

## WHAT BENEFITS FROM COMPLETING THE SINGLE MARKET?

*European integration is endangered by rising fears of sovereign default. Against this background, assessing the economic impacts attached to the Single Market is crucial to measuring the overall benefits provided by the European Union to its citizens. Over the last thirty years, substantial progress has been achieved to better integrate the markets of the member states. New evidence on barriers to trade in services and on non-tariffs obstacle to trade in goods confirms however that this process is far from being complete. Our economic simulation using the MIRAGE model concludes that the elimination of all remaining obstacles to trade would benefit the European Union by an order of magnitude two to three times larger than those already reaped so far. The complete elimination of obstacles to trade across the Single Market is indeed a stylised and unrealistic assumption. However, the magnitude of the potential gains is such that the study confirms undoubtedly the potential of the Single Market as one avenue to boost EU growth in the years to come and to escape from a vicious circle of recession.*

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### ■ The Single Market at the heart of the European project

Since the Treaty of Rome in 1957, economic integration has represented one of the core objectives of the European Economic Community and later the European Union (EU). In the mid-1980s, a lack of progress led the Community to consider a more thorough approach to the objective of removing trade barriers. This resulted in the Single Market Programme set out in the celebrated Commission White Paper of June 1985 and incorporated in the European Treaty by the 1986 Single European Act. Completed on the 1<sup>st</sup> January 1992, the Single Market Programme aimed at removing the remaining obstacles to trade inside the EU in order to foster economic growth through the creation of a large integrated market for goods and services.

Despite all the progress to date, the Single Market remains an unfinished project. This is the main reason why in October 2009, the European Commission President, Jose Manuel Barroso, asked Professor Mario Monti, now in the drive seat of the Italian economy, to prepare a report on the re-launch of the Single Market. Published on the 9<sup>th</sup> of May 2010, this report made a number of far-reaching

recommendations. The report argued strongly that a response is required to the perception by the business community that *de facto* trade integration lags far behind *de jure* integration.

This led to the adoption in April 2011 of the 'Single Market Act' setting out a proposal for twelve priority actions aimed at stimulating growth and restoring confidence in the benefits of market integration in Europe. This initiative has been somehow downplayed by the current crisis and deserves reserved consideration.

### ■ An unfinished agenda

Among the studies published just after the implementation date of the 1992 Single Market programme, the work by Harrison *et al.* (1994) is probably the most advanced. Based on a general equilibrium model with imperfect competition, the authors estimated a gain for the EU of 2.6% of GDP thanks to the Single Market.<sup>1</sup>

1. G. Harrison, T. Rutherford & D. Tarr (1994) "Product Standards, Imperfect Competition, and Completion of the Market in the European Union", World Bank Policy Research Paper No 1293.

However, all studies of that period worked without any reliable information regarding the real level of obstacles to trade across Europe and by sector. Therefore, like most studies of that period, Harrison *et al.* (1994) assumed a unique ad-valorem obstacle to trade of 2.5% across the board (equal in all sectors). Such figure would hardly match the perception of much higher intra-EU trade obstacles by the business community. Economists have recently gathered evidence that this is indeed a large underestimation of the real level of obstacles to trade, even within the goods sector. Intra-EU trade for manufacturing good is around 70% below intra-US states as a percentage of GDP<sup>2</sup> despite the fact that the EU population is much more concentrated (roughly twice the population on a territory half the size the US). Besides, ex post studies commissioned by the EU proved that completion of the Single Market did not induce the kind of effects predicted by trade theories featuring economies of scale in the production of horizontally differentiated varieties.<sup>3</sup>

When taking into account language and geographic factors, trade in goods across European borders is found to be 4.2 lower than what would prevail if the EU were as economically integrated as the US.<sup>4</sup> It means that Europeans consumers and businesses purchase 4.2 times more from domestic producers than from equidistant foreign producers. The fact that trade across countries is lower than trade within countries, the so-called “border effect”, stems from various and complex factors like non-tariff measures, business, social and distribution networks, consumption habits and differences in regulation. There is therefore a fundamental difference between tariff and border effect: while a tariff can be entirely phased out, this is not the case for the border effect. Still, between the late 1970s and the late 1990s, this “border effect” has decreased by a third in Europe.<sup>5</sup> It illustrates that progress has been substantial in Europe over time, but also that a great margin of progress remains available.

## ■ What specific gains from the integration in the services sector?

Apart from the loose measurement of the obstacles to trade across the Single Market, the main limitation of early 1990’s studies is that they did not consider any liberalisation in the services sector. The lack of economic tools and the lack of data prevented any serious analysis in this area. It means that until very recently the economic potential attached to a sector representing the largest part of the economy

remained absent from economic studies of the Single Market. It is only with the recent development of good quality services trade statistics and of estimates of trade obstacles in services that economic assessments have started to be available.

One prominent work in this area is the Copenhagen Economics study (2005), which assesses the effects of an important piece of EU law, the Services Directive.<sup>6</sup> An important feature is the reliance of the Copenhagen Economic study on “trade-restrictiveness indexes” to measure obstacle to trade in services. This methodology presents the advantage to allow disentangling the different types of obstacles to trade, and therefore to allow reproducing a very detailed policy scenario. This may be at the price of underestimating the absolute level of obstacle to trade as revealed by more accurate measures of the effective distortion of trade flows (“gravity estimates” methodology).<sup>7</sup>

Another prominent work by Kox and Lejour (2005, 2006) uses a “gravity estimates” methodology but focused exclusively on one type of extra-costs for businesses: the market-entry costs linked to the necessity to comply with a different set of regulations each time a firm wants to expand to a different EU market.<sup>8</sup> They estimated the extent to which the Services Directive would reduce this heterogeneity in domestic regulations. The reduction of the regulatory divergence across Europe promoted by the Services Directive is shown to boost trade in commercial services by 30 to 62 percent. For their part, intra-EU direct investments in services could increase by 18 to 36 percent, and up to 130 percent if the heterogeneity in regulations is completely eliminated. The macro-economic consequences are estimated by De Bruijn *et al.* (2006) by incorporating the trade impacts (not the FDI effects) into the general equilibrium model Worldscan.<sup>9</sup> The estimated effects in terms of national income are modest, in the range of 0.3 to 0.7 percent of EU national income for the Services Directive scenarios. Like the Copenhagen Economics study, Kox and Lejour focus on a specific range of service sectors and on a partial liberalisation exercise to replicate the effects of the Services Directive.

## ■ What economic benefits of the existing Single Market?

Two recent works assess the economic gains attached to the integration in Europe toward the objective of a single market. Unlike previous studies, they cover goods, services and investment.

2. F. Ilzkovitz, A. Dierx, V. Kovacs & N. Sousa (2007), “Steps towards a deeper economic integration: the Internal Market in the 21st century. A contribution to the Single Market Review”, Ecfm Economic Paper No 271.

3. L. Fontagné, M. Freudenberg & N. Péridy (1997) “Trade Patterns inside the Single Market”, CEPR Discussion paper, 1959.

4. K. Head & T. Mayer (2002), “Non-Europe: The Magnitude and Causes of Market Fragmentation in the EU”, *Review of World Economics*, 2(136): 285-314.

5. L. Fontagné, T. Mayer & S. Zignago (2005) “Trade in the Triad: How Easy is the Access to Large Markets?”, *Canadian Journal of Economics*, 38(4): 1401-1430.

6. Copenhagen Economics (2005) “Economic Assessment of the Barriers to the Internal Market in Services”, commissioned by the European Commission, 92 p. The Services Directive covers about 40% of the services sector. Note also that the Copenhagen study evaluates the likely impact of the draft legislation proposed by the European Commission, not the legislation as finally adopted by the European Parliament and Member States.

7. For a detailed discussion of the merits of the two methodologies, see J. Francois & B. Hoekman (2009), “Services Trade and Policy”, *Economics Working Papers* 2009-03, Department of Economics, Johannes Kepler University Linz, Austria.

8. H. Kox & A. Lejour (2005), “Regulatory heterogeneity as obstacle for international services trade”, CPB Discussion Paper No 49, 46 p. H. Kox & A. Lejour (2006), “The Effect of the Services Directive on intra-EU trade and FDI”, *Revue Économique*, 57 (4): 747-769.

9. R. de Bruijn, H. Kox & A. Lejour (2006) “The trade-induced effects of the Services Directive and the country-of-origin principle”, *Working Paper* 44, ENEPRI, Brussels.

They specifically look backward at the level of integration already achieved, instead of trying to anticipate the effects of recent policy initiatives like the Services Directive or of future ones.

By specifically considering aspects like specialisation of countries, diversification of products, and innovation, Eichengreen and Boltho (2008) conclude that economic integration in Europe may have raised EU GDP by 5%, as a lower bound estimate.<sup>10</sup> This is similar to a recent report by the European Commission that estimated that the Single Market has increased EU GDP by 4.8% to 5.7% since 1987.<sup>11</sup> This does not take into account the effect of the suppression of tariffs across Europe which took place well before that year.

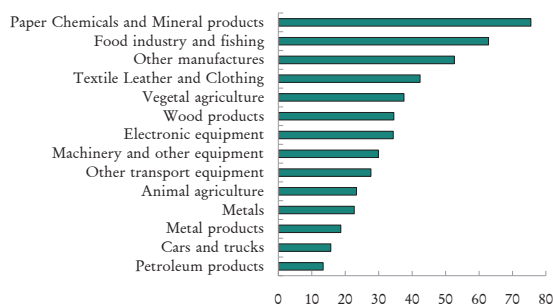
For their part, Straathof *et al.* (2008) points to income gains of 3% for the EU as whole, and up to 10% in the very long-term.<sup>12</sup> Their lower short term assessment can be explained by the fact that the study pays a specific attention to the potential diversion of trade induced by Single Market.

According to Richard Baldwin's domino theory though, this diversion effect should be weighed against the positive effect of further EU integration, both on EU's neighbours and at a global level.<sup>13</sup> It is therefore difficult to define the right counterfactual against which to measure the net trade creation and diversion effects of the Single Market. Such counterfactual is crucial in measuring correctly the gains attached to the level of integration currently achieved. Arguably, its effects cannot simply be measured by comparing trade of EU members and non-members in a context which is itself directly influenced by the European integration process. Such an assumption may lead to an underestimation of the Single Market effects on trade and national income. In sum, the real effect of the Single Market is probably closer to the upper bound than to the lower bound of Straathof *et al.* (2008) estimates.

## ■ An assessment of the remaining trade barriers within the European Union

Kee *et al.* (2009) assess the size of non-tariff obstacles to trade by measuring the variation of the intensity of international trade across a panel of countries.<sup>14</sup> We complement this work by differentiating between intra-EU and extra-EU regulatory discrimination against foreign competition using the estimations of border effects by De Sousa *et al.* (2010) to obtain a bilateral measure of non tariff barriers for each European country (Figure 1).<sup>15</sup>

Figure 1 – Average tariff equivalents of obstacles to trade in goods within the EU

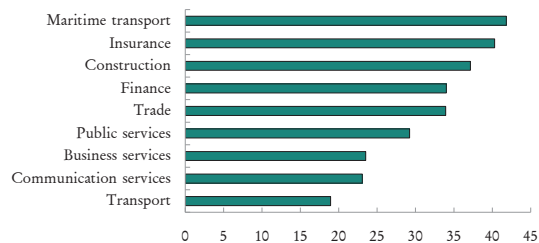


Source: Author's calculation based on Kee *et al.* 2009 and De Sousa *et al.* 2010.

Taking into account this correction, non-tariff obstacles to trade in goods are shown to amount in average to 45.0% of the value of production in Europe for those sectors for which there is data, and to 13.4% in average when assuming that sectors with missing values have no obstacles to trade. The value of 2.5% covering tariffs and non-tariff barriers to trade in goods used in the economic simulations in the 90s is therefore well below the reality of the segmentation of the Single Market.

Fontagné *et al.* (2011) propose a new set of estimates of the barriers to trade in services, focusing on cross border trade (*i.e.* not considering investments and temporary movement of persons).<sup>16</sup> This work specifically addresses the systematic bias in the estimates due to the misspecification problem frequent in previous studies, leading to an underestimation of the actual level of trade barriers (Figure 2).

Figure 2 – Average tariff equivalents of obstacles to trade in services within the EU



Source: Author's calculation based on Fontagné *et al.* (2011).

## ■ What potential benefits of further deepening the Single Market?<sup>17</sup>

The limination of all remaining obstacles to trade across Europe can be simulated using the MIRAGE dynamic computable general equilibrium model developed by the CEPII (Decreux & Valin, 2007) and the new databases on obstacles to trade as described above.<sup>18</sup>

10. A. Boltho & B. Eichengreen (2008), "The Economic Impact of European Integration", CEPR Discussion Paper No 6820.

11. European Commission (2010), "Quantifying the potential macroeconomic impact of the Single Market", Note for the LIME working group, Nov.

12. B. Straathof, G.-J. Linders, A. Lejour & J. Möhlmann (2008), "The Internal Market and the Dutch Economy", CPB Document No 168, 90 p.

13. See for instance R. Baldwin (2006), "Multilateralising Regionalism: Spaghetti Bowls as Building Blocs on the Path to Global Free Trade", *NBER Working Papers* No 12545.

14. H. L. Kee, A. Nicita & M. Olarreaga (2008), "Estimating Trade Restrictiveness Indices", *Economic Journal*, 119(534):172-199.

15. J. De Sousa, T. Mayer & S. Zignago (2010), "Market access in global and regional trade", Mimeo.

16. L. Fontagné, A. Guillin & C. Mitaritonna (2011), "Estimation of Tariff Equivalent for the service sectors", Document de travail 2011-23 CEPII.

17. Further details on the results presented in this section can be found in V. Aussilloux, H. Guimbard, C. Emlinger & L. Fontagné (2011), "The economic consequences for the UK and the EU of completing the Single Market", BIS Economic Paper No 11, February.

18. Y. Decreux & H. Valin (2007), "MIRAGE, Updated Version of the Model for Trade Policy Analysis: Focus on Agriculture and Dynamics", *CEPII Working Paper*, No 2007-15.

The estimates of an extreme and stylised scenario of a complete elimination of all remaining barriers to trade inside the European Union point to very strong positive benefits for all EU member states. After 10 years of implementation of a programme based on removal of all barriers, hence taking into account some of the dynamic gains of economic integration, the European Union's national income could be 14% higher than under a no-change scenario (Table 1). Intra-EU trade would almost double over the period, roughly halving the gap in the intensity of intra-zone trade that currently prevails with the US.

Table 1 – Effect of full integration:  
Change in national income in 2020 by area (%)

Total EU27		14.1
	Benelux	25.3
	France	11.6
	Germany	11.5
	Italy	13.6
	Poland	10.8
	Spain	9.5
	Sweden	10.2
	UK	7.1
	Rest of EU27	27.9

Source: V. Aussilloux, C. Emlinger, H. Guimbard & L. Fontagné (2011).

European Union's benefits linked to the full completion of the Single Market are found significantly greater than in previous studies. These gains are mostly due to modelling a very ambitious scenario which assumes the complete elimination of obstacles to trade across the Single Market, and to a most accurate measurement of obstacles to trade in goods and in services, particularly non-tariff barriers. Such figures do not describe the actual outcome of the Monti proposal, but they characterize its ambition.

In interpreting the reality of these gains, one has to keep in mind a number of caveats. Some limitations of the statistics and the tools used tend to overestimate the gains, some others do the reverse. Reaching the limits of economic analysis in this field, it is difficult to weigh precisely upward against downward factors.

On the downside, the most controversial point is linked to the way behind-the-border obstacles to trade in goods and services are factored in the model. They are assumed to represent deadweight losses for businesses (costs of compliance with

Table 2 – Effect of full integration:  
Change in value added by sector in 2020 (%)

	Agrifood	Manufacturing	Services
Benelux	75.3	81.0	46.6
France	23.1	19.6	23.5
Germany	7.2	21.8	22.3
Italy	15.1	18.2	24.4
Poland	28.9	18.3	21.7
Spain	22.0	10.4	21.6
Sweden	-1.3	20.7	24.1
UK	-2.8	6.2	19.1
Rest of EU27	18.6	52.2	41.3

Source: V. Aussilloux, C. Emlinger, H. Guimbard & L. Fontagné (2011).

stringent and overly cumbersome discriminatory regulations). Therefore, the elimination of their discriminatory bias assumed in this study translates into important social benefits for the economy. In the present study, they amount to half of the total gains that European economies would reap from the elimination of obstacles to trade. Arguably, discriminatory regulations also create large rents for domestic incumbents. It means that their elimination will lead to a redistribution of income between producers and consumers, and among companies. The experiences of the opening up of the telecom and air transport markets in Europe in the recent past show clearly however that the gains in terms of price reduction, increase in innovation, and increase in the size of the market generally far outweigh the losses in rents incurred by incumbent firms.

The complete elimination of obstacles to trade across the Single Market is a stylised and probably an unrealistic scenario. However, the magnitude of the gains is such that our main conclusion stands robustly: any significant improvement in the Single Market, even much less radical than the one considered here, has the potential to change substantially EU growth path for the years to come. This would be a welcome contribution to solving the challenges European policy makers are currently confronted to.

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