

4. The Sleeping Giant: Services in the Transatlantic Economy

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Service activities are the sleeping giant of the transatlantic economy – an economic force that, if awakened and unbound, would further deepen the commercial stakes between the United States and Europe and enhance the global competitiveness of both parties. At present, however, the full potential of the transatlantic service economy remains hampered by internal barriers, regulations and obstacles in the United States and, in particular, in Europe.

As a recent report from the OECD¹ has noted, restrictions at the sectoral level are largely centered in service activities, with sectoral barriers in the European Union and the United States highest in such sectors as transport services, telecommunications, and electricity. Restrictive regulations in these and other sectors have hampered economic growth and reduced the economic efficiencies of the transatlantic economy over the past few decades. Regulatory reform, on the other hand, would help promote growth, create employment and increase the value of cross-border trade and investment.

The Globalization of Services

Service activities are rapidly being reshaped on a global basis. Functions that were once considered non-tradable (e.g. data processing, education and medical services) are now being traded regularly. Activities long classified as domestic endeavors (advertising, legal services and consulting) today easily take place across borders. Industries that were once the domain of the overregulated public sector (telecommunications, insurance and electric utilities) have been privatized and, in many cases, opened to foreign competition. Consequently, service activities have spread globally, notably across the Atlantic.

The global role of services has been recast in large measure because of the accelerating pace of technological change. In Europe and many other parts of the world, technological advances have appreciably lowered the cost of communications, making it more feasible and efficient to retrieve, process and disseminate multiple forms of information. Just as container ships made the physical export of goods possible in the past, fiber-optic cables have made it possible to export more data, information and other knowledge-based

¹ OECD, *The Benefits of Liberalising Product Markets and Reducing Barriers to International Trade and Investment: The Case of the United States and the European Union*, Economics Department Working Paper 432, Paris, June 2005.

services that used to be considered non-tradable. In short, communications technology increasingly allows firms to split and disperse parts of service functions to foreign affiliates or to non-equity joint partners.

As communications costs have fallen, the information infrastructure has expanded and the Internet has proliferated, knowledge-based services of both the United States and Europe have become more linked, promoting more trade and foreign investment in services. Industry deregulation, a more liberal investment environment and falling communications costs all converged in the 1990s to drive a transatlantic investment boom in services. Other variables supporting transatlantic service investment include the rising share of services in economic activity on both sides of the Atlantic; the growing service intensity of the production of goods; and greater competitive pressures in service markets that have pushed firms to seek markets abroad and strengthen their competitiveness.

Against this backdrop, more than three-quarters of global mergers and acquisitions (M&As) in the services sector took place among developed nations during 1987-2003, with the bulk of the transactions occurring either within Europe or across the Atlantic. According to UN figures, services accounted for 36 of the top 100 cross-border M&A deals in 1987-1995 and for 64 of the top cross-border M&A deals in 1996-2003.

Today, the service economies of the United States and Europe have never been as intertwined as they are today, notably in such activities as financial services, telecommunications, utilities, insurance, advertising, computer services and other related functions.

Enhanced Economic Integration through Services

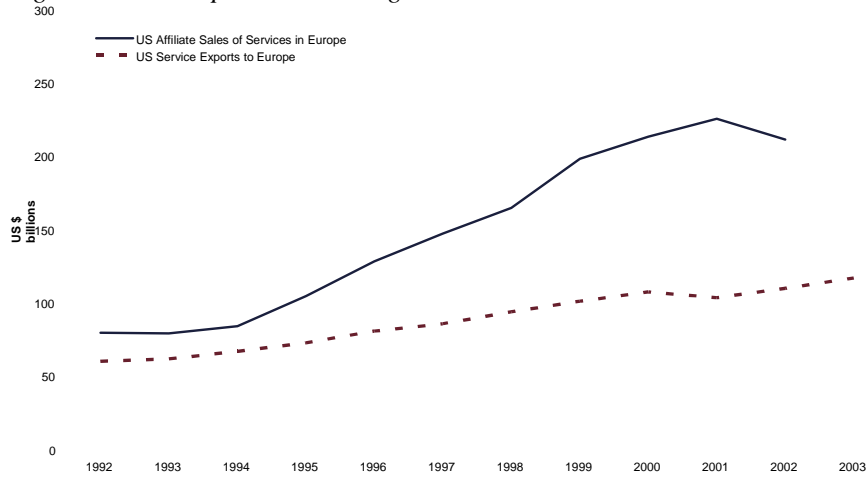
Following in the footsteps of manufacturers, US and European service companies now deliver their services more through foreign affiliate sales than through trade. In the 1970s and 1980s, firms delivered services primarily via trade. In the 1990s foreign affiliate sales became the chief mode of delivery.

Sales of services by US foreign affiliates in Europe soared from \$85 billion in 1994 to roughly \$212 billion in 2002, the last year of available data. That marks a 150% increase, well ahead of the roughly 65% rise in US service exports to Europe over the same period. After being roughly equal to US service exports to Europe in 1992, foreign affiliate sales of services in Europe were nearly double the value of US service exports in 2002, with US service exports to Europe totaling \$117.5 billion.

Europe is the most important market in the world for US foreign affiliate sales of services, just as it is the most important market for US foreign

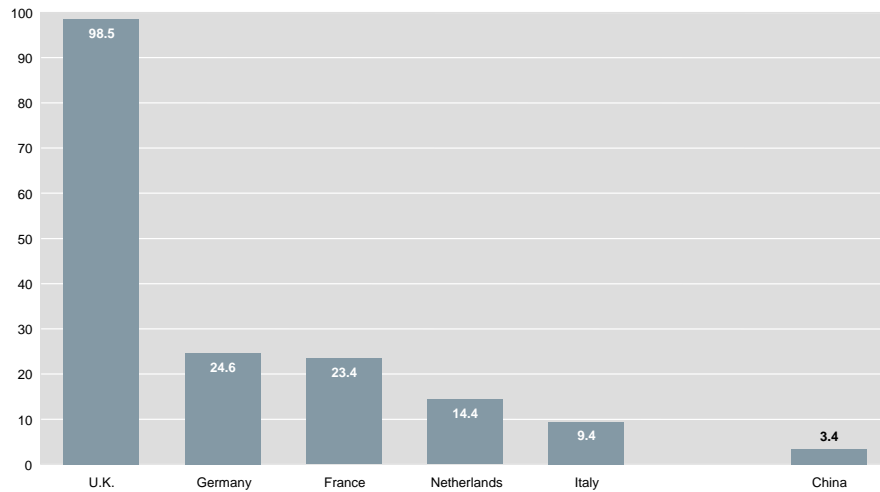
affiliate sales of goods. Indeed, of total affiliate service sales of \$401 billion in 2002, Europe accounted for 53% of the total, with Asia (with 23% share) and Latin America (13%), a distant second and third, respectively.

Figure 1. US-Europe service linkages



Source: Bureau of Economic Analysis, US Department of Commerce.

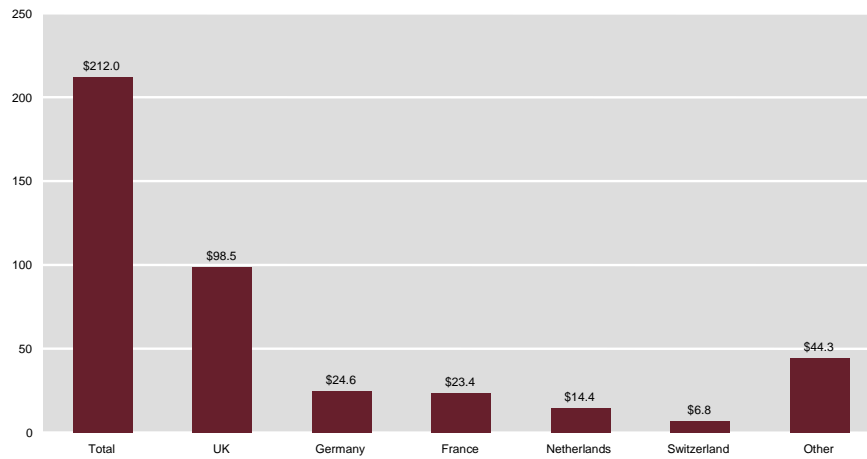
Figure 2. Service Sales of US Foreign Affiliates Abroad – Europe vs. China



Source: Bureau of Economic Analysis, US Department of Commerce.

By country, the UK, whose various service sectors are most aligned with those of the US, accounted for the largest share of US affiliate sales not only in Europe but also the world. In fact, foreign affiliate service sales of \$98.5 billion in the UK in 2002 were greater than foreign affiliate service sales in all of Asia (\$97 billion) and Latin America (\$52 billion). In Europe, Germany (\$24.6 billion), France (\$23.5 billion) and the Netherlands (\$14.4 billion) trailed the UK.

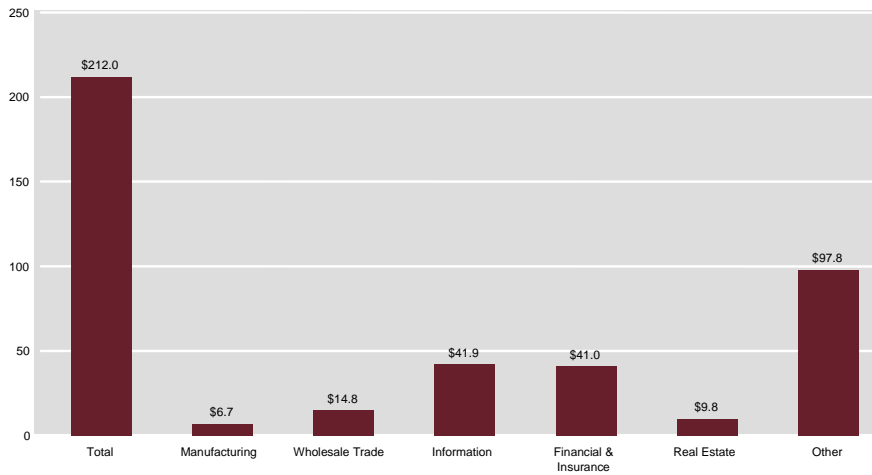
Figure 3. Sales of Services to Europe by US Affiliates, by Country, 2002



Source: Bureau of Economic Analysis, US Department of Commerce.

By industry, sales of services to Europe by US affiliates are quite diverse, with information (\$41.9 billion) and financial and insurance (\$41 billion) leading the way.

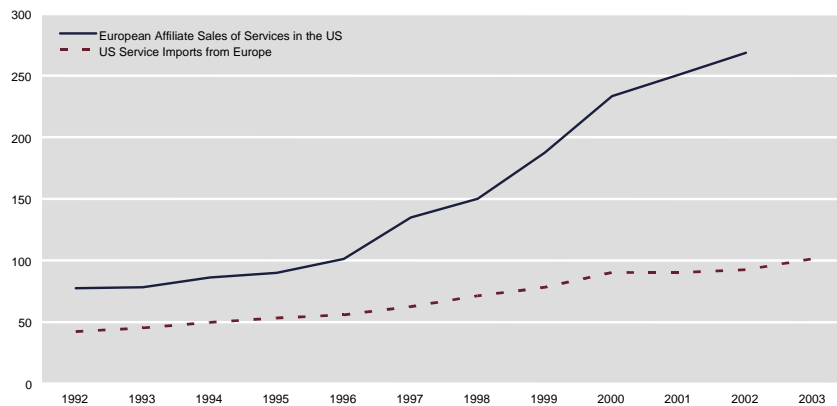
Figure 4. Sales of Services to Europe by US Affiliates, by Industry, 2002



Source: Bureau of Economic Analysis, US Department of Commerce.

Sales of services by US affiliates of European firms have also soared over the past decade. As Europe's investment position in services has expanded in the US, so have foreign affiliate sales of services in the US. The latter totaled \$269 billion in 2002 versus \$86 billion in 1994, a jump of 213%. US service imports from Europe expanded over the same period, by roughly 85%, well below the rate of growth of affiliate sales of services.

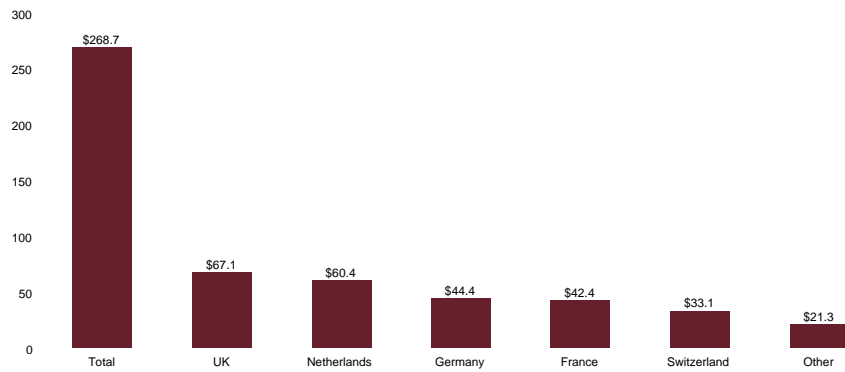
Figure 5. Europe – US Service Linkages



Source: Bureau of Economic Analysis, US Department of Commerce.

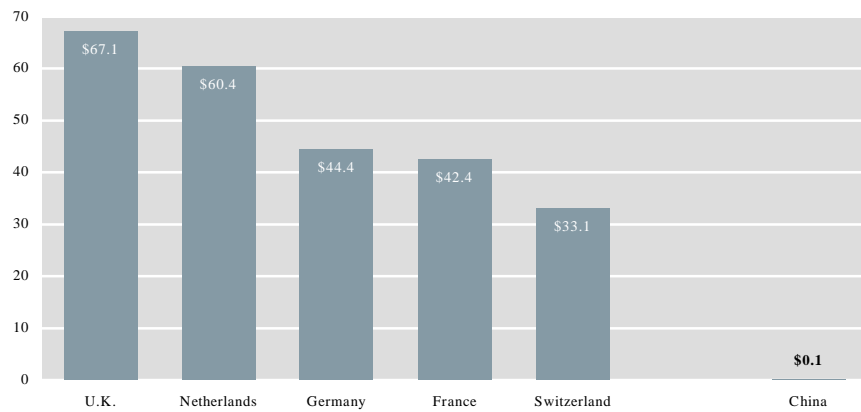
Leading the way were British service firms, whose US affiliate sales in services totaled \$67 billion in 2003, or 25% of total European affiliate sales. German, French and Dutch affiliates in the US posted substantial sales of services as well, totaling \$44 billion, \$42 billion and \$33 billion, respectively, in 2002.

Figure 6. Sales of Services to US by European Affiliates, by Country



Source: Bureau of Economic Analysis, US Department of Commerce.

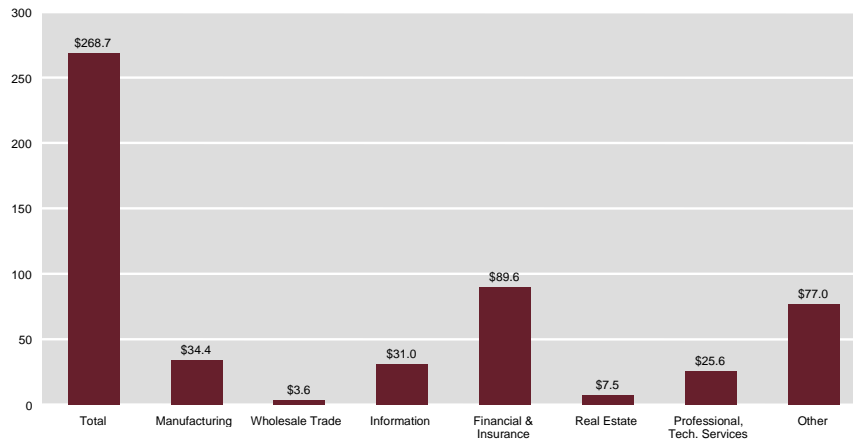
Figure 7. Sales of Services to US by Foreign Affiliates, Europe vs. China, 2002



Source: Bureau of Economic Analysis, US Department of Commerce.

Financial and insurances services accounted for one-third (\$89.6 billion) of total services sales in the US by European affiliates, followed by manufacturing services (\$34.4 billion), information services (\$31 billion), professional and technical services (\$25.6 billion) and a variety of other service sectors.

Figure 8. Sales of Services to US by European Affiliates, by Industry 2002



Source: Bureau of Economic Analysis, US Department of Commerce.

In short, foreign affiliate sales of services on both sides of the Atlantic have exploded over the past decade. In fact, affiliate sales of services have not only become a viable second channel of delivery for US and European multinationals, they have become the overwhelming mode of delivery in a rather short period of time. Moreover, countries where services accounted for close to 60% of overall employment – such as the US, UK, the Netherlands and Norway – had the best record of job creation within the OECD.²

The Services Directive: Impact on the Transatlantic Economy

Despite the major significance of the transatlantic services economy, barriers remain on both sides of the Atlantic. US barriers are most prominent in maritime, legal, engineering, architectural and accounting services. In the EU15 as a whole, barriers appear highest for domestic and foreign firms in accounting, maritime and legal services, and higher for foreign firms relative

² Tobias Buck, “OECD stresses services market reform benefits”, *Financial Times*, April 27, 2005.

to domestic firms in distribution, maritime and architectural services.³ The key issue, however, remains the continued existence of service barriers within the EU itself. Liberalization of inner-EU services would be the single most important stimulus to the transatlantic services economy.

The EU has been committed to a common market for services and goods since its inception in 1957. The EU Single Market was supposed to materialize on January 1, 1993, providing freedom of movement in goods, capital, people and services. Seven years later, EU leaders agreed to announce by the end of 2000 “a strategy for the removal of barriers to services.” Five years later, however, goods continue to move across the Union largely without difficulty, while services remained hampered by 25 different sets of national rules and regulations – even though services account for almost 70% of GDP and jobs in the EU.⁴

Through an initiative called the Services Directive, the European Commission seeks to break down service barriers all at once, rather than by tackling liberalization sector by sector. The Services Directive covers a wide range of services provided to businesses and consumers in all 25 member states. The Directive seeks to provide “a legal framework that will eliminate the obstacles to the freedom of establishment for service providers and the free movement of services between the Member States.”⁵

³ See C. Findley and T. Warren (eds), *Impediments to Trade in Services: Measurement and Policy Implications*, London: Routledge, 2000; K. Kalirajan, “Restrictions on Trade in Distributive Services”, Productivity Commission Staff Research Paper, Canberra: AusInfo, August 2000; D. Nguyen-Hongh, “Restrictions on Trade in Professional Services”, Productivity Commission Staff Research Paper, Canberra: AusInfo, August 2000; Copenhagen Economics, *Economic Assessment of the Barriers to the Internal Market for Services. Final Report*, Copenhagen, January 2005.

⁴ See Tobias Buck, “A recipe for jobs or a race to the bottom? The EU debates a single market in services”, *Financial Times*, March 15, 2005; AmCham EU submission to the US-EU Stakeholder’s Dialogue, December 6, 2004; Daniel Gros, “Europe needs the single market in services”, *Financial Times*, April 7, 2005; and Copenhagen Economics, *ibid*.

⁵ European Commission, “Directive of the European Parliament and of the Council on Services in the Internal Market”, Proposal, COM(2004) 2 final/3, March 5, 2004.

While some controversial elements⁶ of the current Services Directive have caused some member states to question its implementation, analysts estimate that it could be the single most important initiative to improve the continent's competitiveness and employment. Copenhagen Economics, a think tank consultancy in Denmark, estimates that the Services Directive would yield significant economic gains. European consumers, businesses, governments and foreign investors would benefit from enhanced productivity, higher employment, increased wages and lower prices. A comprehensive study by Copenhagen Economics concluded that implementing the Services Directive could result in a total welfare gain of 0.6% of EU GDP, or €37 billion, create up to 600,000 jobs and boost foreign investment by up to 34%.⁷ A second study by Dutch economists, published in 2004, came to similar conclusions. Given the dense interconnections in the transatlantic service economy, implementation of the Services Directive would be very likely to boost US direct investment in the EU considerably.

Implementing the Services Directive would be akin to waking the sleeping giant of the transatlantic economy – services. Ultimately, it could produce a number of benefits and gains for the both the United States and Europe, including the following:

- *Boost transatlantic foreign direct investment flows.* Like the Single Market program, which sparked a rise in more service-related foreign investment, notably in transportation and telecommunications, the elimination or reduction of barriers to service activities in Europe would attract more foreign direct investment from leading service firms in the United States. Under such a scenario, Europe would most likely remain the top destination of US foreign direct investment, continuing the trend of the past half-century. Service deregulation would also promote more intra-European foreign investment, leading to consolidation and greater efficiencies in various service activities.
- *Lower prices while raising productivity and growth.* Service reform and deregulation would trigger greater cross-border competition in services, which would ultimately lead to lower prices, benefiting both consumers and businesses. Productivity levels would rise as costs declined and as firms leveraged more competitively priced services. Since services are a critical component of many manufacturing industries, greater service deregulation in Europe would yield a competitive boost to Europe's

⁶ This includes the so-called 'country of origin' principle, which would grant companies the right to provide services in all member states as long as they follow the laws of their home state, which has caused some critics to warn of 'social dumping'.

⁷ Copenhagen Economics, op. cit.

manufacturing sector. Finally, falling prices, combined with rising productivity, would help boost real economic growth in the EU and a rise in European corporate earnings. In monetary terms, Copenhagen Economics estimates that total value added in the services sector would increase by approximately €33 billion.⁸ Without competitive business services, meeting the EU's Lisbon Agenda objective of forging a world-class knowledge economy in the next few years will be quite difficult.

- *Improve wages and create jobs.* The service sector of the EU already accounts for nearly 70% of total employment; a new regulatory framework that removes tariffs and non-tariffs to services would drive the percentage even higher. Copenhagen Economics estimates that implementation of the Services Directive would boost real wages in the EU by 0.4% and create 600,000 jobs.⁹ Net employment gains would be most noticeable in the new enlargement economies, where service employment (as a percentage of total employment) lags the EU average. In 2003, for instance, only 55.8% of the Czech Republic's work force was employed in services, well below the OECD average of 68.6% in 2003. In Slovakia, the service sector employed only 55.9% of the total work force, while service employment in Poland and Portugal, as a percentage of the total, was 53% and 54.7%, respectively. In terms of service employment catching up to the EU average under a more liberal service framework, Germany and Greece would also benefit, considering that service employment accounts for just 65.6% of total employment in the former and just 61.1% in the latter economy.
- *Stimulate greater cross-border trade in services.* A more deregulatory environment for services would promote greater cross-border transactions in services, helping to boost not only intra-EU trade in services but also cross-border transatlantic trade in services. Cross-border transatlantic trade in services is already quite robust, with total transatlantic trade in services (US service exports to Europe + US service imports from Europe) amounting to \$219 billion in 2003. That is more than double the level of a decade ago.

US service exports to Europe totaled \$117.4 billion in 2003, with Europe accounting for 40% of the global total. Of the top ten markets in the world for US service exports, five are transatlantic partners, with United Kingdom ranked first in the world. Germany ranked fourth, followed by France (6th), Switzerland (8th), and the Netherlands (9th). Of US service imports, roughly 45% were accounted for by Europe in 2003. Service imports from Europe topped \$100 billion for the first time in 2003, with

⁸ Ibid.

⁹ Ibid., pp. 31-32.

service imports from the United Kingdom the largest in the world (\$30 billion).

The Way Forward

Removing barriers to trade and investment in services is one of the key challenges before transatlantic policy-makers. While services presently account for the largest share of gross domestic product in virtually all of the nations that comprise the transatlantic economy, the role of services could be even larger and growth-enhancing if the political will was present to push ahead with more service deregulation and reform.

The lack of service reform represents a significant opportunity cost to the United States, the European Union and the transatlantic economy. The lack of reform could very well undermine the growth, attraction and efficiency of the transatlantic economy – the rest of the world is not standing still.