

Mariniello, Mario; Sapir, André; Terzi, Alessio

Working Paper

The long road towards the European single market

Bruegel Working Paper, No. 2015/01

Provided in Cooperation with:

Bruegel, Brussels

Suggested Citation: Mariniello, Mario; Sapir, André; Terzi, Alessio (2015) : The long road towards the European single market, Bruegel Working Paper, No. 2015/01, Bruegel, Brussels

This Version is available at:

<https://hdl.handle.net/10419/126709>

Standard-Nutzungsbedingungen:

Die Dokumente auf EconStor dürfen zu eigenen wissenschaftlichen Zwecken und zum Privatgebrauch gespeichert und kopiert werden.

Sie dürfen die Dokumente nicht für öffentliche oder kommerzielle Zwecke vervielfältigen, öffentlich ausstellen, öffentlich zugänglich machen, vertreiben oder anderweitig nutzen.

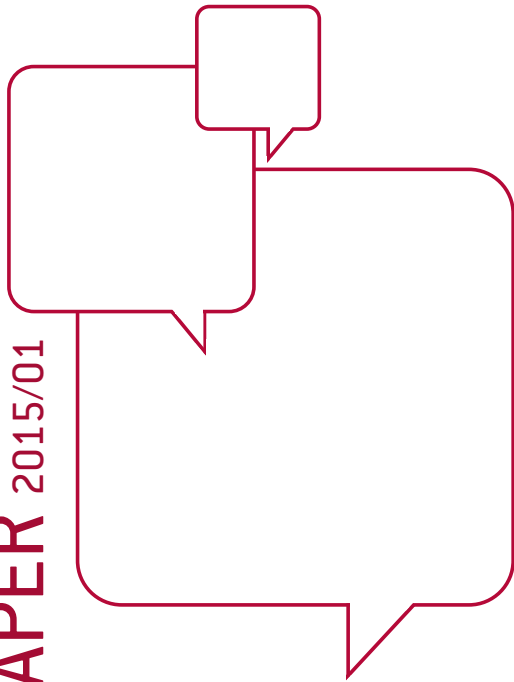
Sofern die Verfasser die Dokumente unter Open-Content-Lizenzen (insbesondere CC-Lizenzen) zur Verfügung gestellt haben sollten, gelten abweichend von diesen Nutzungsbedingungen die in der dort genannten Lizenz gewährten Nutzungsrechte.

Terms of use:

Documents in EconStor may be saved and copied for your personal and scholarly purposes.

You are not to copy documents for public or commercial purposes, to exhibit the documents publicly, to make them publicly available on the internet, or to distribute or otherwise use the documents in public.

If the documents have been made available under an Open Content Licence (especially Creative Commons Licences), you may exercise further usage rights as specified in the indicated licence.



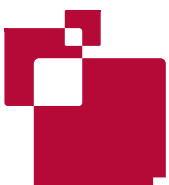
THE LONG ROAD TOWARDS THE EUROPEAN SINGLE MARKET

MARIO MARINIELLO, ANDRÉ SAPIR, ALESSIO TERZI

Highlights

- The single market is often perceived as the panacea for Europe's economic troubles. It is believed that completing the single market would boost welfare, stimulate growth and increase European competitiveness.
- However, identifying and quantifying the channels through which market integration is expected to engender growth is methodologically complex. Although the overwhelming prediction from the literature is for single market integration to generate positive and significant aggregate effects, we conclude that the impact so far has fallen short of initial expectations, because:
 - (1) Barriers continue to prevail in the EU, preventing the exploitation of the potential benefits of full market integration;
 - (2) 'Complementary policies' to support the single market were not, or were insufficiently, put in place;
 - (3) The single market project has not sufficiently been framed as a key part of the process of creative destruction that Europe needs to embrace to successfully modernise its economy.
- That single market integration generates positive and significant aggregate effects does not imply that its effects are positive and significant for every sector. There is therefore an important role for European Union and national distributional policies to ensure that losers are sufficiently compensated by the winners, and to overcome political resistance to completing the single market.

Mario Mariniello (mario.mariniello@bruegel.org) is a Research Fellow at Bruegel. André Sapir (andre.sapir@bruegel.org) is a Senior Fellow at Bruegel and University Professor at the Université libre de Bruxelles (ULB). Alessio Terzi (alessio.terzi@bruegel.org) is an Affiliate Fellow at Bruegel. The authors would like to thank Sergiy Golovin for excellent research assistance, and Reinhilde Veugelers and Guntram Wolff for helpful comments.



1. Introduction

The establishment of a common or single market has been the cornerstone of European integration since its inception in 1957. This was enshrined in the Treaty of Rome (Art. 2) as the main policy goal of the European Economic Community (EEC) but the process to achieve it has proved very complex and ineffective. A commonly held opinion among observers today is that the single market is far from being complete. Tariff barriers and quotas were effectively abolished by 1968, in advance of the 12 year phase-in period initially foreseen by the Treaty. Non-tariff barriers affecting trade in goods, however, proved very hard to dismantle, requiring severe encroachment upon the prerogatives of sovereign member states. The elimination “*of obstacles to freedom of movement for persons, services and capital*” between member states (Article 3 §3 of the Treaty) likewise experienced critical difficulties.

Because of technical difficulties and lack of sufficient political will, the push for integration throughout the 1970s mostly came from the European Court of Justice (with rulings such as Dassonville¹ in 1974 and Cassis de Dijon² in 1979). However, following the oil crises in 1973/74 and 1979, and rising economic difficulties, there was an increasing pressure on Europe to find effective ways to boost growth. The European Commission put forward, in 1985, a white paper on the completion of the internal market, which led to the adoption of the Single European Act in 1986. In 1993 (after having tabled nearly 300 legislative acts), the Commission announced the “completion” of the single market – but the reference was just to the removal of most barriers to trade in goods. The 1993 Commission statement was indeed just the beginning of a long and difficult process of removing barriers to trade in services, including in network activities such as energy, telecommunications and transportation. Twenty years later, and despite various legislative efforts, the European single market is still not a reality in crucial areas such as capital markets, the digital economy and energy. And the recent financial and economic crisis has left some scars, including the fragmentation of financial markets in the euro area and repeated calls to limit the free circulation of persons across EU countries. The crisis has also left behind a devastated economic field with low growth, high unemployment and large (public and private) debt levels. This situation, as well as the necessity to modernise the European economy in the face of ever-growing globalisation and technological change, requires once again a European strategy to boost growth and employment, in which the single market has a central role.

¹ The ruling established that all measures having effects equivalent to quantitative restrictions on trade between member states were prohibited.

² The ruling established the principle of mutual recognition whereby any product lawfully manufactured and marketed in any member state should be accepted by other member states, provided there are not strong grounds for doing so on the basis of public health, the fairness of commercial transactions or the defence of the consumer.

A successful strategy for the completion of the single market requires first a deep understanding of the benefits that can be realistically expected from it. The purpose of this working paper is to review the literature identifying and quantifying the channels through which the European single market was expected to generate growth and employment (Section 2) and to discuss the reasons why the single market project has failed to generate all the benefits that were expected (Section 3). In Section 4 conclusions are provided, together with suggestions for the approach that should be followed in the coming years to improve the actual benefits of the European single market.

2. Theory and evidence of the impact of a single market

2.1 Reviewing the theory of the single market

The way in which the single market can benefit aggregate welfare is by boosting productivity through a variety of direct or indirect channels, both in the medium- and long-term (see Box 1). These have been broadly analysed using the framework of trade integration with imperfect competition, which is most appropriate for an advanced economy like the EU in which most sectors display economies of scale and therefore imperfect competition. In the short term, following the reduction of barriers to cross-border flow of products (goods and services) and factors (labour and capital), firms face a higher degree of competition, which leads them to set lower prices, closer to production costs. In the medium-term, they react to this increased competition by looking for ways to reduce production costs, changing their business models to increase the range of products offered to consumers, and merging across borders to increase the pool of customers they can reach and in order to write-off fixed costs over a larger volume of production (economies of scale). Throughout this process, less-efficient firms exit the market and resources are re-allocated to more efficient firms, through a mechanism of Schumpeterian creative destruction (see Baldwin and Wyplosz, 2012). Finally, in the long-term, these now larger EU-wide firms invest more heavily in innovation as a result of an increased possibility of exploiting economies of scale in research and development and the pursuit of opening new segments of the market – the 'competition escape' innovation incentive (see Boldrin and Levine, 2008; Aghion *et al*, 2013; Aghion *et al*, 2001; Aghion *et al*, 1997).

Channels of productivity growth are not limited to the product markets: an increase in labour force cross-border mobility is also expected to be beneficial to the European economy as firms have access to a larger pool of workers to recruit from, attracting more qualified workers at lower cost and reducing

skill mismatches. A similar predicament applies to the free circulation of capital, which should guarantee that funds reach the most productive investment opportunities and companies, eventually boosting growth.

Box 1: From micro-based benefits to macroeconomic effects

Creating a pan-European market was expected to generate substantial welfare gains originating from multiple initiatives which then, through several channels, would translate into productivity enhancement, growth and prosperity.

As displayed in Figure 1, the establishment of a single market is associated with a reduction (and eventually abolition) of tariff and non-tariff barriers to trade. The reduction in costs for businesses comes through reduced border formalities, harmonisation of standards and increased market transparency. This reduces transaction costs and, mechanically, engenders a net welfare gain (see Viner, 1950; Lipsey, 1957; Baldwin and Venables, 1995). Barriers to the free flow of capital and labour are also to be abolished. Several indirect effects are sparked by these initiatives. These can be divided into two categories: product and factor market. Although somewhat artificial, given that many of these effects interplay, this taxonomy should provide a simple identification of the effect of the single market on growth and productivity.

Product markets

- 1) Economies of scale: Bigger markets can support bigger firms. Firms are better placed to serve a larger pool of consumers and, by spreading fixed costs, reduce the costs of production (assuming increasing returns to scale), and hence boost productivity.
- 2) Firm size: As described by Venables (1985), a wave of cross-border mergers would be expected, as firms attempt to serve different markets and, at the same time, benefit from international value chains, hence pushing down production costs (see also Deneckere and Davidson, 1985; Spector, 2003; Davidson and Mukherjee, 2006). Moreover, these new pan-European conglomerates will benefit from an increased flow of intra-EU information and knowledge, therefore promoting innovation and competitiveness.
- 3) Increased competition: Melitz (2003) shows how the exposure to trade will induce only the more productive firms to enter the export market (while some less productive firms continue to produce only for the domestic market) and will simultaneously force the least productive firms to exit. It then shows how further increases in the industry's exposure to trade lead to additional inter-firm reallocations towards more productive firms. Oligopolistic rents will be reduced as competition stiffens and prices will be set closer to marginal costs, to the benefit of consumers (Venables,

1985). Firms' incentives to be more efficient and reduce marginal costs are increased.

- 4) Innovation: Following from increased competition (effect n. 3), in order to sustain profits, firms are likely to invest in product diversification, in an effort not to compete merely on prices. Nickell (1996) and Blundell, Griffith, and Van Reenen (1999) find a positive linear effect of competition on innovation. Furthermore, as firms grow in size (see effect n. 2) they are likely to be better placed to invest in R&D (see Scherer, 1967) and share ideas cross-border. A bigger scale reduces the relative significance of fixed R&D costs; the benefits of R&D increase the wider and more diversified is companies' market supply.

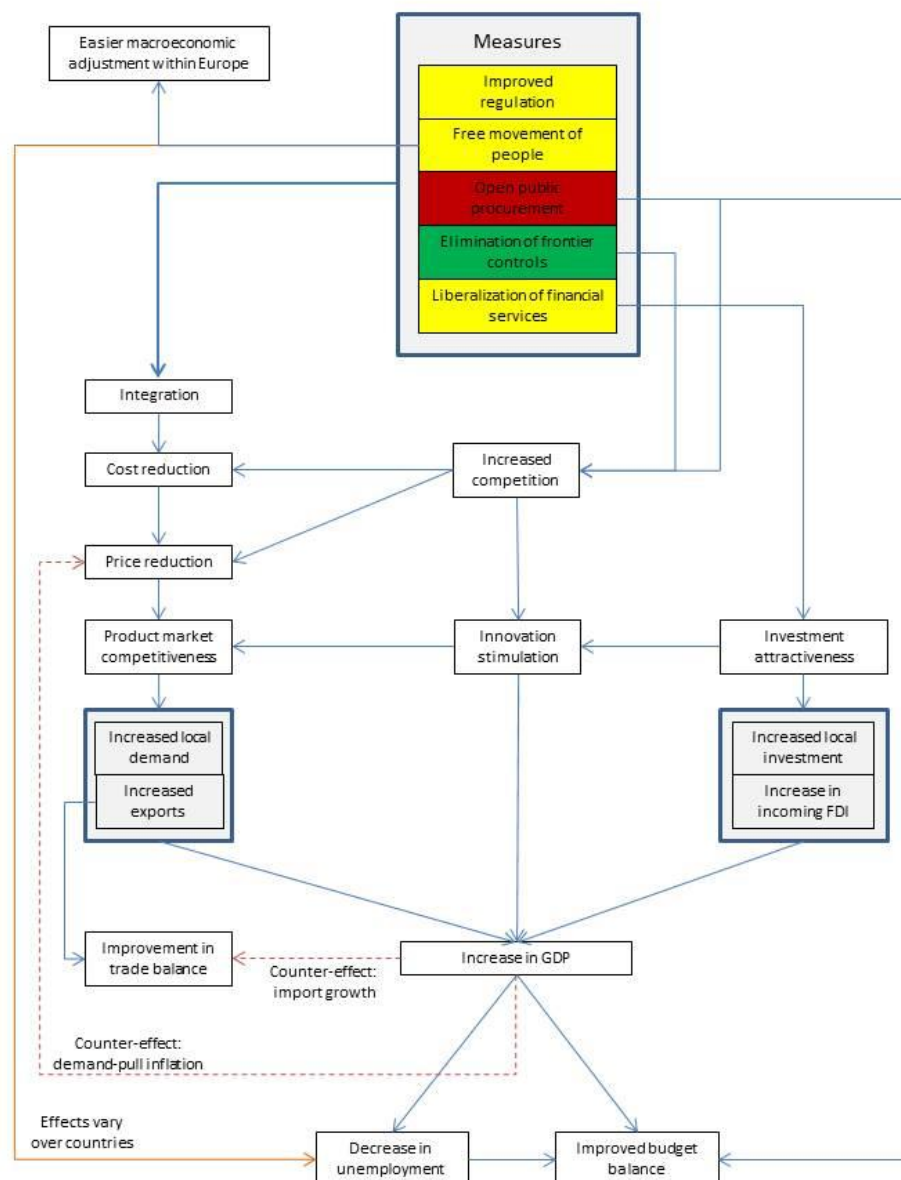
Labour market

Labour market integration: The basic economics of migration predicts that, by allowing freedom of circulation within the EU, this will reduce skills mismatches (and hence unemployment spells) and keep real wages low, increasing firms' price competitiveness (Boeri and Van Ours, 2013; Zimmermann, 2013). Boeri and Brücker (2005) construct a computable general equilibrium model to evaluate the costs of migration in a context of rigid labour markets (*à-la-Européenne*). Their findings suggest that GDP in the incoming country could increase as much as 0.3 percent following a migration inflow of 1 percent of the labour force.

Capital market

Financial integration: Free capital flows within the single market should allow financial resources to reach the most profitable investments. Abiad *et al.* (2007) find that financial liberalisation reduces the variability of marginal returns on capital, supporting the view that financial liberalisation facilitates the equalisation of the marginal return on capital across sectors and, therefore, promotes more efficient allocation of funds (see also Bekaert *et al.*, 2004). Similarly, Kukenova (2011) shows that financial liberalisation can have a positive effect on growth through a more efficient allocation of resources across firms and sectors. Portfolio diversification possibilities should also be enhanced, leading to reduced investment yield volatility and increased returns. Furthermore, extra-EU FDI flows are also expected to increase, as European firms increase in competitiveness.

Figure 1: The single market at work



Source: Bruegel.

Although the literature broadly agrees that the single market should lead to increased welfare from a societal standpoint, the benefits throughout this process are unlikely to be homogeneously distributed. Opening markets to trade integration necessarily entails the creation of winner and losers.

One possible avenue for analysis is the classic economic division between producer surplus and consumer surplus. Whereas consumers are expected to benefit from lower prices already in the short

run, firms will face a narrowing of profit margins (Venables, 1985). The loss of producers' surplus is expected to be lower than the gain in consumer surplus because of an improved allocation of resources and the elimination of deadweight losses, leading to higher aggregate welfare levels (Motta, 2004). In addition, some efficiency gains (known as X-inefficiencies) will be achievable already in the short run (see Bloom *et al*, 2010; EC, 1997), but only in the medium term will firms be able to reshuffle production factors, implement better technologies to significantly reduce costs and benefit from the exit from the market of less efficient competitors.

Even producers, however, are not a homogeneous group. Large firms, which engage in foreign trade, are likely to benefit significantly from the pan-European standardisation of product regulations. On the other hand, the cost of complying with the latter is likely to weigh as an administrative burden on small and medium-sized enterprises, with more limited benefits accruing to them. This was confirmed by recent firm-level surveys conducted under the framework of the UK Balance of Competence review (HM Government, p.42, 2013).

Increased competition amongst workers because of freedom of movement is also expected to have variable effects on the labour supply. Qualified workers from the poorer economies with lower wage levels, benefit from the stronger demand in booming markets, but workers from high-income economies may face stronger competition from their foreign counterparts and may have to settle for lower wages or lower non-monetary compensation. Furthermore, workers with similar skill-sets to those of the immigrants will face the largest wage reductions (see Box 1).

More generally, high-skilled workers are likely to disproportionately benefit from market integration – a concept known in the literature as the disproportionate skill premium resulting from trade liberalisation (see Burstein and Vogel, 2012). However, in absolute terms real wages are expected to increase at all skill levels, as factors progressively get reallocated towards a country's comparative advantage.

Member states on aggregate are likewise expected to benefit in a differentiated way: in the short and medium run, some countries – where competition is weaker and firms less efficient – might suffer from the opening of their markets to foreign competitors. These adjustment costs were already identified in the original Cecchini report (1988). As firms agglomerate to reap the benefits of economies of scale and specialisation, some countries might temporarily lose out, while others gain (see European Commission, 1997). This would result in an adjustment process characterised by poor

growth performance and hence reduced tax revenues for the government. In the long-term, however, with a levelled playing field, resources within member states are expected to naturally flow to the sectors in which the country enjoys a comparative advantage (Heckscher-Ohlin-Samuelson models), to the benefit of potential and actual growth, and public finances.

The literature does not necessarily always provide for unambiguous and straightforward positive effects. With respect to the labour market channel, Friedberg and Hunt (1995) highlight how in a European setting, where union contracts apply to most workers, the adjustment to immigration will come through unemployment rather than reduced wages. Similarly, in a Melitz (2003) context, where active firms in the market are heterogeneous with respect to their productivity levels, and labour market rigidities prevail, Egger and Kreickemeier (2006) illustrate in a theoretical model how market integration, and the consequent selection of the best firms into export status and exit of the least productive producers, might lead to an increase in wage inequality, even for workers with similar skill-sets.

On innovation effects, Aghion *et al* (2002) show that increased competition might have non-linear (inverted U-shape) effects on innovation, in that (i) it generates a 'competition escape' incentive to innovate but, at the same time, (ii) it reduces expected profits, particularly for innovation-laggard firms, thereby reducing their incentive to innovate. In their theoretical model, at high levels of competition, the latter effect prevails.

2.2 The EU single market in practice

In the previous section we outlined the theoretical groundings of the single market. We now turn to the practical functioning of the European single market by reviewing the available empirical evidence on whether the channels are at work and whether the policies enacted have allowed the expected benefits from market integration to be reaped.

2.2.1 Quantifying the micro-based effects of the single market

Box 1 detailed three broad categories under which micro-based effects are likely to impact productivity and growth in the single market: product, labour and capital markets. But the econometric evidence on the magnitude of their effect is far from clear cut. Most of the time, empirical work that tries to estimate

effects at micro level is affected by data limitations. For example: a fully satisfactory estimation of the effect of competition would require the identification of markets at firm/product levels. Often the information available to researchers would be far more limited, forcing the adoption of simplifying assumptions that may question the validity of the results; for example, competition is often estimated at sectoral level, rather than at product market level.

Product market

1. **Pick-up in trade resulting from a reduction of Non-Tariff Barriers (NTB).** Based on Coopers and Lybrand (1993), European Commission (1997) looks at the evolution of intra-EU trade (exports and imports) and compares it with extra-EU trade over the period 1985-95. The underlying assumption here is that the two would have behaved similarly had it not been for the over 280 acts (directives and regulations) enacted in the aftermath of the Single European Act (1986) to abridge NTBs in the EU. In both manufacturing and services, EC (1997) finds a significant pick-up in the share of intra-EU exports over total exports. Less so for intra-EU imports, but still positive effects. Employing an econometric model of demand for imports in the EU at sectorial level, Allen *et al* (1996) confirm that the Single Market Programme (SMP) was trade-creating over the period 1985-95. Ilzkovitz *et al* (2007) notes however that trade integration lost momentum in the 2000s. This development is particularly surprising, because the period coincides with the introduction of the euro, which was, at least theoretically, expected to lead to a further significant boost in intra-EU trade. Baldwin (2006), however, shows that the impact of the euro was limited to a 5-10 percent increase in trade, much below expectations (see also Frankel, 2008).
2. **Economies of scale.** As outlined in section 2.1, a bigger internal market allows domestic firms to be more productive and push their average costs down, because manufacturing larger volumes is generally more cost efficient. This effect was widely foreseen and accepted by the industrial organisation and trade literature, which rested on the assumption of increasing returns to scale. However, EC (1997) found little or no empirical evidence to support the claim that the SMP made it possible to exploit previously untapped economies of scale.
3. **Firm size.** Strictly interconnected with scale economies is firm size, which, according to the theoretical analysis of the single market, was expected to increase. Again, EC (1997) looks at the evolution of firm-size across sectors and finds no evidence that firms in sectors more sensitive to the SMP grew in size. This finding is somewhat confirmed by a later study by Veugelers (2004). Turning to mergers and acquisitions (M&As), Ilzkovitz *et al* (2007) report

how, in line with the literature, the SMP (and the late 1980s) were associated with a wave of cross-border mergers (much faster than domestic M&As), suggesting the use of previously untapped potential (for an analysis of network industries, see European Commission, 2006).

4. **Increased competition.** A common approach in the industrial organisation literature is to attempt to grasp the degree of competition in the market by analysing firms' mark-ups. A study by Sauner-Leroy (2003) found that firms' mark-ups decreased over the first half of the 1990s and recovered in the second half of the 1990s after the efficiency of firms had improved. The reduction was particularly marked for the manufacturing sector, over the period 1990-92 (see London Economics, 1996). Griffith, Harrison, and Simpson (2006) find a particular reduction in mark-ups in those sectors that were particularly impacted by the SMP. However, many studies have found inconclusive evidence on mark-ups (Badinger, 2004; Zarnic, 2010) and some evidence of an occasional increase in mark-ups in the services branch, which would confirm the weak teeth of the SMP on services (Badinger, 2007). This is often attributed to the larger size of the firms and stronger concentration in the industries. Adopting a combination of econometric techniques and a computable general equilibrium model, Allen *et al* (1998) find that (i) the SMP has indeed had a strong impact on competitive behaviour, and (ii) the extent of the impact depends on both changes in the intensity of competition and on the nature of competitive interaction. Turning to firm entry/exit behaviour, Veugelers (2004) finds a significant turbulence in market leadership in manufacturing between 1987 and 2000 in the EU.
5. **Innovation.** Griffith, Harrison, and Simpson (2006) find that the SMP has indeed increased competition and R&D investment, which led to an increase in productivity in selected countries and manufacturing industries. Within this setting, R&D spending was also found to have increased Total Factor Productivity growth within selected industries. However, the overall effect on EU growth seems negligible (Ilzkovitz *et al*, 2007).

Labour market integration

Benton *et al* (2013) look at trends in intra-EU labour mobility, by breaking the time span into three eras: pre-enlargement, post-enlargements (2004, 2007), and the economic crisis. According to their analysis, regional mobility and seasonal migration were small-scale before 2004/2007. According to Brücker and Eger (2012), this is because income levels between the EU15 countries were relatively similar. Migration then picked up immediately after the enlargements, and increased significantly with the economic crisis. This finding is confirmed

by OECD (2014). EU-wide data availability remains however limited. Fertig and Schmidt (2002) suggest that the rather low rates of intra-EU migration despite existing wage and unemployment differentials between EU countries are striking and might reflect rather high costs of moving away from the home country. In public opinion surveys, language and family ties are routinely cited as the main barriers to mobility³. As of 2011, only 2.5 percent of EU citizens were working outside of their home country (see Benton *et al*, 2013).

Capital market integration

Most of the econometric analysis of financial integration has focussed on intra-EU FDI. In this respect, CEPS (1996) and EAG (1996) find that the SMP had a significant impact on intra-EU FDI flows between the mid-1980s and mid-1990s. Similarly, Ilzkovitz *et al* (2007) corroborate this finding, although admitting that the analysis may be significantly hampered by other concurrent phenomena such as the 1990s asset price bubble, the dot com bust, and the weakness of the euro in the early 1990s. Berger (2000) found that there was a large potential for efficiency improvement from financial integration, and that most of the gains appeared to be originating from risk diversification. Somewhat conversely from trade, in this field, the introduction of the euro is expected to have had a major impact. Baele *et al* (2004) look at a set of specific measures to quantify the state and evolution of financial integration in the euro area. They consider five key markets, namely the money, corporate-bond, government-bond, credit and equity markets. Building on the law of one price, they develop two types of indicators: price-based and news-based. They then complemented them by a number of quantity-based indicators, mainly related to the evolution of the home bias. Results indicate that the unsecured money market was fully integrated, while integration was reasonably high in the government- and corporate-bond markets, as well as in the equity markets. The credit market was among the least integrated, especially in the short-term segment.

2.2.2 Aggregating micro-effects to the macro-level

Although the individual theoretical micro-based channels through which the single market is expected to prove beneficial are clear, their aggregation and translation into improved growth performances is all but trivial.

³ See for example DG Communication, Eurobarometer on the Internal Market.

Broadly speaking, effects of any kind arising from the completion of the single market are difficult to input into general equilibrium models. Studies have typically focused, at sectoral level, on (a combination of) selected variables:

- 1) Direct cost reductions resulting from an abolition of trade barriers,
- 2) Indirect cost reductions resulting from economies of scale and learning,
- 3) Reduction in prices because of stiffer competition,
- 4) Indirect dynamic growth effects resulting from increased innovation and organisational change.

Table 1 offers an overview of the main studies conducted over a 20+ year period, in an attempt to quantify the aggregate impact of the single market. Whereas Cecchini *et al* (1988) and Baldwin (1989) carry out an *ex-ante* model-based assessment of the potential gains of the single market, later studies focused on an *ex-post* assessment of the measures taken as part of the 1992 push. The Cecchini report focused on the static effects of trade integration. Later papers tried to refine the analysis by looking also at the dynamic effects of the single market. However, it is widely accepted that quantifying dynamic effects is particularly challenging.

Cecchini *et al* (1988) used macro-sectoral and macro-dynamic models to estimate the impact of (i) the removal of frontier control, (ii) the liberalisation of public sector procurement, (iii) the liberalisation of trade in financial services, (iv) supply effects (or the consequences of the strategic response of enterprises faced with a new competitive environment). The analysis also modelled scenarios with more (or less) active economic policy support measures and allowed for the materialisation of effects in the short and medium run.

Baldwin (1989) attempts to complement Cecchini's static analysis by incorporating (permanent) dynamic effects on the growth rate of GDP over and above changes in the level of GDP. Calibrating an endogenous growth model, Baldwin looks at the indirect effect of market liberalisation on savings rates and investment. It also included effect 4 above, ie tried to account for the impact of innovation. The author himself highlighted however the significant caveats associated with the lack of data and uncertainty surrounding R&D spending.

European Commission (1996) is the first *ex-post* evaluation of the several measures enacted as part of the SMP. Like the Cecchini report, this paper is based on a battery of studies looking at specific sectors, remaining barriers and further impact studies, in addition to a thorough business survey. The results were used to calibrate the Commission's Quest II and GEM-E3-IM computable general equilibrium models. HM Government (2013) highlights that a key limitation of this paper is the short time-span of data available following the 1993 SMP push.

Ilzkovitz et al (2007) is a somewhat smaller scale *ex-post* assessment by the Commission of the SMP, with a strong focus on its interaction with EMU. The study offers both empirical evidence and descriptive statistics of the main channels at work through the single market, and how they are affected by or support EMU. It then offers a macroeconomic simulation of the impact of the SMP on growth and employment by using earlier studies to calibrate the QUEST III model of DG ECFIN. Interestingly, this was the first studies (of those mentioned) to look at the (non-negligible) impact of enlargement.

Boltho and Eichengreen (2008) look at the whole history of European integration and, basing their analysis on previous papers, try to identify the counterfactual scenario had there been no EU institutions and no single market. The assessment then takes a conservative approach in estimating the channels through which the integration process has had an impact on economic growth. This included also the specialisations of countries, the diversification of products and the impact of innovation.

Campos, Coricelli and Moretti (2014) utilise a new synthetic counterfactual method to analyse the impact of EU (political and economic) integration on GDP per capita and productivity levels, both at national and EU level. Although not focussing specifically on the single market, we find it worthwhile to mention this study, which sheds a fresh light on new potential methodological avenues to estimate the effect on market integration. Naturally, we would consider their results an upper-bound estimate of the impact of the single market which, in the end, constitutes the main building bloc of European integration.

Although tempting at first sight, GDP effects from different studies should not be compared. This is because, aside from using different techniques, the studies also diverge in the periods observed and the EU's composition. Whereas Cecchini et al (1988) was looking at a 5-6 year period and EU12,

European Commission (1996) looks at the impact of the single market up to 1994. Ilzkovitz *et al* (2007) looks at an enlarged EU25 over the period 1992-2006 while Boltho and Eichengreen (2008) consider the single market's impact on the EU25's GDP to date.

Table 1: Summary of studies and main macroeconomic effects of the single market

	Paper	GDP effect	Comments
Ex ante evaluation	Cecchini <i>et al</i> (1988)	4.25%-6.5%	Static effect
	Baldwin (1989)	0.2%-0.9% addition to EC long-term growth	Calibrates an endogenous growth model to complement Cecchini's static analysis
Ex post evaluation	European Commission (1996)	EU GDP growth in 1994 was 1.1%-1.4% more than without SMP	Ex-post evaluation with GEM-E3-IM and Quest II models
	Ilzkovitz <i>et al.</i> (2007)	2.18% of EU GDP in 2006 (or 223 billion euro)	Deviation from baseline due to SMP effect over the period 2002-2006 using Quest III
	Boltho and Eichengreen (2008)	EU GDP 5% higher in 2008 than without SMP	Based mostly on previous literature
	Campos <i>et al.</i> (2014)	EU GDP per capita 12% lower on average without EU integration	Synthetic counterfactual method (based on Abadie and Gardeazabal, 2003)

As noted above, quantifying the aggregate effects of the single market on GDP is not easy. At the macro level, this is for multiple reasons, most notably:

1. **Time counterfactual.** The main difficulty is to isolate the effects caused by the market integration process from the effects caused by other factors. This can be particularly hard as several trends were developing concurrently. One of these factors is globalisation, which occurred at an extremely fast pace starting in the 1980s, and which strongly benefited from communication technologies.
2. **Geographical counterfactual.** Common empirical identification techniques often rely on the comparison of performance between a treatment group (exposed to a shock or policy) and a comparison group. The underlying assumption is that the two would have behaved similarly, had there been no treatment. In the case of the creation of a European single market, it is very hard to identify a comparison group. High-income countries in Europe that did not participate in the integration process are not really available, as both Switzerland and Norway were (at least partially) involved in the integration process. The late joiners from central and eastern Europe provide an interesting example, although these countries were already integrating into

the single market before the official accession date, are mostly emerging economies and come from post-Soviet backgrounds. This makes them far from an ideal control group.

3. **Single market as an ongoing process.** The effect of the single market on aggregate economic performance is particularly difficult to identify because the measures (directives, regulations, case law) introduced to progressively introduce the four freedoms were phased in over a period of 40-odd years. Although the White Paper (1985) measures and the Single Market Act (1992) constituted a significant one-off policy 'shock', they came only after the complete abolition of trade barriers and quotas, the introduction of an EU-wide competition authority and the introduction of the principle of mutual recognition ('Cassis de Dijon' case), just to mention a few.
4. **Simultaneous confounding factors.** While the single market is admittedly at the heart of the process of European integration, other national and EU policies have been implemented whose effects on the European economy are very difficult to disentangle from the effects arising from single market integration. A notable example is the introduction of a single currency – the euro – in 1999.

Box 2. At the origin of Cecchini's over-optimism

As outlined in the previous section, the original Commission report analysing the cost of non-Europe pencilled in potential benefits from the completion of the single market in the order of 4.25 percent to 6.5 percent of EU GDP (Cecchini *et al*, 1988). This was without incorporating the (likely) dynamic impact of the single market on GDP growth trends. Notwithstanding the lack of a counterfactual, there is widespread consensus that this estimate proved over-optimistic. We identify two reasons for this overshooting:

Share of services. One recent development in the EU that was not foreseen at the start of the integration process, and that was hence overlooked in the original Cecchini report, was the soaring role of services in the European economy. The GDP share of services in the EU area was below 50 percent at the beginning of the 1970s and grew to over 70 percent by 2010 (Vogt, 2005). However, services constitute only 20 percent of the intra-EU trade volumes (Ilzkovitz *et al*, 2007). This low tradability is partially because of some inherent characteristics of the service sectors, but also to remaining internal market barriers under this heading (as discussed in Section 3.1).

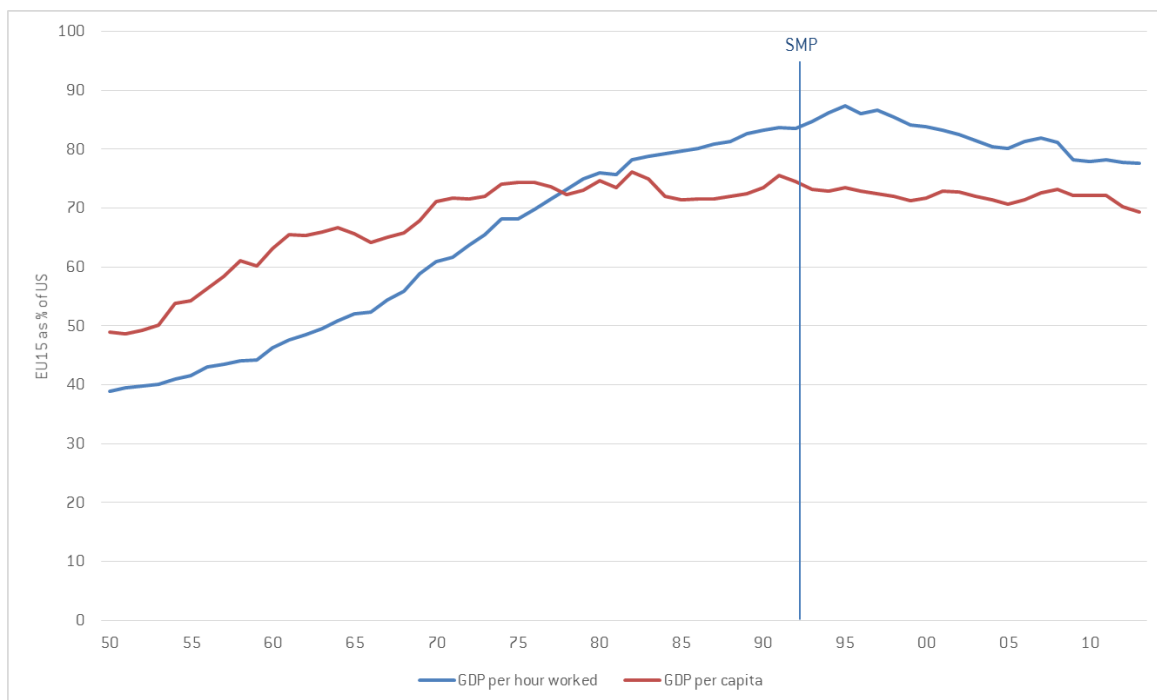
Optimistic policy assumptions. Because of the way policy shocks are fed into the macro-model adopted, Cecchini implicitly assumed the complete abolition of non-trade barriers and liberalisation of public procurement across Europe. Although it is true that policy under these headings has been lagging, such an assumption was probably too bold even when the study was conducted. This assumption is likely to have significantly contributed to the overestimation of the aggregate results, particularly given the sizeable weight of public procurement in European economies (we will expand on this topic in Section 3.1).

3. Explaining the weak single market effect

Abstracting from the technical difficulties faced by empirical research, when evaluating whether the single market has been hitherto a successful policy, one has to bear in mind the ultimate channel through which it was supposed to boost growth and welfare in the EU: productivity.

Figure 2 below provides a long-term comparison between the EU15 and the US in terms of GDP per hour worked (one of the many possible measures of labour productivity) and GDP per capita. As explained neatly by van Ark *et al* (2008), Europe managed to catch up significantly with the US in the post-crisis period, when it was a matter of adopting existing technologies. However, as the technological frontier was reached, Europe did not effectively embrace the ICT revolution. As a number of authors have indicated, the lack of a single market, and particularly the continued existence of barriers to access to financing faced by European innovators, help explain such a failure (see Veugelers and Cincera, 2010). More generally, the SMP did not manage to roll back this trend and, since productivity started eroding vis-à-vis the US in the late 1990s, per-capita GDP has stabilised at around 70 percent of the American level.

Figure 2: Productivity level and GDP per capita, EU15 as % of US



Source: The Conference Board Total Economy Database, January 2014 update; Bruegel calculations. Note: Labour productivity per hour worked in 2013 US\$ (converted to 2013 price level with updated 2005 EKS PPPs).

With this in mind, it seems the impact of the single market on productivity and hence growth can be considered somewhat more muted than originally expected. *Inter alia*, this can be seen in the significant mismatch between the growth effect estimations of the *ex-ante* reports (Cecchini, Baldwin) and the *ex-post* evaluations. This may be down to a number of factors. We identify three: (i) the single market remains far from complete and barriers remain prevalent; (ii) key complementary policies in support of the functioning of the single market at national and EU level were not put in place; (iii) the ‘creative destruction dynamic’, which is key to unleashing the growth potential of the single market, was not allowed to operate fully.

3.1 An incomplete single market

It appears clear that the EU still falls short of having a fully integrated common market for goods, services, labour and capital. The crucial questions in this respect would then be: how far is the EU from achieving a fully-fledged single market, and why?

Measuring the gap

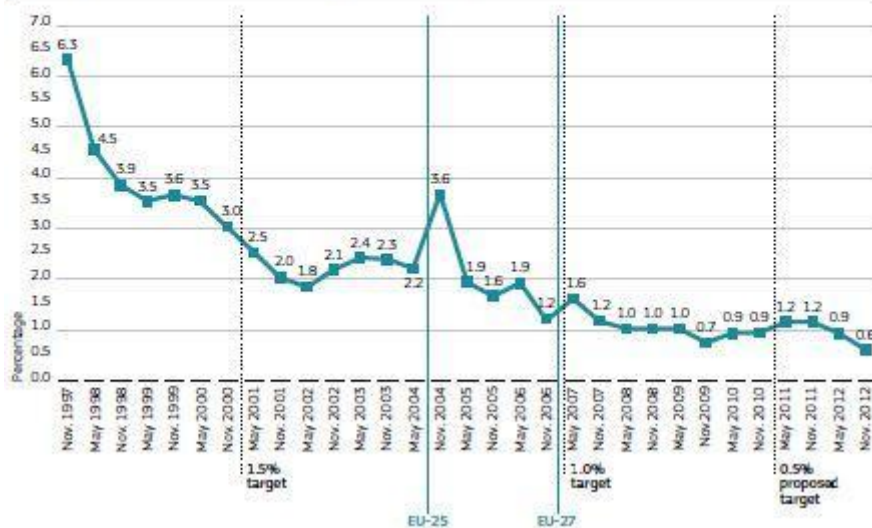
Several studies, mostly by the European Commission, have attempted to track how far Europe is from reaching a genuine single market. The approach here has been twofold: input- or output-based. In input-based studies, the degree of integration has been measured by tracking the progress made in introducing and implementing the directives and regulations that are at the basis of the single market. In this respect, we see that the EU’s average transposition deficit (the gap between the number of single market laws adopted at EU level and those in force in Member States) has decreased steadily to 0.6 percent in 2013, from 6.3 percent in 1997, when the data was first collected⁴. From this standpoint, the single market machinery seems well oiled. But, as detailed among others by Thompson (2010), it is not only a matter of transposition but also of quality of implementation. As highlighted in the OECD’s ‘Better regulation in Europe’ project, complaints have centred on ‘regulatory creep’ (actions that add unnecessarily to the burden of regulation), such as gold plating (implementation that goes beyond the requirements of a directive), unnecessarily early implementation and keeping higher ranking regulations in place.

⁴For more information, please refer to the [Single Market Scoreboard](#).

Average transposition deficit in November 2012

Figure 1: 0.6 % — Best result ever!

The transposition deficit shows the percentage of Single Market directives not yet notified (as national transposition measures) to the Commission in relation to the total number of directives that should have been notified by the deadline. The current Scoreboard takes into account all notifications by 11 November 2012 for directives with a transposition deadline of 31 October 2012. As of 1 October 2012, 1420 directives and 1769 regulations were in force to ensure the functioning of the Single Market.



Source: European Commission.

Output-based measures of market integration build on the theoretical effects outlined in section 2.1 and verify whether such effects actually materialised (see Box 3). Variables used for this purpose include GDP per capita (to verify whether we observe wealth convergence of countries), various measures of trade deepness (share of intra-EU trade over total trade, intra-EU trade as percentage of GDP, etc), labour productivity and costs (as in a fully-integrated market differences in labour efficiency should smoothen out over time), cost of capital (as we would expect to see convergence in borrowing rates), and price levels (in a fully integrated single market, the law of one price should apply). Output-based measures paint a much less rosy picture of the current state of health of European market integration.

Box 3. Output-based measures of European market integration

Borsi and Metiu (2013) look at the period 1970-2010 and find no overall **real GDP per capita** convergence in the EU27. They rather identify subgroups that converge to different steady-state equilibria. This highlights that the idea of a 'multi-speed' Europe prevails 20 years after the Single Market Programme and nearly a decade after the eastern enlargement. They also do not find a clear relationship between clustering and EMU membership in that euro-area countries do not form a single convergence club.

As outlined in section 2.2.1, the **trade effects** of the single market were certainly pronounced: trade volumes

between EU members increased from 12 percent of GDP to 22 percent between 1992 and 2012 (Vetter, 2013). However, Pacchioli (2011) constructs a gravity model and employs it to compare trade patterns in the EU and the US. The estimated results show that an average EU country still trades more within its borders than with other member states – about three to four times as much as the average US state does.

Europe Economics (2013) illustrates how, overall, the dispersion in hourly **wages** in EU countries decreased during the 1970s and 1980s, then in the 1990s the convergence process slowed and even reversed for some sectors. By comparing European convergence to other economies, the paper suggests that the patterns of the 1970s and 1980s cannot be attributed to global trends. These findings are confirmed by Zarotiadis and Gkagka (2010) even when extending the observation period to the 1960s. As illustrated by OECD (2012b), unit labour costs in the euro area have diverged since the beginning of the 2000s and this trend has started to reverse only recently. Turning to **labour productivity**, Sondermann (2012) finds that, even within the euro area only, no convergence can be found at the aggregate level, but only within selected service sectors and manufacturing sub-industries. Looking at the period 1960-1997, Soukiazis (2000) found labour productivity levels to be converging in the EU15 at very slow pace.

Bekaert et al/ (2013) look at both the impact of the SMP and the euro on **financial integration**. Their underlying assumption is that, in integrated markets, discount rates and expected growth opportunities should be similar within one industry, irrespective of the country, implying narrowing valuation differentials as countries become more integrated. They thus analyse the period 1990-2007 and show that EU membership significantly increased integration, whereas the euro did not. These results are robust to an extension of the analysis period to include the euro-area crisis (-2012).

Price convergence. The most pronounced effect of European economic integration was on price convergence between countries. The coefficient of variation of the price level in the EU27 was at 20 percent in 1995, but decreased to roughly 10 percent in 2011. This development was mostly a result of low inflation in the high-income members of the EU and competitive pressure from the new European and global markets which kept price increases low. The members with price levels below the EU average experience an upward convergence because of trade with high-income countries. The newer EU members particularly from central and eastern Europe went through the process of catching up, which increased per-capita income levels and improved product quality, and which contributed to convergence towards the EU average (Ilzkovitz, 2007).

However, some studies argue that the process of price convergence is already close to achieving its maximum, as the coefficient of price variation is close to that observed in the US. Ultimately, some price dispersion will remain as long as the taxation and regulation differences between EU member states are preserved.

However, this approach is not immune from limitations because: (i) it is harder to establish causality given these variables might depend on other (global) patterns and shocks; (ii) it is not clear what the limit of integration is because even sovereign countries do not display maximum values for these variables⁵. These indicators are hence often benchmarked against potential comparison groups such as the United States, Canada and so on. The comparability of a peculiar set-up like the EU, in which member states try to achieve treaty-based market integration while retaining their sovereign prerogatives, to other federal states is however questionable.

Although the degree of integration (or lack thereof) might be difficult to assess, it appears evident that it is far from complete. This might seem as a strikingly dismal result, 50 years after the Treaty of Rome, dozens of rulings of the European Court of Justice, the establishment of the principle of mutual recognition, the Bologna process and the implementation of hundreds of standardisation directives and regulations. There are multiple aggravating factors that contributed to this somewhat disappointing result. First, the achievement of a single market can be seen as a moving target, which, because of product and process innovation, will always require legislative and monitoring effort ('market maintenance'). Secondly, successive waves of enlargement have brought the union from a small club of six (at the time of the Treaty of Rome), to a more heterogeneous group of 28 in 2014. Although this is expected to have contributed positively to pro-competitive dynamics within the single market (see Baldwin *et al*, 1997), it has surely led to a wider dispersion of prices, income levels, wages, labour productivity and cost of capital. Third, political willingness has not always been evident for measures required to ensure a smooth functioning of the single market. This is also due to the fact that, as the level of integration increases, sovereignty may have to be given up on politically-sensitive issues. These include, but are not limited to, migration and asylum rules, recognition of academic and professional titles, pensions (and their portability), public procurement, industrial policy and health and safety issues.

Remaining barriers

The economic literature has identified and analysed at length remaining barriers to the achievement of a true single market. Here is a non-exhaustive list:

Poor quality of implementation of directives. As mentioned by European Commission (1996), often directives are correctly implemented but in an over-complicated way, hence imposing costs on free

⁵ For instance, in Italy, despite over 150 years of political unification, price levels remain roughly 16 percent lower in the south than in other parts of the country (see [Banca D'Italia](#), 2009).

movement and preventing a full exploitation of the potential of the single market (see also Falkner *et al*, 2005; Börzel *et al*, 2010). This point was stressed more recently by OECD (2012a).

Insufficient mutual recognition. Ilzkovitz *et al* (2007) highlights how, although the EU completely abolished internal tariffs back in 1968, the costs of operating cross-border still remain high. A prominent issue is the differing regulation across borders, which imposes costs of bringing a product/service in accordance with multiple national standards (see Guimaraes and Egan, 2014). Differing standards, on the other hand, may reduce the interoperability of the products. Variation in rules brings additional export costs that only some firms are able to overcome (Mayer and Ottaviano, 2007). Moreover, the heterogeneity in rules protects the market share of domestic companies and shields them from foreign competition (Mansfield and Busch, 1995; Lejour *et al*, 2009).

Public procurement. Public procurement remains a thorny point, and one of the most politicised issues of the single market. Ilzkovitz *et al* (2007) illustrate how, while public procurement constitutes 16 percent of EU GDP, only 3 percent of contracts are cross-border in nature and only 22 percent of bids are published. This is because public procurement enjoys significant exceptions to the obligations established by EU single market directives.

Service sectors. Ilzkovitz *et al* (2007) and Monti (2010) explain how some service sectors, particularly network industries, the retail trade and professional services suffer from quite acute regulatory distortions which limit intra-EU competition. De Bruijn *et al* (2006) estimate that a complete liberalisation of services within the EU could lead to an increase in GDP of 0.3-0.7 percent, without accounting for the dynamic effects this would have on GDP growth trends.

Free movement of people. Although barriers for labour mobility were theoretically removed in the late 1960s and early 1970s, cross-border movement of workers remained low. Overall, only 3 percent of the population works in another member state (European Commission, 2013). Migration decisions are recognised by the literature to be complex and dependent on several factors. Surveys highlight how family ties and language/cultural barriers represent one of the major determinants of the low degree of intra-EU labour mobility⁶. However, there are also administrative barriers. These include the poor degree of recognition of professional qualifications, the lack of coordination on social security

⁶ Among those who say that they would not consider working in another EU country, the main reasons are family or personal reasons (47 percent) and simply not wanting to work or live in another country (32 percent). One in five would not consider it because of language (Special Eurobarometer 398, Oct 2013).

schemes (especially unemployment benefits and pensions), on top of a lack of coordination on income taxation (resulting often in double taxation), as illustrated by Lamassoure (2008), Monti (2010), Dhéret *et al* (2013) and Ilzkovitz *et al* (2007).

3.2 Policies supporting the single market

Albeit important, the prevailing barriers in the single market tell only part of the story. In several areas, even fully abolishing barriers does not translate into the automatic engendering of a common market. An example of this is the capital market: although full liberalisation of capital movements was implemented in 1990 as part of the Single Market Programme, a genuine single capital market has failed to emerge. Similar considerations could be made for the free circulation of workers, for which the abolition of any discrimination based on workers' nationality dates back to 1968⁷.

This apparent paradox is because, on top of procedural integration and mutual recognition of standards, a functioning common market calls under many headings for the establishment of key complementary policies. For example, the mere recognition of the right of establishment failed to spark significant integration of the banking sector at European level, which rather required the creation of a single supervisor and a common resolution mechanism. With this view in mind, a banking union is not only required in order to shore up the EMU construction, but rather was needed as part of the single market and, as such, it would have been part of the complementary policies necessary to ensure the four freedoms (in this case, free movement of capital and true solid financial integration). This point was hinted at by Monti (2010) when stressing the importance of a European *“structure of financial supervision [...] such as not to lead to fragmentation of the single market”*.

Similar points could be made about the common market for workers. Aside from the standard discussions on the mutual recognition of professional titles and language barriers being prevalent, we note that, as previously highlighted, at the current juncture it is not possible for workers to bring their unemployment benefits or pension payments with them as they migrate to other European countries. The establishment of a true common market for workers would therefore call for greater welfare-system coordination at EU level.

⁷ Council Regulation 1612/68 & 68/360.

Along these lines, European Commission (1996) stresses the point that, although not strictly falling under the four freedoms, a series of complementary policies would need to be implemented at national and/or European level in order to ensure a smooth functioning of the single market and fully exploit its potential. These include:

Some degree of harmonisation of fiscal rules. Whereas full tax harmonisation is not a requirement for a smooth functioning of a single market and may as well be not desirable (for example because a certain degree of tax competition may contribute to discipline states' fiscal policies), having 28 different tax codes imposes significant administrative burdens on companies operating cross border. In a survey conducted in 2004, the European Commission found that these costs were sizeable and in the order of 1.9 percent of tax collected for large enterprises and 30.9 percent for SMEs. Issues of transfer pricing, VAT refunds and double taxation were seen as generating the greatest compliance costs (Ilzkovitz *et al*, 2007). Copenhagen Economics (2004) placed the welfare gains originating from various tax harmonisation scenarios between 0.02 percent and 0.21 percent of GDP.

Coordinated environmental and consumer policy. Differentiated forms of consumer protection or environmental standards represent a significant cost for firms wanting to operate cross-border and prevent them from fully capitalising on the benefits of a single market. Lamassoure (2008) reports how the EU sets only minimum standards in these fields, leading to member states adopting tighter supplementary regulations. As such, tighter coordination at EU level (and perhaps more mutual recognition) would be needed under these headings.

Investment in infrastructure. In order to fully capitalise on the (potential) benefits originating from the free movement of goods and services, infrastructure must be put in place. This requires investment both at the national and European level. Note that infrastructure is here meant in its broad definition of interconnecting facilities, going beyond mere transportation networks (roads, ports, etc.) and encompassing also financial infrastructure (eg Target2-Securities) and e-infrastructure (eg data grids, centres, etc). This point is also made by Monti (2010).

Naturally, many of the complementary policies have a degree of political unpalatability and were avoided hitherto not out of policy ignorance but rather because they often involve a significant pooling of sovereignty. However, one has to realise that for as long as these supporting policies are not

implemented, the European single market will remain fragmented, failing to deliver on its promises of growth and enhanced prosperity.

3.3 Policies preventing creative destruction

As highlighted above, when discussing the channels through which the single market is likely to spark growth, competition and, more broadly, welfare, the concept of Schumpeterian creative destruction is the cornerstone of success. Once countries open their borders to European competition, some firms (the most unproductive) will exit the market, allowing for a redistribution of resources to the most competitive. This will allow countries to develop and focus on their competitive advantages. However, for this to happen in an effective way, the incentives must be straight at national level.

As already noted by the Sapir Report (2003): *"the European experience suggests that some specific instruments chosen to preserve cohesion in the course of the process of market liberalisation and integration may have exerted too high a toll in terms of growth. This has been both through limiting the deepening of such processes and through trying to counter the unequal spreading of the resulting gains from trade in a distorting manner at both the European and national levels"*.

National regulations protecting undue rents, rigid labour market rules, industrial policy supporting national champions, prevailing public monopolies, cumbersome procedures to set up new businesses, to mention just a few, are all policies that will hamper the process of 'creative destruction' and attenuate the benefits of the single market, even in a situation in which all barriers are removed. All this connects very neatly with the discussions on the structural reforms that are needed in many EU countries in order to boost their competitiveness.

At the same time, an effective national welfare system is fundamental to ensure that there is not just 'destruction' but rather 'creative destruction'. As unproductive firms shut down and workers are laid off, the government, also with the help of EU structural funds, must ensure that these capacities are not wasted but rather re-channelled to productive sectors and firms. Should the result of increased competition be long-term unemployment, this would just translate into destruction of human capital, net welfare losses and growing divergence, rather than convergence, between EU member states.

When taking this view, one can then interpret the single market as a catalyst, rather than a motor, of growth. Reforms of product and labour markets, together with policies increasing the effectiveness of welfare systems, while keeping public finances under control, will boost competitiveness and growth. A complete functioning single market will then amplify the positive effect of these reforms. However, if progress is not made under these headings, the single market cannot act as a substituting policy to bring Europe back to growth.

3.4 Distributional considerations

The analysis leads to a number of fundamental questions, which essentially pertain to the ultimate purpose of the single market from the perspective of EU citizens:

[1] What is the true objective of the single market? Is it (or should it be) a purpose of the single market to leave all agents at least not worse-off? This is important, because only through the identification of clear objectives it is possible to evaluate how much it cost *not to have* market integration – that is a measure of the gap between where we are now and where we would like to be.

[2] If the objective of the single market is leaving everybody better off, what kind of tools should be used to reach such market equilibrium, if at all possible? If instead the single market project should inevitably entail the creation of winners and losers, should it be entirely up to member states to decide how to distribute the gains of market integration within their national boundaries? Or should the European Union attempt to achieve a specific welfare distribution? In that case, what would an ideal allocation of welfare gains from the single market look like according to the principles laid down in the Treaty on European Union?

[3] Suppose instead that the underlying objective of the single market should be to maximise the size of the welfare cake without any explicit or implicit welfare distribution purpose. Still, clearly the distribution among economic agents of the gains and costs from integration would also endogenously affect the size of welfare cake in itself. Potential gains and costs have positive and negative effects on incentives to conduct economic activities within the market. Higher gains rewarding highly productive or innovative activity have a stimulus effect. Capturing this dynamic dimension of the single market is one of the key challenges of the quantification of the absence of integration.

The answer to the above questions is not straightforward. An interesting example is given by the treatment of small and medium-sized enterprises (SMEs) in the context of the single market regulation. New rules are often deployed in order to facilitate SMEs access to markets (this is the case, for example, for the new directive on public procurement⁸). Though this preferential treatment is frequently backed by economic theory (SMEs can be more exposed to market failure), SMEs are often protected from the competitive forces within the single market for the mere fact that it is considered 'fair' to protect small companies. This seems to suggest that there exist principles at EU-level guiding the allocation among agents of welfare gains (and indeed, Art. 173 of the Treaty, for example, lists encouraging an environment favourable to the initiative and the development of small and medium undertakings' among the aims of the European Union and member states). It may well be that favouring SMEs could lead to suboptimal total welfare levels, for example if production in a certain sector features very high economies of scale. But the cost of the lack of market integration should be assessed against the objectives that the single market intends to pursue and appropriate weights should be used to measure the effects of integration. Summarising effects in terms of 'GDP growth' can be tempting (though numbers are hardly reliable). Yet, those kinds of measures can be misleading, if no complementary appraisal of effects on achievements of the single market objective is performed.

Another example is international mobile telecommunication tariffs regulation. There are efficiency reasons why it is desirable to intervene in the market for cross-border mobile calls: competition in that market is hampered by technical barriers, therefore regulatory intervention is warranted. However, the European Commission might also be tempted to intervene to lower roaming fees for the sake of promoting cross-border communication with no evident link to a specific market failure. There is then a risk that regulatory intervention over roaming fees would have 'waterbed effects' on domestic markets, ie it could create an incentive for operators to increase tariffs for domestic calls. If that is the case, EU single market regulation would entail a transfer of surplus between different typologies of users. Customers who only make or receive domestic calls would lose out in comparison to customers who frequently travel abroad, for example. The welfare effect of such transfer of wealth is exacerbated by the fact that the second typology of users might be on average richer or more educated than the first category of users.

Ultimately, regardless of whether the European Union pursues a specific welfare function, member states play the major role in welfare distribution (and they should do, while the main European

⁸ Directive 2014/24/EU of the European Parliament and of the Council of 26 February 2014

institutions remain not fully democratic). This also means that member states affect the distribution of gains and costs brought about by single market integration, feeding back in terms of the size of the welfare cake because of the dynamic effects described throughout this paper. In that sense, not only does the success of the single market depend directly on the effort of member states to delegate part of their powers and give up some of their rents in favour of a centralised EU governance system; the success of the single market also depends indirectly on how each member state would allocate the rents that arise from integration. A 'laissez faire' policy under which the distribution of gains and losses from integration is unaltered by national policies would imply a net negative effect for well-defined social groups. Two economic dimensions appear relevant for identifying these groups:

- (a) the geographical extension of agents' economic interests and spheres of influence, and
- (b) whether the agent is prominently affected by integration in her capacity of acquirer or supplier of goods or services.

At the extreme, agents for whom the economic interests and spheres of influence are entirely confined to national borders and who are mostly affected by the single market in their capacity of suppliers of goods or services are likely to be made worse-off by further market integration. In other words, unless governments implement a (non-necessarily explicit) 'single market rents' redistribution policy', for a Sardinian shepherd, a Polish smallholder or a French plumber etc, the absence of integration is likely to be perceived as a positive development, if the rents they lose because of increased exposure to competition are not fully compensated for by the benefits they receive from market integration (for example in their capacity of customers of other goods or services).

4. Conclusions

Completing the single market is often offered as an answer to most of the current problems of the EU, be it sluggish growth performance, high unemployment or an incomplete monetary union. However, seldom is time taken to explain how the single market could and has benefited the Union. In this Working Paper, we have aimed to bridge this gap by offering a holistic reflection on the theoretical channels of single-market-induced growth and have verified their relevance, building on existing empirical literature.

We highlighted the methodological complications related to the theoretical study and empirical estimation of single market dynamics; even taking that into account, it is safe to conclude that the impact of the single market has somewhat fallen short of expectations. Certainly the Single Market Programme has not succeeded in reversing the declining (though still positive) trend in EU productivity growth and its gap with the US. In our view, this is for three broad reasons:

1. Barriers remain prevalent under several headings and therefore the single market is not complete;
2. Key complementary policies to the abolition of barriers were not put in place;
3. Some national policies were not supportive of the positive effects of the single market.

A key observation is that although the overwhelming prediction is for the single market to generate positive aggregate effects, specific categories might be negatively affected. A large part of the constituencies that currently show support for Eurosceptic parties are possibly to be ascribed to this category. If this were true, and given points 2 and especially 3 above, failures in national policies and welfare systems are to be partly blamed for the opposition that is currently being channelled against the EU and the single market.

An intriguing question in this respect is the relationship between the EU's eastern enlargement and the single market. In principle the enlargement of the single market with the addition of countries from central and eastern Europe should have been viewed as a win-win situation for both old and new EU member states. For the new members, free mobility of goods, services, capital and labour offered the opportunity to catch up with the old ones, as the southern countries that joined the EU during the 1980s did earlier. For the old members, the possibility to expand their markets and to reorganise their

production in a more efficient way offered a way to boost their competitiveness at a time when competition from emerging countries was becoming fiercer.

Until the crisis, this win-win scenario seemed plausible though the backlash against the Services Directive in a number of old member states was a warning about the discontent in (some of) these countries about the way the enlarged single market would operate, and threaten employment in certain labour-intensive service activities. With the crisis, and the rise of unemployment, opposition to labour mobility, including temporary movements of service workers, has considerably risen in old member states, including some where such mobility had been welcomed before the crisis. In addition, southern members of the euro area which have been badly hit by the crisis, have come to realise that they suffer from a competitiveness problem not only (or even not mainly) in relation to the core countries of the euro area, but also (or even mainly) in relation to the EU countries of central and eastern Europe, including those that are not yet in the euro area and enjoy flexible exchange rates.

Such developments explain in part why the enthusiasm for the single market is now relatively muted in some EU member states, especially among categories who view themselves as victims of globalisation, which they often regard as synonymous with, or at least complementary to, European market integration.

Perhaps precisely because of the acknowledgment of the heterogeneous effects arising from further integration, and led by the desire to overcome distributional conflicts, the approach of the Commission in the past has been to adopt wide-ranging directives and regulations aimed at completing the single market across the board – the 1992 SMP being the most notable case. Recently however, we note a policy shift towards a more targeted approach. The Juncker Commission has identified the main priorities for the single market as the establishment of a Capital Market Union, and the completion of the European energy and digital markets. This targeted approach might cater better to focusing on setting up the ‘complementary policies’ we have mentioned. But without comprehensive support from member states entailing not only devolution of powers but also appropriate national redistribution policies, those initiatives are likely to face increasing political resistance, significantly affecting the chances that the single market will deliver the benefits expected of it since its inception.

A broader question pertains to the underlying reasons why the single market had not been completed or why the necessary policies at national level to enable the single market to work have not yet been

implemented. Simply blaming the absence of true political will on the part of member states would seem naïve: any policy entailing a loss of sovereignty and short-term costs in exchange for uncertain medium and long-term benefits would necessarily face strong resistance at national level. Perhaps the more fundamental reason is the absence of a clear definition of the ultimate goals of the single market and of a stable and credible long-term implementation strategy to achieve them.

Throughout the history of the European Union, the absence of clarity about what the single market really means together with an unbalanced focus on process rather than effects has produced an excess of hesitancy in the pro-single market policies and enforcement action promoted by the European Commission. The strength and the legitimacy of the Commission's role must necessarily stem from a unanimous recognition of the end game by stakeholders: where Europe would like to be when the single market will be completed. This requires seeking a single definition and adopting a single principle of assessment.

The single market could be defined as a key input in European citizens' life: hence the ultimate goal would be to maximise what integration can give to citizens in their capacity of recipients and users of the output of economic activities taking place in Europe. And since the benefits that the single market is supposed to bring about are of an economic nature, it would seem straightforward to adopt an economic principle according to which new pro-integration policies and actions would be designed following a strict economic assessment.

Productivity is the key word; competition, the elimination of frictional barriers, cross-border mobility of any economic entity that can potentially switch location are all intended to unleash a potential of value creation which is today held back by (mostly intangible) obstacles between national markets. But it should be clear upfront that the long-term success of a seamless common market will have to be measured by how much of that value will accrue to European citizens. A clear cut commitment by member states led and coordinated by the European Commission to that ultimate goal and principle of assessment would probably be a first step in the right direction, if followed by a convergence of stakeholders' expectations. This is not painless, requiring the acceptance that the single market will result in casualties that will not be compensated within the context of the single market; national policies that are de-linked from the single market should deal with those, but it should not be up to the single market to make everybody happy. Transfers between and within countries also have an important role to play.

As Article 3 of the Lisbon Treaty states, *"The Union shall establish an internal market. It shall work for the sustainable development of Europe based on balanced economic growth and price stability, a highly competitive social market economy, aiming at full employment and social progress"*. In other words the single market is only one, though a crucial aspect of Europe's social market economy. Clarity on long-term objectives would give the European Commission the substantial power it has so far lacked to impose measures that would concretely move forward the European integration process. Confronted with the increasing challenges of highly competitive global markets, acceleration of the implementation process would be not only welcome, but vital to preserve Europe's long-term economic prosperity.

References

- Abiad, A., Leigh, D., and Mody A. (2007) 'International Finance and Income Convergence: Europe is Different', IMF Working Paper, WP/07/64
- Aghion P., Bertola G., Hellwig M., Pisani-Ferry .J, Sapir A., Vinals J., Wallace H. (2003) *An Agenda for a Growing Europe: The Sapir Report*, Oxford University Press
- Aghion, P., Bloom, B., Blundell, R., Griffith, R., and Howitt, P. (2002) 'Competition and Innovation: An inverted-U Relationship', NBER Working Paper 9269
- Aghion, P., Howitt, P., & Prantl, S. (2013) 'Revisiting the Relationship between Competition, Patenting, and Innovation', *Advances in Economics and Econometrics*, 451-455
- Aghion, P, Harris, C, Howitt, P and J. Vickers (2001) 'Competition, Imitation and Growth with Step-by-Step Innovation', *Review of Economic Studies*, vol 68, pp. 467-492
- Allen, C., Gasiorsek, M. and Smith, A. (1998) 'European Single Market: How the programme has fostered competition', *Economic Policy*, 441-486
- Badinger, H. (2004) 'Do we really know that the EU's Single Market Programme has fostered competition?', *EI Working Papers / Europainstitut*, (55)
- Badinger, H. (2007) 'Has the EU's Single Market Programme Fostered Competition? Testing for a Decrease in Mark-up Ratios in EU Industries', *Oxford Bulletin of Economics and Statistics*, 69: 497–519
- Baele, L., Ferrando, A., Hördahl, P., Krylova, E., Monnet, C. (2004) 'Measuring financial integration in the euro area', *ECB Occasional Paper* n. 14
- Baldwin, R.E. (1989) 'On the growth effects of 1992', NBER *Working Paper* 3119
- Baldwin, R.E., Francois, J.F., Portes, R. (1997) 'The Costs and Benefits of Eastern Enlargement', *Economic Policy*, 21, pp. 125-176
- Baldwin, R. E. (2006) 'The Euro's Trade Effects', *ECB Working Paper* No. 594
- Baldwin, R. and Venables, A. (1995) 'Regional Economic Integration' in Gene M. Grossman and Kenneth Rogoff (eds) *Handbook of International Economics*, Volume III, Amsterdam: Elsevier Science Publishing
- Baldwin, R. and Wyplosz, C. (2012) *Economics of European Integration*, McGraw-Hill, New York
- Bekaert, G., Harvey, C.R., Lundblad, C.T., Siegel, S. (2013) 'The European Union, the Euro, and equity market integration', *Journal of Financial Economics*, Vol. 109: 583-603
- Bekaert, G., Campbell, H.R., Lundblad, C. (2005) 'Does financial liberalization spur growth?' *Journal of Financial Economics*, Elsevier, vol. 77(1): 3-55, July
- Benton, M., Petrovic, M. (2013) 'How free is free movement? Dynamics and Drivers of Mobility within the European Union', MPI Report

BEPA (2013) 'The cost of non-Europe: the untapped potential of the European Single Market', London Economics and PwC for BEPA, accessible at http://ec.europa.eu/archives/bepa/pdf/publications_pdf/cone-report.pdf

Berger, A.N. (2000) 'The integration of the financial services industry: where are the efficiencies?', *North American Actuarial Journal*, 4(3): 25-52

Bloom, N., Propper, C., Seiler, S., & Van Reenen, J. (2010) 'The impact of competition on management quality: evidence from public hospitals', *NBER Working Paper Series*, n 16032

Blundell, R., Griffith R., and Van Reenen, J. (1999) 'Market Share, Market Value and Innovation in a Panel of British Manufacturing Firms,' *Review of Economic Studies*, LXVI, 529 –554

Boeri, T. and Brücker, H. (2005) 'Migration, Co-ordination Failures and EU Enlargement', *IZA Discussion Paper*, No. 1600

Boeri, T. and Van Ours, J. (2013) *The Economics of Imperfect Labour Markets: Second Edition*, Princeton University Press

Boldrin, M., and Levine, D. K. (2008) 'Perfectly Competitive Innovation', *Journal of Monetary Economics*, 55(3), 435-453

Boltho, A. and Eichengreen, B. (2008) 'The Economic Impact of European Integration', *CEPR Discussion Paper*, No. 6820

Borsi, M.T., Metiu, N. (2013) 'The evolution of economic convergence in the European Union', *Deutsche Bundesbank Discussion Papers* N. 28/2013

Börzel, T. A., Hofmann, T., Panke, D., Sprungk, C. (2010) 'Obstinate and Inefficient. Why Member States Do Not Comply With European Law', *Comparative Political Studies*, 43/11, 1363-1390

Brücker, H. and Eger T. (2012) 'The law and economics of the free movement of persons in the European Union' in Research Handbook on the Economics of European Union Law, T. Eger and H. Schäfer eds., Edward Elgar Publishing

Busch, B. and Gregosz, D. (2013), 'Europe's Single Market – exploiting untapped potentials', KAS, Berlin

Campos, N., F. Coricelli and L. Moretti (2014) 'Economic Growth and Political Integration: Synthetic Counterfactuals Evidence from Europe', *mimeo*

Cecchini, P., Catinat, M. and Jacquemin, A. (1988) *The European Challenge – 1992* (aka The Cecchini Report), Wildwood House Ltd

CEPS (1996) *The determinants of foreign direct investment flows in Europe and the impact of the Single Market*, European Commission

Coopers and Lybrand (1993) *The cost of capital*, study done for the European Commission

Copenhagen Economics (2004) *Economic effects of tax cooperation in an enlarged European Union*, Report prepared for DG TAXUD (European Commission)

Davidson, C., and Mukherjee, A. (2006) 'Horizontal mergers with free entry', *International Journal of Industrial Organization*, 25 (2007) 157–172

de Bruijn, R., Kox, H., Lejour, A. (2006) 'The Trade-Induced Effects of the Services Directive and the Country-of-Origin Principle', CEPS ENEPRI *Working Papers* No. 44

Deneckere R., Davidson, C. (1985) 'Incentives to Form Coalitions with Bertrand Competition', *The RAND Journal of Economics*, Vol. 16, No. 4 (Winter, 1985), pp. 473-486

Dhéret, C., Lazarowicz, A., Nicoli, F., Pascouau, Y., and Zuleeg, F. (2013) 'Making progress towards the completion of the Single European Labour Market', *EPC Issue paper* no. 75

EAG (1996) *The development of foreign direct investment flows in the EU due to the Internal Market Programme*, European Commission

Europe Economics (2013) *Optimal integration in the Single Market: a Synoptic Review*, Report for BIS

European Commission (2006) *Evaluation of the performance of network industries providing services of general economic interest*

European Commission (1997) 'Economic Evaluation of the Internal Market', *European Economy* n. 63

European Commission (1988) 'The Economics of 1992', *European Economy* n. 35

European Commission (2013) 'EU Employment and Social Situation', *Quarterly Review*, Luxembourg

Falkner, G., Treib, O., Hartlapp, M. and Leiber, S. (2005) *Complying with Europe: EU Harmonization and Soft Law in the Member States*, Cambridge: Cambridge University Press

Fertig, M. & Schmidt, C. M. (2002) 'Mobility within Europe – What do we (still not) know?' *IZA Discussion Papers* 447, Institute for the Study of Labour (IZA)

Frankel, J. (2008) 'The Estimated Effects of the Euro on Trade: Why Are They Below Historical Effects of Monetary Unions Among Smaller Countries?' *NBER Working Paper* 14542

Griffith, R., Harrison R. and Simpson H. (2006) 'Product Market Reform and Innovation in the EU', Institute for Fiscal Studies *Working paper* No. 06/17, London

Guimaraes, H., and Egan, M. (2014) 'Barriers to Business in the Single Market', available at SSRN: <http://ssrn.com/abstract=2399098>

Ilzkovitz, F., Dierx, A., Kovacs, V., Sousa, N. (2007) 'Steps towards a deeper economic integration: the internal market in the 21st century', *European Economy - Economic Papers* 271, Directorate General Economic and Monetary Affairs (DG ECFIN), European Commission

Kox, H. (2005) 'Intra-EU differences in regulation-caused administrative burden for companies', CPB Memorandum

Kukenova, M. (2011) 'Financial Liberalization and Allocative Efficiency of Capital', World Bank *Policy Research Working Paper* n. 5650

Lipsey, R.G. (1957) 'The Theory of Customs Unions: Trade Diversion and Welfare', *Economica*, 24: 40-46

London Economics (1996) *Single Market review 1996: Competition issues*, European Commission

Melitz, M. J. (2003) 'The Impact of Trade on Intra-Industry Reallocations and Aggregate Industry Productivity', *Econometrica*, 71: 1695–1725

Nickell, S. (1996) 'Competition and Corporate Performance,' *Journal of Political Economy*, CIV, 724 – 746

OECD (2012a) OECD Economic Surveys - EUROPEAN UNION

OECD (2012b) OECD Economic Outlook

OECD (2014) 'Migration as an adjustment mechanism in the crisis? A comparison of Europe and the United States', OECD SOCIAL, EMPLOYMENT AND MIGRATION WORKING PAPERS N° 155

Lamassoure, A. (2008) 'The citizen and the application of community law', Report to the President of the Republic

Lejour, A., Rojas Romasgosa, H., Rodriguez, V., Montalvo, C., Van der Zee, F. (2009) 'Trade costs, Openness and Productivity: Market Access at Home and Abroad,' MPRA Paper 21214, University Library of Munich

Mansfield, E.D., Busch, M.L. (1995) 'The political economy of non-tariff barriers: a cross-national analysis', *International Organisation*, 49(4), pp. 723-49

Mayer, T., Ottaviano, G.I.P. (2007) *The Happy Few: The internationalisation of European firms. New facts based on firm-level evidence*, Bruegel Blueprint series, Volume 3

Monti, M. (2010) *A new strategy for the Single Market: At the service of Europe's economy and society*, Report to the President of the European Commission, Brussels, 9 May

Pacchioli, C. (2011) 'Is the EU internal market suffering from an integration deficit? Estimating the "home-bias effect"', *CEPS Working Document*, No. 348

RAND (2014) 'The Cost of Non-Europe in the Single Market – Free movement of Goods', European Parliamentary Research Service

Richardson, J.D. (1990) 'Empirical Research on Trade Liberalisation with Imperfect Competition: A Survey', from *OECD Economic Studies*, No. 1/2, pp. 7-50

Sauner-Leroy, J-B. (2003) 'The impact of the implementation of the Single Market Programme on productive efficiency and on mark-ups in the European Union manufacturing industry', European Commission Directorate-General for Economic and Financial Affairs, *Economic Papers*, No 192

- Scherer, F. (1967) 'Market Structure and the Employment of Scientists and Engineers', *American Economic Review*, 57, 524-531
- Sondermann, D. (2012) 'Productivity in the euro area: any evidence of convergence?', *ECB Working Paper Series*, n 1431
- Soukiazis, E. (2000 b) 'Productivity Convergence in the EU. Evidence from Cross-Section and Time-Series Analyses', *Discussion Paper* n°4, CENEUROP, FEUC
- Spector, D. (2003) 'Horizontal mergers, entry, and efficiency defenses', *International Journal of Industrial Organization*, 21: 1591–1600
- Thompson, R. (2010) 'Opposition through the back door in the transposition of EU directives', *European Union Politics*, Vol. 11 (4): 577-596
- Van Ark, B., O'Mahony, M., Timmer, M. (2008) 'The Productivity Gap between Europe and the United States: Trends and Causes', *Journal of Economic Perspectives*, Vol. 22 (1): 25-44
- Venables, A. J. (1985) 'Trade and trade policy with imperfect competition: The case of identical products and free entry', *Journal of International Economics*, Volume 19, Issues 1–2: 1–19
- Vetter, S. (2013) 'The Single European Market 20 years on', *Deutsche Bank Research*
- Veugelers, R. (2004) 'Industrial Concentration, Market Integration and Efficiency in the European Union', in A. Dierx, F. Ilzkovitz and K. Sekkat (eds) *European Integration and the Functioning of Product Markets*, Edward Elgar
- Veugelers, R., & Cincera, M. (2010) 'Young leading innovators and EU's R&D intensity gap', *Policy Contribution* 2010/09, Bruegel
- Viner, J. (1950), *The Custom Union Issue*. New York: Carnegie Endowment for International Peace
- Zarnic, Z. (2010) 'From Liberalization towards Integration: Have Markups of EU Electricity Firms Changed?' *LICOS Discussion Papers* 26110, Centre for Institutions and Economic Performance, Katholieke Universiteit Leuven
- Zarotiadis, G., and Gkagka, A. (2010) 'Switching from convergence to divergence in the European Union: A case study', *ECINE Working Paper Series*, n 164
- Zimmermann, K.F. (2013) 'The mobility challenge for Growth and Integration in Europe', *IZA Policy Paper*, No. 69