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# Economic Approaches of the Internal Market*

**Jacques Pelkmans****

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** Jacques Pelkmans is Jan Tinbergen Chair and Director of the Economics Department at the College of Europe in Bruges & Chair for Business and Europe at the Vlerick Leuven-Ghent Management School.

## Abstract

What is 'the' EU internal market, as economists see it? The present BEER paper attempts to survey and help readers understand various 'economic' approaches to the internal market idea.

The paper starts with a conceptual discussion of what 'the' internal market is (in an economic perspective). Six different economic meanings of the internal market are presented, with the sixth one being the economic benchmark in an ideal setting.

Subsequently, the question is asked what the internal market (i.e. its proper functioning) is good for. Put differently, the internal market in the EU Treaty is a means, but a means to what? Beyond the typical economic growth objectives of the Rome Treaty (still valid today, with some qualifications), other Treaty objectives have emerged. Economists typically think in means-end relationships and the instrumental role of the internal market for Treaty objectives is far from clear. The 'new' Commission internal market strategy of 2007 proposes a more goal-oriented internal market policy. Such a vision is more selective in picking intermediate objectives to which 'the' internal market should be instrumental, but it risks to ignore the major deficits in today's internal market: services and labour! The means-end relationships get even more problematic once one begins to scrutinise all the socio-economic objectives of the current (Amsterdam/Nice) Treaty or still other intermediate objectives. The internal market (explicitly including the relevant common regulation) then becomes a 'jack of all trades' for the environment, a high level of social protection, innovation or 'Social Europe'. These means/ends relationships often are ill-specified.

The final section considers the future of the internal market, by distinguishing three strategies: incremental strategies (including the new internal market strategy of November 2007); the internal market as the core of the Economic Union serving the 'proper functioning of the monetary union'; and deepening and widening of the internal market as justified by the functional subsidiarity test. Even though the latter two would seem to be preferable from an economic point of view, they currently lack political legitimacy and are therefore unlikely to be pursued in the near future.

**Keywords**: economic integration, common market, internal market, EU.

**JEL codes**: F15, O52.

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## 1. Introduction[1]

What is 'the' internal market, as economists see it? Can economics formulate a single rigorous benchmark, against which Treaty design and the actual practice of building the internal market and making it work well, can be assessed? How useful is it to dispose of a benchmark derived from economic theory, if the politics, the institutional complications of a two-level governance and legal aspects are merely considered as exogenous requirements or simply assumed to be appropriate? What are the benefits and costs of the various steps of the long and steep 'market integration ladder', whether in ex-ante economic analysis or in ex post empirical verification? Once all of this would be known, why would the EU want an internal market (=IM) in the first place? Are such merits of the IM still the same today as 50 years ago, and, if not, what is or should be the value-added of a 'deeper' or 'wider' IM nowadays? Does economics have anything to tell about the political and/ or legal prerequisites or complementarities which would render the IM more effective in serving EU goals?

The present paper is inspired by these questions, without claiming that all of them can be satisfactorily addressed, let alone, solved. It aims to facilitate an understanding of the economic approaches to 'the' IM idea(s) in the framework of this tri-disciplinary project. However, because 'the' IM is a massive undertaking and refers to an incredibly wide spectrum of markets and activities (with profound changes over time as well), it is inevitable to limit the exposition to a survey of the essentials.

The structure of the paper is as follows. Section 2 hopes to stimulate a conceptual discourse by distinguishing six different meanings of the IM, with the sixth one being the economic benchmark in an ideal setting. Section 3 looks at what the IM is meant for: the IM as a means,

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[1] I am indebted to the conference participants for discussion and, in particular, to Michele Chang for very detailed further comments.

indeed as a means to what? This is done, first, by studying the EC Treaty design, followed by the quest for a more goal-oriented IM (presumably, instead of a legalistic or too instrumental approach). Thirdly, one can look at the IM as the ‘workhorse’ of the EU, serving many masters: a true ‘jack-off-all trades’. Apart from some Treaty objectives, there is discussion about services (in a Lisbon context), innovation, social Europe and globalisation. Also a workhorse can be overtaxed.

Section 4 briefly considers the future of the IM: how can deepening and widening be pursued best, and is a functional, economic strategy feasible? Three stylised strategies are considered and the November 2007 Commission proposals are briefly assessed.

The final section sums up the conclusions.

## 2. Concepts of the internal market: an economic perspective

In economics, a market is an abstract notion of demand and supply coming together and determining price and non-price aspects of transactions. Linked to location and space, price and non-price aspects (e.g. quality, newness, etc.) are determined over the relevant geographical space. It is then a minor step to define market integration (Pelkmans, 2006, p. 6) "[…] as a behavioural notion indicating that activities of market participants in different regions or Member States are geared to supply-and-demand conditions in the entire Union". Later in this section, we shall explore a little further what the profound implications of this definition are. To some degree it can also be subjected to empirical measurement.

This 'classroom concept' was not in the minds of the founding fathers of the Community, the authors of the Spaak report (1956). Nevertheless, as shown by the routine application of economics to the definition of (relevant) markets in competition policy, there are ways to bridge the seemingly wide gulf between the theoretical notion and actual practice, also in the EU context. A possibly useful approach to narrow the gap in a stepwise fashion is to consider, in a stylised form, how the internal market notion in the EU was deepened and widened from a minimal initial idea to the much more ambitious IM of today. Four stylised steps will be defined. For all four steps, one has to employ a practical, institutional notion of how to *establish* an IM and subsequently, how to make it *function properly* (i.e. not suffering from market failures). As is well-known, this requires a combination of negative and positive integration. The ideal IM can be defined as follows: "An IM attains the free movement of goods, services and factors of production, including the free establishment where relevant, accompanied by the necessary positive integration for the IM to function properly". Subsequently, the still more ambitious single market notion in economic federalism is touched upon before finally coming back to the purist economic benchmark of a single market.

### 2.1. The 'common market' at the outset

The common market was not defined in the EEC Treaty. Prominent European lawyers all agreed that the four free movements and free establishment formed the basis (i.e. what Tinbergen (1954) called negative integration) but they disagreed about the extent of 'positive integration' complementing the freedoms. Thus, the common market had to include a common trade policy and a common competition policy (for its proper functioning, that is, preventing or correcting market power and other distortions of competition by market agents) but whether the CAP and/or a common transport policy were intrinsically part of 'the' common market was disputed. However, whether this was of much practical importance is doubtful because the Treaty comprised many elements (including, of course, the CAP and a common transport policy) to complement the negative integration which seemed reasonably well specified. There were approximation and harmonisation articles (in some articles these words were used interchangeably, dependent on language) and there always was Art. 235, EEC, a catch-all article (under unanimity) permitting the Council to add new measures for the proper functioning of the common market. Economists mainly regarded the EEC as a customs union, at first, thereby ignoring services and factor movements (which, at least formally, were clearly defined as part of the common market) but also neglecting what were then called 'non-tariff barriers'. In the early days, economists seemed to have little appreciation of the enormous potential significance of Art. 100, EEC (harmonisation) and the related Art.s 30, EEC and 36, EEC (forbidding, with derogations, such non-tariff barriers, now more correctly labeled as 'regulatory barriers').[2] Besides the customs union, economists were interested in the common policies but (except for the common tariff) rarely in connection with the common market in some defined way. Towards the end of the transition period (say, 1969) the common market of the EEC consisted essentially of a common *goods* market, be it with a battery of regulatory

[2] This is likely to have been caused by the disinterest in regulation in economics at the time, but also by the arcane language of Art. 30, speaking of 'measures with an equivalent effect to quantitative restrictions'; until Dassonville, lawyers were also confused whether to assess this legalistically or functionally i.e. economically. One should also not forget that economists, dealing with the EEC in the 1950s and 1960s, were mainly trade economists, normally focusing on tariffs and quotas. Until Baldwin's (1970) seminal work on 'non-tariff barriers', trade economists ignored regulatory and fiscal barriers, with only very few exceptions.

barriers,[3] but including agri-food products (behind towering protection), free FDI inside the EEC, and the common policies for trade, competition and agriculture (not for transport). However, the common policies were not complete either: trade policy was undermined by national quotas vis a vis third countries (even interfering with the common market itself, via Art. 115, EEC) and competition policy (only for goods!) lacked a merger policy while state aids supervision remained weak. The much heralded accomplishment (in 1968) to agree to 'free movement of workers' was largely a phantom: the acquis was only agreed because it would render such migration *residual*, whilst imposing host-country control.

At the time, this common market acquis was viewed as a great achievement. There were two reasons for this praise: the EEC emerged out of a tariff-ridden world full of interventionism – which made the common market more attractive – and the Community appeared effective compared to other instances of regionalism in the world.4 Yet, against the measuring rod of the Treaty, the common market was surely not in keeping with the implicit definition.

### 2.2. The common market after 25 years

Late March 1982 The Economist celebrated the 25$^{th}$ anniversary of the Community with a frontpage showing the leaders of the ten Member States on a graveyard, their faces turned to a headstone saying that the EEC was resting there "after 25 years of useless service". This cynical text was prompted more by Eurosclerosis (and poisonous budget quarrels, caused mainly by the CAP) than a well-defined idea of a deeper or wider IM but the frustration about the latter was evident as well. Why could the EEC not pull the Ten out of stagflation and return to the golden age of growth (1958 – 1973)?

Based on detailed analysis (e.g. Pelkmans, 1985; 1986), the common market in 1982 can be proxied as follows. Added to the acquis of 2.1 above, were very partial attempts to harmonise (under vetoes), always in goods markets, the first beginnings of mutual recognition (all in the food sector), the start of European standardisation (only in electrical goods though), feeble attempts to tackle services (mainly, establishment in financial services, but in rudimentary ways), and the emergence of environmental regulation at EEC level. The economic meaning of much of these efforts was selective and modest. However, there were setbacks too. The agricultural market became more fragmented due to the discrepancies between 'green' and

3 Most of which were not even 'mapped', see Pelkmans & Vollebergh, 1986, although the VAT breakthrough had been accomplished in 1967.

4 Other than EFTA, which was modest but worked well, regionalism in Latin America, Africa or the communist bloc (Comecon) was shallow and non-performing.

normal exchange rates; the so-called NICs (Japan, Hong Kong, Taiwan) caused trade protection to become 'national' via VERs and textile quotas, disrupting the customs union; exchange controls in countries such as France and Italy were tightened; state aids in steel went out of hand and the 'manifest crisis' of the ECSC did not immediately cause relief.

By 1982 a much better understanding had been developed of what it took to accomplish the common market (again, essentially in goods) but policy makers felt trapped in a Treaty which failed to provide the means and hard obligations needed.[5]

### 2.3. The internal market in the Single Act

The internal market idea in the Single Act has to be placed in context. In barely three years since 1982 the internal market had rapidly moved up the ladder of political priorities and the mapping of its many shortcomings had made great progress.

The Community was ready to consider the internal market in its entirety and improve it radically on the basis of the famous White paper. Conceptually, however, the White Paper was not a marvel and the exercise of 'completing' remained remarkably incomplete even when only paying attention to the rough contours of the proposals. Spending merely a few lines on an assertion that the proposals would boost growth in the Community without analytical support or even a clue about how and why, is a curious foundation for a 'strategy'. The paper itself was very rich and no doubt radical at the time. Nevertheless, it was very weak (and selective) in services, silent on network industries, and contained only some unimpressive measures in factor markets or technology. Also, the inevitable links between common policies and the IM were not systematically pursued (see Holmes, 2008; Gstöhl, 2008 and Klages, 2008).

The Single Act comprised two innovations, however, which would serve as powerful complements to the IM strategy. First, QMV was greatly extended to a host of IM topics. Second, the IM was (finally) defined as 'an area without frontiers' in which 'the free movement of goods, persons, services and capital is ensured…' Just as in the White Paper, these frontiers were not just customs frontiers but also fiscal or regulatory frontiers. This

5 In Pelkmans, 1985, it is argued at length that the Rome Treaty could never have accomplished 'the' common market it endeavoured to achieve, due to sequencing problems and conditionalities, the lack of a hard legal definition of the common market and vetoes. This would require Treaty revision on most of these points (which did happen late 1985). It would also require other working methods such as the establishment of an Internal Market Council (late 1982), focussed programmes, new views on standardisation and harmonisation inspired by mutual recognition (which emerged in 1985) etc..

concept of ‘frontiers’ pushed the idea of avoiding or overcoming fragmentation in the IM much closer to the notion of 'economic frontiers' which will be discussed in Section 2.6. Observe that the word 'ensured' strongly suggests that sequencing problems can no longer be in the way of realising free movement. It is the combination of the Single Act and the 1985 White Paper which rendered the IM strategy so successful and enterprising, a sharp contrast with the pre-1985 years. True, it was helped at the outset by a few events which underlined forcefully that matters, first thought to be impossible, suddenly came within reach of a 'can-do Commission’.[6]

Summing up the IM concept in and around the Single Act might carry us too far for present purposes. Essentially, however, one ought to appreciate the definition of the IM in (what is now) Art. 14, EC; a series of horizontal initiatives (e.g. on competitive public procurement; on fostering mutual recognition); over 160 proposals of Old Approach type harmonisation (in industrial and agri-food products) which were expected to be feasible without vetoes; the New Approach (coupled to European standardisation) over a range of very broad sectors (construction products, machines, toys, etc.); a fairly liberal approach to four modes of transport (not rail and air, as network industries); an original approach to liberalisation of financial markets (based on mutual recognition and home country control) which avoided a harmonisation embroglio, but also did not ensure sufficient market access (while failing to reform equity markets in the EU); the link between common policies and the IM was improved (e.g. a merger regulation and the removal of national quotas or VERs); and several technical customs measures as well as some minor initiatives in factor markets. If one accepts that the wider context matters as well – and in an economic perspective, it does - it is easy to find complementary initiatives building on the IM logic since 1985: (i) the new 'horizontal' approach to food products (feasible because of the profound impact of the ECJ mutual recognition doctrine) which transformed, sooner or later, all national food laws in the EU, and underpinned the (near-) removal of 'recipe-laws' in the IM acquis, an impressive instance of 'better regulation' having lowered the regulatory burden while increasing choice; (ii) the

6 In 1983 the so-called 'mutual information’ Directive 83/189 had been adopted (meanwhile 98/34) which would develop into a low-key but formidable watchdog preventing thousands of new barriers from arising [see Pelkmans, Vos & di Mauro, 2000] ; in May 1985, and entirely in the spirit of the White Paper (which advocated 'minimal harmonisation', based on reference to standards), which was then being drafted, a 'new approach to standardisation' was agreed (without this, the goods IM would have remained a dream) ; in December 1984 the leading customs officials of the Member States were forced by their ministers (!) to simplify and completely unify customs formalities into a single customs form (identical in all languages, too), replacing no less than 70 documents and laying the basis for a modern common customs at EU level and, later for eCustoms; also in May 1985 the ECJ sided with the EP and against the Council, since the latter had "failed to act" (Art. 175, EEC) in building the common transport policy, a shock which completely transformed the spirit of working in the Transport Council.

initially slow but gradually firm inclusion of all 7 network industries which is still ongoing today because of its complexity and profound consequences; (iii) a much less restrictive approach to mutual recognition of diplomas, another instance where lead times are simply very long; and, not least, (iv) the ultimate consequence of the emerging 'common customs code', namely, the physical disappearance of customs at the inner frontiers, supported by a 'temporary' reliance on a reporting system keeping the destination principle in place for VAT. Also, (v) the complete elimination of exchange controls was accomplished by 1988 based on a convergence of macro-economic policy orientations of the Member States.

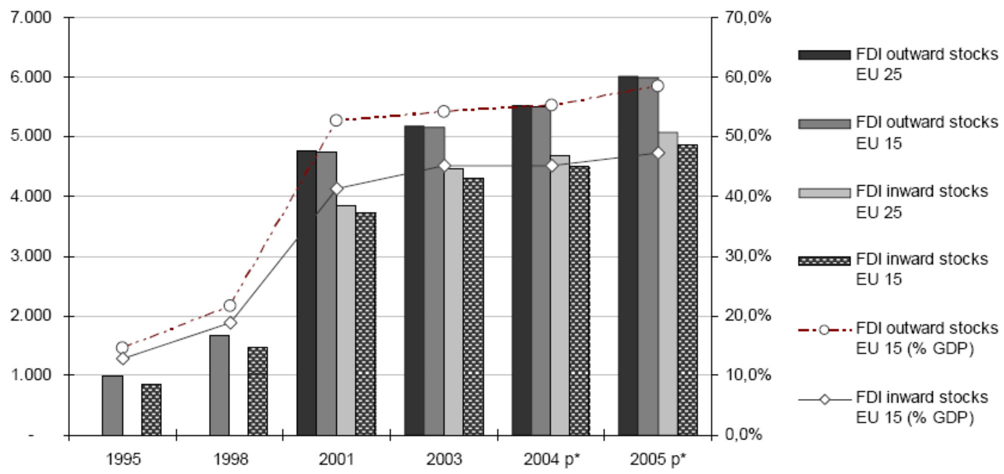
Altogether, the influential concept of the IM in the Single Act and the 'inner dynamics' prompted by it in various ways are impressive results. A simple comparison between the Dekker plan (Dekker, 1985), considered far too ambitious only 5 months before the White Paper, and the much greater accomplishments (than the White Paper had listed in its famous Annex of 300 measures) by the end of 1992, clarifies immediately how much IM ambitions had spiralled up since (see Pelkmans, 1994, for detail). From an analytical economic perspective, the deepening and widening was nevertheless grossly insufficient for it to be labelled as a 'single market'. The practical problems in goods markets remained numerous, a horizontal approach in services was absent and sectoral approaches were few (and seriously incomplete), migration of workers inside the Community was very cumbersome and there was no such thing as an IM for (codified) technology.

### 2.4. The IM concept after 50 years EU

After EC-1992, the glamour of the IM quickly faded. EMU and the EURO took its place, closely followed by 'competitiveness' and a range of worthwhile but splintered actions over a very wide spectrum of EU activities. The one and a half decade since Maastricht have further deepened and widened the IM, however, despite the lacklustre backing at the highest political level. Towards the end of the 1990s, the neglect of IM strategies was partially overcome. Since 1999 two consecutive IM 'strategies' were pursued under Commissioner Bolkestein and a fundamental review was undertaken by the Commission in the autumn of 2006 and later, supported by the Spring 2007 European Council, which urged the Commission to come up with details of a 'vision'. The vision will be addressed in Section 3.2. The Commission proposals of November 2007 are summarised and assessed in strategic terms in Section 4.1. The Bolkestein strategies were in fact no more than splintered programmes of a highly technical nature, except perhaps for services. Appendix 1 provides an illustration of this point with respect to the 2003/2006 strategy. The inclusion of the IM in the Lisbon programme, although superficially fitting due to the 2010 objective, was not convincing because it has nothing to do with the *open method of coordination*.

In terms of achievements since the early 1990s, one cannot fail to mention the great advance in the opening up of network industries[7] and the third wave of financial market integration prompted by the EURO and globalisation. But there is more, such as the almost forgotten repair of the IM for steel (since 1994, no longer distorted by state aids), the emergence of property rights legislation at the EU level (except the sad absence of a Community patent) and a series of EU Agencies dealing with safety questions (food, transport modes, medicines).

**Figure 1. FDI outward and inward stocks in the EU15 and EU-25**
**(FDI stocks in bn Euro.)**



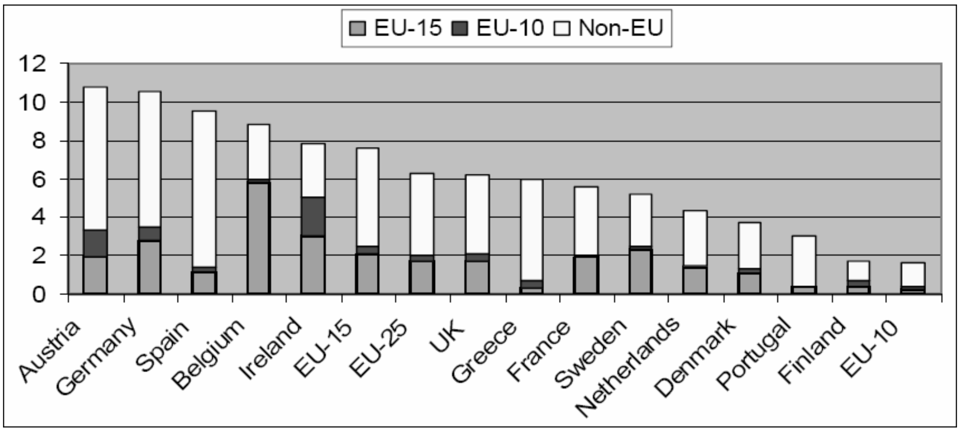

Source: Ilzkovitz et al., 2007.

An encouraging aspect of recent IM activities is that the more sensitive gaps and restrictions are beginning to be addressed, a sign that the IM concept employed is becoming more encompassing (as it should, from an economic perspective). But the going is tough, as if one pushes a powerful spring ever further. Consider the following examples. First, in relying on Art. 86 for network industries, where should the lines be drawn for services of general (non-economic) interest which are formally not part of the IM? Second, the Commission finally addressed services liberalisation (decades too late), but the upshot now is that neither a sectoral approach nor a horizontal approach seems promising (see 3.3.2). Third, intra-EU

7 But one hastens to add that a genuine IM in these sectors has not been accomplished due to political taboos in the Commission / Member States interface and the costly legal taboo of the Meroni doctrine, blocking the emergence of EU regulators.

migration flows of workers are not only very low because of languages and 'social distance', but also because of a host of barriers allowing Member States to regard a migrant (let alone, a frontier worker) as a residual (see Pelkmans, 2006, Chapters 9 and 10, and Figure 2). Since 2004 this is temporarily obscured by a peak in East West flows. Only in 2001, in a low-key COM paper[8] a first attempt was made to start tackling these barriers one by one, a long and difficult route, no doubt. Fourth, (proper) regulation, liberalisation and competition issues in a future IM for professionals seems nothing less than a snake pit. But even here, there has been progress. Thus, in a three steps process, the mutual recognition of professional qualifications (hence, free movement of professionals) has been drastically simplified and somewhat improved.[9] Nevertheless, (domestic) self-regulation by associations of professionals tends to blend anti-competitive (and disproportionate) with justified restrictive regulation, and this has the effect of inhibiting free movement and free establishment, too.

**Figure 2. Share of foreign nationals in percentage of resident working-age population, 2005**




Source: Ilzkovitz et al., 2007.

After many years of neglect, the Commission finally began to address this complex issue, following its COM (2004) 83 of 9 February 2004, Report on Competition in Professional Services. However, the conservative Wouters ruling[10] in 2004, in which the ECJ said that a prohibition in Dutch law for lawyers and accountants to work together in the same company (other Members, rightly, allow this, so long as certain quality guarantees are ensured) could be justified, threw cold water on the efforts of the Commission. Selected progress in this

8 COM (2001) 116 of 1st March 2001, New European labour markets, open to all, with access for all.

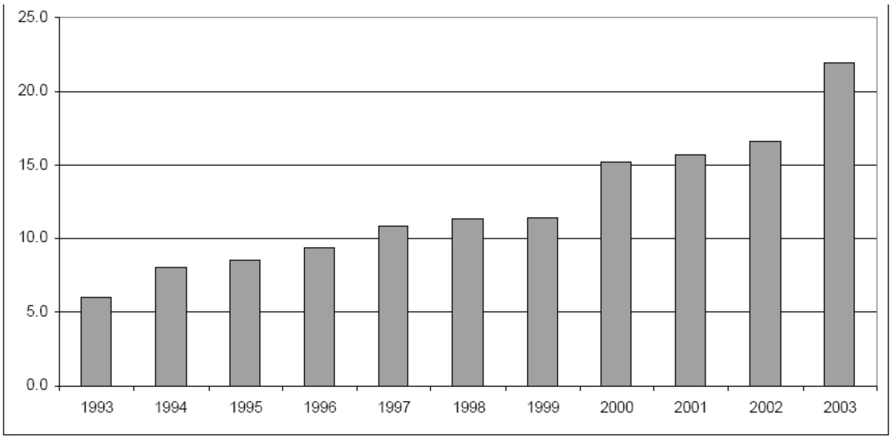
9 Following the 3rd General System of Mutual Recognition Dir. 1999/42 (OJ L 201 of 31 July 1999), consolidating no less than 35 transitional directives concerning crafts and trades professions, a simplification of the legal and procedural regime for professional recognition was accomplished with dir. 2001/19. This was followed by a further consolidation and simplification in dir. 2005/36/EC of 7 September 2005, replacing 12 directives on 7 professions (e.g. doctors, pharmacists, etc..) and 3 general Mutual Recognition directives.

10 ECJ, Case C-309/99 Wouters [2002] ECR 1-1577.

problematic domain is now only found at Member State level and this is unlikely to help the IM much.

The IM after 50 years of EU can be stylised as reasonably working for goods (be it that the brilliant idea of mutual recognition turns out to be much more costly than long understood, and that public procurement is still not very EU-wide, see Figure 3), dramatically incomplete in services overall (and not functioning properly, even where it is formally open), advanced in capital markets and wholesale financial markets (but not retail), and truncated in codified technology.

**Figure 3. Value of public procurement which is openly advertised as a per cent of total public procurement (EU-15)**




Source: DG Ecfin, Ilzkovitz et al., 2007.

Despite recent East West migration, there is no prospect of an EU labour market at all. Within a few years, the East-West labour flows will dry up (given rapid convergence), and return migration is likely to occur, just like in case of Italy (later 1980s) and Spain (early 1990s). For regular migration, when wages are not so disparate anymore, the obstacles are still considerable.

Even stylising the IM in such a rough manner, it is still worthwhile noting that there are interdependencies amongst these points, e.g. a fragmented labour market raises the difficulties for opening up services markets (cf. Boeri, Nicoletti & Scarpetta, 2000), and obstacles in technology markets hinder intra-EU FDI as well as goods market integration.

### 2.5. The ‘single market’ notion in economic federalism

How much further can or should one go in pursuing an ideal concept of the IM? As a functional approach to subsidiarity[11] suggests, taking the IM as the proper conceptual framework for actual or potential cross-border flows (based on internalising the cross-border externalities as subsidiarity requires) or effects, can push the application of the IM idea very far indeed. The current range of restrictions, gaps and opt-outs which characterises the EU's IM can be considered as an indirect proof. Why? Well, lifting the restrictions and filling the gaps would entail very radical consequences, which have little to no socio-political support today. Thus, once the EU would seriously attempt to remove all barriers to cross-border migration (from diploma recognition, health insurance issues, tax problems, housing questions, social eligibility issues, non-portability of occupational pensions, etc.) as well as soften host country control, social policy competition would intensify, in turn leading, sooner or later,[12] to pressures to address some equity or welfare state problems at least partially at the EU level. But equity-driven expenditures in the framework of an EU social ‘union’ are taboo; without political legitimacy for an EU social spending, restrictions have to protect the relative ‘immunity’ of the national welfare state! Similar 'neo-functionalist' incentives to engage in EU-level solutions might arise if services markets would genuinely become exposed to EU-wide competition. It is precisely their pre-emption which forms one key reason for fragmentation of the IM for services!

That is why it is interesting to study the logic of economic federalism and the place of the IM in it. Without going deep into the dynamics of market integration in federations such as Canada and the US (but see Vaillancourt, 2008 and Egan, 2008), it is striking that economists interested in economic federalism (e.g. Oates, 1999 as a leading example; see also CEPR, 2003) pay almost no attention to the internal market. Their tradition emerges from public economics and the typical assumption is that, in a federation, the internal market simply *is* a single market. The actual practice in federations is a good deal more complex, however, whether one looks at company law, or services markets, the autonomy for local taxation, the mutual recognition of some professions or even network industries. One can find amazing (but rarely major) examples of fragmentation in mature federations such as Canada and the US. Still, the overall picture is that negative and positive federal solutions of market

[11] See e.g. Pelkmans, 2005a; Ederveen, Gelauff & Pelkmans, 2006.

[12] Of course, since EU citizens have considerable ‘stay-put’ incentives due to languages, social habits and customs, this statement hinges on sufficient *actual* cross-border labour mobility taking place, even after Central Europe has narrowed the real income per capita gap to a small one. It is far from clear that actual cross-border migration in the Union will indeed be large enough to generate such pressures.

integration dominate, also in services, labour and technology (e.g. Pelkmans & Vanheukelen, 1988). A leaning towards federal solutions is rarely accepted easily in federal countries. Nevertheless, it is not nearly as problematic as in the Union because the federation is simply accepted as a 'given' in such countries, yet *itself* a major political issue in the Union. Hence, the federal level - unlike today's EU - can be assigned with regulatory and/or budgetary tasks which act as prerequisites for such a deep and wide market integration. The causality goes both ways: a federation has much more meaningful citizen rights, including the federal part of social security (including health and elderly care to some degree) and a commonness in parts of labour regulation, so that a 'right' for workers to move around freely is also underpinned by minimal means and less risks, leading to a better functioning of the common labour market; yet, having an IM for labour creates powerful incentives for a minimum of social rules and welfare state outlays at the federal level, since redistributive competition between the states of a federation would destroy itself. Unlike the EU, there is also no inhibition for federal taxation. In network industries, federations have federal regulators because these markets have to be federation-wide. It is probably also a reasonable inference (but hard to measure) that the diversity in the EU between 27 Member States is greater than the diversity in federations such as the US, Germany, Canada, Australia and even Switzerland.

For the future of the IM of the EU, what matters is that integration processes are *'bottom-up'* and, as such, incomparable to federations where decentralisation and centralisation tendencies develop against the backdrop of a single country political system and constitution. Not only can many IM decisions of the EU in future be framed as 'centralisation' (whether negative or positive integration), and this might create opposition, but such decisions might also be regarded as eroding (precious) diversity.

Therefore, resistance to deeper and wider market integration is not always and automatically to be equated with 'protectionism' or vested interests, even if that will never go away. In federal systems, much of such opposition may have little chance, or might not arise in the first place (because there is less diversity) or, if very powerful, can be bought off. This insight has a profound significance for the application of subsidiarity to the IM. Whereas in federations a functional subsidiarity test will lead to relatively heavy and strict assignments to the federal level (both negative and positive), in the current predicament of the Union the roots of diversity in 'new' IM issues might be so strong that more centralisation would no longer satisfy (diverse) preferences. As a result, high (political) costs might be incurred. When preferences are strong and diverse, subsidiarity says that the costs of overriding them are likely to outweigh the benefits of doing things at the EU level, in other words, the costs of IM *fragmentation* might be consciously accepted in the light of the higher costs of *centralisation*. There are strong indications that, for services and labour, this explains the current status-quo to a large extent (Pelkmans, 2005a; Pelkmans, 2007a, 2007b)

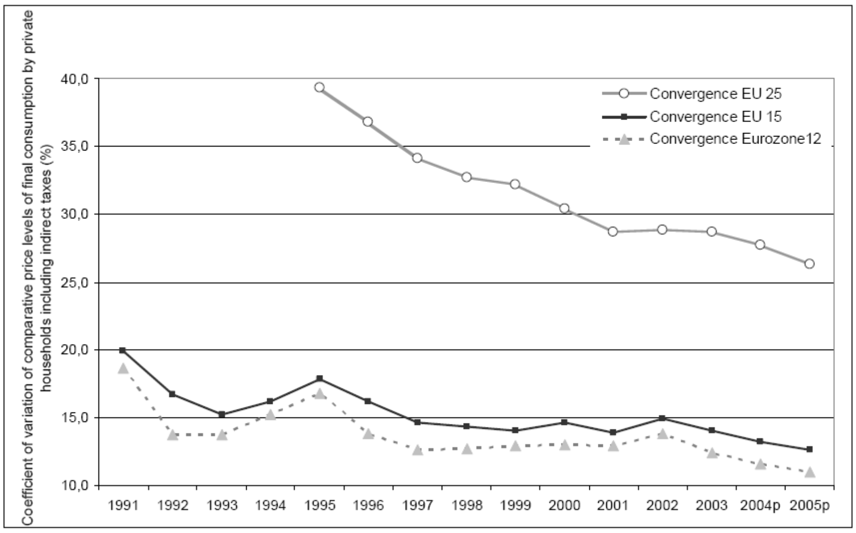
### 2.6. A single market in economic analysis

A purely economic definition of market integration is based on the concept of 'economic frontiers' (Pelkmans, 2006). Markets are integrated if economic frontiers between them have been eliminated. An economic frontier is any demarcation over which actual or potential mobilities of goods, services, capital, labour, technology as well as communication flows are low or absent. On both sides of an economic frontier, the determination of prices, quality and quantity of goods, services and factors is influenced only marginally or not at all by the flows over the frontier. There is no a priori reason for assuming that economic frontiers coincide with territorial frontiers. There may be integration deficits inside countries and between them. Economic frontiers might have numerous reasons, ranging from spontaneous disinterest, conflicts (including bans, embargoes and war), or too high costs of information (given bad infrastructure and /or extreme poverty), to natural obstacles (mountains, swamps), languages and other cultural, ethnic or religious diversities, the conduct of market participants (whether via restrictive business practices or the exclusivity of network ties), regulations, protectionism, or a range of policies as well as equity eligibility and distinct currencies.

In the EU context of today, many of the former elements of economic frontiers hardly matter anymore because of smooth information flows, good infrastructure, the IM achievements thus far, the return of a lingua franca in Europe (be it English, this time), entrepreneurship and selective network effects (e.g. among migrants even when formal barriers would seem to be high). But many other barriers remain. The great advantage of the pure economic definition is that it provides a relatively simple benchmark, which can in principle be measured. The alternative of having no benchmark is daunting: how to deal systematically with a host of disparate barriers, formal or informal, behavioural or structural, regulatory, fiscal or budgetary, cultural and/or social, disparities in infrastructure, languages, network effects (e. g. engineers used to certain technical standards show selection biases), etc. The disadvantage is that the benchmark cannot distinguish desirable from undesirable integration: in using benchmarks, one inevitably suggests that moving closer to the benchmark is 'good'. This is likely to conflict with the justified aspects of ‘diversity’.

Thus, in combining the effects of increasing exposure to competition (EU-wide, one presumes) and diversity, price convergence trends inevitably run up to their natural limits. But nobody knows where such a limit might be. Moreover, price convergence in services – precisely because of subtle, yet far-reaching differentiation – is next to impossible to measure; yet, (tradeable) services become more important and present a paramount issue for any future IM strategy.

**Figure 4. Price convergence between EU Member States**




Source: Ilzkovitz et al, 2007.

In capital markets, interest rate convergence or proof of simultaneous movements (e.g. in equity markets) do not suffer from all these caveats. But in labour markets, wage convergence forms another complicated case. Wages converge both because of market integration *and* independent of it. Singaporean wages have more or less converged with EU-15 wages without being 'integrated' with the Union. The reason is simply 'catch-up', of course. Indirectly, there is a powerful influence via the world economy, hence, also the EU. Inside the EU, intra-EU goods and services exchanges exercise strong convergent pressures on wages, despite the absence of an IM for labour. Similar orientations emerge from FDI with embodied technology in its wake or direct technological catch-up. Intra-EU migration might in theory be a faster route, if wage convergence were a goal in itself, but the residual character of migration in the Union causes it not to contribute much.

In recent years, the idea of economic frontiers has been endowed with a new empirical tool, that of *'home bias'*. Following Delgado (2006), greater market integration has to show up in the extent to which "[…] economic decisions have become less domestic and more

European", in other words, a single market in the pure economic sense should have no 'home bias' at all.[13] Two indicators give an idea of what is measured. One is that the share of a country in any consumption basket is determined by the size (GNP) of its economy. So, if Germany amounts to (say) 18 per cent of the EU economy, German products should weight around 18 per cent in Germany's consumption of EU products; in fact, the figure might be closer to 80 or 85 per cent, leading to a 'home bias' of almost 70 percentage points. Another indicator (based on so-called gravity techniques) estimates that, when size and distance (which is costly in intra-EU trade) is accounted for, Germany would import (say) 15 per cent of its total consumption from a country of equal size and distance (in the EU). However, we know that the current share of German products in German consumption is 85 per cent, leading to a 'home bias' of no less than 70 per cent. The main point of this empirical work is that the EU is very far removed from any purist economic benchmark of a single market. But once again, the meaning of these (and other) home bias indicators is far from clear - even in Canada and the US there is serious home bias - there is no theory behind it, and the reliance on gravity techniques is less than ideal.

Nevertheless, it is crucial to appreciate that today's EU home bias is much more puzzling than that of three decades ago. A telling example can be found in the car industry. Dramatic restructuring over several decades have led 'national' car firms from the larger EU countries to evolve into truly European (if not global) car companies, with component suppliers having Europeanised (or globalised) as well. How French is a Peugeot still, how Italian an Fiat, how German a Volkswagen and how Czech a Skoda, even if there is still a significant degree of local preferences for what are somehow regarded as 'French' or 'Italian' (etc..) cars. Three decades ago, in the mid-1970's, 'national' car markets in the EC-9 had just opened up towards each other, after breaking down high tariffs. Hocking (1980) attempted to test the theory that a sector of differentiated, consumer durable goods will exhibit a very long adjustment period to full market integration, even when substantial economies of scale are a key drive for the 'Europanisation' of production. Inevitably, the initial export drive is based on production structures geared to domestic tastes and domestic income distribution. In other words, a testable proposition is that the share of imports will initially become high in those product types where a nation has relatively small sales, that is, fringe taste goods. Hocking indeed finds for the three car producing countries Italy, France, Germany a negative

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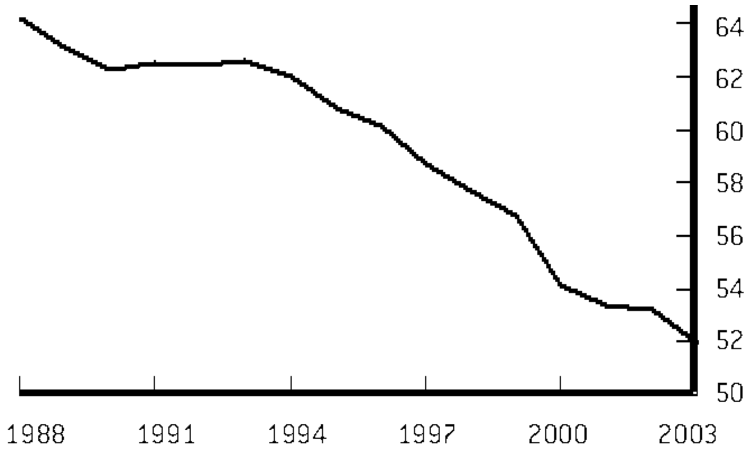
[13] There is a swelling literature on EU home bias, e.g. Head & Mayer, 2000; Nitsch, 2000; Delgado, 2006; Portes & Rey, 2005; Mayer, & Zignago, 2005 and Combes, Lafourcade & Mayer, 2005. No justice can be done here to all the subtleties in these contributions.

correlation between the share of imports (from the other two) and the relative size of that subsector. The home bias, in those days, was thus much stronger than today: car producers had not genuinely broken away from their home markets, components were mainly sourced in the home market or in-company and non-domestic FDI was exceptional (Fiat in communist countries) or absent. Figure 5 shows declining home bias for goods in the EU in the last 2 decades.

It is tempting to interpret this trend decline as a steady improvement of the degree of economic integration in the EU IM for goods. After all, it shows that EU-15 countries have gradually bought a higher share of their goods purchases in other EU countries rather than at home. At the present stage of empirical economic research on home bias it is however better to remain prudent about the exact meaning of these results. There are other estimates giving somewhat different results. In Head & Mayer (2000) the home bias is measured by first constructing the rate of purchases one would expect when buying without intra-EU border effects playing any role, and subsequently defining the bias as the 'excess' of purchases at home beyond this benchmark. The authors find a home bias of around 25 times: i.e. Europeans purchase 25 times more domestically than from equi-distant foreign (EU) suppliers in the mid-1970s, falling to around 13 in 1995. However, it is striking that the decline in the EC-1992 period (between 1987 and 1993) is insignificant (from 14 to 13). Head & Mayer decompose the border effect into a part caused by non-tariff barriers and a part explained by consumer preferences. The former cannot explain the cross-industry variation in the border effects before EC-1992, suggesting that EC-1992 did little to reduce home bias. In Figure 5 home bias (measured differently) also hardly declines in this period but falls considerably, later in the 1990s. Could that mean that the time-lags of the EC-1992 deepening of the IM should be thought of as being almost a decade? If not, why would home bias decline rather strongly recently? Nitsch (2000), employing yet another variant of what Head & Mayer propose, finds a home bias of around 12 - 13 in 1979 for the EU-10, falling to 7-8 in 1990, and a higher bias when including Spain and Portugal falling to around 10 in 1990. Again, the period 1985 - 1990 shows virtually no decline for the EU-10 (it does for the EU-12 but this is likely to be the enlargement effect and not so much the IM deepening). Of course, the present chapter is not the place to discuss the many technical problems of this kind of empirical economic research but it underscores that jumping to conclusions about the implied bolstering of actual market integration (by economic agents themselves) when home bias, as measured, declines, is anything but clear

Indeed, as Balta and Delgado (2007) note, when considering this query with a view to the home bias literature, it is difficult to disentangle to what extent home bias is due to market imperfections that can be corrected by policies and due to non-policy related reasons such as consumer preferences or product characteristics. Moreover, foreign direct investment may well lead to an increase in home bias (other things equal) in so far as it replaces imports by production and this is not overcompensated by larger trade in intermediate inputs. To make matters even more complicated, autonomous trends of declining transport and communication costs have facilitated the spread of multi-stages supply chains over many countries (through off-shoring and outsourcing) and this may well tend to reduce home bias (other things equal). With respect to Figure 5, it is also important to note that the IM of services has been left out out here - when taking goods and services together, the decline of home bias is bound to be much smaller given the strong home bias in services which is caused ( apart from remaining barriers which seem to be much higher than in goods overall) by a greater inclination to serve clients in other EU countries via establishment rather than via free movement, and by the often decisive relationship of trust and proximity between supplier and client which tend to inhibit the search for alternatives even more than in goods.

**Figure 5. Declining home bias in the EU**




Source: Delgado, 2006.

In addition, it is good to realise what (goods) market integration means in actual practice in Europe. When discussing home bias, without further detail of what happens at the firm level in terms of structure and conduct of their economic operations, one has to rely on trade data only. But trade data may give a misleading perspective of how the IM (for goods here) actually functions. Empirical work by the EPIM research consortium and reported by Mayer and Ottaviano (2007) shows that most firms in the Union do *not participate* in the

IM! Of course, this goes against an implicit notion of textbooks and typical IM policies that in principle very large segments of the total population of firms (say, all but the truly local shops) should and eventually would be lured by the Europeanisation of supply and demand and the removal of barriers as well as the more uniform regulatory setting (including standards) to seek opportunities in parts of the IM or throughout the EU at large. And one extra incentive to do so would consist in the arrival of competitive goods, traders and foreign companies in their home markets forcing price or quality changes or new modes of rivalry, as they exploit IM opportunities, too. Three key findings of Mayer and Ottaviano, 2007, include: (i) the exports of any EU country are driven by very few top exporters [ f.i. the top 5 per cent of firms represents between 59 per cent and 88 per cent of all goods exports, dependent on the country] which means that most firms do not participate in the IM or only very marginally so; (ii) true Europeanisation in the sense that a firm exports a high share of its output to other EU countries only occurs in the case of a very small group of companies - if home bias is seen as the measuring rod, one would have to regard only these firms as 'integrated' in the IM, in turn implying that the relatively high home bias in the EU is caused by all these other firms not interested in or not capable of competing in the IM; (iii) these few top exporters also export EU-wide, i.e. to many locations, and do this for many distinct products.

Despite the criticism one might level at these attempts, their message is nevertheless not easy to dismiss: the myriad of measures and further deepening and widening notwithstanding, it is the *actual proper economic functioning* of the single market, and with it the exposure to competition, which matters in economics. The ECJ has often employed language implying that the internal (goods) market should be no different from a domestic market. The interesting query is whether this statement of the ECJ ought to be interpreted in an economic sense, a legal sense (whatever that might mean) and/ or in (political and wider legal) context.

The most interesting aspect of the purely economic interpretation of a single market is to be found in the two types of markets which have remained resistant to deepening: services and labour. Unlike for goods and financial capital, an ambitious interpretation of integration in these two markets may well be the source of profound frustration, if not a misunderstanding of what the drivers are of further progress.

# 3. The internal market as a means

The IM is a means to one or more ends. This is clear from the Treaty. It is also emphasised, inter alia, by the European Commission (2007) in its 'vision' paper of 21st February. [14] Nevertheless, it is exceedingly difficult to come to grips with the 'means-to-ends' relationship(s) between the IM and the Union's aims. This section will touch on three aspects: Treaty design and the IM; the quest of a more goal-oriented IM (including the Commission's 'vision'); and the IM as a 'jack-of-all-trades' serving many masters.

## 3.1. Treaty design and the internal market

The EC Treaty is designed around aims and means, supported by some core principles and an institutional framework. Ever since the Rome Treaty, the principal 'means' of the Community, supposed to foster the aims, is the 'common market'. But in an economic perspective, in fact a much wider internal market concept is required.[15]

The point is that, already in the Rome Treaty, the negative integration via the 'common market' and the positive integration via the means, then called, 'approximating economic policies' ought to be taken together. Without the common policies, some fiscal harmonisation (e.g. VAT) and regulation to overcome market failures (e.g safety, health, environment & consumer protection, or, SHEC; presumably, intellectual and industrial property rights as well), negative (common) market integration would almost certainly not make much progress - in any event, such a common market would surely not function properly. In the Rome Treaty, these two (complementary) means are expected to serve four economic aims.[16] Three of these four aims amount to economic growth objectives, with slight specification. The language is quasi-constitutional, that is, so general and vague that the sharp means-ends relationships needed for economic analysis are lacking. Since Maastricht, the structure has not been altered radically, but the aims have been refined and modernised, and EMU is added as a third means.

One might object and insist that the EU budget should be included as a policy instrument, too. One could argue that structural funds & cohesion money are, in and by themselves, not part of the IM (which is correct), yet support the pursuit of some of the objectives. Similarly, one

[14] COM (2007) 60, A Single Market for Citizens, interim report to the 2007 Spring Council of 21st February.

[15] The following discussion is easier to follow with the help of highly stylised 'flowcharts' on the economic structures of the Treaties of Rome, the Single Act, Maastricht and Amsterdam. See Pelkmans, 2006, Chapter 2.

[16] And one political aim, left out here, the famous "ever closer union between the peoples of Europe".

could maintain that the agricultural outlays have supported standard of living objectives of farmers, first via market mechanisms (be it in a very distorted way) and later via direct payments. In the following, the EU budget is largely ignored and the focus is on regulation, (cross-border) liberalisation and e.g. competition policies and other common policies where relevant.

For economists, the quasi-constitutional *means-ends* relationship between the IM and the Community's goals is ill-formulated. The economic generality significantly raises the analytical barriers to an understanding of the role and economic meaning of the internal market. Sound economic policy is usually seen as dependent on two requirements: a well-defined relationship between instruments and objectives (so that economic analysis can be fairly robust) and an adherence to the Tinbergen rule, that is, employ as many instruments as goals.[17] It is obvious that 'the' IM cannot possibly satisfy these two requirements as this concept is far too general and encompassing. Therefore, one has to decompose 'the' IM in ways, such that meaningful relationships with the Treaty aims can be defined. However, that is not what is happening at the EU level. One reason is that the aims of the EC Treaty have changed. Rewriting of the aims occurred in Maastricht and again in Amsterdam. Neither the original four economic aims in Rome, even less the six of Maastricht, nor the eight of Amsterdam can easily serve the purpose of robust and well-defined *means-ends* relationships required for unambiguous economic policy. Hence, they are better regarded as purposefully wide and politically symbolic elements of the economic constitution of the Community. It is expected that they are made operational in more exact terms, and variable over time, by the European Council and by the political entrepreneurialism of the Commission, and possibly the EP as well.

Another reason is that the positive integration part of the IM (in current Treaty language, the 'common policies or activities') has far outgrown that specific role of overcoming (internal) market failures, in an impressive and long process of widening of scope of the application of EC powers. It is a problematic conceptual issue what exactly the 'economic' boundaries of the IM are, and therefore what positive integration (whether budgetary or regulatory intervention or other incentive-based policies) belongs to the IM and what are merely stand-alone political initiatives related to shared objectives. One can push this reasoning even further in the light of the multi-level-governance (MLG) structure of the Union: to what extent is the

[17] One might add that the relative effectiveness of instruments should lead to specific assignments (sometimes called the Mundell rule).

establishment and proper functioning of the IM hindered or fostered by what *Member States* do (or don't) within the range of competences they have maintained? Despite great progress in the IM and despite the considerable impact of actual or potential cross-border mobilities, hence, also competitive exposure, there can be little doubt that Member States still wield enormous influence with respect to economic structure and a range of social and economic variables (including their budgets and tax and expenditure structures) which matter in the short to medium run for economic agents. Yet another step further, on might query whether the optimal functioning of the IM does not depend as well on the design of multi-level-governance of the Union and the institutions which support or underlie (internal) market functioning. These issues bring us in the realm of subsidiarity. By far the most powerful application of the subsidarity principle is found in the IM in the wide economic sense. This has been discussed elsewhere[18] and will be ignored here.

### 3.2. Towards a more goal-oriented internal market?

The original Treaty design (based on the Spaak report) was clearly driven by an orientation on economic growth, be it under conditions. Catching up with the US, via market size (permitting scale and larger firm size), competitive exposure[19] and technological diffusion[20] were all viewed as being served by the emergence of the common market. During the 50 years of the Community, a combination of political strategy, penetrating case law development, the Commission's guardian role, Treaty amendments and autonomous market developments have resulted in the IM the EU enjoys today.

The paramount question has now become whether a meaningful IM strategy should continue to prioritise 'deepening' in the traditional sense of *overcoming market integration deficits* (negative and positive), or, whether the priorities should be *goal-driven*. If the latter, the IM aspects would then become a derivative of the pursuit of such goals, presumably in combination with means outside the strict IM realm. The first strategy can never be fully given up in the light of the Treaty design and the consequences for case law as well as the guardian role of the Commission. The *link* with the legal perspective is likely to be quite strong here (see Hanf, 2008). The second strategy is based on a strong desire to improve the joint economic performance of the Union and the IM is regarded as one among several means.

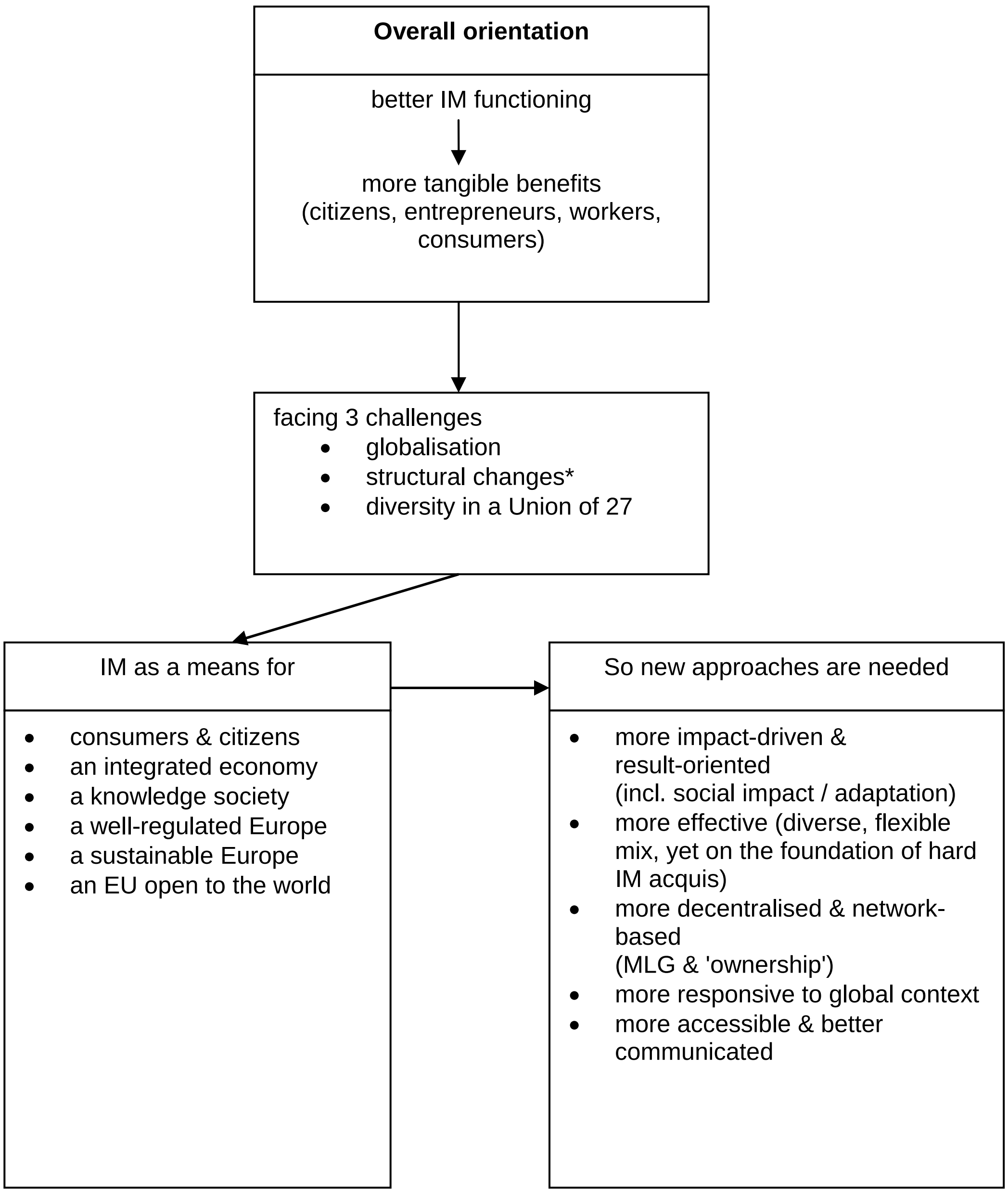
18 E.g. Pelkmans, 2005a; Pelkmans, 2005b; Ederveen, Gelauff & Pelkmans, 2006; several chapters in Gelauff, Grilo and Lejour (eds.), 2008.

19 Deeply influenced by the devastating account of the lack of competitive exposure in Western Europe, e.g. by Tibor Scitovsky (1958).

20 Stimulated by greater market opportunities, as emphasised time and again by the productivity centres of the OEEC at the time.

The latter strategy is bound to be driven much more by a *political* consensus at the European Council level, be it that the IM (and EMU) is 'hard law' based on the Community method, whereas much of the remainder is 'soft law', enjoys only minimal budget EU outlays and uses soft persuasion. This blend of hard and soft instruments would be up against domestic political systems and processes with their idio-syncratic logic. On the other hand, it is bound to be helped selectively by business coalitions and the social partners (and NGOs) at the EU level.

**Figure 6. Internal market vision of the Commission**




* rise of the knowledge economy, services, energy dependency, climate change, and ageing population
Source: COM (2007) 60 of 21 Feb. 2007

The contrast between the two Bolkestein strategies (in the period 1999 and 2006) and the new 'IM vision' paper by the Commission would seem to match the distinction between the two strategic orientations above. See Figure.6.[21]

The foundation of the new 'vision' is the better functioning of the IM, for the sake of 'more tangible benefits' and taking explicit account of three challenges: globalisation, structural changes and diversity in the Union. On the face of it, this is a very different approach than the classical view of (a) pursuing deepening and widening of the IM, (b) based on overcoming integration deficits, and (c) subsequently argue that all this supports the main aims of the Union. The new 'vision' appears to be more selective in first 'picking' fashionable issues such as the knowledge society and a sustainable Europe, and then proposing to employ the IM as a 'means' to pursue these broad aims.

It would seem to blur the definition of the IM, in the beginning of Section 2, by stretching the positive integration very far, without a rigorous link with (internal) market failures. ‘The’ knowledge society is not a sensible way of indicating a market failure if one were to rely solely on negative integration, hence justifying positive integration to overcome it. This does not mean that 'the' knowledge society idea is not rife with market failures but the links with the IM are not always clear and, moreover, very different, hence the compelling link with positive integration for the IM cannot be generalised.

An example: in Pelkmans & Casey (2004, a commentary on the Sapir report) we argued that the Sapir, et. al., 2003 proposal to exercise quality control on *EU-funded* R & D done via European Research Council, though a good idea in itself, misses the point if we wish to raise the quality and effectiveness of publicly funded R & D in the EU.

Since 94 per cent of this R & D is at the Member State level and much is probably sheltered and 'duplicative', the better idea is to subject at least 50 per cent of this R & D to independent European quality control. Of course, nobody knows whether 50 or 80 per cent is the right figure, but the 6 per cent EU-funded is surely not an effective route. The example shows that the discretion in such approaches is so large that the link with the IM as such is entirely dependent on how ambitious one wishes to be in tightening the two levels of governance. Often, such tightening is politically sensitive, or, even outlawed in the Treaty.

[21] For the first Bolkestein strategy, see COM (1999) 464 of 5 October 1999, The Strategy for Europe’s internal market; see Appendix 1 to the present paper for the second strategy, based on COM (2003) 238 of 7 May 2003, Internal Market Strategy-priorities 2003-2006.

Similar reasonings can be set up for a 'sustainable Europe'. Thus, climate strategy is a prominent part of sustainable Europe, but it is a world market failure, not (just) an EU one. Inside the EU the emissions trading system is constrained by the IM but major discretion remains with respect to the emission ceiling, the grandfathering (or not) of existing emissions by handing out permits, the differentiation amongst Member States and sectors, the period of the 'cap & trade', etc. Where the IM link is immediate, improvements can be made relatively easily. Thus, the too large discretion of Member States in the emissions trading systems' national allocation for the experimental period 2005-2007 led to arbitrary differences between national regimes of how a given emission of fully comparable types of output of e.g. two companies in two different Member States would be dealt with. These distortions will now disappear with the proposed harmonisation of national allocation rules. Without a direct IM link, discretion remains considerable.

However, upon a closer look, one can also argue that the new 'vision' amounts to the pursuit of an IM more 'integrated' with current EU policies - thus, an end to the autonomous IM driven by case law and 'required liberalisation' – and modernised in terms of institutions (especially in a MLG setting) and legitimation. The rationale behind that view would be that the classical approach to the IM has more or less exhausted its potential, even if major deficits have remained. Where deficits are significant, progress will depend critically upon a consensus with respect to positive integration.

In services, for example, regulatory consumer protection differs from Member State to Member State and the preparedness to go for a combination of minimum approximation and mutual recognition is, so far, hard to discern. Thus, retail markets are still fragmented in the IM. Indeed, consumer bodies sometimes advocate 'maximum harmonisation', a term going against the IM tradition since the Single Act and seemingly immune to a detached 'regulatory impact assessment' supporting 'better regulation'. Where service sectors are sensitive to (big) wage differentials, the 'origin principle' for services has been framed as the erosion of local wage and non-wage entitlements and/or a recipe for local job losses.[22] The Bolkestein experiment has heightened awareness in Europe that the IM for services has to be addressed much more seriously but a mere reliance on compelling free movement obligations will not do.

[22] On the EU-15 side; remarkably few in the EU-15 have pointed out that the benefits of the origin principle would be appropriated by precisely the relatively *poor* workers from the new Member States (say, for a decade or so), while a rejection of the origin principle puts them at a *disadvantage*, given host country control and the Posted Workers Directive. See also Pelkmans, 2007a.

The predicament of the IM for labour is even worse. The Treaty is not supportive as Art. 3 does not mention the free movement of labour (only persons, and that is no coincidence), whereas Art. 39 (free movement of workers) has a *residual* character and is subjected to the host-country control principle, which eliminates the greatest incentive for migration, namely, a better remuneration. Europeans simply do not want an IM for labour. As Figure 2 shows, except for Ireland and Belgium, EU countries have few citizens from other EU countries (and, on average, only around one third are workers) and more non-EU immigrants and accepted asylum applicants. As mentioned, it took until 2001 before the Commission proposed to begin tackling the numerous barriers to intra-EU migration, barriers that would never be tolerated in the IM for goods. The many linkages between the national welfare states and labour market regulations usually override IM considerations. Given the deeply entrenched preferences in this regard, the subsidiarity principle will be of little help here (e.g. Pelkmans, 2005a).

Therefore, the new Commission 'vision' gets around the hardest instances of non-deepening (so, less risk of losing legitimacy) while addressing well-recognised economic themes. Thus, it should appeal to citizens and consumers. Additional ways to enhance its socio-political legitimacy include that the social impact and adaptation ought to be taken much more into account, there should be better 'ownership' of the IM at the Member State level and it should be better communicated. None of this can be construed as a deviation of the classical IM, but it may raise the appeal of the IM. The vision is firm with respect to globalisation: the EU's IM should be open to the world and responsive to the global context. If the knowledge society is effectively promoted in the Union and, on the other hand, adaptation respected for its costs and difficulties, the IM does not have to be framed as an ‘agent of globalisation’ with the losers in Europe and the winners in e.g. Asia.

### 3.3. Is the internal market a 'jack-of-all-trades'?

In the Amsterdam Treaty, in recent versions of the Lisbon strategy, or indeed in several Commission papers, the IM is apparently expected to serve many masters. A true jack-of-all-trades. If the IM would be literally regarded as a single 'means', this would be plainly impossible. The employment of 'the ' IM for a range of aims or more specific objectives requires a suitable decomposition of both negative and positive integration.

### *3.3.1. Treaty aims and the internal market*

There seems to be little point in discussing at length the (badly drafted) Amsterdam aims. But a few illustrative remarks may be useful. Take aim n. 6, on the environment.[23] This policy area is typically one where regulatory competition would lead to a 'race to the bottom', so that common minimum requirements are inevitable. Interpreting the wording 'high level' is of course up to the EU legislator. The IM has turned out to be the driver of practically all environmental legislation at EU level. This already occurred at a high speed when EU environmental powers were solely based on Art. 235, EEC (for a survey, see Rehbinder & Stewart, 1985), that is, *before* the Single Act.

But what about aim n° 2, a high level of employment and social protection, wording already inserted in the Treaty of Maastricht. The IM may be thought to have added extra jobs (but compared to what? a hard puzzle to solve convincingly) but how could it possibly be tasked with a high 'level', if that level depends on many variables which are *not* a function of the IM strictly spoken[24] and are often national, rather than EU. Neither is a high level of social protection the result of the IM. Such matters are firmly in the hands of Member States. The positive integration[25] is logical *for the migrants inside the IM* but otherwise refers to a decision in the Hannover European Council of 1988 not to engage in a 'race to the bottom', yet, *without* any major social harmonisation. To ensure that, a legal basis was created through this aim and two handfuls of directives (none of them, except the Worker Councils, deviating from the broad status quo amongst the Member States) about social protection were adopted. It amounts to a kind of standstill in the form of EC acquis.

Aims n° 1, 4, 5 and 7 of the Amsterdam EC Treaty all refer to economic growth or are closely related to it. This seems to be the key objective which the IM should be expected to promote. That was true in 1957 and it is true 50 years later. During the early years of the EEC, high economic growth (over 4 per cent real) was presumably mainly catch-up growth, a mixture of high rates of business and infrastructure investment, catching up with technology and productivity increases prompted by exposure to competition and intra-EEC economic openness. But it is hard to be sure since there were no Cecchini or Monti-type reports simulating EEC effects. In other words, in the 15 golden years of economic growth in the

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[23] This is aiming at a 'high level of protection' and 'improvement of the quality of the environment'.

[24] For example relative and absolute wages and wage trends and their link with underlying productivity; non-wage mark-ups; the functioning of the national labour market; industrial structure (e.g. in line with comparative advantage); the local investment climate; etc.

[25] E.g. on the portability of the years of social security entitlements in another Member State, ever since 1971, currently based on Regulation (EC) 883/2004.

Community, which coincided with the first 15 years of the EEC's existence, it is tempting to attribute a good deal of the growth to the IM, but this is analytically hard to justify fully. The economic literature in those days considered the EEC as a mere customs union (including the CAP) and the range of static welfare effects calculated never exceeded a net of 1 per cent gain of GNP, often less. As late as 1972 an authoritative survey found no solid theory or empirical measurement of dynamic effects (labelled as 'nebulous'; see Krauss, 1972). Observe the contrast with today. The EU-15 finds itself in a period of much lower growth, although the new Member States enjoy healthy catch-up growth, with the IM as a significant handmaiden. The Cecchini report (1988) simulated a possible GNP increment of around 4,5 - 6,5 per cent over a number of years together as a result of the deepening of the IM under EC-1992, Baldwin & Venables (1995) report a mere 1,2 per cent, the Monti (1996) report (ex post) found that the Cecchini effect had materialised only to a modest extent, and the recent DG EcFin paper by Ilzkovitz et al., 2007 finds a moderate 0,6 per cent after 10 years.[26] If extended to the EU-25, Ilzkovitz et al report a simulated GNP increment of 2,18 per cent by 2006. Note that GNP increments can be regarded as serving the growth aims of the Treaty, but in economic terms they are not defined as economic growth (which is a path of annual increments over a long period of time); they are *one-off*. Baldwin (1989) once suggested that EC-1992 would have a medium-term growth bonus since the marginal productivity of capital would be pushed up and the medium-term adjustment would result in a higher growth path for a while. I am not aware that this has been empirically verified after 1992 or recently. The conclusion is that the level of sophistication in economic modelling about the growth effects of the IM has improved enormously, only to find that what can be simulated (even if that is far from the full IM effect) yields low GNP increments over a fairly long period of time. Extra GNP might be welcomed as a value-added compared to the scenario in which the IM would not exist.[27] Alternatively, it can be regarded as a risk because the deepening and widening of the IM is usually justified by the EU growth imperative, and, yet, the EU-15 impact, demonstrated so far in empirical economic research (even if very incomplete), turns out to be

[26] It is based on a 0,9 percentage point decline of price-cost mark-ups and a modest increase in total factor productivity (a proxy for dynamic effects) of only 0,5 per cent; as to network industries, only electricity and telecoms were included. Most of this work is related to the kind of modelling in Allen, Gasiorek & Smith, 1998, which links restructuring in sectors directly with competition pressures resulting from the IM. However, exposure to competition due to the IM is bound to have powerful positive effects on cost minimisation and a search for best technology (so-called X-efficiencies); there are numerous informal accounts of drastic X-efficiency improvements in previously sheltered services and network industries. These effects are not included. From Ilzkovitz et al, it is also not clear whether services sectors have been included in the QUEST simulations, or, for that matter, (wholesale) financial markets.

[27] But, presumably, the status-quo of market access under the WTO would, however, have to be assumed as given! This implies that the status-quo of the WTO would have emerged without the EU, a doubtful proposition.

small. Were one to study the growth paths of selected EU-15 countries (even leaving out the special case of Ireland), one is likely to find that the differential of real economic growth between Member States after ten years is going to be much bigger than the yield from the IM. That might be interpreted as follows: sound domestic growth policies are what matters and, for slow growth countries which typically tend to be reform-resistant, the IM is only going to be of marginal help.

Alternatively, one might consider the incomplete coverage of empirical studies as a sign that the factual economic growth impulse from deepening and widening the IM is far greater than such studies suggest. Some illustrations of what is *not* measured or even proxied may help the reader to appreciate the argument: (i) the enormous progress in the IM for codified technology (based on IPRs); (ii) the deepening of the EU financial capital markets (Cecchini merely proxied some financial services in a highly stylised form; see Gianetti et al., 2002, for a much richer approach, suggesting up to 1 % of GNP extra); (iii) network industries such as gas, postal, airlines, broadcasting and freight rail; (iv) sectors with low level of regulation, which can and do exploit the services IM such as testing and certification, industrial cleaning, etc..; (v) despite distortions and budget costs, the IM for agro-food product under common health and safety rules has drastically improved but tends to be ignored; (vi) the gains from intra-EU labour migration (modest but not trivial, certainly not for new Member States); etc. As noted before, X-efficiency improvements (probably far more important than static allocative gains) are not directly measured. Also, the gains from competitive public procurement in the IM are not always in, even if very hard to verify in a reliable fashion.

### *3.3.2. Other deliverables of the internal market*

Given the nature and size of the present chapter, only four other 'deliverables' will be touched upon briefly: the IM in 'Lisbon' as a label for a range of socio-economic performance indicators; innovation; Social Europe and employment; globalisation.

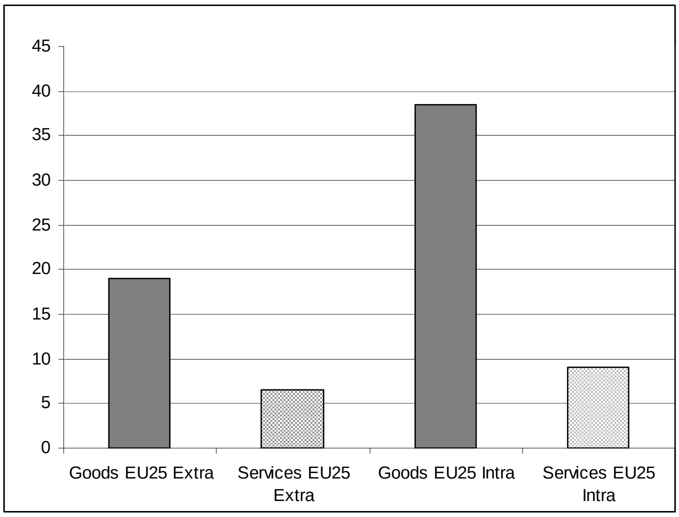
#### 3.3.2.1. The IM in Lisbon

Wrapping the Lisbon blanket around the IM efforts is an ambiguous strategy. It is possibly useful to generate greater commitment at the highest political level for exceptionally sensitive agenda's or dossiers, such as the support for a horizontal services liberalisation programme and (in the 2002 Barcelona European Council) the consistent drive to open up all the network industries. But it creates confusion amongst politicians who fail to understand that the IM is not 'negotiable' and not a voluntary cooperative exercise like the other items of Lisbon. The IM has little or nothing to do with the social indicators or those on e.g. education. And the IM risks being discredited along with the Lisbon process, even though it is driven by a different logic and far more stringent commitments. It is probably best to focus on the dossier par excellence which connects Lisbon with the IM: services!

The EU inaugurated a services strategy at the outset of the Lisbon process, but, in fact, three decades too late! The experiment of the Bolkestein directive, eventually adopted in amended form late 2006,[28] was nevertheless a stimulating one. First, it showed the deep resistance against exposure to competition in many subsectors, be it via requests (to the EP) for more derogations from the origin principle, or plain opposition fuelled by the labour aspects (and uncertainty, it should be added) or based on fears that the borderlines between the services IM and genuinely social services were blurred. Second, it made clear that economists have neglected solid research on the IM for services for decades, reflected in the soft RIA of the Bolkestein draft Directive.

**Figure 7. Services and manufactured goods trade in 2004**

**(as a per cent of GDP)**




Source: Ilzkovitz et al., 2007.

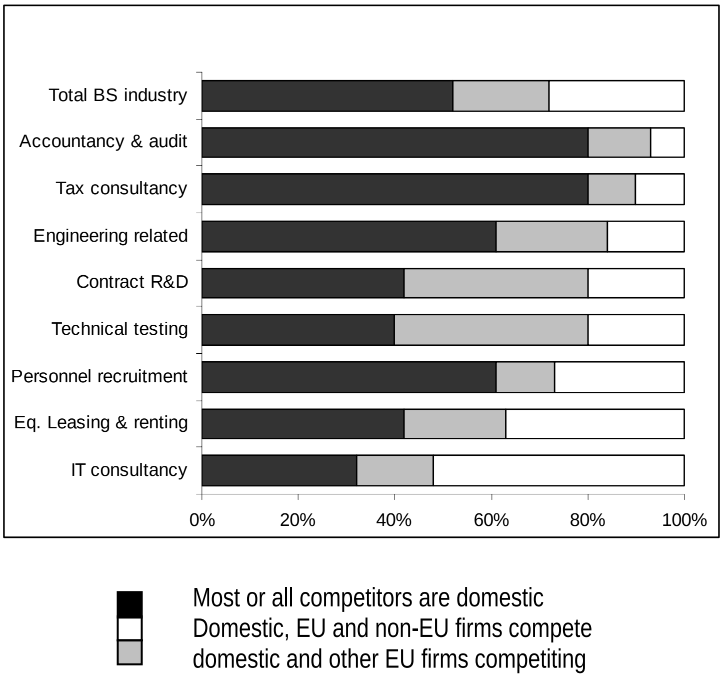
Kox & Rubalcaba (2007) demonstrate that, in particular, business services contribute directly (by strong structural growth, far higher than manufacturing or agri-food) to EU growth for

[28] The Bolkestein draft Directive is found in COM (2004) 2 of 13 January 2004; the adopted Directive on ‘Services in the Internal Market’ is Dir. 2006/123 of 27 December 2006 (OJ EUL 376/36 of 27 December 2006). See Hatzopoulos, 2008, for an authoritative legal survey of all the issues and the links with case-law. See Lejour, 2008 for an economic analysis of the IM for services; see Pelkmans, 2007b for an economic discussion of the Directive.

decades, as well as indirectly via spill-overs (such as innovations, knowledge diffusion and the reduction of human capital indivisibilities at the firm level). Nevertheless, this leads to two queries. First, if the IM for (business) services was so underdeveloped, and the growth in this sector was nevertheless so high, would it signify that a deep IM would further augment growth? Figure 8 seems to suggest, it might.

Second, how can one distinguish rigorously between the retreat to 'core business' in many manufacturing companies, which causes business services (at first being inside companies) to shift from manufacturing to 'the' business services sector and hence boost its (statistical) growth, from a growth effect driven by the IM, weak as it still is due to barriers?[29]

**Figure 8. Exposure of domestic business services markets in the EU to international competition**




Source: Kox & Rubalcaba, 2007

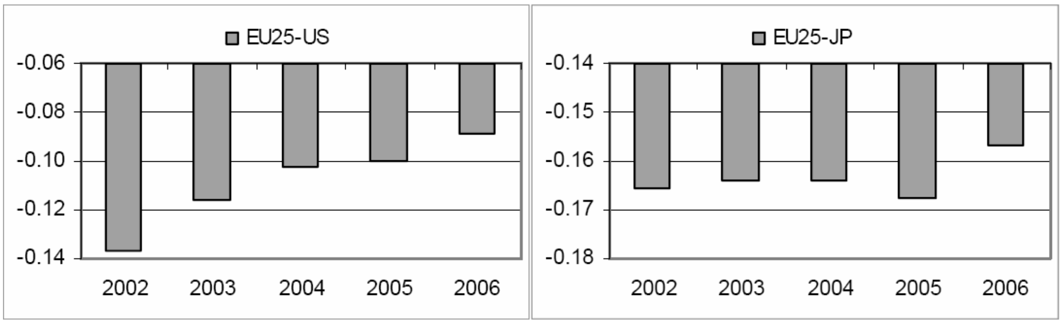
3.3.2.2. Innovation and the internal market

The European Innovation Scoreboard 2006 is the 6th attempt to measure the Union's performance in comparison with major world competitors. It does that by composing an index of 25 input and output indicators. The main conclusion is that the EU-25 is still behind the

[29] An extra difficulty here is the importance of establishment as a mode of market access for business services. Much establishment in business services is not caught by Eurostat statistics (as it is too small) and that renders even a 'guesstimate' of the IM effect next to impossible. See also Lejour, 2008.

US and Japan but catches up slowly with the US, and even more slowly with Japan. What the actual or potential contribution of the IM is, is not discussed. However, that would be an important question to answer, whether from a business point of view or for public policies at both levels of government. The debates typically concentrate on the costly failure of political leaders (since 1962!) to create a Community patent and one at low cost (e.g. translations and later litigation costs). Perhaps it is possible to stylise the contribution of the IM in 'innovation systems' and consider the impact of IM deepening on innovation. After all, everything else equal, market size has a positive impact on innovation.

**Figure 9. EU25 innovation gap towards US and Japan**




Note: The vertical axis represents the difference between SII scores of EU25 and US & Japan respectively.
Source: Innovation Scoreboard, 2006

The main conclusion is that the EU-25 is still behind the US and Japan but catches up slowly with the US, and even more slowly with Japan. What the actual or potential contribution of the IM represents, is not discussed. However, that would be an important question to answer, whether from a business point of view or for public policies at both levels of government. The debates typically concentrate on the costly failure of political leaders (since 1962!) to create a Community patent and one at low cost (e.g. translations and later litigation costs). Perhaps it is possible to stylise the contribution of the IM in ‘innovation systems’ and consider the impact of IM deepening on innovation. After all, everything else equal, market size has a positive impact on innovation.

3.3.2.3. Social Europe, employment and the internal market

Opening up and exposure to competition is one of the keys for obtaining a higher standard of living (aim 7 in the Amsterdam Treaty) or economic growth in general. Yet, it inevitably raises fears about winners and losers. This was true 50 years ago when France, by signing the Rome Treaty, gave up its indicative planning and considerable trade protection (as far as the

EEC-Six were concerned). It was also the case under EC-1992 but did not lead to more than occasional or (sparse) sectoral protests. The Cecchini simulation showed a net gain of 1.8 million jobs, but only after a temporary adjustment which first went through net job losses. Nowadays, many less skilled workers in the EU-15 regard the Eastern enlargement of the IM as a threat to their jobs, whether due to 'delocalisation', direct competition in goods or services markets or direct competition in the local job market. Some labour unions even go so far as mistrusting the IM as 'an agent of globalisation' (see below). These fears were of course most prominent in the year of enlargement. And precisely then, in 2004, the Commission proposed to open up services, based on the widely misunderstood origin principle. For workers in those segments of the labour market, also pressed to engage in domestic reforms of their long-fought entitlements as 'insiders', while made nervous about their pensions in the long run, Europe (read, the IM) was believed to have become indifferent to adverse social impact. If one adds the occasional sentiments about the opening up (and labour shedding) of network industries, justified or not, and the nervousness about the 'safe havens' (against EC competition law or state aids) of numerous social services at the municipal level and in ‘health’ more generally, it becomes clear that all these aspects of Social Europe had not been approached in a 'strategic' fashion. The weak growth performance and relatively high unemployment levels in a number of Member States in that period did not help either.

This chapter is not the place to discuss that[30] but these fears and queries cannot be dismissed by references about the benign effects of the IM in general. Ilzkovitz et al (op. cit.) report an EU-25 job gain induced by the IM of 2,75 million by 2006. If the prospective losers would not fear to be jobless more than very briefly and not incur major wage losses, there would hardly be a problem. But Social Europe is a MLG construction, with the emphasis on the *national* level. Both the (in)flexibilities in labour markets and the social security entitlements are national, not EU, and the overall level of unemployment is only very partially, if at all, a function of the IM. This brings us back to Lisbon, an attempt to come to grips with a MLG Social Europe but with the ever-so-soft open method of coordination. However, from the point of view of the IM, the success of Lisbon does seem to matter: the more successful the national reforms in labour markets and modern social protection, the less resistance to certain sensitive aspects of the IM, which in turn could ignite some extra dynamism in the Union's economy. These sensitive elements would include the free movement of workers from the new Member States and a more ambitious approach to the free movement of services (than in

30 See Pelkmans, 2007a, for the ‘social’ nature of European integration.

the newly adopted directive). Its additional virtue would be that the workers in the Union, East and West, would not be opposed to each other. After all, a detached perspective of the debate on the IM makes one wonder how the use of free movement rights by *poor* (Central European) workers, in the search for a better standard of living, can possibly be *anti*-social? As various migration studies show, the gains for the mobile workers are massive and the loss to local workers in the EU-15 countries tiny, be it that there is a sectoral concentration. It is precisely in these few sectors that two negative effects cumulate: a lot of illegal labour (causing downward pressure of total labour costs and the twisted use of a loophole in Community law about the 'independent-without-personal', who - in accepting negotiated services contracts - can evade host-country control (i.e. compulsory local wages), come on top of all the other concerns. In late 2007, with growth having returned to all of EU-15 and with falling jobless rates everywhere, these sensitivities have (temporarily) faded away. Moreover, convergence with the new Member States turns out to be faster than expected. Indeed, in countries such as Poland and Romania, rapid wage increases can be observed in sectors having seen strong out-migration. This might open the eyes of many to the benefits of an IM for workers.

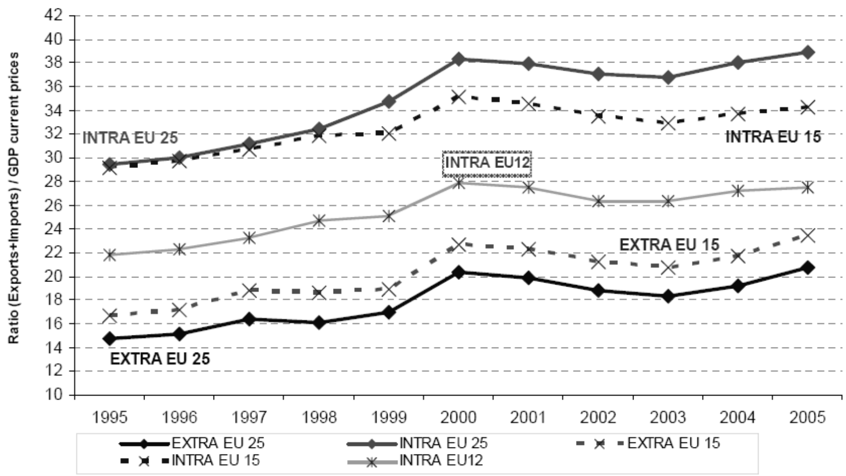
#### 3.3.2.4. The internal market and globalisation

The IM is open except for (selected temperate zone) agricultural goods. It would be good for the EU itself if Doha would succeed, so that tariff barriers in agro-food would drastically decrease, such that imports exercise a disciplinary effect. In services, the IM is, for all its defects, much more open than anything contemplated in Doha. In FDI the EU has always been very liberal indeed (national treatment, already in the Rome Treaty). In capital the EU has no restrictions. In labour the Member States are restrictive but one can discern an increasing preparedness to devise immigration policies for skilled workers and researchers, and to coordinate at least in such a way that wasteful competition for such immigrants is avoided.

The IM can be deepened, especially in services and labour as well as in codified technology. This will raise productivity and reduce vulnerabilities for world competition. Highly specific improvements are harder, yet good to keep on the programme (e.g. the defence equipment market although with few illusions about its speed). But for the remainder, the IM as such is not capable of offering special answers for globalisation. It is no coincidence that Ilzkovitz et al (op. cit.) do not offer convincing answers either. The EU is already quite globalised itself, with massive two-way FDI over the North Atlantic and frantic activities in China and indeed

Asia at large. For many others in the world, Globalisation means that they want to export to the EU! Fears about off-shoring and sub-contracting are understandable but it has little if any connection to the IM as such.

**Figure 10. Ratio of intra and extra-EU manufacturing trade to GDP (per cent)**




Source: Ilzkovitz et al, 2007:

To portray the IM as the 'agent of globalisation' is apparently meant as an accusation. Even if some multinationals might exhibit objectionable conduct in some poor countries, there is no such issue in the IM: in the large and deep IM, the combination of scale, relatively easy entry or rivalry and a credible competition regime disciplines virtually all such companies. Globalisation also implies low or no tariff and quota protection and even regulatory trade policy under the aegis of the WTO SPS and TBT codes as well as the case law of the Appelate Body. This creates opportunities for all in the world (including EU consumers and traders) and forces EU companies to remain on their toes if they find themselves in import competition. If comparative advantages have turned against a Union of high wages and another skill composition, globalisation benefits both (poor) export countries and the rich EU. It is difficult to see why the Union should not globalise and why the IM would have to be changed for that purpose. It is the winners and losers issue that has to be taken serious and the symbolic Globalisation Fund is a political signal to that effect. Economically, its design is likely to be flawed, however (Wasmer & von Weizsäcker, 2007).

Given the manifest case in favour of globalisation, with due attention to losers at both levels of government, the strategy is for business to learn to think and act global and for economic agents in the Union to adjust. In an open IM, these processes are to some extent ‘EU domestic' as the lines between intra-EU and extra –EU are more and more blurred. Thus, the IM has at best a modest additional policy role, unless one counts external market access strategy as part of the IM. Ilzkovitz et al (pp. 79 / 80) suggest that the EU and trading partners should agree on 'common standards', in particular with respect to consumer and environmental regulation. The argument to pursue this is based on the competitive disadvantage of high 'quality of life' standards or regulations. This is a vexed issue, however, also from an economic perspective. Against the drawback of competitive disadvantage, there is the risk of 'raising rivals' costs', a regulatory strategy to throttle the competitive exposure of European business against low-cost rivals.[31] Presumably, a superior approach and not a priori considered 'protectionist' by trading partners, is to organise private intercontinental value-chain management with full and independent certification as well as public reporting, complemented at home in the IM by EU-wide quality marks for recognition by consumers and actively supported by consumer organisations and NGOs. Extreme-low-cost free riders in business would then remain isolated. In environmental regulation, the scope for enforcing EU rules is much greater.

## 4. More internal market: three economic strategies

Three economic strategies to accomplish 'more IM' will be set out. Their logic may be distinct, the underlying economic justifications largely overlap: incremental strategies (in Section 4.1); the IM as the core of an Economic Union serving the 'proper functioning of monetary union'; and deepening and widening of the IM as rationalised by the functional Subsidiarity test (in Section 4.3).

### 4.1. Incremental 'strategies' for the internal market

Should the two internal market strategies under Commissioner Bolkestein now be succeeded by another one under McCreevy? The consultation of mid- 2006 on the internal market gave the impression of 'more of the same'; it did not look 'strategic' at all. However, in September 2006 the Commission suddenly changed course and announced a more fundamental review for the Spring European Council in March 2007. Figure 6 illustrates the 'vision' of an emerging IM strategy proposed by the Commission in February 2007.

[31] In the WTO, the GATT rules impose non-discrimination between all 'like products', irrespective of differences (in 'quality-of-life' standards) in their production process, e.g. labour conditions, animal welfare or (say) less or more $CO_2$- intensive. This legal constraint should also be taken into account.

The Commission suggestions and the responses in the consultation yielded two conclusions: (1) a follow-up strategy should fill *specific* 'gaps' currently found in services, retail financial services, insurance, transport, energy, taxation, free movement of workers and intellectual property (most, if not all, of this is 'more of the same' but helpful); (2) the choice of priorities ought to be more *horizontal*, that is, in fostering market dynamism and innovation (one might query how the EU level can do this?, see 3.3.2.2.), better regulation, better implementation and enforcement taking more account of the global context and more effective communication to citizens and SMEs. Both incremental approaches are up against severe limits. Practically all these areas have been tested more than once and progress is likely to be selective and slow. In by far the most important area – services - no initiative will be possible before 2011 (the rendez-vous clause of Dir. 2006/123), unless the ECJ would declare the adopted directive null and void, which is not impossible. In all other fields the constraints are largely known and the increments when making headway will be modest.

There is indeed a tricky communication problem on the internal market. That was also the case in 1984 / 85. To the experts in those days, accustomed to work in relative obscurity on IM issues, the emergence of business coalitions (such as the European Round Table of Industrialists forging detailed IM plans), business confidence expressed via spectacular cross-border mergers in 1987 and an outright 'europhoria' following the Cecchini report in 1988, came as a total surprise. One should not entertain any hope of this surprise happening again. The EC-1992 episode was unique, it will never come back. Yet, this communication 'trap' creates a very serious obstacle for getting the political attention the IM requires and the publicity it needs for wide support. Dashing any hope that history will repeat itself should not be read as resignation. It means that tackling specific 'IM deficits' will not be facilitated by an overall consensual drive to 'complete' the IM. Thus, each time, the economic case has to be made in a convincing way and socio-political insistence should not be too concentrated so that a 'blocking minority' can be maintained. It also means that a horizontal approach (e.g. justifying a 'deeper' IM as a boost to innovation, or, improving the economic functioning of the IM via 'better regulation') has to be much more than just a cloak. The analytical economic case for a more complete or better functioning IM supporting well-accepted economic aims of the Union will have to be compelling.

The Commission's 'new approach' of the IM, as finally proposed in November 2007, echo some of these points.[32] One may categorise the proposals as 'new' in some respect, as will be briefly outlined below, and more driven by economic analysis than legal 'IM deficits', but as a strategy it is nevertheless an 'incremental' one for the IM. The proposals closely follow the vision paper of February 2007 (see Figure 6, infra, in Section 3.2). They have four aspects:

*i. Deliver more results for citizens, consumers and SMEs.*

This is essentially 'more of the same' but the way it is approached should express that the IM policies are 'responsive to the expectations and concerns of citizens', and 'foster the right conditions for small and medium-sized business'. It includes a 'global approach to consumer rights across the EU' (so far an area with still considerable and resistant fragmentation), tackling more effectively the retail financial services, a new initiative on pharmaceuticals, a Small Business Act for Europe in 2008 as well as a proposal for a European Private Company to facilitate cross-border activities of SMEs.

*ii. Take better advantage of globalisation*

The Commission firmly agrees with our points made in Section 3.3.2.4, noting that the "[…] single market is Europe's best asset in reaping the benefits of globalisation". Apart from a solid but customary plea for multilateral and bilateral (FTA-based) deepening of trade with EU partners and ensuring "that the benefits of openness reach European citizens" (something which critically hinges on sufficient competitive rivalry in wholesale and retail markets but is not new at all), the strategic elements worth paying attention to is for the EU "to take the lead in setting benchmarks", act as a "global standard-setter"[33] and, through regulatory cooperation, convergence of standards and equivalence of rules, to foster "convergence to the top" rather than a "race-to-the-bottom".[34] Somewhat risky, the Commission calls this "expanding the regulatory space of the single market, […] ensuring that European norms are a reference for global standards". Again, nothing new here, except that the EU approach is suggested to change from an ad-hoc case-by-case approach (which indeed has been successful) to a strategic one.

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[32] European Commission, A single market for 21st century Europe, COM (2007) 724 of 20 November 2007. See also SEC (2007) 1518 of 20 November 2007 on 'Instruments for a modernised single market policy'; and SEC (2007) 1519 on the External Dimension of the Single Market Review. Two other papers deal with a quick-scan of the IM acquis (SEC (2007) 152) and the methodology for product market and sector monitoring (SEC (2007) 1517).

[33] In areas mentioned "such as product safety, food safety, environmental protection, public procurement, financial regulation and accounting".

[34] As David Vogel (1995) first demonstrated eloquently with respect to food safety and environmental regulation between the US and the EU.

*iii. Open new frontiers of knowledge and innovation.*

Again the proposals agree with the main point of Section 3.3.2.2, noting that the "Single market can be a platform to stimulate innovation in Europe". The 'single market for knowledge and innovation' is to be stimulated by a new strategy for industrial property rights, a standardisation strategy (with an emphasis on the R&D/standards link) and a series of e-activities.[35]

*iv. Encompass a strong social and environmental dimension.*

This appeal responds to 'legitimate concerns' of workers and citizens about social rights and about compensation of losses. However, though the spirit is clear and the concern about socio-political legitimacy of the IM well expressed, no significant further actions are proposed.

Moreover, the proposals deal extensively with what is denoted as 'delivering results': much more drive to render IM policies 'impact-driven' (e.g. with a consumer scoreboard); better enforcement and still more resources for and use of SOLVIT (the non-judicial consultative, rapid-action approach to remove obstacles in cross-border transactions); rendering the IM more accessible and, above all, better communicated, all elements which are hopefully instrumental to raise awareness and foster 'political and citizens' ownership of the IM.

The present chapter is not the place for a detailed assessment of these proposals. But, as this overview clarifies, the 'newness' of the approach is not its decisive characteristic at all. Anyway, what matters is whether it improves the functioning of the IM and/or accomplishes widening and/or deepening. It also matters strategically that political ownership and socio-political legitimacy is not dealt with lightly. Therefore, given the constraints in today's IM and European integration at large, the proposals can broadly be welcomed.

### 4.2. Economic union, serving the proper functioning of euroland

The IM is the core of the Economic Union, which in turn forms the backbone of the monetary union.[36] A stylised summary of prevailing economic thought is reproduced as Table 1.[37] The table focuses on the macro-economic stabilisation function, in addition to the efficiency function of the EU level of government.

[35] Such as e-invoicing, e-authentication & signatures (mutually recognised) and e-Customs.
[36] The Economic Union is not defined in the Treaty or in any authoritative document endorsed by EU leaders. The economic literature on economic union before Maastricht was undisciplined and unhelpful for Treaty design (Pelkmans,1991)
[37] Table 1 is taken from Pelkmans, 2006, p. 381.

An economic union needed for the monetary union to 'function properly' would have to live up to two requirements: (a) an appropriate adjustment capacity of the union's economy, thereby augmenting the net benefits of the common currency; (b) fiscal policy coordination, such that the price stability aim of Euroland cannot be endangered. For the purpose of the present paper, we are interested in (a).

**Table 1: Economic Union Serving Monetary Union**

**monetary union**
→ irrevocable exchange rates // euro
→ price stability
→ European Central Bank
→ entry conditions
→ policy obligations / Growth & Stability Pact

**EMU** → fiscal conditionalities

**economic union**
IM, plus cohesion + Lisbon/OMC, with appropriate adjustment capacity,
→ Member States' level (structural change / mobilities)
→ social partners / flexibilities / flexicurity
→ (possible) stabilisers (MS/EU levels)
→ regulatory reform at EU and MS levels

It is striking that much of what ought to be achieved can only result from joint strategies with the Member States (allowing structural change, fostering mobilities, regulatory reform, and stabilisers with the right incentives) and to some extent with the social partners at national level (industrial relations; flexicurity). The bottom panel of Table 1 assumes that smooth adjustment can be accomplished this way, without any form of 'political union', which would incorporate what Tietmeyer (1994) calls an irrevocable 'solidarity community'.[38] Again, this would be unique when comparing EMU with any other modern monetary union, say, in federations.

Knowing that the IM is vital for the 'economic union' supporting 'monetary union', the EU cannot avoid a fundamental strategic choice between a kind of *federal economic model* and a soft, consensual approach of economic coordination. The former requires that the IM would have to be deepened in e.g. services and labour as a logical foundation for a significant equity and spending role of the EU level. The latter implies reducing rigidities at the national level,

[38] In a recent review of the economic fundamentals of the EU's monetary union, de Grauwe (2006) concludes that, in the longer run, the euro will only be sustainable with a 'political union'. However, this 'political union' remains completely undefined, let alone, any recommendation of how to get there.

and thereby improving the functioning of the IM without any change in EU powers and without having to opt for a much more ambitious IM in the short-to-medium run. Note how critical this strategic choice is for the future of the IM: either, joint strategies with the Member States work effectively in altering the EU into a flexible economy at all levels (a daring supposition, but one that would reduce the pressure on the IM to be 'complete'), or, substantial progress towards an IM for services and labour is thwarted by the very lack of a convincing 'solidarity mechanism' at the EU level which is irrevocable (i.e. constitutional). Since an EU solidarity community is out of the question for a long time to come, the only option is the former, but the institutional architecture for effective joint strategies with the Member States is weak, at best. Such strategies are bound to be intergovernmental, voluntary, and very 'softly' coordinated. One might interpret the Lisbon approaches (I and II) in this vein. Apart from the obvious problem that Euroland does not coincide with the IM or Lisbon, the 'governance failure' of Lisbon cannot be expected to be overcome. In such a weak setting, and without significant redistribution functions at the EU level, the subsidiarity case for EU coordination (that is, what is the value added to move beyond the Member State level?) is quite limited (see also Pisani-Ferry & Sapir, 2006). In that event, there is little hope that a much more ambitious IM incorporated in the economic union will come into being and/or that joint strategies will yield a major and lasting contribution to the adjustment capacity underlying the monetary union.

### 4.3. IM and subsidiarity

The functional application of a subsidiarity test is inspired by the economics of federalism. It can be helpful in avoiding unjustified centralisation whilst exposing false arguments by unwilling Member States frustrating solid improvements of the IM where a good subsidiarity case can be made.[39] It would be illusionary, however, to suggest that this will carry us very far in actual EU practice. The political sensitivities in areas where subsidiarity would call for considerable change do not go away simply because a rational, analytical case is provided. Thus, the income support in the CAP could better be pursued at the Member State level (in a tight EU framework, to be sure) and EU subsidies to (relatively) poor regions in rich EU Member States would seem to be pointless and roundabout, but politics is decisive here, not a functional test. More narrowly about the IM, there can be little doubt that a genuine IM for

[39] Pelkmans, 2005a; Pelkmans, 2005b; Ederveen, Gelauff & Pelkmans, 2006.

network industries requires regulators at the EU level, but the Meroni doctrine[40] will first have to be circumvented.[41] Despite these political and institutional realities, the systematic employment of functional (not: political) subsidiarity tests is likely to contribute to a less politicised debate about gradual improvements of the IM architecture and substance. The fact that subsidiarity tests are now included routinely in RIAs at the EU level and begin to be practiced by national parliaments (inspired by the new Treaty of Lisbon) might well set in motion a trend of assessing in a more detached fashion what it takes to have a better functioning IM for Europe. Still, many politicians regard subsidiarity as a 'political' tool, expressing in some vague sense sentiments about (too much) centralisation, without realising that the principle ought to be seen as working *both ways*: protecting Member States' powers, where there is no value-added at the EU level, but just as well, shifting (the application of) powers to the EU level when the functional case can be made, so that the IM works better for the economic performance of the EU.

## 5. Conclusions

In economics, there are theoretical approaches to the IM (with a significant increase in sophistication during the last two decades), empirical approaches inspired by such theory, simulations inspired by such theory, empirical approaches verifying the actual degree of market integration (such as 'home bias') and finally there is a great deal of applied economic work which may be inspired by analytical economic traditions but has to cope with the day-to-day practice of the development of specific proposals to deepen and widen it. An unconstrained definition of the IM has never really changed for economists, however: it implies the full liberalisation and proper regulation (combined with common policies where appropriate) of goods and services market as well as those of mobile factors of production. The EU has minor difficulties in goods markets still, but huge obstacles in services and still bigger ones in labour markets. For codified technology, progress has been impressive except

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40 The Meroni doctrine originates from a 1958 ruling of the ECJ. It pre-empts EU-level independent regulators from coming into being on constitutional grounds. However, the functional logic to have EU regulators for the IM of network industries is so powerful that EU networks of national regulators in combination with the Commissions' role in competition policy (and the economic freedoms) become more and more important. In electricity, gas and telecoms, one observes the emergence of EU 'regulatory networks' as an ever closer substitute for a single EU regulator.

41 Note that, in SEC (2007) 1518 of 20 Nov. 2007, p. 27, the Commission once again pleas for strong cooperation between (national) regulators. Examples in financial services, electronic communications and electricity & gas are provided. This is as far as the Commission can go under Meroni. Of course, there is also the query whether the Commission would be all that keen to see fully-independent European regulators emerge!

for patents, and in financial capital markets there are no formal barriers but different standards and high trade costs in equity. The economists' concept of ’the‘ IM is therefore still far away.

Economists have difficulty in coping with the phenomenal differentiation in IM issues, not only with respect to highly differentiated and technical regulation, but also for numerous barriers to market integration. Thus, it may perhaps come as a surprise to political scientists and lawyers that aggregate studies on IM effects are relatively few, but once one realises the magnitude and complexity of the task, the paradox may be appreciated. [42] Aggregated studies on the IM cannot easily be cumulated from the sixties to today, yet, in principle, the economic gains from the IM should be calculated from the beginning. The more recent empirical studies do not report impressive gains, although, in fairness, they do not cover the years before (say) 1990. Nevertheless, until a decade ago, the idea was that the EU's IM had become quite integrated, at least for goods. The 'home bias' literature has presented a new puzzle to economists as it shows that Europeans may not be so integrated after all.

The IM paradox is that it is (too) often regarded as a boring and uninspiring subject in European integration and at the same time, it is used as the EU's workhorse par excellence to pursue an incredible range of objectives. The Treaty design of the EC is even such that the IM (and EMU) are the only significant means, selectively supported by the EU budget, for (in Amsterdam) no less than 8 socio-economic aims. Consultations and the 2007 Commission 'vision' exacerbate this ‘workhorse’ function. An IM driven mainly by the goals to be pursued is likely to be a more fruitful approach than the classical extrapolation of the legal 'completion' route, which is close to being exhausted for political reasons. The economic case for deeper services market integration is only beginning to be built up by economists now; if it comes to the largest segment outside tourism (business services) the contribution to EU economic growth is already disproportionably high and deeper market integration might accentuate that. The link between the IM and innovation is also critical for Europe's growth but current scoreboards fail to indicate *how the IM* can stimulate (except for a true EU patent). The debate about the 'social dimension' of the IM is most curious from an analytical perspective because the anxiety seems to be very much an EU-15 phenomenon (in contrast to the new Member States) and the construction of the IM itself provides few arguments for arguing an 'a-social' outlook (see Pelkmans, 2007a). Anyway, most of the social framework

[42] Moreover, the ‘aggregated’ studies are, in fact, based on sweeping generalisations of e.g. regulatory impact, and invariably leave out a number of details or specific manifestations of the IM (see 3.3.1).

is profoundly national. The EU is itself one of the leading ‘globalisers’ and the IM supports such moves forcefully. It is very hard to understand how the IM with a huge market and such diversity could not be a useful preparatory ground for globalisation. The issue which deserves attention is to appreciate the problem of identifiable losers. A balancing act might be necessary when advocating 'standards' (in fact, what is meant is mainly regulations) at world level for reasons of preserving competitiveness: the 'level-playing field' versus 'raising rivals' costs'.

The political legitimacy of deepening and widening the IM is a paramount issue which has to be taken serious by economists (and the EU institutions). Between the three routes to ’more IM’, the incremental strategy is bound to be selective and cumbersome (as indeed it was under the two strategies pushed by Commissioner Bolkestein), but possibly fruitful in the longer run. The November 2007 Commission proposals on a ‘new approach’ to the IM clearly belong to the class of incremental strategies. Feasible, presumably, but working only gradually and with a piecemeal structure of initiatives. The ‘economic union’ approach is heavily dependent on MLG aspects (which cause complexity without effectiveness, yet, remain inevitable in the Union) and some measure of common equity (or, 'solidarity' in Tietmeyer's famous wording when still Bundesbank president), which is unlikely to come about in the foreseeable future. The functional subsidiarity approach is still insufficiently recognised by the current generation of politicians. Setting consensual aims and firmly backed strategies might work for the IM, if and only if the question of political legitimacy (which, in and by itself, is helped by a goal-driven IM, as long as voters can associate with such goals) is convincingly addressed in the MLG framework at both levels of government.

Appendix 1


IM STRATEGY 2003-2006
Conditions for business (patent; other IPR; I. Acc. Stand; Corporate governance/take-over; SE for SMES
Free movement of goods (MR, standards, eco-design; unsafe goods)
Free movement services (Fin. Services; Action Plan; Services Dir (!); ext. Of 98/34
Network Industries (all + state aids: PPPs)
Reducing tax obstacles (parent/subsidiarity Dir. revision; mergers; corporate tax base harm.; car registr. tax out)
Procurement (SOLVIT for PROC; national supervisors; e-proc.; defense
Better info (various) (new MS)
Enforcement acquis (more/swifter sanctions; decentralising; consumer prot.; administrative cooperation)
Slimming Regulation (see Better Regulation)
Conditions for business (patent; other IPR; I. Acc. Stand; Corporate governance/take-over; SE for SMEs

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