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Services in European Policies♣

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Abstract

This paper's objective is twofold. Firstly, it presents the case for services-related policies in the current European Union (EU). The services economy is frequently misunderstood, due to old and new myths that stem from the classic economic tradition. These myths obscure the role of the services economy in economic development. Nonetheless, the European services economy faces specific problems, such as lack of market integration, which amplifies arguments that justify policy actions toward services within a framework where market and systemic failures do apply. Secondly, this paper focuses on existing services-policies at the EU level, paying special attention to the internal market for services policies and to the complementary role of primarily non-regulatory policies. Within a comprehensive policy framework, each individual policy will have a higher impact, improved implementation and easier acceptance. Synergies among services-related policies should be promoted; the internal market policies, enterprise and industrial policies, competition policies and regional policies may take the lead in such a framework. Since the Lisbon Strategy, services have begun to gain recognition in EU policy agendas. This paper attempts to increase their visibility and to highlight their crucial role in European integration and in economic growth and social welfare.

Keywords: Services, Economic Policy, Europe, European Union.

JEL codes: L80, F02, F15, F53

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1. Introduction

The Lisbon Strategy is a milestone in the European construction project aimed at turning the Old Continent into a new global engine of growth and welfare. The objective of transforming Europe into the most competitive power in the world was proposed in the Lisbon Strategy. Services are incorporated in this ambitious aim as a reality in need of stimulation. The Lisbon Strategy suggests the re-launching of the internal market for services, on a path from the Internal Market for Services strategy designed towards the end of the year 2000 to the recently approved framework directive for services, dated November 2006. However, what was pursued in these six years is far from fully accomplished with the Directive. At present, services require attention beyond the objective of the Directive, quite apart from the many controversies about the framework directive.

When the Lisbon objectives where critically reviewed at the end of 2004, services clearly required priority attention. If references to services were more or less marginal in the Lisbon documents of 2000, despite the fact that these promoted the Internal Market for Services Strategy, services appear recurrently in the Kok report of 2004. The new Commission renamed the DG for Internal Market as DG for Internal Market and Services, assuming some of the responsibilities previously belonging to the DG Enterprises. The period from 2004 to 2006 used a three-track approach to services, with several ongoing initiatives, formulated between 2000 and 2003, and the new boost to the internal market, as well as the proposal for the framework directive presented and discussed at the beginning of 2004. However, only some of the services proposals previously formulated were developed by 2005 and 2006 and indeed only marginally so, and the famous services directive had reduced in scope and ambition.

Within this policy context, it seems appropriate to rethink and discuss services policies, from their justification until the presentation of the current framework of ongoing policies. The majority of services-related policies are still in an embryonic stage, so they require particular consideration. This policy paper deals with the contents of the services-related policies, paying special attention to the internal market for services policies and complementary or mainly non-regulatory policies, in order to show the usefulness of strengthening synergies and possibilities of combined services policies.

2. Myths, realities and challenges in the EU service economy.

Many services-related policies are responding to market failures that justify the regulations and actions undertaken by public administrations. However, there is also a series of context factors that calls for action in the services world. On some occasions, these factors are based on specific problems in the services economy, such as their apparent low productivity, or on the segmentation of European markets, which affects the exploitation of the internal market for services. In fact, some of the problems of the services economy result from an inappropriate interpretation of reality or maybe from several myths inherited from the classical tradition that considered services as secondary activities of economic growth. Adam Smith (1776) stated that services did not generate value ("…seldom leave any trace or value behind them for which an equal quantity of service could afterwards be procured") — and the neoclassical economic theories were developed as part of the goods economy and therefore not specifically relevant to the services economy.

Nowadays, this economic tradition has been amended, although there are some strongly surviving myths with respect to services. These myths are built around actual facts that require policy attention. Four such myths and their policy implications are discussed (these topics can be consulted in more depth in Rubalcaba, 2007).

Myth 1: *Services contribute little to productivity growth.* Since Baumol's theories of the sixties and seventies, services have been considered relatively less productive than goods and one of the reasons for the slowdown of productivity growth in advanced economies. As economies stop being mainly agricultural or industrial, services, which are more personnel-intensive, offer a more limited margin for productivity growth and, therefore, for economic growth. Today, these theories are still around, although they cannot be applied to detailed branches of services - some are extremely productive - and although these theories and the Baumol contributions (1967, 1989) have been revised (e.g., Gadrey, 1996; Outlun, 2001) taking into consideration the methodological problems when assessing the services inputs and outputs. Moreover, some services yield productivity gains to the sectors that use them, so their direct contribution to productivity is “sacrificed” in order to favour contribution to total productivity (Kox and Rubalcaba, 2007). In fact, the crux in services is the identification of sectors and regions with a large productivity growth potential, which is worth promoting by policy actions.

Myth 2: *Services have less room for innovation and new technologies*. The myth of productivity is partially based on the difficulty services have in incorporating technology and innovations. In recent years, this idea has been demonstrated to be partly false, as services may be at least as innovative as goods (Miles, 1999, 2005; Howells and Tether, 2004; Rubalcaba and Gallego, 2007) and services innovation is positively related to the use of new technologies (Licht, and Moch, 1999; Gago and Rubalcaba, 2007). However, many services have specific difficulties in accessing technology and could require particular attention within the framework of innovation and R&D policies (den Hertog et alt., 2006, Rubalcaba, 2006).

Myth 3: *Services operate in segmented markets with little competition*. In this case, the myth involves the fact that many services operated in relatively segmented markets - a widely-known reality- prevent the working of international competition and trade. Recent studies show that, in services, actors opt for very diverse ways of internationalisation (Rubalcaba and Cuadrado, 2002), where preference for foreign direct investment is clear, despite the recent boom of international trade. Also the recent expansion of offshoring, and global sourcing in general (van Welsum and Vickery, 2005) establishes a new rhythm in the international competition of many services. Services generate dynamics that make competition in their markets possible and reproduce trends that are similar to those observed in the goods markets. Another issue is the permanence of markets that are extremely regulated and protected from international competition, even within the EU borders. The policy challenge in this case is to know how to accompany or influence appropriately the globalisation and liberalisation movements that are naturally arising in the services world.

Myth 4: *Countries with strong and high economic growth rates are those with a strong manufacturing base*. As a result of the aforementioned myths, some consider that services economies are an obstacle for growth and that the future of economic growth is in expanding goods economies such as China and other countries of South-East Asia. In fact, these expanding countries led by China are growing due to the increase of manufacturing sectors in their territories, but some of which are also starting to export services and are interacting with the services economies. The case of Ireland and the Baltic countries is significant in Europe and, outside Europe, India is the greatest services exporter leading the offshoring trends. The growth of these countries is partly due to the services trade. On the contrary, many agricultural and manufacturing economies in the world do not grow more, but less than the services economies and can be found to register very unstable growth rates and serious problems regarding competitiveness. Services can be an ally to growth and competitiveness, and there is no reason to consider them as a hindrance.

To sum up, the ideas and praxis about services have been built around a series of myths. Services have been considered less productive, less innovative, less open to trade and competition and, in general, less able to promote economic growth. However, reality has partially refuted these myths, leading to a more correct knowledge of the services economy, which could not be interpreted in the same way as the goods economy, despite the numerous similarities between them. Even so, some aspects of the tertiary sector still correspond to these myths and compel policy action in order to make these services more productive, more innovative and more able to compete in an increasingly global world. These are key challenges faced by the services economy worldwide.

3. Services and market integration in Europe, a paradox[1]

In addition to the general challenges that have been briefly described, the European case adds a specific one. There is an excessive disparity between the outstanding contribution of services to European integration and the high level of segmentation within their markets. There are many obstacles to the services movement within the EU, not only natural but also artificial obstacles, making an effective and prosperous internal services market impossible. This paradox is worth at least a brief section.

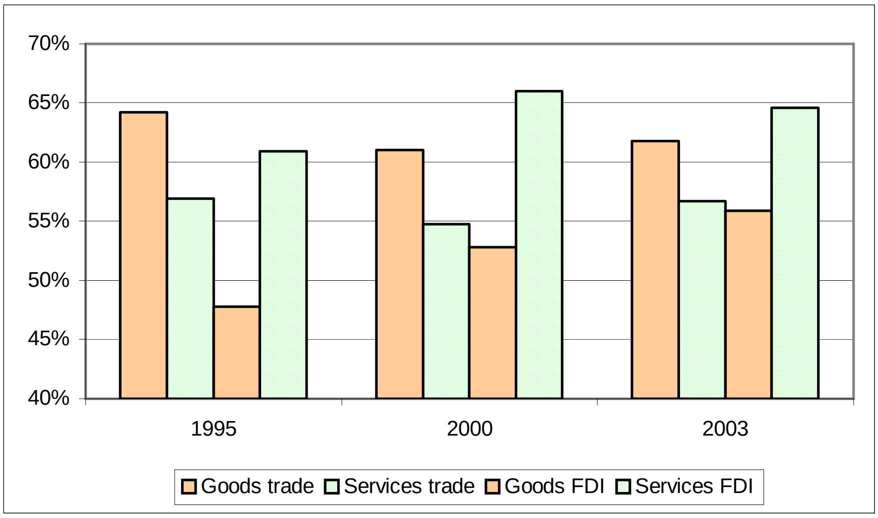
[1] Stefano Visintin has participated in the research behind this section.

Services perform a key function in building the European Union. This is carried out through four main channels:

- Services promote exchanges between EU countries: tourism, transport services, communications.
- Many services provide EU access to inputs: workers, capital, knowledge, innovation. Without the contribution of financial, personnel and ICT services, etc. the access to input would not be feasible. This is true for any geographical area but this is particularly important in the EU case, where political, economic and social links are of great significance.
- Services also provide access to new EU and world markets; services are particularly active players in market integration: fairs and exhibitions, marketing services, market research, distributive trades, communication services, etc. The case of fairs and exhibitions is particularly important, as there has been a secular instrument for the EU economic integration since the Middle Ages (Rubalcaba, 1994) and nowadays it continues to make a notable contribution.
- Services provide access to EU cultures and welfare. Leisure and sport services, cultural and educational services move across Europe promoting EU social integration.

Thus, services contribute on a substantial scale to European integration. However, services are only a little integrated themselves. An empirical analysis follows focusing on the greater relevance of the internal market exchanges with respect to the external ones. This significance is principally due to the fact that European companies share the same legal environment and business background and have to cover shorter distances in delivering their products so intra-European flows should be more important than the extra ones. These factors contribute to a fall in transaction costs and, consequently, to the rise of the trade and foreign investment levels within European borders. This should be even more important for services than for goods, given the facts that regarding services, physical, business and culture distances may be more important in co-productive and interactive activities. To evaluate the efficacy of the efforts made by the European and national institutions, data is used on service trade and FDI, both intra and extra, regarding the aggregate EU15 covering the period from the establishment of the common market until the most recent data obtainable are used.

Figure 1. Share of intra-EU flows within total flows (international trade and FDI)



Sources: based on international trade statistics, Eurostat, 2006

Figure 1 presents, in summary, a picture of the evolution of the intra-flows as a proxy indicator of the relative importance of the Single Market. A comparison taking into account the most illustrative aggregates, goods and services, and the most exploited internationalisation channels, trade and direct investment, consents to several considerations to be made. Regarding international trade, goods market integration was already a reality in 1995 and followed a trend of increased integration, while the services sector lags behind in integration presenting a less substantial index. Both internal markets have been achieving a greater importance in recent years but the globalisation boom between 1995 and 2000 created less room for relative gains of intra-EU flows, with services having a limited tendency to catch-up with respect to goods intra-EU international trade. In a more specific analysis considering different services it can be noticed that most of the services tended to slowly increase the importance of internal trade, but without a clear take off inclination in any of the considered cases with the exception of telecommunications, which seems to be the only sector with strong continental integration propensities.

The exposed weakness of intra-EU service market performance is partially due to the effect that globalisation has on external trade patterns. The internal services market exchanges, in fact, increased at an average rate of 6.1% per year between 1992 and 2004, demonstrating a particular dynamism considering that the whole European economy in the same period grew at an unexceptional rate of 2.3% per year. This dynamism, that can be considered an effect of the market creation and of all the institutional efforts in this direction, does not appear so favourable when compared with the effects that globalisation had on European *extra* trade in services that increased at an average annual growth rate of 6.81% in the same period. However some services are more committed to the internal market, like Communications or Travel services, although others are more keen to develop at a global level, as for example Marketing or R&D services, while the service aggregate is a good substitute for most of the other sectors.

Due to their characteristics, service enterprises normally approach new markets planning international strategies blending direct trade with the start-up of local affiliates, greenfield investments or mergers and acquisitions. If the analysis moves to foreign investment patterns, it can be noticed that the services sector represents the destination of the major part of the European investments, where manufacturing lags behind services in values and trends. European FDI took off after 1998 and intra-EU flows have been more dynamic than extra-EU flows. Since 1998, the gap between EU-directed and overseas-directed investment increased sharply so that in 2002, 65% of the total stock invested, against 35%, found its destination within the Union's borders. A consistent increase was experienced by the services sector, whose annual growth rate between 1998 and 2002 showed an average of 32%, while prior to that year it was 'only' about 18%. The performance of the service operators is even clearer when compared with the data from the manufacturing sector. In this case the relatively low importance of this channel in the industry appears clearly.

In a large integrated market, the most efficient firms, present in national competitive markets, have the opportunity to operate all over the European Union, forcing the enterprises previously performing in a market with low levels of competition, to increase their organisational and productive effectiveness and to reduce their mark-up. The theoretical results include higher product quality and reduced price trends. This can be interpreted as an empirical convergence of the price levels and cost factors in the tertiary sector. However, convergence will not be complete due to several factors regarding country specific differentiations. A sort of price discrimination will persist due to the continuing distinctiveness of each national market.

Data describing trade patterns suggest that the common market opportunities do not encourage European service companies to embark on the direct international selling of their products to the same extent as happened in the past with manufactured and agricultural products. Exchanges are increasing in the intra and extra scenarios, which could signify that the internal market for services is performing effectively, but European operators are still no more inclined to conduct intra-EU business than extra-EU business. The consolidation of the services market at a European level seems, instead, to be using foreign investments as a preferential channel. The direct presence of an enterprise in a member state market appears to be considered the most appropriate method adopted in the companies' internationalisation/ Europeanisation because of the special characteristics of the sector and the barriers to international trade. This way of providing services requires relatively high fixed or sometimes sunk costs in some services markets, that require a certain scale, one which SMEs often find difficult to cope with. This is one of the key reasons justifying an effective internal market policy to facilitate international trade among those companies, mainly medium size companies, having more difficulties in taking advantage of the FDI operations.

4. Economic arguments for services-related policies[2]

The arguments that economically justify a services-related policy originate from three interrelated channels: firstly, the context factors of the European services economy described above, the lack of market integration and the deficit of services regarding productivity, innovation and competition; secondly, the arguments that justify services regulation and, consequently, those policies related to the different regulation and intervention methods in the markets; and finally, there are system failures that superimpose the market failures as justifying arguments.

Let's focus on market failures and regulation. The starting point for approaching these issues is the model of perfect competition, which holds that, given an income distribution, competition leads to the highest possible level of social welfare. However, this situation represents an exception rather than the norm in economic practice: the presence of a series of economic factors, which condition market efficiency (market failures), issues related to equity that justify public intervention, or political and institutional factors. Firstly, economic factors will be considered. Situations in which

[2] Nuria Fernández has collaborated in the drafting of this section.

the market does not operate appropriately, thus generating inefficiency, are especially evident in the case of tertiary activities when a series of failures arises:

1) *Existence of public goods and services*. Within this group of products, so-called social goods and preferential goods can be distinguished. *Social goods and services* (more generally known as 'public goods') are joint-supply and non-price excludable goods. Justice and defence services, for example, have traditionally been considered to be included within the category of public services. The general feature of these services is that private provision is lower than that which is socially desirable (the presence of free riders is important in this context), so the public sector has normally been in charge of their provision (although not necessarily of their direct production). Basic services provided by public administration represent the most evident example in this area. In a context where, of late, international relations have gained a great level of importance in the so-called globalization process (manifested by growing trade, foreign direct investment and capital movements), even the existence of global public goods - whose scope gives them a universal nature - has been considered. In contrast, *preferential goods or services* fulfil, at least partially, the characteristics of private goods, although citizens exhibit irrational behaviour with respect to their demand. This is the case of services such as education, where it is estimated that citizens are not sufficiently aware of the positive effects generated in the medium and long term. Therefore, demand tends to be lower than is socially desirable; as a consequence, the public sector establishes a minimum regulation.

2) *Externalities*. When there are external effects, the utility or *production* function depends not only on elements that can be directly *controlled* by the consumer or provider, but also on other factors out of this direct control. In the case of airports, for example, the delivery of airport services generates negative externalities related to atmospheric or noise pollution, but can also generate positive externalities to the extent that the presence of an airport is a strong attraction for the establishment of surrounding business centres. It seems logical to think of the role of the public sector, when there is an externality, in creating and guaranteeing a system of property rights, enabling the agents to internalize the externalities generated, and thus maximizing the profits obtained (Coase, 1960). However, the conditions required are sometimes highly restrictive and virtually non-existent in practice, hence alternative strategies are set out. Cullis and Jones (1987) suggest some possible alternatives: fiscal action or

establishment of a tax in the case of negative externalities; regulation; subsidies to those affected or to those generating the effect so that they reduce – or promote, in the case of positive externalities – production or use alternative methods to control the externality in question; and also the direct production of the goods or services generating the externality in the public sector.

In the case of business services, Kox and Rubalcaba (2007) analyse the effects of social externalities. External effects arise when transactions between suppliers and buyers of business services have welfare effects on other producers or consumers that are not taken into account by the transaction partners. External effects are not reflected in the costs and prices of the business-services products. As a consequence, the market price for the delivered service is – from a social perspective – either too high or too low. Intervention in markets for a number of knowledge-intensive business-services products has long been based on the social externalities that go along with these services. Specific examples of such services and the social externalities involved are accountancy (guarantees reliable financial information, which is essential for trust in capital markets and the financial system as a whole); legal services (lawyers, notaries; upholds the legitimacy of the constitutional state and the legal system); engineering (underpins the liability of technical systems); architects (upholds the amenity value of the urban environment, and the quality and aesthetic value of housing and other buildings).

Another specific case has been analysed in the framework of innovation policies (Rubalcaba, 2006). Externalities are derived from the public nature of knowledge and its spillovers, which generate problems of appropriability and the use of innovation without the need to pay the market value (free-riding). This market failure justifies the intellectual property protection policies (intellectual property rights) on the one hand, and direct government intervention on the other hand, although the latter is only justifiable where the intervention implies the maximization of net social welfare. As far as services are concerned, appropriability problems seem to be even greater than in the case of goods, due to the limited use of patents and the insufficient protection offered by copyright systems. Scale economies are related to the indivisibility of technological activities requiring a minimum critical mass. The problem of indivisibility in the world of services is probably less than in the case of goods, where R&D processes are better structured and require a higher quantity of inputs. As innovation processes are more diffused in production processes in the case of services, it seems to be easier to reach a critical mass. On the contrary, when innovation effort concerning inputs is put into qualified human capital, an active policy is justified in the field of education and training. At the same time, services are SME markets to a larger extent than goods markets are. This reinforces the traditional justification of SME-oriented policies, where reaching a critical mass and sufficient human capital may be more difficult.

3) *Market power and natural monopoly*. A natural monopoly arises where production minimizes costs when concentrated in a single company. Therefore, it is more profitable that the whole market demand is *satisfied* by a single company than by several competitors. In other words, the natural monopoly is defined as the industry in which the cost function is subadditive. However, as Baldwin and Cave (1999) indicate, the determination of an activity area as a natural monopoly is an extremely complex process. Moreover, a situation of natural monopoly can be altered over time, when changes occur in demand or technology, and are reflected in production and cost functions. By its nature, when a natural monopoly is controlled by a private company, it will produce a lower quantity than the social optimum and at a higher price than is competitive. The benefit to consumers will therefore be reduced (which will be superior to the total production cost, regardless of whether production is attractive to the private company), resulting in incentives for the intervention of the public sector, responsible for the provision of the goods under the most favourable conditions for consumers. Network services have traditionally been the paradigmatic examples of natural monopolies. However, technological advances and variation of demand have caused a change in the market situation, which, alongside the verification of a lower efficiency in those situations where market power exists, has led to a re-definition of those markets. Nevertheless, market power is an important characteristic in most services markets, where segmentation and niches prevail in oligopolistic or monopolistic competition and other "non-perfect competition" market structures.

4) Asymmetric or imperfect information: agents participating in the market do not have access to the same *information*, so the negotiating role in the exchange process is uneven. The most generalized problems in this field are known as *adverse selection and moral hazard*. In some professions, such as medicine and law, attempts have been made to find a solution to the difficulties generated by adverse selection through obligatory certificates or licences, which enables customers to receive a minimum level of information about providers. The most recurrent example of moral hazard is found precisely in the services sector (where this market failure is more common), in the market of vehicle insurance. Coverage of car accident risk can result in a less preventive attitude of policyholders. Therefore, the average accident rate of the population insured is higher than the average of total population. The methods used in this field to increase and homogenize the existing information for all market participants essentially consist in requirements of certifications, licences, product standardisation, etc.

5) From the perspective of equity, the provision of the so-called ‘universal services’ or ‘services of general interest’ is suggested. These are essential services to the extent that they provide security, equal opportunities, or respond to other ‘social responsibilities’, with low-income citizens having a guaranteed access. In such cases, the public sector is responsible for the provision of these services, whose characteristics (large highly-specific investments, scale, scope and density economies, mass consumption, high politicization and small supplying agents) prevent the market from becoming the most appropriate allocation method. According to the EU Green Paper on Services of General Interest, this concept covers "*a broad range of different types of activities, from certain activities in the big network industries (...) to health, education and social services.*" These are the basic needs of population, to which access must be guaranteed under affordable conditions.

Apart from these economic factors, other political and systemic factors can explain regulation and related-policies – although the political and economic aspects are not entirely independent. The aforementioned basically prevents the application of the so-called public interest theory. This is clearly insufficient to explain the important broadening and increasing intensity of regulation that occurred after the Second World War, despite the general perspective from which the concept of ‘public interest’ can be defined, especially on the European continent. Other parallel theories related to private interest have been suggested (within the framework of Public Choice or the economic theory of regulation and rent seekers). Moreover, institutionalist theories provide other factors that determine regulation, based on the existence of social and institutional conditions that affect the behaviour of economic agents.

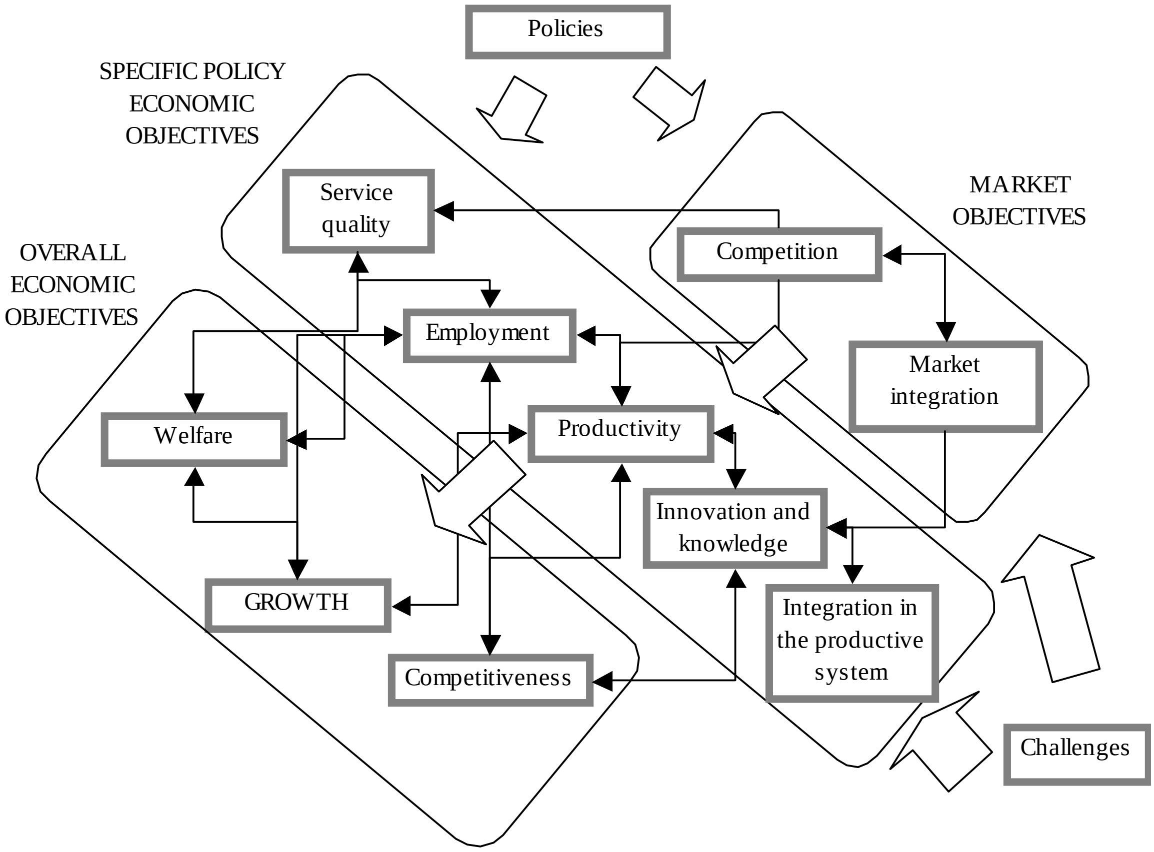
On top of market failures, systemic failures provide powerful arguments for service-related policies and related regulations. Examples are provided by the lack of servicefriendly innovative systems (e.g., R&D programmes directly addressed to non-service industries), financial shortages (e.g. due to the underassessment of intangible assets by the financial system), or institutional asymmetries at regional level (e.g.: due to the lack of advanced services in many less-developed regions). A particular application of systemic failures is useful to justify innovation and R&D related policies (Rubalcaba, 2006).

A final line of argument justifying service-related policies can be identified for the European case. An integrated and structured European service market means an efficient economy where potential macroeconomic shocks are smoothed out and competitiveness is high. This provides the EU with a stable growth pattern in terms of welfare and employment and benefits to consumers who can enjoy a variety of high-quality and competively-priced services.

5. The framework of service-related policies: objectives and synergies

The wide range of factors justifying intervention in services markets and in the systems where these develop, leads to suggest a policy action framework that combines actions on two different levels. The first level is related to regulations and related policies. At EU level, these policies are those regarding competition or the internal market. Moreover, there is a second level of mainly non-regulatory policies that, although having regulatory implications, imply indirect or complementary interventions in the markets in order to correct market or system failures whose resolution surpass the regulation scope. The author of this paper understands that the objectives of some of those policies will only be fully reached if joint progress is made within the group of policies at both levels, and not only at one of them or in one specific type of policy. For example, the need to promote competition and regulation harmonisation within the European Union in order to gain competitiveness and confront the challenges set out at the beginning of this paper, will only be effectively achieved if all services-related policies are coordinated so that a real complementary situation exists. In fact, the objectives of the complementary policies are the same as those of the regulatory policies: growth and employment, innovation, competitiveness, competition and market integration. Achieving this is the way to confront the stated challenges, such as comparative backwardness regarding productivity, competitive weaknesses within the globalisation and the offshoring process, R&D deficit or the heterogeneity of regulations and the lack of market integration and competition. Figure 2 illustrates the different interactions between the objectives of service-related policies.

Figure 2. Interrelations of services policy objectives

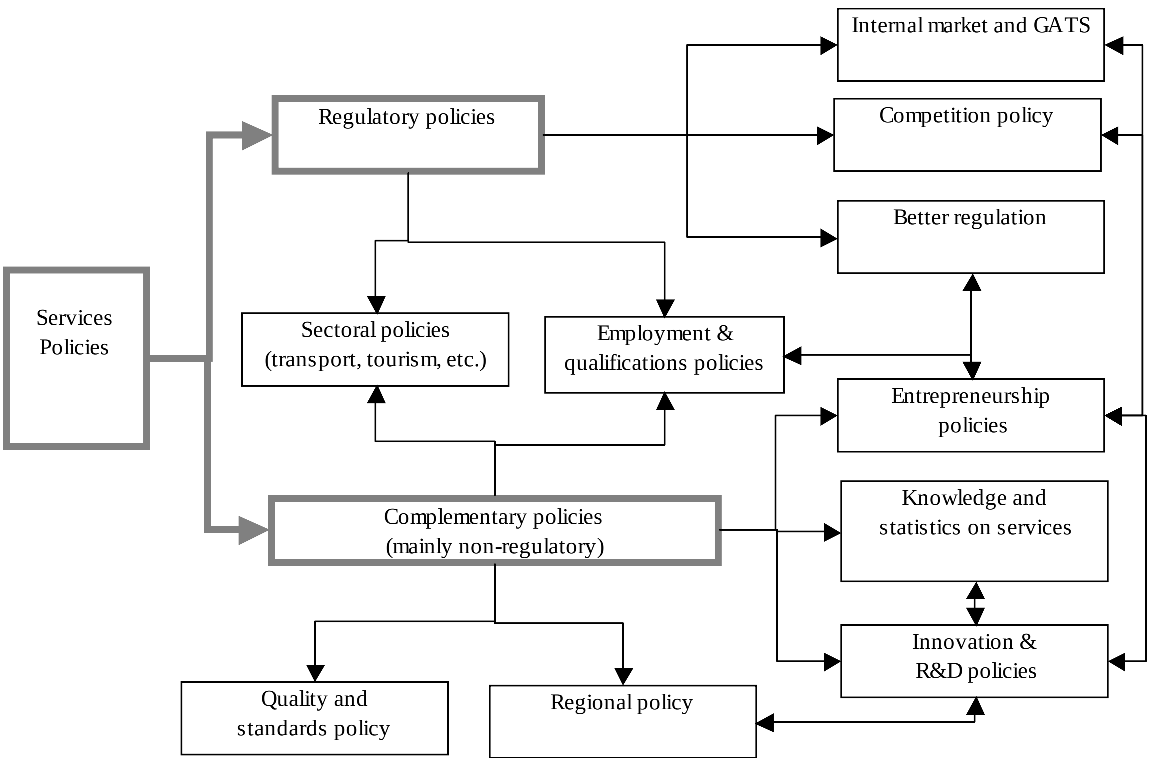


Complementary policies are imperative in order to achieve all the objectives of a services policy. Regulatory policies influence market conduct and aim to pursue particular objectives this way. However, although this is essential, it is not enough to achieve the specific objectives in areas such as services innovation or quality. Other policies must act directly on a series of intermediate objectives on which regulatory policies interact. Finally, the intermediate objectives help to achieve the predominant objective of growth and two other interrelated objectives: welfare and competitiveness.

Obviously, policies have a greater effect on some objectives than on others. For example, competition policy will particularly affect the competition in the internal market, although its application will benefit innovation and growth. Internal market is intended to improve market integration, but this also implies stronger growth and more employment. A policy of services innovation leads to a company's competitiveness, which takes advantage of these investments, and in doing so improves its competitive capacity and possibilities regarding growth and profit.

Therefore, figure 3 shows the six major objectives analysed before, from which the main regulatory and non-regulatory policies are derived. In the case of sectoral policies (transport, tourism, financial services, etc.), as well as policies on employment and qualifications, attention must be paid to both categories. For example, labour market regulations, and also training and qualification policies (non-regulatory to a large extent) are a key factor concerning employment.

Figure 3. Basic policies for a competitive services economy



The diagram includes those policies planned for the promotion of entrepreneurship, which is largely related to all the other policies, whether regulatory or non-regulatory, although particularly to policies on regulation, innovation and competition improvement. Innovation and R&D policy is also linked to regional policy and to that intended for the improvement of statistical and analytical knowledge on services, as will be seen further on.

Complementary policies are necessary for various reasons. Firstly, to amplify the effects intended by legislative or regulatory policies. For example, competition or internal market policies are not sufficient to foster the objectives pursued by them. Competition policy is not enough to guarantee fair competition, but an economic framework is required which renders competition effective.

Moreover, a policy on internal market is needed but is not sufficient for an internal market to function well. While a single market would be possible from a legal point of view, companies could keep on operating in fragmented markets or on a small scale. In order to facilitate effective competition and market integration, other types of secondary tools would be required.

The second reason justifying the complementary policies is the need to face specific problems derived from a framework traditionally orientated to goods industries or infrastructures. Quality, innovation or regional policies have usually been directed towards agriculture, manufacturing goods or infrastructures, and services have remained in a second or third position. Even those policies that are allegedly horizontal, with no sectoral priorities, have been designed in such a way that services have found limited space for their development. Some sectoral aspects have recently been taken into consideration in these and other policies, so that services have a greater scope of action.

The third reason arises as an effect of globalisation. This has increased competition between countries, with companies requiring administrative support in order to reinforce some strategic areas, to define high-quality differentiated services, or to provide incentives to promote competitive production in less-developed regions, to name just a few. The challenges of globalisation demand a combination of different policies in order to achieve a greater effectiveness of objectives regarding competitiveness.

Fourthly, there could occasionally be some policies pursuing contradictory objectives, requiring an approach that reinforces synergies and minimises conflicts. For instance, an interventionist regional policy for the promotion of public services could result in the distortion of competition, which prevents private companies from operating, and in so doing, the attainment of an objective –growth, employment or innovation in a region – may imply the reduction of competition and competitive capabilities in such a region. In the long term, however, this type of action generates a net damage, since the exclusion of the private sector could bring net losses in a local economy. Another example of possible contradiction in quality policies can be found. The guarantee of high quality standards implies, without any doubt, an initial benefit to the quality of services. However, this could also be a concealed protectionist measure to guarantee monopolistic incomes, for example, when quality standards are mandatory and hinder the entry of new agents. In the final analysis, the lack of competition does not only have adverse effects on competition but also on consumers, so that theoretically, the ultimate effect on almost all objectives to be attained is clearly negative. A third example consists in liberalisation without guaranteeing the appropriate regulatory conditions. The mere liberalisation of certain sectors can generate problems associated with the abuse of market power or problems concerning investments and services guarantees for consumers if this process is not underpinned by regulatory measures: market competition and the sustainability of the sector must be ensured, for example, by means of investment guarantee systems. Generally, there is a need to coordinate regulatory policies and policies regarding internal market and competition, as seen in the 2006 debates concerning the directive on services in the internal market (some opposing opinions argue that the great heterogeneity of regulations within Europe could generate asymmetrical effects, which certainly reveals a deficiency in the process of European construction) or in the debate on the internal market of energy (where the need for DG Internal Market and DG Competition to work together in order to solve the contradictions arising from the current strategy of European construction has become evident).

In fact, if the referred policies are taken into consideration jointly, some could be complementary to others: the regulatory ones to the non-regulatory ones, and also within each of the groups, as previously seen. This complementarity acts in all possible directions. A coherent approach to services policy requires the reinforcement of synergies among the different types of policy. Table 1 shows some examples regarding competition policy. Other examples are found in Pelkmans (2006a) about the complementarities between internal market policy and industrial policies; he also argues for a complement of the internal market for services with horizontal policies related to ICT services, useful for any industrial sector.

Table 1. Necessary complementarity between services policies: some examples for competition policy

Specific initial objective	***Policy developed***	***Potentially negative secondary effects***	***Specific secondary objective***	***Complementary policy***
Complementary use of competition policy				
Removal of legal barriers	Internal market	Competition problems	Competition	Competition policy
Promotion of services in poor regions	Regional policy	Marginalisation of private sector	Competition	Competition policy
Competitiveness vis-a-vis third countries	Quality policies	Concealed protectionism	Competition	Competition policy, internal market and GATS
Policies complementary to competition policy				
Competition	Liberalisation of services sectors.	Lack of investments. Worse service	Sustainability of the sector, quality	Regulation
Competition. Defence against concealed state aid	State aid: limits to public services R&D	Services R&D deficit	Innovation and competitiveness	Services R&D&I policy

The contradictory or opposing effects of the application of policies can be reduced by a comprehensive view of services policies and a coordinated implementation. On many occasions, this vision is not produced, not only at a national, but also at a European level, due to the fact that each type of policy is designed and manipulated separately, with no apparent connection with the others. As far as the European Commission is concerned, there are two useful systems which reduce the incompatibility between policies: the system whereby each commissioner is obliged to follow and express his/her opinion on the pertinent issues of the rest of the Commissioners' College, and secondly, the existence of inter-services consultations where the affected services of each directorate general must deliberate on issues of concern brought forward by other directorates general. However, except for transport, and the financial sector to a certain extent, services continue to have a lower consideration in EU policies. When the European Commission changed in 2004, services were situated in a more prominent position (within the newly-named Directorate General for "Single Market and Services") which raised expectations regarding the possibility of an encompassing approach to European services, similar to that intended by the Directorate General for Enterprise and Industry for the manufacturing industry. However, it seems that rather than a specific, complete and coordinated approach to the different services policies, the pretence existing, at least for the time being (February 2007), is the reinforcement of services in the internal market, which could serve other initiatives. The step taken is important, although insufficient. Complementary policies and their coordination should have a higher ranking within the political structure of the European Union, perhaps by means of a horizontal view within the major Commission policies, approaching the service dimension of any economic activity rather than vertical specific sectors (e.g., services within the industrial policy, regional policy and so on), and by reinforcing synergies and coordination tasks.

It is worth mentioning that the emphasis on the services policies is not due to an 'a priori' principle that considers the development of specific services policies always necessary. On the one hand, because, in many cases, horizontal policies developed for the whole economy are justified, and the only requirement is a greater attention to their implications and an adaptation to services. In this sense, services-specific policies (for example, for the internal services market) will coexist with generic policies for all sectors (for example, employment policies) where appropriate. On the other hand, beyond the debate between vertical and horizontal, the reinforcement of synergies and complementarities between policies are desirable, as shown.

6. The existing EU policies towards services.

This final section summarises the main services-related policies under the responsibility of the EU Commission, which are presented and discussed in detail in the background research supporting this paper. In Europe, there are two key regulatory policies that affect services: competition policy and internal market policy. Both share the aim of increasing competition between the Member States of the European Union, so they are directed at commercial and investment operations between countries. For this purpose there are directives, control mechanisms, infringements and case law from the European Court of Justice. Competition policy guarantees the performance of those articles of the

Treaty drafted to safeguard the correct application of market criteria within the Union, and also controls monopolistic power that can lead to the abuse of dominant positions or anti-competitive mergers. The cases in services are more or less proportional to those of their economic weighting, if compared to the goods market, and are directly related to market power. Virtually all services are affected by this policy, although professional services and distributive trades less than average. In the case of professional services, the Commission prefers the first action to be taken by the Member States and the sectors alone, having frequently created self-regulation or protection detrimental to competition. Competition policy faces several challenges, such as the necessary cooperation between EU and national policies, scale changes of markets due to the emergence of globalisation in services markets, and the protectionist resurgence in some countries in 2006, influenced, among other things, by the disillusion created by the French and Dutch “no” votes on the European Constitutional Treaty the year before. This has also affected internal market policy.

Since its foundation, the EU has understood the magnitude of gains derived from the internal market and worked to construct, using the Treaty, horizontal measures such as the internal market strategy for services, and sector specific measures such as the directives on transport or financial services (Pelkmans, 2006b). Internal market policy requires more decisive action on services, according to the Lisbon Strategy. The low services integration in Europe is explained, beyond the natural barriers, by the presence of artificial obstacles that limit the growth of the sectors’ competitiveness. These obstacles hinder the opening of sectors to markets and improvements in innovation and productivity, which affect the overall economy. However, the reports of the Commission, almost unanimously highlight the importance of creating an internal market for services, at least similar to that of goods, in contrast with the bitter controversy which the Directive proposed by the Commission in December 2004 (European Commission, 2004) generated: this was politically used in the French referendum to the Constitution by those in favour of the “yes” and the “no” votes, and was drastically cut back and amended by Parliament in February 2006 and finally adopted in November 2006. The country of origin principle was the subject of many misunderstandings and opposing interests, and criticised to a large extent, despite the exceptions already included in the Commission proposal and the advantages estimated to be gained according to a few independent studies. With the approval of a very limited

Directive, the pursuit towards an internal market for services will have to take alternative directions, as well as follow a more vertical approach, sector by sector. Nowadays, it seems necessary for the internal market to go hand in hand with some actions towards a reduced heterogeneity of regulations - to avoid asymmetrical effects - and a greater importance of complementary policies - to smoothen adjustment.

Apart from regulatory Commission policies, there is a series of non-regulatory policies, and also complementary ones, aimed at responding to market failures and systemic failures in services. Many of them were already proposed in the Communication on business-related services in December 2003 (European Commission, 2003) and in the 2005 draft action plan of the EU Business-Related Service Forum (BRSF). Promoting competition and market integration through internal market and competition policies is not enough to achieve the objectives of growth, competitiveness and social welfare. A comprehensive services policy is desirable which directly affects some of the intermediate objectives having an influence on business efficiency: innovation and R&D, in order to include services in those programs that so far to a large extent have excluded them - ongoing initiatives promoted by DG Enterprise are important to this respect-; regional policy, in order to favour the use of services, particularly knowledge-intensive services, in those regions with more difficulties to converge and lacking a series of services provided by the market – the inclusion of services in the guidelines for structural founds 2007-2013 is a major milestone here-; quality policy, in order to boost the normalisation processes carried out by the services companies and organisation, thus recovering the time lost with respect to the standardisation of goods, as well as providing services with more means to acquire competitive advantages through quality – in a context where offshoring is led by costs professional associations and CEN in particular are working on this-; employment and qualification policies to identify training needs arising from the new services economy and the ongoing specialisation phenomena; information and knowledge policy, in order to improve statistics, analysis and research on all these issues; policy for the promotion of entrepreneurship, which is decisive in the sectors with the highest business start and cessation rates. Also vertical policies can be included in order to boost the development of specific sectors, similarly to what the Commission does with transport, communications and network services (see details in Pelkmans, 2006b). A problem that arises from the group of policies developed for services is the lack of coordination and exploitation of possible synergies between them, and between the Commission policies and those of the Member States. On some occasions, certain contradictory effects or asymmetric advances arise in various directions. In this case, it would be advisable for the Commission to give more prominence to the synergetic management of service-related policies.

7. Conclusions and final remarks

This paper has briefly described some of the key points of the debate regarding services policies in Europe. On the one hand, the challenges related to services policy have been discussed. The most advanced modern economies are services economies, which imply a series of challenges that surpass the myths that have traditionally considered services as hindrances to economic growth. Services have been considered as relatively low productive, low innovative and scarcely open to competition and trade. This is partly false, as it does not take into consideration the high and varied contribution of services to the development of modern economies, as well as the characteristics of services, which require conceptual approaches and the use of varied statistics. However, these myths are partly based on real facts, as there are many services markets with real growth and productivity difficulties. This is, at least in Europe, not only due to the characteristics of services, but more to the prejudicial combination of a regulatory interventionism with market and system failures that have been detrimental to services. In Europe, the most predominant case is in the construction of an internal market for services, which is still far from becoming a reality, despite the large contribution, both past and present, of services to the European construction in many different ways.

On the other hand, this paper has described the justification and framework for the development of services-oriented policies. There are economic arguments related to market failures and system failures that recommend the development of services-oriented policies, both (de)regulatory and non-regulatory, which are complementary policies. Synergies need to be promoted between the different types of policies in order for Europe to follow the path established by the Lisbon agenda. The internal market for services policy would be easier to develop and implement if regulations were less heterogeneous in services and if various complementary policies acted at the same time in order to correct deviations or secondary effects. Some complementary policies that would help the internal market policy include: development of required training and qualifications, good promotion of standards determined by services companies, good development of innovation and R&D services policies and a promotion of public-private services in less-developed regions. The same could be said if an industrial policy integrating services as an essential part of its development in the sense expressed by Pelkmans (2006a) existed. Policies related to knowledge-intensive services (KIS) could be part of a horizontal industrial policy to be used by any type of company and economic sector, according to the European Economic and Social Committee (2006). The EESC opinion makes reference to the deepening division of labour within developed economies and the disaggregation of previously integrated vertical value chains. The type of economy which is developing is one in which services and manufacturing are integrated and complementary in nature. However, this services-industry inter-linkage has so far not been taken into account in the design of policy actions aimed at improving industrial competitiveness. The effect of such measures may be limited if they focus exclusively on industry and fail to address the impact on, and the challenges faced by the associated business related service activities, such as globalisation, skills, investment in research and innovation, and productivity improvement. A new challenge for industrial policy would be to examine the framework conditions which affect the supply, demand and quality of services on which industry depends for its continuing competitiveness.

The large number of issues regarding the services economy suggests that we should consider them not mainly as different economic sectors, but more as horizontal activities that are able to influence overall economic growth (particularly knowledge-intensive services). This requires, on the one hand, that services should be integrated within the main existing policies and policy systems, and on the other, a higher effort of coordination and exploitation of synergies between related policies.

Apart from the way in which services policies are implemented in Europe, the main challenge is perhaps the need for a greater awareness and understanding of what a services economy implies. There are still too many policy actions that do not take the services economy, as well as its challenges and opportunities, into consideration. Too many fears still exist, inherited from protectionism and nationalist interests that do not fit well with a Europe that is supposed to be moving towards a deeper integration. The debate regarding the controversial and misinterpreted framework directive about services has revealed the long path to be gone in order for the advantages of an open and competitive services economy to be incorporated with the experience and opinion of politicians and citizens. Consequently, a basic priority of any services policy should be to raise awareness on the services economy, which could be translated into a triple challenge: 1, identifying and spreading the advantages of more and better services in Europe, as well as the impacts of the different policies implemented or to be implemented; 2, improving knowledge, statistics and information regarding services, their markets and economic and social development; and 3, promoting dialogue with stakeholders, especially in those sectors where the levels of entrepreneurial and trade union representation are relatively low. The three objectives are interrelated, as data, statistics and analyses are necessary for the dialogue with the policy stakeholders and for the policy-making. There are several issues in many heterogeneous different sectors (for example, the more than 60 different types of activities integrating the business services subsector) that require more information – to cope with the huge differences among services activities) and a higher interaction with the stakeholders – for the success and popular support of the main services policies-. If services are defined as co-productive activities where a higher or lower level of interaction exists, one of the greatest challenges of the services policy is carrying out a certain level of co-policy making where companies, associations, workers, researchers and those responsible for public administration should collaborate in order to enjoy better services. An economy with more and better services could provide new energy and encouragement to European society: the benefits of an integrated Europe would be more and better appreciated. In many respects, services play a crucial role for European integration and for European growth and welfare.

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