. Migration policies of EU Member States vary widely. While this provides ample room to learn from each other and to identify what works and what does not work, it also creates a need to deal with undesirable cross-country spill-over effects and to

correct potential co-ordination failures that may arise, for example, from competition for highly skilled migrants. A common approach to migration policies amongst EU Member States could therefore be considered.

(4) The Internal Market rules should be considered within a global context.

The radical reduction of international communication and co-ordination costs implies that EU firms can offshore specific tasks within the production process, leading to what Baldwin names a new paradigm of globalisation. This task-level off-shoring has implications for the strategy to be put in place. Whereas before international competition used to be primarily between firms and sectors in different nations, it occurs now between individual workers performing similar tasks in different nations. The economic and social impact of globalisation has therefore become more difficult to predict. It should be clear however that building up the ability of individual workers to respond to different task requests is crucially important if the EU wants to seize new opportunities and minimise the adjustment costs.

Lessons can also be drawn from the **industrial policies used by our trading partners to enhance their competitiveness**. For example, the dominance of the US in areas such as ICT may be linked to state support for the early development of such technologies. The EU has been less successful in this respect, because markets for high-tech products such as defence equipment are fragmented and Member States have concentrated too much on supporting weak companies and sectors. The new framework for State aid to innovation can be considered as an important first step in tackling this problem.

When drawing up Internal Market rules, it is increasingly important to take the global context into account. This may imply simplifying our regulatory environment and entering into a dialogue with our partners in order to agree on common standards. Such **standards** should neither compromise the ability of EU exporters to sell abroad, nor limit the entry of imports into the EU market. The use of internal standards that are also acceptable internationally offers a competitive advantage to European companies. A wider use internationally of Europe's high standards in terms of consumer and environmental protection would be beneficial in this respect. At the same time one should make sure that strict EU rules do not create a competitive disadvantage for EU businesses globally, a point also stressed by respondents to the public consultation on the Single Market in the 21st century. From this standpoint, the question to be analysed would be whether setting internal EU standards promotes the diffusion and development of technologies or, on the contrary, by pre-empting competition among standards, slows down improvement of existing standards and the development of more efficient alternatives, hurting EU competitiveness in international markets.

Increasing international standardisation improves **market access** for all parties: it also gives third countries better access to a homogeneous EU market. However, it has to be recognised, that the majority of our leading trading partners are less open than the EU. Therefore, trade negotiations have a role in ensuring that markets worldwide are genuinely open and that international rules are applied openly and transparently.

(5) Well-designed Internal Market and external trade policies are mutually supportive.

An integrated and competitive Internal Market helps European companies compete at world level, as scale economies within the home market create possibilities for cost reductions and competition (both from within and outside the Internal Market) ensures that such cost reductions are translated into lower prices. An Internal Market that is in addition **open to competition and investment** from outside will be more innovative because exposed to new technologies and production methods developed elsewhere.

Competitive markets have indeed helped European manufacturing industry to maintain its share in world markets in the face of globalisation. However, the EU is losing ground in rapidly growing markets, particularly in Asia. Well designed external policies that ensure the observation of **fair trade rules** internationally are complementary to internal policies. Only if EU firms are granted non-discriminatory access to markets across the world can the benefits from the Internal Market be fully reaped. It would be desirable to reach an international agreement on standards and regulations, which neither compromises the ability of EU exporters to sell abroad, nor limits the entry of imports in the EU Internal Market.

(6) Potential synergies between the Internal Market policies and competition and innovation policies can be better exploited.

Internal Market policies contribute towards creating the appropriate framework conditions for European firms to be competitive at world level. Other policies, including in particular competition (state aids, merger control and anti-trust) and innovation (R&D, education, ICT) policies, have similar objectives. Potential gains from integrating these different policy instruments within a systemic approach are substantial. The new Strategy for Growth and Jobs is precisely aimed at exploiting the **synergies between the different structural policy instruments** and between macroeconomic and structural policies.

For example, efficiency and innovation considerations should be better taken into account when designing competition policy. Steps in this direction have been taken in the areas of anti-trust, mergers and state aids. For example, the modernisation of anti-trust policy carried out in 2000 allows to better take into account the efficiencies arising from agreements between enterprises. Similarly, the new Merger Regulation includes provisions allowing the consideration of efficiency arguments in the analysis of mergers. In the area of State Aid, the new framework for State Aid for R&D and Innovation gives more leeway to support innovative SMEs. These reforms contribute to better integrate competition and Internal Market policies. Synergies between Internal Market and innovation policies are also crucial. In this respect, a more efficient regulation of electronic communications could contribute to the development of digital technologies in Europe, while a better designed system of IPRs could facilitate the diffusion of innovations within the Internal Market.

There are strong **spillovers between national and Community policies** as well. All Member States contribute to the well-functioning of the Internal Market, which can be considered as a common good belonging to all EU members. For example, overly strict regulation in one Member State may divert investment flows and thus have a negative effect on allocative efficiency. Similarly, the development of innovative technologies

may depend on achieving a critical mass of resources or knowledge, which can only be achieved through a combination of national resources. A better coordination of policies at the EU level and an increased exploitation of synergies between Community and national policies can therefore help ensure that the available resources are used more efficiently.

(7) Adjustment costs associated with market integration need to be considered. This would involve a close monitoring of the impact of reforms undertaken.

Deepening the Internal Market implies the opening up to competition of sectors (such as the services sector), which may be politically sensitive because it directly affects the employment of a large number of people. Although undertaken to increase overall welfare, reforms tend to carry short-term **adjustment costs** for certain groups of economic agents. Benefits usually come only in the longer-term, are more widely spread across wide groups of population and are often not well understood by the population due to the complex nature of processes in the economy and their outcomes. For example, opening-up to competition telecommunication markets will have negative consequences for the incumbents facing a decline in monopoly power while the benefits are shared by all the consumers of telecommunication services. As a result, public acceptability of these reforms is very low and a continuous push towards further reforms may generate "reform fatigue" and become politically unsustainable.

Unless an effort is made to increase the **public acceptability** of market opening and liberalisation it will be very difficult to enact these reforms. In order to increase acceptability, it is crucial to provide unambiguous evidence illustrating the overall benefits of reforms proposed; to identify the most appropriate sequencing of reforms; and to facilitate the process of adjustment particularly for those most directly affected. From this, it should be clear that reform proposals would benefit from theoretical analysis and diagnosis to guide the policy design *ex ante*. This would help to identify social costs associated with the further opening up of sectors to competition and to define policy measures to address these costs. Experience of already existing instruments at the national and Community level, like the European Globalisation Fund, could be useful. Moreover, once the reforms have been implemented it will be important to ensure a close monitoring of the effects of the reforms undertaken. The horizontal evaluation of the performance of network industries is an example of this monitoring.

(8) A move from a legalistic approach to a more economic approach based on the monitoring of markets offers potential benefits.

The legal basis of Internal Market policies is increasingly founded on **economic logic**. Better market regulation depends on a better understanding of the obstacles preventing markets from functioning well. This better understanding can only be achieved by an increased monitoring of market developments. This more economic approach has started to be implemented in the area of competition policy, where sector enquiries, such as those undertaken in the energy and retail banking sectors, have proven to be a valuable tool for identifying the nature and scope of competition problems within the Internal Market. However, the market monitoring to be developed should be wider in scope and also analyse barriers to market integration, market access, technological development and innovation as well as price and wage adjustments to changing market conditions.

Internal Market monitoring aims at diagnosing the sources of obstacles to the good operation of markets. It would benefit from the increased transparency, which would

result from making the outcome of the monitoring process part of the public domain. This would be true in particular if the monitored activities were economically and socially important.

The information gathered in the monitoring of key goods and services markets could improve the governance of the Internal Market, by, amongst other things, allowing to choose the regulatory approach which is the best suited to the specific needs of a given sector. Regulatory questions addressed could be (i) whether there is a need for sector-specific regulation or whether economy-wide regulation and consumer protection policies are sufficient; (ii) the appropriate form of any sector-specific regulation, i.e. self-regulation, legislation enforced through the courts or imposed through specific regulatory agencies; (iii) the appropriate geographical level of regulation (regional, national, EU or supranational); and (iv) the extent of any supervision or coordination of national authorities at the EU level.

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