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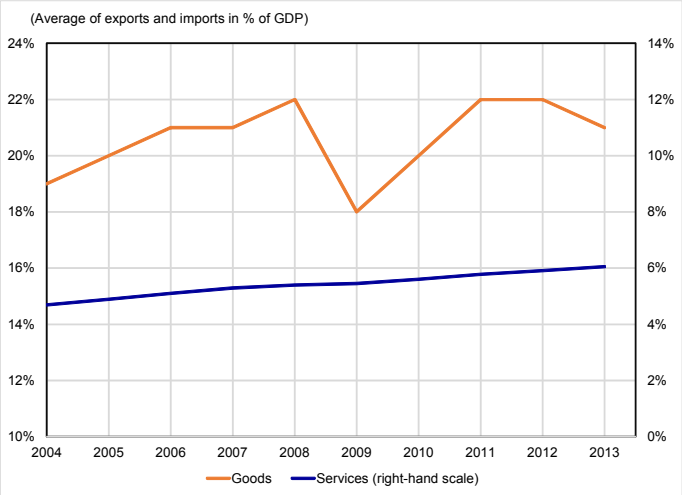
TRÉSOR-ECONOMICS

Deepening the European internal market today: how and why

"The European economic model must be based on three principles: competition which stimulates, cooperation which strengthens and solidarity which unites."
Jacques Delors

- The European internal market has been one of the key goals of the economic and political project of the European Union (EU) since the Treaty of Rome (1957). Its gradual implementation has brought major economic gains and provided momentum for modernising EU economies. The process has promoted strong growth in trade between Member States, followed by closer economic integration. Beyond the lifting of internal trade barriers, the establishment of an integrated market thus depends on the implementation of the four freedoms – free movement of goods, services, capital and persons – and is based on cooperation, regulation and convergence.
- The deepening of the European internal market remains an essential growth driver. Closer integration of European markets is, in particular, a prerequisite for enabling European countries to compete internationally against the other leading players with deep markets, such as the United States and China. This aspect is even more critical in a context of rapid technological changes. In addition, an efficient internal market is especially important for the good functionning of the euro area since it would allow to cope more effectively with economic shocks.
- However, market integration at European level remains uneven. In the goods market, it appears to have made substantial progress; in the services market, by contrast, it is still very limited. In particular, the network industries – transport, energy and telecoms – remain largely fragmented. The deepening of the internal market also requires further integration in two essential areas: capital markets and personal mobility.
- An integration process of such magnitude can, however, create economic, social and territorial imbalances. The consequences of such imbalances can be mitigated by implementing efficient regulation and solidarity mechanisms. A renewed drive for internal market integration should therefore go hand-in-hand with the creation of new regulatory bodies and the revival of convergence mechanisms.

Intra-EU trade



Source: Eurostat.
How to read this chart: the proportion of intra-EU trade in services increased from 4,7% GDP to 6% GDP between 2004 and 2013.

MINISTÈRE DES FINANCES ET DES COMPTES PUBLICS

MINISTÈRE DE L'ÉCONOMIE DE L'INDUSTRIE ET DU NUMÉRIQUE

1. Access to a large and efficient market remains a necessity for European countries

1.1 The construction of a large European market, through the lowering of cross-border barriers on goods, services, capital and persons, has also been accompanied by EU regulatory and convergence policies

The main goal of the internal market is to establish a large trade area without internal borders, in which **the free movement of goods, services, capital and persons** is guaranteed (Treaty on the Functioning of the European Union [TFEU], Article 26). Economic theory offers two main arguments for abolishing trade barriers. The first is the trade effect: lowering of tariff and non-tariff barriers raises demand for exports, generates efficiency gains, and thus increases disposable income. Secondly, the pro-competitive effect of market opening would lower prices, increasing the consummer well-being.

These two effects would be sources of efficiency gains. Indeed, according to comparative advantage theory, the growth in trade leads to increased specialisations of economies in sectors where they are, comparatively, the most productive, which has a positive impact on business activity and employment. Moreover, the increase in competition level could reduce monopoly rents and give firms a greater incentive to achieve productivity gains and innovate in order to remain on the market or to limit their margin losses.

Box 1: **Milestones in the construction of the internal market**[a]

- **Customs union.** The first step in the integration of goods trade in what later became the EU was the creation of a customs union immediately after the enactment of the constitutive treaties: ECSC (1951), Euratom Treaty (1957) and European Community treaty (1957). The customs union was implemented gradually through (1) a freeze on existing customs duties and quantitative restrictions followed by their staged removal, and (2) convergence of the external customs tariff. The union was completed by 1 July 1968.
- **The Single European Act (1986)** launched the construction of a truly integrated market, as advocated by the Delors Report (1985). In addition to extending the competencies of the Community to new policies and introducing the qualified majority, the Single Act called for the gradual implementation of the single market. Nearly 300 directives to remove non-tariff barriers were adopted between 1985 and 1992. In many areas, national regulations have been harmonised or mutually recognised between Member States. The Single Act also introduced cohesion policy into the Treaties.
- **The enlargements of the 1990s and 2000s.** In 1995, Austria, Finland and Sweden joined the EU, while the other EFTA members (Norway, Iceland and Liechtenstein) together with the EU formed the European Economic Area (EEA) in order to fully participate in the European internal market (excluding agricultural products and fisheries). Switzerland signed bilateral free trade agreements with the EU after rejecting EEA membership by referendum. The internal market's geographic coverage has expanded further with the accession to the EU of ten "new Member States" (2004), Bulgaria and Romania (2007) and Croatia (2013).
- **Relaunching the internal market in 2010.** The Monti Report (2010) considered a revival of the internal market project as part of a broader approach. The aim was to elaborate a new compromise between, on the one hand, the deepening of the internal market for goods and services and, on the other hand, the revival of tax and social-policy projects in order to establish the basis for renewed political support. The Single Market Act (SMA 1 and 2) called for a series of actions to promote four priorities: network development, digital market, citizen mobility and social economy.

a. The terms "common market", "single market" and "internal market" are often used interchangeably. The Treaties only refer to the third. In a manner of speaking, it denotes the end-point in the construction of an "area without internal frontiers" (TFEU Art. 26.2) of which the common market (chiefly materialised by the abolition of customs duties) is regarded as one of the stages.

The construction of this large European market has been supported by EU regulatory and convergence policies. EU competition policy, for example, has been strengthened to achieve better control of competition-distorting practices in the private sector (such as cartels and abuse of a dominant position) and the public sector (through rules for government subsidies). Europe has also enacted other policies regarding network sectors such as transport, energy, and telecoms, of which the proper functionning is crucial to the efficiency and integration of the internal market. Structural funds have been set up to promote the economic convergence of Member States. The 1986 Single Act-which followed Jacques Delors's white paper-incorporated the goal of economic and social cohesion into the Treaties.

1.2 The expansion of the internal market is a growth and employment driver

Until now, the gradual integration of European markets has been a significant growth driver for Member States. Several studies have assessed the macroeconomic gains accruing from the formation of the internal market (see Box 2). The findings suggest that the Single Act (including the opening of the telecoms and electricity sectors to competition), combined with EU enlargement, boosted GDP by an average of approximately 2 percentage points (see Table 1). By way of illustration, the European Commission estimates that the implementation of the Services Directive alone stimulated the EU GDP by 0.8 %.

1.3 The rise of the new digital economy makes the deepening of the internal market an even more desirable goal

In addition, the dynamics of production systems and the technical progress generated by the digital revolution raise the issue of whether EU production structures and regulations are well matched. New technologies have stimulated the emergence of new sectors enjoying significant scale and network effects-largely procured by the digital economy[1]. For these sectors, a large market promotes innovation and the emergence of world-class players. A sufficiently large and integrated single market thus seems essential to the development of innovative sectors at EU level[2].

1.4 An efficient internal market is also essential for the euro area

The latest crisis has shown that the proper functioning of the euro requires closer economic and financial integration, and hence an efficient internal market, particularly to cope with asymmetrical shocks, as monetary union members cannot resort to devaluations of their nominal exchange rates. Integrated economies and flexible markets and prices provide greater resilience to economic shocks. Furthermore, increased cross-border holdings of financial assets, promoted by the internal capital market, would ensure a better geographic sharing of risks and income losses when certain Member States suffered such shocks, provided that the market was properly regulated. The vicious circle of risk contagion between the banking and sovereign sectors, and the ensuing financial fragmentation have all demonstrated the importance of a properly functioning, regulated and integrated capital market, especially in the banking sector. This is a prerequisite for financial stability, efficient transmission of ECB monetary policy and economic recovery.

Box 2: How does one measure past and expected gains from the internal market?

The assessment of gains due to the internal market rests on the assumption that **the policies implemented within the framework of the internal market translate into variations of what are called regulatory indices**, such as product market regulation (PMR) indices[a] for the goods and services market and employment protection legislation (EPL) indices for the labour market. The variations of these regulatory indices can be either observed for ex-post assessments of past gains, or imputed for ex-ante assessments of expected gains[b].

While the microeconomic channels for the dissemination of these policies are fairly well identified, their aggregation for the purpose of estimating the combined effects on economic growth is more complicated, particularly because of issues concerning feedback effects between the variables.

To overcome these difficulties, the most recent studies adopt a two-stage approach. The first stage consists in estimating the response of selected supply components (such as productivity or margin ratio[c]) to variations in regulatory indices, which reflect the measures enacted within the framework of the internal market. The second stage consists in introducing the estimates from the first stage into a macroeconomic model, which is used to estimate an impact on the economy as a deviation from a counterfactual scenario in which no measure had been enacted. The choice of variables assumed to be impacted by the measures adopted (total factor productivity, labour productivity, margin ratio, prices, and so on) is decisive, for – in this type of model – the channel chosen strongly influences the macroeconomic results.

The tables below illustrate estimated past gains (Table 1) and expected gains (Table 2) from the deepening of the internal market. It should be recalled, however, that these estimated effects on GDP are not comparable. Not only do the models differ, but so do the periods and countries covered.

a. In the services sector, the European Commission also uses its own binary regulation index.
b. The estimates of expected gains offer scenarios for "top-down" harmonisation of regulatory practices, in which regulatory indices are made to vary in order to converge towards best practices observed.
c. The estimated impact of variations in regulatory indices on productivity is based on the articles by Bourlès et al. (2010) and Bouis et al. (2012) to allow for the short-term dynamics of reforms. To estimate the impact of variations in regulation indicators for corporate margin ratios on prices, we relied on the econometric study by Griffith and Harrison (2004). Bourlès et al. (2010), "Do product market regulations in upstream sectors curb productivity growth ? Panel data evidence for OECD countries", *Working Paper* No. 283, Banque de France.
Bouis et al. (2012), "The short-term effects of structural reforms: an empirical analysis", OECD Economics Department *Working Papers* n°949, OECD Publishing.Griffith et Harrison (2004), "The link between product market reform and macro-economic performance", *Economic Paper* n°209, European Commission.

(1) J.-C. Rochet and J. Tirole (2005), "Two-sided Markets, a Progress Report", *RAND Journal of Economics*, RAND Corporation.
(2) On the effect of market size on innovation, see, for example, P. Dubois et al. (2014), Market Size and Pharmaceutical Innovation, *CEPR Discussion Papers*.

Table 1: Illustration of estimated past gains from internal market

Study	Period studied	Gain: EU	Gain: France	Greatest gain	Smallest gain
European Commission (2007)[a]	1995-2003	+1.2% of GDP in 2003 (EU-15)	+1.7% of GDP in 2003	+3.6% of GDP in 2003 (Suède)	–1.3% of GDP in 2003 (Italy)
		–0.6 pp for average unemployment rate (EU15)	–0.7 pp for unemployment rate	–1.7 pp for unemployment rate(UK)	+2.2 pp for unemployment rate (Italy)
	1992-2006[b]	+2.1% of GDP in 2006 (EU-15)	NA	NA	NA
		+1.5% for employement in 2006 (EU-15)			
European Commission (2012)[c]	2006-2011	+0.8% of GDP in 2011 (EU-27)	+1.1% of GDP in 2011	+1.8% of GDP 2011 (Cyprus)	+0.3% of GDP in 2011 (Bulgaria)
Bertelsman Stiftung (2014)[d]	1992-2012	NA	+0.8% of GDP per capita in 2012	+2.3% of GDP per capita in 2012 (Germany)	–1.3% of GDP per capita in 2012 (Greece)

a. European Commission (2007), "Quantitative Assessment of Structural Reforms: Modelling the Lisbon strategy" *Economic Papers* No. 282.
b. This assessment, presented in the same paper, takes into account not only the reforms in the labour market and the goods and services market (first row of table), but also network-sector reforms and EU enlargement. However, it does not give results at national level. See also Ilzkovitz, F., Dierx A., Kovacs V., and Sousa N. (2007), "Steps towards a deeper economic integration: the internal market in the 21st century – A contribution to the Single Market Review", *Commission Economic Papers*, n°271.
c. Monteagudo J., Rutkowski A. et Lorenzani D. (2012), "The Economic Impact of the Services Directive: A first assessment following implementation", *Economic Papers* n°456. This study focuses exclusively on the effects of the Services Directive.
d. Bertelsman Stiftung (2014) "20 years of the European single market: growth effects of EU integration", *Policy Brief* 2014/02. The estimate described in this paper is, however, simpler and does not use looped models. This may result in double counting.

How to read this table: The effects reported are expressed in percentage-point deviations from a baseline scenario in which none of the reforms studied has been enacted. For example, the 2007 European Commission study estimates that, thanks to the reforms implemented in the labour market and the goods and services market within the framework of the internal market, French GDP gained 1.7 points in 2003 compared with a scenario without reforms.

Table 2: Illustration of expected gains from a deepening of the internal market

Study	Assumption	Time horizon	Average gain EU	Gain: France
European Commission (2012)	Alignment of barriers on average practice in EU countries	Long-term (80% of effects in 5 years)	+0.4% of GDP (EU-27)	+0.5% of GDP
	Alignment of barriers on practice of 5 top-performing EU countries	Long-term (80% of effects in 5 years)	+1.7% of GDP (EU-27)	+1.6% of GDP
IMF (2014)[a]	6% reduction in regulatory barriers in each sector, leading to a 1% rise in total factor productivity in each sector	2 years	NA	+2.8% of GDP
IMF (2014)[b]	Simulated 50% reduction of gaps in indices between euro-area countries and OECD countries	5 years	+1.8% of GDP (euro area)	NA
		Long-term	+7% of GDP (euro area)	

a. IMF (2014), "The EU Services Directive: Gains from Further Liberalization".
b. IMF G20 (2014), "Assessing the gains from structural reforms for jobs and growth". Presented to G20 Framework Group.

2. While the internal market has become more integrated, significant untapped potential remains, particularly in services

2.1 Since the Single Act, the internal market has made further progress, but it is still less integrated than the U.S. market

Various market integration indicators (see Box 3) suggest that EU goods and services markets have become more integrated in the past several decades, since the creation of the single market.

The OECD price convergence index[3] shows an integration trend over the 1995-2010 period (see Chart 1), mainly driven by the new Member States. The OECD's global product market regulation (PMR) indicator shows a clear improvement for the EU since 1998 (see Chart 2).

(3) Coefficient of variation of relative prices of household final consumption expenditure, in percentage points.

Box 3: **How does one measure the degree of internal market integration?**

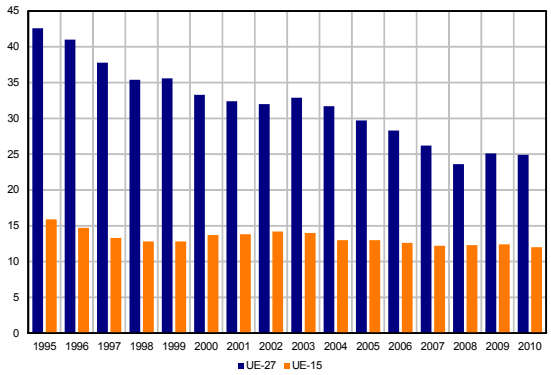
While it is hard to determine the degree of integration of goods and services markets and establish the causal relationship with the introduction of the internal market, one can apply several approaches in order to arrive at an estimate. The most widely used are based on:

- Changes in the **regulation of goods markets**, in particular the indicators for barriers to entrepreneurship and international trade and investment. If such barriers are low, market access is easier.
- **Trade in goods and services** between member States of a common market. Increased trade is read as a sign of closer integration. The reduction of the "border effect"[a] in a common market can, for example, be viewed as a measure of closer integration between members.
- **Price indices** or **competitive intensity**. The greater the integration of national economies into the single market, the more prices should converge and margin ratios narrow[b] because of the lack of specific barriers to each market. For example, Badinger (2007)[c] studied the impact of the creation of the European internal market on margin ratios and found a nearly 30% reduction in industry in the 1990s[d].

More generally, the economic literature uses two types of indicators to measure the degree of convergence of national economies after the establishment of an internal market. First, output-based indicators can tell us about the degree of completion of the internal market with respect to the economic and social results that it is supposed to generate, particularly in terms of convergence (GDP per capita, labour productivity and cost of labour, cost of capital and so on). Second, aggregate indicators have been developed, in particular by the European Commission, to provide a more general measure of the integration of regulations (such as the Single Market Scoreboard), market functioning (such as the Market Monitoring Tool) and benefits to consumers (such as the Consumer Markets Scoreboard)[e].

a. The border effect denotes the reduction in trade-flow intensity due to the existence of a political border by comparison with intra-national trade.
b. Defined as the ratio of the selling price to the marginal cost of production.
c. Badinger H. (2007), "Has the EU's Single Market programme fostered competitition? Testing for a decrease in mark-up ratios in EU industries." *Oxford Bulletin of Economics and Statistics.*
d. In services, by contrast, the creation of the European internal market is believed to have had no impact, or to have had an anti-competitive impact, as margin ratios are thought to have risen during the same period. This suggests a gap between internal-market implementation in industry and services.
e. For a review of these indicators, see Pelkmans et al. (2014), "Towards Indicators for Measuring the Performance of the Single Market", Briefing for the IMCO Committee, European Parliament.

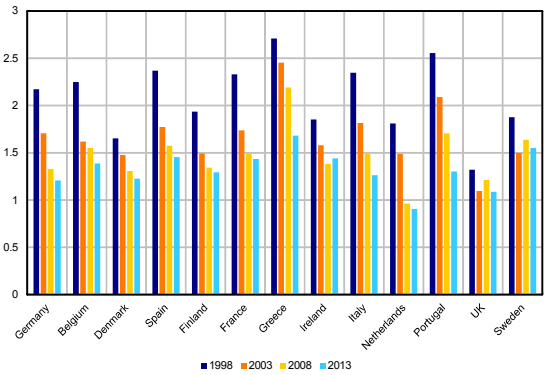
Chart 1: Price convergence indicator



Source: OECD.

How to read this chart: The price levels converged in the EU27 between 1996 and 2010. The coefficient of variation of comparative price level diminished from more than 40% to less than 25% in 2007 and remained stable afterwards.

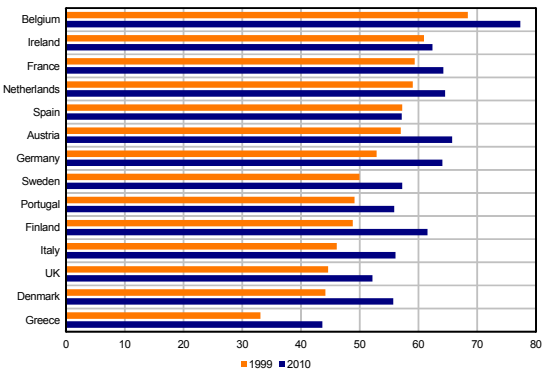
Chart 2: Global PMR indicator



Source: OECD.

Jorg Konig and Ohr Renate[4] have, for example, built an aggregate indicator of economic integration between countries using indicators on intra-EU trade, macroeconomic indicators, and data on economic conditions (see Chart 3). They find closer economic integration in nearly all EU countries between 1999 and 2010.

Chart 3: EU economic integration, 1999-2010

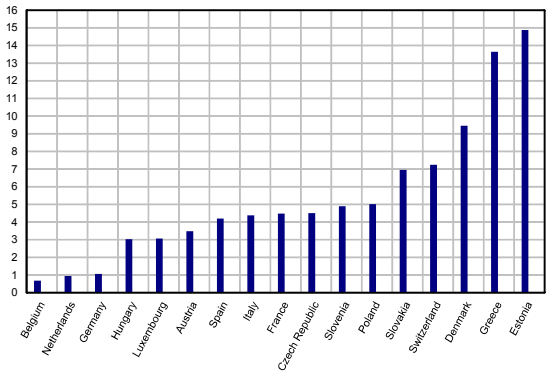


Source: König J. and Ohr R. (2012).

(4) J. Konig and R. Ohr (2012), "Homogeneous groups within a heterogeneous community - Evidence from index measuring European economic integration", *Discussion Paper* no. 138, CEGE, Gottingen.

By contrast, while the "border effect" inside the EU appears to have decreased by one-third since the late 1970s[5], it nevertheless remains significant in most Member States (see Chart 4). Moreover, trade intensity remains weak by comparison with the U.S.. While Europe's population is more concentrated geographically, trade in goods between U.S. states exceeds intra-EU trade by 80%[6]. Indeed, several studies underscore the fact that-excluding language effects and geographic effects-EU economic agents continue to display a domestic bias[7] three to four times greater than the one observed in the U.S.[8,9]. These results suggest that significant additional gains could be achieved by further deepening the internal market.

Chart 4: Border effects in the EU



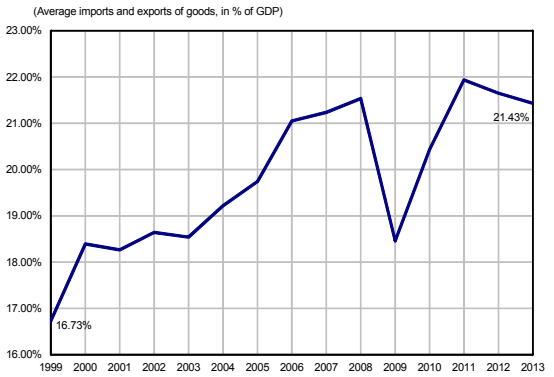
Source : OECD (2014), OECD Economic Studies: European Union, data from H. Braconier et al. (2013), Road Connectivity and the Border Effect: Evidence from Europe, OECD Working Papers, no. 1073. The OECD uses confidence intervals not reproduced here.

How to read this chart: Estonia's intra-national trade is 15 times greater than its international trade, all other things being equal (distance in particular). To calculate the border effect, this chart uses road distance and not distance "as the crow flies" between different pairs of cities.

2.2 The internal market for goods can be regarded as a success today, but there is scope for further integration chiefly by enforcing existing legislation

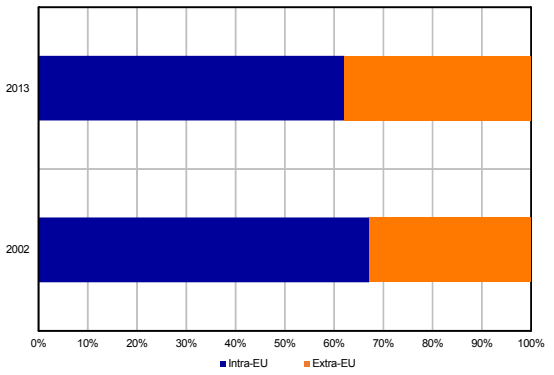
Despite the 2009 crisis, intra-EU trade in goods has grown substantially, from 16% of GDP in 1999 to almost 22% today (see Chart 5). The implementation of the internal market has contributed strongly to the expansion of trade and investment in the EU; studies have failed to find significant crowding-out effects on trade to the detriment of non-EU countries[10]. The concomitant arrival of emerging countries in world trade has naturally pulled EU trade towards the non-EU area ("globalisation effect"). Intra-EU trade still accounts for well over half of EU trade, however (see Chart 6).

Chart 5: Intra-EU trade



Source: Eurostat, authors calculations.

Chart 6: EU trade in goods



Source: Eurostat.

While the formation of the internal market has had a highly positive impact on trade in goods, there is scope for further market integration. To begin with, the integration of countries into the single market is heterogeneous; their participation rates in intra-EU trade are uneven (see Chart 7).

(5) L. Fontagné, T. Mayer and S. Zignago (2005), "Trade in the Triad: How Easy is the Access to Large Markets?", *Canadian Journal of Economics.*

(6) Inter-state trade accounted for 38% of GDP in the U.S. in 2010. See OECD, 2012, Economic Studies, European Union; see also F. Ilzkovitz, A. Dierx, V. Kovacs and N. Sousa (2007), "Steps towards a deeper economic integration: the internal market in the 21st century", European Commission, DG ECFIN, European Economy - *Economic Papers* 271.

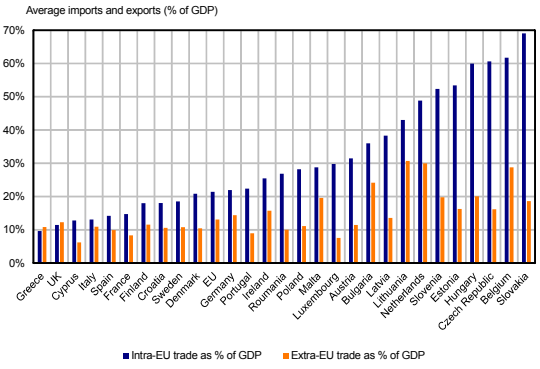
(7) The domestic bias implies that domestic actors trade more within the borders of the country that with foreign countries, all things being equal.

(8) C. Pacchioli (2011), "Is the EU internal market suffering from an integration deficit? Estimating the "home-bias effect"?", *CEPS working document.*

(9) K. Head and T. Mayer (2002), "Non-Europe: The Magnitude and Causes of Market Fragmentation in the EU", *Review of World Economics.*

(10) See, for example, B. Straathof, G. J. Linders, A. Lejour and J. Mohlmann (2008), "The internal market and the Dutch economy: Implications for trade and economic growth", *CPB Document* no. 168.

Chart 7: Intra- and extra-EU trade by Member State



Source: Eurostat.

Given the level of integration reached in the goods market and the substantial body of existing EU regulations, the top priority would appear to be a close monitoring of the proper enforcement of EU law and-if need be-the enactment of additional regulations to address any obstacles that persist or reappear. With this goal in mind, the EU has adopted efficient governance and oversight tools for the internal market, but some of their features could be strengthened. In particular, the pre-dispute mechanisms – Solvit for cross-border disputes, EU – Pilot for disputes relating to the improper enforcement of EU law – should be better coordinated and more visible in order to fully play their role as informal resolution mechanisms[11]. A rationalisation of information networks for businesses – notably by setting up "points of single contact" – should also improve access to the internal market and implementation of the relevant legislation.

Making further progress in integrating EU goods markets requires promoting large-scale cross-sectional actions to reduce the remaining barriers to intra-EU trade and improve the business environment. Such actions include a reduction of administrative costs[12], tax harmonisation, and transparency and publicity of public-sector procurement[13,14]. These are probably the most powerful levers for further integrating the goods markets, but they are also the hardest to achieve.

Box 4: **Internal market oversight mechanisms**

The EU has implemented several formal instruments to address potential bias in the internal market and restrictive practices.

- **Consultative role of the Commission**

Articles 116 and 117 of the TFEU allow the Commission to enter into consultations with Member States to avoid disparities in legislative or regulatory arrangements, or a bias that distorts competitive conditions in the internal market. In practice, these articles are seldom applied.

- **Procedure for notification of new technical obstacles**

Under Directive 2015/1535 (formerly 98/34), Member States must notify the Commission of planned regulations and new technical standards regarding goods and certain remote services. The Commission is required, in turn, to notify all Member States of such developments in order to detect any possible new obstacles. This mechanism is crucial to the effective implementation of the internal market. The Services Directive introduced a similar notification procedure for services-sector regulations, but it has proved far less effective.

- **Early warning procedure (Regulation 2679/98)**

The early warning procedure is designed to counter unexpected obstacles to the free movement of goods (such as abuse committed by producers against products of other Member States).

- **Action for failure to fulfil obligations**

The Commission or a Member State can initiate proceedings at the European Union Court of Justice (EUCJ) against another Member State (TFEU Art. 258-260) for failure to fulfil one of its obligations under EU law (primary or secondary). This procedure is not specific to the internal market. The European Commission uses it routinely to ensure a uniform application of single-market principles and the related secondary legislation. The Court's jurisprudence has thus played a crucial role in the growth of the internal market.

(11) See especially J. Pelkmans and A. Correia de Brito (2012), "Enforcement in the EU Single Market", CEPS.

(12) H. Kox (2005), "Intra-EU differences in regulation-caused administrative burden for companies", *CPB Memorandum,* finds that administrative costs for the private sector account for 3.4% of EU GDP. This aggregate figure masks considerable heterogeneity between countries: costs are particularly high in Greece and Hungary (6.8% of GDP), and far lower in the U.K., Sweden and Finland (1.5% of GDP). Using a simulation on the QUESTIII model, the European Commission estimated in 2008 that a 25% reduction in administrative costs between 2006 and 2010 would raise GDP by between 1 percentage point (scenario with constant number of firms) and 2 percentage points (scenario allowing for entry of new firms) by 2025 (see *Quantitative assessment of structural reforms: Modelling the Lisbon strategy*, op. cit.).

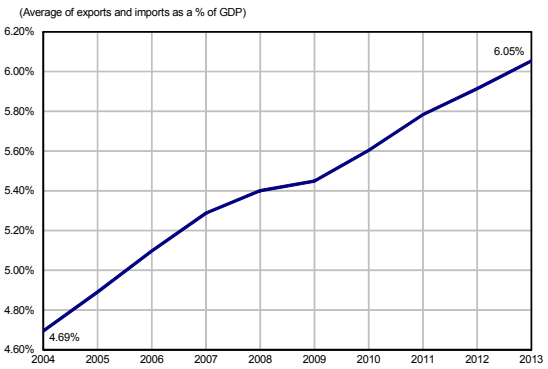
(13) Today, only 20% of public-sector expenditure on goods and services are covered by the EU procurement directives. See Europe Economics (2014), The cost of non-Europe in the single market: public procurement and concessions, study for the European Parliament. The study estimates that greater competition in public procurement would generate annual savings of €36-66bn.

(14) A study prepared for the Commission concludes that a reduction in non-tariff barriers and in obstacles to FDI in the goods market for the average of the five top-performing EU countries (measured by PMR indicators) would raise exports by 1.1 percentage points of GDP. The study uses a partial equilibrium model; the final impact on GDP is not calculated. See RAND Europe (2014), The cost of non-Europe in the single market: free movement of goods.

2.3 The deepening of the internal market in services and network industries is a source of growth

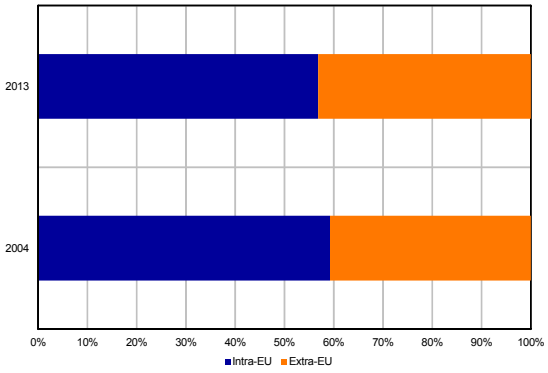
EU action in recent years has allowed some deepening of the single market in services. The enactment of the Services Directive reduced the heterogeneity of regulations between Member States by 25% in 2009[15]. However, the integration of the services market still appears to be lagging well behind that of the goods market. Services accounted for 71% of EU GDP and 67% of EU employment in 2011, but home and local bias is naturally far higher in the services market than in the goods market, given the relatively greater importance of the supplier-customer relationship in the sale of a service. As a result, integration of the services market at EU level, despite its progress, has been weaker and slower than that of the goods market. The share of services trade in EU GDP edged up from 4.8% to 6% between 1999 and 2013 (see Chart 8)[16]. Intra-EU services trade nevertheless continues to exceed extra-EU services trade by a wide margin (see Chart 9)[17], in spite of a mild decline since 2004.

Chart 8: Intra-EU services trade



Source: Eurostat, authors calculations.

Chart 9: EU services trade



Source: Eurostat.

In response to this situation, and beyond a full application of the 2006 Services Directive, the EU should take action in the sectors that display the greatest integration lags and the highest growth potential. The OECD economy-wide and sectoral regulation indicators (PMR and NMR ["non-manufacturing"] respectively) suggest that some sectors are particularly in need of deepening. The same conclusion can be drawn from the shares of these sectors in the total economy (see Table 3). They include professional legal and accounting services, other regulated professions (architecture, engineering), retail and wholesale trade, and the network economy.

Table 3: Status of regulations and shares of selected services sectors in total economy

	OECD PMR - 2013 EU average	OECD PMR - 2013 EU standard deviation	OECD PMR - 2013 EU OECD gap	Share of GDP - 2011 (%) EU
Legal services	2.87	1.17	0.15	3.1*
Architecture	1.62	1.01	0.24	1.3**
Accounting	2.10	0.66	0.08	3.1*
Retailing	1,99	0.91	0.36	4.4
Engineering	1.06	0.92	−0.03	1.3**
Post	2.45	0.7	−0.58	0.5
Telecom	0.81	0.43	−0.17	1.5
Air passenger transport	0.83	1.20	−0.23	0.3
Rail freight	3.2	1.01	−0.92	NA
Road freight	2.16	0.73	0.82	2.3
Electricity	2.03	0.68	−0.94	1.9***
Gas	2.21	0.94	−0.45	1.9***
Network sectors	1.96	0.48	−0.31	NA

Source: OECD PMR/NMR surveys, Eurostat for shares of GDP.

How to read this table: *includes share of legal and accounting services; **includes share of architecture and engineering services; ***includes share of gas and electricity.

(15) J. Monteagudo, A. Rutkowski and D. Lorenzani (2012), op. cit.

(16) It is fairly difficult, however, to compare goods and services trade. The EU distinguishes three modes of cross-border trade in services: (1) trade at a distance (mainly e-commerce), (2) consumer crosses the border (essentially tourism) and (3) supplier crosses the border (central mode covered by the Services Directive). Under this definition, sales by subsidiaries of service firms located in another country (regarded as belonging to trade mode 3 according to GATS terminology) do not qualify as international trade, yet this type of trade probably accounts for the largest share of cross-border supply of services. See A. Bénassy-Quéré et al. (2006), "Échanges internationaux, services compris", *Lettre du CEPII* no. 255.

(17) This is rather logical given the importance of the proximity effect in services trade.

Subject to the findings of in-depth sectoral studies, these sectors – which are highly regulated in most Member States – could benefit from pro-competition reforms designed to ensure coherence in the internal market. Moreover, these sectors produce services that are not only major inputs for most other economic sectors bu – given the growing integration of goods and services production – are also fully incorporated into corporate value chains[18]. The potential efficiency gains achievable in these sectors would spread and therefore be multiplied across the entire EU economy.

One of the most significant potential sources of economic growth in the EU is fuller network integration – with its structural impact on the internal market. In addition to the direct benefits of expanded intra-EU trade, a better interconnection of transport and telecoms networks, by bringing people and businesses closer together, can generate positive externalities in the EU through greater dissemination of knowledge, better matching of supply and demand in the labour market, and other benefits. Furthermore, a closer interconnection of the energy market would make it possible to take advantage of the most economical production processes.

The integration of network industries is likely to continue thanks to the elimination of certain monopolies and the lifting of administrative barriers. In the transport sector, several integration projects have been launched and are on their way to completion, such as the "blue belt" for shipping, the "fourth package" for rail transport and the "single European sky". In the energy sector, beyond the transposition of the third energy package, progress is required in the security of electricity supply. Ultimately, the deepening of the internal market should rely on the expansion of trans-EU energy, telecom and transport networks.

2.4 Meanwhile, concrete progress could also be achieved in the other two major dimensions of the internal market: capital markets union and personal mobility

The internal capital market has made substantial progress in the past 25 years through the removal of restrictions on capital movements and payments since the Maastricht Treaty, the creation of the "single passport" (i.e., single licence) in 1989 for banks and 1992 for insurance companies, and a wide-ranging harmonisation policy with the 1999 Financial Services Action Plan followed by regulation measures since 2008. The integration of financial markets accelerated sharply between 1995 and 2008, before plunging back to its mid-1990s levels with the crisis. It is shown for instance by the FINTEC indicator[19] by the ECB for the euro area. The 2008 crisis highlighted the fact that European integration had failed to prevent financial fragmentation within the EU.

Amid these developments, the first goal of the establishment of a capital markets union (CMU) will be to promote the development of corporate financing channels complementary to the banking sector. Generally speaking, the CMU should aim (1) to offer investors easier access to a broader range of financial products and (2) to bring businesses closer to a more diversified spectrum of financing sources. This requires mitigating uncertainties concerning investment, particularly cross-border investment (such as information asymmetries and differences in standards), encouraging the growth of market segments currently under-developed with respect to their potential (such as securitisation, venture capital and private equity) and fostering the emergence of pan-European players in asset management and venture capital.

This agenda is especially critical for the euro area: by increasing the geographic diversification of financial portfolios, the capital market union will allow greater risk-sharing across the area, making it more resilient. The literature shows that geographic risk-sharing on a private basis is a major adjustment channel in integrated monetary unions such as the U.S., France and the U.K. In particular, many studies[20] show that a substantial portion of shocks in a region is disseminated (and therefore shared) at central level, via financial markets and the credit channel.

The free movement of workers, enshrined in the Treaty of Rome, has been the focus of many subsequent EU legislative measures aimed at ensuring its effectiveness. Labour mobility should provide better matching of labour supply and demand in the internal market – an all the more important priority for the euro area as labour mobility improves resistance to asymmetrical shocks. Greater labour mobility would also promote convergence of working conditions and wages[21].

At this stage, however, labour mobility – in the EU as in the euro area – remains relatively low, particularly by comparison with the U.S. In 2010, 0.35% of inhabitants of one EU-27 country were living in another the previous year; by contrast, in the U.S., approximately 2.4% of residents of one state were living in another the previous year[22].

(18) See, for example, M. Crozet et al. (2014), "The Servitization of French Manufacturing Firms", *CEPII Working Paper* 2014-10.
(19) The ECB's synthetic indicator of financial integration (FINTEC), launched in April 2014, is a composite indicator measuring financial integration in four market segments: money market, bonds, equities and banks.
(20) See the literature derived from P. Asdrubali, B. Sorensen and O. Yosha (1996), "Channels of Interstate Risk Sharing", *Quarterly Journal of Economics*, vol. 111, pp. 1081-1110.
(21) Y.E. Bara, M. Brischoux, and A. Sode (2015), "Labour mobility in the EU: dynamics and policies", *Trésor-Economics*, no. 143.
(22) OECD, Economic Studies: European Union, March 2012.

3. Deepening the internal market implies establishing regulatory mechanisms that can ensure the EU's economic and social cohesion

3.1 The renewed drive towards the internal market goes hand in hand with stronger regulatory, supervisory and support measures

The current EU solidarity mechanisms – structural funds and globalisation adjustment funds– seem unsuited or too modest to effectively support a deepening of the internal market.

The tax and labour disparities in the EU can cause major biases in the allocation of factors of production and distort competition by establishing preferential treatment. Increased competition between the labour and tax policies of Member States can worsen conditions for the EU as a whole. Measures to stimulate the integration of EU markets should therefore be backed by instruments capable of slowing the competition between labour standards that integration could generate.

Special care should be taken to prevent sub-optimal tax competition, notably a "race to the bottom"[23]. A stable, predictable tax base is also needed to finance the social system. Deepening of the internal market should thus be matched by closer coordination in the taxation sphere. Besides preventing harmful practices, a renewed drive towards tax harmonisation – focused on tax bases and cross-border collection procedure – may also have positive effects on the functioning of the internal market, especially by lowering costs for firms[24]. To prevent social dumping and guarantee fairness in EU labour markets, harmonisation could also extend to common standards for employment conditions-including minimum wage rates (for example, relative to the country's median wage[25]).

3.2 A deepening of the internal market should form part of a broader strategy aimed at securing the convergence of EU economies

While a deepening of the internal market would procure long-term gains at a broad level, closer integration is likely to generate adjustment costs, at least in the short term. These costs would probably be higher for certain groups of economic agents[26] and may require the enactment of redistributive mechanisms in and between Member States. For example, greater labour mobility could destabilise emigration countries by undermining their potential growth through the departure of the most productive workers, in other words, a brain drain and loss of human capital.

Beyond the short-term adjustment costs of closer integration, one cannot rule out agglomeration effects that could raise productivity (*cf.* Box 5) but also make some economies more vulnerable to asymmetrical shocks.

Box 5: **Agglomeration effects, monetary zone and internal market**

Agglomeration effects are effects that lead to a concentration of economic activity in areas with the highest productivity, i.e., the areas already enjoying highly developed human capital, infrastructure and corporate concentration. Economic theory identifies two concurrent processes potentially at work:

- On the one hand, a process of productive specialisation could take hold in economies or territories based on their comparative advantages[a], leading to a concentration of activities at sectoral level and making the economies more vulnerable to asymmetrical shocks. This would reduce the effectiveness of monetary policy and, correlatively, increase the need for a central mechanism to absorb shocks.
- On the other hand, a process of productive diversification could occur. Trade opening leads economies to converge, which would help to synchronise business cycles in Member States and enhance monetary policy transmission[b].

For now, it is hard to conclude that one of these two phenomena is prevalent in the EU. The steady rise in the share of intra-industry trade in intra-EU trade seems to indicate a greater diversification of the economies and a closer integration of value chains[c].

However, concentration phenomena cannot be ruled out. The concentration of financial activities in certain Member States as a result of the liberalisation of capital movements (City of London) and strong east-to-west migration within the EU for the past several years (in particular to Germany) are factors likely to promote a gradual polarisation of activities in Europe that may intensify.

a. See the theories of the "new economic geography" school of thought, especially P. Krugman: P. Krugman (1993), Lessons of Massachusetts for the EMU; F. Torres and F. Giavazzi (1993), "Adjustment and Growth in the European Monetary Union", *Cambridge University Press*, pp. 241-260.
b. See, for example, European Commission (1990), "One Market, One Money: an Evaluation of the Potential Benefits and Cost of Forming an Economic and Monetary Union", *European Economy*, no. 44.
c. European Central Bank (2013), "Intra euro-area trade linkages and external adjustment", *Monthly Bulletin*, January, pp. 59-74.

(23) See, for example, J.D. Wilson (1999), "Theories of tax competition", National Tax Journal.
(24) See, for example, P.B. Sorensen (2001), "Tax coordination in the EU: what are the issues?", *Swedish Economic Policy Review*; and (2004), "Company tax reform in the EU", International Tax and Public Finance; E.G. Mendoza and L.L. Tesar (2005), "Why hasn't tax competition triggered a race to the bottom? Some quantitative lessons from the EU", *Journal of Monetary Economics*.
(25) M. Brischoux et al. (2014), "Mapping out the options for a European minimum wage standard", *Trésor-Economics*, no. 133.
(26) W. Stolper and P.A. Samuelson (1941), "Protection and real wages", *Review of Economic Studies*. The authors show that inequality tends to increase in the country that has a comparative advantage in products requiring relatively higher-skilled labour.

Lastly, closer integration could also further weaken the most vulnerable population groups. The economic literature emphasises that technical progress and the growth of new sectors can increase inequalities[27]. New technologies tend to devalue certain skills[28], creating social difficulties in certain sectors. Bearing this in mind, and as these inequalities could make regions exposed to such shocks more vulnerable, market integration should pave the way for the introduction of support mechanisms – as was done at the very establishment of the internal market with the creation of structural funds to ensure the convergence of the EU economies.

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(27) G. Saint-Paul (2008), "Innovation and Inequality", *Princeton University Press.*
(28) E. Brynjolfsson and A. McAfee (2014), "The Second Machine Age", *W.W. Norton.*

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