

EU REGULAR ECONOMIC REPORT

3

GROWTH, JOBS AND INTEGRATION:
SERVICES TO THE RESCUE

▲
FALL 2016



WORLD BANK GROUP

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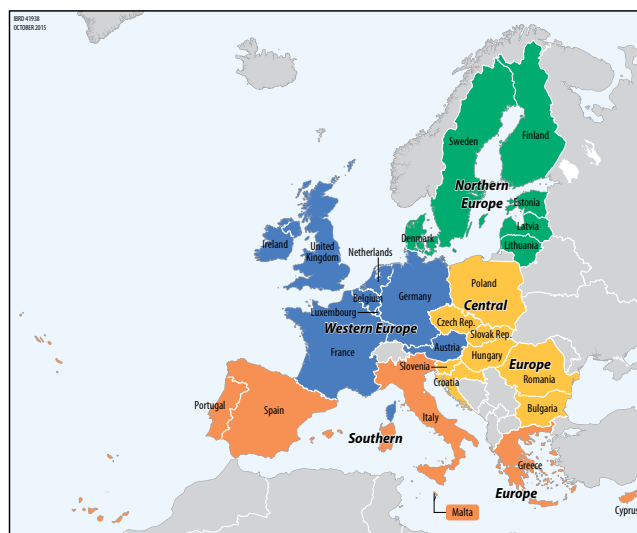
**Growth, Jobs and Integration:
Services to the Rescue**

Fall 2016

Notes and Acknowledgments

The EU Regular Economic Report (RER) is a periodic publication of the World Bank Group and covers economic developments and prospects, as well as economic policies in the European Union.

The report focuses on four regional sub-groups that share broad economic similarities (see map): Central Europe comprises Bulgaria, Croatia, the Czech Republic, Hungary, Poland, Romania, the Slovak Republic and Slovenia; Northern Europe comprises Denmark, Estonia, Finland, Latvia, Lithuania and Sweden; Southern Europe comprises Cyprus, Greece, Italy, Malta, Portugal and Spain; and Western Europe comprises Austria, Belgium, France, Germany, Ireland, Luxembourg, the Netherlands and the United Kingdom. The report covers the European Union, and also provides additional information on European countries that have a stronger operational engagement with the World Bank Group, in particular, Bulgaria, Croatia, Poland and Romania. The focus note of this RER covers “Service Sector Reform in the EU”.



This report is prepared by WB staff economists working on EU countries. The team of authors includes Doerte Doemeland (co-TTL); Sanja-Madzarevic-Sujster (co-TTL); Faya Hayati; Matija Laco; Rogier van den Brink; Vincent Belinga; Mariana Iootty de Pavia Dias; Yohei Okawa; Shawn W. Tan; Johannes Koettl; Marcel Ionescu-Heroi; and Andrei Silviu Dospinescu. Erik van der Marel, Janez Kren and Sofiya Avramova contributed to his report. The team benefitted from excellent advice from Norbert Fiess, David Gould, Roumeen Islam, Jakob Kopperud, Franziska Ohnsorge, Sebastian Saez and Hans Timmer. The dissemination of the report and media relations are managed by an External Communication team comprising Vanja Frajtic, Elena Karaban, Filip Kochan, Artem Kolesnikov, Anna Kowalzyk and John Mackedon.

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Acronyms and Abbreviations

ABSP	Asset-Backed Securities Purchase Program	NSA	Not-Seasonally Adjusted
BRICS	Brazil, Russia, India and China	OECD	Organization of Economic Co-operation and Development
CAB	Current Account Balance	PMR	Product Market Regulation
CBPP	Covered Bond Purchase Program	PPP	Purchasing Power Parity
CLV	Chain-Linked Volumes	RER	Regular Economic Report
EAPP	Expanded Asset Purchase Program	SA	Seasonally-Adjusted
EC	European Commission	SCA	Seasonally and Calendar-Adjusted
ECB	European Central Bank	SME	Small and Medium Enterprise
EU	European Union	SILC	Survey on Income and Living Conditions
GDP	Gross Domestic Product	TFP	Total Factor Productivity
GVA	Gross Value Added	TLTRO	Targeted Long-Term Refinancing Operations
ICT	Information and Communication Technology	UK	United Kingdom
IFRS	International Financial Report Standards	US	United States
IMF	International Monetary Fund	QE	Quantitative Easing
MTO	Medium Term Objectives	VAR	Vector Autoregression
NACE	General Industrial Classification of Economic Activities with the European Communities	VAT	Value-added Tax
NAIRU	Non-Accelerating Inflation Rate of Unemployment	WB	World Bank
NGO	Non-Government Organization	WDI	World Development Indicators
NMR	Indicators of Sector Regulations	WEO	World Economic Outlook
NPL	Non-Performing Loans		

List of Countries

Austria	AT	Italy	IT
Belgium	BE	Latvia	LV
Bulgaria	BG	Lithuania	LT
Croatia	HR	Luxemburg	LU
Czech Republic	CZ	Malta	MT
Cyprus	CY	Netherlands	NL
Denmark	DK	Poland	PL
Estonia	EE	Portugal	PT
Finland	FI	Romania	RO
France	FR	Slovak Republic	SK
Germany	DE	Slovenia	SI
Greece	EL	Spain	ES
Hungary	HU	Sweden	SE
Ireland	IE	United Kingdom	UK

Executive Summary

The EU is going through a difficult period. Deep and prolonged recessions in the wake of the global financial crisis and the subsequent slow recovery of jobs have eroded the trust of many EU citizens in the ability of established national and EU-wide institutions to provide stability, protection and opportunities (European Commission 2016a). Brexit added to the erosion of confidence. The short-term economic impact of Brexit was contained, but Brexit adds to its ongoing political and economic challenges. The large inflows of both economic migrants and forcibly displaced persons in 2015 seem to have further entrenched anxiety. Traditional economic indicators, such as unemployment or wages, have become a weak predictor of policy perceptions, making it more difficult to anticipate the political consequences of reforms and adding to a reluctance to change. According to the latest Eurobarometer survey, many Europeans (especially in the crisis-hit southern countries) believe that the “worst is still to come” in terms of the impact of the economic crisis on jobs, despite a recent recovery in EU labor markets. Growing discontent with established political institutions; entrenched vested interests; and an ageing population could strengthen the opposition to growth-enhancing reforms.

EU growth is projected to remain low and, with aging populations and sluggish investment, to become increasingly dependent on productivity growth. Despite a slow-down in global growth, which reduced the demand for EU products abroad, EU growth was 1.9 percent in the first half of 2016, below the 2.1 percent of the second half of 2015, but above growth in the US. Growth returned to all EU countries, except Greece, as a labor market rebound fueled consumption; this compensated for historically low levels of investment and a decline in exports. Economic growth in the EU is expected to moderate to 1.8 percent in 2016 and 1.4 percent in 2017. Low levels of investment; a decline in the working-age population; and a secular productivity slump have collectively depressed the EU’s growth potential. As investment is unlikely to return to pre-crisis levels and as it will be difficult to stem the decline in the working-age population, productivity growth has become increasingly important for sustaining growth.

Low growth will slow down the resolution of crisis legacy issues and prolong uncertainty. Low growth will make it more challenging to: create jobs; reduce public debt; resolve banking sector vulnerabilities; and rebuild trust in established institutions, which is necessary for unblocking the current reform inertia. At the same time, slower than expected growth in the US and emerging market economies could dampen external demand; China’s rebalancing may add to global weakness and uncertainty. Geopolitical tensions in the EU’s neighborhood could have larger than expected spillover effects; and volatility in financial markets and oil prices could also negatively affect growth. Internally, the pace of structural reforms has slowed down significantly in recent years. There is significant uncertainty with regard to employment, investment, and growth.

There is limited scope for quick policy fixes that can boost growth. Monetary policy has so far been accommodating; it has reduced interest rates to record low and revived credit growth in some EU countries. It has also created new problems: the ECB’s negative deposit rates squeeze the profitability of financial institutions; create funding challenges for pension funds; and could potentially lead to an increased misallocation of resources. Expansionary fiscal policy could, in principle, help boost EU growth. However, those EU-member countries with the largest need for fiscal stimulus also have high public debt, which continues to increase despite fiscal consolidation efforts and historically low interest rates.

Against this background, services can come to the rescue: service sector reforms can increase EU productivity by an average of 5 percent, provide more and better jobs, stimulate investment and further deeper integration. Empirical estimates presented in this note show that Central and Southern EU member states in particular stand to gain from service sector reform, although the impact of such reforms goes beyond productivity. There is strong scope for improving regulation as many EU member states have high regulatory restrictions; and parallel efforts in several EU member states could create large synergies. Deepening EU integration in services could encourage innovation, stimulate much-needed investment and reinvigorate convergence. Deeper integration could also offer qualified workers additional opportunities and better protection, strengthening the EU's role as a bulwark against economic shocks.

Services account for three quarters of GDP and two-thirds of employment in the EU and are much more regulated than in non-EU OECD countries. Services, such as finance, accounting, transportation, communications, legal services, and other commercial services are key drivers of growth in advanced economies. These services generate economic output and provide critical inputs for other economic sectors, notably manufacturing. Most EU member states that experienced above-average growth in recent years relied significantly on services.

Despite the free movement of goods across EU borders, there are many barriers to the exchange of services. Service providers are often not allowed to offer their services in other EU-member states. Even when they are allowed, they may face the need for structural changes to areas of their business such as: residency or nationality; ownership structure; professional association membership; insurance; worker qualifications; or advertising restrictions. A fifth of the EU labor force is employed in regulated professions, and it is these professions—notably legal, engineering and architecture—that face disproportionate restrictions, resulting in large disparities across the EU. In several EU-member states, multidisciplinary practices (e.g. a joint practice of architects and engineers) are prohibited. A survey of its members conducted by the Architects' Council of Europe in 2012 showed that only three percent of architects worked in other EU member states, while around thirty-five percent of those respondents would "seriously consider" relocating if their titles were recognized. Moreover, language seems to be much less of a deterrent for mobility than knowledge of the complex building regulations in EU member states.

The EU has taken steps to facilitate improved service provision in the EU, but service sector reforms face many political constraints. The EU Services Directive was adopted in 2006 with the aim of creating a Single Market for services. This would include the freedom to establish a company in another EU country and the freedom to provide or receive services in any EU country other than the one where the company was established. The Directive covers services accounting for nearly half of the EU's Gross Domestic Product (GDP), and includes retail, tourism, construction, and business services. Implementation of the service directive has been difficult. In many countries, the regulatory environment for services is very complex and highly decentralized. Reforms are often implemented by regulatory bodies, who may have a bias against reforms. Many professions and industries thrive on the rents that regulatory constraints generate and consumers are rarely aware of the costs that these regulations impose on them.

The EU needs a clear roadmap to accelerate the implementation of service sector reforms. The EU has prioritized the removal of barriers such as fee scales and advertising prohibitions, but there is an urgent need to move to the next phase of reforms. Given the current political environment, governments could focus their attention on reforms that yield the greatest economic benefits and that are politically feasible. There are large

differences in service sector regulations by country across the EU and a maximum impact reform map should take these differences into account.

Reforming how service firms can operate and advancing service sector reforms in countries with weak governance indicators could yield large economic gains. A roadmap would need to consider the following criteria: first, conduct regulations would need to be reformed. These constrain how firms operate (as opposed to controlling barriers to entry of new firms) and may yield large benefits for many countries. Conduct regulations appear to have the most negative effect on the economy and they may also act as a deterrent to foreign direct investment. Second, and as measured by the World Bank Governance indicators, service sector reforms are likely to yield large benefits in those member states with particularly weak institutions. A set of complex regulations may create uncertainty and invite discriminatory practices in countries with a weak regulatory environment or an ineffective justice system. Advancing reforms in these countries would bring large payoffs. Third, it is critical to focus on the economic payoff of reducing regulation across sectors; in several EU states some heavily-regulated sectors are economically important. Examples include the Bulgarian energy sector and the transport sector in Romania.

A European passport for service providers and fewer barriers for professional services could yield the largest productivity dividend in many EU countries.

Professional services form a sub-set of the larger business services sector, which tends to be the most dynamic part of the entire service sector. EU member states with highly regulated professional services tend to be less productive and poorer. Our empirical analysis suggests that the impact of reducing regulation of professional services on firm-level productivity is very large: only reforming professional services would yield large productivity gains. Countries with relatively weak governance and high professional services regulations are likely to gain most from improving and streamlining the regulation of professional services. This mainly applies to countries in Central and Southern Europe.

Policy Considerations

- Prioritize service sector reforms across EU member states and formalize it in a roadmap.
- Carry out reforms already agreed, including those in the EU service directive.
- Make service sector reform a competition policy priority for the European Commission and for national competition authorities.
- Create a common market for professional services.
- Facilitate a debate about the benefits and costs of reform with service sector providers and users.
- Retrain workers that could be negatively affected by the proposed reforms.

Lack of information about the costs and responsibilities of regulation creates a strong anti-reform bias.

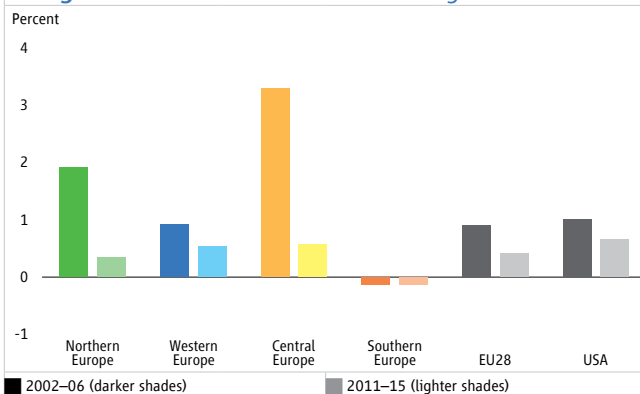
The justification for regulating professional services usually includes information asymmetries and public interests. National authorities often find it difficult to assess the validity of these justifications, and as a result, the process for deregulating services tends to get delegated to professional associations and is then implemented by regulators, leading to a potential conflict of interest. Users, however, are seldom aware of how regulations affect the costs and quality of services.

Service sector reforms could benefit from a reduction of regulatory barriers in the digital economy and clear communication around the benefits of reform. Countries with large professional service sectors have been very reluctant to reform. An open and honest debate and a sound impact analysis of costs and benefits of reforms would need to be integrated into any reform strategy in these countries. Reducing regulatory barriers in the digital economy could provide benefits in terms of employment and productivity growth for a wide array of services providers. This move could also help reduce rents in regulated sectors and change the way that service users interact with service providers, paving the way for additional sector reform.

In conclusion, service sector reforms can boost EU growth. As low investment and a shrinking working-age population undermine EU growth potential, productivity growth becomes increasingly important for sustaining growth. In this context, reforms to the service sector are likely to strongly impact productivity in a relatively short period of time. Such reforms can make a substantial difference in terms of regaining growth, jobs, and confidence across the EU.

EU RER in One Page

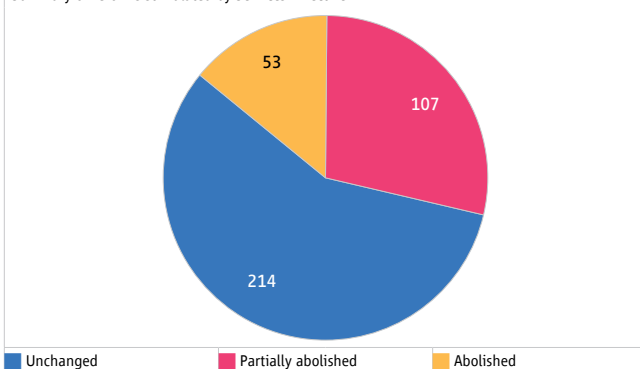
TFP growth in the EU has been declining...



Source: AMECO and WB staff.

Only one-seventh of reported restrictions have been abolished for professional services.

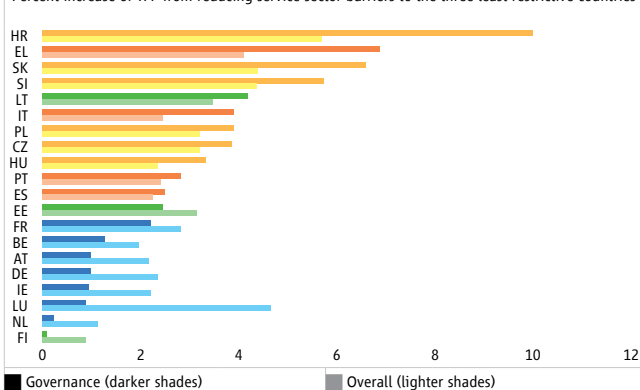
Summary of reforms stimulated by Services Directive



Source: European Commission, 2015

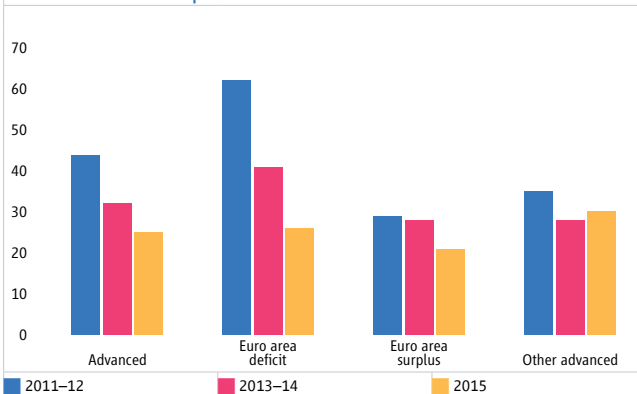
Productivity gains from service sector reforms are large, particularly in member states with weak governance...

Percent increase of TFP from reducing service sector barriers to the three least restrictive countries



Source: Van der Marel, Kren, Iooty (2016).

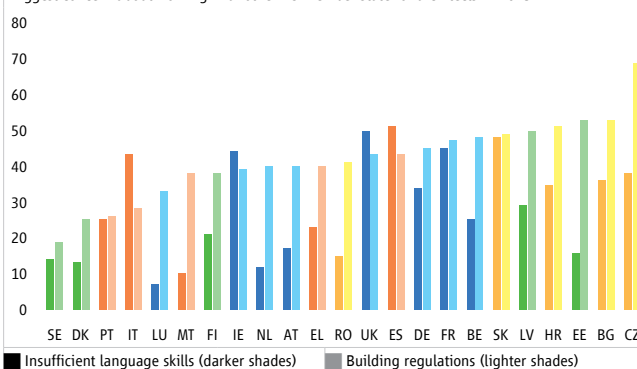
...and reform implementation has slowed down.



Source: OECD (2016).

It seems easier to learn another EU language than other building regulations.

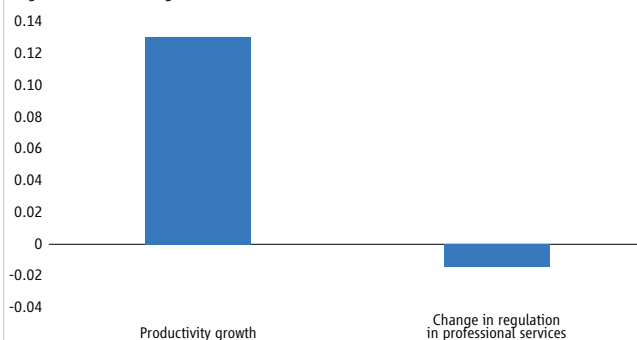
Biggest concern about working in another EU member state for architects in 2015



Source: EU Council of Architects 2015.

...and for professional services.

Percent increase in firm-level TFP from deregulating professional services in EU countries with large barriers and weak governance, 2006-13



Source: WB staff.

Recent Economic Developments

Growth in the EU moderated slightly in the first half of 2016 but showed resilience against internal and external shocks. EU growth in the first half of 2016 was 1.9 percent, down from 2.2 percent in 2015 as a whole, but exceeded US growth for the first time since 2011 (Figure 1). Growth returned to all EU countries, except Greece, as a result of supportive monetary policy; a labor market rebound across the EU; and lower oil prices. Growing wages, low inflation, and a decline in unemployment to 8.6 percent in Q2 2016, a level last seen in Q1 2009, fueled household incomes and private consumption across all EU regions (Figure 2). Consumption growth was particularly pronounced in the Central EU regions. EU exports of goods declined as demand weakened in the US, Russia, China and many Asian countries. Despite exceptionally favorable financing costs, investment in the EU remains historically low, held back by increased business uncertainty and high non-performing loans. Investment growth fell by half, compared to Q2 2015, to 1.9 percent in Q2 2016.

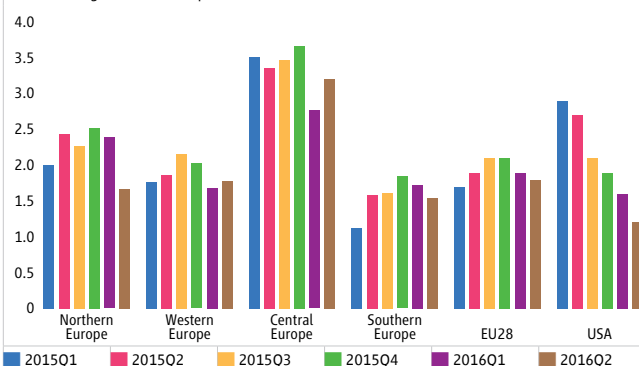
With a challenging global environment and heightened uncertainty, EU growth is now assumed to moderate to 1.8 percent in 2016 and 1.4 percent in 2017. Growth is likely to face headwinds from the uncertainty around Brexit, but is expected to be supported by low oil prices and accommodative monetary policy. External demand is expected to remain weak in both advanced economies and large emerging market economies. Private consumption growth is likely to be supported by low inflation in the near term and by improving labor market conditions. Unemployment is expected to trend down slowly, held back by limited job creation. Eight years after the onset of the financial crisis, Europe employed 1 million fewer workers in 2015 than in 2008 while the US had 5 million more (Figure 4). This is despite sustained increases in the employment rate for women (Box 1). Investment growth is expected to pick up slightly, weighed down by uncertainty but supported by the Investment Plan for Europe. Monetary policy is expected to remain supportive of growth and fiscal policy to remain broadly neutral.

Output gaps are closing slowly and potential growth, a measure of the economy's productive capacity, is dragged down by demographic ageing and weak productivity increases. The output gap measures the difference between the actual output of an economy and its potential output. A negative output gap means that the economy has spare capacity due to weak demand. By 2016, output gaps are expected to have closed in five EU member states (Estonia, Poland, Romania, Slovenia and Sweden). All Southern EU countries, except Malta, have a negative output gap (Figure 5). Downward pressure on EU growth potential is most pronounced in Central and Southern EU (Figure 6 and Figure 7).

Low growth impedes resolution of legacy crisis issues, prolonging uncertainty. Low growth makes it challenging to create jobs, reduce public debt, resolve banking sector vulnerabilities and rebuild trust in institutions. Strong trust is needed to unblock the current reform inertia and restart the European growth engine. Unemployment, although declining, remains high in some EU member states, most of which are experiencing a strong shift to temporary contracts since the crisis. Most Europeans, especially in the crisis hit southern countries, believe that the "worst is still to come" in terms of the impact of the economic crisis on jobs (European Commission 2016a). EU-wide public debt has finally started to decline but is still increasing in many member states with high debt levels. It will be more difficult to raise investment in a low growth environment. The deep and prolonged recessions in the wake of the global financial crisis have eroded the trust of many EU citizens in the ability of established national and EU-wide institutions (European Commission 2016a) to provide stability, protection and opportunities.

Figure 1. Growth in the EU remains slow but resilient...**Real GDP growth by quarters**

Annual change, CLV, NSA, in percent

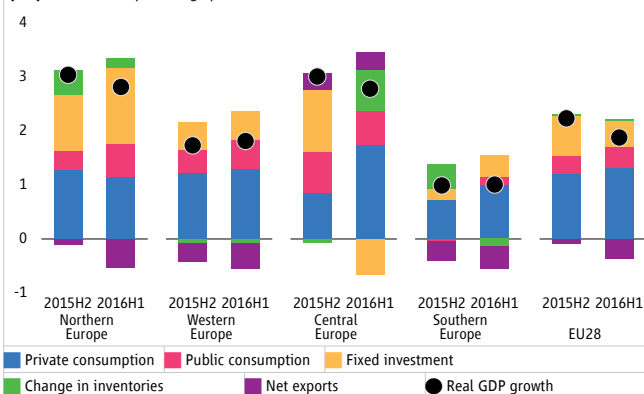


Source: Eurostat and OECD.

Note: CLV - Chain linked volumes; NSA - Not seasonally adjusted.

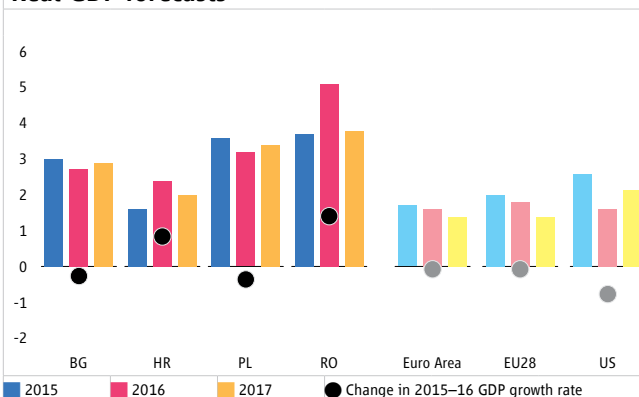
Figure 2. ...as a result of solid consumption growth.**Contributions to real GDP growth**

y-o-y, CLV, NSA, in percentage points



Source: Eurostat.

Note: CLV - Chain linked volumes; NSA - Not seasonally adjusted.

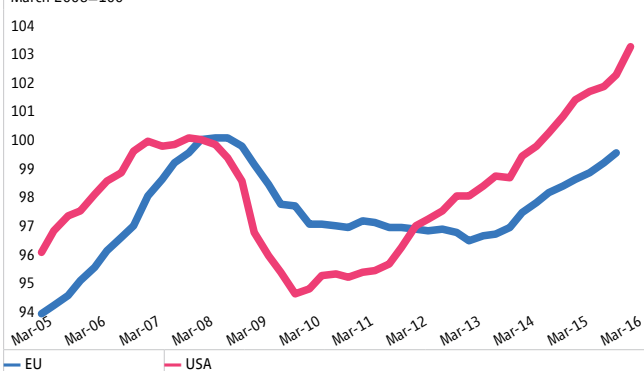
Figure 3. Growth is expected to remain low.**Real GDP forecasts**

Source: Eurostat, World Bank.

Note: Country-specific forecasts are for EU countries with World Bank Macro poverty Outlooks (MPO).

Figure 4. EU Employment is lagging.**Employment**

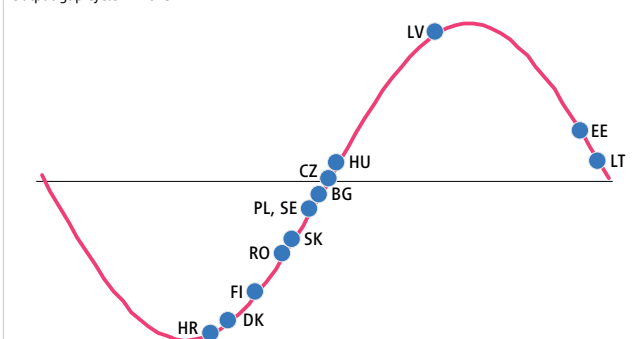
March 2008=100



Source: OECD.

Figure 5. Most EU countries have negative but falling output gaps.**a) North and Central Europe**

Output gap cycle in 2015

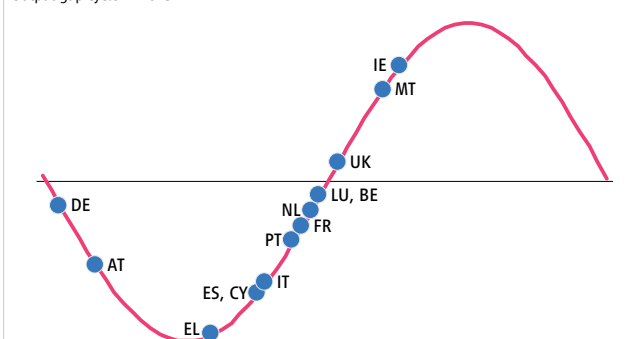


Source: Eurostat and WB staff.

Note: Cycle is described by four stages: (1) output gap negative and widening, (2) output gap negative but closing, (3) output gap positive and widening, (4) output gap positive but closing.

b) South and Western Europe

Output gap cycle in 2015



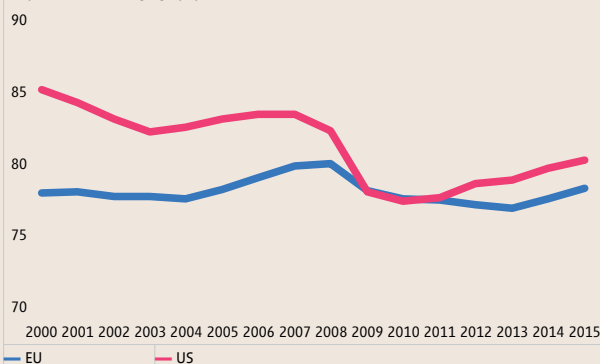
Box 1. Women drive the employment recovery.

Female employment rates in the EU have surged in recent years and have converged to US levels. Women in the EU fared much better than men following the deep jobs cut triggered by the crisis; after 2014 women drove employment recovery. Countries with the highest female job growth included Greece (65 percent) and the Czech Republic (60 percent). The relatively strong female employment growth is part of a longer trend: the EU's female employment rate has increased steadily from 52 percent in 2000 to 66 percent in 2015, as the employment rate of men remained relatively constant. The EU's male-female employment gap was cut in half between 2000 and 2013, when it reached 10 percentage points; it has remained around this level since. As the gap closed, the EU female employment rate converged to US levels (Figure 6 and 7). Employment growth for women was higher than for men across all age groups, but the difference was most pronounced for the 55- to 64-year-old. Though employment rates of elderly women in the EU are much lower than for men and younger women, all regions except Southern Europe employ more elderly women than the US.

Figure 6. The male employment rate remains low...

Male employment rate

In percent of working age population

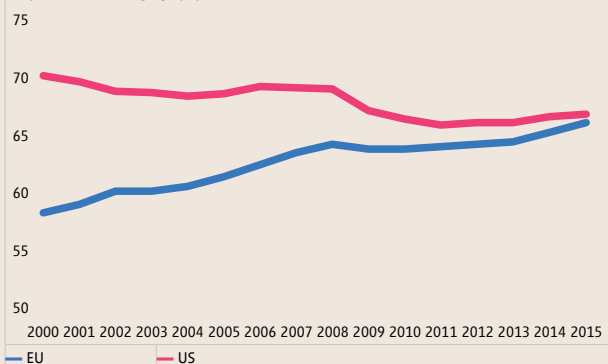


Source: Labor force survey, Eurostat for the EU; OECD (2016), Annual Labor Force statistics for the US.

Figure 7. ...as the female employment rate converges to the US level.

Female employment rate

In percent of working age population



Source: Labor force survey, Eurostat for the EU; OECD (2016), Annual Labor Force statistics for the US.

The decline in the working-age population and the increase in women with tertiary education have likely contributed to the closing of the female employment gap. Both will increase the marginal product of labor as well as the opportunity cost of not participating in the labor market for women. The EU has also undergone a period of important structural changes, with an increase in the share of services, especially in Southern Europe. To the extent that women are more likely to choose professions in the service sector, these sectoral reallocations have probably contributed to the increase of the female employment rate. The largest contribution to female employment growth came from the two sectors that employ mostly women—health and social work, and education. These two industries have contributed 45 percent of female employment growth since 2014 despite having only 30 percent of the female workforce.

With the prospect of a shrinking working-age population, increases in female employment rates could become an important driver of growth. While demographic and macro-economic trends are likely

continued to next page

Box 1 continued

to increase demand for female workers, labor market policies that support women to enter, stay in and return to the labor market are critical to lifting female employment rates. These include policies that support flexible working hours, child care, elderly care, fair and equal pay, and tax-benefit systems for second earners and low income earners. Education policies will be important for preparing an ageing population for a rapidly changing labor market. Moreover, health-sector reform can help increase participation of older women and support extension of working lives (World Bank 2015 and 2016).

Source: WB staff.

Risks to this outlook have increased. On the external side, the pace of US monetary normalization, the slow-down in emerging market growth and uncertainty around China's rebalancing remain sources of concern. Geopolitical tensions in the EU's neighborhood could have larger than expected spillover effects. Internally, the EU faces major political challenges with potentially large repercussions for the economy. The deep and prolonged recessions in the wake of the global financial crisis; the subsequent slow jobs recovery; and the lingering crisis in Greece have eroded the trust of many EU citizens in the ability of established national and EU-wide institutions to provide stability and protection (Eurobarometer 2016a). Although the short-term economic impact of Brexit was contained, in part due to swift action taken by the Bank of England, the outcome of the referendum introduced significant uncertainty, with potentially worse than expected ramifications on employment, investment and growth; it also further complicates the resolution of the EU's other political challenges. Terrorism attacks could further increase uncertainty. Citizens' increasing discontent with established political institutions, entrenched vested interests, and an ageing population are all likely to strengthen the opposition to growth-enhancing reforms; the pace of structural reforms has slowed down-significantly in recent years. Traditional economic indicators, such as unemployment or wages, have become a weak predictor of policy perceptions (World Bank 2016), making it more difficult to anticipate political consequences of reforms and adding to reluctance to undertake change.

Recent experience in the EU and abroad has demonstrated that monetary policy alone cannot lift the EU out of its growth malaise. The ECB has boosted economic growth by expanding quantitative easing and by introducing a new long-term refinancing operation (TLTRO II), improving supply conditions for firms and creating a pickup in demand across all loan types (ECB 2016). Credit growth has resumed following years of contraction, even though it remains weak in some EU member states as a result of elevated NPLs and impaired bank balance sheets. But quantitative easing is also creating new problems. The ECB's negative deposit rates have further squeezed bank margins; increased funding deficits of pension funds; and eroded savings. The drastic decline in funding costs may also lead to excessive risk taking (Arteta, Kose, Stocker and Taskin 2016) promoting an increased misallocation of resources in countries with underdeveloped financial markets (Cette, Fernald and Mojon 2016; Gopinath, Kalemli-Ozcan, Karabarbounis and Villegas-Sanchez 2015). Monetary policy is unlikely to normalize in the near term, since it is key for sustaining growth and reducing deflationary pressures. It could push monetary policy further down the liquidity trap whereby the stimulus is rendered ineffective while the misallocation of resources increases.

High levels of public debt and the EU's fiscal rules limit the scope for counter-cyclical fiscal policy. The average EU fiscal deficit fell below 3 percent for the first time since 2008, reaching 2.4 percent of GDP in 2015. EU-wide public debt declined for the first time in 8 years to 85 percent in the first quarter of 2016, which is below

the US level of 105 percent but significantly above the 60 percent Maastricht threshold (Figure 10). Despite fiscal consolidation efforts and historically low financing costs, public debt continues to increase in highly indebted EU member states, limiting the scope for expansionary fiscal policy in those countries that need it most. In theory, countries with available fiscal space could use fiscal policy to support the EU recovery, which may be particularly effective as cyclical conditions are weak. In reality, EU-wide fiscal policy has been broadly neutral to growth in 2015. The EU institutional framework provides limited flexibility for member states to adopt a more expansionary, counter-cyclical fiscal policy stance if demand is weak, even if debt is sustainable. Since current spending has crowded out public investment spending in recent years, a shift into more public investment spending could support growth in some EU member states (Figure 9).

Figure 8. Potential and TFP growth has been declining.

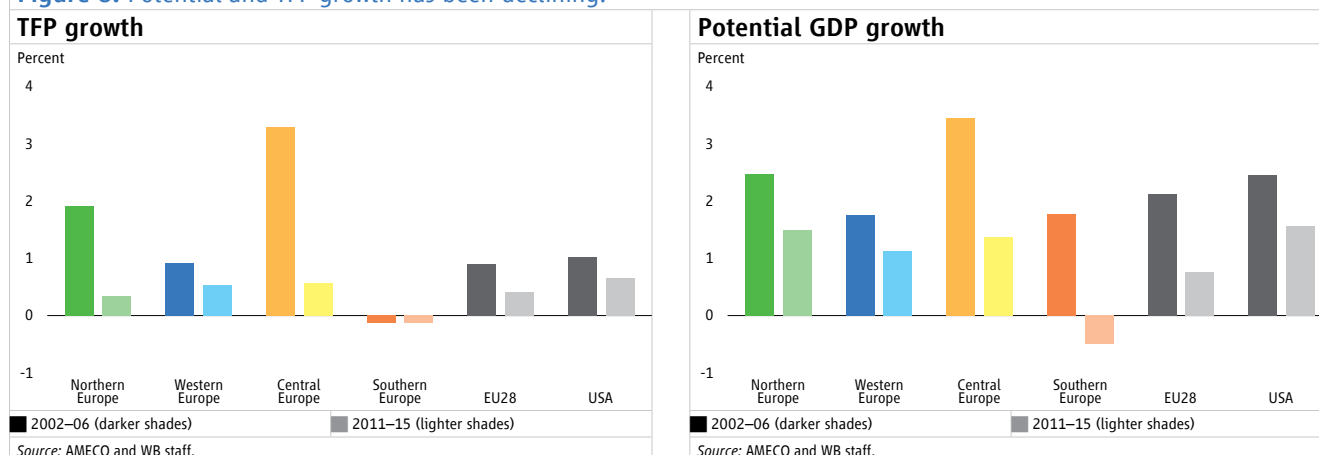


Figure 9. Public investment has not recovered since 2008.

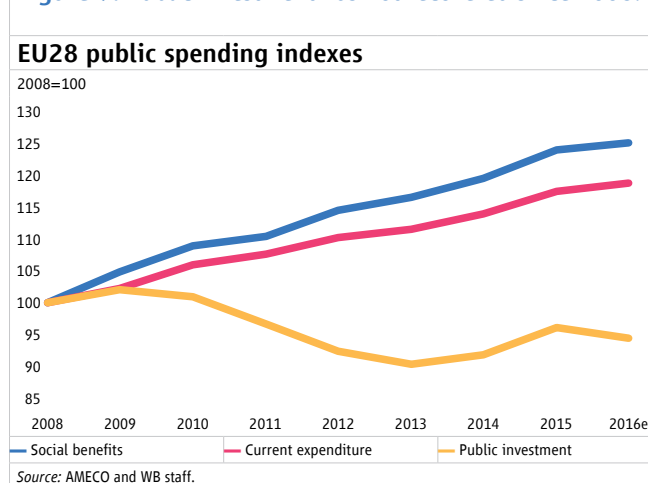


Figure 10. Public debt continues to increase in high debt countries.

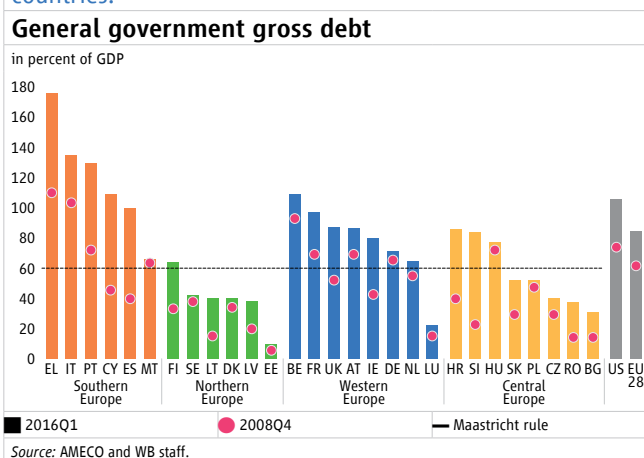
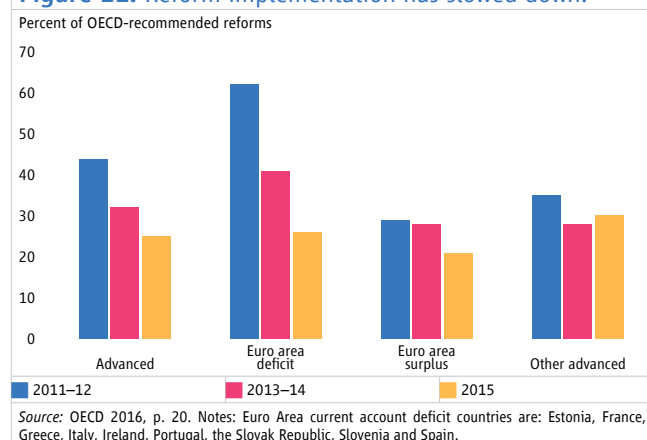


Figure 11. Reform implementation has slowed down.

With constrained macroeconomic policy space and elevated risks, sector reforms could play an important role in boosting productivity and enhancing the EU's growth potential. The services sector, for example, is a key driver of growth in advanced economies; most EU member states with above average growth in recent years have relied significantly on services. Deeper EU services integration could provide service firms with new opportunities for expansion; encourage innovation; and support much-needed investment and job creation. It could also offer qualified workers job opportunities. Simultaneous implementation of labor-market and product-market reforms is also likely to be effective in reflating the

economy (IMF 2016). Population ageing requires decisive and sustained reforms in education, the labor market, the health sector, pensions and migration to mitigate the economic impact of demographic change (World Bank 2014, World Bank 2015). The EU has introduced important services sector reform initiatives which could yield significant economic gains. In the context of weak external demand, progress on trade agreements (Canada, US, Japan) could yield important economic benefits for employment and growth.

Implementation remains the weak spot on this promising agenda. According to the OECD (2016), only one quarter of reforms were implemented, or are in the process of being implemented, in those Euro Area countries that have current account deficits; even fewer have been implemented in surplus countries. The European Commission (2016b) indicates that of the 374 reported restrictions on services, less than 15 percent were abolished. The pace and depth of structural reforms are key to releasing the much needed productivity dividend that would support stronger growth in employment, exports and output. Any delays in the implementation of key structural reforms must be weighed against the very real prospect of a sluggish outlook for years to come.

Box 2. Brexit and the European Union.

The medium-term economic implications for the UK and for the rest of the EU will depend on the duration of the negotiation and the outcome of the agreement between the EU and the UK. Both will have implications for trade, investment, financial sector, labor markets, immigration and public finances. Uncertainty will remain high over the medium-term, adversely affecting investment, employment, consumption and asset prices in the UK. Spillovers to other EU member states will vary depending on: their exposure to the UK; the strength of their macro fundamentals; and the duration of uncertainty. Ireland and the Netherlands have the strongest links to the UK.

continued to next page

Box 1 continued

Table 1. Economic links of EU member states with UK.

	<i>Export</i>	<i>FDI Flow</i>	<i>FDI Stock</i>	<i>Portfolio stock</i>	<i>UK Bank Claims</i>	<i>Remittance</i>	<i>Migrants</i>	<i>UK Tourism</i>
	<i>% of GDP, 2015</i>		<i>% of GDP, 2014</i>	<i>% of GDP, 2014</i>	<i>% of Foreign Bank claims 2015Q1</i>	<i>% of GDP, 2012</i>	<i>% of population, 2013</i>	<i>% of GDP, 2015</i>
Belgium	7.7	0.9	-0.7	8.4	3.3	0.0	0.2	0.2
Bulgaria	1.3	-0.2	6.8	0.2	0.0	0.2	0.7	0.4
Czech Rep.	4.6	-0.8	1.8	2.2	3.3	0.1	0.4	0.1
Denmark	2.0	-0.1	3.0	10.2	2.4	0.0	0.4	0.1
Germany	2.9	-0.2	2.3	9.9	10.3	0.0	0.4	0.0
Estonia	1.6	-0.1	2.1	0.1	0.0	0.1	0.5	
Ireland	7.1	1.8	27.8	123.9	24.8	0.0	8.2	0.7
Greece	0.6	0.1	-0.5	8.1	13.6	0.0	0.4	1.1
Spain	1.7	0.0	6.6	8.0	6.5	0.0	0.2	0.8
France	1.5	-0.1	3.7	14.2	16.0	0.0	0.2	0.2
Croatia	0.5	0.0	1.4	1.3	0.3	0.3	0.1	
Italy	1.4	0.1	2.4	7.6	5.1	0.0	0.2	0.2
Cyprus	0.7	0.2	22.4	3.3	4.2	-0.1	7.0	3.5
Latvia	2.2	0.2	1.7	1.3	0.4	0.0	4.1	
Lithuania	2.8	0.1	1.2	1.0	0.3	0.1	4.9	0.4
Luxembourg	1.4	143.0	551.3	237.1	4.4	0.0	0.4	0.1
Hungary	3.3	1.2	6.6	6.1	2.6	0.2	0.7	0.2
Malta	1.7	0.1	9.5	1.3	30.5	0.0	7.2	3.5
Netherlands	7.1	-0.5	61.5	30.0	14.4	-0.1	0.3	0.2
Austria	1.3	0.0	0.9	5.2	2.9	0.0	0.2	0.2
Poland	2.8	0.2	1.7	3.0	2.7	0.4	1.8	0.2
Portugal	1.9	-0.1	5.2	4.6	8.8	0.1	1.1	1.3
Romania	1.5	0.1	1.2	1.3	0.1	0.2	0.7	0.2
Slovenia	1.4	-0.1	0.7	2.2	2.1	0.0	0.1	
Slovakia	4.8	0.1	0.7	0.1	0.3	0.1	1.0	0.1
Finland	1.3	0.3	1.8	11.7	5.0	0.0	0.2	0.1
Sweden	2.0	-0.4	9.5	11.7	6.5	0.0	0.3	0.1

Source: Eurostat; BIS; Office for National Statistics; WB staff.

Source: WB staff.

Service Sector Reforms in the EU - Benefits and Challenges

The Need of Service Sector Reforms in the EU

EU growth is settling at below 2 percent a year and its population is ageing; EU citizens and policymakers are looking for drivers of economic expansion given stagnating global merchandise trade and a secular decline in global productivity growth. This note suggests that services, including tourism, transportation, education, medical services and modern business process services, offer a tremendous potential for stronger growth in productivity. So far, services in the EU have contributed less to EU productivity than manufacturing, hampered by a plethora of regulatory barriers. Consumers in Germany can easily buy French wine and Italian cars but cannot employ Italian architects and Polish lawyers with the same ease. Only 1.7 percent of accountants applied to establish an office or to work temporarily across EU borders in 2014¹. A similar pattern exists in other regulated professions, depriving many Europeans of opportunities: engineers in Italy, Finland, Spain and Portugal struggle to find work, while Germany and Benelux cannot find enough.²

Figure 12. Services contribute less to output in Central Europe.

Share of Services in GVA, 2015

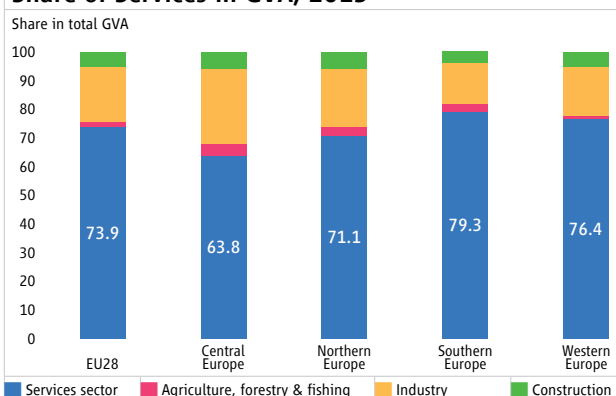
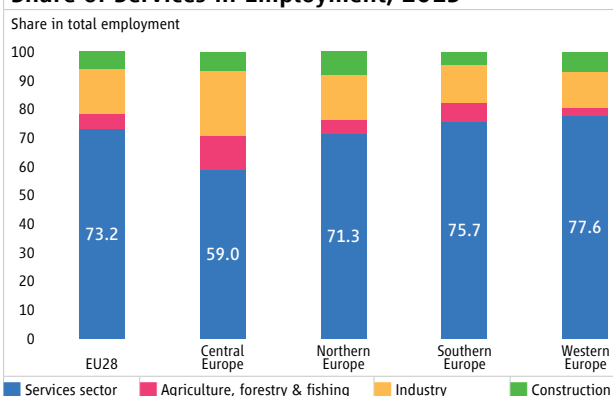


Figure 13. Service sector employment in Central Europe is lower.

Share of Services in Employment, 2015



Services account for more than three-fourths of GDP and almost three fourths of employment (Figure 12 and Figure 13). There are, however, some significant differences in the share of value added for services across EU member states and country groups. For instance, as a result of its reliance on financial sector services, Luxembourg has an extraordinarily high share of value added in services: 94 percent in 2014. With their large tourism sectors, Malta, Spain and Greece rank among the EU member states with the highest share of services in employment at 85, 84 and 78 percent, respectively. Conversely, Romania, Bulgaria and Poland have the lowest employment shares. Countries with a relatively strong manufacturing base have a lower share of value added in services: the Czech Republic has the lowest value added share of services in the EU. Germany's services' share of value added is 74 percent, below the European average and below that of other countries with similar income levels. In Central

¹ Regulated professions database of the European Commission, <http://ec.europa.eu/growth/tools-databases/regprof/>

² There is some evidence of South to North movement of engineering professionals but not enough to fill all the advertised positions in Germany where there are more than 60,000 vacant engineering jobs at any one time.

Europe, services account for 64 percent of GDP and 59 percent of employment, while in Southern Europe services account for nearly 80 percent of GDP and 76 percent of employment.

Productivity growth of services was one-fifth that of the US and half that of productivity growth in the industrial sector. The productivity growth of services in the EU averaged 0.2 percent per year between 2008 and 2014. This is significantly less than in the US (Figure 14) and below productivity growth in the industrial sector.

Figure 14. EU growth in services productivity in lags behind the US.

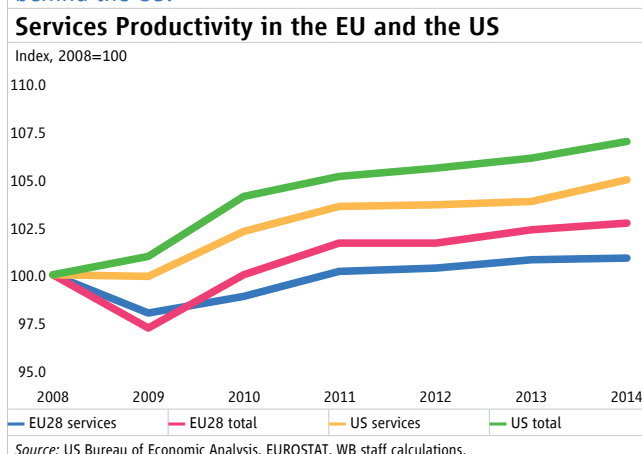
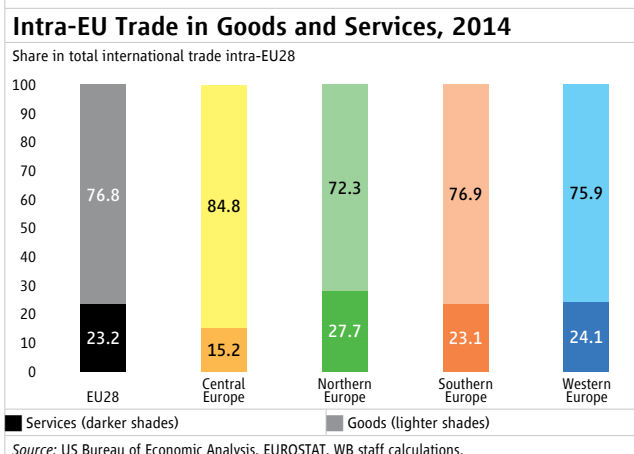


Figure 15. Intra-EU trade in services remains low.



Europeans still buy four-fifths of their services from firms established in their home countries. In 2014, services represented about 23 percent of total intra-EU trade (Figure 15), or only 15 percent for the Central European countries. Some of this is to be expected. Certain services are very location-specific in terms of customer information and feedback; however, many others are simply constrained by borders that the Single Internal Market aims to remove. This stifles growth and productivity enhancement, because small, national markets do not generate high enough levels of competition nor do they offer the economies of scale necessary to drive innovation.

The EU faces many barriers to the exchange of services, in stark contrast to the free mobility of goods. Providers of services face many hurdles to offering their services in other EU member states: they may have to change residency or even nationality; they may need to adopt a different ownership structure, reorganize their insurance; or find workers with different qualifications. They may also be required to become members of professional associations, or abide by unfamiliar advertising restrictions. In several EU member states, multidisciplinary practices are prohibited, for example, a joint practice of architects and engineers. The Architects' Council of Europe carried out a survey of its members in 2012 which showed that only three percent of architects worked in other EU member states while around thirty-five percent would "seriously consider" relocating if their titles were recognized.

Removing these barriers could boost investment, employment and convergence. Services, such as finance, accounting, transportation, communications, legal services and other commercial services generate economic outputs and are also critical inputs for the production of other goods. Empirical studies show that service sector deregulation, as measured by the OECD Product Market Regulation, have positive effects on capital, output and

employment and their effects increase over time.³ Not surprisingly, services are key drivers of growth in advanced economies. In fact, most EU member states with above average growth in recent years relied significantly on services and a large part of the income differential among EU economies can be explained by differences in service sector performance. Reforming the service sector and deepening EU integration in services could provide unprecedented opportunities for service firms and encourage innovation and much-needed investment. This could create new employment opportunities and reinvigorating convergence. All of this would strengthen the EU's role as a bulwark against economic shocks.

Reducing service barriers can raise productivity in the EU by an estimated 5 percent and help pull the EU out of its productivity slump. High-quality, low-cost services can boost firm productivity and enhance overall competitiveness. Our estimates show that limiting service sector restrictions to the level of the three least regulated EU member states (the UK, Denmark and Sweden) would increase productivity of firms that operate in services and in manufacturing by up to 5.3 percent within two years of implementation. In countries with weaker institutions, this effect could be even higher. Few reforms can deliver such an impact in such a short time. There is strong scope for reducing the regulatory burden as many EU member states have very high regulatory restrictions. Parallel efforts in several EU member states would help create large synergies.

Significant political constraints remain to be overcome; progress on service sector reforms in the EU has been slow. The EU's Services Directive was adopted in 2006 to create a Single Market for services. Its aim was to give firms the freedom to establish business in another EU country and the freedom to provide or receive services in any EU country outside the company's country of residence. The Directive covers services that make up nearly half the EU's GDP, including: retail, tourism, construction and business services. Implementation of the Services Directive has, however, been difficult. In many countries, the regulatory environment for services is very complex and highly decentralized. Reforms are often implemented by regulatory bodies which are sometimes trapped by vested interests in the sectors that they regulate; this tends to create a bias against those reforms that are intended to increase competition. Additionally, many professions and industries thrive on rents generated by regulatory constraints, and consumers are seldom aware of the costs imposed on them by these regulations. There is in fact a widespread perception in the EU among EU citizens that reducing regulatory burden leaves the public worse off.

Given the potentially large payoffs, clear service sector reforms should become a priority. The EU prioritized the removal of barriers, and there is an urgent need to move to the next phase and focus on those reforms that yield the greatest economic benefit and that are political feasible. Our empirical analysis suggests that the removal of conduct barriers is likely to yield higher productivity gains in most EU countries and that countries with relatively weak governance would benefit more from service sector reforms. Below, key criteria for prioritizing service sector reforms are outlined.

³ Gal and Hijzen (2016) find that past overall reduction in regulation restrictiveness after two years raised capital by 4 percent, output by 3 percent and employment by 1.5 percent. The Dutch Planning Bureau estimated a contribution of the EU Services Directive implementation at 0.6–1.5 percent higher GDP growth for EU average, the Copenhagen Institute estimates it to be 0.8 percent, while EC's estimate is 1.1 percent.

Services and Productivity in the EU

Productivity is the key determinant of a country's long-term growth. Per capita income can be increased by getting a higher proportion of a country's population into the workforce, investing more (as a share of national income) or by finding new ways to produce more with the same number of workers and the same level of capital. Boosting the labor force has limits, especially in the context of an ageing population. Investment growth has been at an historical low in the EU and is projected to increase only slowly over the medium term (see Recent Economic Developments). However, productivity growth, which combines labor and capital in more efficient ways, can, at least in theory, grow forever. These efficiency gains (referred to as Total Factor Productivity in the literature) have been found to explain many of the differences in per capita income (Caselli 2008). In line with these findings, the background research for this report finds a strong correlation between the average firm-level TFP and aggregate per capita income levels across the EU; many Central European countries have relatively low levels of TFP and per capita GDP (Figure 16).⁴

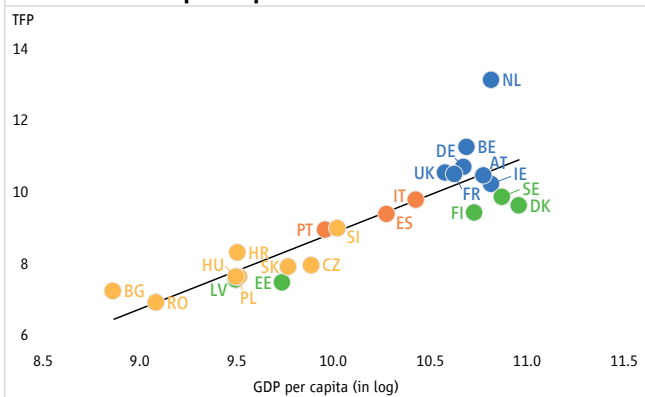
Removing barriers to the provision of services can be an important driver of economy-wide productivity.

Key barriers to the free exchange of services include bureaucratic tape and high costs of entry and may also include: quotas, education and training requirements, and compulsory membership of professional associations (Annex Table 1 for professional services). Barriers also affect how firms conduct business.⁵ When operating across countries in the EU, service providers may need to change their ownership structure; manage new advertising restrictions; or restructure their insurance. In several EU member states, multidisciplinary, or joint, practices such a company with both architects and engineers, are prohibited (Annex Table 2). Removing barriers may allow new domestic and foreign providers to enter the market; it may also reduce rent, as well as improve the quality and the availability of services. Service sector reforms may improve providers' performance as well as the productivity of firms that use services. In fact, across the EU services represent around 22 percent of total inputs in manufacturing and 63 percent in services. Not surprisingly, services help explain cross-country differences in labor productivity among developed countries (van Ark et al. 2008; Blanchard 2004),⁶ largely due to differences in TFP (Inklaar et al. 2008).

EU member states with higher restrictions on services tend to be less productive and less well off. Services and manufacturing firms in EU member states with relatively low service sector regulations, such as the UK, the Netherlands, Sweden and Denmark, have a relatively high TFP, while countries with more stringent service sector regulations, such as Croatia, Poland and Slovenia, have relatively low levels of TFP (Figure 17). Similarly, states

Figure 16. EU member states with more productive firms are richer.

TFP levels and per capita GDP level in 2013



Source: Amadeus/Orbis, World Development Indicators.

Note: TFP levels constructed from firm-level data and averaged as weighted average by size of the firm by country.

⁴ See Akerberg et al. (2006; 2015).

⁵ A Single Market Strategy for Europe - Analysis and Evidence, October 2015.

⁶ Bosworth and Triplett (2003) show that in the 1990s private services were the source of strong US labor productivity growth.

with strict regulations in professional services, such as Croatia, Greece, Poland, Hungary, and Portugal, have lower levels of TFP and GDP per capita (Figure 18). Eastern European countries, which have only recently accessed the EU, and Southern European countries tend to have higher regulatory barriers in services, and lower income levels. Despite this, and contrary to global evidence, the EU also has several rich member states with high levels of service sector restrictions.

Figure 17. Higher services restrictions are negatively correlated with lower productivity.

TFP level and overall services regulation level (2013)

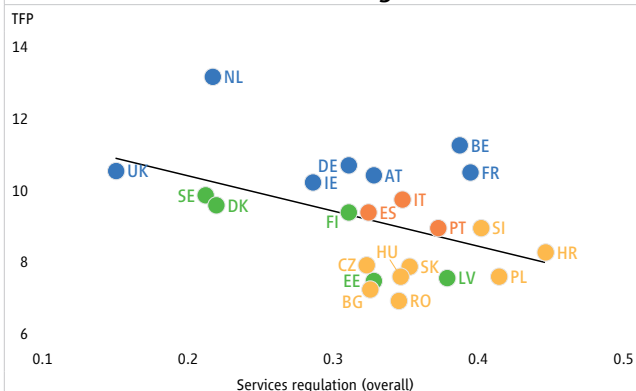
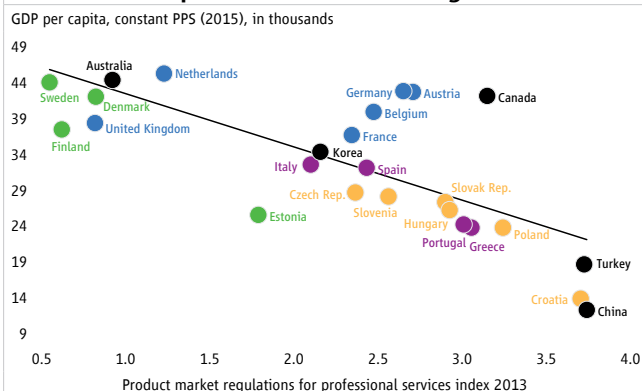


Figure 18. Stricter professional services regulation is inversely related to lower GDP per capita.

GDP level and professional services regulation (2013)



Using firm-level data for a large set of EU countries, new evidence of the economic impact of service sector reform in the EU finds that removing service sector barriers will have a strong impact⁷ (Figure 25). Reducing service sector restrictions to the level of the three least regulated EU member states (the UK, Denmark and Sweden) would increase productivity of firms operating in both services and manufacturing by up to 5.3 percent within two years of implementation. Estimates from a large firm-level panel on many EU member states suggests that economic gains from service sector reforms are substantial.⁸ By using comparable regulatory indices; TFP measures; input-output tables; and firm-level data from a common source, the effect of service sector reform on different EU member states can be compared as discussed below.⁹

Service Sector Regulations and Reforms in the EU

Establishing freedom of services, similar to the free movement of goods, has been on the EU's agenda since its inception and is reflected in its Services Directive. Service integration was first mentioned in the

⁷ A detailed explanation of related studies, the methodology and the results can be found in the EU RER background paper from Van der Marel, Kren, Iootty (2016). The paper used firm-level data from multiple European countries to get a consistent cross-country panel sample that provides estimates of the real economic gains as a result of reform across the entire EU rather than concentrating on one country. This background paper relies on several TFP estimates, while most studies use only one measure (except Fernandes and Paunov (2012). Additionally, sector-specific production functions for 24 sectors were estimated.

⁸ This finding is robust for different measures of TFP.

⁹ Van der Marel, Kren and Iootty (2016) covers 12 service sector-specific reform barriers, including electricity, post and telecommunications, transportation, and professional services.

original Treaty of Rome of 1958;¹⁰ and in 2006, the EU adopted the Services Directive to establish a Single Market for services. Its core principles are: (i) the freedom to establish a company in another EU country and (ii) the freedom to provide or receive services in an EU country other than the one where the company or consumer is established (Box 3). The Directive covers service activities accounting for 46 percent of EU GDP, including retail, tourism, construction and business services, provided within and between EU countries. The European Commission estimates that a more ambitious implementation of the Services Directive by national regulatory authorities would lead to more jobs; lower prices; higher internal and external investment; increased innovation and export market diversification.¹¹

Service reform implementation in the EU has advanced slowly. Only a few member states have made progress with reducing service sector restrictions (Figure 19). Between 2006 and 2013, the countries with most improvement were Greece, Estonia, Italy and Slovenia. Italy also implemented significant reforms. Similarly, progress with the implementation of the EU Services Directive for professional services has been slow. By 2015, the EC was notified of 374 non-discriminatory barriers for professional services, of which only 53 have been fully abolished (Figure 20). There seem to be differences in the pace of liberalization across sectors. Countries with economically important energy and transport sectors, such as Slovakia or the Czech Republic were more likely to reform, although progress in these areas has been limited since 2008. Countries with relatively large professional sectors were less inclined to pursue professional service reforms, suggesting that there are political challenges to reform in countries where professional sector rents are greater.

Figure 19. Progress with reducing service sector restrictions has been slow.

Services regulation in the EU, 2006 and 2013

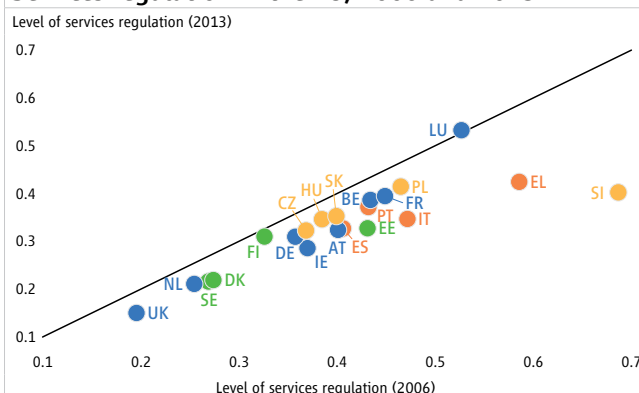
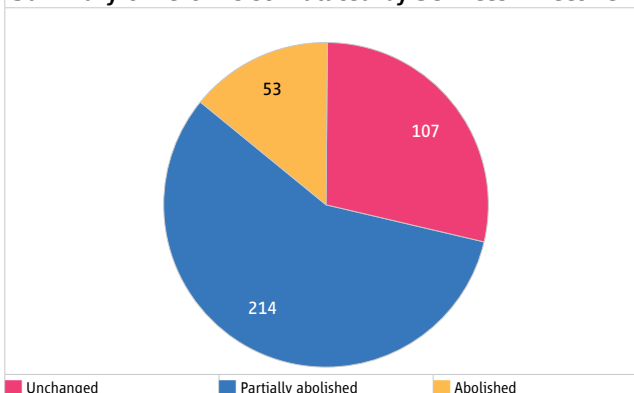


Figure 20. Only one-seventh of reported restrictions for professional services have been abolished.

Summary of reforms stimulated by Services Directive



Professional services continue to face significant constraints to labor mobility and investment. Professional services, which include architects, engineers, accountants and lawyers, generate a significant share of gross value added (GVA),¹² but they tend to have restrictions on entry which reduce the supply of professionals or may increase

10 The original article 59 'prohibits restrictions on freedom to provide services within the Community in respect of nationals of Member States who are established in a state of the Community other than that of the person for whom the services are intended'. The Treaty also said that as long as restrictions on freedom to provide services have not been abolished, each Member State shall apply such restrictions without distinction on grounds of nationality or residence to all persons providing services.

11 http://ec.europa.eu/economy_finance/publications/economic_paper/2012/pdf/ecp_456_en.pdf.

12 The contribution of total professional, scientific and technical services to European GVA was around €625 billion or 4.6 percent in 2014.

Box 3: The Services Directive.

The Services Directive is a framework directive which was intended to deal with ongoing barriers in professional services markets in a proactive way. The preamble to Directive 2006/123/EC on Services in the Internal Market (“the Services Directive”) states that it is intended to improve the competitiveness of services markets and in particular to enable greater exploitation of the European single market by SMEs. The ultimate goal, however, was to require Member States themselves to complete the single market for services by eliminating lingering restrictions on the cross border supply of services. They were also expected to improve transparency and the availability of information for consumers.

The Services Directive recalls that Treaty Articles 49 and 56 prohibit barriers to the freedom of establishment and the freedom to supply services. The main body of the directive sets out specific regulatory requirements which are not permitted: for example nationality or residence requirements; and restrictions on the type of establishment used to provide services. Article 40 also summarizes the Court of Justice’s interpretation of the ‘overriding reasons relating to the public interest’ which may be used to justify the continuation of barriers to the free supply of professional services. It notes how the following are all valid concerns to the public interest and as such, they have been used to justify regulation of certain professional services: public policy; consumer protection; fraud prevention; environmental protection; the protection of creditors; the sound administration of justice; road safety; intellectual property rights; and the preservation of national historic and artistic heritage. The directive also sets out a process of ‘mutual evaluation’ to test whether regulations that allow for these elements of public interest comply with basic principles of European law and good regulatory practice.

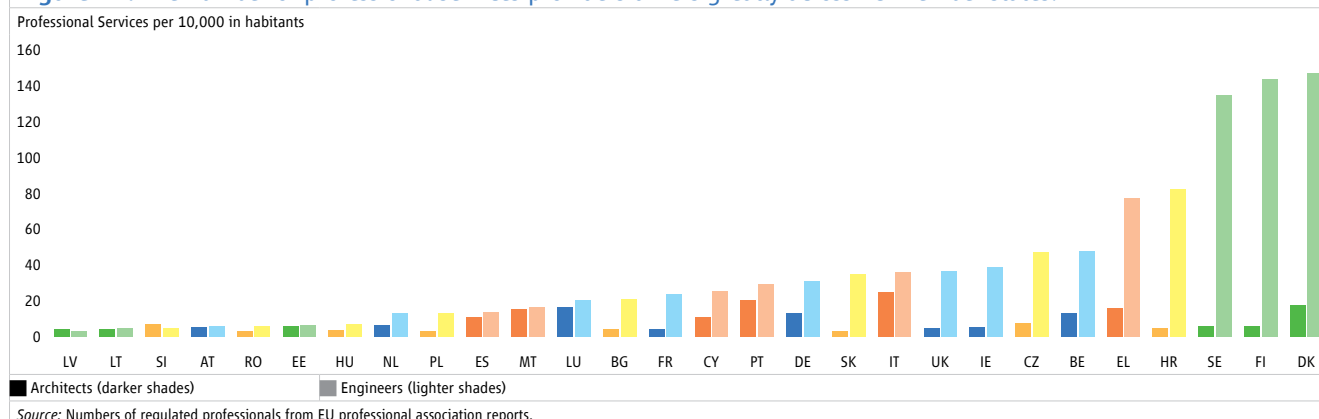
The directive required Member States to provide a report to the EC within three years of its entry into force, confirming the removal of all discriminatory restrictions. This report also needed to provide an evaluation of and justification for the continuation of non-discriminatory restrictions. It is worth noting that the final version of the directive looked very different from the original 2004 EC proposal. The passage of the directive was highly controversial and provoked an unprecedented political backlash from opponents of liberalization, NGOs, labor unions and public sector workers, resulting in considerable watering down of the Commission’s original proposals. This is relevant today because political support for harmonizing measures is significantly reduced in post-financial crisis Europe, and this reduces the EU’s ability to improve the professional services markets.

Source: Hook (2016), European Commission (2016) “Services Directive” http://ec.europa.eu/growth/single-market/services/services-directive/index_en.htm.

the cost to end users (see Annex 1). They also have conduct/practice restrictions in terms of fee arrangements; geographical limits; advertising and publicity; and multi-disciplinary practices (see Annex 2 for a detailed list by EU member states)¹³. Disciplinary barriers to foreign competitors which could also reduce the supply of services across borders through residency or nationality restrictions that continue to be particularly prevalent in legal and audit services (see Annex 3 for a detailed list by EU member states).

There are too many professionals in some countries and too few in others, because of low labor mobility among professional service providers in the EU. Italy has 25 architects per 10,000 inhabitants, compared to

¹³ For example, lawyers are prohibited from sharing ownership with non-lawyers in 23 EU Members States, effectively restricting their business to the provision of legal services. In Croatia, lawyers must obtain the approval of the Croatian Bar Association for any text that appears on their websites.

Figure 21. The number of professional services providers differs greatly across EU member states.

less than 3 per 10,000 in Poland (Figure 21). Only 0.2 percent of EU architects established themselves in another EU member state in 2014.¹⁴ The same holds for accountants and engineers: Italy, Finland, Spain and Portugal have a surplus of engineers, as Germany suffers from shortages. There is evidence that some engineers from Southern EU countries moved to Germany in recent years, but there are still almost 60,000 engineering vacancies at this time.

Differential tax treatment of profit distributions for businesses in sole ownership or partnerships, compared to companies, discourages retention of profits and thus investment. Yet, sole ownership and partnership are the most widely used vehicles for professional service businesses in many EU countries. Most of the estimated 90,000 engineering firms registered in Germany and the 80,600 registered in France are individual enterprises according to industry studies¹⁵.

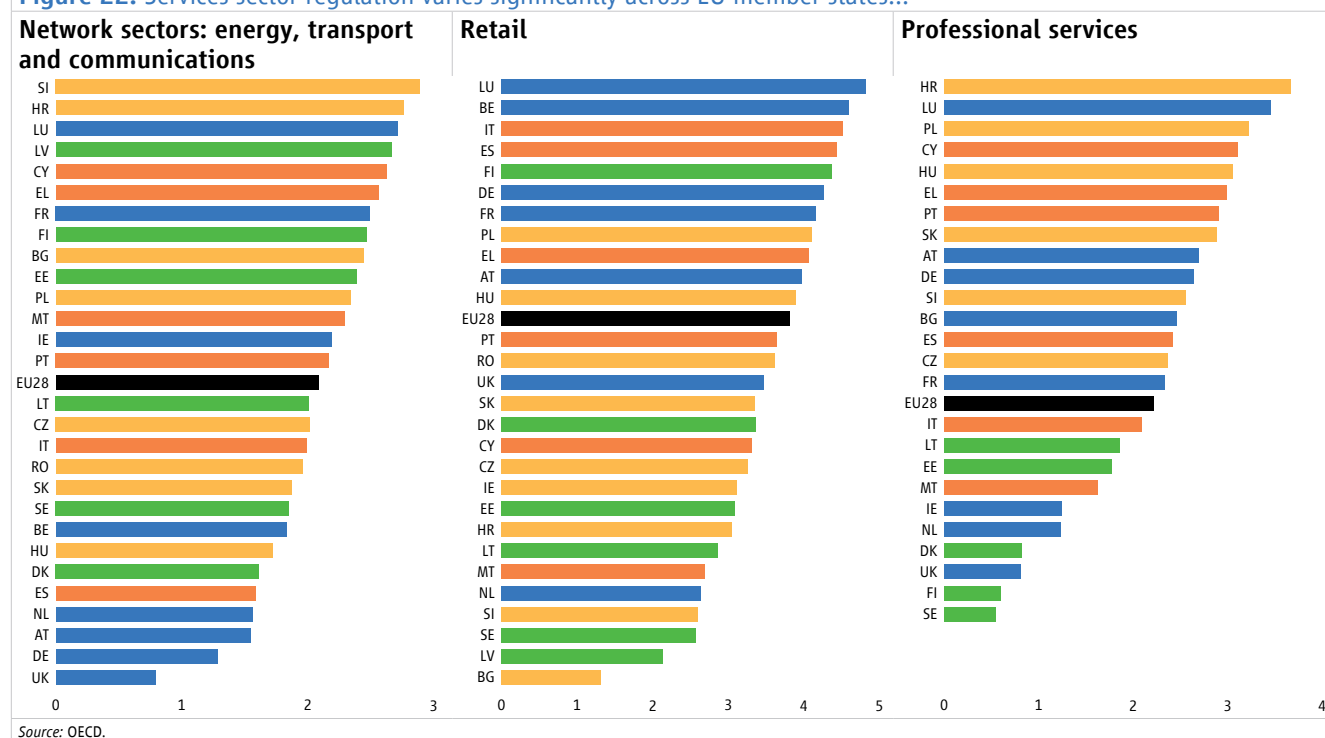
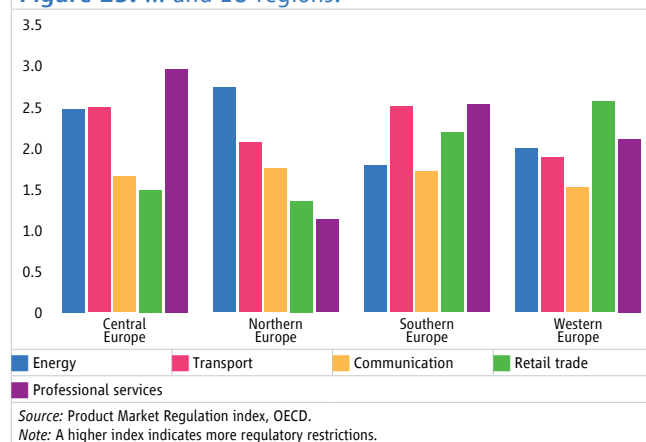
Few professional services providers and users can take advantage of the opportunities offered by the EU. In fact, more than 90 percent of professional, scientific and technical service businesses in the EU have fewer than 10 employees. This high fragmentation means that businesses in the professional services sector do not grow enough to enable them to take advantage of economies of scale within their domestic markets, let alone across the EU as a whole.¹⁶ The internal fragmentation of the European professional services markets is coupled with their relative isolation from external competition from outside the EU; EU multilateral commitments shield some professions, such as accountants and legal services, from international competition.

Service sector regulations are much more restrictive in the EU than in other OECD member states. For instance, retail regulation is more restrictive in most EU countries than in Australia, Chile, Korea, New Zealand and Switzerland. The regulation of professional services is also more restrictive in most EU countries than in Australia, New Zealand, Switzerland and Norway. Central European countries have more restrictive regulations in the energy and transport network and in professional services, and regulation in the retail sector is more restrictive in Western Europe countries (Figure 22, Figure 23).

¹⁴ These numbers may underreport the numbers of accountants actually moving, given that temporary movement is often unreported.

¹⁵ European Industry Review - The Consulting Engineering Sector in Europe, ING Bank (2008).

¹⁶ There are a few noteworthy exceptions to this size condition and a few large industry players in each professional sub-sector have grown to serve large company and government requirements at the top end of the market, these include: The 'Big Four' accounting firms, the UK 'Magic Circle' law firms, some large engineering firms, and a handful of architectural practices that have grown up around a 'big name' principal, such as Foster and Partners, which has just under 500 architectural and design professionals in fourteen offices worldwide.

Figure 22. Services sector regulation varies significantly across EU member states...**Figure 23. ... and EU regions.**

How service sector reform affects employment will depend on how final output and wages respond to the change in TFP. Since labor productivity equals output/employment, employment equals output/labor productivity. If labor productivity increases while output remains unchanged, employment is likely to go down. If firms can take advantage of the lower labor costs that come with productivity growth; reduce prices; and sell more, then employment is likely to increase. If productivity growth outpaces average wage growth so that the wage gap i.e. the share of average wages in terms of productivity declines, employment is likely to increase (holding everything else constant). However, an increase in the real wage that surpasses productivity

growth will reduce firms' profitability; increase prices; reduce the demand for output and, therefore, employment (see Blanchard and Katz, 1999, Blanchard and Summers, 1986).¹⁷ A large body of empirical literature confirms a negative relationship between the wage-productivity gap and employment in Western European Countries (see Karanassou and Sala 2014; Hatton 2007; and Meager and Speckesser 2011). The introduction of new services may also change demand for skills, as discussed below.

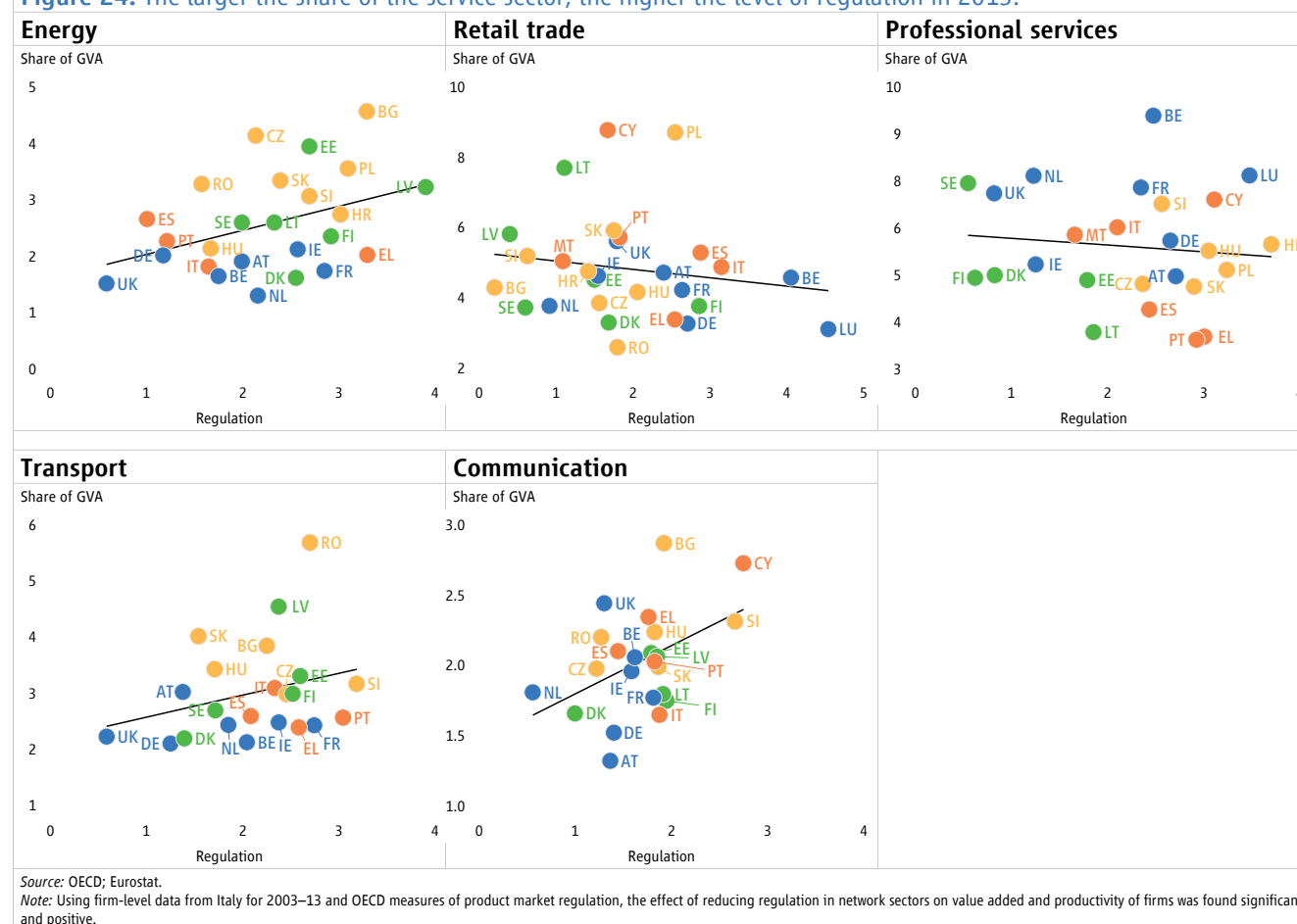
¹⁷ The negative effect of the wage-productivity gap should not affect the equilibrium unemployment (e.g. NAIRU) as the wage level is expected to catch up with productivity in the long term.

A Roadmap for Service Sector Reform

Given the potentially large productivity gains from service reforms and the attendant political economy challenges, it is important to prioritize those reforms with the largest economic impact in order to advance the pace of implementation. So far, the EU has prioritized the removal of barriers like fee scales and advertising prohibitions, but there is an urgent need to move to the next reform level. This would require a focus on reforms such as removing barriers to entry; legal forms of practice; ownership; and the multidisciplinary nature of some services. Our empirical analysis has identified the following priorities:

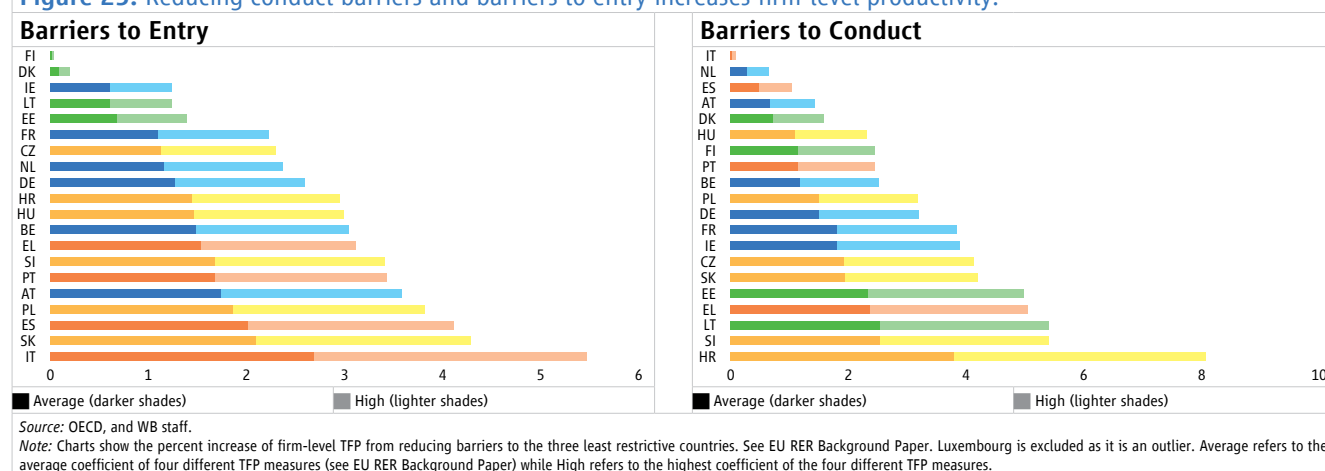
- **EU member states should focus on economically important sectors: these also tend to be more regulated.** Examples include: the energy sector in Bulgaria, transport in Slovenia and Romania or professional services in Croatia (Figure 24). In several EU member states some heavily-regulated sectors are economically very important. The same holds for firms using these intermediates in their production processes. Economically more important sectors tend to be more regulated in the EU: in all sectors, except retail, a higher share of services in GVA on average means more restrictive regulation of the sector.

Figure 24. The larger the share of the service sector, the higher the level of regulation in 2013.



- Removing conduct barriers increases productivity gains more than removing entry barriers** (Figure 25). Reducing entry regulations to an average feasible level of the three EU economies with the lowest entry barriers (Sweden, Finland and Denmark) would increase EU manufacturing and increase firms' productivity level by up to 2.8 percent on average. The average impact of reducing conduct barriers in a comparable scenario is even higher, increasing firm productivity level by up to 3.4 percent.¹⁸ Entry restrictions affect foreign and domestic firms to the same degree but regulations that restrict firm conduct impact foreign firms more negatively than domestic firms.¹⁹ Given the large differences in service sector barriers across EU member states, reforms should focus on removing the leading constraints. Italy, for example, could achieve large TFP gains by removing barriers to entry; it has one of the lowest barriers to conduct in the EU. Croatia, however, would benefit more from removing the restrictions that constrain the way firms can do business.

Figure 25. Reducing conduct barriers and barriers to entry increases firm-level productivity.



- Countries with weaker institutions²⁰, especially in Central and Southern Europe tend to benefit more from service sector reform** (Figure 26). There are many countries in the EU with relatively strong institutions; such countries tend to have stronger regulators and a more efficient judicial system, which may make it easier to navigate numerous regulations. Germany and France are two examples. Service sector restrictions, and entry barriers in particular, are significantly more damaging in those countries with weaker institutions. Entry regulations and institutional quality predict around 50 percent of TFP in downstream manufacturing sectors.²¹ Some Central and Southern European countries²² with high barriers and relatively lower governance indicators will have strong gains from liberalizing entry barriers (Figure 27).

¹⁸ The three EU member states with the lowest average conduct barriers are the UK, Italy and the Netherlands.

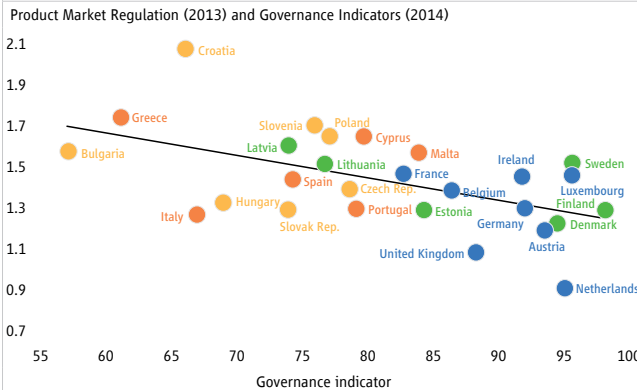
¹⁹ Replicating the regression using UK-based input-output coefficients does not significantly alter results, which remain robust. Including the foreign dummy and alternative TFP measures such as the Olley and Pakes method in the baseline regression also does not significantly change results. Van der Marel, Kren, Iootty (2016).

²⁰ The following measures from the World Bank Governance Indicators were used to assess the impact: Rule of Law, Level of Corruption, Regulatory Quality and a Principal Factor Component of the three.

²¹ Barriers to FDI are also particularly damaging for downstream services in countries with weak institutions.

²² For example: Croatia, Slovakia, Latvia, Poland and Czech Republic. Also Greece, Italy and Portugal.

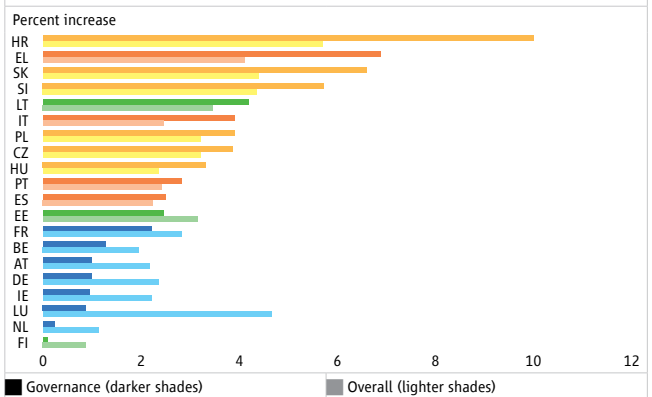
Figure 26. EU member states with weaker governance tend to have higher service sector restrictions, with notable exceptions.



Source: OECD, World Bank Governance Indicators, own calculations. TFP figures are based on Akerberg et al. (2006). TFP estimates are a weighted average taking the size of the firm and its sector. In this case the number of employees of a firm relative to the total amount of employees in the 2-digit NACE sector is used. Luxembourg is excluded as it is an outlier.

Note: Figure 27 show the percent increase of TFP from reducing service sector barriers to the three least restrictive countries. See EU RER Background Paper. Luxembourg is excluded as it is an outlier. Institutions reforms to the estimation that combines service sector reform with institutional quality as measured by the World Bank's Governance Indicators.

Figure 27. Productivity gains are large in EU member states with weak governance.



- **Reform of professional services is likely to yield large productivity gains.** (Figure 28) Our empirical results show that regulatory barriers in these services depress productivity, especially in those sectors that use professional services most intensively. Professional services form a sub-set of the larger business services sector and appear to be the most dynamic part of the entire service sector. Reducing regulation in

Figure 28. Countries with weak institutions and high regulation tend to gain most from professional services reform.



Source: Amadeus/Orbis, OECD
Note: Growth is the simple difference (in logs) between 2006 and 2013.

professional services is expected to have a strong impact on productivity; suggesting that reforming only these could have substantial welfare effects in the EU (see EU RER Background Paper) and overall gains may actually be underestimated. Countries with relatively weak institutions and high professional services regulations, mainly in Central and Southern Europe, are likely to gain most from improved professional services regulation (Table 2). Based on historical data, countries have seen large productivity gains in sectors that were de-regulated or that had used outputs of de-regulated sectors as an input.

Table 2. Typology of countries per strength of institutions and professional service regulations.

	<i>Weak institutions</i>	<i>Strong institutions</i>
High regulations	HR, EL, SI, SK, PL, CZ, ES, HU, PT, BG, CY, LV, RO	LU, BE, AT, DE, FR
Low regulation	IT, LT, CZ, ES	UK, SE, DK, NL, EE, FI, IE, MT

Source: OECD, WB World Governance Indicators.

Box 4. The Political Economy of Professional Service Reform.

Regulation within similar or identical professions varies strongly across EU member states, as professional services regulation remains a national responsibility, despite the importance for the overall European economy.²³ EU Member States determine what activities or titles they regulate. An estimated 5,500 professions are regulated across the EU and the definition of a single profession can vary significantly across states. The number of different regulators is equally large: there are over 1,500 bodies involved in regulating the legal profession across the EU²⁴ and it is estimated that around 21 percent of the EU labor force (around 50 million people) is employed in regulated professions.

The regulatory environment for professional services is extremely complex and highly decentralized. The justification for regulating professional services is usually supported by information asymmetries, and/or specific public policy and public interest grounds but national authorities find it difficult to assess whether adopted regulations are really justified under these principles. Currently, there are no EU-wide tools to monitor regulations.

Reforms are often delegated to professional associations and implemented by regulatory bodies, which may create a bias against reforms. Reforming professional services is particularly challenging as professional associations and chambers are given the responsibility for regulation, which could lead to a conflict of interest. Even in jurisdictions for example in the UK, that have introduced successful reforms, the scrutiny process is largely based on self-assessment by the regulatory bodies themselves; sometimes the profession may even challenge the reforms.²⁵

There is limited public awareness about the costs of regulations. Users are seldom aware how regulations affect the quality and costs of services. Public misperceptions about de-regulation of services also needs to be addressed, including the perception that lower regulation leads to poorer outcomes; and that users or the wider public are the main beneficiaries of smart regulations.

Source: Hook (2016).

²³ The EU Treaty acknowledges that Member States have the right to regulate professional services within some clearly defined parameters.

²⁴ Directory of Legal Regulators, International Bar Association 2016.

²⁵ Commission Staff Working Document on the outcome of the peer review on legal firm, shareholding and tariff requirements under the Services Directive, *European Commission*, 2 October 2013. <http://ec.europa.eu/DocsRoom/documents/14964/attachments/1/translations/en/renditions/native>.

Overcoming Constraints through Digital Dividends

Digital technologies²⁶ could significantly increase the productivity of service firms and create opportunities for reform. Business services are becoming more data/digital-intense. Highly-protected sectors like retail and wholesale trade, finance, transport or public utilities, can increase productivity more than many other sectors by using digital technology. Technology is changing the way service users interact with service providers. Technology facilitates an increase in transparency, which reduces the justification for regulation on the basis of asymmetry of information. Technology can also enable professional services to be embodied in products and services on a commoditized basis²⁷. The German construction company Huf Haus for example, specializes in producing and assembling factory-produced buildings that can be erected in days by its own in-house team and which require no local architectural input. In the engineering sector, technology is influencing process management and product engineering. Technology is also changing the training needs of all professions and may require fewer, or very different, professionals in future, some of which are not covered under existing regulations. The future labor market in the legal sector²⁸ may need new types of workers, including: process analysts, project managers, online dispute resolution practitioners and risk managers.

Service providers now rely on digital technology that creates significant opportunities for growth; however, the use of that technology faces severe opposition in sectors most protected from competition and innovation. The internet has created new types of startups that base their business model entirely on the web but offer traditional services, such as retail trade, finance, transport, logistics, tourism, media, publishing and advertising. Airbnb, for example, was operating in more than 40 countries in 2014, enabling owners to let their homes on a short-term basis, putting competitive pressure on the hotel and tourism industry, which has frequently enjoyed high rents as a result of local market segmentation or exclusive contracts in developing countries. The Estonian startup TransferWise and the U.S. startup Xoom match requests for international currency transfers online, saving direct and indirect transaction fees by clearing reciprocal currency transfer requests. The two startups lower regulatory rents by reducing the prices of international currency transfers by up to 90 percent.

Ridesharing services have expanded to most EU member states, creating new opportunities. In 2015, the ridesharing service, Uber arrived in Romania and became a success among the younger and better educated Romanians. In a city, with fast internet connection, a vibrant start-up community and average monthly salaries of around UD450, there is strong demand for cheaper taxis and a potential supply of Uber drivers. This is all likely to lead to an increase in the overall pie of transport services.

The EU has not yet fully captured the growth benefits of using digital technologies:

- **Few European firms use digital technology for complex, productivity-enhancing tasks.** Internet access is affordable and available in the EU and there is a high level of internet usage among firms: over 96 percent of firms have access to the internet. Many European firms use digital technologies for simple tasks, such as emails and websites but its use for more complex tasks is limited. In most EU member states less than five percent of firms use cloud computing services or e-invoice systems. Exceptions are

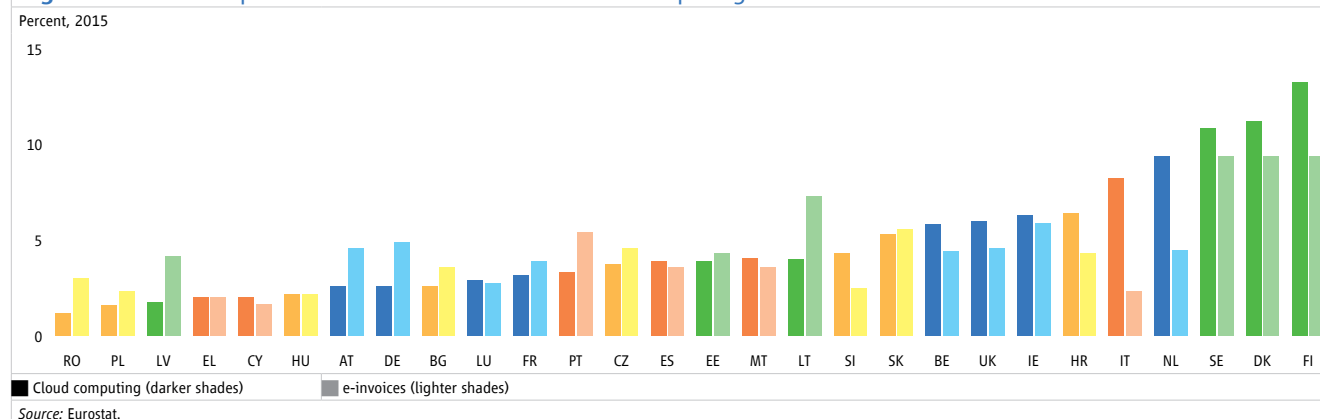
²⁶ Digital technologies is defined in the 2016 World Bank World Development Report as the internet, the mobile phones and other tools to store, collect, analyze and share information digitally.

²⁷ Sariyildiz, S. and S. Ozsariyildiz, "The future of Architectural Design Practice within ICT developments", Delft University of Technology.

²⁸ Susskind R. (2010) "The End of Lawyers? Rethinking the Nature of Legal Services".

Scandinavia and the Baltics, which have been at the forefront of developing digital technologies in Europe (Figure 29). Romania and Poland have the lowest share of firms using cloud computing and e-invoice systems.

Figure 29. Few European firms use E-invoices and Cloud Computing.



- Few firms in the EU participate in e-commerce.** On average, only 16 percent of firms sell their products online (Figure 30), even though it is relatively easy and inexpensive to set up an e-commerce website or use an online platform. Online platforms, such as eBay and Amazon, enable smaller firms to become exporters and to reach more market destinations without having to set up bricks-and-mortar shops. They also provide a digital marketplace for firms to advertise their products and find buyers in foreign markets. In several Southern and Central European states less than 10 percent of firms conducted e-commerce in 2015 (Figure 31). This is also partly a result of increased sensitivity of EU consumers regarding privacy and trust issues when purchasing online (as indicated in the Eurobarometer) as well as due to a home bias where consumers have preference for 'home' goods.

Figure 30. Few European firms sell online...

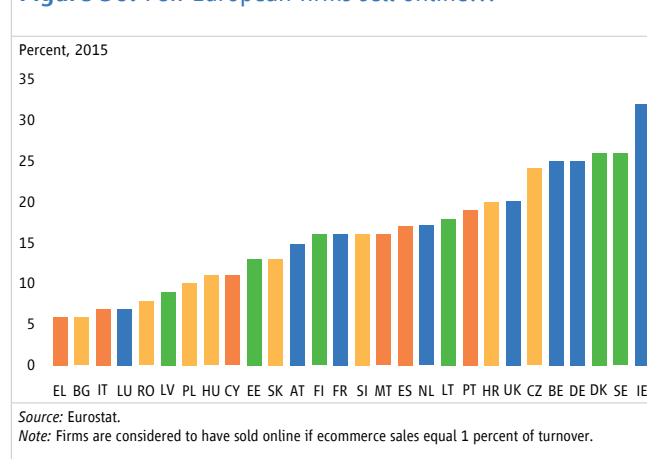
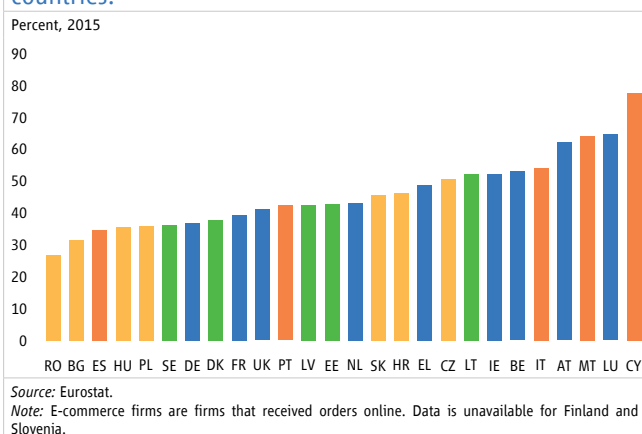


Figure 31. ...or use E-commerce to sell to other EU countries.



Supportive infrastructure and sound labor market regulations are needed for countries to reap the full benefit of digital technologies. Countries can encourage firms to use digital technology in more productive ways

by ensuring that there is a pro-competitive business environment; possibly involving the removal of sector entry restrictions. Competitive pressures can incentivize firms to adopt new technologies and increase their productivity levels.²⁹ Internet access may increase the probability of exports but is most effective if the exporting country has better logistics.³⁰ ICT infrastructure is also important; technological advances have dramatically reduced the cost of delivering many cross-border services, and an electronic infrastructure has a demonstrably positive effect on service exports (Freund and Weinhold, 2000).

There is evidence³¹ that inflexible labor markets are not conducive to growth of the ICT industry; it is prone to shocks and requires flexible hiring and firing conditions. Sectors that adopted the internet experienced a disproportionate increase in total employment: skilled jobs, part-time work, and multiple job-holding after the implementation of telecommunications reforms³². This was associated with increases in telecommuting, non-routine cognitive occupations, and temporary employment.

Digital technologies can increase firm productivity and international trade, but also present challenges to the labor market. As firms increase the use of automation and the application of digital technologies, there will be labor market disruptions, which could result in higher inequality among workers: highly-skilled workers will benefit most from digital technologies; and medium-skilled workers are likely to be worse off as they perform routine tasks that can be automated or outsourced. The result is a polarization of the labor market: demand for high-skilled workers and low-skilled workers increases at the expense of the medium-skilled. Between 2002 and 2007, French firms that were more technology-intensive experienced faster growth; increased the share of higher paid workers; and reduced the share of workers in the middle of the wage distribution, such as office and retail workers.³³ In Romania, the income share of non-routine labor increased from 21 percent to 25 percent, while the income share of routine labor decreased from 18 percent to 16 percent in the 2000s.³⁴ Competitive pressures from high productivity firms and foreign competition facilitated by digital technology can cause firms to exit the market, leading to job losses. Countries need to meet the challenges of job polarization and job loss by ensuring that the labor force has the right skills through education and training systems, as well as appropriate labor regulations and social protection institutions to support affected workers.

Policy Considerations

Economic gains from service sector liberalization in the EU are substantial. Evidence based on a large set of EU firms support much larger gains for the EU as whole than previous country-level estimates suggest. Barriers to conduct are most damaging, their removal would boost EU manufacturing and service firms' productivity levels by up to 3.4 percent on average. All EU member states, independent of income level, could boost their TFP growth through service sector liberalization; in some cases by up to 8 percent. EU member states with relatively weak institutions suffer more from service sector barriers and would gain most from reforms.

²⁹ Bloom et al. (2015).

³⁰ Rijkers (2015).

³¹ Bartelsman et al. (2010).

³² Winkler and Vazquez (2016). Evidence from telecommunications reforms in Europe, forthcoming.

³³ Harrigan et al. (2016).

³⁴ Eden and Gaggl (2015).

Advancing service sector liberalization requires a strong commitment. A combined and sustained push from the European Commission and national governments is needed to advance this agenda. It cannot be solved by any single country but requires active member cooperation to fully reap the benefits of services integration. As highlighted in this note, political economy constraints to service sector liberalization are substantial.

Several recommendations emerge which could help Member States and European Institutions progress more effectively with Europe's professional services productivity problem and overcome political economy constraints

- **Develop a clear road map for prioritizing reforms across EU member states.** Focus on those reforms that have the largest potential impact.
- **Make it a competition policy priority.** The European Commission should continue to make a case for further service sector liberalization; it should also prioritize it as a European Commission competition policy and as a topic for national competition authorities.
- **Use trade agreements as reform tools.** Transparency is the first step toward removing barriers; the public commitment by around 130 jurisdictions worldwide to adopt IFRS as their accounting standard should help remove unnecessary regulatory barriers in auditing and accountancy.
- **Instigate debate about political obstacles to reform.** Broad-based consultations with service sector providers and users about costs and benefits of reforms will help to ensure that reforms are beneficial.
- **Provide support to workers that could be negatively affected by the proposed reforms.** This could involve options for re-training and more effective job matching employment services. Using non-standard labor contracts to reduce the hiring rigidity may increase labor mobility in the services sectors.
- **Create a common market for professional services.** A "European Passport for professional services" may increase mobility within the EU, but will not be enough to create a truly common market. The Architects' Council of Europe conducted a survey of its members in 2012; currently only three percent of architects work in other EU member states; around thirty-five percent of the respondents would 'seriously consider' relocation if their titles were recognized. More than 30 percent expressed concerns about having insufficient language skills or knowledge of local planning or building regulations.³⁵

³⁵ The Architectural Profession in Europe 2012: http://www.ace-cae.eu/public/documents/sector_study_2012_draft_final.pdf.

Annex

Annex Table 1. Barriers to Entry in Professional Services, 2014.

	<i>Exclusive Rights</i>	<i>Education and Training Requirements</i>	<i>Compulsory 'membership'</i>	<i>Quotas or economic needs tests</i>
Accountancy	Some in all EU Member States but much more limited in Ireland and Netherlands	Fairly similar level across EU Members but more accessible and flexible qualification routes in UK and Ireland	Professional membership required in all Member States apart from Sweden, Spain, Finland and Denmark	None reported
Architecture	All except Finland and Sweden and very limited reservations in the UK and Ireland	Some Member States only require tertiary level of education, others require practical experience in addition and in Greece, Ireland, Malta, Romania, Slovakia, Czech Republic, Italy and Lithuania an examination is required	Professional membership optional in Denmark, Estonia, Finland, Ireland, Latvia, Netherlands, Sweden, UK, Lithuania and Malta – otherwise compulsory.	None reported
Engineering	Activities reserved to qualified engineers in Croatia, Cyprus, Italy, Malta and Portugal and many specific activities regulated differently in different Member States	No formal requirement in France, Netherlands, Denmark or Sweden.	Required in Bulgaria, Germany (consulting engineers), Greece, Ireland (chartered engineers), Italy, Luxembourg, Malta, Austria, Poland (civil engineers), Portugal, Slovakia (only civil engineers), Slovenia, Spain, the Czech Republic (certified engineers), Hungary, the United Kingdom (Chartered Engineers or incorporated engineers), Cyprus	None reported
Legal Services	All, to varying degrees, except Finland and Sweden	Similar levels of education required but wide variance in practical experience requirements.	Required everywhere other than Malta	None reported

Source: OECD, European Commission, ACE, CCBE, FEANI, FEE.

Annex Table 2. Barriers to Conduct or Practice Restrictions in Professional Services, 2014.

	<i>Prices and Fees</i>	<i>Physical and geographical limitations on location</i>	<i>Marketing/advertising restrictions</i>	<i>Form of practice and shareholding/ownership</i>	<i>Multidisciplinary practice</i>
Audit/Accountancy	Few restrictions exist	Local residency required for auditors in Austria, Croatia, Denmark, Finland, Italy, Portugal, Slovenia and Sweden	An absolute ban only exists in Slovakia	Austria, Belgium, Bulgaria, Croatia, Cyprus, Denmark, Estonia, Finland, France, Germany, Greece, Italy, Latvia, Lithuania, Malta, Poland, Portugal, Slovakia, Slovenia, Sweden	Widely prohibited for auditors
Architecture	Mandatory fee scales in Germany and Malta. Minimum fees in Greece.	Residency required in Belgium, Hungary, Italy and Slovakia	Prohibitions only in Cyprus and Malta	Non-architects only allowed minority ownership share in Belgium, France, Italy, Austria and the Czech Republic. Restrictions on ability to limit liability in Spain and Malta. Other limitations in Luxembourg, Croatia, Hungary and Slovakia	Collaboration limited to engineering or other compatible professions in Czech Republic, Cyprus, Germany, Italy and Spain, Luxembourg or to the exclusion of commercial entrepreneurs, in Austria.
Engineering	No reported restrictions	No reported restrictions	No reported restrictions	Shareholding restrictions in Austria, Spain, Malta and Cyprus. Other limitations in Croatia, Hungary, Italy, Slovakia	Restrictions exist in Austria, Bulgaria, Denmark and Luxembourg
Legal Services	Various Member States maintain guidance only. Some controls on type of fee arrangements more common (e.g. ban on contingency fees)	In Croatia sole practitioners may only have one office. Only one office permitted in Slovenia Address for service may be required in many MS	Czech Republic, Cyprus, Estonia, France, Croatia, Ireland, Lithuania, Luxembourg, Latvia, Malta, Portugal, Romania, Slovakia and Slovenia	Austria, Belgium, Bulgaria, Croatia, Cyprus, Czech Republic, Denmark, Estonia, France, Germany, Greece, Hungary, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, Netherlands, Poland, Portugal, Romania, Slovakia, Slovenia, Spain, UK	All except – Netherlands, Germany, UK, Italy, Spain, Austria, Denmark

Source: OECD, European Commission, ACE, CCBE, FEANI, FEE.

Annex Table 3. Discriminatory Treatment, 2015.

	<i>Nationality Restrictions</i>	<i>Residency Requirements</i>	<i>Legal Form and Foreign Equity Restrictions</i>	<i>Economic Needs Tests</i>
Accountancy/ Audit	Greece, Spain	Austria, Croatia, Denmark, Finland, Italy, Portugal, Slovenia, Spain	Austria and Bulgaria -25% limit, Cyprus - partnerships only, Latvia, Poland and Slovakia not permitted	For accountancy only ENT needed for: Bulgaria, Czech Republic, Denmark, Greece, Finland, France, Hungary, Latvia, Lithuania, Malta, Romania, Slovakia, Cyprus
Architecture	Bulgaria	Bulgaria, Hungary, Italy, Slovakia	Bulgaria	Austria, Belgium, Bulgaria, Czech Republic, Denmark, Spain, Hungary, Italy, Latvia, Romania, Slovakia
Engineering	None	None	None	Belgium, Bulgaria, Czech Republic, Denmark, Spain, Italy, Latvia, Romania, Slovakia
Legal Services	Austria, Belgium, Greece, Croatia, Bulgaria, Cyprus, Estonia, Germany, Hungary, Lithuania, Luxembourg, Malta, Poland, Portugal, Slovakia, Spain	Austria, Belgium, Bulgaria, Cyprus, Estonia, Finland, France, Germany, Hungary, Italy, Latvia, Spain	Austria and Denmark – 10% limit, France and Portugal -25% limit	Belgium, Bulgaria, Czech Republic, Denmark, Finland, Greece, Spain, Hungary, Italy, Latvia, Lithuania, Malta, Romania, Slovakia

Source: Canada-EU Comprehensive Economic and Trade Agreement.

Annex Table 4. Type of NMR regulatory barriers by sector.

Regulatory barriers NMR		
Sector	Type	Barrier
Electricity and Gas	Entry barriers	Entry barriers
	Conduct barriers	Public ownership
		Vertical integration
		Market structure
Telecom and Post	Entry barriers	Entry barriers
	Conduct barriers	Public ownership
		Market structure
Rail, Airline and Road	Entry barriers	Entry barriers
	Conduct barriers	Public ownership
		Vertical integration
		Market structure
		Prices (Post)
Retail	Entry barriers	Licenses or permits
	Conduct barriers	Regulation of large outlet
		Protection of existing firms
		Shop opening hours
		Price controls
		Promotion/discount
Professional services: Accounting, Engineering, Legal and Architectural services	Entry barriers	Exclusive or shared exclusive rights
	Conduct barriers	Education requirements
		Compulsory chamber membership
		Quotas
		Regulations on prices and fees
		Regulations on advertising
		Regulations on the form of business
	Inter-professional co-operation	

Source: OECD and World Bank. See Koske *et al.* (2014) for further details.

Source: OECD and World Bank. See Koske *et al.* (2014) for further details.

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