

Trapp, Peter

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## The European single market - opportunity or fortress?

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Kiel Working Paper No. 385

**THE EUROPEAN SINGLE MARKET  
- OPPORTUNITY OR FORTRESS?**

by

Peter Trapp

Institut für Weltwirtschaft an der Universität Kiel  
The Kiel Institute of World Economics

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## 1. Introduction\*

In the Single European Act of 1987 the member countries of the European Community have committed themselves to complete the single market by the end of 1992. The single market is defined as an area without internal borders granting free movement of goods, people, services, and capital within this area. The establishment of a single market was already aimed at when the European Economic Community was founded in 1957. But only the customs union was completed by the end of the sixties; in the seventies, no significant progress was made toward further economic integration in Europe (Committee for the Study of Economic and Monetary Union, 1989). One reason for this is that the harmonization of policies and regulations considered necessary for establishing a single market proved to be a rather difficult and time-consuming business and the results, e.g. in agriculture and steel, were not very encouraging (Dicke, 1987). Furthermore, in the seventies, the European economies were struck by low growth and high unemployment; there was disagreement on the appropriate economic policy response and governments increasingly took recourse to putting up non-tariff trade barriers, in particular against imports from Southeast Asia, and to granting massive subsidies to ailing as well as to would-be sunrise industries (e.g. microelectronics and airbus) in order to protect domestic jobs.

As an economic power, Europe fell behind, especially compared to the Pacific Rim countries. This was considered as a challenge calling for political actions (Dicke, 1989a). In June 1985, the European Council of Ministers accepted a White Paper containing a time table for the creation of the single European market. It includes 279 measures on which the European

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\* Revised Version of a paper presented at the Cato Institute on March 22, 1989, Washington, D.C.

Commission has to submit proposals which have to be passed by the Council. According to the Commission, 90 p.c. of the proposals have been submitted to the Council by the end of 1988, but the Council is somewhat behind schedule, having passed only 108 proposals (For an economic evaluation of the directives see Dicke, 1989b). In some important areas proposals have still not been submitted or there is considerable disagreement on how to proceed with the proposals of the Commission, e.g. with the harmonization of indirect taxes or with the introduction of a withholding tax on interest earnings. Nevertheless, in many areas it has become evident what changes are to be expected from the completion of the single market. Companies and banks have started to prepare themselves for the changing economic environment. The number of cross-border acquisitions and mergers undertaken by firms to improve their starting position has strongly increased. The pick-up in business investment since mid-1987, too, is partly credited to the restructuring and streamlining efforts of firms in anticipation of the single market (Grimm, Schatz, Trapp, 1989a).

## 2. Barriers to Trade Within the EC

Trade within Europe is still hampered by many barriers. The Commission has identified three types of barriers dividing the intra-EC-market: physical, technical, and fiscal barriers.

Physical barriers comprise all the red tape and expenses (including time forgone) incurred when crossing a border. Technical barriers are non-tariff trade restrictions and national regulations, that have a similar trade-hampering effect. The possibility of applying non-tariff trade restrictions is conceded in Articles 36, 108, 109, and 115 of the Treaty of Rome. Article 36 allows to restrict the import or the export of certain goods from or to member countries on the ground of security, health, or moral considerations. A typical example for

such restrictions is the requirement that only such goods may be imported and sold in the domestic market that are in agreement with the national standards (principle of national treatment). This practice has been declared unlawful by the European Court in a number of cases. Although it is stated that Article 36 should not be applied to discriminate or restrict trade, it has been widely exploited for this purpose. Articles 108, 109 and 115 allow member countries to take protective measures in the case of balance of payments problems or to shield themselves from "economic difficulties" created by imports. Some member countries have frequently felt the need to apply these provisions. The actions are mostly motivated by the intentions to protect jobs, but the cost to the consumer are rarely assessed. A comparison of car prices in Italy, France and Germany (Spinanger, 1989) reveals that in Italy and France, countries with tough restrictions on the import of Japanese cars, car unit values are significantly higher than in Germany; prices of Japanese cars sold in Italy exceed those sold in Germany by up to 40 p.c.

In addition, regulations are frequently used to restrict market entry and to control prices and the variety of goods available to the domestic market (Grimm, Schatz, Trapp 1989b). In particular, trade in services, e.g. insurances or road and air traffic, is heavily hindered by regulations. Politically, the adoption of such regulations is often justified by referring to national interests or the need to protect consumers. Economically, the argument in favor of government interventions mostly rests on the contention of a market failure; however, evidence for such failures has not been presented in any case (Donges, Schatz, 1986). The economic costs of protection are considerable. A study on the German economy estimates that under free trade conditions (and an elimination of all subsidies) the 1986-GNP could have been 6 p.c. and the employment some 9 p.c. higher than was actually the case (Donges, Schmidt, 1988).

An additional barrier to free trade is seen in the widely diverging rates of the value-added tax and of some excise taxes (Table 1). So far in cross-border trade these taxes have been

*Table 1 - Value-Added Tax Rates in EC-Countries*

	Reduced Rate	Ordinary Rate	Increased Rate
Federal Republic of Germany	7	14	-
France	2.1, 5.5, and 7	18.6	28 and 33 1/3
Italy	4 and 9	19	38
United Kingdom	-	15	-
Spain	6	12	33
Netherlands	6	18.5	-
Belgium	6 and 17	19	25 and 33
Denmark	-	22	-
Greece	3 and 6	16	36
Portugal	8	17	30
Ireland	2.4 and 10	25	-
Luxemburg	3 and 6	12	-

Source: Grimm, Schatz, Trapp, 1989.

levied according to the destination principle (case A1 in table 2). Under this principle the value-added tax is levied where the goods are consumed; exports are tax-exempt, while imports are taxed at domestic value-added tax rates (Boss, 1989b). However, without border controls this system can no longer be enforced because it is not possible to prevent tax-

exempted exports from being re-imported. Therefore, in the single market the value-added tax will be levied on all goods in the country of origin, regardless of whether they are exported or consumed at home. Imports continue to be subject to domestic tax rates but pre-taxes can be deducted. As the domestic VAT-rates apply to all domestic sales the basic feature of the country of destination principle persists. However, the distribution of tax revenues between countries changes and direct imports by consumers will increase. In order to reduce the incentive for direct imports and to reestablish the old pattern of tax revenues the Commission has proposed to harmonize national value-added tax rates within a certain range and to establish a clearing system based on the registration of trade between EC-countries (see case A2 in table 2).

### 3. How Much Tax Harmonization is Needed?

Basically, differences in value-added tax rates or in other indirect taxes do not constitute a barrier to trade. The reasoning behind the drive to harmonize indirect taxation is rather the expectation that countries with relatively low rates of indirect taxes will have an "unfair" competitive advantage and persistent trade surpluses when border controls are abolished and value-added taxation is changed from the country of destination principle to the country-of-origin principle (from case A1 to case B2 in table 2). Such a change in taxation would affect the competitiveness of locations of production but should not be confused with measures that reduce competition by restricting trade.

With regard to the impact of taxation, differences in national income taxes and corporate taxes, too, have a bearing on competitiveness. If the aim were to put up a level playing field in tax matters it would be necessary to take into account all taxes affecting business and not only indirect taxes. However,

Table 2 - Shaping the Value-Added Taxation in the Single Market

TAXATION OF TRADE		
	Export country	Import country
<b>A. Country-of-destination principle</b>		
A1. Present system with border controls	No VAT on exports	Taxation at VAT-rates of import country. No VAT on most investment goods
A2. EC-proposal without border controls	Domestic VAT on all exports to avoid re-imports	Taxation at VAT-rates of import country, but full pre-tax deduction. No VAT on most investment goods
<b>B. Country-of-origin principle</b>		
B1. With pre-tax deduction (in-effective country of origin taxation)	Domestic VAT on all export goods	Taxation at VAT-rates of import country, but full pre-tax deduction. No VAT on most investment goods
B2. With pre-sales deduction	Domestic VAT on all export goods	Taxation at VAT-rates of import country, but full deduction of import purchases (pre-sales deduction). No VAT on most investment goods

Distribution of tax revenues	Impact on trade	Additional measures
Revenues accrue to the country in which consumption takes place	No change in competitiveness of domestic goods vis-a-vis foreign goods	- -
Compared to A1 unchanged revenues if trade is balanced and if VAT-rates and shares of investment goods exports are equal. Otherwise, countries with a trade surplus, a larger share of investment goods exports, or higher VAT-rates have an increase in revenues compared to A1	No change in competitiveness of domestic goods relative to imported goods (if imported goods are resold). With no restrictions on trade high-VAT-rate countries experience increase in direct imports	EC proposes to <ul style="list-style-type: none"> <li>- introduce a dual-rate VAT-system with fixed margins for VAT-rates (14 to 20 p.c. for the normal rate and 4 to 9 p.c. for the reduced rate)</li> <li>- establish a clearing system correcting the change in the distribution of tax revenues</li> </ul>
Same as A2	Same as A2	Either narrowing of VAT-rate differentials by market pressure or political agreement on harmonization of VAT-rates plus clearing system
Countries with relatively low VAT-rates receive higher revenues than in A1 because they export more and import less	Consumption goods from low-VAT-rate countries become more competitive. No change in competitiveness for investment goods	To make domestic consumption goods more competitive high-VAT-rate countries will either <ul style="list-style-type: none"> <li>- reduce VAT-rates</li> <li>or</li> <li>- devalue.</li> </ul> In case of a devaluation investment goods of high-VAT-rate countries become more competitive, correspondingly those of low-VAT-rate countries become less competitive than in system A1

the whole issue can be looked upon from another point of view. Taxes are raised to finance government activities; i.e., the provision of public goods that should contribute to enhancing the productivity of the economy. Government involvement in income distribution, too, has been justified on these grounds. Redistributive policies are regarded as a means to increase or to maintain social peace and, thus, to avoid social frictions and disturbances of the production process. Whether the benefits of more government production of public goods exceed the costs of higher taxation can best be tested by allowing free competition between goods produced in high-tax economies and those supplied by low-tax economies. From this point of view the harmonization of indirect taxes by a government cartel is neither a precondition for the proper functioning of the single market nor desirable. Competition between economies with different degrees of government involvement and differences in the level and structure of taxation can help to identify the optimal scope of government activity. Countries that prefer to maintain relatively high tax rates when the single market is completed will experience a depreciation or - if the exchange rate is fixed - a loss of reserves. In the end, value-added-tax-rate differentials are likely to narrow because governments will tend to imitate more successful competitors. In that respect, the outcome is similar to that of harmonization by political agreement, but competition in tax policy will probably lead to a lower EC-wide tax level and result in less growth of public expenditures than under harmonization (Boss, 1989).

#### 4. Potential Growth and Employment Gains

As to the economic benefits of the creation of the single market, the elimination of physical barriers (border controls) will free resources for productive purposes. This will provide

a once-and-for-all increase in potential output. The effects stemming from the abolishment of (technical) trade restrictions will be more sustained. The removal of such barriers as well as the adoption of the country-of-origin principle for the value-added tax is also a precondition for scrapping physical barriers. The effects may be comparable to those of the abolishment of tariffs within the EEC at the end of the fifties and in the sixties. Trade will not only be stimulated by the mere elimination of restrictions but also by the increase in certainty about the rules governing trade. An indicator of the legal uncertainty resulting from the increased use of non-tariff trade restrictions and regulations is the number of law suits in the European Court. 1974 there were 30 law suits according to Article 169 EEC Treaty, 1985 the number was 503. As to market entry in services, there were 12 complaints in 1976 and 83 in 1985 (Grimm, Schatz, Trapp, 1989b).

The elimination of technical barriers will reduce production costs as products have no longer to be adjusted to different national standards. Furthermore, as the market increases companies can exploit economies of scale. This effect may be important for certain industries, however, the average gains to be realized from establishing larger production units are probably rather small. There is no evidence that companies in the U.S., the biggest single market so far, are systematically more competitive than European or Japanese companies. The real advantage of the single market is not that firms by getting bigger can reduce unit costs but that consumers are confronted with more choices. This intensifies competition between companies and forces them to strive for process and product innovations. Thus, the removal of trade barriers should result in a significant increase in the growth of potential output.

According to a study prepared for the Commission, the Cecchini Report, the creation of the single market would increase the growth rate of real GNP by 4.5 percentage points over a period

of six years. Employment would rise by 1.8 million and the inflation rate would be reduced by 6 percentage points (Cecchini, 1988). Thereafter annual GNP growth would be .7 percentage points higher than otherwise.

In its assessment of the growth effects the study stresses the freeing of resources for the production of consumer and investment goods, the exploitation of economies of scale, and the realization of a more efficient use of resources. The estimates of the impact of removing trade restrictions on production and employment are based on company surveys. But individual companies can only quantify the accounting costs of regulations, they do not possess any information on the synergistic effects that are likely to occur when the markets are opened up (Grimm, Schatz, Trapp, 1989b). Thus, the effects of deregulation and of abolishing non-tariff trade barriers are probably underestimated. This was also the case when major parts of the economy were liberalized in Germany after World War II and when the EEC was founded in 1957.

##### 5. Steps Toward the Single Market

Looking ahead to the prospective benefits of the creation of the single European market one may wonder why it took the EC-countries such a long time to undertake steps to complete the single market. However, looking back at the long history of governments intervening heavily to protect domestic industries by using regulations, subsidies, and trade restrictions the question should be rephrased: What makes the same governments now abolish such policies and open their borders to foreign competition? One reason is the obvious failure of protectionist policies. In spite of (or better: because of) the protection and support given to various industries the European economies have lost competitiveness in many key areas; industrial policies have become extremely expensive. While the

share of EC-exports (excluding intra-EC-exports) in world export stagnated, import penetration increased significantly. Furthermore, the experience in the United States and also in the United Kingdom has shown that deregulation is effective in improving competitiveness and creating additional jobs. Still, many governments have chosen to ignore this evidence, since their constituencies (i.e., lobbies) are against abolishing trade restrictions, regulations, and subsidies from which they profit. However, by putting deregulation and liberalization on an EC-wide level and by framing it as an European response to global challenges the initiative has gained momentum.

The Single European Act contains a number of elements that have greatly contributed to facilitating the completion of the single market. The most important point is a change in the integration strategy: harmonization of regulations is only required for the essential standards, the remaining technical barriers to trade are to be removed by mutual recognition of national norms and standards. This implies a widespread adoption of the country-of-origin principle as an integration strategy. The second point concerns the decision-making process in the council. Until 1987 a unanimous vote was required for all policy decisions. In the Single European Act, the governments of the member countries agreed that the decisions concerning the creation and functioning of the single market can be passed by qualified majority (with the exception of decisions affecting labor, competition, and taxes). Finally, the Act gave the European Parliament a greater role in the legislative process.

#### 6. Shaping the Single Market - Competition Versus Harmonization

The change in the integration strategy had been initiated by the European Court. In the Cassis-de-Dijon decision the Court had pronounced that a good that is produced and sold in a mem-

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ber country in conformity with the standards prevailing in that country may be sold without change in any other EC-country (country-of-origin principle). According to the White Paper of the Commission this rule is to be applied to services and to the activity of companies as well. Consequently, producers and consumers could choose between a greater variety of production possibilities and goods, in those areas, in which regulations have not been harmonized. There would be competition between national standards and regulations. In the longer run, those standards would prevail that allow companies to produce at the lowest costs while maintaining the essential standards required for the production and the quality of the products. Thus, instead of being exclusively based on institutional ex-ante harmonization, the single market would partly emerge from a spontaneous process of integration (Giersch, 1988).

The European Council has subscribed to the country-of-origin principle. But it is easy to predict that agreeing on the principle and applying it to individual industries and markets is quite a different thing. Imagine a French retailer, who serves his customers in France in the evenings or on weekends, intends to produce his services in Germany in the same way. According to the country-of-origin principle, the regulations governing the supply of retailer services in France should be applicable in Germany too. This would be a powerful instrument to undermine restrictive German laws on shop-opening hours. More likely, however, the German government will try to block the strict application of the country-of-origin principle because, in the face of furious protests of German trade unions, it can convincingly argue that social peace is at stake in Germany. Furthermore, the European Commission, which has not fully converted to the new principle, will probably support the German government and stress the need for a harmonization of shop opening hours that is "socially acceptable" in all member countries. Anyhow, the Single European Act may

help that the country-of-origin principle will prevail at least in some areas. In Article 100a, by which the Treaty of Rome was supplemented, it is stated that in those areas for which a harmonization of laws and regulations has not been carried out until the end of 1992 a mutual acceptance of national regulations will take place.

First steps to open up and to deregulate the European economy have already been undertaken, e.g. in the financial sector and in trading. If the single market would be completed as outlined in the White Paper, Europe were to experience a Schumpeterian event (Miller, 1988). This way of completing the single market could be viewed as an institutional innovation (Siebert, 1989), allowing the European economies to enjoy faster growth, and providing a sustained stimulus to the world economy. However, there are still some question marks whether decontrol and open markets will eventually be the dominant features of Europe after 1992. It should be noted that

- the Single European Act contains many elements that call for a European policy cartel, e.g. in fiscal and in monetary policy,
- the discussion of the social dimension in the single market includes a strong tendency to harmonize regulations or to reduce the scope for decontrol to measures that are socially acceptable,
- there is a pressure to establish higher and more comprehensive barriers to outside competitors, while internal barriers are removed, or to require reciprocal action if outside competitors are to be allowed to take part in the benefits of the single market.

7. Economic and Monetary Union - How Essential for the Single Market?

At its meeting in Hanover in June 1988, the European Council restated that "in adopting the Single Act, the Member States of the community confirmed the objective of progressive realization of economic and monetary union." To that end, the so-called Delors Committee has submitted its Report on Economic and Monetary Union in the European Communities. The report rests on the contention that the single European market increases interdependence and, thus, necessitates closer cooperation in macroeconomic policies (monetary and fiscal policy), competition policy as well as in regional and structural policies. In defining the monetary union the report reiterates the three basic elements already mentioned in the 1970 Werner Report (Committee for the Study of Economic and Monetary Union, 1989):

- assurance of total and irreversible convertibility of currencies,
- complete liberalization of capital transaction and full integration of banking and other financial markets, and
- the elimination of margins of fluctuations and the irrevocable locking of exchange rate parities.

Noting that the first two requirements are included in the single market program, the Delors-Report proposes a three-step plan to achieve a monetary union. In the first stage, starting on July 1, 1990, cooperation in economic and monetary policy between the twelve member countries and between the Council of Finance Ministers and the Council of Governors should be intensified. For this purpose all EC-countries should take part in the European Monetary System. Furthermore, consideration should be given to extending the scope of central banks' autonomy.

No dates are suggested for the beginning of the next two steps. In the second step, member countries should transfer some competences in monetary policy to a European System of Central Banks to start the initial phase of collective decision making. Exchange rate realignments would still be possible but should be undertaken only if the costs of applying other adjustment mechanisms are excessive. In the final step, exchange rates would be irrevocably fixed. A joint EC-currency substituting national currencies would be introduced by converting the ECU-basket currency into real money. In fiscal policy, there should be mandatory cooperation to avoid imbalances.

The introduction of a single currency is not strictly necessary for the creation of a monetary union, however, it is intended to "demonstrate the irreversibility of the move to monetary union." Beyond that it is also expected to yield economic benefits; the adoption of a single currency would facilitate the monetary management of the community and it would avoid the transaction costs involved in using different currencies. In addition, the irrevocable fixing of parities would eliminate the exchange rate risk between member countries.

These benefits have to be weighed against the costs of renouncing the circulation of different national currencies and the possibility of exchange rate adjustments. According to the single market program, capital markets in eight member countries will be fully liberalized until July 1, 1990, the remaining countries will follow suit. The removal of all restrictions on capital flows is equivalent to a mutual recognition of different monetary standards. Once money users and investors are free to open accounts, to buy securities, or to take loans in any of the national currencies, competition will force central banks to produce a currency with a stable purchasing power. In addition to the already existing national central banks, an independent European Central Bank could be established. It would supply a European currency which should

be allowed to be used without limitations in all countries as a legal tender and have a freely floating exchange rate (Langfeldt, Scheide, Trapp 1989). Each country could still earn the seigniorage of issuing a national currency, but must compete with the new as well as with the other member country currencies. If the European currency turned out to be a better store of value it would displace the national currencies and yield the benefits of a single currency. This would be the result of a spontaneous market process and there would be no need of an ex-ante agreement on a discretionary political action. Even if the European monetary authority succeeds in displacing national currencies it must continue to behave as if there were competition because national currencies can be re-introduced. This check is missing for the European System of Central Banks as proposed by the Delors Committee. Once established it has a monopoly of issuing money. It is stated that the System is committed to the objective of price stability but it is also expected to support the general economic policy. Furthermore, the questions of convertibility and freedom of restrictions on capital flows is totally unsettled for the single European currency. In a competitive monetary order monetary authorities could not afford to put constraints on the use of money. This could be different if the European currency replaced national currencies by political act.

Most governments of the EC-member countries have a long history of controls on capital flows. In some countries only recently controls have been partly abolished because administrations became aware of the fact that heavily regulated national banking industries cannot successfully participate in the rapidly expanding market of financial services. Other countries still have severe restrictions on the use of foreign currencies. In the absence of controls capital can be used more efficiently. Therefore, capital mobility is probably more important than a single currency (Schlesinger, 1989). However, if there were only one currency and a huge internal financial market the government representatives running the European

System of Central Banks might feel tempted to reimpose restrictions on capital flows whenever balance of payments problems would emerge or the exchange rate would deviate from its target zone.

The locking of exchange rates is likely to impede rather than promote the integration process. The European Community is far from being an optimum currency area. The elimination of barriers will probably aggravate regional problems because regulations that tend to shield weak industries will become ineffective. With one currency regional problems, which will often be problems between nations, can no longer be tackled by exchange rate changes. Instead, wages have to decline in areas with high unemployment or labor has to move to more attractive locations of production. The Delors Report calls for a doubling of funds and closer coordination in structural and regional policies to ensure a regionally balanced growth. However, experience with national regional policies is not encouraging. All in all, the creation of economic and monetary union along the lines described in the Delors Report would imply a revival of the integration strategy that failed in the seventies. It would be equivalent to the abandonment of the country-of-origin principle the adoption of which has given so much momentum to the integration process in recent years.

#### 8. The Social Dimension

The creation of the single market implies an increase in competition between different locations of production. Wage levels, social security systems, and labor market regulations are important determinants of production costs and influence investment decisions. This has given rise to the discussion about the social dimension of the single European market. Concerns have been increasingly expressed in countries with relatively high wage and social costs, like Germany, that companies will undercut local pay, working condition, and codeter-

mination rules by transferring capacities to countries with relatively low production costs like Spain or Portugal. Such emigration of labor-intensive industries from high- to low-wage countries has always taken place in the process of economic development; it provides additional income opportunities for countries with relatively low wage costs and forces companies in advanced countries to strive for process and product innovation. The gain of market shares of low-wage countries in labor-intensive industries has - contrary to the contention of some lobbyists - nothing to do with wage dumping and should not be blocked, as has been the case, by restricting imports and granting subsidies in high-wage countries.

Faster growth in low-income areas stimulates growth in advanced countries, too. E.g., the strong rise in GNP in Spain and Portugal after joining the EC led to a strong expansion of imports from Germany. If, however, companies in economies with high wage costs increase direct investment at the expense of investment at home and reduce domestic employment, this is a clear indication that the overall level of domestic production costs in relation to productivity is too high. In this case, competitiveness can only be restored by cutting costs at home but not by blocking competition from abroad.

If the attempt to impose relatively high standards for wages, dismissal protection, and social benefits on an EC-wide level were successful, regional problems would aggravate. As the free flow of private capital to developing areas would come to a halt, structural funds financed by tax revenues would have to be enlarged in order to channel official funds into those areas. However, experience with national regional policies suggests that this strategy tends to be counterproductive. Administrations have no superior knowledge on investment opportunities and the incentives to minimize losses are lacking because there is no personal financial responsibility.

The EC-Commission has proposed to intensify the "social dialogue" in order to ensure that the single market is socially acceptable. The consensus of what is regarded as socially acceptable generally reflects the interests of large economic lobbies, namely employers and trade unions. Therefore, there is the danger that market signals will be neglected and that the dialogue results in an attempt to overcome economic relationships by political agreements. Experience in the United States has shown that deregulation is mainly at the expense of trade unions and management (Niskanen, 1988). If these two groups were successful in shaping a social order in Europe consistent with their interests, it would hamper deregulation and reduce the potential gains, i.e. higher productivity and improved service and supply.

#### 9. The Fortress Europe

The European Commission stresses that the trade-creation effect of the completion of the single market will be much stronger than the trade-diversion effect which is unavoidable when inside barriers fall and outside barriers remain. But many observers are afraid that the move to abolish non-tariff, regulatory, and tax barriers to mobility and trade inside the community may go along with steps toward more and higher barriers to mobility and trade around the single market. To assess this possibility it seems useful to look how trade is arranged in another large internal market, the United States. In the United States, barriers to imports have been imposed to protect industries like textiles, steel, cars, agriculture and others. Restrictions were justified by claiming that import competition was unfair (dumping), that the loss of jobs would create severe difficulties and social costs, and that the industry needed time to become competitive again. Similarly, the EC and individual European countries have established barriers to trade. The adjustment problems of ailing industries will

probably increase significantly when the internal barriers in Europe are removed. The Cecchini-Report even stresses that because of the initial "adjustment shock" there is likely to be a decline of employment in the first phase of the single market. Under these circumstances most governments will be happy to reserve the benefits from faster growth inside the single market to their own industries while hoping that the increase in growth and in competition will contribute to sufficiently raise productivity in structurally weak industries. If these expectations do not come true the introduction of production quotas in some critical industries cannot be ruled out. Predictably, for regionally highly concentrated industries facing fierce competition from abroad, there will be a strong coalition between unions, employers and politicians in favor of high barriers at the border of the single market in order to keep other competitors out. A case in point are the industries which are protected by import restrictions based on Article 115 of the Treaty of Rome (Table 3). Article 115 allows EC member states to restrict the flow of indirect imports from non-member countries coming through other EC-countries. In the eighties, on average about 120 actions have been initiated each year, while the number of actions remained stable, their impact nonetheless increased markedly as the restrictions were applied for longer and longer periods of time than before (Spinanger, 1989). Originally, Article 115 was mainly used to restrict the import of textiles and clothing. But over the last years it was enacted more and more to block the import of other manufactures as well, e.g., in spring 1989, France stopped the import of car radios from China and Japan and Spain the import of small TV sets from Korea and Japan. Theoretically, Article 115 should become meaningless when the single market is completed as border controls between member countries are to be eliminated. But, of course, the countries that have used Article 115 heavily will demand a compensation. What will be put up in place of it: quotas or voluntary export constraints? As member countries have used trade restriction

*Table 3 - Distribution of Article 115 Actions by Product Groups and Initiating Countries (%)*

Product group/ initiating country	1981	1983	1985	1986	1987	1988
<i>By Product Group Affected</i>						
Agricultural goods	1.8	3.1	5.3	1.9	1.5	7.2
Multi fibre agreement (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
<i>By Country Initiating Action against MFA Products</i>						
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
<i>By Country Initiating Action against Other Industrial Goods</i>						
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.

to very different degrees, and for different industries, they will trade concessions to restrict imports. Those countries that have imposed the strongest limitations on imports in past, e.g. France, Italy and Spain, will probably press for relatively high community-wide restrictions. Therefore, on average, the barriers are likely to be somewhat higher and more comprehensive than before. Attempts to limit the market entry of third-country companies are to be expected for manufactures as well as for services. The proposal on "Television without Frontiers" includes time limits for commercials and determines that TV-stations have to ensure that the program mainly consists of contributions from European production (the agreement implies a 50 p.c. share of European productions, France and Italy are demanding a 60 p.c. share).

Another argument put forward in the United States to justify or to call for protection is that the country cannot afford to fall behind in some key (high tech) industries. One example is the restriction on the import of semiconductors. In Europe, too, politicians, industrialists, and trade union leaders emphasize that the community must not fail in getting access to the new technologies. Much of the enthusiasm behind the movement toward an European single market even stems from the belief that Europe can withstand competition from American and Japanese companies only with a unified industrial base that reaps economies of scale in research, production, and distribution. In order to achieve more competitiveness and progress in high tech areas, such as computers, microchips, telecommunication etc., a number of extensive and expensive research programs has been launched (Eureka, Jessi, Esprit, and the European Air and Space Program). As these high-tech industries are said to need time to become competitive, governments will see a necessity to provide "temporary" protection to help "infant" or "potential infant" industries to grow up (e.g. the Airbus). The experience with previous programs is not encouraging; e.g., the results of subsidizing the development of large computers or of nuclear power plants have been poor, if not disastrous.

Looking at the trade experience of the United States, one salient feature in the view of some European politicians is that the U.S. succeeded in putting the Americans to work for Japanese companies. As unemployment is still very high in most countries of the EC this may appear to be an attractive perspective for some governments. For the time being, countries continue to compete for jobs by granting subsidies. The community as a whole may view barriers to imports as a welcome instrument to have non-EC producers establish production facilities inside the single market. The bigger the market and the more uncertain the future market entry is the more will importers to the single market be inclined to set up production facilities inside the market. But for the right to produce in the single market foreign producers will have to make concessions. Goods produced by foreign companies inside the EC will be only considered as domestic goods if the local content of the goods is high enough. At present, the local content requirement is already around 60 p.c. but, as is evidenced by the refusal of France to accept the Nissan cars produced in the United Kingdom as intra-EC produced cars, there is disagreement on how to determine the local-content share. Furthermore, permission to produce inside the single market will only be granted when the production process includes the technically sensitive parts; i.e., a transfer of technology has to take place. For example, for the planned production of chips the European authorities insisted that the production process consists not only of the assembly of chips but that it includes the sophisticated diffusion process.

Finally, it has to be taken into account that free trade is an ideal, a utopian state of the world. In the real world trade restrictions abound. Because of allegedly unfair trade practices by other countries the U.S. Congress has passed the Omnibus Trade and Competitive Act which provides an arsenal of instruments to restrict trade. The Community will probably consider itself to be in a similar position. Presumably, po-

liticians will argue that in order to cope with barriers to market entry, which are numerous in Japan and other Southeast Asian Countries, the EC needs some trade policy weapons to maintain a balance of deterrence and to have something that can be exchanged for trade concessions. Another feature of the U.S.-trade policy recently has been its tendency toward bilateralism, e.g. the free trade agreement with Canada and the thrust of the Trade Act (Section 301 and Super 301). The counterpart in EC-trade policy is the demand for reciprocity, in particular, with respect to market entry in services. According to the reciprocity principle, the companies of non-member countries may only do business in the EC-market when EC-companies can operate under equal conditions in the non-member country's market - whatever the meaning of equal conditions is. Whereas the country-of-origin principle is equivalent to free trade and the principle of national treatment corresponds to the notion of fair trade, reciprocity comes close to regulated trade. Compared to the most-favored-nation clause, the application of reciprocity would mean a severe set-back in trade policy.

#### 10. Conclusion

On the whole, the fear of a fortress Europe can certainly not be dismissed easily. Even inside the single market, there is - beyond the political rhetoric - still widespread opposition to applying the country-of-origin principle not only to goods but to services and companies as well. The risk that competition will be subdued by ex-ante harmonization and regulation should not be underestimated.

But important decisions on how the single market will eventually look like, - internally and externally - have still to be made. After having deregulated its own economy the British government will hopefully not allow the community to become a

"Europe Incorporated" with a bias toward overregulation and excessive bureaucracy. The glass is not only half empty, it is also half full. No one can expect that the country-of-origin principle will be applied in its pure form. Even if it is applied partially and if its spirit survives, it will contribute to make European markets more open and more competitive.

It should be noted, however, that the outlook for freer trade is dimmed by another tendency. Some politicians in Europe and the United States seem to believe that by starting an "arms race" in trade policy others can be forced to deregulate, to decontrol, and to open their markets. In fact, the recipe seems to have worked in the military field. However, in trade policy it is hard to see who will start "Perestroika". The disastrous results of protectionism in the thirties should be a warning and induce politicians to make more efforts in trade-disarmament. The economic benefits of creating a single European market or of establishing a free-trade area in North America may be considerable but they are small compared to benefits of freer trade in the world market.

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