7 The economics of the single market

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7.1 Introduction

Unlike many areas of EU policy-making, the single market, more precisely the Single European Market (SEM),[1] has been seen in a positive light, perhaps because it has been central to EU development, although today, amid widespread disillusion with the EU, even the SEM is seen as 'less popular than ever, more needed than ever' (Monti 2010, p. 20). The SEM is an important stepping-stone on the route from the customs union to a fully-fledged economic union (see Chapter 1), and many regard monetary union (EMU; see Chapters 10–12) as the last stage and thus the final piece in the jigsaw of 'negative' integration. The SEM is defined as 'an area without internal frontiers in which the free movement of goods persons, services and capital is ensured' (Single European Act (SEA), Article 12; CEU 1987c). This means that borders should disappear within the EU: goods, services, capital and people should be able to move between member states (MSs) as they move between regions within a country. This requires the removal of customs and passport controls at borders; the elimination of any national barriers to the sale of other EU countries' goods and services; and the ending of any national controls on the movement of capital. This is a very extensive agenda that has such wide implications that the subject of virtually every chapter of the book has been affected by its developments. This chapter, therefore, considers the development of the SEM, emphasizing its key characteristics and the continuing debates about its effects.

7.2 Why 'the single market'?

There were provisions for a single market in the 1957 EEC Treaty: Article 3 required not only the removal of all internal tariffs and quotas, but also 'of all other measures having equivalent effect', and 'of obstacles to freedom of movement of persons, services and capital'. The procedure to eliminate these non-tariff barriers (NTBs) was harmonization or the approximation of laws (EEC Treaty, Article 100). After the successful early completion of the customs union (see Chapter 2), internal factors and external events conspired against the completion of the single market. The EEC economy was under strain in the 1970s because of: the world recession associated with the oil price shocks of 1973 and 1979; rapid changes in technology; the changing structure of the world economy; and the emergence of significant new competitors, first Japan and then the newly industrializing countries of South East Asia. With growth slow or negative and unemployment rising rapidly, national governments tried to protect their economies, but with tariffs fixed by GATT (see Chapter 1) and EEC Treaty commitments, only NTBs could be used – the 'New Protectionism'. Barriers went up within as well as without the EU, and these economic strains made countries much less willing to agree to integration initiatives in general and harmonization in particular.

The progress of harmonization was extremely slow for other reasons. It proved difficult to reach agreement on what were often complex technical issues, which were politically sensitive and often the subject of long-standing national legislation – for example, it was difficult to agree a definition for chocolate because in the UK significant amounts of non-cocoa fat could be added, but in the rest of Europe this was not the case. So an agreed definition was seen as either undermining continental European standards or requiring UK manufacturers to change their products. The UK was able to hold up the process in this instance because harmonization required unanimous agreement in the Council. Harmonization was also seen in some countries as over-regulation. The treaty also allowed national measures 'on grounds of public morality, public policy or public security; the protection of health and life of humans, animals or plants; the protection of national treasures possessing artistic, historic or archaeological value; or the protection of industrial and commercial property' (Article 36). This was exploited by some MSs to restrict trade. As a result, between 1969 and 1985, the EC managed to adopt only 270 directives (Schreiber 1991, p. 98). This was too slow to bring about any reduction in technical barriers, since new regulations were being introduced by MS governments at a faster rate.

Gradually, attitudes towards the single market began to change. There was concern over the performance of EC economies, slow growth and the falling share of world exports of hi-tech goods. Big business began to see the segmentation of the EC market into national markets as hampering their international competitiveness. They were unable to get the long production runs to keep costs down and to spread the costs of research and development (R&D). The Round Table of European Industrialists was particularly influential, lobbying national governments and the Commission. The limitations of nationalistic economic policies were being revealed by generally poor performance and failures, such as President Mitterand's abortive attempt to expand the French economy from 1981 to 1983. The European Monetary System (see Chapter 11) was seen as a successful example of what could be achieved by European cooperation. There was also support for further integration, demonstrated by the European Parliament (EP) majority in favour of the Draft Treaty of European Union[2] in 1984. The awkward partner in the EC, the UK, was also prepared to cooperate on further integration for three reasons. First, in 1984 a more permanent solution to the UK's budgetary problems was agreed (see Chapters 2 and 19). Second, SEM was in tune with the free market orthodoxy of the time, particularly with the Thatcher government's philosophy. Third, the British prime minister, Margaret Thatcher, believed that there were large potential gains for the UK from freer trade in services, especially for financial services in the City of London.

The new Commission in 1984, presided over by Jacques Delors, was pushing at an open door when it chose the SEM as the priority for its period in office. Lord Cockfield, the vice-president of the Delors Commission responsible for the SEM, drew up the Internal Market White Paper (CEU 1985a) – at the time a novel approach for the EC – setting out an ambitious but feasible strategy, including a legislative programme designed to sweep away cross-border restrictions and to restore the momentum of economic integration. The necessary institutional changes were contained in the SEA. The features of the strategy and legislation that characterize the SEM programme are as follows:

1. Minimum harmonization: New Approach Directives restrict harmonization to essential requirements: health, safety, environmental and consumer protection. The general harmonization method, originating in too rigid an interpretation of the treaty, was to be abandoned; in most cases, an 'approximation' of the parameters was sufficient to reduce differences in rates or technical specifications to an acceptable level.
2. The deadline of 31 December 1992, combined with regular monitoring, was designed to speed progress.
3. Qualified majority voting (QMV; see Chapter 3) is to apply to most SEM measures, but not to fiscal (tax) provisions, the free movement of persons, or the rights of employed persons.
4. Control of the emergence of new NTBs.
5. Mutual recognition, facilitated by the landmark judgment by the European Court of Justice (ECJ) in the Cassis de Dijon case (see Chapter 2): goods which are 'lawfully' made and sold in one EU MS should in principle be able to move freely and go on sale *anywhere* within the EU, and the same was true of tradable services such as banking or insurance.
6. European standards are to be developed, but (except where they coincide with legal requirements) their absence should not be allowed to restrict trade. The detailed technical definition of these requirements should, where possible, be entrusted to European standards institutions.

To make the SEM for the EU like a national market required the removal of three types of barriers: physical, fiscal and technical.

Physical barriers were checks at borders for the following reasons: (1) the control of the movement of persons for immigration purposes; (2) customs borders were required due to differences in indirect taxes; (3) animal and plant health was protected by inspections at borders; and (4) checks on lorries and drivers were ostensibly for safety reasons and to enforce national restrictions on foreign hauliers. Considerable expense was incurred in preparing the documentation needed and there were delays at borders, further increasing the cost of inter-EU transport. Fiscal barriers were needed to check the goods crossing borders because differences in indirect taxes, VAT, and excise duties on alcohol, tobacco, and so on, were dealt with by remitting these taxes on exports and imposing them on imports (see Chapter 15).

Technical barriers cover an enormous range of measures that affect trade. The most pervasive of these are technical regulations and standards. *Regulations* are legal requirements that products must satisfy before they can be sold in a particular country; these cover health, safety and environmental requirements. Regulations are also important in relation to services (see Section 7.4.1, page 107). *Standards* are not legally binding in themselves; they are technical requirements set by private standardization bodies, such as DIN in Germany, BSI in the UK and AFNOR in France. Although they are only voluntary, they often assume a quasi-legal status because they are used in technical regulations and in calls for tenders in contracts. They are also important in marketing the product. The existence of different regulations and standards imposed additional costs on EU producers, who had to make alterations to their products before they could sell them in other MSs.

Another technical barrier related to *public procurement*: private sector purchases by governments. Governments frequently discriminated against bids from firms in other MSs for a variety of reasons: strategic (e.g. weapons); support of employment; and encouragement of emerging high-tech industries, to maintain employment. However, such policies imposed costs on both the public authorities (who ended up paying more than they needed to) and on firms (because the market available for selling their goods was too limited). One consequence was too many producers, making it difficult to achieve an optimum scale in industries such as defence, electricity generation and telecommunications equipment.

Technical barriers were the main impediment to trade in services. For a range of services, from plumbing to legal services, the problems related to the recognition of qualifications[3] and the rights to establish businesses. For financial services, trade was limited by government regulatory measures. In banking there were particular problems with establishing capital adequacy. Insurance could not be sold in most MSs unless the insurer had a local permanent establishment. Capital movements were controlled by several MSs, which interfered with free trade in financial services.

What was remarkable about the SEM programme was its broad aims and ambitions, and the development of a clear approach to achieving them. It embraced measures as diverse as animal health controls and licensing of banks; public procurement and standards for catalytic converters for car exhausts. It covered not just traditionally tradable services, such as banking, insurance and transport, but also the new areas of information, marketing and audiovisual services. With regard to transport, the agenda included the 'phasing out of all quantitative restrictions (quotas) on road haulage', and further liberalization of road, sea and air passenger services through the fostering of increased competition (see Chapter 16). The aim for audiovisual services was to create a single, EC-wide broadcasting area.

7.3 The economics of non-tariff barriers

NTBs are any non-tariff government policy measure, which intentionally or unintentionally alters the amount or direction of trade. These are government, not private measures. They are artificial, not natural conditions: transport costs, language and cultural factors influence trade flows, but are not NTBs. Natural conditions can, however, be exploited as NTBs – for example, by requiring extensive documentation in the home language. Whether intentional or unintentional, it is the effect on trade that is important, not the declared purpose of the measure. It is notoriously difficult to establish intentions. A trade barrier implies a reduction of trade, but the volume of trade or its direction could be altered by subsidies, which could lead to an excessive amount of trade.

The effects of NTBs are analogous to those of tariffs (see Chapter 6). Figure 7.1, adapted from Figure 6.1 (see page 84), is the basis for a partial equilibrium comparison of tariffs and NTBs. The world supply of this product to the EU, S_W, is assumed to be infinitely elastic at a price D, and this would be the price in the absence of restrictions on trade. At this price, EU demand (D_{EU}) would be OM, EU supply (S_{EU}) OJ and imports JM. If a tariff of AD were levied on imports, the EU price would rise to A, EU demand would contract by LM to OL, EU supply would increase by JK to OK, and imports would fall to KL. Thus the effects of the tariffs are as follows:

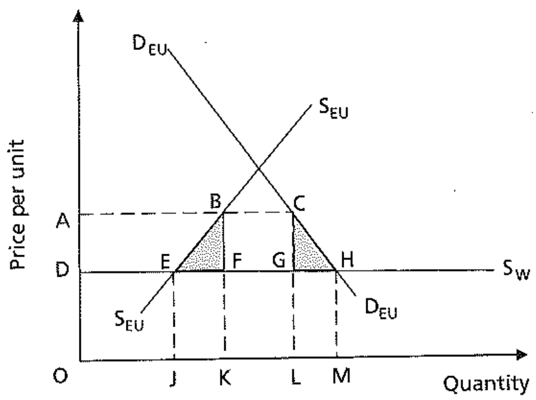

Figure 7.1 The effects of tariffs and non-tariff barriers

1. Consumption is reduced and consumers are worse off. The consumers' loss is equal to the area ACHD,[4] made up of the higher price on their current consumption, an amount equal to the area ACGD, and the loss of the opportunity to buy LM at the lower price OD, the area CHG.
2. Government tariff revenue is BCGF, so part of the consumer loss is transferred to the government.
3. Domestic producers' revenue increases from DEJO to ABKO; of this, EBKJ is the additional cost of production, so producers' surplus[5] increases by ABED.
4. The deadweight (net) loss associated with the tariff is relatively small, equal to the two dark triangles EBF and CGH; most of the additional cost to the consumer is extra tariff revenue for the government or producer surplus.[6]

If instead of a tariff there was an NTB of the same size, the effects on EU consumption, production, imports and producer surplus would be the same. There are, however, two important differences:

1. NTBs are cost-increasing rather than revenue-generating. NTBs protect the market by imposing additional costs on importers – for example, by requiring products to be modified to comply with different national regulations; this increases costs both directly and indirectly by reducing production runs. Complying with customs requirements involves administrative and other costs for importers, in addition to costs for the government of policing the measures. Thus the area BCGF is not government tariff revenue; it is an additional deadweight loss associated with NTBs.
2. Levels of NTB protection can be very high. Tariffs are relatively transparent: tariff rates are published and are subject to international negotiation. It is difficult to measure NTBs and thus levels of protection can be very high. Table 7.1 shows that NTBs in the EC were much higher than tariffs, and their variation across industries considerably greater.

This means that the benefits from the elimination of NTBs are likely to be large for three reasons. First, the cost savings are large. Second, they apply to a larger proportion of output than with tariff reduction. And, third, they may impact more directly on economies of scale because production can be standardized. Thus there are potentially substantial benefits from the elimination of NTBs (OECD 2005b).

7.4 An evolving programme

The White Paper (CEU 1985a) contained 300 proposals for legislation. By the 1992 deadline, 95 per cent of the measures were in place. However, this was not the end of the process, since additional legislation was needed: to close the remaining gaps in the SEM – for example, finance, energy and services; to update and improve the existing legislative framework to ensure it achieves its objectives; and to minimize the administrative burdens on business. Existing legislation needs to be transposed, and directives (see Chapters 3 and 4) need to be incorporated into national legislation, and this can take a considerable time. Continuing vigilance is needed to ensure the implementation of existing legislation; enforcement is the responsibility of national governments and sometimes this is problematic. In addition to legislation, there is the enormous task of developing European standards, which is still far from complete.

By October 2009 there were 1,521 directives and 976 regulations (see Chapters 3 and 4) related to the SEM (CEU 2010f, p. 7), which gives some idea of the increased coverage of the programme.[7] Despite this, the Commission continues to identify areas where

Table 7.1 Measures of protection by country and industry

	Tariff rate		Non-tariff barrier rate	
	Rate[1]	Standard deviation	Rate[1]	Standard deviation
Protection by country				
Belgium	7.0	7.6	19.6	28.2
Denmark	7.1	4.1	18.2	27.0
Germany, West	7.4	6.0	22.3	27.4
Greece	7.0	8.6	25.5	25.8
Spain	6.8	4.8	13.9	22.1
France	7.4	14.3	18.4	26.1
Ireland	7.5	7.5	20.8	27.0
Italy	7.6	14.4	20.9	27.1
Netherlands	7.1	7.6	20.6	28.1
Portugal	7.1	3.4	19.1	20.2
Protection by industry				
Food products	9.8	33.6	45.9	30.0
Textiles	11.7	24.5	69.8	38.2
Apparel	12.3	30.4	71.7	35.7
Footwear	13.3	44.5	33.8	41.9
Furniture	6.4	46.2	0.9	46.5
Industrial chemicals	10.2	23.5	9.1	30.1
Iron & steel	9.8	38.0	47.7	34.6
Machinery electric	8.6	28.3	14.3	33.3
Transport equipment	7.9	30.7	25.5	38.8
Professional & Scientific equipment	6.5	23.6	2.7	30.3

Note:
[1] Import weighted measure.
Source: Lee and Swagel 1997

further progress is needed (Monti 2010; CEU 2007a). These can broadly be divided into three: the traditional SEM; extension beyond its traditional boundaries or into new areas; and improving the context within which SEM operates. The free movement services, standards, consumer rights, network industries; reducing tax obstacles; public procurement; improving conditions for small and medium-sized enterprises, including simplifying the regulatory environment; cross-border debt recovery; a statute for a European Private Company; and EU patent are all traditional SEM issues. Extensions include the digital single market and green industry. The context is both economic and political. The 1985 White Paper recognized that the measures to reduce barriers should be accompanied by an expanding market and a flexible market (CEU 1985a). So the SEM can be seen as both complementary to and dependent on the Lisbon process (see Chapter 14). Politically, if SEM is to operate effectively, there should be a consensus on its importance and its continued development.

Another important issue, which relates to political support, is SEM integrity, the extent to which the existing measures apply and are enforced. Most SEM legislation takes the form of directives, which means that national legislation is necessary to introduce the measure. As a result, two problems occur: first, failure of transposition by national governments to pass the

necessary legislation by the deadline contained in the directive; and, second, incorrect transposition – that is, national legislation does not comply with directive. These two problems mean that 1.5 per cent of directives do not apply correctly across the whole EU; this percentage is improving, but it still remains an issue for the operation of the SEM. The effectiveness of the SEM is also compromised by the problem of enforcement. Measured by infringement proceedings, in cases where MSs are brought before the ECJ for failing to correctly apply the legislation, only limited progress is being made. So SEM rules for the most part apply and are enforced, but further improvements can and should be made.

7.4.1 The services market

A major SEM disappointment has been the limited extent to which services markets have been integrated (Gros 2006; OECD 2005b); in 2009 services accounted for 74 per cent of output and 70 per cent of employment in the EU27 (see Tables 5.4 and 5.5).[8] The limited impact of the SEM in this area is illustrated by the low proportion of Gross Value Added (GVA) that is traded[9] (see Figure 7.2) and the low level of foreign direct investment (FDI) in services industries, which seems to be related to regulatory problems (Kox *et al.* 2004a, b).

The EU has sought to open up the services market with two particular measures: a general services directive and the Financial Services Action Plan (see page 108). The barriers to cross-border trade in non-financial services remain high; national regulatory regimes are very different and complex, with a high level of discretion by MSs, and there is little confidence that they would not be used to protect domestic companies. In sectors such as accountancy, retailing, wholesale trade and IT services, barriers remain high and the gains from their elimination significant. Trade in commercial services could rise by 30–60 per cent and the stock of FDI by 20–35 per cent (Kox *et al.* 2004a, p. 66); this could raise EU consumption by 0.6 per cent and employment by 600,000 (Copenhagen Economics 2005, p. 13).

The original proposal for a services market directive (CEU 2004k) sought to extend the principle of mutual recognition to services: a company able to operate a service in one MS should, in principle, be able to operate that service in any other MS. The directive proposed various measures to achieve these ends: freedom of

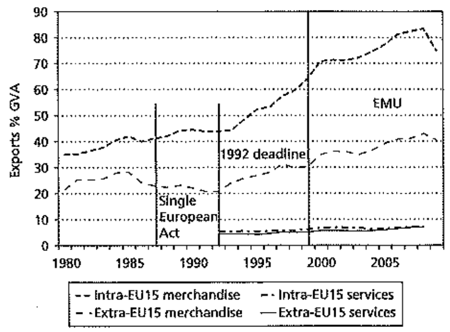

Figure 7.2 Intra- and extra-exports' share of GVA
Source: IMF 2010b; Eurostat 2010e; CEU 2010c

establishment (easing of administrative requirements); freedom of movement (country of origin principle and rights of recipients to use services in other MSs); and measures to establish consumer confidence in services provision. Coming as they did at a time of growing economic nationalism, these proposals proved so controversial as to be labelled the Frankenstein directive, in a pun on the name of Frits Bolkstein, the internal market commissioner at the time. There were concerns over social dumping: social standards (minimum wages and health and safety) would be undermined because foreign services companies could use cheap foreign workers employed on lower standards. Particular concerns were raised over the regulation of private security and social care, where the vetting of workers' suitability – for example, for criminal convictions – could be undermined.

Although there were some problems with the directive, these criticisms were exaggerated. The Posted Workers Directive (Council 1997c) requires employers to pay the minimum wages and satisfy the employment conditions, including health and safety, of the host country, although it would still have been possible to employ foreign workers at below normal wages for the service. Are standards that much lower in other countries? Wages are lower, but whether standards are lower is questionable. A lot of the criticisms are special pleading by interest groups.

These objections have resulted in a significantly modified services directive (CEU 2006a). The modification includes a considerable number of exemptions from the directive: to the original exemptions on financial,[10] electronic communication networks and transport services,[11] are added healthcare and pharmaceutical services, audiovisual services, whatever their means of transmission, gambling services, social services in the area of housing, childcare and support to families and persons in need.[12] The other significant modification is that the principle of regulation by country of origin has gone, to be replaced by the freedom to provide services. The original proposal for mutual recognition was important, since it would potentially have made cross-border services provision much more straightforward, because it meant that cross-border services providers would only have to satisfy one set of regulations. But under the agreed directive, two sets of regulations are going to have to be satisfied. Provided requirements of non-discrimination, necessity[13] and proportionality are met, national authorities may regulate foreign services providers. There are some useful requirements on the authorization regime, such as a single point of contact, charges and processing time. The impact of the directive will only become apparent later, but these modifications are likely to reduce its impact significantly by increasing the difficulty of establishing new services provision in another MS. These difficulties are such that some suggest that from a legal viewpoint little has changed: 'the legal framework of the revised Services Directive remains predominantly the same as under the current legal status quo' (Badinger and Maydell 2009, p. 711). This implies that the benefits of the measure will be limited (de Bruijn *et al.* 2006; Badinger *et al.* 2008).

7.4.2 Financial services

The integration of financial markets is an essential SEM component which not only yields direct benefits, but is essential for the SEM as a whole. The Cecchini Report (CEU 1988a) attributed as much as a quarter of the potential gains for EC GDP from the SEM to the liberalization of financial services. The SEM review in the mid-1990s (Monti 1996) was markedly less optimistic, largely because remaining regulatory and other barriers had inhibited the emergence of genuine pan-EU provision of services. This was especially the case for retail financial services (Schüler and Heinemann 2002), but some barriers also remained in other areas and there was limited cross-border consolidation of the financial services industry. This led in 1999 to the Financial Services Action Plan (FSAP) (CEU 1999j), to restore the impetus towards financial integration, because the potential gains from greater capital market efficiency were being lost. There is still plenty of potential for further integration of financial markets and this will substantially enhance economic growth (Kyla *et al.* 2009).

The key mechanisms through which financial integration translates into improved economic performance can be summarized as follows:

- Improvements in the 'x-efficiency' of financial intermediaries as competitive pressures oblige them to adopt new technologies, to pare operating costs and to restructure to more optimal sizes.
- Lower cost or more innovative provision, such as electronic trading, may lead to increases in retail demand for financial services especially.
- Pooling of liquidity that deepens the supply of finance, an effect estimated to be capable of lowering the cost of capital.
- The potential benefits from integration of financial markets are considerable.

FSAP (CEU 1999j) was designed to raise the efficiency of financial intermediation in the EU and especially to lower the costs of cross-border financing. It had four broad aims:

1. Completing a single wholesale market.
2. Developing open and secure markets for retail financial services.
3. Ensuring the continued stability of EU financial markets.
4. Eliminating tax obstacles to financial market integration.

The first legislative phase of FSAP is now complete: all the original measures have been adopted and transposed (CEU 2010l). The Lamfalussy Directives on securities markets are all adopted, but five MSs still need to complete transposition of three directives (CEU 2010m). But the process continues, with a further thirteen directives adopted, only two of which have been transposed in all MSs.

With the legislative programme still recent, it is early to judge the impact of FSAP. The one study that has been published (Kyla *et al.* 2009) found evidence that FSAP was having an impact in the three areas examined (banking, securities and insurance), but it was difficult to evaluate because of the financial crisis and the short time the measures had been in operation.

The financial crisis has fundamentally changed the environment within which financial market integration is occurring. The EU has responded by changing financial legislation in the areas of deposit guarantees, capital requirements and credit rating agencies, and further measures are in the pipeline (CEU 2010n). One fundamental change has been the development of a new EU supervisory financial framework, consisting of a European Systemic Risk Assessment Board and three new supervisory authorities dealing with banks, insurance/pensions and securities markets (European Parliament 2010). Regulation will still be by national authorities, but more closely monitored at EU level. How effective this framework will prove to be is questionable, but it does mark a significant step towards EU regulation of financial markets.

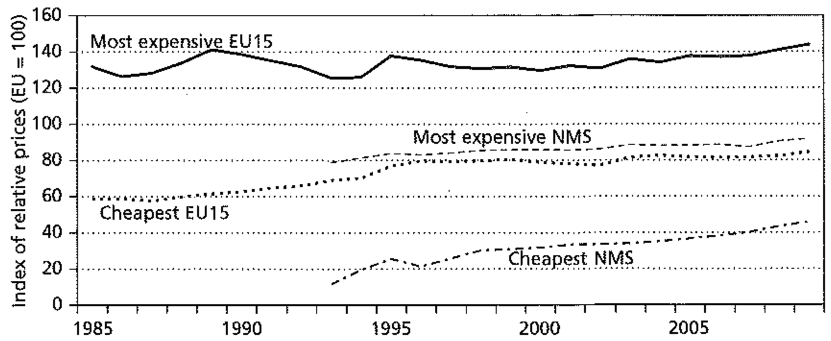

Figure 7.3 Price dispersion in the EU *Source:* CEU 2010c

7.5 Assessment of the single market

The assessment of the SEM has two aspects: (a) the evaluation of the extent to which it has been achieved; and (b) the measurement of its effects on economic performance. These are the subject of the next two subsections.

7.5.1 The extent of integration in the single market

There is a very wide range of potential measures of the extent of integration in the SEM, but two stand out for their generality: price convergence and the extent of trade. A further indicator that needs examination is FDI, because, particularly in services, FDI could be a substitute for trade (see Chapter 8).

The SEM makes trade easier between MSs, which should make it harder to maintain price differences between national markets.[14] Arbitrage[15] and consumer cross-border trade should be much easier in the SEM. There was price convergence in the EU15 associated with the SEM from 1989 to 2000, but since 2000 there has been some divergence (see Figure 7.3). The new member states (NMS) show signs of price convergence both within their group and with the EU15.

The problem, of course, is one of causation: is the SEM the cause of price convergence? Price convergence of tradable goods is the result of arbitrage, but price convergence of non-tradable goods may be the result of the Balassa–Samuelson effect. In poorer countries the price of goods, such as housing, and services, such as restaurant meals, haircuts, and so on, is cheaper. This is partly the result of lower demand relative to supply (causing lower land prices and rents), but also because lower wages mean lower costs of production. The development of these economies leads to increases in productivity, especially in the tradable sector, so wages here can rise without affecting competitiveness. Wages in non-tradable sectors also rise, but without the accompanying increase in productivity, thus prices rise.[16] Therefore, the process of convergence in income levels will cause a reduction in price dispersion within the EU; so is price convergence the result of the SEM or income convergence? Indeed, is some of the income convergence the result of the SEM? In addition, the price convergence process may be very long-term (Mathä 2006).

The SEM should cause price convergence by increasing the proportion of output that is traded. Figure 7.2 shows intra- and extra-EU15 exports as a percentage of

GVA. Intra-EU15 exports increased their share of GVA rapidly after the introduction of SEM measures and this growth has continued. Extra-EU15 exports increased their share of GVA from 1992, but at a slower rate than for intra-EU15 trade. The greater rate of increase of intra-EU share of GVA is a clear indication of the effect of the SEM, because extra-EU15 exports should have been boosted by the faster growth of non-EU GDP. Both intra- and extra-EU15 imports fell in 2009 as a result of the crisis, but the fall in extra-EU15 exports is less, as EU15 GDP fell more than world GDP. The high level of intra-EU15 merchandise trade is a strong indication of the success of the SEM in integrating the EU's economy.[17]

The situation with trade in services is very different: both intra- and extra-EU imports have low shares of GVA in services and, while there is some growth, trade remains at a very low level. Given that a significant proportion of services is non-tradable, a lower share of GVA traded is to be expected. But the low overall growth and the fact that intra-EU15 trade in services is growing no faster than extra-EU15 trade is an indication that the integration of services markets has not been achieved. Trade is of course not the only indicator; the effects of integration could occur in the absence of trade if foreign services providers set up in other economies, but this does not seem to be happening (see Section 7.4.1, page 107). This is also indicated by the significant difference in services trade between countries (Roca Zamora 2009).

These conclusions relate to the EU15; the NMSs have higher overall levels of trade and growth of trade for both goods and services (Roca Zamora 2009). Here it is difficult to disentangle the impact of the SEM from the impact of enlargement, but they do seem to be more willing and able to exploit the potential of the SEM.

The SEM should increase the amount of FDI as companies locate and concentrate production at least-cost locations in the EU; companies invest in new local production for markets that have to be served locally (e.g. retailing); market competition is reconfigured by mergers that were previously off-limits. An acceleration of intra- and extra-EU15 FDI can be noted in 1998 (see Figure 7.4), a time of booming FDI across the world; but from 1999 onwards intra-EU15 FDI began to exceed outward FDI significantly and a clear gap between the two has been maintained. The timing of this development indicates that the single currency has had a

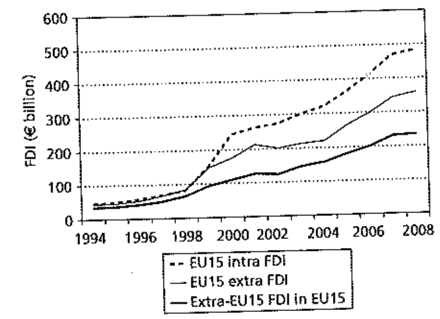

Figure 7.4 EU15 foreign direct investment
Source: Eurostat (2010e)

significant role in encouraging intra-EU FDI. While there is some tendency for FDI to decline with distance, other factors affecting FDI would tend to encourage extra- rather than intra-EU FDI – for example, differences in labour costs and market access. Extra-EU15 FDI has risen continuously, indicating that the SEM is attractive to non-EU multinational companies.

7.5.2 The single market and economic performance

The rationale for the SEM is that it reinforces the market opening principle of the common market by focusing not just on existing trade flows, but also on subjecting hitherto protected sectors to greater cross-border competition. In so doing it establishes a number of channels for improved resource allocation and efficiency gains that, in turn, offer the promise of improved economic performance. The economic gains are both micro- and macroeconomic. Achieving these benefits will require some dislocations: unemployment can result from the changes needed to achieve overall benefits. The benefits and costs of the SEM are analogous to the benefits of the formation of customs unions discussed in Chapter 6.

7.5.3 Empirical research on the single market: Commission studies

There are three major problems in estimating the effects of the SEM. First, the very wide nature of the programme means that its effects are spread across the whole EU economy. Second, both the implementation of the SEM and businesses' response take considerable periods of time. One estimate suggests that by 2007 less than half of the long-term income gains had

been achieved (Straathof *et al.* 2008). For example, the elimination of barriers will encourage the relocation of production to least-cost sites within the EU, but this is a slow process. Third, these two problems compound the general difficulty of identifying the counterfactual: what would have happened in the absence of the SEM (see Chapter 9). SEM is not exogenous since some economic integration would have occurred in its absence, but how much? These general benefits of the SEM are calculated as part of the measurement of the effects of EU integration analysed in Chapter 9. So only a short summary of the potential size of the effects is included here.

The Cecchini Report (CEU 1988a) is based on Commission economic research (Emerson *et al.* 1988) highlighting the benefits of the SEM in the run-up to the 1992 deadline. The study predicted the total potential gain for the EC12 to be 4–7 per cent of EC GDP and 2–5 million jobs. It is important to emphasize the speculative nature of this exercise, and the fact that it was undertaken by a Commission keen to underscore the benefits of the flagship policy. Compared with this very optimistic picture, the findings of the second major exercise conducted by the Commission in the mid-1990s have to be regarded as a disappointment. Enormous effort was put into this research, which comprised some thirty-eight studies, plus a business survey (CEU 1996f). The headline figure this time was that the SEM had raised EU GDP by just over 1 per cent by 1994 and had increased employment by about half a million.

Why was there such a difference in the assessed impact? The Commission (CEU 1996f) identified three main problems. First, it was too soon to observe the medium-term effects of the SEM. Some SEM measures were not implemented until 1994–5, but also economic agents had not yet had time to adjust. Second, the data that could be used were, at best, only up to 1994, and thus only allowed a very short assessment period. Third, separating out the relatively small and incremental impact of market integration is difficult. While the impact of the SEM on economic performance was disappointing, surveys of opinion of company representatives reported a strong and significant impact on output and employment. In particular, the protection the SEM programme provides 'against the introduction of new barriers and the refragmentation of the market' was seen as important, thus indicating a role of the SEM in protecting existing gains rather than providing new ones.

On the tenth anniversary of 1992, the Commission was keen to celebrate the achievements of the SEM. It produced new estimates indicating that the SEM had raised EU GDP in 2002 by 1.8 per cent and increased employment by 1.46 per cent, which means that around 2.5 million extra jobs have been created (CEU 2002q). The latest estimates are provided by Ilkovitz *et al.* (2007), who suggest gains during 1992–2006 of 2.2 per cent of GDP and 1.4 per cent of employment. This indicates a significant, but far from earth-shattering, impact of the SEM, undermining the Commission's explanations for the low estimates in 1996. The idea that the SEM would transform EU economic performance has proved to be wide of the mark: there is no indication in the growth of output or productivity over this period that would support this contention (see Chapter 14).

It is only with the availability of a longer run of post-1992 data and the gradual refining of techniques that more reliable estimation of the overall effects of the SEM has become possible. A good recent example is Straathof *et al.* (2008), who suggest that internal market integration, including the customs union, have raised EU GDP by 2–3 per cent, but that the effect differed significantly between countries, amounting to 4–6 per cent for the Netherlands, for example.

7.6 Conclusion

In political terms the SEM must be regarded as a success. Despite some foot-dragging in the implementation of key measures, the strategic aim of opening up goods markets has been consistently advanced and has retained wide political support. Although, in a sense, the SEM will never be fully completed, because there will always be barriers that give some advantage to indigenous producers, there can be little doubt that the EU has moved a long way. The scope of the SEM has also expanded significantly to encompass most production. Economic nationalism and protection remain potent forces, and the development of the SEM continues to be a battle with these forces. The pace of regulation has slowed and the emphasis has gradually shifted to quality of regulation, implementation and enforcement.

Although much of the rhetoric surrounding the SEM has been about liberalization and deregulation, with the implication that it is principally concerned with *negative* integration (see Chapter 1), the reality is more complex. In a number of areas the outcome has been more a recasting of the regulatory framework than its dismantling, and the resulting regulatory style is one that reflects European values.

In economic terms, the outcome of the SEM is much less clear-cut: ultimately its objective was to raise the performance of the EU's economy, by raising productivity growth. To paraphrase Robert Solow, you can see the SEM programme everywhere but in the productivity statistics.[18] The interesting issue is why this should be so. Various responses are possible: the limited progress in services, the long-term nature of the project and the difficulties of implementation. An alternative view is that the impact of the SEM may have been a transitory shock, with little long-term impact on productivity growth. A balanced view might be that expectations were overblown and limited, but that worthwhile benefits have been achieved. It is also important to note that the SEM is merely part of an increasingly globalized world market, generally subject to liberalization and deregulation; ultimately these developments may have more profound impacts on economic performance. Indeed, European companies' search for competitiveness in this market was at the heart of the SEM, and in this sense it has been successful, enabling large companies to emerge and be competitive in the globalized economy. The SEM remains central to the EU and, despite its apparently limited economic impact, it is a powerful attraction for potential members and a model for its many imitators.

Summary

- The SEM is central to the development of the EU because it is the basis of economic integration and has such wide implications for other policies.
- Provision for the SEM was made in the EEC Treaty, but although the customs union was completed early, NTBs were not removed. This was a particular problem because the costs associated with NTBs are potentially larger than those associated with tariffs.
- After 1973, with the oil crisis and its associated recession, NTBs increased so that the SEM was regressing.
- Attitudes began to change in the early 1980s, with the failure of nationalistic economic policies, the resolution of the UK's budget problem and a dynamic new Commission led by Jacques Delors.
- The Internal Market Programme was supported by all MSs, and in 1987, the SEA, the first major revision of the EEC Treaty, came into force.
- The SEA defined the internal market as an area without barriers, in which the freedom of movement of goods, services, capital and person is ensured.
- The SEA set a deadline of 1992 for the measures and reformed decision-making to make it easier to agree new laws.
- This was a very ambitious programme to remove internal borders, to harmonize taxes and laws relating to product safety, the environmental impact of products, and so on.
- The original legislative programme was completed more or less on time, but there have been problems getting the legislation transposed and enforced.
- Over time the programme has expanded to additional areas, such as network industries (telecommunications, electricity); the scope of existing measures has expanded and updating has taken place, so it is a continuous process.
- The SEM is largely complete, but there are problem areas such as services, where it has been difficult to implement.
- The SEM's economic purpose was to raise the EU's efficiency/productivity by enhancing competition, providing a larger market in which economies of scale could be achieved, and encouraging R&D.
- There is clear evidence that the SEM has integrated markets, as shown by price convergence and increasing trade and FDI.
- The assessed impact on economic performance is significant, but has not lived up to early expectations. This may be because there are problems with the operation of the SEM in relation to services, for example, or that the benefits take a long time so they are not yet complete.
- The SEM is an enormous achievement that has proved to be a magnet for new members and an example for the rest of the world.

Questions and essay topics

1. Why has the SEM been so central to EU development?
2. Why did the EC fail to eliminate NTBs using the powers contained in EEC Treaty?
3. Why are NTBs potentially more costly than tariff barriers?
4. What factors led to the development of the SEM programme in the early 1980s?
5. What were the major provisions of the SEA which facilitated the development of the SEM?
6. What are the problems of transposition and enforcement and why are they important?
7. What does the evidence on price convergence suggest about the SEM's effect on economic integration?
8. How is the SEM expected to raise economic performance of MSs?
9. How has the SEM affected trade in goods?
10. How has the SEM affected trade in services?
11. Why has the SEM had a greater effect on trade in goods than trade in services?
12. What has been the impact of the SEM on FDI?
13. Why is it difficult to estimate the SEM's effect on MSs' economic performance?
14. How would you explain the fact that the impact of the SEM on MSs' economic performance has been relatively limited?

FURTHER READING

Badinger, H. and Maydell, N. (2009) 'Legal and economic issues in completing the EU internal market for services: an interdisciplinary perspective', *Journal of Common Market Studies*, vol. 47, no. 4.

Monti, M. (2010) 'A new strategy for the single market: at the service of Europe's economy and society', Report to the President of the Commission, J. M. Barroso (http://ec.europa.eu/bepa/pdf/monti_report_final_10_05_2010_en.pdf).

OECD (2009) 'Deepening the single market', *OECD Economic Surveys: European Union 2009*, OECD, Paris, Chapter 3.

NOTES

1 The official expression is 'internal market', but 'single market' is the commonly used term. We shall use 'SEM' throughout to refer to this programme so as not to confuse it with the general expression of 'single market'.
2 An EP initiative which got no further, not to be confused with the Treaty *on* European Union (TEU), the Maastricht Treaty.
3 This was also a particular problem for labour mobility.
4 This is the reduction in consumer surplus: the difference between the maximum amount consumers are prepared to pay and the amount they actually have to pay (see Chapter 6).
5 Producers' surplus is the excess of revenue over cost (see Chapter 6).
6 Over time, losses could be larger as a result of inefficiency of protected producers.
7 Although it also relates to limitations in the original strategy, with additional legislation being required.
8 Excluding public services and administration, commercial services account for about half of GDP.
9 Even allowing for the fact that services are less tradable than merchandise goods and services.
10 Subject to separate legislation (see page 108).
11 The exclusion of urban transport, taxis and ambulances, as well as port services, is made explicit.
12 This means that the directive only applies to about one-third of GDP.
13 For example, justified for reasons of public policy, public security, public health or the protection of the environment.
14 This effect should be further reinforced by the single currency.
15 The movement of products from low-price to high-price markets for profit.
16 Competitiveness is not affected because these goods/services are not traded.
17 See also Roca Zamora 2009.
18 The original was Robert Solow's 1987 remark: 'You can see the computer age everywhere but in the productivity statistics.'