The Impact and Implications of European Economic Integration

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In 1985, the European Commission published a White Paper called "Completing the Internal Market". In its final form it contained 279 separate proposals, scheduled for completion by 1992, detailing the elimination of all non-tariff barriers to intra-community trade. The aim of these proposals is to create a single unified internal market for goods, services and factors of production.

This integration process will have many and varied effects. In this paper, attention is focussed on the impact that the enhanced competition it will have on the community. Section one considers the reduction in the dispersion of prices of similar goods across member states that is likely to occur. Section two looks at the way in which competition will induce changes in firm size and resource allocation. Finally, in section three, a discussion of the dynamic effects of competition on innovation and technical progress will be undertaken.

Price effects

To the lay-person, one of the most visible effects of integration will be the convergence of prices for similar goods within the community. This convergence will result from the intensified competition consequent on integration.

In 1985, Eurostat (the Statistical Office of the European Communities) produced a survey detailing the price dispersion existing in the community. It found that the standard deviation of prices for final consumption goods was 22%. This composite calculation masked even greater absolute differences. By way of illustration, the average dispersion of prices for refrigerators/washing machines was 10%. However, the absolute difference between countries at either end of the spectrum was 39% (Ireland-France). Furthermore, only 25% of these differences could be explained in terms of differentials in indirect tax (e.g. Value Added Tax). The remaining dispersion resulted from high-price producers and retailers being protected from competition by non-tariff barriers in their fragmented domestic markets.

These protected sectors witnessed an increase of 5% in price dispersion between 1975 and 1985. In contradistinction, in sectors more open to competition, price differences narrowed significantly (-24%) over the same period. Therefore, integration will cause prices to move towards the lower levels prevailing in the Community, as consumers with access to the wider market seek these out. The experience in Ireland where each Christmas a mass exodus across the border to the North takes place bears testament to this. Estimates of the quantitative benefits which may accrue to the Community as a result of the narrowing of price dispersions range from 1.7% to 8.3% of 1985 Community GDP. This reflects a saving for consumers and a move towards a more efficient Community market as a whole.

Firm size and resource allocation effects

On completion of the internal market in 1991, the arena in which European firms do business will be substantially altered. The competition induced by greater market openness will greatly increase both the opportunities and the risks that obtain. A number of points are worth detailing.

Firstly, there will be downward pressure on price-cost margins as the most efficient (and hence lowest cost) producers in the community dictate the price and cost levels that prevail. Those same efficient producers will benefit enormously from the expansion of the market. No longer will they be constrained to produce only for their domestic market, but will have instead free and open access to the whole of the community. This will intensify competition between European producers, forcing less efficient ones to attack their costs. As seen in section one, this should lead to an overall lowering and convergence of prices in the internal market. However, other adjustments are also likely.

Changes in the behaviour and decision-making processes of firms will occur as efforts to take advantage of economies of scale are made - the key to improving firms' allocative efficiency. All industries exhibit potential for economies of scale to some extent. This potential can be empirically verified using engineering surveys, census data, econometric estimates, and price-cost data. For any firm there is an optimal size and level of production referred to as Minimum Efficient Technical Scale (M.E.T.S.). At this point, operation takes place at the lowest possible unit cost of production. The enhanced competition likely to result from integration will encourage firms to realize their scale economies and improve their allocative efficiency in order to survive.

It must also be noted that the completion of the internal market will result in initial, once-off cost reductions for producers. These reductions will occur when cost-increasing barriers, such as compliance costs and intranational standards are removed. Because of increased competition, these reductions should translate into price falls, stimulating demand. Thus, it is possible to argue that integration and competition will give firms both the impetus and the opportunity to expand and become more efficient.

Finally, a process of natural selection should, in time, force "lame duck" firms within the community out of business. Those industries which succeed in expanding and becoming more efficient will thrive, while others that in the past have only remained viable behind a veil of tariffs and barriers, will languish.

These then are some of the likely effects that integration will have on firm structure. The third and final section now discusses the dynamic effects of competition on innovation and technical progress.

A longitudinal perspective

The superior allocation of resources associated with price convergence and the realization of scale economies represent the static benefits of integration and increased competition. However, as Clarke (1986) notes:

> "While it is clearly important to allocate resources efficiently at any point in time, in the long-run the economic well-being of a community will depend on improvements in the quantity and quality of outputs produced by industry"(1986:143).

In analyzing the benefits of integration with respect to competition, it is vital to take cognizance of the link between competition and innovation. Innovation is a major determinant of economic progress. Anything which has a serious effect on innovation must therefore be viewed as being significant to the viability and overall well-being of the economy. The question arises, therefore, as to whether or not high levels of competition are conducive to innovation. The studies in this area are not entirely conclusive.

There are two broad schools of thought relating to this issue. The first contends that firms possessing a large degree of monopoly power will be more likely to innovate than firms who do not. It is claimed that the profit advantages which accrue to monopolies allow them alone to undertake large research and development projects that are simply beyond the means of smaller firms.

This reasoning does not emerge unscathed from the empirical scrutiny of the second school. Geroski (1987), in a study of British markets, found that low levels of competition were inconducive to innovative activity and also that innovations were more numerous in less concentrated industries (i.e. more competitive ones). Geroski also pointed out that the level of innovation in an industry was likely to be inversely related to the number of entry barriers prevailing in that industry. Ergas (1984) concurred with this latter, arguing that those firms most likely to innovate are new entrants, since they are unconstrained by old investment decisions. Zimmerman (1987) studied innovation in Germany, and found that, as a result of increased competition in the export market, trade liberalization in 1992 should have a positive effect on innovation, with firms striving to keep up with the competition. Finally, in a study by Kamien and Schwartz (1982), it was concluded that high levels of concentration militate against innovation, while competition has a diametric effect.

As already stated, the conclusions of these studies are not definitive, and further investigation in this area is needed before concrete assertions about the precise impact of competition on innovation can be made.

Conclusion

This essay has discussed the likely economic effects that European economic integration will have. Probable price movements, changes in firm structure and dynamic considerations were each discussed in turn.

In the last resort, the ability of firms to utilize the potential benefits of a higher level of competition will be contingent on the attendant economic policies adopted by member governments. That said, the completion of the internal European market will offer the opportunity for significant welfare gains, and should enable Europe to compete in a unified and coherent way with the world's other powerful economic blocs.

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A Defence of Multilateral Trade Liberalization

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Though economic theory from Adam Smith to the present day has consistently emphasized the gains from free trade, a considerable amount of protectionism prevails in the real world. It is arguable that such protectionism has a debilitating effect on efficiency and aggregate welfare. This essay presents a defence of free trade, taking particular account of the relevance of this defence to the European Community.

To begin, section one delimits the theoretical arguments that can be forwarded in favour of free trade. It is argued that multilateral liberalization, through the mechanism of the General Agreement on Tariffs and Trade (GATT), has succeeded quite well, and that its achievements should be safeguarded. In this framework, the European Community is then considered, with a critical analysis of its approach to trade policy. The final section discusses prospects for reform. It will be concluded that greater reliance on the GATT norm of non-discrimination is preferable to the development of hostile regional trading blocs.

Free trade and protection: the arguments

In his classic seminal paper, Samuelson (1962) showed that, in a very general model, under certain assumptions, not only is free trade mutually beneficial but also Pareto optimal. It should be noted that further gains from trade also exist - dynamic improvements derived from the exploitation of economies of scale in larger markets, and through X-efficiency. Such gains correspond to real-world phenomena, and are both tangible and quite significant.

Early arguments for protection tended to be based on the failure of the assumptions of the static Samuelson model to hold. However these arguments were countered by the fact that a tariff is rarely a first-best corrective policy. In dealing with factor price rigidity, for example, a subsidy is less distorting than a tariff. One of the most enduring arguments for protection is the infant-industry proposition, an argument which is tenuous since it is, by definition, a temporary one. To defend this case, it is necessary to rely on such considerations as imperfect capital markets, first-mover disadvantages, and dynamic external economies (once knowledge is created it becomes a public good). Yet protection offers no incentive to gain more knowledge - once again it is not the optimal corrective measure.

Modern theories of protection tend to emphasize increasing returns to scale. Allowing for monopoly power means that an "optimal tariff" is theoretically valid. Countries concerned with national interest should, on this view, restrict trade in order to exploit monopoly rent. The major weakness of this approach is that it ignores the possibility that rivals may retaliate. However it did presage the game-theoretic approach which subsequently emerged.

The development of new oligopolistic models in the last two decades allowed the implications for international trade of increasing returns and strategic environments to be analyzed. Despite the fact that such increasing returns should allow dynamic gains from trade to be realized, Brander (1986) contends that oligopoly survives international trade, and that therefore a strategic, interventionist policy may be desirable in certain instances.

Two arguments can here be identified. Firstly, governments can ensure a larger share of rent for domestic firms in particular markets by imposing an export subsidy or an import restriction. The classic example, expounded by Krugman (1987), is that of the duopolistic situation between Airbus and Boeing, where a government subsidy allows the domestic economy to extract the rent involved. Secondly, the external economies proposition has been resurrected to argue that protection is necessary in certain sectors. The key is to target a few strategic industries, the idea being that restricting a market to certain (domestic) firms helps those firms in other markets.

This approach to trade policy has been criticized on a number grounds (Krugman, 1987; Haberler,1990). Firstly, in practical terms, there are too many informational requirements necessary for a thorough evaluation of monopoly power and external economies. Problems which impinge include the identification of quality differences, the pinpointing of external economies, and the gathering of sufficient knowledge about the market structure to be sure the gains will not be dissipated by the entry of rent-seeking firms. Secondly, adopting a general equilibrium approach, aiding one sector at the expense of others is not, in general, optimal. In a complex strategic environment, it is asked, how can the government be sure that an industry of equal potential is not being hindered?

Hence, even accepting the theoretical validity of arguments for protection, practical difficulties necessitate a rethink.

One of the main problems with strategic intervention, as before with the optimal tariff, is that it can provoke retaliation. Hence the problem can be simplified to a classic Prisoner's Dilemma game situation - intervention in one sector means one country gains relative to another, yet if both countries intervene, they both lose (Richardson,1986). Obviously then, the best outcome is reached through a cooperative policy, with no active intervention. So rather than being unilaterally the best policy, free trade is now promoted only as a second-best strategy in an imperfect world. For stability some sort of rule is needed and free trade is a simple rule (Krugman,1987).

Yet for a stable solution, incentives must be built in: otherwise there will be an incentive to cheat. Axelrod (1983) considered simulated results of this ongoing Prisoner's Dilemma game. He concluded that the most stable result is a tit-for-tat policy: cooperate until cheated, and then retaliate, but only once. This strategy builds in the appropriate incentives to cooperate. However, in the real world such bilateralism will not be stable. With such a guideline, policy becomes a series of special cases, with the associated difficulty of trying to distinguish provocation from retaliation.

Because of it's sectoral approach, this literature emphasizes the political economy of protection. The political process is as likely to be dominated by self-interest as by economic markets (Frey,1985). The pro-protection lobby, including import-competing industries and trade unions, wields greater influence than the anti-protection lobby, including export-suppliers and consumers. The former is generally constituted for a specific reason, and there is often an appropriate method of sanctioning free riders. On the other hand, consumers have little bargaining power, since the decline in welfare induced by protection is difficult to identify. Krugman (1987) uses this as one of the practical arguments against strategic intervention.

In classical trade theory, the fact that other countries refuse to open their markets is not a rationale for domestic protection-such unilateralism can be seen in late nineteenth century Britain. However, as a benchmark for the present-day it is utopian. The political economy literature explains this paradox as the result of the dominance of government by strong protectionist lobbying. Further insights are gained by examining the strategic literature, and its game-theoretic approach, especially since countries are today unwilling to liberalize in certain sectors due to perceived "unfair behaviour" by trading partners. Therefore a bilateral bias is inherent in the present system.

This sectoral approach ignores the fact that strategic policy, even in the event of no retaliation, is unlikely to increase welfare from a general equilibrium perspective (The *Economist*, 1990). Research also shows that the gains from trade are even larger under imperfect competition.

In the absence of unilateralism, the only way of achieving successful liberalization is through international coordination. Following Frey (1984), liberalization can be looked at through the framework of a public good, with dramatic underprovision caused by a free rider problem. Two solutions would be internalization of benefits through selective incentives and coercion: neither of these are really feasible. Therefore for any Pareto-superior move, voluntarily agreed rules must be implemented.

GATT is an embodiment of this idea, establishing the ground rules for liberalization through the three norms of first-difference reciprocity, non-discrimination through the most favoured nation (MFN) principle, and transparency (the latter implies that tariffs are preferred to non-tariff barriers (NTBs))[1]. The GATT was extremely successful in attaining post-war trade liberalization. Between 1950 and 1975 world trade increased by 500% and world output by 220%. In the 1970s, however, a whole barrage of NTBs emerged, including the infamous voluntary-export-restraint (VER). Also in the 1980s, concerns about "unfair trading" lead to the proliferation of anti-dumping duties (ADs) and countervailing duties (CVDs) - reflecting a greater role for strategic and bilateral policies. This has left the GATT as something of an anachronism.

To explain why this change occurred it is necessary to consider the motivating force behind cooperation through GATT. Coordination can be imposed, agreed upon, or implicitly chosen (Richardson, 1988). Historically, the US emerged as the undisputed leader in trade liberalization, embracing GATT norms with an approach based on "cooperative policy tolerance". Other countries accepted this and did not act strategically. However, due to a decline in hegemony and increased dependence on international markets, the US has become a smaller player. Corresponding to this has been a massive protectionist upsurge, caused, according to Bhagwati (1988), by the "diminished giant syndrome", and the perception in the US that America has been victimized by other countries. This has been compounded, as political economy predicts, by deteriorating economic conditions- notably the loss of Latin American markets as a result of the debt crisis, and the squeezing of the traded sector in the early 1980s by the strong dollar.

The international trading system, then, is faced with a major crisis in direction, moving towards an oligopoly of coequals. Can multilateralism survive, given its desirability? The next section examines this in the EC context.

1 It is worth noting that many authors, including Wolf (1988), note an inconsistency here, since the notion of reciprocity adopts the fallacy of treating liberalization as a concession to be granted to foreigners rather than as a benefit to the domestic economy.

The trade policy of the European Community

The EC's external trade has consistently risen at a rate above that of GNP growth for some years now, due mainly to the success of the early GATT rounds. The common external tariff is now quite low at an average value of 3.5%. Yet this disguises the reality of a serious problem that exists with non-tariff barriers.

The maintenance of national trade restrictions militates against attempts to define a coherent policy on NTBs. Hence the VER is used quite extensively, with the EC accounting for 138 of 261 known VERs (they doubled between December 1987 and May 1988). Goods under these provisions include steel, clothing, textiles, cars, machine tools, and electronic goods. One of the most blatantly protectionist schemes is the Multi-Fibre Agreement (MFA), covering textiles through an array of VER style bilateral quotas. Restrictions are reinforced by import licensing at national and Community level, the latter being granted by proving injury from foreign competition. ADs and CVDs are the result. In 1984, the New Commercial Policy Instrument strengthened these weapons.

A further issue that cannot be ignored in discussing protection is that of export-promoting subsidies. These are distortionary, in that they cause countries to attempt to outbid each other on world markets. The most infamous example is the price-support and export refund system of the CAP, where surpluses are sold at deflated prices on world markets. Subsidies are also granted to steel and shipbuilding.

Relationships between the US and the EC have been strained by such policies. In return, the EC has taken issue with the US over technological exports from US companies in Europe, and its neglect of liberalization in the services sector. Tension is increased by uneasiness on the part of the US about the possible emergence of a "Fortress Europe". Even the most insignificant subsidies are being countervailed. The Omnibus Trade and Competitiveness Act allows countries to be accused of a broad range of unfair practices, and unless they back down within twelve to eighteen months, they will face retaliation. From 1980-87, two-thirds of all VERs imposed by the US and the EC were the result of anti-dumping actions. (The *Economist*, 1990).

One of the many anomalies of GATT is that it allows such actions in special circumstances. On average, ADs are four times higher than corresponding MFN tariffs: governments have no incentive to switch to non-discriminatory tariffs, which would destroy its bilateral bargaining power. Of all actions monitored by GATT between 1979 and 1988, 77% consisted of ADs and 18% CVDs. The US was responsible for 427 AD cases 371 CVD cases, while the EC was responsible for 406 ADs and 13 CVDs. In many aspects therefore, trade policy in these two regimes is quite similar. Both feel threatened on one side by advances in high-technology countries, especially Japan, and on the other side by the comparative advantage of many developing countries in low-technology, labour-intensive industries such as clothing and textiles.

The approach of the EC to liberalization is through a customs union, which is allowed under GATT rules provided it covers "substantially all trade". This is justified by the recognition that any liberalization is better that none. The EC, it must be remembered, is a union of twelve individual states so any progress is bound to be slow and piecemeal.

In a similar manner to the enlargement of the Community itself, preferential agreements have been concluded with various parts of the world. These are is based on a recognition that agreements are easier to reach, and free riders easier to sanction, if cooperation is exclusive to a small number of like-minded countries. At the apex of this hierarchy are the ACP countries, with a legal agreement under the Lome convention. This blatant disrespect for the principle of nondiscrimination has been criticized. Stevens (1985) refers to the situation as a "pyramid of privilege". Wolf (1988) is more damning, referring to it as "concentric circles of discrimination".

The implications of this system for 1992 must be considered. Sapir (1990) concludes that trade creation is likely with a unified market. Previous enlargements have always led to more, not less, liberalization, and the existence of low inflation and stable economic conditions in general should serve to buttress this. Trade diversion is more likely the higher the the level of external protection which suggests the necessity of tackling the problems already discussed. One major implication of 1992 is that it will no longer be possible combine national external quantity restrictions with free internal circulation of goods.

A problem created by the EC's external trade policy is the possibility of conflict that could easily upset the hierarchy of preferences. The transfer of policy to a Community level is desirable insofar as consistency is concerned, but if a lukewarm stance on liberalization dominates, the question arises as to whether such a transfer is desirable. Smaller nations will lose bargaining power, but gain nothing in return.

Prospects for change

It must be appreciated that the trade policy of the Community cannot be discussed in isolation. There are wider issues involved in the Uruguay Round.

A crucial emphasis must be placed on institutional change, given that the main barrier to freer trade is the presence of discretionary NTBs. (Bhagwati, 1988). GATT rules should ideally become more stringent, as regards safeguard clauses and suchlike. However, since this is a step in the direction of tackling the free rider problem by coercion, which is not really feasible, a good starting point would be increased neutrality in the dispute-settlement process (Baldwin, 1987). Panels tend to be influenced by disputants, especially if they are major trading powers. For the sake of credibility, GATT must be seen as independent of all parties involved.

The overuse of ADs and CVDs must also be tackled, possibly through the penalization of frivolous complaints, again administered through a consultation-compensation mechanism. Bhagwati (1988) argues that, to counter the lobbying asymmetry in political economy, the full costs of protection, including the cost to consumers, should be built into any system of adjudication. Furthermore, if relief is granted, part of it should be charged to the industry involved. It has already been noted that it is not in the interests of an economy, from a general equilibrium perspective, to invoke protection - Bhagwati's idea is to make this more apparent.

One important issue to be dealt with regarding the transition to free trade concerns adjustment assistance for the industries most displaced by foreign competition. Such assistance, argue the cynics, is nationally controlled and interest-group dominated. This surely is no valid criticism: EC-wide adjustment can - and should - become a reality. The idea of taking from the gainers to compensate the losers is well established, and is vital due to short-run problems of labour immobility. There are, however, practical difficulties: it is extremely difficult to distinguish adjustment aid from a permanent subsidy. Furthermore, a credibility problem impinges: if a sector sees the Government is quite content to allow temporary assistance to become permanent, the likelihood of actual adjustment is diminished (Richardson, 1988).

The GATT norm of transparency means that tariffs are the preferred trade restrictions. Especially when bounded, they allow for greater certainty and less cost than NTBs. One influential proposal, forwarded by Bhagwati (1988), is that VERs should be replaced by tariffs, and the revenue generated used to finance adjustment assistance-this would effectively solve two problems simultaneously. Such suggestions are relevant in the context of the current GATT negotiations.

Conclusion

This essay has forwarded the case for multilateral trade liberalization. The first section considered briefly the gains from free trade, and explained the rationale behind protectionist tendencies. The theory underpinning GATT was then discussed in this light. In section two, the case of the EC was introduced, particularly pertinent given the coincidence of the Uruguay Round and the completion of the single market. Finally, in section three, some proposals for reform were considered.

The viewpoint adopted here is rather pessimistic. If benefits are to be maximized, trading nations must resolve their difference within a multilateral framework. Yet, discrepancies in bargaining power, the political economy of the issue, and fluxing minilateralism all combine to militate against such overall consensus. In the last resort, all trading nations would do well to open their history texts, and look at the success of previous GATT agreements, prior to approaching the conference table. Bilateralism is not the answer.

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