# 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
Commission of the European Communities,
and presided by T. Padoa-Schioppa)

April 1987

II/49/87

CEE/2a EN

443
442

01-071444



From the Chairman of the Study Group
on the Integration Strategy
of the European Community

To Mr. Jacques DELORS
President
Commission of the European Communities

Dear President

In April 1986, the Commission decided to ask a Group of independent experts to investigate the economic consequences of the decisions taken in 1985 to enlarge the Community to include Spain and Portugal and to create a market without internal frontiers by the year 1992. The Group was invited to identify the problems that could arise in implementing these decisions and to suggest solutions.

In submitting the report of the Group to the Commission, I would like to briefly comment on three aspects of the work we have done: the analysis, the recommendations, the perspective.

* * *

At first sight, the two decisions of 1985 may not appear to have immediate "systemic" implications, as they represent a geographical widening and an economic deepening of the common market project, which was the original objective of the Treaty of Rome. For several reasons, however, the implications are considerably more complex.

Through successive enlargements, the Community has become a much more heterogeneous area - in terms of economic structure, living standards, social systems and policy institutions - than the original Community of six. Moreover, the market integration programme to be executed by 1992 covers the most difficult parts of the task originally set out by the Treaty of Rome, as it includes matters that have implications for personal freedom and security, monetary stability and other politically sensitive issues. Indeed, it is not by accident that such parts had been deferred for so many years.

In its analysis, the report shows how both the 1985 decisions affect the functioning of markets and prepare the ground for enormous improvements in the allocation of economic resources. Indeed, in 1992, the completion of an area of 320 million consumers and producers, where goods, services and factors of production circulate freely, will represent a substantial advance - in terms of

efficiency, welfare and economic influence in the world - on the smaller 1985 market, segmented by innumerable internal barriers.

This progress, however, will have profound consequences for the two functions of policy that - in every economic system, including the Community - integrate allocation policies and interact with them. These functions are the stabilization of the economy and the redistribution of income.

On the one hand, the complete liberalization of capital movements is inconsistent with the present combination of exchange rate stability and considerable national autonomy in the conduct of monetary policy; on the other hand, the complete opening of the market in the enlarged Community will have distributive effects that are likely to be stronger and more disruptive than those experienced in the sixties when trade integration proceeded among less heterogeneous countries and in a context of faster economic growth.

If these interactions between policies were neglected, or if the solutions chosen for them were inadequate, what in 1985 were rightly applauded as significant steps in the construction of Europe could encounter obstacles and entail inconsistencies. These could be erroneously taken as signs that the programme was mistaken, or too ambitious. The primary objective of a fully integrated internal market in an enlarged Community would lose political support and eventually fail, thereby depriving the Community of a major source of additional economic welfare.

* * *

It is therefore essential to design and implement - at this early stage of the 1986-92 process - the complementary programme needed to set the evolution of the Community on a balanced course.

In the view of the Group this requires a consistent strategy that would jointly address the three policy functions concerning market integration, stabilization of the economy and equitable distribution of gains. Such a strategy represents a minimum, without which the success of the "allocative programme", i.e. the completion of the internal market, would be jeopardized. This is the central proposition of the report.

The recommendations of the Group are based on this central proposition and can be summarized in the following points:

- first, implementation of the internal market programme within the deadline requires stronger reliance on the principle of mutual recognition of national regulations, a more selective choice of priority areas, less complex Community legislation and effective solutions for the serious problem that is emerging with regard to compliance with Community law. In no circumstances should the 1992 deadline be shifted;
- second, monetary policy coordination and the mechanisms of the EMS will have to be significantly strengthened if freedom of capital movements and exchange rate discipline are to survive and coexist;
- third, in a larger and more differentiated Community, redistributive functions

performed through the budget and the lending instruments of the Community should be considerably developed in size and made more effective in their purpose and design;

- fourth, a stepping up in the growth rate observed in recent years will be necessary if the enlargement and the completion of the internal market are to be successful. This speedup should result from both the market opening process and a "cooperative growth strategy" such as has been proposed by the Commission to the Council.

To implement the recommendations of the report, and particularly those summarized in the first three points above, changes in the rules and working methods of the Community are required. To define such changes in detail was not the task of the Group. What clearly emerges from our work, however, is the scope for combining a gain in the effectiveness of Community action with greater decentralisation of certain functions. The report shows how this principle of "economic federalism", of which the mutual recognition of national regulations is an important example, can lead to effective and realistic solutions in many policy fields.

For each of the four sets of policy recommendations, specific actions are considered and suggested in the report.

* * *

I would like to add some remarks to place the report in perspective and to clarify its aims.

The report develops indications for several policy areas. The main point to stress, however, is the strength of the links between these areas. Too often interdependent issues are considered and negotiated separately, with the result that the overall equilibrium or disequilibrium associated with the chosen solutions is overlooked. Greater Community involvement in stabilization and redistribution policies is the indispensable complement of the ambitious project of completing the internal market: this is our first and most important proposition. Only if this proposition is accepted, will it be possible to agree on the specific action to be taken in each of the three policy areas.

In assessing the adequacy of the proposed strategy, it needs to be borne in mind that the Community's scope for economic action and successful development is, rather paradoxically, limited by the strictly economic nature of the Community itself. This is because the Community, unlike fuller political systems, is not responsible for the provision of essential "public goods" such as defence, justice and social security, with the important economic consequence that distributive issues become more acute owing to the need to balance costs and benefits for members in more narrow terms than in a complete political system. Consequently, the claim of a "juste retour" tends to be stronger than in other systems. Indeed, the budget of a strictly economic Community is both small and much concerned with distributive issues. As a further consequence, the support it can offer to economic activity and macroeconomic stabilization is barely significant.

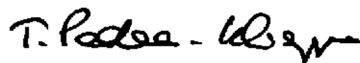
From an economic point of view, if the re-emerging anxieties about European security gave rise to greater involvement of the Community in its own defence, then some of these economic problems could also be considerably eased.

The analysis and the recommendations of the report relate to a critical phase of the historical development of the Community. Since the creation of the European Monetary System in 1979, the evolution of the European Community has followed an agenda in which the efficient allocation of resources and the pursuit of price stability have ranked as the highest priorities. They are the priorities that the most successful economy in Europe has set for itself and proposed for the Community. The process of disinflation promoted by the EMS, the enlargement of the market to include new member countries, the programme for the complete dismantling of internal barriers and the movement towards complete capital liberalization are all items of this agenda. None of them could have been taken for granted ten years ago, when continued access to an open European market, which is the wide field on which the fruits of sound economic management are reaped, was in danger. The two decisions of 1985 – confirmed by the Treaties of Accession and the Single European Act – mark the final acceptance of this agenda. The danger now comes from potentially disruptive imbalances between different policy dimensions in the Community. The success obtained by persuading the Community that efficient allocation of resources and price stability come first is what today makes it necessary to verify the overall consistency of the Community's design for the years to come.

The report does not deal with conjunctural matters, but it deals with urgent matters. It almost exclusively discusses systemic problems, and it offers solutions that have an unavoidable institutional content. These solutions cannot be postponed, but need to be implemented early in the period set for the completion of the internal market.

* * *

In submitting this report let me finally express, Mr. President, a sense of deep gratitude for the privilege the Commission has offered to our Group to work – with your support and in full independence – on important matters of public interest.



Tommaso PADOA-SCHIOPPA
Chairman of the Group

Brussels, 10 April 1987

## Composition of the Group

**Chairman**

Tommaso Padoa-Schioppa
Vice Direttore Generale
Banca d'Italia

**Members**

Prof. Mervyn King
London School of Economics and Political Science

Prof. Jean-H.P. Paelinck
Netherlands Economic Institute and Erasmus University, Rotterdam

Prof. Lucas D. Papademos
Economic Adviser
Bank of Greece

Prof. Alfredo Pastor
Presidente
Empresa Nacional Hidro-electrica del Ribagorzana, Barcelona

Prof. Fritz W. Scharpf
Direktor am Max-Plank-Institut für Gesellschaftsforschung, Cologne

**Rapporteur**

Michael Emerson
Commission of the European Communities

* * *

Jean-Claude Milleron, Directeur de la Prévision, Ministère de l'économie, des finances et de la privatisation, Paris, contributed as a member of the Group to the preparation of the Report, but did not share in all the final conclusions.

The Group met five times between September 1986 and February 1987, in Brussels, London and Paris. Some members of the Group held hearings in Athens, Dublin, Lisbon and Madrid in the course of February 1987. Professor Paul Krugman of the Massachusetts Institute of Technology presented a paper to one of the Group's meetings, and this is published as an annex to the present report. The Group also benefitted from helpful suggestions from Professor Alexis Jacquemin of the University of Louvain-la-Neuve, Professor Jean-Victor Louis of the Free University of Brussels, Dr. Jacques Pelkmans of the European Institute of Public Administration, Maastricht, Professor Luigi Spaventa of the University of Rome and Professor Joseph Weiler of the European University Institute, Florence. Research assistance was provided by M. Vanheukelen, J. Van Ginderachter, F. Ilzkovitz and J. McKenna; with secretarial and administrative support from Alison Molders and Chantal Mathieu.

All members of the Group have participated in a personal capacity, and views expressed in the report are not to be attributed to the various organisations with which they are associated.

The present report was submitted to the Commission of the European Communities on 10th April 1987.

## Contents

**Letter of transmission to the Commission by the Chairman of the Group** iii

**PART A: SUMMARY**

**1. A Strategy for the evolution of the European Community** 3

1.1 Four main points 3
1.2 Appraisal of the Community system to date 5
1.3 Towards a balanced evolution of the Community system 7
1.4 Institutional issues 11

**PART B: THE SCHEMA OF IDEAS**

**2. Subject and structure of the report** 17

**3. Some theoretical propositions and concepts** 19

**4. Historical experiences** 24

**PART C: APPRAISAL OF THE COMMUNITY SYSTEM TO DATE**

**5. Goods and services markets** 33

5.1 Gains from trade and the opportunity cost of its stagnation 33
5.2 Systemic issues in completing the goods and services markets 36

5.2.1 Tariffs and quotas 36
5.2.2 Competition policy and subsidies 39
5.2.3 Government procurement restrictions 40
5.2.4 Technical standards 42
5.2.5 Transport services 43
5.2.6 Financial services 45
5.2.7 Indirect tax harmonisation and fiscal frontiers 48

**6. Labour markets** 50

6.1 Labour migration issues 50
6.2 Wider labour market issues 52

**7. Capital markets** 55

**8. Macroeconomic policy** 60

8.1 European Monetary System 60
8.2 The wider system of economic policy coordination 62

**9. Community budget** 66

**PART D: FOR A BALANCED DEVELOPMENT OF THE COMMUNITY SYSTEM**

**10. Rethinking the system** 71

**11. The internal market as the Community's resource allocation function** 75

11.1 Which priorities? 75
11.2 How much competition? 78
11.3 Measures to favour European enterprise 82
11.4 The emerging compliance problem and institutional issues in the area of market policies 87

**12. Capital mobility, the European Monetary System and the stabilisation function** 92

12.1 Monetary stability and integration 92

12.1.1 Capital liberalisation and monetary regime choices 92
12.1.2 Present regime choices 94
12.1.3 Implications of capital mobility for the EMS 95
12.1.4 Organisation of a "Stage Two" for the EMS 99
12.1.5 Some remarks on monetary Union 105

12.2 Other stabilisation issues 108

12.2.1 The Community budgetary policy model in the long-run 108
12.2.2 Labour costs, industrial relations and social policy 111
12.2.3 A decentralised model for budgetary and labour policies 113

**13. The Community budget and the redistribution function** 115

13.1 General considerations 115
13.2 Redistributive mechanisms in multi-tier government 117
13.3 The regional dimension 120
13.4 Reform of the structural funds 124
13.5 The mix of allocation and distribution in agricultural policy 132
13.6 Fiscal equity and the structure of the Community budget 135

**14. Growth conditions** 142

* * *

**Figures**

A. Number of infringement proceedings under Community law 88
B. Illustrative scenarios for the restructuring of the Community budget 138
C. A safeguard mechanism for the Community budget 140

**Notes** 145

**References** 147

**Annexes**

A. European economic integration: some conceptual issues (by Paul Krugman) A.1

B. The cash flow corporation tax (by Mervyn King) B.1

C. Schemas for macroeconomic policy coordination C.1

D. Distributive aspects of the Community budget D.1

E. The less-favoured regions of the Community E.1

## Part A

## SUMMARY

## 1. A STRATEGY FOR THE EVOLUTION OF THE EUROPEAN COMMUNITY

The Group was asked to assess the implications for the economic system of the Community of recent decisions: adoption of the internal market programme, and the latest enlargement bringing in Spain and Portugal.

Our review leads to the conclusion that there are indeed important linkages between these initiatives and other strategic aspects of the Community system. These linkages pose requirements for other Community policies if the internal market programme is to have a good chance of success, and if the Community's economic and political integration is to proceed in a politically and economically viable way.

### 1.1 Four main points

The main argument may be summarised under four points:

(i) The 1985 White Paper on the internal market* implies a very strong action to improve the efficiency of resource allocation in the Community. The Group strongly supports the final objective and the 1992 target date for its completion. But the programme is getting behind schedule. The most difficult parts are not yet tackled. There are some aspects of the programme where flexibility will be required to permit changes in method and emphasis.

(ii) The internal market programme creates both opportunities and needs for complementary action to foster macroeconomic stability and growth of the Community. As regards monetary stability, the elimination of capital controls, coupled to the requirement of exchange rate stability, means a qualitative change in the operating environment for monetary policy. It will require moving closer to unification of monetary

---

* The expression "White Paper" is used throughout this report without repeating its full title: "Completing the Internal Market: White Paper from the Commission to the Council"(1)

policy. In a quite fundamental way, capital mobility and exchange rate fixity together leave no room for independent monetary policies. In these conditions, it is pertinent to consider afresh the case for a strengthened organisation of monetary coordination or institutional advances in this field. Advantages for stabilisation policy can justify such changes.

iii) There are serious risks of aggravated regional imbalance in the course of market liberalisation. This is because different economic processes will be at work as markets integrate, some tending towards convergence, others towards divergence. Neither dogmatic optimism nor fatalistic pessimism is warranted in these respects. Opportunities for convergence will be increased, but adequate accompanying measures are required to speed adjustment in the structurally weak regions and countries, and counter tendencies towards divergence. In addition, reforms and development of Community structural funds are needed for this purpose - alongside other reforms for the Community budget as regards agricultural spending and its financing.

iv) As for growth, the internal market programme, if successful, must mean a perceptible increase in the rate of macroeconomic expansion. There is no way major benefits could be supposed to accrue without this. Indeed, without generating higher growth, the political cost of negotiation would hardly be worthwhile and the programme would fail. The conversion of better functioning markets into macroeconomic results cannot be taken for granted. This does not mean, however, a call for a burst of short-term demand expansion. On the other hand, something along the lines of the Community's cooperative growth strategy ([36, 37]) must be translated from declarations of principle into reality.

These four points may be regrouped logically in the following way. In terms of overall strategy, the Community has in recent years adopted a clear-cut economic agenda - characterised by the pursuit of (i) competitive markets and (ii) monetary stability. There is increasing consensus over the fundamental wisdom of these choices. They assure, on the one hand, the efficiency of resource allocation and, on the other hand, a vital sustainability condition for economic policy. This agenda

.../...

is, however, incomplete. Two further elements must be added: (iii) an equitable distribution of the gains in economic welfare, and (iv) actual growth performance. Neither of them are adequately assured as of now. Without them, the Community's system would be likely to falter. A successful strategy will therefore require also adequate mechanisms to aid structural change in the regions and avoid distributive inequities and a preparedness to support the growth process through macroeconomic policy.

Agreement on these four points together should, in the Group's judgement, be the basis of the long-term "social contract" between the Community and all its Member States. The essential interdependence between these features of integrated economic systems is well founded in economic theory (Chapter 3) and supported by historical experiences (Chapter 4).

We now spell out our conclusions in a little more detail.

## 1.2 Appraisal of the Community system to date

Goods and services markets (Chapter 5). Empirical and theoretical research in economics support the view that large economic gains have been made by the Community as a result of its market opening measures, especially among the six original member countries. Correspondingly, large economic gains could again be made by the Community with a programme of full integration of the internal market in an enlarged group of twelve countries.

However, since about 1973, trade integration among the original six members has largely stagnated, as new market barriers outweighed new liberalising action, and economic growth was cut in half. These events were significantly related, even if other factors were important in slowing down growth. Some of the main trade barriers are as follows. Important border taxes or national production or trade quotas have been reintroduced in agriculture, steel and textiles. The number of contestable national subsidy schemes has greatly increased. Government procurement restrictions, covering almost one-tenth of the economy, have

.../...

hardly been eased at all. Attempts to harmonise technical standards at the Community level were becoming increasingly frustrated, until 1984, when use of the principle of mutual recognition of national regulations began to open fresh prospects. Civil aviation remains a highly uncompetitive market, and progress in this area, so far very slight, is highly desirable for reasons of commerce and the people's Europe. Financial services are still heavily protected - generally in insurance, and in several countries as regards banking.

The general introduction of the value added tax was an important tax reform, helpful for undistorted resource allocation. However, the task of abolishing fiscal frontiers remains.

Labour markets (Chapter 6). Labour market mobility is assured (or will be in a few years for the new Members) from a legal point of view, but much remains to be done to establish truly open and competitive markets in many professions. On the other hand, the Community should be cautious about venturing further into the fields of labour market or social security harmonisation because there needs to remain scope for national policy experimentation and adjustments.

Capital markets (Chapter 7). Considerable progress is now being made in capital market liberalisation, although unevenly between countries. The removal of capital controls increases the need for associated actions to harmonise regulatory requirements and regimes for the taxation of capital income. It will also profoundly affect monetary and exchange rate policies, as indicated further below.

Macroeconomic policy (Chapter 8). The European Monetary System has effectively promoted a convergence on monetary stability. However, there should not be self-satisfaction with the status quo. The institutional fragility of the system will need to be rectified, notably with the opening of capital markets. Moreover, the system for coordination of budgetary and other policies under the 1974 Convergence Decision has been ineffective.

.../...

Community budget (Chapter 9). The expenditure functions of the budget (agriculture, regional, retraining, industrial, and aid policies) were in principle well chosen. But failure to control agricultural spending, apart from being very costly in itself, has led to problems of "tokenism" in some other Community policies (i.e. contributions towards policy objectives which are too small to be significant), and friction in relation to financial costs and trade policy.

### 1.3 For a balanced development of the Community system

Rethinking the system (Chapter 10. This review of the system shows a mixed pattern of achievement and regress, of innovation and stagnation. The most promising development, the EMS and the internal market programme, do not at present add up to a balanced strategy for the evolution of the Community system as a whole. In fact, they contain inconsistencies. In the pursuit of a systematic rather than ad hoc approach, the Group uses the distinction between allocation, stabilisation and distribution branches of public policy. The Group judges that the Community's important initiative in the allocation branch (through the internal market programme) needs to be balanced by development also in the stabilisation and distribution branches. Such balance is required not to enlarge the competences of the Community for its own sake, but to ensure the success of the allocative programme.

The internal market and the allocation function (Chapter 11). With the 300 or more items of legislation envisaged to complete the internal market by 1992, it is important that the Community intensify its search for methods of action that will minimise problems of implementing Community legislation in the Member States, and thereby also reduce compliance problems. In this context, the Group strongly welcomes the introduction of the mutual recognition principle to lower costs of harmonisation, and feels that this principle can be extended further by taking a more positive view of "competition among rules". This is one of several respects in which we favour positive decentralisation measures, to balance politically in some degree the centralisation of powers implied by the White Paper. Recent trends point to the emergence

.../...

of serious and growing compliance problems, and this calls for systemic reforms in the direction of greater decentralisation of Community policies.

Effective competition policy and discipline over certain types of state subsidies will become more important for the Community with the completion of the internal market. A Community capacity to police mergers becomes more relevant. Major economic benefits from the opening of markets depend upon private sector confidence in the solidity of Community disciplines over state subsidies that sharply affect competitive conditions; without such confidence, enterprises will be hesitant to adopt Community market strategies. However, decentralisation measures should also be considered here, for example through raising threshold sizes below which national subsidy schemes are excluded from, or subjected less to Community surveillance. Steps should also be taken to facilitate private litigation in national courts in support of Community competition policy, and so relieve enforcement bottlenecks in the Community institutions.

Collaborative industrial ventures and policies will not always threaten the advantages of competition policy. Such instances may be found where companies in third countries risk gaining world monopoly or oligopoly situations. Within the Community, it may only be possible to eliminate some restraints (such as in government procurement) by restructuring industries with cross-frontier regroupings of companies. In some cases, this could in turn be facilitated by the privatisation of companies producing tradeable goods.

A new approach to corporation tax harmonisation is suggested, with a view to removing fiscal distortions for European enterprises and capital.

<u>Capital mobility, the EMS and the stabilisation function</u> (Chapter 12). Capital market liberalisation will fundamentally change the environment for monetary policy in a fixed (or nearly fixed) exchange rate system such as the EMS. Domestic monetary policies have to be much more nearly unified, which raises crucial questions about how coordination is

.../...

organised or institutionalised.

With complete capital mobility, the present mechanisms of the EMS and the existing weak degree of monetary policy coordination will no longer be sufficient to foster price stability and to ensure orderly trade relationships in the Community. Institutionalising greater exchange rate flexibility would be an inadequate and potentially dangerous answer to the problems posed by capital mobility. Stronger EMS mechanisms coupled with strengthened monetary coordination is the course to be followed if the basic performance of the EMS is to be preserved.

The Group identifies the characteristics of a "Stage Two" EMS that could reconcile capital mobility and a high degree of exchange rate fixity: (i) stronger coordination and joint management of monetary policy; (ii) strengthened EMS mechanisms to counter speculative capital movements; (iii) a new model of safeguard mechanisms, providing for more effective Community control over exceptional derogations from complete capital mobility; (iv) a well-structured participation of the Community in international monetary cooperation.

These developments would also require: (a) a reconsideration of the roles of the relevant Community bodies (Monetary Committee and the Committee of Governors), and (b) a more developed role for the ECU, with links between its presently separate private and official markets.

The "Stage Two" would not amount to a monetary union. Indeed the Group does not advocate a precipitous move to monetary union, while recognising that this has several first-best properties from an economic point of view. There would have to be further adaptation of attitudes and behaviour among private agents (employers and trade unions), as well as of political attitudes, for monetary union to be a sufficiently low-risk proposition.

As monetary integration progresses, national budgets will also have to be subject to intenser common disciplines. However, the decentralised model evident in the mature federations, where the capital market exerts some restraint on state borrowing, is more plausible in the long-run than power-sharing arrangements that have sometimes been considered.

.../...

The Community budget and the distribution function (Chapter 13). Just as capital market liberalisation will drastically affect the operating environment for monetary policy in the EMS, so also a triple challenge in the "real" economy is going to intensify the need for an adequate regional policy in the Community. This triple challenge consists of the internal market programme, the enlargement of the Community to include more diverse economies, and new trends in industrial technologies. Any easy extrapolation of "invisible hand" ideas into the real world of regional economics in the process of market opening measures would be unwarranted in the light of economic history and theory. In addition, current trends in industrial structure in favour of high-technology industries point on the whole to an aggravation of the problems of backward and peripheral regions, and, sometimes, old declining industrial regions.

The Single European Act, in Article 130 A to E, rightly suggests a wide conception of how the Community should assure its "economic and social cohesion". The structural funds of the Community budget represent only one of several instruments for pursuing this objective. Consistency of macro- and microeconomic policies with the market opening strategy of the Community is of the greatest importance. Also relevant are Community policies towards state subsidies, the stimulation of industrial R&D and the management of quota regimes for various industrial and agricultural products: all should give due attention to the regional aspect.

As regards the structural funds, the Group supports a substantial increase in their size and their proposed concentration on two types of regional problem: (i) the less favoured and often peripheral regions and (ii) the old industrial regions suffering from economic decline. The structural funds should offer incentives to these categories of regions to build up or restore high levels of physical and human capital endowment, such that a faster growth of output and employment could be sustained. An increasing reliance on the programme financing approach is advocated: this can function in a largely decentralised manner. Where budgetary transfers to low income member countries become quite substantial in macroeconomic terms, they should be associated with

.../...

agreement over medium-term macroeconomic policy strategy between the Community and the country concerned.

The agricultural budget has increasingly developed into an instrument of income redistribution, compared to its role for stabilising prices and incomes along trend paths that would be consistent with efficient resource allocation. This reversal of roles, from allocation to distribution, is highly unsuitable for the Community. Income maintenance functions are best discharged at lower levels of government. This would imply re-establishing a proper agricultural resource allocation policy at the Community level, and integrating the distribution function more into national income maintenance systems, on conditions, controlled by the Community, that separated such income support from production aids. There should be corresponding changes in the mechanisms and control of agricultural policy.

For the funding of the Community budget, it is important to support the institutional principle of "own resources". From a distributive point of view, the main revenue sources, beyond customs duties and agricultural levies, should be either neutral or progressive with respect to national income. Together with the other budgetary reforms recommended, there should be a much reduced need for ad hoc budget compensation mechanisms, whose negotiation has been very costly politically in the past. However, the group envisages a "safeguard mechanism" designed to settle problems of budgetary inequity in a systematic and permanent way. As a result, political negotiations over "allocative" policies should be more concentrated on efficiency considerations and divorced from "distributive" considerations.

Growth conditions (Chapter 14). It is necessary to stress the need for consistent micro- and macro-economic strategies in the Community. The internal market programme can deliver valuable benefits in terms of a higher rate of economic growth, and indeed can deliver no real benefits except in this way. Macroeconomic policy must be geared towards supporting the emergence of such a higher growth rate. Economic growth has recently been about 2 1/2% per annum, whereas the Community's cooperative growth strategy envisages a 3 1/2% growth until the

.../...

beginning of the next decade. With vigourous implementation of the internal market programme, the growth rate could even be further raised, possibly to 4% for a period of years (in the nineteen sixties, the rate of growth in the Community was 4.8%). A sustained impetus on both supply and demand sides is needed to get an acceleration of growth clearly underway. In this way, many of the protectionist instincts impeding agreement on the internal market programme could be overcome. Without it the programme as a whole would be implausible.

### 1.4 Institutional issues

Finally, we regroup some of the conclusions in terms of institutional issues. In this respect, three headings appear to sum up the conditions for a viable evolution of the Community system:

More selectivity in Community responsibilities. The Group feels that the Community's effectiveness is undermined by expectations that it contributes to an excessively wide range of policy domains. There are sound principles to govern the selection of priority tasks for the Community. They are those of subsidiarity (the Community only does what it can do better than the nations) and the importance of cross-frontier spill-overs in the impact of given policies. There are a few priority areas where the Community's powers or institutions need to be strengthened or reformed. These concern monetary policy, regional policy, and policies to strengthen the competitivity of European enterprise. There are other areas where the Community's expected role, at least for harmonising legislation, could be lessened: for example social policy and labour market regulations.

More space for decentralised application of Community policies. Within its main areas of responsibility, the Community should prefer techniques of policy-making that allow for decentralised implementation in the details. The Community needs to confirm its recent moves away from conceptions of monolithic harmonisation with Community competences replacing national competences towards a pluralistic, pragmatic and federalistic model in which national policies and legislation are framed within wider Community rules. This will mean, in general terms, more shared policies, rather than instances when policies are entirely

.../...

transferred from national to Community levels of competence. Some examples of the mechanisms that could work in these directions are: (i) maximum use of the mutual recognition principle, in the field of harmonisation; (ii) the programme-financing approach to management of the structural funds; (iii) higher threshold levels exempting subsidies from Community jurisdiction; (iv) more scope for national income maintenance measures in the agricultural sector; (v) executive responsibilities for Community policies shared in some cases through the work of management committees of the Commission and Member States; (vii) maximum decentralised choice of indirect tax rates within the context of abolishing fiscal frontiers; and (viii) a rethinking of strategies for tackling the growing problem of non-compliance with Community law.

<u>Stronger institutional powers in some priority areas</u>. Set against this background of greater selectivity and preference for decentralised techniques of policy management, it becomes more realistic politically to make advances in the Community's institutional capacities in some priority domains. Thus, in the monetary area it is necessary to move towards a European central banking system with considerably enhanced policy coordination and executive responsibilities. In the field of competition policy, it is necessary to provide for reinforced capacity to control the most important infringements. In the field of the Community budget, there should be reforms with a view to better controlling agricultural expenditure, for example through mechanisms that automatically revise intervention commitments when expenditures risk overshooting budgeted amounts. In the domain of the structural funds, the Commission should have greater scope to accept or decline the co-financing of eligible programmes on the basis of quality-control criteria, and, in certain cases, macroeconomic criteria.

# Part B

## THE SCHEMA OF IDEAS

## 2. SUBJECT AND STRUCTURE OF THE REPORT

The Group was asked to review the Community's strategy for further economic integration in the light of recent developments. These include the decision taken by the European Council in 1985 to complete the internal market by 1992, the third enlargement bringing in Portugal and Spain in 1986.

In announcing the beginning of this project, the Commission noted*:

> "These recent developments will generate many interactions in the Community's system of policies and institutions. For example, capital market liberalisation will affect the European Monetary System and the needs for macroeconomic policy coordination. The opening of goods, service and factor markets may also be expected to have important impacts at the regional and sectoral level. In general terms, there arises the question of the desirable degree of parallelism in the development of different common policies, such that the 'Community system' as a whole progresses in a balanced way."

The report is divided into four parts.

Part A is a general summary of the report.

Part B sets out a few theoretical propositions that are of central importance to our report. Some historical experiences are also recalled.

Part C reviews the Community system as it is functioning and developing at the present time. The main features of the internal market programme - for goods, services, labour and capital - are evaluated, followed by a

---

* Commission of the European Communites, Press Release IP(86)533, "Study Group on the Economic Integration Strategy of the Community".

short review of macroeconomic policy coordination questions and the Community budget.

Part D takes a forward look. After summarizing the problems and interactions posed by the completion of the internal market in an enlarged Community, ideas are presented for a harmonious and efficient development of the Community system. This prescriptive part of the report is structured around the familiar distinction made in the economic analysis of public policy between three main branches: resource allocation, macroeconomic stabilisation, and redistribution for reasons of equity.

For the busy reader, Part A and Chapters 3 and 10 amount to a self-contained summary of the report. For the reader with a little more time, the whole of Parts B and D are the next most important.

## 3. SOME THEORETICAL PROPOSITIONS AND CONCEPTS

Although this report is not of a theoretical nature, there are certain concepts that need to be set out clearly from the beginning, since these will be referred to recurrently.

Four propositions, with solid foundations in economic theory and applied analysis, are of central importance to this study.

(i) There are great economic benefits to be obtained from increased openness to trade in goods and services among countries. This has long been recognised to be available to countries which trade on the basis of different comparative advantages. More recently, however, trade theory has drawn attention to great benefits that can also flow from trade integration among countries with similar economic structures. Trade in the Community is largely of this second type. Detailed case studies show the gains from this second category of trade to be of very high orders of magnitude. These gains materialise in terms of lower prices for goods and services, higher quality and wider consumer choice. The mobility of factors of production (capital and labour) also offers economic advantages, albeit on certain conditions for monetary and budgetary policies. Overall, therefore, economic analysis amply supports the intuition behind the Community's programme to complete the internal market, namely that this political initiative could deliver economic benefits of strategic importance.

(ii) The second category of gains from trade just mentioned derive from the fact that many industries can often continue to exploit economies of scale where the structure of companies concerned is becoming oligopolistic, even in an economic region as large as the Community. These are industries with important fixed costs, in which increasing returns to scale lead to the increasing specialisation of enterprises. This means, however, that the risks of an uneven distribution of the gains from trade on the one hand and of transitional employment problems on the other are

serious, and that several types of complementary policies require serious attention: competition policy including strong restraints on industrial policies at the level of individual countries, and policies to help even out the gains in the process of trade rationalisation and expansion. This is relevant to the decision of Member States, set out in the Single European Act, to consider what steps, accompanying the market opening process, may be required to maintain the cohesion of the Community.

(iii) Alongside the accumulation of microeconomic efficiency gains as a result of increased economic interdependence, there is also the build-up of risks in the conduct of national macroeconomic policies. The most probable risk in the event of increasing economic interdependence is that of excessive disinflation in macroeconomic policy management and thus an aggravation of employment problems. These risks have to be countered by an improved coordination of macroeconomic policies, otherwise the microeconomic gains may be significantly offset by macroeconomic losses. The microeconomic efficiency gains from market integration have to be associated with a higher rate of macroeconomic growth, otherwise there is no gain for the economy as a whole. In other words, the reallocation of resources will only be beneficial if the resources freed by rationalisation are actually re-employed.

(iv) Where the market opening process includes the complete liberalisation of capital movements, there is a qualitative change in the operating environment for macroeconomic policy, and monetary policy in particular. Under these conditions, countries which wish at the same time to share stable exchange rates must coordinate their monetary policies to an extremely high degree, otherwise the system will fail. (The reasons why this is the case are set out in section 12.1 and Annex A below). Thus, to seek to maintain open capital markets, stable exchange rates and autonomous macroeconomic policies is fundamentally inconsistent. In considering how to satisfy this requirement for a high degree of monetary policy coordination, it may in several respects be

more efficient to move beyond coordination towards the unification of monetary policies. This has institutional implications, and raises other problems that need to be considered.

These four central propositions call for a fuller justification, and this is provided in appropriate sections of the report. (An account of how these points relate more precisely to current economic thinking is given in Annex A, which also gives references to the literature).

Taken together, these propositions draw attention to the strong linkages that exist between different parts of the Community system. This emphasises also the need for a unifying conceptual framwork to help assess the desirable structure and evolution of the system. Such a framework is offered by two elements: (i) the economic principles of multi-tier government, and (ii) the well-known primary breakdown of the functions of public policy between the allocation, stabilisation and distribution branches.

As regards the first element, in the Community there are often four levels of government in question: local, regional, national and Community. The essential criterion for assessing the most efficient level of government for a given policy function is the incidence of the costs and benefits of the policy action(2) The most suitable level of government, to provide a given public good, is in principle that which encompasses the larger part of these costs and benefits. <u>The right level of government is then the lowest level at which the function in question can be efficiently executed. This is called the "principle of subsidiarity"</u>, because it states that higher levels of government should only exert functions that cannot be efficiently performed at lower levels. However, where significant fractions of the costs and benefits spill over beyond the jurisdiction of the government in question, there is likely to be an inefficiency in policy-making: under-supply of public goods where the benefits spill over, over-supply where the costs spill over. One type of action to correct such bias is through coordination between governments, and another is through systems of budgetary transfers between levels of government. However, the problems of spillovers may be too great for these mechanisms to handle adequately,

.../...

in which case the transfer of competences to a higher level of government is the more radical solution.

The second element of the conceptual framework is the well-known primary breakdown of the functions of public policy between three branches(3). While far from completely separate in practice, the distinction is nonetheless useful for the purposes of exposition. The three branches are:

(a) the resource allocation function, which is concerned mainly with microeconomic policy instruments aimed at the efficient use of resources;

(b) the stabilisation function, which is concerned with the macroeconomic policy objectives of high standards of price stability and high levels of economic activity and employment; and

(c) the income redistribution function, which can have many dimensions including for example inter-personal, and inter-regional aspects.

The Community, at its beginning and now again with emphasis on the completion of the internal market, has been given some important competences in the resource allocation function. This is in line with the view that only a large region can deliver the potential benefits of the market economy.

The stabilisation function has long been regarded as being at the heart of national level macroeconomic policy making. However, as already pointed out, with increasing inderdependence between countries through the opening of markets, the workings of national macroeconomic policy suffer from increased spillovers between countries. With the addition of capital market liberalisation, these effects of national policy actions on other countries become very important. Therefore, the stabilisation function becomes naturally drawn upwards also in the systemic organisation of policies.

The redistribution function is first of all a matter of policies

affecting inter-personal income distribution through tax and social security systems, and the distribution between capital and labour incomes. These are policies which so far in the Community have had rather limited spillover effects between countries. Therefore the case for Community involvement is weak. However, the market opening policies of the Community create distributional issues because there is no *a priori* certainty that the aggregate gains from these policies will translate into gains for all participants at the level of regions or countries. The Community needs to give, accordingly, due attention to these aspects of the distribution function.

Thus the Community's economic system, which has been led by policy functions affecting resource allocation, is having increasingly diffuse implications for the other main branches of public policy. *A certain balance or degree of parallelism in the evolution of the Community's responsibilities under each of three main branches of the public policy system is required, if the integration process is to prove viable and robust.*

This structure of ideas is used in more detail in Part D of this report, which sets out our views for a balanced development of the system.

## 4. HISTORICAL EXPERIENCES

While the following few pages will surely appear excessively simple to historians, there are nonetheless some important messages from earlier historical experiences which need to be remembered. In particular, it is suggested that the theoretical points just made above have also loomed large in the practical history of nations. Three categories of experiences are identified: those relating to (i) economic integration, (ii) monetary unions and systems, and (iii) to differences between economic and political communities.

(i) Economic integration. The history of economic integration suggests that the aggregate welfare gains of market openness are very large, but that the even distribution of these gains cannot be taken for granted. History is replete with examples of regional conflicts over the terms of trade or degrees of protection for industrial and agricultural produce, between north and south geographical divides, and between the interest of initially more versus less advanced economies. There is abundant evidence that those embarking upon the course of economic integration should not rely on simple beliefs about the benevolence of "invisible hands". A few examples illustrate this.

In Germany, following establishment of the Zollverein in 1834, the industrially more advanced Prussia and Saxony increased their market shares in Southern Germany at the expense of British and French competitors, while the south obtained some compensating advantage for its agriculture. Historians now tend to the view that industrial development in the south was retarded by the customs union. That the effect was not more damaging is ascribed to the vigourous industrialisation policies followed by some of the southern states, for which they retained full autonomy, with the exception of a common external tariff and, later, a common currency(4).

In Italy, unification was associated with the lowering of protective tariffs for industry in the south and a general lowering in the level of agricultural protection. In spite of the promotion of major railway

investments in the south, industry there was unable to withstand the competition from the north. Agriculture also in the south, with rigid land-holding and social customs, proved incapable of withstanding competition from the north of Italy and other efficient producers north of the Alps. The widely held view is that the economy of the south suffered rather than benefitted for decades after unification.

In the United States, after the Revolution, the conflict of interest between the industrialising north and the agricultural south, whose economy relied heavily upon slave-labour, was endemic. The north pushed for higher tariffs for industrial commodities, and when, in alliance with the new western states, they succeeded in this, the south resorted to the nullification of inter-state treaties, and, eventually, secession. After losing the consequent Civil War, the south lapsed into a century of economic stagnation from which it has only recently emerged with migration of northern industry to the sun-belt states(5).

(ii) Monetary unions and systems. European history of the last century also offers several case-studies in regional monetary unions(6).

France was the initiating force behind the Treaty of 1865 forming the Latin monetary union with Italy, Belgium and Switzerland. The Treaty agreed that all countries would mint only coins of common weight, fineness, diameter, etc., which would be mutually aceptable to their respective treasuries. Greece also joined, and with further bilateral treaties or unilateral actions as many as eighteen states had by 1880 adopted the French monetary unit as the basis of the national systems. The union then effectively lapsed as silver coinage, the basis to the system, had to be suspended because of its loss of value in relation to gold. More fundamentally, however, the union lacked any mechanism enabling the countries to consult and agree on coordinated actions.

A Germanic monetary union was formed in 1857 with a treaty between Austria and the members of the Zollverein. It dissolved however, with the war in 1866 between Prussia and Austria. A Scandinavian Monetary Union was created in 1873 by Denmark, Sweden and Norway, each country producing standard gold coins, but retaining the right of issuing

subsidiary coinage and notes convertible into gold. The Scandinavian union also established a clearing system for coin and notes, and succeeded in economising in gold and becoming technically considerably more advanced than the Latin union. The success of the Scandinavian system tends to be attributed to the structural similarity of the three participating eonomies. But its demise during the first World War is attributed to the lack of a sufficiently strong managing authority to handle the serious international monetary problems caused by the war.

The gold standard was a unique system characterized by an automatic rule governing balance of payments adjustments and the detemination of the world price level[7,8,9]. From about 1876 to 1913, all the major industrial powers, including the United States, were operating under the rules of the gold standard, with London serving as financial centre of the system. These countries thus gave up independence in monetary policy in favour of free trade, free capital mobility and fixed exchange rates. Fiscal policies were not a source of disturbance, as budget deficits were modest in size.

The automatic coordination of monetary policy was brought about, first, through the willingness of each central bank to maintain a stable ratio of gold reserves to issues of currency and their readiness to increase the discount rate if the ratio was falling, to reduce it if the ratio was increasing. Thus a deficit in the balance of payments, which led to an incipient gold outflow, were reversed by increases in the discount rate in the deficit country and a reduction in the surplus country. The short run variability of interest rates and of currency in circulation was relatively high, especially in Germany, the United Kingdom and the United States. The burden of adjustment on the balance of payments disequilibria was shared symmetrically between the United Kingdom and the other large industrial countries. As a result, actual international gold flows were relatively limited.

The second rule related to the determination of the world price level. As bank note circulation was linked to gold, the supply and demand of monetary gold proximately determined the world price level. In addition, the supply of monetary gold in the world was a declining

function of the world price level. This was because the price of monetary gold was fixed - in pounds. With rising prices, the costs of extracting gold increased (barring technical progress in mining) and profits fell, and so gold production weakened. Therefore inflationary pressures in the world economy as a whole also tended automatically to be countered in the long run by the mechanisms of the system.

The gold standard collapsed in 1914 when the internal convertibility of notes into gold was abolished. The war effort of individual countries led to high budget deficits, inflation and a collapse in world trade. The gold standard which emerged after the First World War can hardly be called a system. Internal convertibility of bank notes into gold was not reintroduced in most countries. The world distribution of monetary gold was very uneven with the United States possessing a very large fraction of it. The balance of payments adjustment mechanism did not therefore work smoothly, since domestic policy objectives were not subordinated to the external constraints. Moreover, free trade and free capital mobility were the exception rather than the rule. There was virtually no attempt at coordinating policies, nor an attempt by the United States to provide the necessary leadership. For example, budget deficits and external indebtedness were able to grow rapidly in Germany, especially in the second half of the 1920s.

The rise and fall of the Bretton Woods system also has lessons to offer(10). The post-war era has had several sub-periods, each representing different mixes of the four strategic components of international economic systems: the trade regime, the exchange rate regime, the capital market regime and the autonomous or cooperative management of macroeconomic policies. The period as a whole supports the proposition that it is not possible to have free trade, freedom from capital restrictions, pegged exchange rates and autonomous macroeconomic policies. Such a system will not work, because it allows inconsistent policies to develop.

The first post-war sub-period, lasting to the end of the 'fifties, saw the return to free trade with a monetary order that pegged exchange rates to the dollar. However, countries were free to impose

.../...

restrictions of capital movements, even encouraged to do so. This left considerable freedom in setting national economic policies, although the United States exerted a dominant influence.

In a second period, from the end of the 'fifties, currencies started to become convertible again, the Euro-currency market was born, and the system moved towards capital mobility. Problems of inconsistency began to emerge in the 'sixties. Monetary cooperation was still of a high order and the consultative mechanisms of the OECD and IMF were effectively used. However, in the end it became evident that this "soft" coordination was not enough to ensure consistency of the system, notably when the United States had recourse to an inflationary financing of the Vietnam War.

A third period opened with the 'seventies. Failure to reconcile national economic policies, coupled with high capital mobility between major financial centres, led to breakdown of the exchange rate system. The United States first suspended the gold convertibility of the dollar in 1971, and then the world switched to the floating exchange rate regime in 1973. The Euro-currency market proved impossible to discipline. The sovereignty of national economic policies was to prevail.

As the years passed, it became increasingly clear that the elimination of the exchange rate constraint had restored only limited autonomy to macroeconomic policies, while the unrestricted floating of exchange rates risked undermining the open trade system and capital mobility. In this fourth period, the drawbacks of the new order (or "non-system" as it is sometimes called) were recognised sooner in Europe than elsewhere, because the links between the European economies were particularly intense. The creation of the European Monetary System reintroduced the exchange rate constraint at a regional level in 1978, albeit with support from remaining capital controls in most participating countries, except Germany which became the centre of the system. At the international level, the United States began to reverse in 1985 its policy of neglect towards the exchange rate, but its unpreparedness so far to constrain its domestic policies to international needs makes it

still difficult to envisage a structured system.

These examples support the proposition that economic proximity and interdependence creates functional demands for monetary integration. They also warn that in the absence of strong rules or institutional foundations, such endeavours tend to prove ephemeral, being incapable of withstanding large disturbances that history continuously generates. This proved true again of the Snake of the early nineteen-seventies, and remains a warning for the European Monetary System which failed to pass to its second, institutional stage two years after its inception as Heads of State and Government originally agreed.

(iii) Economic and political communities. One of the main distinctions between the Community and most earlier integration episodes is that between political and economic contents of the integration process. Political motivation was essential in giving birth first to the Coal and Steel Community, then to the Treaty of Rome, and later to the demands of adhesion that led to three successive enlargements of the original Community of Six. The content of the Community, however, was economic. And the consequence of this difference between an economic and a political union can be seen both in the fact that in the EC the economic costs and benefits tend to be evaluated in rather narrow terms by Member States, and in the weakness of the central political structure. The Community does not have the political power to overide grievances. In any case, current democratic usage is to resort rather readily to referenda both on issues of regional devolution as well as over membership of the Community or other fundamental steps (viz. in 1986 in Denmark over the Single European Act). The threat of secession, while happily not on the horizon in the Community at the present time, cannot be dismissed. The cement of a political community is provided by indivisible public goods such as "defence and security". The cement of an economic community inevitably lies in the economic benefits it confers upon its members.

## Part C

# APPRAISAL OF THE COMMUNITY SYSTEM TO DATE

# 5. GOODS AND SERVICE MARKETS

## 5.1 Gains from trade and the opportunity costs of its stagnation

Recent economic analysis, both theoretical and empirical, supports the basic intuition behind the internal market programme, namely that the opening of markets offers great welfare gains to the economy. (This leaves aside, for the moment, distribution questions). However, empirical evaluations of the gains from increased market integration are far from comprehensive, especially for the European Community. It is therefore appropriate that the Commission has recently commissioned an extensive programme of studies in this domain. These studies aim to cast more light on what has been called "the costs of non-Europe". The results will not be available until later this year. In the meantime, without wishing to prejudge the findings of these studies, it is possible to outline the nature of gains from increased trade, and the results of a few empirical studies.

Gains from trade arise as goods and services are produced more efficiently and sold more competitively. This saves resources which can be used to produce additional goods and services. Real incomes rise as prices are reduced and as extra goods and services are produced. These gains, which are of course conditional upon the released resources being effectively re-employed, stem from three sources.

Most long established in economic literature is the notion of comparative advantage. Countries or regions endowed with different relative skills or natural resources gain by specialising in producing those goods or services for which they have the comparative advantage.

A different notion is that a wider market allows producers to achieve full advantage from economies of scale in production, R&D and marketing. Specialisations develop, leading to trade. Countries with similar endowments in skills and natural resources also find it

beneficial to trade in this way. Much trade in the European Community is of this kind.

The question of economies of scale is linked to the third issue, that of concentration in the structure of industry and competition. With gains from increasing returns to scale come also dangers with fewer enterprises in a given branch, and oligopolistic or monopolistic market conditions. This in turn means less pressures for available efficiency gains to be achieved, and when they are achieved, risks of super-profits and difficulty of market entry on the part of those outside the oligopoly. Accordingly, an effective competition policy is crucial to the process of securing welfare gains from increased trade, and particularly so in relation to trade that exploits economies of scale rather than comparative advantage.

A fuller presentation of these concepts is given in the essay by Paul Krugman in Annex A, which also gives references to more detailed and technical sources.

In practice, trade within the European Community grew rapidly as a share of total intra- and extra-trade and as a share of GDP until about 1972. Since then, only the new Member States have seen major increases in intra-Community trade. For the original Member States, the stagnation of the share of intra-Community trade in GDP coincided with the slow-down in the macroeconomic growth rate. What can be said about the significance of the growth and then stagnation of intra-Community trade for the Community's general economic welfare?

The most detailed attempt to make a bridge between microeconomic studies of trends in trade and a macroeconomic assessment has been provided in a study by Owen(11). Based on detailed studies of some major manufacturing industries such as cars, trucks and household consumer durable goods, it was estimated that increased trade generated gains in economic productivity equivalent to 50 to 100% of the value of the additional trade. These figures may at first sight appear to be high, but are explained by the economic efficiency gains embodied in the entire production of sectors opened to effective competition, whether

that production is exported or domestically sold. When trade becomes an important share of the total market, as is now the case within the Community for many manufactured goods sold to the private sector, production for the home market must respect conditions of external competition.

With the aid of further calculations scaling these findings in relation to the magnitude of total trade expansion, and the extent of induced pressures on the productivity growth also of service sectors, Owen's study concluded with a macroeconomic estimate of the total gains for the original six Member States of the Community. This was the expansion of intra-Community trade since the inception of the EEC was associated with gains in productivity of the order of 3 to 6 percent of total GDP.

Most of these gains took place in the years to 1973. Since then, among the original six Member States, there has been stagnation or even some decline in the share of intra-Community trade in the total of all trade. These trends have been documented in detail for individual countries and product categories([12,13]). Underlying the slight decline since 1973 in the average share of intra-EC imports in total EC imports for manufactured goods, the original EC Member States have seen a more pronounced reversal of their previously fast-growing intra-EC trade trends. The newer Member States have in recent years been converging on the original Member States in their trade structures, as intra-EC tariffs were eliminated. The United Kingdom's trade structure has been converging strongly on the pattern of the other larger Member States. No doubt the new Mediterranean member countries will also follow this pattern. There is already evidence to this effect.

As regards the sectoral composition of these trends, the declining performance of intra-EC trade in relation to extra-EC imports is most sharp in the fields of mechanical and electrical engineering, electronic products, and transport equipment. These are typically branches with fast growth rates of demand in total world trade. By contrast, intra-EC trade has performed relatively more strongly (i.e. stagnated rather than declined) in intermediate products such as foodstuffs, textiles,

.../...

leather, timber, paper and non-metallic minerals and chemicals. These are in most cases product categories that are protected in the EC market either by the Common Agricultural Policy or by the high level of transport costs. Intermediate products are less subject within the Community to non-tariff barriers such as unharmonised technical standards, and government procurement restrictions. By contrast, the potential for continuing trade growth appears to lie especially in branches which have a high R&D content and high level of skilled labour in their value-added. It is these industries that suffer especially from non-tariff barriers.

Thus, while the initial trade-creating impact of the Community was associated with macroeconomically substantial gains, this impetus came to a halt in the course of the last decade, both at the level of market opening measures and actual trade expansion. The new internal market programme, as set out in the Commission White Paper of 1985([1]), could represent a fresh impetus of macroeconomically significant proportions. The size of this possible impact cannot be asserted with any confidence. Some estimates([14],[15]) suggest that there could be a significant increase, over a period of years, in the growth rate of the industrialised countries as a result of a radical dismantling of trade barriers. While these estimates may be only very approximate, there is no doubt that the macroeconomic gains from increased trade in the Community, or opportunity costs of foregoing this, would be substantial.

## 5.2 Systemic Issues in Completing the Goods and Services Markets

### 5.2.1 Tariffs and quotas

The European Community's first major achievement was to eliminate tariffs and quotas on intra-Community trade. However, in recent years, certain frontier tariffs and subsidies and quota restrictions on production have been reintroduced in sectors which were at the heart of the Community's foundation: agriculture and steel.

.../...

In agriculture, a system of border tariffs and subsidies, known as monetary compensatory amounts, was introduced in the nineteen-seventies to prevent exchange rate changes from immediately affecting the level of support prices expressed in national currency terms. These border adjustment were originally viewed as being (a) temporary and (b) attributable to disorder in the exchange rate system. They are now 13 years old, surviving the fact that the European Monetary System has largely re-established order in the exchange rate relations of the Community. In January 1987, the monetary compensatory amounts for the main products (beef, milk, cereals) were in the range of +1.8 to +2.9% for Germany and the Netherlands, 0 for Belgium, -1.1 to -2.1% for Italy, -1.5 to -8.0% for France and -18.4 to -26.3% for the United Kingdom. The pluses represent export subsidies or import taxes or the amounts by which national support prices are higher than the theoretical Community level in some countries; the minuses indicate the lower support prices. Average effective agricultural prices are on average about 4% below their theoretical ECU level, with support prices in Germany and the Netherlands therefore about 6 1/2% above the average.

The Community's subsidisation of an above-average level of farm prices in Germany and the Netherlands is in contradiction with the laws of comparative advantage, as comparatively efficient agricultural producers in the rest of the Community are denied the possibility to increase market share. In a system which guarantees both purchase and price of unlimited quantities, the concept of comparative advantage is hardly relevant. However, with budgetary and production limitations now pressing hard upon the common agricultural policy, the issue of how to allow for comparative advantage to prevail becomes relevant again.

Production quotas have been introduced for milk. Operated at the level of the individual farm, these quotas suppress competitive pressures and structural change within national economies, not just between them. The production quotas for milk have been announced as temporary measures for five years. However, the value of the quotas quickly become capitalised, which makes their removal increasingly difficult. As a second-best policy, it is argued that this quota system enables production to be cut more quickly and surely, thus helping ease the problem of dumping surpluses on world markets.

.../...

The system of production quotas in the steel sector was established in 1980 under the temporary "manifest crisis" conditions that were recognised at that time. By 1986, some small steps were decided for phasing out the production quotas, with certain products amounting to about 20% of all steel production being liberalised. The Community and Member States have also been programming together capacity reductions and the phasing out of state subsidies. However, in the meantime, steel users are faced with non-competitive input prices, steel producers proceed with their "rationalisations" without having to face fully competitive conditions either internally or externally.

Other internal quota systems are also sanctioned by Community policies. Under the multi-fibre agreement of the GATT, the Community has negotiated a matrix of bilateral quotas for individual textile products, specified by each Member State of the EC and 45 textile exporting developing countries. The Common Fisheries Policy determines tonnages of total allowable catches for the fleet of each Member State, but this is more defendable on conservation gounds. There is also between countries a system of bilateral road haulage quota (permits) which is, however, being liberalised gradually (see further below).

Elimination of these restraints on competition in agriculture, steel, fisheries and textiles hardly feature in the White Paper, but are of much greater economic importance than many of the smaller new initiatives proposed. These sectors account for about 6% of total GDP in the Community as a whole. Quotas on production or trade are an extreme form of protection or market rigidity and deny the possibility for the Common Market to deliver its potential benefits. These quota regimes have tended to emerge in sectors suffering from crises of excess capacity. Some of these industries or agricultural branches are fields in which the new Member States might expect to increase their market shares on grounds of comparative advantage, and the Community should indeed assure these countries fair opportunities for expansion as their economies are subjected to the full impact of Community competition. The only proper solution to this problem is to avoid creating new quota systems in the organisation of Community markets, and to phase out existing systems in a fair way.

.../...

### 5.2.2 Competition policy and subsidies

The White Paper is also only brief on this subject, doubtless because Community powers here are already substantial.

The increase in subsidies to industry, while difficult to assess in monetary terms for statistical reasons, is evident in the number of cases notified by Member States to the Commission. Until the early seventies, the number of annual notified cases was 20 to 30, this covering both aid regimes and individual cases. In 1977, the number passed 100, and in recent years has risen to between 150 and 200. The Commission has in recent years taken negative decisions on about 20 cases per year, whereas in earlier years the normal number was 1 to 3. However, the amount of industrial subsidies appears now to be beginning to decline again as budgetary constraints have tightened and the philosophy of public policy has become more critical.

The Commission's policy, following the Treaty, has been to object to state aids which distort competition, but not to other aid regimes. This is in line with the principle that the Community should be concerned where there are important effects on external trading conditions. In practice, Community policy towards state aids has been mainly concentrated on regional aids, subsidy regimes specific to certain sectors of industry, employment subsidies and R&D subsidies.

Regional aids in particular are viewed relatively favourably, subject to a Community regulation of the zoning of regions within each Member State, and respect of maximum rates of grant equivalent for zones with different degrees of regional handicap.

As regards sector-specific aid regimes, the cases of coal, steel, cars, ship-building and textiles have been the most important. The general criteria used by the Commission to evaluate such aids include whether capacity reduction is planned, whether the amounts of aid are limited in time and degressive, whether the firms participate in the financing of investment, and whether the firm is likely to regain financial viability in due course. The regime for coal subsidies is less stringent than some

others, and this is justifiable since production is declining in all countries and there is no problem of Community excess capacity. Aids to the textile and steel sectors have now been largely phased out, after a long adjustment period. Recent Community agreements limit aids to ship-building to 28% of the value of sales.

In 1985, the Commission adopted a new approach towards R&D expenditures, which in general terms was more positive towards state aids of this type because of their strategic importance in industrial policy. A high ceiling of 50% was established for the maximum amount of public aids contributing to the research programmes of private enterprises. Also, competition policy towards private enterprises has become more favourably disposed to collaborative R&D projects of Community interest.

Aid regimes for small and medium-sized enterprises are on the whole favourably viewed by the Commission, since they imply relatively small effects on external trading conditions. Employment aids for training and youth employment are also viewed favourably, but employment subsidy regimes which are firm- or sector-specific are viewed critically.

<u>Commission policy towards subsidies appears in general to be managed in conformity with the most relevant principle, that is the effective importance for trading conditions between countries. Where these effects are weak, national governments must be the arbiter of wise versus unwise subsidy policies. However, there are two policy issues to which further attention is given later: (i) how the general thrust of Community competition policy should be affected by the internal market programme, and (ii) how to respond to a manifest practical problem faced by the Commission with its limited staff in handling the enormous number of aid schemes that exist.</u>

### 5.2.3 Government procurement restrictions

Government procurement is estimated to amount to nearly 200 billion ECU per year in the Community, or about 6% of GDP. This figure is probably an underestimate, since it does not cover all state enterprises. It includes defence procurement, which amounts to about a quarter of the total.

There can be no doubt that government procurement is to a large extent done on terms that are internationally weakly competitive. The import content of government procurement tends to be in the range of 10 to 20% on average for the larger EC Member States, according to the type of product. For the whole economy (i.e. private and public purchases) the import content for the same product categories averages 15 to 50%. By contrast, in small very open economies, such as Denmark, the import content of government procurement is much more similar to the economy-wide average. Studies of price differences between countries of the Community for products bought by government suggest that economies of the order of 25% are often foregone in not buying at the lowest costs offered on competitive markets. These various indicators suggest that economies of the order of 1 to 2% of GDP could be obtained through competitive government purchasing in the Community.

Competitive tendering is required by Community directives for public purchasing in general terms, but important sectors are excluded (energy generating and transport equipment, telecommunications, water supply equipment). In addition, the effectiveness of existing directives, even for the included sectors, is weak with most contracts not published in the ways required and negotiated without open competition. To counter these problems, legislation was passed in December 1986 to ensure more transparency in tendering procedures. Commission proposals are being prepared for extending the coverage of Community directives to the excluded sectors.

Under the Single European Act, the passing of legislation in this field comes under the qualified majority voting rule. In addition, the Community's Treaty powers in the area of competition policy (Article 90) allow the Commission some scope to take action against uncompetitive practices irrespective of the extent of such directives.

Some advances are being made currently in the opening of procurement for the difficult but important field of telecommunications equipment. The policy approach here is a complex and progressive one: concentration on new products, introduction of minimum quotas for open procurement, links to technical standardisation, the combination of Community finance and

.../...

open procurement rules for some large cross-frontier projects. This example suggests that in sectors of strategic importance more is required to open markets than a simple legalistic approach.

The scene is therefore set for the Community to make significant progress in opening up competition in the public procurement area. This could also subsequently put the Community in a more favourable position to negotiate in the GATT improvements to the weakly effective international code in this field. The restructuring of several industries, like energy generating equipment, railway equipment and office machinery, could be quite drastic as a result. This also has implications for strategic industrial policies and policy towards state enterprises and privatisation, which is discussed more directly later.

**5.2.4 Technical standards**

Community policy and decision-making methods towards the removal of technical barriers to trade have been undergoing major reform since 1984. The Community's traditional approach was based on harmonisation directives which had to be agreed by unanimity. By the end of 1983, 158 directives had been adopted by the Council. But this was slow progress, with new national technical regulations accumulating at a much faster pace. For example, in the field of voluntary technical standards, the German DIN institute had by 1983 produced a total of 23000 standards, and equivalent organisations in France and the United Kingdom have together accumulated as many again(16).

In the early eighties, it was evident that a new approach was called for(17). The White Paper confirms and reinforces a set of principles that emerged in 1984 and 1985. Three of the most important were: (i) concentration of the Community's actions on satisfying objectives for the health and safety of citizens, rather than on comprehensive regulatory requirements, (ii) wide application of the principle of mutual recognition of national tests and certification, and (iii) a strengthened capacity to produce European standards where appropriate,

partly through endowing relevant technical organisation (CEN*, CENELEC**) with powers to draw up European standards on a qualified majority voting basis. The Single European Act further strengthens the capacity of the Community to act in this area, since future directives for technical standards can now be adopted by the Council by qualified majority vote.

At the present time, the new mutual recognition approach is being tried out on a number of test cases. The length of technical texts for adoption by the legislature is reduced drastically, which is highly desirable. Also to be welcomed is the increasing emphasis placed upon the setting of standards for new products, such as telecommunications and microelectronics. The capacity of European public and private sectors to establish critical norms early in the product development cycle is an important aspect of the Community's strategy for industrial competitivity world-wide.

### 5.2.5 Transport services

Until recently, almost no action had been taken by the Council to free road, sea or air transport from a mass of restrictions on market entry and effective competition. This even led in 1985 to an action brought in the European Court of Justice, which found that the Council had neglected its duties in this area. Recently, some liberalising action has been taken. In 1986, it was decided to raise the number of permits for road haulage in the Community by 40% per year until 1992 to the point that competition in international trucking would increasingly become effective. In 1986, the Council agreed measures to open up competition in maritime shipping between countries, but left coastal shipping services within Member States unliberalised.

The Community has long been concerned by the subsidisation of railways, but has had little success with efforts to control this field. It may

---

* Comité Européen de Normalisation
** Comité Européen de Normalisation Electronique

.../...

be doubted whether the Community should attempt to do so. The motivation of these subsidies comes from a mix of social and regional policy objectives which are not strongly relevant to the Community, and their economic impact is quite diffuse.

Civil aviation is now easily the most important target of Community transport policy. It has still seen only small progress in the introduction of competition, in spite of a considerable build-up of negotiations in the Council, and warnings of legal actions that the Commission may bring against governments and airlines. Scheduled air transport in Europe has been restricted by a very comprehensive array of barriers to competition: prices, revenues, capacity and market entry have all been fixed in a web of bilateral agreements between governments maintained under the 1944 Chicago convention. This system has only been departed from in the Community under the highly circumscribed 1984 directive for scheduled inter-regional air services. As a result, prices must be substantially higher and service substantially poorer than would obtain in a competitive market. Comparison between the densest routes in Europe with similar routes in the United States show higher prices in Europe of the order of 40 to 75%. Moreover in Europe 50 to 60% of passengers pay the full price, whereas in the United States, only 15% do so. The economic and social problems of restructuring the civil aviation business are not particularly difficult by comparison with many other branches of the economy. Employment issues are relatively slight, in the sense that service networks will have to remain in all countries and regions. Major resources, such as aircraft and skilled personnel, can move between enterprises more easily than in many industries.

The Single Europe Act means more scope for majority voting in the transport field. The jurisdiction of the Community in the field of civil aviation has been clarified and extended by recent Court of Justice decisions (<u>Nouvelles Frontières</u>, etc.). The slow progress in the Council over liberalising civil aviation has led some countries (the United Kingdom, the Netherlands, Belgium, Germany and Ireland) to make bilateral agreements, freeing market entry and prices on certain routes. These agreements have some potential for putting pressure upon

.../...

other governments whose airlines may lose market share as a result. This is an example of the possibility to introduce competition among rules of public policy (this is discussed as a general principle later).

The freeing of transport services for open competition is of critical importance for the whole of the Community to facilitate commercial integration and also to advance the "people's Europe". It is particularly in the interests of peripheral regions and countries as a means to overcome locational disadvantages. These market liberalising measures are therefore particularly favourable to the cohesion of the Community.

### 5.2.6 Financial Services

Insurance, banking and the marketing of securities add up to a sector of the economy that accounts for around 7% of GDP, a share which is growing strongly. The economic importance of the financial services sector is even greater when account is taken of the size of capital flows that it intermediates, the risk of instability that is inherent in financial markets, and the links between finance and all the other fields of economic activity.

The liberalisation across the Community of the financial services industry is conditioned by three special factors. First, the supply of these services is deeply tied in with the ability to move capital freely from one country to another. Secondly, the world market dimension to financial markets is a dominating factor. Thirdly, technological change is currently causing a profound restructuring of the industry. Indeed, the three main branches - insurance, banking and securities markets - are tending to become more closely integrated where liberalisation has gone farthest.

These factors have profound implications for the design of policies of regulation and supervision of these services. The opening of capital markets and technological advances in the world-wide electronic transfer

.../...

of funds means that all countries have to be more concerned with the soundness of the international system. On the other hand, the rapidity of technical and structural changes within the industry means that supervisory authorities have to be able to react very flexibly to new situations.

The strategy for financial services proposed by the Commission basically consists of two elements. First, the harmonisation of essential requirements on prudential controls and the protection of the investor, depositor and consumer; second, freedom to provide services of the whole Community by any company established in a member country on the basis of the principle of mutual recognition and "home country control", meaning that foreign financial products or institutions should be monitored by the supervisory authorities of the country of the parent company.

As regards insurance, the right of establishment in other member countries has been secured. However, except in the case of co-insurance, there has been little progress on freedom to supply services across frontiers, and national markets therefore remain largely segmented. Insurance companies in one country cannot directly contract in another country. Partly as a result of this, premiums for insurances covering virtually homogeneous risks, like fire insurance policies, vary widely from country to country. Important test-cases were taken by the Court of Justice in this area in December 1986. Basically, the Court refused to endorse the full opening of the insurance market in the absence of further legislation by the Council that would harmonise essential regulations concerning prudential standards. By contrast, in the area of co-insurance, the Court judged that the existing Directive was sufficient to justify open competition on the basis of the "home country principle".

The integration of banking is more advanced than in the case of insurance. The right of establishment, as in the case of insurance, has been secured, but its full exercise is still subject to restrictions. Where capital movements have been liberalised, there is generally

freedom to supply banking services. Nevertheless, the market is still far from fully integrated. The definition of activities permitted to banks varies widely from country to country, and so do regulations regarding solvency and liquidity ratios, reserve requirements, concentration of risks, etc. In preparing proposals for Community legislation in these areas, account has to be taken of steps towards international harmonisation world-wide.

Within the Community, banks of one Member State wanting to conduct business in another may still face restrictions on the ability to establish a subsidiary or the number of branches of a foreign bank and their location may be circumscribed. There are unnecessary entry-cost barriers to setting up branches in most member countries. Foreign banks may also suffer from discrimination impeding them from competing on an equal footing for the management of local issues of securities.

Progress in legislating the minimum harmonisation requirements in these services will lead next to the question of how the regulatory and executive powers should be organised in an integrated market. According to one traditional model, the Commission would be responsible for the implementing regulations of Member States, while the Member States would be responsible for the executive responsibilities. Such a complete separation would probably harm the smooth functioning of the single financial services market. It therefore may be advisable to make an exception to normal Community institutional rules and entrust a mixture of regulatory and executive powers to technical bodies (like the EC Banking Advisory Committee) which group together national experts and the Commission.

<u>In general, the opening of the internal market for financial services will have very far-reaching implications for the regulatory and supervisory authorities. The Community will no doubt have to be prepared for considerable innovations in its models of harmonisation, mutual recognition and coordinated supervision in order to handle the dimensions of the task - namely the combination of very rapid technical change, prudential risks of a high order, and strong links to monetary policy.</u>

**5.2.7 Indirect tax harmonisation and fiscal frontiers**

Introduction of the value-added tax, and elimination of a host of earlier sales taxes, has been the Community's major achievement in the tax harmonisation field. The value-added tax has the important quality of neutrality with respect to resource allocation, especially by comparison with the taxes it replaced which often had uncertain and arbitrary incidences (e.g. the cumulative turnover tax), or were used for purposes of trade protection.

The "White Paper" now seeks an approximation of value-added and excise tax rates with a view to suppressing fiscal obstacles at intra-EC frontiers. Details of these proposals are expected to be published soon by the Commission.

For the VAT, the "White Paper" outlined two proposals, intended respectively as interim and final solutions to this problem. The interim solution would be for value-added tax assessment to be made "inland" rather than at the frontier for enterprises which make value added tax returns. This is the proposal of the so-called 14th VAT directive. It is already the method used in the Benelux. According to this system, the VAT payment due at the time of import is delayed until the importer makes his general VAT declaration.

For the definitive regime, the White Paper proposes both a negotiated approximation of VAT rates within bands, and a change in the principles of VAT collection. Importers would buy goods inclusive of the VAT of the supplying country, rather than VAT-free at present. However, a clearing mechanism between fiscal administrations would return to the importing country the VAT revenues paid to the exporter.

In the absence of detailed proposals and supporting analysis, the Group has not attempted to evaluate the strategy outlined by the Commission. There are important empirical issues to be clarified, for example the relative administrative costs of the different proposals for VAT, and the extent to which indirect tax differences can be accommodated with the effective suppression of frontier controls without excessive trade

.../...

distortions. Where VAT differences can be offset by other differences in tax burdens, labour costs or exchange rate adjustments, it is not particularly important that VAT rates be harmonised from the point of view of production costs. This is separate, however, from the question of how much cross-frontier shopping might follow from the suppression of fiscal frontiers, taking into account voluntary adjustments of tax rates that countries suffering revenue losses might make.

It may be noted that the United States has open state frontiers despite wide differences in some excise duties such as tobacco. Sales taxes there range from zero to 7 1/2% and are not levied on out-of-state sales. Theoretically, these inter-state fiscal frontiers are not abolished, and the Community's approach to what constitutes abolition of fiscal frontiers should similarly be reasonably pragmatic.

<u>The objective of suppressing fiscal frontier controls should be supported, and given effect in ways that minimise the burden of indirect tax harmonisation. Fiscal harmonisation is one of the few areas of internal market legislation in the Community that still requires unanimity.</u>

# 6. LABOUR MARKETS

## 6.1 Labour migration issues

Drafted at a time of nearly full employment, the Treaty of Rome viewed labour markets essentially in the context of the common market, and thus laid down the right of Community nationals to work or to be self-employed in any Member State. The Treaty was also concerned with the extra retraining of labour required by the structural change associated with increased trade, hence creation of the Social Fund.

There are several economic arguments which point to benefits from the mobility of labour. Where the marginal productivity of labour is different as between regions, migration will increase the income of the individual and of the aggregate economy. Migrants' remittances to his home region may also mean that all regional economies benefit, although this is not necessarily always the case. The mobility of labour can also help the economy to adapt to structural changes, especially where exchange rates are fixed or nearly so. These arguments are usually related to the case of substantial net flows of migrants from depressed regions to buoyant regions.

A different pattern of migration, and one which may be increasingly pertinent for the European Community, is one in which there are fluid exchanges of individuals with particular skills in all directions, without particularly significant net flows of mass migration. This second pattern is analogous to the distinction made in trade theory between inter-industry and intra-industry trade. The latter category confers benefits through increasing competition and specialisation at fine levels of economic detail.

These general economic arguments are relevant to how the figures on migratory movements are to be interpreted, and how the Community's policies towards labour movements should be viewed.

Direct barriers to the migration of workers and the self-employed have been effectively eliminated among the first nine Member States. For the three newest Member States, the same rights will be fully applicable from 1988 for Greece, and from 1993 for Spain and Portugal. Until these dates, work permits may still be required before employment offers can be accepted.

The Community has also gone far in establishing rules for the coordination of national social security systems to prevent migrant workers from within the Community suffering discrimination or loss of cumulative benefits. This coordination system covers all the major branches of social security (sickness, old-age pensions, unemployment benefits, etc.).

Recent policy initiatives have sought to enlarge the list of protected professions for which the mutual recognition of qualifications is accepted between Member States. Doctors, dentists, vets, mid-wives, architects etc. are now mutually recognized and the self employed have rights of establishment. Further proposals are being discussed. The principle of maximum mutual recognition, to minimise the burden of harmonisation, deserves full support in this field.

Much remains to be done in some major grey areas, where formal barriers may be less important. The mutual acceptability of vocational training qualifications, the mobility of students and the openness of university appointments are all areas to which the White Paper draws attention, and where new initiatives are envisaged.

These actions to open up the professions and exchanges in higher education are very much what is needed to facilitate migratory movements of the intra-industry category, rather than that of the mass migration category. The former category is surely in line with needs of the modern economy, and much less problematic politically than mass migration. Many scientific and academic professions in Europe explain their relative weakness compared to the United States in terms of the small size of segmented national markets in Europe. The economic losses for Europe occur not only through the relative weakness of

.../...

specialisation and competition, but also through substantial "brain-drain" emigration to the United States of Europeans who do attain professional eminence at the world level.

While statistics on migratory movements are not very good, it is clear that mass migration with Europe has stopped in the last decade. Greece, Spain and Porgual have all ceased to be countries of net emigration, although it is possible that when the transitional restrictions are removed in 1988 and 1993, renewed migratory flows may occur. Within the orginal Member States, Italy has during the past decade become a country of re-migration home. Immigration from outside the Community is now severely restricted, except that for Turkey special arrangements exist by virtue of the association agreement between the Community and this country.

The fact that mass migration has stopped does not at all mean that the freedom of movement of labour within the Community is no longer an important matter. On the contrary, it is increasingly important to assure truly competitive labour market conditions at the microeconomic level of individual professions and skills, since this complements the particular structure of intra-industry trade flows that is predominant within the Community.

**6.2 Wider labour market issues.**

The Community institutions are concerned with a wide range of labour market issues, but it is controversial how extensive these responsibilities should be.

In the social policy field, there has been some Community legislation on health and safety regulations, and some also on employment regulations (equal pay, conditions of collective dismissal). Further regulations have been proposed by the Commission but not accepted yet by the Council (e.g. on conditions of part-time and temporary work, and parental leave). As regards social security regimes, there has been no attempt to harmonise with Community directives, but this is sometimes advocated in political debate, for example through the setting of minimum

.../...

standards of benefits.

As regards labour market measures such as vocational training and job creation initiatives, the Social Fund is active in funding, usually at a rate of 50%, schemes that meet criteria negotiated at the Community level. The resources of the Social Fund are quite small in relation to national actions of the same kinds. The Social Fund's original purpose of supporting the retraining of workers because of the opening of markets has become increasingly hard to separate from the vaster problem of mass unemployment. (These issues are further addressed below in the context of reform of the structural funds).

The case for and against Community intervention in these various aspects of labour and social policies may be guided by two principles:

(a) the importance of cross-frontier spill-over effects, i.e. whether the policies in question have sharp external effects, or are primarily of domestic concern; and (b) the priority need to find solutions to the problem of unemployment.

As regards health and safety regulations, the Community has a reason to be involved where these have a sharp influence over the location of investments. The production of dangerous products or processes, such as certain chemicals or nuclear materials, should clearly not be allowed to concentrate in countries that might be prepared to adopt lax standards. In this kind of case, cross-frontier effects may be important, and so Community regulations would be warranted. Otherwise, maximum recourse to mutual recognition of standards, as advocated in the White Paper, is recommendable.

Social security systems and employment protection laws are highly relevant to the employment question. They contribute significantly to labour costs, either directly or indirectly. They affect in important ways the reaction of the labour market to the unemployment problem. On the other hand, policy adjustments in these areas generate relatively weak external, cross-frontier impacts. These are arguments favouring a decentralised (national level) approach to policy in these fields.

.../...

Countries should be free to experiment with policy adjustment in the search of more efficient means of achieving the double objectives of a high level of employment and high standards of social security. Harmonisation of policies would not seem to be recommendable, especially where the initial situation is one of massive labour market disequilibrium. Where policies are seen to be successful, convergence is to be expected. The processes of social dialogue at the Community level, between employers, trade unions and government, can help this convergence materialise.

<u>The principle of subsidiarity recommends minimal responsibility on the part of the Community for many aspects of social policy, but the question of convergence of labour costs is vital in the context of increasing monetary integration (and we return to this later).</u>

## 7. CAPITAL MARKETS

Open and competitive capital markets are an integral part of an efficient process of allocation of resources. Enterprises need to be able to decide upon their investment and commercial strategies without the constraints of segmented, and therefore locally limited, capital markets. Savers need to be able to choose their most profitable investment strategies across the entire economy. Only an open capital market can provide adequate information to enable an efficient allocation of resources to take place in a given economic region.

These are the reasons why the abolition of obstacles to the free movement of capital is stated by the Treaty of Rome as one of the fundamental components of the Common Market.

The implementation of this part of the Treaty made rapid progress with two directives approved in 1960 and 1962, but stood still or regressed thereafter. In the late 1970s, only Germany had a completely open capital market, while extensive restrictions were operating in France, Italy, the United Kingdom, Denmark and Ireland. Safeguard clauses provided for by the Treaty of Rome (art. 108) were widely used, and tolerated by the Commission, to effectively reestablish several of the obstacles that had been removed by the 1960 and 1962 directives.

Meanwhile, starting in the late 1950s, the Euro market, based initially in London and Luxembourg as an "off-shore" dollar capital market to evade certain regulations in the United States, grew to a very large size, became diversified in its currency denomination, and in many ways performed the function of an integrated international market. By 1985, the size of the international money market in EC national currencies and ECU was over 260 billion ECU. The Euro-DM money market amounted to around 35% of the German M3 money stock. The relative size of the off-shore market was, however, still minor for other currencies like the French Franc or the Italian Lira with respective magnitudes of 3% and 0.5%. The international bond market in European currencies in 1985 saw over 320 billion ECU of bond issues compared to 335 billion ECU of domestic bond issues in Member States (exclusive of Belgium and Luxembourg).

A survey conducted by the Bank of England in March 1986 estimated that turnover in the London foreign exchange market averaged $90 billion a day, compared with $50 billion in New York and $48 billion in Tokyo. Out of the $90 billion turnover, only 9% was accounted for by transactions carried out directly with non-bank customers (although it should be noted that a single transaction with a commercial customer may give rise to a number of other foreign exchange deals in the currency market). These daily turnover figures are enormous compared to the daily average of the value of world exports and imports of goods and services in 1985, which equalled some $15.5 billion.

Since the mid-1979 dismantlement of exchange controls in the United Kingdom, a new trend of liberalisation was set that gradually spread over the whole Community. The openness of national markets, however, is still uneven between Member States. Germany, the Netherlands and the United Kingdom are completely open. Belgium and Denmark are very largely, though incompletely, open. In France, important measures of liberalisation were decided in 1986. The other Member States retain an important array of controls, but are gradually removing existing restrictions.

For the four largest EC economies, gross capital flows (average of in and outflows) in 1984 ranged between 15 billion ECU in the case of Italy to 50 billion ECU in the case of the United Kingdom, amounting to 3% and 8% of the respective GDPs. Net capital flows are relatively small in relation to the gross flows (typically ranging from zero up to half the size of the gross flows). This fact, however, does not mean that their economic significance is correspondingly slight. As in the case of migration of labour, the two way flow of production factors across frontiers are largely part of the process of competition and specialisation at the microeconomic level. Thus, analogues to the distinction between inter-industry and intra-industry trade is found in all three branches of the common market: trade, labour and capital. Also, interest rates on domestic markets have shown a tendency to converge and to move together, a further indication that financial integration is progressing within Europe.

The process of creating a single European capital market had been delayed by the difficulty of reconciling it with an exchange rate constraint (first determined by the Bretton Woods system, and later by the EMS), with non-convergent macroeconomic developments, and a desired degree of national autonomy in the conduct of monetary policy. In 1983, a Commission Communication on financial integration reopened the debate on these issues at the Community level. Capital liberalisation was taken up actively in the White Paper.

The Community's actions in this area fall under four headings:

(i) directives to remove obstacles on capital movements,

(ii) regulatory requirements to ensure the stability and efficient functioning of capital markets,

(iii) tax harmonisation measures to remove fiscal distortions, and

(iv) borrowing and lending activity conducted directly by the Community institutions.

To remove obstacles to the freedom of capital movements, a directive was passed by the Council in late 1986 enlarging the categories of capital transactions that are subject to the unconditional obligation of liberalisation (adding share capital and bond issues, and long-term trade credits to the prior list). The Commission has undertaken to formulate in the first half of 1987 a further proposal on how to proceed to total dismantling of exchange controls. This ultimate step would have major implications for the economic and monetary system of the Community. We return to these issues later in this report (section 12.1).

As regards regulatory requirements, some useful steps have been taken at the Community level to harmonise company accounting and auditing standards. For example, Member States are currently implementing a 1983 directive requiring the publication of consolidated accounts, which is a basic information requirement not earlier satisfied in several Member States. The 1980 directive on the coordination of prospectus requirements for the listing of shares on stock exchanges does not provide for the total harmonisation of listing conditions. A Commission proposal for the harmonisation of public offer prospectus requirements

for various sorts of securities is in an advanced stage of negotiation in the Council. This proposed directive draws once more on the mutual recognition principle. This and other recent Commission proposals in this area would facilitate further the access of firms to the capital market of other Member States. Further Commission proposals on "insider dealing" and the freedom to supply investment services are expected later in 1987.

As regards tax harmonisation, the Commission made proposals on corporation tax systems as long ago as 1975, but no agreement has been reached in the Council. However, corporate taxation and the related issue of capital taxation are of the greatest importance, as they may shape the financial system and may divert capital flows from the most efficient uses. In the course of 1987 the Commission will set out its current thinking on how to progress on company taxation. Our own views on the reform of corporation taxes on a harmonised basis are set out in section 11.3 and Annex B.

The Community's own borrowing and lending activities have grown rapidly, from a small base, in recent years. The total of such operations never exceeded 1 billion ECU per year before 1974, but rose to the 8 billion ECU level by 1985. Impetus for this expansion came from the operations of the European Investment Bank and the New Community Instrument (a borrowing power of the Commission) in the less prosperous regions of the Community, and from loans for energy, infrastructure and small and medium-sized enterprises. The Community institutions borrow on the most favourable terms in international capital markets and on-lend in countries whose enterprises or public authorities could have difficulties in attracting this capital on comparable terms, thus deliberately reaching over the barriers represented by national capital market controls and limited local capital markets. The management of Community borrowing and lending activities has so far succeeded in combining the function of effectively promoting investment with the requirement of following orthodox banking criteria. The Community institutions have also taken a leading role in the marketing of ECU denominated financial assets on international capital markets, an aspect of capital market integration that links to the development of the European Monetary System.

.../...

The integration of the Community's capital market is a multi-faceted task, involving the liberalisation of capital movements, the harmonisation of certain regulatory requirements, tax harmonisation issues, and direct borrowing and lending operations by the Community institutions. A considerable momentum of efforts to progress along these general lines has now been established, but much remains to be done.

.../...

## 8. MACROECONOMIC POLICY

### 8.1 European Monetary System

The Community's first attempt at monetary integration did not survive in a stormy international economic environment. Following the adoption of the objective of economic and monetary union at the Community summit of March 1972, a Community exchange rate system was inaugurated in April of that year. This was the so-called "snake in the tunnel", whereby Community currencies were to respect 2 1/4% fluctuation margins amongst themselves, within a set of wider parities related to the dollar. When the dollar floated in 1973, the Snake was left to function on its own. Shortly later, the Pound, Lire and French Franc left the Snake, with the French Franc subsequently entering and leaving again. Economic policy strategies in the wake of the first oil shock were very divergent, and the shrinking of the Snake to a grouping of a few currencies of small countries around the Deutsche Mark reflected this.

The Community's second attempt, the European Monetary System (EMS), has been far more successful. It adopted the 2 1/4% fluctuation margins from the Snake, with Italy, however, joining with wider 6% margins. The European Currency Unit (ECU) was given a central place in the System, for example in relation to the mechanisms for parities, reserves, credit and the "divergence indicator". All the then Member States joined fully except the United Kingdom, which has remained on the outside edge of the system (the Pound is in the ECU and the Bank of England participates in the ECU creating mechanism, but the pound is not in the exchange rate mechanism). The EMS has proved to be a stable system notwithstanding the fact that shocks from the oil market and dollar exchange rate movements, comparable to those of the early 'seventies, have been hitting the system repeatedly since it was set up in 1978. Some commentators have suggested that the EMS survived the second oil shock only because it coincided with a period of dollar strength and Deutsche Mark weakness, which helped the other EMS currencies to maintain their value relative to the DM. However, over the last two years, the dollar has lost much of its earlier gains, and the EMS has experienced only a

.../...

moderate increase in the amplitude and frequency of realignments of parities.

The success of the EMS in relation to its objective establishing a zone of monetary stability in Europe can be inferred from indicators measuring the variability of nominal exchange rates and the convergence price and cost trends among participating countries. Nominal exchange rate variability has been reduced. The average rate of consumer price rise in the EMS group of countries has declined steadily from over 11% in 1980 to 2 1/2% in 1986, compared to 3 1/2% in the nineteen-sixties. Nominal wage costs and unit labour costs have converged even more than in the nineteen sixties.

A traditional case for exchange rate stabilisation has been based on the reduced uncertainty offered to traders and investors, and hence the increased willingness to invest in production and marketing systems aimed at the whole of the market. To these microeconomic arguments must be added issues of macroeconomic stabilisation strategy. Adhesion to the EMS has given the monetary authorities of formerly weak currencies an anchor for price stability. Commitment to the EMS has given to these currencies some of the monetary stability features of the leading currency of the system, the Deutsche Mark. Since the disinflation process is only a gradual one, the countries with low inflation at the outset obtain a certain advantage in terms of competitivity. On the other hand, for the countries seeking to reduce inflation, pegging of the exchange rate on a strong currency can help lower the interest rate required for a given stabilisation strategy, thus lessening the macroeconomic adjustment costs of such a strategy. Also, the clarity of exchange rate commitments within the EMS has often given a valuable point of reference for the coordination of other elements of policy, notably as regards budgetary policy and labour cost trends. This was clearly seen in important policy adjustments in Belgium and Denmark in 1982, and France in 1983. Overall, the stability of the EMS, compared to the Snake, points to the central importance of having convergent domestic policies towards the reduction of inflation.

These comparative successes of the EMS should not lead to excessive satisfaction with the status quo. The evolution of the EMS has been disappointing so far in relation to its founders' intentions to move to

.../...

a second stage which would include stronger institutional developments. In 1982, there was extensive work in the relevant Community bodies preparing possible institutional advances(18). No agreement could be reached on this, and subsequent attempts to prepare packages of measures to strengthen the EMS have given only marginal results. The role of the ECU has advanced only in private markets, where a full range of money and capital market instruments have developed over the last four years. The EMS has led to very little strengthening of the Community's presence in international monetary affairs. The ECU has not emerged as the operational pivot of exchange rate relations between the United States, Japan and Europe.

The institutional fragility of the EMS will be tested in fundamental ways by the process of removing exchange controls, as envisaged in the White Paper. The degree of convergence of inflation rates and coordination of monetary policies will have to be raised to a very high standard, if the present exchange rate system is not to be destabilised. These issues are therefore taken up more thoroughly later in this report.

### 8.2 The wider system of economic policy coordination

The case for economic policy coordination rests upon the need to correct for biases in national policy making that tend to arise where the impact of policy adjustments tends to leak out across national frontiers to an important degree. For example, in a small open economy, budgetary actions intended to stimulate demand will see a significant part of the increased spending flow abroad, with costs to the balance of payments and less benefits for domestic activity. In such a situation, individual countries may take an unduly pessimistic view of the efficiency of budgetary policy adjustments. In the event of a coordinated stimulative action, these leakages of benefits would be partly offset, with each country importing as well as exporting benefits.

Analogous phenomena exist on the side of monetary policy. A country wishing to reduce its inflation rate as a first priority, and which tightens its monetary policy in an uncoordinated policy setting (i.e.

.../...

with a floating rather than managed exchange rate), will achieve extra price stabilisation benefits as a result of an appreciation of its exchange rate. However, the countries experiencing depreciating exchange rates will, as a result, be importing a price rising effect. Thus uncoordinated monetary policy may lead to a competitive process of monetary policy restrictions, leading to a more depressed international economy than policy makers had intended.

The Community's most systematic attempt to assure the coordination of budgetary policy is seen in the Council's Decision of 1974 aimed at the convergence of economic policies in the Community, known as the "1974 Convergence Decision"(19). According to this text, the Commission and the Council should work together to establish Community guidelines for the main aggregates of budgetary policy (budget deficit, expenditures, revenues) in quantified form. The Commission proposes a Community view of desirable national budget aggregates. The Council is required to adopt these guidelines, and bring them to the attention of national parliaments so that they can be taken into account in legislative processes. Mid-year reviews are provided for to examine whether these guidelines need to be maintained or revised. The guidelines, together with support analysis, is published in an Annual Economic Report.

In the course of over a decade's experience, the system envisaged under the Convergence Decision has revealed two fundamental weaknesses. One is quasi-constitutional, the second relates to the philosophy of economic policy.

The constitutional issue is how the Community institutions and national authorities are supposed to share responsibility for the policy-making process. The authors of the Convergence Decision would have the Council deciding on policy guidelines, with a view to these being taken into account by national authorities. However, the Council is composed of the same ministers who have responsibility at the national level. As a result, it establishes guidelines that are hardly different from current national policies. Moreover, in many countries, the budgetary authority is effectively in the hands of the Parliament, which may make it hard for ministers meeting in the Council to take fiscal policy commitments.

.../...

The Commission has the institutional independence to propose a view of how national policies ought, in its judgement, to evolve in the framework of a coordinated and consistent approach. But the Council cannot be expected, as a matter of regular procedures running twice or three times per year, to adopt alternative views of national economic policy.

The economic policy issue concerns the place of short-run and demand-side adjustments of budgetary policy. The 1974 Convergence Decision is clearly looking dated in relation to currently favoured views of how economic policy should best be managed. The frequency of procedural commitments in the texts is, at least as regards budgetary policy, in line with ideas of fine-tuning of the economy that were favoured over a decade ago.

In recent years, there has been a profound change of priorities in budgetary policy, with much increased emphasis on medium-term and supply side objectives for the main taxation, public expenditure and public debt aggregates. The cross-country impact of these strategic aspects of budgetary policy may be less immediate, compared to its short-run and demand-side aspects. Nonetheless there are still issues of common interest involved in the time-path and speed with which the major European countries implement such strategies, and the Economic Policy Committee of the Community has a role to play in evaluating these. Moreover, the adequacy of mechanisms in the budget for automatic cyclical stabilisation should not be neglected.

Constitutional regimes should, of course, accommodate a sufficiently wide range of political and economic conditions. They should certainly not be designed for fashions in economic thinking or ephemeral circumstances. In criticising the Convergence Decision for its dated view of fine-tuning of budgetary policy, the Group would not wish to go to the other extreme, and argue that the system should not envisage circumstances calling for coordinated adjustments of budgetary policy. The Group considers that some interpretations of the Concerted Action decided at the Bonn Summit in 1978 have been excessively critical.

A positive outcome of the Convergence Decision has been the production, in the Annual Economic Report, of a substantial reference document which combines several roles: presentation of economic forecasts on a consistent basis, an integrated view of economic policy at national and Community levels, including micro- as well as macro-economic policies, and an attempt to define a common strategy in relation to common policies. Thus the last two Reports have outlined a Cooperative Growth Strategy with a view to reducing unemployment substantially by the end of the decade.

The idea reflected in the 1974 Convergence Decision of a continuous overlay of Community guidelines for national budgetary policies is implausible for constitutional as well as economic policy reasons, as mentioned. However, the opposite position of rejecting a priori that coordinated actions may at times be called for, or arguing that budgetary policy adjustments can have no useful real impact on the economy would also be mistaken and dangerous. Uncoordinated economic policies in a highly interdependent economy can drift into situations of systematic deflationary bias. The international coherence of medium-term budgetary strategies, and questions of time-path in their implementation requires deeper attention in the relevant Community bodies.

## 9. COMMUNITY BUDGET FUNCTIONS

The Community budget for 1987 amounts to 37 billion ECU, equivalent to 1% of GDP. Two-thirds of this expenditure supports the Common Agricultural Policy. The remainder is distributed among several policy functions (regional, social, energy, indusrial, research, fisheries, development aid), most of which are funded only to a small degree by the Community compared to national budgets. Comprehensive descriptions of the budget's mechanisms are available elsewhere([20,21]).

The budget is funded about one-third by customs duties and agricultural levies, and two-thirds by a share of value added tax revenues. The latter are currently being drawn upon at their maximum level authorised by Treaty legislation, namely 1.4% of the harmonised value-added tax base. In fact, the effective rate of value-added tax revenues is somewhat less because the United Kingdom and Germany contribute at less than 1.4% as part of the agreements reached to correct budgetary imbalances as between Member States.

The budget is authorised in a legislative process involving the Commission, Council and Parliament. The Council has the last word as regards the larger part of the budget including notably the agricultural fund. However, the Parliament has limited powers of final decision for some other domains of expenditure (categorised as "non-obligatory", and notably excluding agricultural expenditure) within the constraint of a maximum rate of growth determined by reference to certain macroeconomic aggregates (essentially nominal GDP and budgetary expenditures of the Member States on average). Conciliation procedures also exist, enabling the Council and Parliament to act jointly when they so agree.

There are problems of political control and policy design in the Community budget. Before turning to these, it should be noted that the main functions of the Community budget can be quite justified at the level of primary systemic choices. Following from decisions to have open agricultural trade combined with market intervention to assure price stability, common control and funding of the intervention mechanisms is logical; indeed necessary because of impossible problems

of externalities and coordination in the hypothesis of national intervention. The Social Fund was introduced to ease labour market adjustment problems associated with structural changes following from the opening of markets. Similarly, the Regional Fund was introduced to ease the regional adjustment problems of market integration. Research expenditure is directed towards projects having supra-national economies of scale or contributing to common strategic industrial policies such as in information technology. On the revenue side, the transfer of customs duties and agricultural levies to the Community budget is equally logical, since the point of entry of imports into the Community is no sound guide to where the tax burden is borne.

The main systemic problems of the Community budget are (i) serious problems in the decision-making system regarding the control of agricultural spending, (ii) complementary problems of "tokenism" in the scale of intervention in the case, for example, of regional and labour market policies, and a consequential weakening of their possible impact in relation to the policy objectives in question, (iii) distributional problems between Member States, which have been settled only at very high costs of negotiation and confusion of purpose, and (iv) tensions over the distribution of powers between the Council and Parliament, which at times override concern for the substantive policy functions in question. There have nonetheless been some positive developments, for example in successive adaptations of the Regional Fund and introduction in 1986 of the Integrated Mediterranean Programmes: both of these instruments have seen moves in the direction of improved incentive mechanisms, and less recourse to quota allocation methods which undermine the incentives to national or regional authorities.

The problem of controlling agricultural spending is a common factor linking these four issues. The agricultural policy is at present generating other negative consequences, for example a cost to the Community in its external trade relations with the rest of the world.

With the successive enlargements of the Community, these various problems have become increasingly acute. As regards the United Kingdom, the budget burden-sharing issue has predominated. As regards the new

Mediterranean Member States, the main issue would seem rather to be whether the Community is to be properly equipped to help the adjustment and development problems of the peripheral and least-prosperous regions, alongside its determination to open markets and increase competition. The years since the first Community enlargement have also seen a spreading of regional problems to many older industrial and urban centres, and completion of the internal market may further intensify the scale of the adjustment problems in some of these areas. These factors point to the need for substantial changes in the way the Community budget is structured and managed and this is discussed in a later section.

The Community budget needs to be seriously reformed, as recognised in recent proposals of the Commission[22]. There are important functions that need to be built up, such as financing industrial research and development and aiding convergence and reconversion efforts of backward and industrially declining regions. Moreover, agricultural spending has to be controlled firmly, and equity problems resolved. The Group returns to these issues later (chapter 12).