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Integrating regulated network markets in Europe*

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Abstract:

This paper assesses the integration strategy of the European Union in regulated network markets. The paper argues that in these markets integration should not be an end in itself. In regulated markets the conventional gains from trade or freedom of establishment may be outweighed by significant welfare losses if integration involves the choice of a misguided deregulation model. Moreover, the design of the integration process will affect the distribution of the gains from integration, and this may be unacceptable to some of the countries and/or social groups involved, leading to the failure of the process. The integration strategy should carefully balance several potentially conflicting interests, with priorities that may not be the same across industries.

The paper provides a comparative analysis of the cases of banking, telecoms and electricity. It suggests that the design of the *deregulation cum integration* process should ensure the maintenance of a level playing field and the preservation of country-specific strategic interests to varying degrees, depending on the industry under consideration. A reasonable equilibrium of this sort is illustrated in the case of banking, but it has not yet been achieved in electricity. In other instances, for example telecoms, the key goal may be very different, with a focus on avoiding excessive regulatory rigidity. Altogether, this implies that integration strategies should combine strong harmonization of some regulations with a large degree of freedom at the Member State level in other domains.

JEL Codes: L51, L89, L94, L96

Keywords: Network markets, European Union integration, deregulation.

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1. Introduction

The process of creating a single European Union (EU) market for goods and services has gone through several stages, from the early removal of tariff barriers to trade in merchandises, to an increasingly complex period of integration in services provision. The integration of services provided over networks is probably one of the last and most sophisticated phases in the long journey towards the integration of the European market.

This paper argues that in regulated network markets, integration should not be an end in itself. The conventional gains from trade or freedom of establishment, which are at the root of the traditional case for economic integration, may be outweighed by significant welfare losses in regulated markets, if integration involves the choice of a misguided deregulation model. Moreover, the design of the integration process will affect the distribution of the gains from integration, and this may be unacceptable to some of the countries and/or social groups involved.

The paper suggests that depending on the industry under consideration, the design of the deregulation cum integration process should ensure the maintenance of a level playing field and the protection of country-specific strategic interests, to varying degrees. This may lead to the use of a variety of integration tools, combining sometimes strong harmonization of some regulations with a large degree of freedom at the Member State level in other domains.

The paper is organized as follows. Section 2 reviews the ways in which product and service markets may be integrated and considers the experience of EU integration regarding product markets and unregulated services markets. Section 3 highlights the distinctive features of network markets and discusses how those peculiarities affect both the evaluation of the gains from integration and the choice of the most appropriate integration strategy. This general discussion is illustrated in section 4 with a brief analysis of the experience so far in the integration of three key network markets: banking, telecoms and electricity. Based upon this industry-specific analysis, section 5 concludes with recommendations for the strategy of the EU in the integration of this type of service industries.

2. Strategies for market integration

The achievement of a single market, beyond the simple formal elimination of trade barriers and the impediments to the establishment of foreign providers, requires that the authorities decide upon the general rules that will be applied to the products or services exchanged in the marketplace and to the firms that provide them. This is the case even in lightly-regulated product and service markets for two reasons. First, because even for the less regulated goods, there may be technical or safety standards that have to be satisfied for the general acceptance of a good in trade. And second, because the existence of these minimal regulations may in fact be used by countries as protectionist devices. That is, as artificial obstacles to trade that maintain market segmentation.

These basic regulations or standards may be of two types: product and process standards. Product standards refer to conditions imposed on final goods, say for reasons of safety or technical compatibility. In services, these standards may refer to the quality of the service being provided, for example. Process standards, on the other hand, deal with the conditions that have to be satisfied within the firm, for example in terms of taxes, environmental controls or the use of some types of inputs (labour).

2.1. Strategies

The creation of a single market may be achieved by a **full harmonization** of all these rules. This is, of course, the most stringent type of integration strategy. It guarantees the free flow of goods and services and the subsequent gains from the increased possibilities of exchange, but it imposes substantial costs in the countries engaged in integration to the extent that some of them will have to sacrifice local regulations and adapt to the regulations of other countries. If existing rules (for example in terms of safety standards) reflect local preferences, this is a real welfare cost. Obviously, the rules may also be pure artificial restrictions to competition imposed by local providers or other pressure groups.

A less demanding type of integration strategy is the **mutual recognition** of regulatory regimes. This integration method implies that countries engaged in the integration process accept each other's regulatory framework. That is to say, the country receiving a foreign product or firm, the host country, recognizes the validity of the regulations imposed on the firm by its home country. This is a very powerful integration method[1], short of the harmonization of rules. It requires a large degree of mutual confidence between the countries involved and a strong political willingness to integrate because mutual recognition may trigger a process of competitive deregulation. If foreign firms are subject to a regulatory regime that diminishes costs, mutual recognition is likely to increase the pressure for deregulation in the host country.

Finally, another strategy of market integration is the use of the **host country rule**. This method implies that the host country need not alter its product and process standards, but,

1. Using a simulation model, Kox and Lejour (2005) show that the use of mutual recognition could dramatically increase trade in services within the EU. However, as highlighted by Ilzkovitz *et al.* (2007, pages 61-62) mutual recognition is hampered by legal uncertainty in practice and further legislation may be needed so that regulatory risk is reduced. This seems to be one of the goals of the recent initiative of the Commission (see European Commission, 2007).

in the spirit of the well-known “national treatment principle” of trade, it is obliged not to discriminate between foreign and domestic providers. Obviously, this strategy leads to a lesser degree of integration to the extent that the rules of the host country may remain intact and foreign providers have to comply with them.

2.2. Products and services markets

Within the European Union the process of integration of product and lightly-regulated service markets has been based upon the use of a variety of integration strategies.

In product markets, integration requires free trade and freedom of establishment without restrictions. Public policy goals, such as the preservation of consumer safety and environmental protection, have been achieved for high-risk products by harmonization of product standards. For the rest of products mutual recognition is the dominant rule. The existing degree of political and institutional integration within Europe allows the mutual recognition of regulations for low-risk products, as well as the mutual acceptance of (moderately different) process standards (for example in terms of tax and social costs).

Things are slightly different for services, even if we talk about lightly-regulated services, as shown by the complex political process lived in the EU for the approval of the directive which sets the basis for integration (the so-called Services Directive[2]). First, the legislation has excluded a large number of activities (such as audiovisual and private security) even though it is hard to claim that these sectors are as heavily regulated as network services. Second, even if mutual recognition has been accepted as the method of integration for service standards, host country rule has been maintained for the key process standards. That is to say, countries are obliged to accept foreign providers of services, but they may require from them the compliance with key domestic process regulations, and in particular with labour conditions and other items that affect social costs. The high labour content of services makes this provision highly restrictive in practice. Moreover, countries are allowed to maintain other local regulations on service providers (ie. economic needs tests, fixed tariffs, restrictions on the number of outlets) which further restrict integration. The goal of the directive, however, is that these local regulations should be subject to a process of mutual evaluation, whereby best practice regulation is promoted and unnecessary restrictions are lifted. All in all, however, it is clear that host country rules dominate and that, due to domestic preferences and/or the pressure of local groups, the integration of lightly-regulated services with this institutional basis is not likely to advance very far.

For both, products and lightly-regulated services, the process of integration is expected to yield substantial economic gains. These have been well researched and documented in the literature[3]. Apart from the comparative advantage gains, they include those arising from increased competition (lower prices, larger number of varieties and increased consumer welfare) and from the achievement of a larger market (increased exploitation of scale economies, both statically and dynamically). Most importantly, however, the integration

2. European Commission (2006).
3. For a recent review of the gains from economic integration see Ilzkovitz *et al.* (2007) and the references therein.

process in products (and to a lesser degree lightly-regulated services) is likely to have limited adverse effects which may thwart its political viability. The process of integration is mostly market driven and its distributional effects are likely to be moderate with a relatively disperse impact on different social groups. Moreover, if the product and process standards are guaranteed in the key high-risk markets, the potential adverse effects on quality, variety and social conditions at large, are also –in principle– moderate. As we have seen for the case of services, the integration strategy is substantially more difficult when the areas involved (East and Western Europe) and the markets to be integrated (services which are intensive in unskilled labour) are perceived to lead to significant impacts in terms of the geographical distribution of the gains and losses of integration.

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