The Directive on Services: Rent Seekers Strike Back

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Liberalising Services Trade in the EU

The internal market for services, which are estimated to account for 60 to 70 per cent of economic activity in the European Union, is still rife with legal and administrative barriers to cross-border trade. The problems involved in integrating national services markets into one large internal market are highlighted by the ongoing fierce controversy over the Commission's proposed services directive.The following contributions discuss some pertinent issues.

Patrick A. Messerlin*

The Directive on Services: Rent Seekers Strike Back

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

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

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

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[1] For instance, Raoul Marc Jenner: Audition par la Commission IMCA, Parlement européen, 11 novembre 2004.

[2] For instance, a recent study on French subsidies for housing shows that 50 to 80 per cent of these subsidies have been absorbed by rent increases, that is, passed from the poor to the housing owners. Cf. Gabrielle Fack: Pourquoi les ménages les plus pauvres paient-ils des loyers de plus en plus élevés ?, Fédération Paris-Jourdan (Cepremap), mimeo 2005.

[3] Marc Guillaume: Audition par la Commission IMCA, Parlement européen, 11 novembre 2004.

ment genuinely concerned with public interest if these three professions represented a quarter of the French GDP ...

Remembering the Past: the Logic behind the Directive

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

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

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

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

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

The second way to liberalise services – opened up by the Dassonville and Cassis de Dijon rulings – consists of limiting harmonisation to the "key" provisions of the common regulation to be adopted jointly and imposing the "mutual recognition" principle for the rest of the provisions. This approach is conceptually clever. But its effective success depends on the balance between the harmonisation and mutual recognition parts (a large harmonisation part is equivalent

[4] Patrick Messerlin: Measuring the Costs of Protection in Europe, Institute for International Economics, Washington DC 2001.

[5] Rapport sur les obstacles à l'expansion économique (Rapport Rueff-Armand), Imprimerei nationale, Paris 1960.

to full harmonisation) and there is a systematic bias in this process. As the balance between these two parts is generated by negotiations on the provisions to be harmonised, there is a systematic drift towards expanding the scope of harmonisation and contracting the scope of mutual recognition. This is because negotiations often involve a majority of Member States fearful or reluctant to liberalise and only a handful of Member States convinced of the benefits of liberalisation.[6] Moreover, European decision-makers have feared that liberalisation in many services could lead to a rough and fast shift from monopoly to competition because of the large over-capacities built up in decades of public "over-investment" in a context of controlled prices, massive subsidies, and public monopolies. For instance, in the early 2000s, the electricity sector has an estimated average over-capacity of 20% in almost all the EC countries (up to 30% in France); retail banking is still provided through vastly oversized networks; and the telecom networks of railways or electricity public monopolies have been hugely oversized (in the mid-1990s, SNCF, the French railways company, was reportedly using only 10% of its own telecom network capacity).

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

Why Such an Outcry over the Directive?

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

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

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

Why is cross-border trade so sensitive and establishment uncontroversial? First, establishment has proved not to be a very pro-competitive strategy in services – threatening vested interests much less than cross-border trade. When constrained by the host country regulations, investors in services from other Member States have strong incentives to follow the prevailing behaviour in the market in which they have invested (after all, this behaviour has been tested by the domestic incumbents as the most profitable one in the legal environment, a conclusion which

[6] For instance, Steil has documented this evolution in the Investment Services Directive case. Cf. Ben Steil: Regional Financial Market Integration: Learning from the European Experience, Royal Institute of International Affairs, London 1998.

Table 1
Indicators of Product Market Regulation in OECD Countries
(0=least restrictive, 6=most restrictive)

	Ranking in 1998		Ranking in 2003	
	Country	Indicator	Country	Indicator
1	**UK**	1.1	**UK**	0.9
2	Australia	1.3	Australia	0.9
3	USA	1.3	USA	1.0
4	Canada	1.4	Iceland	1.0
5	New Zealand	1.4	New Zealand	1.1
6	**Denmark**	1.5	**Denmark**	1.1
7	**Ireland**	1.5	**Ireland**	1.1
8	Iceland	1.6	Canada	1.2
9	**Netherlands**	1.8	**Sweden**	1.2
10	**Austria**	1.8	Japan	1.3
11	**Sweden**	1.8	**Finland**	1.3
12	Norway	1.8	**Netherlands**	1.4
13	**Germany**	1.9	**Austria**	1.4
14	Japan	1.9	**Germany**	1.4
15	**EC-15**	2.0	**Belgium**	1.4
16	**Belgium**	2.1	**Slovakia**	1.4
17	**Finland**	2.1	**EC-15**	1.4
18	**Portugal**	2.1	Norway	1.5
19	Switzerland	2.2	Korea	1.5
20	**Spain**	2.3	**Portugal**	1.6
21	Mexico	2.4	**Spain**	1.6
22	**France**	2.5	Switzerland	1.7
23	**Hungary**	2.5	**France**	1.7
24	Korea	2.5	**Czech Rep.**	1.7
25	**Greece**	2.8	**Greece**	1.8
26	**Italy**	2.8	**Italy**	1.9
27	**Czech Rep.**	3.0	**Hungary**	2.0
28	**Slovakia**	3.0	Mexico	2.2
29	Turkey	3.1	Turkey	2.3
30	**Poland**	3.9	**Poland**	2.8

Source: Paul Conway, Véronique Janod and Guiseppe Nicoletti: Product Market Regulations in OECD countries: 1998 to 2003, OECD Working paper ECO/WKP(2005)6.

has no reason to change since the legal environment remains unchanged). In sharp contrast, cross-border trade opens the door to more competitive behaviour because it generates competition between the regulations in different Member States – hence it puts firms in contact with different incentives provided by different legal environments. This pro-competitive impact of cross-border trade exists even if constraints on labour movement (or on some other aspects, such as the environment) remain, as is the case with the Directive, which maintains all the existing Member States' labour laws, be they on minimum wages, work conditions, diplomas etc. Even within such limits, freer labour movements are likely to improve resources allocation in every Member State. Of course, these improvements may be smaller than in the situation where constraints from labour laws were relaxed. But bigger improvements would then be countervailed by larger adjustment costs for workers in the Member States, and the current Directive is based on the presumption that the net impact of these two aspects would be negative.

The Costs and Benefits of the Directive: a Few Points

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

As a result, most Europeans do not understand that the PCO was adopted in the Directive simply because the other two options did not work well. Recent research by the OECD Secretariat[7] allows us to obtain a quantitative assessment of the extent to which the SMP has really not bitten so far. Based on an international database on the regulations enforced in OECD countries, it provides indicators (from least (0) to most (6) restrictive) of product market regulation in 30 OECD countries for 1998 and 2003.[8] Despite its intrinsic limits, such an exercise produces two crucial results (see Table 1) confirming earlier observations.[9] First, the

[7] Paul Conway, Véronique Janod and Giuseppe Nicoletti: Product Market Regulation in OECD countries: 1998 to 2003, OECD Working paper ECO/WKP(2005)6.

[8] These indicators focus on products, but they include services, such as distribution, covered by the Directive. They are calculated for the EC15 Member States plus the Czech and Slovak Republics, Hungary and Poland.

[9] Patrick Messerlin, op. cit.

EC15 lags behind the non-European OECD Members (Australia, Canada, Iceland, Japan, New Zealand and the USA) as much in 2003 as in 1998, improving its relative situation only with respect to Switzerland and Norway. Second, there is no convergence among the various EC Member States: some of them still enjoy better regulations while the others are still at the bottom of the whole OECD group of countries – suggesting that so far the SMP has had little impact and that most services liberalisation has been generated by technological progress (starting mostly in telecoms, then spreading to telecom-intensive services) or by Member States' own decisions. The only change between 1998 and 2003 is the remarkable progress made by some new Member States (Slovakia, but not Poland, despite the allegations of the opponents of the Directive).

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

A Look at the Proposed Amendments and a Final Remark

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

The proposed amendments have two additional major flaws. First, they introduce a host of considerations which mix up resource allocation and the distribution of income or rights. Economics is like plumbing: each tool is appropriate for specific tasks, and using the wrong tool is a recipe for disaster. So far, the Community has been successful in not mixing up market reforms and distribution regulations. The amendments go in the opposite direction. Such a messing up will not be sustainable because Member States have very different views on distribution (some accept more short-term inequality than others). Second, the amendments adopt a much more sectoral approach. Looking at the Hearings, there is little hope that the parliaments and governments of most of the Member States will be able to resist such a fragmentation of regulatory reforms. The broad coverage of the Directive re-established the primacy of governments over narrow vested interests. The amendments are re-opening the door to the capture of the European governments by these narrow vested interests.

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

Anders Sejerøe, Christian Jervelund, Patrik Svensson and Claus Kastberg Nielsen*

The Copenhagen Economics Study on the Economic Impact of the Services Directive

In a recent speech Manuel Barroso, the president of the European Commission, emphasised the importance of service sectors for European growth as they account for almost 70% of jobs and have been the major driver for growth and job creation for over two decades. Nevertheless, service sectors may have been held back by internal market barriers. Cross-border trade and investments remain at a modest level, and intra-EU trade in services has not increased at all since 1992. In contrast, intra-EU trade in goods has increased by one third and has added 1.8% to the EU GDP every year. Mr. Barroso said, "Today, the greatest unexploited potential clearly lies in services. If we are not able to tap this potential, European workers and consumers will be the real losers."[1]

The speech related to the discussion on the proposed services directive drafted by Frits Bolkestein on behalf of the Commission (January 2004). The services directive would eliminate internal market barriers in order to allow for free establishment and movement of services between member states. For the Commission, the services directive will be a key step in making the EU the most dynamic and competitive economy in the world by 2010 as targeted in the Lisbon agreement.

The proposed directive has been heavily debated, and central in the debate have been the perceived economic benefits of the directive. In the debate, figures such as 600 000 new jobs and consumption increases of €37 billion (0.6%) following the implementation of the directive have frequently been quoted.

The source of these particular figures is a recent study conducted by Copenhagen Economics ApS[2] which also concludes that new jobs would be created in all member states and output would rise in every sector. The study is by far the most detailed economic analysis of the services sector reform ever.

The logic behind the results is that lower barriers will bring down operational costs and stimulate competition within and between member states. This will again lead to lower prices, higher productivity and higher wages, all of which will stimulate demand and giving rise to a net gain of new jobs, value added and consumption. A significant result of the study is that all member states are to gain and there will not be a significant shift of jobs across borders.

The following is a closer presentation of the study by Copenhagen Economics, which allows the reader a better understanding of how these figures are obtained.

The Economic Impact of the Services Directive

The study follows a new methodological approach, which captures many, albeit not all, of the nuances of the consequences of the directive. It traces the effect of the directive by following how the legal reforms directly affect the performance of actual firms in the service sectors, and it calculates the direct and indirect effects showing the full impact of the services directive on sectoral and macroeconomic performance.

The study proceeds in three steps. The first step measures the barriers to establishment and trade in the service sectors, for both domestic and foreign firms, before and after the implementation of the directive. The second step analyses how the barriers affect prices and productivity in the service sectors only based on a dataset containing more than 275 000 firms. The third and final step calculates the indirect economic consequences on the whole economy as other sectors take advantage of lower prices and higher productivity in the EU service sectors.

First Step: Measuring of Barriers

The first step translates qualitative legislation into quantitative measures that can be used in the quantitative analysis. Barriers are measured and transformed into numbers by answering a large number of objective and detailed questions regarding restrictions on

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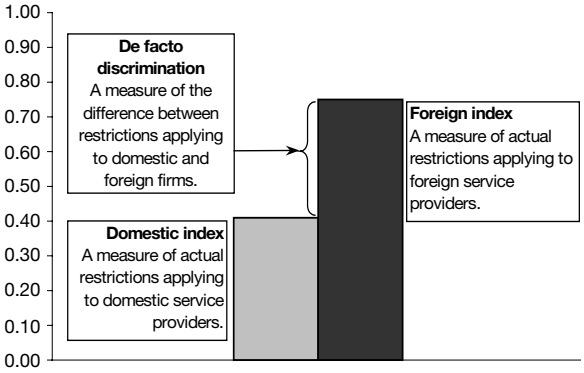
[1] J. M. Barroso: Creating a Europe of opportunities, The 2005 Robert Schuman Lecture for the Lisbon Council, 14.03.2005.

[2] Copenhagen Economics: Economic Assessment of the Barriers to the Internal Market for Services, 1.1.2005. The full report is available at www.copenhageneconomics.com.

Figure 1
An Illustration of the Domestic IMRIS and the Foreign IMRIS



Source: Copenhagen Economics: Economic Assessment of the Barriers to the Internal Market for Services, 1.1.2005.

service provision in the Internal Market. Questions are asked for the four sectors: accountancy, retail, wholesale and IT-services in order to estimate the barriers before and after the implementation of the directive.

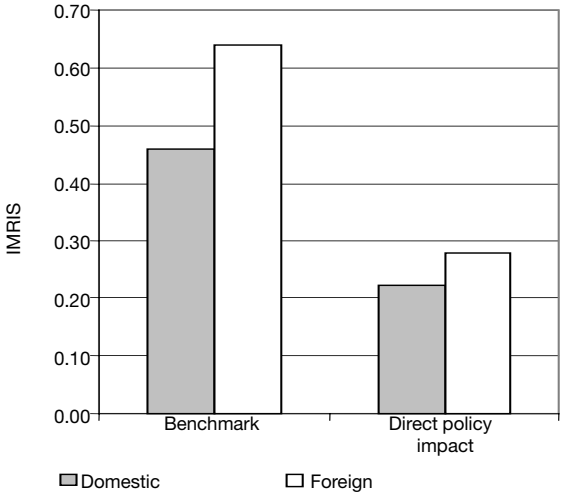
All in all, 200 questions are asked about legal and non-legal barriers to service provision in each sector in each Member State. The questions are organised in different categories covering all steps from establishment and promotion to distribution, sale and after sales aspects. Also non-legal barriers such as legislation only in national language or opaque public procedures are considered.

The qualitative answers are transformed into quantitative measures called IMRIS (Internal Market Restrictiveness Index in Services) using a system of scores and weights according to their relative importance. Different indices are calculated for domestic and foreign companies, as they do not face the same barriers.

Residence requirements, for example, affect only foreign firms and restrictions on the use of temporary foreign workers may be stricter for foreign than domestic firms. Furthermore, even in the case when all discriminatory legal barriers have been eliminated, foreign firms may still face barriers to establishment in another Member State. Not because of outright discrimination, but simply because the rules and regulations in the foreign Member State are different from the rules and regulations in the home country.

Figure 1 illustrates the result of the calculation of the IMRIS with different scores relating to domestic and foreign firms. The foreign index is by definition higher than the domestic.

Figure 2
The Size of the IMRIS Indices in the Policy Scenarios



The IMRIS (for both domestic and foreign firms) is then recalculated to reflect the situation after the implementation of the services directive. The result is a whole different set of IMRIS showing the direct policy impact of the services directive.

The study reveals the following general tendencies. First, barriers are largest in the accountancy sector, while barriers are lower in retail distribution, wholesale distribution, and IT-services. Second, barriers seem to be lower in new member states than in old member states. Third, barriers tend to be either high or low in all sectors within a member state.

Furthermore, the study estimates that the services directive, on average, reduces barriers to service provision by more than 50 per cent. The reductions are largest for regulated professions such as accountancy and smallest for other business services such as IT-services.

Figure 2 shows the impact of the services directive on barriers to trade and establishment in the regulated professions sector in Belgium.

Second Step: Calculating the Impact of Barriers on Firm Performance

The second step calculates how the price-cost margins are influenced by the change in barriers as captured by the change in the IMRIS. This is done econometrically on the basis of a very comprehensive dataset containing more than 275 000 firms from 19 countries. The scope of this estimation vastly surpasses any previous study of this kind. The price and cost impacts are expressed in tariff equivalents, i.e. as per-

centage impacts on prices. The tariff equivalents can be thought of as hypothetical taxes that are computed to create economic effects that are equivalent to the economic effects of the actual barriers as measured by the IMRIS indices.

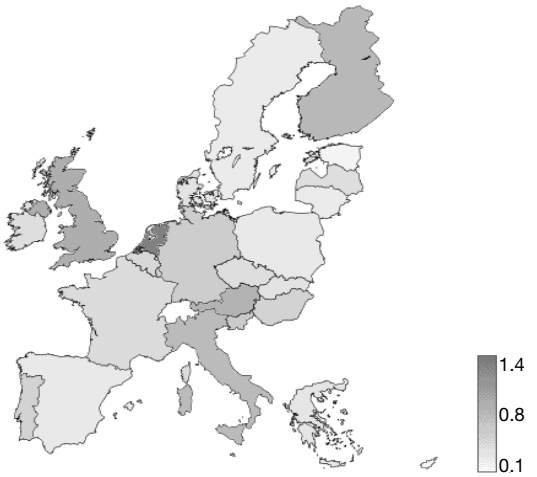
The study uses a specification of firm profitability that takes into account barriers as well as firm specific differences. Each firm's profitability is affected by several factors specific to that firm. The econometric model needs to control for these factors, for example profits earned on other activities, operational efficiency, size of firms, capital and labour intensity in production, and solvency of the company. Finally, at the economy-wide level each country's barriers as well as other aggregate economic variables are included to measure the direct impact on firms' performance.

Barriers affect firms in two ways: as rent-creating and cost-creating. Rent-creating barriers reduce competition between service providers, for example requirements that firms must be owned or controlled by local professionals. This provides protection for incumbent providers. Rent-creating barriers reduce competition, inflate prices above costs and generate rents to the incumbent firms. This type of barrier is represented through an exogenous mark-up over costs. The barrier can be thought of as creating a price-wedge between producer prices and producer costs. The more indirect and dynamic effects of rent-creating barriers, by limiting competition and thereby reducing productivity, are not considered in the model.

Cost-creating barriers increase the use of real resources. For example, it may require extra use of labour to overcome a given barrier. This type of barrier is represented through an exogenous productivity factor. That is, removal of this type of barrier improves productivity in the sense that more output can be produced with the same amount of input (or the same output can be produced with smaller amounts of input).

The barrier reductions reduce prices and increase productivity. This is because lower rent-creating barriers imply a smaller price wedge between producer prices and producer costs resulting in lower prices of services and creating an allocative efficiency gain. Lower cost-creating barriers imply productivity gains because the same output can be produced with fewer resources. In turn, productivity increases, leading to higher wages and return to capital. Output will therefore increase most in those sectors where barriers are reduced the most. Similarly, welfare gains will be largest in those Member States where barriers are reduced the most.

Figure 3
Impact of the Services Directive in Individual Countries



Note: A darker shading reflects larger welfare gains. Welfare is measured as comprehensive consumption.

Source: CETM model – Copenhagen Economics

As noted, reductions in cost-creating barriers increase productivity. Productivity gains enable creation of higher value added and lower costs thus creating a surplus for the sectors involved. This surplus is distributed as lower prices to consumers, higher wages and increased return to capital. Because the surplus more than outweighs lower profits for incumbents from rent-creating barriers, the net effect is a rise in income. Lower prices and higher spending combine to stimulate demand in all sectors of the economy. Increased demand calls for higher output which compensates for jobs lost through improvements in labour productivity.

Third Step: Estimating the Economy-wide Consequences

In the final step, the economy-wide effects of reducing barriers to service provision are calculated. This is done in a sophisticated global computable general equilibrium model – the Copenhagen Economics Trade Model (CETM) – that captures all linkages between the different sectors of the economy and therefore allows for an economy-wide assessment of the economic impact of removing barriers to service provision. All in all, the study estimates that the implementation of the directive will increase total consumption in the EU by 0.6% followed by the creation of up to 600 000 new jobs across Europe.

The directive directly affects business services, services provided to both businesses and consumers, and consumer services. In addition, it also has important knock-on effects on other sectors. The knock-on effects arise partly because the affected services are important inputs to the rest of the economy, and partly through the markets for labour and capital. Production and employment changes in industrial sectors also generate feedback effects on the services sectors. The Copenhagen Economics Trade Model captures both the direct effects on the service providers and the indirect effects on their suppliers and customers. The model, therefore, captures the important backward and forward linkages both among firms and between firms and final consumers, i.e. ordinary households and government.

The CETM model focuses particularly on the individual countries in the EU and on the sectors where barriers have a significant economy-wide impact. The model also incorporates the rest of the world and a goods-producing sector, but does so in a more stylised manner to ensure both transparency and tractability of the model.

The impact of the services directive in each country is illustrated in Figure 3. The two primary determinants for each country are the size of the service sectors and the size of the reduced barriers. For example, the barriers in the regulated professions in the UK are below the EU average, but the consequences are more noticeable than on average because of the large size of the sector.

It should be noted that the results of this study are based on the implementation of the proposed services directive as drafted by Bolkestein. Currently, it seems doubtful that the proposal will be accepted in its original form. If the services directive is revised it follows naturally that a more modest removal of barriers most likely will be followed by more modest welfare and job gains.

Does This Really Matter in the Big Picture?

That removal of barriers has a direct effect on the overall economy is evident. The Internal Market programme implemented through the last 10 years has increased the overall EU GDP by 1.8 percentage points making it €164.5 billion higher. Analysis shows that 2.5 million extra jobs have been created in the EU as a result of the opening of frontiers.[3]

[3] European Commission: The Internal Market – ten years without frontiers, SEC(2002) 1417 of 7.1.2003.

The services directive will add to these gains of the Internal Market increasing consumption by 0.6% and jobs by 600 000. These gains seem to be significant, albeit not extraordinary, additional gains especially taking into consideration that they are the consequences of a single directive – and not a whole package of legal reforms.

Furthermore, the real impact is likely to be even higher as the above calculations are based on rather conservative assumptions. The study includes only three service sectors: regulated professions, distributive trade and business services. These three service sectors account for roughly two thirds of the scope of the services directive. The economic impact of the services directive may therefore be higher as sectors excluded from this study such as construction services and leisure services are also affected by the services directive. On the other hand, due to the lack of sufficiently reliable data we cannot rule out the possibility that the impact of the services directive is less positive for the sectors excluded from the analysis.

Who Will Win and Who Will Lose?

The member states mostly affected by the directive are those with relatively high barriers and large service sectors. The most regulated sectors are accounting and auditing and the least are IT-services and operational services. This means that even though regulated professions, lawyers and auditors, represent a relatively small sector, the contribution is substantial because of the large barriers. In contrast, distributive trade, retail and wholesale have below average regulation but due to the large size of the sectors even a modest reduction of barriers has significant effects.

It is argued that the services directive will especially benefit SMEs as barriers today make it costly to engage in cross-border activities with qualification requirements that are mostly independent of firm size, i.e. larger companies can more easily pay entry costs or are able to establish subsidiary firms. This study does not give any firm indications whether this is valid or not but in contrast to most other studies, the results, which show a positive effect, are based on the direct performance of enterprises of all sizes – including small and medium sized.

If there are winners, there may also be losers. Total employment will rise, but reallocation of labour may lead to isolated declines in employment in some sectors. However, according to the study the overall increase in demand in the EU will be significantly larger than before such that the net result in all member

states and all aggregate sectors seems to be a gain in jobs. However, we cannot rule out the possibility that there may be a net loss in some very specific sectors.

The main fear is that local or national producers of services will be overrun by foreign companies offering cheap alternatives based on more lenient legislation and lower wages, and that the directive thereby would initiate a race to the bottom as companies might re-establish themselves in the countries with the lowest legal standards.

This may be a real risk, but EU-wide rules already support minimum levels of consumer protection and a large part of the regulation with regard to any EU worker is still based not on the country of origin but on place of work. This includes health, safety, maximum work periods and minimum rest periods and many more. Finally, a race to the bottom in quality would only occur if no one wanted to pay more for better services.

In the long run it is likely that high-regulation countries would remove some of their excessive formality, making national governments' regulations more streamlined or replacing them by EU standards.

Summing Up on the Mechanisms of the Directive

To sum up, the key mechanisms of the directive are as follows. The directive makes it easier and less costly to start new enterprises – entry costs are brought down. More enterprises stimulate competition, in particular on markets with few, large firms. Competition brings down prices.

The directive also makes it easier, less costly, to run enterprises – operating costs are brought down. Lower costs increase productivity. Higher productivity leads to lower prices and higher wages.

Lower service prices and higher wages stimulate demand – giving rise to a net gain of new jobs, value added and consumption.

Wernhard Möschel*

Wage Dumping and Germany's "Entsendegesetz"

The German law on the posting of workers abroad – the "Entsendegesetz" of 1996 – primarily applies to the construction industry.[1] It makes obligatory minimum wages in this industry possible. Observation of low-wage competitors from the countries that acceded to the EU in 2004, and from Poland in particular, has prompted plans on the part of the German government to extend the application of the law to all sectors of the economy. According to trade union figures, 26 000 butchers alone have been displaced from the German labour market by cheaper workers from the new EU member states.

This contribution begins by clarifying the legal situation, which is complex and confusing.[2] It then goes on to discuss whether such legal amendment is supportable within the context of economic policy. The result will be that it makes sense for government policy to stand by workers who are particularly badly affected by structural change. However, the proposed approach is counter-productive. Rather than putting an end to Germany's labour market plight, it actually makes it worse.

Free Movement of Labour

The employment of EC-foreigners touches on Community law and national norms. One speaks of the free movement of labour when, for example, a Polish worker takes up dependent employment in Germany. This was not possible prior to Poland's accession to the EU. Nor will it be possible in future – at least within a transition period which can be extended up to 2011.

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[1] Primary construction industry and secondary construction work. The latter includes demolition and wrecking, painting and lacquering, and the roofing trade. On the initiative of the city-state of Hamburg, the law was extended at the last minute to encompass the maritime shipping assistance services (harbour tugs). The aim of this initiative was to protect around 100 jobs in Hamburg from competition from unemployed harbour tug crews in the new Länder of eastern Germany.

[2] There is a good overview in Bundesministerium für Wirtschaft und Arbeit: Informationen über die Anwendung des EU-Beitrittsvertrages bei der Beschäftigung von Staatsangehörigen der Beitrittsstaaten of 28th January 2004: http://www.bmwa.bund.de/Redaktion/Inhalte/Pdf/eu-beitrittsvertrag-beschaeftigung-frage-antwort,property=pdf.pdf

In this respect, the applicability of Art. 39 ff. of the EC Treaty has been foreclosed. Exceptions exist on the basis of bilateral agreements. This is the case with regard to seasonal workers placed in temporary jobs, notably in the agricultural sector and in the hotel and catering industry. These are joined by guest workers who wish to spend a year in Germany – with a possible six-month extension – as part of their vocational training and in order to improve their language skills. Both of these groups require an individual work permit, which can also be obtained through their future employer. A work permit can only be issued "if the worker is not employed at less favourable working conditions than comparable German workers" (Art. 285 (1)3 of the Social Security Code III). This legal discrimination ban already ensures wage equality at this point. In certain peripheral cases it is also possible to take up dependent employment without prior permission, e.g. if a Polish citizen studying in Germany carries out a holiday job for a period of up to three months.

The real problem in relation to the free movement of labour is that of clandestine employment. Such employment remains illegal.

Free Movement of the Self-employed

Free movement of the self-employed, otherwise known as freedom of establishment, encompasses the right to take up and pursue activities as self-employed persons and to set up and manage companies, branches or subsidiaries by nationals of any Member State established in the territory of any Member State (Art. 43 ff. EC Treaty). Here, in contrast to the free movement of dependent employees, there are no transitional regulations. Admittedly, anyone making use of the freedom of establishment must comply with vocational and trade law regulations in the same way as any national citizen. This means, for example, that it is not admissible for a Polish subsidiary company in Germany to employ cheaper Polish workers. This would require their freedom of movement, which is ruled out as a matter of basic principle until the year 2011.

In practice, the problem in this context is that of dependent workers acting as supposedly self-employed persons ("Scheinselbständige"). Their activities remain illegal.

Freedom of Services

The legal focus is on the freedom to provide services (Art. 49 ff. EC Treaty). This covers cross-border activities of an industrial or commercial character, as well as those of craftsmen and professionals. In contrast to the freedom of establishment, these services are always selective, temporary activities. Admittedly, the freedom to provide services also covers cases in which a subcontractor takes up a temporary activity for a particular construction project. Here it is important to distinguish between two groups of regulations. The first group concerns transitional regulations that are only valid up to the year 2011. The second group consists of permanent regulations. These include the EC's "Posting Directive"[3] as well as the German law on the posting of employees abroad ("Entsendegesetz"), which is based on the EC directive and is now to be comprehensively extended. The two groups of regulations overlap in places.

In accordance with the transitional rules for EU accession states, certain bilateral agreements and individual national provisions remain in force for the time being. These include above all the agreement governing the posting of workers on the basis of a "Werkvertrag" – a contract for particular services, as

Table 1
Negotiated Wages Declared by the Federal Minister of Economics and Labour to be Generally Binding on the Basis of the Law on the Posting of Employees Abroad ("Arbeitnehmer-Entsendegesetz")

		Per hour in euro		Per month in euro		Percentage of the industry's average wage	
		Semi-skilled workers	Skilled workers	Semi-skilled workers	Skilled workers	Semi-skilled workers	Skilled workers
Primary construction industry	Western Germany	10.36	12.47	1,758	2,116	60.5	72.8
	Eastern Germany	8.95	10.01	1,518	1,690	52.2	58.1
Demolition and wrecking industry	Western Germany	9.49	11.60	1,527	1,867	52.2	64.2
	Eastern Germany	8.95	9.65	1,557	1,679	53.5	57.7
Painting and lacquering trade	Western Germany	7.69	10.53	1,338	1,832	46.0	63.0
	Eastern Germany	7.00	9.20	1,218	1,601	41.9	55.1
Roofing trade	Western Germany	9.30	9.30	1,578	1,578	54.3	54.3
	Eastern Germany	9.30	9.30	1,578	1,578	54.3	54.3

Notes: Roofing trade: single wage group; Monthly wages: based on regular weekly working hours. Original data: Federal Ministry of Economics and Labour, Federal Statistics Office.

Source: iwd, No. 15 of 14 April 2005, p. 8.

[3] Directive 96/71/EC of the European Parliament and of the Council of 16 December 1996 concerning the posting of workers in the framework of the provision of services, OJ L 018, 21 January 1997, pp. 1-6.

opposed to a contract of employment – which affects the following sectors: the construction industry and related branches, the cleaning of buildings, fixtures and means of transport, and the activities of interior decorators. This is where German work permit law steps in. It leads to the proscription of discrimination mentioned earlier as set out in Art. 285 (1)3 of the Social Security Code III. Moreover, a double quota mechanism is in place. Ceilings exist for each accession country with regard to the number of workers to be posted. For Poland, this ceiling is currently set at 13 185. In the second half of last year, 79% of this quota was used up. In addition, there is a quota with regard to the company in Germany that takes on these contract workers ("Werkvertragsarbeitnehmer"). In the construction industry, for example, no more than 15 contract workers are permissible in cooperation with a contractor with up to 50 employees. In the case of a general contractor with more than 50 employees, the number of contract workers can increase to 30% of regular staff. The absolute limit is 300 contract workers per general contractor.

In all other sectors, such as the cross-border and temporary rendering of consulting and IT services, transitional regulations are already a thing of the past.

In practice, regulations are abused in that workers are only ostensibly posted from abroad. The employer e.g. in Poland, with whom an employment contract must exist, is no more than a letter-box company.

Germany's "Entsendegesetz"

In Germany, the most important restrictions stem from the law on the posting of employees abroad, the "Arbeitnehmer-Entsendegesetz". When it was passed in 1996, it had nothing to do with the accession of new member states to the EU. It served at the time as a defence against construction workers from Portugal, England and Ireland. It is valid for an indefinite period. Even today, some regulations already apply across the board, irrespective of the particular industry; these include rules on maximum working hours and minimum rest periods, the minimum length of paid holiday, as well as safety, health protection, and hygiene at work. Beyond this, according to the stipulations of Article 1 of the "Arbeitnehmer-Entsendegesetz", minimum wages are to be paid to all workers in the construction industry and some related fields[4] including foreign contract workers. This is subject to the condition that the application of the relevant collective labour agreement has been declared to be generally binding.[5] Here, in deviation from the general rule of Article 5 of the Law on Collective Labour Agreements ("Tarifvertragsgesetz"), no agreement between the parties is required. At the request of a trade union, the Federal Minister of Economics and Labour may alone declare a collective labour agreement to be generally binding on an entire industry. He does this by means of an executive order ("Rechtsverordnung"). Table 1 provides an overview at the end of 2004.

The planned extension of the "Arbeitnehmer-Entsendegesetz" now intends to extend such minimum wages, which dock on to collective wage agreements and are not legally defined,[6] to all branches of the economy. Such extension is not in breach of the EC "Posting of Workers" directive.[7]

Economic Objections

First of all we may note that the terms "wage dumping" or "social dumping" as used in the political debate could be misleading. In foreign trade theory we speak of "dumping" when a foreign worker offers his labour for a wage that is lower than in his home country.[8] This is not the case at present, for the differences in wage costs between the eastern European EU states and Germany are still immense. On average, labour costs in eastern Europe are roughly one seventh of German levels.[9] However, politicians are not obliged to use a term in the specific meaning which experts associate with it. Moreover, it is probably fair to say that the public is not being misled simply because they are not familiar with economic terminology.

From the perspective of liberal economists, minimum wages are in the neighbourhood of a thing of the devil, striking the concept of the Single Market with its free flow of products and production factors at the very core. The promise of increasing wealth for all, born of a division of labour that even transcends

[4] Cf. footnote 1.

[5] Besides minimum tariffs, the length of holiday time, holiday pay or additional holiday money are also covered.

[6] In theory, statutory minimum wages can also be introduced in Germany by means of executive order in accordance with the Minimum Employment Conditions Act of 11 January 1952.

[7] Cf. recital (12) of the directive: ".. the Community law does not preclude Member States from applying their legislation, or collective agreements entered into by employers and labour, to any person who is employed, even temporarily, within their territory, although his employer is established in another Member State; ... Community law does not forbid Member States to guarantee the observance of those rules by the appropriate means."

[8] Cf. Kronberger Kreis: Entsendegesetz – ein Irrweg, Financial Times Deutschland, 22 April 2005, p. 34.

[9] Details in H.-W. Sinn: Basar-Ökonomie Deutschland. Exportweltmeister oder Schlusslicht?, in: ifo Schnelldienst, No. 6, 2005, pp. 1, 20.

national borders and of the comparative advantages of specialisation, is retracted. The steering function of prices is revoked. It is as if the hand of a thermometer were bound in place. Losers are found everywhere:

- the foreign workers, who are hampered in their efforts to take up employment in this country;
- the consumers in this country, who have to pay higher prices than would be necessary under competitive conditions;
- the workers in this country, who cannot find any work for the factual minimum wage – in Germany this is true of construction workers in the eastern Länder for example – and for whom no jobs are created that would otherwise result from the alternative use of the money saved by the consumer;
- companies in this country, so far as they are dependent on low-cost labour for maintaining or developing their competitiveness.

Since David Ricardo there has been widespread consensus on this liberal credo among economists. Let there be a warning, however: this view requires functioning, i.e. sufficiently flexible, labour markets. This is the only way to absorb the burdens of adjustment inherent in massive structural change with a minimum of friction. This flexibility could be missing.[10]

There is great doubt as to whether the minimum wage is really a suitable instrument to protect domestic workers and industries from foreign competition in the long term.

The minimum wage requirement can be sidestepped relatively easily. One example found in the construction industry is the practice of charging for fewer hours than actually worked. Preventing such practices requires an extensive monitoring bureaucracy. While there is no doubt that this generates costs, it is questionable whether it can really achieve its goal, for the creativity of those involved in finding methods of evasion to serve their mutual interests can be assumed to be practically unlimited.

This is augmented by the substitution of excluded or hindered factor mobility by trade in goods. The foreign worker is employed abroad; his cheap labour enters the country in the form of correspondingly low-priced products. Alternatively, domestic demand is met by having services rendered abroad. Thus, for example, the hotel industry in Berlin has its daily washing done in neighbouring Poland. From there it is sent back to Berlin. These phenomena are part of the process of factor price equalisation, which is imposed by the forces of cross-border competition: wages in the old industrialised countries, including Germany, are subjected to a process of convergence in which, on the other side, the wages inter alia in the new EU Member States of eastern Europe participate. The process of factor price equalisation "has an inherent power and doggedness that is impossible to hold back indefinitely."[11] Qualifying this view, however, it must be recognised that such adjustments can take a very long time. It is estimated that wage costs in eastern Europe will not reach 50% of those in western Germany until the year 2030.[12] In many cases, moreover, it is not easy to implement the substitution of factor mobility mentioned above. A Polish construction labourer who is not permitted to work in Germany could help build pre-fabricated houses for export from Poland to Germany. However, such exports are not realistic for a number of reasons.

Finally, to the list of economic reasons for objection to the planned extension of the "Entsendegesetz" should be added that clinging to outdated structures could weaken the incentive to initiate far-reaching reforms. In many cases, problems resurface at a later date with increased urgency and under more difficult conditions. The reform of Germany's statutory pension insurance scheme, which has been put off for 25 years, may serve to corroborate this view.

Mistaken Arguments

The counter-argument that many other countries have established a statutory minimum wage bears little weight, since they have not proven effective.[13] In many cases they are substitutes for ensuring a minimum income, which in Germany is guaranteed by the "Arbeitslosengeld II" unemployment benefit, or else their binding effect is minor. One reason for this is that they often affect only a small number of companies. Or a minimum wage set in nominal terms loses real value through inflation. In cases where a minimum wage has a genuine impact, the disadvantageous effects on employment are well documented. One example of this is the relatively high level of youth unemployment in France.

[10] Cf. sections below on competition of regulatory systems and softening the impact of structural change.

[11] According to H.-W. Sinn, op. cit., p. 40.

[12] Ibid., p. 20 with evidence.

[13] Cf. W. Franz: Protektionismus, in: ZEWnews, April 2005, p. 8; Kronberger Kreis, op. cit.

In Germany, the Minimum Employment Conditions Act of 1952 allows for a statutory minimum wage. It requires a corresponding executive order from the Federal Ministry of Economics and Labour, which in turn is preceded by a resolution on the part of a main committee and an expert committee. Regulations established by collective bargaining override such minimum employment conditions. The law has never been applied. Its existence has been virtually forgotten – from an economic point of view justifiably so.

Two arguments frequently brought forward by opponents of an extension of the "Arbeitnehmer-Entsendegesetz" are also mistaken, however. One is the fear of protectionist counter-measures affecting trade in goods on the part of the foreign countries affected. Just as people in Germany speak of wage dumping, so could people in other countries look on German goods as a form of "capital dumping" or "education dumping".[14] Such an approach is possible. Yet it is important to realise that there is an asymmetry in European Community law between the freedom of movement of goods, which is strictly protected, on the one hand, and the freedom to provide services, which enjoys only limited protection, on the other. The "Posting of Workers" directive, which constitutes binding, if only secondary, European law, explicitly does not prevent the Member States from applying their laws or collective wage agreements to all those employed within their sovereign territory, even if the employer is established in another Member State.[15] The European Court has given its blessing to this regulation.[16]

Finally, the theory that foreign employers could only be forced to abide by the minimum wages laid down in German collective bargaining agreements if they are universally applicable is inaccurate. It is argued that this would pave the way for a situation – which must be regarded with a critical eye – in which collective agreements on pay and conditions would have a single national structure.[17] What is correct is that a national ruling may not include any discrimination to the disadvantage of employers established abroad (Art. 49/50 EC Treaty). Such discrimination can also be avoided within the framework of regional collective agreements.[18]

Competition of Regulatory Systems

The catalogue of traditional objections to any form of protectionism is incomplete even from a strictly economical point of view. Moreover, the catalogue is limited in as far as it fails to take non-economic considerations into account. This is particularly true of social policy considerations such as the provision of help for workers who are suddenly or severely affected by structural change. If one is open to such ideas, it is not so much a question of "whether" regulatory intervention is necessary, but of "how". In this case, however, the catalogue of economic objections becomes part of a weighing-up process and is no longer able to generate a definitive answer on its own.

This catalogue of objections does not address the dimension of competition between regulatory systems that inevitably occurs in the case of a classic liberal approach. Such competition is not necessarily efficient.[19] The question remains justified: what sense does it make for a legal order to remove certain objects from the market and thus from competition, only to then re-introduce competition through the back door in the form of competition between the systems? The answer can lie in the innovative and at the same time power-limiting effects of such competition. In this case, however, economic analysis is already open to the necessity of weighing up the alternatives. It was along these lines and with regard to the conflict between a "place of establishment principle" and a "place of production principle" for labour and social regulations that in its annual report of 1989/90 – i.e. years before the introduction of the "Arbeitnehmer-Entsendegesetz" – the German Council of Economic Advisors for example spoke out in favour of applying the latter approach.[20] Its intention was to avoid the emergence of "split labour markets". These would trigger off negative external effects. Social tension would ensue. The scope of the legislator to shape and organise would ultimately be undermined in an uncontrolled manner. These effects would lead to conflicts between the countries in question and this might then possibly result in unwelcome standardised

[14] Cf. J. Eekhoff: Entsendegesetz – eine Aushöhlung der Wirtschaftsordnung, in: Zeitschrift für Wirtschaftspolitik, Vol. 45, 1996, pp. 17, 24.

[15] Cf. quotation in footnote 7.

[16] Judgment of the Court of 23 November 1999 in the joined cases C-369/96 and C-376/96 (Arblade and Leloup), European Court reports 1999, pp. I-08498, I-08526.

[17] According to the Kronberger Kreis, op. cit.

[18] For details cf. W. Koberski, G. Asshoff, D. Hold: Arbeitnehmer-Entsendegesetz, 2nd edition Munich 2002, Article 1, No. 167 et seq.

[19] Cf. for example H.-W. Sinn: The New Systems Competition, Oxford 2003.

[20] Annual Report 1989/90, Stuttgart 1989, subindex 465; very critical, however, with regard especially to the German "Entsendegesetz" Annual Report 1995/96, Stuutgart 1995, subindex 390 et seq. and Annual Report 1996/97, Stuttgart 1996, subindex 320 et seq.

European regulations. "Weighing up these disadvantages of the place of establishment principle against the advantages ultimately gives preference to the place of production principle: that those labour and social regulations are to be applied that are valid at the place of production."[21] These considerations cannot be limited to labour and social regulations in a narrow sense, for wage levels and labour and social regulations have a reciprocal influence on one another – they are connected like two communicating tubes. One could argue that functioning competition necessarily leads to an alignment of wages for identical tasks at one and the same location. What is important is that the uniform result is exacted by competition and not by means of cartel-like measures (collective bargaining) or government regulations. "It (i.e. competition) reduces wage differentials for similar tasks at a particular location to productivity or cost differences, i.e. Portuguese construction workers will receive lower wages to the extent that they are less productive and the enterprise is faced with higher costs. Only when German wage levels (the result of collective bargaining) exceed market wages can the wage differential go beyond these differences."[22] This ultimately refers us to fully functioning labour markets as the better regulatory option. This aspect will be revisited at a later juncture.[23]

Softening the Impact of Structural Change

Economic criteria are abandoned when socio-political considerations come into play. Whether or not a social order comes to the aid of workers suffering hardship as a result of structural change is a normative question, the answer to which is often positive. This is demonstrated for example by the numerous transitional regulations related to developments that bring about severe structural fractures. The same is true of the question of whether a legal order should take deep-rooted notions of social fairness into account in its regulations. Thus large sectors of the population associate wage dumping with circumstances in which, for example, a posted construction worker dwells in a cheap building-site accommodation unit provided by his employer and lives on bread and milk and an occasional hard-cured sausage brought from home. With the low wage earned in Germany he provides for his family who stayed behind in his home country. In contrast, a German worker competing with the posted employee has no means of escaping the far higher costs of living in Germany. Differences in living circumstances of this nature, which have nothing to do with job performance, are often considered to be a distortion of competition.

While Germany's legislators have not closed their eyes to such considerations, they have adopted a relatively cautious approach. The "Arbeitnehmer-Entsendegesetz" allows for minimum wages in just a few branches of industry. They tend to amount to between 50 and 60% of the average wage in the industries concerned.[24] If this were to remain the case following a general extension of the "Entsendegesetz" to the rest of the economy then the protectionist effect of this change in legislation would be relatively modest.

From this point of departure, the decisive question for legislative considerations is which options are available to solve socio-political problems. Essentially, this is a question of whether the side-condition of the strictly liberal model can be realised, i.e. whether functioning competition in the labour markets can be created. There is no lack of proposals.[25] Examples include:

- efforts to introduce more flexibility to the labour markets, in particular by disposing of anything that hampers the creation of simple jobs;
- a continuation of the Hartz IV reform in the direction of an activating social benefit, moving away from wage substitution and towards wage supplementation;
- investive wage concepts within the framework of collective bargaining in which cash wages are partly replaced by a savings element;
- promoting innovations, which is most readily achieved through an efficient school and university system;
- promoting employee qualification;
- providing mobility grants for those affected by structural change.

In this context too, however, sobriety of judgement remains the order of the day. It is not a question of solving problems within a fictitious world, a model world, but in a real world that is just as it so happens to be. It is therefore necessary to bear the following in mind:

[21] Ibid.

[22] Cf. J. Eekhoff, op. cit., p. 21.

[23] Cf. footnote 25.

[24] Cf. Table 1.

[25] A typical example is H.-W. Sinn: Ist Deutschland noch zu retten?, Munich 2003, pp. 451 et seq.

- the concrete effectiveness of individual proposals is uncertain (e.g. promoting innovations);
- in part their effects will be felt in the long term at best (expansion of the education system);
- the idiosyncrasies of the political system hamper far-reaching reforms. In politics, to be right, but not to be seen by voters to be right, is not usually an option. Conversely, the temptation to avoid painful reforms is immense if the related costs are not booked until some future date.

In summary it may be concluded that, from an economic point of view, an extension of the "Arbeitnehmer-Entsendegesetz" will do more harm than good. From a socio-political and politico-economic perspective it is a measure that is at best acceptable under conditions created by otherwise mistaken policies.

Rudolf Adlung*

The (Modest) Role of the GATS

The EC was among the main proponents, towards the mid-1980s, calling for the creation of a services agreement within the multilateral system. The Communities' (and Commission's) proactive approach may be attributed to a variety of factors, including: (i) commercial interests in improving trading opportunities in rapidly growing sectors such as telecommunications, financial and a variety of business services; (ii) the need to counterbalance the retarding influence of agriculture in trade negotiations with a positive perspective in more dynamic sectors; (iii) the political advantage of using external commitments to protect progress in EC-internal deregulation and liberalisation of services from backsliding; and (iv) the possibility to strengthen the Community/Commission position *vis-à-vis* the Member States in areas of shared competence (investment, movement of persons, etc.).[1] Given the fierce resistance of a number of developing countries, in particular India and Brazil, however, the services negotiations of the Uruguay Round (1986-93/94) were all but plain sailing.[2] Somewhat surprisingly, nevertheless, the Agreement that ultimately emerged from the negotiations has functioned very smoothly since its entry into force in 1995. In the same vein, the current round of services negotiations, launched in January 2000, has taken on a similarly low profile, drawing only little (too little?) attention from Member governments and is certainly not to blame for the failed Ministerial Meeting in Cancun.

The apparent "success" of the GATS or, at least, the absence of major problems to date may be due in part to the shallow levels of commitments bound at the end of the Uruguay Round. An element of liberalisation was achieved in possibly only two areas, telecommunications and financial services, where negotiations were extended until 1997. The EC was able, given the state of internal market integration in these sectors, both to contribute to and to capitalise on these negotiations. In virtually all other areas, however, the commitments bound by WTO Members under the GATS remained confined to locking in status quo conditions in a rather limited number of services. The flexibility provisions of the Agreement had made it particularly easy for individual countries to adjust their trade obligations to prevailing conditions and constraints in individual sectors.

Breadth of Coverage vs. Depth of Obligations

Given the diversity of political and economic conditions among WTO Members, flexibility is an

* Trade in Services Division, WTO Secretariat, Geneva, Switzerland. The article is based in part on a paper prepared for the World Trade Forum 2004 in Berne ("The Single Undertaking After Cancun: Diversity and Variable Geometry in the World Trading System"). All references in the following are to the European Communities, reflecting its membership status in the WTO, rather than to the European Union. The views expressed are those of the author and cannot be attributed to the WTO Secretariat.

[1] R. Adlung: Liberalisierung und (De-)Regulierung von Dienstleistungen in der Welthandelsorganisation: Versuch einer Zwischenbilanz aus Sicht der Europäischen Gemeinschaft, in: P.-C. Müller-Graff (ed.): Die Europäische Gemeinschaft in der Welthandelsorganisation, Baden-Baden 1999/2000, Nomos, pp. 131-156.

[2] J. Croome: Reshaping the World Trading System – A History of the Uruguay Round, The Hague, London, Boston 1999, Kluwer Law International.

indispensable element in an agreement that reaches far beyond traditional concepts of cross-border transactions ("mode 1") to cover as well the conditions governing outbound movements of service consumers ("mode 2"), domestic commercial establishment ("mode 3") and the presence of foreign nationals supplying services ("mode 4").[3] The broad modal scope of the GATS is counterbalanced by much leeway in individual countries' assumption of trade obligations. In particular, the GATS offers not only more room than the GATT for departures from most-favoured-nation (MFN) treatment – one of the few horizontal obligations that apply across virtually all services – but also allows for the continued operation of market access restrictions, including quotas, and denials of national treatment. Even in sectors in which access obligations ("specific commitments") have been assumed by a Member, market access and national treatment may be subjected to scheduled limitations. Virtually any policy concerns can thus be accommodated within the structure of the Agreement. The GATS does not even establish a hierarchy of more or less preferable forms of intervention, let alone priorities among modes of supply. There are no built-in incentives that would encourage, for example, a shift from numerical access barriers to price-based interventions, nor are there disciplines on governments' strategic use of restrictions under one mode, e.g. cross-border trade, to promote trade under other modes, e.g., inward investment under mode 3.

Even within otherwise integrated markets, individual regional units may continue to operate their own restrictions under one or more modes of supply. Relevant cases can be found in the schedules of many federal states, including the USA, Canada and, to a lesser degree, Switzerland.[4] Not surprisingly, there are many similar entries in the Communities' schedule. These include a sweeping cross-cutting limitation that provides cover for any public or private monopolies in individual member States (MS) which are tasked to supply "services considered as public utilities".[5] The legal status of such monopolies would be protected as well if the EC was not treated as a single unit, but as an economic integration area pursuant to Article V, the equivalent to Article XXIV of the GATT. The relevant provisions require participants to eliminate in their internal relations "substantially all discrimination" within the meaning of Article XVII (national treatment), but there is no obligation, whatsoever, to abolish non-discriminatory access barriers, whether in the form of monopoly rights or quota restrictions. Thus, regardless of the Communities' status, the GATS provides wide scope for the perpetuation of divergent internal trade regimes.[6]

These flexibility provisions, though indispensable, may come at a cost in particular to the EC. Given the absence of binding (and biting) framework obligations, the GATS may prove less effective than the GATT in helping "Brussels" to establish, and promote compliance with, a common trade regime among the MS. Of course, the Agreement is perfectly suitable to bind services reforms and, thus, enhance their internal and external credibility, but it is difficult to see how it could help to launch projects that are resisted by incumbent service suppliers and their political proponents.[7] The ministries responsible for, e.g., banking, insurance, health, education or immigration will certainly resent sacrificing national competencies on the altar of international trade negotiations.

Nevertheless, whenever the Communities manage to push through internal reforms, these may have positive external effects even within existing patterns of GATS obligations. Full commitments on national treatment, where they exist, create a situation comparable to trade in goods under the GATT, where Article III provides for the automatic extension of any new internal laws and regulations etc. to imports. Within the broader modal framework of GATS, however, the notion of "imports" – and, as a result, the potential reach of the national treatment concept – has been extended to three more types of transaction.[8]

The following sections seek to trace the status of core GATS provisions and their application within the Communities' trade regime.

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[3] For a more detailed discussion of the modal scope of the Agreement and its application to individual sectors see, for example, WTO: Guide to the GATS: An Overview of Issues for Further Liberalization of Trade in Services, The Hague, London, Boston, 2001, Kluwer Law International.

[4] For example, the schedule of Switzerland provides for the continued operation of public monopolies on fire and national damage insurance in 19 cantons; access to other parts of the country is largely unrestricted.

[5] If such services are provided in "the exercise of governmental authority", i.e. neither on a commercial basis nor in competition, they are completely exempt from the GATS in any event.

[6] The individual EC MS are WTO Members as well. While the Uruguay Round commitments scheduled by the Communities apply only to the then 12 MS and the results of the extended negotiations on telecom and financial services to 15 MS, the schedule envisaged to result from the ongoing round is set to cover all 25 current MS.

[7] R. Adlung: GATS and Democratic Legitimacy, in: Aussenwirtschaft, Vol. 59, No. II.

MFN Treatment: Cornerstone with Fuzzy Edges

The MFN requirement is the only core obligation that has a similar status in both GATT and GATS. However, apart from "traditional" departures covering, for instance economic integration projects (Article V), the GATS contains a sweeping exemption for all MFN-inconsistent measures that Members listed at the end of the Uruguay Round or, if later, the date of accession. Pursuant to Article II:2 and a related Annex, WTO Members are entitled to maintain the measures inscribed in their exemption lists for periods not exceeding ten years "in principle", and subject to negotiations in any subsequent trade rounds. Moreover, given the Agreement's broad modal coverage and the dearth of international standards in services, the drafters of GATS provided more scope for (discretionary) recognition of foreign standards, licences and certificates than exists under the GATT.

An overview of existing *MFN exemptions*, produced in 2000, lists over 420 measures, involving more than two-thirds of WTO Members.[9] The sector focus is on various transport services (35 per cent) as well as audiovisual services (20 per cent), a particularly sensitive sector for the EC. The vast majority of the exemptions, including those inscribed by the EC, are intended to apply for an open-ended ("indefinite", "unspecified" etc.) period, which needs to be set, of course, against the ten-year timeframe provided for in the Agreement. The current exemption list of the EC contains some 40 measures, concerning mostly audiovisual and transport services, about one-half of which are maintained at the level of individual MS.[10] Very few have been earmarked for termination in the Communities' initial offer.

Table 1
Commitments by Country Group, March 2005

WTO Members	Average number of sub-sectors committed per Member	Range (lowest/highest number of scheduled sub-sectors)
Least-developed economies	24	1 – 111
Developing & transition economies	52 (104)[1]	1 – 147 (58 - 147)[1]
Developed economies	105	86 – 115
Accessions since 1995	102	37 – 147
ALL MEMBERS	50	1 – 147

[1] Transition economies only.

Total number of sub-sectors: ~160; total number of Members: 148, including the EC MS.

The need to provide scope for *recognition measures* appears particularly pressing in the context of a services agreement that covers not only product flows, but extends to factor movements. Conformity with prevailing standards and other regulatory requirements is a core determinant of foreign products or producers being permitted to compete. Article VII of the GATS is thus intended to provide legal cover for the autonomous or mutually agreed recognition of qualifications, licences, certificates etc. obtained in another country. The relevant provisions are combined with procedural disciplines designed to prevent recognition measures from being used "to dilute entirely the MFN obligation".[11] In particular, interested Members must be afforded "adequate opportunity" to negotiate their accession to such agreements or, in the event of autonomous recognition, to demonstrate that their education, licences etc. should be recognised as well (Article VII:2).

These provisions have rarely been used, however. Between January 1995 and April 2005, no more than 44 notifications under Article VII:4 were submitted,

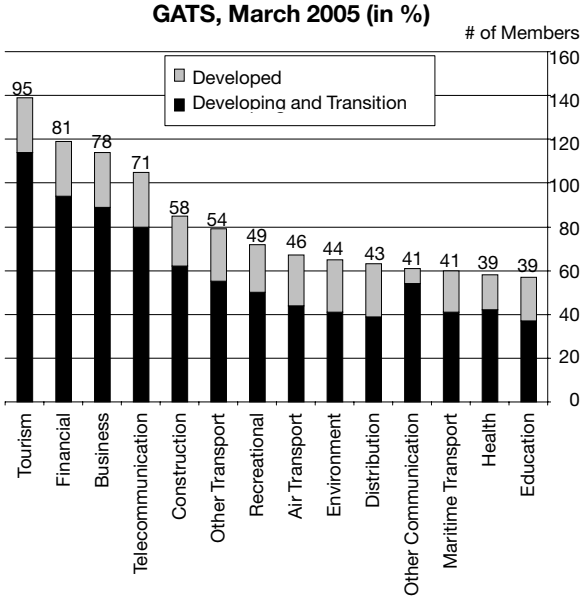
[8] For example, the existing EC commitments on health services under the GATS could imply that current Commission proposals aimed at facilitating the mobility of patients between the MS, including through streamlined reimbursement procedures for health care costs, are applicable as well to patients seeking treatment in third countries. (All MS, except Finland and Sweden, have undertaken full national-treatment commitments on consumption abroad for hospital services and, except Finland, for medical and dental services.) The Commission's explanation of the proposed Services Directive – "... is an internal market instrument and therefore concerns only service providers established in a Member State ..." – may thus need to be qualified. The actual impact of the Communities' commitments may depend, nevertheless, on whether the relevant foreign-established facilities and their staff provide "like services" and are recognised to meet relevant EC qualification requirements and standards. See Commission of the European Communities: Proposal for a Directive of the European Parliament and the Council on services in the internal market, COM(2004)2final/3, Brussels 2004, p. 15.

[9] The overview was prepared by the OECD Secretariat on the basis of an informal document by the WTO Secretariat. See OECD: Trade in Services: A Roadmap to GATS MFN Exemptions, Working Party of the Trade Committee (TD/TC/WP(2001)25/FINAL), Paris 2001. The EC is counted as one entity.

[10] Examples include not only traditional arrangements favouring citizens of Commonwealth, Francophone and Portuguese-speaking countries (UK, France and Portugal), but also reciprocity requirements *vis-à-vis* third countries (Austria: access of financial service suppliers; Finland and Sweden: maritime cabotage; France: capital participation in news agency services and access to press agency services; Germany: chartering of foreign ships; Italy: purchase of real estate as well as capital participation in broadcasting and publishing services; Spain: establishment of commercial presence in road transport services).

[11] K. Nicolaïdis, J. P. Trachtman: From Policed Regulation to Managed Recognition in GATS; in: P. Sauvé, R. M. Stern (eds.): GATS 2000 – New Directions in Services Trade Liberalization, Washington DC 2000, Center for Business and Government, Harvard University and Brookings Institution Press, pp. 241-282.

Figure 1
Sector Focus of Current Commitments under the GATS, March 2005 (in %)



Note: The vertical axis displays the number of WTO Members that have scheduled at least one sub-sector out of the 14 sectors, from business services to other transport (mainly road and rail transport), listed on the horizontal axis. The numbers at the top of each bar indicate the percentage of Members with commitments in the area concerned. EC MS are counted individually.

Source: R. Adlung, M. Roy: Turning Hills into Mountains? Current Commitments under the GATS and Prospects for Change, WTO Staff Working Paper (ERSD-2005-01), Geneva 2005.

covering some 125 agreements or measures, about two-thirds of which relate to "old" agreements predating the GATS or the relevant dates of accession.

Most participants in integration agreements, including the EC and the other signatories to the Europe Agreements and the Agreement on the European Economic Area, seemingly hold the view that recognition measures among participants are covered by Article V on Economic Integration, rather than Article VII.[12] (The only notification made by the EC under the latter provisions dates from 1997 and relates to an agreement with Switzerland on direct insurance.) This interpretation seems to offer at least two "advantages": no obligation to afford third countries an opportunity to negotiate participation, and no automatic extension of the relevant benefits to third-country nationals that have been licensed by institutions within the integration area. Members of integration agreements are required, pursuant to Article V:6, to extend the relevant benefits, possibly including recognition measures, to any juridical person constituted under the laws of a party to the agreement that is engaged in substantial business operations in the integration area. However, there are no equivalent provisions applying to third-country nationals. In other words, while any *company* licensed to supply services in Norway, whether national- or foreign-owned, may enjoy the same regulatory status in Germany, third-country *professionals* licensed as doctors, architects etc. in Norway would not need to be recognised by German regulators on a par with their Norwegian colleagues. Moreover, concerning the recognition of diplomas within the EC, the Communities' schedule contains a national treatment limitation under mode 4 that explicitly excludes nationals of third countries from the scope of relevant EC Directives. The initial offer submitted by the Communities in the ongoing round does not provide for change.

Diversity of Access Conditions across Sectors and Modes of Supply

Given the broad spectrum of services transactions and, even more so, permissible trade barriers falling under the GATS, it is far more difficult than in merchandise trade to provide a reasonably accurate picture of the access obligations undertaken by individual WTO Members. The number of sectors inscribed in schedules – regardless of their economic importance and the existence of limitations – may, nevertheless, provide a cursory indication of Members' propensity to bind access conditions in services. Table 1 suggests a relatively clear relationship with the level of development, despite wide variations within individual country groups. With the exception of post-Uruguay Round accession cases, developing countries have, on average, scheduled far fewer sectors than developed Members as a group, thus apparently availing themselves of the flexibility afforded by the architecture of the Agreement which, in turn, is also reiterated in various development-related provisions (Articles IV and XIX:2).

A comparison across the large service sectors shows, not surprisingly, that tourism has drawn the highest number of commitments. Given the traditionally open regimes in many countries, the sector is an obvious candidate for specific commitments. Apart from tourism, current schedules are largely dominated by producer-related services, i.e. services that per-

[12] By end-April 2005, there was only one notification under Article V: 7(a), from Australia and New Zealand, that had been submitted "also in recognition of any notification requirements under Article VII:4" (WTO document S/C/N/66 of 21 October 1997). For a brief discussion of the relationship between the two Articles and for further references see OECD: Service Providers on the Move: Mutual Recognition Agreements, Working Party of the Trade Committee (TD/TC/WP(2002)48/FINAL), Paris 2003.

form infrastructural functions such as a broad array of business services, telecommunications and financial services. In contrast, the health and education sectors have apparently proved far less popular. While the sector pattern displayed in Figure 1 essentially reflects the scheduling decisions of developing countries, which account for some 80 per cent of the WTO membership, the latter two services also have been shunned completely by several developed economies.[13] Among the eight developed WTO Members that have not scheduled any health-related and social services are two EC MS, Finland and Sweden. Also, Sweden is one of the four WTO Members that have not committed any educational service. The Communities' initial offer in the ongoing negotiations, consolidating for the first time all 25 MS in one schedule, does not foresee any changes in this regard.

The diversity of access conditions – or, at least, of *bound* levels of access – across sectors is reflected in a similar diversity across modes. Commitments on consumption abroad (mode 2) tend to be the most liberal: on average for all WTO Members, about one-half of the relevant entries for both market access and national treatment do not carry any limitations.[14] Commercial presence (mode 3) is the most economically important mode of supply, representing some 50 per cent of all trade falling under the GATS. About four-fifths of all entries under this mode guarantee some degree of access, subject to various limitations. In contrast, virtually all commitments on mode 4, presence of natural persons, are very tightly circumscribed. Starting from an "unbound", most WTO Members have scheduled undertakings with regard to a limited number of categories, normally higher-level employees or intra-corporate transferees, which are permitted access for limited periods of stay. Even these undertakings are frequently subject to tight numerical ceilings or discretionary economic needs tests. The EC's initial offer contains certain improvements for this mode, including the abolition of economic needs tests. However, as in the case of virtually all other WTO Members, the focus remains on relatively skilled professionals that are sent from, or transferred by, companies established abroad. In any event, given the scope of the offer, deeper integration moves within the EC, as envisaged under the heavily discussed Services Directive, are unlikely to benefit third-country nationals.

Outlook: Don't Wait for "Geneva"

Given the absence of tightly binding (and biting) obligations, the economic implications of the GATS are likely to differ from those of the GATT. Protection-seekers will find it easier to defy broad-based liberalisation and survive in niches, and the scope for reciprocal exchanges, in which export interests might be mobilised to overcome resistance, is far more limited than in merchandise trade. What common yardstick could be used to measure and compare, across sectors and modes, the interventions of country B with those of A?

Nevertheless, the prospects are not equally bleak in all sectors. There are circumstances where services liberalisation has proven virtually irresistible. Technical progress, not least the ascent of new communication technologies, has created new alternatives to long entrenched regimes or rendered them unenforceable. Telecom reform, to an extent, consisted of many governments, including in the EC, recognising and adjusting to what was happening in reality. And there has been less internal resistance to change in such rapidly expanding sectors than in agriculture, steel or mining, where specific skills and expertise may be lost for good. In these circumstances, the ongoing services round can be expected to help to accelerate and, within limits, modify reform projects that are already under consideration and, on entry into force, protect the new regimes from reversals. From that perspective, presupposing a continued commitment to services liberalisation and harmonisation, the EC – and its trading partners – stand to be among the main beneficiaries. The same applies, in principle, to EC-internal moves aimed at deepening integration in sectors and modes that are covered by current commitments. (Mode 4 may prove a special case, however.) The national treatment rule, wherever applicable, should ensure that internal reforms also benefit foreign companies established within the EC and, depending on the circumstances, suppliers competing from abroad under modes 1 and 2.[15]

The initial momentum, however, would need to come from "Brussels".

[13] Among developed countries, only "Other communication services" have proven less popular. They consist of postal, courier and audiovisual services. Maritime services are a special case insofar as the negotiations were not completed at the time, but suspended until the current round.

[14] R. Adlung, M. Roy: Turning Hills into Mountains? Current Commitments under the GATS and Prospects for Change, WTO Staff Working Paper (ERSD-2005-01), Geneva 2005.

[15] See footnote 9.