HM Government

Review of the Balance of Competences between the United Kingdom and the European Union

The Single Market: Free Movement of Services

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Executive Summary

This report examines the balance of competences between the European Union (EU) and the United Kingdom (UK) in the area of the free movement of services, and is led by the Department for Business, Innovation and Skills. It is a reflection and analysis of the evidence submitted by experts, non-governmental organisations, businesspeople, Members of Parliament and other interested parties, either in writing or orally, as well as a review of relevant material in the academic literature. Where appropriate, the report sets out the current position agreed within the Coalition Government for handling this policy area in the EU. It does not predetermine or prejudge proposals that either Coalition party may make in the future for changes to the EU or about the appropriate balance of competences.

This report considers the rights created by Article 49 of the Treaty on the Functioning of the European Union (TFEU), which describes freedom of establishment, allowing companies and individuals to do business in another Member State on a long-term basis, and the freedom to provide services described in Articles 56 and 57 which concerns the temporary provision of cross-border services by either a company or an individual. In addition to the freedom to provide services on a temporary basis and the freedom of establishment for individual professionals and businesses, this report examines EU company law, which underpins the right of businesses to establish in another Member State and open branches and subsidiaries. This report also examines the topics of public procurement and defence procurement, two areas where the EU has attempted to extend the single market principles of free movement into national markets which have traditionally been more closed.

Chapter One sets out the historical development of the free movement of services. EU competence in this area has developed as part of the Single Market as a whole, from its inception in the Treaty of Rome in 1958, through the reforms of the Single European Act (SEA) of 1986 to the present day. As the economic importance of the services sector has increased, the body of case law has grown and secondary legislation has been adopted, including notably harmonising qualifications for some professions, and then more generally, the 2006 Services Directive. Different approaches have been used: mutual recognition was used for professional qualifications but political controversy over the impact of mutual recognition, which in its fullest form constitutes the country of origin principle, led to a less ambitious approach in the Services Directive based around removing barriers to entry. EU competence in public procurement and company law has developed incrementally through secondary legislation, drawing on Single Market Treaty bases. EU competence on defence procurement has generally been limited by Article 346 TFEU, which allows Member States to override Single Market principles when doing so is in the ‘essential interests of [national] security,’ but there have recently been moves to deepen integration in the European defence market.

Chapter Two describes the current state of competence, including the key Treaty provisions on freedom of establishment and the free movement of services, supported by subsequent case law and secondary legislation. The Services Directive is arguably the most significant piece of secondary legislation, but it is complemented by sector-specific legislation. Legislation in two important areas, on both mutual recognition of professional qualifications (MRPQ) and public procurement, has recently been revised and it is too early to predict the impact of these changes. The legislation discussed here primarily concerns the provision of services on a commercial basis. In EU law, public services, such as education and healthcare, but also the supply of energy and transport, are considered Services of General Economic Interest (SGEIs). SGEIs illustrate the tension between national competence for key services typically provided by the State and the free movement of services within the Single Market.

Chapter Three assesses the impact of the free movement of services on the UK national interest: an effective Single Market that gives UK service providers access to markets across the EU and allows UK consumers to benefit from fair and open competition. Services make a very important contribution to the overall EU economy but the trade in services within the Single Market is much less integrated than that of goods. Notwithstanding the fact that services are typically less tradable than goods, evidence submitted to this review attributes this underperformance of the single market in services to a number of factors, but particularly to poor implementation of the Services Directive, with national restrictions remaining as barriers to trade. EU competence is seen on a continuum from international competence, through the General Agreement on Trade in Services in the World Trade Organisation (WTO), through national competence to sub-national competence, as much of the regulation of service provision takes place through the devolved administrations and local authorities.

Whilst there was general support from respondents for the current balance of competence, there were also some calls for greater integration in the single market for services, particularly from business organisations, with better implementation of the Services Directive and the completion of the Digital Single Market being cited as examples. On the whole, the majority of respondents felt that, within the current balance of competence, the advantages of EU action outweighed the disadvantages for service providers. Whilst it was recognised that the costs fell on service providers that were not active in overseas markets, as well as those that trade internationally, economic analysis shows that non-exporting businesses have benefited from liberalisation in domestic service markets, and that any national legislation on services would not have been that dissimilar from the current EU regime.

There was less evidence submitted on consumer benefits, but it was felt that consumers had gained from increased competition and choice in service provision. Some respondents felt that the creation of an additional EU company law regime, the so-called ‘29th regime,’ was a distraction from ensuring full freedom of establishment. The public sector has also gained from competitive public procurement, although the current level of EU competence could be exercised in a less burdensome manner. Respondents identified trade-offs between the free movement of services and the ability of national governments to regulate service provision; between the free movement of services and immigration policies, as the free movement of services often requires the free movement of people; and between the free movement of services and the ability for Member States to develop and maintain national defence supply capabilities.

Chapter Four considers the likely future challenges and options affecting the free movement of services in the future. New business models, particularly through the Digital Single Market, are blurring the distinctions between goods and services, with many traditional goods now being provided as digital services (such as downloads) and an increase in 'serviceisation,' the bundling of goods into a wider package of services. Incomplete and ineffective implementation of existing services legislation has hindered the development of the free movement of services, but full implementation of existing legislation within the current level of EU competence may have implications for Member States' ability to make decisions in this area. There is scope to go further on services liberalisation, extending the application of the country of origin principle, either within specific sectors or across the piece, and either at EU-level or within a smaller group of Member States through enhanced co-operation. Further liberalisation could also be achieved through a sectoral approach, focusing firstly on those sectors of greatest economic importance.

Introduction

This report is one of 32 reports being produced as part of the Balance of Competences Review. The Foreign Secretary launched the Review in Parliament on 12 July 2012, taking forward the Coalition commitment to examine the balance of competences between the UK and the European Union. It will provide an analysis of what the UK's membership of the EU means for the UK national interest. It aims to deepen public and Parliamentary understanding of the nature of our EU membership and provide a constructive and serious contribution to the national and wider European debate about modernising, reforming and improving the EU in the face of collective challenges. It has not been tasked with producing specific recommendations or looking at alternative models for Britain's overall relationship with the EU.

The review is broken down into a series of reports on specific areas of EU competence, spread over four semesters between 2012 and 2014. More information can be found on the review, including a timetable of the remaining reports to be published, at: www.gov.uk/review-of-the-balance-of-competences.

The Objectives of this Report

For the purposes of this review, we are using a broad definition of competence. Put simply, competence in this context is about everything deriving from EU law that affects what happens in the UK. That means examining all the areas where the Treaties give the EU competence to act, including the provisions in the Treaties giving the EU institutions the power to legislate, to adopt non-legislative acts, or to take any other sort of action. But it also means examining areas where the Treaties apply directly to the member states without needing any further action by the EU institutions.

As part of the Balance of Competences Review, a review on the overall application and effect of the Single Market was published in July 2013.[1] The Single Market is made up of four freedoms: goods, services, persons and capital; this report will focus in more detail on the free movement of services in the Internal Market and will also consider the related areas of public and defence procurement and company law.

The objectives of this report are:

- To examine how EU competence over services policy has developed;
- To identify and explain what the current balance of competence is between the UK and the EU in respect of policy relating to the free movement of services;

[1] HMG, *The Balance of Competences Between the UK and the EU: The Single Market Synoptic Report* (2013).

- To explore how competence is exercised in practice and whether it is working in the UK's 'national interest;'
- To explore the EU's current direction of travel, including the potential future developments in services policy, and future challenges and opportunities for the UK.

An integral part of the free movement of services is the free movement of professionals to provide those services. Whilst the Free Movement of Persons is being considered in a separate report to be published in parallel with this report, the legislation on the recognition of professional qualifications will be considered as part of this report.[2]

The Nature of this Report

The analysis in this report is based on evidence gathered following a Call for Evidence. It draws on written evidence submitted, notes of seminars or discussions held during the call for evidence period and existing material which has been brought to our attention by interested parties, such as past select committee reports or reports of the European Commission. A programme of engagement events was held in London, Paris, Brussels, Madrid, Prague, Copenhagen, Berlin and Frankfurt, drawing on business, think tanks, governmental and academic expertise. A literature review of relevant material, as well as opinions received in the course of regular business from a range of organisations, people and countries, has also been drawn on. These are set out in the Annexes.

Definition of EU Competence

The EU's competences are set out in the EU Treaties, which provide the basis for any actions the EU institutions take. The EU can only act within the limits of the competences conferred on it by the Treaties, and where the Treaties do not confer competences on the EU they remain with the Member States.

There are different types of competence: exclusive, shared and supporting. Only the EU can act in areas where it has exclusive competence, such as the customs union and common commercial policy. In areas of shared competence, such as the Single Market, environment and energy, either the EU or the Member States may act, but the Member States may be prevented from acting once the EU has done so. In areas of supporting competence, such as culture, tourism and education, both the EU and the Member States may act, but action by the EU does not prevent the Member States from taking action of their own.

The EU must act in accordance with fundamental rights as set out in the Charter of Fundamental Rights, such as freedom of expression and non-discrimination, and with the principles of subsidiarity and proportionality. Under the principle of subsidiarity, where the EU does not have exclusive competence, it can only act if it is better placed than the member states to do so because of the scale or effects of the proposed action. Under the principle of proportionality, the content and form of EU action must not exceed what is necessary to achieve the objectives of the EU Treaties.

[2] HMG, *The Balance of Competences Between the UK and the EU: Free Movement of Persons Report,* published in parallel.

Chapter 1: Development of the Free Movement of Services

Summary

This chapter sets out the historical development of the free movement of services. EU competence in this area has developed as part of the Single Market as a whole, from its inception in the Treaty of Rome in 1958, through the reforms of the SEA of 1986 to the present day. As the economic importance of the services sector has increased, the body of case law has grown and secondary legislation has been adopted, including notably harmonising qualifications for some professions, and then more generally, the 2006 Services Directive. Different approaches have been used: mutual recognition was used for professional qualifications but political controversy over the impact of mutual recognition, which in its fullest form constitutes the country of origin principle, led to a less ambitious approach in the Services Directive based around removing barriers to entry. EU competence in public procurement and company law has developed incrementally through secondary legislation, drawing on Single Market Treaty bases. EU competence on defence procurement has generally been limited by Article 346 TFEU, which allows Member States to override Single Market principles when doing so is in the 'essential interests of [national] security,' but there have recently been moves to deepen integration in the European defence market.

1.1 The development of free movement of services has mirrored that of the Single Market as a whole, set out in the Single Market Balance of Competence review.[1] The free movement of services covers both (i) the freedom of establishment for individuals and companies to provide services in another Member State on a 'permanent' basis and (ii) the freedom to provide cross border services to a recipient established in another Member State on a 'temporary' basis. The latter may involve cross-border movement by the service provider or the recipient, or, in the case of services delivered online or at a distance, no cross-border movement by either party.

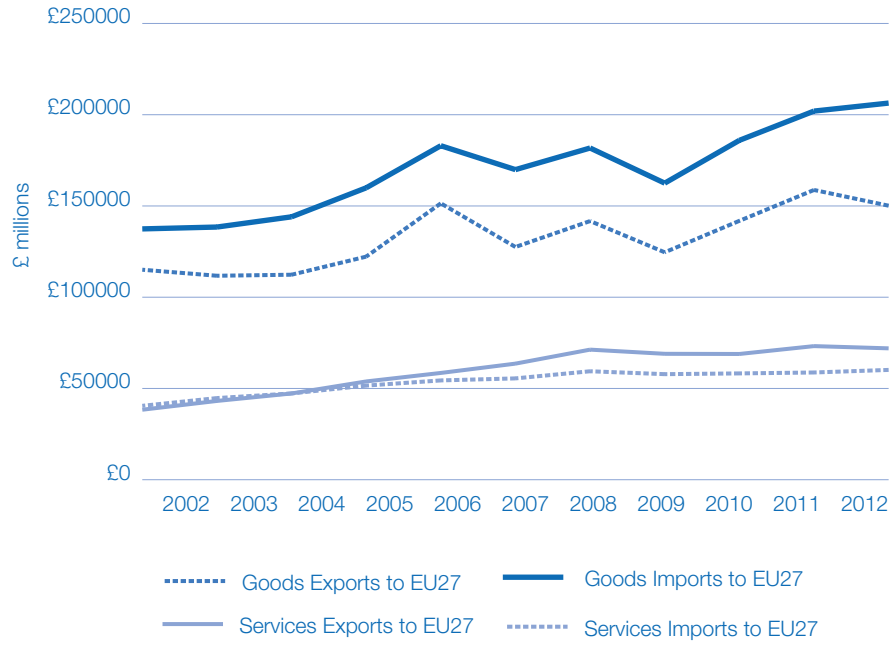
1.2 The Treaty of Rome set out the concept of a 'common market,' based on the 'four freedoms' of goods, services, persons and capital. Following the entry into force of the Treaty of Rome on 1 January 1958, there were few amendments to the Single Market provisions in the Treaty until the SEA was adopted in 1986. The Act amended the Treaty of Rome to set a clear objective of 'completing' the Single Market by the end of 1992.

1.3 Despite the clear basis in the Treaty, free movement of services was perhaps seen as the poor cousin to the other freedoms. During the post-war period, the overwhelming political focus was on the recovery of the manufacturing sector, with less emphasis on services.

[1] HMG, *The Balance of Competences Between the UK and the EU: The Single Market* (2013).

The services sector was only a minor part of the overall European economy, with trade in goods dominating the economic activity of most Member States. Both the Cockfield White Paper of 1985, seen as the blueprint for the Single Market, and the later Cecchini report of 1988, which estimated the potential gains, dealt mostly with goods, and focused mainly on financial and telecommunications services.[2] [3] In recent years, despite the inherent differences between goods and services, the UK's trade with the rest of the EU remains dominated by goods (see Figure One).

Figure One: UK Trade in Goods and Services with the EU, 2002-2012[4]



1.4 The growth of trade in services led to an increase in European Court of Justice (ECJ) cases during the 1990s, seeking to clarify and apply the general Treaty provisions on the free movement of services and establishment. The development of the case law is described more fully in Chapter Two, but the seminal case of *Säger* marked a change in the Court's approach to determining cases involving the free movement of services.[5] In this case, the Court adopted a market access test, widening the scope of the Treaty articles so that they caught not only directly and indirectly discriminatory measures but also non-discriminatory measures that restrict free movement of services. This has led to the Court increasingly finding that national measures fall within the Treaty articles on free movement of services, before going on to consider of whether the measure in question is justified and proportionate.

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2 Commission of the European Communities, *Completing the Internal Market: White Paper from the Commission to the European Parliament COM (85) 310 final, June 1985.*

3 Cecchini, P., M. Catinat & A. Jacquemin, *The European Challenge 1992: The Benefits of a Single Market* (1988).

4 Office for National Statistics, *United Kingdom Balance of Payments – The Pink Book* (2013).

5 Säger, Case C-76/90 [1991].

Freedom of Establishment for Professionals

1.5 Member States usually regulate access to professions such as medicine, nursing and engineering in order to protect the public. However, requiring professionals to re-train if they want to work in another Member State would discourage mobility and limit their freedom of establishment. To avoid this, a body of secondary legislation was adopted to facilitate the mutual recognition of professional qualifications.

1.6 During the 1970s, the EU used a vertical approach, harmonising national rules one profession at a time, leading to directives covering qualifications required for doctors, nurses, dentists and vets, as well as for trades in the construction, food and retail industries.[6] A similar approach was used at the time for harmonising the technical standards for physical goods. Although this had the advantage of guaranteeing automatic recognition for professionals who met the required standard, negotiation of each of these directives was a gruelling process.

1.7 The Single Market programme of 1985 heralded a different approach: under the impetus of Internal Market Commissioner Lord Cockfield and with the support of the UK, the European Commission produced a White Paper setting out a package of measures needed to complete the Single Market. On the issue of professional mobility, the report explained that the Commission:

> Considers that Community citizens should be free to engage in their professions throughout the Community, if they so wish, without the obligation to adhere to formalities which, in the final analysis, could serve to discourage such movement.[7]

1.8 This led to a directive on the mutual recognition of professional qualifications at or above degree level, which was later followed by another directive covering professional qualifications below degree level.[8] These two Directives have been subsequently reformed through the Professional Qualifications Directive, which itself was recently revised.[9]

The Services Directive

1.9 In 2004, the European Commission proposed a new horizontal Services Directive, covering both the right of establishment and the provision of services within the Single Market. The initial draft was proposed by the then Internal Market Commissioner, Frits Bolkestein, towards the end of the Commission's mandate and was based on the 'country of origin' principle.

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6 For example: Directives 75/362/EEC for doctors; 77/452/EEC for nurses; 78/686/EEC for dentists; 78/10126/EEC on vets, all of which have now been repealed. They have now been replaced by: Council Directive 89/48/EEC of 21 December 1988 on a general system for the recognition of higher-education diplomas awarded on completion of professional education and training of at least three years' duration, 1998.

7 Commission of the European Communities, *Completing the Internal Market* (1985).

8 Council Directive 89/48/EEC on a general system for the recognition of higher-education diplomas awarded on completion of professional education and training of at least three years' duration, 1988; and Council Directive 92/51/EEC on a second general system for the recognition of professional education and training to supplement Directive 89/48/EEC, 1992.

9 Directive 2005/36/EC of the European Parliament and of the Council of 7 September 2005 on the recognition of professional qualifications, 2005 and Directive 2013/55/EU of the European Parliament and of the Council of 20 November 2013 amending Directive 2005/36/EC on the recognition of professional qualifications and Regulation (EU) No 1024/2012 on administrative cooperation through the Internal Market Information System, 2013.

The 'Country of Origin' Principle

Under the 'country of origin' principle, no Member State would be able to prevent the provision of services by a service provider from another Member State, if the regulations governing that service provision in the country of origin of the service provider were met. In other words, the regulatory regime of the country of origin would apply, rather than the country in which the service was provided. This principle can be considered analogous to the 'mutual recognition' approach embodied in the *Cassis du Dijon* case and on which the free movement of goods is based. For more details of the *Cassis du Dijon* case, see the Balance of Competences review of the Free Movement of Goods.[9] However, in the services sector the country of origin principle is more controversial because it could potentially allow poorly regulated and/or cheaper service providers from one Member State to undercut local service providers in another Member State. Concerns may also arise about consumer protection or evasion of legitimate regulatory standards.

1.10 The proposal provoked a sharp backlash and protests from trade unions in particular, who feared that the proposed Directive would undermine national regulations governing working conditions. In a foreshadowing of the current debate on the free movement of workers, the debate in France in particular focused on the proverbial 'Polish plumber,' who would, it was claimed, be able to provide services in France whilst potentially being subject to Polish social, employment and professional regulation.

1.11 In the face of this opposition, negotiations on the draft directive swiftly became blocked. After attempting to reach a compromise on the original text, Bolkestein's successor as Internal Market Commissioner, Charlie McCreevy, brought forward a new draft based on amendments proposed by the European Parliament.

1.12 Instead of using the country of origin principle, this compromise instead banned some national restrictions on service provision, for example, discrimination between service providers on the grounds of nationality, while permitting others in certain circumstances, for example, requiring service providers to take on a particular legal form or have a certain number of shareholders.[11] The final text also excluded a number of service sectors from its scope, as a result of concerns from Member States about the impact on national markets. These include broadcasting, postal and audio-visual services, legal and social services, public transport and healthcare and temporary employment agencies, some of which are covered by sector-specific pieces of legislation.

1.13 Following negotiations, the Services Directive was adopted in 2006 and the deadline for its transposition into national law was 28 December 2009. In some cases, this transposition was a complicated process because the new Directive outlawed many restrictions to the free movement of services that depended on national rules that had to be reformed or repealed. This effort was later estimated by the Commission to have resulted in changes to over a thousand pieces of domestic legislation across the Member States.[12] As the most significant piece of EU legislation governing the services sector, the effects of the Services Directive are discussed in detail in this report.

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[10] HMG, *The Balance of Competences Between the UK and the EU: Single Market Free Movement of Goods Report* (2014).

[11] A full list of the rules on national restrictions is included in Table One in Chapter Two.

[12] European Commission Communication, *Towards a Better Functioning Single Market for Services — Building on the Results of the Mutual Evaluation Process of the Services Directive*, COM (2011) 20 final, 2011.

1.14 A Commission evaluation of the implementation of the Services Directive conducted in 2012 found that whilst most Member States had transposed the Directive itself, by this stage, full implementation had yet to be completed.[13] Whilst the economic benefit to date of the Services Directive could be conservatively estimated to be 0.8% of EU GDP, the Commission estimated that further gains of up to 1.6% of EU GDP could be realised if all Member States reached the degree of liberalisation of the five Member States with the lowest barriers in any given sector. This would equate to removing all of the existing barriers in various sectors. The legal content of the Services Directive is discussed in Chapter Two and its economic impact is discussed in more detail in Chapter Three.

Sectoral Legislation

1.15 In addition to the Services Directive, further sectoral legislation has been adopted to regulate the free movement of services in a range of specific sectors, including the Audio Visual and Media Services Directive (2010/13), which covers television broadcasting, and the E-Commerce Directive (2000/31). The approach taken by these Directives is discussed in more detail in Chapter Two. Financial services is another sector which is comprehensively regulated by EU legislation, and this area is considered in a separate report published in parallel to this one.[14]

The Development of Competence in Company Law

1.16 The EU has traditionally viewed the harmonisation of rules relating to company law, including corporate governance, accounting and auditing, as essential for creating a Single Market. EU action in this area aims to ensure that companies have the freedom to establish themselves anywhere in the EU. Common standards also underpin the ability of companies to expand internationally without having to comply with new rules in every Member State. It is therefore one of the cornerstones of the Single Market, and as such, was one of the first areas in which the EU and its forerunners sought to put in place a common framework.

1.17 The first Company Law Directive was agreed in 1968 and set minimum standards for the information that limited liability companies should be required to publish. Further Company Law measures, mainly directives, have since been introduced and revised over the years. They usually set minimum requirements and include some degree of flexibility for Member States by allowing them to exercise options in their implementation. They deal with a wide range of areas of company law including capital requirements, shareholders' rights, accounting, audit, takeovers, mergers and divisions, and market regulation. However, many areas have not been harmonised. Other directives, whose main purpose is not to regulate companies generally, may either modify these provisions, for example, sectoral regulation, or contain provisions which impact on company law.

The Development of Competence in Public Procurement

1.18 The purchasing of goods and services by public authorities represents a significant part of the European economy, and a framework of rules governing the awarding of such contracts within the Single Market has been developed. Although the Treaties prohibit discrimination on the basis of nationality in general in relation to the freedom to provide services, barriers to open public procurement within the internal market persisted, leading

[13] Josefa Monteagudo, Aleksander Rutowski and Dmitri Lorenzani, 'The Economic Impact of the Services Directive: A First Assessment Following Implementation', *European Commission Economic Papers 456* (2012) p3.

[14] HMG, *The Balance of Competences between the UK and the EU: Financial Services and Free Movement of Capital Report*, published in parallel.

to secondary legislation to address the issue. In 1966, a Directive was adopted prohibiting any requirements for the use of national products in public procurement, supplemented in 1970 by a similar prohibition on such requirements for public supply contracts.[15] A further Directive introduced three fundamental tenets for EU public procurement, but not for public utilities:[16]

- Contracts must be advertised Community-wide;
- Technical specifications which are discriminatory are prohibited, and;
- The award of tenders must be done using objective criteria.

1.19 As part of the legislation flowing from the SEA of 1986, the directives governing public supplies contracts and public works were revised to mandate open tendering, with negotiated agreements only permitted *in extremis*. Transparency was enshrined through the requirement to publish details of each contract award, and mutual recognition of national technical standards was established.

1.20 In 1990, the first Utilities Directive brought the energy, telecommunications, transport and water sectors into a harmonised framework.[17] The Public Service Contracts Directive, contributed to the liberalisation of public procurement by including sixteen categories of priority services, but other services, such as health and education services, were only subject to minimal rules on the grounds that these were not likely to engender cross-border activity.[18] The same approach was also adopted when services were covered in the revised Utilities Directive.[19] A consolidation and updating of public procurement rules in 2004 led to a consolidated public sector Directive and a consolidated Utilities Directive, governing procurement by entities in the water, energy, transport and postal services.[20] The Public Sector Directive replaced three previous directives on the procurement of public works contracts, public supply contracts and public service contracts. It provided for modern procurement practices, such as the use of framework agreements.

1.21 A new package of public procurement rules was adopted in early 2014. This replaced the two 2004 Directives and introduced a new Concessions Directive. The package is discussed in greater detail in Chapter Two, which considers the current state of competence in this area.

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15 Commission Directive 66/683/EEC eliminating all differences between the treatment of national products and that of products which, under Articles 9 and 10 of the Treaty, must be admitted for free movement, as regards laws, regulations or administrative provisions prohibiting the use of the said products and prescribing the use of national products or making such use subject to profitability, 1966; and Commission Directive 70/32/EEC on provision of goods to the State, to local authorities and other official bodies, 1970.

16 Council Directive 77/62/EEC coordinating procedures for the award of public supply contracts, 1977.

17 Council Directive 90/531/EEC on the procurement procedures of entities operating in the water, energy, transport and telecommunications sectors, 1990.

18 Council Directive 92/50/EEC relating to the coordination of procedures for the award of public service contracts, 1992.

19 Council Directive 93/38/EEC coordinating the procurement procedures of entities operating in the water, energy, transport and telecommunications sectors, 1993.

20 Directive 2004/18/EC of the European Parliament and of the Council on the Coordination of Procedures for the Award of Public Works Contracts, Public Supply Contracts and Public Service Contracts, 2004; and Directive 2004/17/EC of the European Parliament and of the Council Coordinating the Procurement Procedures of Entities Operating in the Water, Energy, Transport and Postal Services Sectors, 2004.

The Development of Competence in Defence Procurement

1.22 Defence procurement broadly covers those items which are for 'specifically military purposes.'[21] According to an early Council Decision, this extends to a broad range of military items, including warships, combat aircraft and missile systems.[22] While the procurement of these goods is theoretically covered by the general EU public procurement legislation described above, and therefore should be openly competed across the EU, much of it has tended to be excluded as the result of the wide interpretation of the exemption provided under Article 346 TFEU. In essence, this provision allows a Member State to exempt the production and trade of these 'warlike stores' from EU Single Market rules where this is necessary for the protection of its 'essential interests of security.'

1.23 Although the wording of this exemption has remained unchanged from the Treaty of Rome, there was relatively little activity from either the Commission or the Court in this area until the late 1990s. This was in part due to an apparent unwillingness by both to be seen to interfere in the sovereignty of Member States. However, this inactivity began to change as the Commission sought to break down the barriers to a more integrated European defence market, in part for economic reasons, but also in support of an increasing EU role in defence policy more generally. The European Security and Defence Policy was established in 1998, and an integrated defence market is considered by the Commission as one of its key components.

1.24 The Commission's efforts to bring about a change in the use of Article 346 arguably began in 1996 when it published its first Communication on defence.[23] This was followed in 1997 by another paper, which invited the European Council to engage on this issue, something which was rejected by Member States at the time.[24]

1.25 Though the Commission had largely been rebuffed, the ECJ also began to play a key role, starting in 1999, with its decision in the case of *Commission v Spain*.[25] Here the Court clarified that Article 346 does *not* grant Member States an automatic exemption from the Treaty and that it must be interpreted narrowly. This interpretation was subsequently confirmed and refined by the Court, including in *Commission v. Italy*, where the Court found that there should be 'the existence of exceptional circumstances justifying the derogation.'[26]

1.26 On the back of this developing case law, the issue was raised again by the Commission in 2004, through the publication of its Green Paper on Defence Procurement.[27] This signalled the beginning of a new determination by the Commission to regulate the use of Article 346 and open up the defence market to competition. The Commission then published a communication setting out its view of the correct interpretation of Article 346.[28] Whilst confirming that it remains the responsibility of each Member State to 'define and protect their security interests,' the Communication stresses that reliance on Article 346 cannot be automatic and can be used only 'in exceptional and clearly defined cases.'

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21 Article 346 TFEU.

22 Council Decision No. 255/58, *Drawing Up a List of Products to Which Article 223(l)b Applies* (1958).

23 European Commission Communication, *The Challenges Facing the European Defence Related Industry, a Contribution for Action at European Level*, COM (96) 10 final, 1996.

24 European Commission, *Implementing European Union Strategy on Defence Related Industries*, COM (97) 583 final.

25 Commission v. Spain, Case C-414/97 [1999].

26 Commission v. Italy, Case C-337/05 [2008], para 58.

27 European Commission, *Green Paper of 23 September 2004 on Defence Procurement,* COM (2004) 608 final, 2004.

28 Interpretative communication on the application of Article 296 of the Treaty in the field of defence procurement, COM 2006 0779 final.

1.27 This was quickly followed by the defence package of 2007, consisting of directives on defence and security procurement and intra-EU transfers of defence technology.[29] The first of these set out specific rules for procurements in the defence sector and can be seen as 'the regulatory backbone' of that market.[30]

1.28 In parallel with these efforts at the EU-level, work was also undertaken at the inter-governmental level between groups of Member States eager to promote a more efficient European defence market. OCCAR, the Organisation for Joint Armament Co-operation, was established in 1996 by the UK, France, Germany and Italy, later joined by Spain and Belgium, in order to help consolidate their demand by managing collaborative procurements on their behalf. In 1998, the EU's six main arms-producing States (the four original OCCAR countries plus Spain and Sweden) signed the 'Letter of Intent Framework Agreement.' This set up a cooperative framework amongst these governments, which was to facilitate the restructuring of the EU defence industry, albeit one that failed to materialise to the level expected.[31]

1.29 In 2004, the European Defence Agency (EDA) was created. One of its four core functions was creating a competitive EU defence equipment market and strengthening the EU's defence, technological and industrial base. In 2006, the EDA launched a voluntary code of conduct for defence procurement, which sought to encourage transparency in the use of Article 346 and cross-border competition. In 2010, the UK and France signed the Lancaster House Treaties, which includes provision for further bilateral action to improve the competitiveness of the defence industrial sector.

1.30 Though it is too early to make any assessment of the more recent actions, it is fair to say that, so far, many of the 'older' initiatives have not lived up to their ambition. As noted above, the consolidation in the defence sector anticipated in the late 1990s failed to materialise. The EDA's Code of Conduct had only a marginal impact on competition before being shelved to make way for the Defence Procurement Directive. And implementation of the Directive itself has also been slow, with the Commission only confirming in 2013, two years behind schedule, that the Directive had been correctly transposed into all Member States' legislation.

The Approach of the ECJ

1.31 The ECJ has also played a role in the development of the balance of competences in these areas. The main development of its case law on the freedom of establishment and the free movement of services has been the concept of a non-discriminatory restriction. This approach recognises the fact that even measures that are not explicitly discriminatory can constitute a barrier to intra-EU trade. This is particularly true for services, partly because of the diversity of services in question and partly because national regulation is often more rigorous than for goods.

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[29] Directive 2009/81/EC of the European Parliament and of the Council on the Coordination of Procedures for the Award of Certain Works Contracts, Supply Contracts and Service contracts by contracting authorities or entities in the fields of defence and security, 2009, O.J. L 216/76; and Directive 2009/43/EC of the European Parliament and of the Council Simplifying Terms and Conditions of Transfers of Defence-related Products within the Community, 2009.

[30] European Commission, *Annual Report on Relations Between the European Commission and National Parliaments,* COM (2012) 565 final, p1.

[31] For example, BAE Systems instead opted for a greater focus on the US market.

1.32 The Court's general approach in evaluating whether a non-discriminatory measure constitutes a restriction, and whether or not this restriction can be justified, has been influenced by policy as well as legal concerns. Increasingly, the Court has found that most non-discriminatory measures are indeed restrictions, and has then focused on whether these can be justified. In cases where this raises particularly sensitive issues, the Court has applied both public interest justifications and the principle of proportionality with some flexibility, leaving a considerable amount of room for manoeuvre to Member States. Nevertheless, the general result of this approach has tended to favour increasing choice for consumers and improving the competitiveness of the Single Market, reducing the scope of Member States' regulatory autonomy accordingly.

Chapter 2: Current State of Competence in Services

Summary

This chapter describes the current state of competence, including the key Treaty provisions on freedom of establishment and the free movement of services, supported by subsequent case law and secondary legislation. The Services Directive is arguably the most significant piece of secondary legislation, but it is complemented by sector-specific legislation. Legislation in two important areas, on both the mutual recognition of professional qualifications and public procurement has recently been revised and it is too early to predict the impact of these changes. The legislation discussed here primarily concerns the provision of services on a commercial basis. In EU law, public services, such as education and healthcare, but also the supply of energy and transport, are considered SGEIs which illustrate the tension between national competence for key services typically provided by the state and the free movement of services within the Single Market.

2.1 As explained in Chapter One, the general principle of the free movement of services was included in the original Treaty of Rome and its formulation has remained more or less unchanged since then. Article 3(3) of the TEU requires the EU to 'establish an internal market' and this internal market is defined in Article 26(2) of TFEU as:

> An area without internal frontiers in which the free movement of goods, persons, services and capital is ensured in accordance with the provisions of the Treaties.

2.2 The Single Market is underpinned by these four freedoms. The free movement of services covers the exercise of two rights:

(i) The freedom of establishment of individuals and companies; and

(ii) The free movement of services.

Treaty Provisions on the Freedom of Establishment

2.3 The freedom of establishment is set out in Article 49 TFEU, which deals with the self-employment of individuals and Article 54 TFEU, which states that companies must be treated in the same way as individuals.

2.4 Together, Articles 49 and 54 cover a number of situations:

(i) The self-employment of an individual in another Member State;

(ii) The establishment and management of companies in another Member State by individuals or companies; and

(iii) The right of secondary establishment in another Member State for a company by setting up agencies, companies and subsidiaries.

2.5 The exercise of the freedom of establishment implies that the person, either an individual or a company, creates a longer term presence in the host Member State. In contrast, the freedom to provide services covers the provision of services by a provider established in one Member State to a recipient established in another, and any cross border movement of service provider or recipient is on a temporary basis.

Treaty Provisions on the Free Movement of Services

2.6 The freedom to provide services is set out in Articles 56 and 57 TFEU. Services are defined under Article 57 as those services provided for remuneration that are not governed by the provisions on the free movement of goods, people or capital; voluntary services are therefore not in scope as they are not provided for remuneration.[1] Article 57 continues:

> Services shall in particular include (a) activities of an industrial character; (b) activities of a commercial character; (c) activities of craftsmen; (d) activities of the professions.

2.7 Case law has established that the following services are included within the definition in Article 57 TFEU: employment agency services, tourism, education, some medical services, broadcasting, lotteries, judicial recovery of debts and building loans provided by banks.[2]

2.8 Articles 56 and 57 can cover three situations:

(i) The freedom to travel to provide services – this was the classic situation envisaged by Article 57;

(ii) The freedom to travel to receive services – this situation was not spelt out by the Treaty but it was covered by early secondary legislation and subsequently confirmed by the case law; and

(iii) The provision of services where neither the provider nor the recipient moves to another Member State, as is the case for online service provision.

[1] Article 58 states that transport services, banking and insurance services shall be governed by the relevant parts of the Treaty, rather than under Articles 56-60.

[2] For more details of these cases, see Professor Catherine Barnard, *submission of evidence.*

Public Services: Services of General Interest

Although this report is primarily concerned with services provided on economic basis within the private sector, some of the most widely-used services are provided to meet a public good which the market might not supply sufficiently or at all if left alone. Examples include health and social care, compulsory education and the supply of water, energy and transport services.

There are widespread differences in the organisation and provision of public services across the EU, reflecting long-standing cultural traditions. For many citizens, services such as health care and social security form a fundamental part of their relationship with the state, and there has therefore been some resistance to the EU developing competence in this area. Nevertheless, these services can represent a significant portion of EU GDP, so disregarding the Single Market framework entirely would limit the potential benefits of competition.

In EU law, these public services are known as 'services of general interest.' These can be further subdivided into non-economic social services of general interest (SSGIs), such as the court system or healthcare; and SGEIs, where there is a more direct economic relationship between the consumer and the supplier, as is the case with gas and electricity supplies, and where the EU has been more active in controlling the application of EU rules on competition and State aid.

Article 106 (2) TFEU stipulates that SGEIs are subject to the other provisions in the Treaties, particularly the rules on competition, as long as these rules do not prevent the operation of the service. A practical example of this is the rules relating to state funding of SGEIs which allow sufficient support for the service to be performed whilst not adversely affecting competition or trade. Where public services are provided by private sector organisations under contract with public authorities, then EU rules on public procurement, discussed elsewhere in this report, may apply.

Some SGEIs form part of network industries, where there is scope to connect individual national markets. For example, the EU has attempted to foster the creation of a single market for energy and transport services. Energy was considered in the report published in February 2014 and transport will be considered in a report to be published later this year.

The Relationship between the Free Movement of Services and the Free Movement of Goods

2.9 The boundary between goods and services can increasingly be hard to draw and the Courts have sometimes had difficulty identifying the scope of the right in a given case. The Court's approach has been to consider in each case whether the measure predominantly affects goods or services or whether the transaction in question primarily relates to goods or services. Generally, the Court's view has been that where the goods are merely ancillary to the main activity, the free movement of services provisions of the TFEU will apply.

2.10 The distinction can be a significant one for Member States. A particular measure might include restrictions that would be permissible in the context of goods because they constitute non-discriminatory selling arrangements and are hence outside the scope of Article 34 TFEU on the free movement of goods, following *Keck.*[3] According to *Keck*, certain non-discriminatory selling arrangements which do not hinder market access do not breach Article 34 TFEU. There is no direct equivalent in the field of services and

[3] Keck and Mithouard, Joined Cases C-267/91 and C-268/91, [1993]. The case law on free movement of goods is summarised in: HMG, *The Balance of Competences Between the UK and the EU, Single Market* (2013).

the Court has been consistently reluctant to apply *Keck* in this context. Therefore, a restriction, which might not need to be justified in the context of free movement of goods, would need to be justified if it instead fell within the scope of Article 56 TFEU.

Application of the Treaty Articles

2.11 Individuals can directly enforce their rights under Articles 49, 54, 56 and 57 TFEU against Member States, and a wide body of case law in this field has found that various restrictions placed on the provision of services by Member States in national law were breaches of these Articles. Whether these Treaty articles apply to private bodies is less clear. Some see the case of *Viking* as an indication that these articles may also be enforceable against private parties.[4] This case concerned proceedings taken by an employer against a trade union when it proposed strike action to protest against the employer's decision to reflag its Finnish vessels in Estonia and the changes in employment conditions that this would bring about. The Court concluded that Article 49 TFEU could be relied upon against such a trade union or an association of trade unions. The rationale for this case may be, however, that bodies such as trade unions have enough power to restrict free movement rights through their role in collective bargaining and so are exercising a quasi-State function. It remains to be seen whether the application of these articles can be extended further to completely private bodies acting in the private sector.

The Discrimination Approach

2.12 The early approach of the Court, following the language of Articles 49 and 57 TFEU, focussed on prohibiting direct and indirect discrimination on the grounds of nationality or place of establishment.

2.13 A directly discriminatory measure is one that treats non-nationals less favourably than nationals. Direct discrimination was the issue in *Reyners.*[5] The Court found that a Belgian rule preventing a qualified Dutch national from practising as a lawyer in Belgium on the grounds of his nationality breached Article 49 TFEU. A directly discriminatory measure can, however, sometimes be allowed by making reference to the specific derogations set out in the Treaty, see below.

2.14 An indirectly discriminatory measure ostensibly treats non-nationals and nationals in the same way but in fact disadvantages the non-national. Examples of such measures are: a residence requirement; a rule requiring professionals to hold a licence before they can practise; and a language requirement. On the face of it, these rules apply to all self-employed individuals but they in fact disadvantage non-nationals. Such a rule can sometimes be justified on public interest grounds and the Court has found that indirectly discriminatory measures can be justified. For example, in *Gullung*, the Court found that a French requirement that lawyers be registered at the Bar before practising could be justified by the need to maintain the ethical principles and disciplinary control of the activity.[6] Similarly, in *Commission v. Germany (insurance cases)* the Court found that rules requiring that the provision of insurance in Germany could only be done by insurance

[4] Viking Line ABP v The International Transport Workers' Federation, the Finnish Seaman's Union, Case C-438/05, [2007].

[5] Reyners, Case C-2/74, [1974].

[6] Gullung, Case C-292/86, [1988].

companies both established and authorised in Germany could be justified on the ground of consumer protection.[7]

2.15 In the case of *Vlassopoulou*, the Court developed its approach of non-discrimination to apply reasoning based on mutual recognition.[8] In this case, a Greek lawyer was rejected by the German Bar on the grounds that she had not studied or qualified in Germany (despite holding a doctorate from a German university). The Court ruled that:

> National requirements concerning qualifications may have the effect of hindering nationals of the other Member States in the exercise of their right of establishment guaranteed to them by Article [49 TFEU]. That could be the case if the national rules in question took no account of the knowledge and qualifications already acquired by the person concerned in another Member State.

2.16 The Court found that Member States had to consider whether a non-national's qualifications were equivalent to those required by nationals of that Member State – in effect, they had to apply the principle of mutual recognition.

The Market Access Approach

2.17 In the early years, the Court considered that non-discriminatory measures – those that apply to all service providers, irrespective of their nationality – did not breach the freedom to provide services. However, such measures could nevertheless be obstacles to free movement. The mutual recognition approach developed in *Vlassopoulou* described above did not fully address this issue and the Court has therefore changed its approach in respect of non-discriminatory measures by placing the emphasis on market access and asking whether the measure is, despite being non-discriminatory, an obstacle to free movement.

2.18 This new approach is evident from the case of *Säger*, which concerned a German law requiring those monitoring patents to have a licence which would be granted if the individual held certain professional qualifications.[9] The Court ruled that Article 56 required:

> Not only the elimination of all discrimination against a person providing services on the ground of his nationality but also the abolition of any restriction, even if it applies without distinction to national providers of services and to those of other Member States, when it is liable to prohibit or otherwise impede the activities of a provider of services established in another Member State where he lawfully provides similar services.

2.19 This judgment has subsequently been widely used by the Court and was extended to the freedom of establishment by *Gebhard* in which the Court said:

> That national measures liable to hinder or make less attractive the exercise of fundamental freedoms guaranteed by the Treaty must fulfil four conditions: they must be applied in a non-discriminatory manner; they must be justified by imperative requirements in the general interest; they must be suitable for securing the attainment of the objective which they pursue; and they must not go beyond what is necessary in order to attain it.[10]

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7 Commission v. Germany (insurance cases), Case C-205/84, [1986].

8 Vlassopoulou, Case C-340/89, [1991].

9 Säger, Case C-76/90, [1991].

10 Gebhard, Case C-55/94, [1995].

2.20 The Court's formulations: 'liable to prohibit or otherwise impede' (*Säger*) or 'liable to hinder or make less attractive' (*Gebhard*) gave way to the simpler question of whether the measures in question were 'obstacles' or 'restrictions' to free movement. This approach was seen in *Carpenter* where the Court found that the deportation of the Filipino wife of a UK national who looked after their children while her husband was working abroad but had overstayed her visa was an obstacle to his freedom to provide services:

> It is clear that the separation of Mr and Mrs Carpenter would be detrimental to their family life and, therefore, to the conditions under which Mr Carpenter exercises a fundamental freedom. That freedom could not be fully effective if Mr Carpenter were to be deterred from exercising it by obstacles raised in his country of origin to the entry and residence of his spouse.[11]

2.21 The judgment in *Carpenter* demonstrates how wide-reaching the restrictions and market access approach is and the potential for it to be applied to a wide range of areas regulated by national rules. It also blurs the line between the free movement of services and persons.

2.22 The Court has found a range of measures to amount to restrictions on freedom of establishment and free movement of services. These include:

- Rules restricting the number of establishments in a particular area;[12]
- Advertising restrictions;[13]
- Residence requirement; and[14]
- Authorisation requirements.[15]

Justifying Restrictions

2.23 Once the Court has found that a measure should be categorised as a restriction to free movement, it will ask whether the measure can benefit from an express derogation set out in the Treaty or a public interest justification as developed by case law.

2.24 Articles 52(1) and 62 TFEU provide that Member States may derogate from the freedom to provide services or the freedom of establishment on the grounds of public policy, public security and public health. As a general rule, a derogation must be interpreted narrowly and must be proportionate.[16] There is also a specific exemption for the exercise of official authority, providing services closely connected to state power, in Articles 51 and 62 TFEU. Again, this is to be construed narrowly.[17]

2.25 As mentioned above, directly discriminatory measures can only be saved by an express derogation. Indirectly discriminatory and non-discriminatory measures that restrict free movement may benefit from a public interest justification. The main ones were listed in *Gouda*, and include, but are not limited to:[18]

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[11] Mary Carpenter v. Secretary of State for the Home Department, Case C-60/00, [2002].

[12] Commission v. Italy (extra-judicial debt recovery), Case C-134/05, [2007].

[13] Gourmet, Case C-405/98, [2001].

[14] Festersen, Case C-370/05, [2007].

[15] Commission v. Netherlands (private security firms), Case C-189/03, [2004].

[16] Église de Scientologie, Case C-54/99, [2000].

[17] Reyners, Case C-2/74, [1974].

[18] Gouda, Case C-288/89, [1991].

- Professional rules intended to protect the recipients of a service;[19]
- Protection of intellectual property;[20]
- Protection of workers;[21]
- Consumer protection;[22]
- Fair trading and the protection of consumers;
- Conservation and dissemination of the national historic and artistic heritage; and
- The need to safeguard the reputation of financial markets and to protect investors.[23]

2.26 Finally, once justified, a Member State must also demonstrate that the steps taken to achieve the objective are proportionate. This means that they must be suitable to achieve the objective and no more restrictive than necessary.

Secondary Legislation

2.27 In addition to the Treaty articles discussed above, there is a range of secondary legislation in this area. Some of this legislation is horizontal, that is to say that it applies across sectors, and some is sector-specific.

The Services Directive

2.28 As the discussion above sets out, there was already a considerable body of EU law on service activities before the adoption of the Services Directive.[24] As its recitals record, the Directive was intended to liberalise the market in services by building on and complementing this existing case law, but as described in Chapter One, there was political disagreement about how best to achieve this.

2.29 The Directive establishes a general legal framework that applies to a wide variety of services but which takes into account the distinctive features of different activities and regulatory systems. The framework is based on the approach of removing barriers by launching a process of evaluation of existing barriers and by harmonisation of specific issues. Many of the provisions of the Directive codify the existing case law of the Court. Where a provision of the Directive conflicts with the provision of another piece of EU legislation governing a specific aspect of a service activity, the other, more specific, rules will prevail.

2.30 The Services Directive contains a list of services that are excluded from its scope. The list is broad and includes important sectors such as healthcare services, financial services, electronic communication services and transport. Some of these areas are covered by sector-specific EU legislation whereas others, for example, gambling, are not covered by EU legislation. Nevertheless, the Directive covers a very wide range of services which according to some estimates account for around 46% of EU GDP, as shown in Figure Two.

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[19] Van Wesemael, Cases C-110/78 and C-111/78, [1979].

[20] Coditel, Case C-62/79, [1980].

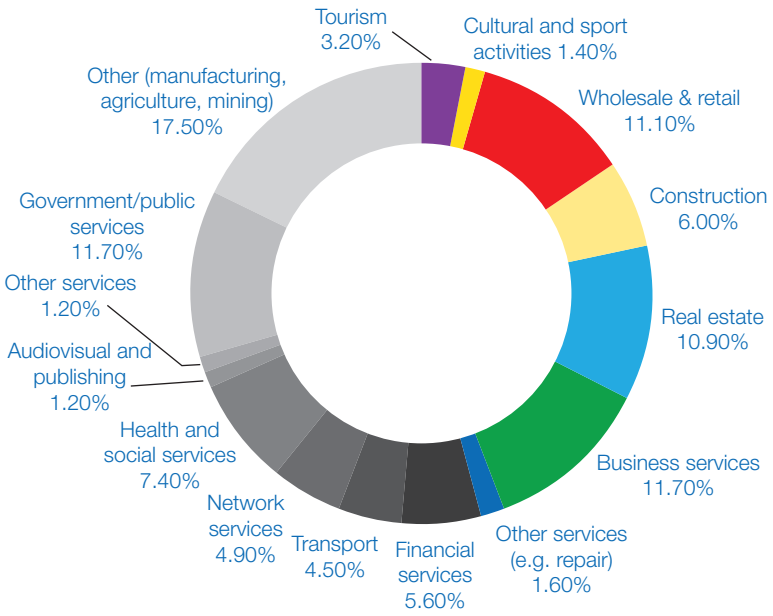
[21] Webb, Case C-279/80, [1981].

[22] Commission v Italy (Tourist Guides), Case C-180/89, [1991].

[23] Alpine Investments, Case C-384/93, [1995].

[24] Directive 2006/123/EC of the European Parliament and of the Council on Services in the Internal Market, 2006.

Figure Two: Composition of EU27 GDP in 2011[25]



2.31 Chapter Three of the Services Directive deals with the right of establishment. It deals with two groups of rules:

(i) Authorisation schemes; and

(ii) Other requirements which are either prohibited or subject to evaluation. Under the Directive, authorisation schemes must be non-discriminatory, justified and proportionate and the conditions for granting an authorisation must also satisfy these requirements as well as being unambiguous, objective, made public in advance and accessible.

2.32 In the context of establishment, Article 14 of the Directive lists eight requirements that Member States are prohibited from imposing on those seeking to establish on their territory. The prohibited requirements include nationality requirements for the provider, its staff, individuals holding the share capital, or members of the provider's management or supervisory bodies; or a rule forbidding a provider from having an establishment in more than one Member State. In addition, Article 15 lists a further eight requirements that have already been considered 'restrictions' by the Court but which are permissible so long as they are non-discriminatory, necessary and proportionate. Table One summarises the requirements covered by the Service Directive.

2.33 Chapter IV of the Directive deals with cross border service provision on a temporary basis. Article 16 provides that Member States must allow providers established in another Member State to provide services on their territory and may only make that service provision subject to a requirement if it is non-discriminatory, necessary and proportionate. It sets out seven 'suspect' requirements that may only be imposed if saved by express derogations or case-by-case derogations set out in the Directive or a narrow list of public interest justifications also set out in the Directive. The requirements which need justification are based largely on the Court's case law and include: an obligation on the provider to have an establishment in the territory of the host state; a ban on the provider setting up a certain form or type of infrastructure, including an office or chambers; the application of specific contractual arrangements between the provider and the recipient preventing or restricting service provision by the self-employed.

[25] Source: European Commission, EU Services Brochure (2014). Colour slices represent activities covered by the Services Directive 2006 (46%).

Table One: Summary of Restrictions Listed in Articles 14 and 15 of the Services Directive 2006/123/EC

Article 14 – Prohibited requirements	Article 15 – Requirements to be evaluated
Member States may not do the following when assessing whether a service provider should be able to do business on their territory:	*Member States may do the following when assessing whether a service provider should be able to do business on their territory, provided any restrictions are non-discriminatory, necessary and proportionate:*
Discriminate on ground of nationality	Apply quantitative or territorial restrictions
Restrict a company's ability to be established in more than one Member State	Require a company to take on a particular legal form
Require that a company establishes its main place of doing business in that Member State	Require a company to have a certain number or type of shareholders
Apply conditions of reciprocity between two Member States	Restrict the provision of certain sensitive services to qualified providers in a way that is incompatible with other legislation on Mutual Recognition of Professional Qualifications
Require economic means tests or assessments of the economic impact of a business	Restrict a company to doing business in just one location
Involve competing operators in the decision about granting an authorisation	Require a certain number of employees
Require a service provider to take out insurance from a provider in that Member State	Impose fixed minimum or maximum prices
Require a service provider to pre-register or provide the service for a certain length of time	Require the provision of other services alongside those initially proposed

2.34 As described in Chapter One, the original 'Bolkestein' proposal for the Services Directive would have used the 'country of origin' principle to regulate temporary service providers. Article 16, as adopted, replaced this proposal with a rule requiring Member States to accept home state regulation of temporary service providers except where it is necessary and proportionate for host states to impose non-discriminatory requirements.

2.35 How significant the distinction between the original Article 16 and the current Article 16 really is has been the subject of some commentary. Under the country of origin principle, host States must take into account the regulation that a provider is already subject to in its home State, which is the primary regulator, with the result that a host State may only impose supplementary requirements where they are proportionate. Under the Services Directive, host States may impose additional requirements only where they are non-discriminatory, necessary and proportionate. The difference may be a nuanced one.

2.36 The UK, along with other Member States, has lobbied for greater clarity over the criteria that states apply in order to determine whether their requirements are necessary and proportionate. There is considerable divergence between different Member States' interpretations of necessity and proportionality, a topic which is discussed further in Chapter Three.

Case Study: Applying Services Legislation

The Services Directive and the MRPQ Directives both regulate the free movement of services, but work in different ways. The former allows a business to provide services overseas on a temporary or permanent basis, while the latter concerns the ability of individual service providers to have the qualifications that allow them to provide a specific service recognised. For some professionals, both sets of rules can apply at different times, as this example illustrates.

The Situation

A UK family has purchased a second home in another EU Member State. They are happy to have local contractors carry out repairs, but have asked a UK architect to design an extension to their second home.

Services Directive

Their architect, who normally works in London, can provide her services in another EU Member State on a temporary basis without having to establish a branch or a subsidiary. She cannot be prevented from working overseas merely on the grounds that she is from a different country or qualified there. The authorities can impose other requirements, such as insisting that she is properly qualified, but they have to demonstrate that these are necessary and proportionate and that they apply to all businesses equally so that they do not represent *de facto* discrimination against UK architects.

If the architect is worried about the rules that apply and whether she needs to register before starting work, she can get in touch with the 'Point of Single Contact' for the country concerned, which will provide her with the relevant information or put her in touch with the government department responsible for architects. As she is already qualified in the UK, she should only have to provide evidence that he has met the same standards required of local architects. If she does need to apply for a specific licence or authorisation, she can do this over the Internet from the UK.

She is then free to design the extension from her usual offices in London and travel to the building site to supervise construction – this is the temporary cross-border provision of services that the Services Directive is intended to facilitate.

Mutual Recognition of Professional Qualifications

After completing the job, the architect realises that there is a gap in the market and would like to start a business serving British second home-owners. To do so, she can exercise her right to freedom of establishment, which allows her to set up as an architect in a different Member State and to have the authorities there recognise her qualifications.

By speaking again to the Point of Single Contact again, she can find the details of the competent authority for architects in that country, which may be a professional body, like in the UK, or a government department. Because she has one of the qualifications listed in Annex VI of the Directive, the architect can be recognised by producing evidence of her training–usually her diploma.

If her qualifications do not appear on the list in Annex VI, for instance, because she trained a long time ago or in a third country, then she will have to produce evidence that her training is equivalent to that required for local architects. Alternatively, if her original training does not meet the national requirements, she can choose between two 'compensation measures,' either sitting an aptitude test of her ability in certain areas or only practising under supervision for a set period.

Sector-Specific Legislation

2.37 Taking Articles 53(1) and 62 TFEU as its legal base, the Audio Visual and Media Services (AVMS) Directive 2010/13 seeks to provide freedom to provide television services, covering both linear (broadcast) and non-linear (e.g. web content) services. The Directive is based on a form of the country of origin principle, whereby the transmitting state is responsible for ensuring that broadcasters comply with domestic legislation on the 'organisation and financing of broadcasts, and the content of programmes;' other Member States may not restrict the reception of such broadcasts. In other words, a broadcast legitimately made in one Member State can be rebroadcast in another Member State without restriction, subject to certain public policy conditions. The UK, for instance, banned the Red Hot Dutch channel on grounds that it may seriously damage the physical, mental or moral development of minors (Article 27, AVMS).

2.38 The E-commerce Directive 2000/31 has its origins in a 1997 Commission Communication ('A European Initiative on Electronic Commerce' (COM(97)157)), which included the objective of implementing an appropriate Single Market regulatory framework for electronic commerce.[26] [27] This was followed by a proposal from the Commission (amended September 1999) for a Directive to establish a coherent legal framework for electronic commerce within the Single Market.

2.39 The objective of the Directive is to create a legal framework to ensure the free movement of information society services between Member States. It establishes harmonized rules, for example in relation to electronic contracts and the limited liability of intermediary service providers. It includes an Internal Market clause, based on the country of origin principle i.e. information society services should in principle be subject to the law of the Member State in which the service provider is established.

2.40 This version of the country of origin principle limits the powers of regulators in other Member States to place restrictions on information society service providers, unless they can demonstrate that the service provider's actions prejudice, or present a serious and grave risk of prejudice, public interest objectives; that they are acting proportionally; and that the regulator in the home Member State has failed to respond to a request to resolve the situation, except in cases of urgency. The Member State taking the measures must notify the Commission and the home Member State of its intention to take such measures.

[26] Directive 2000/31/EC of the European Parliament and of the Council on Certain Legal Aspects of Information Society Services, in particular Electronic Commerce, in the Internal Market, 2000.

[27] Commission Communication, *A European Initiative in the Sector of Electronic Commerce*, COM (1997) 157 final.

The MRPQ Directive

2.41 As described in Chapter One, two separate directives covering professional qualifications below and above degree level were replaced by a single directive.[28] This directive provided for the recognition of professional qualifications, whether achieved by formal qualifications, an 'attestation of competence' and/or professional experience, thereby covering both academic and vocational qualifications. The Directive required that:

> The recognition of professional qualifications by the host Member State allows the beneficiary to gain access in that Member State to the same profession as that for which he is qualified in the home state and to pursue it in the host Member State under the same conditions as its nationals.

2.42 The Directive enabled a professional to be established in a host Member State on a stable basis in order to provide professional services there. It provided for a system of automatic recognition of qualifications on the basis of an agreed minimum training standard for a number of specific professions, including doctors, nurses, dentists, vets, midwives, pharmacists and architects. Automatic recognition was also extended to certain industrial, craft and commercial professions on the basis of professional experience. For those professions not covered by automatic recognition, a 'general system' of recognition was established which allowed for compensatory measures to make up where there may be differences between different national requirements for professional training.

2.43 This Directive has recently been revised through the MRPQ Directive 2013/55, adopted in November 2013. The revised directive introduces some important new features, including:

- Partial access arises where the differences between professions are too great to be resolved by 'compensatory measures;' a professional should nevertheless be granted partial access to a profession in the host Member State, allowing them to carry out certain activities for which they are fully qualified in their home Member State.
- Under the transparency process, the regulation of professions in each Member State will be subject to peer review and challenge, with the aim of greater coherence on the professions that are regulated in the EU and potentially an overall reduction in the number of regulated professions.
- The alert mechanism, based on the existing Internal Market Information (IMI) system, requires Member States to notify when any individual professional is disbarred or otherwise disqualified from professional practice.
- The European Professional Card is an electronic document attesting to a professional's qualification and is to be adopted on a profession-by-profession basis where there is sufficient interest expressed by the relevant professional bodies to implement it. Member States will be required to issue a European Card upon the request of the professional.

[28] Directive 2005/36/EC of the European Parliament and of the Council of 7 September 2005 on the recognition of professional qualifications, 2005.

The Digital Single Market

The Digital Single Market refers to a broad range of measures and initiatives related to the operation of the single market in a digital age, its aim being to ensure that goods and services can be traded as effectively online as in the real world. It covers a wide range of issues. The Commission published its Digital Agenda for Europe in 2010, followed by a Digital Roadmap in 2012, prioritising 16 actions to achieve the goal of 'completing' the Digital Single Market by 2015. Copenhagen Economics has estimated that the EU could gain 4% GDP (equivalent to €1,000 per person) by stimulating the rapid development of the Digital Single Market by 2020.

The UK Government is strongly committed to the Digital Single Market agenda, convening a cross-border e-commerce taskforce in 2013, and the Business Taskforce on EU regulation called for a fully-functioning Digital Single Market to be created.[29] As the Digital Single Market agenda is potentially sprawling, the UK Government has established six priorities for action:

Copyright: ensuring that the EU copyright regime works in the digital age, including the adoption of the Copyright Rights Management Directive. EU competence on copyright and other forms of intellectual property was discussed in the Free Movement of Goods report.

Data Protection: ensuring that EU legislation on data protection strikes the right balance between privacy for citizens, regulatory burdens on businesses and the need for a functioning digital single market. EU competence on data protection is covered in the Information Rights report.

Payment services: ensuring that EU regulation on payment services reflect developments in online payment, including the revision of the Payment Services Directive. EU competence on payment services is included in the Financial Services report, published in parallel with this report.

Broadband: ensuring that EU regulation facilitates the roll-out of high-speed broadband, including regulation to reduce the cost of the necessary civil engineering works. EU competence on internet services will be included as part of this report.

Telecoms: ensuring that EU legislation to further liberalise the EU telecoms market does not undermine the current UK market or impose unnecessary transition or regulatory costs. EU competence on telecommunications will be included as part of this report.

E-commerce: pressing for action to remove barriers that hinder cross-border e-commerce by requiring separate treatment for each national market. EU competence on e-commerce (and retail more generally) will be included as part of this report.

The UK Services Sector

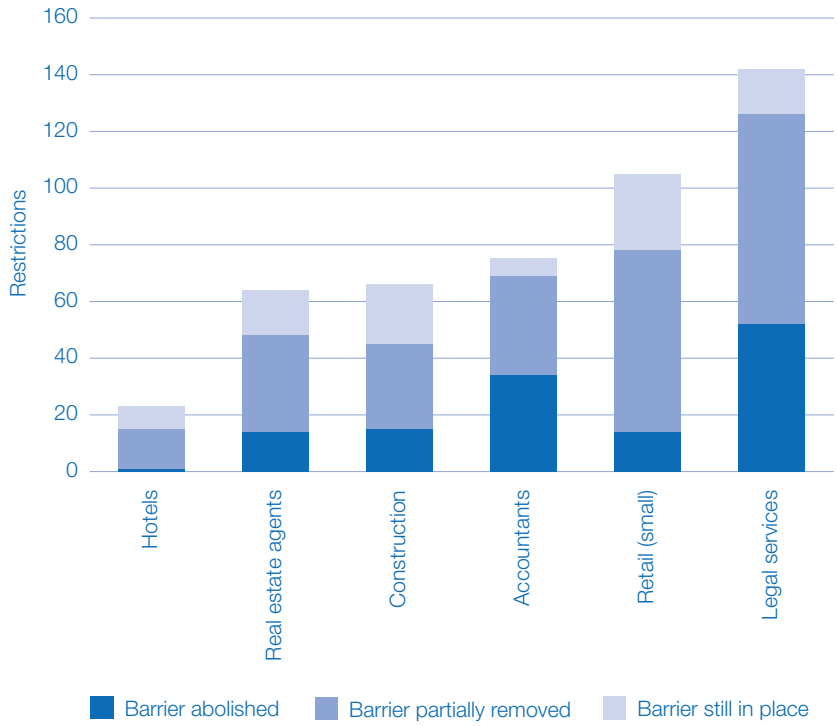
2.44 Within the UK, the services sector is diverse and covers a wide range of economic activities, from professional business services to construction and from retail to hospitality. As described above, some of these activities are governed by sector-specific legislation. This includes both transport and energy services, which are the subject of other reviews, and broadcasting and online services which are discussed elsewhere in this report. However, some of the key legislation on the free movement of services, such as the Services Directive and the MRPQ Directive, both described above, is horizontal in nature and lays down general principles which do not distinguish between different services sectors.

[29] 'Cut EU Red Tape:' A Report From the Business Taskforce (2013).

2.45 Naturally, this legislation has a different impact on different sectors, in part because of variations in the nature of the services themselves. At the same time, some sectors have traditionally been more closely regulated by Member States than others, such as education, construction, retail and financial services; financial services is the subject of a separate review being published in parallel with this one.[30] EU rules such as the Services Directive have therefore had a greater impact in removing national restrictions in these sectors than in those sectors that have always been less tightly regulated. These national restrictions may cover a range of aspects, from the right of establishment, such as the right of a retailer to open a new branch in another Member State, required legal forms and shareholdings, for example, in financial or legal services, or regulation of the professionals providing the service, such as architects in the construction sector, or accountants in the professional & business services sector.

2.46 The extent to which Member States imposed varying restrictions on different sectors can be illustrated by the number of restrictions removed as part of the implementation of the Services Directive. Figure Three shows a wide variation in the number of barriers to entry in each sector, as well as those removed or repealed as a result of the Services Directive, demonstrating differing impacts that the Directive's implementation has had on different parts of the economy.

Figure Three: Status of Barriers to Entry to National Services Markets Assessed after Implementation of the Services Directive in a Selection of Sectors[31]

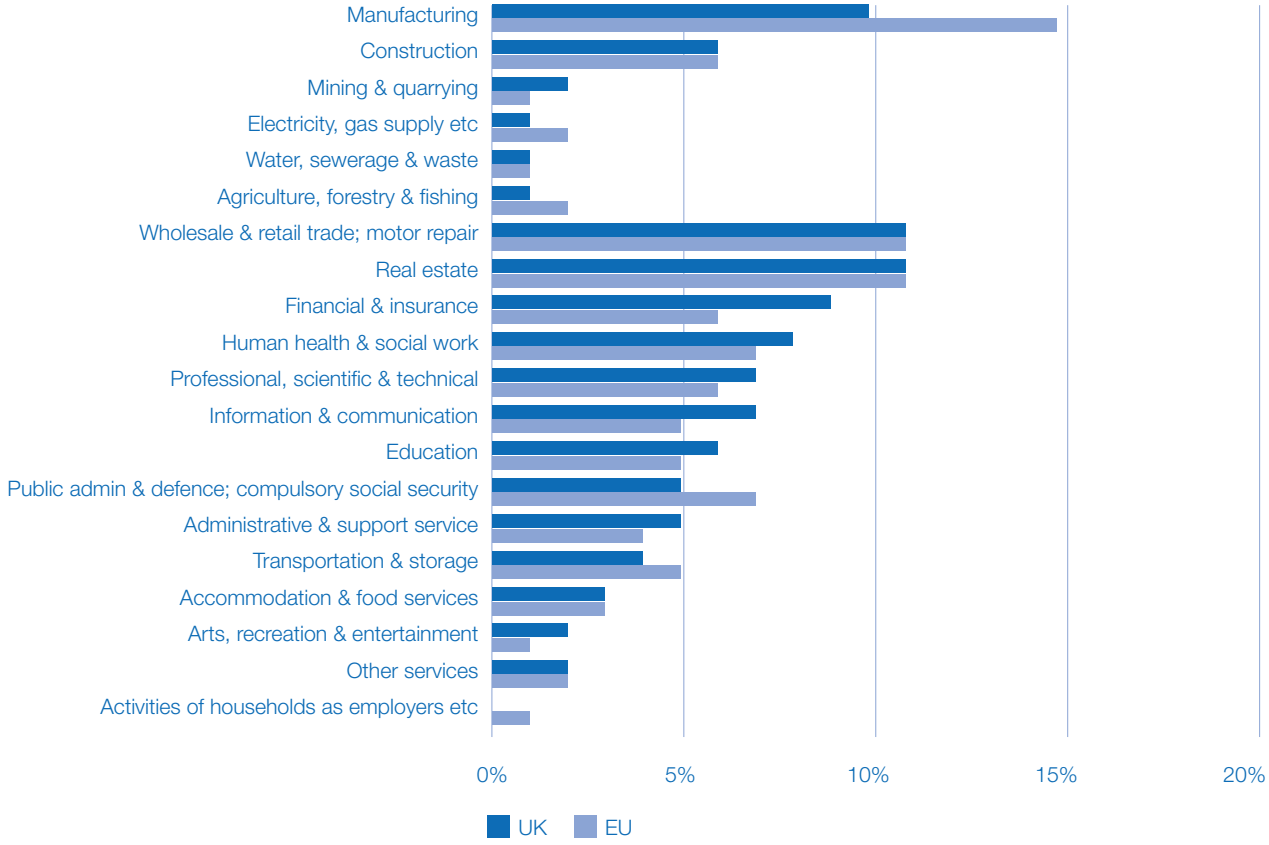


[30] HMG, *The Balance of Competences Between the UK and the EU: Financial Services and Free Movement of Capital Report,* published in parallel.

[31] Based on data set out in: Monteagudo et al., 'The Economic Impact of the Services Directive' p71.

2.47 EU legislation may also have a differential impact on the UK economy where a particular sector is particularly significant to the UK economy, compared to the EU average. Figure Four shows the contribution of different sectors, including non-service sectors, to total UK economic output, measured as Gross Value Added, compared to the EU as a whole. The construction, information & communication services, financial & insurance services, professional, scientific & technical services and education sectors all make a greater contribution to the UK economy than they do to the EU as a whole. Although this report does not examine the effect on individual parts of the services sector, because they represent a larger part of the economy than in most other Member States, it is possible that they will face a bigger impact from EU regulation than elsewhere in the EU.

Figure Four: Contribution to Total Gross Value Added by Various Services in the EU and the UK[32]



Treaty Provisions and Secondary Legislation on Company Law

2.48 Companies largely remain established under national law. However, in EU company law there are three distinct EU legal entities which facilitate a closer business relationship across Member State borders, creating what is sometimes known as the '29th regime' of company law, sitting alongside existing provision in each of the Member States. Introduced in 2001, the European Company (*societas europae* or SE) is a European Public Limited Liability Company.[33] It is treated as a public limited company formed in accordance with the law of the Member State in which it has its registered office. UK national laws that apply to public limited companies also apply, in many respects, to SEs

[32] Eurostat Dataset reference: [nama_nace21_c]'.

[33] Council Regulation 1435/2003/EC on the Statute for a European Cooperative Society (SCE), 2003.

registered in the UK. A separate statute allows the creation of European co-operative societies, a corporate form for non profit-making organisations.[34]

2.49 Finally, the European Economic Interest Grouping (EEIG), which dates back to 1985, is a legal form allowing companies from more than one Member State to do business together. It is not a company and cannot make a profit on its own behalf. Rather, it is an association which can be composed of companies, firms and other legal entities governed by public or private law, which have been formed in accordance with the law of a Member State and which have their registered office in the EU. The purpose of the grouping is to facilitate or develop the economic activities of its members by pooling their resources, activities or skills. A number of prominent examples include cross-border ventures such as Franco-German TV channel Arte and international rail services like Thalys and Eurostar. It is also sometimes used by businesses in the defence sector to form consortia to bid for defence procurement contacts, an issue discussed in Chapter Three.

2.50 In 2002, a Regulation requiring EU listed companies to produce their group accounts in accordance with International Accounting Standards was adopted.[35] This was part of a wider global move to such standards, designed to make the capital markets work more efficiently. These standards are revised regularly.

2.51 European Court of Justice case law has also had a significant impact in this area. The Court has proceeded mainly on the basis of its interpretation of the freedom of establishment provisions of the Treaty. There have been two key issues. The first concerns the recognition by the host state of companies established under a different legal system. The CJEU has consistently upheld this through cases like *Centros*[36] and *Inspire Art*[37] which concern the recognition of branches of companies from Member State A by Member State B. Following these cases, Member State B cannot require a company from Member State A to reincorporate under Member State B's laws. This is true even where Member State B is aware that the company was established in Member State A in order to circumvent rules on company formation in Member State B. For instance, in *Centros*, the Court upheld a decision to form a company in the UK to avoid stricter Danish laws on capitalisation although the company was intended to operate solely in Denmark. Similarly, the ECJ has held that a company can move its headquarters from one Member State to another (*Überseering*) provided it acts in accordance with the rules of its state of incorporation.[38] In *Überseering*, the German courts relied on their national stance on company seats to rule that a Dutch company that had moved its principal office to Germany had no legal standing to bring proceedings for breach of contract in Germany since it had failed to reincorporate in Germany and therefore had no legal personality. The ECJ overruled this on the basis that it went against the principle of freedom of establishment.

[34] Council Directive 2003/72/EC supplementing the statute for a european cooperative society with regard to the involvement of employees, 2003.

[35] Regulation 1606/2002/EC of the European Parliament and of the Council on the Application of International Accounting Standards, 2002.

[36] Centros, Case C-212/97, [1999].

[37] Inspire Art, Case C-167/01, [2003].

[38] Überseering, Case C-208/00, [2002].

2.52 The second issue concerns the extent to which a home State can restrict a company's ability to move to a host Member State. In *Daily Mail*, a tax law case, the Court refused to recognise an unrestricted right of exit for companies in cases where the company moves without reincorporating.[39] Home Member States can therefore impose restrictions on emigrating companies in these situations. *Cartesio* upheld this principle with some nuances.[40] It stated that a company should be able to reincorporate in the host State, to the extent that it is permitted by the host State's laws to do so, without encountering barriers from the home Member State. Any restriction by the home State on a company's ability to reincorporate in another Member State would, the Court found, be a restriction that could only be justified by overriding requirements in the public interest. In both *Daily Mail* and *Cartesio* the companies had sought to remain incorporated under the law of the Member State they exited. The ruling in *Cartesio* also suggested that the European Commission should come forward with formal proposals relating to transfer of registered office.

2.53 The ECJ has also recently ruled (*Vale Építési*) that if a Member State has provisions that allow domestic companies to convert their legal forms then companies from other Member States must also be able to use substantially similar provisions to convert into the host Member State's legal forms.[41] Host States cannot, therefore, have rules that discriminate between domestic companies and cross-border companies and which make it harder for a cross-border company to reincorporate or convert.

2.54 These judgments have had greater impact on some other Member States than on the UK. UK company law applies to a company that is incorporated in the UK with no other requirements as to the company's connection with the UK. Company law in some other Member States, however, requires a closer connection between the company and the home State. As a result, the principle that a company incorporated in the UK might do much or all of its business overseas is a familiar one in the UK and is fully compatible with the UK company law framework. In other States, however, a greater adjustment has been required. These judgements put into question the compatibility with EU law of the real seat theory. This theory dictates that the applicable law to a company is the law in which a company has its head office and is a cornerstone of company law in many Member states like Germany and France.

2.55 Now that standards have been agreed in many areas, the pace of change in EU company law is slowing, and it is proving increasingly difficult to reach agreement on new proposals. In many cases, this has been as a result of Member States preferring to maintain greater flexibility in this area. The extent to which national standards for company law vary across the Single Market is a central debate within company law and is discussed further in Chapter Three.

Treaty Provisions and Secondary Legislation on Public Procurement

2.56 The other areas of competence covered by this report, public and defence procurement, are not explicitly described in the Treaties but have been considered essential for the proper and efficient functioning of the Single Market. The procurement sector concerns not only the purchase of services but also the purchase of goods and its scope is, in this respect, wider than the internal market in services. Even within a context of general budgetary restraint, the purchasing of goods and services by public authorities makes a substantial contribution to EU GDP, and EU competence in this area is designed to

[39] The Queen v H.M. Treasury and Commissioners of Inland Revenue, ex parte Daily Mail and General Trust, Case C-81/87, [1988].

[40] Cartesio Oktató és Szolgáltató Bt, Case C-210/06, [2008].

[41] Vale Építési, Case C-378/10, [2012].

extend the Single Market into an area where the 'home bias' has traditionally been very strong. Reliance on domestic suppliers is perhaps even stronger in the area of defence procurement, where a number of further restrictions apply.

2.57 In January 2014, the EU adopted a public procurement package which replaced Directive 2004/18/EC on public works, supply and service contracts and Directive 2004/17/EC on procurement in the water, energy, transport and postal service sectors, and introduced a new Directive on concession contracts.[42] [43]

2.58 The revision of the directives aims to streamline the process by which public tenders are awarded, for instance by reducing the documentation required in the procurement process and providing more flexibility to achieve better commercial outcomes, through the use of negotiation for non-standard procurements.

2.59 The new Concessions Directive brings service concessions into the EU procurement rules framework for the first time and modernises the rules governing works concessions. In this context, concessions arise where a service provider or contractor is granted a right to exploit an opportunity, and takes the economic risk from doing so. This may involve provision of a service or infrastructure to the public, for example, a toll road or bridge might be built and operated as a concession. The concessions approach is not common in the UK, but some public-private partnerships are run as concessions.

Treaty Provisions and Secondary Legislation on Defence Procurement

2.60 As explained in Chapter One, whilst defence procurement is covered by the general Treaty provisions on the Single Market, there is an important derogation in Article 346 TFEU, whose wording has remained unchanged since the Treaty of Rome. In particular, it specifies that:

> Any Member State may take such measures as it considers necessary for the protection of the essential interests of its security which are connected with the production of or trade in arms, munitions and war material; such measures shall not adversely affect the conditions of competition in the internal market regarding products which are not intended for specifically military purposes.[44]

2.61 This derogation takes exempted matters out of the scope of the Treaty and its rules about the Single Market altogether. While it is vital to protect the essential security interests of Member States its use has inevitably helped sustain the fragmented nature of the European defence market – perhaps not surprisingly, most governments wish to see most of their taxpayers' funds spent on local industry and jobs. Thus the defence market could be categorised generally as twenty-eight separate defence markets, with a significant proportion of procurement budgets being placed directly with national suppliers, and only a limited proportion open to cross-border competition. For example, the EDA estimated in 2013 that 'roughly 80% of defence procurement expenditure is spent nationally, that is, outside co-operative projects.'[45]

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[42] Directive 2004/18/EC of the European Parliament and of the Council on the Coordination of Procedures for the Award of Public Works Contracts, Public Supply Contracts and Public Service Contracts.

[43] Directive 2004/17/EC of the European Parliament and of the Council Coordinating the Procurement Procedures of Entities Operation the Water, Energy, Transport and Postal Services Sectors, 2004.

[44] Article 346 (1) (b) TFEU.

[45] European Commission, *Towards A More Competitive and Efficient Defence and Security Sector, Commission Staff Working Document* (2013) 279 final, 2013, p12.

2.62 It was in part to address the low use of the existing procurement legislation and the lack of open competition, that the Commission proposed the introduction of the Defence and Security Procurement Directive as part of its 2007 'defence package.'[46] This Directive is largely based on the Public Contracts Directive, but makes provision for the security of supply and security of information requirements that are specific to defence procurements.[47] By including these provisions, its aim is to limit the use of Article 346 so that Member States 'keep most of their procurement activities inside [the] Directive.'[48] There are, however, a number of specific exclusions contained within the Directive. These include procurements by an international organisation for its own purposes, such as NATO and OCCAR, contracts involving the disclosure of information for intelligence activities, contracts in the framework of co-operative agreements and government-to-government sales.

2.63 The Commission emphasises that these exclusions from the Directive need to be interpreted strictly and that the basic Treaty principles of proportionality and non-discrimination still apply. The Commission intends to issue further guidance on government-to-government sales and procurement through international organisations. This reflects the Commission's concerns that government-to-government sales are being misinterpreted. The UK thinks that such additional guidance is unnecessary when the Directive has only been recently implemented.

2.64 Whilst it is clear that the introduction of the Defence Directive, which is secondary legislation, cannot amend or alter Article 346, it does provide Member States with a tailor-made framework for the protection of their security interests that should be sufficient to address most concerns that were previously raised under Article 346.

2.65 It is arguable that before the introduction of the Defence Directive, Member States would have been equally able to take the protective measures now made explicitly available to them and so the introduction of the Defence Directive in procurement terms may change very little. However, the establishment through the Defence Directive of a framework expressly setting out these measures may make it more difficult for Member States to sustain arguments based on security of supply and security of information under Article 346.

2.66 It has also become easier for the Commission to intervene and the Court to claim competence to consider such matters as they have the terms of the Directive to enforce. This may allow the European Institutions to limit the use of Article 346 by Member States and to seek to effect a change to behaviour that appears to have become entrenched in some Member States.

2.67 In accordance with the Articles of the Directive, the Commission will report on the Directive's effectiveness to the European Parliament by 21 August 2016. In advance of this report, the Commission announced that it would be closely monitoring the implementation of the Directive to ensure it was having the desired effect of opening up the defence market.

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[46] Directive 2009/81/EC of the European Parliament and of the Council On the Coordination of Procedures for the Award of Certain Works Contracts, Supply Contracts and Service Contracts by Contracting Authorities or Entities in the Fields of Defence and Security, 2009.

[47] Directive 2004/18/EC [2004]. For more information, see the relevant sections of this chapter on public procurement.

[48] Martin Trybus, 'The Tailor-Made EU Defence and Security Procurement Directive: Limitation, Flexibility, Descriptiveness, and Substitution,' *European Law Review* 38(1) (2013).

2.68 This announcement was made in the Commission's Communication.[49] In addition, the Communication sets out further proposals in the areas of the internal market, industrial policy, research and innovation, and international trade. The broad nature of these actions signals efforts by the Commission to utilise other policy instruments beyond the Defence Procurement Directive to create a single market in defence and arguably reinforces its own role in the defence sector.

2.69 This Communication, and the broader priorities for the defence industrial sector, was discussed at the 2013 December European Council; and the Commission now intends to develop a high level road map for implementation. The Government has made it clear that it does not support any extension of Commission competence.

The Crown Dependencies and Free Movement of Services

The Crown Dependencies (the Isle of Man and the Bailiwicks of Guernsey and Jersey) are not members of the EU, but certain aspects of EU law relating, in particular, to trade in goods and the Customs Union apply to them, as set out in Protocol Three to the UK's Treaty of Accession. Protocol 3 does not cover services, so the Crown Dependencies are generally treated as third countries for the purposes of EU services legislation. Nevertheless some domestic services legislation in the Crown Dependencies is often based on relevant UK/EU legislation as a matter of good practice.

The Crown Dependencies' economies are services based. Selling such services into the EU market is only practicable if (a) a Single Market has been established in the sector (still not always the case) (b) the relevant EU legislation contains a provision concerning third country market access, and (c) the Crown Dependencies are assessed as meeting any requirements set out in such a provision.

Many of the broadcast and online services available and consumed in the Crown Dependencies emanate from Member States, principally the UK, so viewers are therefore protected by the standards set out in the Audio Visual Media Services Directive (AVMSD).

Similarly, the Crown Dependencies are affected by the EU's competence in telecommunications. For example, the Crown Dependencies are not members of the International Telecommunications Union and OFCOM manages and licences spectrum rights of use on the Crown Dependencies' behalf. The Crown Dependencies are therefore directly affected by the relevant European legislation concerning spectrum and benefit from being part of a larger European group when harmonising spectrum usage in international negotiations. The Crown Dependencies are part of the UK telephone numbering plan which is managed by OFCOM in accordance with the EU Directives. However, Crown Dependencies consumers going abroad (and UK/EU consumers visiting the Crown Dependencies) do not benefit from the lower voice and data charges secured by the EU Roaming Regulations; nor do Crown Dependencies consumers (and UK/EU consumers calling the Crown Dependencies) benefit from EU regulations concerning the price of intra-EU international calls.

[49] European Commission, *Towards A More Competitive and Efficient Defence and Security Sector* (2013).

Conclusions

2.70 The Treaty rights of free movement of services and the freedom of establishment are complemented by various pieces of secondary legislation, of which the 2006 Services Directive has the widest scope and perhaps the largest ambition. As well as covering a large number of service activities, including tourism, retail and business services, the Directive attempted to codify several decades of jurisprudence. Over time, the ECJ has sketched the limits of what constitutes a service, and more importantly, the types of restrictions on the free movement of services that it is legitimate for Member States to apply and those which constitute an unjustified barrier. The next chapter will consider how this legal framework affects the UK economy, business and consumers in practice.

Chapter 3: The Free Movement of Services and the UK's National Interest

Summary

This chapter assesses the impact of the free movement of services on the UK national interest: an effective Single Market that gives UK service providers access to markets across the EU and allows UK consumers to benefit from fair and open competition. Services make a very important contribution to the overall EU economy but the trade in services within the Single Market is much less integrated than that of goods. Notwithstanding the fact that services are typically less tradable than goods, evidence submitted to this review attributes this underperformance of the Single Market in services to a number of factors, but particularly to poor implementation of the Services Directive, with national restrictions remaining as barriers to trade. EU competence is seen on a continuum from international competence, through the General Agreement on Trade in Services in the WTO, through national competence to sub-national competence, as much of the regulation of service provision takes place through the devolved administrations and local authorities.

Whilst there was general support from respondents for the current balance of competence, there were also some calls for greater integration in the Single Market for services, particularly from business organisations, with better implementation of the Services Directive and the completion of the Digital Single Market being cited as examples. On the whole, the majority of respondents felt that, within the current balance of competence, the advantages of EU action outweighed the disadvantages for service providers. Whilst it was recognised that the costs fell on service providers that were not trading in overseas markets, as well as those that are active internationally, economic analysis shows that non-exporting businesses have benefited from liberalisation in domestic service markets, and that any national legislation on services would not have been dissimilar from the current EU regime.

There was less evidence submitted on consumer benefits, but it was felt that consumers had gained from increased competition and choice in service provision. Some respondents felt that the creation of an additional EU company law regime, the so-called '29th regime,' was a distraction from ensuring full freedom of establishment. The public sector has also gained from competitive public procurement, although the current level of EU competence could be exercised in a less burdensome manner. Respondents identified trade-offs between the free movement of services and the ability of national governments to regulate service provision; between the free movement of services and immigration policies, as the free movement of services often requires the free movement of people; and between the free movement of services and the ability for Member States to develop and maintain national defence supply capabilities.

3.1 Impact on the UK Economy

3.1 The free movement of services is one of the four fundamental freedoms of the EU, and has long been considered an essential element of the Single Market. Along with the free movement of goods, capital and persons, it has been protected by the Treaties since the earliest days of the EU and its forerunners. Nevertheless, as described in Chapter One, for many years, the EU focused much of its effort on using legislation to complete the Single Market for goods, leaving many services unregulated at the European-level. Now, though, European rules cover the vast majority of services provided to both businesses and consumers: 90% of all services in the EU are covered either by the horizontal Services Directive or by specific pieces of sectoral legislation.[1] Although it contains a long list of exclusions, the Services Directive has by far the widest scope, and this section focuses mainly on its effects on the UK economy; the following section will consider its effects on individual businesses and consumers. Where relevant, the impact of sector-specific pieces of legislation is also discussed.

3.2 The provision of services makes a significant contribution to the EU economy, and the sector's relative importance is continuing to rise. Service activities account for just over 70% of EU GDP and close to 70% of EU employment.[2] Over recent years, there has been a widening gap between the contribution made by the services and manufacturing sectors to both EU gross value-added and overall EU employment.[3] In the ten years from 1998-2008, the services sector outpaced the general economy, growing by an average of 2.8% per year, compared to average EU growth of 2.1%.[4] Finally, the EU services sector proved more resilient than other parts of the economy during the financial crisis: turnover in the sector fell by 8.5% across the EU in 2009 but bounced back in 2010 with 5% growth.[5] Figure Five shows growth in various parts of the EU economy since 2000. Although the services sector did contract as a result of the 2008 financial crisis, it was the least severely affected part of the economy.

1 BusinessEurope, *submission of evidence*, p1.

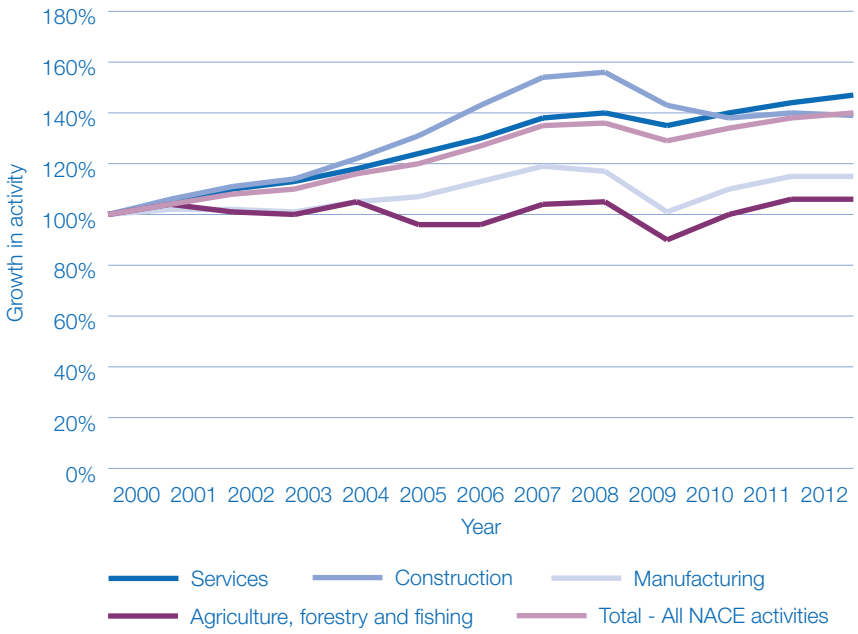
2 72.9% of EU GPP and 69.5% of EU employment. Eurostat, Dataset reference: [Nama_nace64_c and lfsa_egan22d].

3 OpenEurope, *submission of evidence*, p8.

4 BusinessEurope, *submission of evidence*, p1.

5 BusinessEurope, *submission of evidence*, p1.

Figure Five: Growth in Economic Activity over Time within the EU28 by Sector – (2000 = 100)[6]



3.3 Services are important to the economy of the entire EU, but they have historically played a stronger role in the UK than in many other Member States. The UK economy is therefore disproportionately exposed to changes affecting the sector. Business organisations in particular welcome UK participation in the Single Market for services because of the commercial opportunities that this generates. For example, commenting on efforts to open up European services markets, the Business Services Association points out that 'liberalisation […] at EU-level particularly benefits the UK,' citing BIS statistics that show that the UK's 'mature services sector' accounts for 79% of domestic economic activity, above average for the EU, where the figure is 70%.[7] The recent Industrial Strategy for Professional Business Services highlighted the fact this sector alone generates around 11% of UK GVA and provides nearly 12% of UK employment. Further, despite the economic downturn the PBS sector has seen growth of nearly 4% per annum over the last decade.[8] According to the British Chambers of Commerce (BCC), 'free movement of services is a critical aspect of EU membership as it provides our members with access to a market of 500 million people. The UK is the second-largest exporter of services in the world.'[9] The London Chamber of Commerce & Industry refers to the UK's 'competitive advantage in the export of services, in particular financial and business services concentrated in London.'[10] The Federation of Small Businesses notes that although its exporting members are more likely to trade goods rather than services, those that do business overseas do so overwhelmingly with other European countries.[11]

6 Eurostat Dataset reference: [nama_nace10_c, nama_nace21_21].

7 Business Services Association, *submission of evidence*, p2.

8 HMG, *Growth is our Business: A strategy for Professional Business Services* (2013).

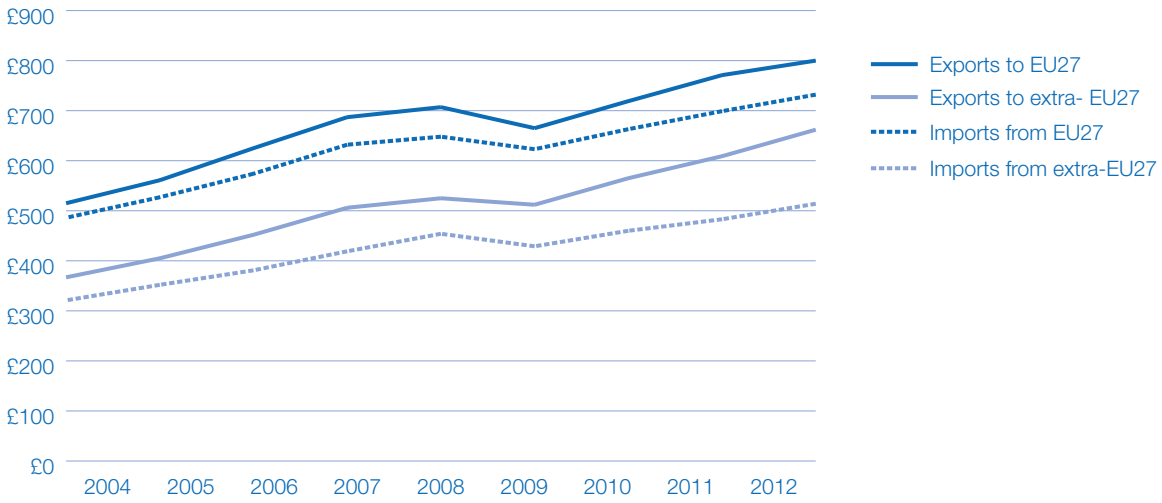
9 BCC, *submission of evidence*, p1.

10 London Chamber of Commerce and Industry, *submission of evidence*, p1.

11 FSB, *submission of evidence*, p5.

3.4 Despite their economic importance, however, services make up a much smaller proportion of intra-EU trade than goods. Services, which often require the physical presence of both provider and consumer, are generally less easy to trade than goods. As such, it may be more appropriate to establish a subsidiary in another country (foreign direct investment rather than pure trade) to deliver services rather than provide them from another Member State. However, even accounting for this fundamental difference, there is consensus that the Single Market for services is not as effective as the Single Market for goods.[12] For example, only around a fifth of the services provided in the EU cross Member State borders.[13] In the words of the BCC, 'the reality for businesses is that, compared to trade in goods, the internal market for services has hardly got off the ground.'[14] The situation is similar for small businesses: the Federation of Small Businesses (FSB) reports that just 7% of its members export services from the UK. Considering the EU as a whole, over 40% of intra-EU trade in services is taken up by travel and transport services, which are by definition cross-border in their nature.[15] This suggests that there is room for expansion of EU trade in services in some sectors, with for instance the fast-growing ICT sector accounting for just 7% of all trade between EU Member States.

Figure Six: EU27 Trade in Services with other Member States and Rest of World, 2004-2012[16]



3.5 Some services are more tradable than others. The provision of some services, such as catering or accommodation, are physically linked to a specific location. Others are relatively straightforward personal services with only limited added value for which individual service providers or recipients may not see any reason to move to another Member State, such as hairdressing or dry cleaning. However, others are significantly more mobile and much more likely to be traded across borders. These include professional business services, such as accountancy and auditing, which can to a large extent be provided at a distance, provided that all of the relevant documents are available.

[12] However, within the EU, many of the figures on cross-border trade in services are estimates. Compared to other sectors, such as agriculture and manufacturing, national statistics authorities and Eurostat do not collect data on the number of service companies establishing branches overseas. The vast majority of service providers in Europe are micro-enterprises, defined as businesses with no more than ten employees. Many of these are individuals working independently as cleaners, personal tutors or driving instructors for instance, and it can be very difficult to draw conclusions about this very diverse group.

[13] BusinessEurope, *submission of evidence*, p1.

[14] Business Services Association, *submission of evidence*, p2.

[15] Eurostat Dataset reference: [bop_its_det].

[16] Eurostat Dataset reference: [bop_its_det].

3.6 Public procurement, the purchase of goods and services by public sector bodies, represents a substantial chunk of the EU economy: in 2009, contracts amounting to over €2 trillion were awarded.[17] Such contracts have a direct impact on the UK economy when they represent tenders conducted by UK public authorities or awarded to companies based in the UK, but there is also an indirect effect on UK GDP. The expansion of the traditionally closed market for public procurement to companies from any Member State should lower costs for contracting authorities by increasing competition. The European Commission investigated the economic impact of the two 2004 public procurement Directives and found that savings were in line with previous estimates.[18] At the time of its initial proposal, the Commission had estimated that overall prices for EU advertised procedures should be 2.5-10% lower than expected. Using estimated savings of 5% across the €420bn of public contracts published at the EU-level would translate into savings in excess of €20bn every year. In preparation for the negotiations of the recently adopted public procurement package, the Government prepared an impact assessment in January 2011. This assessed the UK savings to be around £4.15bn per year on £83bn of contracts published, significantly outweighing the costs estimated at around £0.48bn per year.[19]

3.7 Since the Defence Procurement Directive has only recently been implemented, it is not yet possible to determine the extent of its impact on the UK economy. Though there is no specific research on the impact of a more open defence market on the UK, theoretical research at the EU-level would imply that there should be benefits both in lower equipment costs to the UK MOD and greater UK defence exports.[20] Thus for example recent research on the European defence market, derived from analysis in the 1990s, states that a truly Single Market in defence, without any recourse to the Article 346 exemption described in Chapters One and Two, would reduce EU defence procurement costs by 10-20%.[21] The European defence procurement market was valued in 2012 at approximately €90bn.[22] Other commentary suggests that Europe as a whole might be paying 30-40% more than it should for its military equipment and that excess capacity is as high as 30% in combat aircraft, land vehicles and naval shipbuilding.[23] While the benefits to the UK from open competition could therefore be significant, there are two other elements considered essential to a more efficient defence market: more common procurements amongst nations, which could help generate greater economies of scale; and further defence industry consolidation.[24] These will be discussed below.

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17 European Commission Directorate-General for Internal Market and Services, *EU Public Procurement Legislation: Delivering Results – Summary of Evaluation Report,' Executive Summary* (2011).

18 Directive 2004/18/EC consolidated previous public procurement legislation; while Directive 2007/17 governed the awarding of contracts in the water, energy, transport and postal service sectors 2004. For more details, see Chapter One.

19 HMG, *Explanatory Memorandum on Document 18966/11, Draft Directive on Public Procurement* (2012).

20 BAE Systems, *submission of evidence*.

21 Replace with: Keith Hartley, 'Defence Industrial Policy in a Military Alliance', *Journal of Peace Research* (2006).

22 EDA Defence Data.

23 'Europe's Defence Industry: A Hard Pounding, This,' *The Economist* (2 March 2013).

24 See for example: Keith Hartley, 'Creating a European Defence Industrial Base,' *Security Challenges*, Vol 7 (2011).

The European Defence Sector

The European defence industry is a sizable proportion of the European economy, having a turnover in 2012 of €96bn, directly employing about 400,000 people and another 960,000 indirect jobs. Though it remains a world leader in a number of areas, it suffers from significant over capacity and duplication. Thus, it has roughly three times more major programmes in development than the US, despite collectively having less than one third of the procurement budget.[24]

In the words of the *Economist*: 'Europe's defence industry, which is organised largely on national lines, remains locked in a downward spiral of high costs, chronic over-capacity and declining military budgets.'[25]

While the overall European outlook may be considered bleak, the UK defence industry remains in relatively good health. It generated £22.1bn of turnover in 2011, £10.6bn of which was on exports. It is the largest defence industry in Europe, including major Primes, such as BAE Systems and Rolls Royce, an expanding support service sector, such as Babcock International and Serco, significant multinational presence including Thales and MBDA, and several thousand defence and security Small and Medium Sized Enterprises (SMEs). It is also the second largest global exporter and continues to attract significant overseas investment, from companies such as Finmeccanica, Lockheed Martin and Saab.

Level of Regulation

3.8 Free movement of services inside the EU is part of the broader framework of international trade policy. Amongst those who commented on the level at which to regulate the provision of services, there was general agreement that regulating the services sector is best done at the EU level, and that in this sense, the balance of competences in this area is broadly appropriate.[27] Services could, however, also be regulated at a higher level, such as the World Trade Organisation.[28] In their joint submission, the Law Societies of England & Wales and Scotland point out that negotiating a common framework in the EU currently requires the agreement of 28 Member States, something which would be substantially more complicated with even more parties to the negotiation. Such negotiations would also involve finding agreement with emerging market countries, often the most protectionist in the areas of services and public procurement.[29] Despite ongoing concerns about EU-level regulation, the FSB makes a similar argument, concluding that, 'a body such as the WTO could not be seen as an addition or an alternative to the EU for regulating intra-EU trade in services,' and that:

> Given the degree of market integration, the FSB cannot see how a single market of […] European countries can be created at anything other than EU level.[30]

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25 European Commission, 'Commission Staff Working Document on Defence', SWD (2013) 279 final, 2013.

26 The Economist, 'Europe's Defence Industry,' *The Economist*.

27 For example, FSB, *submission of evidence*, p5; Business Services Association, *submission of evidence*, p2. Wirtschaftskammer Österreich, *submission of evidence*; Liberal Democrat Party Group in the European Parliament, *submission of evidence*, p1.

28 It is notable that whilst other regional economic groupings such as the Caribbean Community and Common Market and the Southern African Development Community have included chapters on services in their programmes, integration of their services markets remains at a much lower level.

29 Liberal Democrat Party Group in the European Parliament, *submission of evidence*, p1.

30 FSB, *submission of evidence*, p4-5.

3.9 Equally, it is possible that allowing individual Member States to govern their own service sectors would risk fragmentation of the Single Market for services. In the words of BT, 'internal market policy must clearly remain an EU-level competence if it is to have any meaning.'[31] The Law Societies considered the potential difficulties of a less coordinated regime for the European services market, suggesting that:

> If all action were taken at a national level, then trade […] among the current 28 Member States would need to be negotiated and enforced on a bilateral basis, […] significantly increasing complexity for businesses in providing services across borders.[32]

A similar view was expressed in the evidence received from stakeholders in other Member States, with the Wirtschaftskammer Österreich for example arguing that for the free movement of services, regulation at 'the national level would be too narrow.'[33]

3.10 In the area of company law, the EU is able to adopt international accounting and audit standards following negotiations with all Member States. As new standards emerge, EU legislation is updated to reflect any changes to ensure comparability across markets to allow companies to operate globally. Audit standards are subject to both European and international standards, and some participants at discussion events were concerned about suggestions that international standards that have been adopted are appropriate, a point raised during negotiations of both the International Standards on Auditing and the new EU Audit Directive and Regulation.[34]

3.11 Almost all the responses that commented specifically on company law matters agreed that there were benefits to certain levels of harmonisation, although some expressed concern about specific areas of company law. The Institute of Directors in particular felt that corporate governance matters including the structure and composition of boards and narrative reporting should be left to national rules. They felt that diversity in these areas was acceptable as there was not a direct cross border issue, and therefore no impediment to the single market.[35] The ICAEW also felt that a number of current directives were not necessary and implementation of these directives incurred costs which could have been avoided.[36]

3.12 Along with harmonisation and a convergence of international audit and accounting standards there has been debate as to whether there should be a '29th regime' of company law. There is already a pan-European public company form; agreement was reached in 2001 on a form of EU-wide law for public companies, also known as the *societas europea* or SE. However, take-up of the SE form has been both slow and limited, with only around two thousand across the whole EU and just 77 registered with the UK authorities, a tiny fraction of the over three million companies on the UK company register (on 1 February 2014). One of the principal attractions of the SE form was the ability to transfer the company seat from one Member State to another, an issue which had proved controversial within 'traditional' EU company law, and was the subject of a number of notable ECJ cases discussed in Chapter Two. However, there is not yet a uniform approach to the SE form across Member States, and the EU Regulation refers in many places to provisions in the domestic legislation of the country where an SE is registered, creating much uncertainty. The SE has been most popular in just a handful of Member

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[31] BT, *submission of evidence*, p1.

[32] Law Societies, *submission of evidence*, p3.

[33] Wirtschaftskammer Österreich, *submission of evidence*, p1.

[34] *Notes of BIS London Events.*

[35] Institute of Directors, *submission of evidence*.

[36] Institute of Chartered Accountants of England & Wales, *submission of evidence*.

States, suggesting that it is not meeting the needs of all of its potential users and that its attractiveness depends to a large extent on the national rules in place. The European Commission is expected to make proposals for reforms to the SE form later in 2014, with the aim of making it more attractive and simpler to use.

3.13 For private companies, the European Commssion proposed the introduction of the European Private Company or SPE, but following several years of negotiation and attempts to reach agreement, the proposal was withdrawn in 2013. This failure to reach agreement demonstrates that although Member States are prepared to harmonise company law to a certain extent, there is little appetite to move away from domestic regimes which have been established for many years. Some business organisations have noted that rather than promoting the creation of a 29th regime of company law, EU resources would be better directed to removing other obstacles associated with freedom of movement, such as cultural, language or taxation issues. In addition, the mere introduction of a new form complicates the landscape adding costs to businesses; the Association of Chartered Certified Accountants (ACCA) noted in its evidence that 'business prefers the structures it knows and understands.'[37]

3.14 International standards also apply in the area of public procurement, and respondents noted that a framework of public procurement rules would need be to provided even if the UK were not part of the EU. As a member of the EU, the UK is subject to the WTO's Government Procurement Agreement (GPA). This brings the benefits of guaranteed access to the public procurement markets of the world's developed countries, including the US, Canada, Japan and the Republic of Korea. The EU negotiates improved public procurement access in such countries, both through improvements in the GPA and through bilateral Free Trade Agreements. Such market access is very important for services, as well as goods, and is an area where the Bar Council believes that the UK stands to benefit substantially from improvements in access.[38]

Effects of Regulation

3.15 In assessing the impact of the Services Directive, several early *ex-ante* studies took the initial 2004 proposal based on the country of origin principle as their baseline. One 2005 analysis predicted a 0.3% increase in EU employment, as well as a 0.6% increase in EU GDP, but did not disaggregate the effects on the economy of each Member State.[39] Another contemporary study of the new Directive's likely impact suggested that, if fully implemented, it could add an average of 0.3-0.6% to EU GDP by 2040, but just 0.1% to UK GDP, potentially because the service sector in the UK was already relatively open compared to other EU countries.[40] These and other forward-looking studies conducted around the time of the original proposal relied on a similar set of assumptions, such as uniform implementation across all Member States and no effects on purely domestic service providers.

3.16 Evaluating the economic impact of the Services Directive since it came into force has proved challenging. As the Directive's primary aim was to stimulate cross-border trade in services by removing unjustified barriers across the EU, assessing its impact on the UK, or indeed any other Member State, requires an assessment of the barriers removed in all Member States. Furthermore, modelling the effects of changes in regulation is complicated

[37] ACCA, *submission of evidence*, p5.

[38] Bar Council, *submission of evidence*, p6.

[39] Copenhagen Economics, *Economic Assessment of the Barriers to the Internal Market for Services*, (2005), p7.

[40] Netherlands Bureau for Economic Policy Analysis, *Expected Economic Benefits of the European Services Directive* (2007).

by a wide range of static and dynamic factors involved. The majority of studies have therefore focused on the EU as a whole. The most comprehensive recent evaluation of the effects of the Services Directive was conducted by the European Commission in 2012.[41] Based on observations of the actual non-tariff barriers removed during implementation of the Directive, rather than a hypothetical removal of all barriers, the report concludes the Services Directive could contribute an additional 1% to UK GDP over time, with 80% of that benefit being felt within the first five years after implementation, that is, by 2014. The most important factor in this increase was a forecast productivity increase in the services sector arising from the wider impact of administrative simplification, and benefitting not only exporters of services, but also the far larger number of companies trading only on the domestic market. These knock-on effects of EU services legislation on 'stay at home' companies will be discussed in the next section.

Implementation

3.17 Many respondents, including participants at all of the discussion events highlighted the problems with implementation and interpretation of the Services Directive.[42] Amongst responding business organisations, the most common perception was that the Services Directive was a useful step, but that it has not yet been fully implemented across all Member States. For example, according to the Business Services Association, whilst the Services Directive 'has seen some benefits to the UK services sector, these benefits have not been fully realised.'[43] In its submission, the London Chamber of Commerce & Industry reports that:

> The Services Directive has had an overall positive impact on delivering the free movement of services, and London businesses believe that no further regulation or legislation in this area is necessary. That said, problems have arisen regarding the uniformity of enforcement of the Directive across the EU.[44]

3.18 The main reason for what BusinessEurope calls a 'grey zone' is the considerable amount of discretion left to Member States to decide which restrictions should remain in place and assess their proportionality, with some participants in discussion events feeling that this power is sometimes used for protectionist purposes.[45] [46] The BCC noted that their members feel that 'the balance of competences between the EU and Members States in this area is not appropriate and Member States should not be able to maintain certain types of restrictions on the free movement of services.'[47] Restrictions permitted by the Directive under certain circumstances include for instance the requirement that a service provider takes on a certain legal form, Article 15 on establishment, or limits on their ability to open an office to do work, Article 16 on temporary provision of services.

[41] Monteagudo et al., 'The Economic Impact of the Services Directive'.

[42] For example, *Notes of BIS Brussels Event* and *Notes of BIS London Events*.

[43] Business Services Association, *submission of evidence*, p2.

[44] London Chamber of Commerce & Industry, *submission of evidence*, p4.

[45] BusinessEurope, *submission of evidence*, p2.

[46] For example, *Notes of BIS Brussels Event.*

[47] Commercial Broadcasters Association, *submission of evidence*, p2.

3.19 Although the European Commission's own figures show that the current transposition of services legislation across the EU is now at an all-time high, any incorrect transposition can chip away at the integrity of the Single Market for services, undermining its viability.[48] [49] Indeed, the nature of the exceptions allowed under the Services Directive means that transposition of the text of the Directive itself into national law is not sufficient: full implementation requires the reform or removal of a wide number of pieces of domestic legislation that constitute *de facto* barriers to entry, as well as a commitment to ensure that any further domestic regulations do not impose further barriers.[50] Poor implementation was described as particularly frustrating by service providers who have the impression that they are economically disadvantaged when doing business with other Member States who have not removed barriers to entry, but whose businesses can freely export their services into the UK.[51]

3.20 Recognising the wide variety of potential barriers to the free movement of services contained within national legislation, the Services Directive called for a mutual evaluation exercise to monitor the progress of implementation. This peer review process, which took place in 2010 and 2011, required governments to assess each other's implementation of the Services Directive in clusters of five Member States. It revealed that many specific barriers to entry, including discriminatory requirements on nationality, legal form and the number of shareholders, have indeed been removed, reduced or abolished in Member States' legislation – but that others still remain.[52] The Business Services Association welcomed mutual evaluation as it 'highlighted where in the EU the Services Directive has not been fully embraced,' and advocated a rolling implementation of this process as an immediate step towards ensuring full implementation of the Services Directive.[53]

3.21 The Services Directive requires the removal of unreasonable barriers to trade in services whether these are applied by national, regional or local authorities, or indeed by third parties such as professional bodies. For UK exporters, the complicated patchwork of legal powers, in particular in countries with a federal system of government, can be confusing.[54] To take just one example, when the European Commission investigated the construction sector, it discovered that while professional installers of electrical equipment were regulated throughout Spain, only two autonomous communities regulated plumbers.[55] More generally, the provision of small-scale services such as cafés and bars is often regulated at local level across the EU. In the UK, devolved administrations and local authorities are responsible for implementing various aspects of the Services Directive, which the Local Government Association suggests can lead to problems with coordination.[56] Where authorities are responsible for licensing service providers, the Services Directive requires them to allow online applications in order to facilitate the access of businesses from other Member States. However, the Northern Ireland Department for Enterprise, Trade and Investment expressed scepticism about whether the cost of implementing this procedure

[48] European Commission, *Internal Market Scorecard 26* (2013).

[49] FSB, *submission of evidence*, p6.

[50] European Commission Communication, *Towards a Better Functioning Single Market for services — building on the results of the mutual evaluation process of the Services Directive*, COM (2011) 20 final.

[51] London Chamber of Commerce and Industry, *submission of evidence*, p5.

[52] European Commission Communication, *Towards a Better Functioning Single Market for Services — Building on the Results of the Mutual Evaluation Process of the Services Directive,* COM (2011) 20 final.

[53] Business Services Association, *submission of evidence*, p3.

[54] Point raised at stakeholder discussion event, *submission of evidence*, p1.

[55] European Commission, *Performance Checks: State of Play of the Internal Market in the Construction Sector: Background Note: Expert Group Meeting: 22 March 2012* (2012) p8.

[56] Local Government Association, *submission of evidence*, p3.

is outweighed by the benefits gained, especially when very few online applications have been received.[57]

3.22 Much trade in services relies on individual practitioners exercising their right to freedom of establishment in another Member State. EU rules for the mutual recognition of professional qualifications create processes that allow professionals to demonstrate that they are adequately trained to practice in another country. The job of assessing qualifications falls to Member State Competent Authorities, who regulate professions nationally. Given the wide number of professions concerned and the differing practices across the EU, UK Competent Authorities have reported a wide range of experiences, and these effects on individual professions and practitioners will be discussed in more detail in the next section. Nevertheless, it is possible to consider the impact that the mutual recognition of professional qualifications has had on the UK on a broad level. For example, the bodies responsible for registration in the medical sector acknowledge that both doctors and nurses from the EU and beyond have made a positive contribution to the NHS in the UK.[58] Other professions, including architects, describe a perception that the UK is a particularly attractive destination for mobile professionals.[59] The widespread teaching of English as a second language elsewhere in the EU may increase the attractiveness of the UK as a destination for mobile professionals from elsewhere in the EU.[60]

3.23 Outside the scope of the Services and MRPQ Directives, the provision of many other services within the EU is regulated by specific pieces of sectoral legislation, some of which adopt a very different approach. One example is the broadcast media sector, with TV and radio covered by the Audio Video Media Services (AVMS) Directive, which is described in more detail in Chapter Two. Unlike the Services Directive, this legislation uses the country of origin principle, and therefore allows broadcasters licensed in one Member State to transmit their programming in any other. As Ofcom acknowledges, broadcasting is in many ways 'intrinsically linked with national cultural and public interest concerns […] for which the Member States remain exclusively competent.'[61] However, when broadcasting is a commercial activity, it is considered a service which should be available across the Single Market. The use of the country of origin principle in the Directive allows broadcasters to register in just one Member State, 'lowering the regulatory and administrative burdens on industry and thereby encouraging the availability of pan-European (broadcast and video on demand) content.'[62] As in other sectors, the UK has been able to act as a 'gateway to Europe' for several broadcasters from outside the EU, and over half of all channels broadcasting in the EU are now licensed in the UK, of which around half broadcast either partly or exclusively in other EU Member States.[63] As a result, the organisation representing producers in this sector believes that the national economy has benefitted from growth in the UK's independent production industry to the benefit of the national economy,[64] while broadcasters note that the UK has become an important centre for broadcasting across Europe, better able to compete at the global level.[65]

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57 Northern Ireland DETI, *submission of evidence*, p5.

58 British Medical Association, *submission of evidence*, p1; Royal College of Nursing, *submission of evidence*, p2.

59 Architects Registration Board, *submission of evidence*, p2.

60 All-Party Parliamentary Group on Modern Languages, *submission of evidence*, p5.

61 Ofcom, *submission of evidence*, p5.

62 Commercial Broadcasters Association, *submission of evidence*, p1.

63 Ofcom, *submission of evidence*, p5.

64 Pact, *submission of evidence*, p4.

65 Commercial Broadcasters Association submission 51, p2.

3.24 The broadcasting sector illustrates an inherent tension in Europe-wide regulation. Cultural norms and perceived standards of taste vary from one Member State to another, but regulators are, in theory, prevented from restricting programming acceptable in the broadcaster's home Member State but considered unacceptable in the host country. The AVMS Directive attempts to resolve this problem by applying certain minimum standards across the EU for this particular sector. Agreeing what these rules should be across all the sectors covered by the horizontal Services Directive would be much more complicated. This broader need to strike a balance between opening up the Single Market at the European-level and the importance of national standards will be discussed in more detail in section 3.3.

3.25 The provision of services over the Internet in Europe is regulated by the 2000 E-Commerce Directive, whose scope extends to the online purchase of goods to be delivered to the customer. It is described in more detail in Chapter Two. Like the AVMS Directive, it relies on a version of the country of origin principle, so if a trader is allowed to do business in one Member State, it can trade online across the entire EU. The Advertising Association, which represents both producers and distributors of advertising, supported this approach, describing it as 'fundamental to the functioning of the Single Market in media and advertising services.'[66] More generally, business organisations contributing to the review expressed general support for further integration of the digital single market.[67] For many small businesses, the low barriers to entry mean that trading online is their first step towards exporting their services.[68] However, it is also possible that the relative success of e-commerce in domestic markets is disguising the more lacklustre growth in cross-border e-commerce. A certain degree of caution on the part of the customer in dealing with a seller trading from a different country and speaking a different language is perhaps inevitable, but a number of legal barriers and incompatibilities remain in place, acting as a brake to the expansion of cross-border e-commerce.[69] Providers of digital services are also increasingly affected by a number of other pieces of legislation, including new rules on data protection currently under discussion.[70] The potential for further growth in the provision of services online is discussed in Chapter Four.

Limitations

3.26 One complication in assessing the overall economic impact of EU services legislation is the connection between the services sector *per se* and other parts of the economy. For example, many businesses provide services not to consumers but to other businesses whose primary activity may be in manufacturing, agriculture or indeed the provision of other services. Apart from the very smallest micro-enterprises, almost all UK companies have recourse to professional services in areas such as accountancy, audit or recruitment. The European Commission estimates that all business-to-business activity between the 20 million companies active in the EU accounts for 75% of internal trade in services.[71] This is especially true in the UK, which has traditionally been an exporter of business and financial services, and which had a trade surplus in services with the rest of the EU to the tune of €14.3bn in 2012, and in particular London, which is an important global centre for this industry.[72] [73]

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66 Advertising Association, *submission of evidence*, p3.

67 BusinessEurope, *submission of evidence*, p9; BCC, *submission of evidence*, 5.

68 FSB, *submission of evidence* to: HMG, *The Balance of Competences Between the UK and the EU: Free Movement of Goods,* p8.

69 Business Services Association, *submission of evidence*, p5.

70 *Notes of BIS London Events*.

71 COM(2001) 20 final, p3.

72 Eurostat Dataset reference: [bop_its_det].

73 London Chamber of Commerce and Industry, general comments in *submission of evidence*.

3.27 Companies in other sectors have also begun to diversify, offering services in addition to goods. Examples include manufacturers who sell products with on-going contracts for maintenance or training. Measuring the extent of this 'serviceisation' of other parts of the economy is difficult, but this further underlines the extent to which services are connected to the rest of the economy. Some participants at discussion events stressed the importance of bearing this in mind when making policy, expressing concerns that the industrial policy of some Member States can be biased towards traditional manufacturing industries.[74] The potential future impact of this trend is discussed in more detail in Chapter Four.

Conclusions

3.28 As a vital part of the UK economy, the services sector benefits from access to the EU's Single Market. Whether they are covered by the horizontal Services Directive or sector-specific legislation, UK businesses are able to trade with a wide range of businesses across the EU which benefits the economy. However, market integration is not complete and there remain barriers to the free movement of services that could have a sizable impact on GDP. The different legal regimes applying to different parts of the services sector reflect the compromises on how to strike the balance between market integration and other policy goals. The next section examines some of the implications of these compromises on individual service providers.

3.2 Impact on UK Service Providers and Users

3.29 The previous section outlined the costs and benefits to the UK economy of participation in the European Single Market for services, and in particular the impact of EU legislation in this area. But the macroeconomic effects of the single market for services are merely the aggregate of the direct effect that these rules have on businesses and consumers providing and consuming services, which will be discussed in more detail here.

3.30 UK companies provide services in a wide range of sectors. Some of them export their services into the Single Market, but most do not. Although the vast majority of service providers are operating in sectors regulated by EU legislation, most of these rules have their origin in Directives transposed into UK law, so it is possible that many individual businesses do not even realise that they are affected by EU rules.[75] Around half of all firms polled in the English Business Survey said that they did not know how EU legislation affected service provision.[76] This lack of awareness is likely to be even more pronounced amongst the micro-enterprises that make up 95% of this sector, some of whom do not realise that their activities are affected by European legislation at all.[77] Amongst businesses that *do* see an impact from EU legislation, as many as 31% are unsure about whether this makes a positive or a negative contribution to their business.[78] A typical view came from a manager at a mid-sized business services firm:

> I don't ask "was the legislation made in the UK or Europe?" I just need to know the regulations that impact on us but where they are made is of no concern, well […] not my priority, on the basis that as a very small employer I can't change the rules.[79]

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[74] *Notes of BIS Brussels Event* and *Notes of BIS Prague Event*.

[75] BusinessEurope, *submission of evidence*, p1.

[76] English Business Survey ad hoc questions commissioned by BIS, *Summary Results from the July and August 2013 English Business Survey Questions relating EU Regulation on Employment and Service Provision* (2014).

[77] European Commission Communication, *Towards a Better Functioning Single Market for Services — Building on the Results of the Mutual Evaluation Process of the Services Directive*, COM (2011) 20 final, p5.

[78] EBS ad hoc questions commissioned by BIS, *Summary Results from the July and August 2013 English Business Survey Questions.*

[79] IFF Research commissioned by BIS, *UK Business Views of The Balance of Competences between the EU and the UK* (2014). p 13.

This diversity and lack of awareness both may help to explain the divergent range of opinions that UK companies have about the EU's single market for services, as well as the fact that more contributions to this review came from representative organisations, which generally have more awareness of EU level issues than individual businesses.

3.31 Despite the wide spread of views, a number of recurring concerns emerge about how the EU services market works at the level of individual service providers, whether they are individual professionals seeking recognition of their qualifications in another Member State or larger businesses seeking to export their services to a new market. Each one of these will be investigated in turn:

- The overall perception that the benefits of participation in the single market for services generally outweigh the costs, including those that stem from the fact that this market is still far from complete;
- A recurring impression that the remaining barriers to completion of the single market stem not from legislative inaction but from a persistent failure to fully implement existing rules;
- The importance of administrative and other burdens that can act as *de facto* restrictions on the free movement of services;
- Low awareness of some of the mechanisms designed to address these problems; and
- The significance of effects of EU services legislation on providers who do not trade in other Member States

Costs and Benefits

3.32 Overall, a majority of respondents to this review felt that UK service providers have benefitted from participation in the single market for services, and that the advantages of having access to this market far outweigh the disadvantages associated with the fact that it does not function perfectly.[80] This is in line with the majority of evidence submitted to the earlier Single Market review.[81] In particular, respondents highlighted the large size of the single market for services and the number of potential customers available to exporters of services as a major advantage – notwithstanding the remaining barriers that prevent them from reaching customers in some markets.[82] One typical sentiment expressed by the owner of a medium-sized business in the transport, retail and distribution sector was that:

> Ultimately, I want to protect my business by remaining competitive, and only a truly level playing field can achieve this […] so by default EU regulations are the only way to ensure this.[83]

3.33 Indeed, this view is shared by businesses in a wide range of sectors and of differing sizes: amongst those interviewed for this exercise, 'the prevailing view tended to be that operating as part of the EU (even if there were some concerns, as described later) was ultimately beneficial

[80] For example, FSB, *submission of evidence*, p4; Business Services Association, *submission of evidence*, p2; Institute of Chartered Accountants of England & Wales, *submission of evidence*, p4; ACCA, *submission of evidence*, p6; London Chamber of Commerce & Industry, *submission of evidence*, p1; Law Societies, *submission of evidence*, p4.

[81] HMG, *The Balance of Competences Between the UK and the EU: The Single Market* (2013).

[82] Business Services Association, *submission of evidence*, p2; Liberal Democrat MEPs, *submission of evidence*, p1.

[83] IFF, *UK Business Views of the Balance of Competences*, p15.

for UK businesses.'[84] Businesses in a number of other Member States express similar points of view, suggesting there is general agreement within the business community that integration in the European Single Market for services is a desirable objective.[85]

3.34 In some service sectors, there is evidence that consumers have directly benefitted from EU action where this has improved the competitiveness of particular markets. One example is telecommunications, where Ofcom describes end users as having 'benefitted from increased competition […], enjoying greater quality and variety of communications services, at consistently low prices, while innovation and indeed investment have continued apace.'[86] Three, which operates in this sector, expressed this in more general terms, suggesting that 'European mechanisms for delivering free movement of services […] have delivered for consumers and businesses in the UK. We doubt that the UK Government would have been able to deliver the same outcomes in isolation.'[87]

3.35 However, the effects of horizontal legislation such as the Services Directive on individual consumers can be hard to quantify, and few contributors to this review discussed these potential effects in detail. There are a number of possible explanations for this. Firstly, the largest customer base for most service businesses is in fact other businesses: three-quarters of cross-border trade in services is represented by business-to-business transactions.[88] Some of the remaining trade in services is represented by procurement by public authorities, further limiting the share of direct cross-border purchase of services by individual consumers. Finally, in some of the cases where UK consumers do purchase services in another Member State, specific sectoral legislation applies. One such example is international air travel, where specific rules apply and which was discussed in a separate balance of competences review. [89]

3.36 Online service provision is one way in which UK consumers can readily access services from other Member States. The Digital Single Market, which is described in more detail in Chapter Two, is governed by a patchwork of different pieces of legislation, but the E-Commerce Directive in principle guarantees the free movement of goods and services based on the country of origin principle, that is, providers must only comply with the regulations of their home Member State. Although UK consumers are the third most active online shoppers in the EU, with 68% of consumers having made a purchase online in the past year, only 20% of people had made a purchase (of either goods or services) from other Member State.[90]

3.37 Despite these consumer benefits, some have argued that UK businesses, 92% of whom do not export, would be better served by the UK being outside of the Single Market because they would not have to comply with costly EU regulation, thus lowering prices for their domestic customers.[91] Entering into a bilateral relationship with the EU along the same lines as countries like Norway or Switzerland, would, it is claimed, allow UK businesses to benefit from substantial deregulation but without hampering access to export markets. The potential future direction of the Single Market for services will be discussed in Chapter Four.

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84 IFF, *UK Business Views of the Balance of Competences*, p12.

85 All discussion events.

86 Ofcom, *submission of evidence*, p1.

87 Three, *submission of evidence*, p5.

88 BusinessEurope, *submission of evidence*.

89 HMG, *The Balance of Competences Between the UK and the EU: Transport Report* (2014).

90 European Commission, *Flash Eurobarometer 358: Consumer Attitudes Towards Cross-Border Trade and Consumer Protection* (2013).

91 David Campbell Bannerman MEP, *submission of evidence*, p1.

3.38 As discussed above, UK businesses stand to gain from EU rules on public procurement which govern their ability to provide goods and services to public authorities in other Member States. The European Commission's evaluation of the 2004 public procurement Directives found that UK businesses have indeed been successful in winning tenders overseas: between 2007 and 2009, UK firms won 17% of direct cross-border supply contracts in the EU and 13% of indirect supply contracts, the second strongest performance after Germany.[92] Anecdotally, the CBI also reports benefits for UK companies who have won business outside the EU, arguing that 'the test for any balance of competences is whether it […] creates opportunities for UK firms to win new business outside the UK. At the moment, the EU-level procurement legislation has had a positive impact in this regard.'[93] Although there is an often expressed perception that UK public procurement is more open than the procurement of other Member States, the Commission's evaluation showed that UK firms won more than 95% of UK contracts advertised EU wide, either by number or value.'[94]

3.39 Despite this, a number of concerns were expressed by contributors about some of the restrictions that EU public procurement rules impose. For instance, several raised the question of whether the level of detail in the current EU public procurement regime is needed to ensure that public contracts are awarded in line with the principles of transparency, equal treatment and non-discrimination.[95] The costs of following procurement processes was seen to be the main disadvantage, and in particular, the 2004 revision of the directives in this area has not necessarily led to simplification or a reduction in costs. Costs accrue both to bidders and contracting authorities, some of whom report spending more time on ensuring legal compliance than they do on assessing the quality of bids.[96] The perceived complexity of the existing rules led contributors to welcome the potential for further simplification, which has been the aim of the recently adopted package of Directives.

3.40 The free movement of services often relies on the ability of service providers to exercise their Treaty rights to freedom of establishment in another Member State. The ECJ is able to test Member States' national rules against the Treaty provisions related to freedom of establishment, and has, on the whole, broadly interpreted this as not only forbidding overt discrimination, but also other national measures that would effectively obstruct the effective exercise of this freedom.[97]

3.41 The case law on freedom of establishment allows Member States to determine the rules for establishment of a company within their territory, but companies are able to decide in which Member State they wish to register and which company law rules they have to follow. For example, an entrepreneur may decide that the UK's company law regime offers him the most flexibility and decide to incorporate a new company in the UK. The company could be established in the UK with a registered office here, but the company may decide to undertake the majority, or all, of its business outside the UK. This approach offers maximum flexibility for the company to formally establish itself anywhere in the EU and then site its business as close to its customers, suppliers or labour as it requires.

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92 European Commission, *Final Report: Cross-Border Procurement Above EU Thresholds*, (2011).

93 CBI, *submission of evidence*, p3.

94 European Commission Staff Working Document, *Evaluation Report: Impact and Effectiveness of EU Public Procurement Legislation: Part 1*, SEC (2011) 853 final, July 2011, p137.

95 BIS London events, *submission of evidence*, Liberal Democrat Party Group in the European Parliament, *submission of evidence*, p4.

96 Local Government Association, *submission of evidence*, p4.

97 See Chapter One for more details about legal decisions concerning the freedom of establishment.

3.42 However, other Member States may determine rules of establishment differently to the UK, and require a company to have both its registered office and its primary place of business within their own jurisdiction, whilst still allowing companies to site subsidiaries and/or branches in other Member States.[98] It can be argued that competition between Member States to encourage companies to set up in their own territory has led to more convergence across the EU. For example, the levels of capital required to incorporate a private limited company have significantly fallen in many Member States to compete with those jurisdictions that require very low or no minimum capital levels for incorporation. This has by default led to a situation in which national rules have become more harmonised without the need for further legislation.

3.43 The costs of implementing changes to the company law regime across the whole EU are difficult to quantify. The Commission does produce an impact assessment when it adopts a legislative proposal, but as the Law Societies noted in their joint submission, as negotiations move forward, there is no requirement to reconsider how the costs associated with the proposal change as it is amended.[99] In 2011, the EU's Reflection Group on Company Law recommended the harmonisation of EU law on cross border transfer of registered office, suggesting that companies be allowed to change the company law regime applicable to them, but a balance needed to be struck between Member States' right to ensure proper taxation and a company's right to freedom of movement. The European Commission's 2012 Action Plan considered whether a new proposal for a directive on cross-border transfer of registered office should be adopted. Should the Commission come forward with a new proposal, it will be necessary to demonstrate the value of the benefits. In 2004 the Commission came forward with a similar proposal, but this was not approved by the Impact Assessment Board as the benefits did not outweigh the costs.

3.44 The Treaties guarantee freedom of establishment not only for companies but also for individual professionals. In the area of professional qualifications, most respondents broadly welcomed the general principle of professional mobility within the EU.[100] To take one example, the Bar Council commented on the specific regime in place for lawyers, describing the division of responsibilities as 'a good example of an appropriate balance of competence between the EU and the Member States.'[101] [102] There have also been more indirect benefits. For example, in the nursing profession, where attempts at harmonisation began as early as the 1970s, the Royal College of Nursing describes a general improvement of standards across the EU as countries with less stringent requirements have improved training in order to comply with the common European framework.[103]

3.45 Nevertheless, organisations representing a wide range of professions including nursing, medicine and architecture, all stressed the importance of maintaining a degree of national autonomy over standards in order to protect consumers.[104] For example, the BMA argued that healthcare providers would be unable to accept a model in which the language

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[98] This is the 'real seat' theory described in Chapter Two.

[99] Law Societies of England & Wales and Scotland, *submission of evidence*, p11.

[100] For example, ACCA, *submission of evidence*, p3; Law Societies, *submission of evidence*, p10.

[101] Governed by the Lawyers Services Directive 77/249/EEC for the temporary provision of legal services, 1977; and the Lawyers Establishment Directive 98/5/EC allowing establishment in another Member State and full integration into that country's profession after three years, 1998.

[102] Bar Council, *submission of evidence*, p4.

[103] Royal College of Nursing, *submission of evidence*, p3.

[104] Royal College of Nursing, *submission of evidence*; British Medical Association, *submission of evidence*; Architects Registration Board, *submission of evidence*.

proficiency of practitioners cannot be tested.[105] The need for a doctor to communicate clearly with his patients and colleagues is a very clear example of a case where there are legitimate reasons to limit access to a profession, but the attitude of the British Medical Association on this topic typifies many responses:

> Facilitating the movement of professionals is an important principle […] [but this principle] must not restrict the actions of the General Medical Council [the Competent Authority for doctors] and employers in undertaking essential language checks. The EU should set the requirements that facilitate free movement whilst providing member states with the ability to implement additional controls where there is evidence that indicates a legitimate need.[106]

Other examples of cases where consumers may need protecting include situations where there are strong information asymmetries: it would be difficult to expect ordinary customers to assess the quality of a professional's qualifications.[107]

3.46 In short, with some particularly sensitive services, the desirability of creating a true single market with minimal barriers is tempered by the need to regulate access in order to protect consumers.

Implementation

3.47 In addition to these broad questions about the balance between reducing barriers and the need to protect consumers, the area of mutual recognition of professional qualifications also illustrates the second common thread running through discussions about the EU services market: the importance of implementation. In one sense, implementation in this field is bound to be complicated: in assessing the suitability of a doctor, dentist or engineer, the devil is in the detail, and each case of personal mobility implies a unique body of professional knowledge and experience to be evaluated by the authorities of the host Member State. The Treaty provisions on freedom of establishment are complemented by minimum standards and a framework to structure communication between national regulators outlined in secondary legislation. However, in many cases, organisations representing certain professions felt that it is precisely the implementation of these systems that hinders the effectiveness of legislation and by extension puts unnecessary limits on the free movement of services.[108]

3.48 In the case of inbound mobility to the UK, some Competent Authorities complain that they are forced to invest time and resources in assessing the qualifications of professionals coming from Member States where implementation is less thorough, making it harder for them to justify these costs with reference to the ability of UK professionals to practice elsewhere in the EU.[109] The sense of unfairness that this creates is exacerbated when some professions find themselves in the perverse situation of having to grant access to nationals of other Member States with what they perceive to be *less* thorough training than would be required for a UK national because the home country's qualifications are judged to be equivalent under the Directive. However, one Competent Authority interpreted a low annual volume of complaints in their sector as a sign that the system is broadly working well.[110]

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[105] British Medical Association, *submission of evidence*, p2.

[106] British Medical Association, *submission of evidence*, p2.

[107] Centre for European Reform, *How to Build European Services Markets* (2012), p8.

[108] Law Societies, *submission of evidence*, p10; Engineering Council, *submission of evidence*, p1.

[109] Institution of Civil Engineers, *submission of evidence*, p2.

[110] Engineering Council, *submission of evidence*, p1.

3.49 Incomplete implementation of rules about mutual recognition of qualifications also has a direct impact on the outward mobility of UK professionals. In this case, the perception of non-reciprocity becomes even more acute, with a distinct perception amongst respondents that it is more difficult for UK practitioners to enter the market in some 'highly-regulated' EU Member States, and that these regulations have more to do with protecting local providers rather than the consumer. Some UK professionals seeking to practice abroad report problems with over-reliance on exact equivalency by national governments or else responsibility being devolved to regional or local authorities that are more difficult to access for professionals coming from another country.[111] [112]

3.50 Poor implementation of the Services Directive, which was discussed on an aggregate level in the previous section, hinders the creation of a truly European Single Market for services. The implementation period for the Services Directive concluded in 2009, but reports of breaches continue. Members of the BCC complain that 'some EU Member States are still applying ownership requirements or fixed tariffs for professional services, legal form and shareholding requirements; or worse, discriminating against service providers on the basis of nationality.'[113] These anecdotal reports seem to be confirmed by the findings of the European Commission's 2012 'Performance Check' exercise. For instance, in the area of professional business services, where the performance check examined in particular the provision of tax advice services, the Commission concluded that:

> Despite the implementation of the Services Directive, various corporate structure limitations and capital ownership requirements have remained in place in many Member States for the provision of certain professional services.[114]

3.51 This investigation asked Member States to report on how they would treat a fictional tax advisory company that wanted to expand into their country. Although a purely theoretical exercise based on the legal framework that was in place in 2012, it provides a useful illustration of some of the restrictions that a service provider which would like to become established in another Member State might face. For example, the company in the scenario would only be able to establish a branch under certain corporate forms in Greece because of national rules requiring professionals to hold a certain amount of the capital in businesses of this type.[115] In Germany, partnership in a tax consultancy is restricted to members of certain professions, including lawyers, auditors and chartered accountants amongst others.[116] Portuguese law, on the other hand, considers the services of lawyers and chartered accountants to be incompatible, so in this scenario the fictitious tax consultancy would be unable to provide both via one company. The performance check revealed many further restrictions and the situation facing the hypothetical company would be different in almost every Member State. Although there is no suggestion that any of the individual restrictions is legally incompatible with the Services Directive, and indeed, many of them may have been removed in the intervening period, it is clear that the Directive's original ambition of radically reducing the barriers to the cross-border provision of services has not been fully met.

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[111] Engineering Council, *submission of evidence*, p2.

[112] British Association of Snowsport Instructors, *submission of evidence*, p1.

[113] British Chambers of Commerce, *submission of evidence*, p3.

[114] European Commission, 'Commission Staff Working Document on the Results of the Performance Checks of the Internal Market for Services construction, business services and tourism' SWD (2012) 147 final, p9.

[115] European Commission, 'Performance Checks: State of Play of the Internal Market in the Business Sector: Background Note: Expert Group Meeting: 28 February 2012,' p9.

[116] Ibid, p12.

3.52 These inconsistencies lead a wide range of business commentators to suggest that the European Commission should take a proactive role in ensuring correct implementation through enforcement.[117] The situation is particularly troubling for SMEs, as even barriers that appear slight in absolute terms can prove insurmountable for the smallest companies, especially when their cumulative effect is considered.[118] However, it seems likely that assessing huge volumes of national regulations to check for potential violations of the Services Directive, not to mention applying the more subjective test of proportionality and necessity, would require significant resources.[119]

3.53 Since the 2009 Defence and Security Procurement Directive only came into force in 2011 and at a time of financial austerity, the general view was that it was too early to draw any firm conclusions on its impact.[120] That said, most contributors to this review were enthusiastic about its potential, especially as the UK defence industry is already used to a competitive local environment, making it well-placed to benefit from the opening up of other EU markets. In its submission, BAE Systems noted that 'the introduction of internal market disciplines and the eventual enforcement of EU legislation may prove historically to have been the most important single act to develop a cross border market in defence.'[121] Though latest Commission evidence that only a limited number of contracts advertised in accordance with the Defence Directive are being awarded to non-national suppliers, highlights the scale of the challenge.[122]

3.54 The benefits of a more open defence procurement market were highlighted specifically with regard to support services. This is an area of the defence market which has yet to expand to its full potential. Currently the UK outsourcing market represents approximately 21% of the total defence budget, which is comparable to the US 24%; while the rest of Europe only spent 3%.[123] As a result of the UK's lead in this field, it is hoped that UK companies could gain a comparative advantage over other would-be competitors as the market grows across Europe. However, there are concerns over whether the market will reach its potential, with many barriers preventing the opening-up of these markets. For instance, Thales highlighted how the UK is used to working with contractors on operational deployments, but this seems to be limited or forbidden by some nations on the presumably mistaken basis of EU employment law.[124] In addition to suggesting EU clarification on this issue, Thales recommended that that the UK should do a lot more to promote the provision of services in other Member States.

3.55 In keeping with concerns over other EU procurement legislation, a common complaint was the bureaucratic costs of the Directive for procurers and suppliers alike. This was felt to impact substantially on SMEs, who could be put off by the high costs involved in tendering. For example, one week of delay in a £1m proposal could add £10,000 to

[117] BusinessEurope, *submission of evidence*, p2; FSB, *submission of evidence*, page 6; London Chamber of Commerce & Industry, *submission of evidence*, p4.

[118] FSB, *submission of evidence*, p3.

[119] Business Services Association, *submission of evidence*, p3.

[120] Directive 2009/81/EC of the European Parliament and of the Council on the Coordination of Procedures for the Award of Certain Works Contracts, Supply Contracts and Service Contracts by Contracting Authorities or Entities in the Fields of Defence and Security, and Amending Directives 2004/17/EC and 2004/18/EC, 2009.

[121] BAE Systems, *submission of evidence*.

[122] From August 2011 to March 2013, of the €1.8bn of contracts placed under the Directive, less than 3% (€53m) were awarded cross-border, although it is not clear how companies with subsidiaries and branches in other Member States are handled by these statistics (European Commission, 'Commission Staff Working Document On Defence', SWD(2013) 279 final (2013), p17.

[123] EDA Defence Data 2011.

[124] Thales, *submission of evidence*.

total costs for each of the bidders.[125] Another drawback raised by BAE Systems was the potential for the Directive to discourage private sector research by requiring the contracting authorities to compete the follow-on production contracts.[126] Indeed, BAE Systems questioned the whole rationale of focussing on the number of competitors as a mark of the Directive's success as being best-suited to the defence market, where long-term supplier relationships are more important and there are costly supplier certification processes.[127]

3.56 Inconsistent use of Article 346 TFEU to avoid the procurement rules set out in the Directive was another key area of concern. While industry accepted the general need for the exemption, as well as the fact that Member States have differing national security interests, the common view was that it was often being misused for economic reasons rather than reasons associated with national security. [128] [129] In support of this, participants at a discussion event noted that Article 346 was often used to justify placing a contract to a local supplier.[130] Another procurement option is to hold a more limited competition outside of EU rules. This can then be used to overtly require 'offsets,' the participation of local industry, itself a distortion of competition and contrary to EU internal market rules.[131]

3.57 Even in cases where a competition is held under the rules of the Directive, there are suspicions that it can nevertheless be weighted in favour of local competitors. This concern over national bias was illustrated through the example of the widespread use of the EU entitlement of a ten day cooling-off period, in which procurement decisions can be appealed. The view at this discussion event was that overseas companies do this in their home markets as a matter of course, often citing impenetrable local regulations, while UK companies rarely do.

3.58 To remedy these concerns, ADS called for more transparency in the use of Article 346 and for it to only be used against clearly defined criteria, as is the case in the UK.[132] As with other pieces of legislation discussed in this review, there have been calls for the European Commission to be proactive in ensuring that it is implemented correctly.[133] Without such action, it falls to businesses who suspect inappropriate use of Article 346 to challenge decisions, which is a costly process and creates a risk of being excluded from future business.

3.59 A related issue which inhibits the establishment of an internal market is the public ownership and control of defence companies across the EU. With a substantial proportion of defence companies either owned or controlled by their national governments, it was felt that UK companies were at a disadvantage in those local markets, to the extent that it is sometimes not even worth making a bid.[134] [135] Similarly it was felt that essential defence industry consolidation was being unduly hindered by public ownership. As

[125] *Notes of MoD London Event*.

[126] BAE Systems, *submission of evidence*.

[127] BAE Systems, *submission of evidence*.

[128] Thales, *submission of evidence*.

[129] Centre for European Reform, *submission of evidence*.

[130] *Notes of MoD London Event.*

[131] AgustaWestland, *submission of evidence*.

[132] ADS, *submission of evidence*.

[133] Thales, *submission of evidence*; AugustaWestland, *submission of evidence*.

[134] DG for External Policies of the Union, *The Development of European Defence, Technological and Industrial Base (EDTIB)* (2013). According to this study, of 40 major European defence companies assessed, four were State owned and 14 had State involvement.

[135] Cammell Laird, *submission of evidence*.

noted by Thales 'the creation of a level playing field will be shaped as much by defence industry consolidation as it is by open competition.'[136] But at the same time, the failure of the proposed merger between BAE Systems and EADS highlights the perils of national interference.[137] At the defence industry discussion event, it was suggested that the Commission could do more to ensure that market forces were allowed to operate effectively in a market comprised of private and state owned companies.[138]

Administrative Burdens

3.60 The Services Directive outlawed overtly discriminatory restrictions on the freedom to provide services, but as discussed above, a number of other limits on the free movement of services are still in place. Many of the remaining restrictions are administrative in nature, with new entrants to a national services market needing, for example, to comply with registration requirements or to take on a particular legal form. The intention of the Services Directive was to reduce these restrictions wherever possible, and where it has been correctly implemented, it has indeed helped to eliminate unnecessary administrative burdens for some businesses.[139] One participant in a discussion event described it as 'the greatest exercise in deregulation in recent European history.'[140] Further successful implementation and a broadening of the principle of mutual recognition should, in theory, allow for further reductions in administrative burdens, as host Member States grow more willing to trust the procedures applied by authorities in the home country.[141] In sectors governed by the country of origin principle, such as telecommunications and broadcasting, this significantly reduces the administrative burdens, because businesses wanting to operate in a second Member State only have to comply with regulatory requirements at home.[142] Nevertheless, in their submissions to this review, small business representative bodies insisted on the importance of ensuring that any further initiatives in the EU services sector follow the principles of better regulation.[143]

3.61 Service providers argued that they still face a whole range of other regulatory requirements, some of which can have a strong dissuasive effect. BusinessEurope points to the example of insurance, with some service providers obliged to take out insurance to provide services in another Member State, despite being adequately insured in their country of origin.[144] The European Commission has stated that such requirements can only be maintained where they are proportionate and legally justified, but notes that some service providers have found it difficult to obtain reasonably-priced insurance in another Member State.[145]

[136] Thales, *submission of evidence*.

[137] Sir Peter Luff MP, *submission of evidence*.

[138] *Notes of MoD London Event*.

[139] FSB, *submission of evidence*, p5.

[140] *Notes of BIS Brussels Event.*

[141] BusinessEurope, *submission of evidence*, p8.

[142] Ofcom, *submission of evidence*, p5.

[143] FSB, *submission of evidence*, 3; British Chambers of Commerce, *submission of evidence*, p4.

[144] BusinessEurope, *submission of evidence*, p6.

[145] European Commission Communication, *Towards a Better Functioning Single Market for Services — Building on the Results of the Mutual Evaluation Process of the Services Directive*, COM (2011) 20 final, p8.

3.62 Company law, which regulates the formation and governance of businesses, affects providers of both goods and services within the EU. Law in this area is complicated by the fact that all 28 Member States have their own national rules, which are affected to a varying extent by EU legislation dating back to 1968.[146] The development of competence in this field is outlined in Chapter One, but one of the main themes in this area is the choice of the correct approach for regulating the single market. One approach is harmonisation of rules to a common standard, while another approach, mutual recognition, where each Member State respects the standards imposed by its peers, is more flexible, but runs the risk of national regulators trying to impose incompatible rules. Proponents of the latter approach argue that it is inappropriate to fully harmonise national law on corporate governance, saying that a 'one size fits all' approach is not appropriate in this area.[147] More broadly, there is an argument that harmonisation is only appropriate where national company law systems are incompatible with the functioning of the Single Market.[148]

3.63 The European Commission's recent 2012 Action Plan on the EU's corporate governance framework acknowledged that there is currently a combination of legislation and 'soft law,' such as guidance and communications, and suggested that the financial crisis had demonstrated shortcomings with this approach. A number of contributors to this review supported the flexibility of the current approach, although it was suggested that soft law can be more difficult to implement in newer Member States, some of whom have requested clearer guidance in the form of explicit regulation.[149] [150] The European Commission has yet to transform this 'Action Plan' into formal proposals.

Coordination Mechanisms

3.64 In order to support the efficient operation of the Single Market, a number of coordination mechanisms exist. The Services Directive requires Member States to open 'points of single contact' to allow service providers setting up in a new Member State a single interlocutor with the administration in the host country. Although the UK's implementation of this system seems to be generally well regarded, business organisations complained about variability in the quality of service provided across the EU, in particular when the national point of single contact is responsible for liaising with other bodies in order to receive a final decision on a licensing application.[151] [152] However, the fact that no individual businesses referred to their experiences with points of single contact, reinforces the anecdotal impression that awareness levels amongst their intended users are generally low.

3.65 SOLVIT is an informal EU-wide problem-solving coordination mechanism for resolving difficulties faced by businesses and individuals exercising their free movement rights when there has been a breach of EU legislation. It creates a framework for co-operation between the authorities in the two Member States concerned, allowing them to attempt to find a constructive solution within a ten-week time period. Some of the cases handled by SOLVIT concern the free movement of services or the freedom of establishment for individual professionals, with competent authorities referring to SOLVIT when they are unable to

[146] The High Level Group of Company Law Experts, 'Report of the High Level Group of Company Law Experts on a Modern Regulatory Framework for Company Law in Europe.' (2002).

[147] Institute of Directors, *submission of evidence*.

[148] Law Society of England & Wales, Law Society of Scotland, *submission of evidence*.

[149] Law Society of England & Wales, Law Society of Scotland, *submission of evidence*.

[150] *Notes of BIS London events*.

[151] Serafin Pazos-Vidal, *submission of evidence*, p7.

[152] BusinessEurope, *submission of evidence*, p5.

resolve a problem.[153] In general, participants in discussion events that were aware of SOLVIT welcomed its role in solving disputes around the free movement of services. However, a number of individual commentators suggested potential improvements such as shortening the ten-week deadline and expanding its remit to include other issues.[154]

3.66 As with the points of single contact, which are specific to the services sector, there is however little evidence that SOLVIT is widely known to businesses exporting or seeking to export their services within the EU. In the words of the Commission's own analysis of the service in 2012:

> SOLVIT still only works for the "happy few." Too few potential users are finding their way to SOLVIT, meaning many single market problems remain undetected and unresolved.[155]

The same report explains that only 4% of SOLVIT cases so far have involved the free movement of services or freedom of establishment. Given the wide range of problems experienced by individual businesses, this would suggest that there is potential scope for a more effective use of the SOLVIT service in this area.

The 'Domestic Channel'

3.67 Thus far, this section has discussed the impact of EU services legislation on the provision and consumption of services in another Member State. However, only a very small number of firms participate in the cross-border trade in services, and there is evidence that consumers are reluctant to purchase services from abroad.

3.68 This does not mean that 'domestic-only' service providers are unaffected by changes in the European Single Market for services. In theory, these businesses are exposed to greater competition than they otherwise would be by virtue of their presence in the Single Market, which is by definition larger than the UK market. In recent years, attempts to open up the European Single Market for services should have increased this competitive pressure on UK businesses, but given the low barriers to entry in much of the UK services sector, this effect is likely to have been limited.[156]

3.69 Nevertheless, it is likely that service providers who operate entirely within the UK will have benefitted from the reduction of barriers to entry as a result of the Services Directive. In effect, the implementation of the directive provided an opportunity for national governments to review their stock of regulation and in many cases, unnecessary administrative burdens were reduced and removed across the board, and not just for cross border service providers. For example, although a Member State may have decided to remove or simplify registration requirements for some service providers to comply with the Services Directive, those requirements would also no longer apply to all businesses in that country. So although the changes were made on the basis, many will have applied to domestic businesses. Indeed, it is this 'domestic channel' that the European Commission estimates has been the source of most of the existing benefits of the Services Directive.[157]

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[153] Institute of Civil Engineers, *submission of evidence*, p3.

[154] *Notes of BIS London events*.

[155] Commission Staff Working Document, *Reinforcing Effective Problem-Solving in the Single Market – Unlocking SOLVIT's full Potential at the occasion of its 10th anniversary*, SWD(2012) 33 final (2012), p5.

[156] Monteagudo et al., 'The Economic Impact of the Services Directive' p81.

[157] Ibid., p4.

Conclusions

3.70 EU services legislation does not act in a vacuum, and although many of the directives in this area are broad in scope, they leave a significant amount of room for Member State action. This impacts specific sectors of the economy in different ways, and the effects are often most directly noticeable at the level of individual firms. For most respondents, the benefits of the free movement of services outweigh the costs, many of which they feel are imposed either by incorrect implementation of existing rules or burdensome administrative procedures. Unfortunately, even where systems exist to try and counteract these problems, many service providers do not know enough about them. In some cases, this is because businesses might not even know that they are affected by EU rules at all. However, most EU services legislation affects UK businesses whether they trade overseas or not, and many of the company-level and economy-level benefits that stem from liberalisation of services markets, are as a result of removing restrictions on these 'domestic-only' firms.

3.3 Underlying Themes

3.71 Services are directly connected to the rest of the economy, and society at large, and cannot be considered in isolation. At the same time they are often personal in nature and vary according to local practice, so guaranteeing their free movement is not straightforward. Both these facts mean that any examination of how well the Single Market for services serves the UK's national interest, runs into the fundamental political tensions which underlie this area. The debate around the initial proposal for the Services Directive described in Chapter One is just one example of the link with broader social and economic questions and the difficulty of finding a compromise that satisfies all Member States. In the area of defence procurement, increasing cooperation touches on competences that have traditionally been at the heart of national sovereignty.

3.72 In particular, the free movement of services raises a number of key policy tensions, some of which have already been identified in the preceding sections:

1. The trade-off between deepening integration in the single market for services and maintaining national restrictions;
2. The extent to which liberalising the single market for services requires legislation or broader cultural change;
3. The link between the free movement of services and the rest of the four freedoms, in particular, the free movement of persons; and
4. Some specific concerns about national security in the area of defence procurement.

The following sections will consider each of these in turn.

Trade-offs

3.73 As discussed in sections 3.1 and 3.2, there is a widespread perception that a number of barriers to 'total' free movement of services remain, and that the single market for services is therefore incomplete. Given the personal nature of many services, cultural and linguistic constraints will impose a certain number of barriers to the free movement of services.[158] But beyond these, some other regulatory limitations on the free movement of services are always likely to be needed because of the fundamental tension between market liberalisation and the need to meet other objectives. The importance of other public policy

[158] CBI, *submission of evidence*.

goals, such as protecting consumers and the environment, means that there will always be a legitimate need for some restrictions to the free movement of services while these remain regulated at the Member State-level.

3.74 Some restrictions are clearly examples of the 'overriding reason relating to the public interest' referred to by Article 10 of the Services Directive. Rulings from the ECJ have set out some of the grounds on which it is acceptable to impose restrictions, and these are set out above in Chapter Two. In other cases, the recourse to other public policy goals is less direct. For example, access to some professions in Germany is restricted to those who have completed an apprenticeship in the sector. Although these services could be provided by providers from other Member States, there is a strong public desire to maintain the traditional apprenticeship system as an attractive training option for young people in particular.[159] In this case, the public policy goal of reducing youth unemployment and maintaining traditional trades takes precedence over liberalising the market for some services.

3.75 The compromise reached on the final text of the Services Directive in 2006 was an acknowledgement by Member States there may be legitimate reasons for maintaining some barriers to the free movement of services by attempting to define where this is acceptable. Although it imposes an outright ban on certain restrictions such as discrimination on the grounds of nationality, the directive also allows Member States to impose others, provided they can demonstrate that they are non-discriminatory, necessary because of 'an overriding reason relating to the public interest' and proportionate.[160] These provisions represent an attempt to resolve this trade-off between more open markets on one hand and a legitimate desire to maintain national or local control over individual services in order to protect consumers on the other.

3.76 In short, by banning some restrictions and limiting Member States' ability to impose others the Services Directive shifted this balance away from national control and towards greater liberalisation. The original 2004 proposal would have gone further down this road by restricting the ability of national authorities to regulate service providers registered in another country. By accepting the 2006 Services Directive, EU Member States and the European Parliament took a particular stance on this fundamental trade-off which has a number of practical implications:

- Allowing Member States to continue to apply restrictions which act as a barrier to entry for incoming service providers has an economic impact;
- There is also a risk that Member States apply unnecessary or disproportionate restrictions with the aim of protecting national service providers (this suggestion is discussed in section 3.2) or as a response to political pressure, for example in the case of a health scare;[161]
- Service providers finding a barrier to entry in the national law of a Member State have very limited recourse to challenge it without resorting to a lengthy and costly procedure, potentially requiring the Court of Justice of the European Union to rule on whether the relevant provision of national law is compatible with EU law;

[159] *Notes of BIS Berlin Event.*

[160] Directive 2006/123/EC of the European Parliament and of the Council on Services in the Internal Market, 2006.

[161] *Notes of BIS Brussels event*.

- The limited resources of the European Commission as well as the very specific nature of individual cases mean that very few infringement proceedings are brought against Member States for poor implementation of the Services Directive.[162]

These effects are a natural consequence of the compromise struck over the Services Directive in 2006 and removing them would imply either substantial institutional change or an adjustment of the balance between open services markets and national regulation, both of which would have wider implications. For example, more robust implementation by the Commission, which is something that business organisations who contributed to this review called for, would require extra resources.[163] Equally, giving more power to Member States to impose restrictions would allow them to take retaliatory action if their service providers faced discrimination in other Member States. This could of course lead to a substantial reduction in trade in services, thus going against the original intentions of the Directive.

Cultural Change

3.77 The difficulties in finding an acceptable compromise on the Services Directive can be attributed to cultural differences about how the provision of some services is viewed in different parts of the EU. For example, the diversity of regulated professions, around a quarter of which are only regulated in one Member State, demonstrates the extent to which perceptions of which activities represent a significant risk differ.[164] The implementation of the Services Directive, and the subsequent reform or repeal of significant volumes of national legislation was described by one contributor as 'shock therapy' for administrations forced to evaluate the necessity of existing legislation.[165] Nevertheless, the consistent record of poor implementation suggests that in some Member States, this cultural change has been at best superficial. Indeed, it may be the case that legislative action may be unable to change cultural attitudes and that there is therefore a natural limit to the extent that services markets can be opened.

3.78 In the area of company law, national rules still differ widely and often reflect long-standing traditions as well as differences in the typical size, structure and complexity of companies in the local market. This flexible approach allows each country to adopt its own approach, which is easier than lengthy negotiations around harmonisation. There is, however, a perception that EU-level company law has been used as a vehicle for encouraging cultural change in some cases, with the objectives of some legislation expanding beyond the remit of the EU competence laid down by Article 50 TFEU, making their legal base unclear.[166]

Links with Free Movement of Persons

3.79 The legislation discussed so far has covered the ability of businesses to provide services in other Member States, but in some cases this requires a physical presence in the host country. Although an increasing number of services are provided online, many of them are fundamentally personal in nature and require the service provider to travel to the

[162] It is worth noting that the European Commission has been more active in bringing proceedings against Member States who fail to respect their obligations under Article 14 of the Directive (restrictions which are expressly forbidden, for example, discrimination on the grounds of nationality) than it has for Article 15 (restrictions which are permissible in certain circumstances provided they are non-discriminatory, necessary and proportionate).

[163] BusinessEurope, *submission of evidence* p2; London Chamber of Commerce and Industry, *submission of evidence*, p4.

[164] BusinessEurope, *submission of evidence*, p6.

[165] *Notes of BIS Brussels Event.*

[166] Institute of Chartered Accountants of England and Wales, *submission of evidence*.

customer or vice versa. The link between the free movement of services and the free movement of persons was an issue raised by participants at discussion events and in evidence submitted by the ACCA and OpenEurope.[167] Restrictions on the free movement of persons could in theory impact on the free movement of services by preventing service providers from travelling to another Member State. Equally, liberalising the services sector to encourage more cross-border trade in services could encourage more service providers to travel around the EU.

3.80 The question of the extent to which cross-border provision of services is connected to the movement of individuals involved in their provision is not unique to the EU. Trade agreements such as the General Agreement on Trade in Services (GATS), which regulates cross-border trade in services between WTO members, establish a framework to regulate the movement of persons where this is necessary for the cross-border supply of services. In the case of the GATS, this defines four different 'modes of supply,' as shown in Table Two below, ranging from the provision of services at a distance through to the physical presence of the individuals on the territory of a country where they are providing services. The scope of the Mode 4 commitments in the GATS reflects the fact that the cross-border supply of, for example, legal or architectural services, may require the service supplier, or its overseas employees, to be temporarily present on the territory of the client. Mode 4 commitments accordingly typically cover the temporary entry and stay of business visitors, intra-company transfers, and contractual service suppliers. While the Mode 4 commitments in the GATS do not amount to a free movement regime equivalent to the movement of EU citizens within the territory of the EU, they do have the purpose of ensuring that the movement of persons in connection with the supply of services takes place in an environment of some regulatory certainty.[168]

Table Two: Modes of Cross-Border Service Provision under GATS[169]

Mode	Short Description	Description
Mode 1	Cross-border supply	Supply of services at a distance with no movement of supplier
Mode 2	Consumption abroad	Supply of services to a customer who travels to the supplier
Mode 3	Commercial presence	Supplier sets up a subsidiary or a branch in the customer's country
Mode 4	Presence of a natural person	Supplier is in the customer's country as a natural person

Defence Procurement

3.81 The links between defence procurement and the national interest in its broadest sense are clearer than with other parts of the Single Market. This is reflected by the existence of Article 346. As discussed above, this retains a significant amount of discretion for Member States, allowing them to deviate from the general principles of the Single Market for defence procurement in the name of national security.

[167] *Notes of BIS Brussels Event.*

[168] GATS and trade issues more generally are considered in HMG, *The Balance of Competences Between the UK and the EU: Trade and Investment* (2014).

[169] General Agreement on Trade in Services, Article 1 (2).

3.82 Several commentators stressed that the UK should resist any attempt that would extend EU competence in defence procurement to the detriment of Member State competence and that we should resist any new EU legislation in the defence sector not least as the effects of the recent Defence Directive are not yet evident.[170] The UK's participation in NATO was also raised as a key political issue, with a number of industrial and political contributors cautioning against EU action that might undermine this relationship.[171]

3.83 At the same time, there was also a view that the UK could support a more open market and therefore a more proactive Commission without compromising on national competence. Sir Peter Luff MP stated: 'while a more robust approach to Article 346 infringements may occasionally cause the UK some challenge, overall it should bring greater opportunities for UK companies as they gain access to contracts that would not otherwise have been open to them.'

3.84 While rejecting further EU institutional encroachment, defence industrial stakeholders, such as ADS and Thales, highlighted the importance of more equipment collaboration between nations. Though some previous examples of European collaboration, such as Typhoon and the NH90 Helicopter suffered from excessive costs, the general view remains that greater demand consolidation could help to build the economies of scale to deliver capabilities at globally-competitive prices and lead in time to further defence industry consolidation.[172] Accordingly, ADS called for a step-change in consolidation of demand across Europe and recognition by Member States that collaboration should be the default, but non-binding, option for major new programmes and greater use of common purchasing.

3.85 In general, it was considered that such cooperation should be driven by the key Member States with substantial defence industries, essentially the Letter of Intent Framework Agreement signatories, rather than the EU as a whole.[173] Though stakeholders such as AgustaWestland and Sir Peter Luff MP also suggest that the European Defence Agency could have more of a role in coordinating Member States' common procurements.

3.86 While the majority of evidence concentrated on the European defence market, it was also stressed that the UK should remain free to establish relationships outside of Europe, noting its wider defence interests and global trade.[174] Geoffrey van Orden MEP stated that the UK should be able to engage in cooperative defence industrial arrangements with whatever country or group of countries, whether inside Europe or not, is most beneficial to our national interest without being constrained by EU policy. In this context, it is also worth noting that of the £10.6bn of UK defence exports in 2012, £7.7bn went to non-EU markets.[175]

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[170] *Notes of BIS London Events*.

[171] Geoffrey Van Orden MEP. *Submission of evidence.*

[172] Keith Hartley, *White Elephants?: the Political Economy of Multi-Defence Projects* (2012).

[173] These are: UK; France; Germany; Italy; Spain; and Sweden.

[174] Thales, *submission of evidence*.

[175] ADS Defence Survey 2012.

3.87 In 2013, the European Commission published a Communication about the future of EU defence industrial policy.[176] As discussed in Chapter Two, this reflects the Commission's intention to use other policy instruments beyond defence procurement legislation to influence the development of the sector. Several of the document's recommendations were challenged by contributors to this review, who felt that they would represent a significant transfer of competence away from Member States and towards the EU. In particular, contributors contested the suggestion that the European Commission might:

- Consider the potential negative effects of offset arrangements in contracts to supply third countries;
- Become involved in the marketing of EU defence products to third countries;
- Publish a Green Paper on the control and ownership of critical defence industrial assets.[177]

3.88 Instead, contributors suggested that there are other ways that EU-level action could be useful in supporting SMEs for example. One suggestion was the expanded use of the European Economic Interest Grouping (EEIG) legal form described above in Chapter Two as a way of partnering between SMEs, as this is less complicated and expensive than setting up a formal joint venture. This could potentially be expanded to allow co-operation between two or more companies from a single Member State rather than requiring the participation of businesses from more than one country as is currently the case.[178]

3.89 Another aspect of the Communication which saw more enthusiasm was the potential increased focus on research in the defence sector. Thales for example made the point that the UK needs to do more to maximise its ability to shape EU R&D funding streams, and should increase industry presence on the relevant assessment bodies. However, the defence industry discussion event considered the Commission research rules too complex, pushing up the cost of research and making the programmes less attractive than those sponsored by national governments elsewhere in the world. Those at the discussion event were also concerned that there seemed to be few examples of the results of research successfully making it on to the market and that it enabled other countries and companies to profit from their knowledge.[179]

3.90 Several stakeholders also suggested that more could be done at EU level to improve confidence in security of supply. The issue of whether customers can be confident of receiving supplies from another country at a time of crisis is vital in defence procurement, and lack of trust is one of the key barriers to the internal market.[180] In its evidence, ADS encouraged the UK to secure an intergovernmental commitment on security of supply of defence goods and services which would provide a political guarantee that no Member State would veto exports destined for another Member State's armed forces. The Centre for European Reform (CER) suggested that the EU could act to enforce security of supply in times of crisis.[181] Others suggested that more could be done to make use of the

[176] European Commission Communication, *A New Deal for European Defence: Towards a More Competitive and Efficient Defence and Security Sector*, COM (2013) final.

[177] ADS, *submission of evidence*; Sir Peter Luff MP, *submission of evidence*; Thales, *submission of evidence*.

[178] *Notes of MoD London Event.*

[179] *Notes of MoD London Event.*

[180] CER, *submission of evidence*.

[181] CER, *submission of evidence*.

Intra-Community Transfers Directive, which simplifies the administrative licensing process for transferring goods within the EU.[182]

Conclusions

3.91 The discussion of the impact of the free movement of services on the UK economy and individual service providers in the first two sections of this chapter revealed a number of underlying political tensions. The current balance of competences in this area reflects one possible compromise between deepening integration in the Single Market on the one hand and the desire to retain national restrictions to meet other policy goals on the other. The next chapter looks at how this may change in future, but any future adjustments to this balance will have to address this fundamental question, even if they suggest different answers. Future policy options will also face other challenges, including the link between the free movement of services and the free movement of persons and the extent to which it is acceptable for Member States to cede competence to the EU in the area of defence procurement.

[182] Directive 2009/43/EC on transfers of defence-related products. 2009.

Chapter 4: Future Options and Challenges

Summary

This chapter considers the likely future challenges and options affecting the free movement of services in the future. New business models, particularly through the Digital Single Market, are blurring the distinctions between goods and services, with many traditional goods now being provided as digital services, such as downloads, and an increase in 'serviceisation,' the bundling of goods into a wider package of services. Incomplete and ineffective implementation of existing services legislation has hindered the development of the free movement of services, but full implementation of existing legislation within the current level of EU competence may have implications for Member States' ability to make decisions in this area. There is scope to go further on services liberalisation; extending the application of the country of origin principle, either within specific sectors or across the piece, and either at EU level or within a smaller group of Member States through enhanced cooperation. Further liberalisation could also be achieved through a sectoral approach, focusing firstly on those sectors of greatest economic importance.

4.1 The preceding chapters outline the development of the free movement of services within the EU, and examine the impact that this has had on the UK's national interest, both at the macroeconomic level and for individual businesses and consumers. One of the major themes to emerge from this analysis is that integration in the Single Market for services is not as deep as it is for goods. While services are less likely to be traded between countries because of their intangible nature, there is a general consensus that more can be done to complete the Single Market for services in the EU, and that this would be in the interest of UK service providers and consumers. As discussed in Chapter Three, any further liberalisation must be traded off against other policy objectives, such as protecting consumers and respecting social and environmental standards. Striking the right balance between competing objectives is not straightforward, and the services sector presents a moving target. It is evolving rapidly, so future policy responses may have to be more radical than a simple revision of existing approaches. This chapter examines some of the major forces driving change in the services sector, before considering how potential future developments might imply an adjustment to the current balance of competences and how this might affect the UK's national interest.

4.1 Drivers

4.2 The sector is diversifying and becoming more complex: one contribution to this review talks about a growing 'economy of services'.[1] Some of the underlying political tensions may remain unchanged, such as the extent to which Member States prefer open services markets, and some legitimate restrictions on service provision are likely to always be needed, for example to protect consumers or public health. Nevertheless, the evolving nature of the sector means that different policy choices may be necessary in the future.

4.3 A number of emerging trends are driving change in the Single Market for services and will likely have a bearing on how the sector is regulated at the European level, and by extension, has the potential to affect the balance of competences between the EU and the UK. The development of the services sector in the years ahead will of course be affected by the performance of the wider economy, but four principal drivers are likely to have a particular impact:

1. 'Serviceisation', or the increasing overlap between goods and services;
2. The inclusion of trade in services in free trade agreements concluded by the EU;
3. The growing importance of the Digital Single Market; and
4. Recent attempts by the European Commission to increase integration in the defence market.

Serviceisation

4.4 Chapter Three describes how the increasing connection between the production of goods and the provision of services has already complicated efforts to regulate both sectors within the EU, and Chapter Two discusses some of the challenges this has posed for the ECJ. The increasing overlap between goods and services in the global economy was also identified in the separate reports into the Single Market, the Free Movement of Goods and Trade and Investment.[2] [3] [4] Anecdotal evidence provided by participants at discussion events suggests that serviceisation is likely to drive further change in the European economy.[5]

4.5 Serviceisation is a global trend which first became prominent in the 1980s when it was recognised as a way for manufacturing companies to add value to their offer.[6] Classic examples include the provision of training or maintenance services on an ongoing basis after the delivery of a piece of equipment, but there have also been some more fundamental adjustments between goods and services. For instance, suppliers of aircraft engines offer 'performance based logistics' contracts, which guarantee their customers a certain number of flying hours. The engine manufacturers commit to providing all of the necessary maintenance, and the airline has a better idea of how much it will have to pay over the long term.[7] The Swiss Body of Trade has said that 'services are necessary for

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1 BusinessEurope, *submission of evidence*, p1.

2 *Notes of BIS Brussels Event.*

3 Idem.

4 HMG, *The Balance of Competences between the United Kingdom and the European Union: Trade and Investment* (2014), p13.

5 BIS Brussels event, *submission of evidence*, p3.

6 Vandermerve, Sandra. 'Serviceisation of Business: Adding Value by Adding Services.' *European Management Journal*, Volume 6, Issue 4, pp 314-324.

7 T. S. Baines et al. 'The Serviceisation of Manufacturing: A Review of Literature and Reflection on Future Challenges,' *Journal of Manufacturing Technology Management*, Volume 20, Issue 5, pp 547-567.

any [manufacturing] firm seeking to take advantage of global value chains and to move up these chains to capture more value.'[8]

4.6 At the same time, increasing numbers of business services, such as communications, marketing, financial and human resources functions that might once have been carried out within a business are now provided as business-to-business services, a sector which represents 75% of all traded services and 10% of the UK's total workforce.[9] [10]

4.7 As this trend accelerates, maintaining distinct regulatory regimes for goods and services may become increasingly challenging. In the short term, however, the distinction between the regulation of goods and services is likely to remain, not least because the existing EU legislation in the two areas has its base in separate parts of the Treaties. Nevertheless, as more and more firms that previously concentrated on producing goods add services to their offer, they will find themselves affected by EU rules concerning the free movement of services discussed here.

Free Trade Agreements

4.8 Whether conducted within the multilateral framework of the WTO, of which the EU and all of its Member States are members, or on a bi- or pluri-lateral basis, the European Commission negotiates free trade agreements on behalf of the EU. The Treaty of Lisbon clarified the Commission's ability to negotiate trade agreements involving services, granting it exclusive competence to negotiate agreements with third countries and international organisations covering almost all aspects of service provision.[11] [12]

4.9 Over time, as progress has slowed in multilateral trade negotiations, the EU has become more ambitious in negotiating its own free trade agreements, which have become increasingly comprehensive. The separate Trade and Investment review considers these issues in more depth, but two agreements currently under negotiation could have a significant impact on the EU services sector in the medium term.[13]

4.10 The Transatlantic Trade and Investment Partnership (TTIP) between the EU and the US will cover the largest bilateral relationship in trade in services in the world. Typically services firms with global networks have operations in both the US and EU, and barriers to transatlantic trade in services are generally low. Noting the UK's position as a significant exporter of services, the BCC argued that 'it is imperative that the TTIP negotiations with the US reach a broad-based agreement for the unimpeded trade of services as well as goods.'[14] That said, as in the EU itself, many of the remaining barriers to trade in services between the EU and the US relate to issues of regulation, including for example, the recognition of professional qualifications. As the experience of the Services Directive has shown, removing these non-tariff barriers is not straightforward.

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8 Quoted in HMG, *The Balance of Competences Between the United Kingdom and the European Union: Trade and Investment* (2014), p12.

9 BusinessEurope, *submission of evidence*, p1.

10 Business Services Association, *submission of evidence*, p1.

11 Article 207 TFEU.

12 Transport services remain a shared competence, while the Council must also act unanimously in adopting agreements in the areas of cultural and audiovisual services 'where these agreements risk prejudicing […] cultural and linguistic diversity' and of social, education and health services 'where these agreements risk […] prejudicing the responsibility of Member States to deliver them,' (Article 207 (4) paragraph 3 (a), (b) TFEU).

13 HMG, *Review of the Balance of Competences between the United Kingdom and the European Union: Trade and Investment* (2014).

14 British Chambers of Commerce, *submission of evidence*, p3.

4.11 Negotiations on Trade in Services Agreement (TiSA) began in March 2013 between 50 WTO members (counting the EU as 28 individual Member States). This represents two-thirds of the global trade in services. The UK is a strong supporter of TiSA, both because of our position as a major exporter of services and because of the Prime Minister's commitment to pursuing trade liberalisation through 'coalitions of the willing.'[15] Although currently being negotiated by a group of interested countries, the aim is to create an agreement that can be integrated into the WTO General Agreement on Trade in Services at a later date, while also remaining open to new participants.

Digital Single Market

4.12 Given the pervasive influence of technology on all areas of the economy, it can be difficult to quantify the size and potential of the digital economy. However, several sources indicate that even without a 'true' Digital Single Market, digital services already make a substantial contribution to the EU economy. The ICT, media and telecoms sectors accounted for 4.7% of EU GDP in 2012, employing 6.3 million people across the EU27.[16] There is strong potential for future growth: the European Commission has calculated a gain to EU GDP of €204bn if only 15% of retail activity switches to e-commerce and existing barriers to the Digital Single Market are removed.[17] Nevertheless, the Digital Single Market remains fragmented, with, for instance, different copyright and consumer protection rules in place across the Member States. By comparison, the US represents a more homogenous online marketplace, and many digital services which are available in the US are only available in some larger Member States, rather than on an EU-wide basis.

4.13 The lines between goods and services are increasingly blurred on the Internet, where consumers are often unclear about whether they are purchasing goods or services. The review of the Single Market for Goods describes the example of buying digital content such as music or films online: a physical CD is clearly a Good and a subscription to a streaming platform is clearly a Service, but the status of the downloaded tracks themselves is less clear.[18] This situation provides a clear illustration of how policy paradigms from the offline world do not always clearly translate online, something which will have an increasing impact on the free movement of services in the future. On the European-level, the response to these changes has taken the form of initiatives to promote a Digital Single Market, described in more detail in Chapter Two. Although the need to legislate to keep up with rapid technological shifts was recognised, some participants at discussion events criticised what they perceive as a large number of proposals in this field which may have created an unnecessary burden.[19]

4.14 Within this context, it is unsurprising that the use of digital technologies was referred to by a wide range of business organisations as a key driver of potential future growth for the EU economy as a whole and the services sector in particular.[20] The predicted benefits are two-fold: digital technology allows businesses to work more efficiently, but also reduces the costs of reaching a much wider range of potential customers. In the words of the CBI:

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15 Prime Minister David Cameron, *Speech at Davos in Switzerland, 26 January 2012*.

16 Eurostat Dataset reference: [nama_nace10_c] and [nama_nace10_e].

17 European Commission Communication, *A Coherent Framework for Building Trust in the Digital Single Market for E-Commerce and Online Services,* January 2012, COM (2011) 942.

18 HMG, *The Balance of Competences between the UK and the EU: Single Market: Free Movement of Goods Report* (2014) p52.

19 *Notes of BIS London Events.*

20 BusinessEurope, *submission of evidence*, p9; BIS London events, *submission of evidence*, p1; Association of Chartered Certified Accountants, *submission of evidence*, p2; British Chambers of Commerce, *submission of evidence*, p5.

> Digitalisation is not just revolutionising the way that firms do business, it can also be used to unlock broader economic benefits [including] a larger 'online' customer base.[21]

In particular, online trading is seen by many SMEs as an effective platform for exporting both goods and services, and one with fewer barriers to entry than trading offline.[22]

4.15 Nevertheless, there is also evidence to suggest that cross-border e-commerce is not growing as fast as it is on the national level. In its own analysis of the situation, the European Commission identifies the patchwork of national systems of consumer law, payment systems and VAT rates as one reason for this.[23] BusinessEurope argues that this fragmented marketplace harms consumer confidence in the digital Single Market.[24] This would seem to be borne out by statistics which suggest that, overall, while around two-thirds of European consumers would make an online purchase in their own country, only a third would be prepared to take part in cross-border e-commerce.[25]

4.16 As more and more private and public services become available online, it is likely that existing legislation, largely drafted with the aim of regulating services offline, will need to be updated. Although online services may be hosted on servers located in a particular country, they are much more likely to be cross-border in nature, posing particular challenges in cases where there are legitimate reasons to retain restrictions on the provision of certain services. In some cases, it may be difficult to establish in which country a service provider is based, and therefore which regulatory framework should apply. At the same time, the speed of development of digital services may outstrip the speed of regulatory change, requiring a move away from prescriptive regulation towards more enabling or facilitative regulation.

Defence Procurement

4.17 The defence market and industry faces a number of long term challenges that are likely to mean significant changes in the medium to longer term. Defence budgets in Europe are shrinking, particularly in R&D, while the defence market and defence industry are becoming more global. Thus in addition to competition from traditional arms producers, procurers in rising new markets, which currently support Europe's defence exports, are themselves likely to become competitors in the future. The pressures on national defence budgets are likely to increase the requirements for more international co-operation, such as through NATO's Smart Defence initiative, and moves by participant nations in individual military platforms to recognise each other's test and certification standards. Policies based on protecting national markets will become increasingly unaffordable, though this may lead some to argue for protection at the European-level. At the same time, the defence sector in the EU contains many areas of excellence that should continue to prosper in a global marketplace and support economic growth. The security market is likely to offer increasing market opportunities and diversification for the defence industry, while the use of civil technology in the defence sector is likely to increase. This may in turn increase the opportunities for more private venture funding of defence capabilities. With the main European defence companies significantly smaller than their US counterparts, they have now broadly reached their national market limits, so a further round of European/global

[21] CBI, *submission of evidence*, p2.

[22] Federation of Small Businesses, *submission of evidence*, p4.

[23] European Commission Communication, *A Coherent Framework for Building Trust in the Digital Single Market for E-Commerce and Online Services,'* January 2012.

[24] BusinessEurope, *Submission of evidence*, p9.

[25] European Commission, *Flash Eurobarometer 358: Consumer Attitudes Towards Cross-Border Trade and Consumer Protection* (2013).

consolidation can be anticipated.

4.2 Potential Future Developments Services

4.18 As discussed in Chapter Three, UK business organisations highlighted the potential for improved implementation of existing legislation, in particular the Services Directive, although amongst those participating in discussion events, opinions on the extent of possible future gains were divided.[26] [27] It is possible that the UK's existing trade surplus in the services sector represents a comparative advantage, meaning that it stands to gain more than most other Member States. This was explored in more depth in the European Commission's 2012 study of the economic impact of the Services Directive.[28] This study modelled two alternative scenarios: one in which all Member States removed as many barriers as the EU average, and one in which they reduced barriers to the same level as those five countries where they are lowest for any given sector. Under this second scenario, the UK would stand to make the third-largest gains amongst all Member States, probably by securing much better access to overseas markets. Furthermore, although the study does not explicitly list the five 'best' countries in each industry, it can be inferred from the relatively low number of remaining barriers in the UK that this scenario in effect models a hypothetical situation in which most other EU countries 'moved up' to the UK's level of openness. This finding was cited directly in evidence from Open Europe and the Business Services Association, both of which argued in favour of the UK pushing more strongly for aggressive action on implementation of the Services Directive.

4.19 However, it is also possible that the UK would gain relatively little from further services liberalisation as our services market is already very open and the economic gains that this entails have largely already been realised. This possibility is hinted at in the first of the two scenarios modelled by the European Commission study discussed above: if all EU Member States were to open up their services markets to the same extent as the average EU country, rather than the average amongst the five best-performing countries, then the UK would stand to gain nothing at all. This implies that the UK has already removed more barriers to entry in its service sector than the majority of other Member States, or that it never imposed them in the first place.[29]

4.20 Although quantifying the future benefits of improved implementation is difficult, a broad base of business organisations called for action in this area.[30] Despite the European Commission's 'zero tolerance' policy in this area, business associations still feel that more needs to be done. Due to the fact that Article 15 of the Services Directive allows Member States to maintain barriers where these are justified, non-discriminatory and proportionate, its implementation across the EU depends on a series of subjective interpretations of these criteria.[31]

4.21 One potential way of harmonising implementation would be to provide guidance on

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[26] For example, BusinessEurope, *submission of evidence*, p2; Federation of Small Businesses, *submission of evidence*, p6; London Chamber of Commerce & Industry, *submission of evidence*, p4.

[27] *Notes of BIS London Events.*

[28] Monteagudo et al., 'The Economic Impact of the Services Directive.'

[29] However, the study was unable to model all of the relevant dynamic effects, such as innovation and competition, which may mean it underestimates the potential benefits.

[30] For example, FSB, *submission of evidence*, p6; Business Services Association, *submission of evidence*, p3; London Chamber of Commerce & Industry, *submission of evidence*, p; Three, *submission of evidence*, p7; British Chambers of Commerce, *submission of evidence*, p3; CBI, *submission of evidence*, p2.

[31] See Chapter Two for more details on the Services Directive.

how these criteria are to be applied, including for example through the definition of a 'proportionality test,' something that was suggested by participants at a discussion event.[32] While the ECJ may eventually provide guidance on the matter, it assesses the validity of individual restrictions in cases brought before it, so the extent to which it can set a broader precedent is limited. The European Commission could also use a non-binding Communication to set out some basic principles, which would likely require it to take a more pro-active role in 'policing' the retention of barriers to trade in services that fell outside of its own guidelines. This would not lead to a change in the balance of competences *per se* but could lead to the impression that the Commission is 'interfering' in the regulation of sensitive services by Member States which it has so far hesitated to do.

4.22 Both of these options would likely satisfy those respondents to the call for evidence who suggested that implementation of the existing rules would be preferable to new legislation at the EU level.[33] Another option that would not involve further legislative action would be for the Commission to adopt a sectoral approach, setting out how to strengthen market integration in specific service sectors where there is the greatest potential to encourage cross-border trade. This could also allow progress to be made in sectors where further market integration is less sensitive. 'Soft law' options for strengthening market integration could include closer co-operation between national regulators. Some participants at discussion events also suggested that the European Commission could do more to focus on deepening integration of services markets as part of the European Semester process, including by making country-specific recommendations where Member States continue to maintain unjustified barriers to service providers.[34]

4.23 However, some think-tanks have suggested a more radical approach to opening up services markets around the EU, likely to require legislation. One way to do this would be to extend the use of the 'country of origin principle' currently used in some areas to some or all of the sectors covered by the Horizontal Services Directive. As discussed in Chapter One, the European Commission's original 2004 proposal for the Services Directive would have extended the use of the country of origin principle to a very wide range of sectors. In a discussion paper on how to deepen integration of European services markets, the Centre for European Reform (CER) focuses on the sources of resistance to the original draft:

> The "big bang" approach taken in the […] draft – trying to push the country of origin principle across many markets – inevitably led to opposition. Instead, the EU needs a plan to gradually extend mutual recognition, market by market. By advancing slowly, it would be less painful for national politicians and MEPs, who face opposition from labour and producer interests at home.[35]

[32] *Notes of BIS Brussels Event.*

[33] For example, Local Government Association, *submission of evidence*, p8; Business Services Association, *submission of evidence*, p2.

[34] *Notes of BIS Brussels Event.*

[35] CER, '*How to Build European Services Markets'* (2012), p8.

Instead of attempting to repeat this 'big bang,' the CER argues in favour of attempting to apply the country of origin principle to individual sectors. As well as potentially being more politically feasible than the original proposal, this approach would also be flexible, leaving room for stronger safeguards in sensitive services sectors, such as healthcare and education. At the same time, a gradual extension of mutual recognition would also allow national regulators to develop trust in one another, something which will be needed if they are to have confidence in the standards applied in a service provider's country of origin.

4.24 The downside of this approach is that progress is likely to be piecemeal, and a significant amount of legislative time may be devoted to harmonising minimum standards for individual sectors. Indeed, in other areas of EU regulation, such as product regulation, there was a deliberate shift towards horizontal mutual recognition, rather than technical harmonisation of specific rules, precisely because the latter can be slow and complicated to negotiate.[36] Sectoral interest groups may also successfully mobilise opposition to plans to pursue this approach within specific sectors, diluting their impact.

4.25 Recognising these issues, OpenEurope has instead proposed that the country of origin principle could be pursued via 'enhanced cooperation.' This procedure, introduced by the Treaty of Lisbon, allows a group of at least nine Member States to pursue action as a group when consensus is not possible – a situation which may become increasingly common in an EU of 28 Members. Any such move would have to comply with the requirements set out in the Treaties, which stipulates that any enhanced co-operation should not undermine the Single Market; constitute a barrier to trade or discrimination between Member States; or distort competition between them.[37] It is difficult to predict the approach that the ECJ might take in assessing whether these requirements are met because so far, enhanced cooperation has only been used three times, and case law is restricted to just one of these cases.[38]

4.26 On the subject of whether this would undermine the Single Market, there is an apparent contradiction between using enhanced cooperation, which would result in some Member States imposing different rules on service providers from certain other Member States, and the underlying principle of the Services Directive, to deepen integration in the Single Market for services. More fundamentally, this poses the question of whether enhanced cooperation would risk undermining the Single Market by fragmenting it, or rather whether deeper integration in some parts of the market, that is those countries taking part, would be better than no further integration.

4.27 The case law of the Court broadly defines discrimination as the different treatment of similar situations. This means that if Member States participating in enhanced cooperation are to treat otherwise similar service providers from different Member States differently, they would need an objective justification for doing so. If, say, the enhanced co-operation measures impose greater mutual assistance provisions on participating Member States, this could be an objective justification for treating service providers from Member States outside the co-operation differently.

4.28 From an economic point of view, it seems reasonable to envisage that the potential gains from services liberalisation are most likely to accrue when those Member States with the greatest level of barriers to entry take part in further liberalisation. If participation is

[36] Catherine Barnard, *The Substantive Law of the EU: The Four Freedoms* (2010), p636.

[37] TEU Article 20 and TFEU Article 326 on Enhanced Cooperation.

[38] Enhanced co-operation has been used by different groups of Member States to: harmonise the rules applicable to divorces involving citizens of two Member States; create a European patent system; and launch a financial transaction tax. The legality of this last measure is contested by the UK.

limited to economies where the service sector is already relatively open, there are likely to be diminishing returns from participating in further market opening through enhanced cooperation.

4.29 These potential difficulties raise the question of whether or not any further liberalisation between Member States participating in enhanced cooperation would have to be extended to non-participating countries. One proposed solution to this is so-called 'unilateral free trade,' in which the countries participating in enhanced cooperation open up their services markets to other EU Member States without any reciprocation.[39] While this may get round the Treaty prohibitions on discriminating between Member States and creating trade barriers between them, it is also unlikely to be palatable to many countries.

4.30 An additional issue with enhanced cooperation on services is the extent to which it would deliver significant economic benefits. It is most likely to appeal to Member States who already have relatively open services markets, limiting its effects; countries traditionally reluctant to embrace the liberalisation of services markets are unlikely to participate.

Public Procurement

4.31 In the area of public procurement, the EU has recently adopted a package of new rules. In preparing this review of the existing balance of competences, a number of contributors commented on the potential benefits of the new Public Procurement Directive, while also noting that it will take a certain amount of time before these are realised. In particular, organisations welcomed the ability for contracting authorities to assess contacts on the basis of criteria other than price, which they believe will lead to an improvement to the quality of services delivered.[40] From the point of view of contracting authorities, the NHS Confederation has commented on the likely benefits of the new legislation for the NHS, as they should make the public procurement process faster, more flexible and more effective. In a briefing on the proposed new directives, the NHS Confederation added, 'while the new [public sector] Directive has a similar overall structure to the existing rules, and still requires public contracts to be competed for and awarded transparently and without discrimination, it can be expected that the new flexibilities it provides will enable better commercial outcomes to be achieved.' The CBI added that it expected that the modernisation process would have a positive impact on the performance of public procurement in the UK, and would provide a positive framework within which the Government's own programme of commercial and procurement reforms could be completed.[41]

Defence Procurement

4.32 The balance of competences between the EU and Member States in the area of defence procurement is currently evolving. As described in Chapters One and Two, a number of recent initiatives by the European Commission have seen it claim more competence in this particular area, and it is clear from its 2013 Communication that it sees an even broader European role in the area of defence procurement.

4.33 Opinions accordingly differ on the future direction of European defence procurement policy. A number of the defence industry contributions and some political commentators are concerned about the possibility of 'competence creep' and the potential for the

[39] OpenEurope, *submission of evidence*, p12, footnote 26.

[40] British Medical Association, *submission of evidence*, p6; National Council for Voluntary Organisations, *submission of evidence*, p4.

[41] CBI, *submission of evidence*, p3.

balance of competences to shift away from Member States.[42] Arguably, many of the changes that need to be brought about to improve the long term competitiveness of the defence sector reside with the defence industry and Member States, rather than the EU. ADS for example state that 'the defence industry should remain a Member State competence and be protected from further EU integration across the internal market.' In evidence for this review, BAE described how the European Commission has relied on the 2007 Defence Package to argue that it also has competence for external defence trade.[43] External trade had not featured in the original discussions, but as a result of existing case law, the Commission then justified including defence procurement in its draft mandate for TTIP.

4.34 While working within existing competence, there are some areas considered in this report where there is scope for the European Commission to take a more proactive stance on implementation without infringing the UK's national security interests. These include in particular preventing abuses of Article 346 and ensuring that it is not being used to restrict fair competition for economic or protectionist reasons. Similarly, the Commission could be encouraged to ensure that competitors from outside national borders are not being disadvantaged in competitions with local firms, rather than rely so much on the companies themselves complaining.

4.35 The EU could also support market-driven defence consolidation by ensuring Article 346 is not being used to provide State aid to prop up inefficient parts of the defence industry and by using some of its financial tools, such as structural funds, to help encourage companies to leave the defence industry and re-specialise.[44] Other potential areas where the EU could do more include using some of its broader industrial policy tools to help promote growth in the defence sector, such as new finance for SMEs in the defence sector and more dual use research; but again it is important to stress these efforts must be market driven.

4.36 Industry groups and participants at discussion events also feel that the European Commission could make more of an effort to reduce the level of bureaucracy entailed in defence procurement. As discussed earlier, the costs entailed can be substantial, especially for SMEs, leading to some industry commentators to make the point that they prefer trading in non-EU defence markets because of the reduced regulatory burden.[45]

4.37 On the other hand, some contributions did speak in favour of a stronger European competence, albeit in very specific areas. AgustaWestland suggested that the EU could have a role in supporting the European defence sector, ensuring it can use economies of scale to compete with its main competitors, especially the US.[46] Arguing in the same vein, the Centre for European Reform and Charles Tannock MEP suggested that defence procurement *should* be part of TTIP and that European free-trade agreements with other NATO countries could be in the UK's national interest. Another option along the same lines could be a general licence of sorts covering the US and EU defence goods and services.[47]

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42 ADS, *submission of evidence*; Thales, *submission of evidence*.

43 BAE Systems, *submission of evidence*.

44 EU policy on State aid is discussed in: HMG, T*he Balance of Competences Between the UK and the EU: Competition and Consumer Policy Report*. Structural funds are covered by: HMG, *The Balance of Competences Between the UK and the EU: Cohesion Policy Report*. Both published in parallel to this report.

45 Thales, *submission of evidence; Notes of MoD London event*.

46 AgustaWestland, *submission of evidence*.

47 European Commission DG Enterprise, *The Nature and Impacts of Barriers to Trade with the US for European Defence Industries* (2009).

Conclusions

4.38 As described in Chapter One, the basic principle of free movement of services as part of a wider Single Market guaranteeing the free movement of goods, capital and workers, has remained relatively constant over time. At the same time, however, the European services market has changed in both size and shape, and frameworks such as the Directives on Services and the mutual recognition of professional qualifications have been put in place. There is already pressure to ensure that these rules are fully implemented to ensure the smooth functioning of the existing Single Market, something that the government supports. In the future, calls for some of the more radical options outlined in this chapter may become stronger, something that the deep changes in the sector that the digital Single Market and serviceisation are likely to exacerbate.

Annex A: Submissions to the Call for Evidence

The following formal responses to the Call for Evidence were received:

- ADS
- Advertising Association
- AgustaWestland
- Airbus Group
- All-Party Parliamentary Group on Modern Languages
- Anglo-French Chamber of Commerce
- Architects Registration Board
- Association of Charted Certified Accountants
- BAE Systems
- Bar Council
- Binley, Brian, MP et al
- British Association of Snowsport Instructors
- British Chambers of Commerce
- British Film Institute
- British Medical Association
- British Standards Institution
- BT
- Business Services Association
- BusinessEurope
- Cammell Laird
- Campbell Bannerman, David, MEP
- Centre for European Reform

- Commercial Broadcasters Association
- Confederation of British Industry
- Engineering Council
- Federation of Small Business
- Institute for Chartered Secretaries and Administrators
- Institute of Chartered Accountants of England and Wales
- Institute of Chartered Accountants of Scotland
- Institute of Directors
- Institution of Civil Engineers
- Law Society of England & Wales, Law Society of Scotland
- Liberal Democrat MEPs
- Local Government Association
- London Chamber of Commerce and Industry
- Luff, Sir Peter, MP
- National Council for Voluntary Organisations
- Northern Ireland Department for Employment and Learning
- Northern Ireland Department for Enterprise, Trade and Investment
- Ofcom
- OpenEurope
- Pazos-Vidal,Serafin
- Producers Alliance for Cinema and Television
- Royal College of Nursing
- Scottish Government
- Tannock, Dr Charles, MEP
- Thales
- Three
- TIGA
- Valenta, Petr
- van Orden, Geoffrey, MEP
- Wirtschaftskammer Österreich

Any references to MEPs reflect their status at the time of the Call for Evidence period.

Three contributions to this report were specifically commissioned:

- Ad hoc questions were added to the English Business Survey in July and August 2013 to gauge business views on this area
- IFF Research was commissioned to conduct interviews with businesses in a range of sectors
- Professor Catherine Barnard, Professor of European Law, University of Cambridge, was commissioned to provide a legal analysis of the development of European competence in this area.

Annex B: Engagement Events

A number of engagement events were held during the duration of the call for evidence period to explore the issues raised in the call for evidence. These events included:

- Roundtables with business representatives and other interested stakeholders on 14 November 2014 and 27 November 2017;
- A Brussels-based discussion event organised by Malcolm Harbour, MEP on 7 November 2013;
- A roundtable discussion dedicated to the defence procurement issues raised in this report hosted on 17 December 2013;
- Discussions with businesses and other stakeholders across the EU:
  - In Madrid on 12 November 2013
  - In Frankfurt on 4 December 2013
  - In Berlin on 5 December 2013
  - In Paris on 11 December 2013
  - In Copenhagen on 16 December 2013
  - In Prague on 22 January 2014

Attendees at these events included:

- Alliance for Intellectual Property
- American Chamber of Commerce in the EU
- Architects Registration Board
- Association of British Insurers
- Association of Chartered Certified Accountants
- Association of Foreign Banks, Germany
- Association of German Industries
- Authors Agents Association
- Babcock International
- Barony Consulting

- BCCG Germany
- BDO AG Wirtschaftsprüfungsgesellschaft
- British Airways
- British Association of Snowsport Instructors
- British Chambers of Commerce
- British Equity Collecting Society
- British Film Institute
- Bruegel
- BT
- Business Services Association
- BusinessEurope
- Cammell Laird
- Chartered Institute for Securties & Investment
- Cleary Gottlieb Steen & Hamilton LLP
- COBCOE
- Commerzbank
- DB Research
- Deutsche Bank AG
- DLA Piper
- EADS
- Engineering Council
- EuroCommerce
- European Central Bank
- European Consumer Centre for Services
- European Parliament
- European Small Business Association
- Federation of Small Businesses
- FMSA Bundesanstalt für Finanzmarktstabilisierung
- Foreign Ministry, Germany
- Foundation of Family Owned Businesses, Germany
- Frankfurt Main Finance
- Frankfurt Rhein Main

- Freie Universitaet Berlin
- Good Relations
- Health and Care Professions Council
- Institute of Chartered Accountants of England and Wales
- Institute of Chartered Accountants of Scotland
- Institution of Civil Engineers
- KPMG
- Law Society
- Local Government Association
- Ministry of Finance, Germany
- Monckton Chambers
- Music Publishers Association
- OpenEurope
- OpenEurope Germany
- Pericap AG
- Royal Bank of Scotland
- Royal College of Veterinary Surgeons
- Royal Mail
- Scottish Government
- Senate Chancellery, Berlin
- Single Market Observatory
- Solicitors Regulation Authority
- Standard Chartered
- Commerzbank
- Surrey County Council
- Thales UK
- UEAPME
- United Artists