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# Protectionism – a Necessary Price for Achieving the European Internal Market?

by Hans-Eckart Scharrer, Hamburg\*

**Trade policy will have to be unified if the member states of the European Community are to achieve their declared objective of creating a homogeneous internal European market by the year 1992. On what principles should such a Community trade policy be based?**

By signing the Single European Act<sup>1</sup> on 17th February 1986, the member states of the European Community set themselves a new and ambitious objective: to create a Western European economic area without internal frontiers by 1992. Since then, the Commission's White Paper on Completing the Internal Market<sup>2</sup> has served as the starting-point for numerous studies<sup>3</sup> that have examined the components of the internal market and ways of achieving it, but the problems of the foreign trade regime of the "enhanced" Community have been largely ignored. The central issue in this regard is whether realisation of the internal market will permit a further liberalisation of trade with the rest of the world or oblige the Community to erect additional external defences, notably against Japan, the USA, the CMEA and the newly industrialising countries.

In the light of the "philosophy" and wording of the Treaty establishing the European Economic Community, the answer to that question should be unequivocal. The preamble declares the "desire" of the member states "to contribute, by means of a common commercial policy, to the progressive abolition of restrictions on international trade". Paragraph 1 of Article 110 of the Treaty reaffirms this objective; paragraph 2 then goes on to say that "The common commercial policy shall take into account the favourable effect which the abolition of customs duties between Member States may have on the increase in the competitive strength of undertakings in those States." What applied in 1957 to the dismantling of intra-Community customs duties, which were the most important instrument of trade policy of that time, should also apply today to the removal of non-tariff barriers. Indeed, the European Council assumes that "action to achieve a single market" will create "a more favourable

environment for stimulating enterprise, competition and trade".<sup>4</sup> Accordingly, higher protective barriers against trade from outside would be both inadmissible and unnecessary. This view of the internal market as a pacesetter for further liberalisation is expressed mainly, though not always convincingly, by the Federal Republic of Germany,<sup>5</sup> supported primarily by Denmark and the Netherlands.

France is the most prominent, but by no means the only proponent of the opposite view – namely that the internal market should be strengthened only if external protection is increased. In 1983 the French Government lent particular force to its argument when it agreed to a series of technical harmonisation regulations – relating to instantaneous water heaters, electrically operated lifts and lawnmowers, for example – only on condition that the New Commercial Instrument<sup>6</sup> was adopted.<sup>7</sup> This Regulation of 1984 "on the strengthening of

<sup>1</sup> Single European Act, in: Bulletin of the European Communities, Supplement 2/86.

<sup>2</sup> Commission of the European Communities: Completing the Internal Market, White Paper from the Commission to the European Council, COM(85) 310 final, Brussels, 14th June 1985.

<sup>3</sup> See inter alia Wissenschaftlicher Beirat beim Bundesministerium für Wirtschaft: Stellungnahme zum Weißbuch der EG-Kommission über den Binnenmarkt, BMWi Studien-Reihe, No. 51, 1986; Hans-Eckart Scharrer: Die Einheitliche Europäische Akte: Der Binnenmarkt, in: Integration, No. 3, 1986, pp. 108 ff.

<sup>4</sup> Quoted from: Commission of the European Communities, op. cit., paragraph 2, p. 4.

<sup>5</sup> With regard to the debate in the Federal Republic of Germany, see Fritz Franzmeyer: Mehr gemeinsamer Markt bei verstärktem Außenschutz in der EG – Die Bundesrepublik im handelspolitischen Dilemma? in: Rudolf Hrbek, Wolfgang Wessels (eds.): EG-Mitgliedschaft – Ein vitales Interesse der Bundesrepublik Deutschland?, Bonn 1984, pp. 80 ff.

<sup>6</sup> Council Regulation (EEC) No. 2641/84 of 17th September 1984, in: Official Journal of the European Communities, No. L 252, 20. 9. 1984, pp. 1 ff.

<sup>7</sup> Georg Koopmann: Abschließung oder Öffnung des gemeinsamen Marktes nach außen. Unpublished discussion paper (1986).

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common commercial policy with regard in particular to protection against illicit commercial practices" supplements the 1982 Regulation on common rules for imports<sup>8</sup> and the 1984 Regulation on antidumping measures and countervailing duties,<sup>9</sup> in that it covers all other distortions in international competition as a result of illicit trade practices by third countries and thus closes a gap in the Community's arsenal of trade policy weapons.<sup>10</sup>

Member states' differing interests and notions of foreign trade have been able to coexist up to now within the flexible framework of the EEC Treaty and its safeguard clauses. However, this has only been feasible because the continued existence of border controls within the Community makes it virtually impossible to get round national trade restrictions (and exchange controls) by channelling business through "open" member states, a situation that is tolerated in practice by all the member states and the Commission, even though it conflicts with the objective of free trade in goods and services, which has already been achieved formally. However, the choice between opening the Community's doors and restricting access further will become unavoidable at the very latest when internal borders are removed and the "common" internal market is transformed into a "uniform" one.

### National Elements in Trade Policy

Concrete trade policy problems will arise mainly from the institution of a "genuine" Community policy to replace the following practices and arrangements geared to serve national objectives and interests:

- national import quotas, Community import barriers to suit particular member states and Community quantitative import restrictions distributed among member countries (including export restraint agreements extracted from important supplying countries);
- the division of Community preferences for third countries (especially tariff preferences for developing countries) into national quotas;
- special arrangements governing relations between individual member states and particular non-members designed to favour the latter.

Other problems will arise when the "new approach" on the harmonisation and reciprocal recognition of national standards and requirements is applied to imported goods from third countries.

As far as the first category of trade measures is concerned, responsibility for trade policy passed de jure

from the member states to the Community when the transitional period under the EEC Treaty expired on 31st December 1969. Member states thus lost their power to set national import quotas for products from third countries, but existing quotas remained in force and countries were free to modify them as they saw fit. Some national import restrictions have since been incorporated into Community regulations, while nevertheless retaining their character as instruments to protect producers in particular member states. The number of product groups subject to quotas is particularly high in Italy, France and Ireland but insignificant in Germany, the United Kingdom and the Benelux countries. Most of these restrictions are directed against imports from specific countries, in particular Japan, Taiwan, South Korea and Hong Kong; in other words they are discriminative.<sup>11</sup>

In addition to these overt import restrictions, "voluntary" export restraints by efficient exporting countries have gained increasing importance, both at Community level and in direct trade with individual EC countries. The best known are the ceilings on sales of Japanese cars in the United Kingdom, France and Italy. It is obvious that such agreements can be monitored and enforced only if the importation of Japanese cars – or other similarly restricted goods, such as machine tools destined for France – via other EC countries and independent importers can be effectively prevented; the removal of internal frontiers destroys the principal means of control.

### Segmentation of the EC Market

Acting on behalf of interested member states, the Community itself has also concluded voluntary restraint agreements with individual countries for a growing number of products or has imposed quantitative import restrictions. The foremost example is that of the textile and clothing sector, for which the Community has concluded trade agreements under the Multi-Fibre Arrangement providing for quotas on a series of particularly "sensitive" goods (including cotton yarn, T-shirts, trousers and shirts) from 23 exporting countries in Asia, Latin America and Eastern Europe.<sup>12</sup> In view of

<sup>8</sup> Council Regulation (EEC) No. 288/82 of 5th February 1982, in: Official Journal of the European Communities, No. L 35, 9. 2. 1982, pp. 1 ff.

<sup>9</sup> Council Regulation (EEC) No. 2176/84 of 23rd July 1984, in: Official Journal of the European Communities, No. L 201, 30. 7. 1984, pp. 1 ff.

<sup>10</sup> See Hans-Hagen Härtel et al.: Neue Industriepolitik oder Stärkung der Marktkräfte? Strukturpolitische Konzeptionen im internationalen Vergleich, Hamburg 1986, p. 158.

<sup>11</sup> Georg Koopmann: Nationaler Protektionismus und gemeinsame Handelspolitik in der EG, in: Bodo G e m p e r (ed.): Protektionismus in der Weltwirtschaft, Hamburg 1984, pp. 31 ff.

the intended completion of the internal market, it is particularly significant that the "Community quotas" negotiated with the exporting countries are divided among the EC member countries according to a "burden-sharing key". "Hence it is not only the common market but also each national market that is being protected."<sup>13</sup> Moreover, "discussion in the Council has shown that countries are interested mainly in the national sub-quotas, and less in the overall Community quota".<sup>14</sup>

Article 115 of the EEC Treaty is the most important instrument for protecting national manufacturing interests within the Common Market, which already exists formally. By virtue of this escape clause, the Commission can empower member states to deny Community treatment to goods from third countries that are in free circulation within the Community, in other words to prohibit their importation from other member states. Between 1977 and 1985 this provision was invoked 1,451 times to curtail such "roundabout" imports; 554 instances favoured France, 317 Ireland, 210 the Benelux countries and 203 Italy; Germany resorted to this instrument only 27 times and Denmark only four times.<sup>15</sup> In addition, the Common Rules for Imports sanction national monitoring and protection measures on certain conditions. The segmentation of the Community as far as non-member countries are concerned could not be maintained once internal borders had been removed. As the Commission rightly observes, all import restrictions would then "have to be applied on a Community-wide basis".<sup>16</sup>

#### Preferences in Favour of Third Countries

The same applies to national quotas under preference arrangements for non-member countries. At present, the Community quotas for the duty-free importation of products from developing countries under the Community's Generalised System of Preferences are divided into sub-quotas for each member country; only a residue generally amounting to 20% of the overall quota remains unallocated. If a member country's quota for "sensitive" goods is used up, the Community reserve is first drawn upon, but then customs duty is automatically reimposed, even if unused quota is still available in other countries, and hence in the EC as a whole.<sup>17</sup> In its present form, the Community's preferential tariff system therefore works less in favour of the developing countries, as it was designed to do, than in favour of national importers who hold the import licences, while at the same time containing the "damage" to national producers of competing products. Nonetheless, the European Court of Justice ruled in 1985 that the quota shares allocated

to individual member countries did not cease to be "Community" quotas; if the imported goods were in free circulation in one member state, their re-exportation (duty-free) to another member state might not be restricted.<sup>18</sup> However, member states have clearly succeeded in shielding themselves to a large extent from (duty-free) roundabout imports and protecting their domestic producers. For a given level of Community quotas, the removal of internal borders should increase competition within the region as a whole.

Problems of a particular kind arise as a result of special arrangements between individual member states and certain third countries designed to favour the latter. The special quotas granted to the United Kingdom for specific agricultural imports from Commonwealth countries, such as butter from New Zealand, are of relatively little significance in this respect. More problematic is the trade status of the German Democratic Republic sanctioned by the EEC Protocol on German internal trade, under which no EC customs duties or price adjustment levies are imposed on imports of goods from the GDR to the Federal Republic of Germany; the tax treatment of goods from the GDR is also more akin to that for products from the Federal Republic than for imports.<sup>19</sup> It could be said that the GDR has a trade association agreement with the Federal Republic, but not with the EC as a whole. In accordance with the Protocol, the shipment of goods from the Federal Republic into the wider EC market is subject to "appropriate measures to avoid harming the economies of the other Member States".<sup>20</sup> The creation of a unified internal market would be bound to affect the relationship of the Federal Republic – or the other EC countries – to the GDR and would presumably have implications for relations with other CMEA countries. The form such relations should take is an open question.

<sup>12</sup> Cf. Hans-Hagen Härtel et al., *op. cit.*, p. 161.

<sup>13</sup> *Ibid.*, p. 162.

<sup>14</sup> *Ibid.*, footnote 6 to chapter 4/IV, p. 207.

<sup>15</sup> According to a compilation by Georg Koopmann. For the period 1977-83, see Georg Koopmann: *Nationaler Protektionismus und gemeinsame Handelspolitik in der EG*, *op. cit.*, p. 30.

<sup>16</sup> Commission of the European Communities, *op. cit.*, paragraph 36, p. 11.

<sup>17</sup> See Axel Borrmann et al.: *The Significance of the EEC's Generalised System of Preferences*, Hamburg 1985, pp. 36 f.

<sup>18</sup> Judgement of the European Court of Justice of 7th October 1985 in Case 199/84, in: *Official Journal of the European Communities*, No. C 277, 29. 10. 1985, p. 10, and the article "Aufteilung eines Zollkontingents", in: *Handelsblatt*, 6. 8. 1986.

<sup>19</sup> Purchasers of goods from the GDR can currently claim a rebate of 11% on value added tax; exports to the GDR bear duty at a rate of 6%.

<sup>20</sup> Protocol relating to German Internal Trade and Connected Problems, 25th March 1957 (Protocol to the EEC Treaty of the same date).

### **“New Approach” towards Internal Trade**

Finally, there are other problems associated with the Community's “new approach” towards the harmonisation of legislation and the reciprocal recognition of national requirements, standards and health and safety regulations. In future, legislative harmonisation is to be confined to laying down the essential requirements for a product; technical implementation will be left to standards organisations and any necessary testing and certification to the country of manufacture. For many products, there will be no harmonisation at all; in such cases, the principle that goods lawfully manufactured and marketed in one member state must be allowed free entry into other member states will apply, in accordance with the ruling of the European Court of Justice in the *Cassis de Dijon* case.<sup>21</sup> Neither the White Paper nor other EC documents mention the application of these procedures and principles to goods from third countries; indeed, the repeated references to goods manufactured in a member state suggest that products from outside the Community will not necessarily be subject to the same rules. It therefore remains to be seen whether a discriminatory solution will ultimately be adopted for these products or the Community will be guided by the principle of equal treatment.

The remarks made so far have shown that access to the domestic markets of member states by third-country suppliers differs owing to countries' pursuing their own individual trade policies and to nationally differentiated Community measures. This lack of uniformity vis-à-vis third countries necessitates protective measures against roundabout imports via member states with “open access”. The unification of trade policy as demanded in Article 113 of the EEC Treaty is therefore a necessary condition for the realisation of the internal market and, vice versa, the creation of the internal market enforces the unification of trade policy. The question arises as to the principles on which the common trade policy should be based.

### **Arguments for Protection**

At first sight, there appear to be several arguments in favour of a defensive policy geared towards protection.

□ The removal of national protective barriers against suppliers from third countries increases the pressure on affected industries and regions to adjust if it is not accompanied by a raising of the defences at Community level. The existence of regional differences in import regulations indicates that the industries in some countries are not yet able to withstand international competition.

□ In any case, the disappearance of numerous non-tariff barriers as a concomitant to the realisation of the internal market will intensify competition among suppliers within the Community, force many marginal producers out of business and hence have not only beneficial but also negative effects on employment and regional development, at least in the short term. Since firms' “adjustment potential” is limited, it is argued that this tendency must be offset by easing the pressure of foreign competition. It is an argument that becomes all the more compelling, the more the Commission presses for implementation of Article 92, paragraph 1, of the EEC Treaty, which prohibits the granting of state aid that distorts competition.

□ “The unification of the internal market must be accompanied by an external commercial policy designed to strengthen the competitiveness of European industry: the Community must create the conditions that will gradually put its industry in a position to fight international competition on its own market on equal terms ...”<sup>22</sup> (the infant industry argument).

These concerns will undoubtedly translate into political pressure, which will probably be all the more effective the less the member states succeed in solving their employment problems. However, this does not mean that greater protectionism towards the rest of the world be a suitable means of tackling the problems within the Community itself.

### **Dynamic Effects of the Internal Market**

The advocates of the protectionist approach underestimate the dynamic effects of implementing the single large market. The creation of an internal market of 320 million inhabitants (compared with 235 million in the USA) and with an output on a par with that of the USA (GNP of the Community of 12 in 1984 \$3,525 billion, compared with \$3,625 billion in the case of the USA)<sup>23</sup> is an objective whose importance for the Community's investment activity, innovative power, technological capability and international competitiveness, and hence for employment, growth and prosperity, cannot be ranked too highly. If pursued resolutely, the realisation of a common economic area can stimulate industrial efficiency, release new economic energy and help

<sup>21</sup> Commission of the European Communities, *op. cit.*, paragraphs 68 (p. 19) and 77 (p. 22).

<sup>22</sup> Memorandum from the Commission to the European Council on strengthening the technological base and competitiveness of Community industry, in: *Bulletin of the European Communities*, No. 3, 1985, p. 100.

<sup>23</sup> At current prices and purchasing power parities according to OECD: *National Accounts 1960-1984*, Vol. 1, p. 118.

combat "Eurosclerosis". It is this dynamic stimulus to competition and growth that should be kept in the front of one's mind when considering the creation of the internal market.

The economic costs and disadvantages of protectionist measures also tend to be underestimated. Protectionist measures offer only the illusion of a remedy. For one thing, the burden is often only transferred from protected to unprotected sectors, as can be seen clearly in the case of financial protectionism, where the subsidies awarded to one sector must be "earned" by the rest. It is also evident in the barring of market access for intermediate industrial products; if the car industry is prevented from using cheaper foreign steel or installing the most modern foreign-made machine tools, it too will soon find itself in difficulties. If the current account surplus increases or the deficit contracts as a result of a fall in imports, the exchange rate may rise, to the further detriment of unprotected products.

#### **False Signals to the Markets**

Trade protectionism also gives false signals to investors and to labour markets, since yields and wages in protected industries are too high by comparison with those elsewhere. Scarce capital is wasted, to the detriment of future growth and employment, and labour is tied up artificially in unproductive activities. Excessively high interest rates and wages impede the development of new, internationally competitive lines of production. Finally, the general reduction in competition is accompanied by a loss in economic dynamism; the exploitation of state aid (sometimes by dubious means) and concerted efforts by firms and trade unions to exact further state resources promise higher profits than investment in the development of new products and methods, which always entails risk. The efficiency of the economy as a whole declines.

All of this holds true even without taking account of possible retaliation by other countries. If retaliatory action is also brought into the equation, the employment gain in the sector competing with imports is directly offset by job losses in the export sector. There is no net employment gain, only a decline in overall productivity.

As for the infant industry argument in the high technology field, there is a danger that shielding firms in the Common Market from international competition and perhaps also supporting them with government funds will lead them into a technological backwater. Japan's ability to develop technological innovations to the production stage within a short period of time is to some extent the result of the keen competition to which

Japanese firms are exposed at home and abroad. Another point to note in this connection is the trend towards greater industrial concentration in Europe, which the Commission cannot counter with the existing instruments established by Articles 85 and 86 of the EEC Treaty. The creation of a European cartels office is probably inevitable in the long run, but in the meantime competition on price and performance with foreign suppliers in the European market is a necessary corrective to the danger of a lessening of competition.

#### **Treatment of the Causes**

Although the advocates of protectionism are promoting the wrong remedy, it must be conceded that they have drawn attention to economic misdevelopments that may attend the realisation of a common internal market. Appropriate treatment, however, must attack these ills at their root:

- Monetary and exchange rate policy must be used if exchange rate distortions without or within the EMS are responsible for causing current and potential competitive disadvantages.
- A widening of regional disparities during the completion of the internal market would call for regional policy measures (including a regionally differentiated wages policy), but also measures under the general economic policy of the countries concerned. Efforts to adjust might be encouraged by equalising the financial burden between favoured and disadvantaged countries and regions ("cohesion"), especially through the financing of infrastructure investment, retraining, etc.
- If Europe is perceived to be lagging behind in the development of new products and production processes, research efforts should be strengthened. This is not always a matter of financial resources but also research objectives (basic research versus applied research), research organisation and the translation of research results into marketable products. That Europe is guilty of a certain amount of neglect in this regard can be judged from the examples of video recorders, compact discs and above all computer technology.
- In general, a recommended policy would be a supply-side policy in the widest sense that was not confined to fiscal measures but designed to improve the conditions for investment, innovation and new lines of production. This would include a wage structure with greater differentiation according to qualifications and sectors and which created incentives for occupational and regional mobility, as well as a capital market policy that also enabled small and medium-sized firms to widen their capital base.