CEPS POLICY BRIEF
Thinking ahead for Europe

Unleashing Competition in EU Business Services

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In most EU member states, the business services industry has booked no productivity growth during the last two decades. The industry's performance in the other member states was weaker than that of its US counterparts. Exploring what may be causing this productivity stagnation, this policy brief reports that weak competition has contributed to the continuing malaise in European business services. The study analyzed the persistence (over time) of firm-level inefficiencies. The evidence further suggests that competition between small firms and large firms in business services is weak. Markets for business services work best in countries with flexible regulation on employment change and with low regulatory costs for firms that start up or close down a business. Countries that are more open to foreign competition perform better in terms of competitive selection and productivity.

'Business services' is a catchword for a heterogeneous group of services industries. It includes not only professional services (accountancy, legal, engineering, marketing, tax and management consultancy, architects), but also IT, software services, technical testing, contract research, labour search services (temporary work, headhunting), industrial cleaning and security services. Business services are mainly used as inputs by other firms.

The policy simulations in this paper show that greater import openness strengthens competition in business services markets. The largest positive impact comes from lower regulatory barriers for growing and shrinking firms. More particularly, competitive selection would be fostered by a reduction of administrative and regulatory costs related to labour contracts, bankruptcy and start-up requirements.

A key element of the European Commission's Europe-2020 strategy is the Single European Market for Services. Business services form one of the largest industries in Europe – and given its productivity stagnation, it deserves to be a priority target of the Europe-2020 strategy. Improving the way the business services market functions may have large positive knock-on effects for the EU economy.

1. Houston, we have a problem!

Business services have seen impressive employment growth since the early 1990s, and the industry nowadays accounts for 10-20% of total employment. In some countries, business services employ more people than manufacturing does. About half of the business services industry has a knowledge-intensive profile. It makes significant contributions to innovation and to the dissemination of 'best-practice' knowledge across industries and firms.

Be that as it may, the business services industry in most EU countries has had zero productivity growth since 1980. Knowledge-intensive business services have fared no better than the rest.[1] Table 1 shows that the contribution of business services to productivity growth of the economy as a whole

[1] Rubalcaba & Kox (2007: 81).

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was zero (or even negative) for a representative group of countries – despite the fact that the business services industry accounts for one-eighth to one-fifth of total production in these countries. Of the EU countries, only the UK performed reasonably well; elsewhere, the results were disappointing.[2] The poor productivity performance of business services throughout Europe appeared to explain a major part of the EU's productivity gap with the US. Timmer et al. (2011) show that between 1995 and 2005 business services contributed +0.7% annually to productivity growth in US commercial services and −0.1% annually in the European Union.[3]

Table 1. EU business services: Hardly contributed to aggregate productivity growth, 1992-2005

Country	1992-1997	1997-2005
	% points per year	
United States	0.1	0.7
France	0.0	−0.1
Germany	−0.2	−0.2
The Netherlands	0.0	0.1
United Kingdom	0.6	0.5

Source: Antipa & de la Serve (2010).

Some disbelieving people have offered the suggestion that measurement errors explain the productivity stagnation in business services. However, the methodology of measuring productivity growth hardly differs between the countries in Table 1, and there is no hard evidence that different ways of measurement could explain the differences in country performance.[4] Hence, the stagnation must have other causes. Two recent studies conclude that most of the productivity gap between the European business services industry and its US counterpart is explained by the total factor productivity, often related to the functioning of markets and the institutional environment.[5] Our findings support this diagnosis.

2. How to detect malfunctioning markets?

Weak productivity performance by firms may have several causes, varying from reasons that are specific to a particular firm to factors that are embedded in the structure of markets. Management may make faulty choices: buying bad inputs, employing the wrong workers, making products that they had better left to others, miscalculating consumer demand. These things happen all the time, but they cannot explain why a complete industry with more than 15 million workers in the EU has been experiencing stagnation in productivity for the past two decades.

Is something wrong with business services markets across Europe? What would have happened if business services markets had experienced full competition? In an industry with homogeneous products and strong competitive interaction, firms with weak productivity and high costs would have been punished by a lower market share and low profits. Conversely, efficient firms would have grown much faster than others, and thus have ended up with a greater weight in this industry. Such market selection ensures that firms cannot be careless about their efficiency performance.[6] As a first diagnostic tool, we compare the actual developments in the business services markets with a hypothetical situation in which markets would have perfect selection.

In many industries, setting up production involves certain necessary fixed-cost expenditures – for offices, computer networks, hiring of personnel with specialised knowledge, setting up research capacity or outlay for sales campaigns. In firms with few employees and small sales, these fixed costs weigh more heavily per unit sold. Consequently, contrary to common belief, the smallest firms tend to be the most capital-intensive firms in terms of fixed production costs per worker. Figure 1 shows this to be true also for European business services. A large firm that sells more products will more quickly recover its fixed-cost investments than will a small firm. Size-

[2] Since 2005, the productivity growth in business services has further deteriorated in several countries. In the Netherlands this was −0.7% annually during the period 2006-09 (see Antony et al., 2012).

[3] See similar results in Antipa & de la Serve (2010), O'Mahony et al. (2010) and O'Mahony & van Ark (2003).

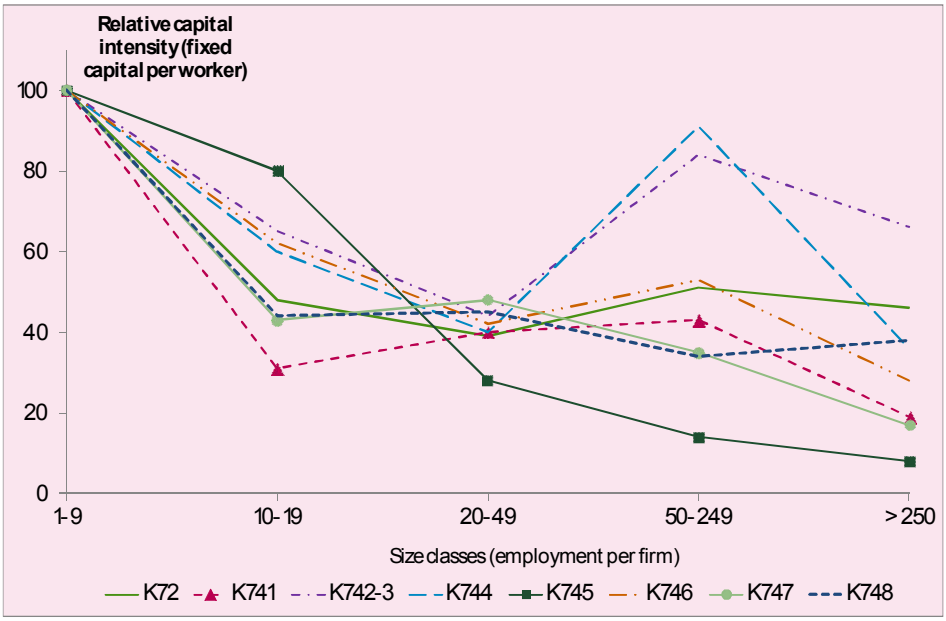
[4] On measurement issues, see further Pilat (2007) and Inklaar et al. (2008).

[5] While labour productivity measures how efficiently labour inputs have been used by firms, total factor productivity can measure the use-efficiency of all production inputs in a wider sense; see Antipa & de la Serve (2010) and Timmer et al. (2011).

[6] The background study (Kox & van Leeuwen, 2012) demonstrates that this mechanism also works in markets where firms produce differentiated product varieties.

related efficiency differences thus form a competitive advantage. Per unit sold, the large firm has less fixed costs and makes more profit. If all firms compete with each other, such size advantages should be attractive to all of them, thus forming an incentive to grow.

Figure 1. Smallest firms invest the most capital per worker, 2005



Note: Smallest size class = 100. The graph gives industry averages for 13 EU countries.

Industry legend: K72: IT and computer services; K741: Accountancy, legal, administrative and consultancy services; K742_3 Architectural and engineering services; K744: Marketing services; K745: Labour recruitment services; K746: Industrial cleaning; K747: Security services; K748: Miscellaneous business services.

Of course, the sky is not the limit with respect to scale advantages. Beyond some size threshold, cost disadvantages occur due to internal bureaucracy, diminished flexibility or to problems with motivating and monitoring employees. Mammoths are seldom the most efficient firms. The same holds for the smallest firms: not only are they relatively capital-intensive, but they have also few benefits of labour specialisation. Their managers constantly have to switch between all kinds of tasks.[7] Which size class is optimal differs by industry. In a competitive market we expect that all firms try to achieve the optimal size, either by growing or by shrinking. Inefficient small or large firms would 'automatically' lose market share, have lower profits or go broke. Thus, after some adaptation period, only firms of optimal size would be left standing.

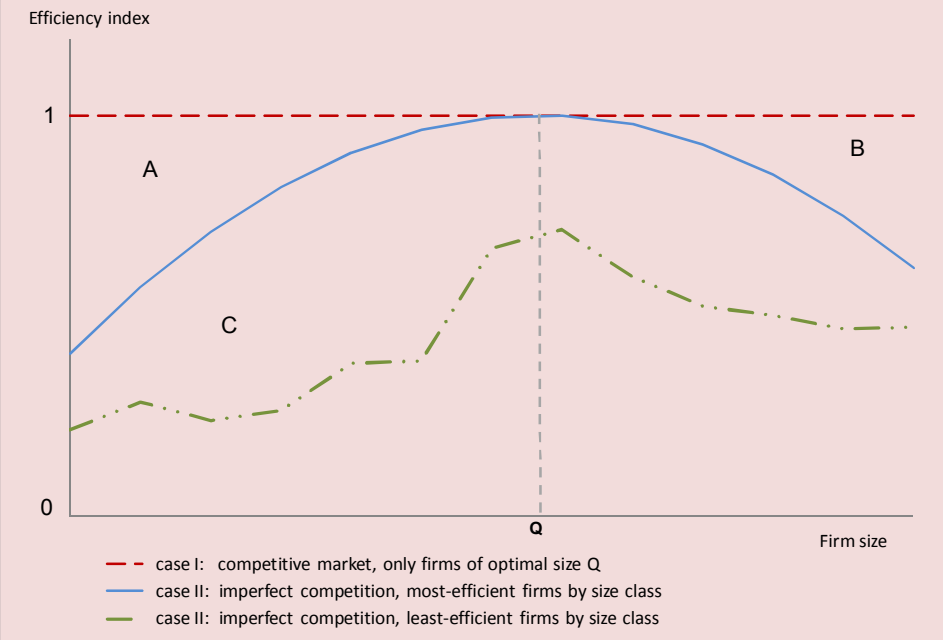
The framework for assessing the effectiveness of market selection has two elements. First, it distinguishes firms by size class and ranks firms within a particular size class by their efficiency. This is called X-efficiency. Second, it compares the best-performing firms in each size class with the best-performing firms in the most-efficient size class. The latter is called scale efficiency; it measures efficiency differences that are scale-related. Taken together, our approach measures what happens with efficiency performance within a size class and between different size classes. This provides an indication of competitive interaction.

Figure 2 shows a snapshot of a possible result at a given moment. It compares two cases. Case I is our benchmark; it is a fictitious situation in which the market is fully competitive. All firms have attained optimal size Q and other firms have disappeared. The efficiency of the optimal-sized firms Q is represented by the red dashed line.[8] Case II comes closer to the actual situation in the market: not all firms have achieved optimal firm size. Here, one finds firms of all size classes, larger and smaller than Q. The solid blue line describes the efficiency of the best-performing firms in each size class.

[7] Small firms can apply less internal division of labour and their employees are more involved in multi-tasking. This comes with some productivity disadvantages as shown earlier by Adam Smith, and more recently by Coviello et al. (2010).

[8] The efficiency index is based on the average costs of optimum-sized firms; it includes variable and fixed costs.

Figure 2. Framework for analysing firm size, productivity and market selection



The picture shows that even the best-performing firms in the smallest and largest size classes do worse than those in the most-efficient size class. The worst-performing firms in each size class are depicted by the green dot-dashed line. All firms operate between the solid blue line and the green dot-dashed line. Figure 2 allows us to distinguish three deficiencies in competitive market selection:

- Region **A** reflects market obstacles (such as commercial set-up costs, or regulatory entry barriers) that impede firms growing towards size Q. There may also be post-entry growth barriers (such as administrative burdens, tax obligations or labour laws) that contain size-specific hurdles.
- Region **B** reflects obstacles that make shrinking to size Q less attractive. Such exit or shrinking barriers may stem from labour laws, bankruptcy laws or the tax system. The market power of the large firms could also diminish their need to operate at optimal size.
- Area **C** covers all forms of competitive weakness that allow sub-frontier firms to survive in shallow or non-transparent markets with weak competitive interaction (location in rural areas, no import competition, product niche markets). Product-market regulation that protects inefficient incumbent firms against new entrants may be another reason.

Regions **A** and **B** of the graph have a clear relation to firm size; they are called scale-inefficiency. The remaining inefficiencies have no clear relation to firm size; they are called X-inefficiency (depicted by area **C**). In a perfectly selecting market, the inefficiency areas **A**, **B** and **C** should become smaller over time. If that does not happen, and inefficiencies appear to be persistent over time, then extra policy attention will be necessary. This warning device will now be applied to European business services.

3. EU business services: Weak competition

When asked to name a typical business service firm, many people will probably mention large firms such as PriceWaterhouseCoopers, Ernst & Young or KPMG in accountancy, consultancy firms like McKinsey or software giants like SAP and Microsoft. These large firms, however, are the exception rather than the rule. Business services are overwhelmingly dominated by small firms: 93% of all firms in the 13 EU countries have fewer than 10 employees. The typical small firm has a local network of clients, often based on personal contacts. Very few of them export to other countries.

Table 2 shows which size class uses the smallest amount of labour and capital to produce one euro

of value added.[9] The group of firms with 50-249 employees forms the most efficient size class (like the Q in Figure 2). That size is much larger than the size of the average business services firm in the EU, which only employs 5.6 people. Table 2 shows that firms with 1-9 employees have a scale-efficiency score of only 0.48, which is more than 50% lower than the most-efficient size class. If the large mass of small firms with such low-scale efficiency can survive, this hints at weak competitive interaction between size classes. The table shows also that if the smallest firms would grow only one size class bigger (10-19 employees), their scale-efficiency gap with the most-efficient size class would almost evaporate.

Table 2. Scale efficiency and X-efficiency differ strongly between size classes

Size class of firm (no. of persons employed)	Scale efficiency between size classes (optimal size = 1)	Average X-efficiency within size class [a] (best practice = 1)
1–9	0.48	0.92
10–19	0.93	0.61
20–49	0.97	0.62
50–249 (most efficient)	0.99 [b]	0.67
250+	0.98	0.81

Note: The table provides the average scores per size class for 13 EU countries and eight sectors of business services over the period 1999-2005.

[a] Shows the average gap with the frontier firms of the same size class.

[b] The most productive size class scores 0.99 rather than 1.00 – due to averaging across industries, countries and years.

The last column of Table 2 shows the efficiency gaps between firms within each size class (corresponding with area **C** in Figure 2). For three size classes, the average score is just about 0.60. This says that firms within these size classes are on average almost 40% less efficient than the best-performing firms in their own size class. Such a result hints at poor competitive selection. Finally, the last column also holds a 'big surprise': the X-inefficiency for the smallest firms is only 8%. This means that all small firms tend to have a very similar input structure and efficiency.[10]

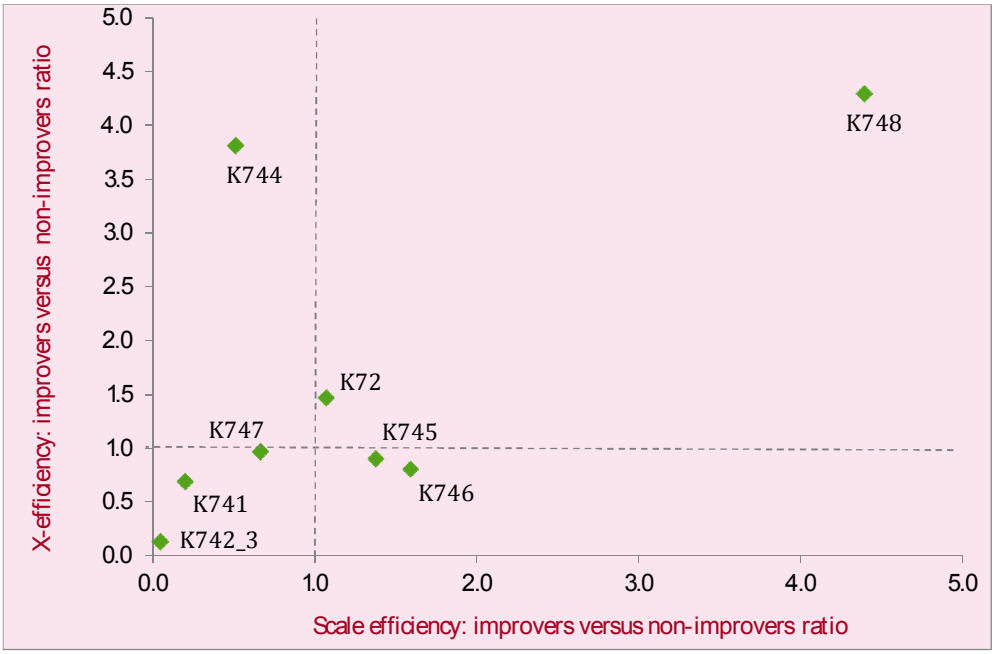
Did the inefficiency gaps become wider or smaller in the years between 1999 and 2005? Figure 3 shows what happened by industry, both for scale efficiency and for X-efficiency. If the number of efficiency improvers in an industry was larger than the number of observations with falling efficiency, the figure is above 1. It is below 1 if the observations with falling efficiency formed the majority. In markets with effective competitive selection, the number should be above 1. Using this criterion, only two sectors of EU business services experienced an improvement of both scale efficiency and X-efficiency: "miscellaneous business services" and "IT/computer services". On the opposite side, three large sectors of business services witnessed falling scores on both types of efficiency: "accountancy, legal, administrative and consultancy services", "architectural and engineering services" and "security services". The remaining sectors had mixed scores. Overall, this test shows a gloomy result for dynamic market selection in European business services.

Figure 4 shows that this result is not driven by just a few European countries. The graph is comparable to Figure 3. It presents the efficiency changes by country, taking together the eight sectors of business services. France is the only country where both types of efficiency improved between 1999 and 2005, in the 'northeast' quadrant (I). Most EU countries are, however, located in the 'southwest' quadrant (IV). For them, both X-efficiency and scale efficiency deteriorated during 1999-2005. Five countries (UK, Sweden, Spain, Belgium and Austria) with mixed results are found in the 'northwest' quadrant (III). For them, X-efficiency improved, but scale efficiency deteriorated. Figure 4 shows that the results are not driven by just a few countries, but hold broadly across Europe.

[9] The data cover eight sub-sectors with five firm-size classes in 13 EU member states during the period 1999 to 2005. The countries in the sample are: Austria, Belgium, Denmark, Finland, France, Germany, Ireland, Italy, the Netherlands, Portugal, Spain, Sweden and the United Kingdom.

[10] Additional research shows that this result is not due to strong competitive interaction within the smallest size class. The distribution of X-efficiencies within the smallest size class did not show the pattern that one would expect in a very competitive sub-market (Kox & van Leeuwen, 2012, Fig. 6).

Figure 3. Efficiency change disappointing in most industries between 1999 and 2005



Note: The graph depicts the change in scale- and X-efficiency between 1999 and 2005.

Industry codes: K72: IT and computer services; K741: Accountancy, legal, administrative and consultancy services; K742_3 Architectural and engineering services; K744: Marketing services; K745: Labour recruitment services; K746: Industrial cleaning; K747: Security services; K748: Miscellaneous business services

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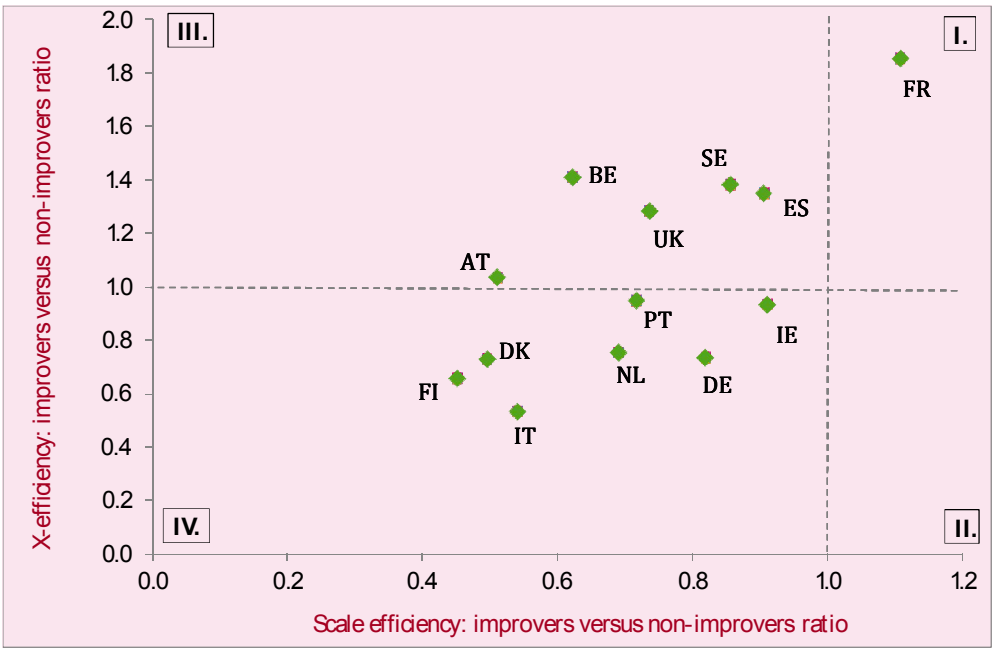
Figure 4. ... and the same held for most EU countries between 1999 and 2005



Note: The graph depicts the change in scale- and X-efficiency between 1999 and 2005.

Country codes: AT: Austria, BE: Belgium, DE: Germany, DK: Denmark, ES: Spain, FI: Finland, FR: France, IE: Ireland, IT: Italy, NL: Netherlands, PT: Portugal, SE: Sweden, UK: United Kingdom.

A qualification must be made with regard to the results obtained thus far. The competition 'warning device' used here works best in industries where product prices are important, where products are more or less standardised or where firms sell product varieties that compete for the same customer budget. Such conditions are found for business services like industrial cleaning, or routine security, administration, testing and marketing services. There are also

parts of business services with complex products, where quality and specialised knowledge matter, and where provider-client interaction is important. In such markets, the product price is not among the first reasons for which a client chooses a particular service provider. Product differentiation has the double effect that it makes cost levels less comparable, while it also tends to strengthen the importance of information asymmetry between firms and clients. Search and switching costs for clients are often high.[11] This type of market structure applies in parts of the worst-scoring sectors of Figure 3: the "accountancy, legal, administrative and consultancy" and "architectural and engineering" services.

Wrapping up, the analysis provides evidence of weakened market selection in European business services: a) the efficiency gaps within size classes remain large and b) efficiency differences between small and large firms tend to become larger, which hints at poor competitive interaction between size classes. Efficiency performance has weakened most in industries with specialised knowledge-intensive services. In our framework this indicates poor competitive selection – but given the degree of product differentiation, a more detailed study is required before reaching final conclusions.[12]

4. Factors that drive market selection

The literature suggests two prime suspects for malfunctioning market selection: insufficient outside competition and overly stringent regulation.[13] Markets are called 'contestable' if incumbent firms have to fear potential market entry by outsiders attracted by the profits earned in a particular market. The threat of entry by outsiders (such as domestic start-ups and foreign firms) imposes market discipline and self-restraint for incumbent firms. The question is whether regulatory factors and a lack of outside competition can indeed explain the persistence of scale-related inefficiencies in European business services.

Outside competition is measured by import penetration in national markets for business services and by domestic start-up ratios.[14] Import penetration from other EU members appears to be weak in several countries. Ireland and France have, respectively, the highest (60%) and the lowest (6%) import penetration rate. Import competition in the Irish market is therefore strong, whereas imports play a small role in France and several other large EU countries. Country size plays a role, because larger countries have a bigger domestic supply of product varieties and more domestic providers to choose from – so that their firms are less inclined to buy from foreign suppliers.

Regulation is the other suspect for explaining weak dynamic market selection. Regulation may hinder competitive selection in several ways:

- By creating market-entry barriers – such as administrative start-up costs for new firms and foreign market entrants;
- By creating exit barriers that deter entry or hinder the exit of inefficient firms, e.g. bankruptcy costs and labour laws that hamper downsizing of firms if that be required by market conditions;
- By creating obstacles to firm growth, such as size-related legal and administrative burdens, tax breaks or subsidy eligibility;[15] and
- By creating obstacles to import competition, such as sunk costs for policy compliance and differences in national tax systems.[16]

Figure 5 depicts the relative differences between the EU countries, with respect to three important regulatory indices and import penetration in business services.

[11] See Baker & Miles (2008), CSES (2001), European Commission (2002), Fuchs & Garicano (2012), Kox (2002), Nahuis & Noailly (2005) and Rubalcaba & Kox (2007: ch. 15).

[12] Due to data limitations, this paper is based on a 3-digit level of industry detail – but a 5- or 6-digit level of industry detail would be preferable.

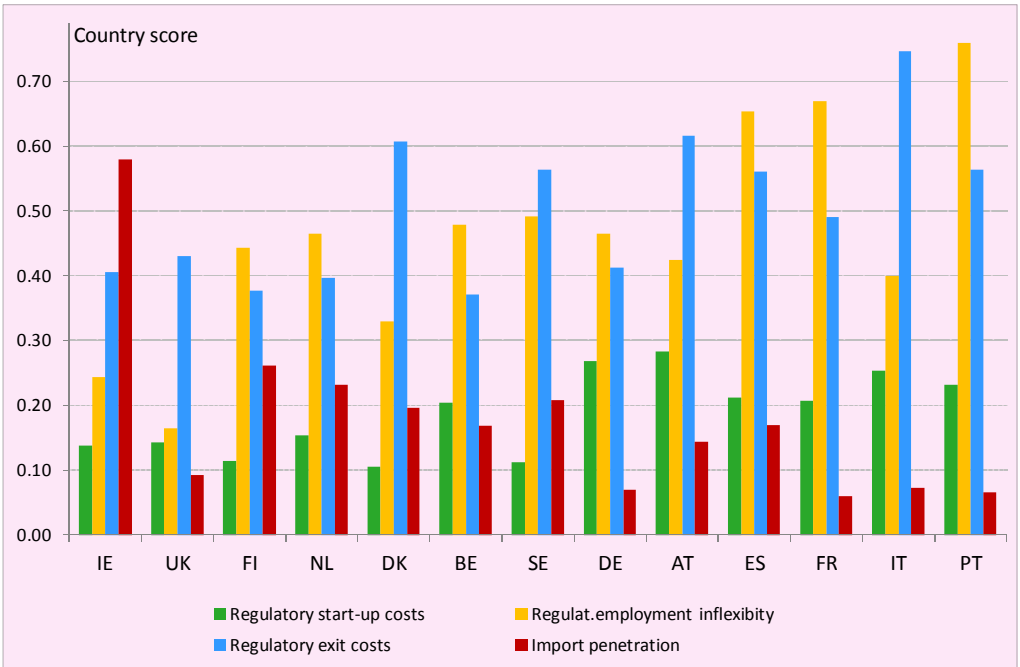
[13] See Arnold et al. (2006, 2008, 2011), Bourles et al. (2010) and Restuccia & Rogerson (2008).

[14] Actual start-up ratios and actual import penetration are used as proxies for potential market entry. Import penetration is calculated from Eurostat input/output tables as the share of business services imports in total domestic demand for business services (net of exports). Start-up ratios measure the number of new firms as a percentage of the total number of incumbent firms.

[15] Garicano et al. (2012), Bartelsman et al. (2012) and Guner et al. (2008) conclude that government restrictions on the size of large firms or policies that promote small firms, have a negative impact on productivity by distorting firm growth.

[16] For example, De Bruijn et al. (2008) and Adam & Smith (2011: Ch. 5-6).

Figure 5. Large country differences in regulatory costs and import penetration, 2005



Note: All variables are expressed as index numbers.

Country codes: AT: Austria, BE: Belgium, DE: Germany, DK: Denmark, ES: Spain, FI: Finland, FR: France, IE: Ireland, IT: Italy, NL: Netherlands, PT: Portugal, SE: Sweden, UK: United Kingdom.

Source and for further details: Kox & van Leeuwen (2012, annex).

Econometric analysis shows that the environment variables of Figure 5 are important for explaining the country and industry patterns of scale-efficiency and X-efficiencies in EU business services. Table 3 shows the main calculation results: by what percentage would efficiency change if the environment variable increases by 10%? The first line, e.g., says that scale efficiency drops by 1.5% if regulatory start-up costs increase by 10%, while there is no effect on X-efficiency. Similarly, 10% more import penetration would have no effect on scale efficiency, but it raises X-efficiency by on average 0.8%.

Table 3. Market contestability and regulation explain the inefficiency patterns, 1999-2005

A 10% increase in ..	gives a ..% change in scale efficiency	gives a ..% change in X-efficiency
Regulation-linked start-up costs	− 1.5%	--
Regulation-induced labour inflexibility	--	− 1.6%
Regulation-induced exit costs	--	− 2.2%
Import penetration	--	+ 0.8%
Domestic start-up ratio	--	--

Source and for further details: Kox & van Leeuwen (2012). This table reports only the main, statistically significant results.

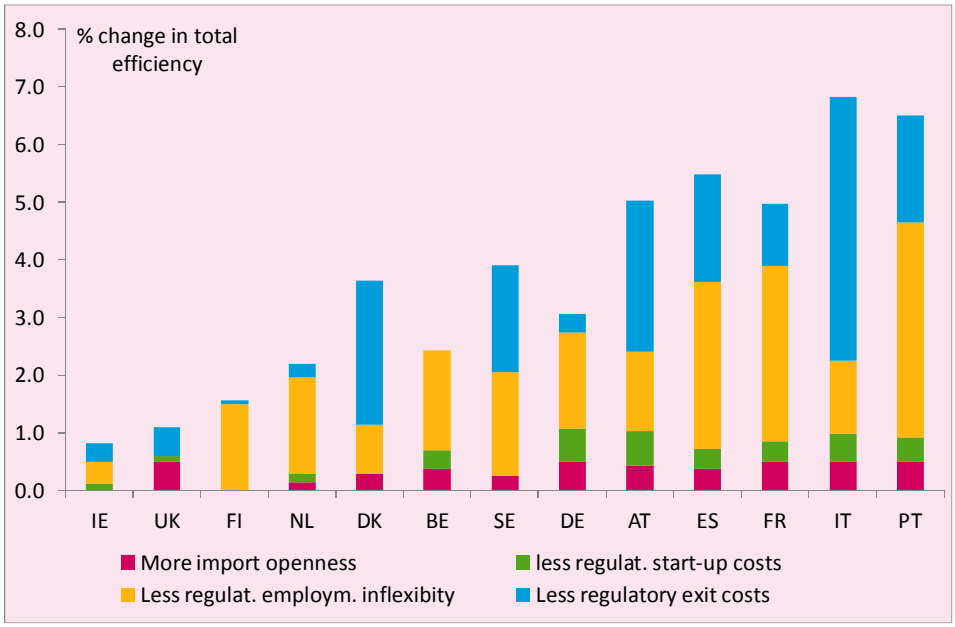
The results of Table 3 can also be used to calculate the potential effects of policies that would lower regulatory costs or promote greater import openness. Two policy reform packages have been simulated. In Reform Package 1, the countries lower their regulation costs and increase import openness in the direction of the 'best-practice' country.[17] In Reform Package 2, all countries lower their regulation costs by 10% and increase import openness also by 10%.[18]

Figure 6 shows that Reform Package 1 would raise the business-services efficiency in the Mediterranean EU countries and in Austria by between 5 and 7%. The largest effects arise from reducing the regulatory labour inflexibility and from a reduction of regulation-induced exit costs (such as bankruptcy rules).

[17] Reform Package 1 assumes a mild policy reform: each country diminishes 25% of its gap with the 'best-practice' country (per variable). A full closure of the gap would make the effects four times larger.

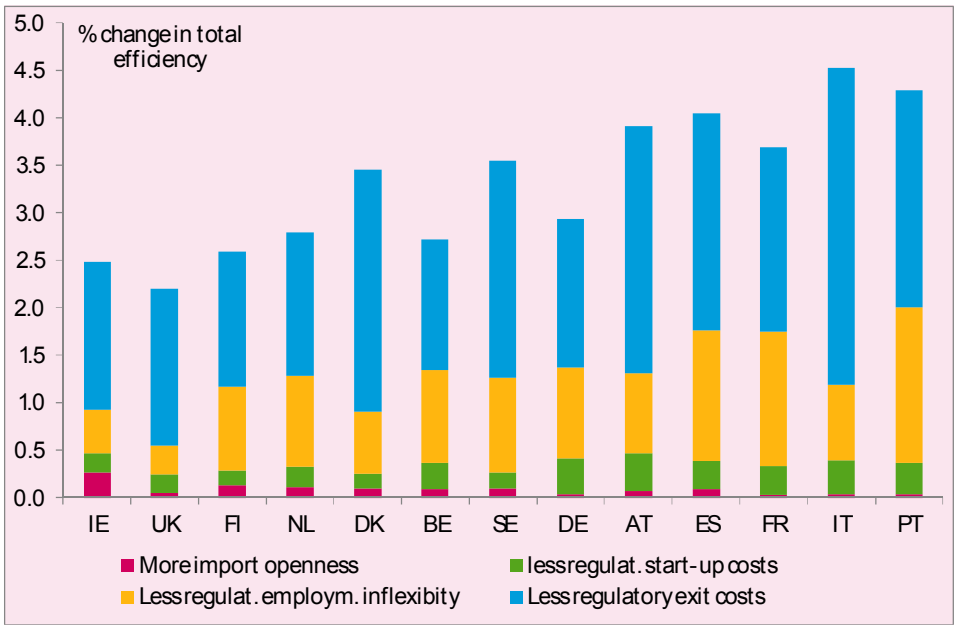
[18] The base year for the policy simulations is 2005. For import penetration we take Finland as the best-practice country (26% import share in domestic use), because Ireland is too much of an outlier. The simulations show the effect of policy changes on total efficiency (equals scale efficiency times X-efficiency), taking into account the full regression results (only partly shown in Table 3).

Figure 6. Simulation of Reform Package 1:
Countries lower regulation costs and increase import openness towards the level of the best-performing country



Reform package 2 reflects a uniform reform shock, also carried out by the best-practice countries – even though for them the marginal benefits are likely to be smaller. Figure 7 illustrates how the impact of Reform Package 2 is also mostly driven by the changes in labour inflexibility and exit costs. This type of regulation has more impact on dynamic market selection than does import openness and start-up rules for new firms. Regulatory exit costs slow the exit or shrinking of inefficient firms, which therefore stay longer in their market 'slots' than they would have done otherwise. Labour adjustment costs are a growth barrier in good times and a shrinking barrier in bad times. In both cases they diminish the pace of dynamic market reallocation towards more efficient firms. Since these regulatory policies often are not industry-specific, similar economic benefits of these measures will also emerge from most other industries in a country.

Figure 7. Simulation of Reform Package 2:
10% less regulation costs, 10% more import openness



5. Policies to unleash new competitive powers

Business services is not 'just another' industry. It is large in terms of employment – but even more importantly, it provides key inputs for other European industries. Several studies show that services inputs have a great impact on the productivity, innovation and competitiveness of manufacturing and other industries.[19] Without productivity growth, business services tend to become relatively expensive for the industries that consume them. Weak competition makes profits and prices higher than they would be otherwise.[20] Business services typically account for 15-20% of the inputs used by firms, and this share is rising over time (see Figure 8). So, the stakes for future European economic growth and Europe's external competitiveness are high.

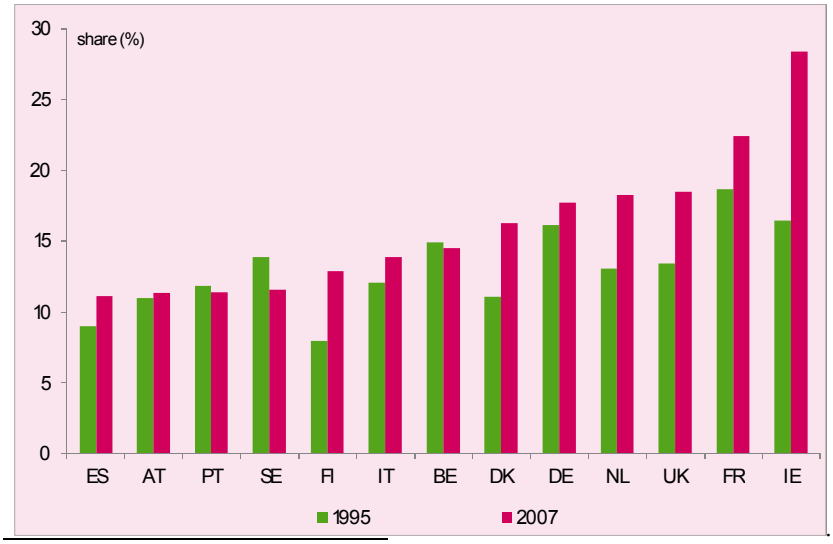
Three types of policies seem appropriate in terms of stimulating better competition and markets selection in business services: a) generic pro-competitive policy reforms; b) policies that strengthen the role of the internal market for services in the EU and c) specific policies that increase market transparency and lower search costs for buyers of complex business services products. Several generic policies may help to unleash new competitive powers in the European market for business services:

a) Policies that bring more labour-market flexibility. For fast-growing small firms it is important to remain flexible in testing new markets, products and competition concepts. They need leeway for experimentation, and this would be greatly facilitated by more hiring and firing flexibility.

b) *Policies to remove obstacles to the exit and shrinking of incumbents*. A European initiative to lower the costs of restarting after a bankruptcy could prove helpful. Similarly, initiatives that break up domain monopolies of certain professions or business services providers may generate more competition dynamics in some countries.

c) *Policies that facilitate post-entry growth by small and innovative firms*. Small and innovative firms may face size-related hurdles in their administrative burden, in taxes or in employment legislation that may easily impair their growth. Our evidence indicates that a lack of new firms is no longer the main obstacle for the competitive selection process (see Bartelsman et al., 2012). More attention is now required for the distortions caused by policies that are specific for certain firm sizes (see Garicano et al., 2012).

Figure 8. Increasing input share of firms comes from business services



Legend: Reports share in total intermediary input use (domestically plus foreign produced).

Source: Calculated from Eurostat input-output tables.

[19] See Bourles et al. (2010), Forlani (2010), Giovannetti et al. (2010), Nordås (2008), Rubalcaba & Kox (2007) and Arnold et al. (2006).

[20] The European Central Bank has compared profit rates across European industrial sectors and concludes: "[...] the services sector has the highest profit share (the ratio of profits to nominal value added)" (Maurin et al., 2011).

The opening of the single market for services is a key element in the Europe2020 plans of the European Commission (European Commission, 2010). Especially in professional services there is a high density of national regulations that constitute major barriers to cross-border trade. This factor limits market contestability in those industries where we found the largest indications for poor competitive selection. It is important to give way to foreign providers of these services. Research by the CPB Netherlands Bureau for Economic Policy Analysis has projected that full implementation of the Commission's original Services Directive proposals from 2004 could have had the effect of a large increase in intra-EU services trade, with an economic effect that would equal 1.5% of total EU GDP.[21] One-third of these gains (0.5% of total EU GDP) was due to a particular mechanism in the 2004 Services Directive proposals, the so-called country-of-origin principle (CoOP). This principle guaranteed that member states could no longer impose their own regulatory requirements on service providers from other EU member states if these service providers had already complied with the regulatory requirements in their country of origin. Discussion in the European Parliament in 2006 resulted in removing the CoOP from the Services Directive. Nowadays, the revised Services Directive of 2006 has largely been implemented, and member state governments have evaluated each other's regulations to assess their impact on intra-EU services trade (European Commission, 2011, 2012). The results of this 'mutual evaluation' effort show that the following national regulatory elements are still hindering the EU single market in services:

- Regulations on required professional qualifications of services-providing personnel
- Regulations on legal form of the services provider
- Regulations on capital ownership of the services provider
- Regulations on required local insurance.

The European Commission is now considering "a swift and more ambitious implementation of the Services Directive" (European Commission, 2012). A possible way forward is to reintroduce the CoOP from the original 2004 Services Directive in order to remove remaining obstacles to foreign market entry. This deepening of the internal market for services will stimulate market selection in business-services markets, remedying the productivity stagnation through more market contestability. The resulting lower prices will have positive knock-on effects in other industries.

Switching costs can be important obstacles to market selection: clients face substantial search costs when looking for an alternative provider.[22] Especially small- and medium-sized clients tend to solve this dilemma by using hearsay information on the reputation of service providers. This necessarily leads to a geographical limitation of the alternatives: the extent of the market is limited by the geographical reach of local, hearsay business reputations. Additional research is required to assess, industry-by-industry and market-by-market, what keeps large firms from competing with less-efficient small firms, and what business models could change this situation. More in general, market functioning can probably be improved by policy initiatives that reduce the search costs for small clients, e.g. by voluntary, administrative quality tests comparable to ISO certification.

6. Conclusion

This policy brief provided research results indicating that a lack of competitive selection contributes to the productivity stagnation in European business services. Competition between small firms and large firms in business services is found to be weak. Inefficiencies also persist within size classes, which indicate a lack of competitive pressure. Markets for business services appear to work best in countries with flexible regulation on employment changes, and with low regulatory costs for firms that start-up or close down a business. Countries with more openness to foreign competition perform better in terms of competitive selection and productivity. Policy simulations show that many countries can do better than they do now – but the potential gains from policy reform are largest in the EU Mediterranean countries and Austria. A strengthening of the single market for services will contribute to more competitive selection and better productivity performance in European business services. Because of its large weight in the inputs of other industries, the business services industry should be a key industry in the Europe2020 strategy of the Commission.

[21] See Kox & Lejour (2006a, 2006b) and De Bruijn et al. (2008).

[22] See Fuchs & Garicano (2012).

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