

CHAPTER 5 Product Market Integration: The Method

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The methods for achieving product market integration are multi-variate, because product market integration requires the removal of very different kinds of intra-union barriers. Among modern, regulated economies with interventionist governments, which also impose taxes, the CU will not be sufficient to attain a single product market. The CU will merely remove intra-union tariffs and quotas. Moving beyond the CU to accomplish true product market integration requires the removal of a host of regulatory barriers, of fiscal barriers and of discrimination in public procurement and public works. Where sectoral interventionism is particularly heavy (e.g. coal, steel, agriculture in the 1950s), it might even require a considerable degree of joint interventionism before free movement can be realised.

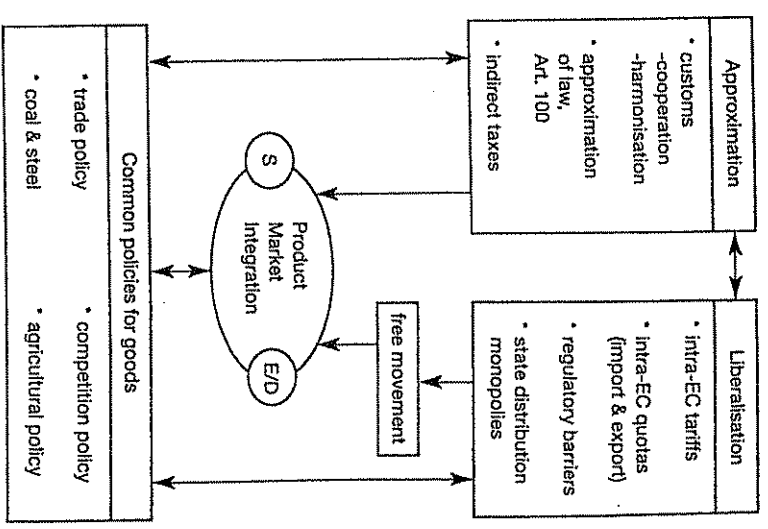
Section 5.1 discusses the Rome Treaty framework for product market integration as a combination of liberalisation, approximation and common policies for goods. Section 5.2 explains the building of the customs union in some detail, both internal removal and the setting of common tariffs and quotas. The mechanisms for shifting from the CU to true product market integration is addressed in the following section. Section 5.4 provides short surveys of the methods of removing discrimination in public procurement, technical barriers and fiscal ones in the internal market for goods.

5.1 The framework for product market integration

Product market integration is governed by a treaty framework going far beyond a mere customs union. As a subset of the structure sketched in Figure 3.1, it contains a mixture of liberalisation, approximated national regulation and common policies. Figure 5.1 depicts these three constituent elements of the Rome Treaty regime and enumerates the most important provisions comprised by each one of them. The picture is completed by a reference to flanking policies and to (temporary and permanent) exceptions to, and derogations from, free product movement.

5.1.1 Liberalisation and approximation

As noted in 1.6, the Rome Treaty opted for a CU covering all product trade. The treaty also takes a comprehensive view of what GATT, Art. 24, calls 'other restrictive regulations of commerce'. This maximalist ambition should be read in the liberalisation box in Figure 5.1: para-fiscal charges, stamp duties (beyond the cost price of a service provided) and other 'charges with equivalent effects to tariffs'; intra-EC import and export quotas as well as measures with an equivalent effect to quotas; and any discrimination in the purchasing and distribution of products by the various state trading monopolies still existing in the late 1950s (e.g. on tobacco, salt, newsprint paper, matches) were all outlawed. Although more ambitious than any CU thus far, one could still argue that this CU, essentially the result of the liberalisation box, was within the overall terms defined by GATT. However, it does have the unique



Note: S = Support policies E/D = Exemptions/Derogations

Figure 5.1 Product market integration in the Rome Treaty

feature of 'free movement', one of the key principles of EC market integration. Since the application of this principle is subject to common judicial review, it has a powerful liberalising effect. What definitively moves the EC framework for products beyond a GATT-based CU to a regime for product market integration are respectively approximation and common policies on which the GATT is silent.

The aims of the approximation box are unclear because it is open-ended. Its evolutionary character would largely depend on the political will to approximate (if not 'harmonise') so as to remove or reduce remaining distortions (indeed, sometimes outright blockages of free product movement). In a grouping

of six, twelve or fifteen countries, the perceived need to approximate will rarely be completely uniform. More often than not, distortions hint at vested interests being promoted or protected. Therefore, a critical factor consists in the efficiency of the decision-making system to produce joint regulation reducing product market failures of this kind. The most important inefficiency in the early EEC consisted in compromise regulation far beyond the need to deal with the market failure at issue. The latter was generated by an endless search for consensus, under veto threats, resulting in superfluous details so as to 'buy off' the vested interests of one or more Member States. In the first 25 years of the Community these

problems have plagued virtually all approximation efforts, but especially those referred to in Figure 5.1. So progress was slow, many failures (i.e. vetoes) were encountered and the harmonisation achieved often overcame the market failure in the CU only by imposing a degree of regulatory failure. This flaw would only be removed by a complete overhaul of the regulatory economic strategy of the Union, which emerged from the EC-1992 programme. (see 4.3.3).

The problems about scope and economic justification of approximation apply to all three categories specified in the box. This is surprising in so far as customs cooperation and approximation are concerned. In the light of the ambitious CU opted for, the liberalisation and approximation boxes were hardly consistent. Thus, whereas the liberalisation box combined with EC competition policy aimed at a competitively functioning internal product market, the approximation provisions for national customs (Vaulont, 1981) were designed to do no more than the barest minimum, without much regard for the costs of cross-border business. Since the customs also handled the complicated border adjustments for indirect taxes, an EC failure to use the competence for indirect tax approximation exacerbated this inconsistency. The general provision for approximation of laws (Art. 100) added to these contradictions: with tariffs and quotas removed, a string of regulatory barriers still effectively prevented product market integration in the CU. Lacking international precedents in removing regulatory barriers, the EC dramatically underestimated both scope and technicality of this kind of approximation. Moreover, one should bear in mind that the postwar period witnessed a significant intensification of economic regulation in the entire developed world. For the EC's product market integration, this meant that a permanent regulatory drive at national level was not governed by a binding EC framework. All that Art.100 suggested doing was to remove barriers, under unanimity, once they were in place and identified. Unlike tariffs, there was no easy way to identify regulatory barriers. Apart from a few complaints numerous new barriers would go unnoticed. Hence, in an almost invisible way, regulatory barriers actually *increased* in the CU. Until 1985, the EC had no regulatory strategy to cope with this profound problem.

5.1.2 Common policies for goods markets

The common policies box is no doubt highly ambitious, at least in a political sense. The economic

question is whether the common policies were facilitating product market integration by addressing actual or potential market failures or removing costly inconsistencies in national policies. Set against this test, the treaty regime is less than satisfactory or at best open-ended.

The common trade policy appears to match the aims of the liberalisation box. The establishment of the CET is largely specified in non-discretionary terms and a common trade policy, going far beyond the CET requirement in GATT, is introduced. Both elements are explicitly placed in a liberal context by stressing the goal of contributing to multilateral trade liberalisation. Initially, the Community lived up to such expectations. Although the CET would come into force in 1970, its actual introduction was brought forward by 1.5 years. By that time the EC had already negotiated the arithmetically calculated CET in two GATT Rounds, thereby reducing it on average by nearly 30 per cent from the originally foreseen level. Also, at the outset, very few EC-wide quotas were adopted - the thrust was to abolish remaining national quotas as leftovers of the OEEC liberalisation programme (see 2.2).

But in three distinct areas the EC was not living up to the letter or the spirit of GATT. In agriculture the GATT had never been allowed to work: European countries (with the partial exception of the UK) had been protectionist and agricultural trade resulted largely from shortages, hardly ever from free trade and specialisation. The USA, though less protectionist on some agricultural goods, obtained a GATT waiver in 1953 for not having to apply GATT rules to agricultural trade. The EEC treaty options of the common agricultural policy did not necessitate high external protection, but one could have few illusions about it. Of the Six only the Netherlands practised a mixture of openness and moderate protection of agriculture (see chapter 11). The second exception were national quotas *vis-à-vis* third countries. A consistent application of the GATT concept of a CU implies either the removal of them or their replacement by CU-wide quotas. *A fortiori*, this would be necessary if the aim is product market integration rather than a mere CU. In contrast to other rules for the transition to CU, the treaty is not explicit about it, however. Thus, EC countries claimed that the so-called hard-core GATT waiver on national quotas (from 1955) meant that the GATT could not impose a fully fledged EC regime on quotas. There were also a number of national quotas, predating the EEC treaty,

which were tied to their acceptance of some new GATT members, notably Japan. Again, EC countries felt that these quotas had to remain national. The problem grew worse with the advent of special protection against cotton textiles imports from Asia and some other countries. Led by the USA, the Long Term Arrangement on Cotton Textiles was concluded in 1963, effectively carving this trade out of the purview of GATT. The Arrangement was first based on national quotas (*vis-à-vis* third countries). As a telling example of inconsistency, while the GATT's Dillon Round and the Arrangement were diplomatically linked, the EC as a whole was only involved in the former while Member States negotiated the latter. The upshot was that hundreds of national quotas were *added* and a common EC trade policy in this sector became illusory (see chapter 13).

The third exception was preferentialism. The Rome Treaty was negotiated in an era of decolonisation. France, Belgium and the Netherlands insisted on preferentialism with existing or former colonies. Thus, the CET should not apply to them (see chapter 13).

Competition policy is dealt with in a fairly strict and comprehensive fashion. Both collusion among independent firms and monopoly abuse were prohibited, with explicit criteria for exemption in the case of the former. There was a compromise clause on public enterprises and utilities (Art. 90). State aids were also prohibited, with explicit criteria for exemption. An anti-dumping clause for intra-EC trade would not extend beyond the transition period. These rules were intended effectively to prevent subsidies or restrictive business conduct from replacing the removed tariffs and quotas and to help to make the internal product market function properly (see chapter 2.1).

The common agricultural markets and a host of interventionist instruments for them such as price regulation, production subsidies, 'common machinery for stabilizing imports or exports' and, as an option, agricultural guidance and guarantee funds, are already specified in the treaty. The critical Art. 39 (on objectives and policy constraints) is rife with political and social compromises. These several compromises reflect the political reality that the alternative to the CAP - namely, having *mutual* protectionist agricultural policies - would have been at least as costly, if not more so. As chapter 11 will clarify, the intention was not so much to regulate the market to prevent market failures but above all to guide a very long-term adjustment process in a socially and politically acceptable fashion.

Two instruments, subsequently chosen in the heavily politicised decision making about the basics of the CAP, have caused product market integration with these socio-political objectives to be realised at extremely high economic costs: the variable levies on imports from third countries and the administrative price level chosen for the linchpin of the most interventionist product market regime - grain. Chapter 11 gives details but the essentials can be noted here. The variable levies were specified in such a way that they throttled import competition, irrespective of world prices. The intra-EC price level chosen was so high that inefficient German agriculture would hardly be forced to adjust. The implication was that the CU's normal function of stimulating specialisation through trade between areas with different cost levels (caused by comparative advantages and inefficiencies) was largely pre-empted.

Finally, the coal and steel sector fell under the Paris Treaty of 1951. For decades the EEC and ECSC treaties were applied side by side although the two are quite different for product markets. First of all, the ECSC treaty has no CET and no common commercial policy. Strictly spoken, it is not a CU but an FTA. Secondly, the ECSC treaty is rather interventionist, especially when a 'manifest crisis' is declared by Council (Art. 58, ECSC). Two case studies on the ECSC and on steel crises in chapter 14 will give further details.

Gradually, however, the EEC and ECSC regimes began to converge in a pragmatic way. The greatest contribution to this development is, no doubt, the EC Court's doctrine of 'implied powers', pronounced in 1978. It means that the ECSC does imply a common commercial policy if, and in so far as, the pursuit of its objectives and the use of (intra-EC) instruments require such a policy for consistency. In the early 1990s the Union decided to integrate the ECSC into the EC treaty by 2002, when the former will expire.

5.1.3 Support policies and exceptions

The triangular regime of liberalisation, approximation and common policies makes for a quite comprehensive system seeking to ensure product market integration. This was bolstered by supporting policies. Most prominent was the common transport policy as an essential complement of the free movement of goods. Of course, transport is a service, but its free movement was part of a separate treaty chapter on a common

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transport policy. The double question was: how to make EC transport both least distorted and cheap? How could the nationally regulated transport markets be regulated at EC level, while providing the greatest possible freedom for market agents? A gain, views differed partly because of a fear of losing market share at home, partly because of national differences in social charges and taxation, partly because the public and economic function of some modes of transport was perceived differently, partly because of fears of free-riding on one another's infrastructure. As a result, the Council was convinced by the EC Court as late as 1985 for a 'failure to act' (Art. 175, EEC) on a common transport policy. Meanwhile, this policy is in place (see chapter 7). A second issue was how to obtain an efficient EC transport system serving product market integration effectively. Great progress has been achieved on this point despite the lack of a common policy: the timely establishment of a common policy could undoubtedly have enhanced the efficiency drive as the response to EC-1992 in transport has shown (see chapter 8). In its absence, improvements were obtained through technological progress of the means of transport, and domestic infrastructural investments (weakly coordinated in the UN Economic Commission for Europe and the OECD-linked European Conference of Ministers of Transport, but not by the EC for long), and the resulting shifts in the modal split (especially the increase in the market share of road haulage).

Exchange rates, or rather balance of payments problems - the form they took in the Breton Woods system of adjustable pegs at the time of treaty drafting - constituted another support policy problem. Misaligned rates could cause such tensions in foreign exchange markets and such a drain of foreign exchange reserves that far-reaching national safeguards were provided for in Arts 108 and 109. No change of regime was introduced once flexible exchange rates had become accepted (after 1970). The upshot was that product market integration was permanently in danger, and worse, was permanently hampered by retained or varying exchange controls. In 1986 six out of twelve EC Member States still related exchange controls. Measures to restrict intra-EC trade (as distinct from financial) flows directly had been prohibited by the EC Court in the mid-1970s but the safeguard only disappeared with the EC-1992 programme (see chapters 9 and 16).

1 Hence the so-called 'modal split' (the substitution between and complementarity of different modes of transport) differed significantly between Member States.

Other supporting policies were of minor importance: an endeavour to achieve social policy approximation was very weakly formulated and led to little except for the (explicitly treaty-based) laws regarding equality between men and women; the Social Fund served as an adjustment fund but was trivial; and the European Investment Bank initially remained marginal (see chapter 15).

Finally, it is interesting to observe that there were exceptions to the regime. The temporary exceptions were concerned with product-related difficulties of establishing the CET or solutions for quotas during transition (see 5.2.1). The permanent exceptions include some important limitations of the treaty:

- The CU does not apply to military goods: the difficulty is then to delineate 'double-purpose goods' from purely military goods - for a long time, this delineation remained a unilateral national act with great incentives to distort competition, for instance in public procurement.
- Member States: the EC never had any influence on privatisation or nationalisation - in actual practice this weakened the EC competition policy vis-à-vis public enterprise up to the 1980s (see chapter 12).
- Industrial and intellectual property rights are similarly in the purview of national jurisdictions (because they refer to 'ownership', too); this has yielded incentives to exploit the possibilities for price discrimination between Member States: the EC Court curbed this potential by courageous case law but the weaker instance of market failure continued to trouble the internal market up until the early 1990s (e.g. patents, trade marks). (see chapter 9).

The regime of product market integration is the hard core of the EEC treaty. The products regime is a condition *sine qua non* for the Community. It is also the regime with the widest scope and the greatest impact.

5.2. Building the Customs Union

Article 9, EC defines the CU. It is to cover all goods and '... tariffs and all charges having equivalent effect'. Described in this way the CU applies also

to agriculture, even though the CAP is treated in a separate Title. In a simple economic analysis one could define the CAP as an agricultural CU, with internal and border interventions ensuring a politically agreed minimum price. Art. 9 defines the CU purely as a 'tariff union'. Quotas and import and distribution monopolies are dealt with in a separate chapter. Strictly, this is not in keeping with GATT. Practically it hardly matters, for national quotas quotas must be removed anyway. For national quotas vis-à-vis third countries the distinction does matter and the problem can only be resolved by an appropriate common commercial policy specified elsewhere in the treaty.

5.2.1 Internal liberalisation**

As noted in chapter 2, intra-EC tariff removal was expected to take 12 years (with a maximum delay of three more years) and would be across the board. The 12 years transition period was broken down into three stages. The timing and percentages shed off were prescribed for the first two stages. This automatically combined with modest flexibilities for the first stage, for purposes of varying the speed and reducing the costs of adjustment for sensitive sectors.³ Though not explicitly mentioned, the idea was to have 60 per cent sliced off after two stages. It did specify the aim for the Member States to slice off at least 25 per cent per tariff line in both stages. Although the third stage is not detailed, the timetable of reductions is subject only to a qualified majority in Council.

Since initial tariffs of some countries were high, tariff disparities were likely to influence the time path and country distribution of adjustment costs. Thus, the first reductions of a prohibitive tariff would have no impact whilst, at the same time, similar reductions of a medium or lower tariff might cause strong import competition. Later on, a relatively sudden exposure to import competition would follow for the high tariff country. Not only could this cause social or political resentment, it might have the unfortunate effect that, initially, export opportunities would be denied to the adjusting sector in the low tariff country, whereas such export opportunities would be available for the high tariff country by the time that

sector would be forced to adjust. Of course, for this scenario to have economic meaning, one must assume either that the sector in the low tariff country is less competitive than the exports from the high tariff country - which is unlikely, coming from behind a high tariff, except when scale is decisive for costs - or that the tariff-protected sector penetrates the low-tariff country via dumping. To mitigate the first possibility the treaty could have prescribed an accelerated reduction for peak tariffs or a decaying procedure, cutting off all peaks beyond a given ad valorem duty. However, a politically less sensitive obligation was opted for: all tariffs higher than 30 per cent had to be reduced by one-tenth each time in the first stage, allowing no flexibility. The case of dumping was dealt with in the competition rules. A procedure for protection against dumping during the transition period is provided for in Art. 91(1). The fact that injury does not have to be proven makes it more a remedy to deal with tariff disparities than a competition issue. More interesting, however, is the 'reverse dumping' clause of Art. 91(2): exploiting tariff disparities via dumping is made risky because dumped goods can be re-imported into the exporting country free of tariffs or quotas. If transaction costs are not too high, 'reverse dumping' sets an effective limit to dumping practices.

The strictness of the internal liberalisation in the transition period was combined with cuts upon Member States to suspend tariffs on imports from other Member States unilaterally and to accelerate tariff cuts. The latter option was used twice by all six together so that the actual transition period took only 10.5 years. Figure 5.2 shows the actual reduction path. The success of the internal tariff removal should not mislead the reader into believing that no problems were perceived when negotiating the treaty. Two sets of provisions reflect those: the procedure to move to stage 2 and the 'special regime' for France. As noted in chapter 2, the original CU proposal by the Benelux countries had been criticised for not providing a stages approach to full intra-CU liberalisation. A complicated Art. 8, EEC defines three stages, each of four years. The real problem is feared to consist in the transition from the first to the second stage. Failing unanimity the first stage can twice be extended for a year,⁴ only after six years the Council

2 This refers to import duties; export tariffs had to be removed in four years. The 12 years procedure was based on a stand-still clause (Art. 12), and specified national tariff regimes preceding the treaty.

3 For instance, every tariff line had to be reduced by at least 5 per cent.

4 However, a Member State could not block the decision merely because it had not fulfilled the first stage obligation in time (Art. 8 (3)).

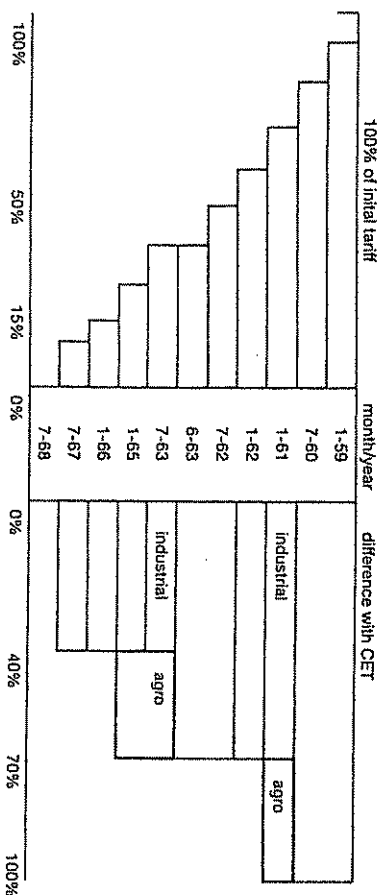


Figure 5.2 Intra-EC tariff reduction and CET building

shifts to qualified majority. Those outvoted could opt for an arbitration procedure described in the same Article. Although uniquely strict for diplomatic practices in those days, a measure of uncertainty and political discretion was created. What if no qualified majority could be found for whatever cyclical or other reason? What if arbitration sided with the outvoted Member State? These uncertainties would undoubtedly have been magnified if economic times during transition had been bad. As it turned out, a high-growth/low-unemployment climate facilitated the transition period and the special procedures in Art. 8 were never used. It should also be noted that greater automaticity was imposed for the other two stages (any Member State could veto an extension, i.e. a delay) and unambiguous obligations were prescribed for the expiry of the transitional period.

The 'special regime' for France reflected another weakness: a CU with pegged exchange rates is unsustainable if misalignments cannot be prevented or readily resolved. However, imposing far-reaching coordination of macro-economic policies to prevent realignments and/or common decision making before accepting realignments would have increased the ambition of the CU enormously. The sections on 'economic policy' (macro-economic policy was meant) in Arts 103-9 mirror this dilemma as noted in chapter 3. Although Art. 107 (1) says that each Member State shall treat its exchange rate policy as a

matter of common concern, and Art. 104 that each Member State shall pursue '...the economic policy

needed to ensure the equilibrium of its overall balance of payments and to maintain confidence in its currency', the common machinery to back up these provisions was weak. As a consequence, Arts 107(2), 108 and 109, EEC, had to deal with the possibly disruptive consequences of misalignments, a major devaluation or restrictions with a view to uphold the exchange rate at the expense of intra-EC economic intercourse. Worse still, before signing and during the ratification procedure of the Rome Treaty, French attempts to solve the balance of payments problem for the franc area (which included its colonies in West Africa) threatened to undermine intra-EC liberalisation commitments from the outset. In a special Protocol France had been allowed to keep its system of across-the-board export subsidies and special import charges for the protection of the franc, until balance of payments equilibrium and sufficient foreign exchange reserves would enable the Council (by qualified majority) to abolish this 'special regime'. This regime amounted to a hidden devaluation. The protocol requires sufficient uniformity across goods but also imposed maximums and a standstill provision. In August 1957 France introduced uniformity in the 'special regime' such that in fact a devaluation of no less than 20 per cent was implied.⁵ As this was far above the ceilings, such a major set of restrictions hardly

inspired confidence in the liberalisation process once the EEC treaty came into force (1 January 1958). Other Member States were now dependent on the French political resolve to impose domestic austerity or otherwise would face a major devaluation or, worse still, would have to take safeguard measures themselves. After more than a year of hesitation, a new French government decided to opt for a devaluation in late 1958 combined with the abolition of the special regime, just before the first intra-CU tariff reduction would come into force. A much weaker protocol on Italy states that the underdevelopment of the Mezzogiorno would have to be taken into account if Italy were to be restricted by the EC in its use of the (balance of payments) safeguards Arts 108 and 109.

The conclusion is therefore that the CU regime combined strictness with some significant weaknesses: automaticity was not fully accepted and the unquestioned preference for pegged exchange rates was tied to inadequate coordination provisions, thereby risking to prompt restrictions and safeguards undermining the very market integration one was aiming for.

The internal liberalisation of quotas built on the liberalisation in the OEEC framework (see chapter 2). It improved on the OEEC process in several ways. First, unlike in the OEEC, the quota removal covered agriculture and products traded by commercial state monopolies. Both were highly sensitive and the unambiguous commitment to liberalise was no mean achievement. Second, a standstill clause and the 'ratchet effect' made rearward protectionist lobbying practically impossible. The 'ratchet effect' refers to the definitive nature of liberalisation: there being no going back. This was accomplished by a combination of automaticity (based on specific treaty percentages and timeables), the across-the-board coverage rather than discretion per tariff line and the prohibition of unilateral reimposition of quotas. No element of this combination was present in the OEEC process. Third, and critical for the preparedness of low tariff countries to liberalise, the CU imposed tariff and quota removal simultaneously (see chapter 2). Fourth, just like in the case of quasi-tariffs, measures with an equivalent effect⁶ to quotas would also be forbidden (Art. 30), except for certain derogations for health and safety, and so on. (Art. 36). However, for the latter, 'approximation' was provided for under Art. 100. Fifth, not only were quotas under state trading (i.e. state import and distribution monop-

lies) forbidden, but Art. 37 prescribed that, by the end of the transitional period, all discrimination with respect to imports or domestic procurement and marketing or distribution had to be eliminated.

Technically, liberalisation took place by first transforming bilateral quotas into 'global' quotas, that is, open without discrimination to all other Member States' (Art. 33(1)), after one year. Subsequently, these quotas had to be enlarged in value by 20 per cent overall annually, and at least 10 per cent per product. For very small quotas 3 per cent of national production had to be allowed in after one year and a higher than average growth formula was imposed by the treaty. After 10 years all quotas had to be equal to at least 20 per cent of the national production of the relevant products. Unlike with tariff removal, no special delays were possible. An acceleration clause was included. At the end of the transitional period, quotas had to be abolished.

Initial intra-EC quota abolition was therefore stricter than tariffs. Discretion was very limited and there were no provisions for a staged approach or delays. This probably reflected a mirror image of the asymmetry between tariffs and quotas in the pre-EEC period (see chapter 2).

5.2.2 Setting common tariffs and quotas

Setting the CET and, where necessary, common quotas is likely to be more politicised than internal liberalisation. When participating in a CU all players are expected to accept the GATT rule of zero intra-tariffs and no intra-CU quotas. Adjustment problems may cause a transitory political economy but the goal remains unambiguous. This is not the case for the CET. One would expect the CET to have a protective function (see also chapter 6). So there is bound to be active lobbying for influencing the CET at the level of individual tariff lines, but also with respect to the overall restrictive effect for end-products, the structure of tariffs over respective processing stages ('reflective protection'), the downward or upward adjustment of tariffs between members with tariff disparities and the position of outsiders via bilateral pressures and the Art. 24, GATT, review procedure. All this political economy can be constrained or even pre-empted by automaticity in treaty rules, just as with internal liberalisation. But achieving such rules will be extremely difficult for the CET because setting the CET boils down to a shift from one set of tariffs

⁵ Note that this only applied to articles falling under the 'special regime', hence significant distortions were inevitable.

to another set of tariffs, not to an adjustment from one set of tariffs to zero for all. Moreover, the GATT 'general incidence' clause (see chapter 1) is vague. Although at the time of drafting the treaty, CU theory (see chapter 6) was available as a rough guide to interpret the general incidence clause, its practical application leaves ample room for discretion.

Since the negotiators of the EEC treaty wanted simple rules to minimise the political economy and because they did not want to lose the momentum of political will, Art. 19(1) specifies the CET as the arithmetic average of the *ex ante* national tariffs. This arithmetic average of the ex ante national tariffs implied that, in most cases, France and Italy had to reduce tariffs and the Benelux countries to increase tariffs. Germany was in an intermediary position. However, as might be expected from the contrast between internal and external tariff adjustment in a CU, all kinds of exceptions and amendments were introduced. In this way a rule-based CET setting was *ad facto* transformed in a mixture of basic rules (see Figure 5.2) and negotiated adaptation. Broadly speaking, and excluding agricultural products, the deviations did not have the effect of increasing the protectionist impact, but individual tariffs can be identified where this was the case. The following provides a summary for purposes of clarification.

Additional reading

First, France and Italy obtained various ad hoc assurances as the applied and the legal duties differed in a number of cases.⁶ Second, four product lists were subject to CET ceilings, which had the effect of obtaining CETs lower than the average.⁷ Third, two lists were simply negotiated: list F was finished before signing the treaty, list G was not but had to be negotiated before the third stage. List G could be extended with products together covering up to 2 per cent of imports. This open invitation to lobbying could have led to problems but in fact it did not in any serious way. Fourth, responding to the treaty's call for a lower CET via trade negotiations (Art. 18) two GATT Rounds were initiated by the US (Dillon and

Kennedy Rounds) which sliced some 30 per cent off the calculated CETs. Note that these GATT Rounds took off the sharpest edges of the splitting up of Western Europe into two trade blocs, the EEC and EFTA. Fifth, in three different ways it was possible to get around the CET by tariff quotas. Up to the volume of allowed imports, a tariff lower than the CET (or zero) could be granted if supply shortages arose or a change from a world supplier to an intra-EC source of supply would entail harmful consequences for producing industries.⁸ Of course, this escape route could only be used for domestic supplies; it was not allowed for exports to other Member States. For this reason tariff quotas were decided at EC level. Finally, Art. 29 contains five guiding principles for the Commission with a pro-trade flavour.

The CET did not apply to a group of associated overseas countries and territories, mostly (ex-) colonies (Arts 131-6, later amended in the Yaounde treaty, now adapted and expanded into the Lomé Conventions).

The contrast between tariffs and quotas was even greater on the external side than for internal liberalisation. In the free movement of goods title of the treaty there is no reference to quotas *vis-à-vis* third countries. From an economic perspective this is curious since significant disparities in national (external) quotas are likely to result in different competitive pressures, and hence may create distortions of product market integration. Whether they will, depends on whether the treaty allows trade deflection to take place. Trade deflection is a response to differentials in external trade policies and hence characterises a free trade area, not a CU. Thus, an FTA may see imports to high tariff member B deflected via low tariff member A if certificates of origin would not prevent this. However, once CU members have very different external quotas (or some have no quotas), national prices will be higher in countries with binding quotas than in those with big or no quotas. Hence, trade deflection will pay. This creates an issue of principle because a CU (like the EEC) would not normally impose certificates of origin for internal trade. In order to control trade deflection however, it will have to. The silence on this issue in the free movement title

is therefore inconsistent with a CU. The issue is addressed in the treaty chapter on the common commercial policy but in an unsatisfactory way. Article 11(5) reads that Member States shall 'aim at securing as high a level of uniformity as possible between themselves' with respect to such quotas. They merely have to inform the Commission if they abolish such quotas during the transitional period. This weak endeavour clause, without any bite and any implementation rules, meant that little attention was paid to it. This would not have been a problem if the common trade policy, following the transition, had been spelled out in such a way so as to arrive at joint quota removal and perhaps some joint quotas. But Art. 113 merely speaks about 'uniform principles' such as 'the achievement of uniformity in measures of liberalisation' (here, 'liberalisation' refers to quotas). For almost two and a half decades following the end of the transition period this problem remained unresolved. In a package deal in December 1993, based on the EC-1992 programme, remaining national quotas *vis-à-vis* third countries were finally eliminated (see chapter 13).

5.3 From customs union to product market integration

5.3.1 Searching for a mother principle

The *reciprocity* notion behind the EEC CU is not clear. Defined merely as a tariff union (as the treaty does in Art. 9(1)), it suppresses one type of border intervention for trade, without having a clue about the change in quotas, VERA, fiscal or regulatory barriers. If the latter substitute for the former, the gains from trade may remain small. Even if there is no conscious effort to substitute forgone tariff protection, intra-CU tariff removal is still a far cry from internal free trade in goods. A tariff union would neither imply that all sectors are equally exposed to intra-CU imports nor that all sectors have equal opportunities to penetrate other countries' markets in the CU.

The *policy concept* behind a CU is problematic, too. The origin of CUs goes back several centuries (Winer, 1950) when levying tolls or customs duties were the only trade interventions (other than import bans). Early in the twentieth century quotas came

into fashion, especially for cases where the tariff equivalent would be very high or bound by bilateral treaties. In the EEC treaty internal quota removal is part of the title 'free movement of goods', but not of the customs union chapter therein. In a strict sense this chapter is not in keeping with GATT Art. 24, which speaks about 'other restrictive regulations of commerce'. This vague term is open-ended but would in any event include quotas. But would it include other border interventions? In fact, the implicit CU concept in the EEC treaty could be said to consist of four elements: a tariff union, an indirect tax union, abolition of internal quota and 'equivalent effect' measures and, in principle, uniform external quota liberalisation (the word 'common quotas' is not found anywhere). The latter three however entail great problems of interpretation which are hard to resolve without a first or mother principle. A major weakness of the Rome Treaty was the lack of such a basic guideline. As a consequence Member States retained interpretations or vetoed proposals, such that fully fledged product market integration remained unattainable. In this sense the CU could not be completed.

There are two mother principles which suggest themselves. Applying them would have meant a significant increase in ambition, that is, a deepening. The *reciprocity approach* would use product market integration as the benchmark: all (artificial) economic frontiers in the product markets would be removed. This would go far beyond the implicit CU as described above, as it would also encompass an adequate competition policy, appropriate common sectoral policies where necessary, and such a degree of macro-economic coordination that safeguards would not be used. All these additional elements have a place in the treaty but they are not sufficient. The ambition of the CU, as defined by the four elements mentioned, would also greatly increase if measured against the benchmark of product market integration. For example, what are 'measures with an equivalent effect' to quotas (Art. 30)?

Initially, the interpretation of Art. 30 was constrained by the lack of a mother principle; hence Member States took a legalistic view of what the EC could do. The EC Court understood the grave inconsistencies this would give rise to. In the Dassonville case (case 8/74, European Court Reports 1974, p. 837) it provided an economic definition of such measures: 'all trading rules enacted by Member States which are capable of hindering, directly or indirectly, actually or potentially, intra-Community trade'. In so

⁶ See Art. 19(2) and List A in the Annex to the Treaty, List A (for France) consisted of suspended tariffs, because strict quotas applied.

⁷ List B (raw materials, 3%), C (semi-manufactures, 10%), D (inorganic chemicals, 15%), E (organic chemicals, 25%). In List E some Benelux tariffs were so low that, for purposes of calculating the CET, they were assumed to be 12 per cent - this had the effect of raising

the CET.

⁸ These somewhat different legal grounds apply to the inputs on lists B, C, and D, to lists E and G, and to agricultural products. Moreover, for coffee and bananas special protocols on tariff quotas were annexed to the Treaty.

doing it recognised that regulatory barriers had to be added to the elements of the CU already specified. At the same time the actual application of the Dassonville definition was limited by major derogations in the treaty, such as Art. 36, which could only be resolved by approximation. Also, for the application of the definition to (indirect) fiscal frontiers or national external quotas there was no legal basis in the treaty. The conclusion is inescapable: getting product market integration accepted as a mother principle would require treaty revision.

The *policy approach* would simply carry the notion of a customs union to its logical conclusion: a customs union should only apply union customs rules and internal frontier controls would therefore have to disappear. From a policy perspective this is attractive for several reasons. First, such a bench mark is straightforward. Its automatically pre-emptis a great deal of political economy, arising from vested interests. Second, it dictates a clear and exhaustive policy agenda and facilitates judicial review. Third, it does not impinge upon national regulatory objectives as long as other domestic instruments are found which do not discriminate imports from other Member States.

Removing internal frontiers was not, however, included in the Rome Treaty, so this approach would thus require treaty revision. In the period 1970-85 there were few indications that such a revision was ever going to be undertaken. On the contrary, as late as 1979 the Commission prepared a Multi-annual Programme for the Attainment of the CU (OJ C 84 31.3.1979) comprising all kinds of elementary implementation issues, prompted by the fierce independence of the national customs services. It merely referred to the tariff union and even ignored the customs role for statistics about intra-EC trade.

5.3.2 How the Community pursued product market integration

The intrinsic difficulties of trying to achieve product market integration with the three boxes depicted in Figure 5.1 would continue to plague the Community from the end of the transition period (1970) up to 1985. All three boxes suffered from shortcomings and there was no mother principle to remedy them once and for all.

Liberalisation measures were implemented if they did not depend on the other two boxes. The cases of state distribution monopolies led to repeated rulings of the EC Court of Justice, with the upshot that most

of them became defunct or that discrimination was minimised. However, Art. 30, prohibiting 'measures with an equivalent effect to' quotas, only began to bite long after the Dassonville ruling. Its effective scope was greatly limited by the derogations in Art. 36 (largely on health, safety, consumer protection and the environment) and, therefore, by the required 'approximation' under Art. 100.

But, as noted in 4.3.2, approximation turned out to be a failure in two ways. On the one hand, crippled by the unanimity rule, many proposals were blocked in Council or not even tried out by the European Commission. On the other hand, when approximation did result in EC legislation, a degree of regulatory failure crept in because approximation was invariably interpreted as detailed and rigid 'harmonisation'. Thus, in none of the three items specified in the approximation box of Figure 5.1 did the EC make much progress. As late as 1985, approximation results were modest, as shown in Table 5.1.

Where common policies were affecting product market integration, gaps and distortive solutions could be observed, both preventing product market integration from being realised. In trade policy gaps included the failure to remove national quotas *sic-a-vis* third countries for various reasons. In competition policy, the neglect of Art. 90 (on utilities and state-owned enterprises with 'entrusted tasks') and the weak enforcement of the prohibition of certain state-aids were major problems. Also the sectoral policies for agriculture and coal and steel led, at best, to rather distorted forms of intra-EC trade, and not to the removal of economic frontiers.

All this does not mean that intra-EC trade in goods was not intense. The initial liberalisation in the 1960s had caused rapid growth in intra-EC trade and had pushed up the intra-EC share in every Member State's foreign trade, hovering around 50 per cent after the transition period (see chapter 6). The CU-plus, accomplished by 1985, exhibited much 'deeper' product market integration than anywhere else on the globe. This can be seen from Table 5.1. However, it is still far away from complying with the mother principles. Based on those benchmark marks achieving genuine product market integration is much more ambitious than a CU-plus. It required the Single Act, which incorporates a definition of the internal market (Art. 8A) embracing free movement and no internal frontiers virtually unconditionally.

As noted in 4.3.2 this led to a new regulatory strategy. What is conveniently summarised in Table 4.2 came about only gradually after the late 1970s. With

Table 5.1 Product market integration in 1985 and EC-1992 proposals

Market access	Dismantling Barriers	Common policies or approximation	Rating 1985	White Paper Proposal
Tariffs	Abolished intra-EC	Common extra-EC	A	
Quotas	Abolished intra-EC	Selective national quotas in sensitive sectors	B	Unspecific call on Member States to align
Voluntary export restraints	Prohibited intra-EC	Not common yet	B	No specific proposal
Measures with equivalent effects to quotas	Prohibited; EC Court review effective, but limited	Inefficient and incomplete approximation for health, safety, etc.	B	Traditional harmonisation; numerous proposals; also a flexible 'new approach' (only ideas)
Payments	Free (for intra-EC traded goods)	Exchange controls not to affect trade; otherwise, variable national controls	A,B	No specific proposal on removal of safeguards (but see Single Act)
Transport of goods	Some quota enlargements; intra-EC road haulage; other modes modest or no liberalisation	Various, but degrees of failure according to mode	B,C	Far-reaching proposals
Indirect taxes and excises	(Some abolition, following the introduction of VAT) tax frontiers remain	One VAT system, one taxable product base, with material exceptions	B	Far-reaching proposals being formulated
Customs cooperation		Approximation and unification of procedures and execution	A,B	Proposed common customs code; abolition of intra-EC frontier controls
Competitive conditions				
State aid to industry	Forbidden, with substantial exceptions	Commission/Court surveillance, weakened by Member States	A,B	Call on Member States; promise of special paper on state aids
Public procurement	Formal prohibition of discrimination	Shallow harmonisation of procedures	C	Far-reaching proposals
State distribution monopolies	Prohibition of discrimination and effective judicial review		A	
Competition policy		Common for restrictive practice and abuse of dominant position; fairly effective Commission + Court surveillance	A,B	Proposals for merger control
Market functioning				
Regional policy	Restrictions on national measures	Some approximation of national policies; early common policy	B	No detailed proposals
Research and development policy	Ceilings for national subsidies	Modest common policy in some sectors	B	Some specific proposals (e.g. telecoms and information technology)
Legal conditions	(see also market access)	Approximation or harmonisation or unification of standards and some company law	B	Several proposals, some outside the purview of the EEC Treaty (e.g. patents)

continued

Table 5.1 continued

Sectoral policy	National restrictions	Common, except for monetary, compensatory mechanisms and controls for plant/animal health	B	Proposals to abolish all frontier controls, in the C-AP
Common agricultural policy	abolished			
Steel, coal	National restrictions abolished (exceptions for some subsidies)	Common: the steel crisis regime; freezes intra-EC trade and especially in some products	A, B	Call to reduce subsidies further

Ratings: A = accomplished; B = some achievements, but supplementary action needed; C = costly omission or failure to act. Source: Polkman (1986, 1988)

respect to judicial review of the EC Court, based on Dassonville, a case law was built up removing regulatory barriers, or at least minimising their distortive impact. This judicial review initially had a strongly liberalising effect. Gradually, a doctrine on the free movement of goods emerged, consisting of a few basic principles that invariably apply. Ignoring the many subtleties of this judicial review, the more important principles include the following:

- *non-discrimination*: this is a treaty principle; national regulation ought not to discriminate between domestic and other EC goods; in a series of rulings the Court extended this even to extreme disparities between taxing domestic spirits (low) and foreign substitutes (high);
- the Dassonville test;
- *mutual recognition* as developed from the Cassis de Dijon ruling of 1979; if health or safety objectives are 'equivalent' between Member States, products⁹ from other Member States have to be (mutually) accepted, despite differences in the detailed specifications of the

relevant national laws (this implies a drastic curtailment of the possibilities for hiding behind Art. 36 to maintain regulatory barriers);

- *proportionality*: if an objective (filling under Art. 36) is pursued in national regulation, the regulatory obligations should be proportional to that objective; in actual practice, this often means that labelling requirements are sufficient and import prohibitions 'disproportional';
- *reversing the burden of proof*: in Art. 36 cases, the burden of proof of showing that a health (or similar) objective justifies a national restriction or is not 'equivalent' to those in another Member State falls on the Member State creating the barrier; usually, this proof must hinge on objective scientific evidence or measurable differences in for example safety preferences. A rare case in which the EC court acknowledged measurable differences in safety preferences can be found in French requirements for wood-working machines, reflecting distinct ways of protecting workers, compared with, for example, those used in Germany.

CASE STUDY 5.1 Beer purity law and judicial mutual recognition

German production and consumption of beer is larger than in any EU country. Unlike in some other EU countries where dominant brands are often found (in Denmark, 70 per cent of the 1990 home consumption was supplied by Tuborg/Carlsberg; in France, 47 per cent by BSN; in the Netherlands, 50 per cent by Heineken; in Belgium, 60 per cent by Artois-Piedboeuf-Intereven), concentration is extremely low. The largest market share of a brewery in Germany (1990) is 6 per cent, with over 1,150 competitors. On the face of it,

therefore, Germany is an attractive market for foreign (EU) producers, penetration of which would not seem to run into a powerful quasi-monopolist. Yet, this inference is incorrect. The German beer market turned out to be very hard to penetrate, for two reasons. First, a technical barrier called the 'beer purity law' (dating back to 1517, when health rules for beer were a major improvement) essentially eliminated the prospects for (foreign or domestic) mass beers, produced with economies of scale and chemicals catalysts (to speed up the brew-

CASE STUDY 5.1 continued

ing process) and preservatives (for long-distance supplies and storage). A seemingly innocuous regulation thereby protected beers with a short life-span, produced in smaller volumes and unsuitable for consistent marketing in far-away markets. Second, strong localised preferences for 'own' local brands, and local control of outlets (beer houses) also form a barrier to entry as the acceptance of 'national' or 'foreign' brands will require very high sunk costs in marketing and distribution. The internal market regime should ensure that at least the regulatory barrier is removed or minimised. Judicial mutual recognition has accomplished that in the wake of Cassis de Dijon.¹⁰ Once the health objectives of national regulations on beer are 'equivalent', mutual recognition becomes compulsory for Member States. Thus, one would presume that the European Court would apply mutual recognition, so that foreign brands, marketed lawfully in any one Member State, could not be prevented from entering the German beer market, even though these brands might contain residues of catalysts and/or preservatives. Before Court the German government argued that beer containing additives should be prohibited because of a danger to health. The Court rejected this argument: not only did other drinks (imperfect substitutes for beers) in Germany lawfully contain additives, it also

held that other national governments were just as concerned about the health of their citizens; indeed, millions of Germans routinely consumed beer on holidays or travels in the EU without any trace of fear for their health. The burden of proof was reversed (see 5.3.2) so that Germany had to provide scientific evidence to the contrary. The Court ruling in 1987 confirmed mutual recognition on the basis of equivalence, and the 'beer purity law' was held to violate 'proportionality' (note that the Court thereby wisely avoided having to assess the health grounds in detail; it only established 'equivalence'). If consumer protection were to be of overriding concern, proportionality suggests objective labelling about ingredients should do. The ruling implies that German producers therefore face higher costs as the law retains its validity for them (except, of course, for exports).

The Cecchini report (1988), while recognising very fine product differentiation and taste niches, based its estimate of static 'welfare' benefits on scale arguments, given a best guess about (small) import penetration via supermarkets; the range was ECU 90 - 215 million a year. The actual long-run impact is hard to estimate as contestability of local breweries may slowly increase over time, yet strong preferences for quality beers are unlikely to alter much.

Ever since the late 1970s the judicial doctrine on free movement of goods has greatly reduced the number and intensity of regulatory barriers on the internal market. A celebrated example is the German Beer Purity law (see case study 5.1).

The other approach was regulatory and largely represented by EC-1992.¹⁰ The EC-1992 programme in the 1985 White Paper should be understood against the EC achievements at the time. Table 5.1 attempts to capture the main achievements to date with respect to liberalisation, approximation and common policies (in columns 2 and 3), gives them a simple rating and adds the EC-1992 original proposals. The measures at issue (first column) are divided into four categories: market access (between Member States), competitive conditions in product markets, the rules ensuring market functioning by preventing market failures, and sec-

¹⁰ Not entirely because two breakthroughs were already accomplished before the 1985 White Paper was published: a common customs document and the 'new approach' for removing technical barriers. Also, the Court ruling on transport - against the Council - was (one month) before the White Paper.

¹¹ Customs law is too specialist for the present volume and is ignored. Most other items mentioned are touched upon elsewhere in this book.

5.4 Removing barriers in the internal market

5.4.1 Towards competitive public procurement

The purely formal prohibition of discrimination in national and regional public procurement, established at the end of the transition period, was totally ineffective. Two procedural EC directives (for procured goods and for public works) gave far too much latitude to continue *de facto* discrimination: moreover, they were not enforced or monitored. The Cecchini (1988) report's crude estimates indicated that protectionist procurement and monopolistic supplies to state agencies led to welfare losses of perhaps up to ECU 20-25 billion, quite apart from effects upon innovation (see *European Economy*, March 1988). The report also showed that, in failing to tackle public procurement practices, up to ECU 500 billion of demand for goods would be carved out of the internal market. In a simple CU this might be defended as outside its purview – although even GATT rules have some impact here – but when striving for product market integration, this huge omission has to be resolved.

Additional reading

By 1994 the EC had adopted a series of directives imposing strict procedural rules promoting competitive public procurement (see EC, 1994b, pp. 118-30). The main principles applied include timely and sufficiently detailed publicity (including publicity in the EC Official Journal, if the purchase is above a certain threshold), special obligations for tenders restricted to preselected bidders, mandatory reference to European standards and strict monitoring by the European Commission. The latter can intervene if urgent complaints can be substantiated. The scope of the rules goes far beyond goods bought by public buyers in competitive markets: public works, purchases by utilities (whether public or private) and services bought by public authorities are also covered.

The economic effects of this procurement regime are doubtless positive. But whether intra-EC trade in 'procurement goods' would become comparable (say, in terms of shares) to other products is not *a priori*

clear. Both price and quality of best bidders from other EC countries may be 'matched' by domestic suppliers, thereby realising 'welfare' gains and greater competitiveness at home, without increasing intra-EC trade directly.¹² Also, with respect to major contracts (e.g. supplying to utilities), the procurement regime has sparked numerous joint ventures and alliances across intra-EU borders, with much greater possibilities for tendering 'locally' without loss of competitiveness or of access to technology or to other special assets. Again, this form of interfirm collaboration suggests a strong indirect effect on intra-EC trade. Presumably the greatest economic impact of breaking down procurement barriers is the credible threat of potential competition in many markets where procurement protection had come to be taken for granted. It is this potential competition which removes the very negative effects on technical efficiency and company performance that protectionist national procurement long had.

5.4.2 Removing technical barriers

There are three types of technical barriers to trade, those arising from:

- differences between (national) product regulations;
- differences between (voluntary) standards;
- differences in, or duplication of, conformity assessment.

Whereas the first one is obvious, the second one might be thought to present no problems since market access is not legally blocked. Yet, where local standards are dominant, market share of foreign entrants may not develop before adherence to that standard is observed. The third barrier can be costly if testing and certification have to be performed in many EU countries.

It is hard to generalise on technical barriers, except that, in very different degrees, they arise in many product markets. In a qualitative sense the economic effects of removing them include cost savings due to fewer interruptions of scale production, lower storage requirements, the facts that retooling is no longer required and conformity assessment is cheaper and faster, and welfare gains following greater contestability of markets, as well as greater incentives to compete on the basis of quality.

Since technical barriers are regulatory barriers, the judicial review to overcome them had to come from the solution review about the Art. 30 prohibition of 'measures with an equivalent effect' to quotas, combined with the Art. 36 derogations and the approximation called for in Art. 100. We have briefly touched upon the judicial review, which had become very effective in the course of the 1980s. This was initially not the case for the regulatory track: The 'old' approach to approximation boiled down to a mixing up of regulation and standards, that is, not only health and safety objectives were specified in the directives but exhaustive technical specifications of product aspects and test methods were also included. With such EC laws, there were no incentives to write (voluntary) European standards in those fields any more. In the relatively few cases where EC directives were adopted despite unanimity, all three barriers were removed in one stroke but at high costs of rigidity and complexity. Moreover, a major economic and regulatory issue for the internal market was that a steady flow of new national regulations were added to the large stock of technical barriers while the speed of removal was extremely slow (see below and Pelkmans, 1987a; see also CENES, 1992 and Nicholas & Reppasard, 1995).

As shown in 4.3.3, the solution was found in a new regulatory strategy. For the removal of technical barriers it took shape as follows. Inspired by the judicial

review of the EC Court, by the reference-to-standards

approach in Germany and by the 1973 Low Voltage Directive, a 'new approach' was developed in 1983 for the regulatory track. Based on the principle of 'minimum harmonisation', approximation would henceforth consist of harmonising only the 'essential requirements' of health, safety, consumer protection and the environment. In other words, the health (etc.) objectives of machine or toy legislation would be included in the EC directive but not the technical specifications. This has two economic advantages: first, by referring to European standards, much greater flexibility is achieved for business as CEN and CENELEC¹³ will usually prefer performance standards;¹⁴ second, standards are voluntary and leave room for innovators to 'go around' them, if desired.¹⁵

Besides the new approach to harmonisation, the so-called 'global approach' has removed the barriers in the conformity assessment for regulated products. The crux here is mutual recognition between Member States if mandated bodies, selected on the basis of quality criteria, certify. This implies independence of the country of certification from the country of production or country of sales: so one can certify in EU country A even though one produces in B. Given minimum quality criteria for test houses, it also leads to competition in testing. The cost reduction from the global approach is therefore likely to be very considerable (for an authoritative survey see Maehado Jorge, 1995).

CASE STUDY 5.2 Technical barrier in weighting equipment

In the market for weighting equipment there is asymmetry of information between buyer and seller: the buyer cannot verify scaling and calibration. Member States use regulations to correct this market failure. This has led to technical barriers in the internal market.

The Cecchini report concluded that technical certifications for mechanical and electro-mechanical scales in the Member States were divergent (French regulation especially deviated), giving rise to additional costs and trade impediments. When removing technical barriers by making scaling and calibration uniform at an EU-level, the number of

components used could be reduced drastically. Material costs could be cut by 15-20 per cent (with material costs being 40-50 per cent of total manufacturing costs). However, the extensive use of components is not just caused by divergence of regulation, but also by the desire to use product variety as a marketing tool. Therefore, only a direct result of harmonisation. In this way a 1 per cent cost reduction could be achieved.

The resistance to changes in regulation in the weighing industry is much greater for mechanical and electro-mechanical scales than for electronic

¹² Of course, any domestic suppliers would themselves purchase rationally in the single market or beyond, hence, there is likely to be considerable EU input in their final supplies to the government. For a theoretical 'welfare' analysis see, for example, Tovanis (1990).

¹³ CENELEC (the European body for electronic/electronic standards) and CEN (the European body for non-electric standards) consist of the national standards bodies in Western Europe. For telecom standards ETSI was founded in 1988.

¹⁴ Unlike prices and rigid design standards, performance standards focus on what (tolerance or other safety, etc) performance should be met and, if necessary, how this should be tested. This leaves great discretion for product differentiation and innovation among producers.

¹⁵ Since complying with the referred standard is 'presumed' (in the new approach) to be equivalent to compliance with the 'essential requirements', a product solution outside the standard will require independent certification in order to confirm compliance with the directive.

CASE STUDY 5.2 continued

scales. With old technology mechanical scales are in the final phase of their product life cycle. National regulations can work as hidden protectionism against competition of similar products from other Member States. Electronic balances have rapidly increased market share throughout

the EU. These highly reliable machines need only a minimum of testing, thereby reducing costs and dispensing with technical barriers. The few remaining producers of mechanical and electro-mechanical balances try desperately to hold onto their ever-shifting position.

The new and global approaches in conjunction with the judicial review regarding Arts 30 and 36 have created an effective mechanism to tackle thousands of technical barriers. They are complemented by other elements that, together, will have led to a virtual disappearance of technical barriers towards the end of the 1990s.¹⁶ The most important one of these is the 'information' directive 83/189. This remarkable directive provides the EU with a power to intervene in national drafting of legislation if it would give rise to (new) technical barriers to trade. Prompted by the regulatory drive of the Member States, this unique power is now used routinely. Given hundreds of (mandatory) notifications a year by Member States, with amendments or indeed a standstill proposed in more than one-third of the cases and sometimes an EC directive instead, this seemingly technocratic instrument has inevitably become the great protector of market integration against new technical barriers.

5.4.3 Removing fiscal frontiers

Not entirely dissimilar from technical approximation, the initial proposals on tax harmonisation were often centralised, rigid and uniformist.¹⁷ These extreme positions kept fiscal frontiers alive in the EC customs union until the early 1990s because Member States neither liked to give up so much tax autonomy nor accepted a looser regime inducing fiscal competition for fears of revenue losses.

5.4.3.1 The economics of fiscal harmonisation

Tax harmonisation for product markets refers to indirect taxation, that is, sales taxes (or like taxes)

and excise duties. If a CU also wishes to be an indirect tax union, it must remove border tax adjustments or whatever controls will be needed under the destination principle. This principle is the customary one for international trade within a CU. The *destination principle* says that goods should be taxed at the place of consumption, at the local tax rate. Since exports are not consumed locally, they ought to be zero-rated. In so doing consumption in the destination country will be trade neutral: if the domestic and import pre-tax prices are equal, the tax-inclusive prices will also be equal. The fiscal frontiers under the destination principle consist of two activities: once the export goods physically pass the frontier, a form will be obtained from customs declaring that they are now eligible for zero-rating; upon entering the fiscal jurisdiction of destination, they will become subject to local indirect taxation. Hence, a CU having abolished border instruments of protection for intra-CU trade, such as tariffs and quotas, will still witness double fiscal frontiers.

This sets intra-CU trade apart from domestic trade for which the *origin principle* is used. According to this principle, a good is taxed at the place of production irrespective of where it is consumed, locally or abroad. Were this principle to be used for international trade, it would not be trade-neutral, but distortive. Only in the purely hypothetical scenario that all national tax regimes were identical and rates (across many goods) uniform, would the distortion of competition disappear. If that were true, the origin principle would of course be superior since the heavy compliance cost of fiscal frontiers would not arise. Politically, this is not feasible. But defending the origin principle from this perspective is also economically undesirable. The objections come in two classes.

The most fundamental ones derive from the economic suboptimality of completely uniform tax regimes and rates among countries, even in a CU. Differences in taxation are a function of differences in income levels, and their distribution, and also of different priorities and ambitions in public spending, in turn derived from differences in voters' preferences, revealed in one way or another via the political system. These differences are reflected in disparities in indirect tax structures because of different exemptions and different peak levels for what are seen as 'non-essentials' across the spectrum of taxable goods. Imposing uniformity between the Member States' tax regimes and rates would therefore suppress the satisfaction of preferences in many, if not all, Member States in a number of ways. This class of objections forms a strong argument against the early Community pursuit for uniformist tax harmonisation, rather than tax diversity.

The second class of objections becomes relevant once the plea for the origin principle is, in turn, based on the advocacy of fiscal reforms so as to minimise distortions (see e.g. Smith, 1993). Based on simple general equilibrium two-goods models of an open economy, the domestic reform advocated for indirect taxes would typically be to adopt uniform rates across goods (since dispersion of rates across goods tends to augment the 'welfare' costs of distortions). The international reform would consist of a shift to the origin principle. It is accepted that such uniform indirect tax rates could differ between countries (because of income levels or spending preferences) but, assuming factor immobility, its effect upon trade and competition could be fully neutralized under flexible exchange rates or flexible prices.¹⁸ Hence, tax harmonisation becomes superfluous in a CU, yet Member States retain tax autonomy without revenue losses.

However, this conclusion breaks down once one allows for the fact that tax rates do differ across the goods spectrum. In actual practice, there are three distinct issues behind disparities of indirect taxation between Member States – all three are relevant to the EU experience. First, the systems of indirect taxation may differ. During the build-up phase of the CU, all EC-Six countries except France operated so-called 'cascade' taxes: every sale at intermediate stages of production and to final consumers was taxed. This idea is not compatible with uniform domestic rates, even if tax rates did not differ per sale, as some goods take several stages before reaching the final consumer, others only one, the latter enjoying a lower tax burden.

It also led to fiscal incentives for vertical integration: if a three-stages production could be completed in one company, two intermediate taxes would be avoided. In trade the problems were even greater. Zero-rating for exports meant that the prepaid tax from intermediate sales had to be refunded but such compensations could only be approximate and case-by-case. This gave rise to the fear of hidden export subsidies but also to numerous complaints by business about too low refunds. Border tax adjustments for imports within the CU tended to be higher the closer the goods were to the final consumer which, again, provided discretion for 'protectionist' levies. France, however, operated a value-added tax (VAT) where invoices of any sale would always report the tax of the value added up to that point – this could be reclaimed by business and tax on additional value-added would be shifted to the next user or the final consumer. VAT made both domestic and intra-EC trade fiscally easy, neutral and non-arbitrary, and hence was proposed for all EC-Six countries. It was adopted in 1967.

The systems problem was not so great in excise duties where very tight tax controls and the absence of complicated processing stages (unlike cars or machinery) facilitated border tax adjustments. Second, the *tax-base* may differ. The issue here is which goods are actually taxed and which ones are exempted or treated specially (with higher or lower taxes). Disparities in the tax bases would also cause the origin principle to be distortive. The EU approximated the national VAT bases in 1977 in the Sixth VAT directive without making them fully uniform. One might argue for this approximation on the grounds of preparing for the origin principle, because under the destination principle there is no economic reason to approximate. However, such a defence would conceal the real political reason at the time. The EU budget had meanwhile established a system of 'own resources' (revenues), part of which consisted of a tiny share of the national VAT revenues. Since the national tax bases differed greatly, and since the ratio of direct over indirect tax revenues varied significantly among the Member States, the national contributions to the 'own resources' were far from proportional. Approximation reduced these discrepancies. In actual practice the introduction of VAT and base approximation amounted to a (presumably welfare-increasing) tax reform as it drastically simplified indirect taxation in practically all Member States, while doing away with all kinds of anachronistic taxes. This was also true for excise duties, the goods

¹⁶ There are four elements: some 90 approximation proposals for industrial goods and some 75 for agricultural goods and live animals were dealt with following the White Paper – this proved possible because of qualified majority voting; directive 83/189 (the mutual information directive) dealt with the regulatory drive of the Member States, such that new national regulations could not create new technical barriers (see text); standards *not* connected to legislation were more often Europeanised; and the EOTC was established in 1990 to promote mutual recognition for testing and certification of non-regulated products (on the latter, see Machado Jorge, 1995).

¹⁷ An interesting difference is, however, that the Treaty (Art. 99) speaks of harmonisation in the case of indirect taxation and approximation (1990 and 1992A) in the case of regulatory barriers. (However, only harmonisation is used in the French text of Art. 100.)

¹⁸ Assuming away the compliance cost under the destination principle, the destination and origin principles become fully equivalent after such hypothetical reforms.

basis of which was narrowed to a few major products with special health (alcoholic beverages and tobacco products) and environmental and infrastructural (fuels for transport) problems, causing externalities. It is claimed that, when Greece became a member in 1981, around 100 different taxes had to be abolished.

Third, the *tax rates* may differ. This effect is represented in two goods general equilibrium models about trade and goods taxes. Be that as it may, one could argue that the economic case for the origin principle would be strengthened after the shift to VAT and the approximation of the bases. The answer is that the case is only strengthened marginally. There are both analytical and practical reasons which should be addressed before the case becomes convincing. Both are relevant to the EC-1992 and post-1992 processes moving towards this objective. Analytically, two-goods trade models assume factor immobility and this conflicts with the achievement of the free movement of capital in the EC-1992 programme (see chapter 9). Furthermore, there is balanced trade which, in a bilateral sense, is of course not normally the case in the Union. Yet, bilateral trade balances will induce revenue effects if rates differ between Member States and this would create a need for complex compensatory transfers. Yet another problem is that trade with non-Union countries would remain subject to destination taxes. This combination of origin taxation in the Union and destination taxation with third countries is called the 'restricted origin principle' (Shibata, 1967). But, as in a free trade area (see chapter 1), this will cause (fiscal) trade deflection. Companies in high tax Member States will have an incentive to import goods from third countries via a low tax Member State. Due to the origin principle, no further tax adjustment would take place within the Union. Clearly, this is distortive and would also undermine revenues in the high tax Member States. Short of cumbersome alternatives, this forms an argument for approximation of rates in the EC in such a way that these incentives become trivial.

The practical issues cannot be disregarded either. By far the most important question concerns the revenue effect for individual Member States during transition and the impact they have on other elements of taxation and/or on Member States' capacity to spend on public and merit goods. The political sensitivity of this point hardly needs emphasis, amplified as it is by unanimity requirements in the Council

of Ministers. The corollary is, however, that it weakens the economic case for the origin principle since fiscal autonomy and diversity are affected negatively. As it turns out there are also complex 'welfare' effects that go beyond the scope of this book (see for instance Fehr, Rosenberg & Weigard, 1994).

5.4.3.2 Fiscal EC-1992 and beyond

During the 1980s the Community gradually shifted away from the supposed need for uniformist harmonisation of the rates. A degree of diversity and measured fiscal competition among the Member States have been accepted towards the end of the EC-1992 process. Thus, low and high VAT products were defined and fiscal competition among high-VAT products has been allowed by only establishing a minimum VAT rate of 15 per cent. The Member States acknowledged the imposition by EC-1992 to remove fiscal frontiers but have not formally agreed to a shift to the restricted origin principle. The viewpoint of the EC Commission is that by 2000 the origin principle should govern intra-EC trade.

The fascinating history of the interaction between Commission and Council will not be dealt with here (see, e.g. CEPS, 1989; Smith, 1993). The compromise reached is a 'temporary' solution until a 1996 review¹⁹. The compromise boils down to the retention of the destination principle for companies and commercial traders, but without the fiscal frontiers at the borders. As noted above, border controls were used to verify whether zero-rated goods had actually left the exporting country and to ensure that destination VAT was imposed by the importing country. In the post-1992 system these two controls are shifted to the companies themselves.

Additional reading

Thus, the benefits of removing customs controls for tax purposes have to be weighed against the actual administrative burden at the company level plus the costs of close administrative cooperation between the tax authorities of Member States to prevent or detect fraud. The exporting and importing companies have to report (national) VAT numbers on their invoices, zero-rating for exports is maintained and import VAT

CASE STUDY 5.3 Elimination of fiscal frontiers

Since 1 January 1993, the fiscal internal borders have disappeared. The old border procedures have been partly replaced by new administrative procedures to be fulfilled by the company. Furthermore enterprises are obliged to present intra-EU business transaction statistics to the authorities. A Dutch institute for SMEs studied the actual administrative cost reduction for 80,000 Dutch companies involved in intra-EU trade. Fig. CS 5.1 shows that the total structural cost reduction of 249.2 million ECU can largely be attributed to an enormous decrease in administrative costs related to imports and exports. The new procedures add only little to the administrative burden.

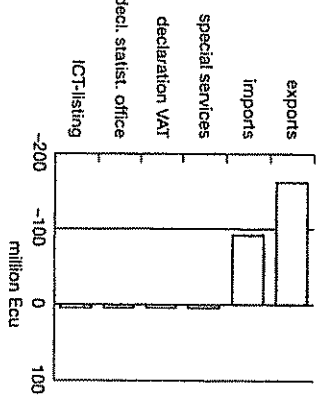


Figure CS 5.1 Structural cost changes, new VAT regime

The new VAT regime forces the companies involved to make once-only adjustment costs. These costs amounted to 48.7 million ECU. Fig. CS 5.2 distinguishes the aspects contributing to these costs.

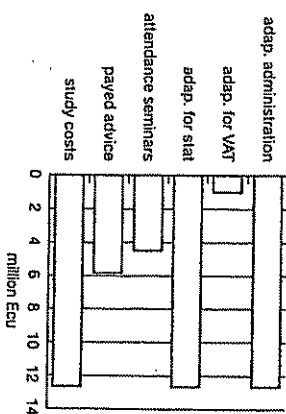


Figure CS 5.2 Once only adjustment costs, from new VAT regime.

Although on average the structural cost decrease for a Dutch company involved in intra-EU trade is 311.5 ECU, some companies complain.

is levied on the importing company. The enforcement problem is thus resolved by tax audits and administrative supervision at national level and intensive administrative information and cooperation between national tax authorities. If the enforcement problem is effectively resolved at low costs, this transitional system of cooperation is in accordance with the subsidiarity test of chapter 4.

The compliance costs and estimates of residual fraud²⁰ are among the reasons for the Union to shift, in 2000 or so, to the origin system as proposed by the

Commission in 1987 and once again in 1996. The origin system would do away with zero-rating for intra-EC exports, but it would protect the Member States from revenue shocks by the setting up of a Clearing House. The importing company would claim the VAT paid in the origin country from the destination country's tax authorities (against the company's own VAT liability). This would maintain neutrality for trade and competition. The policy problem would be found in the changes in revenues of the Member States. However, in this form, the administrative costs

¹⁹ When this book went to press, Commissioner Monti had presented proposals for common VAT, based on the origin principle, to be realised by 2000. The essence of the discussion in the text above is not affected, however. See COM (96)138 of 22 July 1996.

²⁰ The self-enforcing nature of VAT drastically reduces the incentive for fraudulent business behaviour. Suppose it is feared that a zero-rated export would be diverted back into the domestic economy, facilitated by the lack of customs control. First, the tax authorities would not have to accumulate VAT without proof of paid invoices or delivery forms. Even if that failed somehow, the user or distributor would have to collaborate (as they cannot reclaim VAT either) and final consumer (including businesses reclaiming VAT) should never be expected to report. This would seem unsustainable on a large scale. With respect to compliance costs, there is the erstwhile issue of the (net) benefits of the removal of the fiscal frontiers (see case study 5.3) as well as the relative costs of domestic and cross-border intra-EC costs of fiscal operations. The Commission's (autumn 1991) claims the latter cost five to six times more than domestically under the post-1992 system.

would be considerable as every national tax authority would have to handle millions of invoices from all Member States. The revenue problem is not trivial either because the system would positively affect revenues of Member States with above-average VAT rates (origin rates) as well as those with bilateral trade surpluses within the Union, and engender revenue losses for deficit and relatively low tax countries.²¹ The Union Clearing House would bring together the accumulated net bilateral claims and make transfers accordingly. Apart from the need to do this by statistical approximation (as the transactions-based approach would be too cumbersome), there is a problem of enforcement asymmetry (Smith, 1993). Whereas so-called 'output' VAT (in the destination country) will be controlled as usual, the origin country may feel few incentives to control 'input' VAT (on its exported products) because the destination country is held to pay the 'input' to the origin country unless fraud is suspected. Why would the origin country's administration audit VAT claims which are not submitted to its own administration?

Under the origin principle, trade deflection forms a stronger argument to bring VAT rates closer together. The 1996 Commission proposals suggest three rounds of approximating national VAT rates up to 2000.

5.5 Summary

The Community has gone through different aims in pursuing product market integration. The Rome Treaty implicitly comprises a tariff union, complemented by open-ended approximation (under unanimity) and four common policies: trade policy (though incomplete), competition policy, agricultural policy and – based on the Paris Treaty – coal and steel.

Although complicated by various protocols and stages of liberalisation, the internal tariff removal turned out to be easy, due to a high degree of automaticity in the treaty and the favourable economic

climate. The internal removal of quotas was almost entirely automatic. The problems of the customs union were minor with respect to the CET – again, due to far-reaching automaticity – but enormous and stubborn with respect to national quotas vis-à-vis third countries. The latter turned the CU into an FTA for certain products, above all textiles and clothing.

Moving beyond the CU to veritable product market integration could be done with the help of a 'mother principle: the ideal one of explicitly defining product-market integration (an area without economic frontiers in the product market) as the bench mark, or the less far-reaching one of removing all internal frontier controls. Article 8A of the Single Act comprises the second one and goes far into the direction of the first. The famous EC-1992 programme brings this out (Table 5.1 provides a concise summary of the EC-1992 proposals in product markets).

Apart from the physical removal of the customs services and other controls at the internal borders of the union, three kinds of barriers were removed by a combination of negative and positive integration:

- Discrimination in public procurement: this led to more competitive purchasing with potentially large 'welfare' gains.
- Technical barriers (technical regulations which differ between Member States; similarly for standards and conformity assessment), a huge area of regulatory barriers held another promise of great welfare gains, although only after a long lead-time to write European standards for reference.
- Indirect tax frontiers: the key issues there are whether a degree of fiscal competition is accepted by Member States (in VAT this was accomplished) and whether the origin principle is introduced for the EU (this was delayed); if, by 2000, a common origin-VAT were to be realised, some degree of approximation of VAT rates is likely to have been adopted.

CHAPTER 6 Product Market Integration: Economic Analysis

- 6.1 The basic theory of customs union
- 6.2 Customs union and technical efficiency
- 6.3 Customs union and decreasing costs
- 6.4 Empirical studies
- 6.5 The Pro-competitive effects of a CU
- 6.6 The economic impact of EC-1992
- 6.7 Price convergence in the internal market
- 6.8 Summary

Product market integration has been the subject of an extensive literature both in economic theory and empirical analysis. As noted in chapter 5, product market integration includes, but goes far beyond, the mere establishment of a CU. Removing also quotas for third countries, as well as regulatory and fiscal barriers among members, while preventing private anti-competitive behaviour is ambitious indeed. If successful, it should lead to strong tendencies towards price convergence in the union. The present chapter will be limited to the main themes and reduce technicalities to a (graphical) minimum. The first three subsections deal with the basic theory of customs union. The scope and assumptions of this basic theory are first explicitly defined. Trade creation and diversion and some other effects of CU will be analysed including its impact in the presence of scale economies and (initial) technical inefficiency. The question of whether CUs can be economically justified will also be tackled. Section 6.4 will discuss the empirical literature studying the emerging EC CU in the 1960s, using the basic CU theory as the framework of reference.

Only when the restrictive assumptions of the basic theory are further relaxed can the pro-competitive effects of a CU be better understood. Section 6.5 discusses three such effects: intra-industry trade, deepening product market integration under imperfect competition (making price discrimination no longer possible) and removing national quotas vis-à-vis third

countries (a key issue under EC-1992 in some sensitive industries). The chapter closes with the economic impact of EC-1992 in product markets, following the Cecchini report (1988) and the analytical debate it sparked (in 6.6), and a digression on price convergence (in 6.7).

6.1 The basic theory of customs union

Any economic theory of (regionally) discriminatory trade has to address the question whether the preferential arrangement would be superior to participation in worldwide liberalisation. Given a decision to go for regionalism, a further choice is to be made between the various methods of regional trade liberalisation. Different options can be defined dependent on whether one wishes to leave some national trade policy autonomy or not, and on how one copes with the effects of different national protection vis-à-vis third countries. If one wishes merely to liberalise intra-group trade regionally, and refuse to constrain national trade policies, massive transit trade would arise, exploiting differences in tariff or volume protection among partners by leading imports from third countries through the partner country with the lowest protection. This is called 'trade deflection'.

Following section 1.5, a customs union can be defined as a group of countries, eliminating tariffs for intra-group trade and unifying their national tariffs into a common external tariff for trade with third countries. A customs union differs from a free trade area in the alternative way of preventing trade deflection: in the free trade area, the national tariff disparities remain but their exploitation is outlawed with enforcement based on certificates of area origin, while in the customs union, tariff disparities are simply eliminated by erecting a common external

²¹ For some indicative short and long run calculations, see CEPIS (1989). These calculations combine the 1987 proposals on rate harmonisation with the Clearing House

tariff (CET). As noted in chapter 2, the European Community has explicitly opted for a customs union rather than a free trade area.

The question addressed in basic customs union theory is what the trade and 'welfare' effects are of a change from national (tariff) protection to a customs union. Our exposition of the basic theory of customs union will be built upon a set of nine assumptions, taken from the standard theory of tariffs. CU theory proper is derived from variations in five supplementary assumptions.

The basic assumptions include the following:

- 1 It is a static theory - the workforce, capital stock and technology are given;
- 2 Numerous atomistic economic agents;
- 3 Homogeneous and smoothly substitutable factors of production;
- 4 No internal or external (dis-)economies;
- 5 Free access to the full range of technologies;
- 6 Complete information (i.e. perfect foresight, hence no uncertainty);
- 7 No international (and perfect intra-national) factor movements, that is, no direct investments;
- 8 No new products are introduced;
- 9 Governments do not interfere in the economy, except at the border and only with tariffs.

The supplementary assumptions include two (namely 10 and 13 below) that define the minimum institutional properties of a customs union for the purposes of analysis:

- 10 The number of countries (the minimum is three since A and B will discriminate in trade with the rest of the world, C):
- 11 Cost assumptions (or supply elasticities) (constrained by 4 above):
- 12 Assumptions on demand elasticities;
- 13 Assumptions on the ex-ante national tariffs and the ex-post height of the common external tariff (CET), as noted in section 1.6, the CET's 'general incidence' should not exceed that of the previous national tariffs of member countries (GATT, Art. 24.8.) but GATT's interpretation and enforcement have remained unclear, for reasons explained in chapter 5 the EC has taken the arithmetic mean of ex-ante national tariffs (Art. 19.1, EC Treaty);
- 14 Assumptions on the number of goods; the standard theory of customs union hinges on the one-good, partial equilibrium approach although some of the crucial concepts can be extended to a two-good general equilibrium context; further insights can be gained from a multi-good analysis.

Basic customs union theory consists of analytical exercises suggested by variations of the five supplementary assumptions, with different degrees of technical sophistication.

6.1.1 Trade creation and diversion

The central tenets of customs union theory can be explained for highly simplified combinations of assumptions 10 to 14. In this section, only one good is explicitly studied (ass. 14), the demand schedule is of the normal, downward sloping variety (ass. 12), the CET will be $t < \text{CET} < t_A$ (ass. 13) and the rest of the world supplies good x at constant costs (ass. 11). Cost assumptions for the two countries A and B, forming the CU, will be varied. However, decreasing costs are ignored because assumption 4 applies (but see section 6.3).

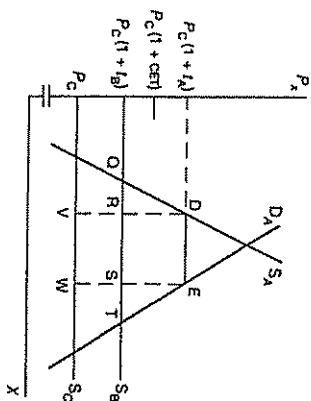


Figure 6.1 Customs union, trade creation and diversion

Now, consider Figure 6.1, where A's x -market has been portrayed. In the figure A's supply schedule shows increasing costs: B and C (the rest of the world) supply at constant costs, C being the lowest-cost supplier. The situation before the CU in the A-market is that A imports DE from C at $P_C(1+t)$ yielding a tariff revenue DEW. After the CU is established, B will supply A the volume of QT of x behind the CET. Basic CU theory, developed from Viner's (1950) pioneering study, defines the following effects:

trade creation is the welfare change due to the replacement of (higher-cost) domestic production of import goods by (lower-cost) imports;

trade diversion is the welfare change due to the replacement of imports from a low cost source by imports from a high cost source.¹

In terms of the world allocation of resources or the world division of labour, it is clear that trade creation is beneficial to 'welfare', whilst trade diversion worsens allocation. Applied to Figure 6.1, trade creation is the welfare gain from the replacement of QR production, previously supplied by A itself, by imports from B: this is DRQ. Trade diversion is the resource cost of replacing DE of imports from C by intra-CU imports (free of tariffs, and behind the CET which, in this case, keeps C out) from B: this is the tariff revenue, now lost for A, minus the gain to A-consumers (DESR), being RSWV. Besides trade creation and diversion, there is a consumption effect EST, the 'welfare' gain of the increase in consumption due to the price fall of x in A. These effects can also be derived as follows: the total gain in consumer surplus is the area between the price axis, the line $P_C(1+t)$ up to E and S_B up to T; A-producers see their producer surplus decrease by the area between the price axis and D and Q whereas the government loses DESR as part of the lost revenue. Hence, DRQ and EST remain as net gains; RSWV is the uncompensated part of revenue loss and represents a net loss. As drawn, the CU in Figure 6.1 incurs a small loss if trade creation, the consumption effect and diversion are added up. Note that it is merely a net loss in static 'welfare' terms, under restrictive assumptions.

Several conclusions follow from this analysis. First, to call a CU 'trade diverting' or 'trade creating' is often inappropriate: in a product analysis as simple as Figure 6.1, the CU gives rise to both effects at the same time.²

Second, the naive idea that customs unions are necessarily a step towards free trade - an idea that underlies the GATT exemption of preferential trade agreements for customs union (and free trade areas) - is incorrect. In Figure 6.1 it all depends on a series of variables. Viner's contribution consists of dealing a fatal blow to this naïveté by a simple device: once trade creation and diversion are defined, it follows that the net effect on the world efficiency of production can be either positive or negative. Adding the consumption

effect does not alter this fundamental conclusion. Later, Viner's insight has been generalised in the theory of second-best: the shift from one sub-optimal situation to another does not permit generalisations on the direction of the change in 'welfare'.

Third, the likelihood of welfare gains increases if ex-ante tariffs are high, ex-ante imports from the rest of the world are low, ex-post CU prices are close to the world level and if the number of Member States would be large relative to that in the rest of the world.

Fourth, static 'welfare' effects (for a given world forms of trade) are small. Empirical studies usually find effects for the EC-Six to no more than 0.5 per cent of GDP. Simple ex-ante calculations by Johnson (1958) suggested an upper bound of 1 per cent of GDP. Intuitively, this is not hard to understand, once it is realised that trade creation for the bigger EC countries will only reduce the domestic supply to domestic consumption by a few percentage points, while C will often capture the consumption expansion. Also, the triangles vertical lines only measure the tariff decrease to the level of the CET (say, for Italy, on average, perhaps from 25% to 15%), and this, in turn, is only 1/10 of the relevant price (multiplied by half, so as to get the surface of the triangle). Similarly, net trade diversion is small once C would capture the consumption effect.³ Only under extreme differences in costs and/or tariffs and very large replacements would these effects become more significant: this is only to be expected in a few sectors, if indeed the political economy would allow such shifts to take place rapidly.

Consider next Figure 6.2. It is assumed that both A and B experience rising costs in producing x , and that they are *ex ante* importers. It would be misleading to depict the A-market only, since the cost of production in B will also be affected. Therefore, the supply and demand for A and B is depicted both separately and as S_{CU} and D_{CU} (by horizontal addition). In country A the previous imports DE (from C) rise to QT, with QR supplied by partner B and RT by C. This gives a trade creation of DRQ and a consumption effect of EST. Whether there will be trade diversion depends on the reactions in B's x -market.

¹ The reader is warned that trade creation and diversion are frequently referred to in trade flow, rather than welfare, terms. Trade flow changes are not a precise indicator of welfare changes: sometimes they are misleading. (See e.g. Torvik (1982) and Pelkmans & Grémion (1983).)

² In the 1950s, 1960s, and early 1970s the question whether a 'trade diverting' CU could still be welfare-improving was debated. This was prompted by Viner's analysis, based on constant costs for all countries (also A). In this very special case, one obtains either trade creation or trade diversion - this is so because, with constant costs in A, a tariff is either prohibitive or a pure revenue duty. Outside Viner's framework the either/or issue need not arise. When there are scale economies, the problem is relevant again, but overshadowed by other effects (see 6.3).
³ For a numerical example in some detail, see Pelkmans (1984, pp. 202-21).

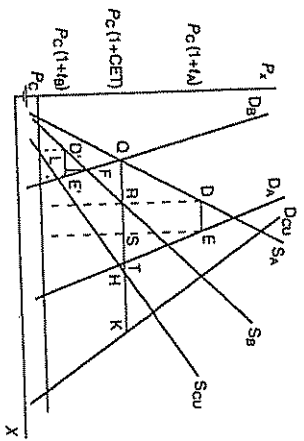


Figure 6.2 Customs union, both partners rising costs

What one might fail to see in a one-country diagram, focusing on country A, is immediately obvious in a union diagram: the chosen CET changes country B from an importer ($D'E$ from C) to an exporter (QR) to A. Figure 6.2 has been drawn in such a way that $D'E = ST$. Thus, the ex-ante imports of the two CU-partners from C are equal to RT. Since $RT = HK$ (by definition), it follows that - as drawn - C's exports to the customs union have remained constant. The QR-part of the extra imports of A represents trade creation as it comes from a cheaper source (B) than domestic producers (though not from the cheapest source, C). However, as soon as B's exports to A become larger than QR, B would encroach upon the ex-ante A-imports from C ($DE = RS$) and this would amount to trade diversion. This would occur when S_b became more elastic than drawn, or when the CET became a little higher than indicated in Figure 6.2.

The welfare effects are quite complex. Trade creation is DRQ in A, but in B trade creation is *negative* ($D'LF$) as relatively inefficient B-production replaces (at rising costs) C-imports.

Trade diversion may or may not occur dependent on whether B's exports to A are bigger or smaller than QR. The consumption effect is positive (EST) in A but *negative* in B (FLE), while gains accrue to B from becoming an exporter (FQR).

Two other interesting conclusions follow from this analysis. The first one is concerned with an implicit, if not explicit, purpose of all customs unions: the promotion of intra-group trade. Figures 6.1 and 6.2 make clear that a CU can only promote trade among its member countries if the CET is distinctly protective for the relatively efficient producer in the union (here, B). For many agricultural products, the European

Community raises high to very high border levies, that have enabled explosive growth in intra-EC agricultural trade at the cost of substantial trade diversion, with France, Ireland, the Netherlands and Denmark being relatively efficient exporters of well-protected non-Mediterranean products. Spain, and to a lesser extent Greece and Italy, have boosted citrus and olive exports to EC partners based on high protection. In textiles and clothing, EC tariff and volume protection has long enabled Italy and later Portugal to expand greatly their intra-EC exports, while in automobiles British volume protection vis-à-vis Japan since 1977 has led to a substitution of British production by more efficient EC imports during the 1980s.

The second conclusion is concerned with C's market access. It is usually incorrect - though often stated - that regionalism would lead to a closure of the (CU's) market, a kind of a 'fortress'. In the case of the EC, only in agriculture was the CU explicitly used for this purpose (see chapter 11). Moreover, to derive such an inference from Figure 6.1 is very misleading analytically since it ignores the case of increasing costs for all Member States. In Figure 6.2 C's exports to the union remain exactly the same. An increase in the CET could let HK shrink to zero and a lower CET would induce even larger exports from C to the union than before.

The GATT rule, that the 'general incidence' of the CET should not exceed that of the ex-ante national tariffs, interpreted in terms of arithmetical means (as in Art. 19.1, EC Treaty), acquires strange economic implications in this model: in Figure 6.1 C is excluded and in Figure 6.2 it all depends, but C is likely to be excluded from the B-market in most instances while supply to A may (but need not) increase, possibly outweighing export losses in B. As observed in chapter 1, the clause would best be dispelled as an anachronistic remnant. Its amendment in the Uruguay Round permits a more sound economic assessment.

6.1.2 An economic case for the customs union?

Customs union theory can be endlessly extended by taxonomy. Since the marginal utility of the taxonomic approach decreases very quickly, a more fruitful avenue may be to produce conclusions that, with due regard to the restrictive assumptions of the model, could be of relevance to the policy makers.

If there is a manifest political commitment to European integration, the CU will be established as a stepping stone to 'deeper' integration. Given this political motivation, policy makers will be interested in the expected welfare effects of a customs union and presumably in ways to minimise the adverse ones. The partial equilibrium analysis of the previous section - of course only appropriate for the static welfare effects - leads to the following conclusions:

- 1 Fully general rules of thumb on the net beneficial effect of customs union on 'welfare' cannot be derived. This follows directly from the theory of the second best.
- 2 Net benefits to 'welfare' will tend to be higher, if *ex ante* tariffs are high, *ex ante* imports from the rest of the world are low (reducing trade diversion or negative trade creation) and *ex post* CU prices are close to the world level (augmenting trade creation and positive consumption effects).
- 3 Net benefits to 'welfare' will tend to be higher as well if the CU comprises a relatively large part of world trade (minimises trade diversion) and if the participating economies are of a potentially competitive nature. With strictly complementary economies, say most EC countries compared with most Arab countries up to recently, customs duties have little or no effect on the mutual division of labour and usually have a pure revenue function (like excise duties). A customs union in this case would not yield a noticeable contribution to welfare.

Policy makers can use these insights to design the CU in ways which would promote net welfare benefits.

On the other hand, if there is no manifest political commitment to European integration, but a search for optimal foreign economic policy, traditional customs union theory can be used as a rigorous, though restrictive, approach to formulate an economic case for a customs union. One central conclusion is, of course, that a customs union is necessarily inferior to free trade.⁴ But the theory can be taken further than that.

Additional reading

Cooper & Massel (1965) have pointed out that to compare the establishment of a customs union with

free trade is not interesting, since customs unions are typically formed because free trade is not a realistic policy alternative. Customs union, as a joint commercial policy option, ought to be juxtaposed to unilateral commercial policy options, before a meaningful comparison can be made. This question is central in formulating the economic case for the customs union in the traditional approach. The answer of Cooper & Massel is straightforward: "... a customs union is necessarily inferior to an *appropriate* policy of non-preferential protection" (their emphasis).

This result is puzzling: even when taking a major political constraint into account - free trade as the first best option is unachievable - a customs union is still inferior to appropriate policy alternatives. Why, then, would countries join a customs union, assuming no overriding political commitment to integration?

The puzzle vanishes as soon as one specifies some of the five supplementary assumptions differently. One qualification (Arndt, 1968) is that a variable terms of trade with C (ass. 11) can make a customs union superior to its appropriate unilateral alternative. Given the substantial weight of the EC in world trade, this possibility is not without importance. But even for a given terms of trade, Wonnacott & Wonnacott (1981) have shown that, if the rest of the world also employs tariffs (ass. 13) - an issue usually neglected in CU theory - the Cooper & Massel proposition is not valid for certain ranges of relative prices. Their analysis also explains why customs unions tend to be established among neighbouring countries (the transport cost differential can be the determining factor). It suggests as well that a CU is more likely to be the superior economic option in a tariff-ridden world economy, while its advantages can be eroded by multilateral tariff reduction. Both inferences appeal to common sense notions, that, when focusing merely on the Cooper & Massel proposition, cannot be readily understood.

One should, however, be cautious in jumping from basic customs union theory, which is built on restrictive assumptions, to policy conclusions. Economic analysis of CU has moved beyond this basic model in essentially two ways. Numerous extensions have been published by varying the five supplementary assumptions. This ranges from incorporation into general equilibrium models (e.g. with other curves, two goods) to variations, one by one, of the respective assumptions: more than three countries, more than two goods,

⁴ For a given terms of trade with the rest of the world. However, a big CU like the EC may improve its terms of trade if the world's export opportunities would be affected negatively. This has certainly been an issue in agriculture (see Figure 11.6) and textiles and clothing.

different cost combinations (ignoring decreasing costs for the moment) and special trade policy assumptions (see e.g. Tovias, 1994a, for a survey). The restrictiveness of the basic model is exemplified when comparing a two-good/three-countries model with a three-by-three model.⁵ In the former, truly multilateral trade is impossible as at least one of the three bilateral trade relations is cut and, if two flows remain, they both have to balance bilaterally. So there is either balanced trade or no trade. One has to touch upon the (thus far) invariable set of nine assumptions to get out of this peculiar context.

In sections 6.2 and 6.3 two important categories of 'welfare' effects are studied which arise from variations in some of the nine assumptions of basic tariff theory. In section 6.2 technical efficiency (cost minimisation) is no longer given, but variable. This must imply less than perfect competition. Customs unions may positively influence technical efficiency. In section 6.3, assumption (4) is changed by introducing economies of scale. They may greatly influence the welfare gains of a CU.

6.2 Customs union and technical efficiency

Technical efficiency is defined as input minimisation at any given output level, given the employment of the best techniques available. To suggest that firms are technically inefficient (often called X-inefficient) must imply that somehow competition is not perfect, permitting departures from cost minimisation without going bankrupt. For enterprises competing in markets from day to day, this is not a particularly surprising insight. For entrepreneurs and managers competitive firm behaviour is a complex variable, not insensitive to the overall state of competition in the product and factor markets, or indeed in the relevant economy as a whole. From there it is a small step to suggest that various forms of private or public shelter from (perfect) competition will eventually lead to higher costs per unit of marketable output than necessary.

In actual practice, therefore, firms will not exhibit equal performance in cost minimisation: every sector will have best-practice firms and higher cost ones. However, in basic CU theory, this crucial notion is assumed away by postulating perfect competition. For policy makers and business, however, it is impor-

tant to understand whether a CU intensifies competition, and thereby induces (technical) efficiency gains.

In the Western Europe of the 1950s many observers were of the opinion that a number of industries were technically inefficient due to numerous public interventions, public regulations, border protection and, occasionally, highly traditional patterns of organisation of industry (e.g. Scitovsky, 1958). It was believed that European industrial market integration could have a 'cold shower' effect on the competitive behaviour of industrial firms. To put it in more analytical terms, decreases in the degree of technical inefficiency of European industry could be induced by decreases in the degree of border protection - giving rise to import competition and export opportunities in the EC customs union - complemented with a tougher surveillance of restrictive business practices via a common competition regime.

It can be shown that the 'welfare' consequences of an improvement of technical efficiency after the reduction of protection are likely to be many times larger than the usually rather trivial net gains from trade creation over trade diversion.

The essential argument is that a gain in technical efficiency, leading to a cost reduction per unit of production, would remove 'waste' and therefore constitute a gain to society. No netting of producer vs. consumer surpluses would be required, let alone losses of tariff revenues. It is also important to see that the gains relate to the entire output, which, for import-competing sectors, is usually much larger than the relevant trade volumes.

Consider Figure 6.3 (Pelkmans, 1982b) where the home country has rising costs as output increases and an initial tariff t_1 . Supplies from the rest of the world S_w are at constant costs. Now, assume a tariff decrease to t_2 . Because of the cold shower of sharply increased foreign competition on the domestic market (the foreigner's y -market share would rise from QR/KR to M/NLN), assume that technical efficiency of home y -producers improves and that this results in a downward shift of S_1 to S_2 . For simplicity, the resulting cost difference is supposed to be equal to the absolute tariff difference per unit of the *ex ante* output. In this case, the triangle gains *only* would be $QSM + RTN$ whereas the technical efficiency gains comprise $KQSL$ - the 'cost reduction' of the entire *ex ante* production - a multiple of the triangles. It should be emphasised that, *ceteris paribus*, for a given tariff reduction and a given effi-

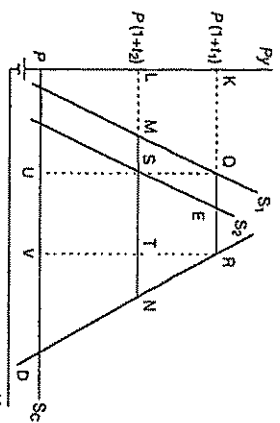


Figure 6.3 Technical efficiency and lower protection
Source: Pelkmans 1982b

ciency improvement per unit of output (in Figure 6.3, both QS), the ratio of technical efficiency gains over triangle gains increases, the smaller the initial market share of foreigners is and the more inelastic demand and supply are. The extent of technical efficiency improvement per unit of output, in turn, may also be related to the *ex ante* market share of foreigners. It seems plausible to expect that the possible leap from a small market share to what rival home producers might think of as a 'large' market share, would induce a relative big technical efficiency improvement compared with the cost reduction induced by enlargement of an already sizeable market share. It follows that truly sheltered economies can reap large X-efficiency gains (and, of course, the triangle consumer gains as well) by engaging in trade liberalisation.

The analysis can be extended to a customs union. In Figure 6.4, country A's market for x is depicted. The initial tariff is t_A , the common external tariff (CET) is either CET or CET', depending on the arithmetical average of all EC tariffs (Art. 19.1, EEC Treaty). S_{cu} is the union supply of x in A (the horizontal addition of S_A and the excess supply of partner B) and S_w is perfectly elastic world supply. It is assumed that the 'cold shower' shifts A's supply schedule from S_A to S_A' .

For the higher CET, trade diversion (STVU) clearly outweighs trade creation ($QSM + RTN$). The cold shower alters the picture since the 'cost reduction' effect is $KQSL$ which is (drawn so as to be) approximately equal to the trade diversion, leaving a consumption gain of RTN. However, the case of the

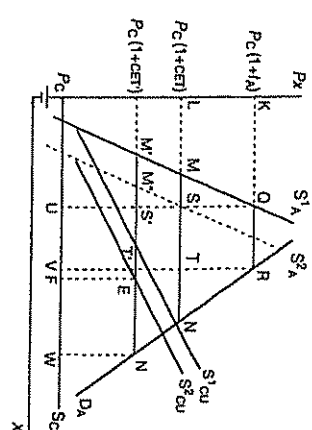


Figure 6.4 Technical efficiency and customs union

relatively higher CET would be atypical since C-exporters lose all access to the customs union.

For CET', C's exports would still be EN', yielding a union tariff revenue of EN'WF. The overall effects of the customs union would then be the 'cost reduction' effect ($KQSL$) plus trade creation (on the production side: $SM'S'$; on the consumption side: RTN'), plus the *ex post* tariff revenue ($EN'WF$), minus trade diversion ($ST'VU$). It is obvious that the formation of such a customs union would be highly advantageous in 'welfare' terms.⁶

6.3 Customs union and decreasing costs

This section adheres to some restrictive assumptions of CU theory: the supply of goods is studied at the industry level (hence, technical economies of scale of plant-output represent those of the industry), perfect competition and homogeneous goods. Other than scale, the basic assumptions of CU theory are maintained. The problem that perfect competition and scale are inconsistent is ignored, so that all effects can be attributed to the CU itself. The additional variations are: one good analysis (ass. 14), 'normal' demand schedules (ass. 12), a CET between t_A and t_B (ass. 13) and constant costs for the supply of the rest of the world (ass. 11).

Consider Figure 6.5. If A and B have equal access to well-known process technology (ass. 5), it is a reasonable simplification to assume that $S_A = S_B$. This

⁵ Note that, following Mundell (1964), it is assumed that the three goods are gross substitutes (and not homogeneous) in the sense that a rise in the price of any country's exports, all other prices remaining constant, creates an excess demand for the exports of every other country.

⁶ There are a number of qualifications of this analysis. See Pelkmans (1982b).