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COMMISSION STAFF WORKING PAPER

**EXTENDED IMPACT ASSESSMENT OF PROPOSAL FOR A DIRECTIVE ON
SERVICES IN THE INTERNAL MARKET**

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1. INTRODUCTION

At the Lisbon Summit, EU leaders agreed a strategic goal of making Europe by 2010 “*the most competitive and dynamic knowledge-based economy in the world, capable of sustainable economic growth and more and better jobs and greater social cohesion*”. As part of the programme of actions designed to achieve this, the Council concluded that there should be “*by the end of 2000 a strategy for the removal of barriers to services*” and also emphasised that the EU should aim to increase employment in services as part of the effort to raise the overall employment rate to 70% by 2010. The European Council concluded, moreover, that “*further efforts are required to lower the costs of doing business and remove unnecessary red tape, both of which are particularly burdensome for SMEs*”.

The Commission Communication of December 2000² set out a two-stage strategy in response to the European Council’s request. The first stage involved the identification and analysis of existing barriers to the cross-border provision of services and establishment and was completed by the Commission’s report on the “State of the Internal Market for Services”³. The second stage, based on that analysis, was to bring forward appropriate solutions to the problems identified.

The Commission's report published in July 2002, and based on a large-scale consultation of stakeholders and a review of current economic and statistical sources, described how the Internal Market for services was not functioning as a result of legal and non-legal barriers affecting service providers and consumers. It concluded that the key global competitiveness goal set by the Lisbon European Council could not be met unless sweeping changes were made to the functioning of the Internal Market for services in the near future.

This Extended Impact Assessment analyses the options for addressing legal barriers affecting the Internal Market in services. It emphasises that, as services are everywhere in the modern economy, Internal Market barriers to services have a significant adverse effect on economic growth, employment and competitiveness in the EU. This conclusion is supported by the latest economic research and by evidence of the effect of regulatory barriers at the individual company level gathered during extensive consultation with stakeholders on problems encountered in Member States and Accession and Candidate Countries.

It then examines a variety of options and assesses their suitability for meeting the objective of creating a well-functioning Internal Market in services in time to meet the deadline set by the Lisbon Summit. The Assessment concludes that legislative action at Community level is required and that a horizontal instrument is the most appropriate solution. The content of two possible horizontal options is described, and their economic, social and environmental impacts are examined.

Finally, the Assessment sets out arrangements for implementation of the proposal, its monitoring and evaluation, details of accompanying policies⁴ and provides further information on the consultation carried out in the context of the Services Strategy.

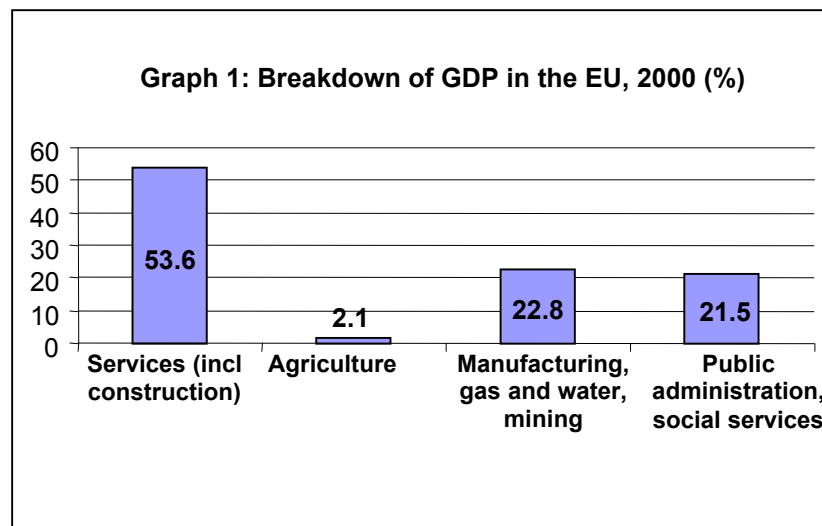
² COM (2000) 888 of 29.12.2000.

³ COM (2002) 441 of 31.07.2002.

⁴ In particular, this proposal has been developed in parallel with the Commission’s Communication on the Competitiveness of business-related services and their contribution to the performance of European enterprises, COM (2003) 747, December 2003.

2. ECONOMIC AND SOCIAL IMPLICATIONS OF THE FRAGMENTATION OF THE INTERNAL MARKET IN SERVICES

In order to assess the effects of the current fragmentation of the Internal Market in services, it is necessary to understand the significance of services in the EU economy (Graph 1).



Services are everywhere in the modern economy. In the EU, market services⁵ account for 53.6 % of GDP.⁶ Service providers represented 86% of the EU firm population in 2000 with wholesale and retail distribution activities alone accounting for 34% of the total population of enterprises⁷. However, even these data underestimate the role of services in the EU economy⁸, not least because statistics are based on distinctions between the service (tertiary), manufacturing (secondary) and primary sectors which are now considered obsolete⁹. In addition, services are increasingly found in what have been traditionally regarded as manufacturing sectors¹⁰, with many companies whose core business is manufacturing also deriving substantial revenues from the provision of a wide range of services.

The contribution of the main service sectors to the economy is shown in Graph 2.

⁵ In this context, services include construction (which is often neither categorised as a service nor a manufacturing activity in statistical classifications), but not public administration.

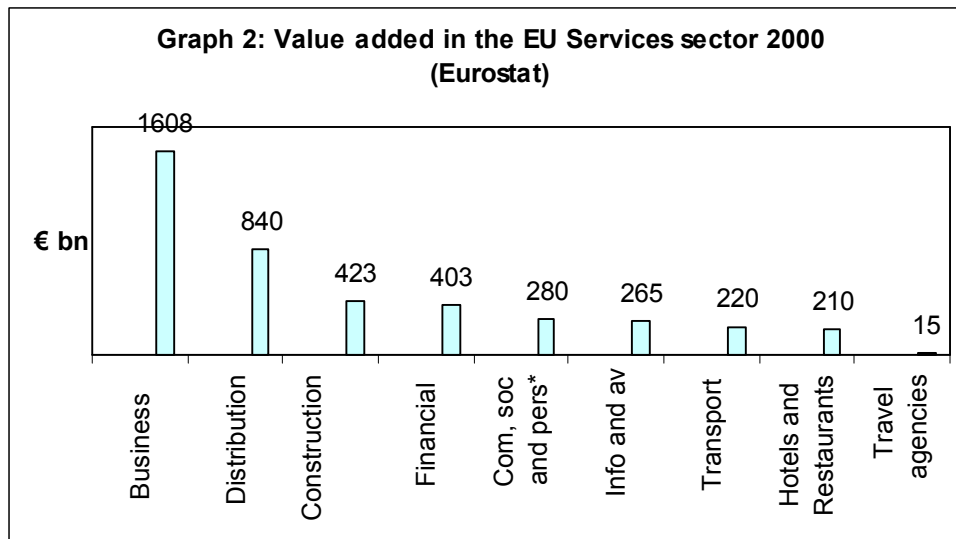
⁶ Services including public administration represented almost 70 % of EU value added at factor cost in 2000. EU GDP was €8569 bn in 2000. In the Accession Countries, services account for between 58% and 76% of GDP (2002 figures, excluding construction: Commission Monitoring Reports on preparation for EU membership, 2003).

⁷ See section 2 of the statistical annex.

⁸ See section 1 of the statistical annex.

⁹ Andersen, B. and Corley, M. (2003): "The theoretical, Conceptual and Empirical Impact of the Service Economy: A Critical review" United Nations University, World Institute for Development Economic Research. Discussion paper No.2003/22, March 2003. These distinctions date back to the 1930s when economies were dominated by manufacturing. They have been contested for nearly fifty years as underestimating the true role of service activities. See Stigler, G.J. (1956). "*Trends in Employment in Service Industries*". Baltimore: Princeton University press.

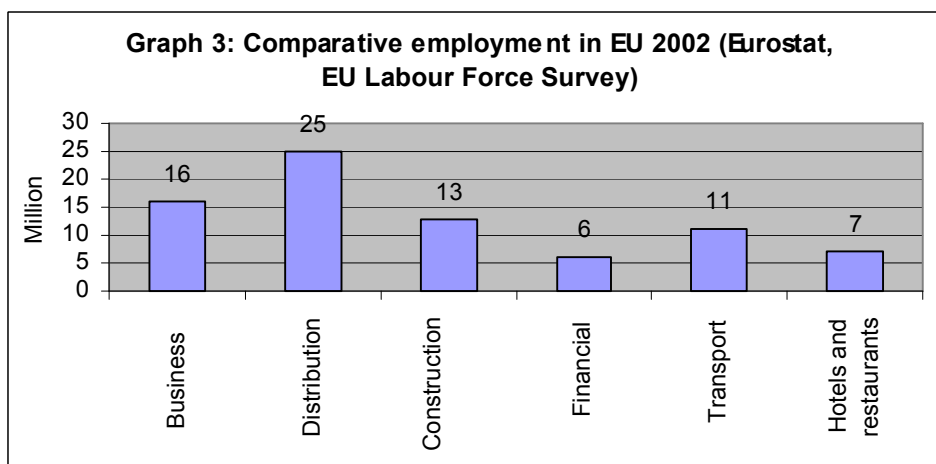
¹⁰ Giarini, O. (2002). "The globalisation of services in economic theory and economic practice: some conceptual issues" in *Trading Services in the Global Economy* edited by Cuadrado-Roura, J.R., Rubalcaba-Bermejo, L. and Bryson, J.R. Edward Elgar Publishing Inc (2002). Giarini goes on to explain: "for each product purchased, be it an automobile or a carpet, the pure costs of production or of manufacturing is very seldom higher than 20 per cent of the final price. More than 70 to 80 per cent is accounted for by the cost of making the complex service and delivery system function. This implies that service functions now account for the greatest part of investment even within the most traditional industrial companies. It must therefore be clear that the service economy does not exist in opposition to the industrial economy, but represents a more advanced stage of development in economic history".



*Community, social and personal services

Taking the period 1991 to 2000, the only two statistical branches that registered increased shares of EU GDP were those covering, firstly, financial intermediation, real estate, renting and business activities (+2.6%) and, secondly, distributive trades, hotels and restaurants, transport, storage and communication services (+0.9%)¹¹. These two branches grew annually during this period by 3.3% and 2.6% respectively¹², compared with an average annual growth rate of 1.5% in the rest of the EU economy over the same period. In terms of net enterprise creation, services consistently yield the highest levels of start-ups in the Member States.

In terms of employment, services accounted for 116 million jobs in the EU in 2002, representing 68.1% of the active workforce¹³, with wholesale and retail distribution registering 25 million jobs (14.6%; see Graph 3). This compares to the manufacturing sector which in total accounts for 33 million jobs (19.4%)¹⁴.



For the accession countries, the services sector accounts for a lower proportion of employment of the working age population compared to the EU, at less than 60% for the majority of these countries. Malta and Cyprus stand out as having as high a proportion of their economy devoted to services as existing EU members.

¹¹ Eurostat (2002) European Business: Facts and Figures.

¹² In terms of value added at constant prices.

¹³ Including construction, but not public administration.

¹⁴ European Commission: "Employment in Europe 2003, recent Trends and prospects", September 2003.

Despite the current dynamism of the services sector, it is clear that there is considerable untapped potential for growth in services, allowing for considerable further leverage in terms of employment and competitiveness. The economic evidence, as set out below, shows that the current state of fragmentation of the Internal Market has adverse effects on trade and investment flows, on innovation and productivity and on consumer prices.

2.1. Effect on trade and investment

The specific characteristics of the way that services are provided across borders¹⁵, together with Internal Market barriers, have important implications for cross-border trade and foreign direct investment (FDI) flows. Services, unlike goods, are typically not standardised, i.e. they are often tailored to meet the needs of an individual customer¹⁶. They are traded primarily through direct personal contacts¹⁷ which are necessary to allow a client to assess the quality, reliability and consistency of the service¹⁸.

This means that cross-border services are provided primarily either through temporary movement of the service provider into another Member State (which would be regarded as intra-Community trade) or through permanent establishment in another Member State (which would be regarded as intra-Community investment). For SMEs, especially for innovative enterprises, temporary movement is likely to be the key method of cross-border service provision, given that, at least initially, they often cannot afford the investment required to establish a permanent presence. Temporary provision may also precede, or be combined with, other modes of services supply. This is significant for the development of cross-border investment, in particular because barriers to temporary provision may also have knock-on effects for establishment strategies. Both temporary service provision and permanent establishment are, however, hampered by the wide range of Internal Market barriers identified in the Commission's report on "the State of the Internal Market for Services"¹⁹.

Because of the complex and intangible nature of services and the importance of the know-how and the qualifications of the service provider, the provision of services is often subject to much more complex rules covering the entire service activity than is the case for goods. The wide divergence in these rules between Member States may all too often render cross-border service activities unnecessarily costly, or even impossible.

This complexity and the effect of Internal Market barriers identified in the Commission's report help to explain why services account for a disproportionately low share of trade and investment in the Internal Market. In 2001 intra-EU exports of services were valued at

¹⁵ Dunning John H (1993) "The Internationalisation of the Production of Services: some general and specific explanations" in Aharoni (ed.) "Coalitions and Competition: the Globalisation of Professional Business Services", London and New York: Routledge.

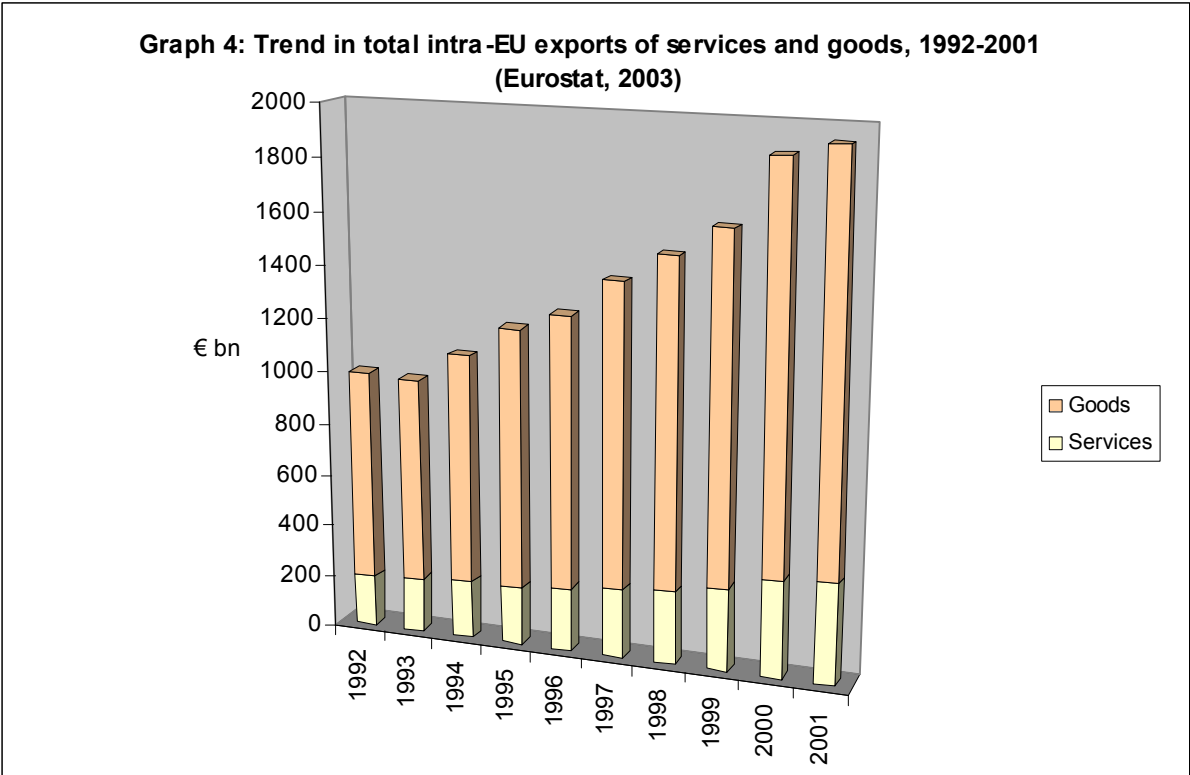
¹⁶ Rubalcaba-Bermejo L and Cuadrado-Roura J.R. (2002) "Services in the age of globalisation: explanatory interrelations and dimensions" in Trading Services in the Global Economy op cit. explain that "... *global movements of services are not so much associated with cross-border movements but rather with the transmission of processes, knowledge or techniques or with the exchange of residents and non-residents and the transfer of workers, managers and technology. The flows are not of products but of people and of ideas*".

¹⁷ OECD (2002), "Service providers on the move: the economic impact of mode 4", Working Party of the Trade Committee, Paris 11-12 December 2002 (TD: TC: WP (2002)12REV1).

¹⁸ See Giarini op cit.

¹⁹ Op cit.

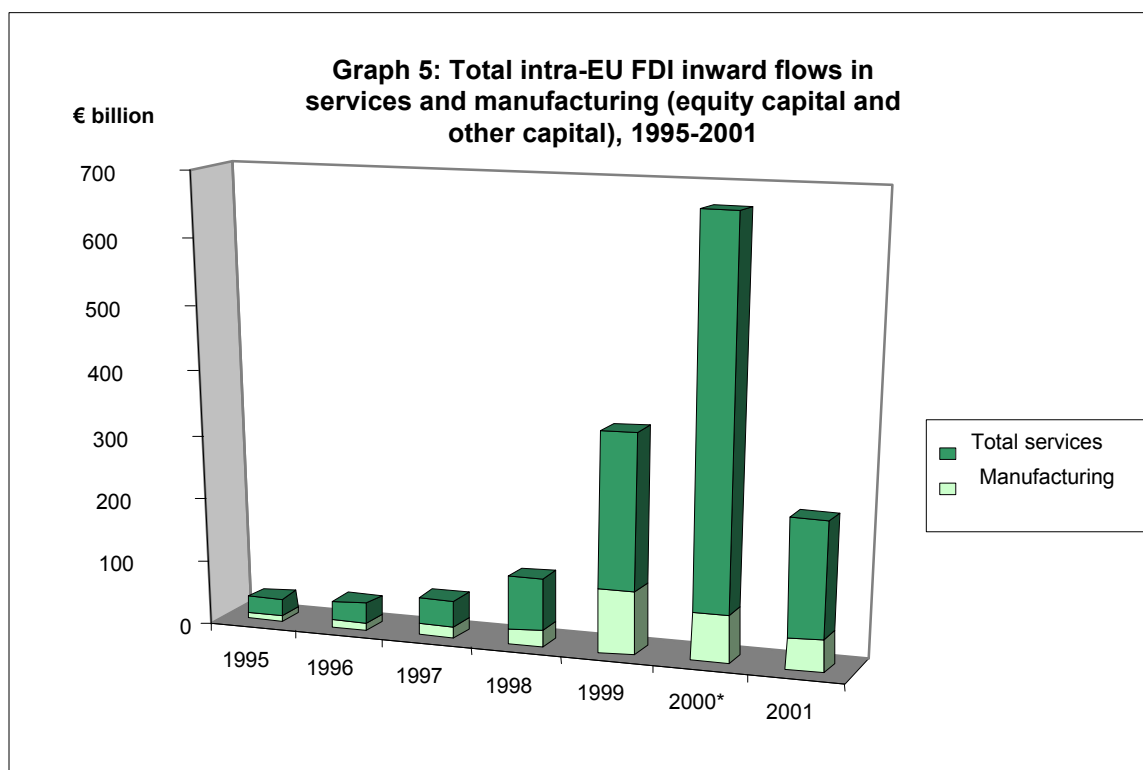
€386.4bn which only represented around 20% of trade in the Internal Market, compared with services' 53.6% share of GDP (see Graph 4)²⁰.



Intra-EU inward net investment flows for services in 2001 amounted to €181.2 bn²¹ (see Graph 5). This also appears low compared with the level of services activity in the economy. Given the dominance of services in the economy, there would appear to be significant untapped potential for further growth in intra-community trade and investment.

²⁰ Intra-EU goods exports were €1556 bn. See section 3 of the statistical annex. Section 1 of the statistical annex sets out the measurement problems and biases or underestimations that result in existing trade statistics.

²¹ Net investment flows for manufacturing were €50.25bn in 2001. A low level of manufacturing FDI might be expected given that the Internal Market in goods works relatively well.



* the unusually high figure for 2000 is as a result of one very large acquisition and other related ownership changes of companies in the telecoms sector. (Eurostat 2003)

2.2. Effect on employment

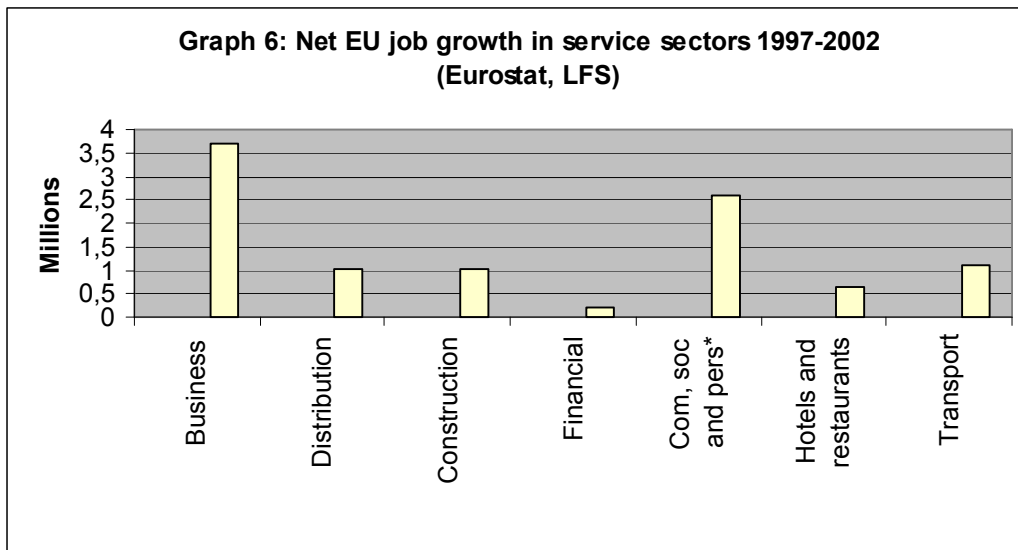
Service job creation will need to be prolific in order to reach the Lisbon 70% employment target²² since it implies 22 million extra jobs within EU 25 by 2010. All impediments to reaching this goal, including Internal Market fragmentation, must therefore be addressed urgently. Enlargement brings a particular challenge in this respect because accession countries have overall considerably lower employment rates than the current EU (55.9% compared to 64.3% for EU15 in 2002)²³.

Between 1997 and 2002 services accounted for approximately 11.4 million new jobs in the EU, representing 96% of total net job creation in the EU during that period²⁴ (see Graph 6).

²² See chapter 1 of European Commission: "Employment in Europe 2003" op cit.

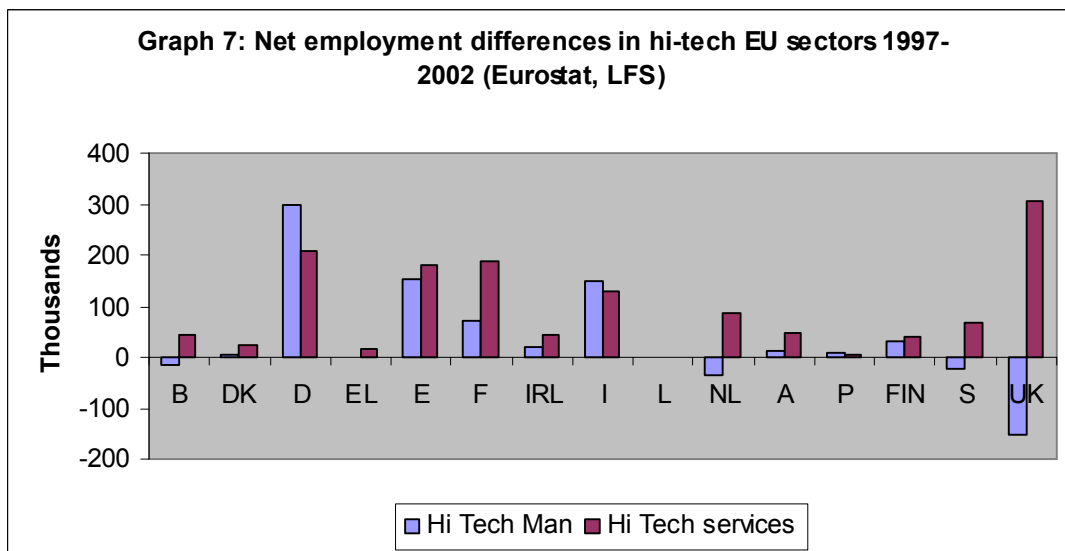
²³ The fact that these countries have a lower proportion of their workforce employed in services (less than 60%) compared with the EU 15 suggests that with entry into the EU, service market growth driven by new market opportunities will be even more critical for their employment performance.

²⁴ "Employment in Europe 2003", op cit.



*Community, social and personal services

Although service sectors employ both skilled and unskilled workers, it is important to note that services account for an important source of skilled employment creation within the EU. Between 1995 and 2002, some 7.5 million jobs in the EU were created in knowledge intensive service sectors²⁵. Furthermore, while over the same period all Member States experienced net job creation in high technology services²⁶, amounting to 1.4 million new jobs in the EU as a whole, the rise in hi-tech manufacturing jobs was less pronounced and did not cover all the Member States (see Graph 7).



It is therefore clear that services are playing an increasingly essential employment generating role in the EU economy, though this is largely as a result of demand at national level. Internal Market barriers to services mean that cross-border demand and competition are being suppressed. Since services are relatively labour-intensive, it can be presumed that the negative implications for employment growth are particularly significant. These negative implications

²⁵ These cover computer and related services (NACE 72), R&D (NACE 73), other business-related services (NACE 74), education services (NACE 80) and health and social services (NACE 85)

²⁶ These cover computer and related services (NACE 74), R&D (NACE 73) and post and telecommunications (NACE 64).

are likely to be compounded in the hi-tech and knowledge-based service fields, given the importance of investment in human capital for the growth of these activities.

2.3. Effect on SMEs

SMEs are the type of companies most affected by Internal Market barriers and are predominant in the service economy. In terms of firm size, the average number of employees in European enterprises is 6, whereas in the US the average is 19²⁷, reflecting the fact that employment growth in US companies in the years after their creation is much faster than in Europe²⁸. The fragmentation of the Internal Market, in particular in the area of services, may partly explain why average firm sizes are smaller in the EU than in the US²⁹ and why service start-ups have a higher risk of failure than in manufacturing within the EU³⁰, which in turn has an impact on sustainable employment growth.

There is clear empirical evidence that SMEs are keen to undertake cross-border operations. For example, according to one survey, about one third of European SMEs report an increasing number of initial international business contacts over the past five years, ranging from 30% for micro enterprises to 50% for medium-sized enterprises³¹. This suggests that the relatively low levels of intra-Community trade and cross-border investment in services reflect the scale of Internal Market barriers rather than a lack of potential for cross-border service activities.

SMEs are also particularly affected by barriers to the operation of cross-border networks, the formation of which may enable them to overcome particular problems. In the tourist sector, for example, four giant tour operators hold 80% of the global market. For small firms, unless and until they achieve a critical size that will allow them to have a commercial presence, they must often set up networks that involve moving their employees around³². Restrictions on the posting of workers, therefore, would undermine network formation, which in turn limits the potential for SMEs to benefit from the Internal Market.

2.4. Effect on innovation

Internal Market barriers often prevent companies from entering new markets and thus limit innovation in the Union's services sector. In 1996³³, 40% of enterprises engaged in service activities were "innovating" i.e. investing in R&D (this ranged from 58% in Ireland to 13% in Belgium) compared with 51% of the enterprises involved in manufacturing.

Innovation in services is often undertaken in order to specialize or create niche markets and for SMEs in particular, the exploitation of niche markets depends on their flexibility and responsiveness to client needs. According to one study, SMEs had on average a lower

²⁷ Observatory of European SMEs (2002), "SMEs in focus: main results from the 2002 Observatory of European SMEs".

²⁸ Sapir, A. ed. (2003), "An agenda for a growing Europe – making the EU economic system deliver", Report of an independent high-level study group appointed by the President of the European Commission.

²⁹ Eurostat (2002), "SMEs in Europe: Competitiveness, innovation and the knowledge-driven society".

³⁰ Eurostat estimate on the basis of 1999-2001 data: survival rates of new enterprises were highest in the industrial economy (90.2% survived into their second year of operation) and lowest in the service sector (86.7%), Eurostat (2002) "Business Demography in Europe – result for 10 Member States and Norway".

³¹ Observatory of European SMEs (2002) No1: "Highlights from the 2001 Survey".

³² OECD (2002), "Service providers on the move: the economic impact of mode 4", op cit. referring to an ILO report.

³³ Eurostat (2002) "SMEs in Europe: Competitiveness, innovation and the knowledge-driven society" op cit.

propensity to innovate³⁴, but they equalled or surpassed large firms in terms of intensity of innovation; that is, small firms who were innovators invested proportionately more in innovatory activity than large firms measured as expenditure in R&D/turnover³⁵. Hi-tech service SMEs also make an important contribution to European competitiveness because of the essential services they provide to all European enterprises³⁶.

The viability of an investment in niche markets largely depends on the level of foreseeable demand: if the estimated demand is limited to national borders, the resulting potential may not warrant the investment. Barriers to cross-border service provision are therefore particularly harmful to innovating SMEs (particularly those in peripheral or small Member States), who depend on being able to offer their services beyond their Member State of establishment in order to survive³⁷.

These restrictions on the scope for innovation also have knock-on effects on those sectors that rely on innovative business services as input. Overall, there is therefore likely to be less innovation than would be the case in the absence of Internal Market barriers.

2.5. Effect on labour productivity

Productivity in services depends on human capital, i.e. knowledge and skills. Unlike in manufacturing, it is difficult to replace labour with physical capital such as new technology. There is a wide spread of productivity levels in services across the Member States, which can only be partly explained by differences in national wage structures³⁸. As barriers to services in the Internal Market limit cross-border competitive forces and the diffusion of best practice, they remove some of the factors which would encourage an increase in and convergence of labour productivity levels across Member States.

Average labour productivity growth in the service sectors has in recent years been lower in the EU than in the US. The Commission's work on competitiveness³⁹ has found that the performance of the US in market services in terms of both productivity and employment growth is superior to that of most EU Member States, in particular in ICT-using services

³⁴ Although in Ireland 60% did and there was an equal split of innovators in the UK and Portugal between large and small enterprises. See Eurostat (2002) op cit.

³⁵ In 1996, in the services sector, Germany, Ireland, the Netherlands, Portugal, Finland and the UK all reported that small enterprises had higher innovation ratios in service activities than medium or large enterprises. In 1996, according to the available data, SME service innovators were on average investing 10.2% of their turnover to innovation compared to 3.1% in large enterprises (calculating averages over innovators rather than over the whole population of firms). Eurostat (2002) "SMEs in Europe..." op cit.

³⁶ For example, 45% of hi-tech SMEs in Europe-19 (EEA plus Switzerland) – a total of 340,000 companies - are in the computer and related services sector. See European Commission: Observatory of European SMEs 2002 / No 6 High-tech SMEs in Europe.

³⁷ Eurostat (2002) "SMEs in Europe: Competitiveness, innovation and the knowledge-driven society" op cit.

³⁸ See section 5 of the statistical annex. Productivity statistics should be treated with caution. Ideally, the economic performance of services should be measured over the life-cycle of the contract and not be evaluated in terms of static productivity measures. The once commonly held view that services have a low level of productivity may simply have reflected a failure to measure their value properly because of a methodology of measurement based on static concepts that date back to the industrial revolution. The same is true for labour productivity measures. As Andersen and Corley (op cit.) state: "... those industries that use new technology the most are determined as having the lowest levels of measured productivity. However, one of the arguments is not that these industries are unproductive, but that our attempts to measure such productivity with the data and definitions that we have available are flawed. Similar problems become visible when measuring the services knowledge base and service-innovation, as well as services' impact on global productive systems".

³⁹ European Commission (2002), "European Competitiveness report 2002", Commission staff working document (SEC (2002)528).

sectors such as wholesale and retail distribution. The current fragmentation of the Internal Market and insufficient economic integration in services sectors may have been one of the reasons delaying the diffusion of ICT and may have prevented European firms from benefiting from the large productivity increases by their US competitors in recent years⁴⁰.

This is supported by recent studies which suggest that, amongst other things, differences in market regulations affect productivity growth⁴¹. The OECD has found evidence that regulations which limit market entry hinder the adoption of existing technologies, and the creation and development of new high-tech firms⁴².

2.6. Effect on consumer prices

Barriers to cross-border trade and investment in services limit competition in the Internal Market, which keeps prices high and limits consumer choice.

Persistent price divergences across Member States suggest that the Internal Market still has significant potential for providing more benefits to consumers. EU services markets are typified by the lowest price convergence levels in the Union⁴³ indicating the extent to which national markets remain shielded from cross-border competition⁴⁴. Moreover, the lack of spread of best practice across national borders in certain service sectors (including those, such as retailing, which have a direct impact on consumers) also undermines price convergence in certain goods markets (notably branded goods)⁴⁵.

In addition, current price inflation is reported to be caused mainly by inflationary pressures in the services sectors⁴⁶. This may be explained by the fact that strong demand for services, combined with a relatively low degree of competition, allows higher cost pressures on suppliers to be passed onto consumers in the form of higher prices in their national markets with relatively greater ease than is the case for goods⁴⁷.

The inflationary pressure arising from certain cross-border restrictions should not be underestimated. For example, regional restrictions on the establishment and location of petrol pumps in one Member State have been estimated by that Member State's competition authority to have prevented the development of price-competitive petrol sales by general retailers (including retailers from other Member States) wanting to penetrate the petrol sales market. Such sales account for less than 1% of that country's sales, compared with 55% in a neighbouring Member State of comparable size where retailers are not subject to such restrictions. In addition, restrictions on sales below cost also help to keep prices high. For

⁴⁰ European Commission (2002), "Economic reform: report on the functioning of community product and capital markets", COM (2002) 743 final: see annex 2. O'Mahoney estimates that between 1995 and 1999 aggregate labour productivity in service provision increased by 16% in the US whereas it remained static in the EU.

⁴¹ Scarpetta, S., Hemmings, T. and Woo, J. (2002), "The role of policy and institutions for productivity and firm dynamics: evidence from micro and industry data", OECD Economic department Working Paper No. 329; Salgado, R. (2002), "Impact of structural reforms on productivity growth in industrial countries", IMF Working paper No. 10.

⁴² Nicoletti, G. and Scarpetta, S. (2003), "Regulation, productivity and growth: OECD evidence", *Economic policy*, 18: 9-72.

⁴³ European Commission (2002) "Economic Reform: report on the functioning of Community product and capital markets" op cit.

⁴⁴ The Commission has launched an invitation to tender for work on the development of a statistical methodology for price surveys of services provided to consumers in Europe.

⁴⁵ Statistical and technical annex to European Commission (2001) "Economic Reform: report on the functioning of Community product and capital markets", 7 December 2001. COM (2001)736 final.

⁴⁶ PriceWaterhouseCoopers (2002), "European Economic Outlook", September 2002.

⁴⁷ European Commission (2002), "The EU Economy: 2002 review" (COM (2002)712).

example, one Member State's competition authority found that such restrictions on groceries contributed only to higher gross retail margins for retailers.

3. OVERALL EFFECT ON COMPETITIVENESS

It is clear that, by reducing cross-border operations, lowering productivity levels, undermining innovation and suppressing competition in service markets, Internal Market barriers have an adverse effect on the overall level of competitiveness in the EU.

Competitiveness entails: "the ability of an economy to provide its population with high and rising standards of living and high rates of employment on a sustainable basis"⁴⁸. An increasingly used benchmark for the relative competitive performance of economies is the microeconomic competitiveness index⁴⁹. This index is based on an evaluation of four inter-related areas that have a determining effect on an economy's competitive performance⁵⁰. These areas are: factor conditions (which includes the legal and administrative framework as well as, amongst other things, scientific and technological infrastructure, information infrastructure and human resources); the context for firm strategy and rivalry (intensity of competition and quality of firm strategies); the presence of related and supporting industries (including suppliers from other Member States) and the quality of local demand conditions (pressure from buyers both domestic and in other Member States to upgrade products and services). The fact that Internal Market barriers to services affect each of these four areas suggests that the level of competitiveness of the EU economy is much lower than it otherwise could be.

Firstly, on factor conditions, it is recognised that an efficient and transparent regulatory framework is crucial to competitiveness. The evidence reported by companies of costs resulting from existing barriers⁵¹ indicates that the current EU regulatory framework in the services field is not meeting this competitiveness requirement⁵². Complex or inappropriate regulation in the official economy is, according to recent research⁵³, one of the key elements which encourages the development of the "undeclared" (or "shadow") economy. Barriers such as detailed, lengthy and complex authorisation requirements therefore encourage undeclared work with all its associated costs⁵⁴. This results in both significant allocative inefficiency and welfare losses⁵⁵, and also undermines the development of quality employment in the EU services economy. In addition, the fact that Internal Market barriers

⁴⁸ See the European Commission's 2001 competitiveness report.

⁴⁹ See Michael Porter's article in World Economic Forum (2002), "The Global Competitiveness Report 2001-2002", Oxford University Press.

⁵⁰ Competitive performance is typically approximated by total factor or labour productivity levels.

⁵¹ See section 4 below.

⁵² The Commission's Internal Market Scoreboard no. 9, November 2001 noted in respect of the regulatory burden on all companies in the Internal Market (not just service providers) that "*Several studies have estimated total regulatory compliance costs for companies to be between 4% and 6% of GDP. Assuming them to be 4%, the savings to be had from improving the quality of regulation in Europe could be of the order of € 50 billion.*"

⁵³ Enste, D.H. and Schneider, F. (2002), "Shadow economy: size, causes and consequences", Journal of economic literature Vol. XXXVIII March 2002, p 77-114.

⁵⁴ See also Commission Communication on Undeclared Work, COM (1998) 219 final: "*The weight of excessive overheads and administrative procedures, for example for registering as a service provider or for formalising an employment relationship, may discourage the declaration of work where both sides can see the advantages of not declaring it.*" This is likely to be the case, in particular, for service providers who only occasionally provide services into other Member States, and where the administrative formalities are out of proportion to the economic benefits.

⁵⁵ Estimates vary, with Enste and Schneider op cit. suggesting that in the EU Member States the shadow economy ranges between 13% and 30% of national GDP.

and administrative red tape prevent the efficient mobility and supply of skilled labour and human resources across borders undermines another key factor condition for competitiveness.

Secondly, the level of firm strategy and rivalry is being negatively affected in a number of ways. For those firms considering, entry into other EU markets by permanent establishment, two broad options are available. Either they enter by mergers and acquisitions, or they enter by a greenfield operation (i.e. through a new, custom-made operation or site)⁵⁶. Legal and administrative barriers to establishment result in costs which add an incentive to growing by acquisition.⁵⁷ Although mergers and acquisitions can be an effective commercial strategy, there is no doubt that such growth is not optimal for the economy as a whole, in particular in terms of competition. This is, amongst other things, because the trend towards cross-border mergers and acquisitions is likely to encourage defensive strategies at national level. There is, in particular, a risk that companies who will be more familiar with the local regulations and national regulators in their domestic markets will oppose the elimination of existing barriers or even promote the creation of new regulatory barriers to entry of foreign competitors. This risk of "regulatory capture" is increasingly highlighted in the economic literature⁵⁸.

Thirdly, as regards the presence of related and supporting industries, the current fragmentation of the Internal Market is not allowing users of services including manufacturers, to benefit from innovation and best practice from service providers throughout the EU because these firms are unable to offer their services beyond their national borders. This lack of diffusion of best practice is likely to be a key variable in explaining the divergent levels of labour productivity within similar service branches across the EU.

Fourthly, Internal Market barriers reduce the quality of local demand conditions. Consumer confidence in cross-border services is low, not least because of a lack of information about both the service provider and the quality of his service and how, if necessary, to obtain redress - issues which were identified in the Commission's report as important non-legal barriers⁵⁹. In addition, the current regulatory framework in some cases prevents users from taking advantage of services from another Member State; in other cases, users are not aware of services from other Member States because of restrictions on commercial communications across borders. Finally, the lack of competition in services markets results in higher consumer prices which in turn weakens demand.

In conclusion, it seems clear that barriers to services in the Internal Market have a negative effect on all four areas of competitive performance. Changes to the current regulatory framework, as well as accompanying non-legislative measures, are essential in order to enable the EU economy, in line with the Lisbon objectives, to provide its population with high and rising standards of living and high rates of employment on a sustainable basis.

⁵⁶ UK and US firms, because of the nature of their domestic capital markets, remain far more prone to expansion by acquisition than other companies. It is interesting to note in this respect that over the period 1989-1999, Europe surpassed the U.S. in both sale and purchase of service companies and in purchase growth rates. Moreover the service sector is more active in M&A activity in Europe than in the U.S. EU acquisitions grew by 39% compared to 32% in the US. See Cuadrado-Roura, J.R, Rubalcaba-Bermejo, L. (2002) op cit.

⁵⁷ The motives underlying cross-border mergers were discussed at length in the 1990s, notably at the time that the need for European merger control was being considered see, for example, "Continental mergers are Different: Strategy and Policy for 1992" (1990), Centre for Business Strategy report Series, London Business School. Parchment Ltd.

⁵⁸ Sapir (2003) op cit. emphasises that a growth enhancing regulatory environment must not only be conducive to the creation of business opportunities and the challenging of existing established positions, it must also protect new entrants from anti-competitive behaviour by incumbents, i.e. prevent regulatory capture.

⁵⁹ "Report on the State of the Internal Market for Services", op cit.

4. EVALUATING THE EFFECTS OF BARRIERS

Given the current weakness of services statistics and limitations on economic modelling, it would be very difficult, if not impossible, to provide a reliable global estimate of the effect of Internal Market barriers to services on the EU economy.

In order to evaluate the overall economic effects of Internal Market barriers, a macro-economic forecasting model would be required that would take account of the complexity of the linkages between service activities and their inter-relationship with manufacturing operations, while and using appropriate regulatory variables as proxies for the Internal Market barriers. Currently, no suitable model exists. Even if such a model were developed, the paucity of sufficiently detailed service statistics⁶⁰ would prevent the estimation of a global cost figure through the running of appropriate simulations. Equally, although general equilibrium models could be used to evaluate the scale of impacts of regulatory barriers on certain key economic growth and competitiveness indicators⁶¹, such models involve some radical assumptions and would again depend on the design of appropriate Internal Market barrier regulatory indices which currently do not exist⁶².

It is therefore currently not possible to provide meaningful figures for the more general economic and social effects of the costs resulting from Internal Market barriers. However, the fact that services are ubiquitous, inter-linked and integrated into manufacturing means that the implications for the level of trade in services in the EU, the level of economic and employment growth in general, inflation, labour productivity, innovation and competition in services, and on the level of undeclared working, are considerable⁶³.

4.1. Effect on individual service providers and users

The conclusion that there are considerable negative effects on the economy is supported by the evidence from both providers and users of services of the direct impacts Internal Market barriers have on them. The wide-ranging consultation carried out by the Commission⁶⁴ showed that there were several types of impacts. In the worst-case scenario, existing barriers prevented outright service providers from entering other Member States' markets. In other cases, they led to long delays and lost opportunities. In those cases where companies eventually did carry out cross-border business, Internal Market barriers resulted in considerable extra costs, which rendered their services less efficient and less competitive.

4.1.1. Barriers affecting cross-border establishment

In some Member States there are barriers to establishment which simply prohibit the taking up and pursuit of certain activities by service providers from other Member States. These include: nationality requirements in several Member States in respect of service providers, shareholders, management and staff of service enterprises; quantitative restrictions, which

⁶⁰ See section 1 of statistical annex.

⁶¹ Most of the current modelling work is associated with the WTO service negotiations. Examination of current OECD work indicated that existing models are not sufficiently developed to provide valid estimations for the current problem. The Commission's services have commissioned a group of economists associated with this most recent general equilibrium modelling work to adapt an existing model and develop appropriate regulatory indices such that it could be used to evaluate the impacts arising from the policy option selected by this impact analysis (see Section 5).

⁶² Existing indices focus exclusively on discriminatory barriers or absolute entry barriers. They do not take account of barriers resulting from requirements which are indistinctly applicable to national and foreign operators but which render cross-border services more onerous or more costly and which therefore can be contested under Community law.

⁶³ Efforts to address the weaknesses in statistics and modelling will be made as part of the evaluation and monitoring of the Internal Market in services. See section 8 below.

⁶⁴ See section 9 below.

some Member States impose on access to service activities, - e.g. *quotas* governing the number of service providers, in terms of population or *geographical distance* - or requirements to have one single establishment or the principal establishment in the Member State concerned.

For example, a medical laboratory wanting to establish subsidiaries in another Member State was prevented from doing so because of a legal requirement in that Member State which prohibited laboratories from having more than one establishment.

In other cases, cross-border establishments, although legally possible, are prevented, because existing barriers are dissuasive for service providers. Such barriers include administrative burdens surrounding, in particular, authorisation and licensing procedures, notifications and declarations, the number and format of documents to be provided, the number of different authorities which companies find too complicated and costly to deal with and the lack of single contact and central information points.

For example, a company estimated that the lack of central information points in Member States concerning information about legal and administrative requirements, registration procedures, authorisations etc., meant that it had to add one extra member of staff in each of its national planning divisions across the fifteen existing Member States and in the three Accession States it had entered. The resulting annual costs for the company were estimated at €3,600,000.

European businesses in general consider administrative barriers as a major hurdle to starting a services business⁶⁵. These result in information search costs due to the need for an assessment of which rules and procedures must be followed, and for more detailed analysis to determine how to meet these relevant procedures⁶⁶. In a Eurobarometer survey of companies starting a business in their home market, 69% held the view that administrative procedures were complex⁶⁷; moreover, administrative regulations represented the third most important constraint on European SMEs in general.

It is evident that, for non-domestic companies, who are not familiar with national procedures or language and who first have to investigate the procedures themselves, the resulting delays and costs are far more significant than for their local competitors, and are further aggravated if they want to operate in several Member States.

For example, a company reported that in one Member State each application for an authorisation took six months to negotiate and cost on average in internal staff and external legal fees €65,000. Foregone profits were estimated to amount to many millions of euros, and the company had to post a permanent expansion team for the negotiation with public authorities in the Member State in question.

In other cases, SMEs reported that they lost contracts because of the long delays involved in getting the necessary authorisations or in fulfilling other administrative formalities such as declarations or subscriptions to professional bodies and that eventually they decided to give up. Such delays occurred, in particular, when Member State authorities requested documents which did not exist in the Member State where the company came from.

For example, in some Member States, companies had to produce documents such as

⁶⁵ European Commission (2003), Green Paper on "Entrepreneurship in Europe", (COM(2003)27).

⁶⁶ Observatory of European SMEs (2002), "Recruitment of employees: administrative burdens on SMEs in Europe", 2002 / No. 7.

⁶⁷ Flash Eurobarometer 107 "Entrepreneurship", November 2001.

certificates of nationality or residence, certificates of solvency or reliability, or other documents (which also may have to be certified by a notary) concerning their activities in order to obtain necessary authorisations. If such documents did not exist in the service provider's home country, lengthy negotiations were necessary before the relevant authorities accepted equivalent documents.

Where service providers are not prohibited or dissuaded from market entry, they nevertheless incur considerable compliance costs. At least three types of such costs can be identified. The first is significant legal search costs. Extensive search needs to be carried out for any applicable legal or administrative requirements and for procedures and formalities which have to be fulfilled.

For example, one services trade association calculated that the direct costs of gaining the requisite advice on legal and regulatory requirements in order to establish a presence in a single EU member state stood at between €80,000 and €160,000.

These costs are additional to costs resulting, in particular, from different languages or cultural differences in commercial and consumption habits, which a company might in any case be expected to bear. Since such costs may occur at each stage of the business process, they will multiply throughout the provision of the service. SMEs are hit much harder than their larger rivals, since legal search costs are usually fixed and not proportionate to firm size.

In terms of the criteria which need to be met in order to obtain permission to operate, "economic needs tests" are among the most burdensome and costly for new entrants to deal with. They offer the greatest opportunity for discretionary and therefore unpredictable decisions. To be successful, applicants must pay for detailed market studies to show that their entry onto the market will not destabilise local competition⁶⁸.

A company indicated that the costs of undertaking a market study, hiring external consultants and using internal co-ordinating staff, ranged from €165,000 per test to €475,000 depending on the complexity of the tests in each Member State. The total cost to the company of preparing reports for "economic needs" tests, for 22 applications across the EU, amounted to €5.9m.

The second type of cost results from administrative complexity which may lead to delays in establishing or result in service providers, particularly SMEs, turning down or limiting cross-border activities.

The third type of compliance cost results from necessary changes to a service provider's business model due to differing legal and administrative requirements. Legal advice or consultancy may be required in order to assess how the legal or administrative requirements affect the service provider's business model: whether he can export it or whether parts of it, such as his promotional strategy, will have to be altered. The impossibility of using the same business model throughout the Internal Market prevents companies from taking advantage of economies of scale and impacts particularly on cross-border service providers.

⁶⁸ A retailer estimated that in one Member State, an "economic needs test" (that was not required in its home Member State) for each planned store resulted in an average lead time of seven months before a decision was given. The costs involved in this process were estimated at €20,000 per potential store and there was no guarantee that the application to operate would be approved. There then followed an average delay per accepted opening of eight months to get planning permission. The success rate for this firm was between 33% and 50%

Examples of requirements which force service providers to change their business model include those which necessitate a different legal form or internal structure from one they have in another Member State, requirements which prohibit companies from offering the same range of services they offer in another Member State because of restrictions on multidisciplinary activity, or requirements which impose the use of fixed prices.

It should be emphasised that service providers and users are rarely affected by a single barrier, as is demonstrated by the experience of a service provider in an accession country.

The company reported that, in order to build and operate a hotel, it had, amongst other things, to deal with three levels of authority (neighbourhood, district and town), each involving a separate negotiation process; it was mandatory to use local professional advisers; use of staff from the Member State of origin of the hotel chain had to be justified; rules were more strictly enforced on this company than on domestic competitors and overall it took 4 years to open one new hotel.

4.1.2. Barriers affecting cross-border service provision including cross-border use of services

In some Member States there are legal requirements which simply prohibit cross-border service provision. This concerns in particular cases where service providers are required to be established in the Member State in question before they can provide services there, which is the very negation of the freedom to provide services. These requirements also include: bans on setting up temporary offices by service providers not established in the Member State concerned, prohibition on the supply of a service by self-employed providers, or by ones who are not publicly appointed.

For example, in one Member State tourist guides were obliged to work as employees of travel agencies and were prohibited from offering their services as a self-employed provider. This excluded self-employed tourist guides from other Member States from offering their services there.

In other cases, cross-border service provision, although legally possible, is rendered very difficult by legal or administrative requirements which are burdensome, costly and often dissuasive for SMEs. This concerns, for instance, cases where Member States indistinctly impose all legal and administrative requirements applicable to suppliers established on their territory on suppliers established in other Member States who only wish to provide services there temporarily. As a result, service providers from other Member States are often made subject to national authorisations and other administrative procedures, involving the above mentioned administrative complexity, costs and delays. This is particularly harmful for SMEs and for suppliers who start exploring neighbouring Member States' markets by occasionally providing services to some clients there; when the time required to deal with administrative formalities is taken into account, the costs are disproportionate compared to the expected benefits.

Evidence collected from SMEs and SME support organisations⁶⁹ suggests that many SMEs back off after initial inquiries about administrative requirements and procedures because they feel they do not have the necessary resources to deal with the current complexity. Such agencies reported that micro-enterprises in particular were easily dissuaded from engaging in cross-border activities.

Where service providers are not prohibited or dissuaded from offering cross-border services they often incur considerable additional costs which make their services less efficient and less competitive. As with cross-border establishment, service providers must bear a range of compliance costs. These include legal search costs, which concern not only information about a multitude of national requirements applicable in the countries where the service is provided, but often also involve legal advice necessary to determine which Member State's rules apply. The legal uncertainty resulting from differing and sometimes conflicting Member States' rules is a major cost factor and a disincentive to cross-border service provision.

For example, a technical engineering company estimated that it had to spend approximately 3% of its annual turnover on research into the differing legal requirements potentially applicable to their service in two other Member States where it wanted to supply services. An electronic hardware and services company spent €100,000 on external legal advice to search only the applicable advertising rules in 5 Member States.

Again like cross-border establishment, service providers must bear costs resulting from the necessary adjustment of their business model in order to comply with differing national requirements. This includes additional guarantees or deposits and insurance necessary because of a lack of recognition of those already provided in the Member State of establishment.

A further cost factor for service providers is the legal and administrative requirements surrounding the posting of workers necessary to provide a service in other Member States. The costs include the search for information about the applicable minimum working conditions in the Member State where the service is provided and the administrative formalities which have to be fulfilled.

⁶⁹ 10 années d'expérience, rapport 1991-2001, Bureau de Développement Transfrontalier des Entreprises, Région Nord-pas de Calais.

A multinational IT company reported that it spent €8700 per year on administrative and legal support for the intra-EU posting of each of its 700 intra-EU assignees giving rise to a total annual cost of €6 million. Micro-enterprises in a border region posting workers into a neighbouring Member State reported that they spent several hours a week searching for information and dealing with formalities.

The problem is compounded for companies employing and posting workers from third countries, which is the case in particular for the IT and hi-tech sectors due to skills shortages in the EU.

For example, for an EU professional services firm seeking to post a consultant from a third country to work on a short term project in two EU Member States, obtaining the required work permit took almost 7 weeks for the first and 10 weeks for the second Member State. In addition, the work permit was only valid for a single entry. Furthermore, the application for the work permit for the second Member State could not be handled in the first Member State, so the consultant had to return home to complete the formalities, which in turn meant that he had to reapply for the work permit in the first Member State. As a result of this complexity the applications were withdrawn and the consultant taken off the project.

The above mentioned barriers to cross-border services affect not only providers but also users of services, whether business users or consumers. Due to differing rules and restrictions preventing cross-border provision of specialist business services, users of such services have to incur the cost of either relying on local suppliers, and thus establishing new contractual and business relationships or of setting up identical in-house support and technical services in every Member State.

For example, a company in the leisure industry explained that restrictions on the cross-border provision of architectural services meant that, for the design of buildings in an accession country, it was obliged to use local architects instead of relying on architects it worked with in its home country.

Individual citizens wanting to use cross-border services are affected by barriers which either simply prevent them doing so or which make such services more costly or less attractive. Areas where such barriers occur include tourism, sport and leisure activities, retail distribution, transport, broadcasting and telecommunication services, education and professional training and health services. Examples of cases where citizens are prevented from receiving cross-border services include: free-to-air broadcasting services encrypted to prevent reception outside the Member State where the broadcaster is established. Cases where cross-border services are rendered more costly or less attractive occur for example when nationals or residents of other Member States are prevented from benefiting from preferential tariffs and prices or promotional offers in a Member State, or when citizens have to pay higher taxes on services from other Member States, cannot benefit from tax deductions in the case of services from other Member States or do not receive subsidies for services in or from other Member States.

For example, in some Member States professional or language training can be deducted from income tax only if the training is carried out in the same Member State. In other Member States employees are entitled by law to grants from their employers only in the case of language training received in their own Member State.

A particular problem that citizens face is the refusal of Member States' social security systems to reimburse costs of medical treatment received in other Member States, which is reflected in numerous complaints to the Commission and cases brought before the European

Court of Justice. This often results in citizens either being dissuaded from receiving medical treatment in other Member States or having to bear higher costs than for services in their own Member State.

5. POLICY OBJECTIVE

The objective of the Commission's Services Strategy⁷⁰ is to create a well functioning Internal Market for services by facilitating cross-border service provision and establishment through the removal of the identified barriers and associated costs described above. This is a key component of the Lisbon European Summit's agenda of ensuring that the Union can become the most competitive and dynamic knowledge-based economy in the world, capable of sustainable economic growth, more and better jobs and greater social cohesion by 2010. In addition to calling for a strategy for services, the Lisbon Summit also defined the aim of raising the employment rate overall from an average of 61% to as close as possible to 70% by 2010. Member States have restated their commitment to this target⁷¹.

The objective of the Commission's proposal is also reflected both in the Broad Economic Policy Guidelines and in Employment Guidelines for the EU 2003-2005⁷². In line with the Lisbon Strategy, these emphasize the need to increase competition and competitiveness as well as job creation, including by removing barriers to cross-border trade and market entry in services.

Since the Lisbon Summit, the evidence collected from stakeholders, as described in the Commission's Report on the State of the Internal Market for Services⁷³, has confirmed the urgent need to remove Internal Market barriers to services. The European Council has reaffirmed its call for the Commission to take action in this field at subsequent summits⁷⁴. In addition, the Competitiveness Council concluded that very high political priority should be given to the removal of both legislative and non-legislative barriers to services in the Internal Market⁷⁵. Finally, the European Parliament has given its strong support for efforts to create a fully functioning Internal Market in services, including through legislative action⁷⁶.

The objective of the proposal considered in this Extended Impact Assessment is to provide a policy response that will remove Internal Market barriers restricting cross-border service activities sufficiently quickly and effectively for there to be a positive impact on the competitiveness and job creation of the EU economy by 2010. In addition, the competitiveness of the services sector will be supported by further non-regulatory measures at EU level⁷⁷.

⁷⁰ Op cit.

⁷¹ See Council Decision of 22 July 2003 on guidelines for the employment policies of the Member States (2003/578/EC).

⁷² Commission Recommendation on the Broad Guidelines of the Economic Policies of the Member States and the Community (for the 2003-2005 period), COM (2003) 170 final, 8.4.2003, Council Decision of 22 July 2003 op cit.

⁷³ Op cit.

⁷⁴ Conclusions of the European Councils of Stockholm (March 2001), Barcelona (March 2002) and Brussels (October 2003).

⁷⁵ Internal Market Barriers to the provision of services: Conclusions of the Competitiveness Council, Brussels, 14 November 2002.

⁷⁶ European Parliament resolution on the Communication from the Commission to the Council, the European Parliament, the Economic and Social Committee and the Committee of the Regions: 2002 Review of the Internal Market Strategy – 13 February 2003.

⁷⁷ These are set out in the Commission's Communication on the Competitiveness of business-related services op cit. See section 8 below.

This policy objective is in accordance with Article 3 of the EC Treaty which aims to establish an Internal Market by the removal of obstacles to the free movement of goods, persons, services and capital, and more specifically with Articles 43 and 49 concerning the freedom of establishment and the free movement of services. The proposal for a Directive is based on Articles 47(2) and 55 of the Treaty⁷⁸, the specific Internal Market legal base for services, as well as on Articles 71 and 80(2) of the Treaty concerning transport. Action at EU level is required because of the scale of the barriers in the Internal Market for services, the very large differences between Member States' regulatory systems, and the failure of existing policies to make any significant impact on the problem.

6. MAIN POLICY OPTIONS

6.1. General policy approach

The barriers identified as affecting the Internal Market for services have been analysed in accordance with the Commission's Internal Market policy approach in order to determine how they can be resolved. This analysis has shown that a number of barriers both to cross-border establishment and cross-border service provision are clearly discriminatory or disproportionate in the light of jurisprudence of the European Court of Justice and should be removed.

In order to facilitate cross-border establishment, there is an obvious need for administrative simplification, a need to remove restrictions resulting from over-complex, intransparent or discriminatory authorisation procedures and a need to remove a number of other requirements which currently hamper service providers' strategies for cross-border establishment.

The barriers affecting the freedom to provide services require mainly that Member States refrain from applying their own rules and regulations to incoming services from other Member States and from supervising and controlling them. Instead they should rely on control by the authorities in the country of origin of the service provider. This would remove the legal uncertainty and costs resulting from the application of a multitude of different rules and control measures to which cross-border service providers are currently subject. However, this means that Member States must have trust and confidence in each other's legal systems and control measures.

In particular, a Member State where a service is received must be able to trust that the Member State where the service provider is established is adequately supervising the provider and the quality of his service. This would require a minimum set of common rules relating to transparency, information and other quality requirements. It would also necessitate an efficient system of administrative cooperation between Member States, establishing their respective responsibilities in the context of cross-border service provision.

In summary, a measure to address the Internal Market barriers identified must as a result consist of a combination of the three inter-linked elements of the country of origin principle, harmonisation and administrative cooperation.

6.2. Available policy options

The following policy options have been examined:

- No policy change
- Voluntary self-removal of barriers by Member States

⁷⁸ Article 55 refers to Article 47(2), making it applicable to the free movement of services.

- Infringements launched by Commission
- Sectoral options
- Horizontal options

6.3. Initial screening of options

These policy options have been screened in order to determine which of them would be best suited to facilitating the creation of a well functioning Internal Market in Services in the timescale defined by the Lisbon Summit. In particular the options were examined in terms of whether they could address the horizontal barriers efficiently and in a way consistent with other Community policies.

6.3.1. No policy change

If no specific action were taken to remove the horizontal barriers identified by stakeholders in the consultation, the EU economy would remain as described in sections 2 and 3 above, and economic operators would continue to be burdened by the costs described in section 4. As was concluded in the Commission's report in July 2002, it is clear that the goal set by the Lisbon Council to make the European economy the most competitive in the world cannot be met unless sweeping changes are made to remove barriers to cross-border services in the near future. This conclusion has been supported by the Council and the European Parliament, as explained in section 5. No policy change is therefore not an acceptable option.

6.3.2. Voluntary self-removal of barriers by Member States

Member States recognised at the Lisbon Summit that the Internal Market in services was not working optimally and that a new approach was required to improve the situation. Unilateral action by Member States would allow them the flexibility to remove barriers at the national level, and indeed Member States are undertaking reforms at the national level aimed at promoting economic and employment growth⁷⁹. They have also contributed to the identification of barriers in the context of the development of the Commission's Strategy.

However, the Commission's Report has shown that a large number of economically significant Internal Market barriers to services are not being addressed and that little progress has been made since the Lisbon European Council towards removing them. Although national programmes of reform might have improved the prospects for cross-border service activities in some cases, in other areas changes to the national legal framework have erected new barriers. In the absence of agreement on a common and co-ordinated approach at EU level, individual action by Member States is likely to result in further fragmentation of the legal framework. It is clear that unilateral action by Member States is unlikely to yield sufficient results by 2010, while Member States themselves have recognised that action at the EU level is necessary⁸⁰.

6.3.3. Infringements launched by Commission

Infringement procedures have, together with preliminary rulings given by the Court, resulted in the development of a body of important case law concerning the freedom of establishment and free provision of services. However, it is clear from the experience of the Commission in pursuing infringement proceedings in this field over many years that the range and scale of the problems identified cannot be addressed by infringements alone in the timescale envisaged by the Lisbon Summit.

⁷⁹ See for example Report from the Commission (2002): "Economic Reform:..." op cit.

⁸⁰ Conclusions of the Competitiveness Council, November 2002, op cit.

Although infringement procedures are an essential part of the Commission's role as guardian of the Treaties, and will still be necessary in particular cases, they cannot be used to meet the strategic objective of creating a well-functioning Internal Market for services. Firstly, they could not resolve restrictions which, in the absence of a minimum set of harmonised rules and administrative co-operation, may be justified and which require such a legal and administrative framework at Community level for them to be removed. Secondly, infringements pinpoint very specific cases of misapplication of Community law and therefore cannot be used to tackle barriers in a systematic way. For example, in the event of a judgement of the Court, the Member State concerned complies normally just with the judgement in that particular case and does not screen other legislation to see if a similar barrier exists in other fields. In addition, the restriction which is removed may be replaced with a new restriction which will give rise to new infringement proceedings. Moreover, other Member States not directly concerned by a judgement tend not to take any action as a result of judgements given against one Member State. Thus, there is a very high probability that in an enlarged Union of 25 Member States hundreds of new infringement procedures would need to be launched just to address those identified barriers to the Internal Market in services that can be removed without a Community legal framework.

Finally, infringement proceedings are a slow, costly and resource-intensive option. In each case, a solution and/or a judgement by the Court might not be reached for several years and extra resources would be needed at national and EU level over many years to handle the large number of procedures which might be expected.

6.3.4. Sectoral options

Sectoral instruments have in the past been applied to a number of service sectors and have been successful in removing barriers in some areas, such as financial services. However, according to the NACE classification, there are 83 service sectors (at three digit level, excluding financial services); at five digit level there are over 300, without taking into account the continuous development of new services activities. This implies that, if sectoral options were chosen, a very large number of individual instruments would need to be put in place in order to have an appreciable effect on the operation of the Internal Market in services.

Sectoral instruments would need to take into account the "horizontal" character of many barriers, i.e. those identified as being common to a large variety of services. For example, the legal requirement to have a permanent establishment in a Member State in order to provide a service there currently restricts the provision of a number of different services. A sectoral approach would mean that a number of sectoral instruments would have to be put into place just in order to remove this requirement, and they would need to do so in the same way.

Such an approach would therefore involve the negotiation of a large number of sectoral instruments, resulting in duplication of effort and the use of significant resources by both Member States and the EU institutions. It is difficult to see how such a workload could be completed in time to have an effect by the target date of 2010. A sectoral approach would also fail to take into account the nature and dynamism of services markets. Businesses often provide a range of different services and a sectoral approach would carry a considerable risk that essentially the same issues (but affecting different services) would be addressed in different ways, resulting in new inconsistencies in the legal framework. In addition, since new services are constantly emerging, additional sectoral instruments would be continuously required. Nevertheless, for certain issues, such as cash-in-transit services, gambling and judicial recovery of debts, additional sector-specific instruments may be required, as these raise particular public policy issues which may need to be addressed by more detailed harmonisation. For horizontal barriers, by contrast, sectoral instruments do not constitute a realistic option.

6.3.5. *Horizontal options*

The consultation with stakeholders and Member States showed that there are a large number of horizontal legal barriers to the working of the Internal Market in services. Analysis of the barriers by the Commission services suggests that these barriers could be addressed by action at Community level which combines administrative co-operation, the application of the country of origin principle and harmonisation of some basic quality requirements for services. A single horizontal instrument would allow horizontal barriers to be addressed using this combination of techniques in a coherent and efficient way. It would furthermore take into account existing Community *acquis* and ongoing specific initiatives in the field of services. It should also be noted that the Council concluded that Internal Market barriers should be addressed as far as possible in one single instrument, while the European Parliament called for a horizontal approach⁸¹.

A horizontal **Recommendation** could presumably be proposed and agreed relatively quickly and might encourage the process of regulatory and administrative simplification in a more coherent way than unilateral voluntary action by Member States. However, as a Recommendation is non-binding, there is no guarantee that Member States would implement it substantively or quickly enough. For example, the Commission Recommendation of April 1997 on Improving and Simplifying the Business Environment for Business Start-Ups⁸² contains a number of elements (e.g. single contact points or disciplines on the granting of licences) which, if applied in a cross-border context, would facilitate cross-border services. However, although some progress is being made in a number of Member States, a considerable amount still remains to be done to achieve the goals set out in the Recommendation.

A horizontal **Regulation**, which would be directly applicable, would require very detailed and precise harmonisation. This could not easily provide also for the combination of mutual recognition, administrative co-operation and harmonisation necessary to deal with the range and dynamism of services markets. Attempting to do this via a Regulation, rather than making use of national implementing measures, could result in regulatory over-complexity and would take considerable time and resources to negotiate.

A horizontal **Directive** could provide legal certainty for service providers without imposing over-complex rules. It could also provide for a system of administrative co-operation, the application of the country of origin principle, and where necessary harmonisation, in a single instrument. It would be possible to agree essential requirements at Community level while providing for the necessary flexibility for Member States and economic operators.

6.3.6. *Conclusion of initial screening of options*

On the basis of the initial screening, it can be concluded that co-ordinated action at Community level is necessary to remove the identified Internal Market barriers and that a horizontal Directive would be best suited to meeting the policy objective of creating a properly functioning Internal Market for services. In accordance with the case law of the European Court of Justice, certain barriers may be justified in the absence of a Community instrument and therefore require co-ordination of national regimes, including through administrative cooperation, in order to remove them. In addition, Member States have failed to remove even those obstacles which have already been judged by the Court as incompatible with the Treaty. It is therefore clear that the policy objective cannot be met by unilateral

⁸¹ European Parliament Resolution, 13 February 2003, *op cit*.

⁸² C(97) 1161, 22 April 1997.

action by Member States but requires action at Community level. The choice of a Directive therefore complies with the principle of subsidiarity.

Finally, the content of the Directive is limited to those issues which it is strictly necessary to address and which have been identified as requiring action in the consultation. A horizontal Directive which addresses the barriers identified as being common to a large variety of services, proposes a balanced combination of different methods of regulation (a mix of the country-of-origin principle, administrative cooperation and, where necessary, harmonisation) and which avoids detailed sector-specific harmonisation, would therefore fully respect the principle of proportionality. Given the large number and complexity of Internal Market barriers it is possible to envisage two approaches. The first would be a “single-stage” Directive which would seek to remove all barriers immediately. The second, “phased” Directive, while requiring Member States to remove a significant number of barriers on transposition, would set up a framework to deal with remaining barriers on the basis of mutual evaluation between Member States, stakeholders and the Commission.

7. IMPACT ANALYSIS

The following analysis sets out the key elements of the selected options and examines their expected impact on the economy, social issues, the environment and on national administrations. The major impacts of both options are expected to be economic and social, in terms of economic growth, consumer choice and net job creation.

There will also be an impact on national administrations, which would incur some initial costs associated with modernisation and simplification of their legal and administrative framework. However, as programmes of administrative reform are already underway in a number of Member States, the net additional costs are unlikely to be very significant and should in any event be outweighed by economic gains.

Analyses undertaken to mark the 10th anniversary of the completion of the Single Market Programme show the benefits that have been achieved by improvements in the functioning of the Internal Market. These indicate that EU GDP in 2002 was 1.8 percentage points, or €164.5 billion, higher thanks to a better functioning Internal Market, and that about 2.5 million jobs which had been created in the EU since 1992 are the result of the opening up of frontiers⁸³. However, the majority of the benefits have been achieved as a result of measures addressing the free movement of goods and of liberalisation of the network industries. The creation of a well-functioning Internal Market in services, based on a comprehensive, modernised legal framework which takes account of the evolution of services in the economy, could result in gains on an equivalent scale.

As already stated, measuring the impact of regulatory reform on services markets and the expected gains to the economy as a whole from a better functioning Internal Market is very difficult. Work by the OECD suggests that considerable gains could be achieved by far reaching regulatory reform in certain service sectors. One study dealing mainly with the network industries and retailing estimated that more heavily regulated economies could experience real increases in GDP of 3%-6%⁸⁴. Overall, the expected gains from the implementation of the Directive are unlikely to be as large as this since, although the Directive covers a broader range of services than in the OECD study, it does not address the issue of liberalisation of state-controlled enterprises or public utilities.

⁸³ “The Internal Market – Ten Years without Frontiers”, European Commission Staff Working Paper, January 2003.

⁸⁴ OECD Report on regulatory reform, 1997

Sectoral OECD studies have demonstrated more specific potential gains from regulatory reform, for example in retail distribution and in construction. For retailing, they suggested that employment in this sector in one Member State would have been 20% higher between 1975 and 1998 had there not been heavy restrictions on the establishment of new large outlets⁸⁵. It also found that over-regulation damaged consumers' purchasing power and impeded modernisation of the sector. In construction, another study demonstrated links between a high level of regulation on the one hand, and low productivity and high prices on the other⁸⁶. Although these studies concern gains to be expected from regulatory reform at national level, they give an indication of gains which could be expected from a better functioning Internal Market and increased cross-border competition.

7.1. Key elements of the selected options

The selected options - the single-stage Directive and the phased Directive – share a number of key elements, but where they differ, this is explained below.

7.1.1 Scope

Both versions of the Directive would apply to a large variety of services within the EU including, but not limited to: business services such as management consulting, certification and testing, maintenance, facilities management and security services, advertising services, employment agencies or commercial agents; services which are provided to both business and consumers such as legal or fiscal advice, architectural services, real estate agents, construction services, distributive trades, travel agents, organisation of trade fairs and exhibitions and car rental; and services provided to consumers such as tourist guides, entertainment-related services (including audio-visual services, sports centres and amusement parks), health services and personal domestic services, such as assistance for old people. However, financial services, which are already the subject of a comprehensive Internal Market policy under the Financial Services Action Plan⁸⁷, transport services to the extent that they are regulated by other Community instruments, and issues covered by the recently agreed regulatory package for electronic communications⁸⁸, are explicitly excluded from its scope.

7.1.2. Administrative Simplification

Both options would provide for administrative simplification. For example, when requesting a document to prove the fulfilment of a requirement, Member States could not insist on a specific type or format of document, but would have to accept relevant documents from other Member States even if they are in a different form. Member States would also have to ensure that a service provider could fulfil all the procedures and formalities relevant to the access to and exercise of his activity through a single point of contact. The detailed implementation of this requirement would be left to Member States; so, for example, the number of these points of contact in each Member State could vary according to regional and local competencies or according to the activities concerned. Member States would also be required to provide all

⁸⁵ Regulatory reform in retail distribution, O. Boylaud and G. Nicoletti, OECD economic studies no. 32, 2001/i.

⁸⁶ Deregulation and privatisation in the service sector, Hoj, Kato and Pilat, OECD Economic Studies, No. 25, /1995/11.

⁸⁷ Communication of the Commission: Financial Services: Implementing the framework for financial markets: Action Plan COM(1999)232, 11.05.99. See also 8th Progress Report on implementation of the FSAP, SEC/2003/655.

⁸⁸ This comprises Directive 2002/21/EC (Framework Directive); Directive 2002/20/EC (Authorisation Directive); Directive 2002/19/EC (Access Directive); Directive 2002/22/EC (Universal Service Directive); Directive 2002/58/EC (privacy and electronic communications).

relevant information on legal and administrative requirements linked to service activities and to introduce electronic means for the fulfilment of procedures and formalities.

7.1.3. Reduction of the number and increased transparency of authorisation schemes

Member States would be required in both options to make authorisation schemes more objective and transparent by eliminating discriminatory and arbitrary requirements and by defining clearly the criteria which the service provider has to meet. Member States would also have to reduce the length of authorisation procedures, to fix reasonable deadlines which were known in advance, and to provide for proper motivation of refusals of authorisations. Ultimately, the Directive would have the effect of reducing the number of authorisation schemes. However, the options would vary in that the single-stage Directive would specify service activities for which authorisation schemes had to be removed immediately and replaced by less restrictive measures (such as simple notification schemes), whereas the phased Directive would, for a variety of services, first make authorisation schemes subject to evaluation and a consultative process before their removal could be proposed.

7.1.4. Removal or evaluation of other requirements

Member States would be obliged to abolish a number of discriminatory and other provisions, such as nationality or residence requirements. Whereas the single-stage Directive would list all such requirements immediately, the phased Directive would list only a limited number of requirements for immediate removal and would make others subject first to mutual evaluation and a consultative process, with their abolition, where appropriate, being required at a later stage.

7.1.5. Country of origin principle

Under both options, the Directive would ensure that a service provider who wants to supply services to clients in another Member State would in general be subject only to the rules and regulations of the Member State where it is established. Member States where the service is received would, be prevented from restricting the provision of the service. For example, Member States would not be permitted to force a service provider to establish on their territory nor to obtain an authorisation before providing its service there. Nor could Member States impose on the service provider their own requirements governing the exercise of the service. Both versions of the Directive would provide for a number of derogations from this principle. The phased Directive would, in addition, provide for further temporary derogations from the country of origin principle (for cash-in-transit services and judicial recovery of debts) which would be phased out at a later stage once additional harmonisation instruments were in place or at the latest by 2010. The single-stage Directive would not provide for these additional temporary derogations.

7.1.6. Clarification of the rights of users of services

Both versions of the Directive would prevent Member States from discriminating against users of services or imposing restrictions on them, such as authorisations for the use of services from other Member States or tax discrimination which would render services from other Member States more costly. Both options would also address the specific question of reimbursement of costs for medical care received in other Member States and would clarify the conditions under which such reimbursement should be granted.

7.1.7. Facilitation of the posting of workers

Administrative burdens on the posting of workers would be reduced in both options. Member States would not, for example, be permitted to impose on service providers the obligation to file prior declarations (with the exception, temporarily, of the construction sector) each time a worker is posted, or to have a representative in the country where they have posted workers.

Nor would it be possible to impose formalities such as temporary work permits in the case of the posting of workers from third countries who were legally resident and employed in the Member State of the service provider.

7.1.8. Harmonisation of quality requirements

In order to enhance trust and confidence in cross-border services, the Directive would in both cases provide for a minimum set of harmonised rules to protect the interests of users (which would apply in addition to rules established in other Community instruments). Service providers would for instance have to provide basic information to their clients, such as their place of establishment, and, at the request of the client, information about their service, its price and any warranties. Moreover, service providers whose services carried a particular risk for the health, security or financial situation of their users would have to take out appropriate professional indemnity insurance.

Furthermore, both versions of the Directive would require Member States to remove bans on commercial communications for members of regulated professions, while also requiring that, in the interest of users, such commercial communications respected professional rules aiming to ensure the independence of the profession and professional secrecy. With respect to multi-disciplinary partnerships (i.e. between members of different professions), Member States who allow such partnerships would be required to ensure that the independence and impartiality of the service provider is guaranteed and that the deontological (i.e. professional ethics) rules applying to, for example, lawyers and tax advisors, are compatible.

Finally, the Directive would encourage the use of certification and quality labels and would facilitate cross-border redress.

7.1.9. Cooperation between Member States' authorities

Both versions of the Directive would provide for enhanced cooperation between Member States. Member States would have to assist each other and share information about any risks related to particular service providers or their services. Authorities in the Member State where the service provider is established would also be obliged to supervise its activities when these are provided to users in other Member States, with the cooperation of the authorities of that Member State. This would improve cross-border enforcement, and at the same time avoid the duplication of control with which cross-border services are currently burdened.

7.1.10. Process of further convergence

The single-stage Directive would seek to address all relevant issues immediately, whereas the phased Directive would address a significant number of issues, while setting out a framework for a process of further convergence of national rules. This process would comprise the encouragement of codes of conduct at Community level - in particular with respect to deontological rules for regulated professions - additional harmonisation measures with respect to cash-in-transit services, gambling and judicial recovery of debts, as well as to certain other areas which could be identified through the process of mutual evaluation. This process is without prejudice to the elaboration of future Community measures as regards consumer protection.

7.2. Economic and social impacts

The aim of the Commission's proposal is to foster greater economic and employment growth, by removing barriers to cross-border service provision and establishment. In terms of direct impacts on service providers, an attempt has been made to describe the different implications of the two options. However, given the statistical and measurement problems referred to above (and the difficulty in quantifying even the effects of existing barriers) it is not possible accurately to measure detailed differences between the wider economic, social and

environmental impacts. Therefore the overall effect on SMEs, employment, innovation, productivity, consumers and other factors is described without evaluating the differences between the two options.

7.2.1. *Direct impacts on service providers*

A major impact of both versions of the Directive would be to encourage more cross-border activities by reducing administrative and legal complexity and improving legal certainty. This would stimulate cross-border growth of companies who currently are legally prevented from doing cross-border business or turn down business opportunities because of administrative costs or legal risks. The Directive would significantly reduce compliance costs such as legal search costs resulting from widely diverging regimes in Member States and adjustment costs arising when service providers have to modify their business model to take account of different legal requirements. As stated above, while it is impossible to provide a precise estimate of these costs, it is clear that they are borne by many service providers, irrespective of size, or type of activity, and that they affect in particular SMEs. Therefore, it can be expected that the elimination of these costs, and the increase in opportunities for cross-border activity, would be of significant benefit to business, including manufacturers, consumers and ultimately the competitiveness of the EU economy as a whole.

For service providers seeking to establish in another Member State, administrative simplification, increased transparency of authorisation schemes (and the criteria underpinning them) and the removal of a number of discriminatory and disproportionate requirements would significantly reduce compliance costs⁸⁹. These measures would also increase legal certainty for service providers and users, which, combined with the possibility of completing all formalities through a single point of contact, would allow for far more efficient planning of cross-border expansion⁹⁰. The resulting savings would be available for investment in human capital or innovation within those enterprises. The measures should therefore have a significant positive impact on allocative efficiency within EU companies.

The scale of this impact will differ according to which of the two options (single-stage or phased Directive) is selected. The single-stage Directive, if adopted and implemented, would have a greater impact since it would require Member States, on transposition, to remove more requirements affecting cross-border establishment than the phased Directive, which would remove a limited number of barriers immediately while the remainder would be subject to further evaluation.

For cross-border service providers, the application of the country of origin principle would ensure that they would have to comply only with the legal and administrative requirements in their own Member State, instead of a multitude of differing and sometimes conflicting rules in other markets. This would also significantly reduce legal search and adjustment costs⁹¹. In particular, the removal of the requirement to establish a permanent presence in order to provide a service would, alone, lead to significant savings given the costs involved with a

⁸⁹ See example in section 4.1.1 on compliance costs resulting from economic needs tests: a company indicated that the costs of undertaking a market study, including hiring external consultants and using internal co-ordinating staff, ranged from €165,000 per test to €475,000 depending on the complexity of the tests in each Member State.

⁹⁰ In Portugal, *Business Formalities Centres* have been set up since 1997 to bring together representatives of all public departments responsible for the different formalities required to register a new firm. Procedures have also been simplified; as a result, the time to set up a business has been reduced by as much as 80% compared with the mid-1990s. See Commission's Green Paper on Entrepreneurship in Europe, COM(2003)27 final, 21.01.2003.

⁹¹ See example in section 4: an electronic hardware and services company spent €100,000 on external legal advice to search only the applicable advertising rules in 5 Member States.

permanent establishment⁹². The single-stage Directive would apply the country of origin principle to a greater number of areas than the phased Directive which, in some cases, would allow for temporary derogations, but in either case, this is likely to have a significant positive impact on allocative efficiency.

At the same time, the harmonisation of basic quality requirements for services could result in some costs to service providers. The level of information which service providers would be required to make available to clients would be higher than that given by some suppliers at present. However, most of the information would have to be given only on request – something which a business might in any case be expected to provide. Resulting additional costs, if any, are likely to be marginal. Similarly, the requirement for mandatory professional insurance for activities involving a particular risk should not result in significant additional costs. Such a requirement already exists in many Member States for a variety of economic activities. But, even where insurance is not mandatory at the moment, it is already likely to be normal business practice to take out professional indemnity insurance, at least for those activities which create a particular risk⁹³. Resulting costs, again if any, should be marginal. Moreover, as these quality requirements are aimed at increasing the trust and confidence in cross-border services, they are likely to increase market opportunities for service providers which should compensate for the small extra cost involved.

7.2.2. Impacts on SMEs

The expected economic benefits would be particularly important for SMEs, who are more likely than larger firms to turn down cross-border opportunities because of complex legal and administrative requirements. Administrative simplification would therefore be particularly important to SMEs⁹⁴. Furthermore, the application of the country of origin principle would significantly reduce legal search costs. This again is particularly important for SMEs, given that legal search costs are fixed, and so they hit smaller firms disproportionately hard. Similarly, the simplification of administrative requirements relating to the cross-border posting of workers will significantly reduce compliance costs. Finally, the increase in trust and confidence in cross-border services resulting from harmonisation of quality requirements and enhanced administrative cooperation between Member States should also be of particular benefit for these firms, who are unable to afford the required investment to create and promote international brands. Given the predominance of SMEs in service operations, the resulting positive impacts are potentially significant.

7.2.3. Impacts on innovation and productivity

The benefits noted above should facilitate growth in innovation (and innovation intensity). By increasing the potential for more cross-border service operations, the diffusion of best practice within service sectors across the Union is likely to be accelerated. Business services themselves play an important role in spreading innovation and best practice (for example as a result of increased out-sourcing or use of consultancy) as they use experience of working for one client to provide solutions for another⁹⁵. Thus, increased availability of and competition in

⁹² See example in section 4 of the costs of establishment.

⁹³ Risk management is far more important in cross-border service activities than for goods. Insurance and liability management are therefore key factors in any service activity. See Giarini *op cit*.

⁹⁴ See section 4.1 above

⁹⁵ “The contribution of business services to aggregate productivity growth”, Henk L.M. Kox, CPB Netherlands’ Bureau of Economic Policy Analysis. Paper presented to Commission seminar on business-related services, October 2003.

business services, including in key areas such as professional IT services, would have benefits for the wider economy, including through increased productivity⁹⁶.

7.2.4. *Impacts on consumers*

Increased cross-border competition, diffusion of best practice and development of quality niche markets would give rise to more choice for consumers of more competitively priced, high quality services. In turn the inflationary pressure on the economy as a whole resulting from a lack of cross-border competition in service activities ought to be reduced. This is likely to result in greater competitive price convergence across the EU⁹⁷.

The increase in competition would have a positive impact on consumer choice, whilst the harmonisation of some basic quality requirements would strengthen their trust in cross-border services. In particular, consumers would be in a better position to make informed choices as a result of new obligations, firstly, on service suppliers, to provide information on themselves and the quality of their service and, secondly, on Member States to provide assistance to consumers. This would be enhanced by the encouragement of comparative quality tests at Community level. EU citizens would also be able to gain access more easily to health services in other Member States as a result of the clarification of the principles applying to reimbursement of medical costs incurred in other Member States, within the confines of recent jurisprudence of the European Court of Justice. This has the potential to benefit patients, health professionals and national health systems by allowing the most efficient possible use of resources across the EU.

At present, patient mobility is negligible, but those patients who do receive treatment in another Member State experience significant problems in obtaining reimbursement, as is reflected in numerous complaints to the Commission. Although the Directive is aimed at facilitating reimbursement in those cases, it should not result in significant consequences for the financial balance of Member States' social security systems. As has been underlined by the recent Court judgements, there is no indication that there would be large numbers of patients travelling to other countries for treatment, given linguistic barriers, geographical distance and the cost of travelling and staying abroad. In any event, reimbursement of the costs of the treatment received would only be granted within the limits of the cover provided by the sickness insurance scheme of the Member State of affiliation of the patient.

7.2.5. *Impacts on the undeclared economy*

To the extent that regulatory complexity and fragmentation tend to increase undeclared work, administrative simplification and the reduction of legal complexity resulting from the application of the country of origin principle should narrow its scope. The transformation of undeclared work into regular employment which this may well help to trigger is itself a key factor for economic growth since it increases fiscal revenues and thus decreases the overall fiscal burden on the declared economic base⁹⁸.

⁹⁶ See annex 2 to the Commission report (2002) "Economic reform...":op cit. which argues that "the difference in performance of the services sectors using information and communications technologies (ICT) is one of the main reasons behind the increasing competitiveness gap between the US and EU economies".

⁹⁷ See section 2.6 above.

⁹⁸ See section 3 above. See also the Commission Communication on The future of the European Employment Strategy (EES) COM(2003) 6 final Brussels, 14.1.2003, and Council Decision 2003/578/EC op cit., and the Resolution of the Council on Employment, Health, Social Policy and Consumer Affairs of 20 October 2003. According to these, the policy initiatives to be promoted to reduce undeclared work include simplification of procedures and legislation.

7.2.6. *Impacts on economic growth and employment*

The improvement of the Internal Market in services is a key element of the programme to develop a sustainable and inclusive economy⁹⁹. The Directive is intended to help create a well-functioning Internal Market for a range of services which account for almost 50% of EU GDP¹⁰⁰ and 63% of employment¹⁰¹. It could therefore result in major benefits to the economy as a whole through removal of barriers to cross-border trade and investment and consequential improvements in innovation and productivity and increased competition¹⁰². In addition, because services are relatively labour intensive and since service activities are the central source of job creation in the EU, it is likely that the resulting better functioning of the Internal Market for services will give rise to significant new employment opportunities in the EU.

In service enterprises that are suffering from low levels of productivity and are vulnerable to the pressures of cross-border competition, a better functioning Internal Market for services could lead to the loss of jobs. However, enterprises which are only surviving by passing on their relatively high costs to consumers in the form of higher prices are fuelling inflationary pressures that dampen GDP and adversely affect the employment market in general. The current legal and administrative complexity both restricts cross-border demand and prevents firms from responding quickly and in an innovative manner to new opportunities. Thus, the removal of these barriers should result in the growth of a new more dynamic and innovative EU service economy.

SMEs should benefit in particular, improving their survival rate and therefore the durability and sustainability of employment. At the same time, a more predictable and transparent legal framework resulting from administrative simplification will reduce the attraction of the undeclared economy and therefore lead to improvements in employment quality¹⁰³.

There is no evidence to suggest that the increased opportunities for posting of workers would give rise to net decreases in levels of employment in host Member States. This is because the existing Community *acquis* prevents social dumping since it ensures that the minimum working conditions, including minimum salaries of the country to which the workers are posted, have to be respected¹⁰⁴. Furthermore, the posting of skilled or white collar workers would help the process of job creation through the transfer of know-how into local markets which in turn is likely to raise productivity and investment levels. The promotion of innovation in services as well as other sectors is an important driver for improving competitiveness and standards of living.

The change towards a system of authorisation and licensing based on objective and transparent criteria, and limiting the opportunity for incumbent operators to influence decisions, is in line with efforts to improve standards of governance and should widen the access of entrepreneurs from all backgrounds to the services economy.

⁹⁹ See European Commission: Annual Policy Strategy for 2003, SEC(2002) 217/9, Brussels, 27/02/02.

¹⁰⁰ See section 7.1.1 on the scope of the Directive.

¹⁰¹ Calculations by Commission services from Eurostat and business data for GDP (2000).

¹⁰² Overcoming low geographic mobility is one of the three main challenges identified in the Commission's Action Plan for skills and mobility, 13.2.2002, COM(2002)72 final. Improving the Internal Market in services is one of the 25 key actions in the Plan.

¹⁰³ See the Commission Communication on The future of the European Employment Strategy (EES), *op cit.* "Undeclared work affects all Member States in variable degrees and is usually connected with low quality jobs with little or almost no security to the job holders."

¹⁰⁴ 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.

7.2.7. *Impacts on economic cohesion and the accession and candidate countries*

Improving competitiveness is key to improving economic cohesion in the sense of strengthening the capacity of weaker regions to generate economic growth and employment. Given that enlargement will initially result in a major widening of the gap between the richest and the poorest regions (in terms of GDP per capita), economic cohesion will become even more important in an enlarged Union. This requires, amongst other things, further encouragement of entrepreneurship, to make it easier to start and run businesses¹⁰⁵, and fostering of innovation. The wider availability of business services, which in themselves spread innovation and best practice, could significantly accelerate this process.

In addition, service SMEs in small and peripheral regions would in particular benefit from joining or creating cross-border networks, as this would help them to develop new niche markets¹⁰⁶. The simplification of the legal framework, a reduction of the number and greater transparency of authorisation schemes and the removal of other restrictive requirements, as envisaged by the Directive, should increase opportunities for this type of cross-border co-operation.

Overall, better priced and more accessible services would increase the demand for services in peripheral regions and Accession Countries, and would thus potentially improve economic cohesion.

In terms of the effect of the Directive on the Accession Countries, the consultation identified a number of barriers which hindered service providers in these markets¹⁰⁷. In addition, barriers have been identified as part of the accession negotiations, as Accession Countries have screened their legislation to ensure compliance with the Treaty principles of the free provision of services and freedom of establishment¹⁰⁸. In both cases many of these barriers are horizontal and affect service providers and users in the same way as barriers in the current Member States. It should be noted that significant changes are already being made to the regulation of services in the Accession and Candidate Countries and a number of barriers to establishment of service providers and to cross-border service provision are being removed. At the same time, as in the current Member States, new legislation in some areas is putting in place new barriers to the freedom of establishment and the free provision of services. The impact of the Directive on the Accession Countries (and the Candidate Countries, if and when the Directive is implemented there) is therefore likely to be broadly similar to that on the current Member States.

7.3. Environmental impacts

Impacts on the environment are likely to be negligible under both versions of the Directive. Removal of barriers should lead to increased economic activity, which implies increased use of resources, through the growth in service activities and in impacts resulting from the delivery of services (such as greater travel between Member States). However, the environmental impact of many services activities, which rely primarily on intellectual expertise, is not related to the activity itself but to the infrastructure which supports it, such as buildings, equipment or transport. It is therefore policies relating to these infrastructures that will manage the impacts on environment.

¹⁰⁵ See Green Paper “Entrepreneurship in Europe”, COM (2003) 27.

¹⁰⁶ For the significance of these, see “Regional clusters in Europe”, Observatory of European SMEs, 2002/3.

¹⁰⁷ See examples in section 4.

¹⁰⁸ Summaries of these assessments can be found in the Commission’s Regular Reports on Accession and Candidate Countries’ Progress towards Accession: <http://europa.eu.int/comm/enlargement/report2002/>.

Movement of service providers (particularly SMEs) should be increased as they find it easier to cross borders to organise and offer their services. At the same time, the obligation on Member States to ensure that administrative requirements can be fulfilled by electronic means and at a distance would reduce travel. Experiences in some Member States have clearly demonstrated this. For example, in France, on-line posting of notifications and returns has cut journeys considerably: 60,000 in the case of notifications of associations to prefectures, 12 million in the case of vehicle registration applications and 230,000 in the case of applications for secondary school teaching licences¹⁰⁹. Thus, although growth in cross-border economic activity may give rise to an increase in travel, this will be balanced by a decrease in travel currently resulting from administrative procedures.

Travel may further be reduced for companies in border regions if they can offer services into neighbouring border regions instead of travelling long distances to clients in far away areas of their own Member State. For example, a Chamber of Commerce in a border region reported that its members regularly travel about 400 kilometres to the capital region of their country to supply their services there. They know a market exists in a neighbouring Member State (in this case just over the river, literally a few hundred metres away), but have been deterred from exploiting this by complex and burdensome administrative requirements they would have to fulfil to enter the neighbouring Member States' market. If these impediments were removed, at least some of their activity in the capital region could be displaced by much more localised activity just across the border.

At present, the legal requirement to create a permanent establishment in order to provide services in a Member State also gives rise to greater environmental impacts in terms of fixed operational sites than would be the case if this requirement was removed. For example, a service provider would no longer need a permanent office and staff based in each country where he provides services, with all the costs and environmental impacts which these entail. This net gain could be magnified once restrictions to pan-EU service contracts are addressed. However, this environmental gain might be offset partially by larger headquarters or a larger central base in the EU¹¹⁰.

More competition and increased information on services should enable consumers to choose from a wider range of services and make better informed decisions as to their quality. Removal of barriers to service providers should also help to spread innovation and best practice through greater availability of environmental services.

7.4. Impacts on national administrations

A number of the requirements relating to administrative simplification would result in initial costs to Member States under both versions of the Directive. For example, administrative reform, including transparency of authorisation procedures, or the setting up of single points of contact, would initially require some additional resources. Similarly, the move towards electronic procedures including completion of authorisation applications would imply initial investment in new technologies. However, such measures are fully in line with the ongoing programmes of administrative reform - including the development of e-government - which Member States are already implementing and which are considered to be key to

¹⁰⁹ "From Red Tape to Smart Tape: Administrative simplification in OECD countries". OECD publications office, Paris.

¹¹⁰ Multinational companies have provided examples of how they would like to be able to sub-contract management of all their outlets in the EU (for example petrol stations) to a single contractor. For the contractor, legal or administrative barriers are currently forcing it to set up its own establishment in each Member State to manage the outlets there, when in fact an establishment in one Member State could manage facilities in all, or at least a number of neighbouring, Member States.

administrative reform in a number of OECD countries¹¹¹. It is therefore difficult to assess the precise impact of the measures proposed in the Directive. However, it seems likely that initial investments would be recouped by recurrent savings, which, in the longer term, should lead to overall net benefits for administrations. For example, the German Government estimates that the Bund Online 2005 initiative which puts German public services at the federal level on-line, will have investment costs of €1.65 billion set against annual savings of €400 million per year¹¹².

The number of national e-Government projects within the EU¹¹³ demonstrates the efficiency gains for administrations in terms of better allocation of resources towards enforcement and higher productivity of processing. For example, a report for the Commission services on electronic invoicing for tax requirements¹¹⁴ estimates that the greater ease of use of electronic data and its lower costs of processing and storage has given rise to considerable administrative cost savings. On average a paper invoice costs between €1.13 and €1.65 to handle. In contrast the comparable cost of the collection, processing and storage of an invoice by electronic means is €0.28 to €0.47. In this example of electronic data collection and handling, the impact over time is a reduction of administrative costs by between 72% and 75%. Similar savings can be expected for other types of electronic procedures.

The establishment and running of the information exchange systems and the mutual assistance and partnership between Member States in the case of cross-border service provision would also give rise to initial investments by national administrations. In this respect, it is important that national e-government systems are interoperable and open to cross-border users¹¹⁵. Balanced against this investment will be savings due to the reduction in control measures and administrative procedures and the more efficient deployment of enforcement resources.¹¹⁶

7.5. Conclusion of Impact Analysis

It is clear that a horizontal instrument which would remove barriers to the Internal Market in services would bring major benefits for the EU, in particular through economic growth and job creation. However, the effectiveness of the chosen option will also depend on how long it takes to negotiate and implement. Although the single-stage Directive would, once adopted and implemented, have a greater impact in removing Internal Market barriers, it is likely that the time required to reach agreement on it would be much longer. This has to be balanced against the likelihood of a quicker agreement on a phased Directive, which may be more effective in the short term and leaves open the option of further action at Community level. Given this consideration, the phased Directive would appear to be the better option.

¹¹¹ See for example Commission Communication on e-Europe 2005 COM (2002) 263. EU Ministers at the Como e-Government conference, July 2003 agreed that “The deployment of ICTs by governments...should cement further the four freedoms of the single market enabling citizens and enterprises from one EU Member State to settle, work or trade in another Member State”.

¹¹² See Deutsche Bank Research series “E-nomics”, October 2002.

¹¹³ See also Communication from the Commission: a simple and paperless environment for customs and trade, Brussels, 24.07.2003 COM(2003) 452 final 2003/0167.

¹¹⁴ PriceWaterhouseCoopers (1999), “Study on the requirements imposed by the Member States, for the purpose of charging taxes, for invoices produced by electronic or other means”, final report, 23 August 1999.

¹¹⁵ This aspect is stressed in the Commission’s staff working paper “Linking up Europe: the importance of interoperability for e-government services”, Brussels, 3.7.2003 SEC(2003) 801.

¹¹⁶ “From red tape to smart tape” op cit. An example of how information exchange within or across administrations can result in significant cost savings is provided by the following example. Instead of requiring applicants for civil service posts to provide the documentary proof that they had no criminal record, the French authorities decided simply to check existing criminal record data. The saving in postage costs alone amounted to € 1.1 million per year.

8. IMPLEMENTATION, MONITORING AND EX-POST EVALUATION

8.1. Implementation

The Directive would be implemented by the Member States two years after its adoption (which is envisaged by the end of 2005), i.e. by the end of 2007. In addition, an additional year (until the end of 2008) is foreseen to achieve the move to electronic administrative procedures, to put in place single points of contact, and to set up systems of assistance for and information to users of services. This additional time for implementation takes account of the initial administrative investments that may be required.

The two options ("single-stage" and "phased" Directive) would differ in that the phased Directive would ensure a more progressive approach to implementation than in the single-stage Directive. As a result of the process of mutual evaluation between Member States and further consultation with stakeholders foreseen in the phased Directive, further proposals to remove an additional range of barriers would be launched and implemented between 2007 and 2010.

8.2. Monitoring

8.2.1. Monitoring of transposition

The Commission services, assisted by a committee consisting of Member States' representatives, will actively monitor and assist the 25 Member States in the transposition of the Directive. The large scope and wide range of issues addressed in the Directive require partnership between the Commission and Member States to ensure the smooth and homogeneous transposition and functioning of the Directive across the Union.

8.2.2. Monitoring of impacts

For both options (single-stage and phased Directive) the Commission services would monitor the expected impacts of the Directive as set out above in section 7 and more specifically, will seek to track the following economic indicators¹¹⁷:

- Compliance costs of service firms involved in cross-border trade and investment in services
- Community cross-border trade in services
- Community cross-border FDI in services
- Involvement of SMEs in cross-border trade and investment in services
- Mobility of labour involved in cross-border services
- Investment in training in human resources by service suppliers
- Investment in R&D by service suppliers
- Productivity differentials between Member States for different service activities
- Aggregate productivity differentials between EU and US service activities
- Proportion of mergers and acquisitions against greenfield investments in FDI in services activities
- Price differentials between Member States for different service activities

¹¹⁷ As data underlying at least some of these indicators is not readily available, the Commission has begun work to identify the best way of developing and maintaining suitable indicators. This will form part of a wider study to assist the Commission in assessing the overall economic impact of the identified restrictions on cross-border trade in services in the EU.

As regards social impacts, the Commission will also encourage stakeholders to participate actively in this monitoring exercise. In particular, it will seek to collaborate with the social partners to track employment effects in service activities across the Member States.

In order to improve information on patient mobility and the implications for social security systems, consideration is being given, amongst other things, in the context of the High Level Reflection Group on Patient Mobility and Healthcare Developments in the EU, to establishing a framework for systematic data collection on patient movements between Member States.

8.3. Ex-post evaluation

8.3.1. Approach and reporting

Since the real economic and social impacts will not be measurable until such time as the Directive has been fully working, it is proposed that the first ex-post evaluation will feature in the report that will be presented by the Commission by 2008 and that further evaluations will feature in the reports to be presented every three years following the first report.

The Commission has begun work to develop the indicators and relevant benchmarks necessary for the monitoring of the impacts of the Directive, and more broadly to measure the functioning of the Internal Market in services¹¹⁸. This will include use of the most up-to-date modelling techniques for the services economy. In this way, the success of the Directive can be gauged in economic terms and appropriate policy implications can be drawn. In addition to the economic evaluation of the Directive, the ex-post evaluations will also provide social impact evaluations.

8.3.2. Accompanying measures

The proposal is part of the Internal Market Strategy for Services that also covers a wide range of associated policies, notably in the fields of enterprise, consumer issues and employment. The success of the strategy in creating a well-functioning Internal Market in services will therefore also depend on these accompanying measures.

The Commission will launch flanking measures to support the competitiveness of the EU services sector. These are set out in the Commission's Communication on the competitiveness of business-related services¹¹⁹ which will establish a European Forum on business-related services including all relevant stakeholders. The Communication will set in place a number of policy actions to enhance the competitiveness of business-related services, including a long-term strategy for services statistics which will underpin the monitoring, ex-post evaluation and future policy decisions in this field¹²⁰. The conclusions of the Forum are intended to lead to an Action Plan to be proposed by the Commission in the first half of 2005. This Action Plan will be complementary to and reinforce the measures undertaken in this Directive.

¹¹⁸ A study has been launched to assist the Commission in this: see section 8.2.2. above.

¹¹⁹ Op cit. The scope of this Communication is different from that of the Services Directive. The Communication relates to business services, distributive trades, network services and financial services, and inter alia sets out actions on quality and standards, intangibles, R&D and innovation, skills, entrepreneurship, competition and regional development.

¹²⁰ As a consequence of the dynamic development within the services sector, Eurostat and the national statistical institutes have developed proposals for improving the data availability on services in the area of structural business statistics. The outline of future user needs and the proposals for new indicators and variables have been built upon the future amendments of the Structural Business Statistics Regulation proposed by Eurostat. The user needs mainly concern the domain of structural business statistics, but due to the cross-cutting nature of services, other statistical domains are addressed as well. New ways of exploiting existing data sources should also be examined in order to limit the burdens on stakeholders.

In order to stimulate entrepreneurship and consumer demand, as wide a diffusion as possible of the information of the new Internal Market possibilities offered by the Directive should be ensured. The assistance and information to be given to providers and users of services foreseen in the Directive should be backed up by awareness-raising and information campaigns in particular for SMEs and consumers, as an integral part both of the Commission's entrepreneurship and business services policy and its consumer policy.

The extent to which services are included in the scope of R&D and innovation programmes both at national and EU level will influence the level of productivity gains to be made. This will also depend, firstly, on the extent to which service firms, in particular SMEs, are encouraged to use the resulting compliance cost savings in order to invest in more R&D and innovation and, secondly, on the degree to which best practice is diffused rapidly across the European Union¹²¹.

The proposal is fully consistent with the Action Plan on Skills and Mobility¹²². The range of measures set out there to foster employment growth and increase occupational and geographic labour mobility should further enhance the benefits of a better functioning Internal Market for services. It is nevertheless worth underlining that Member States are not equally well placed to benefit from this improvement. There is likely to be a need for positive action targeted towards disadvantaged regions. Such action could for example take the shape of training and technical assistance to SMEs and other actors concerned.

Much remains to be done at the EU level in the consumer protection area, for instance as regards retailing, enforcement co-operation and contracts. Some Commission initiatives have already been adopted such as the proposal for a Regulation on consumer protection co-operation¹²³, the proposal for a framework Directive on unfair commercial practices¹²⁴, and the Action Plan on the European Contract law¹²⁵. Further steps will be taken, notably in the context of the review of the *acquis communautaire* as regards consumer protection.

As far as the safety of services is concerned, the Commission has presented a report on this issue¹²⁶, which notes that systematic data collection and accident monitoring is limited to a few sectors like transport and health. Consequently, in a number of service sectors, there is not enough quantitative data available to carry out a proper risk assessment, to compare risk levels in different countries, or to identify gaps and weaknesses in the existing national risk management systems. The report therefore suggests the introduction of a system for an exchange of information, systematic collection and assessment of data on risks, and procedures for setting European standards.

Subject to the results of a feasibility study, the Commission also intends to propose the extension of the transparency mechanism for draft national technical regulations, to cover services. This will require an amendment to Directive 98/34/EC, which already covers information society services.

9. STAKEHOLDER CONSULTATION

In the Commission's Communication on an Internal Market Strategy for Services issued in December 2000, Member States, other Community Institutions and interested parties were

¹²¹ See Centre for Research on Innovation & Competition (CRIC, 2002), "Innovation in the services sector", working paper No. 11, November 2002.

¹²² Op. cit.

¹²³ COM (2003) 443 final.

¹²⁴ COM (2003) 356 final.

¹²⁵ COM (2003) 68 final.

¹²⁶ COM (2003) 313 final.

asked for their views on the functioning of the Internal Market for services. Given the complexity and the extremely wide scope of the issue, it was decided to extend the consultation and run it throughout 2001 and early 2002.

The objective of the consultation was to collect information on problems encountered by providers and users engaged in any sort of economic services activity in the EU, in other words including manufacturers, consumers or any other economic operator. It therefore covered all private sectors of the economy and was not limited to the tertiary sector. Barriers faced by EU service providers in the Accession and Candidate Countries were also taken into account.

The consultation was carried out through a number of mechanisms and channels in order to maximise participation. First an independent survey of over 6,000 companies of all sizes in 14 EU Member States¹²⁷ was carried out on behalf of the Commission by a market research company. This survey provided a valuable overview of the scope of the problem in that more than one in three of the companies interviewed had direct experience of problems in relation to the free provision of services or freedom of establishment. The problems encountered were spread across all economic sectors, affected all sizes and types of companies and occurred at all stages of the business process.

Second, several separate mailings were subsequently sent to European and national associations representing stakeholders in all relevant fields. Individual service providers and users including consumers were contacted either directly or through national associations. Bilateral meetings were organised in order to follow up issues and participation in conferences and workshops was ensured in order to raise awareness of the consultation process. Where necessary, the Commission developed more detailed informal questionnaires aimed at particular audiences (for instance, SMEs). All this resulted in around 700 responses directly from stakeholders.

Third, the Commission also drew information from the questions and petitions put to it by the European Parliament. The Commission has received a significant number of these since the launch of its Services Strategy and they provided a very useful source of information about the preoccupations of European businesses and consumers. Furthermore, formal complaints to the Commission and infringement cases, of which a significant number has also been received since the launch of the strategy, provided an important source of information. These sources were particularly helpful in identifying cases where individual citizens were finding it difficult to use services from another Member State because of restrictions in their own or other Member States. Likewise, information received from consultation and problem solving mechanisms, such as the Commission's Dialogue with Citizens and Business and the Member States' Internal Market co-ordination centres and contact points for citizens and business, was examined.

Finally, the Commission used economic and statistical studies from established sources and its own services as well as from Member States and other bodies.

In addition to the call for contributions made in the Communication of December 2000 in the Internal Market Strategy for Services, the Commission wrote to Member States in September 2001 with a more detailed request for responses, including any economic or statistical data on national and European services markets. A further request was addressed to Member States in the first quarter of 2002 concerning the organisation at the national level of the follow-up to the Court judgements concerning the freedom to provide services and the freedom of

¹²⁷ Germany was excluded because of complications arising from rules relating to market research, but the Commission services gathered comparable information through a separate exercise.

establishment. Most Member States replied to these requests and their contributions also reflect consultations which they have held at national level with interested parties. In November 2001, the Commission established an expert group of Member States to advise it on the strategy. This has met 5 times. A number of Member States organised workshops on the strategy and the Commission services participated in some of these.

The consultation and other data collected resulted in some key conclusions:

- Services dominate the economy
- Services are intricately intertwined and are often provided and used in combination. As a result, barriers to one service will trigger knock-on effects for others
- Internal Market barriers are widespread and affect every stage of the business process, starting from the initial establishment of the business and the use of inputs such as labour, technical assistance supplied by other service providers and equipment - through to promotion, distribution, sales and after-sales activities
- Services are much more prone to being hindered by Internal Market barriers than goods and are harder hit. Because of the complex and intangible nature of many services and the importance of the know-how and the qualifications of the service provider, the provision of services is often subject to much more complex rules than is the case for goods
- Barriers hit the whole economy, but especially SMEs and consumers

More specifically, the consultation showed that barriers arose due to both discriminatory measures - i.e. where a service provider faces restrictions on the grounds of nationality or residence – and also due to non-discriminatory measures, i.e. those which apply equally to service providers established in the country of the service provision and those established in other Member States. Barriers arose from regulatory or administrative action by Member States and also from self-regulation. They included, for example, complex, lengthy and burdensome authorisation procedures, highly detailed and divergent rules on advertising, or simply the duplication of requirements such as for deposits and guarantees, professional insurance or quality controls which the service provider had already fulfilled in his Member State of origin.

These points were emphasised in the Commission's Report on the State of the Internal Market for Services¹²⁸, which provided as realistic as possible a picture of the Internal Market in services, including an inventory of barriers and tentative analysis of their effects. The evidence from the consultation was the major input to the analysis of Internal Market barriers and the effects described in section 4 above. Only those barriers which it can be demonstrated have a real effect on citizens and business in the Internal Market have been addressed in the Commission's proposal.

Following the Commission's report in 2002, a number of stakeholder and trade associations have responded to the Commission with further information on barriers, including estimates of the cost of barriers, which are reflected in this Impact Assessment. The Commission has also held bilateral discussions with business, consumer and workers' organisations in order to be able to assess the potential impacts more accurately.

In order to allow for stakeholder input into the policy to be maximised, in addition to encouraging stakeholders to respond to the proposal in the negotiation process at both Parliamentary and Member State level, the phased Directive foresees that stakeholders, including national consumer associations, be directly consulted during the implementation of the Directive (notably by being consulted on the national evaluation reports). It can be

¹²⁸ The report was made publicly available on the Commission website at http://europa.eu.int/eur-lex/en/com/rpt/2002/com2002_0441en01.pdf.

expected that an even greater number of stakeholders, including those from the Accession and Candidate Countries, will respond at this stage of the policy process since both suppliers and users will be better able to assess the impacts of the requirements listed in the Directive which are subject to evaluation.

10. COMMISSION DRAFT PROPOSAL AND JUSTIFICATION

10.1. What is the final policy choice and why?

The analysis of the adverse effects of the current state of fragmentation of the Internal Market for services on economic growth, innovation, job creation and the competitiveness of the European economy has shown that no policy change is not an appropriate option. This also takes into account the fact that enlargement will inevitably result in even larger divergences of national rules and a more complex legal framework across the EU.

The available policy options have been screened to assess how suitable they are for achieving the policy objective. This screening has demonstrated that legislative action is required. It has also shown that, among the available legislative instruments, horizontal measures would be more efficient and effective than sectoral measures given the horizontal nature of the Internal Market barriers affecting a large variety of different services, which were identified during the consultation and explained in the Commission's report¹²⁹. Other options - such as a Recommendation, use of infringements or voluntary removal of barriers - were not chosen because they were assessed as not being sufficiently effective in the timescale envisaged by Lisbon. In particular, they would not be capable of removing quickly enough the wide range of horizontal legal barriers to free provision of services and freedom of establishment identified in the Commission's report.

The analysis of the barriers by the Commission's services has shown that they can be addressed by a combination of administrative co-operation, the application of the country of origin principle and harmonisation. A horizontal Regulation could not provide the required administrative co-operation whereas a horizontal Recommendation risks being ineffective because of its non-binding nature. Thus, the appropriate measure to achieve the objective is a horizontal Directive.

Two variants of such a Directive can be considered. The first, more ambitious, approach would consist of a "single-stage" Directive which would seek to address all barriers at the same time. The second option, a "phased" Directive, would address a significant number of legal barriers immediately while setting up a framework to resolve, within fixed time periods, the remaining barriers on the basis of mutual evaluation between Member States, the Commission and other stakeholders. The process provided for in the Directive does not prejudge the future initiatives that will be taken at Community level in the consumer protection area.

An assessment of impacts for both variants has been undertaken. This analysis shows that the single-stage Directive would, once adopted and implemented, have a greater immediate economic impact than the phased Directive. However, for the reasons set out below the chosen policy option is the phased Directive.

10.2. Why was a more/less ambitious option not chosen?

The more ambitious single-stage Directive was not chosen for two reasons. Firstly, there is a high risk that such an approach would result in more difficult and longer negotiations in the Council and in the Parliament, which could significantly slow down the implementation of the

¹²⁹ Report on the State of the Internal Market for Services, op cit.

policy as a whole. It has to be recalled that, in order for the Lisbon objective to be met, the basic Internal Market framework set out in the Directive needs to be in place well before 2010 to produce measurable results by then. This means that the Directive will need to be agreed quickly and to be adopted not later than 2005, so that a significant number of Internal Market barriers are removed by 2007 or 2008 at the latest. It is very unlikely that this would be achieved if the more ambitious "single-stage" Directive were chosen, as the negotiation of this option could take much longer than the phased Directive.

Secondly, the single-stage Directive would be more prescriptive and allow for less flexibility in the implementation than the phased Directive. The phased Directive, with its process of mutual evaluation of a number of barriers, aims at solutions based on a partnership between Member States and the Commission, diffusion of best practice and sharing of experience of economic reform between Member States, and input from stakeholders. This is more consistent with the principles of subsidiarity and proportionality, and more likely to produce the desired results than the more prescriptive approach of the single-stage Directive.

Less ambitious options were not chosen because, as stated above, it was concluded that they would be ineffective in the timescale allowed.

10.3. What are the trade-offs associated with the chosen option?

The impact analysis has shown that the benefits to the whole economy which can be expected from an appropriate policy action far outweigh the costs to Member States of implementing such a proposal. While the Directive may result in marginal additional costs to service providers, these would be outweighed by significant new business opportunities and compliance cost savings. Administrative reform may necessitate some initial costs for administrations which will, however, be outweighed by more efficiency, better enforcement, and, over time, cost savings. A better functioning Internal Market would likely result in job losses in less competitive enterprises, but this would be more than balanced by employment growth in other services companies, particularly in SMEs. Consumers would benefit from a wider choice of competitive services and lower prices.

The Directive seeks to achieve a careful balance with respect to three key issues. Firstly, this concerns, on the one hand, the country of origin principle and, on the other hand, derogations from this principle. The Country of origin principle maximises legal certainty for service providers, reduces compliance costs and encourages wider choice and competition in services markets. The derogations would allow Member States - in areas and under conditions defined in the Directive - to restrict incoming services from other Member States by applying their own national rules. Derogations are limited to areas where they are strictly necessary to secure general interest objectives including the protection of workers and consumers. Some of these derogations should however be phased out, over time, in tune with further harmonisation of national rules.

A second important balance is between harmonisation and administrative co-operation. Instead of detailed and extensive harmonisation of substantive national law, the Directive largely relies on partnership between Member States in the form of administrative co-operation and the process of mutual evaluation and will therefore better comply with the principles of subsidiarity and proportionality.

A third important balance is between the need to improve the quality of services at Community level in order to enhance trust and confidence in cross-border services and the need to avoid disproportionate costs for service providers resulting from detailed and complex legal requirements. The Directive, therefore, limits itself to harmonising essential quality requirements and for the rest encourages voluntary quality enhancing measures and codes of conduct at Community level.

10.4. Have any accompanying measures to maximise positive and limit negative impacts been taken?

As set out in the Commission's Services Strategy of December 2000, the Commission will launch flanking measures to enhance the competitiveness of the EU services industry¹³⁰. These will, amongst other things, improve dialogue with stakeholders by establishing a forum for business-related services, and set in place a number of policy actions including a long-term strategy for services statistics¹³¹. To maximise positive impacts the Directive should be backed up by awareness-raising campaigns in particular for SMEs and consumers. Moreover, the Action Plan on Skills and Mobility¹³² and the range of measures set out there to foster employment growth and increase occupational and geographic labour mobility should further enhance the benefits of a better functioning Internal Market for services.

¹³⁰ See section 8.3.2. for more information on accompanying measures.

¹³¹ Communication on the Competitiveness of business-related services, *op cit.*

¹³² *Op. cit.*

STATISTICAL ANNEX

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LIMITATIONS OF SERVICE STATISTICS

General

As services sectors increase in importance, the lack of sound services statistics is becoming a greater problem for policy makers. The historical failure to collect services statistics is probably not so much because services were not important in earlier years¹³³ but because of other aspects, such as the predominance of SMEs in services (which in turn reduced the wider influence of services sectors). Other factors explaining the lack of statistics are the rapid structural changes (outsourcing, e-commerce), the blurring boundaries between services and manufacturing, the diversity of service activities and the intangible nature of services¹³⁴.

A major problem in services statistics is the very broad classification of services activities in national accounts data, which results in a complete lack of information for many service activities¹³⁵. Manufacturing industry is covered by 241 distinct activities compared to 32 for market services, which means that information on a large part of services activities is covered by one single residual "other market services" category¹³⁶.

Internationalisation of services

Since the signing of the GATS in 1995, the UN and the OECD have produced a manual on statistics of International Trade in services. It describes the four different modes under which trade in services are classified in GATS¹³⁷. The manual is innovative in that it takes a broader and at the same time more detailed view of international trade in services than the conventional BOP (Balance of Payments) perspective. It provides a more detailed classification of services, includes a treatment of local delivery of services through a foreign local presence and takes a first step towards linking these two systems¹³⁸.

For information on international trade in services, Balance of Payment (BOP) statistics are the primary source of information. In BOP statistics, trade is defined as transactions between residents of one country and non-residents. BOP statistics broadly correspond to mode 1, mode 2 and part of mode 4¹³⁹. However, a given BOP service category generally includes transactions corresponding to several modes. Moreover, several modes of supply may be used for a single service transaction¹⁴⁰.

¹³³ 130 year ago services had already nearly as important a weight in the economy as industry. See Eurostat (2002): "Future challenges for services statistics, proceedings from the seminar in Lisbon 23-24 March"

¹³⁴ "Future challenges for services statistics" op cit.

¹³⁵ More details on statistics for business related services and the problems in collecting them can be found in the Commission's Communication on "The Competitiveness of business-related services and their contribution to the performance of European enterprises" December 2003. Annex III of this Communication sets out clearly what is required to resolve these problems in the longer term.

¹³⁶ Eurostat (2002), "Services statistics: strategy for services statistics - a complement to the strategy on short-term statistics".

¹³⁷ Mode 1 includes cross-border trade in services, mode 2 includes consumption abroad, mode 3 includes commercial presence abroad and mode 4 includes the temporary movement of natural persons.

¹³⁸ United Nations (2002), "Manual on statistics of international trade in services", joint publication by 6 organisations (European Commission, IMF, OECD, UN, UN Conference on Trade and Development, WTO).

¹³⁹ See footnote 4.

¹⁴⁰ United Nations (2002): "Manual on statistics of international trade in services", joint publication by 6 organisations (European Commission, IMF, OECD, UN, UN Conference on Trade and Development, WTO).

BOP statistics ignore services delivered through affiliates established abroad (i.e. mode 3), such as branches or subsidiaries. This type of trade is measured by Foreign Affiliates Trade in Services (FATS) statistics.

The limitations in measurement of cross-border service provision (mode 1)

Measurement of trade in services is inherently more difficult than measurement of trade in goods, largely because of the intangible nature of many services. Services trade does not involve packages crossing the customs frontier and therefore services trade measurement cannot be based on an administrative system based on customs duty collection¹⁴¹.

BOP statistics¹⁴² give an indication of, amongst other issues, the level of trade in services. However, results from BOP statistics should be interpreted with care. In reality, trade in services can be expected to be significantly higher than current figures indicate. The following factors need to be taken into account:

- In services, other ways of internationalisation play a much more important role compared to goods. FDI plays a key role given the importance of a local presence for several of the multitude of service activities. Also cross-border service provision by means of temporary movement of natural persons and intra-firm trade play an important role.
- Services trade incorporated in trade in goods is not measured, resulting in severe underestimates of trade in services. The "Institut der deutschen Wirtschaft" estimates that, in Germany, services exports would be twice as high if indirect exports of services incorporated in exports of goods were included¹⁴³.
- Many firms traditionally classified as manufacturing firms should be considered, and usually consider themselves, as services firms¹⁴⁴. Production value is more and more based on services. Giarini¹⁴⁵ estimates that the pure cost of production is seldom higher than 20% of the final price. 70 to 80% is accounted for by complex service and delivery systems. Service functions now account for the greater part of investment, even within the most traditional industrial companies. One leading manufacturer of elevators estimates that, in the near future, manufacturing jobs will be reduced to 8% while the remaining 92% of employees will be involved in the provision of services. According to one major car manufacturer, only one-third of turnover is generated from the sale of the vehicle itself. The rest comes from car-related services (loans, leasing insurance, technical services, fleet management, mobility services etc.).

The lack of precision of FDI statistics (mode 3)

While this is a less developed area than BOP statistics, some FATS (Foreign Affiliates Statistics) may be found in existing statistics on domestic production, including national accounts statistics¹⁴⁶.

¹⁴¹ OECD (2001), "Trade in goods and services: statistical trends and measurement challenges", statistical brief October 2001 No.1.

¹⁴² These are the statistics currently used by Eurostat to compile service trade data.

¹⁴³ BDI (2001), "Opening the world market for services".

¹⁴⁴ A recent US study on the service industry indicates that the world's largest service businesses are actually firms traditionally classified as manufacturing firms such as IBM or General Electric. See: S.W.Brown, B.A. van Bennekom, K.Goffin, J.A. Alexander (2001), "S-Business: defining the services industry", Association for Services Management.

¹⁴⁵ O. Giarini (2002), "The globalisation of services in economic theory and economic practice: some conceptual issues" in: "Trading services in the global economy" (2002), edited by Juan R. Cuadrado-Roura, Louis Rubalcaba-Bermejo and John R. Bryson.

¹⁴⁶ United Nations (2002): "Manual on statistics of international trade in services", op cit.

FATS measure the activities of service providers through their foreign affiliates in foreign markets and are therefore closely linked to statistics on FDI. FDI is the category of international investment that measures transactions involving a resident entity in one economy obtaining a stake in an enterprise in another economy¹⁴⁷. FATS statistics and FDI statistics are often used in conjunction with each other. FDI is generally considered to exist when an investor owns 10% or more of the voting equity of a business enterprise. FDI statistics cover only transactions and positions of the direct investor and exclude those of any other investors who might have a stake in the enterprise. If an investor only owns 20% of a foreign business and the other 80% is owned by local investors, only the 20% would be included in the FDI position. By contrast, FATS statistics offer a far more precise picture. For inward FATS, two approaches for the data collection are possible. One is the breakdown of Structural Business Statistics by the nationality of the enterprises exercising the foreign control. This approach can be used for inward FATS because foreign affiliates constitute a subset of all enterprises in an economy. Alternatively, foreign affiliates can also be conceptualised as a subset of foreign direct investment enterprises. Data are collected currently in both frameworks because both practices have their respective advantages and disadvantages. The advantage of the first approach is the ability to link data on foreign controlled enterprises to data on the economy in general and to provide the data by a detailed activity breakdown. In particular, this means that the characteristics of foreign affiliates as economic actors can be compared to the characteristics of other enterprises within the same economy. The second approach has the benefit of being able to complement the picture by data on outward FATS (statistics on foreign affiliates controlled from the reporting economy), thus providing information on the other side of the coin. When we combine both approaches, we obtain a complete picture of the role played by foreign-controlled affiliates. The Commission services (ESTAT) have set in process, on a voluntary basis with 12 Member States, data collection for FATS for the past six years. These very useful statistics will soon be available for all Member States since the Commission services are preparing a Draft Proposal for a Regulation of the European Parliament and of the Council on Community statistics on the structure and activity of foreign affiliates. For inward FATS, the proposal has reached agreement by the Member States. The current FATS statistics, since they only cover 12 Member States, have not been included in the statistical tables below.

Some mode 3 transactions are hidden in BOP mode 1 statistics. An unincorporated site office carrying out a short-term construction project would be recorded in BOP under construction services. However, such a site office could also be considered as mode 3 because commercial presence may be any kind of establishment owned or controlled by foreign entities, even those created for a short period¹⁴⁸.

Current FDI statistics are not able to distinguish between different ways of establishing a commercial presence abroad. For example, greenfield investment and mergers and acquisitions (M&A) data come from different sources which are not comparable.

The very limited data on mode 4 services provision (incl. posted workers)

Empirical measurement of the economic impact of mode 4 is still at a preliminary stage. Several methodological problems remain unsolved, e.g. related to the definition¹⁴⁹ of this

¹⁴⁷ OECD (2001), "Trade in goods and services: statistical trends and measurement challenges", op cit.

¹⁴⁸ United Nations (2002), "Manual on statistics of international trade in services", op cit.

¹⁴⁹ GATS defines mode 4 as: "the supply of a service...by a service supplier of one member, through presence of natural persons in the territory of another Member". In general mode 4 is seen as covering business trips by sales staff or company executives (often limited to 3 months), temporary movement of personnel of a service supplier and temporary movements of self-employed or independent service

mode and the absence of accurate statistical measures¹⁵⁰. Statistics are incomplete and not easily comparable between countries. Neither statistical systems for trade in services nor data collection systems for the movement of natural persons across borders can provide separate statistics which exactly capture mode 4 activities¹⁵¹.

Concerning the use of trade in services statistics, these are normally measured in BOP statistics. These statistics partly cover mode 4 in the categories 'labour income', 'worker remittances' and 'migrant transfers'. The WTO secretariat has used these statistics to estimate the monetary value of mode 4. However, none of the categories mentioned correspond exactly to the definition of mode 4.

The lack of measurement of consumption abroad (mode 2)

Coherent accurate statistics on consumption abroad are currently missing. The travel category in BOP broadly corresponds to mode 2, although it does not categorize all the types of services supplied to travellers. Travel is divided into 'business travel' and 'personal travel'. The latter can be further divided into 'health-related expenditure', 'education-related expenditure' and 'all other personal travel expenditure'¹⁵². In particular, improvements are needed to exclude goods purchased by travellers¹⁵³. Moreover, the category 'all other personal travel expenditure' should be subdivided into more detailed services activities. The same is true for spending on services by business travellers.

In addition surveys by national tourism organisations could provide some information on average spending per nationality in the different countries. Surveys carried out in airports belong to the category of "Border Surveys". They often act as a complement to household surveys which are seen as too expensive, in particular for big countries. The discussions in the international meetings of tourism statistics experts have shown that there is no common methodology among countries and therefore there still is a strong need for harmonisation. Currently, responsible Commission services (ESTAT and ENTR) are supporting the implementation of the system of Tourism Satellite Accounts, which, when fully implemented, will provide detailed information about tourism consumption. However, the majority of EU Member States are not yet in a position to provide results (most of them are taking their first steps to implement this system).

suppliers (between a few months to a few years). It remains unclear exactly which categories of service suppliers covered or what is meant by temporary.

¹⁵⁰ OECD (2002), "service providers on the move: the economic impact of mode 4", OECD working party of the trade committee.

¹⁵¹ OECD (2001), "Service providers on the move: a closer look at labour mobility and the GATS".

¹⁵² OECD (2003), "Measuring trade in services, a draft training module for the world bank", OECD paper prepared for the OECD-Eurostat meeting of experts in trade in services statistics 8-10 April 2003.

¹⁵³ United Nations (2002), "Manual on statistics of international trade in services", op cit.

The lack of data on intra-firm transfers

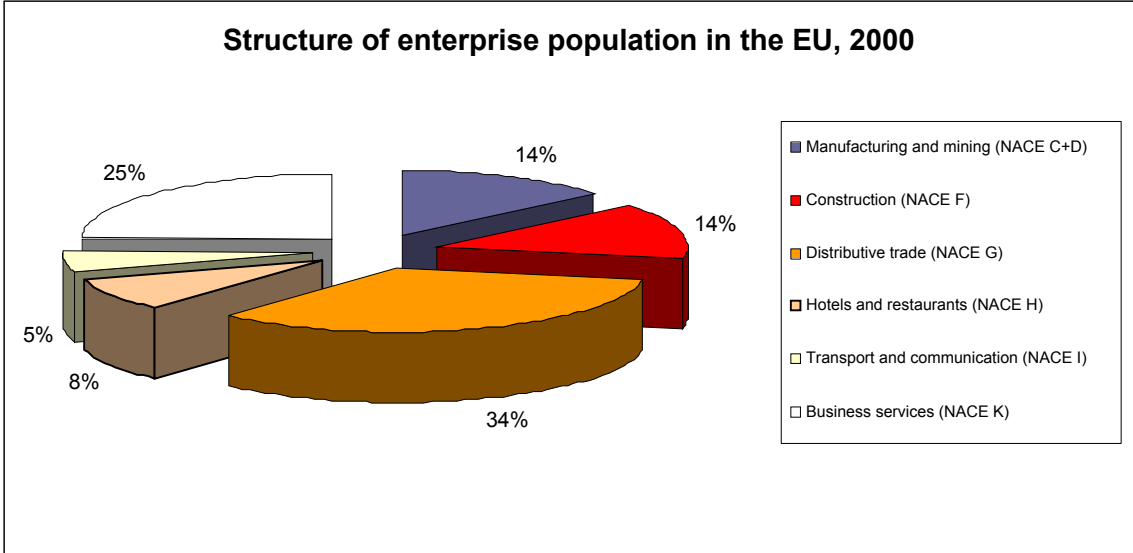
An indication of intra-firm trade in services can be found in BOP statistics, which reports on "services between affiliate enterprises". However, this category is a risky proxy since it is defined as a residual category: it covers payments between related enterprises for services that cannot be specifically classified to any other component of EBOPS¹⁵⁴.

¹⁵⁴ EBOPS is the Extended Balance of Payments Services Classification, as defined in the "Manual of Statistics of International Trade in Services", op. cit.

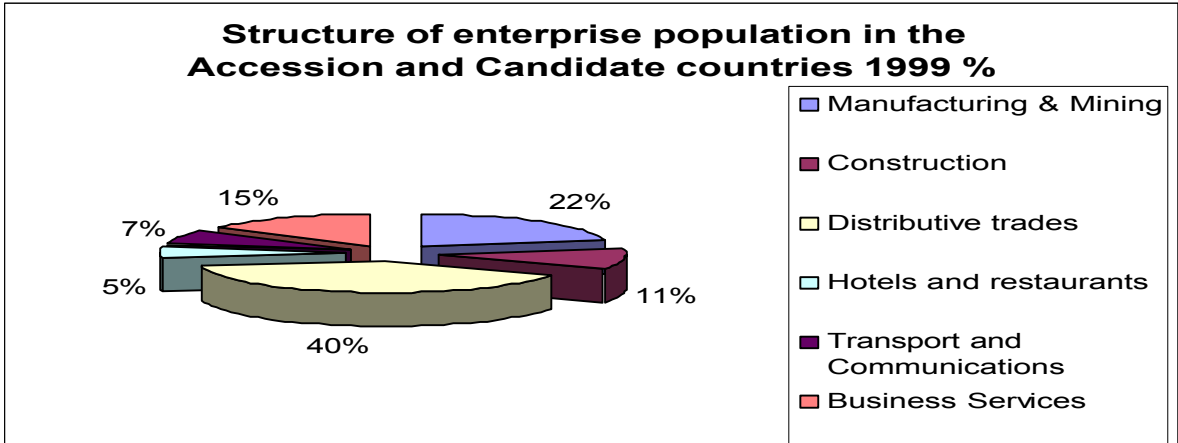
EUROPEAN SERVICE FIRM DEMOGRAPHICS

Service firms account for the majority of enterprises in the EU Community

In 2000, service activities excluding the construction industry and electricity, gas and water¹⁵⁵ sectors, accounted on average for 72% of enterprises operating within nine Member States of the Union for which full data sets are available (B,F,I,NL,A,P,FIN,S and UK)¹⁵⁶. This ranged from 69% in Portugal and Finland to 77% in Sweden.



Source: Eurostat



Source: Eurostat

In contrast, in the Accession and candidate countries for the nine countries where full data sets were available (CZ, EE, HU, LT, LV, RO, SI, SK), the average percentage share of enterprises accounted for by service activities (excluding construction and electricity and water) was slightly lower at 67%.

¹⁵⁵ That accounted for a mere 0.1% of enterprises.

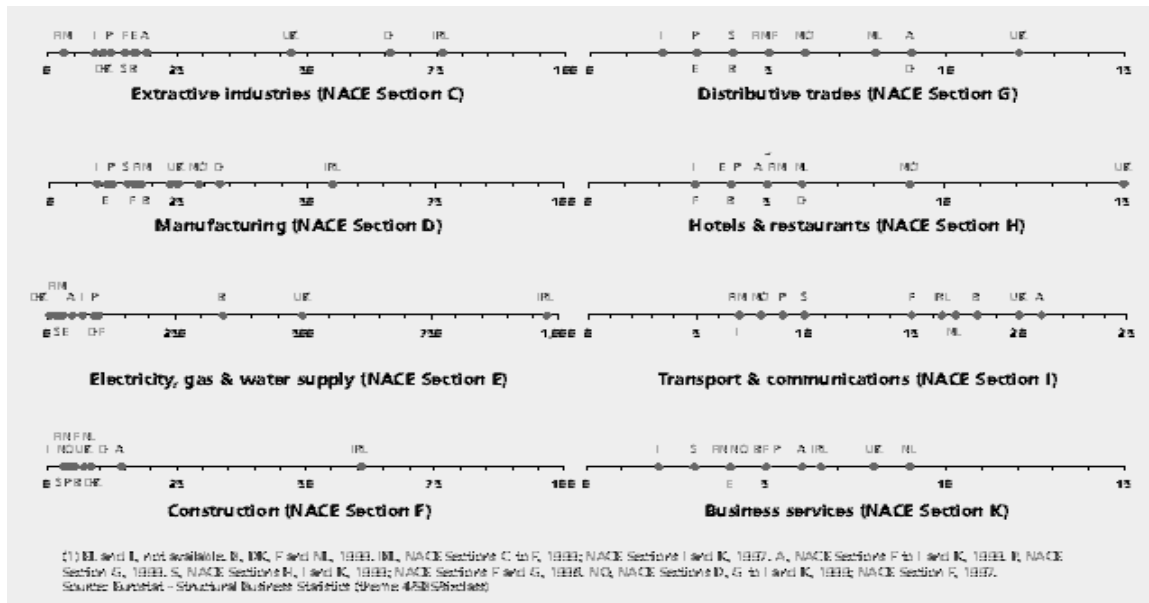
¹⁵⁶ Source: SMEs in Europe (2002 edition): Competitiveness, innovation and the knowledge-driven society: Eurostat. This is the source of data for the following two figures.

Service firms are dominated by SMEs

SMEs in the EU account for 99.7% of all enterprises¹⁵⁷. SMEs also account for 66% of the workforce in the economy. Services activities except for public utilities are even more strongly dominated by small enterprises than manufacturing. The figures below on the average number of employees per enterprise in 2000 for the differing sectors published by Eurostat demonstrate this clearly.

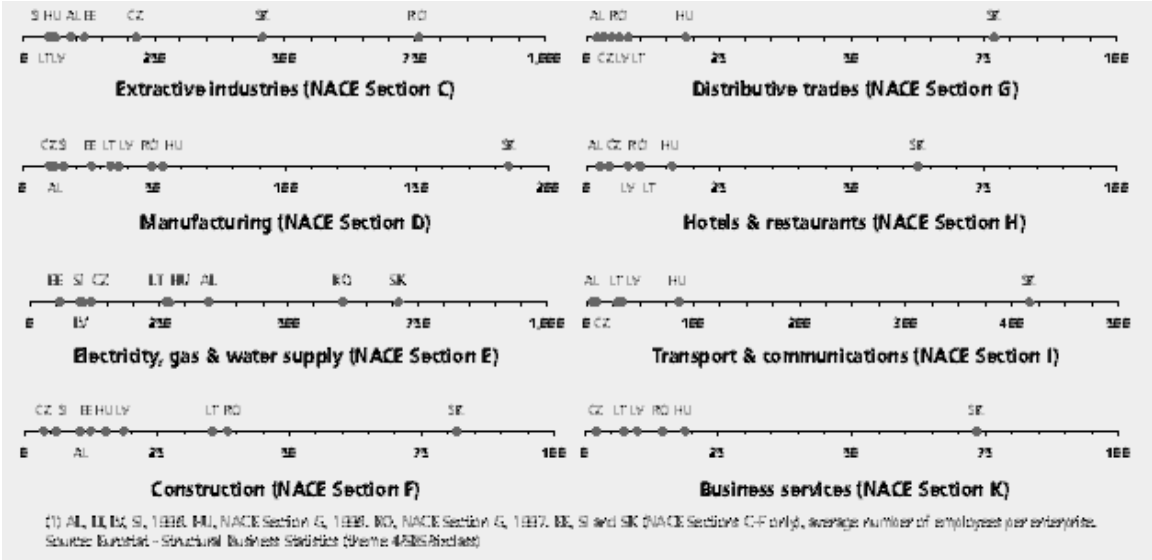
Average number of persons employed per enterprise, 2000 in current Member States (1)

Source : Eurostat 2002.



¹⁵⁷ Eurostat (2002): "SMEs in Europe: Competitiveness, innovation and the knowledge driven society". This is the source for all graphs and tables in this sub-section.

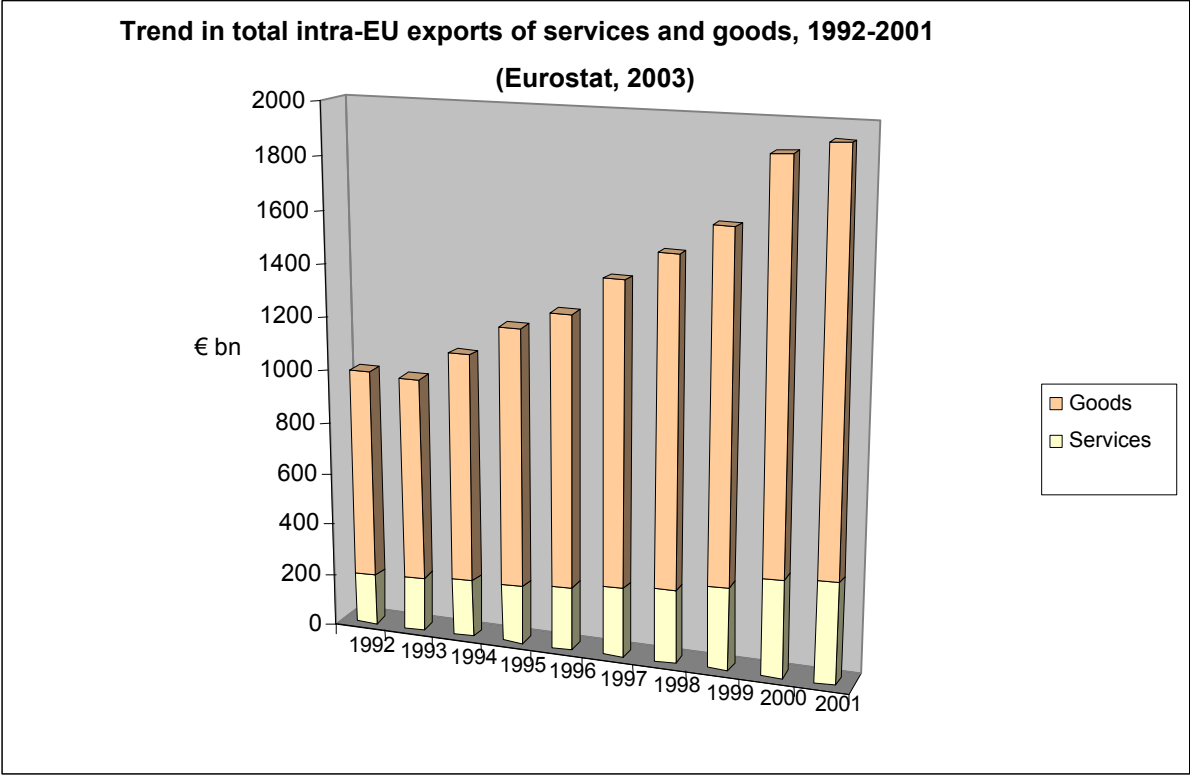
Average number of persons employed per enterprise per activity in Accession and Candidate Countries 1999(1)



As regards the accession and candidate countries, the equivalent data demonstrate that SMEs are more prevalent in service sectors than in goods sectors but to a lesser extent overall than in the existing Member States.

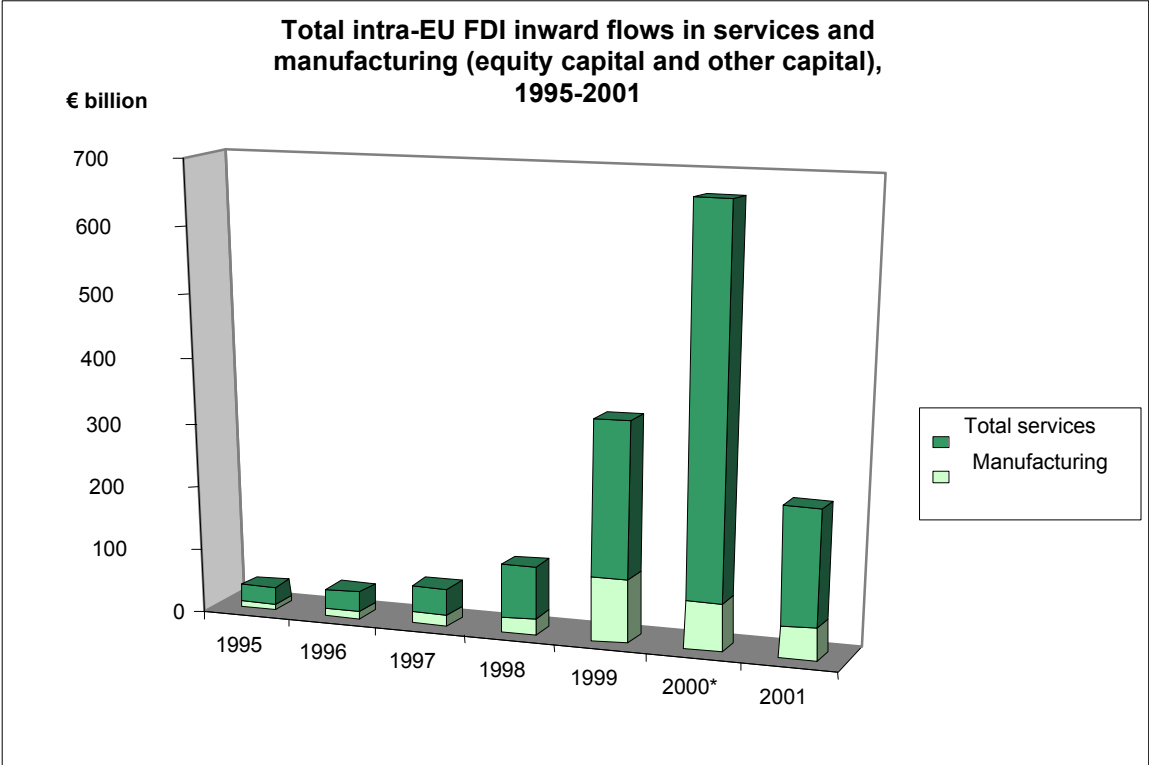
INTRA-COMMUNITY TRADE & FDI OF SERVICES

Intra-Community trade is growing, but at a slower rate than for goods, which continue to dominate trade flows.



Source: Eurostat 2003

Intra-Community FDI flows in services are more significant for services than for goods.

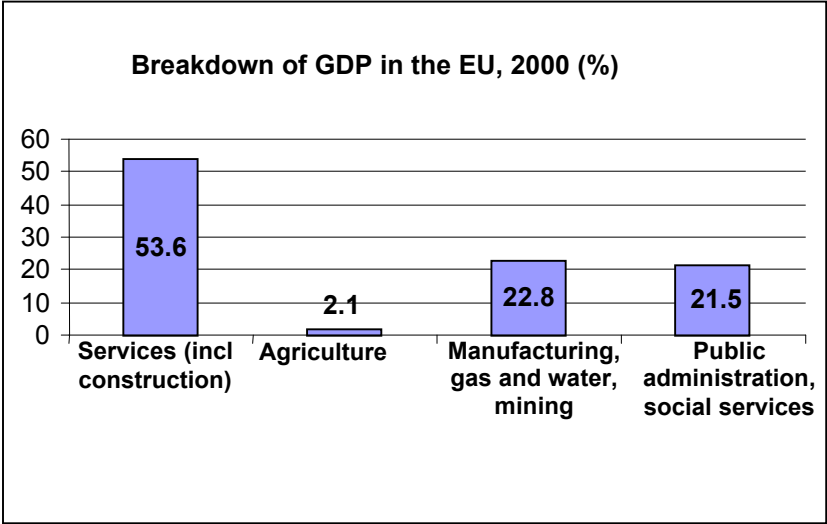


* the unusually high figure for 2000 is as a result of one very large acquisition and other related ownership changes of companies in the telecoms sector.

Source: Eurostat 2003

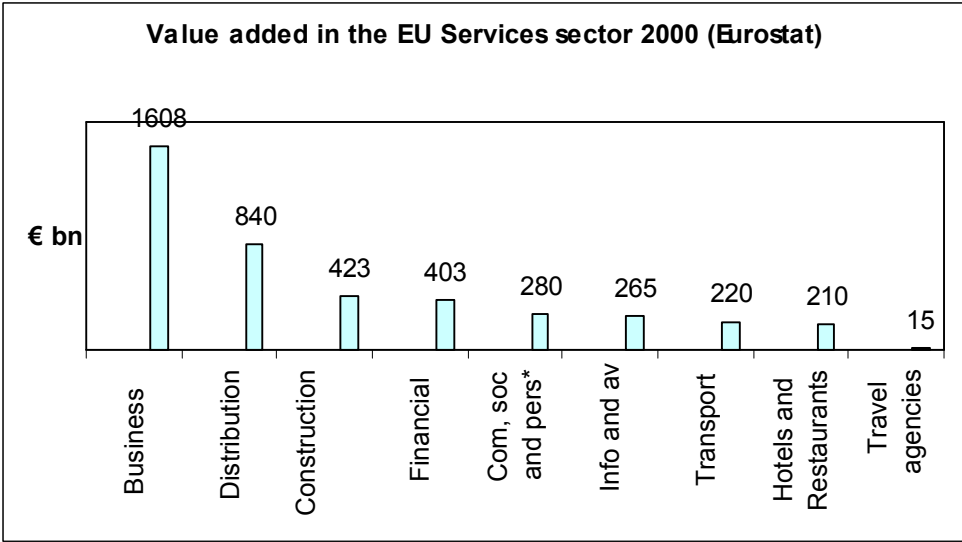
CONTRIBUTION OF SERVICES TO EUROPEAN GDP

Services account for the largest proportion of GDP in the EU economy



Source: Eurostat (2002) European business: Facts and figures

Within the value added¹⁵⁸ services, business services and distributive trades respectively account for 38% and 20% of the total.



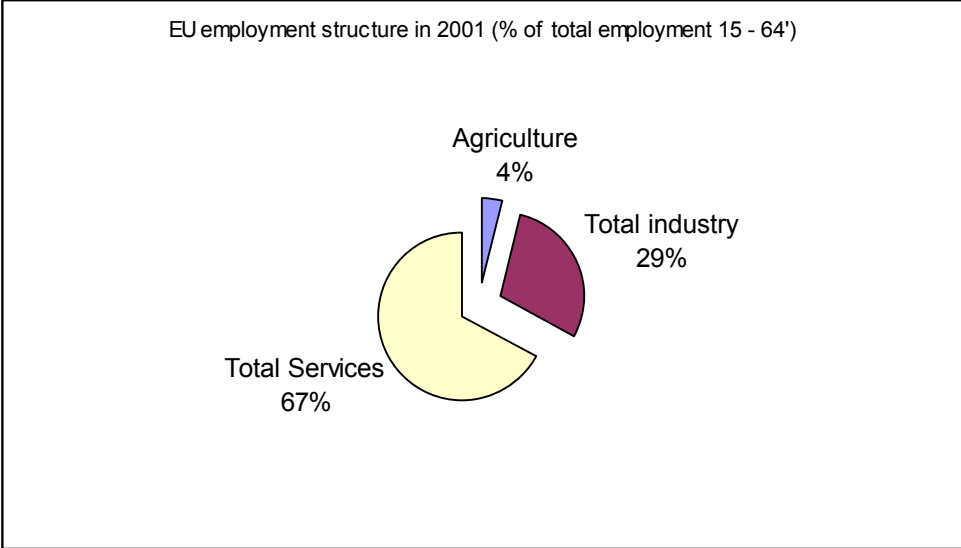
*Community, social and personal services

Source: Eurostat

¹⁵⁸ Gross value is final output minus intermediate consumption plus subsidies minus taxes linked to production. It is the "output" side measure of GDP.

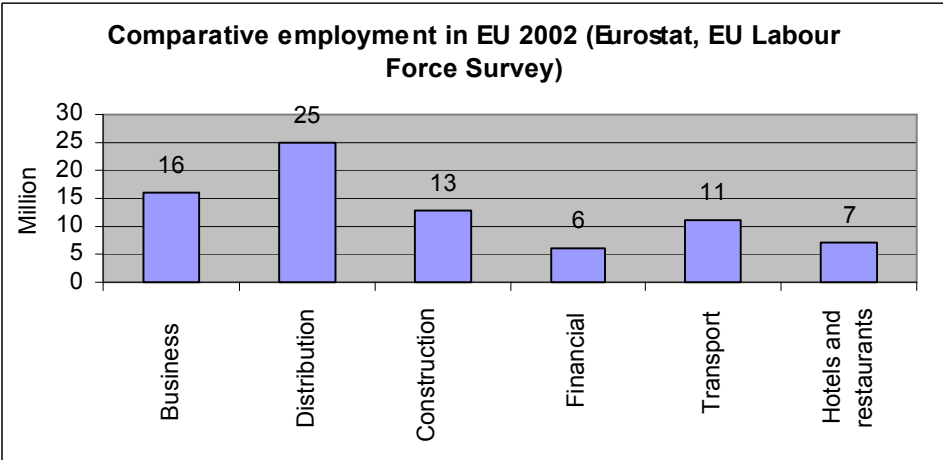
SERVICE EMPLOYMENT AND LABOUR PRODUCTIVITY LEVELS

Services accounted for 67.3% of jobs in the Union in 2001.

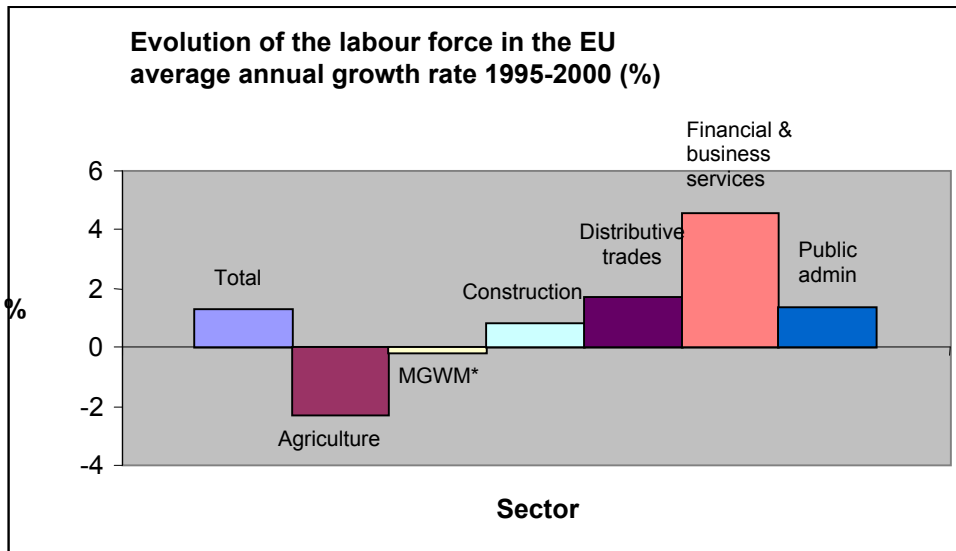


Source: Eurostat LFS

Business services and the distributive trades are key sources of EU employment.



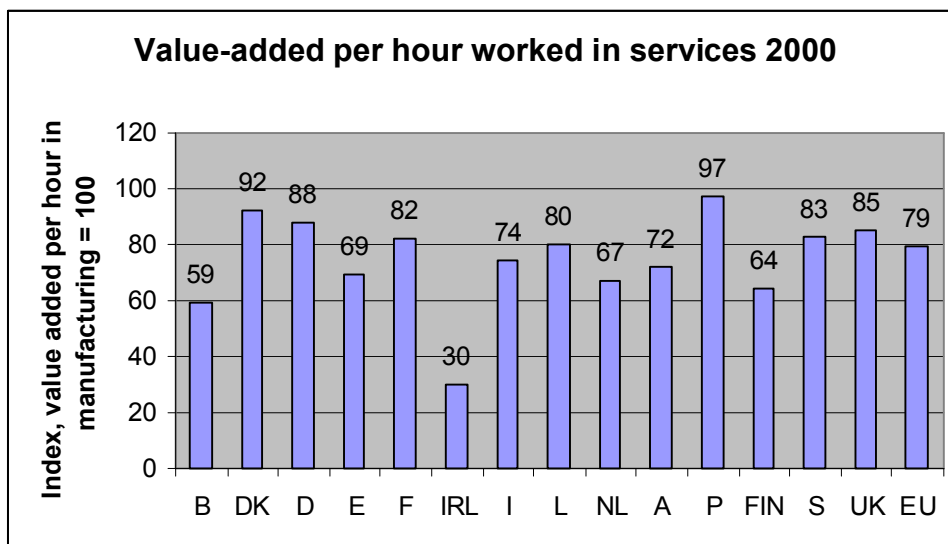
Services are the key source of employment growth in the Union.



*Manufacturing, Gas, Water and Mining

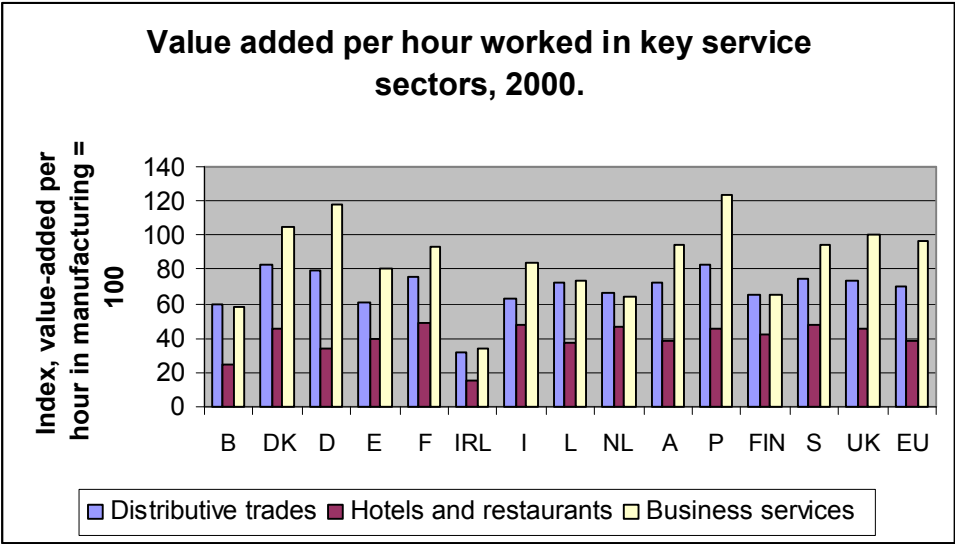
Source: Eurostat/LFS

Given the high level of temporary working in services compared to manufacturing, a measure of labour productivity to compare levels between services and manufacturing is value added per hour worked. This shows that labour productivity is not only lower than in manufacturing but also varies significantly across Member States.



Source: Eurostat (2003) "Employment in the market economy in the European Union – an analysis of the Structural Business Statistics".

This variation is not due to sectoral differences in the composition of services across Member States, as the following graph shows.



Source: Eurostat (2003) "Employment in the market economy in the European Union – an analysis of the Structural Business Statistics". Given the inherent problems in estimation of such productivity measures, the data displayed in these two tables should be treated with caution. See annex III of the Commission's Communication on "The Competitiveness of business-related services", op cit.