The Directive on Services: Rent Seekers Strike Back

Patrick A. Messerlin

The November 2004 Hearings of the European Parliament on the Directive on Services (hereafter the Directive) offered a fascinating preview of the current debate. It was already dominated by the unholy alliance of the supporters of a social model based on "public service" tied to public monopolies and narrow vested interests based on private monopolies. "Rent-seekers of all Member States, unite!" could be the appropriate motto.

On the one hand, some testimonies[1] compare an idealised "European social model" (ignoring its negative sides in terms of low growth, massive and permanent unemployment and a host of perverse effects caused by "good intentions"[2]) to a demonised market economy (ignoring its contribution to faster growth and reduced unemployment). Worrisomely, this unbalanced approach (which was largely driving the public campaign against the Directive in April and May 2005) places the "founding countries" of the European Community (lavishly granted with the best possible social systems in every respect) in opposition to the other EC Member States (accused of social dumping and unfair competition). Clearly, shifting from 15 to 25 Member States is not so much a question of the number of countries but is, rather, a profound change in the Community, torn apart between the Member States reluctant to change and those which have already changed, often under harsh pressure from the former.

On the other hand, the power of narrow vested interests and the extreme weakness of some European governments is also prevalent in the Hearings. The best illustration may be a testimony[3] of which half is devoted to a plea to exclude French *huissiers*, *notaires* and *avocats près les Cours suprêmes* (bailiffs, notaries and barristers to the Supreme Courts) from the Directive coverage. Such a focus on three tiny legal professions suggests the following quick calculation: assuming that the Directive covers half of the French GDP, such a focus would be consistent with a government genuinely concerned with public interest if these three professions represented a quarter of the French GDP ...

Remembering the Past: the Logic behind the Directive

The current debate on the Directive largely ignores the two long developments in European integration which led to the Directive.[4] First, the Directive is the natural continuation of the Single Market Programme (SMP), itself the heir of the Common Market. This is best underlined by the fact that the SMP in services was launched in 1984-85 by a group of industrialists -- the European Round Table of Industrialists (ERT) -- who did not limit the scope of the EC reforms to be undertaken to manufacturing issues, but who included the opening to intra-EC competition of key services for industry, such as telecommunications and other essential infrastructure services. Second, the Directive is largely a "rationalisation" of a long and rich series of rulings by the European Court of Justice which started with the well-known 1974-79 Dassonville and Cassis de Dijon rulings, and which focused on the elimination of obstacles to intra-EC trade.

Recognising these two lineages is essential because it presents the Directive as a *logical evolution* -- not a change in course -- of European integration over the past forty years. It reveals an intrinsic demand for the current Directive which will continue to exist if the Directive is not adopted. And the rationalisation generated by the Directive will not really reduce the level of legal uncertainty (the Court has been so time-consistent in the matters covered that there is little doubt about its future rulings) but it will reduce the high transaction costs associated with bringing new cases to the Court unnecessarily. The "logical" nature of the Directive does not mean that the Directive will be adopted, or that it will be adopted with changes that will not deeply reduce its current scope and depth. It means that the failure to adopt the Directive in the coming months will unavoidably impose heavy costs on the European economies and hence will generate renewed efforts to get back to the current Directive -- at the Community level or at a plurilateral level in the Community.

Indeed, it is interesting to note that the demand for such a Directive dates from long before the European integration process itself. Ironically, the Directive echoes a well-known French Report -- the Rapport Rueff-Armand on the "obstacles to economic expansion" -- written in 1959 at the request of General de Gaulle before France embarked on European integration. Indeed, irony almost turns to cruelty: the Rueff-Armand Report[5] devoted a lot of attention to *notaires* (again!) underlining the inefficiency of these private monopolies -- a point echoed today by the consumers' association Que Choisir [No. 426, May 2005] which has just

published an issue on the bad quality of the services provided by the *notaires*. *Plus ça change, plus c'est la même chose ...*

The Three Options for Liberalising Intra-EC Cross-border Services

The two last decades have slowly revealed three ways to liberalise services. First, there is the option of fully harmonising the existing domestic regulations, either by adopting the regulation of one of the Member States or by adopting a common regulation through negotiations. Adopting the regulation of one of the countries is a rare occurrence. It happens when the Community fully imposes the *acquis communautaire* to the new Member States. That has happened only in a few narrow domains mainly related to trade policy. And it did not take long for the Europeans to realise that negotiating and adopting a harmonised regulation differing from all the existing national ones is a very costly endeavour. It is time-consuming (often more than ten years for regulations dealing with tiny services). It does not necessarily lead to more efficient regulations. It tends to progress on a service by service basis and hence to distort economic decisions (investors are induced to invest (or not) in harmonised services as a consequence of the harmonisation process, not on purely economic grounds). It is easy to reverse because a harmonised regulation can be quickly "dis-harmonised" by Member States imposing additional (peripheral) provisions when implementing the new "harmonised" regulation. And last but not least, it is often simply impossible.

The second way to liberalise services -- opened up by the Dassonville and Cassis de Dijon rulings -- consists of limiting harmonisation to the "key" provisions of the common regulation to be adopted jointly and imposing the "mutual recognition" principle for the rest of the provisions. This approach is conceptually clever. But its effective success depends on the balance between the harmonisation and mutual recognition parts (a large harmonisation part is equivalent to full harmonisation) and there is a systematic bias in this process. As the balance between these two parts is generated by negotiations on the provisions to be harmonised, there is a systematic drift towards expanding the scope of harmonisation and contracting the scope of mutual recognition. This is because negotiations often involve a majority of Member States fearful or reluctant to liberalise and only a handful of Member States convinced of the benefits of liberalisation.[6] Moreover, European decision-makers have feared that liberalisation in many services could lead to a rough and fast shift from monopoly

to competition because of the large over-capacities built up in decades of public "overinvestment" in a context of controlled prices, massive subsidies, and public monopolies. For instance, in the early 2000s, the electricity sector has an estimated average over-capacity of 20% in almost all the EC countries (up to 30% in France); retail banking is still provided through vastly oversized networks; and the telecom networks of railways or electricity public monopolies have been hugely oversized (in the mid-1990s, SNCF, the French railways company, was reportedly using only 10% of its own telecom network capacity).

The last option for liberalising services consists in extending the mutual recognition principle to all the regulatory provisions -- the so-called principle of the "country of origin" (hereafter PCO). However, this approach is often combined with "non-harmonisation" commitments by the Member States on some related laws, such as labour or social security regulations which remain under the control of the host Member States.

Why Such an Outcry over the Directive?

The Directive makes significant use of the third option. But it is not the first one to do so, and it is far from being entirely based on this third option -- a situation which raises the question of the reasons why the Directive has been subjected to such an outcry.

First, the Directive has several precedents relying on the PCO, the most interesting one being the 1989 and 1997 Directives on "Television without Frontiers" (TWF) and the 2002 Communication on the implementation of the 1997 TWF Directive. Both state that foreign TV channels follow the regulations of their country of origin, including regulations concerning quotas. Why did the PCO attract almost no attention in such a sensitive sector as the audiovisual one? The first (and probably the most powerful) reason is that technology makes it impossible to reject the PCO -- except by completely banning foreign TV channels, a measure that could be perceived as hurting consumers much more easily than prohibiting *huissiers* or *notaires* from operating in several Member States' markets. The second reason is that major "natural transaction costs" (languages and/or tastes) constitute impediments limiting the development of cross-border trade. By contrast, such natural costs seem absent for services covered by the Directive on Services, and the opponents to the Directive have always developed their arguments in terms of final consumers (a horde of Polish tilers invading Germany or Polish plumbers invading France). But the Directive is likely to be

much more important for medium or small enterprises than for large enterprises (which have been largely able already to build their networks of services providers) or for final consumers (for whom the natural costs of hiring a Polish tiler or plumber are huge, except in a few border regions).

Second, the Directive on Services is far too wide-ranging to be based only on the PCO. This is because liberalising intra-EC services could be done through investment in foreign markets (often called "establishment") or cross-border trade in services. In the intra-EC context, cross-border trade in services can be "physical" trade (such as legal advice sent by fax by a foreign expert to a domestic operator) or the trading of the service through labour (or another factor) movements (such non-permanent stays of experts from a Member State in another Member State). The current debate on the Directive focuses on cross-border trade (mainly of the second kind) whereas the Directive provisions on establishment have been relatively uncontroversial, as illustrated by the fact that they have almost escaped proposed amendment to the European Parliament (amendments are only at the early stage of proposals).

Why is cross-border trade so sensitive and establishment uncontroversial? First, establishment has proved not to be a very pro-competitive strategy in services – threatening vested interests much less than cross-border trade. When constrained by the host country regulations, investors in services from other Member States have strong incentives to follow the prevailing behaviour in the market in which they have invested (after all, this behaviour has been tested by the domestic incumbents as the most profitable one in the legal environment, a conclusion which has no reason to change since the legal environment remains unchanged). In sharp contrast, cross-border trade opens the door to more competitive behaviour because it generates competition between the regulations in different Member States -- hence it puts firms in contact with different incentives provided by different legal environments. This pro-competitive impact of cross-border trade exists even if constraints on labour movement (or on some other aspects, such as the environment) remain, as is the case with the Directive, which maintains all the existing Member States' labour laws, be they on minimum wages, work conditions, diplomas etc. Even within such limits, freer labour movements are likely to improve resources allocation in every Member State. Of course, these improvements may be smaller than in the situation where constraints from labour laws were relaxed. But bigger improvements would then be countervailed by larger adjustment costs for workers in the Member States, and the current Directive is based on the

presumption that the net impact of these two aspects would be negative.

The Costs and Benefits of the Directive: a Few Points

In addition to the above-mentioned reasons, the outcry over the Directive also flows from the fact that it covers a large proportion of services (50 per cent of the GDP according to the Commission). Such a wide scope has a huge economic benefit: it minimises the distortions which would have been generated by regulatory reforms based on a sectoral approach. But it has a heavy political cost: it has generated the unholy coalition of the few remaining public monopolies and a host of tiny, but highly powerful, private monopolies. The problem is compounded by the fact that there are almost no available evaluations of the costs and benefits of alternative solutions to these private monopolies to be shown to the general public. For instance, there is no information on the costs and benefits of the current system of pharmacies (or *notaires*!), that is, on its ability to deliver the expected quality of the services at the lowest possible cost and on the ability of alternative solutions. Such evaluation studies are incorporated in the Directive process, but that is too loose and too late.

As a result, most Europeans do not understand that the PCO was adopted in the Directive simply because the other two options did not work well. Recent research by the OECD Secretariat[7] allows us to obtain a quantitative assessment of the extent to which the SMP has really not bitten so far. Based on an international database on the regulations enforced in OECD countries, it provides indicators (from least (0) to most (6) restrictive) of product market regulation in 30 OECD countries for 1998 and 2003.[8] Despite its intrinsic limits, such an exercise produces two crucial results (see Table 1) confirming earlier observations.[9] First, the EC15 lags behind the non-European OECD Members (Australia, Canada, Iceland, Japan, New Zealand and the USA) as much in 2003 as in 1998, improving its relative situation only with respect to Switzerland and Norway. Second, there is no convergence among the various EC Member states: some of them still enjoy better regulations while the others are still at the bottom of the whole OECD group of countries – suggesting that so far the SMP has had little impact and that most services liberalisation has been generated by technological progress (starting mostly in telecoms, then spreading to telecom-intensive services) or by Member States' own decisions. The only change between 1998 and 2003 is the remarkable progress made by some new Member States (Slovakia, but not Poland, despite the allegations of the opponents of the Directive).

The PCO generates regulatory reforms, each Member State trying to ensure that its domestic service providers would enjoy competitive advantages by adopting more efficient laws and regulations. This competition in regulations generates the strong fears of a "race to the bottom" in Europe. These fears are based on an analysis of Member States' fundamental behaviour which ignores the impact of "reputation" on the Member States' decision-making process. Member State governments simply cannot afford the economic, and hence political, risks of racing to the bottom -- they will simply lose the next elections. The reputation incentive induces governments to design competitive regulations not detrimental to domestic "quality" (whether the quality of products, services or working conditions) and the more countries are democratic, the more powerful are such reputation effects. The race to the bottom also conveys implicitly the idea that all the Member States will converge to the same (worse) regulations. This is the opposite of the way competitive markets work in modern economies: firms compete by differentiation of their products or services as much as (if not more than) by prices -- and modern states tend to do the same when designing new regulations.

A Look at the Proposed Amendments and a Final Remark

The Rapporteur of the European Parliament has proposed a first set of amendments which boils down to a return to harmonisation and/or mutual recognition. The OECD score reminds us that there is little hope to be expected from these approaches. There is even less reason for hope than before. Full harmonisation will be even more difficult to achieve in an enlarged and more heterogeneous Community than in a smaller and more homogeneous Community. The same could be said about the mutual recognition approach if it is remembered that behind the nice concept of mutual recognition there is the tough and dirty work of negotiating the harmonisation core. The drift towards expanding this core to the detriment of the mutual recognition part will undoubtedly be much stronger in a Community with 25 heterogeneous Member States than in a Community with 12 or 15 relatively similar Member States.

The proposed amendments have two additional major flaws. First, they introduce a host of considerations which mix up resource allocation and the distribution of income or rights. Economics is like plumbing: each tool is appropriate for specific tasks, and using the wrong tool is a recipe for disaster. So far, the Community has been successful in not mixing up

market reforms and distribution regulations. The amendments go in the opposite direction. Such a messing up will not be sustainable because Member States have very different views on distribution (some accept more short-term inequality than others). Second, the amendments adopt a much more sectoral approach. Looking at the Hearings, there is little hope that the parliaments and governments of most of the Member States will be able to resist such a fragmentation of regulatory reforms. The broad coverage of the Directive re-established the primacy of governments over narrow vested interests. The amendments are re-opening the door to the capture of the European governments by these narrow vested interests.

Reputation and trust are two related concepts. The Directive may have been passed more easily in the pre-enlargement Community because trust existed between the 15 Member States on the basis of the past (all these Member States shared the same history). The Community with 25 Member States may generate a different kind of trust -- trust between countries sharing the same desire to improve things. Such a trust could generate a plurilateral initiative for restoring the current Directive, but limited to the Member States sharing the same confidence in the gains from regulatory reforms. Such an evolution would be ironical: it would resurrect the concept of the "core" or the "avant-garde" in European integration, but with the opposite membership than the one expected ten years ago.

[1] For instance, Raoul Jenner: Audition par la Commission IMCA, Parlement européen, 11 novembre 2004.
[2] For instance, a recent study on French subsidies for housing shows that 50 to 80 per cent of these subsidies have been absorbed by rent increases, that is, passed from the poor to the housing owners. Cf. Gabrielle Fack: Pourquoi les ménages les plus pauvres paient-ils des loyers de plus en plus élevés ?, Fédération Paris-Jourdan (Cepremap), mimeo 2005.
[3] Marc Guillaume: Audition par la Commission IMCA, Parlement européen, 11 novembre 2004.
[4] Patrick Messerlin: Measuring the Costs of Protection in Europe, Institute for International Economics, Washington DC 2001.
[5] Rapport sur les obstacles à l'expansion économique (Rapport Rueff-Armand), Imprimerie nationale, Paris 1960.
[6] For instance, Steil has documented this evolution in the Investment Services Directive case. Cf. Ben Steil: Regional Financial Market Integration: Learning from the European Experience, Royal Institute of International Affairs, London 1998.
[7] Paul Conway, Véronique Janod and Giuseppe Nicoletti: Product Market Regulation in OECD countries: 1998 to 2003, OECD Working paper ECO/WKP(2005)6.
[8] These indicators focus on products, but they include services, such as distribution, covered by the Directive. They are calculated for the EC15 Member States plus the Czech and Slovak Republics, Hungary and Poland.
[9] Patrick Messerlin, op. cit.

Table 1. Product Market Regulation Indicators in OECD countries

	Ranking in 1998		Ranking in 2003	
	Country	Indicator	Country	Indicator
1	**Britain**	1,1	**Britain**	0,9
2	Australia	1,3	Australia	0,9
3	USA	1,3	USA	1,0
4	Canada	1,4	Iceland	1,0
5	New Zealand	1,4	New Zealand	1,1
6	**Denmark**	1,5	**Denmark**	1,1
7	**Ireland**	1,5	**Ireland**	1,1
8	Iceland	1,6	Canada	1,2
9	**Netherlands**	1,8	**Sweden**	1,2
10	**Austria**	1,8	Japan	1,3
11	**Sweden**	1,8	**Finland**	1,3
12	Norway	1,8	**Netherlands**	1,4
13	**Germany**	1,9	**Austria**	1,4
14	Japan	1,9	**Germany**	1,4
15	**EC-15**	2,0	**Belgium**	1,4
16	**Belgium**	2,1	**Slovakia**	1,4
17	**Finland**	2,1	**EC-15**	1,4
18	**Portugal**	2,1	Norway	1,5
19	Switzerland	2,2	Korea	1,5
20	**Spain**	2,3	**Portugal**	1,6
21	Mexico	2,4	**Spain**	1,6
22	**France**	2,5	Switzerland	1,7
23	**Hungary**	2,5	**France**	1,7
24	Korea	2,5	**Czech Rep.**	1,7
25	**Greece**	2,8	**Greece**	1,8
26	**Italy**	2,8	**Italy**	1,9
27	**Czech Rep.**	3,0	**Hungary**	2,0
28	**Slovakia**	3,0	Mexico	2,2
29	Turkey	3,1	Turkey	2,3
30	**Poland**	3,9	**Poland**	2,8

Source: Conway, Janod and Nicoletti 2005.