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The Single European Market - A Schumpeterian Event?

by Horst Siebert

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Introduction

It is now four years after the White Paper launched the project on the completion of the internal market [Commission, 1985]. 300 steps were packaged and sold in a manner by Delors and Lord Cockfield that "caught on". The basic strategy is simple: abolish or reduce market segmentations that still exist, facilitate free market access, as well as establish the free movement of people, goods, services, and capital (the so-called four freedoms).

Will the single European market prove to be an institutional innovation - a Schumpeterian event in a region of the world that has been characterized by Eurosclerosis [Giersch, 1985] and overregulation? Is Europe '92 an example of political entrepreneurship in the sense of Schumpeter and shall we see "new combinations of means of production" [Schumpeter, 1934, p. 74] being carried out? Or is Europe' 92 a "flash in the pan", flambé à la Delors, concocted by Cockfield, propagated by the press, public speeches and scientific conferences, but eventually dying from internal rent-seeking and protectionism?

The Single Market as an Institutional Innovation

Out of the 300 directives, which were actually slimmed down to 279, 127 have been adopted by the European Council (as of 30th September 1989), or a common position has been reached on them. Some of these steps refer to such trivial points as the harmonization of statistics, directives for the eradication of contagious bovine pleuro-pneumonia in Portugal and Spain and of Blue Tongue in the Greek Isles and the "Implementation Directive 87/402/EEC" for tractors and agricultural machines specifying "rollover protection structures (incorporating two pillars and mounted in front of the driver's seat on narrow-track wheeled agricultural and forestry tractors)". Other steps already taken are more important, relating to the liberalization of the capital market and the mutual recognition of university degrees. Still to come are decisions on such vital issues as the harmonization of the value added tax rates and a sweeping liberalization of transport services.

In the Single European Act, unanimity in the Council of Ministers was replaced by majority voting (in a weighted form) for the larger part of the 279

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I appreciate comments from Hugo Dicke, Dean Spinanger and Holger Schmieding.

directives. Unanimity is still required in the areas of taxation, the free movement of labor and the rights of employees. This procedural change has added speed to the internal market program, but whether the decisions are superior to those taken by unanimous voting cannot be taken for granted. This might be even more questioned in the field of trade policy decision-making, where the free trade approach of some member states might become the minority.

It may be surprising that, despite the pronouncements in the Treaty of Rome (1957) about creating a Common Market, Europe is still permeated by market segmentations. Where are they to be found? Market segmentations still prevail in the form of border controls, barriers to market entry, to some extent in quota systems such as national "grandfather" quotas in automobile imports, multifiber quotas, and in distortions caused by national subsidies.

Border controls exist because of statistical purposes, differences in indirect taxation and the enforcement of national regulations. With the principle that the value added tax is levied in the country of destination, reimbursement for intra-European exports requires the statistical monitoring of exports at the national border if the tax rates differ as they do. For example, the normal value added tax rate is 14 percent in the Federal Republic of Germany and 22 percent in Denmark. For specific commodities, Belgium, France, Greece, Italy, Portugal and Spain have tax rates around 30 and more percent (Table A1 in the Appendix).

Barriers to market entry arise from differences in national regulation. Technical standards or product norms for consumer protection are cases in point, for instance product norms for pharmaceutical products and hazardous material, licencing of new products in the chemical industry, and environmental product standards.

Market entry conditions for firms result from licencing processes in land-use planning, from activities with environmental impacts, in regulated industries and in public procurement. Entry barriers are not only influenced by the system defining entry per se, but also by national regulations on the conduct of business such as the licencing of freight rates, insurance rates and conditions of the banking industry. Moreover, exit conditions influence entry. Barriers to market entry may also be due to specific forms of property rights as in common carrier problems (electricity). Finally, public procurement is a reason for severe entry barriers (postal services, telecommunications). These market entry barriers for firms represent the most severe market segmentations.

Institutional Competition versus Prior Harmonization

When the Common Market was established in 1958, the approach was to create a common European institutional setting by explicitly harmonizing the legal systems of all European countries. In the last two decades, this approach has given way to the realization that an ex-ante harmonization on the European level has proven to be impractical.

In 1979, the European Court of Justice handed down its *Crème-de-Dijon* ruling. *Crème de Dijon* or *Crème de Cassis* - an input of the *Kir Royale* or *Kir Ordinaire* - is a fruit liqueur that was forbidden in Germany because it had (and still has) an alcohol content of roughly 17 percent whereas the German "*Branntweinmonopolgesetz*" of 1922 required a much higher alcohol content (32 percent) - in order to "protect" the German consumer.

According to the *Cassis-de-Dijon* ruling, a product legally brought to market in one country of the EC can automatically enter the markets of the other countries. Hence, Belgian beer can now be sold in Germany even if it is not brewed according to the German purity law of 1517. And German noodles (not made of hard wheat) can now be sold in the home of the *pasti* (made of hard wheat). Finally, French *pâté* can compete with the German *liverwurst* even if the former doesn't comply with German sausage regulations. All of this is the result of decisions made by the European Court.

Thus, in the trade of products it is not the regulation of the country of destination but of the country of origin that applies. By mutual recognition of the institutional arrangements of the country of origin, ex-ante harmonization is not required.

The Commission is determined to extend the principle of mutual recognition to the service industries. A service allowed according to the rules of one country is allowed in other countries under the norms of the country of origin: English insurance rates can be offered in Germany; Dutch freight rates apply for Dutch truckers doing business in Germany. Together with the liberalization for capital movement this may prove to be a tremendous stimulus for the service industries.

One of the major implications of the country-of-origin principle is that there will be institutional competition between national regulations. What does it mean? An important ingredient of the country-of-origin principle is the arbitrage of households and firms. With markets no longer being segmented, households and firms can take advantage of price differentials in the commodity and factor markets. Households will buy the commodity with the lower value added tax or they

will shop in the country with other lower indirect tax rates. Trading houses, direct mailers and wholesalers will have scope for arbitrage between different countries.

Firms will exploit price and factor price differentials and differences in regulation. Location arbitrage will be the reaction to differences in production and business taxes, in market entry regulations, in environmental policy, in wage rates and labor market conditions and in price differentials of other immobile factors. Firms, or at least their subunits, will migrate to the most favorable location.

Location arbitrage results from the interplay of mobile and immobile factors of production and endowment. Immobile are such factors as land, most types of labor and the institutional setting; capital is the mobile factor. Technical knowledge, when incorporated in physical capital and in immobile labor, is itself immobile. Technical knowledge in the heads of mobile labor is itself mobile. Immobile factors determine the price of the mobile factors before arbitrage takes place and thus influence the attractiveness of a region (nation). After arbitrage, prices for mobile factors should be equal. Locational competition is the competition of the immobile factors for the mobile factor.

The arbitrage of consumers and firms will clearly reveal which national regulatory system is best in the eyes of the consumer or the producer: national regulation has to pass a litmus test of private agents voting with their purses and with their feet. Accordingly, there will be pressure on national regulations to adjust over time.

The advantage of the country-of-origin principle and of institutional competition is that harmonization is an open-ended process, the results of which are not known *ex ante*. Thus, institutional competition can be interpreted as an exploratory device in the sense of Hayek [1968]. Another advantage is that harmonization is not undertaken *ex ante* at the political bargaining table under the influence of the interest groups, but it follows from an anonymous market process in which the power of interest groups evaporates. This relates to issues of taxation, product standards which can no longer be defended by a national interest group, and market entry conditions.

The conflict between the strategy of institutional competition versus prior harmonization reflects a more fundamental conflict of orientation: on a constitutional level, i.e. concerning the manner in which a society is organized in terms of institutions, it is the conflict of federalism versus centralization. On a philosophical level, it is the conflict between liberalism in the European sense versus a more planning-oriented approach. We have diverging views in Europe on such

issues as confidence in the functioning of markets or some type of controls and interventionism, sovereignty of the consumer or the need for consumer "protection", the role and the size of the government, spontaneity of autonomous decision-making and decentralized processes versus a constructivism, or the English case law versus the logic of the Roman law. Europe is in a process of searching for its institutions, and the showdown between the British and the French concept of Europe is still to come.

The Economic Impact

The country-of-origin principle will make market entry easier, and markets will become more contestable. Entry is an important prerequisite for the contestability of markets. If entry is possible, the firm already present is restrained in its price setting behavior: high prices and high profits attract the newcomer. Thus, the threat of market entry will reduce prices and rents.

Access to a restricted market can be interpreted as a property right, freeing market access is a change in the property right and in the rent associated with it. A freer market access will be especially relevant for those sectors that are heavily regulated. This holds true for important service sectors and public procurement:

- In banking, banks will have easier access to the market in another country and they can take advantage of differences in national regulations. Bank customers can use the services of a bank in a foreign country due to the liberalization of portfolio capital. Moreover, investment banks may enter the market of the more traditional universal bank.
- In insurance, the principle of mutual recognition will allow the regulation of the country of origin to be applied. An English insurance company can offer insurance rates licenced in Great Britain anywhere in Europe. Insurance companies and banks are becoming strong competitors with respect to attracting loanable funds and allocating them to competing users. The institutional arrangement for these sections will have to be redefined (capital adequacy requirements, avoidance of bank runs, etc.).
- In trucking, free market access will imply the extension of "cabotage" rules for the foreign trucker; existing licences, again property rights because of restricted entry, will lose (part of) their value, and competition will be intensified with this type of deregulation (reductions in transportation costs of 30 percent in Germany are expected). With such cost reductions, the relative position of

other means of transportation will be affected, implying a loss in volume for the railroads. Issues such as financing the transportation infrastructure (roads), treating railroad and roads in an equivalent fashion and internalizing environmental effects of trucking will have to be solved.¹

- In the airline industry, free market entry implies that routes in Europe will no longer be licenced bilaterally to the respective national airlines but to other competitors as well. Allocating landing slots with a price mechanism is another important step. Again, a change in property rights will influence the intensity of competition. Air traffic control has to be improved.
- In the electricity industry, free market entry can be established if a new property right for the common carrier is defined. Moreover, the French energy utilities are interested in supplying energy across their national borders. Germany's "century contract", securing the coal industry's sales to the electricity sector, is being questioned.
- Postal and telecommunication services, being close substitutes, have been supplied by state-owned companies in most countries since the last century. Splitting up these services and privatizing some functions are preconditions for opening these markets.
- In public procurement, institutional arrangements and actual practices favor a generous use of public funds because there is no control by competition and no allocation of funds by market principles. A Europe-wide invitation of tenders may, however, not bring about a radical change.

In all these areas, depending on how daringly market entry will be introduced, we can expect an increase in the contestability of markets.

Other factors also point into the direction of more contestable markets. The size of the European market with 320 million people will change the economic environment of firms. To the extent that the large internal market is not already being tapped, it will mean falling average costs, at least for a certain range. In production, firms will move down the average cost curve by allocating high fixed costs to a larger number of units. But at the same time there will be learning effects, that is the accumulation of experience. Such so-called dynamic effects occur in activities involving highly qualified labor (electronics, aerospace products). For multiproduct firms, spillovers from one product to the other may be relevant. Moreover, there are economies of scale in research and development.

¹ Problems include user charges for roads and splitting railroads into one company owning the infrastructure and operating companies, possibly private.

Economies of scale not only hold for production but also for marketing, for instance in establishing a Europe-wide brand name, and for distribution. They also should be relevant for some services such as insurance because of risk-spreading and to banking because of the fixed costs of headquarter services - which can be apportioned to a larger number of transactions. Empirical evidence, however, is not available.

To what extent potential economies of scale can be realized depends on the size of the market and on the preferences of the consumer for the firm's product. There we observe two different trends in Europe: on the one hand, we can expect that demand (and preferences?) will become more similar in Europe because living conditions and income per head will level out to some extent. This trend makes for a larger market and more economies of scale. On the other hand, there is a demand for more variety with a higher income, a demand for choosing between a Peugeot and a Fiat, and this wish for product differentiation will create market niches for individual firms. The net effect is open.

Another factor influencing the realization of economies of scale are organizational costs which may represent a brake on falling costs and may eventually cause average costs to rise.

The argument of falling average cost curves applies to numerous sectors, namely aircraft production and other transport equipment (e.g. the automobile industry), the chemical industry, manmade fibers and paper, printing and publishing. Also the pharmaceutical industry and biochemical products have been mentioned. Table 1 shows empirical estimates of falling average costs for selected sectors in manufacturing. Economies of scale are measured by halving the "minimum efficient technical scale" (METS).

In the realm of high fixed costs and falling average costs, life for the small firm is not easy. The small firm has to find a market niche into which the large firm will not enter, or has not entered. It has to produce a new or better product, or a specialized product and it has to use a more innovative production process. Fortunately, these firms tend to be more flexible and have better contact with their customers. Their potential will also be enhanced by the extent to which large firms are of the Dinosaur type where the head does not know what the tail is doing. Small and middle-sized firms can be a vigorous force for innovation, and Europe would be well advised not to favor the "Super Corporations" and become a "Europe Incorporated". Empirical evidence from the United States suggests that "small entrepreneurial firms and not their larger counterparts ... have been the

Table 1 - Branches of Manufacturing Industry Ranked by Size of Economies of Scale

NACE Code	Branch	Cost gradient at half METS (percent)
35	Motor vehicles	6 - 9
36	Other means of transport	8 -20
25	Chemical industry	2.5-15
26	Man-made fibres	5 -10
22	Metals	≥ 6
33	Office machinery	3 - 6
32	Mechanical engineering	3 - 6
34	Electrical engineering	5 -15
37	Instrument engineering	5 -15
47	Paper, printing and publishing	8 -36
24	Non-metallic mineral products	≥ 6
31	Metal articles	5 -10
		(castings)
48	Rubber and plastics	3 - 6
41-42	Drink and tobacco	1 - 6
41-42	Food	3.5-21
49	Other manufacturing	n.a.
43	Textile industry	10
		(carpets)
46	Timber and wood	n.a.
45	Footwear and clothing	1
		(footwear)
44	Leather and leather goods	n.a.

Source: Emerson et al. [1988, Table 6.1.1.].

catalyst for new jobs and innovation in the U.S. during this past decade" [Audretsch, 1989].

Besides free market access, the size of the market and economies of scale, there is an increased potential for cost minimization and location arbitrage of firms. Thus, we observe relocation of firms in Europe, especially to Spain, or the establishment of new branches of firms. The spatial restructuring of firms is an intrafirm realization of comparative advantages. It goes hand in hand with an increased mobility of capital.

Expectations of firms also play a role, and expectations of the business community seem to be positive with respect to the Single Market. An observable reaction is the organizational restructuring of industry and the service sector, for instance in defining new firm strategies for the Single Market or establishing new forms of cooperation between firms supplying the national market (due to only nationally-established brand names). Mergers and acquisitions represent a vehicle

by which a firm can establish itself in the market of another country and streamline its product mix. According to a report of the European Commission, there were 383 mergers between members of the Community, up 26 percent from 1987. In Germany, mergers exploded from 34 in 1973 to 635 in 1980 and to 1159 in 1988 (Table A2).

As a long-run trend, investment in Europe relative to North America and Japan and the Four Tigers (South Korea, Hong Kong, Singapore, Taiwan) has declined. In the Figure, the relative performance of the EC (I_{EC}), North America (US and Canada, I_{NA}), and Japan plus the Four Tigers (I_{AS}) with respect to locational investment is illustrated.¹ The position of the EC declined over time, with a reduced trend after 1985. Locational investment in North America, which during the 1960's and 1970's moved in line with the EC, increased considerably during the first half of the 1980's.

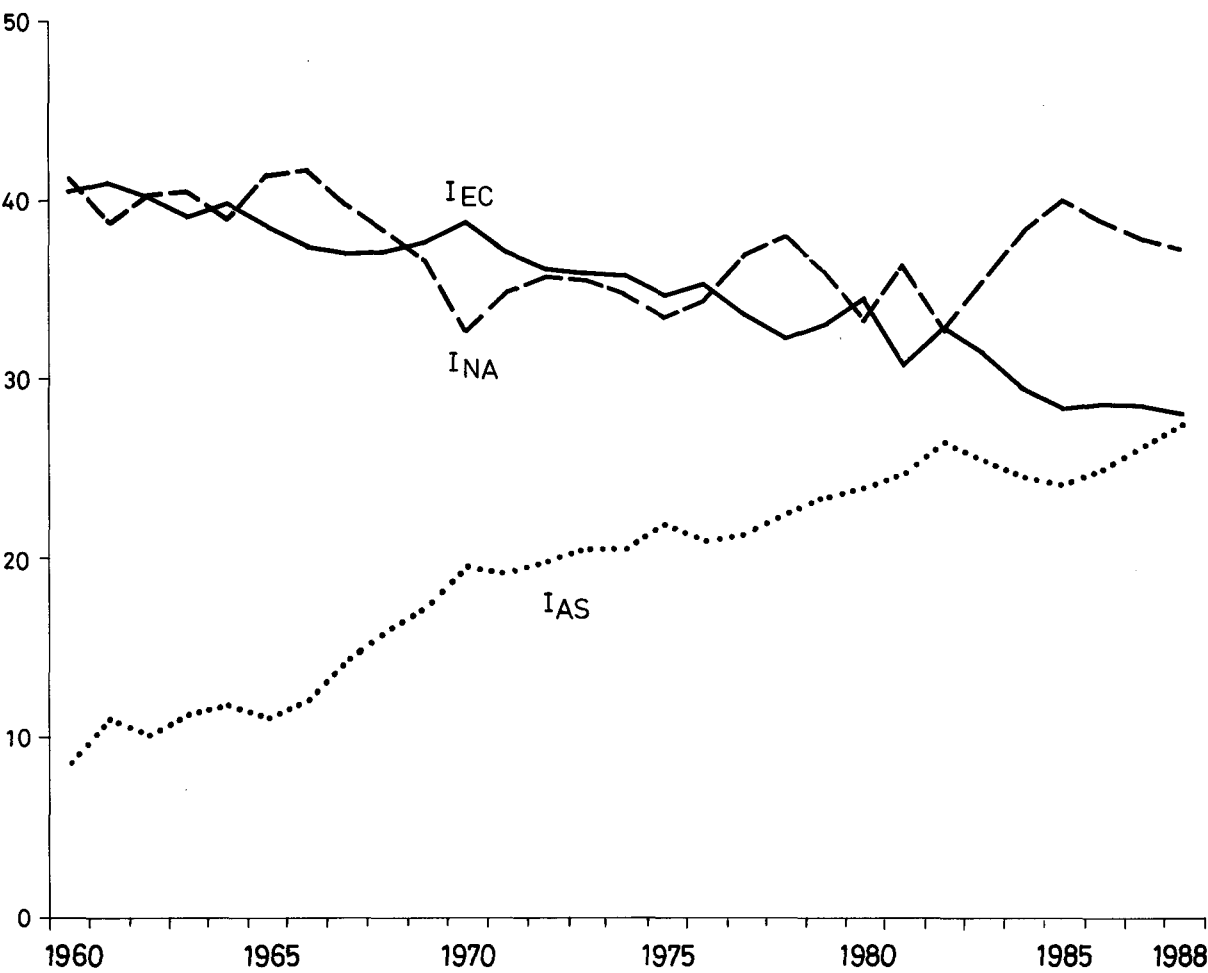
Foreign direct investment in Europe has increased. The stock of US direct investment in the EC went up from US\$80.8 billion (1980) to US\$119 billion in 1987. The stock of Japanese direct investment has tripled from US\$7.1 billion (1983) to US\$21 billion (1987). Canadian and Swedish direct investment have also increased. Within the EC, Great Britain, Spain and Portugal succeeded in attracting the largest share of direct investment.

There are four major issues which I do not explicitly address in this paper:

- The macroeconomic impact. Here we can expect the opening of markets and intensified competition to lead to efficiency gains and a higher growth rate. The Cecchini report expects an increase of 4.7-7 percent of GNP [Cecchini et al., 1988].
- The allocation impact may be influenced by the evolution of the monetary system; for instance, the liberalization of capital markets is linked to the monetary system with safeguard clauses still possible [Siebert, 1989c].

¹ Locational investment is defined as investment within each of the three country groups as a fraction of total investment in all industrialized countries [Sinn, 1989]. Changes of this indicator may serve as a measure of a location's attractiveness for internationally mobile capital [ibid.]. The group of industrialized countries comprises all OECD countries plus the Four Tigers. Investment is defined as real gross domestic investment in international dollars at constant purchasing power parities and at constant national prices. Data for 1960 to 1985 have been calculated from Summers and Heston [1988], those for 1986 to 1988 are an estimate based on Summers and Heston's [ibid.] 1985 values and growth rates of real gross capital formation. The OECD National Accounts [1987a] evaluate gross fixed capital formation at the price levels and exchange rates of 1980; gross fixed capital formation in 1987 is US\$734.83 million for North America and US\$720.41 million for the EC.

Figure - Locational Investment in Regions of the World (percentage share)



- The social charter is an issue. It will influence the labor market and the demand for labor. As a general rule, we know that the price of an immobile factor of production has to be different in different locations. This is especially true if the realignment of exchange rates can no longer be used as a shock absorber.
- Another important issue is environmental policy. Should it be centralized in Brussels or can it be decentralized? Similar to labor, if the environment is a purely national good (as a receptacle of waste), environmental policy can be nationalized. Emission taxes then are the price for an immobile factor of endowment, and such prices may very well differ. Besides, emission prices (and taxes) do not segment markets whereas regulatory systems will. In the case of transfrontier pollution, countries have to agree on international diffusion norms [Siebert, 1989a].

Europe in the World Economy

Is the stimulating effect of the Single Market only a dream in Delors country - a frenzy in Deloria? What are the stumbling blocks for keeping '92 from becoming a Schumpeterian event?

Institutional competition will abolish national regulations that in the past have benefitted certain sectors or groups of an economy. Institutional competition and market entry will reduce rents, and thus the Single Market will meet with political opposition. With possibilities for protection and rent-seeking being reduced internally, there is the risk that the external barriers to trade will be made higher - to the extent that GATT obligations can be circumvented (e.g. Article 24) or already have been circumvented (e.g. MFA or VERs). Sectors being exposed to more contestable markets inside Europe may attempt to eliminate or reduce outside competition. Fortressphobia, having been around in the U.S., sees the successors of the French fortress-builder Sébastien Le Prestre de Vauban constructing walls, ramparts and moats.

National quantitative restrictions on imports from nonmember states have so far been allowed according to Article 115 of the Treaty of Rome. This implies restricting the flow of indirect imports from nonmember countries coming through other EC countries. There are some 700 of these restrictions relating to shoes, textiles, fresh bananas, television sets, motor cars and car radios. Five countries have set more or less voluntary limits on Japanese car imports: Italy (virtually 0 percent), France (3 percent), Britain (11 percent), Spain and Portugal. There

seem to be indications for a loose "voluntary export restraint" between Germany and Japan allowing car imports from Japan to increase by 1 percent of domestic consumption per annum.

In the eighties, there has been no increase in the annual frequency of application for quantitative restriction (except in 1983), but the length of time for which the restrictions applied increased 10 percent (from 156 days in 1981/83 to 172 days in 1987/88). More importantly, there has been a shift from MFA products to other manufactured goods such as film, paper, machines, and electronic equipment [Spinanger, 1989, p. 8]. On the whole, Article 115 has not been merely applied as an emergency measure, but rather as a protectionist policy tool for specific industries.

It is interesting to note that France and Ireland have accounted for over 85 percent of the cases in 1986-1988 (see Table A2). It can be expected that it will be tempting for the labor-rich countries in the European periphery competing directly with the NICs and other developing countries to push for new trade barriers. These national quantitative restrictions on imports are, according to Article 115, not consistent with the Single Market;¹ the question is whether the national restrictions will be substituted by higher EC tariffs, by lower European quotas or by voluntary export restraints relating to Europe as a whole.²

Ailing industries such as shipbuilding, parts of the steel industry and coal have been protected by a set of policy instruments such as subsidies. Here the political process - a strong coalition among firms, unions and politicians - may be tempted to establish outside protection at the European level. Last but by no means least, agriculture has to be added to this picture.

Antidumping actions are proving to be an increasingly important means of keeping competition out or at least reducing its impact. Of course, it can only be taken in accordance with the GATT rules and using the newly formulated EC Dumping Regulation (OJ, 2423/88). Based on evidence submitted by injured EC companies, the Commission must prove that a non-EC firm is selling its product in Europe at a lower price than at home. The foreign supplier then has to pay anti-

¹ It should be underlined that this article runs counter to one of the cornerstones in setting up a common market in the Treaty of Rome, namely the principle of free movement of goods laid down in Article 9.

² Comments by Calvet (Peugeot - Citroen) in "Die Zeit" (8th September 89) underline the intention of the European automobile industry to maintain a *highly restrictive stance* vis-à-vis the importation of Japanese cars. Compare also the "Süddeutsche Zeitung" (12th September 89) for the position of a German car producer.

dumping import duties or he has to agree to raise his price in Europe. There have been about 100 complaints a year [The Economist, 1989, p. 38], with proceedings initiated in about 50 cases and dumping being found in 30. A caveat is necessary: there has been a noticeable increase since 1986 in the number of cases and an ever larger share of these cases are aimed at the PACRIM countries [Messerlin, 1989].

Quantitative restraints on the European level as a substitute for national restraints (Article 115), antidumping and regional preferences (for instance, the free trade arrangement with EFTA) require local content rules. Moreover, a non-EC supplier may attempt to europeanize its product by producing the final stage in Europe ("screwdriver plant"). Rules of origin are the result of intervention in trade. Thus, one intervention implies the next. The basic definition of 1968, that goods originate where they undergo their "last substantial transformation", has long been changed in specific cases by excluding pure assembly, by requiring "diffusion" for integrated circuits and by requiring percentages of value added as local content (60 percent for EFTA cars, 35-45 percent for goods to be protected by Article 115, 80 percent in the case of subsidies). Clearly, local content is a severe blow to free trade in a world becoming more and more interdependent.

Strategic trade policy, a rediscovery of ideas of Friedrich List by American economists, has been reimported to Europe and made its impact on some politicians in Europe. Of course, it has been long forgotten in the policy debate that the underlying oligopolistic models are naive, and that the results are not robust with respect to the assumptions. Moreover, the debate on strategic trade policy shows its proponents have not understood what is called "Ordnungspolitik" in Germany.

Politicians like to see their countries competitive in high-tech products such as computers, chips and telecommunications equipment. A number of research programs have been launched (Eureka, Jessi, Esprit and the European Aero-Space Program). The experience with previous programs subsidizing the development of nuclear plants and of large computers is disappointing, "if not disastrous" [Trapp, 1989, p. 16]. Politicians may be tempted to "temporarily" protect the sectors they have chosen as the promising ones in order to justify their original choice. Finally, the European Commission is inclined to consider competition policy as being instrumental for strategic trade policy. Such a philosophy is certain to be a source of inefficiency in the long run.

When voicing these concerns, one should not forget that the EC is more open than North America and Japan. Taking the trade share¹ in GNP as indicator for

¹ Share of exports plus share of imports in GNP divided by 2.

openness, the EC has a trade share of 9.15 percent whereas North America has a share of 6 percent and Japan of 7.9 percent (Table A4). According to some estimates, Article 115 refers to 3-4 percent of community imports; antidumping actions relate to 1 percent.¹ But these percentages may be so low because potential suppliers anticipate import restraints.

The principle of mutual recognition inside the EC is the sister of the most-favored-nation clause. Whereas the most-favored-nation clause is a vehicle to prevent discrimination in trade policy, the principle of mutual recognition is an institutional device to allow effective market access in a regulatory framework.

It may be tempting to extend the principle of mutual recognition to the world as a whole, but this is impractical. In reality, reciprocity is the key word of economic diplomacy relating both to trade barriers in the narrow sense and to the issue of market access in different national regulatory settings. Both the trade and access aspects overlap.

Reciprocity may be instrumental in bringing about the liberalization of trade and a less restricted market access but reciprocity may also prove to be a vehicle that will increase protectionism and reduce market access. One aspect of its impact can be seen in the different forms of reciprocity, another aspect is how reciprocity will be used. At one extreme of a continuum, reciprocity interpreted as bilateral balance in the value of trade is sheer nonsense; overall reciprocity at the other extreme means an opening up of countries without a matching sector by sector. Sectorial reciprocity refers to a "do ut des" in liberalizing sector by sector. In between are reciprocities in the treatment of firms such as national treatment reciprocity, national treatment with effective access or equivalent treatment.

An important issue is whether reciprocity will imply another orientation of international trade policy. The paradigm of the triad has become a powerful picture of the world with North America having a GNP of US\$4900 billion (and a population of 280 million), Europe a GNP of US\$4200 billion (and a population of 320 million) and the Pacific Rim with a GNP of US\$3350 billion (and a population of 1600 million). We get accustomed to thinking of the world in terms of regional blocks and we are not far from interpreting the international division of labor as a zero-sum game. This is the arena where strategic trade policy flourishes, where reciprocity is en vogue and where regionalism wins over multilateralism. Unlike the "économie dominante", Great Britain, in the last century, which was clearly going for free trade, the dominating economic power of today, the United States, is signalling

¹ Informal information from the Commission of the European Communities.

that a different path may be followed. After all, the "Omnibus Trade and Competitive Act of 1988", passed by the U.S. Congress, contains an arsenal of instruments to restrict trade.

The European Community of the Twelve should not close itself to Europe as a whole. There is a free trade area arrangement in manufacturing between the EC and EFTA since 1973. Moreover, some EFTA countries copy EC product norms so that they prevent market segmentation.

The success of the EC has had its impact on Eastern Europe. An important issue for the future is in which way Eastern Europe can become part of the EC in economic terms. At this time, both Hungary and Poland are strongly interested to find access to the Common Market [Kádár, forthcoming; Winiecki, forthcoming]. Participation of these countries in the EC, for instance via the vehicle of EFTA, will increase the chances for liberalization in Eastern Europe. The Kiel Institute of World Economics has proposed that Hungary and Poland become members of EFTA. This would be possible if they make their currencies convertible, abolish state export monopolies, admit private firms and allow free prices, at least for tradeables [Kostrzewa, Schmieding, 1989].

With respect to the German Democratic Republic, there is de facto an internal market without trade barriers between the Federal Republic and the GDR so that the GDR basically has free access to the Europe of Twelve.¹

Conclusions

There is, no doubt, a strong potential for Europe to become a Schumpeterian event, an institutional innovation. The reduction of internal trade barriers will only be important in those areas where individual countries have indeed used various nontariff barriers to protect certain industries. Generally speaking, however, their reduction should not prove to be crucial, since in commodity trade most obstacles within the EC (except border controls) have already been eliminated. A much greater stimulus will come from allowing free market access in regulated sectors, especially in services, from more contestable markets and from mutual recognition and institutional competition. This competitive process pitting the various national regulatory systems against each other, should it come about, will

¹ Trade from the German Democratic Republic has virtually unrestricted access to the Federal Republic of Germany, and consequently to other EC members.

result in the extinction of the least efficient regulations and hence will make the power of vested interests which generated their existence crumble; it will imply a true liberalization of the European economies.

There are, of course, internal forces that restrain the stimulus. These forces are embodied in the centralization of European regulations - call it a Brusselization of attempted deregulation (BAD). The BAD forces would weaken dynamic gains from institutional competition and lead to internal rent-seeking, particularly vis-à-vis nonmember countries in the form of protectionist trade policies.

Needless to say, the overall outcome for the world economy not only depends on Europe's trade policies but also on the behavior of the other major trading partners. The experience of the thirties suggests that the world would be better off preventing regionalism and the strategically-oriented behavior of individual nations or regional blocks. If Europe's Schumpeterian event is to be more than just a one-night stand, if it can really play at Peoria, then the key lies in the door to the world economy - with mutual recognition inside and the most-favored-nation clause as well as world market openness outside.

Appendix

Table A1 - Rates of the Value Added Tax in the EC Countries, 1989

	Reduced Rate	Normal Rate	High Rate
Belgium	6 and 17	19.0	25 and 25 + 8
Denmark	-	22.0	-
Fed. Rep. of Germany	7	14.0	-
France	2.1; 5.5 and 7	18.6	28
Greece	3 and 6	16.0	36
Ireland	5 and 10	25.0	-
Italy	4 and 9	19.0	38
Luxemburg	3 and 6	12.0	-
Netherlands	6	18.5	-
Portugal	8	17.0	30
Spain	6	12.0	33
United Kingdom	-	15.0	-

Source: Mennel [1988, S. 8]; updated material.

Table A2 - Number of Mergers in the Federal Republic of Germany, 1973-1988

	Number of Mergers		Number of Mergers
1973	34	1981	618
1974	294	1982	603
1975	445	1983	506
1976	453	1984	575
1977	554	1985	709
1978	558	1986	802
1979	602	1987	887
1980	635	1988	1159

Source: Report of the German Cartel Office on its activities in the year 1987/1988.

Table A3 - Distribution of Article 115 Actions by Product Groups and Initiating Countries (percent)

Product group/ initiating country	1981	1983	1985	1986	1987	1988
By Product Group Affected						
Agricultural goods	1.8	3.1	5.3	1.9	1.5	7.2
MFA products	74.6	74.4	70.2	74.1	69.5	59.5
Other industrial goods	23.7	22.5	24.6	24.1	29.0	33.3
Total (actual)	114	160	114	108	131	111
By Country Initiating Action against MFA Products						
Benelux	17.6	12.6	2.5	0.0	1.1	1.5
France	37.6	27.7	38.8	55.0	45.1	40.9
Ireland	27.1	38.7	36.3	37.5	42.9	42.4
Italy	7.1	6.7	8.8	3.8	8.	15.2
United Kingdom	9.4	10.9	13.8	3.8	1.1	0.0
All others	1.2	3.4	2.3	0.3	2.1	0.0
Total (actual)	85	119	80	80	91	66
By Country Initiating Action against Other Industrial Goods						
Benelux	3.7	11.1	3.5	0.0	0.0	0.0
France	37.0	27.7	35.7	26.9	36.8	37.8
Ireland	11.1	5.6	7.1	7.7	7.9	0.0
Italy	40.7	47.2	35.7	61.5	28.9	21.6
United Kingdom	7.4	8.3	14.3	0.0	0.0	0.0
All others	0.0	0.0	0.0	3.8	26.3	40.5
Total (actual)	27	36	28	26	38	37

Source: Spinanger [1989].

Table A4 - Exports and Imports as Share of GNP, 1970-1987

	EC(a)		Japan		U.S.		North America (U.S., Canada)	
	share of exports	share of imports	share of exports	share of imports	share of exports	share of imports	share of exports	share of imports
1970	9.0	9.1	9.5	9.3	4.2	4.0	3.6	3.0
1971	9.0	8.7	10.4	8.5	4.0	4.2	3.3	3.1
1972	8.5	8.4	9.3	7.7	4.0	4.6	3.2	3.5
1973	9.1	9.4	8.9	9.3	5.1	5.2	4.2	4.0
1974	11.2	12.6	12.1	13.5	6.5	6.9	5.4	5.5
1975	10.6	10.7	11.2	11.6	6.5	6.1	5.3	4.9
1976	10.8	11.9	12.0	11.5	6.3	6.9	5.1	5.4
1977	11.3	11.8	11.6	10.2	5.8	7.5	4.7	6.0
1978	10.8	10.9	10.0	8.1	6.1	7.7	5.0	6.2
1979	10.4	11.8	10.2	10.9	7.1	9.0	5.9	7.3
1980	10.6	13.0	12.3	13.2	7.9	9.5	6.9	7.8
1981	11.7	13.1	13.0	12.1	7.5	9.0	6.4	7.4
1982	11.5	12.7	12.8	12.0	6.6	8.1	5.7	6.5
1983	10.5	11.7	12.4	10.6	5.8	8.0	4.8	6.3
1984	11.4	12.6	13.6	10.7	5.8	9.1	4.6	7.2
1985	11.5	12.3	13.3	9.6	5.3	9.0	4.4	7.3
1986	9.8	9.6	10.7	6.1	5.1	9.1	4.0	7.5
1987	9.1	9.3	9.6	6.2	5.5	9.4	4.2	7.8
(a) 1970-1971: EC 6; 1972-1979: EC 9; 1980-1982: EC 10; since 1983: EC 12.								

Source: OECD [a;b]; GATT [various issues].

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