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Two short essays on services markets and services regulation

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Abstract:

The first of both short essays deals with two structural constraints that distinguish services markets from e.g. markets for manufacturing products. The 'nearness restriction' requires that producer and consumer of the service product are present on the same location. The 'non-storability restriction' is even more binding and requires that producer and consumer are present at the same time (synchronicity); the implication is that the consumer is a co-producer. Services branches differ with respect to the binding intensity of both restrictions. The nearness and non-storability limitations define a services market in space and time, with impacts for market functioning, productivity (capacity use) and product tradability. Technological trends, especially digitalisation are oriented at relieving the bindingness of both restrictions, and indirect also of the co-producer role for the service consumer. The second essay links the services market characteristics to the role of the *a priori* product quality uncertainty, which always drove product market regulation by local and national authorities. Regulatory differences between countries nowadays are an important obstacle to international services trade.

1. Factors that constrain services markets

Service markets in broader context

Service activities are pervasive in any production process. Historically, commercial services have developed as specialisations out of other, non-services production and consumption activities. They became market-provided services after having first been in-house activities of private households, farms, crafts, manufacturing, banks, or other services.

Agriculture and manufacturing always included business functions like planning, management, administration, assessment of quantity and quality of products and inputs, product improvement, labour recruitment, learning and education, dealing with legal issues, marketing, transport, cleaning, repairing, storage and distribution. While these were not the main activity of the firm, they absorbed an increasing amount of management time. The span-of-control issue further aggravated when several of these services-related business functions required more specialized skills and knowledge to keep up with competitive business standards. It created a problem of economic scale. Smaller and medium-sized firms usually cannot afford to fully employ services professionals in their company. This left firms with three choices: either they had to grow to allow full-time use of the required professionals, or they had to abstain from such professional functions (with negative consequences for their competitiveness), or they had to hire such specialists from outside on a time-based fee. The latter choice became dominant in most developed countries after the 1990s. The process has made the small-firm's growth less dependent on internal scale economies (e.g. Axtell, 2006). Independent outside service professionals gradually took over the delivery of many business functions that formerly were in-company activities. However, it was not just a matter of "hanging new name plates", because it went along with innovations, scale-related efficiency gains, and increased variety of service products. Through out-sourcing of service activities by other industries we now see specialized services products without matching prior in-house equivalents. The development of services markets is the exponent of a structural specialisation process. Especially the variety of producer-oriented services supply may be considered as a yardstick for the refinement of the social division of labour in a country.

The household as a consumption unit historically contained many production-like elements like cleaning, preparing meals, laundry, child care, clothing, shopping, and various forms of personal care. Here a similar process took place of 'insourcing' these production elements from outside providers. The process drivers in this case were not economies of scale, but primarily the emancipation of women and their increased

participation in the labour market. It resulted in many forms of typical consumer-oriented market services, ranging from hair shops, and shopping services to commercial providers of child and elderly care.

When studying services markets it is useful to distinguish a few categories. One way to classify services is to look at their customers. Consumer services are mainly provided to private households; they do not serve as an input for commercial production. Examples are the activities of nail studios, meal delivery, and online movie services. Conversely, business services are primarily sold to firms and public authorities and they are used as intermediary inputs in the customer's own productive and governance activities. Examples are technical consultancy, wholesale trade, personnel recruitment, or patenting services. Between strict consumer services and pure business services there is a broad range of bi-polar services that provide a specific part of their products to households and another to firms. Examples are retail trade, cleaning services, banking, postal services, transport, and telecommunication. The present paper uses the term "commercial services" to identify a broad spectre of services activities that are mostly provided by independent private firms, and that are (mostly) not performed by public authorities. "Public services" are produced by or on behalf of public authorities as a response to some market failure: private production cannot or does not deliver insufficient quality or quantity of particular services. Typical examples are public governance, judicial judgement, health, educational, care activity, or prison services. The balance between private and public provision of these services differs by country, depending on history and political choices.

Factors constraining services markets

It is difficult to find a concise catch-all definition that separates services from non-services activities. For a long time, services used to be defined as what they were *not*: activities that cannot be classified as agriculture or manufacturing, activities that not productive, products that are not goods, or bluntly as "things that cannot drop on your foot". This negative approach of the services definition can to some extent be traced back in the standard statistical classification of industries (e.g. the Standard Industrial Classification), where services still tend to be considered as a residual category, even though they represent the majority of jobs in many countries. The literature nowadays broadly accepts the positive services definition by Hill (1977). He demarcates the difference between goods and services. Goods are physical objects that are appropriated and therefore transferable between economic units. However, a service provided by an economic unit is not an object that can be appropriated and transferred. In Hill's definition, it represents "a change in the condition of a person, or of a good belonging to some economic unit", provided by the activity of the service producer, "with the prior agreement of the former person or economic unit". Hill's definition

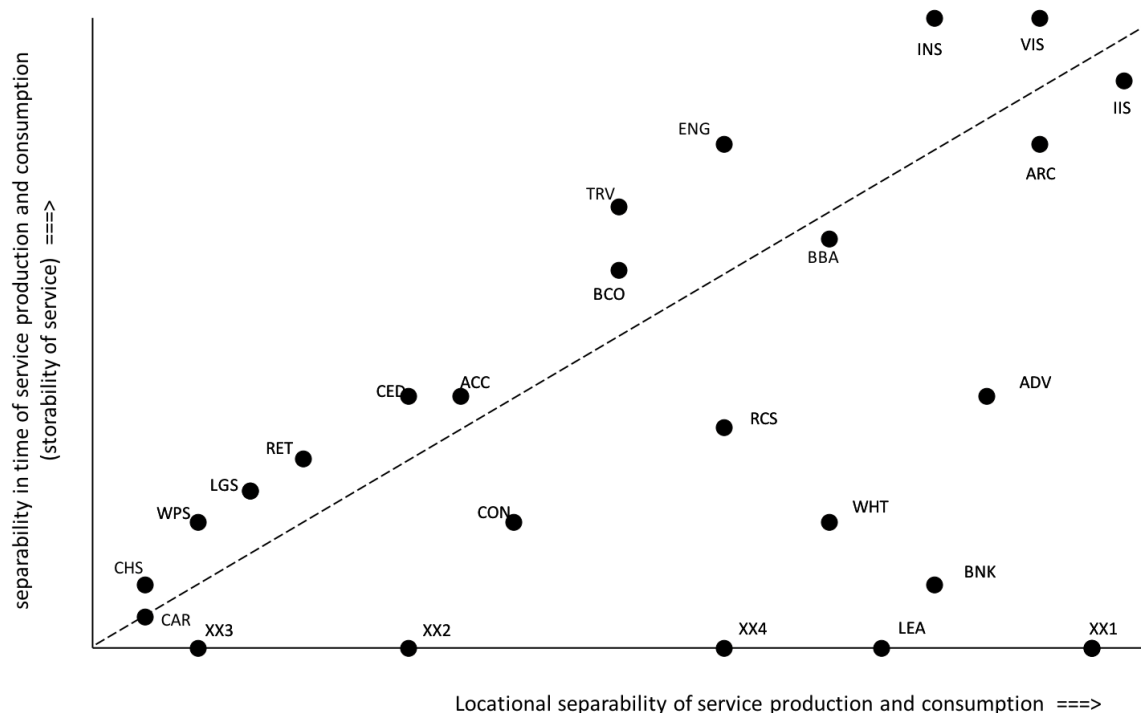
highlights the contact intensity with customers that is a key characteristic of many services markets. Services change the physical, mental or intellectual condition of individual customers, or the quality, experience value, or ingenuity of goods that belong to another economic unit (firms, private households).

A simple exchange of boxed products against money may form the characteristic business transaction in manufacturing. The commercial services transaction is much more complex, because the customer self is almost always involved as a co-producer or facilitator. This implies that services products intrinsically have a higher degree of uniqueness and more variety than most manufacturing goods. Standardisation is therefore more difficult in services compared to manufacturing.

In many cases, the production and consumption of a service is non-separable in time and place. This imposes two important restrictions on the functioning of services markets. Firstly, the customer and the service provider must meet in the same location: the *nearness restriction*. This not all. It is often impossible that the service provider creates the service product at a time of his own convenience, and later hands it over to the client. To the extent that services are non-storable, the service provider also faces a second market restriction, namely *synchronicity*. The provider has to meet the customer (or his employees) at the same place and time to complete the service transaction. As a co-producer, the customer has to invest his own time and effort in the production and consumption of the service.

The nearness and the synchronicity restrictions differ by services branch. These differences matter for the way the services providers can run their business, for productivity of services firms, and for the role of competition in services markets. Figure 1 provides a ranking of services branches in terms of the nearness and the synchronicity restrictions, depicting the current situation in many OECD countries. The tentative position of the different services branches is projected in terms of the separability of production and consumption in time and place. The figure must be regarded as a best guess, and much additional empirical work (not yet existing in the literature) is needed to quantify the score by industry and country. Moreover, the role of nearness and synchronicity restrictions must be viewed in a dynamic frame. The digital revolution has dramatically lowered the costs of the information component for many services products. It allows instantaneous multiplication of information-intensive services products at almost zero marginal costs, distributing them over thousands of miles. There are with potentially large negative competition effects for non-digital service providers.

Figure 1 Tentative ranking of services branches in terms of separability in time and place of the service production and consumption



Legend of industry codes:

XX1: Sea transport; XX2: Air transport of passengers; XX3: Rail transport of passengers; XX4: Road transport of goods; TRV: travel and tourism services; POC: Postal and courier services; TLC: Tele-communication services; IIS: Information provision services; CON: construction services; RET: retail trade; WHT: Wholesale trade; INS: Insurances; BNK: banking services; LEA: Operational leasing; LGS: Legal services; ACC: Accounting, auditing services; BCO: Business and management consultancy; RCS: Recruitment services; ADV: Advertising and marketing services; ARC: Architectural services; ENG: Design and engineering services; WPS: Waste treatment and de-pollution services; CAR: Personal care services; CRS: Cultural and recreational services; VIS: Audio-visual and music services; CED: Commercial education services; CHS: Commercial health services.

Market definition in services

The economic literature frequently uses the adjective "non-tradable" for services in which the nearness restriction applies. However, this must be regarded as a misnomer. Services where the nearness restriction applies, are definitely traded, although requiring a travelling action by the customer. Such travelling happens within countries, e.g. because cities generally offer more product variety than villages, but also cross-border trade like in the case of persons travelling abroad for consuming cheap commercial surgery (e.g. dental, body-correction, or eye surgery), or in the case of international tourism. The terminology of the World Trade Organization even has a name for trade requiring cross-border travelling of customers to obtain the service: "mode-2 trade in services".

Nonetheless, the nearness restriction for services markets makes it important to look at spatial dimensions of services markets. The services markets of two regions are

considered as two separate markets, if a price change of an identical service in one of both regions does not lead to travelling activity by consumers in the region where the price of the service product then becomes relatively more expensive. The economic jargon states that the cross elasticity of demand is zero for fully separate markets. Of course, the travelling activity is conditional on the presence of connection infrastructure and transport costs. Lower transport costs reduce local market separation. A full regional market separation is often found for the provision of simple haircuts. But to obtain more exclusive haircuts, customers may be already be willing to travel a little more.

The haircut case may be extended to other basic services like primary food sales, shoe repair, or simple care services: often their provision takes place in strictly local markets. In rural areas with low population density, this can give rise to substantial diseconomies of market-size area. Many services production units in strictly local markets operate at a capacity utilization of far below 100%. The reason is that they lose potential sales by waiting for clients and by reserving spare capacity for dealing with differentiated client service time. The random effects in customer arrivals and the variance of service time per individual consumer forms the reason that small local services firms often cannot afford to work at or even near full capacity (cf. Khinchin, 2013). The implication is that these providers operate with relatively high fixed costs per delivered service unit. They could make more profits by growing, and from that point of view, their current size is sub-optimal. A producer could make queuing times longer (more waiting time for customers), or reduce the variability of service time per consumer by offering only a standard product. Both options tend to be negatively appreciated by consumers, causing them to travel to more distant service providers. For small local producers of high-value services like medical or dental services, the capacity-planning problem due to random customer arrivals may be solved by the use of time slots (fixed appointments). This solution is generally not available for basic services. Interestingly, the recent COVID-19 pandemic has temporarily invoked the use of time slots for customers in various other services branches, allowing firms to apply a better capacity planning.

The spatial definition of services markets is relevant for many branches, but individual firms differ in their spatial reach. What unifies them is the adagium that the division of labour is limited by the extent of the market, brought forward by Adam Smith, one of the first economists (Smith, 1776). Three special firm groups must be mentioned. The most obvious case is formed by the international super specialists, often small- to medium-sized firms that offer special and often high-priced services products to a niche-market of customers across the whole world. The indivisibility of their expert knowledge forms their key scale advantage against local and foreign competitors. Then there are the multinational services firms. They have managed to obtain large

economies of scale and scope via product concepts that are often standardized and applied across borders through direct national subsidiaries or sold arm's-length via national franchising formulas. Their headquarter may benefit from scale advantages in obtaining financial inputs, and often they run international online platforms or pool international specialist knowledge. They are able to organize internal value chains between national subsidiaries based on the national comparative cost advantages. On this basis, they sell financial and knowledge services intra-company to national subsidiaries or local franchise takers. A third category is formed by large national services firms that run parallel operations in many sub-national regions. Their economies of scale are based on pooling of overhead costs that gives them fixed-cost advantages over purely regional firms.

In sparsely populated areas and in regions with rapidly falling or ageing population, the fixed-cost disadvantages for small services producers may lead to the complete disappearance of particular local services branches. This happens in the countryside of many countries with rapidly ageing population. What we see there is the market form of apoly (no producers). It may need public action to preserve the most necessary services that are needed to keep such regions liveable.

The market form of monopoly is characterized by one dominant regional services provider. Such a firm may exploit its market position by artificially reducing local supply to gain a more than proportional increase in prices, and thus achieve monopoly profits at the expense of local customers. The market form of oligopoly occurs when there are only a few providers in a local market for (more or less) standardized service products.¹ Competition for market share between them may give several competitive outcomes, including a price war or competition on service quality. The worst outcome for local customers is when the group of oligopolistic firms engages in open or tacit collusion to keep prices high. As a group they then emulate the operation of a monopoly firm.

The dominant market form in services, however, is monopolistic competition. It is linked to the special services characteristic that production and consumption of a service is often non-separable in time and place. Because of the role of customers as co-producer, each services product is in some way unique, and each services provider has to some extent a specific variety of the product. In this sense, the provider is a monopolist for its own variety of the services product. The name "monopolistic" means acting like a monopolist in segmented markets. Firms tend to overstate their degree of uniqueness and quality, all to create customer loyalty. Marketing effort is used to exploit and increase asymmetric information on (real) product quality of each provider, thereby lowering market transparency. Customers are not informed on the

¹ Duopoly is a special case of oligopoly with just two competing firms.

cheapest seller or the best quality, but primarily lured into staying or becoming loyal to a specific service provider. Misinformation may lead to higher-priced products of inferior quality being preferred above other products (cf. Kox and Rubalcaba, 2007). In this sense, segmented monopolistic markets represent a form of imperfect competition. Monopolistic competition differs, however, from oligopoly. The market-segmentation barriers between the services varieties are quite low. Typically, there are many small firms that all have minimal market shares, and there is much entry and exit activity of firms. These factors prevent the perpetuation of supernormal profits. Due to the small market shares of individual services firms, an action by one firm does not trigger a significant chain reaction of competing firms. Each firm keeps "doing its own thing", but the enormous amounts of resources that are spent on advertising, marketing and misinformation could be considered as a large social waste.

Finally, there is the market form of perfect competition in which everyone has full information, products are sold at marginal costs, and there is a unique market price for similar products. This is a theoretical construct that is often used as a benchmark to compare different market forms. However, in services, this market form is virtually non-existent. Perhaps the closest approximation is found in stock-market trading.

Dynamic trends in services markets

Much of innovation efforts in services are directed at relieving the role of the nearness and synchronicity restrictions, and at producing standardized services packages that can reduce the co-producer role of the individual customer. At the core of this process is enabling role of the digital technological revolution. The costs of obtaining, processing and distributing of information has dropped dramatically since the Internet was opened to commercial parties in the early 1990s. The digital revolution and its impacts on services markets can hardly be overstated (e.g. Hsieh and Rossi-Hansberg, 2019, MGI, 2016).

The costs of searching information (on consumer preferences, business opportunities, and productivity-improving technologies) have dropped severely due to digital search platforms. Lendl et al. (2016) have proved that a digital market platform like eBay reduced the negative impact of physical distance on market transactions by two-thirds. Online housing search substantially reduces the role of real estate agents. Critical medical services like monitoring of intensive-care units in hospitals may now be commercially provided from thousands of mile distance (Hsieh et al. 2019). So-called "tech firms" like Amazon, Uber, PayPal, Apple, Booking.com, and Spotify typically thrive on diminishing the role of nearness and synchronicity restrictions in markets for information-intensive consumer services. Producers enjoy huge scale economies once the network costs have been absorbed. The fixed-costs of the online platforms themselves form huge entry barriers to potential entry, and provides the scope for

power abuse if the exploiting firm is engaged in downstream activities. For instance, a firms like Google and Facebook may grant substantial competitive information privileges to its own advertising subsidiaries.

The platform-based firms now even compete with strictly local service providers, not by setting up local subsidiaries, but by outsourcing the actual customer contact to local delivery or implementation firms. Exploiters of media cables and Netflix are commercially successful not only by making media products storable and footloose but by standardizing services via bundled media products, so that they need less adapting to individual customers. The local cinema is now challenged by a foreign digital media company. And the revolutionizing role of digital information technology is likely to extend even stronger in business services like engineering, design, consultancy, software, or marketing where information is the key service product. Rather than visiting the client firms, the large platforms offer the possibility of dedicated cloud environments, in which clients may get multi-channel direct exchange and consultancy, without anyone leaving his office. Probably, many traditionally operating local services firm will not survive such intensification of local competition. On the other hand, there will be new and more affordable service products for customers because of the scale economies that are released by these developments.

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2. Regulation in services

Reasons for regulating services markets

The production and consumption of the service product often cannot be separated in time. This adds uncertainty, because the customer has no a priori certainty regarding the quality of the service. In the case of complex services, the customer may not even have sufficient knowledge to judge the service quality. Such information asymmetry between producer and customer holds for many medical and knowledge-intensive business services. The information gap offers room for cheating charlatans, and for this reason, quality-related regulations have since ancient times been applied to particular services. For instance, the Royal College of Physicians of London received its charter in 1518. They got a monopoly over the practicing medicine in London, and the oversight of physicians throughout England. Fellows of the College were not allowed to engage in trade, practice surgery or compound or sell medicines. These 'pure physicians' were limited to examining patients, diagnosing disease, and prescribing (but not dispensing) medications (Carr-Saunders and Wilson, 1993). In the medieval guilds system, guild masters took care for their collective reputation. They designed rules for professional conduct that must be obeyed under penalty of being turned out of the guild (and thereby losing their livelihood). To prevent blurring of the rules they imposed restrictions on the allowable side activities of their members, like in the case of the Royal College of Physicians. Comparable professional self-regulation still exists in several services branches like legal, accountancy, engineering, and medical services, first with a regional coverage.

Self-regulation of service professions occurred first on regional basis, and later on a national basis. National regulatory systems diverged, because good governance meant and means different things in different countries (Andrews, 2010). A historical constant is that regulations typically occur when the free play of market forces does not automatically deliver a socially desirable outcome. Economists speak of a market failures in such cases. Market failure exists when the private-market prices for services systematically differs from the marginal social costs and benefits. Three types of market failure that may affect services markets are: information asymmetry, undesired external effects, and abuse of market power.

The first type of market failure is information asymmetry. Professional self-regulation not always exists or does not function adequately in the market for knowledge-intensive or otherwise complex services. This creates "business opportunities" for charlatans. It has been the basis for government regulation, in order to prevent deceptive over-supply and over-pricing of these services. The other regulatory

objective is to safeguard the independence, reliability and accountability of the service providers.

A second reason for government intervention arises when the market does not adequately account for external effects of services transactions for others than the producer and customer. As a consequence, the market price for the delivered service is – from the social perspective – either too high or too low. Some services branches could have positive external effects for the rest of society, particularly in the areas of innovation and productivity development. Governments may intervene through state-controlled production when the free play of markets generates not enough of such services (public transport, energy supply, education, medical care, communication). In other cases, regulatory intervention is used to guarantee that enough high-quality services with positive external effects are supplied. Accountancy, for instance, is important for the safeguarding of reliable financial information. It is essential for trust in capital markets and in the financial system as a whole, and therefore must answer to high quality standards. Well-functioning legal services (lawyers, notaries) are important for upholding the legitimacy of the constitutional state, the system of property rights, and the legal system at large. Engineering specialists and architects are vital for the reliability of technical systems, for upholding the amenity value of the urban environment, and for the quality and safety of bridges, houses and other buildings. Similarly, the reliability of banking, insurance and other financial services is a necessary condition for the integrity of the monetary and financial system in a country.

The third type of market failure is the abuse of market power. It relates to imperfect competition forms such as excessive profit margins, collusion between suppliers, barriers to entry of outsiders, or excessive marketing disinformation. For professional services, the customer may not be adequately able to judge their product quality. The market-based correction mechanism for this is the reputation premium, often based on hearsay information. The reputation is based on the expectation that the provider will act in the same way as in the past. Firms with a proven reputation for being able to supply a high-quality service product can earn a price premium. The premium is a reward for time-consistent "good behaviour" by the provider. Markets get segmented by reputation of the suppliers. Customers pay premium prices for high-reputed suppliers, although their product quality may not really be superior. Established reputations of incumbents form a barrier to entering the premium segments of their market, and it shelters from competition by newcomers. Hence, the reputation mechanism forms a barrier to increased market entry of new firms, and it may be reason for policy intervention. As a rule, the market failure of imperfect markets yields (too) high prices for consumers and (too) high external costs for society at large.

Regulation is a container concept for a wide set of rules, standards, statutes, requirements, or norms. All elements aim at achieving behavioural change of market parties. Regulations tend to be backed up by some set of positive stimuli, penalties or other enforcement rules. Once in place, regulatory systems tend to persist. Regulatory interventions were initially motivated by the desire to achieve changes in the behaviour of services firms (and/or customers). Ideally, the regulatory interventions should be periodically evaluated and adapted. Without a proper and timely evaluation, the chosen regulatory policy could cause the substitution of market failures by government failures. This may take the form of unnecessary bureaucracy, regulatory opacity, rent creation for protected business interest groups, risky behaviour when government intervention artificially lowers the risks for firms, or stagnation when regulation lowers incentives to innovate. Regulatory evaluation can be complicated when there are confounding factors that co-determine the behavioural outcomes. Important confounders are technological change, regulatory changes in other areas, tax changes, and cross-border influences from foreign service providers.

Public regulations can be adopted by local, regional and national authorities. In the latter case, the regulations may be codified in law. In federal states (like USA or Germany), it may imply that services regulations differ at sub-national level.

Most product-market rules are found in services markets where the market failure of information asymmetry is important (knowledge-intensive business services, health-related services) and in markets for network-based services (energy, transport, communications). Table 1 depicts the types of regulatory intervention by group of services.

Table 1 Dominant forms of industry-specific regulatory intervention, OECD

| Category of intervention | Services industries |
|--------------------------------------|--|
| Public ownership | energy (production and distribution); rail transport; communication industries (post, telecom, internet); airlines |
| Entry regulation | professional services (engineering, legal, accountancy, architects); energy; rail transport; communication industries (post, telecom, internet); airlines; retail distribution |
| Vertical integration rules | energy; rail transport |
| Market conduct regulation | professional services (engineering, legal, accountancy, architects); retail distribution; energy; rail transport; communication industries |
| Source: Conway and Nicoletti (2006). | |

Licenses and permits are typical instruments of entry regulation in retail distribution, energy services and rail transport. In professional services, the entry regulations have

the form of education requirements, economic needs tests and restrictions on the legal form of firms. Vertical integration rules restrict the number of upstream or downstream activities, in which energy and rail firms may get engaged. Market conduct regulation may include price caps, regulated fees, cost-plus regulation, allowable business form, and other operational requirements for firms. In professional services, countries often apply restrictions on marketing and advertising, restrictions on allowed side activities², compulsory membership of national professional organisations², compulsory insurance, and special restrictions for foreign competitors.

Services providers are not just affected by industry-specific regulatory policies. Labour and environmental regulations, land-use planning, tax and consumer-protection policies are other wide-scope domestic governance areas that may have large operational (cost) consequences for services firms.

Regulatory impacts on international services trade

The special nature of services products (required nearness of producers and consumer, limited storability) makes services firms strongly exposed to regulatory intervention, more than for instance manufacturing firms. This regulatory exposure becomes most visible by considering international trade in services.

The General Agreement on Trade in Services (GATS) that was negotiated in the World Trade Organization distinguishes four ways ("modes") in which services can be traded across national borders. In mode 1, only the service product crosses the border. This is comparable to manufacturing products. This mode applies to a limited category of storable services products (e.g. recorded film or audio media) and services products that can be sent via phone, fax or Internet (e.g. software, legal or engineering reports, medical diagnosis, financial services). In mode 2, the customer crosses the border to consume the foreign service product, e.g. as a tourist, or to enjoy a particular education or to receive medical surgery. In mode 3, the services firm sets up a foreign subsidiary to have a commercial presence and provide services in the foreign market. Finally, in mode 4, the service provider himself or his employee temporarily crosses the border to deliver a service product to a foreign customer, after which the person returns home. According to the best available estimates, the four supply modes had, respectively, the following shares in the 2017 world trade in services: 28%, 10%, 59%, and 3% (Wettstein et al., 2019). Especially the foreign firms that use modes 3 and 4, representing large majority of all incoming services trade, are exposed to domestic regulation in their destination market.

² Like in case of the Royal College of Physicians of London in 1518 (cf. Introduction section).

Some types of national regulation are outright discriminatory towards foreign service providers, e.g. restrictions on foreign ownership, the requirement that management includes local persons or should have a local residence, and regulations requiring requalification of foreign service personnel according to domestic standards. Multilateral service-trade negotiations during last decades have achieved a reduction in such discriminatory policies. This holds for EU and OECD members states, but elsewhere there is still a long way to go.

Apart from discriminatory policies, there are still other regulatory aspects that matter for services imports. Regulating authorities are primarily concerned with domestic issues and tend to have little concern for trade issues. Domestic regulation that does not explicitly discriminate against foreign firms, may still raises the costs of imported services. Foreign firms already comply with regulations in their origin country, but they have additional compliance costs for adopting to the local regulations before being allowed to sell their products. The additional compliance costs can be substantial, because each country has historically used different regulatory instruments and standards in services markets. A government's choice to adopt certain items and not others, is in most cases a response to purely domestic considerations (Andrews, 2010). This makes it difficult to converge to a common "best practice" regulation model. Moreover, regulatory changes occur frequently in reaction to national incidents (e.g. fraud, crises, epidemic, terrorism, disasters, social injustice), which then cause a strong political urge to intervene and to act immediately. This local political factor means that national regulations have a constant tendency to drift apart from regulations in other countries.

Service exporters are thus confronted with very different regulations and requirements in each destination country, as shown in Koske et al. (2015) and Kalinova et al. (2020). The additional costs of regulatory compliance grow with the degree of regulatory heterogeneity between each country pair (Kox and Nordås, 2007; Nordås and Kox, 2009). The OECD Services Trade Restrictiveness Index (STRI) quantifies the comparative trade-affecting policies of countries, by services industry and year.

Nordås (2016) calculates that the trade costs associated with the average score on the regulatory heterogeneity index is equivalent to an import tariff of between 20% and 75%. This implies a heavy protection of domestic services firms via the national regulatory system. When adaptation costs to domestic regulation are between 20 and 75% of the price, many potential foreign suppliers will stay at home with their service product. It is simply unprofitable for them. The adaptation costs are strictly country-specific, thus representing a risky sunk-cost investment in market entry. A service exporter will want to recoup such entry investments in due time. Regulatory

heterogeneity thus raises prices and lowers the variety of imported services at the expense of domestic consumers.

A rational reaction would be to reduce regulatory heterogeneity in services markets. This can either be done through multilateral harmonization according to some "best practice", or via mutual recognition of national regulations. The EU's Services Directive (2007) was a step in the latter direction. It required a scrutiny of national regulatory systems by the civil servants of other EU member states comb out unnecessary and undesired export barriers for foreign service providers. Reduction of regulatory heterogeneity in service markets will lower import prices and increase the variety of services supply in national markets. Countries are better off, when they reduce mutual regulatory differences. Small countries will gain most by adapting their service market regulation to the regulation of large adjacent countries. For that reason, Switzerland and Norway almost fully adopt the services regulation of the EU.

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