

EF. RESEARCH ON THE "COST OF NON-EUROPE"

BASIC FINDINGS

VOLUME 8

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THE "COST OF NON-EUROPE"
FOR BUSINESS SERVICES

Document

COMMISSION OF THE EUROPEAN COMMUNITIES

This publication was prepared outside the Commission of the European Communities. The opinions expressed in it are those of the author alone; in no circumstances should they be taken as an authoritative statement of the views of the Commission.

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by

Peat Marwick McLintock

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The "Cost of Non-Europe"
for Business Services

Peat Marwick McLintock

THE "COST OF NON-EUROPE" FOR BUSINESS SERVICES

EXECUTIVE SUMMARY

Prepared by Peat Marwick McLintock

Dated: April 1988

THE "COST OF NON-EUROPE" FOR BUSINESS SERVICES

EXECUTIVE SUMMARY

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1. INTRODUCTION

This study is part of a research programme undertaken at the European Commission by the Directorate General for industrial Affairs and the Internal Market, under the title the Cost of Non-Europe. The studies in this programme investigate the costs to the Community economy of the continued fragmentation of the internal market, each study addressing a particular sector or type of cost. This study addresses the cost of non-Europe for business services. By implication the study also assesses the economic benefits which are implied by the removal of barriers to trade in business services envisaged through the completion of the internal market by 1992.

The main elements of the study were to:

- examine the process of externalising services, that is contracting services out to specialist firms and investigate the degree of externalisation in the European Community,
- examine whether the existence of barriers within the internal market limits the ability of firms to purchase the most cost effective business services provided within the Community, and to provide estimates of the extra costs borne by enterprises,
- estimate the benefits from completing the internal market, both for enterprises purchasing business services, and for the business services sector itself.

Business services include the technical, professional and operational services generally consumed by firms rather than households and are those commonly defined as business services for most statistical purposes in European countries. They exclude financial services such as banking, insurance and securities.

This executive summary outlines the main findings of the study. The broad findings of the existing research helped shape our questionnaire and the conclusions were tested and in the main confirmed by our sample interviews. Despite our small sample, therefore, we felt happy with the overall trends in our conclusions.

2. METHODOLOGY

2.1 General

The original research for the study was based on two sets of face-to-face interviews and the completion of two corresponding questionnaires. One set related to the demand side, the users of business services, and consisted of a sample of companies in sectors spread across the economy from Benelux, France, Germany, Italy and the United Kingdom. The other related to the supply side of the question, and consisted of interviews with companies which provide business services. In order to draw on a broad spread of experience we interviewed trade associations rather than individual firms in those sectors, generally at the national, but in some cases at an international, level.

The demand questionnaire on which the interviews have been centred covered a number of aspects of service provision:

- the demand and supply of business services: the range of services employed, the source of supply (whether internally or externally supplied), the extent to which externally supplied services are imported, and the domestic availability of services,

- decision making and trends in the demand for business services from outside sources: the factors underlying the decision to externalise (i.e. shift the provision of a business service function from in-house to an external supplier of those services), or to internalise, the process of decision making, recent trends, and the effect in terms of cost implications and employment turnover of these trends,

- the internal market for services: perceptions of barriers to trade which exist in the business services market, and the effects of removing barriers on the demand for business services and on the overall economic activity.

The supply side questionnaire had four points of emphasis:

- the extent to which services are traded internationally,
- the trend towards externalisation,
- the importance of trade barriers in the internal market,
- the likely effects on cost and demand for business services as a result of the completion of the internal market.

In addition to the supply side and demand side surveys we carried out a literature search which provided statistical information about the business services sector, insight into the economics of the externalisation process, as well as price and income elasticities. Further information about the business services sector in Europe came from the Peat Marwick McLintock factsheets, prepared for DGIII, which gave indications of the turnover in the main business service categories.

Finally, for guidance on the quantitative analysis of the cost of non-Europe for business services some existing econometric research was consulted, as was Peat Marwick McLintock information relating to comparative cost structures within Europe in certain business service sectors.

2.2 The survey

Wide ranging interviews were carried out with 100 companies which are users of business services and 20 trade associations representing business service suppliers. These were more or less evenly spaced between France, Germany, Italy, Benelux and the United Kingdom.

2.2.1 Demand side

The companies selected constituted a sample representing a wide spectrum of industries. They were of sizes ranging from small family run businesses to the larger corporations. They ranged from companies operating only in local markets to multi-national organisations with

links worldwide. Around one-third of the sample consisted of small and medium sized enterprises. One-third of the sample had a turnover of less than 5m ECU in 1986, and a similar proportion had turnover in excess of 250m ECU.

In all 61% of the panel was made up of service sector companies (of which around one-third were the financial services sector): the remaining 39% were companies in the manufacturing sector.

Nearly two-thirds of the sample functioned in some capacity in at least one Community state other than their own. Around half the sample operated additionally in non-EEC markets, North America being the most frequently mentioned.

2.2.2 Supply side

The trade associations covered commercial communications (2), engineering and related services (5), management consultancy (4), computing services (3), various operational services (such as security) (3) and legal services (2).

3. THE USE OF BUSINESS SERVICES

Having established the characteristics of the company sample the questionnaire then sought to establish the nature of the demand for, and sources of supply of, business services.

3.1 Degree of externalisation by service

Table 1 summarises the degree of externalisation of each category of business service.

Table 1 Degree of externalisation of business services

<u>Sector</u>	<u>Degree of Externalisation</u>			
	<u>Purely External</u>	<u>Combination</u>	<u>Purely Internal</u>	<u>Subsidiary</u>
Engineering & Related Services	55	29	14	2
Management Consultancy	36	25	36	3
Advertising	48	25	25	2
Public Relations	10	31	59	0
Computing Services	21	54	24	0
Research & Development	13	22	58	7
Financial Review	48	18	32	2
Operational Services	59	17	21	3
Legal Services	40	38	21	1
	—	—	—	—
TOTAL	40	27	31	2
	==	==	==	==

Some 40% of business services used by our sample were entirely sub-contracted, 31% were provided exclusively in-house, 27% were provided in combination and 2% were provided by a parent or subsidiary company. This broad picture conceals considerable disparities between the individual business service sectors.

Operational services followed by engineering and related services had the highest degree of pure externalisation. Financial review and advertising services also had an above average degree of pure externalisation. Public relations, research and development, and computing services had the lowest degree of pure externalisation.

The services with the highest degree of pure internalisation (in-house provision) were public relations and research and development, with management consultancy also above average in this category.

Those services most often done by combination of in-house and external provision include computing services, legal services and public relations. Provision by subsidiary or parent companies represents everywhere an insignificant proportion of total provision.

3.2 Degree of externalisation by country

Table 2 shows the degree of externalisation for each country in the survey.

Table 2 Degree of externalisation by country

	<u>Externalisation</u>	<u>Internalisation</u>	<u>Combination</u>
	%	%	%
France	57	31	12
Germany	32	47	21
Italy	48	35	16
Netherlands	39	18	43
United Kingdom	35	22	43
	—	—	—
TOTAL	40	31	27
	==	==	==

Based on our sample, France has the highest percentage of exclusively externalised business services (57%) and the lowest degree of combined provision (12%). Italy follows a similar pattern with 48% of business services externalised and only 16% provided in combination. The United Kingdom and the Netherlands have very similar externalisation profiles. Both have a below average degree of in-house business service

provision and a considerably above average level of combined business service provision (40%). Germany has the highest percentage of in-house provision of business services, with correspondingly below average levels of both pure externalisation and combined provision.

3.3 Degree of externalisation by company size

The very smallest companies internalised a very high percentage of business services (45%) (see Table 4). This drops sharply for medium sized firms which externalised a high proportion of business services (54%) and internalised only a very low proportion. For larger companies a larger proportion of services were internalised and the degree of externalisation drops (as it becomes economic to bring services in-house). However, perhaps reflecting an awareness of the wider benefits of externalisation, the percentage of combined provision is above average for the larger firms. These broad findings bear out the conclusions of the current literature on business services.

Table 3 Degree of externalisation by size

<u>Employment</u>	<u>Externalisation</u>	<u>Internalisation</u>	<u>Combination</u>
	%	%	%
0 - 50	36	45	19
51 - 500	54	21	24
501 - 1,000	39	30	31
1,001 - 5,000	39	35	26
5,000+	36	33	31
	---	---	---
TOTAL	40	32	28
	==	==	==

3.4 Trends in externalisation

A significant increase in the last five years in the amount of services bought from external companies was reported by 53% of demand side respondents. A significant re-internalisation of business services was reported by over 4%. The services most frequently mentioned in the context of a higher degree of externalisation in recent years were:

- marketing and sales promotion,

- computing services,
- taxation advice,
- legal services,
- consultancy,
- external audit.

The reasons cited for an increased trend towards externalisation included changes in company policy in favour of externalising all non-core activities. In a number of cases this was as a result of a strategic review of all company operations. Other reasons mentioned included cost cutting (implying that companies see externalisation as a money saving option), the need to reduce the workforce to a minimal sustainable level, and the need for flexibility arising from using services provided on a contract basis. Organic growth was also mentioned as a factor in increasing externalisation. The implication here is that companies find expansion easier by sub-contracting rather than by building up internal resources, particularly in the absence of the internal expertise necessary to start the process.

In the handful of cases in which services were being re-internalised the reasons cited included cost-cutting (as the company grew to a size at which services could be provided economically in-house) and company policy for reasons of control.

The supply side interviews confirmed these trends.

3.5 The externalisation decision process

3.5.1 Decision factors

Companies were questioned on all aspects of their decision making with particular reference to externalisation decisions taken in the recent past in order to ascertain the likely effect of a reduction in the cost of business services or any other changes resulting from the completion of the internal market.

Table 4 ranks the general factors underlying the selection of external business service suppliers. The table shows that although cost and availability are undoubtedly important factors in the selection of externally provided business services, the quality of these services is ultimately more important. This has clear implications when assessing the likely benefit that result from eliminating barriers in Europe.

Table 4 Service supplier selection factors (%) (1)

	<u>Very Important</u>	<u>Quite Important</u>	<u>Less Important</u>
Quality	70	8	0
Cost	32	50	4
Availability	39	27	4
Tradition	0	16	51

(1) Expressed as a percentage of total panel (multiple responses allowed)

3.5.2 Decision processes

The evidence of the survey is that in many cases a strategic decision is taken to externalise non-core activities after the general benefits of such an approach have been assessed often by external review of operations. In the majority of cases, however, and particularly prevalent in France, Germany and the UK, it would appear to be a management philosophy which has evolved as a means to cost cutting and reducing the workforce to a sustainable minimum, possibly in response to the painful experience of many countries in the world recession of the early 1980s. Given this underlying philosophy, individual cases are then decided on their own merits. The initial externalisation of a service, or the externalisation of a one-off need, is often subject to some form of cost-benefit analysis. Established contracts are managed via the business's usual annual operating process. In the few cases where inertia is given as a reason for externalisation it is often in areas of very long standing externalisation, such as for legal services.

3.5.3 Externalisation and economic performance

Firms had great difficulty quantifying either cost or employment effects suggesting that very little subsequent analysis of decision outcomes is made to assess whether externalisation decisions had been justified in practice. However, interviewees usually had overall perceptions of the costs and benefits of externalisation:

- cost: Over half the sample were unable to say whether savings had been achieved or not. Of those companies able to answer the question, 84% claimed that expected services had been realised and 89% found that the quality of services matched expectations. In the cases for which estimates of cost savings could be made these averaged between 10 and 15% for each business service (although the point was repeatedly made that cost is often not the prime motivation for externalisation).

- employment: Some 38% of the sample reported that contracting out of services had enabled them to reduce their own staff, compared to 14% who reported no change in the level of employment. The picture is not as straight forward as these figures might suggest. Frequently, externalisation appears to occur as a natural part of the organic growth process of a company. In these cases, representing 12% of the sample, job growth is foregone as companies sub-contract rather than recruit. Altogether, therefore, from the point of view of the client company there are negative effects on the employment levels which would have occurred without externalisation. It is difficult to quantify "average" employment effects from the survey since estimates (when they do exist) range from a "handful" of staff to "substantial" numbers where externalisation is undertaken as part of a general cost cutting exercise.

Clearly, however, there is a potentially positive effect on employment of externalisation arising from:

- additional company growth from externalisation benefits,

- additional employment by business service companies.

Average job losses were between 0.6% and 0.9% of the total workforce. This average is somewhat distorted by the exclusion of firms reporting either no job losses, foregone job growth, or those unable to quantify jobs lost.

The overall conclusion is that externalisation undoubtedly has an effect on employment, at the very least shifting employment from client companies indirectly to the business service sector. The net effect is not quantified by this survey, but the overall effect is unlikely to be significant relative to the size of the workforce.

3.5.4 Motivations for externalisation by business service

Particular examples of externalisation which had taken place in the last five years were examined to identify which sectors have featured in recent trends towards externalisation (discussed in Section 2.1.3)

The reasons which emerge can be classified into the categories shown in Table 8 together with a broad indication of the frequency of occurrence.

Clearly the list is not exclusive: externalisation may be motivated by more than one of these factors. The list is also not exhaustive but it does include all the factors which occurred frequently. There is also clearly an overlap between some of the motivations.

The cost motivation for externalisation is straightforward to interpret and applied particularly to operational services. Lack of internal expertise generally applies to areas which require a high degree of specialist knowledge and therefore includes computing services, marketing (often in overseas markets), research and development and consultancy. While cost saving is the single most important motivation, altogether cost motives account for only a third of cases of externalisation.

Table 5 **Motivations for externalisation by business services used**

<u>Motivation</u>	<u>Main Sectors</u>	<u>Frequency</u> %
Cost saving	Operational, IT, Marketing	26
Lack of internal expertise	IT, Marketing (overseas), R&D, Consultancy	18
Desire to cut employment/ fixed costs	IT, Operational services	10
Need for external perspective	Consultancy, IT, PR	10
Flexibility	Marketing, Consultancy, IT	10
Economies of scale	Operational, Legal, Marketing	8
One-off exercise	Consultancy, Audit, Recruitment	7
Lack of internal resource	IT	7
Need for higher quality service	Operational, IT	5

Other sectors such as engineering and related services and legal services, although falling into the specialist category, are already widely externalised and do not feature in this analysis of recent trends.

4. BUSINESS SERVICES AND THE INTERNAL MARKET

In this section we examine the issue of trade in business services within the Community and trade barriers encountered. We begin with the experience of the demand side in obtaining an adequate supply of business services domestically (4.1) and the extent to which they go beyond their national borders for services (4.2). We then address the nature and significance of barriers to trade in business services both from the demand side (4.3) and supply side (4.4) experience. Finally, we consider these barriers in the context of the volume of intra-Community trade (4.5).

4.1 Domestic availability of services

Some 26% of companies reported that they had tried to contract out a service but had failed to find a suitable domestic supplier. These companies were concentrated particularly in Italy, but also in the Netherlands. In the former case difficulties appear to be largely associated with recent changes in company accounting procedures for which the domestic accounting profession is not yet fully prepared. The most frequently mentioned services included:

- audit,
- consultancy,
- taxation advice,
- specialist software,
- marketing in foreign markets,
- foreign legal and tax advice.

With the exception of areas such as audit, tax and consultancy, in which countries such as the UK and the US appear to have developed internationally recognised expertise, services which are unavailable locally usually relate either to the need for local knowledge of a foreign market or are of a highly specialist nature (such as the example of research and development in a specialist field) of a type not generally available.

4.2 Purchases of services from foreign owned companies

In the sample 68% of firms bought some of their externally provided services from a foreign-owned firm. The services affected are generally those mentioned in 4.1. It was frequently stated that nationality is irrelevant in the selection of sub-contractors and that work is given to firms purely on the basis of the most favourable tender. Specific reasons given for using a foreign firm were:

- policy to use local firms by overseas subsidiaries,
- the reputation of foreign firms (in terms of cost and quality) in certain fields, mainly audit, consultancy and computing services,
- the need for advice on foreign markets or legal and taxation systems.

Reasons were also mentioned for not using foreign owned firms. These included:

- adequacy of locally available services,
- language, cultural and geographical barriers,
- government procurement policies (discriminating against contracts with a significant element of foreign sub-contracting)
- lack of information about the availability of foreign services.

The conclusion of this section of the survey is that there is already considerable cross-border provision of business services within the EEC and that generally firms were not averse to using those services, their main concern being to obtain the best available product. It was not, however, possible to tell from the replies how important lack of information was and whether the use of foreign firms would have been larger if their existence were known.

4.3 Barriers to trade in business services: demand side view

Only 17% of the sample recognised barriers to business services, over half the sample stating that they were aware of no barriers. For those companies recognising barriers, the most common reasons fell into the "fact-of-life" category and included mainly language and cultural differences or proximity. Availability of information and shareholder or official pressure to buy domestically were also mentioned.

The ranking of those barriers which were recognised is given in Table 6.

Table 6 Importance of selected business service barriers

<u>Barrier</u>	<u>Rank</u>
Financial	1
Administrative	2
National Standards & Regulations	3
Legal	4

Financial barriers (such as exchange controls) and administrative barriers (such as paperwork) were regarded as marginally more important than barriers related to differences in national standards and regulations and legal barriers. These results are, however, based on a very small sample and should be treated with appropriate caution.

Larger companies with offices throughout the Community indicate that barriers were not really regarded as obstacles, given the systems and structures which had evolved for trade within the Community.

4.4 Barriers to trade in business services: supply side view

The overall picture from the supply side is that most business services are perceived by their suppliers to suffer from some barriers even though they are not considered to be of great significance. Two of the services on the other hand could think of no barriers at all (beyond problems such as cultural and market differences, which we are not classifying as trade barriers), these being management consultancy and operational services.

Table 7 Barriers to trade in business services

<u>Sector</u>	<u>Nature of Barriers</u>	<u>Overall Significance of Barrier</u>
Commercial Communications	Satellite broadcasting barriers Differences in advertising law (regarding permissible advertising material) Limitations on media time for advertising Lack of access to equity markets (Germany) Qualifications of professionals	Generally regarded as reasonably free market
Engineering & Related	Government procurement Technical standards Licensing of professionals Tax treatment	1) Engineers: barriers quite significant ii) Architects: barriers very restrictive
Management Consultancy	None	No barriers of significance
Computing Services	Government and PTT procurement of computer services	UK reports this barrier only
Research & Development	Bias in government procurement	Reported by Germany (demand side interview)
Operational Services	None	Largely unregulated market
Legal Services	Freedom to practice	Not generally recognised by professional bodies as significant

In four sectors barriers are recognised but are not viewed as very significant impediments to the exchange of services - namely commercial communications, computing services, research and development and legal services. The associations generally replied that the significance of these barriers for individual service companies would depend on the nature of the services they provided. Some would be affected quite significantly while others hardly at all. The view of

all these four services is that the removal of barriers will have some, if quite a limited, effect on the ability of service providers to sell in other European countries.

Some specific points should be made in relation to individual services:

- in advertising, the development of satellite broadcasting is creating a new medium of international broadcasting which allows cross-border television advertising. As cross-boarder advertisements are not currently allowed for there could be a significant raising of barriers in the near future unless changes are made to the current regulations,
- with regard to legal services, the profession does not regard the most fundamental restriction on cross-border services, that is the existence of entirely separate legal systems in each member state, as a trade barrier but as a fact of life. This is understandable given that the removal of such a restriction could only be a long term aim. Nevertheless, there are examples of lawyers being restricted in practising even when appropriately qualified,
- while we did not formally interview representatives in the accountancy profession, it is common knowledge that within certain member states accountants are prohibited from offering non-auditing services to their audit clients. Moreover, non-auditing activities have become an important growth market for most large firms. However, in practice there is said to be only a moderate inconvenience in setting up legally separate firms for consultancy and tax services. In no countries have firms been prevented from providing all the services which they would like to offer.

The remaining sector, engineering and related services, appears to suffer most from barriers, which were described as a significant limitation on competition. This is reflected in the degree of trade in these services, which is quite limited within the Community. The barriers which have most effect are the licensing of professionals and

bias in public procurement. While these professions are significant exporters Table 5 shows that very little of the export market is within the Community. Instead exports are concentrated on developing countries which lack the skills to perform these services themselves. In countries where qualified professionals do exist (which would include the whole of the Community) such services are imported to a very limited degree. Bias in public procurement is an important barrier, given that public bodies are significant purchasers in relation to infrastructure projects. While both consulting engineers and architects feel that barriers are significant, the latter group appears to find them particularly restrictive.

Finally, one should note that there were some more general problems reported by some sectors, although they are not business service barriers directly. In particular the high costs of air transport and telecommunications created by an imperfect market were raised by several respondents. Some also reported restrictions on access to foreign exchange and the repatriation of profits.

4.5 Extent of intra-Community trade in business services

Supply side respondents were asked for information regarding the significance of exports for domestic suppliers. This information, combined with data taken from a series of service sector factsheets is presented in Table 8.

Table 8 Internationalisation of business services

<u>Business Service</u>	<u>Location of Business Service Clients</u>		
	<u>Domestic</u>	<u>(% of turnover)</u>	
		<u>Other EEC</u>	<u>Non-EEC</u>
Engineering & Related	55	4	41
Consultancy	90-95	2-5	2-5
Commercial Communication	50	40	10
Computer Services	90	5	5
Research & Development	N/A	N/A	N/A
Financial Review	N/A	N/A	N/A
Operational Services	98	1	1
Legal Services	N/A	N/A	N/A

Source: Supply side interviews and PMM factsheets

Business service sectors divide into three clear categories:

- engineering and related services and commercial communications, where roughly half the turnover of business services is for foreign clients. In the case of commercial communications, most exports are within the Community, against only a small proportion of engineering and related services (where developing countries are the biggest export market),
- consultancy, computer and operational services in which there appears to be very little international trade,
- research and development, financial review and legal services, on which there is no data available on export shares of turnover.

The picture given by Table 5 roughly bears out our demand side interviews. Those services which are not traded significantly according to the table were generally contracted to local firms, with the exception of consultancy. For this service, Table 5 is probably misleading since international consultancies generally have subsidiaries or partnerships in European countries. "Foreign" services of this kind would therefore not be registered as exports. This also applies to financial review, on which there are no figures in Table 5. Foreign accountancy services are very widely used in the sense that the "Big Eight" firms are international partnerships, though this would not be reflected in export figures.

The highly domestic orientation of operational services was also reflected in our demand side interviews.

4.6 Conclusion

Most business service trade associations recognise the existence of barriers. While they feel that their significance is somewhat limited this view does seem at variance with the demand side perception

of barriers, whereby most firms know of no barriers and the few that do acknowledge their existence believed them to be either insignificant or marginal.

The following seem the most likely explanations of this dictotomy:

- the associations say that only some of their services are affected and these have not touched upon our demand sample significantly,
- barriers are not fully recognised by users of business services and despite prompting, are taken as facts of life,
- many services are not sophisticated and can easily be provided by local firms, such that consumers of services may not feel deprived by having local supply only (though it could mean a more restricted choice and possibly higher prices). It is perhaps significant that those services for which consumers most often turn to foreign suppliers are specialised, sophisticated services not available in the local market.

The general impression from the interviews is that the latter two explanations are most likely. Interestingly companies did not tend to regard the purchase of foreign services as a natural option, even though many imported foreign inputs in the goods sector in substantial quantities.

5. THE COST OF NON-EUROPE FOR BUSINESS SERVICES

5.1 Background and methodology

In order to quantify the economic and financial costs of non-Europe for business services we used a number of sources. The literature review and the Peat Marwick McLintock factsheets provided background statistical information about the business services sector and the underlying economics of externalisation. The factsheets also discuss the current state of internationalisation of business services within the Community. The demand and supply side surveys and some existing econometric studies provide the mechanisms by which to quantify the effects of completion of the internal market.

Four factors complicate the analysis of the cost of non-Europe in the case of business services:

- relative lack of statistical information,
- absence of existing studies in the area of service sector trade barriers,
- poor perception of barriers by questionnaire respondents,
- complexity of quantifying indirect effects for an intermediate service.

Given these difficulties the emphasis in this section is on a discussion of the elements of the costs of non-Europe supported by quantitative assumptions as to the range and likely values of these effects. These effects are summarised below in Table 11.

5.2 The size of the business service sector

The Peat Marwick McLintock factsheets yielded estimates as to the size of the business service market in the Community. Turnover figures are shown in Table 9.

Table 9 Business services turnover, 1986

<u>Sector</u>	<u>Turnover</u> bn ECU
Engineering & Related Services	7.5
Consultancy	3.5
Advertising (1)	57
Public Relations	2
Computing Services	13
Research & Development	15
Financial Review	13
Legal Services	13
	<hr/>
TOTAL	124.0
	=====

(1) including media costs

Business services are an important sector in the Community economy. The sector is also one of rapid growth even when compared to other service industries.

5.3 Effects of the removal of business service barriers

Respondents in the demand-side questionnaire were asked about the likely effects of removing business service barriers.

5.3.1 Changes in demand for business services

Even in the cases in which barriers were recognised over half of the respondents did not consider that removal of these barriers would affect purchases of business services.

5.3.2 Price sensitivity

Companies were asked to assess the price reduction for business services which would be required to induce additional purchases. Although average response was in the region of 10% there was a considerable spread from 5% to 20% plus.

5.3.3 Effect on company sales

Of those companies recognising barriers to trade in business services 41% considered that removal of those barriers would have no effect on sales and 44% thought that sales would increase by up to 5%. The remainder anticipated larger increases.

Almost equal weight was given to the following factors as explanations for anticipated sales increases:

- reduction in product prices,
- improved competitiveness,
- ability to enter new markets in Europe,
- generally faster market growth.

5.4 Cost of non-Europe

We have divided the costs of non-Europe for business services into four sources:

- i) The higher costs of business services which results from limited competition.
- ii) Lower output across the economy which results from these higher business service input costs.
- iii) Lower demand for business services which results from higher costs and more limited range of business services.
- iv) Lower levels of (cost-saving) externalisation which result from higher costs, and more limited range, of business services.

The completion of the internal market for business services can therefore be expected to produce the following corresponding benefits:

- i) Savings due to reduction in business service prices.
- ii) Increase in output across the economy.

- iii) Increase in output of business service sector.
- iv) Savings due to increase in externalisation of business services.

In the commission's model of direct and indirect effects, the 1) above is a direct effect of removing business service barriers. Effects ii) to v) are the indirect effects on the economy as a whole of the completion of the internal market for business services. One should stress however that these are effects of removing business service barriers in isolation. In reality completion of the internal market as a whole will result in changes in many sectors, which will impinge on the business service sector.

5.4.1 Reduction in business service prices

One of the fundamental arguments for an internal market is that opening sectors to increasing competition will result in efficiency gains and cost savings which will then be passed on to consumers (in the case of business services to intermediate consumers). A reasonable assumption therefore, is that business services prices might gravitate to those of the state which is currently the most efficient producer, or at least move part of the way to that level.

There is very little comparative information on the cost structures of business services which limits the analysis which can be undertaken. The information which is available relates only to general consultancy, accountancy and tax consultancy. The figures suggest that if all prices when converted using purchasing power parity to reflect differing local overheads in different markets, and if all producers of business services were to reduce costs to that of the most efficient a maximum reduction of 15% might be expected. If all prices were to fall to the current average level (a working lower limit assumption) then a reduction of 3% might be expected.

However, this rather simplistic analysis needs to be tempered with the conclusions of the demand-side and supply-side surveys. One of the main conclusions of the demand side survey was that quality of business services was a major factor in determining demand - frequently

costly services were used when cheaper were available for reasons of quality. Such behaviour tends to support the view mentioned in many of the supply-side interviews that competitors are not likely to enter new markets on a price cutting basis, but rather by offering an improved product. Clearly this does not imply that business services clients will not be better off; it does however make it very difficult to quantify the gains to be made.

This view is further supported by the fact that when companies do go to foreign companies for business services it is invariably because of availability or quality reasons and not for reasons of cost.

It must also be stressed that very few respondents on the demand side recognised any barriers other than "fact-of-life" type barriers (such as language, proximity etc) to prevent them already from obtaining the best possible service in Europe. This was borne out by those on the supply-side of the business service sector, most of whom did not foresee a significant fall in price.

Combining these survey results with the fact that the statistical comparison of cost is limited by lack of data and narrowness of coverage it seems reasonable to assume that the 3% price fall mentioned below might be seen as the most likely estimate of cost reductions to be expected from the completion of the internal market in business services. Based on existing turnover and a price reduction of 3%, the cost savings to users of business services will be around 3.5 bn ECU.

The gains in efficiency made from access to better quality services may be considerably greater but they cannot be quantified. It is also clear that there will be differences between sectors. Sectors in which substantial barriers exist (e.g. legal services) may witness larger price falls than advertising which already has a high degree of internationalisation.

5.4.2 Increase in output in all sectors

Any reduction in the price of business services or improvement in quality will ultimately have a positive effect on demand for the final output of business service consumers, and for goods generally.

Several factors must be considered, however when the extent of this increase in demand is assessed. Firstly, externalised business services represent only a small though increasing proportion of a firm's total costs (typically in the region of 3%). Secondly, the hypothesis of section 5.4.1 is that prices of business services will not fall greatly. Thirdly, and confirming the first two points, demand side respondents did not expect a large increase in general sales as a result of the removal of barriers to business services. Even in instances in which business service barriers were recognised, effects on general sales were not perceived to be significant. The general effect on sales of around 0.1%, and maybe less seems reasonable. A range of between 0% and 0.2% (0 to 3 bn ECU) might be the lower and upper limits.

5.4.3 Increase in business service output

A relative price reduction and general increase in economic activity will, via price and income multipliers, increase the demand for business services. The conclusion of the demand side survey is that price elasticity is low. Competition is mainly on quality, and respondents indicated that an average 10% price reduction would be required before any increase in demand for business services would be realised. However, there was a considerable spread around this average. There is no econometric work which includes a price or income elasticities of business services but there are figures for the service sector as a whole which we have used as a base for estimating business service elasticities. Income elasticities in the service sector seem typically in excess of 1%. Our survey results point to a very low price elasticity but a reasonably high income elasticity of demand for business services, most probably higher than for services as a whole which includes income inelastic government services. Long run price elasticity of 0.2% and a long run income elasticity of 1.4% was a reasonable working assumption using these figures. The increase in demand for business services derived from a relative price reduction and income growth and range between 0.7 and 2.5bn ECU.

Table 10 Elements of the costs of non-Europe

<u>Element</u>	<u>bn ECU</u>
Fall in prices of business services	0 - 3.5
General sales growth	0 - 3.0
Growth in business service sales	0.7 - 2.5
Savings due to increases in externalisation	0.1 - 0.2

5.4.4 Increases in externalisation

Increased competition in the business services market will reduce costs, improve quality, increase availability and improve the information and marketing of business services, consequently increasing the degree of externalisation (that is the number of services externalised). The demand side survey has revealed that this leads to cost savings. The true opportunity cost of non-Europe from this source is the net gain, since externalisation implies a transfer of jobs and income from the consuming sector to the business service sector.

The demand side survey suggest that of those firms recognising business service barriers (a small proportion) only about half, representing 8% of the sample, expected to contract out more services on their removal. This small figure is again consistent with the finding that business service barriers are not substantial. The increase in externalisation from this source is therefore unlikely to be very significant and overall business service demand is unlikely to rise by more than 1% from this source (on the basis of demand side questionnaire responses). This represents a maximum gain of 1.25bn ECU for the business service sector and, on the basis of 10 to 15% savings stemming from externalisation, and on the fact that business services account for only 3% of total costs, it accounts for a 0.1-0.2bn ECU saving on the cost of business services to consumer companies.

5.5 Conclusions

Table 11 summarises our estimate of the costs of non-Europe.

Table 11 Estimates of the cost of non-Europe

	<u>Direct effects</u>	<u>Range (bn ECU)</u>
i)	Higher costs of business services	3.5
	<u>Indirect effects</u>	
ii)	Lower output in whole economy	0-3.0
iii)	Lower demand for business services	0.8-2.5
iv)	higher costs from foregone externalisation	0.1-0.2

The corporate sector has for several years been in a process of externalising many of its business services and this process is clearly continuing. Moreover this process is economically beneficial, largely because of the higher quality of service which specialists are able to provide, but in some cases also because there are cost advantages.

In contrast to the purchase of goods as inputs into their products, firms are not inclined to look abroad for the provision of business services. It is clear that some trade barriers exist for several services, even though they have limited effects in impeding trade. In general, however, these barriers are not acknowledged by service users, largely because of their tendency to rely on domestic provisions. Trade in most business service sectors is low; service companies are heavily dependent on domestic markets, which have been growing strongly in most countries. This fragmentation of the market is not only unusual in comparison with the goods sector and some other services, it also seems at odds with the varying strengths and weaknesses of different countries in each sector.

The continued fragmentation of the market has effects on both providers and users of services. For providers it hinders the expansion of their services and reduces the range of services they provide in other countries. As a result it has some effect of inflating prices (effect i) above).

However it has more significant implications in terms of the quality and range of service available, which is a more significant determinant of whether business services are purchased from outside. Thus the use of external business services is lower in a fragmented market (effect iii) above). This in turn means that the benefits of the foregone externalisation are lost (effect iv) above) and output as a whole is reduced (effect ii) above).

THE "COST OF NON-EUROPE" FOR BUSINESS SERVICES

FULL REPORT

Prepared by Peat Marwick McLintock

Dated: January 1988

THE COST OF NON-EUROPE FOR BUSINESS SERVICES

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APPENDICES

- I DEGREE OF EXTERNALISATION OF BUSINESS SERVICES
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1. INTRODUCTION

This study is part of a research programme undertaken at the European Commission by the Directorate General for Industrial Affairs and the Internal Market, under the title "The Cost of Non-Europe". The studies in this programme investigate the costs to the Community economy of the continued fragmentation of the internal market, each study addressing a particular sector or type of cost. This study addresses the cost of non-Europe for business services. By implication the study also assesses the economic benefits which are implied by the removal of barriers to trade in business services envisaged through the completion of the internal market by 1992.

The main elements are to:

- examine the process of externalising services, that is contracting services out to specialist firms and investigate the degree of externalisation in the European Community,
- examine whether the existence of barriers within the internal market limits the ability of firms to purchase the most cost effective business services provided within the Community, and to provide estimates of the extra costs borne by enterprises,
- estimate the benefits from completing the internal market, both for enterprises purchasing business services, and for the business services sector itself.

Business services include the technical, professional and operational services generally consumed by firms, rather than households, and are those commonly defined as business services for most statistical purposes in European countries. They exclude financial services such as banking, insurance and securities.

2. METHODOLOGY

2.1 General

The original research for the study is based on two sets of face-to-face interviews and the completion of two corresponding questionnaires. One set relates to the demand side, the users of business services, which was a panel of companies in all sectors of the economy from Benelux, France, Germany, Italy and the United Kingdom. The other relates to the supply side of the question, companies which provide business services. In order to draw on a broad spread of experience we interviewed trade associations in those sectors, generally at the national, but in some cases at an international, level.

The demand questionnaire on which the interviews have been centred covers a number of aspects of services:

- the demand and supply of business services: the range of services employed, the source of supply (whether internally or externally supplied), the extent to which externally supplied services are imported, and the domestic availability of services,
- decision making and trends in the demand for business services from outside sources: the factors underlying the decision to externalise (that is shift the provision of a business service function from in-house to an external supplier of those services), or to internalise, the decision making method, recent trends and the effect, in terms of cost implications and employment turnover, of these trends,
- the internal market for services: perceptions of barriers to trade which exist in the business services market, and the effects of removing barriers on the demand for business services and on general economic activity.

The supply side questionnaire had four points of emphasis:

- the extent to which services are traded internationally,
- the trend towards externalisation,
- the importance of trade barriers in the internal market,
- the likely effects on cost and demand for business services as a result of the completion of the internal market.

In addition to the supply side and demand side surveys we carried out a literature search which provided statistical information about the business services sector, insight into the economics of the externalisation process, as well as price and income elasticities. Further information about the business services sector in Europe came from the Peat Marwick McLintock factsheets, prepared for DGIII, which gave indications of the turnover in the main business service categories.

For guidance on the quantitative analysis of the cost of non-Europe for business services some existing econometric research was consulted, as was Peat Marwick McLintock information relating to comparative cost structures within Europe in certain business service sectors.

2.2 The survey

Wide ranging interviews were carried out with 100 users of business services (that is companies) and 18 trade associations representing business services in France, Germany, Italy, Benelux and the United Kingdom.

The companies selected constitute a panel representing a wide spectrum of industries. They are of sizes ranging from small family run businesses to the larger corporations. They range from companies operating only in local markets to multi-national organisations with links worldwide.

Interviews were carried out with senior personnel best placed to have a broad view of their organisation's activities and the potential impact of completing the internal market. These were predominantly chief executives, managing directors, finance directors, strategic planners or marketing executives. We are therefore confident that the results of the survey capture the views of a very wide section of the economy of the European Community.

In the following sections the company panel is analysed more rigorously in terms of company size (measured by employment and turnover), sectoral distribution and countries of operation. We also identify the service trade associations interviewed in section.3.3

2.2.1 Demand side profile

Company size distribution

Companies were asked about the level of employment of both full and part-time staff. Counting part-time staff as half, the size distribution of companies interviewed, given in Table 1, was estimated.

Around one-third of the sample consists of small and medium sized enterprises.

Table 1 Employment profile of company panel

<u>Number of Employees</u>	<u>%</u>
0 - 50	9
51 - 500	7
501 - 1,000	15
1,001 - 5,000	4
5,000+	5
TOTAL	100
	===

Turnover information was not available from all the companies surveyed and the size distribution based on turnover is therefore less reliable. Table 2 gives the turnover profile of the sample in percentage terms.

Table 2 Turnover profile of company panel

<u>Turnover ECUm 1986</u>	<u>%</u>
0 - 2.5	25
2.5 -5	10
5 - 25	8
25 - 50	5
50 - 250	19
250 - 500	11
500+	23
	<hr/>
TOTAL	100
	===

One-third of the sample has a turnover of between 0 and 5m ECU in 1986, and a similar proportion had turnover in excess of 250m ECU.

Sectoral distribution

The companies in the panel represented the full range of industrial activities as can be seen from Table 3.

Table 3 Sectoral distribution of company panel

<u>Sector</u>	<u>%</u>
Banking, Finance & Insurance	20
Foodstuffs	9
Plastic & Rubber Industries	6
Clothing & Textiles	5
Chemicals	9
Electrical & Electronic Goods	7
Company Services	4
Building & Property Services	3
Holding Companies	4
Other Manufacturing Companies	18
Other Service Companies	11
	<hr/>
TOTAL	100
	===

In all 57% of the panel is made of service sector companies (of which around one-third represent the financial services sector), the remaining 43% represent companies in the manufacturing industries.

Internationalisation profile of company panel

Companies were asked to specify their main countries of operation and also those countries in which they had significant production or distribution arrangements or joint ventures of subsidiaries. The value of this question is in identifying those companies likely to have a global perception of the issues raised by the completion of the internal market for business services. Table 4 analyses the degree of internationalisation of the panel.

Table 4 Internationalisation profile of company panel

<u>Area of Operations</u>	<u>%</u>
Domestic market only	33
Domestic and other EEC markets	14
Domestic, EEC and other markets	51
TOTAL	100
	===

Nearly two-thirds of the sample function in some capacity in at least one Community state other than their own. Around half the sample operate additionally in non-EEC markets, North America being the most frequently mentioned.

2.2.2 Supply side profile

The survey of the supply of business services was carried out with national trade associations. We undertook to cover 20 trade associations and Table 5 lists the full sample.

Table 5 Supply side interviewees

<u>Sector</u>	<u>Country</u>	<u>Name of Organisation</u>
<u>Commercial Communications</u>	Germany	Gesamtverband deutscher Werbeagenturen
	UK	Advertising Association
<u>Engineering & Related</u>	Belgium	Burobel/European Committee of Consulting
	International	Firms International Association, (CEBI)
	Ireland	Association of Consultancy Engineers of Ireland
	Netherlands	Association of Consultancy Engineers of the Netherlands
	Netherlands	Dutch Federation of Architects
<u>Management Consultancy</u>	Germany	Bundesverband deutscher Unternehmensberater
	UK	Federation of Recruitment & Employment Services
	Italy	Assco
	Netherlands	National Association of Management Consultants of the Netherlands
<u>Computing Services</u>	Germany	Bundesverband deutscher Unternehmensberater
	Italy	Anasin
	UK	Computing Services Association
<u>Research & Development</u>		None
<u>Financial Review</u>		None
<u>Operational Services</u>	International	International Professional Security Association
	International	International Associations of Conference Organisers
	Netherlands	Netherlands Association of Travel Agents & Tour Operators
<u>Legal Services</u>	International	Consultative Committee of the Bars and Law Societies of the European Communities, (CCBE)
	UK	Law Society

3. THE USE OF BUSINESS SERVICES

Having established the characteristics of the company panel the questionnaire then seeks to establish the nature of the demand for and sources of supply of business services. A key issue in this discussion is the relative use of external business services as opposed to internal resources and the externalisation process formed a focal point of the questionnaire. This chapter contains results of interviews held with both the demand and supply side. The information on the relative use of internal and external services came essentially from the demand side, though important background information on reasons for, and trends in, the externalisation of services, was obtained in the supply side interviews.

3.1 Degree of externalisation

Table 6 summarises the degree of externalisation of each business service. Figures for detailed sub-sector breakdowns are given in Appendix I.

Table 6 Degree of externalisation of business services (%)

Sector	<u>Degree of Externalisation</u>			
	Purely External	Combination	Purely Internal	Subsidiary
Engineering & Related Services	6	28	14	2
Management Consultancy	35	25	37	3
Advertising	49	25	24	2
Public Relations	11	30	59	0
Computing Services	22	55	26	0
Research & Development	12	23	58	7
Financial Review	50	18	30	2
Operational Services	58	17	22	3
Legal Services	41	37	21	1
	—	—	—	—
TOTAL	41	26	30	3
	==	==	==	=

In all 41% of business services are entirely sub-contracted, 30% are provided exclusively in-house, 26% are provided in combination and 3% are provided by a parent or subsidiary company. The overall picture

conceals considerable disparities between the individual business service sectors. Operational services followed by engineering and related services have the highest degree of pure externalisation. Financial review and advertising services also have an above average degree of pure externalisation. Public relations, research and development, and computing services have the lowest degree of pure externalisation. The services with the highest degree of pure internalisation (in-house provision) are public relations and research and development, with management consultancy also above average in this category. Those services most often done by combination of in-house and external provision include computing services, legal services and public relations. Provision by subsidiary or parent companies represents everywhere an insignificant proportion of total provision.

3.2 Degree of externalisation by business service

Appendix I gives externalisation figures for the detailed sub-sectors which make up each individual business service sector.

3.2.1 Engineering and related

Apart from project management all the areas of engineering are extensively externalised. In the case of architecture this is externalised in 74% of cases and internalised in only 7% of cases. Building, construction and maintenance and interior design are externalised in over 50% of cases (although many companies have internal maintenance departments). It is clear that in most cases engineering services are generally in demand for one-off projects requiring a high level of skill and expertise which cannot be economically employed in-house because of insufficient demand. Indeed only the largest companies employ architects and even in these cases, they are generally employed to manage work undertaken by external contractors, or on small scale projects.

Interior design is often externalised: as is the case for many other business services, it is not perceived as part of the core business of a company and is therefore left to specialists who have the expertise and resources to fulfil the function. Project management in

contrast is often seen as a vital function of management and one over which ultimate control should remain with the company, hence a much higher proportion of internal or combined provision is found for this service.

The high degree of externalisation in engineering and related services reflects the fact that these skills are unrelated to the core activities of most kinds of company. Architecture and interior design are required by firms only on a sporadic basis which does not generally warrant permanent staff. Maintenance work is most often performed by a combination of internal and external resources. A typical approach would be to use internal resources for routine and straightforward maintenance while more sophisticated equipment is maintained by outside specialists, often on a service contract with the manufacturers.

The experience of the demand side is largely confirmed by the supply side interviews with engineers and architects. They add that much of their work is for investors in their projects (both in relation to private property and public infrastructure) where there is generally no question of using internal resources as there is often only a very limited organisation in the initial stages.

3.2.2 Management consultancy

Overall externalisation of consultancy broadly reflects the average for business services in general and this is generally reflected in the categories which constitute consultancy. The exceptions are financial management which has a higher than average proportion of in-house provision, and general management consultancy with an above average degree of external provision.

The supply side interviews and a number of sources on the consultancy market all indicate the strong growth in recent years in consultancy services. The attraction of external consultancy services to companies is partly the flexibility which the use of consultants allows (as opposed to the long term commitment of permanent staff). It is partly also the speed with which new services can be provided by consultants, without the delays involved in setting up internal resources. Indeed much of the increased use of consultants does not

constitute the classic case of switching from internal to external resources but simply involves greater use of external resources to perform services which have never been performed internally.

3.2.3 Advertising

Advertising consists of media marketing, sales promotion and direct marketing. The first of these is seen as a highly specialised activity even by large companies and in 63% of cases is purely externalised: and in only 25% of cases is it provided entirely in-house. Sales promotion and direct marketing, however, are almost equally split between external, in-house and combined provision. For these, detailed product knowledge and appropriate contacts are important features requiring perhaps that companies participate more rather than simply externalising.

The supply side interviews confirm that advertising has always tended to be performed externally in Europe. Although most companies need advertising services on a continuing basis most feel that this service requires a constant renewal of ideas and the specialist attention of personnel in constant touch with advertising techniques. There is general agreement that to produce effective publicity, knowledge of advertising is much more important than knowledge of the product. Public relations, on the other hand concerns establishing long-standing contacts with the press, and often government, and therefore tend to be handled in-house, albeit sometimes with outside advice.

3.2.4 Public relations

Public relations in all its aspects (press/media relations, shareholder relations and employee relations) is widely seen as an important strategic variable over which management must retain control. Consequently it has a very high proportion of in-house provision ranging from 48% for public relations to 73% for employee relations. Very rarely is the function completely externalised (in only 3% of cases for employee relations).

3.2.5 Computing services

Computing services encompasses a considerable range of activities which include software development, data processing, consultancy, information services, communications services and facilities management.

In general computing services are rarely completely externalised. This applies particularly to software, data processing and facilities management which all have a high company specific element. Consultancy is the service most frequently completely externalised, the reason frequently cited being the need for a dispassionate strategic overview of information technology strategy and direction.

Computing services are generally characterised by a high degree of combined provision of service. This reflects a number of factors:

- the need for highly specialised input which companies often do not have in-house,
- the difficulties of retaining qualified information technology staff,
- the need at the same time for a company specific input
- the need to manage contracts in a field in which during its short history, management problems have often arisen, owing largely to rapid rates of development and volatile markets.

Communications services and facilities management are the only two services with a significant degree of purely in-house provision.

There are tendencies within computing services, according to supply side interviews, which push towards both externalisation and internalisation. The increasing levels of computer literacy, even among non-computer specialists, and the hardware developments which have made computers a much more broadly available product, as well as the sheer extent of computer penetration into business management, have tended to promote internalised computer services. Other pressures work towards externalisation, in particular:

- the supply and demand of staff (particularly in the public sector),
- increasing complexity and level of knowledge required to build and support systems,
- the one-off nature of large projects,
- the realisation by companies that they "are not in the computer business",
- increasing maturity of the computer services market as suppliers are becoming more respected and trusted.

The result of these conflicting trends is the very mixed picture regarding the externalisation of services. Most companies report that when computers were first used in their businesses, services were performed externally, because of both lack of internal expertise and the investments required for hardware. A clear switch took place in most businesses towards internalisation when hardware developments and the growth of expertise allowed. The provision of computing services in a business, now tends to depend on the relative importance of the factors mentioned above.

3.2.6 Research and development

Both product and service development and research are viewed as integral company activities and consequently have the second highest overall level of exclusive in-house provision (this occurring in nearly 60% of all cases). In only 12% of cases overall is the function purely externalised.

Most demand side respondents attributed their internalisation of R&D to the highly specific nature of the technologies involved. External consultants would need to go through a significant learning curve to catch up with their internal R&D services. A good number of firms, however, sub-contract discrete elements of a development to R&D consultants where a technology outside the field of the company is involved. This might occur, for example, in the case of software or micro-processor elements in a new product design.

We were regrettably unable to find a trade association for R&D companies. R&D companies themselves confirmed to us that no such bodies exist in Europe.

3.2.7 Financial review

Financial review is divided between internal and external audit and reporting. Since internal review is generally a key management tool it is not surprising to find that in over 60% of cases it is a purely in-house function. External audit is usually subject to statutory regulation and in over 80% of cases is completely externalised.

The allocation of auditing functions between internal and external resources is generally not a matter of choice. External audit must be carried out by independent auditors, though such an audit is not compulsory in all countries. Interestingly, in Italy, where auditing requirements are least stringent among the countries under study we interviewed several companies which had begun external audits voluntarily. This had been decided in order to give added respectability to the company, to serve as a further financial control, or in some cases to prepare for flotation on the stock exchange.

3.2.8 Operational services

Operational services, although part of the business service sector, are characterised by generally low skill requirements. They are also easily "defined" tasks. In the case of travel services and catering they are frequently (and to an increasing degree) externalised, reflecting the ease with which this can be done, the inconvenience of providing the service in-house (even where it can be done more cheaply) and the fact that they are viewed as only peripheral activities. Security is slightly less frequently purely externalised. A not uncommon feature of the security service seems to be internal provision of day-time security but externalisation of night-time security.

These are also functions which companies feel can be offered more cheaply by outside companies because the economies of scale which can be achieved are thought to be self-evident.

3.2.9 Legal services

Legal services is a highly specialist activity and one which small companies in particular externalise to a relatively high degree (41% overall). Larger companies however frequently employ in-house lawyers to oversee on-going legal work (a steady level of demand making this an economic deployment of resources) and to instruct outside lawyers. There is thus a relatively high level of combined provision but a relatively low level of exclusively in-house provision. Corporate legal matters and patent and trademark matters have a higher degree of externalisation than personnel and employment law and trade related legal matters.

3.3 Degree of externalisation by country

Table 7 shows the degree of externalisation for each country in the survey.

Table 7 Degree of externalisation by country

	<u>Externalisation</u>	<u>Internalisation</u>	<u>Combination</u>
	%	%	%
France	56	30	14
Germany	32	47	21
Italy	47	33	18
Netherlands	39	18	43
United Kingdom	34	23	43
	—	—	—
TOTAL	39	31	28
	==	==	==

Based on our sample, France has the highest percentage of exclusively externalised business services (56%) and the lowest degree of combined provision (14%). Italy follows a similar pattern with 47% of business services externalised and only 18% provided in combination.

The United Kingdom and the Netherlands have very similar externalisation profiles. Both have a below average degree of in-house business service provision and a considerably above average level of combined business service provision (over 40%). Germany has the highest percentage of in-house provision of business services, with correspondingly below average levels of both pure externalisation and combined provision.

In summary, France and Italy are characterised by high levels of externalisation and low levels of combined provision, the Netherlands and the United Kingdom by relatively high levels of combined provision, and Germany by a high level of internal provision.

3.4 Degree of externalisation by user industry

The sample size prohibits the calculation of reliable figures for individual industrial sectors of purchasing organisations. However, a simple split between service sector/non-service sector was estimated, to try to identify different patterns of behaviour in externalising business services. The results are shown in Table 8.

Table 8 Degree of externalisation by industry

	<u>Externalised</u>	<u>Internalised</u>	<u>Combined</u>
	%	%	%
Services	40	27	33
Non-services	42	33	25
	—	—	—
TOTAL	41	31	28
	==	==	==

There is relatively little apparent difference in the likelihood of externalising business services between service sector and non-service sector organisations. Several service sector organisations made the point that as service providers themselves they were more aware of the benefits of externalisation and therefore considered themselves more likely to externalise some of their own requirements. This seems to be reflected in a higher percentage of combined provision of business services and a lower level of internal provision.

3.5 Degree of externalisation by company size

The hypothesis raised in some of the literature relating to business services is that small companies tend to perform all functions in-house (at the extreme owner-managers performing all the business service functions themselves); medium sized companies have a higher demand for business services but still insufficient demand to justify internal provision of those services. Larger companies then re-internalise as demand rises such that they can do so economically. Clearly, in practice a whole range of other factors will impinge on the relationship between size and externalisation, though the relationship between company size (in terms of employment) and externalisation may yield some insight. Table 9 shows the results of the analysis.

The data conforms fairly closely with the hypothesis outlined above. The very smallest companies internalise a very high percentage of business services (44%). This drops sharply for medium sized firms which externalise a high proportion of business services (54%) and internalise only a very low proportion. A larger proportion of larger companies have internalised services, and the degree of externalisation drops (as it becomes economic to bring services in-house). However, perhaps reflecting an awareness of the wider benefits of externalisation, the percentage of combined provision is above average.

Table 9 Degree of externalisation by company size

<u>Employment</u>	<u>Externalisation</u>	<u>Internalisation</u>	<u>Combination</u>
	%	%	%
0 - 50	37	44	19
51 - 500	56	22	22
501 - 1,000	38	29	33
1,001 - 5,000	39	35	26
5,000+	37	33	30
	—	—	—
TOTAL	42	31	27
	==	==	==

3.6 Trends in externalisation

A significant increase in the last five years in the amount of services bought from external companies was reported by 54% of respondents. A significant re-internalisation of business services was reported by 5%. The services most frequently mentioned in the context of a higher degree of externalisation were:

- marketing and sales promotion,
- computing services,
- taxation advice,
- legal services,
- consultancy,
- external audit.

The appearance of external audit in the list is largely due to the introduction of a statutory requirement for external audit in Italy. Transport and distribution was also mentioned as being frequently externalised, although this is not strictly defined as a business service. The reasons cited for an increased trend towards externalisation included changes in company policy in favour of externalising all non-core activities. In more than one case this was as a result of a strategic review of all company operations. Other reasons mentioned included cost cutting (implying that companies see externalisation as a money saving option), the need to reduce the workforce to a core sustainable level, the need for flexibility arising from using services provided on a contract basis. Organic growth was also mentioned as a factor in increasing externalisation. The implication here is that companies find expansion easier by sub-contracting rather than by building up internal resources, particularly in the absence of the internal expertise necessary to start this process.

In the handful of cases in which services were being re-internalised the reasons cited included cost-cutting (as the company grew to a size at which services could be economical in-house) and company policy for control reasons.

3.7 Provision of business services to other companies

A large proportion of companies supply business services to other companies. Unfortunately the picture is somewhat confused by the inclusion of a large number of service companies in the sample. Of the services provided by non-service companies, or the non-core services provided by service companies, the most frequently mentioned services are:

- specialist consultancy,
- software,
- research and development.

These are examples of companies developing specialist "products", such as software, or "expertise" which can then be sold to companies in related fields in order to make in-house provision more economic, or in the case of research and development, excess capacity can be sold, again improving the economics of in-house provision.

A related concept is entering into joint marketing and distribution contracts in which a number of companies are engaged, particularly when entering foreign markets.

3.8 The externalisation decision process

An important aspect of the externalisation debate is the motivation for sub-contracting, the importance of various factors, such as cost, in decision making, the way in which the decision is taken and also the outcome in terms of cost savings, quality of services and employment effects of externalising in practice.

3.8.1 Decision factors

Companies were questioned on all these aspects of their decision making, with particular reference to externalisation decisions taken in the recent past.

In terms of the general factors underlying externalisation decisions, virtually every firm ranked quality and cost as either "quite important" or "very important" factors. Some 80% of all firms

considered cost to be an important factor, 31% considering it to be very important. Quality was considered by 80% to be a factor in decision making, 72% considering it to be very important. The implication is that although cost is undoubtedly an important factor in the demand for externally provided business services, the quality of these services is ultimately more important. This is further borne out by the frequent citing of strategic policy rather than economic considerations as the motivation for externalisation.

Table 10 Service supplier selection factors (%) (1)

	<u>Very Important</u>	<u>Quite Important</u>	<u>Less Important</u>
Quality	72	8	0
Cost	31	49	4
Availability	39	28	4
Tradition	0	17	0

(1) Expressed as a percentage of total panel (multiple responses allowed)

The availability of services is considered by 67% of firms to be either quite important or very important thus giving further weight to the significance of lack of information as a potential barrier to market integration for business services.

Of the firms considering "tradition" to be a factor in selecting service suppliers, only 17% considered it to be important, suggesting that inertia is unlikely to be a significant impediment to greater trade in business services.

3.8.2 Decision processes

The way in which externalisation decisions are taken is a more complex issue. Firms were asked to choose between long term strategic planning, annual operating process, cost benefit analysis and inertia as the decision making process which most closely matched how they decided whether or not to externalise.

Inertia was only rarely mentioned (14% of cases). The other three processes were mentioned with almost equal frequency, often more than one method being specified.

The evidence of the survey is that in many cases a strategic decision is taken to externalise non-core activities after the general benefits of such an approach have been assessed. There are several examples where this can be traced back to a specific strategic review of activities. In the majority of cases, however, and particularly prevalent in France, Germany and the UK, it would appear to be a management philosophy which has evolved as a means to cost cutting and reducing the workforce to a sustainable minimum, possibly in response to the painful experience of many countries in the world recession of the early 1980s. Given this underlying philosophy, individual cases are then decided on their own merits. The initial externalisation of a service, or the externalisation of a one-off need, is often subject to some form of cost-benefit analysis. Established contracts are managed via the business's usual annual operating process. In the few cases where inertia is given as a reason for externalisation it is often in areas of very long standing externalisation such as legal services.

It is clear from this analysis that there is no dominant decision making process. The most notable feature is that the preference of over half the firms in the survey is to externalise as a matter of policy or philosophy.

3.8.3 Externalisation and economic performance

Companies were asked to quantify savings derived from externalisation, employment effects, and whether quality and cost outcome had matched expectations at the time decisions had been made.

Firms had great difficulty quantifying either cost or employment effects, suggesting that very little subsequent analysis of decision outcomes is made to assess whether externalisation decisions had been justified in practice. However, interviewees usually had overall perceptions of the costs and benefits of externalisation.

Over half the sample were unable to say whether cost savings had been achieved or not. Of those companies able to answer the question, 83% claimed that expected savings had been realised, and 88% found that the quality of services matched expectations. In the handful of cases where some dissatisfaction was recorded problems had been rectified either by changing contractors or by closer internal supervision and management of contracts.

In only one case were services re-internalised. The point was made that externalisation usually entails changes in working practices which cannot be anticipated a priori and it is therefore not easy to compare expectations with outcomes.

In the cases for which estimates of cost savings could be made these averaged between 10 and 15% for each business service (although the point was repeatedly made that cost is often not the prime motivation for externalisation).

Employment effects appear equally difficult to quantify. In the sample 39% reported that contracting out of services had enabled them to reduce their own staff, compared to 16% who reported no change in the level of employment. However, the picture is not as straightforward as these figures might suggest. Frequently, externalisation appears to occur as a natural part of the organic growth process of a company. In these cases, representing 13% of the sample, job growth is foregone as companies sub-contract rather than recruit. Thus, from the point of view of the client company, there are negative effects on employment in nearly half the panel. It is difficult to quantify "average" employment effects from this survey since estimates (when they do exist) range from a "handful" of staff to "substantial" numbers where externalisation is undertaken as part of a general cost cutting exercise.

Clearly, however, there is a potentially positive effect on employment of externalisation arising from:

- additional company growth from externalisation benefits,
- additional employment by business service companies.

An illustration of the net employment effect at its simplest is the selling of a marketing support department to its employees, thus reducing company employment, but correspondingly increasing service sector employment leading to a zero net employment effect.

Of the firms which were able to identify job losses the average loss was between 0.5% and 0.9% of the total workforce. This average is somewhat distorted by the exclusion of firms reporting either no job losses, foregone job growth, or those unable to quantify jobs lost.

The overall conclusion is that externalisation undoubtedly has an effect on employment, at the very least shifting employment from client companies indirectly to the business service sector. The net effect is not quantified by this survey, but the overall effect is unlikely to be significant relative to the size of the workforce. The survey has also identified significant cost savings attributable to externalisation (even where cost is not the primary motivation) - a factor which will have a positive effect on company growth and hence employment.

3.8.4 Motivation for externalisation by business service

An important part of the survey exercise was to examine particular examples of externalisation which had taken place in the last five years, and to identify which sectors have featured in recent trends towards externalisation and, more particularly, to isolate specific motivations for such decisions.

The reasons which emerge are many and diverse but can be classified into the categories shown in Table 11 together with a broad indication of the frequency of occurrence.

Clearly the list is not exclusive: externalisation may be motivated by more than one of these factors. The list is also not exhaustive but it does include all the factors which occurred frequently.

The cost motivation for externalisation is straightforward to interpret and applied particularly to operational services. Lack of internal expertise generally applies to areas which require a high degree of specialist knowledge and therefore includes computing services, marketing (often in overseas markets), research and development and consultancy.

Other sectors such as engineering and related services and legal services, although falling into the specialist category, are already widely externalised and do not feature in this analysis of recent trends.

Table 11 Motivations for externalisation by business service used

<u>Motivation</u>	<u>Main Sectors</u>	<u>Frequency</u> %
Cost	Operational, IT, Marketing	25
Lack of internal expertise	IT, Marketing (overseas), R&D, Consultancy	18
Desire to cut employment/ fixed costs	IT, Operational services	11
Need for external perspective	Consultancy, IT, PR	12
Flexibility	Marketing, Consultancy, IT	10
Economies of scale	Operational, Legal, Marketing	8
One-off exercise	Consultancy, Audit, Recruitment	9
Lack of internal resource	IT	7
Need for higher quality service	Operational, IT	6

Many companies saw externalisation as a means of reducing fixed costs, particularly those relating to overheads associated with high levels of employment. This applied particularly to operational services.

In many cases companies sought an external review of their operations: consequently services such as general strategic consultancy and information technology strategy review are frequently externalised.

Flexibility, as an end in itself, to cope with rapid technological changes, to operate in volatile markets, to cope with peak or seasonal workloads, or to adapt quickly to changing circumstances was cited as a reason for externalising marketing services, consultancy and computing services.

Economies of scale, or insufficient internal demand to provide services in-house, was given as a reason for externalising operational services, legal services and marketing services.

Frequently companies required one-off exercises to be carried out, such as strategic consultancy, financial review (for example, preceding a share flotation), and specialist or senior recruitment. These are externalised since there would be unlikely to be recurrent demand for such services on a regular basis in-house.

Lack of internal resource with which to establish an in-house service was given as a reason for acquiring computing services externally, thereby avoiding setting up costs.

Finally, externalisation was in some cases due to a perceived need for a higher quality of services and examples occurred in the sectors of operational and computing services.

3.8.5 Summary

Externalisation appears to lead to cost reductions of between 10 and 15% per service for users of business services. A company electing to externalise is also likely to shed up to 1% of its total labour force.

In general however, companies rarely quantify either the financial or employment effects of externalisation. Furthermore, the net employment effects of externalisation are unclear from this analysis.

The sectors particularly subject to externalisation in the last five years include, predominantly, operational services, computing services, consultancy (particularly strategic consultancy) and marketing services. The primary motivations for externalisation are cost

reductions, lack of internal expertise, the desire to cut fixed overheads, the need to gain an external perspective of strategic issues, and the need for flexibility in the face of rapid technological change and volatile markets.

4. BUSINESS SERVICES AND THE INTERNAL MARKET

In this section we examine the issue of trade in business services within the Community and trade barriers encountered. We begin with the experience of the demand side in obtaining an adequate supply of business services domestically (4.1) and the extent to which they seek and obtain services beyond their national borders (4.2). We then address the nature and significance of barriers to trade in business services both from the demand side (4.3) and supply side (4.4) experience. Finally, we consider these barriers in the context of the volume of intra-Community trade (4.5).

4.1 Domestic availability of services

Some 25% of companies reported that they had tried to contract out a service but had failed to find a suitable domestic supplier. These companies were concentrated particularly in Italy, but also in the Netherlands. In the former case difficulties appear to be largely associated with recent changes in company accounting requirements for which the domestic accounting profession is not yet fully prepared. The most frequently mentioned services include:

- audit,
- consultancy,
- taxation advice,
- specialist software,
- marketing in foreign markets,
- foreign legal and tax advice.

With the exception of areas such as audit, tax and consultancy, in which countries such as the UK and the US appear to have developed internationally recognised expertise, services which are unavailable locally usually relate either to the need for local knowledge of a foreign market or are of a highly specialist nature (such as research and development in a specialist field) of a type not generally available.

4.2 Purchases of services from foreign owned companies

In the sample 70% of firms buy some of their externally provided services from a foreign-owned firm. The services affected are generally those mentioned in 4.1.7. It was frequently stated that nationality is irrelevant in the selection of sub-contractors and that work is given to firms purely on the basis of the most favourable tender. Specific reasons given for using a foreign and firm were:

- policy to use local firms by overseas subsidiaries,
- the reputation of foreign firms (in terms of cost and quality) in certain fields, mainly audit, consultancy and computing services,
- the need for advice on foreign markets or legal and taxation systems.

Reasons were also mentioned for not using foreign owned firms. These included:

- adequacy of locally available services,
- language, cultural and geographical barriers,
- lack of information about the availability of foreign services.

The conclusion of this section of the survey is that there is already considerable cross-border provision of business services within the EEC and that generally firms are not adverse to using those services, their main concern being to obtain the best available product.

Table 2 below gives broad breakdowns of turnover between domestic and foreign markets where available.

Table 2 Internationalisation of business services

<u>Business Service</u>	<u>Location of Business Service Clients</u>		
	<u>Domestic</u>	<u>Other EEC</u>	<u>Non-EEC</u>
Engineering & Related	55	4	41
Consultancy	90-95	2-5	2-5
Commercial Communication	50	40	10
Computer Services	90	5	5
Research & Development	N/A	N/A	N/A
Financial Review	N/A	N/A	N/A
Operational Services	98	1	1
Legal Services	N/A	N/A	N/A

Source: Supply side interviews and PMM factsheets

The information in Table 15 is taken from the Peat Marwick McLintock factsheets prepared for DGIII. Business service sectors divide into three clear categories:

- engineering and related services and commercial communications, where roughly half the turnover of business services is for foreign clients. In the case of commercial communications, most exports are within the community, against only a small proportion of engineering and related services (where developing countries are the biggest export market),
- consultancy, computer and operational services in which there appears to be very little international trade,
- research and development, financial review and legal services, on which there is no data available on export shares of turnover.

The picture given by Table 2 roughly bears out our demand side interviews. Those services which are not traded significantly, according to the table, were generally contracted out to local firms,

with the exception of consultancy. For this service Table 12 is probably misleading since international consultancy generally have subsidiaries or partnerships in European countries. "Foreign" services of this kind would therefore not be registered as exports. This also applies to financial review, on which there are no figures in Table 12. "Foreign" accountancy services are very widely used in the sense that the "Big Eight" firms are international partnerships.

The highly domestic orientation of operational services was also reflected in our demand side interviews.

4.3 Barriers to business services: demand side view

Companies were asked to identify any barriers preventing them from obtaining the best possible business service with the European Community. Only 18% of the panel recognised such barriers, over half the panel stating that they were aware of no such barriers. For those companies recognising barriers, the most common reasons fell into the "fact-of-life" category and included mainly language and cultural differences or proximity. In addition, availability of information and shareholder or official pressure to buy domestically were also mentioned.

The question relating to barriers to business services was reversed by asking respondents to indicate the degree of importance attached to various specified barriers. A ranking of barriers is given in Table 13.

Table 13 Importance of selected business service barriers (%)

<u>Barrier</u>	<u>Rank</u>
Financial	1
Administrative	2
National Standards & Regulations	3
Legal	4

Financial barriers (such as exchange controls) and administrative barriers (such as paperwork) were regarded as marginally more important than barriers related to differences in national standards and regulations and legal barriers. These results are, however, based on a very small sample and should be treated with appropriate caution.

Specific examples of barriers prompted by this question included different national regulations on food contents, problems with accrediting technical personnel, different building standards, discriminating public procurement policy, import and export related paperwork and measurement of national content to comply with EEC regulations.

The point was made, often by larger companies with offices throughout the Community, that the operations had for a long time been geared towards the current regulatory framework and that barriers were not really regarded as obstacles, given the systems and structures which had evolved for trade within the Community.

4.4 Barriers to trade in business services: supply side view

The overall picture from the supply side is that most business services are perceived by their suppliers to suffer from some barriers even though they are not considered to be of great significance. Two of the services on the other hand could think of no barriers at all (beyond problems such as cultural and market differences, which we are not classifying as trade barriers), these being management consultancy and operational services. Table 14 summarises the position by business service sector.

In four sectors barriers are recognised but are not viewed as very significant impediments to the exchange of services - namely commercial communications, computing services, research and development, and legal services. The associations generally replied that the significance of these barriers for individual service companies would depend on the nature of the services they provided. Some would be affected quite significantly while others hardly at all. The view of all these four services is that the removal of barriers will have some, although probably limited, effect on the ability of service providers to sell in other European countries.

Table 14 Barriers to trade in business services

<u>Sector</u>	<u>Nature of Barriers</u>	<u>Overall Significance of Barrier</u>
Commercial Communications	<p>Satellite broadcasting barriers</p> <p>Differences in advertising law (regarding permissible advertising material)</p> <p>Limitations on media time for advertising</p> <p>Lack of access to equity markets (Germany)</p> <p>Qualifications of professionals</p>	<p>Generally regarded as reasonably free market</p>
Engineering & Related	<p>Government procurement</p> <p>Technical standards</p> <p>Licensing of professionals</p> <p>Tax treatment</p>	<p>i) Engineers: barriers quite significant</p> <p>ii) Architects: barriers very restrictive</p>
Management Consultancy	None	No barriers of significance
Computing Services	Government and PTT procurement of computer services	Only UK reports this barrier
Research & Development	Bias in government procurement	Reported by Germany (demand side interview)
Operational Services	None	Largely unregulated market
Legal Services	Freedom to practice	Not generally recognised by professional bodies as significant

Some specific points should be made in relation to individual services:

- in advertising, the development of satellite broadcasting is creating a new medium of international broadcasting which allows cross-border television advertising. As cross-border advertisements are not currently allowed, there could be a significant raising of barriers in the near future unless changes are made to the current regulations,
- with regard to legal services, the profession does not regard the most fundamental restriction on cross-border services, that is the existence of entirely separate legal systems in each member state, as a trade barrier but as a fact of life. This is understandable given that the removal of such a restriction could only be a long term aim. Nevertheless, there are examples of lawyers being restricted in practising even when appropriately qualified,
- while we did not formally interview representatives in the accountancy profession, it is common knowledge that within certain member states accountants are prohibited from offering non-auditing services to their audit clients. Moreover, non-auditing activities have become an important growth market for most large firms. However, in practice there is said to be only a moderate inconvenience in setting up legally separate firms for consultancy and tax services. In no countries have firms been prevented from providing all the services which they would like to offer.

The remaining sector, engineering and related services, appears to suffer most from barriers, these being described as a significant limitation on competition. This is reflected in the degree of trade in these services, which is quite limited within the Community. The barriers which have most effect are the licensing of professionals and bias in public procurement. While these professions are significant exporters, Table 14 shows that very little of the export market is within the Community. Instead exports are concentrated on developing countries which lack the skills to perform these services themselves. In countries where qualified professionals do exist (which would include

the whole of the Community) such services are imported to a very limited degree. Bias in public procurement is an important barrier, given that public bodies are significant purchasers in relation to infrastructure projects. While both consulting engineers and architects feel that barriers are significant, the latter group appears to find them particularly restrictive.

Finally, one should note that there were some more general problems reported by some sectors, although they are not business service barriers directly. In particular the high costs of air transport and telecommunications created by an imperfect market were raised by several respondents. Some also reported restrictions on access to foreign exchange and the repatriation of profits.

4.5 Extent of intra-Community trade in business services

Supply side respondents were asked for information regarding the significance of exports for domestic suppliers. This information, combined with data taken from a series of service sector factsheets is presented in Table 15.

Table 15 Internationalisation of business services

<u>Business Service</u>	<u>Location of Business Service Clients</u>		
	<u>(% of turnover)</u>		
	<u>Domestic</u>	<u>Other EEC</u>	<u>Non-EEC</u>
Engineering & Related	55	4	41
Consultancy	90-95	2-5	2-5
Commercial Communication	50	40	10
Computer Services	90	5	5
Research & Development	N/A	N/A	N/A
Financial Review	N/A	N/A	N/A
Operational Services	98	1	1
Legal Services	N/A	N/A	N/A

Source: Supply side interviews and PMM factsheets

Business service sectors divide into three clear categories:

- engineering and related services and commercial communications, where roughly half the turnover of business services is for foreign clients. In the case of commercial

communications, most exports are within the Community, against only a small proportion of engineering and related services (where developing countries are the biggest export market),

- consultancy, computer and operational services in which there appears to be very little international trade,
- research and development, financial review and legal services, on which there is no data available on export shares of turnover.

The picture given by Table 15 roughly bears out our demand side interviews. Those services which are not traded significantly according to the table were generally contracted to local firms, with the exception of consultancy. For this service, Table 14 is probably misleading since international consultancies generally have subsidiaries or partnerships in European countries. "Foreign" services of this kind would therefore not be registered as exports. This also applies to financial review, on which there are no figures in Table 14. Foreign accountancy services are very widely used in the sense that the "Big Eight" firms are international partnerships, though this would not be reflected in export figures.

The highly domestic orientation of operational services was also reflected in our demand side interviews.

4.6 Conclusion

Most business service trade associations recognise the existence of barriers. While they feel that their significance is somewhat limited this view does seem at variance with the demand side perception of barriers, whereby most firms know of no barriers and the few that do acknowledge their existence believed them to be either insignificant or marginal.

The following seem the most likely explanations of this dichotomy:

- the associations say that only some of their services are affected and these have not touched upon our demand sample significantly,
- barriers are not fully recognised by users of business services, and despite prompting, are taken as facts of life,
- many services are not sophisticated and can easily be provided by local firms, such that consumers of services may not feel deprived by having local supply only (though it could mean a more restricted choice and possibly higher prices). It is perhaps significant that those services for which consumers most often turn to foreign suppliers are specialised, sophisticated services not available in the local market.

The general impression from the interviews is that the latter two explanations are most likely. Interestingly companies did not tend to regard the purchase of foreign services as a natural option, even though many imported foreign inputs in the goods sector in substantial quantities.

5. CASE STUDIES

5.1 Introduction

In addition to the overall survey results presented above we present in this chapter a number of case studies in the use of business services and trade barriers encountered. These case studies relate to the supply and demand side. We first cover a number of business service sectors (marketing, advertising, computing, management accountancy and consultant engineering), in which we look at the use of the service as a whole and the perceived effects of the completion of the internal market. We then look more closely at a number of companies from a variety of sectors and countries, which use business services. We hope these case studies provide useful background information of a qualitative nature to complement the broader survey.

5.2 Supply side

5.2.1 Marketing services

Marketing services is a sector defined broadly as the management activity concerned with the identification of a consumer need, the development of a specific product to fulfil that need, the subsequent promotion of the product and ultimately its profitable sale.

Marketing is an activity which is integral to each company/organisation to a greater or lesser extent. The integral activity is supplemented by commissioning specific companies which offer discrete marketing services; three examples are advertising, design and or public relations agencies.

Measurement of the size of the marketing services industry is based on estimates of employment and turnover as reported by associations which represent those professionals in the various marketing disciplines. Any other estimation process would require very extensive market research.

Advertising dominates the major marketing services, both in value of turnover and in the numbers of people employed in advertising agencies. Approximate ratio of the value of the services are 25:2.5:1 for advertising, public relations and market research respectively.

The amount of money spent on marketing services, throughout the Community, was approximately 28,000 - 34,000 million ECU in 1985. Of this advertising expenditure was estimated to be 24,435 million ECU, and market research 1,000 million ECU for 1985. Public relations expenditure breakdown is broadly estimated to be 2,000 - 2,500 million ECU for 1985.

The growth in size of the marketing services profession is predicted to continue. The amount of money spent on advertising and other marketing techniques rises and falls in proportion to the affluence of the country concerned. As the overall health of the member states improves, it is likely that the amount spent by individual companies and organisations on marketing services will increase.

The structure of the industry has been affected over the past four years by several factors which also affect the turnover and employment figures:

- expansion of the range of services through acquisitions as well as organic growth, with some marketing service firms expanding in order to provide a full range of services to their clients,
- global marketing which involves the promotion of product throughout a number of countries. Often the same promotional theme and creative promotion package will be used in marketing a single product or range of products in several national markets. This relies to a large degree upon the co-operation of national offices within the growing international networks of the marketing services firms.

An important factor which is fostering the growth of the industry, is also the trend for companies to externalise marketing and promotion services. The national marketing associations and the users of marketing services which were interviewed in this study indicate a growing trend to contract out for services which were either provided by internal sources, or not previously required. Companies turn to external providers in order to receive the most effective marketing

services to address specific needs. In this way, they can tend to their primary business without the added overhead of maintaining a comprehensive internal marketing service.

According to two national associations, the marketing profession is maturing. Qualifications are being established, thus raising standards and limiting access. The result is that companies which use marketing services are able to make decisions based upon expected quality and value. Therefore, those firms which previously opted to develop internal marketing departments for reason of quality control, are able to contract out with assurances of quality.

The marketing profession has become very popular and attractive to those entering professional life. The Dutch Institute of Marketing Professionals reports a seven-fold increase in the number of applications for its qualifying examination and increased co-operation between the Institute and the universities.

The barriers to entry are low. Many small companies are formed each year by enterprising staff from established agencies, and some succeed. There are few barriers within the Community which might restrict the free trade of marketing services among member states.

The free flow of professionals from one member state to another allows most firms to provide services in any market. Some barriers do exist in the transport of specialised production equipment across borders.

Fiscal and financial barriers or impediments restrain the growth of some firms in certain national markets. In Germany, for example, advertising/public relations firms are prohibited from being quoted on the stock market. Unrestricted access to financial markets has enabled the UK based firms, for example to acquire firms in various national markets. The Saatchi & Saatchi organisation has been able to emerge as the world leader because of its success in attracting investors via the stock markets.

Cultural barriers, such as language difficulties, local custom and behaviour impede the cross-border trade of marketing services.

Through acquisitions, joint ventures and strategic alliances, European marketing services companies are providing services across national borders. The top advertising, public relations and marketing research firms all operate in many of the member states' markets. The large American firms have developed partnerships and affiliations with European firms. This trend is likely to continue.

The marketing services sector expects to benefit from the completion of the internal market. The national associations suggest that due to the expected increase in the flow of goods across borders, those services which help to bring the goods to the market will be in greater demand.

The free flow of communications which should result from the integration of telecoms and broadcasting systems should prompt member states governments to lessen restrictions on advertising. Satellite television, for example, will bring programmes into local markets from across borders. Local governments will have no direct control or influence on the amount or type of advertising broadcast via satellite.

The increase in demand for services is welcomed by those firms which are experiencing a great number of newcomers to the market. Competition and specialisation among providers is likely to increase. Aggressive and innovative firms will be able to flourish in a market which fosters open and free trade. A clear example is that of the British marketing services companies which have taken advantage of deregulated capital markets in order to expand their businesses internationally. It may be possible for other European firms to expand through investment and become major players in the international markets, providing marketing services to third country markets.

5.2.2 Advertising services

There is relatively good statistical coverage of parts of the advertising industry in the UK and the Community in general. Total advertising expenditure in the UK in 1985 was 7,540 ECU. Total spending

in the whole of EEC stood at nearly 25bn ECU. The UK followed by Germany has the largest advertising expenditure. In the UK and in the Community as a whole advertising expenditure grew by around 4% per annum in real terms between 1981 and 1985.

In volume terms a very large number of companies undertake direct advertising (for example, placing advertisements in newspapers). In terms of total advertising expenditure, however, these firms are insignificant. Larger firms invariably retain marketing agencies to carry out the advertising function whilst maintaining in-house departments which determine overall marketing strategy and manage product advertising budgets. There is no recent trend towards externalisation since the industry has grown along these lines throughout its development.

The major obstacle to expansion of the advertising services industry within the Community is seen as the current regulation of cross-border satellite broadcasting. The Commission is currently attempting to reverse by directive the judgement on which this policy is based but the threat then is that agreement will only be secured on the basis of a ban on satellite broadcast advertising because of widely different regulations and regulatory authorities which exist between member states. A dynamic effect which will have repercussions for domestic advertising is thus feared.

Beyond this barrier, which is seen as overwhelmingly the most significant, cultural barriers are also apparent in a field which is essentially creative.

The advertising industry has always had a degree of internationalisation, usually led by US companies driven by "global" products (such as Coca-cola). However, in recent years the degree of internationalisation amongst European countries, primarily UK companies has increased dramatically, again in response to increasing globalisation of products and companies. Given UK strength in the field, particularly in the creative and film-making areas, the UK has been at the forefront of this trend.

Other than cultural and satellite broadcasting barriers the industry (at least from the UK point of view) is already relatively internationalised and completion of the internal market for advertising services is not expected to have a dramatic direct effect. More generally however, the single European market is seen by UK agencies as a very considerable opportunity as competition increased and the markets expand, and one which they keenly anticipate.

5.2.3 Computer services

The European Computer Services Association (ECSA) compiles an annual survey on computer services which estimates the Community market to be around \$15bn and the employment in the sector to be around 200,000. The most significant factors influencing growth and productivity are the innovations in hardware which offer greater power at lower prices and enhanced networking possibilities. In particular, the introduction and enhancement of the micro-computer has led to considerable structural changes in the industry. The long term trend is for processing to decline as a percentage of the total market.

According to the latest ECSA survey the computer service market in Europe is growing at the healthy rate of 22%, with a fairly even pattern over the Community between 18% (Denmark) and 28% (Greece).

The factors behind externalisation are said to be:

- i) supply and demand of staff, especially in the public sector, which is a strong growth area for computer services,
- ii) increasing complexity and levels of knowledge required to build and support projects (particularly those of a "one-off" nature),
- iii) the realisation by many companies that they "are not in the computer business",
- iv) an increasing maturity in the market, in that suppliers are becoming more respected.

The associations do not believe that trade in the main computer services is seriously inhibited by barriers. Indeed the only barrier considered a problem in some countries is bias in government and PTT procurement. Despite this general lack of regulation, there does not seem to be a significant exchange of services between Community countries in computer services. All three country associations consulted, estimate that domestic demand accounts for 90% or more of the market. The low level of exports may be explained by:

- time to establish presence,
- cultural factors,
- structure of local services.

The Italian and Germans are also firmly convinced that their computer service industries are not sufficiently conscious of the potential of export markets and how to exploit opportunities. This feature is similar to consultancy services; the strong growth of domestic markets has simply meant that domestic services have not needed to turn their attention beyond national frontiers.

Regarding the effect of completing the internal market, some associations feel that there may be dangers of foreign computer service companies infiltrating their domestic markets. In Germany and Italy this is already happening because of the relatively free market access. The completion of the internal market in 1992 may well accelerate this process because it will integrate the European economies as a whole even more than at present. This could well have a negative effect on domestic service providers as the foreign competitors, mainly US and Scandinavian, are far more experienced at taking advantage of export markets than the domestic firms. Overall, however, it is not thought that these developments would have any significant effect on prices.

5.2.4 Management consultancy

All three management consultancy associations interviewed confirm the overall European trend of strong growth in the management consultancy market, with average trends of 10 - 15% in Germany, 15 - 20% in the Netherlands and even higher in Italy. Figures from the

European Federation of Consultancy Associations, FEACO, indicate that the turnover of consultancies as a whole is around \$3bn and data completed by an independent organisation, Alpha Publications, estimate the market in the Community itself to be around \$2.5bn. FEACO reports that its members' growth currently averages 10% a year and Alpha forecasts future growth to 1992 to be in the order of 15% per year. Figures produced by both these sources indicate total employment in consultancy services to be some 40,000 to 50,000.

The use of consultancy can be seen as a classic case of externalisation since most decisions to engage consultants are direct choices between internal and external consultants. All the associations report a strong trend towards externalisation confirming the results of the company interviews that most companies were making increasing use of consultancy. The associations believe that there are a number of reasons for this, in particular:

- a) the desire to confirm internal decisions objectively,
- b) the greater technical complexity of decision making,
- c) the uncertain economic and market environment,
- d) the speed of technological change and need to acquire the use of technologies more rapidly than can be achieved by creating internal resource.

As far as the internal market is concerned, the associations agree that consultancy is a largely unregulated market and that there are no trade barriers encountered of any significance. However, compared to other sectors consultancy is not a service which is traded significantly internationally. In Germany and Italy over 90% of turnover is in the domestic market and in the Netherlands this figure is around 80%. Survey returns to FEACO give figures on export share of turnover in six countries as indicated in Table 16.

Table 16 Exports as share of consultancy firms' turnover

<u>Country</u>	<u>Export Share of Turnover</u>
	%
France	16
Germany	8
Italy	1
Netherlands	10
Spain	5
UK	10

Source: FEACO

With exports so limited associations are not aware of the split between the Community and non-Community as export markets. However, Table 17 gives figures on the absolute value of imports and exports as estimated by Alpha for five countries. In all five the value of imports is very low and always lower than exports. Given that much of the import volume would be from the US intra-Community trade must be very limited. Indeed it is generally acknowledged in the European consultancy industry that developing countries are the major export markets, especially for the larger exporters such as France and the UK.

Table 17 Exports and imports of consultancy services

<u>Country</u>	<u>Imports</u>	<u>Exports</u>
	\$m	\$m
France	27	69
Germany	10	86
Italy	15	100
Netherlands	7	12
Spain	6	39
Total	55	306

Source: Alpha Publications

The associations differ somewhat in their explanation of the limited export volume, given the lack of artificial barriers. All recognise language as an important factor. The Dutch and Germans feel institutional factors are important while the Italians feel that the

cost advantage of domestic services (with lower subsistence and travel charges) are significant. All, however, agree that a key factor is that their consultancy industries are insufficiently "export-minded". They ascribe this attitude to the strength of domestic demand. In the words of the Bundesverband deutscher Unternehmensberater, "Germany feeds all".

There is a feeling, nevertheless, that the completion of the internal market may have some effect. The Germans and Italians in particular feel that while the effect will be slow, the prospect of foreign consultancies entering their domestic markets in the medium term is a real one and that it will be on the basis of permanent presence rather than project-based visits. However it is not thought that prices will be significantly affected because the new entrants would not be competing on price but on the quality and sophistication of services. The Italians feel that while a part of the market, in particular, the more procedural services like information and other systems, may be somewhat price-elastic, the rest, especially the more strategic services, are very inelastic. This was confirmed by demand side interviews where the reputation of consultancy firms emerged as a clear selection criterion.

5.2.5 Consulting engineering

Consulting engineers cover a wide range of activities and professional skills and provide a variety of services. The skills and activities overlap and to some extent complement those of planners, architects, quantity and land surveyors; construction and process engineering contractors; and engineers (civil, chemical, electrical, mechanical and structural).

To measure the size of the profession we have turned to the International Federation of Consulting Engineers (FIDIC) which has national associations as members and as such is an umbrella organisation dealing principally in international matters. At the end of April 1987 the FIDIC membership in ten of the 12 EEC countries (Consulting engineers in Greece and Portugal have not yet joined FIDIC) was as follows:

Table 18 FIDIC Member Associations in EEC - April 1987

	Individual members or firms	Total employees
	-----	-----
Belgium	84	507
Denmark	525	6,689
France	760	2,700
Germany	2,664	9,409
Ireland	169	953
Italy	51	250
Luxembourg	25	214
Netherlands	345	6,724
Spain	55	609
UK	1,082	26,770
	-----	-----
TOTAL	5,761 =====	54,825 =====

In addition to FIDIC, CEBI also carries out a statistical survey of consulting engineers. CEBI tends, however, to cover a somewhat broader range of consultants, including architects, agricultural specialists and bankers.

Those consulting engineers who are truly independent tend to belong to FIDIC and those who are less independent (for example, they are subsidiaries of contractors or manufacturers, or are part of the public sector) tends to belong to CEBI. FIDIC and CEBI estimate that together they cover some 60-70% of consulting engineers.

With these qualifications, the statistics for CEBI members are:

Table 19 CEBI statistical survey 1985: Consultancy services

1985	Firms	Staff	Turnover M.ECU	Exports	Exports as % turnover
United Kingdom	287	45,000	2,460	1,846	75
France	134	19,880	1,750	830	47
West Germany	143	15,000	1,000	520	52
Italy	105	19,600	1,620	825	50
Spain	67	12,000	466	118	25
Denmark	38	6,756	265	64	24
Holland	31	4,282	227	97	43
Belgium	36	4,500	205	61	30
Greece	40	1,140	30	6	20

As independent practitioners, the consulting engineers are normally external providers of services to business, government and industry. Those construction, production and process related industrial engineers which have been traditionally attached to corporations are becoming externalised due to the following key factors:

- general health of the economy: the economic crisis of the late 1970s and early 1980s has slowed investment in new buildings and production facilities. The reduction in demand for services has been reported by individual consulting engineers, national associations such as The Association of Consulting Engineers of the Netherlands, and by international associations such as FIDIC and the European Committee of Consulting Firms (CEBI). However, there is now evidence of an increase in activity across the EEC particularly in the UK and West Germany,
- increased competition: the fee structures of independent, external services are sometimes reduced by increased competition. The decreased demand for architects' services,

for example, has compelled the architects to intensify their efforts to obtain business from related areas. Some major users have found it advantageous to contract out for specialised services which they may previously have provided internally,

- specialised skills: the increase in demand for specialised skills has been an additional lure to practitioners which are not qualified consulting engineers. Planning consultant with various skills have taken over some of the new business opportunities,
- the specialisation of requirements for consulting engineers has opened new opportunities for independent practitioners who offer specialised skills. Therefore, some have opted to specialise and become external consultants for reasons of professional fulfilment, flexibility and prosperity.

Trade barriers have been identified in three categories:

- technical barriers - consulting engineers must work within the technical environment of the given client. Process, mechanical and industrial engineers practicing in one national market must comply with local technical standards and regulations. Each member state maintains its own set of standards and requirements. These normally reflect local safety considerations and traditional construction methods,
- administrative barriers - Licensing procedures in certain member states restrict the free trade of consulting engineering services. This applies to many professions related to the construction industry. Some national associations are taking action to break down these barriers by arranging reciprocal licensing arrangements and international standards,

- cultural barriers - these remain the most important and restrictive. Cultural barriers such as language and custom manifest themselves in various ways. For example, the price of a construction project is a combination of the cost of personnel, land and natural resources, machinery and materials. Local service providers have the advantage of an established network of providers of each of the required components. Each project, or product is a prototype, even if it comprises design or structural elements which have been part of previous projects. In other words, in the field of consulting engineering, as in most services, mass production is not possible. Therefore, most of the costs related to a project are calculated at a local cost index. The price advantage, therefore, will be achieved by the consulting engineer who can best manage the local resources.

Successful international consulting engineers have overcome many cultural barriers through joint-venturing and sub-contracting, in order to mitigate the disadvantage of not having the established local resources network.

Consulting engineers tend to be export-orientated. Recent increase in the degree of internationalisation are due mainly to changes in the general health of the national economies. Some consulting engineers have witnessed the downturn of business in foreign markets.

In order to establish a true common market for consulting engineering services four specific areas would need to be studied and differences among member states reconciled. These four areas are:

- administration of contracts and licensing,
- legislation which biases selection of service providers,
- fiscal consideration, especially tax treatment, of consulting engineers,
- technical codes, restrictions, and requirements.

The unified market is likely to present the following changes:

- more competition in local markets within the member states due to the freer flow of the professionals within the Community; it is predicted by the national associations that the home market specialists will be more aggressive in seeking business in a broader market area, if some of the costs related to the above area are lessened or removed,
- the net effect may be that the highest quality service available in the Community will be delivered at the lowest possible price. This is a conclusion reached by the French, Dutch, Belgian and German national consulting engineering firms, all of which are promoting the integration of the European Market,
- greater potential for European providers to export services to third country markets; this benefit would result from stronger cooperation of member states' consulting engineers. The integration of the profession would provide for easier joint venturing in order to address requirements of third country projects. Consulting engineering work tends to follow bilateral aid.

5.3 Demand side

5.3.1 ITALY: Company A : Insurance Services

Background

Company A is a major insurance company in Italy with a turnover of Lire 1,103 billion. Like the sector as a whole the company has been growing substantially over recent years, with typical growth rates of 10% a year. The company has a significant overseas network, although exports represent only about 3% of its turnover. The company employs just over 2,000 staff, a number which has been very stable in recent years, growth having off-set productivity improvements.

Use of business services

The broad picture regarding the company's use of internal and external services is as follows:

- engineering and related services are performed almost wholly externally, though there are internal employees for this service who are responsible for controlling the external providers,
- strategic and general management consultancy has been supplied externally, largely in relation to the setting-up of new structures and not replacing internal resources. The main consultants have been a US strategic consultancy company, though two small Italian companies have been used too,
- for marketing, the US consultancy has advised on setting up new services internally and some specific market research projects have been undertaken. Otherwise the internal marketing department covers marketing services,
- financial management is performed internally, though the consultancy wing of the company's auditors undertook a major one-and-a-half year review of the whole financial system recently,
- most advertising and public relations work is done by an external (Italian) agency though there is a limited internal service for the production of leaflets and the like. The companies products are sold entirely by agents who are independent from the company; in this sense sales promotion and direct marketing has always been wholly externalised,
- product development is completely internal,
- the company has external auditors who also advised on setting up the internal audit department which now exists,

- operational services, are mostly externalised (including travel, security, printing and probably in the near future, the management of archives); there is no catering service,
- for legal services, an internal department handles routine matters while external legal advisers deal with litigation and other more technical requirements.

Overall the company relies on quite a number of external services and this has been the case for some time. Consultancy, however, is an area which has seen a substantial growth of external services in recent years. Interestingly, though, much of the consultancy has been directed at setting-up new internal services, such as marketing and internal auditing. The one clear cut example of externalisation in recent years is printing; archive management may well also be externalised soon.

Decision making

The quality and availability of services are the key criteria for this company and it ranks them as very important. Cost and tradition are regarded as quite important.

Some services are contracted on a three to five year basis, particularly accountancy and advertising. Operational services are contracted out annually while one-off projects, such as consultancy assignments, are decided on an ad hoc basis.

Printing is the only area which has been contracted out for the first time in recent years. In 1985 this function was switched to an outside contractor and the internal service closed down. The company is now considering doing the same to archive management, which is an important, if rather passive, function within the company. For both printing and archive management the motives are not those of cost (indeed printing costs are higher externally). Rather the company wanted a better quality service and, also of some significance, wanted to circumvent industrial relations problems which were particularly acute in these areas.

Regarding the cost implications, printing is some 30 - 35% more expensive outside, as was anticipated. The cost implications of externalising archive management are now under study. The internal employment losses through externalisation are as follows:

- printing : 14,
- porters : 2,
- archives (proposed) : 30.

These represent currently less than 1% cut of labour staff and prospectively (including archives) 2.3%.

Expenditure on external services in the last five years is as in Table 20. Consultancy is clearly the most significant service, accounting for 54% of expenditure on external services in 1986. The other two important services are computing (30%) and legal services (11%). No other service accounts for more than 2% of the total.

Table 20 Italian Company A: Expenditure on external services (Lire m)

<u>Service</u>	<u>1982</u>	<u>1983</u>	<u>1984</u>	<u>1985</u>	<u>1986</u>
Engineering & Related	63	97	87	128	216
Consultancy	12,793	13,525	16,214	19,560	22,159
Computing	4,192	6,427	8,540	8,400	12,049
Advertising/PR	42	114	158	300	497
Financial Review	91	348	480	286	409
Security	234	409	454	580	794
Legal Services	3,251	4,397	4,428	4,034	4,675
	-----	-----	-----	-----	-----
TOTAL	20,666	25,317	30,361	33,288	40,799
	=====	=====	=====	=====	=====

The use of services has doubled in the five year period. Consultancy has increased by 73%, computing services by 187% and legal services by 43%. This growth reflects a general attitude that external services should be used wherever they can provide a better or cheaper

service. The emphasis is on "better" rather than "cheaper", which is illustrated by the switch to external services even where this is the more costly option.

Business services and the internal market

The company has encountered no difficulties in obtaining services from other countries or at home and is aware of no barriers interfering with its use of foreign business services. The company uses international consultants and accountants, though these both have permanent establishments in Italy. The consultants have a worldwide reputation for strategic consultancy and the accountants are one of the "Big Eight" international firms which almost all large companies in Italy use. Both these choices, therefore, have been based on the quality and reputation of the services, which have been significantly more costly than entirely domestic-based providers would have been.

5.3.2 Italy Company B : Computers & Other Office Equipment

Background

Company A is a subsidiary of a large US multi-national manufacturing computers, printers and many other types of office equipment. It had a turnover of Lire 247 billion in 1986 which has been increasing by 3 to 5% in recent years. It employed 1,803 staff in 1986, a figure which has declined by 18% in the last two years. The company does very little exporting as the group has subsidiaries in all countries with any significant market for their products.

Use of business services

The broad picture of the company's use of internal and external services is the following:

- engineering and related services are mainly provided externally by Italian firms except for interior design which is provided internally. There is one internal employee to oversee external contractors,

- strategic, general management and financial management consultancy is provided internally in that policies and practices in these areas are determined at group level,
- other types of consultancy are provided both internally and externally, with the emphasis on internal provision,
- advertising is handled entirely externally by a US agency appointed on a group-wide basis. Public relations are dealt with partly internally and partly by an external (Italian) agency,
- research and development is undertaken entirely at group level,
- external auditing is performed by one of the large international practices, while internal audit is handled internally,
- most operational services, including travel, catering and security, are provided by external, local resources,
- there is an internal legal department but most legal matters are handled by independent advisers.

The company clearly makes extensive use of external services, which is in part due to the fact that it is a foreign subsidiary which has not built up a large internal service infrastructure in Italy. On the other hand several functions are performed within the group to ensure worldwide uniformity.

Decision making

Quality and availability of service are "very important" selection criteria for the company. Cost is ranked as quite important and the traditional source as not very important. Generally services are contracted out on an annual basis, except in the case of one-off projects such as consultancy, which are decided on an ad hoc basis.

Most external services have been provided in this way for several years. However, since 1985 use is being made of a new type of marketing service which has become available which the company finds particularly useful. It is not a service which could be easily set up internally.

The company could not provide detailed data on expenditure on external business services but estimates that total spending on these was Lire 3 billion in 1981, Lire 5.5 billion in 1985 and Lire 6 billion in 1986. This two-fold increase in expenditure in five to six years has been quite typical of companies which have been able to provide figures. It is much larger than the approximately 25% increase in company turnover in the same period.

Overall, the company estimates that it has saved some Lire 0.5 billion annually by using external services in recent years. It estimates a saving of only seven or eight jobs on the basis of externalisation, however, in comparison with an overall employment reduction of over 300 in the last three years.

5.3.3 UK Company A: Banking services

Background

Company A is one of the biggest and most successful of the UK retail banks. It employs nearly 110,000 people and has subsidiaries in all parts of the EEC except for Luxembourg and every part of the globe except for Eastern Europe.

To complete the questionnaire the central planning department collated the responses of the major central departments of the bank, and although the departments covered a wide range of activities their answers were broadly similar.

Use of business services

All the business services listed are carried out through a combination of internal and external resources. Of those used externally the vast majority are UK based, with a few from the United States:

- engineering and related services are either carried out in combination between a subsidiary of the company and an external consultant or a combination of internal resources and external consultants. The only exception is computer equipment maintenance which is carried out by an external firm,
- management consultancy is carried out from within the company or a subsidiary, except for information technology which is done by an outside firm and a subsidiary. In addition to the standard list of business services, the company utilises some outside resources in combination with internal personnel to carry out training,
- on all categories of information technology external consultants are used in some combination with internal or subsidiaries or company staff. These external firms are either British or American,
- in the field of commercial communications internal staff tend to work with outside consultants both in advertising and public relations,
- some external advice in combination with internal staff is also given for new product or service development, travel services, catering, security and most matters relating to legal services.

The company does buy in specialist advice form foreign owned (US) companies because in two particular areas the quality of the services provided domestically does not meet its required standards, namely:

- legal advice on foreign jurisdictions,
- computer maintenance and information technology services.

Decision making

The company decisions regarding the contracting-out of services are generally made annually although occasionally by ad hoc cost benefit analysis. These will be in the context of the longer term strategic planning process.

The key factor in this decision making is the quality of service, followed by the cost and availability of service.

The only new area contracted-out in the last five years has been strategic consultancy because of insufficient internal specialist skills. Services in more general terms have matched the savings estimates at the time not in staff numbers but in cost terms, the quality of the contracting-out services has also kept up with expectations. In most cases staff numbers were not reduced since services externally provided were additional to those provided in-house.

Business services and the internal market

Banking business is obviously affected by the restrictions in Europe, such as in capital markets, exchange controls, difficulties in payments systems, and lending restrictions. It is not surprising that the company regards this as an important barrier which needs to be removed if their business is to expand with the completion of the internal market.

The company has a general belief that if barriers to the internal market being completed are removed by 1992 then this will cause them to contract more services out (possibly, legal, information technology and marketing); but they have no views on the sort of cost reductions that might be achieved. However, they do believe that they would benefit

from the removal of barriers, mainly because of their ability to enter current markets and their belief in the faster growth of the market once barriers are removed.

5.3.4 UK Company B: Computer services

Background

Company B has in recent years experienced rapid growth. Turnover has doubled in four years (1982-86) from £22 million to £44 million; number of staff employed over the period has nearly doubled, rising from 760 to 1,127. Although they mainly operate in the UK, they do have distribution outlets in other EEC countries, namely France, Germany, Spain, Portugal, Netherlands and Italy. Outside the Community they cover the United States and Japan.

Business services

Although the company contracts out, it has a policy of working closely with outside suppliers; many business services provided are by way of a genuine combination of internal and external resources

- engineering and related services were carried out by a combination of internal and external sources, except for architecture and project management which are totally externalised,
- management consultancy skills are largely provided in-house although both marketing and financial management services have been carried out in conjunction with an external contractor,
- advertising is dealt with by a combination of internal and external skills, although public relations are performed by internal employees,
- computer services are carried out either internally (remote data processing, computing strategic consultancy, facilities management) or in combination with other firms of computer consultants (software development and maintenance, information services, communications services),

- research and development is carried out in combination with outside consultants, as is internal audit, catering and security matters,
- travel services and external audit are carried out externally,
- legal services are carried out in conjunction with outside counsel either totally or in combination.

In general terms the company has increased the volume of work which it has externalised over the last few years. All externalised services are provided by UK firms, mainly because for the services concerned foreign firms do not seem to be well represented.

Decision making

Decisions about contracting out are usually taken as part of a strategic planning process, although occasionally there may be a need to take shorter term decisions. The key factors influencing such decisions are:

- quality of service,
- timing of availability of service,
- cost of service,
- traditional source of service,
- continuity of supply (especially if a longer-term relationship develops),
- credibility and track record,
- the need for a reasonable mix of culture between the two firms.

This decision-making process has recently led to the contracting out of architectural services, catering, travel services and advertising because the company took the view they did not wish to develop in-house resources, but rather maintain a cutting edge by buying in agency skills. This has meant that they have not always looked for "savings" as such but have evaluated whether the best use of resources is internal or external. Much of the "savings" from externalisation have therefore arisen from not having to recruit people internally.

Business strategy and the internal market

This area proved to be a difficult one not only conceptually but also in terms of 'believing' that the internal market would be completed by 1992, given the rate of progress to date.

The only real barrier identified by those interviewed was language - a perennial British excuse - and the differences in national standards. A strong belief emerged that if national standards were harmonised the company sales would marginally increase. However, scepticism was expressed regarding whether Britain as a whole would benefit from the "EEC.....all singing off the same hymn-sheet", as one interviewee put it.

Nevertheless, even if the internal market is completed the company does not believe it will make any difference to the amount of services they would contract out. This may reflect the fact that it does not use any foreign contractors at present and therefore has not considered potential market changes.

5.3.6 UK Company C: Chemicals

Background

The company is, a chemicals company headquartered in London but with operations around the country. In recent years they have experienced rapid growth in turnover which has risen in the four years 1982-1986 from £7b to £10b. Profitability has also improved due to major restructuring in the early 1980s. However the number of staff has only increased by some 2,000 people over the period. They operate throughout Europe and the rest of the world with manufacturing plants in 57 countries and sales outlets in 150 countries.

Business services

They were unable to give any centralised cost figures in terms of the use of business services. Each individual operating unit of the company costed decisions out and had clear ideas of the benefits of contracting out. However it would be impossible to do the rounds to obtain a complete picture.

Although there has generally been an increasing use of outside services, in some areas they have been re-internalising since they found their internal core team too small to cope with the increased business of recent years. One area that has been affected by this has been management consultancy/strategic consultancy where they are now providing many of the previous services themselves.

Among the various services there was often a mixture of external and internal use except for engineering and related services which were almost entirely external. The use of external engineering and related services has been increasing and is likely to continue doing so. So is commercial communications, computing services, operational services and legal services.

Use of foreign suppliers

Being a truly international firm the nationality of the service supplier was directly related to the country of operation. They perceived no appreciable barrier to trade in services although there were problems in terms of customs procedures and their requirements, legal compliance and different registration procedures. Nevertheless the cost in terms of salaries of a handful of people was not considered significant. They also stressed that if all barriers to trade were abolished they would probably see little difference in their business because of their international network of operations. They also claimed that the cost of border procedures on unit of output in Europe varied only marginally between countries. Nevertheless, interestingly, they are using two people full-time at the moment to work out the effect on their company of the completion of the internal market.

5.3.7 UK Company D: food manufacture

Background history

Company D is a large British owned foods company engaged principally in the manufacture and marketing of confectionery and soft drinks. The brands are sold in more than 100 countries around the world. The company employ 27,000 worldwide and this includes 11,500 in the UK. The strength of the firm lies, besides the UK, mainly outside Europe in North America, Australasia and South Africa.

Business services

Ten years ago the company decided to concentrate on their "core" business, "on the things they do best", which they believed to be the manufacture and marketing of their products. The effect of this is that the firm now seeks to contract all but core business to outside firms. This means that compared to some years ago, when their factory sites were like a mini-village with company electricians, maintenance workers, and carpenters carrying out all tasks that were required on-site, today all these tasks are contracted out. The extent of this is enormous. The company at their major site in £400m worth of services a year of which £180m are for products; hence £220m must be some type of business service.

The company have floated off former parts of the empire and then bought back the services. This has largely been the case with both engineering services and computing services.

The people we spoke to do not perceive any barriers which prevent them buying from Europe, especially because about 75% of their equipment is bought from overseas, Germany, Switzerland, Denmark, Holland and Italy. They work through these firms English agents. As long as firms can respond very quickly to any problems that arise then the company see no difficulties in buying in services for Europe and the United States.

Marketing is a particular area of expansion for outside contractors. The marketing services department has been run down and outside consultants have been extensively used in all areas especially shareholder relations. There is a growing awareness that commercial communications are seeking to address a variety of audiences, shareholders, employees, customers, press, media and competitors. This policy has been part of an on-going dynamic strategy designed to concentrate on "making chocolates".

Decision making

Company C adopts a policy of decentralisation for planning factory managers have autonomous powers to decide their own budgets and what to contract out.

The key factors that managers considered when deciding what to contract out and to which firm were:

- the reputation of the firm in the particular field,
- quality,
- cost,
- accessibility of the firm,
- personal contact with people in a particular firm.

The policy of contracting out has certainly saved staff. In 1977, Company C had 11,500 staff; in 1987 only 6,000 staff. This reflects partly the policy of contracting out since in volume terms to some amount is produced.

Business strategy and the internal market

The firm suggested that there was a lot of enthusiasm about the completion of the internal market in 1992. The opportunities are believed to be very great since in the UK manufacturers are low cost, high exports and low imports and have a price advantage over competitors. It will certainly "force" them to look more towards the European market, even though it means they will have to alter their product to cater for the different European taste. This Europeanisation of the market might break national monopolies and benefit producers, for example, importing milk from France and not having to buy from the Milk Marketing Board.

The issue according to the company is whether national governments can look European-wide and realise that only by merger and acquisition can the European compete in world markets. Chocolate, biscuit and cake producers in the UK will want this addressed, but they fear that few other parts of British industry have similar interests.

5.3.8 Netherlands Company A: Steel and specialised steel products

Background

With annual sales of 100m Dfl, this firm, like many heavy industries has recently gone through a period of retrenchment and restructuring. After a significant downturn in sales, it reported a 19.4% increase in turnover in 1986 over the previous year. Over 50% of its products are exported, mainly to other EEC member states. The firm has reduced its full time staff by over 30%, mainly through natural wastage, to reach a current figure of 432 full-time staff. It remains a profitable enterprise with 6m Dfl profits on some 401,000 Dfl sales per employee.

Use of business services

Due to drop in demand and increase in world competition mainly coming from Japan and Korea, the European steel industry has been forced to reduce production. In the case of the Dutch industry this has meant rationalising back staff while respecting strict social laws which protect the employee.

The result is that almost any service which was formerly provided by company staff which could be transferred to external service has been, with one important exception, research and development, which has remained an important part of the firm. The nature of the steel business requires that those firms which are to profit in the future must provide a quality and speciality product line. In order to meet this objective, the research and development services have been strengthened.

Research and development is considered a key to the firms future. It excels in this area and employs its own R&D management and staff. The demand for speciality steel development expertise is great. For this reason, this firm is currently studying the possibility of hiving off a service which could stand on its own as a profit centre and provide selected services to the industry at large.

Decision making

Most business services are required by this firm. There is an underlying philosophy which a new management team has attempted to put into practice. The company will endeavour to increase the quality of its products while decreasing costs of production. To this end it selects providers of business services based upon value as measured in quality and price.

The firm does maintain figures on costs of individual services but it has not disclosed them to this study. The management estimates that about 70% of services costs have been transferred to outside providers.

Business services and the internal market

Most operating services are available on the local market. Some speciality software systems have not been available locally and have been purchased in Switzerland. Some software is bought elsewhere in order to take advantage of favourable sales and service agreements and price differences which are due to foreign exchange rates.

The company has not encountered any barriers to trade in services, except in the area of transport services. There appear to be no problems in identifying or employing service providers from other EEC

member states. The effect of foreign exchange rates on the price of the service was mentioned as a factor in long-term contracting of service providers. However, the aim for quality has been the reason for purchasing some higher priced services, such as software and consulting services from abroad.

The completion of the internal market is expected to benefit the medium-sized steel producer because delays and administrative costs related to patenting, licensing and transport will be reduced. Currently patents must be applied for in each of the member states, thus increasing costs of this procedure twelve-fold.

Strengthening the EEC steel producers through any and all means is the only way which this management team expects to compete with third country producers.

5.3.9 Germany: Company A Research and development services

Background

Company A does contract research and development for third parties. It is part of the an international network of research centres of which the main centre is located in the US. Legally the organisation is set up as a charitable foundation but its profit making activities make up the bulk of its work. There are sister centres within the Community in Italy, France and the UK. The company employs 600 staff.

Use of business services

The broad picture regarding the use of internal and external business services is as follows:

- engineering and related services are provided more externally than internally. Architectural and interior design services are wholly externalised as are most building requirements, though there is an internal building service for small projects. Project management is wholly internal,

- limited use is made of external consultancy. Recruitment is handled externally and there has been a strategic consultancy programme, but otherwise the company relies on its own resources,
- advertising is always commissioned to outside agencies, though is limited in its scope,
- research and development, which is the company's own business, is naturally done internally, though certain types of development may well be sub-contracted to another party,
- for financial review, the company is externally audited but performs its own internal audit,
- the company has operational services performed externally, including travel and catering and has most of its security services externalised,
- legal services are performed by a combination of external and internal services, with routine matters handled internally and litigation externally,
- computer services are provided entirely by internal resources.

Overall the company uses an equal mix of external and internal services. With its own product dependent on technical expertise, technical services such as research and development, and computing, are resourced internally while for professional services, including a major strategic consultancy exercise which looked forward to the year 2000, external services are used.

Decision making

The organisation put the highest value on three selection criteria: quality of service, availability of service and the international capability of a service provider. This last criterion is

particularly important as the company requires its services to be delivered to all its operation in Europe. Regarding the timing of procurement decisions, some are made on an annual basis and others on a more long term, three to five year basis.

The company has been in process of externalising many services in recent years. They are as follows:

- public relations was externalised in 1982 because internal resources did not have the experience to do international public relations and the international dimension of the company had become much more important,
- strategic consultancy was commissioned in 1985 because it was thought that rapid technological change called for a strategy, which until then had never been formulated,
- security was hived-off in 1984 for cost-saving reasons,
- certain technical workshop services was also externalised in 1985 for cost reasons,
- translation services were contracted out for cost and flexibility reasons, though this has not been a success because translation agencies have not produced the same quality of work as the internal service. As a consequence the department has been built up again.

The company was unable to provide information about costs of business services, although it did have information about the employment implications. The losses as a result of contracting out are as follows:

- translation; three (but two were subsequently re-employed),
- publications: three,
- security: four,
- technical workshops: five,
- cleaning: four.

The net total of 19 jobs saved is just over 3% of the total, which is one of the highest percentage job reductions encountered.

Business services and the internal market

The company has made considerable use of foreign business services, almost always because the type of service available, namely one offered on an international basis, was not available from a solely German firm. For personnel, for example, the company needs to recruit from an international pool of technologists. Public relations need to be tackled on a worldwide basis, as does audit. The same applies to strategic consultancy as the consultant must have global experience of the appropriate technologies. In no cases are the foreign suppliers engaged because they are less costly.

The company has encountered only one problem in the form of trade barriers in services, though it has been significant at times. Some governments take exception to the company building a significant level of foreign sub-contracted work into services provided to the public sector. There is inevitably a high level of sub-contracting of specialist work within an overall R&D exercise being performed for clients so a public procurement attitude of this kind can be very restrictive. Otherwise, the company does not feel that there are any other barriers to its access to business services.

5.3.10 Germany, Belgium, Netherlands: Company B Packaging products

Background

This is a well established firm with administrative headquarters in The Netherlands and operating subsidiaries in Belgium and Germany with a turnover of around 170m Dfl in 1985 and 630 employees. The firm's assets are split among five production facilities and other investments.

This firm reports sales per employee at some 370,000 Dfl per year. Automated production facilities are run by skilled labour and supported by a myriad of service specialists ranging from technicians to graphic design and production assistants. The sales and administrative staff conducts business throughout Europe and the Middle East and is supported by financial, marketing, promotion and legal experts.

Use of business services

The firm uses most tradeable business services. The nature of the paper and packaging business places emphasis on design services and process engineering services as they relate to production. The international nature of the firm's marketing activities has meant that legal and administrative services related to patents and trademarks and shipping services are very important. There is an overall increase in demand for all services as the company is growing both organically and through merger and acquisition.

Decision making

This firm has adopted a management philosophy of quality in production. This has been the justification and motivation to turn outside for key services. Decisions to procure from the outside market are based primarily upon internal demand for the service required. When the demand increases to a point which justified hiring a specialist to work for the company, it does so in order to control quality. This policy is most easily applied to specific operational services such as design and engineering services where requirements are constant.

Those professional services which are required intermittently or for one-off special purposes are bought from outside services. The precept of quality prevails in decisions on purchasing external professional services as well as for internal functions.

The cost of the service is the second important criterion for selecting a service provider after the decision to buy the service from an outside vendor has been taken. Availability of appropriate service is also a key consideration.

A breakdown of costs of services is given in Table 21.

Table 21 Germany Company B: Expenditure on external services
(000 DfL)

<u>Service</u>	<u>1982</u>	<u>1983</u>	<u>1984</u>	<u>1985</u>	<u>1986</u>
Project engineering	546	906	761	442	441
Transport	3,595	4,040	9,912	5,170	4,952
Design services	1,271	2,082	2,042	2,072	2,029
Storage	204	229	365	333	401
Security	75	113	128	119	143
Consulting	307	358	171	366	360
Auditor	165	146	90	156	152
IT services	49	323	70	68	117

Business services and the internal market

The firm has experienced some problems in identifying and buying specialised services in its home markets and from markets across Europe. The need for advanced skills in packaging engineering has not been easily met by the European market. The management of the firm attributes this in part of the lag in research and development in packaging in Europe and in part to the highly fragmented market. Quality engineering services have been obtained in America to put to use in European production facilities. The explanation is that the American industry is well organised via national associations and easily accessed.

The dismantling of barriers to transport is the most likely to effect this company. Much of its business flows to the UK and France where it does not presently have production facilities. Therefore, shipping costs as measured in time and charges is very important. Any reduction in costs will make it even more competitive in the EEC market.

The firm recently designed and built new production facilities using local and UK design specialists. A problem related to the restrictions on architects qualified in one country being accepted in another caused some delays and confusion on the project. Such licensing or qualification-oriented barriers are impediments to doing business in Europe. The removal of these barriers are likely to increase operating efficiencies.

6. THE COSTS OF NON-EUROPE FOR BUSINESS SERVICES

6.1 Background and methodology

In order to quantify the economic and financial costs of non-Europe for business services we used a number of sources. The literature review and the Peat Marwick McLintock factsheets provided background statistical information about the business services sector and the underlying economics of externalisation. The factsheets also discuss the current state of internationalisation of business services within the Community. The demand and supply side surveys and some existing econometric studies provide the mechanisms by which to quantify the effects of completion of the internal market.

Four factors complicate the analysis of the cost of non-Europe in the case of business services:

- relative lack of statistical information,
- absence of existing studies in the area of service sector trade barriers,
- the lack of perception of barriers by questionnaire respondents,
- complexity of quantifying indirect effects for an intermediate service.

Given these difficulties the emphasis in this section is on a discussion of the elements of the costs of non-Europe supported by quantitative assumptions as to the range and likely values of these effects. (These effects are summarised below in Table 24).

6.2 The size of the business service sector

The Peat Marwick McLintock factsheets yielded estimates as to the size of the business service market in the Community. Turnover figures are shown in Table 22.

Table 22 Business services turnover, 1986

<u>Sector</u>	<u>Turnover</u> bn ECU
Engineering & Related Services	7.5
Consultancy	3.5
Advertising (1)	57
Public Relations	2
Computing Services	13
Research & Development	15
Financial Review	13
Legal Services	13

TOTAL	124.0
	=====
(1) including media costs	

Business services are an important sector in the Community economy. The sector is also one of rapid growth even when compared to other service industries.

6.3 Effects of the removal of business service barriers

Respondents to the demand-side questionnaire were asked about the likely effects of removing business service barriers.

6.3.1 Changes in demand for business services

Even in the cases in which barriers were recognised over half of the respondents did not consider that removal of these barriers would affect purchases of business services.

6.3.2 Price sensitivity

Companies were asked to assess the price reduction for business services which would be required to induce additional purchases. Although average response was in the region of 10% there was a considerable spread from 5% to 20% plus.

6.3.3 Effect on company sales

Of those companies recognising barriers to trade in business services 40% considered that removal of those barriers would have no effect on sales and 46% thought that sales would increase by up to 5%. The remainder anticipated larger increases.

Almost equal weight was given to the following factors as explanations for anticipated sales increases:

- reduction in product prices,
- improved competitiveness,
- ability to enter new markets in Europe,
- generally faster market growth.

6.4 Cost of non-Europe

We have divided the costs of non-Europe for business services into four sources:

- i) The higher costs of business services which results from limited competition.
- ii) Lower output across the economy which results from these higher business service input costs.
- iii) Lower demand for business services which results from higher costs and more limited range of business services.
- iv) Lower levels of (cost-saving) externalisation which result from higher costs, and more limited range, of business services.

The completion of the internal market for business services can therefore be expected to produce the following corresponding benefits:

- i) Savings due to reduction in business service prices.
- ii) Increase in output across the economy.
- iii) Increase in output of business service sector.
- iv) Savings due to increase in externalisation of business services.

In the commission's model of direct and indirect effects, the i) above is a direct effect of removing business service barriers. Effects ii) to v) are the indirect effects on the economy as a whole of the completion of the internal market for business services. One should stress however that these are effects of removing business service barriers in isolation. In reality completion of the internal market as a whole will result in changes in many sectors, which will impinge on the business service sector.

6.4.1 Reduction in business service prices

One of the fundamental arguments for an internal market is that opening sectors to increasing competition will result in efficiency gains and cost savings which will then be passed on to consumers (in the case of business services to intermediate consumers). A reasonable assumption therefore, is that business services prices might gravitate to those of the state which is currently the most efficient producer, or at least move part of the way to that level.

There is very little comparative information on the cost structures of business services, thus limiting the analysis which can be undertaken. The information which is available relates only to general consultancy, accountancy and tax consultancy. The figures suggest that converting all prices using purchasing power parity to reflect differing local overheads in different markets, and if all producers of business services were to reduce costs to that of the most efficient a maximum

reduction of 15% might be expected. If all prices were to fall to the current average level (a working lower limit assumption) then a reduction of 3% might be expected.

However, this rather simplistic analysis needs to be tempered with the conclusions of the demand-side and supply-side surveys. One of the main conclusions of the demand side survey was that quality of business services was a major factor in determining demand - frequently costly services were used for reasons of quality, even though cheaper were available. Such behaviour tends to support the view mentioned in many of the supply-side interviews that competitors are not likely to enter new markets by price cutting, but rather by offering an improved product. Clearly this does not imply that business services clients will not be better off; it does however make it very difficult to quantify the gains to be made.

This view is further supported by the fact that when companies do go to foreign companies for business services almost because of availability or quality reasons and not for reasons of cost.

It must also be stressed that even now very few respondents on the demand side recognised any barriers other than "fact-of-life" type barriers (such as language and proximity) to prevent them already from obtaining the best possible service in Europe. This was borne out by those on the supply-side of the business service sector, most of whom did not foresee a significant fall in price.

Combining these survey results with the fact that the statistical comparison of cost is limited by lack of data and narrowness of coverage it seems reasonable to assume that the 3% price fall mentioned above might be seen as the most likely estimate of cost reductions to be expected from the completion of the internal market in business services. Based on existing turnover and a price reduction of 3%, the cost savings to users of business services will be around 3.5 bn ECU.

The gains in efficiency made from access to better quality services may be considerably greater but they cannot be quantified. It is also clear that there will be differences between sectors. Sectors

in which substantial barriers exist (e.g. consulting engineers) may witness larger price falls than advertising which already has a high degree of internationalisation.

6.4.2 Increase in output in all sectors

Any reduction in the price of business services or improvement in quality will ultimately have a positive effect on demand for the final output of business service consumers, and for goods generally.

Several factors must be considered, however when the extent of this increase in demand is assessed. Firstly, externalised business services represent only a small though increasing proportion of a firm's total costs (typically in the region of 3%). Secondly, the hypothesis of section 6.4.1 is that prices of business services will not fall greatly. Thirdly, and confirming the first two points, demand side respondents did not expect a large increase in general sales as a result of the removal of barriers to business services. Even in instances in which business service barriers were recognised, effects on general sales were not perceived to be significant. The general effect on sales of around 0.1%, and maybe less seems reasonable. A range of between 0% and 0.2% (0 to 3 bn ECU) might be the lower and upper limits.

6.4.3 Increase in business service output

A relative price reduction and general increase in economic activity will, via price and income multipliers, increase the demand for business services. The conclusion of the demand side survey is that price elasticity is low. Competition is mainly on quality, and respondents indicated that an average 10% price reduction would be required before any increase in demand for business services would be realised. However, there was a considerable spread around this average. There is no econometric work specifically on a price or income elasticities of business services but there are figures for the service sector as a whole: we have used these as a base for estimating business service elasticities. Income elasticities in the service sector seem typically in excess of 1%. Our survey results point to a very low price elasticity but a reasonably high income elasticity of demand for business services, most probably higher than for services as a whole which includes income inelastic government services. Long run price

elasticity of 0.2% and a long run income elasticity of 1.4% was a reasonable working assumption using these figures. The increase in demand for business services derived from a relative price reduction and income growth, range between 0.7 and 2.5bn ECU.

Table 23 Elements of the costs of non-Europe

<u>Element</u>	<u>bn ECU</u>
Fall in prices of business services	0 - 3.5
General sales growth	0 - 3.0
Growth in business service sales	0.7 - 2.5
Savings due to increases in externalisation	0.1 - 0.2

6.4.4 Increases in externalisation

Increased competition in the business services market will reduce costs, improve quality, increase availability and improve the information and marketing of business services, consequently increasing the degree of externalisation (that is the number of services externalised). The demand side survey has revealed that this leads to cost savings. The true opportunity cost of non-Europe from this source is the net gain, since externalisation implies a transfer of jobs and income from the consuming sector to the business service sector.

The demand side survey suggest that of those firms recognising business service barriers (a small proportion) only about half, representing 8% of the sample, expected to contract out more services on their removal. This small figure is again consistent with the finding that business service barriers are not substantial. The increase in externalisation from this source is therefore unlikely to be very significant and overall business service demand is unlikely to rise by more than 1% from this source (on the basis of demand side questionnaire responses). This represents a maximum gain of 1.25bn ECU for the business service sector and, on the basis of 10 to 15% savings stemming

from externalisation, and on the fact that business services account for only 3% of total costs, it accounts for a 0.1-0.2bn ECU saving on the cost of business services to consumer companies.

6.5 Conclusions

Table 24 summarises our estimate of the costs of non-Europe.

Table 24 Estimates of the cost of non-Europe

	<u>Direct effects</u>	<u>Range (bn ECU)</u>
i)	Higher costs of business services	3.5
	<u>Indirect effects</u>	
ii)	Lower output in whole economy	0-3.0
iii)	Lower demand for business services	0.8-2.5
iv)	Higher costs from foregone externalisation	0.1-0.2

The corporate sector has for several years been in a process of externalising many of its business services and this process is clearly continuing. Moreover this process is economically beneficial, largely because of the higher quality of service which specialists are able to provide, but in some cases also because there are cost advantages.

In contrast to the purchase of goods as inputs into their products, firms are not inclined to look abroad for the provision of business services. It is clear that some trade barriers exist for several services, even though they have limited effects in impeding trade. In general, however, these barriers are not acknowledged by service users, largely because of their tendency to rely on domestic provision. International trade in most business service sectors is low; service companies are heavily dependent on domestic markets, which have been growing strongly in most countries. This fragmentation of the market is not only unusual in comparison with the goods sector and some other services, it also seems at odds with the varying strengths and weaknesses of different countries in each sector.

The continued fragmentation of the market has effects on both providers and users of services. For providers it hinders the expansion of their services and reduces the range of services they provide in other countries. As a result it has some effect of inflating prices (effect i) above).

However it has more significant implications in terms of the quality and range of service available, which is a more significant determinant of whether business services are purchased from outside. Thus the use of external business services is lower in a fragmented market (effect iii) above). This in turn means that the benefits of the foregone externalisation are lost (effect iv) above) and output as a whole is reduced (effect ii) above).

DEGREE OF EXTERNALISATION OF BUSINESS SERVICESTYPE OF SERVICE

	<u>Degree of Externalisation</u>			
	<u>E</u>	<u>C</u>	<u>I</u>	<u>S</u>
1. <u>Engineering & Related Services:</u>	56	28	14	2
a. Building, construction and maintenance	51	34	11	4
b. Architecture	74	18	7	3
c. Interior design	56	27	18	1
d. Industrial (project management)	30	39	29	2
2. <u>Management Consultancy:</u>	35	25	37	3
a. Strategic consultancy	40	21	35	4
b. General management	45	16	37	2
c. Human resources	38	34	25	3
d. Marketing and economics	30	40	27	3
e. Financial management	18	33	45	4
3. <u>Commercial Communications:</u>	29	27	42	2
a. Advertising:	49	25	24	2
- media	63	29	6	2
- sales promotion	30	30	37	3
- direct marketing (mail, telephone)	38	30	32	0
b. Public relations:	11	30	59	0
- press/media relations	19	32	48	0
- shareholder relations	6	38	56	0
- employee relations	3	24	73	0

		<u>Degree of Externalisation</u>			
		<u>E</u>	<u>C</u>	<u>I</u>	<u>S</u>
4.	<u>Computing Services:</u>	22	55	26	0
	a. Software development and maintenance	7	75	20	0
	b. Remote data processing	6	56	38	0
	c. Computing strategic consultancy	29	47	24	0
	d. Information services	13	51	36	0
	e. Communications services	20	25	55	0
	f. Facilities management	9	30	61	0
5.	<u>Research & Development:</u>	12	23	58	7
	a. New product or service development	11	26	58	5
	b. Licensing/patent/technology development research	17	15	58	10
6.	<u>Financial Review:</u>	50	18	30	2
	a. Internal audit and reporting	15	20	62	3
	b. External audit and review	82	16	2	0
7.	<u>Operational Services:</u>	58	17	22	3
	a. Travel services	74	13	8	5
	b. Catering	61	16	20	3
	c. Security	43	20	34	3
8.	<u>Legal Services:</u>	41	37	21	1
	a. Corporate legal matters	42	47	11	0
	b. Patent, trademarks	51	31	14	4
	c. Personnel/employment related	36	33	30	0
	d. Export/import related	31	37	30	2

NOTES

E: Degree of pure externalisation (= E/T)

C: Degree of combination (= C/T)

I: Degree of pure internalisation (= I/T)

S: Degree of subsidiary provision (= S/T)

Where total = T = E + C + I + S.

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