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The European Services Directive

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It is a truism that if you try to please everyone, you end up pleasing no-one. Europe's controversial Services Directive has arguably fallen into this trap. When it was passed on February 16, 2006 by the European Parliament, angry trade unionists gathered at the doors of the Parliament, protesting that the parliament had gone too far. Frustrated supporters of liberalization, for their part, dismissed it as a watered-down version of the original proposal that would do little to advance the goal of a single market for services in Europe.

The Services Directive aims to increase competition by eliminating restrictions on market access for service providers and by removing obstacles to the cross-border provision of services. Since the presentation of the first draft at the beginning of 2004, the directive has been the center of vigorous debate throughout Europe. The directive was perceived as putting at risk the "European social model" by allowing service providers to cross borders without abiding by local labor and social regulations. Many of the wealthier member states saw in the document an open door to service providers from new member states where wages are lower and social protection systems less developed. Moreover, the state plays an important role in the provision of many services in Europe (e.g. local transport, utilities, education, and health services) and many perceived the Services Directive as an attempt to privatize such services while ignoring their social component and in the process reducing quality standards.

The Services Directive has been depicted by its opponents as a symbol of the free market bias and the lack of social content of the European Constitution. In particular, a strong antipathy to the directive in France played an important role in the May 2005 "no" vote on the European Constitutional Treaty.

In fact, the Services Directive is a fairly modest attempt to improve the implementation of the principle of free trade in services that has been a part of the European Union since its inception. Service industries represent more than two-thirds of all economic activity in Europe, but growth and productivity in the service sector has lagged behind that of the United States. Liberalization of cross-border trade in services has the potential to increase European growth, but the various controversies over the Services Directive have already considerably narrowed its ambitions. Even in its the current form, though, the directive would still represent a small, but important step in liberalizing trade in services and in countering the recent revival of protectionist rhetoric in Europe.

An Introduction to the Services Directive

Imagine the case of a realtor based in country A that wants to sell a house located in country B to one of her clients. Country B does not however recognize the professional qualifications of realtors in country A and therefore does not allow them to work within its territory. They have to operate through a local intermediary or to obtain the relevant local qualifications. If the realtor wants to set up an office in country B, the company has to go through a complex administrative process that includes providing evidence that it will not “destabilize” its local competition. Also, local legislation requires a loan guarantee from a local bank and does not recognize equivalent guarantees from country A. Various other bureaucratic procedures need to be duplicated because country A and B’s administrations lack confidence in each other.

This is an extreme example, but it illustrates the obstacles a European company may face when attempting to set up or to provide a service in another European country. While the European Union has made substantial progress in the removal of obstacles to trade in goods, the service sector has remained largely sheltered from international competition. Following the large-scale initiatives during the 1990s to open to competition heavily regulated services industries such as telecommunications, electricity and financial services, Europe is now getting into the details by addressing more subtle obstacles to competition in a broader range of industries. The Services Directive seeks to create a free trade area for services as it already exists to a large extent for goods.

This is not a trivial process. Although the freedom to provide services throughout the EU is part of the treaty establishing the European Union, in practice, that freedom is often severely curtailed. The provision of services are generally more regulated than goods and the local nature of services regulation means that such regulations are not well suited for crossing borders. Moreover, the provision of some services requires the movement of service providers to the location of the customer. This implies that trade in services might imply movement of labor across borders, and thus might run up against a very large set of heterogeneous social and labor regulations that exist throughout Europe.

Conflicts concerning obstacles to trade in services or to cross border establishment of service providers have traditionally been referred to the European Court of Justice which is slow to rule. The Services Directive does not add anything new to the existing jurisprudence, but provides a systematic list of principles derived from case law that aims to simplify market entry regulation and to remove obstacles to trade in services. The advantage of having a directive is that it is easier to implement: while courts rule on a case-by-case basis, the directive establishes general principles that apply to a broad range of sectors and situations.

The Services Directive aims to cover a broad range of industries—from lawyers to hairdressers—and defines its scope by exclusion rather than by inclusion (i.e. by listing those industries that are not covered by it).

Why does Europe need a directive for services?

The service sector represents more than two-thirds of the economic activity and employment in the European Union and is the main driving force for growth within the European economies.

Services have accounted on average for more than 75% of the growth rate of the last decade. However, European economies have grown more slowly than the United States in the last decade. Services, in particular, have grown faster-as much as 30% faster-and their contribution to growth has been proportionally larger (above 85% of the growth rate) in the United States than in Europe.

Productivity growth in services has also been stagnant in the EU. The differences in productivity growth between the United States and the EU have been particularly important in the distributive trade (i.e. wholesale and retail trade and hotel and restaurant services) and financial services sectors. These industries not only account for an important share of GDP (19.3% in the EU and 26.9% in the US) but also play an important role as instruments for other industries. Their impact on the economy derives not only from their direct contribution to total value added but also from their role in facilitating the efficient functioning of other sectors of the economy.

Several explanations have been offered for the underperformance of the service sector in the EU, including the lower level of innovation, the lower rate of adoption of new technologies and the excessive regulation that limits access to the market.¹ The Services Directive does not aim to solve all the problems of the service sector in the EU but it focuses on the removal of regulatory obstacles to market entry and trade. This may help solve other structural problems since the existence of regulation limiting entry and restricting trade certainly hinders diffusion of existing technologies and innovation by new firms.

The potential impact of the Services Directive is difficult to evaluate given the abstract nature of its scope and the vague nature of the principles it contains. According to a study commissioned by the European Commission, the directive could increase GDP by 0.8 % and create about six hundred thousand new jobs. Another study foresees a boost in intra-EU trade of 30-60%.²

What does the Services Directive do?

The directive addresses three issues:

The first set of articles aims to remove obstacles to the freedom of establishment of service providers across Europe. To this aim the directive provides for administrative simplification measures and establishes the principles that regulation of services must respect. In particular, it

¹ See Mary O'Mahony and Bart van Ark, editors (2003), *EU Productivity and Competitiveness: An Industry Perspective. Can Europe Resume the Catching-up Process?* Published by the European Commission, Enterprise Publications, Giuseppe Nicoletti and Stefano Scarpetta, (2003), *Regulation, Productivity and Growth: OECD Evidence, World Bank Policy Research Working Paper No. 2944*, and Philippe Aghion and Peter Howitt (2005), *Appropriate Growth Policy: A Unifying Framework*, mimeo.

² Copenhagen Economics (2005), *Economic Assessment of the Barriers for the Internal Market for Services* at http://europa.eu.int/comm/internal_market/services/docs/services-dir/studies/2005-01-cph-study_en.pdf, and Arjan Lejour, Henk Kox and Raymond Montizaan (2004), *The free movement of services within the EU*, CPB Document 69.

establishes that regulation has to be relevant and proportional to the policy aim pursued and cannot discriminate between domestic and foreign companies.

Second, in order to facilitate trade in services, the initial proposal of the directive introduced the so-called “country of origin” principle, according to which a service provider would only be subject to the regulation of his home country. Under this principle, states would not be able to restrict the provision of a service by a company established in another Member State. Such a principle would certainly have helped to boost trade between EU states since companies would not need to abide by local regulations in order to provide a service in another country. Moreover, it would have created incentives for national governments to simplify their regulation in order to put every company in the market on equal footing to compete. As will be discussed in the next section, the “country of origin” principle was the subject of a great deal of controversy and was eventually removed from the directive by the European Parliament.

Finally, the directive provides for a minimum level of harmonization for issues such as consumer protection and safety standards and for mutual cooperation between the different national authorities.

The directive will apply to all companies established in the European Union, irrespective of their nationality. The simplification of procedures and the removal of measures that restrict or distort competition will facilitate market entry for EU and for non-EU firms, while the removal of obstacles to trade will make the cross border provision of services for any company established in the EU easier.

What are the controversial aspects?

The Services Directive has been hotly contested especially by trade unions and some national governments with regards to its scope, which country’s regulation should be applied, and the implications of the directive for labor mobility.

On the scope of the directive, there was a lot of controversy over which industries were affected by the directive. In addition to the services excluded in the first draft (i.e. those sectors covered by sector-specific legislation such as energy, telecommunications, financial services, and gambling), the Parliament has excluded services such as healthcare, social services and transport services and has opened the door to the exclusion of other services by Member States by allowing them to exclude those services “which are subject to specific public service obligations which have been assigned to the service provider by the Member State concerned to meet certain public interest objectives.”

A second controversial aspect is the application of the so-called “country of origin” principle. Many people feared that the application of such a principle would leave many services historically provided by each member state outside of government control. The principle was also criticized for the fact that it would require 25 different regulatory regimes within the same territory. The principle has been dropped by the Parliament and replaced by a non-comprehensive list of vague rules (such as non-discrimination, necessity, and proportionality) that must be included with any requirement imposed on service providers. The new wording is narrower than the “country of origin” principle and its effects on trade therefore more limited.

A third controversial aspect was the issue of labor mobility. Labor regulation remains a national issue in Europe. National governments retain the capacity to set labor markets standards and regulations. This has resulted in the existence of a broad variety of labor and social protection systems among the different European countries, as well as wide disparities in wage levels.³ Wage discrepancies are particularly significant between old member and new member states. In addition, free movement of people from new to old member states is not yet effective. Twelve out of the fifteen old member states retain restrictions on the entry of workers from new member states.

In contrast to trade in goods, trade of some services requires the cross-border movement of labor. Though the Services Directive did not modify labor legislation, many feared that this could be used as a way of circumventing local labor legislation, that is, that service providers could hire workers from cheap-labor countries under local conditions in order to temporarily perform jobs in high-wage countries.

The Parliament opted to remove any reference to labor markets from the directive. This however does not solve the problem but does avoid a confrontation. Trade in services cannot be fully liberalized without addressing the issue of cross-border labor mobility.

What are the future prospects?

The process of adopting the Services Directive has just started and the road to final approval will not be a short one, nor free of obstacles. The most optimistic predictions do not foresee the directive entering into force before the end of 2007. The European Parliament passed a heavily amended version of the directive with the support of the main parliamentary groups (the parliament's equivalent of political parties.) But, as an indication of just how divisive the directive is, more than 30% of the parliamentarians belonging to the groups that support the directive did not vote in favor of it. The new version substantially waters down the initial proposal but is still a useful instrument for the removal of barriers to entry and the promotion of further competition in the services industry.

The directive still has to go through scrutiny by Member States at the European Council. Although some states (such as the United Kingdom, the Netherlands, Spain, Poland, Hungary and the Czech Republic) have shown strong support for a comprehensive liberalization of the service sector, others have not yet taken a position. The adoption of the directive will require the support of at least seven other members, including France, Germany and Italy.

In March 2006 the European Council timidly welcomed the European Parliament's amendments. However, the Council reserved its final opinion until they received the analysis of the new draft that was recently presented by the Commission which incorporated most of the amendments proposed by the Parliament.

³ See André Sapir (2005), Globalisation and the Reform of European Social Models, *Bruegel Policy Brief 2005/0*.

In its current form, the directive would play an important but limited role in the opening the service sectors in Europe to competition. The main question now is how much the directive will be watered down in the remainder of the legislative process.

The implementation of the directive is however not trivial and will probably take a long time to complete. The directive establishes the principles all regulations must comply with and leaves in the hands of Member States whether or not current sectoral regulation conforms to the wording of the directive. Given the broad scope of the directive and the heterogeneity of the industries covered, many conflicts will have to be resolved on an individual basis.

Whatever the final result, there will be still room for further liberalization of the service sector in the EU mainly by extending the scope of future harmonization to all sectors and by addressing in a coordinated way the liberalization of trade and the reform of labor regulation.

In any case, the adoption of the Services Directive will be a breath of fresh air in a Europe that has of late experienced episodes of protectionism along with doubts about the member governments' commitment to complete the single European market.