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The European Internal Market Thirty Years On

SETTING UP THE SINGLE EUROPEAN MARKET

The goal of economic integration constituted the principal focus of the 1957 Treaty of Rome, specifically the establishment of a common internal market, characterized by the freedom of movement of goods, services, and productive factors (labor and capital). In addition to serving as a free trade area and a customs union with a common external tariff, its distinguishing features were its aim of eliminating “technical” barriers arising from national rules for the protection of health, safety, and the environment, and, to a limited extent, of tax barriers as well.

Three features stand out in this regard (Craig 2003). First, integration entails not only the elimination of barriers (“negative” integration) but also the harmonization of legislation that provides protection standards for worthy goals of general interest (“positive” integration) applicable throughout the Single European Market (SEM). Second, the elimination and prevention of barriers also concerns behavior that may distort the level playing field in the SEM after the market opened, i.e., by means of public subsidies and protections granted in the domestic market to national players or anti-competitive actions by national players. These distortions are addressed through competition policy and in particular state aid policy – a policy unique to the European construction that directly constrains the member states. Third, market opening and liberalization do not preclude public intervention to help weaker economies withstand the impact of market opening. Common policies will normally be administered by the Commission – often under Council oversight through specialized Council committees.

Already in the early years of the Economic Community, the Court of Justice of the European Union (ECJ) emerged as a fundamental player in the integration process through its adjudication of cases and “preliminary” rulings on questions raised by national courts regarding the treaty’s interpretation. Its central role in the development of the SEM came to the fore with early decisions establishing the direct effect¹ and the supremacy over national legislation² of Community rules in areas of Community competence. These laid the foundation for landmark decisions such as *Reyners*,³ *Dassonville*,⁴ and *Cassis de Dijon*,⁵ with pa-

¹ Case 26/62, *Van Gend & Loos vs. Administratie der Belastingen* (1963).

² Case 6/64, *Costa vs. Enel* (1964).

³ Case 2/74, *Reyners vs. Belgian State* (1974) recognizing direct effect to freedom of establishment to what is now Article 47 of TFEU.

⁴ Case 8/74, *Procureur du Roi vs. Benoît and Gustave Dassonville* (1974).

⁵ Case 120/78, *Rewe-Zentrale AG vs. Bundesmonopolverwaltung für Branntwein* (1979) establishing the principle of mutual recognition of national rules and thus opening the way to the application of Article 34 TFEU to indistinctly applicable national rules.

ramount consequences for the subsequent evolution of legislation.

The White Paper included proposals for Treaty changes that would simplify and speed up the legislative process. In the ensuing months, an intergovernmental conference swiftly reached an agreement on those proposals, leading to the Single European Act (SEA) that was signed in February 1986. After ratification by member states, it entered into force on July 1, 1987. The SEA provided

KEY MESSAGES

- **Over the past thirty years, the Single European Market (SEM) has made impressive progress, growing to cover the main economic activities – from manufactured goods to all categories of services, network utilities and public services, public procurement, and the recognition of professional qualifications, as well as the market for codified technology, which for long time was lagging behind. An ambitious initiative still underway is aiming to establish a fully-fledged online digital market**
- **Implementation, however, has been wanting in a number of critical areas, notably affecting the realization of the internal market for services. Apparently, the financial crises have impoverished the working classes and seemingly drained the appetite for further market opening. As a result, the growth dividend of integration has been weaker than hoped for**
- **National policies have been insufficiently supportive, if not downright hostile, toward the goal of market integration. As a result, the past ten years have seen little progress in market opening within the Union, even in areas where there would be low-hanging fruit to pick – e.g., the completion of the SEM for natural gas and electricity**
- **A new twist in EU policies has come from NextGenEU, an ambitious and richly funded program (EUR 750 billion to be deployed by 2026) to foster the digital and green transition in the EU. Its emphasis, however, seems to fall on domestic investment rather than cross-border integration**
- **Herein lies a paradox: while the SEM would in itself be a powerful engine for higher growth and better employment prospects, without higher growth it is not likely to find sufficient support among European citizens. This increases the risk that protectionism will return and that the Union will slide into a phase of regression**



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the definition of the SEM as an “area without frontiers in which the free movement of goods, persons, services, and capital is ensured” (now in Article 26(2) of the Treaty on the Functioning of the European Union, TFEU) and introduced (qualified) majority voting in the Council for SEM measures, together with a new cooperation procedure with the European Parliament, which later led to full co-decision under the Maastricht Treaty.

In network industries, the presence of increasing returns and, sometimes, natural monopoly market structures inevitably pushed SEM initiatives beyond market opening into the domain of regulation to ensure open access by competitors and a level playing field in the provision of services to final users. Network services were normally also services of general interest; Article 86 TEC⁶ (now 106 TFEU) provided the flexible framework required to ensure that free movement and competition rules would apply to these services without compromising their specific mission (European Commission 2000b). The tensions with some member states on the delicate balance between national social preferences and SEM rules led, with the Amsterdam and Nice Treaties, to a new provision – now Article 14 of the Treaty on the European Union – reaffirming the special role of services of general interest in the “shared values of the Union.”

Two main market opening initiatives in the new millennium concerned services in general and financial services specifically. The first one was prompted by a Commission Report on The State of the Internal Market for Services (European Commission 2002), which thoroughly described the sorry state of integration in this sector, the main legal barriers, and their impact on the economy – notably on small and medium-sized enterprises (SMEs) and consumers. The Services Directive,⁷ approved by Council and Parliament in 2006, provided an adequate legislative response but implementation has been lagging.

The second initiative is a decade-long attempt to integrate financial markets and set up a supranational regulatory structure for financial services, in response to repeated bouts of financial instability. Two reports – one prepared at the beginning of the 2000s under the chairmanship of Alexandre Lamfalussy (leading to the so-called Financial Services Action Plan, to be completed by 2005), the other by Jacques de Larosière at the end of the same decade – mapped out comprehensive interventions for removing remaining restrictions to securities markets and creating a new regulatory and governance system for financial services capable of avoiding a repeat of the dramatic financial crisis of 2008–09. This eventually led to the establishment of three Financial Services Authorities (ESMA, EBA, and EIOPA), which did not, however, gain direct supervisory powers over their activity domain. The euro area sovereign debt and banking crisis at the beginning of the 2010s convinced governments and regulators to

raise the stakes and go for a full Banking Union (with the transfer of banking supervision to the ECB and the creation of a new resolution procedure for banks in crisis, but not yet the cross-border deposit insurance) and Capital Markets Union (as yet at an early stage of design due to lack of political support).

Finally, in recent years, a comprehensive initiative has aimed to establish a Digital Single Market to allow the Union to exploit the full economic potential of ICT technologies (European Commission 2015a). The initiative covers a broad range of themes and activities, organized around three pillars: i) consumer and business access to online markets across the Union, ii) the legal and competitive environment, and iii) secure and trustworthy infrastructures.

AN INNOVATIVE REGULATORY MODEL

The SEM is built on an innovative regulatory model that aims to open the markets of member states to free movement while respecting, as much as possible, the diversity of national institutions and regulatory approaches. This approach was built on the landmark *Cassis de Dijon* decision by the ECJ (1978), which established the principle of mutual recognition of national rules. With one stroke, a myriad of technical barriers to free movement of goods were made illegal, thus relieving the European Commission of the task of seeking new legislation to bring them down. The decision was followed by other decisions refining the principle and extending its application to services and to persons seeking to move to another member state to reside and work.

The other building block was a more flexible legal basis provided by the SEA with new Article 100a TEEC (now Article 114 TFEU). Under this legal basis, harmonization was based on majority voting to achieve three main goals:

1. Substantive legislation to harmonize safety, health, and consumer protection legislation by laying down essential health and safety requirements, together with European standardization to offer an optional means of compliance, with harmonized requirements providing a presumption of conformity with EU law;
2. Procedurally oriented legislation to improve transparency of information on national technical standards and regulations and, later on, for public procurement;
3. Extension of mutual recognition by legislation, notably in the recognition of professional qualifications and the services directive.

The combination of the principle of mutual recognition with the three pillars of legislative activity mentioned above brings about a radical shift in economic philosophy: market opening is placed at the center of economic policies not only to foster growth, but also to improve

⁶ Treaty Establishing the European Community.

⁷ Directive 2006/123/EC.

the welfare of citizens (Barnard 2013; Weiler 1999). Majority voting means that governments may, sometimes, be obligated to accept substantial departures from their national policies and regulatory traditions. Common policies have been sensitive to member states' and citizens' concerns, and have developed their tools so as to strike an acceptable balance between the Community goal of free movement and national preferences in shaping protections.

THE ECONOMIC IMPACT OF THE SINGLE EUROPEAN MARKET

Over thirty years have elapsed since the enactment of the SEA, which brought about a jump in integration in the EU through the creation of the SEM. The creation of the euro added a powerful integration factor. And yet, the performance of the EU economy has been far from satisfactory, and the legacy of the economic and financial crises of the past decade still looms large.

Of course, the SEM policies cannot be held responsible for all that does not work in the European economy, nor could they claim all the credit for what has worked well in economic integration. The creation of the SEM was expected to bring about distinct economic benefits on a number of fronts, including cost reductions through the elimination of border tariffs and regulatory barriers; economies of scale, as companies restructured and merged to exploit the larger market size and optimize their cross-border productive structure and logistics; efficiency increases due to stiffer competition; increased labor and capital mobility for cross-border direct investment; and lower financial transaction costs as a result of the liberalization of capital flows and greater financial integration, possibly with an increased role played by capital markets in the direct financing of business (equity and bonds). The euro was expected to boost the beneficial effects on all these fronts, thanks to full price transparency.

While there has been progress on all these fronts, the attendant benefits seem to have been less than hoped for and, moreover, to have affected countries, regions, and activities quite diversely.

The economic literature generally agrees that the SEM has had a positive effect on its members' economies, although there is wide disagreement on quantification. Strong positive effects are evident in intra-EU trade in goods (Eichengreen and Boltho 2008), which between 1992 and 2012 increased from 12 to 22 percent of GDP. It has been estimated that since 1960, exports and imports within the Union have climbed to a level 8 percent higher than they would have without the SEM (Straathof et al. 2008). Fournier et al. (2015) estimated the overall impact of accession to the European Economic Area to be roughly a 60-percent increase in trade intensity. However, they also find that regulatory restrictions and regulatory heterogeneity still represent an important impediment to trade.

The numbers are much smaller for trade in services, which represents about 6 percent of Union GDP, but has shown steady increases in recent years with little adverse impact from the twin crises of the past decade. Business services have been one of the most dynamic components.

In the 2000s, intra-EU trade between EU15 countries remained unchanged at around 20 percent of GDP, while strong increases were observed for the incoming EU13 countries. In recent years, the latter countries thus account for much of the trade creation in the SEM (European Commission 2015b).

The degree of integration is normally gauged by the observed degree of convergence of prices and productivity. The aggregate price level convergence slowly improved through the 1990s and the 2000s until the financial crisis; afterward, it stabilized in the euro area and even went into reverse in the EU28, probably reflecting exchange rate adjustments between the euro and non-euro currencies. However, price dispersion remains well above that observed for the United States and Canada – confirming once again that integration in the SEM is still far from fulfilling its potential.

Productivity, on the other hand, did not converge at all, and in fact showed growing divergences within industries and across countries, especially within the euro area. The rise in the relative price of manufactured products in higher-inflation countries encouraged a shift in the allocation of resources toward services and construction, typically characterized by lower productivity.

The Cecchini Report (Cecchini et al. 1988) held the promise that the removal of border controls, the liberalization of public procurement and financial services, and the supply effects deriving from market responses to the new competitive environment would raise EU12 GDP by between 4.25 and 6.5 percent and create two million jobs. Most subsequent analyses have concluded that the actual outcome was considerably smaller, around 2 percent (Vetter 2013; Ilzkovitz et al. 2007), but higher estimates have not been absent. Most notably, Eichengreen and Boltho (2008) gauged that European integration has added at least 5 percent of extra GDP growth, although they recognize that much trade opening would probably have happened anyway.

POLICY CONCLUSIONS

Over the past thirty years, the SEM has made impressive progress, growing to cover the main economic activities – from manufactured goods to all categories of services, network utilities and public services, public procurement, and the recognition of professional qualifications, as well as the market for codified technology, which for long time was lagging behind. An ambitious initiative still underway is aiming to establish a fully-fledged online digital market.

Implementation, however, has been wanting in a number of critical areas, notably affecting the realiza-

tion of the internal market for services. Globalization, technological change, and the financial crises have impoverished the working classes and seemingly drained the appetite for further market opening. All too often, national policies have been insufficiently supportive, if not downright hostile, toward the goal of market integration. As a result, the past ten years have seen little progress in market opening within the Union, even in areas where there would be low-hanging fruit to pick – e.g., the completion of the SEM for natural gas and electricity.

A new twist in EU policies has come from NextGenEU, an ambitious and richly funded program (EUR 750 billion to be deployed by 2026) to foster the digital and green transition in the EU. Its emphasis, however, seems to fall on domestic investment rather than cross-border integration.

Herein lies a paradox: while the SEM would in itself be a powerful engine for higher growth and better employment prospects, without higher growth it is not likely to find sufficient support among European citizens. This increases the risk that protectionism will return and that the Union will slide into a phase of regression.

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