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Liberalisation of the Internal Market: Efficiency Advantages and Requirements

The expected welfare effects of the completion of the internal European market by 1992 will differ markedly from one member country to another. What requirements must be met for liberalisation of the internal market? How could the disparities in the distribution of welfare effects be lessened?

As one might expect, assessments of the economic impact of the single European market differ very widely. Some economists see the internal market as a "magic potion"¹ that can give the partly stagnating economies of the European Community impressive economic growth and internationally competitive enterprises. Others are much more sceptical about the potential integration effects, pointing especially to the regional consequences of liberalisation of the internal market and a further widening of the disparities in national prosperity.

Such scepticism is not unjustified, for the accession of Greece in 1981 and Spain and Portugal in 1986 increased the Community's gross domestic product by 10% but its population by 22%, the number of persons employed in agriculture by 57% and the number of unemployed by 30%. The population of regions where per capita GDP (measured in terms of purchasing power parities) is at least 25% below the Community average has risen from 24 million (just under 10%) to 62 million (around 20% of the total population of the Community of Twelve).² It is therefore doubtful whether the opening-up and liberalisation of markets will reduce the development differentials, particularly as the relative convergence of real per capita GDP had already come to a halt after the first enlargement of the EC in 1973, so that the income differential has stabilised or even widened slightly.³ It is therefore necessary to assess the expected welfare effects of the Common Market on individual countries, and especially structurally weak member states and regions, and to identify the economic measures that should be taken if these effects are unevenly distributed.

The completion of the European internal market is intended to remove the constraints on market forces and competition within the Community and consequently to create pan-European manufacturing and business structures that are internationally competitive.⁴ A study initiated by the EC Commission, the Cecchini Report, expects the liberalisation of the European markets to produce the benefits shown in Table 1.⁵

Comparable estimations at the macro-economic level indicate that the micro-economic efficiency gains will lead to the creation of up to 5 million new jobs and a reduction in consumer prices of between 4.5 and 6.1% without placing any burden on government budgets or balances of trade.⁶ The employment, price and growth effects are deduced from sectoral analyses in which the impact of complete freedom of movement of goods and services is forecast. Despite the sometimes considerable differences between the estimates, the factors contributing to the expected welfare effects can be identified clearly. Efficiency gains stem firstly from the

¹ See "Die Zeit", 15. 1. 88, pp. 19-21.

^{2,3} T. Padoa - Schioppa, et al.: Efficiency, stability and equity. A Strategy for the evolution of the economic system of the European Community (Report of a study group appointed by the EC Commission and presided over by T. Padoa - Schioppa), Paris 1987.

⁴ Compare for example Commission of the European Communities: Improving competitiveness and industrial structures in the Community, Com (86), 40 final, Brussels; Commission of the European Communities: Annual economic report 1987-88. Using the Community dimension to reinforce internal growth, European Economy, No. 34, November 1987.

⁵ Commission of the European Communities: The economics of 1992. An assessment of the potential economic effects of completing the internal market of the European Community, European Economy, No. 35, March 1988; P. Cecchini: The European Challenge 1992 - The Benefits of a Single Market, Aldershot/England 1988.

⁶ P. Cecchini, op. cit.; Commission of the European Communities: The economics of 1992, op. cit., pp. 17-22 and 149-169.

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reduction in costs and delays currently caused by border formalities and the associated administrative work (item 1 in Table 1). Item 1 also includes the benefits of reducing or harmonising non-tariff trade barriers, especially industrial standards. It should be borne in mind, however, that the real obstacles are often not the standards themselves but the accompanying regulations – such as those of professional bodies, of which there are around 160 in Germany – and/or guidelines, such as the 1,200 laid down by the Association of German Engineers.⁷ Further welfare effects derive from the reduction of costs arising from restrictions on market access (as in public procurement) and/or authorisation (as in financial services).⁸

The removal of these restrictions will make it possible to exploit the considerable scope for cost reductions in individual industries, generate high returns to scale and approach the optimum plant size for the industry (item 2).⁹ The resulting specialisation of EC enterprises will increase intra-Community trade, on the one hand, and drive out less efficient suppliers, on the other. The monopoly profits that could previously be wrung out of compartmentalised national markets will decrease or disappear entirely. Prices will tend to fall when the removal of the remaining restrictions on the movement of goods and services within the Community and the accompanying liberalisation of financial flows accentuates competition throughout the EC and the resulting benefits are passed on to consumers (item 3).

At the same time, however, both the Cecchini Report and the Padoa-Schioppa Report, also commissioned by the EC Commission, clearly demonstrate the need for macro-economic measures to safeguard the working of the Common Market. This will require above all the harmonisation or approximation of laws and regulations in individual industries, although in accordance with the

subsidiarity principle Community schemes would be implemented only if they offered appreciable advantages over national arrangements.¹⁰ Controls will also be needed to prevent market domination as a result of pan-European corporate mergers and the creation or extension of restrictions on competition.¹¹

Although the opinions commissioned by the EC Commission are in broad agreement on these points, they differ sharply with regard to the distribution of the benefits among member countries. According to the Cecchini Report, there is no evidence that liberalisation of the internal market will harm rather than benefit the poorer or smaller member countries. Indeed, the advantages to those in the South could be greater than the average if one takes into account the doubling of the Community's structural funds.¹²

The Padoa-Schioppa Report, on the other hand, sees clearly that a levelling of per capita incomes in the EC can be expected only if very specific conditions are met. It points to the absence of rising returns to scale and the lack of specific location or agglomeration advantages that could influence investment decisions within the integrated area. If these conditions are not met – and past and expected future developments in the Community suggest that they will not be – the integration effects are at best uncertain as regards regional convergence or divergence of development levels.¹³

Regional Implications

In fact, greater micro-economic efficiency in individual markets does not necessarily also produce the expected positive results at the macro-economic level. The reduction in tariff and non-tariff barriers to trade (item 1), the exploitation of rising returns to scale (item 2) and increasing Community-wide competition (item 3) will in all probability lead to a structural shift

Table 1
Integration Benefits of Liberalisation
of the Internal Market

Welfare effects	ECU billion	% of GDP
1. From the removal of tariff and non-tariff trade barriers	65-80	2.2-2.7
2. From rising returns to scale and optimum plant size	61	2.1
3. From heightened competition and reduced monopoly profits	46	1.6
4. Welfare effects of market integration	62-107 ^a	2.1-3.7 ^a
5. Total effects for EUR 12 at 1988 prices	170-250	4.25-6.25

^a The welfare effects of market integration (4) cannot be deduced by adding (2) and (3) as they depend also on the implementation of macro-economic policies.

^{7,8} For details see the studies concerning specific types of barriers and concerning specific industries and service sectors conducted for the "Costs of non - Europe" project. These studies will be published in the course of 1988 by the Office for Official Publications of the European Communities in its series "Documents".

⁹ See for example C. Pratten: A survey of the economies of scale. Report prepared for the EC Commission, Brussels 1987; N. Owen: Economies of scale, competitiveness and trade patterns within the European Community, Oxford 1983.

^{10, 11} Compare the corresponding statements of the Commission of the European Communities: Completing the internal market. White paper from the Commission to the European Council, Brussels 1985.

¹² See EG-Nachrichten. Berichte und Informationen - Dokumentation, No. 3, 5. April 1988: Wirtschaftlicher Nutzen des Programms "Binnenmarkt 1992", edited by the Commission of the European Communities.

¹³ T. Padoa - Schioppa et al., op. cit., p. 91.

between regions and sectors that will entail risks and adjustment costs especially for the structurally weaker member states. Empirical studies show that the peripheral areas of the Community have been at a structural disadvantage in the process of integration that has been occurring already and that even a more than proportional expansion in funds for regional promotion has not enabled the outlying regions and structurally disadvantaged areas to catch up.¹⁴

Far from being a chance occurrence, this is a continuous trend that can be explained satisfactorily in theoretical terms; agglomeration advantages of areas of industrial concentration, rising returns to scale and oligopolistic competitive structures often lead to a regional and sectoral polarisation of industrial activities

in an integrated area of countries at different stages of development.¹⁵ Admittedly, it is difficult to test this empirically, since the continuation or accentuation of differences in the level of development is not always linked causally with the multinational liberalisation of markets in the integrated area. Existing differences in the level of development are also the result of national economic strategies and characteristics on the one hand, and individual economies' adjustment problems caused by world economic conditions, on the other. Whatever the problems of empirical attribution, the EC must in any case counter a possible accentuation of the existing "North-South prosperity gap" if the ensuing distribution conflicts are not to become the main obstacle to liberalisation of the internal market.

¹⁴ Compare for details Commission of the European Communities: First, Second and Third Report on the Social and Economic Situation of the Regions of Europe, Brussels 1981, 1984, 1987.

¹⁵ P. Robson: The Economics of International Integration, London 1987, pp. 73-75; N. Kaldor: Economics Without Equilibrium, New York 1985.

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This book sets out to develop further the existing theory of allocation in small, open economies within the framework of a general theory of equilibrium of international trade relationships, so that the external dependencies of national allocation processes can be analysed systematically. The author succeeds in unveiling the consequences of the specific conditions of production in individual countries which are the reason for the structural differences between industrial and developing countries. Significant differences are revealed between the allocative and distributive effects of an export boom in countries at different levels of development.

VERLAG WELTARCHIV GMBH-HAMBURG

When estimating the regional and structural impact of the Common Market on the Southern European countries of Portugal, Spain and Greece it must be borne in mind that the economies of these countries have a strongly dualistic structure. A large number of crisis-prone small and medium-sized firms orientated mainly towards the domestic market exist alongside a small number of large companies, mostly dependent on foreign capital or under state control. Despite the fact that the Southern European countries have been granted a transitional period until 1993 as far as tariff reductions are concerned, the removal of tariff and non-tariff trade barriers that will accompany the liberalisation of trade is likely to increase the pressure of imports from Western European countries, without it always being possible to offset the resultant adjustment problems by stepping up export efforts.¹⁶

Implications

It must therefore be feared that in particular many small and medium-sized enterprises will have difficulty withstanding the increased competition caused by the reduction in tariffs owing to their relatively low productivity and low research and capital intensity, so that macro-economic problems such as fluctuations in production and employment are not to be excluded. Certainly heightened competition within the EC is bound to raise productivity in many industries in Southern European countries, but in countries with the structural characteristics outlined above there is a danger that dismantling the obstacles to trade and mobility too rapidly will confront infant industries and small or medium-sized enterprises with almost insuperable problems of adjustment. Hence it cannot be ruled out that some countries will revert to national industrial policy measures and attempt to cushion the effects of any adjustment problems by granting state subsidies.

If less efficient firms are forced out of the market as a result of the necessary structural change and keener competition, the resources "released" must be channelled into potentially competitive industries with growth prospects if they are not to remain idle. In this connection, it must also be borne in mind that, assuming

a "typical or normal" trend, around 50% of the agricultural labour force in Greece, 25% in Portugal and 33% in Spain will be "released" by 1990, placing an additional burden on the labour market.¹⁷ It may prove difficult for industries with high growth potential to absorb the labour "released" by structural change and liberalisation of the internal market, since keener competition within the Community will also force them to adopt labour-saving rationalisation and modernisation measures and since the workers available will not always be adequately qualified. In addition, the comparatively competitive industries (steel, shipbuilding, textiles, clothing, artificial fibres) are often precisely the ones that are already classed as sensitive in the EC and accordingly covered by crisis schemes and quotas. Industries are described as sensitive if their international competitiveness is jeopardised by an imbalance of supply and demand but production is not to be abandoned, for instance on account of labour market and industrial policy considerations.

To overcome the structural weakness of the Southern European countries and prepare individual industries for Community-wide competition would primarily require an increase in private sector investment and a technological modernisation of the industries concerned. This will certainly not occur spontaneously or, as it were, automatically as a result of liberalisation of the internal market. Consequently, there is a need for political action to create the conditions for safeguarding the efficiency advantages of the Common Market.

Safeguarding the Efficiency Advantages

Articles 130 A to E of the Single European Act,¹⁸ which was signed in February 1986 and came into force in July 1987, present a package of measures designed to counter the risks of uneven development in member states. It is planned that by 1992 the resources of the structural funds¹⁹ will be increased in real terms from ECU 7 to 14 billion, equivalent to 15% of the total budget and 0.3% of the Community's total gross domestic product.²⁰ The funds are to be used primarily for financing programmes in the following areas, with decentralised incentive mechanisms and flexible financing criteria being given priority over quotas:²¹

¹⁶ R. Clement: Zur Notwendigkeit entwicklungspolitischer Maßnahmen in der Europäischen Gemeinschaft, in: Konjunkturpolitik, Vol. 34, 2/1988 (forthcoming); see also J. B. Donges, W. Schatz: The Iberian Countries Facing EC Membership. Starting Conditions for Their Industry, in: Weltwirtschaftliches Archiv, Vol. 121, 1985, pp. 756-778.

¹⁷ R. Clement, op. cit.; for details see J. B. Donges et al.: The Second Enlargement of the European Community. Adjustment Requirements and Challenges for Policy Reform, Tübingen 1982, pp. 65-70.

¹⁸ Commission of the European Communities: The Single European Act. Supplement to the Bulletin of the EC, No. 2/86, Brussels.

¹⁹ The Structural Funds include the European Regional Development Fund (ERDF), the European Social Fund (ESF) and the European Agricultural Guidance and Guarantee Fund (EAGGF).

^{20,21} For details see Commission of the European Communities: Reform of the Structural Funds, Com (87), 376 final, Brussels.

- ☐ the promotion of backward regions,
- ☐ support for regions particularly disadvantaged by structural change,
- ☐ measures to combat long-term unemployment,
- ☐ action to ease the integration of young people into employment, and
- ☐ the promotion of rural development in connection with the reform of agricultural policy.

The increase in the structural funds' resources is considered sufficient to give a decisive boost to development in the structurally weak regions. Accordingly, the measures concentrate on the most important types of capital formation needed for regions or countries to build up or expand efficient production facilities. First priority goes to forming human capital. For that purpose occupational training, further training and retraining schemes are subsidised by the funds, whereas the general educational system is to be assisted financially only in exceptional cases. Secondly, grants are to be provided for infrastructure investment in transportation, education, communications and energy. Bringing the basic infrastructure of the least prosperous regions of the Southern European countries up to at least 80% of the EC average will require total expenditure of ECU 105.4 billion over the next ten years.²² Thirdly, private investment is to be stimulated by means of Community loans and grants of budgetary funds to the structurally weak regions of the EC. Depending on the method of calculation, an additional growth of 1 percentage point in GDP requires an increase of between ECU 12.7 and 16.7 billion in gross fixed investment in the Southern European countries.²³

The measures outlined above are unlikely to be sufficient to overcome the existing structural problems in the Southern European countries, however. The internal market programme mainly affects the supply side, and thus neglects the demand side of the economic process. It is probably barely enough to create favourable supply-side conditions for growth and employment through deregulation and liberalisation of the internal market hoping that enterprises will take advantage of the opportunities. Business surveys make it clear that expectations of the effects of liberalising the internal market are predominantly positive, but the basis of such expectations must be regarded as fickle. To that extent the Cecchini Report rightly calls for an expansionary trade cycle and growth policy that would use any newly

emerging budgetary scope and would form part of an economic policy co-ordinated among the member states.²⁴

Conclusions

It can therefore be concluded that the completion of the European internal market will create additional trade, stimulate growth and increase prosperity as a result of a more intensive division of labour among the member states but will also have disadvantages that can only partly be quantified but must nonetheless be taken into account when making an overall assessment.²⁵ Many firms and the people who work in them will suffer material loss if keener competition leads to structural rationalisation and a common competitive code forces the abolition of subsidies. In extreme cases, this may mean that entire industries will die in certain regions or countries because more favourable production opportunities develop in other regions or countries.

It cannot be ruled out that structural change of this kind will confront the disadvantaged regions and countries of the EC with adjustment problems that they can no longer overcome on the national level. The reallocation and redirection of "labour" and "capital" must therefore be accompanied by a targeted social policy in those sectors and regions that experience regional and structural adjustment problems. If the burden of adjustment is very unevenly distributed, there must be a substantial transfer of resources within the Community, which would have to be borne to varying degrees by national budgets and therefore requires countries to be ready to make more than proportional financial sacrifices.

Since many measures only make sense on a pan-European scale in view of the countries' interdependence, the narrowing of the scope for national policy also has a political cost. Doubts and resistance to the completion of the Common Market are therefore to be expected on this score as well. Hence in future it will be important to make it clear that the integration process may entail substantial costs, both tangible and intangible at the national level, but that it will open up greater room for action at a higher level, in other words on a pan-European plane.

²⁴ P. Cecchini, *op. cit.*; compare also Commission of the European Communities: *The economics of 1992*, *op. cit.*; ifo-schnelldienst: *Was bringt der Europäische Binnenmarkt?*, Vol. 41, 1988, No. 16.

^{25,26} For details see F. Franzmeyer: *Was kostet die Vollendung des europäischen Binnenmarktes? – Eine Bewertung aus wirtschaftlicher, sozialer und politischer Sicht*, in: *Konjunkturpolitik*, Vol. 33, 3/1987, pp. 146-166.

^{22,23} T. Padoa-Schioppa *et al.*, *op. cit.*