

**ECONOMIC SURVEY OF THE EURO AREA 2005:  
INTEGRATING SERVICES MARKETS**

*This is an excerpt of the OECD Economic Survey of the euro area, 2005,  
from the section on services in chapter 4 ....*

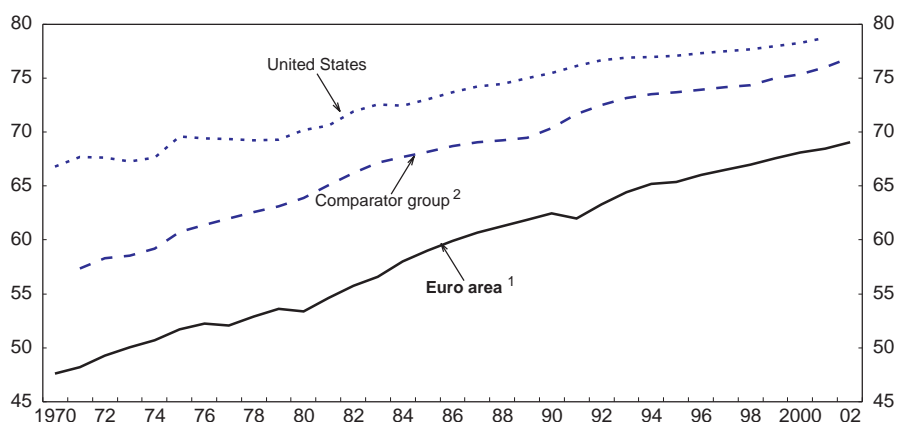
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1. The primary aim of the Internal Market Programme is to open up national markets to competition within the European Union. In the early stage, the Programme focussed on eliminating non-tariff barriers to trade and investment by legislative means and mutual recognition of national regulation. Barriers to trade in goods have largely been removed – those that remain mainly concern complex products or where risks to health are a major concern. But barriers to the integration of services are still important. Removing these barriers would raise the euro-area's growth potential – indeed enhance the benefits from EMU – and heighten its resilience to shocks. And, of course, consumers would benefit from lower prices and improved quality of services, while new job opportunities would arise.

***Why does it matter to integrate services markets?***

2. Services, which have become increasingly important for growth and employment in all OECD economies (**Figure 4.7**), account for two thirds of total output and 68% of total employment, but exports represent only one-fifth of intra-euro area trade (but would be higher, if services provided by foreign affiliates are added). Greater integration of services markets in the internal market would provide opportunities for outsourcing and scale economies. Services are even more important for job creation than their share of employment might suggest since the service sector has been steadily recruiting over the last three decades while the workforce has been shrinking in manufacturing and farming. Examples of the United States and the United Kingdom, where services account for an even higher share of employment, suggest that services still offer considerable job creation potential in the euro area.

**Figure 4.7. Employment in services**  
As a share of total employment



1. Excluding Ireland.

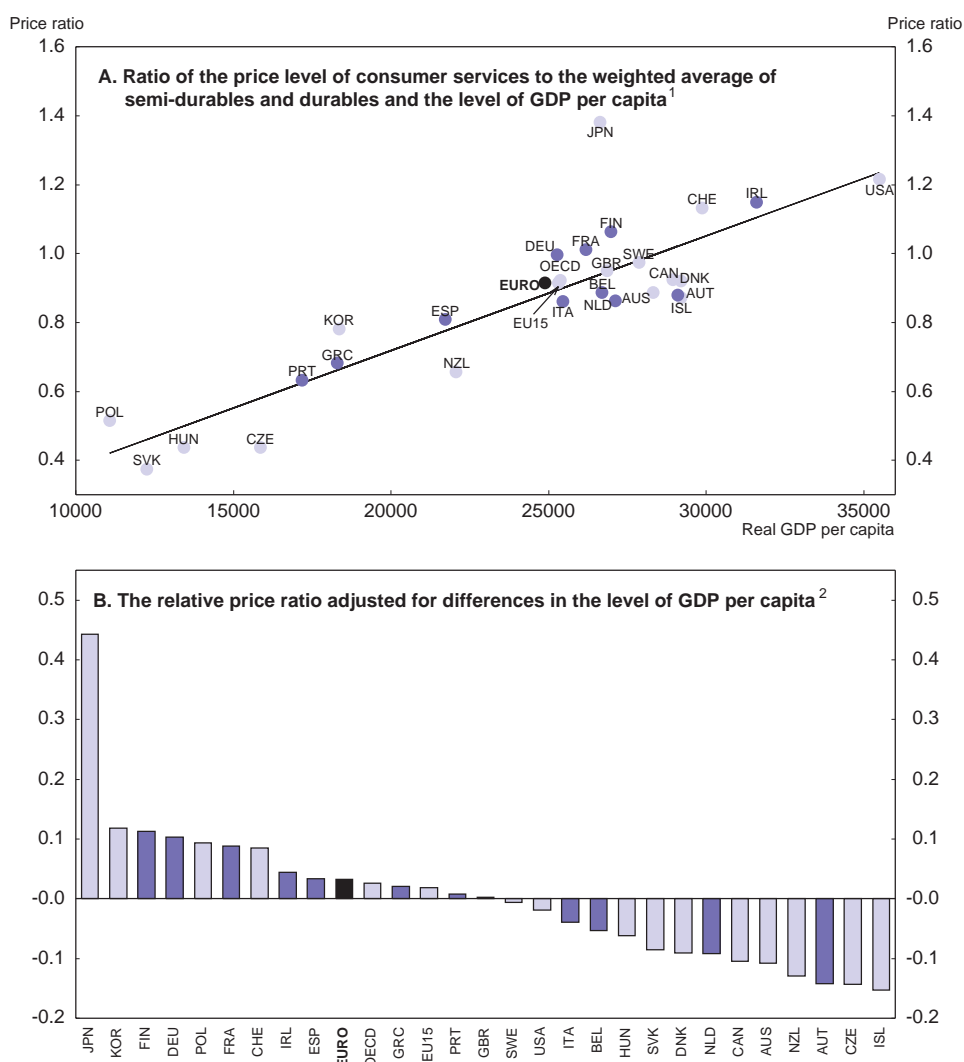
2. Includes Australia, Canada, Denmark, New Zealand, Sweden and United Kingdom.

Source: OECD, STAN database.

3. The potential gains from the integration of services markets fall into two broad categories:

- Welfare effects associated with the convergence of prices towards the best performers.* The wide dispersion of services prices in the euro area countries is an indication that a large scope for efficiency gains is being left unexploited (**Figure 4.8**). Comparatively high levels of services prices are found in Germany, Finland and France and the lowest in Portugal. Adjusted for cross-country differences in per capita GDP, the country ranking changes somewhat, but the aforementioned three countries still show the highest service prices. The dispersion of services prices within the euro area looks somewhat less pronounced when a larger sample of OECD countries is considered (Dresdner Kleinwort Benson Research, 2000), but this is not surprising given that distance effects explain a significant amount of price variation even for durable consumer goods (Beck and Weber, 2001; 2003). The upshot is that prices for services can and should converge in the euro area.
- Faster trend economic growth.* Growth of labour productivity in the service sector in the euro area has been poor in international comparison (**Table 4.4**). The productivity growth gap is particularly marked for business sector services where market conditions are most likely to weigh on measured efficiency. Labour productivity in business sector services grew at the sluggish rate of 0.3% per annum in the period 1995-2003 in the euro area against 2.8% in the United States and 2.1% in the United Kingdom – even though for statistical reasons the latter two countries portray a slight upward bias in comparison with the euro area.<sup>1</sup> The integration of services markets would spur trend growth by realising economies of scale, better exploiting comparative advantages and improving the allocation of resources at large.

**Figure 4.8. Relative prices of services and GDP per capita**  
2003



1. Consumer services is a proxy for non-tradable goods and semi-durables and durables are a proxy for tradable goods. The price level of services is based on 2002 data and 2002 PPPs while the GDP per capita is for 2003 on the basis of 2000 PPPs.

2. Measured as the difference in the actual minus the fitted value of the price ratio appearing in panel A.

Source: Eurostat; OECD, *National Accounts and Purchasing Power Parities and Real Expenditures: 2002 Benchmark Year, 2004 ed.*

Table 4.4. **Labour productivity growth by activity**  
Annual average percentage changes, 1995-2003<sup>1</sup>

Sectors	Euro area <sup>2</sup>	FRA	DEU	ITA	AUS	CAN	NZL	GBR	USA
Agriculture, hunting, forestry and fishing	2.0	3.3	4.8	2.7	5.9	3.4	9.1	5.2	2.3
Manufacturing	1.6	3.3	1.9	0.7	2.6	2.4	1.4	1.8	3.7
Business sector services	0.3	0.0	1.4	0.0	2.6	1.6	0.5	2.1	2.8
<i>of which:</i>									
Wholesale and retail trade	0.6	0.3	0.8	0.8	3.0	2.7	1.3	2.4	4.7
Restaurants and hotels	-1.9	-0.7	-6.3	-1.5	1.1	0.2	-2.2	-0.1	0.1
Transport and storage <sup>3</sup>	1.6	1.0	2.3	-0.2	3.3	2.0	4.2	2.0	0.6
Post and telecommunications	10.9	7.1	14.5	10.0	5.8	2.3	..	7.9	3.9
Finance and insurance	1.3	-1.2	3.5	0.9	3.2	1.9	6.3	2.8	5.2
Real estate and business services	-2.4	-1.4	-1.8	-2.6	0.4	-0.8	-3.6	0.6	-0.3
		AUT	NLD	BEL	FIN	GRC	LUX	PRT	ESP
Agriculture, hunting, forestry and fishing		6.9	1.9	2.8	5.0	1.2	1.4	1.3	2.7
Manufacturing		4.3	1.7	3.3	4.0	3.7	2.7	2.5	1.1
Business sector services		1.2	1.0	1.0	1.7	2.6	0.0	2.1	-0.1
<i>of which:</i>									
Wholesale and retail trade		1.8	1.7	1.2	2.3	3.3	2.7	0.9	0.1
Restaurants and hotels		0.7	-1.4	-0.5	0.6	2.6	-1.1	-1.8	-1.4
Transport and storage <sup>3</sup>		0.3	0.8	1.4	1.7	8.1	5.2	3.9	1.2
Post and telecommunications		6.8	8.9	..	10.7	8.2	..	..	6.4
Finance and insurance		2.2	1.5	0.2	7.6	4.7	-0.5	13.0	1.9
Real estate and business services		-1.8	-0.8	-0.4	-1.9	-2.5	-5.1	-0.8	-2.7

1. Or nearest available year.

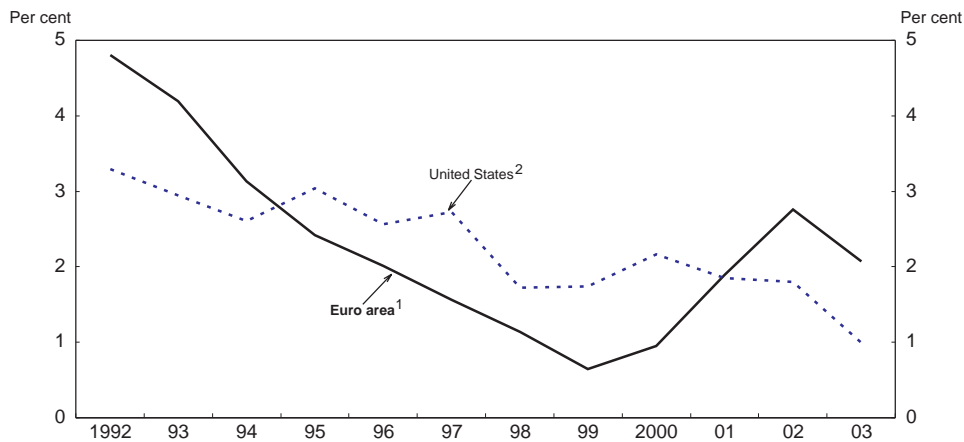
2. Excluding Ireland.

3. Including post and telecommunications for Belgium, Luxembourg, New Zealand and Portugal.

Source: OECD, STAN database.

4. Higher growth in labour productivity in services and the convergence of services prices would help lower inflation persistence in the euro area – arguably one of the main culprits of the area's weak resilience to shocks. As highlighted in Chapter 2, services constitute the most persistent component of overall inflation. While service sector inflation has been declining in the United States since 2000, it has been accelerating in the euro area (**Figure 4.9**). In comparison with the United States, euro area inflation was particularly strong in wholesale and retail trade, two sectors where most euro area countries impose stringent regulations (Conway *et al.*, 2005). Some of the increase in service prices in the euro area may be related to the introduction of the cash euro in January 2002 which boosted restaurant prices in all countries and in the area as a whole in 2002 (Adriani *et al.*, 2003). Hobijn, Ravenna and Tambalotti (2004) state that the increase in restaurant prices right after the introduction of euro coins and notes – which they estimate at 16% on average – should not be unexpected, since the existence of menu costs caused all firms to raise their prices at the time when the euro was introduced and at a higher rate than in the absence of the new currency. This shows that the adoption of a new currency is not necessarily neutral in a monetary sense. Eurostat, however, although acknowledging a significant increase in restaurant prices in 2002, concluded that the changeover effect cannot be seen as one of the main factors driving inflation in 2002 (Eurostat, 2003).

**Figure 4.9. Price developments in market services**  
Annual percentage changes, GDP deflators



1. ISIC 50-74, average using real business sector services GDP 2000 weights, excluding Ireland.

2. Industry 34 to 67.

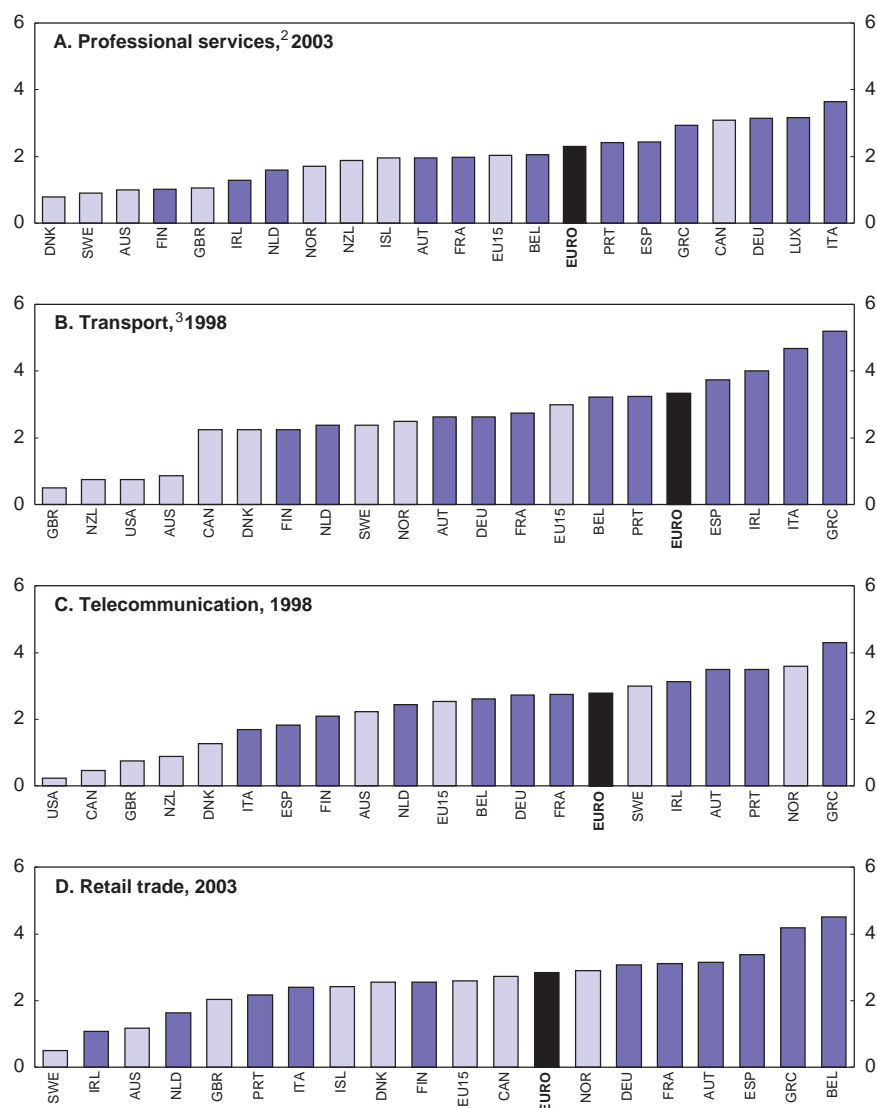
Source: US Bureau of Economic Analysis and Eurostat.

### *The impediments to integration*

5. Regulatory obstacles to an integrated, competitive internal market for services can be classified in two broad categories: anticompetitive regulations within countries and rules that restrict the provision of services across national boundaries. Data from the OECD Product Market Regulation database show that euro area countries tend to impose more stringent restrictions on the provision of services than other OECD countries (**Figure 4.10**).

6. In addition to weakening domestic competition, national regulations are obstacles to intra-European trade in services. The breakdown of service trade by category corroborates the view that the regulatory environment is far from being conducive to services flowing freely within the European Union. The bulk of EU service exports consist of travel and tourism, which is mostly driven by natural endowments rather than by the regulatory environment. Cross-border trade in business and transport services are comparatively underdeveloped, while trade in personal services is almost non-existent. In business services, the Netherlands, the United Kingdom and to a smaller extent Spain have a strong openness to trade, whereas France, Germany and Italy appear to be rather inward-oriented – a pattern that is correlated with the regulatory environment (CPB, 2004b).

Figure 4.10. Domestic regulation in selected service sectors<sup>1</sup>



1. Index 0-6 scale from least to most restrictive.

2. Simple average of indicators for legal work, architectural work, accountancy and engineering.

3. Simple average of air, rail and road transport.

Source: OECD, Product Market Regulation database.

7. The European Commission has pulled together a comprehensive inventory of barriers that continue to inhibit trade in services in the internal market (European Commission, 2002). The major obstacles that were found are:

- Some services are *national monopolies*, for instance part of postal services.
- *Quantitative restrictions* governing the number of service providers give national operators an advantage over potential new entrants.
- *Residence requirements* can apply to shareholders, management and/or staff for some regulated professions.

- *Unbundling rules*, which prohibit the provision of certain different services by the same company, can in effect prevent sales by companies operating in countries where such restrictions are absent.
- *Favourable tax treatment* can be reserved to services purchased from local providers. Tax provisions of this nature abound in the area of financial services such as life insurance, pension savings accounts and mutual funds.
- Different *company tax regimes* and *accounting rules* can place high compliance costs on service providers operating across national borders, especially small- and medium-sized enterprises. The *European Tax Survey* published by the European Commission has provided evidence of high tax compliance costs, in particular for SMEs and companies with cross-border operations (EC, 2004b).
- Exceptions to the rule that *value-added tax* (VAT) is due in the country of establishment can considerably complicate the reimbursement of VAT on cross-border service providers and put them at a disadvantage to national firms.
- *Professional qualification* rules, requiring the holding of certain diplomas, can have the effect of denying the access of foreign-established operators when the equivalence of degrees cannot be established.
- Country-specific *technical standards* can also severely disadvantage potential new entrants established abroad. The telecommunications and rail transport sectors are particularly affected by such obstacles to intra-EU trade.
- *Economic needs tests*, imposed by the host country authorities to ensure that there is enough demand to make a new establishment economically viable, may act as a market entry barrier protecting incumbents.
- Application of the *host country rule* to service providers originating from another member state (for instance the need to establish a local infrastructure or to have a local guarantee).

### ***The services directive***

8. Unleashing market forces in services is key to the Lisbon agenda; hence it is not surprising that the European Commission has been focussing extensively on this issue. The main instrument to that end is the draft *Directive on services in the internal market* (henceforth referred to as the services directive) tabled by the Commission on 13 January 2004.<sup>2</sup> The services directive builds on EC Treaty Articles 43 and 48, which concern the “freedom of establishment”, and Article 49, which concerns the “freedom to provide services within the Community”. But in practice these principles meet a large number of obstacles. Decisions by the Court of Justice only affect individual infringements of the EC Treaty and one country at a time. The services directive aims at making these work in practice throughout the Union, and not only accessible through case law. The services directive does not cover some sectors such as financial services, transport and telecommunications which are already covered by other Community-instruments and where further Community initiatives are underway (see below). Services performed by the State for no consideration as part of its social, cultural, educational and judicial functions where there is no element of remuneration are also excluded from the scope of the proposed directive

9. The services directive contains two main elements: *i*) freedom to establish a business in another member state; and *ii*) free trade between member states. In order to eliminate obstacles to the freedom of establishment, the proposal provides for administrative simplification, notably by establishing a single point of contact through certain principles and requirements. In order to reduce obstacles to the free movement of services, the proposed directive lays down a country of origin principle, so that a service

provider is mainly subject to the legal regime of its country of establishment. The proposal also aims at removing barriers to the use of services from foreign providers by recipients, especially consumers. More specifically, the directive would require member states to repeal any provision favouring domestic providers.

10. The country of origin principle, however, does not overrule the Posting of Workers Directive, which states that temporary workers abroad are subject to host country provisions with regard to all employment conditions, including minimum wage, holidays, sickness insurance and collective agreements that have been extended to a whole sector (**Box 4.2**). Moreover, there is amongst others a general derogation for postal services and distribution of electricity, gas and water and derogations regarding specific requirements applicable in member states where the service is provided, linked to the particular characteristics of the place and which are necessary in order to maintain public safety and health provisions or the protection of the environment.

#### **Box 4.2. The Posting of Workers Directive and its link with the services directive**

The employment conditions of workers posted by their employer in another country on a temporary basis are regulated by the Posting of Workers Directive (PWD).<sup>1</sup> The PWD requires that posted workers should benefit from similar employment conditions to those applicable to local workers in the host country. More specifically, the working conditions covered by the directive include minimum wages, working time, minimum paid leave, the protection of temporary workers, health and safety standards and anti-discrimination measures. The PWD applies regardless of whether the corresponding rules stem from acts, regulations or administratively extended collective agreements. The administrative simplification provisions enshrined in the services directive have however prompted fears that workers' rights will be eroded and have played an important role in the trade union movement expressing strong reservations about the proposal (European Trade Union Confederation, 2004).

The PWD aims at protecting local workers against the competition of posted workers with lower compensation claims (Davies, 1997). To take one topical example, estimates reported by Meier (2004) show that the German construction sector counted between 100 000 and 200 000 foreign posted workers, whose wages averaged about 30% below their German counterparts, while 300 000 German construction workers were unemployed. As Meier (2004) observes with an analytical model, rising costs in the sectors that are covered by the directive pull down real wages in the rest of the economy, have an ambiguous effect on real wages in the construction sector and are most likely to reduce overall social welfare. The PWD limits the scope for enhancing competition and greater gains that are likely to ensue. Nonetheless, the services directive does not attempt to reform the PWD.

However, the services directive would have major implications for self-employed workers. Since they are not covered by the PWD, self-employed workers could supply services cheaply in the host country – indeed perhaps undercut rates in the black economy in that country. They would still have to comply with host country regulations on consumer protection and on safety and health risks, and any workers hired in the host country would be covered by local law. Several high-cost EU-countries view the freedom of self-employed workers to supply services on a temporary basis as a threat to social interests, and this partly explains the reticence in e.g. Germany and France.

1. The directive 96/71/EC concerning the posting of workers in the framework of the provision of services was adopted on 16 December 1996.

11. With its very wide scope, the services directive can be expected to bring about large employment and welfare gains. The fragmented and diffuse nature of the many obstacles to the free flow of services implies that the impact of the directive is very difficult to quantify. In its impact assessment, the EU Commission (2004) noted that the creation of a well-functioning internal market for services could result in gains equivalent to those generated by the Single Market Programme in the field of goods (1.8% increase in GDP and 2.5 million jobs). At the other extreme, a very conservative reckoning by Copenhagen Economics (2005) puts employment and welfare gains at 0.3 and 0.7% respectively. But the Copenhagen Economics figures include static effects only – even though most of the gains from stronger competition are of a dynamic nature – and are thus bound to underestimate the benefits by a wide margin. In particular,

the Copenhagen Economics study focuses only on the effects of price convergence and does not account for the labour productivity gains that the directive would entail. The CPB Netherlands Bureau for Economic Policy Analysis (2004a) found firm indications that the proposed services directive will create a substantial increase – up to a third – in cross-border trade and investment, which are currently severely restricted by the heterogeneity of regulation across countries.

#### **Box 4.3. The services directive and the movement of posted workers and the self-employed**

The freeing up of the provision of services across borders has raised anxieties in high-cost countries. For example, even though the free movement of workers is covered by other legislation and not by the services directive, fears have been expressed that the services directive would prompt movement of workers from the new to the old EU member countries, not least since the implementation of the directive would coincide with the ending of transitional arrangements restricting migration flows from the new EU member countries.<sup>1</sup> West German wages, for instance, are six times those in Poland, even though in purchasing power parities, differences in real wages are considerably smaller.

Since the services directive does not overrule the Posted Workers Directive (PWD, see **Box 4.2**), posted workers in the old EU member countries would be subject to host country labour market regulations. Hence for posted workers to be able to undercut labour conditions in the host country, one would need to assume that the PWD will prove difficult to enforce. However, even if the PWD is enforced, posted workers will exert downward pressure on host-country wages. While the services directive is likely to generate substantial economic gains for the Union as a whole, the question thus arises as to whether nationals of high-cost countries would be less well off if the services directive raised cross-border provision via migration.

In a broader context and apart from the specific scope of application of the services directive, theory suggests that the free movement of people will be advantageous for all countries in the Union. What immigrants earn exceeds the loss in output at home caused by emigration, while what they earn in the old EU countries is normally less than their output. Only the last immigrant receives a wage that equals the immigrant's contribution to national output. Migration will, of course, affect wages. Assuming an aggregate production function with constant returns to scale in the host country, immigration will raise labour supply and reduce the wage rate of occupations that offer similar services as the immigrants. But the national income accruing to nationals in the host country will rise – the so-called immigration surplus (Borjas, 1994) – as the owners of capital and real estate will gain as well as the occupations that are not subject to competition from immigrants.<sup>2</sup> This model implies that there will be losers in the west, but also that there will be a gain from immigration, with the winners winning more than the losers lose (Sinn, 2004). At the same time, wages will go up in the country of origin as labour gets scarcer. The shrinking in wage differentials over time will reduce incentives to migrate. They will cease to have an effect, when the wage differential equals the migration costs.

While immigration could hurt the wage income of some occupations, immigration also expands the size of the market and could thus lead to economies of scale, while the services directive is likely to generate large efficiency gains. In this case the marginal product of both labour and capital increases, which could increase the size of the immigration surplus substantially and even those occupations subject to pressure from immigration may not suffer.

Of course, gains from immigration will be smaller, if labour markets do not function well. If real wages fail to adjust in the host country, immigration will lead to higher unemployment. But this is not an argument against the services directive, but in favour of labour market reforms.

In addition, the services directive could trigger an outflow of capital towards the new EU member countries as companies may take advantage of the comparatively low labour cost. If so, the demand for labour in the new member countries would rise and eventually real wages would adjust up to a level where the real wage differential between the new and old member countries would be exactly offset by the migration cost of capital. Meanwhile the demand for labour in the old member states would fall, and unemployment would increase in the absence of labour market reforms.

1. All euro area countries have administrative restrictions on immigration for a seven year period. However, it does not apply to the posting of workers. The Ifo Institute projected that 4 to 5% of the population of the new member countries will emigrate to the old EU countries (Sinn, 2004).
2. Davis and Weinstein (2002) have challenged the notion of a positive immigration surplus. They argue that a large, technologically superior region is likely to experience a terms-of-trade deterioration from immigration, because at initial prices, the production of the immigrants leads to an excess supply in world markets and adjustment occurs through the deterioration in the terms of trade. The better integration of services in Europe is unlikely to lead to strong terms of trade effects, however, and while lower export prices could hurt the income of nationals, the net effect on welfare has also to take into account lower consumer prices for the nationals.

12. Despite its anticipated benefits, the services directive has met heavy opposition from different parties, in particular the labour unions. Its transversal approach implies eliminating rents in many sectors, including the regulated professions, thereby making it advantageous for a variety of powerful special interests to coalesce against the proposal. In addition, misunderstanding about the interaction of the proposed services directive with the existing Posting of Workers Directive and scepticism regarding the possibility of enforcing this directive has fuelled excessive fears of social dumping (**Box 4.2**), while others have argued that services, such as health care should be excluded. In public comments the country-of-origin principle has been misinterpreted and the directive has been linked with the issue of movement of persons from the new to the old EU member countries (**Box 4.3**). Skilful use of this misunderstanding has enabled interest groups to create considerable resentment in public opinion against the proposed directive. In order to address these fears and enhance the public acceptance of the directive the Commission signalled its willingness to review aspects of the directive.

13. The European Council in March 2005 underlined that the internal market for services has to be fully operational, but that the European social model should be preserved. It also stated that the ongoing debate shows that the directive as it is currently drafted does not fully meet these requirements. The directive is currently being discussed in the European Parliament by ten committees, with the Committee on the Internal Market and Consumer Protection as the lead committee. The committee has presented amendments (Part 1, more is expected), which propose a substantial narrowing of the scope of the directive and to replace the country of origin by a mutual recognition principle (**Box 4.4**). The Committee will vote on these amendments in July 2005, while a plenary vote of the Parliament is set for October. Based on the feedback from the Parliament and the Council, it seems likely that the services directive will be revised. It is, however, important that the European Commission resist a heavy watering down of the directive's main objectives in order not to lose the economic benefits.

#### **Box 4.4. The Gebhardt draft report**

The draft services directive has been submitted to the European Parliament for a first reading. This has led to a proposal by MEP Evelyne Gebhardt for an amendment to the Parliamentary Committee on the Internal Market and Consumer Protection.<sup>1</sup> The amendment considerably narrows the scope of the directive. Specifically:

- It exempts "services, which are commercial, but pursue a general interest objective", which is much broader than "public services", from the Directive. It leaves it to the member countries to define "services of public interest", but this is understood to not only include health care (including private provision), but also regulated professions and crafts – thus removing most of the potential economic benefits from the Directive.
- It drops the "country of origin principle" in favour of a "mutual recognition" clause, but only explicitly applies this to business-to-business services and certain business-to-consumer services, with a very long list of derogations. The rewrite would force the Commission to launch a massive harmonisation operation, which is potentially costly. The Commission would prefer to harmonise regulations on consumer protection only and then apply the country of origin principle, as is the current practice for e-commerce and television broadcasting.
- While the rewrite maintains the freedom of cross-border business establishment for services, the reduced scope of the directive would also affect this principle. Moreover, the impediments to cross-border trade of services due to these amendments would deprive medium-sized business from the possibility to test markets abroad before they decide to establish a foreign subsidiary. This is less of a concern for big companies which can afford to cope with a different regulatory regime in the host country.

There is also a more fundamental problem associated with applying the mutual recognition principle, as opposed to the country of origin principle, in the case of services. The mutual recognition principle assumes that the specific service at hand is regulated. However, in practice the service provider rather than the service itself is usually regulated. For example, there often is regulation regarding the standards of certification of skills (diplomas), but not regarding the service itself because service products are often relatively heterogeneous or tailor-made and not well defined. As a result, it will prove very difficult to enforce the mutual recognition principle in practice, whereas the country of origin principle is relatively easy to enforce.

1. European Parliament, *Draft Report Part I on the Proposal for a Directive of the European Parliament and of the Council on Services in the Internal Market*, Committee of the Internal Market and Consumer Protection, provisional, 2004/0001(COD).

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1. The greater use of hedonic methods in inflation measurement and the higher share of ICT products in consumption inflate productivity estimates to some extent. Timmer *et al.* (2004) show that, if measurement in the retail and wholesale sectors were the same in the United States as in Europe, productivity growth would be 0.8 and 1.5 percentage points lower in the retail and wholesale sector, respectively. But this would still imply a considerable productivity growth differential.
2. Commission proposal COM (2004)2.