Europe after the 'no' votes : mapping a new economic path

Patrick Messerlin

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PATRICK A. MESSERLIN

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WITH COMMENTARIES BY
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From 2002 to 2005 he was co-chairman with Dr Ernesto Zedillo, former president of Mexico and director of the Yale Center for the Study on Globalization, of the Task Force on Trade in the UN Millennium Project launched by Secretary-General Kofi Annan. In 2001/02 he was special adviser to Mike Moore, WTO director general.

He has published a dozen books and more than a hundred papers on trade policy and political economy. His most recent book is *Measuring the Costs of Protection in Europe: European Commercial Policy in the 2000s* (Institute for International Economics, Washington, DC, 2001). The UN Millennium Project Task Force released its report on *Trade for Development* in May 2005 (available at www.gem.sciences-po.fr or www.millenniumproject.org).

FOREWORD

A recurring theme in recent Wincott Lectures has been the need to defend the virtues of economic liberalism against interest groups which, whether out of ill will or ignorance, seek to restrict the functioning of markets. In his 2000 lecture, for example, Professor David Henderson warned against the threat posed by what he called 'new millennium collectivism', a view of the world in which global capitalism is portrayed as sweeping peoples and governments before it, exploiting workers and driving down environmental standards. These attitudes are by no means confined to a lunatic fringe, and they have to be rebutted vigorously by those who believe in the market economy.

Professor Leszek Balcerowicz, in his 2001 lecture, drew on Polish experience to explain why some ex-communist countries in eastern and central Europe had handled the transition to the market more successfully than others. A crucial ingredient, he pointed out, was the presence in government of competent and determined reformers, who were able to explain and win support for the changes that were needed. Without such leadership, there was a danger that the anti-reformist camp, nostalgic for the supposed stability of the communist era, would gain ground.

This need for persuasive reformers is particularly acute at the present time in the European Union. Although the Union, in its original 'Common Market' form, was built on free trade, enthu-

siasm for liberalisation appears to be waning. One indication has been the extreme difficulty that the European Commission has faced in attempting to open up trade in services. Another is the fierce resistance, especially in Germany, to the proposed takeover directive, which would have facilitated cross-border acquisitions and increased competition in European industry. This lack of progress on market-opening measures reflects in part a widespread unease about the impact of competition – and about 'globalisation' – which political leaders have done too little to dispel.

To make matters worse, there is a lack of trust in European institutions which was manifested most dramatically in the rejection by voters in France and the Netherlands of the proposed European constitution. Yet, as Professor Patrick Messerlin shows in this IEA Occasional Paper – containing the text of his 2005 Wincott Lecture, together with three commentaries – these votes can be seen, not as a disaster for Europe, but as an opportunity to rethink the purpose of the Union.

Professor Messerlin argues persuasively that the Union has been trying to do too much, especially in pushing for a Europe-wide social agenda, covering matters that should largely be left to national governments. Instead of promoting the idea of the European Union as some kind of super-state, political leaders should refocus their efforts on measures that can genuinely improve the well-being of their citizens – and contribute to a better world.

The lecture identifies the potential gains for Europe from further economic liberalisation, particularly in agriculture and services. On the former, Professor Messerlin shows that the European Union would be the big winner from reform – it would obtain around half of all global gains from full liberalisation by the developed countries alone, and roughly one third of the gains from worldwide liberalisation. On services, he points out that the level of protection is much higher than in goods; an opening up of the market would have the same dynamic effect in services as it already has had in goods. It would have the additional advantage of bringing the single market within the reach of the small and medium-sized service providers that have been largely excluded from it to date.

If the gains from reform are so large, why is there no popular consensus behind it? Part of the answer lies in the timidity of political leaders, and this has contributed to ignorance and misunderstanding among the public at large. One of Professor Messerlin's central themes is the urgent need to develop in Europe a stronger 'culture of evaluation' – a continuing flow of well-researched assessments, produced by independent think tanks and other institutions, of the costs and benefits of specific economic reforms. As he puts it, 'By showing that any liberalisation brings global gains but leaves some net losers, a culture of evaluation shifts the spotlight to two key questions: is there a need for an adjustment policy, and, if yes, what would be the best compensation instrument to use?'

This lecture, by setting out some of the key issues that should be on Europe's economic agenda, provides an admirable starting point for this evaluation process. The trustees of the Wincott Foundation are grateful to Professor Messerlin for accepting our invitation to deliver the 2005 Wincott Lecture, and to Lord Brittan, Pedro Schwartz and John Gillingham for their thoughtful and constructive comments.

SIR GEOFFREY OWEN

Chairman of the Trustees,

The Wincott Foundation

April 2006

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My thanks are due to the Wincott Trustees for honouring me with the invitation to give the 2005 Wincott Lecture. I would especially like to thank the Chairman of the Trustees, Sir Geoffrey Owen, for his helpful contributions at various stages of planning and preparation. I would also like to thank Lord Brittan very much for his insightful contribution to the debate, and John Gillingham and Pedro Schwartz for their commentaries. Last, I would like to express my warm thanks to David Henderson for his very useful comments on a first draft, and to Ben Shepherd for our discussions and his generous help.

SUMMARY

- The 'No' votes in the French and Dutch referenda on the proposed EU constitution highlight the need to design an economic agenda for the EU that fits soundly with the fundamental nature and purpose of the EU.
- The 'No' votes mark the end of the idea that the EU can be a European 'super-state' providing a wide range of social policies and instead can lead to the return of the EU to its origins set out in the slim Treaty of Rome.
- The first part of an economic agenda for the future of the EU is to establish a genuine single market that is truly integrated and open and not subject to restrictive regulation. This will involve challenging European protectionism and fears about globalisation.
- Liberalisation of agricultural policy is an important component of a genuine European single market. Domestic support to agriculture should be removed and subsidies significantly reduced with a view to their complete elimination.
- While the single market in manufacturing is relatively advanced compared with agriculture, there is still a lot to do to eliminate the trade barriers between the EU and the rest of the world and facilitate greater inter-EU trade.

- The 'strategic casino-and-yogurt policy' of prohibiting takeovers of domestic firms deemed essential to national economies (nowadays dubbed 'economic nationalism') must be opposed if a genuine single market is to develop.
- The prospect of a single market in services has generated even more and deeper fears than the single market in goods. Harmonisation and mutual recognition have proved ineffective means of liberalising services. Allowing the largest possible freedom to invest in other member states' services markets offers a more fruitful way forward.
- The EU's trade policy is effectively its foreign policy. Trade agreements with Turkey and other non-EU countries may be used to secure the traditional foreign policy goals of maintaining good international relations and promoting democratic governance.
- Successful reform will require a 'culture of evaluation' within Europe in which independent think tanks and research institutes inform public debate about the costs and benefits of different EU policies and proposed reforms.

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1 EUROPE AFTER THE ‘NO’ VOTES: MAPPING A NEW ECONOMIC PATH

Patrick A. Messerlin

Introduction

The ‘No’ majorities in the French and Dutch referenda on the proposed European constitution were so large, and the two countries so different, that they have created a sense of crisis or resignation across much of Europe. Both reactions are, however, unjustified. On the contrary, these votes should be seen as bringing with them a sense of clarification that the EU has been so sorely lacking over the last two decades. In short, they highlight the need to design an economic agenda that fits soundly both with the EU’s real purpose and with its fundamental nature.

Properly understanding the ‘No’ votes requires us to take a broad approach. First, far from being an accident or a surprise, the French ‘*Non*’ was in fact quite predictable. French people with a positive opinion of EU membership have been a minority (48 per cent) since 1998, while those with a positive opinion of the benefits of the EU have been an even smaller minority (45 per cent) since 1993.[1] Both figures provide quite accurate forecasts of the ‘Yes’ vote (44 per cent), and one can only be flabbergasted by the gamble taken by the French government when it asked for a

1 These figures are simple averages of the Eurobarometer Standard poll results published every spring. That the annual results have a very small standard deviation (2.5) over the period underlines the persistence of French opinion.

referendum. Second, the same source shows that German public opinion is similar to French as regards EU membership, but significantly more negative (much closer to British public opinion) on the benefits of the EU. Had a referendum taken place in Germany, a '*Nein*' certainly could not have been ruled out.

In this context, what the French '*Non*' really does is lift a weighty burden from the EU's shoulders, namely the desire that it should be some kind of 'super-state'. In particular, the French referendum makes it clear that the hodgepodge of issues referred to during the campaign as the 'social model' (labour market regulations, income distribution, etc.) should remain matters of strictly national competence. Although French voters as a whole apparently have very little idea as to what their future 'social model' should actually look like, their votes mean that they are not ready to accept a Europe-wide social agenda. This is in direct opposition to what their political masters have pushed for since tabling the notion of a Social Charter. In sum, the French '*Non*' marks the comeback of the slim Treaty of Rome as against its somewhat more obese successors of the last decade or so.

Another hallmark of the French campaign was the unholy alliance of, on the one hand, vocal NGOs profoundly opposed to markets per se and, on the other, a myriad of much more discrete lobbies primarily concerned with hanging on to the rents they derive from regulated markets. This situation has led some observers to express doubts about the viability of a European economic agenda for the coming years.

I will argue that, on the contrary, the agenda is surprisingly vast. First, nobody during the two campaigns argued against the single market in goods. Indeed, the French referendum may even have moved things forward in relation to one sacred cow (no pun

intended), namely agriculture. Beyond the pathetic rearguard actions of the French government at the Hong Kong Ministerial of the World Trade Organization (WTO), there are clear signs that a wide array of French farmers are desperately looking for a way out – meaning a serious reform of the Common Agricultural Policy and an opening of European farm markets. Second, only one – arguably crucial – aspect of the single market in services hit a raw nerve: the principle of the country of origin included in the initial proposal for a Services Directive and the regime of regulatory competition that it establishes amongst member states. This still leaves a lot to be done with respect to the other, apparently uncontested, aspects of the single market in services, and it suggests key actions for successfully addressing the unavoidable issue of regulatory competition in a pro-growth strategy. Third, the foreign dimension of the European agenda – most notably the EU's relations with Turkey – has reached a point where it requires a drastic reformulation that market-based initiatives could help to design.

The single market in goods: unfinished business

European politicians tend to talk about the single market as if it really existed. Europeans themselves are not so convinced, and they are right. There is still a lot to do, even in goods. If the single market were truly deeply integrated and open, it would exhibit two features: regulations in all the member states would be roughly equally pro-competitive (reflecting intra-EU openness) and they would tend to be less restrictive than those of the other OECD countries (mirroring extra-EU openness). The available evidence does not support either test. As Table 1 shows, some

Table 1 **Product-market regulation (PMR) indicators**

Rank	*EC15/25 member*	*OECD members**	*PMR 1998*	*PMR 2003*	*Change (%)*
1	EC15	Britain	1.1	0.9	–18.2
2		Australia	1.3	0.9	–30.8
3		USA	1.3	1.0	–23.1
4		Iceland	1.6	1.0	–37.5
5		New Zealand	1.4	1.1	–21.4
6	EC15	Denmark	1.5	1.1	–26.7
7	EC15	Ireland	1.5	1.1	–26.7
8		Canada	1.4	1.2	–14.3
9	EC15	Sweden	1.8	1.2	–33.3
10		Japan	1.9	1.3	–31.6
11	EC15	Finland	2.1	1.3	–38.1
12	EC15	Netherlands	1.8	1.4	–22.2
13	EC15	Austria	1.8	1.4	–22.2
14	EC15	Germany	1.9	1.4	–26.3
15	EC15	Belgium	2.1	1.4	–33.3
16	EC25	Slovakia	3.0	1.4	–53.3
17		Norway	1.8	1.5	–16.7
18		Korea	2.5	1.5	–40.0
19	EC15	Portugal	2.1	1.6	–23.8
20	EC15	Spain	2.3	1.6	–30.4
21		Switzerland	2.2	1.7	–22.7
22	EC15	France	2.5	1.7	–32.0
23	EC25	Czech Rep.	3.0	1.7	–43.3
24	EC15	Greece	2.8	1.8	–35.7
25	EC15	Italy	2.8	1.9	–32.1
26	EC25	Hungary	2.5	2.0	–20.0
27		Mexico	2.4	2.2	–8.3
28		Turkey	3.1	2.3	–25.8
29	EC25	Poland	3.9	2.8	–28.2
EC15	All member states		2.0	1.4	–28.7

Source: Conway, Janod and Nicoletti, 2005
*Not all the EU member states are OECD members

member states were among the most regulated OECD countries in 1998 and 2003, while others were among the least regulated ones for both years.[2] In sum, member states follow the general trend of regulatory reforms in OECD countries, not a specific European pattern.

The EU's half-century-long history shows that progress towards a single market very much depends on having an open trade policy. There are two reasons for this. World competition tends to be a more powerful force than intra-European competition (Jacquemin and Sapir, 1991). And multilateral market opening has offered EU member states new trade-offs, in addition to those available within Europe, thereby making intra-EU deals easier to swallow. Examples abound. The Kennedy Round was essential to resolving conflicts over the level of the common external tariff; the Uruguay Round was instrumental in bringing about more integrated European markets in cars, chemicals, etc.

The current lack of progress in the Doha Round is thus not only a danger for the world economy, but also a serious threat to European integration. But is any progress possible when France and a few other member states remain so stubbornly protectionist-minded? Posing the question in this way demonstrates the need to move beyond the traditional clichés. Opinion surveys have repeatedly shown that a large majority (65 per cent) of the French population have a 'very or somewhat favourable opinion' of freer trade, only marginally less than is the case among the British (72 per cent), the Germans (70 per cent) and the Americans (66 per

2 Table 1 is based on 'product market regulation' indicators from an international database on the regulations imposed on products and services in OECD countries (Conway, Janod and Nicoletti, 2005). They vary from least (0) to most (6) restrictive regulation in thirty OECD countries in 1998 and 2003 (they do not cover all the new EU member states).

cent) (German Marshall Fund of the United States, 2005). These figures do not capture French fears about globalisation; neither do they capture German, British or American ones. But these fears are much more closely related to what happens in services, and so are discussed in more detail in the services section, below.

Agriculture

If there is one goods sector in which the single market's progress depends heavily on multilateral trade opening, it is agriculture. Modelling the gains from farm liberalisation suggests that the EU is a key winner: the EU alone would obtain around half of all global gains from full liberalisation by the developed countries alone, and roughly one third of the gains from worldwide liberalisation (Anderson et al., 2001). But on the other hand, liberalisation by the EU is also a key condition for net gains by other countries, in particular a large number of developing countries (Diao et al., 2003).

The CAP: implacable foe of the single market in agriculture

The Common Agricultural Policy (CAP) has systematically prevented the emergence of pan-European farm markets because its subsidies and price supports protect each member state's inefficient farmers from more efficient ones, be they from foreign countries or from other member states. The 2003 CAP reform is a shining example of this. As it maintained support prices and the level of domestic subsidies (FAPRI, 2003; OECD, 2004), it did not open EU farm markets to world competition. This is best captured by the fact that the reform has reduced the EU's average tariff-like

protection level by a miserable two points, from 57 to 55 per cent (OECD, 2004).[3]

As a result, the 2003 reform was nothing more than a 'box game' – i.e. the EU just used sleight of hand to shift its subsidies from the WTO's Blue Box to the Green Box by 'decoupling' them (defining them independently from the current level of production). But decoupling has fuelled fears of a mass movement of large farmers towards new crops, all the more so because the 2003 reform has done nothing whatsoever to eliminate, or even weaken, the CAP's strong bias in favour of large farms – the largest 20 per cent of European farms get more than 70 per cent of all European farm subsidies. As a result, some member states have begun to protect the relatively less subsidised crops (such as fruits and vegetables) against investments funded by decoupled subsidies – one more step in fragmenting EU farm markets. The 2003 decoupling policy has an additional major shortfall. As no deadline was imposed on the decoupled payments (leaving the impression that such payments were there for ever) the 2003 reform tried to justify subsidy decoupling by a renewed insistence on a wide range of 'cross-compliance' criteria based on statutory environmental, food safety, animal welfare and animal and plant health standards. A non-exhaustive 'priority' list of eighteen such statutory standards has been added to two more general conditions (farm land must be kept in 'good productive' condition, and there should be no significant decrease in total permanent pastoral area). All these norms will fragment member states' farm

3 This shift in subsidies concerns only acreage- or headage-based subsidies, i.e. only 30 per cent of total EU farm subsidies. The average tariff-like protection level is measured by the 'producer support estimate', which takes into account the various instruments of protection used by the CAP.

markets even more – there is no such a thing as 'uniform' enforcement of norms.

Even in the only case (rice) where the 2003 reform includes a serious price cut and possible market opening, it has been a source of fragmentation.[4] The rice price cut was dictated by the Everything But Arms (EBA) initiative, but as EBA beneficiaries are not among the most efficient rice producers in the world, the EC is expected to introduce import quotas for rice exported from non-EBA developing countries – one more step towards a 'Multi-Food Agreement'.

So Commissioner Mandelson is only half right (or wrong) when he asserts that 'Agricultural reform is painful politically. We know because we have done it' (Mandelson, Geneva, 28 July 2005).

The Doha Round: the single market is agriculture's best friend

The Doha negotiations are absolutely critical for generating a single market in farm products. Focusing them on export subsidies would be a dreadful mistake. It would allow EU negotiators to sell a rapidly depreciating asset (EU export subsidies have decreased by half since 1995 (European Agricultural Guidance and Guarantee Fund, annual reports)) at a grossly inflated price. All it would do in any case would be to bring about the trading environment that manufactured goods faced in the early 1950s, hardly evidence of real progress in terms of trade liberalisation

4 The two other cases have involved an even more marginal product (rye) and a sizeable product (butter). But the fact that butter is one of the many possible dairy products significantly dampens the negative effects of the price cut, and the transfer of support from consumers to taxpayers is huge (OECD, 2004).

– indeed, a cost for non-EU consumers of farm products. Last but not least, export subsidy elimination alone will generate welfare losses to many developing countries since it will reduce EU farm supply without bringing enough incentives to increase non-EU agricultural supply (Anderson et al., 2005). This last point will play a crucial role in the ongoing Doha Round negotiations during 2006. As the EU has de facto agreed to eliminate export subsidies, it should reduce tariffs and domestic support if it does not want to be seen as responsible for a deterioration in the welfare of developing countries – in particular of the poorest countries – or of the net food importers (many of them located in northern Africa or in the Arabian peninsula).

Almost all the welfare gains (93 per cent) from world farm liberalisation will come from tariff reductions, and two-thirds of these gains from tariff reductions undertaken by the industrial countries. What, then, would be the ideal tariff decrease pattern to be followed by the EU? Economic analysis shows that a 'uniform' level of protection (that is, the same level for all products in question) provides most of the gains that could be expected from free trade – if this level is moderate. This is because investments and resources are allocated according to relative domestic prices, which are themselves undistorted by different levels of protection, and hence aligned to the world relative prices (everything is in relative terms). Over time, because a uniform level of protection gives no advantage to one industry over others, it also drastically reduces opposition to further tariff reductions, as illustrated by the few countries that have adopted uniform tariffs since the 1980s – Chile, Hong Kong and Singapore.

The current level of EU protection (in PSE – producer surplus equivalent – terms, that is, combining tariffs and subsidies) ranges from roughly 20–25 per cent to several hundred per cent (sugar and meat). Targeting 15–20 per cent as the basis for a uniform level of protection at the end of the Doha Round implementation phase would thus represent a substantial liberalisation of the most protected sectors, and would provide a strong stimulus for the massive resource reallocations that must, in the long run, take place among farm products.

This move would imply reductions in CAP production subsidies (domestic support). Removing subsidies will have to take account of the state of the 'conventional ignorance' – we cannot speak here of 'conventional wisdom' – in Europe. Some European farmers have said that they would accept the elimination of all subsidies if farm gate prices were to increase (von Reppert-Bismarck, 2005), yet they do not realise that this would indeed be one of the outcomes of a substantial farm liberalisation.

Political economy issues

Politically, domestic support reduction may be more difficult than tariff reduction. It has a more visible distributive element than is the case for tariffs, which apply to all farms producing the same product. This difficulty can be addressed by drawing a clear distinction between large and small farmers. Awareness-raising campaigns in several member states, including France (Boulanger, 2005), have shown that the CAP's main beneficiaries are large farms – and this is the Achilles heel of the current CAP, since European public opinion supports the CAP largely to the extent that it targets small farmers.

It is often argued that the concentration of domestic support on large farms merely reflects the decision (perpetuated by the

decoupled payments introduced by the 2003 reform) to define EU farm production subsidies on an acreage or headage basis – hence the larger the farms, the higher the subsidies. But the implicit assumption behind such a definition can be challenged in two ways. From an efficiency perspective, one may question why farm subsidies have been systematically considered as subject to constant returns to scale, with no element of scale economies. From a distribution point of view, one may wonder which logic could support both 'flat' subsidy rates and increasing income tax rates – a more consistent pairing would be increasing tax rates and decreasing subsidy rates.

The Doha Round of world farm liberalisation should therefore not only be an opportunity to reduce European tariffs and domestic support. It should help small European farmers to realise that their interests are not the same as those of large commercial operators. Hence, it should help politicians reassess the respective roles of large and small farms, if only by taking into account the fact that the large farm sector is the one that is the most involved in world trade, and the most able to adjust to liberalisation.

A rebalancing of domestic support between large and small farms may put more pressure on the most free-trade-oriented member states since they have a higher proportion of large farms.[5] It has escaped the attention of many observers that the CAP protects, on average, the farm sectors of these member states

5 The current data on farm size may, however, provide an imperfect view of the situation. For instance, French regulations have systematically constrained the size of individual farms, but they could not prevent members of the same family or investment club from jointly managing their individually owned lands – hence French farms could be more concentrated than they seem under current data. Indeed, improving such information could be a helpful by-product of fuller information on the concentration of farm subsidies.

Table 2 **Assistance to domestic farmers, 2002**

Rank	Member state	Level of assistance* absolute	relative†
1	Malta	37	67
2	Greece	40	73
3	Portugal	43	78
4	Spain	43	78
5	Hungary	44	80
6	Italy	45	82
7	Poland	47	85
8	Netherlands	53	96
9	Denmark	54	98
10	Slovakia	54	98
11	Estonia	55	100
12	Belgium	57	104
13	Czech Rep.	57	104
14	Slovenia	57	104
15	Austria	59	107
16	France	59	107
17	Latvia	59	107
18	Germany	61	111
19	Lithuania	62	113
20	Sweden	71	129
21	Britain	72	131
22	Finland	72	131
23	Luxembourg	75	136
24	Ireland	99	180
–	Cyprus	n.a.	n.a.
EC-15		55	100

Sources: OECD on PSEs, EC on farm production
*Measured by the producer surplus equivalent (PSE). Member-state PSEs are EC PSEs by product weighted by member-state production
†EC15 = 100

more heavily than those of the most protectionist member states. This is because CAP trade barriers are defined at the EU level, while their effective impact on each member state varies with its individual production structure: a member state producing

mostly goods protected by high EU measures is de facto more 'protected', on average, than a member state producing mostly moderately protected goods. As a matter of fact, EU barriers provide an average level of protection of more than 70 per cent to the farm output of free-trade-oriented member states, such as Britain or Sweden, compared with 59 per cent for protectionist France, and 55 per cent for the EC15 (see Table 2). En passant, this little-known fact reveals the fundamental hypocrisy (or incompetence) of French farm trade policy: the French people believe that it is designed to protect small, traditional farmers, yet their governments persistently allow the agenda to be driven by the interests of large operators, which grow the same kinds of crops as British farms do. Although small farmers are much more numerous in France than in Britain – and provide a much more diverse product mix than their larger counterparts – their interests have not counted for much in the French government's farm trade 'strategy'.

These higher pressures on the most free-trade-oriented member states can be softened, even possibly eliminated. Reduction of domestic support could be modulated by member state and by region. For instance, the European global subsidy reduction would be shared between member states via a Europe-wide formula, while the resulting member-state reductions would be shared between farms of different sizes according to a formula to be defined by each member state. As a result, some member states could decide to share uniformly their own subsidy reductions independently of farm size, while others could do so by taking into account such a criterion.

Manufacturing

In sharp contrast to the largely non-existent farm single market, the single market in industrial goods is relatively advanced. But there are still a few crucial things to do, and many essential things *not* to do.

Still a lot to do …

That there is still a lot to do to bring about an effective single market in industrial goods is revealed by the fact that price dispersion across member states is, on average, 20–25 per cent higher than within member states (even on the basis of comparable, highly tradable goods, and after controlling for distance and other specific characteristics) (de Serres et al., 2001). This kind of market fragmentation is deeper in Europe than in the two other large OECD economies, and it amplifies the costs of protection for European consumers.

The first order of business should therefore be the elimination of the remaining extra-EU trade barriers, which are still substantial, as documented by Table 3, in the thirty-eight sectors (out of a total of ninety-seven sectors) with maximum tariffs higher than 10 per cent.

Lack of intra-EU competition also mirrors persistent and severe problems in regulatory matters, particularly in norms and standards. Roughly half of the existing 1,600 Directives deal with norms and standards. Moreover, the notifications of a few member states well known for their transparency (Denmark, the Netherlands and Sweden) show that member states remain prolific producers of norms and standards, as shown by Table 4; the low figures for the other member states may be more due to

Table 3 **Sectors with a substantial level of protection, 2004**

Sectors (HS2)	*Products*	*Average tariff (%)*	*Maximum tariff (%)*
04	Dairy products, birds' eggs, etc.	38.4	209.9
02	Meat and edible meat offal	28.9	192.2
07	Edible vegetables	13.2	150.1
20	Preparations of vegetables	20.9	146.9
08	Edible fruit and nuts	10.4	118.1
17	Sugar and sugar confectionery	23.6	114.4
01	Live animals	20.6	107.8
10	Cereals	39.6	101.1
16	Preparations of meat	18.5	97.2
11	Products of milling industry	22.2	84.5
23	Residue from the food industry	7.0	76.0
15	Animal or vegetable fats	8.9	75.8
24	Tobacco and tobacco products	18.3	74.9
18	Cocoa and cocoa products	17.9	68.9
22	Beverages	5.7	58.6
12	Oil seeds	2.0	52.3
19	Preparations of cereals	20.3	49.6
29	Organic chemicals	4.3	39.8
37	Photographic goods	5.6	23.3
35	Albuminoidal substances	7.1	23.2
03	Fish and crustaceans, etc.	12.2	23.0
38	Miscellaneous products	5.6	22.2
87	Vehicles other than railway	6.4	22.0
21	Miscellaneous edible preparations	9.6	21.1
13	Lac, gums, etc.	2.2	19.2
33	Essential oils	2.9	17.3
64	Footwear	9.9	17.0
85	Electrical machinery	2.8	14.0
09	Coffee, tea, etc.	3.1	12.5
56	Wadding, felt, etc.	6.1	12.0
61	Articles of apparel (knitted/crocheted)	11.7	12.0
62	Articles of apparel (non-knitted/crocheted)	11.6	12.0
63	Other made-up textiles	10.0	12.0
69	Ceramic products	4.8	12.0
91	Clocks and watches	3.8	11.2
70	Glass and glassware	4.8	11.0
06	Live trees	6.0	10.9
76	Aluminium and articles thereof	6.3	10.0

Source: WTO, Trade Policy Review, 2004

Table 4 **Notification of EC norms and standards to the WTO, 1995–2003**

	Notifications			
	Number		*Number per million euros GDP*	
	1995–99	*2000–03*	*1995–99*	*2000–03*
Austria	5	0	27	0
Belgium	150	57	709	230
Britain	12	18	14	12
Denmark	133	54	965	315
Finland	24	13	240	99
France	59	37	49	26
Germany	14	0	7	0
Greece	0	0	0	0
Ireland	1	0	20	0
Italy	0	3	0	3
Luxembourg	4	0	290	0
Netherlands	459	105	1,447	261
Portugal	0	0	0	0
Spain	34	32	76	51
Sweden	84	49	443	189
EC15	167	61	25	7
Total	1,144	429	86	25

Source: WTO, Trade Policy Review, 2004

reporting problems than to regulatory lethargy. These problems, which are very similar in nature to those faced in services, require the same approach as that suggested below for services – that is, nurturing a 'culture of evaluation' that aims to regularly assess the real value of the enforced norms and standards at both the EU and member-state levels.

… and a lot not to do

In addition to these positive steps, it is also important to counsel a certain degree of 'masterly inactivity' in other areas. One example

is the need to resist the emerging calls for a 'strategic casino-and-yogurt policy', which would aim to impose limits on takeovers in order to protect some firms deemed essential to the national economy. For instance, a French decree published on 31 December 2005 allows the French government to block foreign takeovers in eleven designated sectors related to national security, one of them being casinos. This surrealistic casino case, the strong French government pressures in the Taittinger (champagne) and Danone (yogurt) cases, and the nationalistic reactions to the Arcelor-Mittal (steel) case generate suspicions about the real limits of capital mobility in Europe. In the past, the EU has already faced such calls for internal liberalisation accompanied by more aggressive and autarkic trade policies (Henderson, 1991).

The threat is all the more serious because nowadays there are plenty of other opportunities to invest all over the world, meaning that the member states playing with the strategic casino-and-yogurt policy may pay a high price for it – in terms of forgone investments leaving for better skies. These costs are amplified by the fact that the member states where this policy has some appeal face high debt and mounting public deficits, meaning that their governments' hands are largely tied, and hence they may lose long-term credibility by ultimately doing nothing – except awakening and flattering nationalistic feelings.

A crucial condition – too often forgotten – for beneficial international investment is uniformly open markets, so that international investors are not induced to invest in the most protected sectors of a country. In this respect, the EU's increasing tendency to use contingent protection as a back-door route to protection is very worrying – all the more so when one knows the vast capacities of such protection to hit specific targets and distort economic decisions in detail. Since mid-1995, the situation has seriously deteriorated. First, the number of anti-dumping measures in force increased by 56 per cent between 1991 and 2003, and this does not even include the 'grey' agreements between firms aiming to keep import prices high and/or imported quantities low under anti-dumping measures. Interestingly, member states do not seem to have the same interest in anti-dumping policies. Table 5 shows two apparently stable coalitions of member states, one that routinely supports the imposition of anti-dumping measures, and one that opposes them – a delicate balance that allows the Commission to magnify its grip on the whole process (Evenett and Vermulst, 2004). It remains to be seen whether the latest enlargement will change this situation. One may fear that the new member states are more sympathetic to anti-dumping measures (at least in the short run) because the competitive pressures on some of their industries may have increased since their accession.

Second, this steady increase in anti-dumping has not prevented the EU from using a steel safeguard (2002) as a substitute for the many anti-dumping cases already filed by that industry. The EU steel safeguard has proved to be worse than any anti-dumping case, in every possible respect. Its import coverage was thirty to fifty times the coverage of an average anti-dumping case. Its capacity to discriminate among foreign producers was as severe as anti-dumping, because it imposed individual tariff-rate quotas on exporting countries, each with very few (often only one) domestic steel firms. Its capacity to generate a domino effect of similar measures around the world was much greater than that of anti-dumping duties – within the space of a few months, the EU's actions spawned a worldwide web of steel safeguards. The WTO's legal conditionalities on safeguard use (existence of an

Table 5 **Voting records and views expressed by EU member states on anti-dumping matters, 1991–2003**

		Views on anti-dumping matters		*Votes on anti-dumping duties*	
*Rank**	*Member*	*Total number of views expressed*	*Percentage in favour of restrictive measures or steps leading to restrictive measures*	*Total number of votes expressed*	*Percentage in favour of definitive duties*
1	Germany	27	0.0	4	0.0
2	Sweden	20	0.0	3	0.0
3	Denmark	20	0.0	2	0.0
4	Finland	16	6.3	3	0.0
5	Netherlands	24	8.3	3	0.0
6	Britain	32	15.6	5	0.0
7	Ireland	21	23.8	3	0.0
8	Luxembourg	14	14.3	5	20.0
9	Austria	19	26.3	6	33.3
10	Belgium	16	37.5	4	75.0
11	France	22	95.5	6	83.3
12	Spain	20	85.0	5	100.0
13	Greece	13	92.3	5	100.0
14	Italy	20	95.0	5	100.0
15	Portugal	19	100.0	5	100.0

Source: Evenett and Vermulst, 2004
*Countries are ranked by increasing percentages of votes and views, and decreasing number of votes expressed.

import surge, unforeseen developments, serious injury) were blatantly misused. For instance, the alleged motive of a potential import surge caused by the US steel safeguard deliberately ignored the persistent Chinese boom since 1995 and declining excess capacity since 1999 (Messerlin, 2004). That a European steel firm (VoestAlpine) could proclaim the year 2001/02 as 'the best business year ever in the company's history', and the year 2002/03 as the second-best one, may be the shortest, most accurate and most damning assessment of the impact of this safeguard.

EU contingent protection has made one more step in the wrong direction with the measures recently imposed on Chinese clothing. The measures were adopted even though EU consumer prices of Chinese clothing did not seem to have fallen much, implying that intermediaries have pocketed the gap with the lower Chinese export prices. Moreover, there is the persistent rumour that EU imports of clothing from the whole world have not changed very much, meaning that what happened was mostly just a change in the sources of European imports.

The worst news of all is that the EU's protection has taken the form of 'voluntary export restraints' (VERs), an instrument banned by the Uruguay Round. There is a serious feeling of déjà vu for those who observed the myriad of VERs imposed on a never-ending number of Japanese products over the three decades following Japan's accession to the GATT (the WTO's predecessor). A parallel between China and Japan naturally has many limits. But this is not overly reassuring. In the Japanese case, rents were fully transferred to Japanese firms because the national bureaucracy was not corrupt. This feature ultimately helped stop the use of VERs: as time went on, Japanese firms used these rents to upgrade their products, making European (and US) firms learn the hard way that VERs were not a solution, but a problem. By contrast, Chinese regional and national bureaucracies will take their share of the rents. Internal conflicts over rent-grabbing may impede the efficiency gains of Chinese firms, leading them to fight for retaliation against the EU (in sharp contrast with the unfailing cooperation of the Japanese).

What is needed is much less a rewrite of the WTO rules on contingent protection than an effort to assess the impact of EU contingent protection on the EU's own economy. All these cases have the same Achilles heel: they involve very narrow vested interests. This allows us to shift away from the general debate on 'protection versus free trade' – a debate too general to convince unconvinced people – towards a series of cost–benefit analyses on a case-by-case basis. The advantage of such an approach is that it highlights the net costs for the EU, at the same time as setting them against the benefits appropriated by 'the happy few'. It is also a natural starting point for developing non-protectionist solutions to possible adjustment problems. Contingent protection cases therefore offer an excellent opportunity to assess public policy measures – what I refer to as a 'culture of evaluation' below. Such a task cannot be undertaken by the Commission itself, since it has instigated the measures in question. It is up to independent European think tanks to reveal the untold side of these cases.

The single market in services: the promised land?

The single market in services is clearly generating more and deeper fears than the single market in goods – and not only in France. Polls capture these fears when they shift from questions on freer trade to those on globalisation. For instance, a majority (55 per cent, a figure amazingly close to the French '*Non*' vote) of the same French people who support freer trade so strongly nonetheless have a 'very or somewhat unfavourable opinion of globalisation'. The figure for Germany is not so different (48 per cent), in contrast to those for Britain and the USA (39 and 36 per cent, respectively), as one might expect.

If not overcome, these fears will be very costly for European consumers. The welfare gains to be expected from an open single market in services are huge – indeed, much larger than those from goods – for three mutually reinforcing reasons. First, the services sector itself is huge: 70 per cent of European GDP, almost three times the size of manufacturing. Second, the level of protection in services is much higher than in goods – a crucial point, since welfare costs grow much faster than the level of protection (the rule of thumb is that they are a square function of the protection level). Most available estimates of the level of protection in services are within the 15–25 per cent range, when expressed in *ad valorem* tariff-like terms, compared with roughly 10 per cent in goods. But because they generally cover broad services sectors, such as 'telecom services' or 'distribution', these figures do not include all the devils-in-the-detail that characterise protection in services. When looking at services on a disaggregated basis, anecdotal evidence suggests a level of protection often above 50 per cent when expressed in tariff-like terms.[6]

Finally, protection in services occurs not only at the member-state level, but also at the sub-national level – a big difference when compared with the goods case. For instance, opening a large retail store or a hotel in France is a successive mix of barriers at the town, *département* and national levels. This much higher degree of market fragmentation exacerbates the possibility of nurturing a myriad of local collusions, creates repeated costs for new entrants, and magnifies the costs of protection.

6 Lack of systematic evidence prevents us from providing estimates of the costs of protection in services comparable to those available for protection in goods.

Harmonisation and mutual recognition: ineffective instruments

So far, the Directives adopted for liberalising services have attempted to address people's fears using two instruments. Harmonisation seemed apt to eliminate fears of 'unfair' competition, while mutual recognition seemed a workable approximation of harmonisation. These two approaches have, however, proved to be largely ineffective in opening markets.

Harmonising existing domestic regulations by negotiating common European regulations has proved to be very costly (some Directives have required more than fifteen years of negotiation), too easy to reverse (since a harmonised regulation can be quickly 'de-harmonised' by member states imposing additional 'practices' when implementing the harmonised text), and in any case has provided no guarantee of efficient regulation. The recent EU enlargement makes these handicaps even more severe: the more negotiators there are, the more hopeless it is to try to get them to agree on a single, harmonised rule.

The mutual-recognition approach was seen as the appropriate answer to the harmonisation impasse. It consists in harmonising only the 'key' provisions to be included in the new common regulation, and imposing 'mutual recognition' for the rest of the provisions existing in individual member states' regulations. Its benefits have, however, been much more limited than expected, for two reasons. First, they depend critically on the relative importance of the mutual-recognition component as compared with the harmonisation component. The negotiations among member states which determine this balance have systematically inflated the latter to the detriment of the former.

Second, the benefits from mutual recognition increase with the diversity of the regulations involved: the more diverse the regulations of the countries concerned are, the more numerous can be the varieties of competitive pressures that a mutual-recognition agreement can offer. Contrary to what happened with trade in goods, however, the single market in services did not benefit from a genuine multilateral services liberalisation, and from the wider diversity it could offer. Once again, the recent EU enlargement can only amplify these problems by involving more negotiating member states, without necessarily getting a more substantial diversity of regulations.

The Services Directive

In this context, the proposed Services Directive (hereafter 'the Directive') tabled by the Commission constitutes the first serious attempt to create an effective single market in services by going beyond harmonisation and mutual recognition. It has faced unprecedented opposition, however, which needs to be understood and properly assessed in order to define a workable long-term strategy. (What follows focuses on the Directive initial proposal, since the Directive has not yet been adopted by the Council.)

The first serious attempt to create an effective single market in services

An effective single market in services is not a simple matter – after all, it is not yet completed even in a fully fledged federation like the USA. The creation of such a market needs to satisfy three basic conditions; the Services Directive indeed does so.

The first condition is to have the widest possible sectoral coverage. This feature provides for the most 'uniform' level of protection possible across different services sectors, a point that

has attracted surprisingly little attention so far. Service providers whose inputs are modestly protected but whose outputs are highly protected benefit from a level of 'effective' protection much higher than the 'apparent' level of protection imposed on their outputs alone. For instance, such effective levels of protection (expressed in tariff-like terms) in the French audiovisual services range from less than 8 per cent in the movie theatre segment to more than 70 per cent in the broadcasting segment, and more than 100 per cent in the movie production segments (Messerlin, 2003).

Indeed, the Directive covers a huge share of GDP (50 per cent according to the Commission), much more than all the existing Directives on services put together, and twice that of the goods sector. The uniform protection it would help bring about would have the same beneficial effects in services as those highlighted above for agriculture and manufacturing.[7] Its dynamic effects on market structures and innovation may also bring the single market more within the reach of the small and medium-sized service providers that have been largely excluded from it to date. Sectoral services liberalisation is easier to manage for large firms than for small and medium-sized ones. For instance, large firms could cope with the absence of a single market in legal services more easily than smaller firms by hiring the services of large legal firms with worldwide operations, a move out of reach of most smaller firms. If small and medium-sized firms are an essential source of innovation, their fuller integration into the single market would boost

7 The previous Directives could not offer these gains because their narrow sectoral coverage lowered the effective level of protection of the services they liberalised, but increased the effective level of protection of other services. They have thereby systematically distorted the production pattern of services, since firms operating in liberalised sectors have incentives to shift their activities into more protected sectors.

innovation, and hence variety, in European services, as has been the case for goods.

The second condition for an effective single market in services is the largest possible freedom of establishment (that is, investment in agencies, branches or subsidiaries in the other member states' services markets). Too often, host member states still infringe EU rules and impose 'requirements' on investors, limiting entry to such an extent that consolidations in still-fragmented markets turn into anti-competitive strategies – making entry more difficult.

Indeed, the initial proposal of the Directive addresses this issue in two steps. First, it 'systematises' the rulings of the European Court of Justice by providing a list of host member states' requirements that the court has consistently banned over time, and hence for which there is no risk of the jurisprudence being reversed in the future. For instance, the proposal prohibits requirements based on nationality, conditions on the maximum number of member states in which a firm can be established and the case-by-case application of an 'economic test' in order to be registered (Article 14). By banning these requirements, the Directive proposal eliminates the need for firms to bring new suits before the court on a one-by-one basis, thereby decreasing transaction costs massively. Second, the Directive proposal lists another set of requirements, such as quantitative or territorial restrictions, requirements fixing a minimum number of employees, etc., which have not been systematically condemned by the court because they can make economic sense in specific circumstances (Article 15). As a result, the proposal makes the elimination or the adjustment of these provisions conditional on an assessment procedure of 'mutual evaluation' (Article 41). This is a very interesting procedure to the

extent that it defines a dynamic process of liberalisation as well as a liberalisation programme per se.

The last condition necessary for an effective single market in services is the liberalisation of 'cross-border trade' in services, be it the 'physical' trade of services (such as legal advice sent by fax by a foreign expert to a domestic operator) or the trading of services through labour movement (such as a non-permanent sojourn of experts from one member state in another member state). Cross-border trade under a 'principle of country of origin' (hereafter PCO) regime would invigorate firms' competitive behaviour by injecting a new layer of competition, namely competition between member states' regulations. When constrained by host-country regulations, investors in services from other member states are induced to follow the prevailing behaviour in the market in which they are investing (after all, this behaviour has been tested by host-country firms and found to be profitable in that particular environment). In sharp contrast, exporting firms under the PCO can design, more often and/or more strongly, a strategy different from the one followed by host-country firms, because they can use their home-country legal environment to exploit their comparative advantages.

The tabled proposal does indeed open cross-border trade by stating that 'member states shall ensure that [services] providers are subject only to the national provisions of their member state of origin' (Article 16). The PCO boils down to adopting the mutual recognition principle for all the provisions of the regulations in question – there is no longer any need to negotiate the harmonisation component.

Assessing the opposition to the Directive: rent-seekers strike back

The Directive came under strong attack during the French referendum campaign. Anti-market NGOs were, predictably, very vocal against it. The French president chose to placate them by declaring that the Directive was finished, even while it was still under examination by the European Parliament. A French press largely ignorant (and eager to remain so) rarely reported accurate information on the basic facts that were at the root of people's main fears (such as the fact that the Directive kept intact member states' individual rules governing national labour markets, including minimum wages, work conditions, diplomas, etc.). All this has given the impression that the opposition to the Directive was concentrated in France. But this is inaccurate.

Opposition to the Directive is much broader because its wide sectoral scope (a key asset from an economic perspective) has produced heavy political costs by uniting a huge number of monopolies or collusive firms all over Europe. The Hearings of the European Parliament on the Directive in November 2004 (well before the French campaign) provide a fascinating view of the Europe-wide unholy alliance between the supporters of public monopolies (see, for instance, Jennar, 2005) and those of the many narrow private monopolies under threat, particularly in the areas of professional and legal services – one of the best illustrations is the case of the French *huissiers*, *notaires* and *avocats près les Cours suprêmes* (bailiffs, notaries and barristers of the Supreme Courts) (Guillaume, 2005).

At the same time, the silence of the Directive's potential beneficiaries has been as deafening as the vocal opposition, and it is important to understand it. Large firms might get what they want most, namely the prohibition of the most blatant

barriers to foreign establishment (Article 14). But they may have conflicting interests with regard to the second list (Article 15), to the extent that some of the listed requirements might actually play a positive role in their corporate strategies. And they may have only a marginal interest in the cross-border trade to the extent that, as argued above, they have been able to cope with the existing barriers to trade in services by investing directly in the various member states. Small and medium-sized firms have similar incentives to large firms with respect to foreign establishment, although these incentives may be weaker, since investing in other EU markets is generally more costly for them. By contrast, they may have stronger interests in opening cross-border trade and adopting the PCO, except insofar as they may be benefiting from the current barriers (for instance, by hiring Polish plumbers or tilers in the French and German grey markets). Few small and medium-sized firms seem to have developed an export strategy, however, and many of them have not been aware of the Directive proposal, and its potential benefits for them.

As usual, the strongest supporters of the Directive should have been consumers – be they households or firms. But consumers have been torn between the gains in terms of price cuts or variety increases and the fears of losing in terms of information or legal protection in the case of defective services. In sum, the Directive is facing an uphill struggle, not only because services are a source of cosy monopolies or collusive oligopolies much more often than is the case for goods, but also because most suppliers and consumers find it more difficult to assess the net welfare effects of services liberalisation.

Lines of action

The combination of a strong opposition and a lack of support has differing impacts on the three conditions required for an effective single market in services.

First, the opposition may reduce the Directive’s sectoral scope. This is a frequent, though unfortunate, turn of events in relation to liberalisation policies. If the final proposal of the Directive covers a substantial share (say 25 per cent) of GDP, however, it would still represent a huge step forward, equivalent to all goods market liberalisation over the last fifty years. Moreover, if the expected benefits from the Directive materialise, they will induce use of the Directive as a blueprint for liberalising other services, including those covered by the existing Directives – a perspective that has already triggered pre-emptive strikes against the Directive from some sectors, such as financial services. As in any incomplete trade liberalisation, the thing to do is to look at the most blatant remaining cases of protection, and estimate their welfare costs for consumers.

Another possibility is to envisage a ‘two-speed’ introduction of the Directive, with a first group of member states adopting and implementing the Directive provisions as they are, the other member states being free to join the first group whenever they wish, on the existing conditions (i.e. no renegotiations to accommodate latecomers). Since this approach is a severe breach of the consensus-based method adopted so far by the EU, it may require some a priori definition of the ‘first group’ in order to be accepted. The best definition could be provided by a concept that was used in the first years of the WTO – the ‘critical mass’; that is, a number of countries large enough to represent a share of imports or value-added higher than a predetermined threshold.

A final possibility is to buttress intra-EU liberalisation with multilateral negotiations. As underlined above, GATT negotiations made much more palatable to member states intra-EU deals that were initially impossible within the EU forum alone. The same could be done with the services negotiations in the General Agreement on Trade in Services (GATS), all the more so because it is now clear that for a substantial number of developing countries (including key ones in terms of negotiations, such as India) opening trade in services will bring far more welfare gains than opening trade in goods. The GATS legal framework is much weaker than that of the GATT, however, making it difficult to bring about substantial concessions in services in a multilateral environment, as illustrated by the current Doha Round negotiations.

The damage would be much more serious if the price to be paid for the Services Directive were to be a Directive on ‘public and/or universal services’ (instead of reduced sectoral scope). Such a development would insulate small but critical sectors from competitive pressures for a long time to come, and would bring with it the likelihood of distortions spreading to other sectors through cross-subsidisation and network-based foreclosures. Preventing it is therefore crucial. It would mean not only estimating the costs of the distortions artificially created by such a Directive, but also highlighting the gains from alternatives to public monopolies for providing these types of services.

Second, criticisms have been moderate on the foreign establishment dimension of the Directive proposal. In fact, foreign establishment seems to be viewed more often than not as labour-friendly (foreign firms tend to use member-state nationals to develop their services in the host state). This is consistent with the fact that the successive campaigns against 'offshoring' in services have not been successful so far, despite many efforts by NGOs.

There is, however, a need to strengthen the procedure of mutual evaluation that the Directive introduces for assessing the requirements on foreign establishment. The current procedure is weak because it limits the assessment task to just three criteria – whether the requirement under examination is non-discriminatory, whether it is justified by an overriding reason related to the public interest, and whether it is proportional to its objective. These criteria are the ones used by the court in examining a requirement pertaining to the second list. The problem is that the Directive leaves the evaluation of these criteria to (undefined) national authorities and to the Commission. This is a recipe for volatile and inconsistent decisions, all the more so because this procedure can pose a serious threat to vested interests, and hence trigger strong opposition. Promoting a vibrant 'culture of evaluation' is therefore crucial – the idea is developed below in more detail.

Finally, opposition to the Directive has focused on the PCO. Many of the criticisms against the PCO were fuelled by confusion, if not by outright disinformation. In particular, opening cross-border trade was understood by many people as equivalent to eliminating member states' regulations on national labour markets (minimum wages, work conditions, diplomas, etc.), even though the Directive proposal makes it crystal-clear that it does not deal with such rules.

To restore some sanity to the debate, one should recall that the Directive is not the first one to use the PCO. Both the 1989 and 1997 Directives on Television without Frontiers require foreign TV channels to follow the regulations of their country of origin,

including the sacrosanct regulations on broadcasting quotas. Why, then, did the PCO attract almost no attention in such a sensitive sector as audiovisuals, whereas it touched a raw nerve in the case of the Services Directive? Two reasons seem paramount. First, technology made it hard to ban the PCO in audiovisuals – any other rule would mean jamming radio or TV waves, hardly acceptable in democracies. There are no such technological and political constraints in the services covered by the Directive. Second, 'natural' transaction costs (languages, tastes) are strong impediments limiting cross-border trade in broadcasting. Such natural costs are lower for most of the services covered by the Directive, which then represents a much greater potential threat to vested interests. There is also, however, a deeper explanation for the outcry against the Directive.

A regime of regulatory competition requires a vibrant culture of evaluation

There have already been instances of regulatory competition in Europe. What is new in the Directive is the institutionalisation of that process: it effectively makes it part of the EU legal regime. This change has triggered two different types of systemic fears.

First, regulatory competition clashes with the idea of 'convergence' in regulations. Convergence is a weak form of harmonisation – the vague hope that in the long run there will be a unique set of regulations for a given service sector in the EU. This hope prevails in most EU circles because it gives EU decision-makers something to make decisions about. It is also a commonly held view among European populations because it looks reassuring, in particular when national governments have a tendency to let their citizens believe that 'convergence' in fact implies nothing more than an extension of their own national standards to the rest of the EU.

By contrast, a regime of regulatory competition offers no systematic outcomes in terms of convergence, and above all no apparent guarantee for individual citizens that the standards applied in their own country will not change. It may lead to regulatory convergence in some cases, but also to a wider range of regulatory varieties in other cases. In modern economies, firms compete by differentiating their products or services at least as much as by charging different prices for similar products or services. There is no a priori reason why member states will not behave in the same way when designing their regulations, and this is a perspective that does not sit easily with the idea of integration as unification (often understood as 'uniformity').

Second, regulatory competition is often associated with the idea of a 'race to the bottom'. This is fuelled, in fact, by a twin lack of trust. On the one hand, most Europeans certainly do not trust the governments of the other member states. The recent EU enlargement has exacerbated this mistrust, with the new member states still suffering from their past: conservative 'Wessies' are suspicious of these reformed communists, while leftist 'Wessies' cannot find it in their hearts to forgive these countries for abandoning the communist 'dream' and shifting to a market economy. The good news is that this situation can be expected to improve over time, in particular if there is a big success story to focus on, a kind of 'central European Ireland'. The bad news is that the second lack of trust generating fears of a 'race to the bottom' is potentially much more serious: many Europeans simply do not trust their *own* governments. And unfortunately, their governments do not seem

to be doing much to remedy the situation, in particular as they let the distance between rhetoric and action grow (see the 'strategic casino-and-yogurt policy' above).

Overcoming fears of a race to the bottom cannot be achieved by a general argument about the benefits of regulatory competition. Such arguments convince only the already convinced. What is needed is a culture of evaluation relying on the best and most systematic cost–benefit analysis of concrete cases. By showing that any liberalisation brings global gains but leaves some net losers, a culture of evaluation shifts the spotlight to two key questions: is there a need for an adjustment policy, and, if yes, what would be the best compensation instrument to use? Nowadays, there is a strong tendency to ignore the first question, and to assume that any net loser deserves adjustment support – an approach that imposes excessive constraints on a market economy. The answer to this question should not be a systematic yes, however, but rather should flow from a careful examination of each case, including from a political perspective. For instance, the question of whether large farmers who have been subsidised by the poorest consumers and by taxpayers during the last four decades have a 'right' to be compensated deserves a thorough debate.

If the culture of evaluation is such a necessary condition for getting an effective single market in services, then who should generate this culture? Of course, there is a role for governments, and some countries have indeed taken this approach, such as Australia with the Productivity Commission (Banks, 2005), or the USA with the Office of Management and Budget (Hahn and Litan, 2004).

The EU situation, however, is clearly far from satisfactory in this respect. Table 6 shows how far (not how effectively) member

Table 6 **Regulatory impact assessment: the situation amongst the member states, 2005**

	Does a better regulation programme exist?	*Does a specific RIA policy exist?*	*Are RIAs obligatory?*	*Are alternative instruments considered?*	*Do RIA guidelines exist?*	*Is there a coordinating body for RIAs?*	*Consultation part of RIA?*	*Do formal consultation procedures exist?*	*Does direct stakeholder consultation exist?*	*Are there tests of impact on SMEs?†*	*Does an exemption exist for SMEs?*	*Total**	*Rank*
Britain	3	3	3	3	3	3	3	3	3	3	0	9.1	1
Denmark	3	3	3	3	3	3	3	3	3	3	0	9.1	2
Poland	3	3	3	3	3	3	3	3	1	0	3	8.5	3
Latvia	3	3	3	3	3	3	3	3	0	3	0	8.2	4
Sweden	3	3	3	3	3	3	3	3	3	0	0	8.2	5
Finland	3	3	3	3	3	1	3	3	3	0	0	7.6	6
Austria	3	3	3	3	3	0	3	3	3	0	0	7.3	7
Netherlands	3	3	0	3	3	3	0	0	3	1	3	6.7	8
Hungary	3	1	3	0	0	3	1	1	3	3	3	6.4	9
Luxembourg	3	0	3	3	0	3	3	3	0	0	3	6.4	10
Germany	3	0	0	0	3	3	3	3	0	0	0	4.5	11
Italy	1	3	0	1	3	1	1	0	3	1	0	4.2	12
Estonia	0	0	3	3	3	0	0	0	0	0	3	3.6	13
Lithuania	0	3	3	3	3	0	0	0	0	0	0	3.6	14
Spain	3	1	3	3	1	1	0	0	0	0	0	3.6	15
Malta	3	0	0	0	0	1	0	0	3	0	3	3.0	16
Belgium	1	0	1	0	1	1	0	1	1	1	1	2.4	17
Czech Rep.	3	0	0	3	0	0	0	0	0	1	0	2.1	18
Ireland	3	0	0	1	1	0	1	1	0	0	0	2.1	19
Greece	1	1	0	0	0	0	3	0	0	0	0	1.5	20
Slovenia	3	0	0	0	0	0	0	0	0	0	0	0.9	21
Slovakia	0	0	0	0	0	0	0	0	1	0	0	0.3	22
Cyprus	0	0	0	0	0	0	0	0	0	0	0	0.0	23
France	0	0	0	0	0	0	0	0	0	0	0	0.0	24
Portugal	0	0	0	0	0	0	0	0	0	0	0	0.0	25
EC15	2.1	1.4	1.1	1.3	2.2	1.8	1.7	1.5	1.4	0.8	0.2	4.7	--
EC25	2.1	1.5	1.1	1.4	2.1	1.8	1.7	1.5	1.4	0.8	0.3	4.7	--

Source: European Commission, Communication COM(2005) 97 final, March 2005.

*Total scores are divided by 33 (maximum indicator) and multiplied by 10

†Small and medium-sized enterprises

states have introduced 'regulatory impact assessments' (RIAs) by giving indicators varying from a 'no' answer to the question raised in the heading (0) to a fully fledged RIA answer (3). Only ten member states (seven for the EC15, three for the EC10) have introduced RIAs in any significant way (with a score higher than 60 per cent), and, ironically, the EC10 score is better than the EC15 score. More worrying than the overall picture is the existence of a small number of truly awful performers, such as France. The situation at the Commission level is not much better. There has been an annual average of 25–30 RIAs undertaken by the Commission, a number that compares poorly with the average annual production of 60 Directives and 1,200 basic legal documents for the 1990s. Moreover, most of these RIAs do not fulfil the minimum conditions for being really useful (Vibert, 2004; Messerlin, 2006).

As a result, the vibrant culture of evaluation needed for an effective single market in services would require active independent research centres and think tanks, all the more so in light of the public's growing mistrust of their own governments. It is striking that such institutions – which have been instrumental in the bipartisan changes of approach observed in the USA and Britain since the 1970s – are largely missing from continental Europe.

Trade policy as foreign policy

As noted above, French and Dutch voters have clearly rejected the EU as a 'super-state'. But paradoxically, many of the same voters see the EU as a 'superpower'. Europe's 'superpower' is not now, and will not at any time soon, be based on a foreign policy with worldwide goals and means (an army). It can rely only on the

use of trade policy. During the last decade, the EU has mostly conceived of its trade policy in a mercantilist way by slowly returning to its age-old 'addiction' to discrimination (Wolf, 1994), despite its official allegiance to multilateralism. This drift has taken the form of bilateral preferential agreements, often qualified as WTO-plus because they extract concessions from EC trading partners (on TRIPs, investment, political commitments, etc.) that these partners would never have dared to make in the WTO. This drift has been made easier by a similar move from the USA, hence this emerging coalition of the two 'world aristocrats' confronting increasingly impatient 'world bourgeois' – the Brazils, Indias and Chinas.

Trade policy could be conceived in a much more generous perspective, whereby the EU would try to be a 'benevolent' trading partner – that is to say, a partner convinced that the extension and exercise of economic freedom make for closer economic integration, both within and across national boundaries (Henderson, 2001; Wolf, 2004). What follows suggests that the two key pending issues – the EU's relations with Turkey and with the Afrian–Caribbean–Pacific countries (ACPs) – would benefit from the second approach.

Freeing Turkey

Turkey's accession to the EU is facing strong opposition in many European quarters. To appease mounting fears or even outright hostility, EU governments are becoming increasingly rigid about the conditions to be imposed on Turkey. As a result, successive Turkish governments will face a more and more difficult challenge: no democratically elected government can easily survive twelve years of negotiations without a strong commitment from its partners. All this is related to the fact that some member states long to have much more integrated societies than others (at least ideally), and that most member states perceive the EU as a political endeavour as much as an economic entity – and hence do not envisage the possibility that a political entity including only some member states could develop. Such an uneasy situation is a sure recipe for suspicion and bitterness on both sides – and ultimately for a disastrous failure for both parties.

Promising some 'preferential' status in the future (if the EU membership option is abandoned) while keeping Turkey tied to the EU through the current customs union agreement is not the solution. In the EU perspective, a customs union is an immediate loss of sovereignty in trade matters which is balanced out in the longer run by a seat at the Council table, allowing for shared sovereignty on all matters of common interest. Not only does Turkey have no certainty as to its future seat at the Council, but it cannot even derive the full benefits of its current customs union with the EU for the following reason: it cannot duplicate the preferential agreements that the EU is concluding with many other countries because those same countries are dragging their feet in granting Turkey the same concessions they have granted the EU. Indeed, these problems contribute to the unsatisfactory functioning of the current EU–Turkey customs union.

If the EU feels unable both to make a distinction between its economic and its political goals, and to make a firm commitment in favour of Turkish accession in the next couple of years, it should take the initiative in some other way. Nothing would be more dangerous than an increasingly poisonous atmosphere.

A first option would be for the EU to give Turkey back its

full sovereignty in trade matters by offering the transformation of the current customs union agreement into a free-trade agreement. Such a solution raises a few technical issues, most notably the regime of rules of origin and of contingent protection, which could be resolved with some good will from both sides. Moreover, this solution keeps all the economic incentives necessary for a continuous rapid growth of the Turkish economy – the most crucial ingredient for a Turkish society becoming closer to European societies. The success of this option would critically depend on whether it would be seen as the signal that the EU trusts Turkey's capacity to go on its own in the direction desired by the EU – and not as a backward step by the EU. A Turkey treated in this way could provide more robust – because more internally rooted – reforms, and might be a more powerful example for the Middle East region than a Turkey under anxious and acrimonious scrutiny by EU governments. Its accession – if finally decided by the two parties – will be a lot easier.

The second option would be for the EU member states to make a much clearer distinction between the economic and political aspects of the European endeavour – Turkey being seen as part of the first aspect, but not of the second, along with quite a number of other member states. This second option will critically depend on the ability to reformulate the political contours of Europe – definitely not an easy task (Gould, 2005). It may also depend on an improved situation in the Middle East, which may induce Turkey to play a pivotal role between the EU and the Middle East countries, without being too firmly attached to either of these two regions.

Freeing the African–Caribbean–Pacific countries (ACPs)

The EU is negotiating Economic Partnership Agreements (EPAs) with the ACPs, arbitrarily regrouped by the EU into six regions (four in Africa, one in the Caribbean and one in the Pacific). The EU invokes two motives for this policy. First, there is a WTO rule that allows for non-reciprocity only in the case of the least-developed countries (LDCs). All six EPAs, however, include both developed countries and LDCs, a feature hardly compatible with this provision.

Second, the EU presents the EPAs as promoting intra-regional trade – that is, echoing EU history. This perspective both ignores the crucial support for intra-EU liberalisation from multilateral rounds and aims to inhibit any moves by ACPs towards multilateral concessions. The latter is very unlikely to happen, however, because the EPAs as currently conceived amount to a very little liberalisation coupled with a very big fiscal problem – one could hardly imagine a worse package. ACPs can keep their most restrictive barriers, which generate the highest welfare costs. The price is that they have to cut small and moderate tariffs, which will have a significant negative impact on their tariff revenues: three-quarters of the ACPs are expected to lose 40 per cent or more of their current tariff revenues based on imports from the EC at the end of the transition period (around 2027) (Stevens and Kennan, 2005).

Looking to EU aid to solve the ACPs' fiscal problems is not the best solution. Even if we put to one side the EU's own budgetary problems for the next decade, not to mention the disastrous experience of EU aid to the ACPs over the last 40 years, such massive transfers will weaken the ACPs even more, by depriving them of the sovereign right of collecting taxes and pursuing their own policies.

In sharp contrast, a strong EU 'trade for development' policy would be based on three principles. First, it should eliminate self-proclaimed, but rich, developing countries from its scope (one tenth of the ACPs have a higher GDP per capita than the poorest EU member states) and it should focus on the 'poorest' countries, be they ACPs or not. Second, the EU could substantially improve the situation of the poorest countries by adopting a 'conditional reciprocity' approach that should be defined as the commitment by the poorest countries to decrease and bind their most-favoured-nation (MFN) tariffs on a basis as non-discriminatory and as uniform as possible. Such an approach would allow the poorest countries to keep the lion's share of their tariff revenues, while at the same time reducing a major source of tax evasion and corruption in their economies – hence allowing them to use these funds for implementing their own development policies. Last, but not least, the EU could go one step farther by launching, in the WTO, a joint initiative by all the industrial (and emerging) economies in order to provide to all the poorest (ACP and non-ACP) countries a worldwide regime based on the principle of conditional reciprocity. The outcome achieved at the 2005 Hong Kong WTO Ministerial is a far cry from this objective. Not only does it open rich countries' markets to the extent of only 97 per cent (3 per cent of all tariff lines could be set aside, more than enough for blocking exports from the poorest countries) but it leaves unsolved crucial problems, such as an objective definition of the 'poorest' countries (which should encompass two or three dozen non-ACP countries), appropriate rules of origin and strong disciplines on the use of safeguard measures by the rich countries, to mention only the most blatant ones.

Concluding remarks

The economic agenda set out in this paper – increased market openness and a vibrant 'culture of evaluation' – might attract two major criticisms.

The first one is economic in nature. The above agenda has entirely focused on the markets for goods, services and capital, and has remained silent on labour markets. Hence, it seems to ignore the large distortions and inefficiencies generated by most of the current EU labour market policies, and the massive welfare gains to be derived from more flexible labour markets coupled with time-limited international labour migrations, both intra- and extra-EU (Winters, 2003).

There are two reasons for this silence. It mirrors the political landscape shaped by the 'No' votes whereby the 'social model' belongs to the agenda of each individual member state, and not to the European agenda as such. But it also mirrors economic logic based on an obvious inverse relationship between the rate of economic growth and the pain caused by labour market reforms. The above agenda of deeper liberalisation of goods and services markets has precisely the virtue of improving European growth performance (even though the growth dividends from more flexible labour markets might arguably be even greater). Recent studies have shown the very substantial benefits from liberalising markets in goods and services (with a strong focus on services (Vogt, 2005)) without improving the functioning of the labour markets. Reforms reducing competition-restraining regulations, cutting tariff barriers and easing restrictions on foreign direct investment to 'best practice' levels in the OECD countries could lead to gains in GDP per capita of 2 to 3.5 per cent in the EC15 (over an average 40-year working life of a European, the cumulated addition to earnings would be around a full year's worth of earnings) – an estimate ignoring the dynamic gains (OECD, 2005). Table 7, which recapitulates the wide differences in practice among the EU member states, echoes these gains.

Moreover, increasing labour market flexibility before liberalising markets in goods and services would bring lesser economic gains because newly mobile workers would be attracted to firms that capture rents from imperfectly competitive markets. Weak competition and barriers to trade have been shown to undermine the growth effects of structural real wage changes in the euro zone by allowing incumbent firms to appropriate larger rents (Estevão, 2005). These results underline the potential costs generated by the recent evolution of the EU competition policy when looking at services of public interest or by the first set of amendments to the Services Directive. And they show how important it is that the above liberalisation agenda be launched as soon as possible, while labour market reforms might have to wait for major (presidential or legislative) elections: only newly elected governments will be likely to have the backbone required to run the political risks of such reforms.

The second criticism strikes a more political note. The interpretation of the 'No' votes adopted in this paper may seem too rosy to many. It is true that at the present time there are many Messieurs Hyde prowling the streets of Europe, playing on people's fears and toying with a wide range of worrying notions – from 'patriotic' behaviour to corporatism to closures of all sorts. So far, most Europeans have failed to be swayed by the supposed charms of these failed politicians, who are unable to distinguish between goals and instruments – a dreadful mistake in economic policy. This may not last for ever, however, and something has to

Table 7 **Summary rankings**

EC15/25 member	*PMR indicators (see Table 1)*	*Assistance to farmers (see Table 2)*	*Votes on anti-dumping (see Table 5)*	*RIA indicators (see Table 6)*
Britain	1	21	6	1
Denmark	2	9	3	2
Ireland	3	24	7	19
Sweden	4	20	2	5
Finland	5	22	4	6
Netherlands	6	8	5	8
Austria	7	15	9	7
Germany	8	18	1	11
Belgium	9	12	10	17
Slovakia	10	10	–	22
Portugal	11	3	15	25
Spain	12	4	12	15
France	13	16	11	24
Czech Rep.	14	13	–	18
Greece	15	2	13	20
Italy	16	6	14	12
Hungary	17	5	–	9
Poland	18	7	–	3
Malta	–	1	–	16
Estonia	–	11	–	13
Slovenia	–	14	–	21
Latvia	–	17	–	4
Lithuania	–	19	–	14
Luxembourg	–	23	8	10
Cyprus	–	–	–	23

be done about it. It is largely impossible to deal with these forces at the EU level, meaning that it is up to each and every member state to confront its own demons in this regard.

This is precisely why the culture of evaluation nurtured by independent think tanks is so crucial. It is the only way to calmly and sensibly address the fears attached to reform of the so-called 'social model'. A recent French example makes the point well. At

a time when housing – particularly in Paris – is a major political and 'social' issue, Fack (2005) has shown that 50 to 80 per cent of housing subsidies granted to the poor in France have in fact been captured by their landlords. Publicising this kind of result – no surprise for most economists, but far from obvious to non-economists – is a necessary step in convincing the French people that there are much better ways of helping the poor. Another Europe-wide illustration would be to show the benefits for the patients (and for the social security regimes) brought by the Services Directive proposal which systematises the court's jurisprudence on the rights to be reimbursed for healthcare provided in another member state. A last example is the decisive impact of campaigns showing the negative impact of the CAP on consumers *and* farmers in key member states, such as France.[8]

Transposing the famous phrase 'a battle has been lost, but not the war', the EU and member states face a situation in which 'a war has been won, but not the battles'. Today, nobody in Europe seriously promotes an alternative plan to a market-based economy – in this sense, the war has been won. But that leaves an endless number of battles on very specific topics (genetically modified organisms, geographical indications – indications of origin on goods such as champagne or cognac whose qualities and reputation are due to their place of origin – drug patents, healthcare, water, etc.) that powerful coalitions of anti-market NGOs and private vested interests present disingenuously as limits to the market model, with very limited reactions from governments and politicians. One by one, these battles have to be fought with rigorous facts and arguments, and ultimately won.

8 For updated information, see the GEM website at www.gem.sciences-po.fr.

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2 COMMENTARY

Pedro Schwartz[1]

Introduction: back to the Treaty of Rome

Professor Messerlin brings a welcome dose of common sense to the debate about what to do with the European Union after the rejection of the proposed constitution in the French and Dutch referenda. Instead of prolonging the debate between those who want a European 'super-state' and those who would be content with a loose confederation, he tries to find common ground in what could be done in the next few years which would be acceptable to both sides. His proposal is to examine what parts of the economic agenda of the Treaty of Rome (1957) have not been put into practice. The surprise is to discover that so much of it is still to be applied.

As a starting point for any discussion of what is to be done, one must accept that reviving the proposed constitutional text will be singularly difficult, if not impossible. Proceeding with the ratification process until enough members have approved it and an opportunity opens for a rerun of the French and Dutch referenda is an uncertain proposition in itself and would deepen the impression of a democratic deficit in the EU. There would also be strong objections to de facto application of some of the arrangements of the rejected text, such as the active participation of the EU High Representative for the Common Foreign and Security Policy in the deliberations of the Council. A proposal to renegotiate the Constitutional Treaty poses further questions as to the constituency and the venue.

The results of the two referenda indicate how open to controversy such courses of action would be:

- In France the '*Nons*' obtained 54.7 per cent of the votes, and the '*Ouis*' only 45.3 per cent. Despite that, a Eurobarometer poll taken after the vote shows that nearly nine out of ten French people are in favour of continued French membership of the EU. Even 83 per cent of those in favour of the '*Non*' vote declared themselves pro-European.
- In the Netherlands 61.6 per cent voted 'No' and only 38.4 per cent voted in favour. According to the Eurobarometer poll, however, 82 per cent of Dutch citizens consider that being a member of the EU is a good thing, although 61 per cent admitted to having a negative image of European institutions.

Public opinion in other European nations would also appear to be divided along different but similarly incongruous lines.

If the proposed constitutional text must be put in one of those inaccessible crates that regularly travel from Brussels to Strasbourg and back, then a more modest and realistic path can be trod. Much progress can be made simply by asking how far the freedoms proclaimed in the Treaty of Rome have been achieved and then proceeding to make them effective. Is it true that the EU guarantees the free movement of persons, goods and capital within the internal market? Can these freedoms be extended to services and to business establishments?

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The single market in goods

Professor Messerlin presents convincing evidence that the single market in goods does not exist within the EU.

As regards *agriculture*, it may appear that food circulates freely within the EU; indeed, one of the arguments repeated by the defenders of the CAP is that without this kind of public intervention members would try to protect their agriculturists from the competition of other Europeans. But food consumers are not 'free' to choose the suppliers of the goods they consume if supply is distorted by discriminatory subsidies. Despite the appearance that goods travel freely, when the combined protection level (tariff plus subsidies) for meat is in the hundreds of per cent, and the average for food is 20–25 per cent, there is no single market because competition is skewed. Also, the trumpeted reform of the CAP, by 'decoupling' subsidy from production, is in effect unfairly financing large farms with public funds, enabling them to invade agricultural sectors covered by small farmers. The reaction of national governments is further fragmenting the agricultural market. To this must be added, notes Professor Messerlin, the fact that environmental and safety conditions erect new non-tariff barriers within the single market.

The market for *industrial goods* is also fragmented. Norms and standards are variously used by the different member states, as can be seen in the fourth of the instructive tables presented in Messerlin's lecture – a discriminatory procedure that could be curbed with the help of the 'principle of country of origin' (PCO). This much-invoked principle consists in freely accepting goods that comply with the standards of the place where they were produced. It can however be made less effective by raising the minimum common standards agreed by the different parties,

a likely development in a Union consistently bent on harmonising rules, regulations and taxes and thus reducing institutional competition among states and regions.

The single market in services

The biggest challenge lies in *services*, a sector producing more than 70 per cent of Europe's GDP, and one where the single market is farthest from realisation. The aborted Services Directive would have been a great step forward in the realisation of the economic aims of the Treaty of Rome. The backlash against it shows that there is strong resistance within many countries to free intra-European movement in services, explicitly in France and Germany, covertly in Italy and Austria and many other countries.

Such resistance varies, however, among different services. Most acceptable across the EU is foreign direct investment, widely seen as enhancing employment and serving consumers, which means that freedom of establishment could be more easily sold to national public opinion than the fate of the Directive indicates. The opposition to the free movement of providers of physical services would be reduced if it were realised that national labour regulations would not be affected by the opening up of the services market; and its compounding with the hostility against the free migration of labour from new members would soon be lessened if it were seen that economic convergence brought about by EU membership brings mass migration to a halt – as happened in the case of Italy, Spain and Portugal. Here is where the PCO faces most resistance, especially in the field of professional services.

The internal expedients Messerlin proposes for freeing services are ingenious and may be effective. First he warns against easy solutions that may worsen the situation: such is the proposal to exclude 'public or universal services', such as postal, minimum telecom or essential energy services, from inter-state competition, for these services are critical to an open market. He goes on to suggest that only some sectors be included in the freeing of services, for they would serve as a blueprint for later moves. Third, he proposes that some countries implement the Services Directive unilaterally: indeed, the obsession with reciprocity in international matters did much harm in the twentieth century; the expected advantages to consumers and producers flowing from free competition in services would serve as an incentive for more backward countries. This has been the experience with business-friendly tax cuts in Ireland and some of the new members.

Ways to overcome protectionism

Messerlin's Wincott Lecture is at its most interesting in its suggestions for facing protectionist lobbies directly.

One way is to use WTO rules and Doha Round negotiations to deepen the European single market. Multilateral trade opening, Messerlin shows, has been a principal factor in easing competition among European nations. An example is the slashing of sugar prices by the EU in response to Doha requirements. Reduction in subsidies and especially in tariffs brought about by international trade rules and agreements could turn out to be the nemesis of barrier builders. As the phrase went in late-nineteenth-century America, 'the tariff is the mother of the trust'. In agriculture

compliance with such rules could lead the CAP towards a uniform level of protection; also, as Messerlin notes, uniform protection reduces the resistance to further tariff cuts. The same could be said of industry, where a reform of dumping and safeguard rules by the WTO would much increase competition in this sector. The General Agreement on Trade in Services (GATS) may, however, turn out to be a weak reed with which to try to prise open European service markets.

The principal way to tame 'sinister interests', as Jeremy Bentham used to call them, is through a 'vibrant culture of evaluation'. The European continent lacks a tradition of independent think tanks as exists in the UK and the USA. This is especially cheering for us workers and dealers in ideas. Denouncing the hypocrisies of rent-seekers can be both enjoyable and effective. From personal experience I can aver how effective an argument it is against the CAP to point out that the greatest recipient of agricultural subsidies in Spain is the Duchess of Alba. If it could be shown convincingly that giving up the CAP would increase world prices and benefit small landowners, the political argument could be won.

An opportunity for European freedom lovers

Those of us who believe that the setting up of the EU has not all been to the bad will have been cheered by the rejection of the proposed constitution for the opportunity it affords to bring the EU back to its original modest intent. As defenders of free markets and competition we may not relish the idea of an ever 'deeper and ever closer union' leading to the creation of a federal state, but we can agree with the Euro-enthusiasts on the widening and full application of the freedoms of the Treaty of Rome: the free circulation of persons, services, goods and capital, within the framework of ever wider world free trade.

3 COMMENTARY[1]

Leon Brittan[2]

Lord Brittan congratulated Professor Messserlin on a penetrating analysis of the EU's economic situation. He agreed with the broad thrust of the lecture but found it more difficult to accept some of the speaker's specific points.

In particular, he did not agree with Professor Messerlin's interpretation of the rejection of the constitutional referendum – the idea that Europe was not ready to accept a social agenda and that therefore the EU should steer clear of this issue. On the contrary, Lord Brittan argued, the key objection on the part of the voters was to the liberalisation agenda, a widespread fear that the application of pro-market policies would be disruptive and damaging to the way society was organised.

These were objections that had to be tackled energetically by all those who were committed to further liberalisation, and much of the persuasion might have to be conducted at the national level. But it was quite wrong to be pessimistic about the outcome; Europe should not give up too easily.

On the broader topic of economic liberalisation, Lord Brittan suggested that reform of labour markets, crucially important

1 This is a transcribed version of Lord Brittan's comments which immediately followed Professor Messerlin's lecture and led the discussion.

2 Lord Brittan of Spennithorne was a member of the European Commission from 1989 to 1999. For the latter part of that period he was responsible for external economic affairs and trade policy.

though this was, presented great political difficulties and should not necessarily be regarded as the first priority; further progress on trade in goods and services should come first.

Lord Brittan questioned Professor Messerlin's suggestions on reform of the Common Agricultural Policy. The speaker had been critical of the role played by large farmers, but any reform that singled out this group for attack would have unfortunate repercussions in the UK; it would complicate the task of those in the UK who were seeking to push the EU in a more liberal direction.

On the mechanics of CAP reform, Lord Brittan agreed that reducing the level of tariffs was at least as important as cuts in direct support and export subsidies, but he thought that Professor Messerlin had underestimated the consequences of the reforms that had already taken place; it was quite unfair to describe these reforms as sleight of hand. Lord Brittan was also sceptical about the suggestion that further reform would encourage farmers to diversify into new crops on a large scale; where was the evidence for such a prediction?

On industrial goods, Lord Brittan agreed that some of the tariff peaks were too high and should be reduced, and he supported Professor Messerlin's view that a liberal external trade policy had had, and would continue to have, a beneficial impact on internal liberalisation. He also pointed out, however, that tariff peaks in the USA were much higher, especially on textiles. As for the recent deal on textiles with China, Lord Brittan questioned whether it deserved as much criticism as Professor Messerlin and others had directed at it; the agreement was probably the best that could have been negotiated in the circumstances, and did not imply a drift towards protectionism.

On the issue of industrial policy and Professor Messerlin's reference to France's 'strategic casino-and-yogurt policy', Lord Brittan noted the speaker's comment that, whatever their rhetoric, governments would not be able to intervene in industry on any significant scale because they did not have the money to do it. While that view had force, Lord Brittan emphasised the importance of clear and enforceable rules that would discourage governments from moving in an interventionist direction.

Lord Brittan agreed with Professor Messerlin on the importance of the Services Directive and regretted the way the directive had been diluted. To get services liberalisation back on track would require a considerable effort of persuasion. While Lord Brittan sympathised with Professor Messerlin's suggestion that a 'culture of evaluation' should be developed in Europe, and that independent think tanks could play an important role in this process, he was concerned about the timescale involved, and wondered whether the work of think tanks, however valuable, would be sufficient to combat populist pressure against liberalisation in the services sector.

Lord Brittan's strongest disagreement with Professor Messerlin was on the issue of Turkey's accession. The Turkish government, he said, had no interest in abolishing the customs union – that would be the clearest signal of moving backwards.

4 COMMENTARY: THE DECONSTRUCTION AND RECONSTRUCTION OF THE EUROPEAN UNION

John Gillingham[1]

Patrick Messerlin sets out an ambitious economic agenda for the EU, which makes good sense in a Europe that seems to have lost its bearings since the rejection of the proposed constitution by the French and Dutch at the beginning of summer 2005. His sound proposals have little chance of gaining public acceptance, however. They will rather encounter scepticism, and even resistance. The EU public not only lacks a sense of European nationhood; it mistrusts Brussels. Although Professor Messerlin proposes a number of ways to overcome and circumvent this opposition at the European level, he nonetheless also acknowledges that real EU reform must begin nationally.

The common problems of Europe – the over-costly welfare state, the many disincentives to wage earning, and the inflexibility of labour markets – can indeed only be overcome by strong representative governments acting with public consent. Few examples of such robust regimes can be found today, in part because EU policy has eroded member-state sovereignty and undermined national authority. Governments must therefore be strengthened to deal with what they face. The devolution of

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authority and responsibility is paradoxically thus needed for the resumption of progress towards eventual European political and economic union. Without such a transfer of power from centre to periphery, the integration process will grind to a halt. The success of Europe's 'great experiment in supranational governance' hinges on the adoption by elected national political leaders of the reform policies espoused by Professor Messerlin. What is needed are new Margaret Thatchers.

The construction of Europe must be put on ice until the EU can be reformed. Enlargement, the crowning achievement of the integration process, should be the exception to this rule; strengthening and spreading democracy – even more than the creation of a single market – is the European Union's *raison d'être*. It can become the source of a renewed legitimacy. The promotion of self-government under law is thus an end as well as a means of EU policy-making.

Messerlin sets out a sound agenda for progress. He does not, however, discuss the European Monetary Union (EMU), which must be redesigned for sustained growth to resume. Additional reforms will also be needed to set the stage for his problem-solving agenda. A somewhat despairing optimist, Professor Messerlin views the referenda as a welcome opportunity to clarify Europe's current predicament. The French public was not alone, he argues, in rejecting the attempt to build 'social Europe'; it voted in line with public sentiment across the EU. To which one might add that the refusal to delegate new powers to Brussels extends to economic issues as well: public mistrust is general.

Pleasantly surprised that opposition to free trade did not figure in the electoral outcome, the author presents a strategy for transforming groups well disposed (or at least not ill disposed) to reform into a constituency for it. This is a mighty large task. Economic liberalism is still a dirty term on the Continent. Even the small, professedly liberal parties, at least in western Europe, back away from imposing free-market agendas. Many are hard to distinguish from the socialists to the left and the corporatists to the right.

The infamous Common Agricultural Policy (CAP) is Messerlin's first target. Europe, he emphasises, would be the main net gainer from its elimination, though most developing exporting countries would benefit as well. CAP's bizarre system of subsidies and price supports obviously protects inefficient at the expense of efficient producers; it is also strongly biased in favour of large as opposed to small farmers, especially in member states (like Britain) with relatively small CAP payments, which tend to have few but large farm holdings. The decoupling of payments from production since 2003 ('soil banking') merely aggravates inequities. Absurdly, it pays rich idle landowners to become even idler.

Messerlin advocates a uniform incremental cross-sectoral tariff rate reduction from the 20–25 per cent prevailing in most of industry to 15–20 per cent, but admits that winning support for such a policy will not be easy. The CAP stitch-up at the December 2005 summit and the lack of progress in the current Doha Round of WTO negotiations nevertheless leave open no other path to CAP reform than the domestic approach. In so many words, Messerlin calls for repatriating farm policy to the member states and allowing each of them to devise its own formulas for reducing – or presumably also abolishing – farm subsidies. Such a shift would entail far-reaching reorganisation of the Brussels institutions.

To secure a reform consensus, as Messerlin points out, political leaders must re-educate electorates, which mistakenly subscribe to the Arcadian myth that CAP protects the peasant cultivator from the pressures of the market and spares the countryside the ravages of modern, capital-intensive, high-technology agriculture. Farmers know this is bunk. Though many of them still like to feed at the EU trough, others, Messerlin hopes, will recognise that their real interest lies in allowing the market to distinguish between winners and losers. He expects such dynamic cultivators to lead the charge for reform. The adoption of blue-sky laws in several member states will, he suggests, help; they are the best means available for exposing the scandalous inequity of the price support programme to the public. Yet nowhere has the political opposition in any member state yet seized upon the fairness issue. Fear also perpetuates the wasteful CAP programme: governments in power are afraid that undoing it could lead to loss of their own privileges and to eventual dissolution of the EU.

Messerlin next directs his sights at the inaccurately named and only half-completed Single European Market (SEM), in which price dispersion across EU member states remains greater than within them, and is also larger than in big OECD nations. Regulation in the SEM is, moreover, a mess. While 'clean government' member states continue to issue their own rules, norms and specifications, the less fastidious ones set, but do not publish, them. Transparency often being absent and opacity and translucency often present, the creation of a 'culture of evaluation', something by which Messerlin sets much store, is at best a long-haul project. Requiring years of nurturing, such standard-based decision-making can facilitate but does not obviate the need for public oversight and control.

Several dragons, which have been reviving over the past decade, must also now be slain. They are, according to the author, strategic industrial policy (a costly luxury in a globalising economy) and contingent protection (a back-door method used with increasing frequency to favour insider interests). The latter's ugly stepchildren, anti-dumping policy and strategic safeguards, must also be dispatched, as must its bastard progeny, the 'voluntary export restraints' (VERs). Messerlin archly notes that whereas in the 1980s rents yielded by VERs applied against Japan benefited incumbent producers, a relatively benign outcome, those being invoked today against China will profit regional Communist Party satrapies.

Appealing once again for action at the national level, Messerlin calls for public assessments of net costs and benefits of protectionist policies in the hope of convincing sceptical electorates that they invariably favour insiders at the expense of all others. He is, however, well aware that in the absence of new competition such a campaign requires uphill struggle and that the apparent failure of the Doha Round will make it even more difficult to draft and enforce the ground rules needed to stimulate the entrance of outsiders. The trade picture is darkening and sadly, for now, little can be done about it.

Reform of the service sector requires even tougher sledding. The welfare gains from a single market in services would be huge, much larger, Messerlin points out, than in the SEM for goods: the sector comprises 70 per cent of European GDP, the level of protection is substantially higher, and protectionist barriers in services (as opposed to goods) also exist at the sub-national level, magnifying costs. The attempt to 'level the playing field' by harmonising regulations, the method favoured by the current

Austrian Council presidency, deprives developing economies of comparative advantage and is, according to Messerlin, unenforceable. He adds that the effort to minimise damage by substituting 'mutual recognition of standards' in all but 'key' provisions is arbitrary, administratively complicated and difficult to enforce with increases in scale and diversity.

Professor Messerlin deservedly praises the draft Services Directive (SD) – pilloried in the French referendum as the Frankenstein Directive – for meeting the three essential conditions for a single market. It has the widest possible scope – indeed, encompasses half the economy – and will be of particular benefit to small and medium-sized enterprises (SMEs), which benefit less than larger ones from outsourcing. It also rests on precedents set by the European Court of Justice, which proscribe practices like nationality weighting, branch restrictions and vexatious qualification requirements, while allowing other, economically justifiable ones, such as zoning regulations and certain workplace restrictions.

Finally, he commends the SD's country of origin principle, which liberalises cross-border trade and encourages regulatory competition. It permits Poles working in France, for instance, to remain subject to Polish regulations, albeit with certain exceptions, such as minimum wages laws, technical qualifications and workplace standards. The odds are strongly against the draft SD's adoption, however, not least because the Austrian presidency intends to dilute the features of it that Messerlin admires. Once again, progress will have to develop at the grass roots.

The Services Directive, of course, became the bogeyman of the French '*Non*' campaign, but it aroused similar fears elsewhere, Messerlin tells us, by threatening the same two special interests: public monopolies and privileged providers of professional and legal services. The lack of support for the SD he nonetheless finds somewhat hard to explain. Big firms, he suggests, are ambiguous about its enforcement rules: they approve of the elimination of the biggest barriers to foreign establishment, but also appear to benefit from smaller, localised ones. Such large producers can, moreover, jump borders more easily than smaller ones. Small firms would seem to have a greater relative interest in opening up borders (to lower labour costs), except to the extent that they already benefit from local grey markets. The biggest potential SD beneficiary group, consumers, was virtually silent during the referendum campaign in France, because of feared job loss. The prognosis for the SD is grim.

Still, Messerlin makes two bold recommendations. One is a partial Europe-wide liberalisation, which, though less ambitious than the draft of the present SD, would still cover about a quarter of the economy, enough to have a cascading effect. Messerlin's alternative would be – in a clear-cut break with 'community method' – to introduce a multi-speed process, whereby pace-setting nations would induce followers to liberalise. He holds forth little hope after Doha of a top-down opening of the service sector and warns that any attempt to introduce liberalisation by sector would only reinforce the power of public monopolies.

Messerlin concludes that regulatory competition will have to be the solvent for reform. It does not prefigure outcomes, least of all the dreaded race to the bottom, but also offers no guarantees, which, politically, makes it a 'hard sell', a very hard sell indeed in the new Europe of 25. Further enlargement will not make matters easier – unless a wave of reform, he adds, should sweep west from a free-market East. Is this Europe by a wing and a prayer? Messserlin is guarded. He cautions that adaptation policy will

be required to accommodate liberalisation losers, but insists it should be based on 'regulatory impact assessments' to prevent over-burdening of market economies. Such evaluations presuppose, he admits, the creation of a US-like think-tank culture.

Patrick Messerlin is right: the spectre of a European superstate has been banished, indeed run into the ground by Jacques Delors and the many men and women who have followed in his footsteps over the past ten years. And he is right again: the only workable economic prescriptions are those he prescribes. And also right a third time in emphasising that national revivals must provide the necessary substructures for a functional EU. He also properly insists on an obvious but often overlooked point: that in the absence of a European armed force only trade can drive EU foreign policy. While the survival of the integration process requires nothing less than what Messerlin recommends, there remains more to the story.

Growth must be restored before anything can happen. The European Monetary Union (EMU) is a heavy drag on it – by most reckonings a full percentage point. The eurozone is not an optimal currency area. The attempt to apply a uniform monetary and fiscal standard is like using a single thermostat to regulate temperatures in Helsinki and Lisbon. The European Central Bank's sole mandate is to promote stability, not encourage growth. It has an intrinsic deflationary bias, lacks feedback loops and is responsible to no person or institution. To protect its authority in the face of rising inflation and deteriorating fiscal situations, the ECB is now raising interest rates and the external value of the euro just as the recovery process appears to be getting under way.

The euro is, on balance, not only economically harmful but politically useless: it was conceived as a rung on a ladder that has now, as a result of the referenda, broken apart and cannot lead, step by step, to the higher plane of European political and economic union. To restore growth and save what remains of the European project, the euro should be transformed from a single to a parallel currency which, circulating together with restored national issues, can find its level in the marketplace. There is nothing either new or particularly difficult about this idea. The conversion of the euro will be much easier than its introduction.

But why stop with the overhaul of EMU? Messerlin's formula clearly implies something more radical: scrapping CAP and thereby liberating nearly half the EU's budget, not to mention several thousand Eurocrats. Once this reverse Robin Hood transfer mechanism, which benefits chiefly France, is abolished, the second one, regional funding, will be sucked down the drain behind it. The EU will then be left with only three chief responsibilities: competition policy, the development of the internal market, and trade policy – or at least what remains of it after Doha.

With the complicated deals that glue the European Union together becoming unstuck, the EU will need to develop a new sense of purpose and demonstrate cost effectiveness. Enlargement will provide economic, political and geopolitical rationales. Efficient operation requires drastic reduction of the European Commission, the transformation of the European Parliament into a purely advisory body, and the reconstruction of the EU on an opt-in, as opposed to an opt-out, basis – something that can be engineered by the European Council. The EU can thereby become, as originally intended, a treaty-based organisation. A European Union that yields real and tangible benefits – peace, prosperity and cultural revival – will be one worth having. It will then no longer be necessary to manipulate and coerce the public, but only to trust it.

The only European consensus existing today is grounded in doing nothing. The end result of this stand-pat attitude will less likely be gridlock than long-term decline. In a globalising world economy driven by Chinese modernisation and American innovation, Europe will simply count for less. Although things could indeed be worse, decline is not an optimal outcome, and least of all in a world on the move.

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