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SERVICES DIRECTIVE: AN ECONOMIC ANALYSIS

In January 2004, the European Commission presented a draft directive aiming at eliminating trade barriers in services within the EU. The directive set off a vast controversy. Its proponents point out that services constitute 70% of the Union's GDP and jobs and that extending liberalization to this sector will benefit growth and employment. Its opponents claim that this liberalization, coming just after the Eastern Enlargement, will reduce employment and wages in comparatively disadvantaged Western services sectors. They also fear a race to the bottom in regulatory standards. These risks can be put into perspective by a detailed examination of the content of the directive. Then, the directive's political viability is analyzed by identifying potential efficiency gains and redistributive effects. Various measures that would preserve the former as much as possible while reducing the latter are discussed.

Objective and content

De jure, the European Union is a common market in which goods, services, people and capital circulate freely. At first sight, the fact that a directive is needed to eliminate barriers to trade in services and that it has triggered a vast controversy therefore appears somewhat surprising. Yet, the difference between the *de jure* and the *de facto* common market is large. While European integration has gradually lowered barriers on goods among EU members and led to a *de facto* common market in this field, the barriers to trade in services remain substantial. A 2002 report by the Commission[1] has taken stock of this situation. Because most services call for geographic proximity between service provider and receiver and thus the mobility of one or the other, the barriers to trade in services often consist of domestic regulations that limit this mobility. These can be described with reference to the four modes of services trade defined in the WTO's General agreement on trade in services, with "O" being the service providing country, or country of origin, and "A" being the receiving country:

✦ Mode 1 ("cross border") denotes trade where the service crosses the border between O and A. This is the case of services provided by a call center. Among the barriers to this mode of services trade the Commission finds requirements placed on the service provider (establishment, legal form or internal structure of the companies). For example, a call center established in O, which provides after-sales services in A, may be required to have an establishment in A.

✦ Under mode 2 (consumption abroad), the receiver from country A moves to O to consume a service. This type of services trade can be constrained by nationality or residence requirements, or by discriminatory taxation. A resident of A who takes professional training in O may, for instance, not benefit from tax deductions for training carried out in A.

✦ Mode 3 denotes establishment of affiliates (commercial presence). This may be restricted by quantitative limits, authorization and registration procedures, and qualification or nationality requirements. A retailer of country O who establishes an affiliate in country A may, for instance, be subject to zoning regulations.

✦ Mode 4 ("movement of natural persons") implies a movement from O to A of service providers who are self-employed (say mode 4a) or who are employees of services companies (say mode 4b). Currently, all of mode 4 is subject to the rules of the receiving country. For instance, the relevant qualification or registration requirements are those of the receiving country. Thus, an architect from O who provides a temporary consulting service in A may have to register with a professional association in A even though he is already registered in O. A construction company from O that regularly posts workers for short periods to various construction sites in A has to obtain a new authorization each time. Mode 4b is regulated by the Posted Workers Directive of 1996[2] which explicitly subjects working conditions such as minimum wages, work duration, *etc.* to the rules of the

1. European Commission (2002), "State of the domestic market for services," Commission report to the Council and to the Parliament.
2. Directive 96/71/CE of the European Parliament and Council concerning the secondment of workers in the framework of providing a service.

receiving country. The 2002 report indicates that this directive may restrict trade.[3]

The draft Services Directive (SD) aims to eliminate obstacles to the free establishment (chapter II) and free movement in services (chapter III).[4] Services of general non-economic interest provided by the State (education, justice, etc.) are not covered. Services of general economic interest are within the scope of the SD, but in its latest version various sectors are exempted (health, audio-visual services, notarial and legal services, games and lotteries).[5] Financial, telecommunications and transport services, covered by other directives, are excluded from the SD. Thus, the services sectors covered by the SD are construction, retail, hotels and restaurants, real estate, personal services. According to Eurostat data, these sectors account for 59% of employment and value added of services in the EU.

The measures in the *freedom of establishment* chapter concern mode 3 of trade in services. The SD aims at simplifying administrative and authorization procedures and establishes a list of requirements that will be prohibited or will be subject to evaluation. For example, zoning rules will be subject to evaluation.

The measures in the *free movement of services* chapter concern modes 1, 2 and 4. There are two types of measures. The first (as for mode 3) establishes the list of requirements that are now prohibited. For example, tax non-deductibility of the service received abroad will be prohibited.

The second type of measure (art. 16.1) introduces the "country of origin principle" (CoOP)[6]: The service provider – except for services of general economic interest – may provide a service in any member country while being subject only to the regulations of its country of origin. In reality, it is important to note that the introduction of this principle will affect only one mode of trade in services: Sub-mode 4a. Concerning mode 1, remember that it is the service, and not the service provider, that crosses the border. For this reason, the service provider is generally[7] not subject to the rules of the country where the service is provided. Introducing the CoOP does hence not affect services trade under mode 1. In the case of mode 2, it is the receiver who crosses the border. The service provider is, here again, subject to the rules of its country of establishment. So mode 2 is not affected by the CoOP either. Only mode 4a is directly concerned. The self-employed architect who is currently subject to the requirements of the receiving country will, according to the CoOP, only have to comply with the rules of his country of origin. On the other hand, mode 4b remains subject to the 1996 Posted Workers Directive and thus to the rules of the receiving country.

The introduction the CoOP therefore only affects services traded through the temporary movement of self-employed service providers (table 1). Note, however, that in practice trade in services often combines several modes. A self-employed architect who is temporarily working abroad (mode 4a) can employ workers posted by a temporary work agency on his construction site (mode 4b). This temporary work agency is subject to the 1996 Posted Workers Directive and thus to the labor law in the receiving country, but the quality standards and certifications required from the architect are those of his country of origin.

Table 1 – Impact of CoOP by mode of trade in services

Mode of trade of services		Rules applied: Before SD	Rules applied: After SD
(1) Cross border		Country of origin	Country of origin
(2) Consumption abroad		Country of origin	Country of origin
(3) Commercial presence		Receiving country	Receiving country
(4) Movement of natural persons:	(4a) self-employed	Receiving country	Country of origin
	(4b) posted worker	Receiving country	Receiving country

As from the other measures of the SD, the Commission expects a trade liberalizing effect from the CoOP. The provision of the architect's services in other member countries will no longer be restricted by the heterogeneity of domestic regulations. Wherever he operates, he will now have to comply only with a single regulatory system, which is that of his country of origin. But while the other measures of the SD (prohibited requirements) eliminate rules that the Commission has identified as protectionist, the introduction of the CoOP may affect regulations that are justified by economic theory, in the sense that they correct for market failures (imperfect information of the consumer, for example). Let us take the case of the architect who enters a country's market (combining modes 4a and 4b) and applies the lower quality requirements of his country of origin. The minimum and average quality standards of the receiving country are thereby automatically reduced (static effect). Moreover, the government of the receiving country may react to the increase in competition faced by domestic architects by lowering the domestic level of quality requirements (dynamic effect leading to a race to the bottom). The country thus runs the risk of moving away from

3. For example, a difference in the way the annual salary is calculated (13th month paid in O but in A) may result in the service provider of O having to pay a worker posted to A a minimum wage that is higher than the legal minimum wage in A.
4. European Commission (2004), Proposal for a Directive of the European Parliament and the Council on Services in the Internal Market.
5. Version adopted on 22 November 2005 by the Commission on the Internal Market of the European Parliament.
6. In the latest version of the SD, the expression "country of origin principle" has been replaced by the expression "free movement of services" but the spirit of art. 16.1 remains unchanged.
7. The principle is that a service provided according to mode 1 may be subject to certain rules in the receiving country (rules concerning the service itself, and not the service production process). However, services are often intangible which limits the rules they may be subject to.

its preferred level of quality requirements. But it may also move towards it, if the initial level of quality requirements was above the preferred one. A rigorous evaluation would call for information on national preferences of which the economist does not dispose.

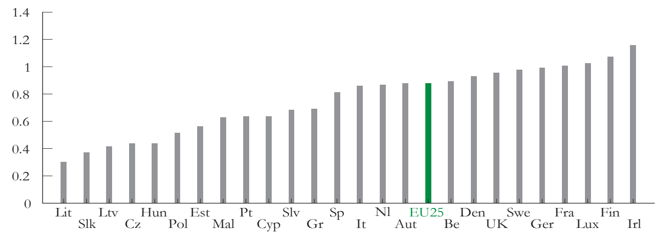
It should also be recalled that introducing the CoOP concerns only some sectors and some modes of providing services. In particular, it does not affect labor market standards. Moreover, service providers do not only compete on price but also on quality, safety or environmental friendliness. If the standards required in these fields are reduced, their competitiveness in areas other than price may be reduced as well.

Overall, the risks of competition on rules introduced by the CoOP appear to be limited in theory.[8] On the other hand, the effect of the SD, and of the CoOP in particular, in terms of liberalizing trade is potentially large.[9] The below analysis addresses the latter issue.

Efficiency and redistribution

The basic argument in favor of liberalizing trade in services, as in goods, is based on the static gains to be expected from specialization of countries according to their comparative advantages. Instead of producing the goods and services for which their prices are relatively high, countries can import them and specialize in those where their relative prices are low. The relative price differentials existing in the EU indicate that there are potential gains to be expected from liberalizing trade in services (graph 1).

Graph 1 – Price of services as a ratio of the price of goods



Source: OCDE (2004), Purchasing Power Parities and Real Expenditures: 2002 Benchmark Year.

These traditional static gains from trade result from an increase in the surplus of the producer who has a comparative advantage (thanks to an extended access to the market) and an increase in the surplus of the consumer (who benefits from lower prices). Economic theory indicates that these combined gains always exceed the losses of the producer subjected to increased competition from imports. Liberalization of services can also lead to increased productivity (by economies of scale, elimination of less productive firms, lower costs of intermediate consumption of services). This can produce both static gains and dynamic gains (acceleration of potential growth).

In general, it is resorted to computable general equilibrium models to quantify the economic effects of trade liberalization. These models do typically not integrate all the potential channels of welfare gains from trade liberalization. Two simulation exercises indicate that the SD would increase the EU's GDP by the order of €40 billion, or about 0.6%.[10] These simulation exercises consider the gains resulting from increased sectoral specialization (assuming inter-sectoral mobility of labor) and lower input prices. They thus reflect only the static gains of the SD and ignore its effects on potential growth. An impact analysis conducted by the European Commission extrapolates the gains expected from the 1992 Single Market Program for goods and services, and obtains the highest gains (+1.8% of GDP).[11]

The opposition to the SD is not concerned with the in global efficiency gains expected from liberalization but instead with its potential redistributive effects. In particular, opponents to the SD expect that it will cause large wage and employment losses in comparatively disadvantaged services sectors in Western member states of the EU.

The redistributive effects of commercial liberalization are generally analyzed in the long term framework of a Heckscher-Ohlin model, and assume perfect mobility of labor across sectors. The model's main prediction is that the relatively abundant factor in one country gains from liberalization while the relatively scarce factor loses. As unqualified labor is the scarce factor in the West, it would thus be expected that exclusively unqualified workers oppose the SD in these countries. Yet one particular feature of the opposition to the SD is that it is exerted both by coalitions representing workers with low qualification (construction workers) and very qualified workers (doctors). Another notable feature is that some governments of the West (United Kingdom, Ireland) are in favor of the SD while others are opposed to it (Germany and France). This means that the H-O model does not provide the appropriate framework for analyzing the redistributive effects of the SD. The main alternative is provided by the short term specific factors model that assumes perfect immobility of labor across sectors.[12]

8. Note that the CoOP allows for the possibility of re-introducing the standards of the receiving country if this is in the general interest.
9. According to Kox *et al.*, the heterogeneity of the rules, beyond the absolute level of regulation, is a major barrier to trade. The application of a SD including the CoOP could increase trade in commercial services by 30% to 60% in the EU. H. Kox, A. Lejour & R. Montizaan (2005), "The free movement of services within the EU," CPBdocument no. 69 (revised September 2005), The Hague.
10. Copenhagen Economics (2005), "Economic assessment of the barriers to the internal market for services," report prepared for the European Commission; R. O'Toole (2005), "The Services Directive: An initial estimate for Ireland," Forfas (revised February 2005).
11. European Commission (2004), "Extended impact assessment of a proposal for a Directive on Services in the Internal Market," Staff Working Paper.
12. In the short term, labor is immobile across sectors because individuals have qualifications specific to the sector they are employed in. Moreover, moving from one sector to another creates the risk of temporary unemployment, especially if the costs of hiring are high. Finally, entry into some sectors is limited by regulatory barriers.

Here, it is not the *factors* of production that win or lose from liberalization according to their relative abundance, it is the *sectors* that win or lose depending on whether they benefit from enlarged access to the market or are affected by increased import competition. In this framework, both high and low qualification sectors in the West may experience an increase in competition from the East. This makes it easier to understand that the opposition to the SD is formed along sectoral lines. For his part, G. Saint Paul[13] considers that the redistributive effects in the West depend on the difference between the levels of inter-sectoral labour mobility in the East and in the West: they are larger the lower mobility is in the West relative to the East. Saint Paul thus explains that the opposition to the D was stronger in countries (France, Germany) where this mobility is generally considered to be low.[14]

Economic analysis thus allows us to expect efficiency gains from the SD and redistributive effects due to the imperfect inter-sectoral mobility of labor. While the gains are dispersed among a large number of individuals or firms, the losses are concentrated on a small number of individuals who become organized and exert political pressure against the SD.

One type of measure would increase the political viability of the SD without limiting its efficiency effects. This would require to get at the source of the redistributive effects, or in other words increase the inter-sectoral mobility of labor by training and compensation programs. The "globalization fund" proposed by the European Commission could be used for this purpose. Inter-sectoral mobility of labor could also be enhanced by reducing hiring costs. A further measure would consist in reducing regulatory barriers to entry into some professions. This is a delicate measure, though, since it requires a distinction between regulations that are justified by economic theory[15] and those that are not.

Another type of measure would strengthen the viability of the SD, but it would call for sacrificing part of the efficiency gains to reduce its redistributive effects. One possibility would consist in introducing more exceptions to the CoOP in order to limit its trade liberalizing impact and associated redistributive effects. Some quality, safety or environmental standards could, for instance, be exempted from the CoOP. However, as noted above, the CoOP affects only one sub-mode of services provision and applies neither to services of general economic interest nor to labor law. Reducing its scope would practically be tantamount to eliminating it and the sacrificed efficiency gains may be large. The heterogeneity of rules across countries is a powerful brake on services trade (see footnote 9), if only by the information costs it entails. Yet the CoOP, as argued above, eliminates this heterogeneity for the service provider. Moreover, excluding quality, safety or environmental standards from the CoOP would open the door to abuses on the part of member states that could use these exceptions as a justification to re-introduce protectionist measures.

Another possibility would be to exempt the most politically sensitive sectors from the SD. Ideally, these sectoral exemptions should be granted on a temporary basis so as to give the affected sectors time to adapt to the directive. If there are permanent exemptions, a periodic re-examination of their justification could be introduced. As the SD essentially adopts a horizontal approach that includes many sectors, a few sectoral exceptions should not substantially reduce its scope. Moreover, the abovementioned risk of opening the door to the re-introduction of protectionist measures does not exist in this case. To strengthen the political viability of the directive, exempting the most sensitive sectors thus appears more appropriate than exempting some types of rules from the country of origin principle.

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13. G. Saint-Paul (2005), "Making sense of Bolkestein-bashing: Trade liberalisation under segmented labour markets," CEPR Discussion Paper no 5100.
14. As indicated in note 12, the cost of hiring is one of the obstacles to inter-sector mobility. It is interesting to note that the political opposition to the SD has been greater in those countries where this cost is relatively high (see World Bank indicators, *Doing Business Report*, 2005).
15. For example, barriers to entry into regulated professions are partly a response to the problem of imperfect consumer information on the quality of the service.

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