Chapter 7. Services Market Integration: The Method, *European Integration: Methods and Economic Analysis*, J. Pelkmans, 1997, pp. 105-09

Services market integration differs in many ways from product market integration. Cross-border services are rarely tangible and not subject to tariffs, hence there is no such thing as a services CU. The EC treaty, especially the Rome Treaty version, contains a stark contrast between detailed liberalization obligations for products and a virtual absence of details on services liberalization, which is also conditional in important cases. In addition, the history of the EC differs sharply between the two: whereas the CU was achieved by mid-1968 and regulatory barriers were at least addressed subsequently, little to nothing was accomplished in services until the early or mid-1980s.

A great problem of services liberalization is its sector-specific nature. Important service sectors have distinct characteristics, terminology and regulation.

7.1 The Legal Framework for Services Market Integration

Familiarity with services is generally much less developed than with products. It is good to realize that the treaty deals with services in a different fashion than with products.

The treaty section on services contains virtually no detail on how and what should be liberalized. Large sectors such as transport and financial services are either under a special regime or conditional. No clear stages are defined and no time-table is foreseen. The related section on the right of establishment is clearer, but typically, this applies equally to goods and services suppliers.

The reasons for this asymmetry are not hard to find. They include the (in the mid-1950s) limited share of tradable services in total services output, the inherent difficulties in providing many services – requiring trust and close contact between supplier and consumer – in jurisdictions with different languages ad customs, and the then low stock of EC direct investment in the EC (providing few incentives for business services to 'follow'). Accomplishing approximation was probably seen as a daunting task, given idiosyncratic regulatory and supervisory regimes in the Member States. (These include self-regulation of professional services with *de facto* entry barriers for non-nationals.) Initially, therefore, little more than tourist services (for which there is little to liberalise) and transport services (as a necessary corollary of product market integration) could be identified as being of any economic significance fro cross-border transactions in the Community.

The Treaty

There are four ways of providing cross-border services. Recasting them in EC treaty language, one may distinguish temporarily or permanently provided services in another Member State. The *temporary* services are defined as 'services' within the meaning of the treaty (Arts 59-66, EC). The three temporary services consist of pure cross-border services (between immobile consumers and immobile providers), or alternatively, services for the consumption (or provision) of which the consumer (or supplier) crosses borders. The *permanent* provision of services in another Member State falls under the regime for the right of establishment (Arts 52-8, EC).

Both services and establishment in the treaty framework suffer from considerable limitations, be it for different reasons. The services chapter would seem to be generally applicable but it is not. Transport services are dealt with in a separate 'transport' title of the treaty, pursuing what is called a 'common transport policy'. In the 1950s the various modes of transport tended to be subject to restrictive national regulation, including (major) subsidies, administered prices, discriminatory taxation and managed inter-modal competition. Reasons included forms of 'capture', protectionism, limitations of infrastructure, 'public service' obligations and even national security (for maritime shipping). (Capture in a regulated sector refers to the situation where the cost/benefit ratio of regulation for society is significantly worsened because companies being regulated have a hold on those who regulate and supervise. Capture is a form of regulatory failure, which may possibly offset the benefits of overcoming market failure.) This explains the ambiguous wording of the transport title, suggesting a balance between 'harmonisation' of socio-economic interventions and liberalization. As a result, progress on transport services remained largely deadlocked until the European Parliament won an EC Court case against the Council, in 1985, accusing it of a 'failure to act' (Art. 175, EC). Ever since, the emphasis has heavily been on liberalization, limiting approximation merely to 'essential requirements' (e.g. safety, professional competence, etc). Rapid progress was the result.

Financial services liberalisation was conditional upon 'the progressive liberalization of movement of capital' (Art 61.2, EC). But as late as early 1986 six out of 12 members States still practiced exchange controls and one had a dual currency market; little liberalization had actually taken place, except in the right of establishment for banks and insurance companies.

Telecoms services and postal services had also been 'carved out' of the services chapter. Art. 90, EC was widely interpreted as accepting 'exclusive rights' (in other words, for the national postal and telecoms monopolies) and the PTT's universal service obligation. As a result Art. 59 on the free movement of services was simply not applied to telcoms and postal services for a long time. Liberalisatioin under conditionality, only began in the late 1980s.

But what economic meaning does the treaty's services chapter have without the four most important services sectors (other than unregulated tourism)?

Indeed, such economic significance is very limited. The most important overall category outside big and free-market tourism comprises cross-border services by professional such as lawyers, accountants, physicians and pharmacists. However, in these cases other obstacles arise, such as a lack of mutual recognition of diplomas. The diploma issue is somewhat special here as national laws and practices (e.g. for lawyers, notaries) or health traditions and insurance conditions (e.g., for doctors, pharmacists, dentists) may justify local traineeships or some measure of local education. Nonetheless, there are indications, too, that 'capture' plays a role here as well, in other words, that diploma recognition is made more cumbersome than justified so as to protect vested interests by extra barriers to entry. At the same time, it is good to realize that even with recognition, the economic incentive for temporary cross-border services of professionals is weak; non-incidental services will require close and regular contact with the customers, so that services will eventually prompt local establishment. One interesting exception is consultancy, where little regulation applies and cross-border services are more often an alternative to establishment. (A case study on accountancy shows that a single market for accountancy services is impeded by a host of obstacles, not just diploma recognition.)

The establishment regime has different limitations. In analogy with products, obligations to abolish restrictions are imperative and Art. 54 especially details a number of specific duties for Commission and Council. Indeed this framework has formed a good basis for direct investment and some specialized service sectors with a low degree of (self-) regulation (e.g. consultancy, voluntary certification). Where regulation is prominent, however, achieving freedom of establishment proved more difficult. For financial services establishment directives were only adopted after the transition period, a decade or more too late. In telecoms, postal, air and rail transport, legal or factual monopolies with public ownership made establishment in another Member State taboo. Thus far, the Court has not used Art. 52 on free establishment against public service monopoly, only Art. 59 on free movement of services. Furthermore, Art. 56 allows significant derogations of the kind that Art. 36 allows for products, which requires well-developed case law to prevent misuse. As noted, a major services area where establishment could have an impact is in professional services (lawyers, accountants, architects, dentists, physicians, and pharmacists). The stumbling block was similar to the removal of technical barriers under Art. 100: an extremely strong attachment to the very details of education, training and examination of professionals backed up by unanimity.

The method of establishing an internal market for services is straightforward. The method combines (a) an obligation (in Art. 59) to abolish restrictions on the free movement of services, (b) a standstill clause, (c) a programme approach (in Art. 63) and (d) a non-discrimination clause for remaining restrictions extended to all residents. The scope does not extend to nationals of a third country, except when the Council so decides. The provisions are also silent on whether there should be an external policy for services, and whether the EC has exclusive power (as with trade in goods). In the transport title Art. 84 caused great uncertainty because it could seem to make free movement in sea and air transport service optional, to the discretion of the Council.

The method of accomplishing the right of establishment is broadly similar to that in services. There are three differences, and all three are important. First, rather than having a non-discrimination clause, companies receive 'national treatment'. National treatment, a principle in EC and GATT law, refers to treatment of non-domestic establishments no different than for domestic companies. Second, as noted there are wide derogations in Art. 56, similar to Art. 36 for goods. Via a cross-reference in services (Art. 66) these derogations are applicable to services, too. This raises the question of how widely or narrowly the EC Court would interpret these rules. Again, these ambiguities have not helped to make progress in these areas. Third, regulatory mutual recognition is introduced for diplomas of professionals but in an 'old' approach, hence not based on minimum harmonization. This has proved no less cumbersome than ordinary approximation under Art. 100 for goods.

Free movement in case law

The case law on the free movement of services has gradually become similar to that for goods, with a delay of a decade or so. Of course, this applies to the principles, not to the specific details.

As with goods, there is first the distinction between discriminatory and non-discriminatory barriers. Discrimination on account of the provider's nationality or the provers's member State of establishment is prohibited, but broad derogations under Art. 56 are possible. For non-discriminatory restrictions, it would seem that the case law on goods (that is, Art. 30) has inspired the jursprudence on services, too. In the Sager case (case C-76/90, ruling 1991) and later, there is an analyogy with Dassonville: restrictions 'liable to prohibit or otherwise impede* cross-border services of the 'temporary' type are not allowed. This economic approach covers those measures affecting the ability to provide, those increasing the cost of the relevant service (a very wide-ranging prohibition, as in Dassonville), and those discouraging its provision. Interestingly, it also explicitly protects consumers who are prevented from receiving the services of their choice.

It is then a small step to introduce the analogy with Cassis de Dijon, with the notion of (judicial) mutual recognition. A Member cannot normally prohibit the provision, in its own territory, of a service lawfully provided in another Member State, even if the conditions in which it is provided are different in the country where the service provider is established. If there are no justified derogations this is mutual recognition. As with goods, this even overrides derogations if the legitimate objectives pursued in different Member States are equivalent, even though th3 way the service fulfils the objective is different from the way imposed on domestic service providers.

In an analogy to Art. 36, the wide derogations of Art. 56 and a host of related other objectives (such as the coherence in he tax system) legally need not be incompatible with free movement of services. To verify whether this is so, national regulations have to pass three tests. The first one is the justification test, that is, overriding reasons related to the public interest. But this is restrictively interpreted (indeed, like Art. 36). Thus economic aims or administrative convenience do not qualify. Second, there is a kind of home country control test, a judicial forerunner of the regulatory home country control principle later introduced in the Second Banking Directive and subsequent services legislation. Statutory conditions (if equivalent), already satisfied in the home country, cannot be duplicated by the host country, and the supervisory authority of the host country must take into account supervision and verifications in the home country (in other words, identical testing should not be duplicated). Finally, there is the proportionality test: the restrictions should be indispensable and least restrictive (that is, no less restrictive means be available). Since services regulation is pervasive, these tests for the legality for restrictions of free movement are still important. However, since EC-1992, approximation and mutual recognition have enabled a much wider applicability of the free movement of services. Utilities services are a special case. The justification test in Art. 90 should be based on 'legitimate national objectives', which includes 'universal service' or another well-defined public service concept. The proportionality test then asks whether there are alternatives to 'exclusive rights' which are less restrictive. If not, restrictive rights are allowed.

Given the wide scope for derogations and special services regimes, considerable EC regulation is necessary for an internal market for services to be established. Nevertheless, case law has appreciably strengthened free movement from what appears to be conditional treaty language. In relying upon similar principles as in the goods market, it facilitated the development of the EC regulatory strategy in the case of services as well.

7.5 Summary

Services market integration is different in nature from product market integration. The original treaty section on services contrasts starkly indeed with the treaty sections on product market integration. Moreover, the economically most important services (financial, telecoms, postal, all transport modes) are under separate treaty sections, with initially very little progress in intra-EC market access. Of the big services sectors, only the unregulated tourism services escaped special treatment but precisely in this case there is next to nothing to liberalise. Among the other services without special sections in the treaty, the overall category of cross-border services provided by professionals is the most important one. Severe difficulties in the mutual recognition of diplomas for professionals have long throttled the actual provision of these cross-border services.

Both the right of establishment (for services and for goods suppliers) and the free movement of services suffer from considerable derogations. Hence, case law has been critical to interpret the derogations narrowly. In the 1980s and early 1990s, EC case law on services gradually developed principles similar to those protecting the free movement of goods, or example formulations similar to the Dassonville and Cassis de Dijon cases and proportionality tests.

A single market for financial services can only function properly in a context of a Union-wide financial area, including free movement of financial capital and money, a single currency as well as fiscal and accounting approximation. The regulatory principles for establishing the internal market for financial services include, besides free movement of course, minimum harmonization (focused on financial institutions, not so much on financial service products), mutual recognition based on home country control of financial institutions operating across intra-EU borders and very limited host country control. Great progress has been made but obstacles such as fiscal barriers and different accounting standards remain.

The single market for transport services has become possible only after the 1985 Court ruling that the Transport Council of Ministers had 'failed to act' on its main treaty obligation. Harmonisation since that date has been mostly technical (and 'minimal') whilst liberalization has practically been completed in most of the modes. In road haulage the conflict about the proper allocation of infrastrructural costs centered around the territoriality principle (you pay user charges where and when you use infrastructure) versus the residence principle (taxation in the home country). Cabotage (the right for foreign firms to supply intra-national services) has been implemented in road transport.

In air transport the regulatory problem in essentially found in the scheduled passenger market. Given the oligopolistic structure, EC competition policy is crucial for proper functioning. In 1997 there will be full cabotage. However, the world market is still bilaterally and restrictuively regulated. Given network effects and the weight of intercontinental turnover for European trunk carriers, this market segmentation has the practical effect of making substantial inroads by new entrants very difficult.

Telecoms services are currently in the process of being liberalized. The previous telecom monopolies have first had to focus on network operations (since 1990), while transferring regulatory functions to newly established national telecoms regulators. Then, a limited number of 'competitive' services were liberalized first, followed by mobile, and in 1998, by all previously 'reserved' services (that is, voice, fax). Fixed-wire networks must be 'open' and this access as well as interconnection (critical for new entrants to provide telecoms services) are now regulated. Major complications about costing principles (given significant 'joint costs', which should be allocated), universal service for all citizens, and appropriate and swift application of competition policy (in a market with very dominant suppliers, initially) have to be properly addressed, for the single market in telecoms services to function properly and for it to encourage innovation and advanced infrastructural investment for the 'information society'.

Chapter 8. Services Market Integration: Economic Analysis,

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The economic analysis of services market integration has long been neglected. There are three reasons why that is no longer justified (if it ever was). First, market services in the EC-12 accounted for 48% of GDP and 42% of employment in 1990. Another 15% of GDP is generated by non-market services. The economic importance of services therefore exceeds that of agriculture and industry together. Secondly, the former grow relatively and absolutely, in contrast to the latter. The 1990 services share of GDP was up 10% points from 1970, while job creation between 1980 and 1990 amounted to 10 million for market services, compared to a loss of manufacturing jobs of 3.6 million (Buigues and Sapir, 1993). Thirdly, economic significance of EC-1992 is especially to be found in services. Whereas, in say 1980, a focus on EC product market integration was factually justified by the almost total absence of progress in services market integration, in the years after EC-1992 a neglect of services market integration would be a serious omission.

The groundwork for analysis of services rests in a discussion of the economic justification for regulating services trade and the appropriate balance between regulation and liberalization. There are also digressions on the four modes of cross-border service supply and emerging economic theories of services trade (taking account of the market failures which should be addressed). A brief comparison of market structures in various service sectors is also helpful.

8.1 The Economics of Services Trade

Liberalisation often requires regulatory solutions before an EC services market can emerge. Regulation is economically justified by three market failures: internalities such as asymmetric information; market power or imperfect competition; and externalities. All three play an important role in services, although sectoral specificities always need to be taken into account.

The most general market failure in services is *internalities*. This is caused by the fact that services, unlike goods, are non-storable or intangible. This intangible nature makes it even more difficult to assess quality than with products, indeed, it is impossible to do it prior to consumption. Services being 'experience goods' rather than 'search goods', services markets should be expected to suffer from asymmetries of information. Usually, this means that the seller knows more *a priori* about service quality than the buyer, although quality may sometimes depend on interaction between buyers and sellers (e.g., education, consultancy) and occasionally buyers may cause information problems for sellers (e.g., insurance). There are basically two problems to be overcome for services markets to function properly in this respect: moral hazard and adverse selection. *Moral hazard* refers to market behaviour induced by imperfectly observable information: thus, suppliers can make higher profits by reducing the actual quality of the service below the perceived or expected quality. The problem is acute for non-repeat purchases in the absence of any controlling knowledge (e.g., a taxi ride for a tourist). The market solution for moral hazard is to signal commitment to quality by means of investing in reputation, brand names and easy access to complaint procedures. However, since these solutions are not watertight (especially for high risks such as some insurance or medical services) and, in any case, are based on repeat purchases and comparability, some regulation may be justified. (Services are extremely differentiated products. Only comparable services can benefit from reputation effects by word of mouth.)

Adverse selection, caused by asymmetric information, is more evenly a problem of both buyers and sellers. Sometimes sellers may not have (or ask) enough information about buyers so as to distinguish them according to risk (hence, pricing, including risk premiums, is problematic). In other cases, buyers may be confronted with a number of services suppliers (say in the yellow pages of a phone directory) but have no way of distinguishing their (divergent) qualities or competence. Market solutions for adverse selection may include self-regulation of (minimum) professional qualities, self-regulation of conduct or standard contracts agreed between, say, consumers bodies and suppliers associations. Such solutions decrease the uncertainty for the buyers due to minimum standards of quality; hence, confidence may be increased. However, self-regulation might only come about when (a credible threat of) regulation exists, otherwise free-riding among suppliers may prevent agreement. The reason is obvious: higher competence and quality services would tend to be driven out of the market as both their prices and frequency of sales would be continuously undermined by charlatans exploiting lack of information on the part of the buyers. Apart from the rationale for 'back-up' regulation, societies have judged the risks to individuals, the impact on individual household expenditure and the smooth functioning of services markets, so important that all kinds of structure and conduct regulation (including licensing and supervision by special agencies) have been introduced. Sometimes sellers are allowed to refuse buyers if insufficient information is supplied. All this regulation might be wholly or partly justified.

The second market failure is imperfect competition. Sellers of many services tend to enjoy some degree of market power. The latter results from a low degree of contestability of the established firms in the market. This may depend on economies of scale or (for multi-services supply) scope or on product differentiation. But the observation of any of those three is not a sufficient condition. What matters is whether new entrants can enter and exit as such low costs (and such high speed) that potential competition becomes a credible discipline on the behaviour of established firms. Given such entry and exit conditions, and given that market power is exploited, 'fly-by-night' companies might enter at virtually no-costs, and erode the profitability of established firms. If the entry costs are determined by the exit costs and are low (that is, if there are well-functioning markets for buildings and equipment so that entry costs can be recouped upon exit), and cost functions of established companies are similar to those of new entrants, then contestability is high and market power cannot be exercised.

Among services, contestability varies enormously between sectors. At one extreme of the spectrum, scale and /or scope are absent, while at the other extreme, barriers to entry and exit are high. The latter means that costs incurred with entry cannot be recouped upon exit: they are sunk. Thus, one could hardly imagine a well-functioning market to exist for a railway network or a telecom cable network; however, for aeroplanes, second-hand markets have emerged. So, one has to assess tangible exit barriers from case to case. Intangible entry/exit barriers may be more important in services, however. Especially, investment in reputation and consumer loyalty is specific to the company and hence sunk. The costs to acquire reputation and loyalty can be extremely high and may serve as very effective barriers to entry, alone or even more so in combination with network externalities (e.g., airlines; retail banking).

Of course, internalities and market power may mutually reinforce each other. Thus, consumer loyalty may be due to consumer switching costs, which consumers may perceive to be high between experienced services (from the supplier they are loyal to) and inexperienced ones, the quality of which they cannot judge. It is claimed that this explains consumer loyalty in retail banking. This makes contestability by new entrants very difficult (because discounting may be distrusted as low quality) and hence may lead to concerted or parallel pricing behaviour in an oligopoly of the established companies. Another example of interaction between the two market failures is self-regulation which, in addressing the problem of asymmetric information, may actually raise barriers of entry (too much) or stifle innovative conduct. This is often said to be the case for certain professionals, for example, notaries.

It goes without saying that these features require application of a sophisticated and active competition policy to services. Unfortunately, asymmetric information (as well as the third market failure) has often prompted regulation which reduces the scope or effectiveness of competition policy. Carefully assessing the complementarity between regulation and competition policy is absolutely critical for the understanding of the establishment and proper functioning of the internal market for services.

The third market failure is *externalities*. Where these are negative externalities (e.g., for the environment) they may give rise to regulation. More complicated are the positive externalities in goods and services networks (e.g., telecoms, rail, postal, gas/electricity; to some extent airlines). Economies of scale are such that 'natural monopoly' may be justified on efficiency grounds. More precisely, these effects may play a role on the supply and demand sides. In some utilities supply scale effects may not be exhausted until a single national network is formed, for example, in rail, gas electricity, and up to the 1980s, a fixed-wire telecom network. On the demand side, the term used in economic theory is 'network externalities': existing subscribers to a telephone or fax network benefit from every new subscriber, which in turn attracts more new subscribers. In airlines, network externalities result from economies of scope in scheduled (not charter) traffic, as many city-pair services are offered with smooth (and cheaper) connections within one network. The typical US response up to the early 1970s has been to regulate these natural monopolies or network services strictly. In Europe responses have varied but often regulation, based on exclusive rights, has been combined with public ownership, not infrequently supplemented by loss-covering subsidies. There are two reasons behind such far-reaching interventions. First, a natural monopoly's market power is so large, potentially, that it was thought to be superior to resort to non-market means so as to control quality and price as well as other conduct. Second, societies perceived precisely these services as 'basic' to both the economy's infrastructure and citizens' socio-economic rights.

Network externalities can be very strong but these benefits may be offset by high costs on the periphery of the network. A well-developed network would therefore be expected to exhibit sharply different prices. If this would lead to too little demand, the network would simply not be fully developed. That is why service and goods utilities were given exclusive rights: equality of service everywhere in the (fully developed) network at affordable prices, was 'bought' at the costs of no entry. The combination of this universal service with monopoly in turn requires regulation forcing the monopolist to reduce prices below costs in the periphery. The cross-subsidisation between trunk sections and periphery requires no entry: otherwise new entrants would undercut the high price/cost margins on profitable trunk connections of the network, leaving peripheral deliveries unattended or subject to extremely high prices. Such 'cream-skimming' behaviour by entrants would prompt competitive reactions by the incumbent, and in the end the universal service would become unsustainable. Since the 1970s, however, technological change in some services as well as the appalling price/quality ratios of utilities almost everywhere have led to a questioning of existing regulation. For instance, what is the proper economic underpinning of 'natural monopoly' and what part, if any, can be subjected to competition? It also led to a greater acceptance of market processes, since the imperfections of the regulatory and public ownership approach were seen as intolerable. In turn, this prompted a debate in Europe about 'universal service' in a more competitive environment of utilities.

Modes and incentives of services trade

Services differ from goods: production and consumption occur at the same time. Often it may also happen at the same location, although new technologies may make this characteristic more and more service-specific (Sampson & Snape, 1985). For these two reasons four modes of international services transactions are distinguished, which are now also recognized in the GATT/WTO:

- Type 1 Immobile users in country A consume services produced by immobile providers in country B; this cross-border trade is comparable with ordinary goods trade but remains the exception; today, it can take place with data transmission, airline tickets and certain financial services (via telecom services, which are inputs into these services);
- Type 2 Mobile users from A consume services in B (tourism, ship repair, special education and health care);
- Type 3 Providers from A establish a branch or subsidiary in B in order to produce services locally (This is the dominant pattern in business services, financial services and distribution and is a direct consequence of internalities.)
- Type 4 Mobile providers from A provide services in B (business services such as accountancy and consultancy, transport and some forms of construction services).

These four modes make abundantly clear that the old notion of services being typically 'domestic' is false. Types 3 and 4 are called 'service factor trade', permanent for the first one and temporary for the latter (Ruane, 1990). The prevailing models in services trade theory usually follow a form of types 3 or 4 (Sapir & Winter, 1994).

In actual practice the distinctions are somewhat blurred. Relying on types 3 or 4 may sometimes facilitate type 1 trade; type 3 transactions may be complemented by additional type 4-ones; type 3 ones may be a response to type-2 flows (e.g., German hotels serving German tourists on the Spanish coast).

The taxonomy of modes helps to classify the barriers accordingly. Cross-border trade was often impossible in the EU before EC-1992 since host country control tended to be unquestioned. Mobile users (type 2) are relatively free as a rule although subsidies and insurance problems may reduce the entitlements of foreigners to have access to services such as special health care and higher education; for tourists, special insurance products have largely resolved these problems. Note that the modes here are complementary: tourists may consume tourism services on Italian beaches but their travel insurance will normally be provided in the country of origin (but perhaps by a foreign-owned company) and their air travel may be provided by Alitalia, or by the origin country's airline(s) or by a services of competitors from other EC countries, be they charters or trunk carriers. Mobile providers (type 4) have traditionally been severely hindered by barriers. EC-1992 and other initiatives have largely been concerned with removing these (e.g., entry restrictions, discretionary licensing). Barriers to foreign direct investment in the EU (type 3) have been low or negligible since the early 1960s and national treatment is provided directly by the treaty, but type 4 barriers frequently pre-empted its actual relevance. The dominance of type 3 services is demonstrated by recent empirical work (Sapir, 1993): one-quarter of the ECU value of goods trade, in the period 1984-88 services accounted for nearly half of all inflows of FDI into EU countries. Thus, the ratio of FDI services inflows to services imports was three times the comparable ratio for manufacturing.

A Note on Services Trade Theory

The recent theoretical work on services trade does not provide a basis comparable to that for customs union of goods. The main preoccupations have been to prove that comparative advantages apply to services trade just as well as to goods trade and that cross-country differences in factor endowments and technology are key determinants of services trade, too. The work on the welfare implications of barriers to services trade is more developed by highly disparate. Concentrating on imperfect competition, for reasons noted above, a range of different models ahs been produced. Given complementarity beween goods and (some) services trade, Kierzkowski and Jones (1989) find that the liberalization of trade in services is crucial to ensure an efficient international allocation of production regardless of whether trade is inter- or intra-industry. Francois (1990a) show in a complex model where services are used for coordinating and linking together specialised intermediate producers (these expanded opportunities for trade in differentiated goods result in increased specialization, a growing production of services and a rise in welfare. In Francois (1990b) services and goods are produced with different types of labour with which the two economies are differently endowed. With free trade in goods but not in services, services will be cheaper in the country better endowed with the relevant factor. With services trade opening up, the number of product varieties increases as does scale, leading to greater specialization in both goods and services and a relative price decrease of manufactured goods. The returns from increased specialization are in addition o the standard (comparative advantage) gains where liberalizing services.

These various approaches would seem to provide an economic underpinning of EC-1992 in services, if not worldwide services liberalization. They do ignore market failures and regulatory issues, however. The model of Grossman and Horn (1988) is possibly more relevant for EC-1992. They connect services protection and asymmetric information in a model of infant service industry. One should expect the outcome to be second best, as regulation rather than protection is the direct way of addressing the market failure. However, informational barriers might justify the infant service protection. Without protection of their domestic market, efficient new entrants may not be able to compete with well-established foreign firms that have acquired a reputation, so crucial in services.

In the EU it is well-known that although services were protected everywhere to some degree, regulatory protection and restrictiveness were especially severe in Portugal, Spain, Italy and Greece. Before EC-1992 this could have been viewed as a legacy of the 'developmental state' (Italy) of the 1950s or simply as infant protection. If such protection were justified, EC-1992 would have led to welfare losses in these countries and possibly to greater dominance of 'Northern' service providers. The crux of the matter is that, without regulation, fly-by-night firms (without reputation and permanence) preclude the entry of efficient domestic firms since the latter's reputation is not yet known (in the first period), but their costs are higher than those of charlatans. The fly-by-night firms hardly affect the (foreign) companies with established reputations. Grossman and Horn (1988) consider two ways to rectify the sub-optimal market equilibrium: public policy through trade protection, and market response in that domestic entrants build up their reputation through investment; however, the market response takes time. Because a two-period analysis could take this reputation effect into account, the authors distinguish cases with temporary and permanent protection, and with and without investment in reputation, four combinations in all. They show that trade protection cannot correct the market failure and hence that either infant service protections lowers welfare, or, if it increase welfare, protection must remain forever. To understand the core issue, take the combination of temporary ('tariff') protection and private investment in reputation. Initially, protection is bound to lower welfare because the temporary tariff protects both charlatans and serious entrants. Protection does not correct for the moral hazard problem because it does not alter the incentives to provide high quality rather than pretend. The rents will attract additional charlatans and thereby exacerbate adverse selection. If protection were maintained in the second period (i.e., be permanent), it owed ossify excess capacity precisely caused by additional charlatans having entered the market. Such a promotion of services as an industry would be welfare decreasing. One implication is that the economic case for liberalization will have to be combined with the appropriate legislation for the EU as a whole.

8.2 Competition in Services Markets

Perfect competition in services is rare. Before going into the specifics of main services sectors in the EU, it is useful to offer a more general framework for assessing the nature of competition and the resulting market structure across many services activities. Because EC-1992 has proved to be so important for services, the characteristics relate to the situation before EC-1992 started to have an impact (late 1980s). The F column anticipates EC-1992 and technology effects. As Table 8.1 shows, the framework would imply the explicit consideration of six determinants of market structure: product differentiation, concentration, sunk costs, (intensity of) regulatory measures and the actual and potential degree of competition. Product differentiation tends to be high in services but in simple road haulage and basic telecoms it hardly applies. In road haulage and telecoms one observes attempts to raise the degree of product differentiation by, respectively, offering logistic services of which transport is only an element, and, offering value-added telecoms services of many kinds.

The degree of concentration is high where network externalities are strong (scheduled airlines, telecoms) and fairly high in banking and insurance (because of the scope to spread risks and reputation effects). In four out of eight sectors however, suppliers are numerous and new entry (potential competition) is a credible threat. On sunk costs the assessment in perhaps somewhat subjective. Where sunk costs are physical, they are easy to verify. However, investment in reputation may partly go into image-building or brand-name recognition via heavy advertising and the question arises to what extent these are unavoidable sunk costs. Luxury hotels and scheduled airlines do a lot of the latter. Where the services themselves are positively affected by such investments (e.g., frequent flyer benefits, discounts and extra service for regular users of a given hotel chain), they surely classify as such costs. The intensity of regulatory measures is a product both of severity of market failures and 'capture'. In the political economy of regulation the legislators, when drafting, or the regulatory agency, when supervising, can be heavily influenced by the parties to be regulated. This may happen because of asymmetric information or career perspectives in the presence of sharp income disparities between the public agency and the private sector, or for political or social reasons. Therefore, the single-word indications in this column may in fact vary (or have varied) somewhat between different EC countries.

A case in point is road haulage where, for example, German and Spanish regulation used to be heavy whereas Dutch regulation was traditionally much more liberal. Also in the case of European flag carriers in scheduled air transport, until the early 1980s all publically owned, there was an extreme instance of capture which made regulation overly restrictive. Distribution regulation in Europe is typically about land-zoning for shopping centers (with restricted entry) an shop opening hours, a sensitive issue for the numerous family businesses everywhere.

Four forms of market structure result: a competitive market (simple road haulage), monopolistic competition (with high product differentiation, especially for business services), oligopoly and regulated monopoly (basic telecoms, but also rail and basic postal services, all examples not included in Table 8.1).

The conclusion is that services markets are often characterized by imperfect competition. Moreover, non-price competition, especially services differentiation and actual as well as perceived quality ('reputation'), is often more important than price.

Table 8.1

Determinants of market structure in services (late 1980s)

Sector	Characteristics of the market						Mkt type
	1	2	3	4	5	6	
Banking	High	Med	Med	High	Low	Med	OC
Insurance	High	Med	Med	High	Low	Med	OC
Road haulage	Low	Low	Low	Med	High	High	C
Air transport	High	High	High	High	Low	Med	OC
Telecoms	Low	High	High	High	Low	Med	M
Distribution	High	Low	Low	Med	Med	High	MC
Hotels	High	Low	Low	Low	High	High	MC
Business	High	Low	Med	Low	Med	Med	MC

1: Degree of product differentiation
2: Degree of concentration in the industry
3: Sunk costs as a measure of barrier to entry
4: Regulatory measures (intensity)
5: Degree of competition, actual
6: Degree of competition, potential

Market structure types:
C: pure competition
OC: oligopolistic competition
M: regulated monopoly
MC: monopolistic competition