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1992, Hype or Hope : A review

by Alexander Italianer\*

Internal paper



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## 1992, HYPE OR HOPE: A REVIEW

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## 1. INTRODUCTION

In the spring of 1988, two events concerning the European Community stirred politicians, business people and scientific researchers. The Brussels summit of February of that year removed a number of major obstacles to further progress of the European integration process through agreements on the financing of the Community, limits on agricultural spending and the doubling of the so-called structural funds (regional fund, social fund and guidance section of the European Agricultural Guidance and Guarantee Fund). This made headway for an increase in the speed with which the measures needed to complete the EC internal market along the lines spelled out in the 1985 White Paper (Commission of the EC, 1985) were adopted. By June 1989, over 50 per cent of the programme of 279 measures was approved by the Council (Commission of the EC, 1989a). This included important measures in the areas of capital movements, public procurement, banking services and the mutual recognition of university diplomas. The integration process did not stop at the internal market. On the basis of a report by the Committee for the Study of Economic and Monetary Union (1989), the European Council decided at the Madrid summit of June 1989 to embark on stage 1 of the Economic and Monetary Union on the 1st of July, 1990. The obstacles removed in February 1988 thus provided a significant political impetus to the process of European integration.

Shortly after the Brussels summit, the results were published of a major study into what was called the "cost of non-Europe" (Commission of the EC, 1988a). This study not only provided a detailed economic analysis of the sectoral impact of most aspects of the completion of the internal market, but also tried to give an overall quantitative estimate of the "Cost of non-Europe", which, in terms of integration theory, may be put equivalent to the gains from further integration. Thus, even though other research had attempted to analyse comprehensively the impact of the completion of the White Paper (cf. Pelkmans and Winters, 1988), this study, most widely known as the Cecchini report, was the first attempt at global quantification. Two, complementary, approaches were followed with a view to estimating the gains from the internal market. On the basis of a microeconomic approach

using partial equilibrium analysis possible welfare gains in the range of 4 1/4 - 6 1/2 per cent of Community GDP were calculated (for details see Cawley and Davenport, 1988). Since this approach was mainly restricted to calculations concerning changes in consumer surplus and producer surplus without the repercussions for other macroeconomic variables, it was complemented by a macroeconomic approach. The latter was based on the use of dynamic econometric international linkage models: the HERMES model of the European Commission and the INTERLINK model of the OECD. The results from the macroeconomic model calculations, reproduced in Table 1, indicated a possible medium-term increase in GDP of 4.5 %, a decrease in the price level of 6 % and an increase in employment of 1.5 % equivalent to almost two million jobs (for more details, see Catinat et al., 1988, and Catinat and Italianer, 1988). Further use of the budgetary room for manoeuvre could increase the effect on GDP to 7% while expanding employment by 5 million jobs (cf. Commission of the EC, 1988a).

Subsequent to the Brussels summit and the publication of the Cecchini report, there was a considerable improvement in the business climate in the EC and elsewhere. Most economic forecasts dating from the beginning of 1988 were still imbued with moderately negative expectations about possible detrimental effects of the October 1987 stockmarket events. The January 1988 economic forecasts of the European Commission, for instance, foresaw a volume increase for Community investment in equipment in 1988 of 4.1% (Commission of the EC, 1988b). This forecast was increased throughout the year to end up with a realisation of 9.3% (Commission of the EC, 1989b), thus more than double the initial forecast. To ascribe this doubling of investment in equipment with respect to initial forecasts to the positive "news" concerning European integration would be a reasoning of the type post hoc, ergo propter hoc. The provision of adequate liquidity, in the wake of the stockmarket crash, by the monetary authorities and the enhanced efforts in the field of international economic co-ordination have undoubtedly exerted a major influence in downplaying the threats of a recession as contained in the forecasts. Nevertheless, there is some evidence which suggests that "1992" may have had, and probably is still

**Table 1:** Detailed aggregated macroeconomic simulation results of the completion of the internal market for EUR12, percentage differences from baseline, unless otherwise indicated

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6
Private consumption	0.6	1.3	1.9	2.3	2.7	3.1
Government consumption	0.9	0.8	0.9	1.0	1.0	1.1
Gross fixed cap. formation	2.3	3.7	4.4	5.1	5.4	5.4
- Government	0.0	0.0	0.0	0.0	0.0	0.0
- Residential	0.5	1.8	3.2	4.2	4.6	4.7
- Firms	3.7	5.5	6.2	6.8	7.0	7.0
Exports of goods and serv.	3.4	5.5	7.4	8.6	9.6	10.5
Imports of goods and serv.	2.9	4.4	5.4	6.1	6.7	7.2
Gross domestic product	1.1	2.3	3.2	3.6	4.1	4.5
Private consumption	-1.6	-2.7	-3.7	-4.7	-5.5	-6.7
Export prices	-0.9	-2.0	-3.3	-4.3	-5.0	-5.6
Import prices	-1.3	-2.1	-3.2	-3.9	-4.5	-5.0
Nominal wage rate	-1.0	-2.2	-2.9	-3.4	-3.8	-4.0
Real wage rate	0.8	0.8	1.1	1.5	1.9	2.2
Terms of trade	0.5	0.1	-0.2	-0.4	-0.5	-0.6
GDP deflator	-1.7	-2.9	-4.0	-5.0	-5.9	-6.5
Employment <sup>1)</sup>	-533	-40	552	1043	1462	1866
Employment	-0.4	-0.0	0.5	0.8	1.2	1.5
Unemployment <sup>1)</sup>	446	13	-396	-746	-994	-1255
Unemployment rate <sup>2)</sup>	0.3	0.0	-0.3	-0.3	-0.6	-0.7
Labour productivity/head	1.6	2.4	2.7	2.8	3.0	3.0
Utilization rate industry <sup>2)</sup>	0.9	1.7	2.1	2.2	2.3	2.5
Budget surplus <sup>3)</sup>	0.1	0.7	1.2	1.6	1.9	2.2
Current balance <sup>3)</sup>	0.3	0.4	0.6	0.8	0.9	1.0
Gr.op.surplus <sup>3)</sup>	0.5	0.7	0.6	0.2	-0.1	-0.4
Real disp.income households	0.9	1.4	2.0	2.3	2.7	2.9

1) Thousands

2) Absolute difference in percentage points

3) Absolute difference in per cent of GDP

Source: Catinat et al., 1988. Simulations with HERMES and INTERLINK models

having, a non-negligible impact on business expectations and a fortiori on investment. The business survey conducted for the study into the cost of non-Europe showed an average expected increase in sales of 5% due to the completion of the internal market (Commission of the EC, 1988a), indicating positive demand expectations. In a more recent survey by the Commission of the EC (1989d) concerning the effects of the internal market in the

manufacturing industry, the positive expectations about the evolution of sales, investment, employment and productivity are largely confirmed. On the whole, it would therefore seem justified to ascribe at least part of the investment boom which started in 1988 to factors related to the acceleration of the process of European integration. Incidentally, it may be noted that despite annual increases in labour productivity of 2%, employment in the Community is forecast to increase with 1.5 million jobs more over the period 1988-1990 than it did over the period 1985-1987 (Commission of the EC, 1989c). In the Cecchini report it was estimated that the productivity gains of the internal market could initially lead to employment losses. Insofar as the present productivity increases embody internal market effects, their possible negative impact on employment seems thus to be absent or negligible.

Aside from political developments and economic performance, the prospect of the internal market has also stirred economic research. The purpose of the present paper is to provide a concise, but by no means exhaustive overview of the abundant literature that has developed over the past 18 months concerning the economic implications of the internal market\*). Within this literature, two strands of research may be distinguished. On the one hand, research devoted to the analysis and conclusions contained in the Cecchini report. This line of research is the subject of section 2. On the other hand, research has concentrated on the "white spots" in the Cecchini report, subjects which due to lack of information or resources were not extensively covered by the research into the "cost of non-Europe". Here, five themes may be distinguished. The first concerns the regional effects of the internal market with the Community, and is discussed in section 3.

Secondly, there is the sectoral impact within the Community. This is the subject of section 4. Thirdly, there are the external implications of the internal market, taken up in section 5. In section 6 the dynamic effects are analysed, while the concluding section regards the role of accompanying policies.

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\*) This excludes a discussion of the evolving literature concerning the progress towards Economic and Monetary Union.

## 2. 1992: POTENTIALITY OR REALITY?

There appears to be confusion about the nature of the quantitative gains of the completion of the internal market as estimated in the Cecchini report. In terms of economic implications, three situations may be distinguished, representing a descending order of magnitude of effects. The first situation is that in which all maximum potential effects of the internal market are realised. For this to happen, two conditions have to be met. In the first place, all the White Paper measures would have to be adopted and effectively implemented into national law. Secondly, given an internal market which exists on paper including the necessary accompanying policies (such as an effective competition policy), the economic structure in the integrated market would be that which is theoretically expected. This would correspond to an integration scenario in which prices differ only due to transport costs. A second situation is that in which the constrained potential gains of the internal market come into effect. This would also require the effective implementation of the White Paper, but would, concerning the degree of market integration, hinge on a realistic estimate of the effects of increased market size and enhanced competition. This scenario would thus not necessarily correspond to what is theoretically expected. The third situation is that of the realised gains. These are the gains as corresponding to the actual degree of implementation of the White Paper, as well as the realised increase in effective market integration.

The estimates contained in the Cecchini report may be considered to vary between those corresponding to the maximum and constrained potential effects. For instance, for the microeconomic calculations, different hypotheses about the degree of market integration have been used in order to obtain a range of effects from economies of scale and enhanced competition (X-inefficiencies, monopoly rents). Another example concerns the effects of the liberalisation of financial services, where it was assumed that only about 50% of the potential price decrease (i.e. convergence to the lowest price levels) would be realised. Consequently, even the upperbound of the range estimated for the welfare effects from the microeconomic calculations probably underestimates the maximum possible

effects of the internal market. This is even more true given that some possible dynamic effects were not included in the calculations (e.g. effects of competition on innovation and technical progress). Similarly, the macroeconomic calculations are probably closer to the constrained rather than the maximum potential effects (cf. Commission of the EC, 1988a, p.117 and Catinat and Italianer, 1988).

A good case in point concerning confusion is the paper by Kay (1989), who states that

*"The Commission's estimates of the costs of 'non-Europe' tend, for obvious political reasons, to err on the high side, and it is improbable that trade formalities will be eliminated completely or a free market in road haulage achieved."*

This statement apparently identifies the estimates of the Cecchini report with the "realised effects" of the internal market described above. The awareness of the Commission of the difference between "potential" and "realistic" outcome is, however, exemplified by the following statement (Commission of the EC, 1988a, p.155).

*"... a possible source of overestimation is the policy hypothesis about 'completing' the internal market. This may turn out stronger than the actual outcome... it is not for the present study to offer alternative scenarios on this point. On the contrary, the study aims to supply information on the potential gains."*

Thus, if Kay states (p.9) that a realistic assessment of the cost savings obtainable from reductions in distribution costs would be half the level estimated in the Cecchini report, this should not be interpreted as an alternative view on the potential gains, but rather as an estimate of the actual outcome as referred to above. Moreover, this view itself does not seem to be corroborated by the number of White paper measures adopted by the Council halfway through 1989.

The Dutch Central Planning Bureau (1989), on the other hand, which made its own calculations on macroeconomic effects of the internal market at Community level as a reference case for its simulation for the Netherlands, clearly makes a distinction between the potential effects contained in the Cecchini report and its own hypotheses geared to obtaining a realistic estimate of the actual effects. In order to obtain the latter, several of the model shocks given for the Cecchini simulations were scaled down, thus reducing the macroeconomic consequences accordingly. In addition they contain an interesting new element with respect to the Cecchini simulations in the form of an assumption about increased inward investment in the Community (cf. Bakhoven, 1989). Although these calculations have the merit of spelling out clearly where they depart from the Commission's hypotheses, they do not seem to add new information since they lack the empirical content on which the latter were based, even for the shock given to inward investment. Stated bluntly: if the inputs are halved, the results are halved, but what does this tell if the inputs are halved due to other "expectations"?

A second confusion about the potential benefits of the internal market has to do with the nature and the composition of the effects giving rise to them. The Cecchini report makes a distinction between the direct cost of barriers and the (indirect) market integration effects. The former may be decomposed further into the cost of barriers affecting trade such as delays at the border or cost related to administrative formalities and the cost deriving from barriers to market access such as restrictive public procurement practices or prudential regulations concerning financial services.

Market integration effects are those arising from the increase in market size and enhanced competition. In principle, increases in market size allow for economies of scale or economies of scope, while enhanced competition may be expected to put pressure on the efficiency of firms previously operating in a protected national segment of the Community-wide market, together with a decrease in the monopoly rents they could enjoy in that situation.

**Table 2: Origin of welfare gains, microeconomic analysis, percentage of total gains**

	Variant <sup>1</sup>			
	A-I	A-II	B-I	B-II
<u>Direct cost of barriers</u>				
1. Barriers affecting trade	5	6	5	6
2. Barriers affecting all production	33	45	38	50
<u>Market integration effects</u>				
3. Economies of scale	35	13	33	11
4. Competitions effects on X-inefficiency and monopoly rents	27	36	25	32
<b>Total<sup>2</sup></b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>
PM: Welfare effect, % of GDP	5,8	4,3	6,4	4,8

<sup>1</sup> Variants A and B correspond to the minimum and maximum of the range of direct cost effects. Variants I and II correspond to two alternative calculations for the market integration effects

<sup>2</sup> Figures may not add due to rounding

Source: Calculated from Commission of the EC, 1988a, pp. 154-156

As Table 2 shows, and depending on the scenario which is adopted, economies of scale contribute for one-tenth to one-third to the total welfare gains as calculated in the microeconomic analysis of the Cecchini report. Taken together, the most important effects (60-80%) arise, however, from the elimination of restrictions to market entry and the effects from enhanced competition. In the Cecchini report it is recognized that possibilities for economies of scale are not present in every sector of industry: it is estimated that one-third of industry would be capable of moving closer towards the minimum efficient technical scale (cf. Commission of the EC, 1988a, p.154). Thus, if Geroski (1989, p.33) writes

*"The view of the Commission appears to be that economies of scale are present and unexploited in most sectors" ... (and) "that the potential gains of restructuring are so large that only a fraction of the total benefits that are expected to flow from 1992 will be directly associated with removing barriers."*

there is apparently confusion about the size of the contribution of economies of scale to the total welfare gains relative to that of the abolition of market entry restrictions (which are directly linked to removing barriers).

### 3. REGIONAL EFFECTS WITHIN THE COMMUNITY

The macroeconomic effects for the Community in its entirety as calculated for the Cecchini report were the result of a linear extrapolation of the outcomes obtained with linked macrosectoral or macroeconomic models for a limited number of countries. In the four simulations which were executed (customs barriers, public procurement, financial services and the so-called "supply effects"), only results for Germany, France, Italy and the United Kingdom were present in all four cases (cf. Catinat et al., 1988). Belgium was represented in three of the four cases (no inputs were available for "supply effects"), the Netherlands in two out of four (customs barriers and financial services), while results for Spain were only available for the simulation concerning financial services. Moreover, for the "supply-shocks", which accounted for an important share of the medium-term effects on GDP, the inputs for the effects of economies of scale and competition were the same for all four countries. Consequently less significance could be attributed to the individual country results than to the Community result which was derived from it. In any case, the differences between the aggregate results for the four big countries were not sufficiently large to be significant (see Table 3).

Given that for Belgium three of the four simulations are available and given the procedure followed for the "supply effects", the average of the results of the "supply effects" for the four big countries could be added to the other results in order to obtain an estimate for the total effects of the completion of the internal market for Belgium. This is the procedure which was followed by the Belgian Bureau du Plan (cf. Van Sebroeck, 1988) and Italianer and Vanheukelen (1989), and the results have

been included in Table 3 since they are comparable to the results for Germany, France, Italy and the United Kingdom. Compared to the Community average, two differences stand out for Belgium: the medium-term effect on employment and the effect on the balance on current account. The latter seems to be due to its relative openness within the Community (exports of goods and services represented 69% of the value of GDP in 1988), combined with an intra-EC trade share of almost 75%. This is probably also the reason why despite a lower increase in labour productivity the same increase in GDP as for the Community average is attained, together resulting in a stronger effect on employment.

**Table 3:** Comparison of medium-term "potential" macroeconomic effects of the completion of the internal market

	B	D	F	I	UK	EC
<u>Percentage differences</u>						
Gross domestic product	4.5	4.2	5.1	5.5	4.0	4.5
Deflator private consumption	-5.1	-6.2	-4.9	-7.1	-7.4	-6.2
Deflator GDP	-5.0	-5.2	-5.6	-8.3	-8.1	-6.5
Real wages	2.2	3.1	1.5	1.2	2.7	2.2
Labour productivity	2.1	2.5	3.5	3.9	2.9	3.0
Employment	2.0	1.7	1.6	1.4	1.4	1.5
<u>Absolute differences</u>						
Employment ('000)	73	438	342	308	385	1866
Budget surplus (% GDP)	3.0	1.5	2.6	3.7	1.8	2.2
Current balance (% GDP)	2.4	0.7	1.4	1.0	0.6	1.0

Source: Catinat et al. (1988), Italianer and Vanheukelen (1989), Van Sebreeck (1988)

The calculations made by the Dutch Central Planning Bureau (1989) concerning the macroeconomic consequences of the completion of the internal market for the Netherlands cannot be compared to those of Table 3 due to the fact that it concerns so-called "realistic" estimates, based on the CPB's "expected" outcome of the internal market completion, rather than "potential" estimates, as discussed in the previous section. Table 4 therefore compares the "realistic" estimates of the CPB for the Netherlands

to its own "realistic" estimates for the average effect on the EC. The somewhat better performance for the Netherlands compared to the average for the Community is attributed by the CPB to the relative openness of the Dutch economy. This result is therefore in accordance with that for Belgium. Furthermore it is noteworthy that the CPB simulations for both the Netherlands and the EC imply real wage increases which exhaust completely the increase in labour productivity. It is stressed by the CPB (e.g. p.6) that if this would only be partially the case (as in Table 3, for instance), employment would probably benefit more than it does according to the present calculations.

The Cecchini report seldom includes results for the peripheral countries of the Community (Denmark, Greece, Spain, Ireland, Portugal). Only the results of the business survey are available for all member countries. These results indicate expected increases in sales of 7.3% in the five peripheral countries compared to 4.7% in the other member countries (Commission of the EC, 1988a, p.152). On this basis, the European Commission estimates that the gains of the internal market as calculated on the basis of an extrapolation of the results for mainly the latter countries could well be underestimated. So far, relatively little evidence is available in this respect. Results for Ireland have been published by O'Sullivan (1989). His results have an interesting dimension because, while starting from inputs comparable to those of the Cecchini report, this author has been trying to introduce an explicit timing for the introduction of the shocks. In doing so, the medium-term effects from the Cecchini report have, in most cases, been assumed to occur over a seven-year period, and have been introduced in equal amounts over such a period starting in years varying between 1990 and 1993, as a rule in 1991 or in 1992. Given that the Irish simulation results have not been published for years beyond 1994, the figures for this year cannot be considered to be the medium-term effects for Ireland. This is partly because the medium-term effects have not had time to work themselves fully out, and partly because the shocks have not been introduced completely. The effects for 1994 are therefore to be considered as lying somewhere between the initial and third-year effects of the Cecchini report, which started from the hypothesis that the internal market was completed at the start of the simulations. This conclusion is

**Table 4:** Comparison of medium term "realistic" macroeconomic effects of the completion of the internal market

	Netherlands	EC
<u>Percentage differences</u>		
Gross domestic product	3.25	2.25
Deflator private consumption	-2	-1.75
Deflator GDP	:	-2
Real wages	3.50	2.50
Labour productivity	3.25	2.25
Employment	0	0
<u>Absolute differences</u>		
Employment ('000)	0	0
Budget surplus (% GDP)	0	0
Current balance (% GDP)	0.25	0

Source: Central Planning Bureau (1989) and own calculations. Both columns include the effects of full use of room for budgetary manoeuvre (tax decrease), even although the latter is small (e.g. 0.3% of GNP for the EC, cf. Bakhoven, 1989)

**Table 5:** Macroeconomic effects of the completion of the internal market for Ireland in 1994 compared to initial average EC effects from the Cecchini report.

	Ireland	EC		
	1994	Year 1	Year 2	Year 3
<u>Percentage differences</u>				
Gross domestic product	1.8	1.1	2.3	3.2
Deflator private consumption	-1.1	-1.6	-2.7	-3.7
Real wages	0.3	0.8	0.8	1.1
Labour productivity	1.2	1.6	2.4	2.7
Employment	0.7	-0.4	-0.0	0.5
<u>Absolute differences</u>				
Budget surplus (% GDP)*	0.5	0.1	0.7	1.2
Current balance (% GDP)*	-0.3	0.3	0.4	0.6

\* % GNP for Ireland

Source: O'Sullivan (1989) and own calculations for Ireland. Catinat et al. (1988) for EC. Results for Ireland include effects of indirect tax harmonisation (+0.1% of GDP in 1994).

illustrated by Table 5, which compares the 1994 results for Ireland to those for the first three years for the EC as calculated for the Cecchini report. The only variable whose behaviour diverges in a negative sense from that for the EC average is the current balance, which turns negative. According to O'Sullivan (1989, p.61) this is due to a temporary surge in imports to meet the expansion of industrial investment. Another remarkable result is the slow evolution of real wages with respect to that of labour productivity and the ensuing positive consequences for employment. It is difficult to conclude on the basis of Table 5 that a peripheral country such as Ireland would indeed profit more from the completion of the internal market than the Member States in the centre. What seems to stand out, however, is that the Irish economy should not lose from the process of integration (as is sometimes asserted for the peripheral economies), and that, as in the case of the Netherlands, assumptions about the behaviour of real wages in relation to the productivity gains are crucial for the final effects on employment.

The importance of assumptions about wage behaviour is also stressed by the Danish Economic Council (Det Økonomiske Råd, 1989). On the basis of its own "realistic" assumptions about the effects of the internal market for Denmark, three variants are presented each with different assumptions about the likely evolution of nominal wages (see Table 6). The scenario with unchanged nominal wages is equal to the scenario with the base case "realistic" estimate. This scenario uses the Cecchini hypotheses for the direct cost barriers, but excludes, for no stated reason, those for economies of scale or other market integration effects. This scenario being partially based on a factor productivity shock of 2.4%, the latter may be seen to be almost completely exhausted by the real wage increase of 1.9%. Scenarios B and C, with real wage increases in Denmark of 1.5% and 1.0% respectively, show the crucial role of real wage moderation in influencing unemployment and components of GDP other than private consumption.\*

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\* As may be seen in Table 3, the nature of the relationship between real wage moderation and employment creation is not unique: it depends, inter alia, on the size of the Phillips curve effect.

**Table 6:** The effects of different wage assumptions on a "realistic" estimate of consequences of internal market for Denmark, percentage difference from baseline unless otherwise stated.

	Year 0	Average Years 1-5	Average Years 6-10
<b>A. Unchanged nominal wage</b>			
Gross domestic product <sup>1</sup>	0.2	0.8	1.2
Private consumption	0.2	1.2	1.7
Deflator private consumption	-1.1	-1.9	-1.9
Current balance (% GDP)	-0.3	-0.5	-0.5
Unemployment ('000)	22	16	10
<b>B. 1% nominal wage decrease, EC including Denmark</b>			
Gross domestic product <sup>1</sup>	0.2	1.1	1.5
Private consumption	0.0	1.0	1.5
Deflator private consumption	-1.4	-2.5	-2.5
Current balance (% GDP)	-0.3	-0.5	-0.4
Unemployment ('000)	21	11	4
<b>C. 2% nominal wage decrease in Denmark; 1% in rest of EC</b>			
Gross domestic product <sup>1</sup>	0.3	1.5	1.9
Private consumption	-0.2	0.8	1.3
Deflator private consumption	-1.7	-3.1	-3.0
Current balance (% GDP)	-0.2	-0.2	0.0
Unemployment ('000)	19	2	-6

<sup>1</sup> At factor cost

Source: Det Økonomiske Råd, 1989, p.89.

#### 4. THE SECTORAL IMPACT

Although it has been demonstrated in the previous sections that the internal market programme bears consequences of macroeconomic magnitude, its chief influences as a deregulatory programme will be felt at a sectoral level. Given differing degrees of deregulation and liberalisation at the outset, sectors will be affected and transformed as a consequence of the internal market in many different ways and in varying degrees.

Three different approaches seem to have been followed in order to analyse the sectoral impact of the internal market. The first approach is the horizontal one: for one particular sector (e.g. telecommunications) or subject matter (e.g. economies of scale), the implications for one or more member countries are analysed. Secondly, there is the vertical approach: for one particular country or region, the effects on all sectors are being investigated. Finally, a matrix methodology may be used in which several sectors and countries are scrutinized simultaneously on a comparable basis.

The horizontal approach was the one followed in most contributions to the research into the "cost of non-Europe" (cf. the list of reports in Commission of the EC, 1998a), and it has since then been used for other studies as well, e.g. in financial services (cf. Van den Bempt and Quintyn (eds), 1989) or the welfare effects of restructuring with imperfect competition and economies of scale in Portugal and Spain (cf. Corado and Leite, 1989). This approach has the advantage that it can take account of the individual characteristics of a particular sector and can thus adapt its methodology accordingly. While this allows to present results that fit the need of a single sector or problem area, it does not permit in general to draw conclusions that may be compared among sectors. From the point of view of economic policy this may be suboptimal, for instance in the case where a particular sector is weak relative to its foreign competitors but at the same time strong compared to other sectors in the same country and should therefore be stimulated.

Obviously, this problem is not resolved through the use of the vertical approach, which simply turns the question around by 90 degrees. In the case of the vertical approach, a common denominator has to be found by which the effects of the internal market may be compared intersectorally. One example of this approach are the sectoral results for output and employment in the Netherlands as simulated by the Central Planning Bureau (1989). As Table 7 shows, the liberalisation of transport and financial services implied by the White Paper would have particularly positive effects on production in the corresponding sectors within the Netherlands, but would imply negative effects on employment in these sectors, which is important information for a policymaker. Nevertheless, this information does not tell anything about the evolution in similar sectors abroad, and therefore lacks the international dimension.

The macroeconomic and microeconomic approaches applied for the Cecchini report are examples of matrix approaches. The sectoral models used for the macroeconomic simulations were of a relatively aggregate nature (9 sectors) and moreover they were not used for all countries and all simulation exercises. This would therefore provide an intercountry/intersectoral picture which would be too incomplete and of a too aggregate nature in order to draw sensible conclusions at detailed sectoral level. The microeconomic approach offers more hold in this respect. Table 8 shows, in column 1, the EUR 7 welfare gains for 37 sectors as published in the Cecchini report (average of minimum and maximum) expressed as a percentage of final production (value added). The sectors most affected in terms of welfare gains are those for intermediate goods and equipment goods, with welfare gains ranging from 12% to more than 20% (except for basic metal products: 7.4%).

For consumer products the gains are somewhat less on average, varying between 4% and 14%. In the service sectors, the biggest welfare gains (12%) come from the financial services sector, for most other sectors the gains do not exceed the Community average of 5.2%. These results show the enormous potential impacts at sectoral level which are not displayed in the macroeconomic aggregate due to the relatively high shares of the sectors for building, wholesale and retail trade, lodging and catering, renting and

non-market services (together representing 52% of final production) which are hardly affected.

**Table 7:** Indicator<sup>1</sup> for sectoral production and employment effects in the Netherlands due to EC'92

	Production volume	Employment
Agriculture	(+)	0
Food, beverages and tobacco	+	+
Textiles and clothing	++	+
Chemicals	++	+
Metals	++	+
Other manufactures	+	+
Mining and quarrying	(+)	0
Oil refinery and public utilities	+	0
Construction	(+)	+
Commerce	++	+
Traffic and transportation	+++	-
Other tertiary services	++	--
Total for all enterprises	+	0

<sup>1</sup> On the basis of the cumulative effect after six years. The output effects are all positive. A + sign indicates an effect of the same order of magnitude as for total enterprises. A (+) sign indicates a relatively small effect, etc. The employment effects are zero for total enterprises. Sectoral deviations are self-explanatory.

Source: Central Planning Bureau (1989)

**Table 8: Comparison of welfare gains and sensitive sectors, EUR7**

NACE-CLIO (R44) Branches	NACE Groups	Description	Welfare gains %	Sensit. sectors	Share in '85 final product.
		<u>Goods</u>			
01		Agricultural, forestry and fishery products	6.9		1.20
03		Coal, lignite (brown coal) and briquettes	2.6		0.13
05		Products of coking	0		0.03
07		Crude petroleum, natural gas and petroleum products	3.5		2.33
09		Electric power, gas, steam and water	6.5		1.87
11		Production and processing of radioactive materials and ores	0		0.06
13		Ferrous and non-ferrous ores and metals, other than radioactive	15.8		0.54
15		Non-metallic mineral products	12.4		0.49
	247	-Glass (plate, hollow, technical, fibre glass)		4	
	248	-Ceramic products		4	
17		Chemical products	17.5		2.33
	251	-Basic chemical products		4	
	256	-Other chemical products, mainly for industrial and agricultural purposes		4	
	257	-Pharmaceutical products		2	
19		Metal products except machinery and transport equipment	7.4		1.63
	315	-Products of boilermaking		2	
21		Agricultural and industrial machinery	12.3		3.45
	321	-Agricuilt.machinery and tractors		4	
	322	-Machine tools for metal working tools and equipm.for machinery		4	
	323	-Textile mach. and accessories, sewing machines		4	
	324	-Machinery for the food and chemical industries: bottling, packaging, wrapping and related machinery, rubber artificial plastics working machinery		4	
	325	-Mining equipment, machinery and equipment for metallurgy, for preparation of build.materials, for building and construction, for mechan.handling and lifting		4	
	326	-Gears and other transmission equipment		4	

NACE-CLIO (R44) Branches	NACE Groups	Description	Welfare gains %	Sensit. sectors	Share in '85 final product.
23	327	-Machinery for working wood, paper, leather and footwear laundering and dry-cleaning equipment	21.4	4	1.06
		Office and data processing machines: precision and optical instruments			
25	330	-Office and data process.mach.	20.8	1	2.84
	372	-Medico-surgical equipment, orthopaedic appliances		1	
		Electrical goods			
	341	-Insulated wires and cables		3	
	342	-Electrical motors, generators, transformers, switches, etc.		3	
	344	-Telecommunic.equipment, meters and measuring equipment, electro-medical equipment		1	
	345	-Electronic equipm., radio and television receiving sets, sound reproducing and recording equipm., gramophone records and prerecorded tapes		4	
27	346	-Electric household appliances	14.9	4	3.58
	347	-Electric lamps and other forms of electric lighting		4	
29	351	Motor vehicles	18.9	4	0.87
		-Motor vehicles and engines			
31	361	Other transport equipment	5.0	3	1.30
		-Boats, steamers, warships, tugs floating platforms and rigs, materials from the breaking up of boats			
	362	-Locomotives, other railway and tramway rolling-stock, vans and wagons		2	
33	364	-Aircraft, helicopters, hover- craft, missiles, space vehicles and other aeronautical equipm.	6.3	4	1.47
		Meats, meat preparations and preserves, other products from slaughtered animals			
35		Milk and dairy products	6.3		3.00
		Other food products			
	417	-Food pastes		3	
	421	-Cocoa, chocolate, sweets, ice- creams		3	

NACE-CLIO (R44) Branches	NACE Groups	Description	Welfare gains %	Sensit. sectors	Share in '85 final product.
37		Beverages	5.9		0.93
	425	-Champagne, sparkling wines, wine-based aperitifs		2	
	427	-Malt, beers, brewers' yeast		2	
	428	-Mineral waters, soft drinks		2	
39		Tobacco products	4.4		1.14
41		Textiles and clothing	4.3		2.53
	431	-Wool industry		4	
	432	-Cotton industry		4	
	438	-Carpets, carpeting, oilcloth, linoleum and other coated fabrics		4	
	453	-Ready-made clothing		4	
	455	-Household linen, bedding, curtains, wall coverings and awnings, sails, flags, bags		4	
43		Leathers, leather and skin goods, footwear	6.9		0.63
	451	-Ready-made footwear		4	
45		Timber, wooden products and furniture	4.7		1.07
47		Paper and printing products	13.7		0.94
49		Rubber and plastic products	12.9		0.45
	481	-Rubber products		4	
51		Other manufacturing products	10.5		0.46
	491	-Precious and costume jewellery, goldsmiths' and silversmiths' products; working of precious and semi-precious stones; diamond cutting and polishing; striking of coins and medals		4	
	493	-Products for printing and developing cinematographic and photographic films		4	
	494	-Games, toys, sports goods		4	
53		Building and construction	2.2		8.74

NACE-CLIO (R44) Branches	NACE Groups	Description	Welfare gains %	Sensit. sectors	Share in '85 final product.
		<u>Market services</u>			
57		Wholesale and retail trade	1.3		11.44
59		Lodging and catering services	1.8		3.46
61		Inland transport services	4.9		1.15
63		Maritime and air transport serv.	4.5		1.15
65		Auxiliary transport services	2.4		0.21
67		Communication services	6.1		0.96
69		Services of credit and insurance institutions	12.3		3.03
55+71+75+ 77+79		Other market services	4.0		5.19
73		Services of renting of immovable goods	0.8		7.37
81+85+89 +93		<u>Non-market services</u>	1.1		20.98
Total			5.2		100

Source: Column 1 calculated from Commission of the EC (1988a), Table A.3, average of columns x and xi, expressed as a share of final production from Cawley and Davenport (1988, Table A.1), which is also the source for column 3. Column 2 from Buigues and Ilzkovitz (1988a), explanation of categories: see text

The size of welfare gains provides a general indication of whether a particular sector will see changes due to the internal market and if so, whether they are relatively large. For an individual sector, however, this approach offers little more than the knowledge that "something will happen". A very useful complement to this method is therefore provided by the method applied by Buigues and Ilzkovitz (1988a). On the basis of a number of characteristics such as importance of non-tariff barriers, price dispersion among countries, possibility for economies of scale, degree of concentration, demand growth and degree of openness to intra-EC trade, these authors provide, through a two-way classification, four different categories of sectors likely to be affected by the internal market. All these sectors are characterised by a high level of non-tariff barriers through public procurement practices or different technical regulations. Based on detailed sector data (NACE 3 digit) for the non-peripheral Community countries (EUR7), their analysis provides a representative X-ray for each Community sector concerning its weak and strong points. Group 1 is characterised by a relatively high intra-EC import penetration ratio, and a low level of price dispersion. These are the high-tech sectors associated with the liberalisation of public procurement (automation, telecom, medical equipment). Group 2 has a low level of intra-EC import penetration and a high level of price dispersion, and concerns more traditional industries protected as being "national champions" (boilers, railway, pharmaceuticals). The sectors of group 3 also have a low degree of import penetration but a low level of price dispersion, and concern typically sectors undergoing major restructuring (shipbuilding, electrical and electronical equipment, certain food-processing industries). The largest group is group 4 with very strong import penetration but a rather high price dispersion due to existing technical and administrative barriers. These sectors (many of them consumer goods) will primarily be affected downstream (distribution networks) through intensified competition. Table 8 provides the lists of sensitive sectors with the categories to which they belong. It may be seen that with the exception of textiles the sensitive sectors all fall into NACE-CLIO R44 branches with higher-than-average welfare gains. Although for entirely different reasons, the sectors of groups 1 and 3 all belong to branches with welfare gains around 20%.

On the basis of similar and additional characteristics, characterisations of the positions of national sectors could be obtained. This was already done for Belgium (cf. Buigues and Ilzkovitz, 1988b), and will be published for other Community countries in the near future.

## 5. EXTERNAL IMPLICATIONS

Viewed from the outside, the completion of the internal market may have negative consequences if it would be accompanied by trade diversion. In the classical theory of economic integration, trade diversion occurs if, through the formation of a customs union, the common external tariff of the countries forming the union implies that products which were imported from outside the union under the previous tariff are imported from inside the union afterwards. In empirical analyses of the effects of economic integration, trade diversion is usually assumed to occur if the value of imports from outside the customs union decreases after the formation of the union (cf. Pelkmans, 1984). The internal market programme does not deal with tariff barriers, but rather with the breakdown of non-tariff barriers (NTBs) inside the Community. Conceptually this is not very much different from the classical integration case, however, and it is therefore no surprise that the partial equilibrium calculations for the direct cost of barriers (which run along the lines of classical integration theory) show decreases in extra-Community imports of 2 - 2.5% for stage 1 of the direct cost calculations (barriers affecting trade) and 5.5 - 7.5% for stage 2 (barriers affecting production), together yielding a range of 8 - 10.5% (cf. Commission of the EC, 1988a, pp. 180-182).

The decrease in extra-Community imports implied by the direct, static cost calculations will however diminish if regarded in the context of the economic growth brought about by indirect, market integration effects, which will also benefit producers outside the Community. In the end, even though intra-Community trade will expand much faster, the macroeconomic simulations for the Cecchini report seem to suggest that extra-Community imports could increase as well (cf. the calculations in Italianer and Vanheukelen, 1989, p. 344 fn).

The initial trade-reducing effect of the removal of trade barriers and the trade-enhancing demand increases provoked by the indirect integration effects have led to mixed reactions from the Community's main trading partners. Positive reactions are associated with the increase in economic

activity providing opportunities for extra-EC exporters on the Community-wide market (for a US view, see Calingaert, 1988, p. 82). These reactions arise notably from the industrialised countries, which are well-equipped to compete inside the Community, even though it has been estimated that also the growth rate of the value of exports of developing countries as a consequence of the completion of the internal market could increase permanently by 1% (cf. Kol, 1989).\*

For non-European countries, the attitude towards the breakdown of the NTBs inside the Community per se is one of benign neglect: one cannot deny a group of countries the right to proceed with its internal economic integration, and as far as this results in higher economic activity, the trade diversion effects might be partly or wholly compensated. The EFTA countries regard the steps at further integration in the Community from a different angle: while the degree of trade integration between the EFTA and the Community was previously roughly comparable through their free-trade agreement, the accelerated move towards integration inside the Community is considered to bear costs for them (cf. Krugman, 1988, and Pintado et al., 1988). Consequently, in the context of the European Economic Space agreed between the EFTA and the Community in 1984, ways are presently being investigated through which EFTA countries could participate in some aspects of the internal market. The recently concluded negotiations between the Community and Switzerland concerning the mutual access to each other's markets for non-life insurance companies could provide an example for such a participation, or serve as a blueprint for agreements in the area of services in the framework of the multilateral GATT negotiations, for that matter. Quite apart, individual EFTA countries could apply for membership of the Community, as Austria did in July 1989. The "cost" of non-membership implied by the internal market and the benefits of membership for this

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\* This particular calculation seems to be surrounded by uncertainty, however, since it assumes a) a permanent increase in the growth rate of the Community and b) no relative price effects.

country have been simulated by Breuss and Schebeck (1989), see Table 9. Contrary to the conclusions reached by Krugman and Pintado et al., their simulations suggest that the effects of the internal market for Austria would be unequivocally positive, even without membership. Given that the simulations are based on the results of the Cecchini report, it is somewhat surprising to find a positive effect on the balance on current account in the "status quo" scenario. Closer scrutiny of the inputs used for this simulation reveals that net real exports have been assumed to increase, contrary to what was implied by the Cecchini simulations for the non-Community countries on average, a result confirmed by Bakhoven (1989), for instance.

The neutral stance of countries such as the United States and Japan with respect to the dismantling of intra-Community NTBs has initially been overshadowed by fears for an increase in barriers towards non-Community countries (for an overview, see Henderson, 1989). These fears mainly concerned two issues. The first relates to the problem that it will not be possible in the internal market to maintain intra-Community border controls ex Art. 115 of the EEC Treaty in order to impose the remaining national import quotas. The main sectors exposed to this problem are those for automobiles and textiles (under the Multifibre Arrangement). Often the fear is expressed that the existing national quantitative restrictions would be transformed into Community-wide restrictions which would possibly be more severe than the average of existing restrictions. Quite apart from the desirability of new Community-wide restrictions (e.g. individual Commissioners have already expressed the opinion that restrictions for cars should disappear in the long run), they would be hard to defend in the context of the GATT, and it is therefore difficult to imagine how the existing restrictions would have to be converted on a Community-wide scale. The second issue concerned the liberalisation of the services sectors and notably financial services, or more generally the issues of national treatment and reciprocity. At present, Community countries have granted each other national treatment in the area of services (Art. 58 - 66 EEC). Progressively, the principle of national treatment will be replaced by that of mutual recognition, combined with the establishment of minimum

**Table 9: Medium-term macroeconomic consequences of the completion of the internal market for Austria, with and without Community membership**

	Status quo	Integration
<u>Percentage differences</u>		
Gross domestic product	1.6	3.5
Deflator private consumption	-1.6	-5.2
Deflator GDP	-1.2	-5.2
Real disposable income households	1.7	4.0
Labour productivity	0.8	1.9
Employment	0.7	1.5
<u>Absolute differences</u>		
Employment ('000)	21	43
Budget surplus (% GDP)	0.4	-1.1
Current balance (% GDP)	0.8	-1.3

Source: Breuss and Schebeck (1989). Integration scenario contains effects of internal market and budgetary consequences of membership, including assumptions about indirect tax harmonisation.

prudential rules applicable throughout the Community. In the most widely discussed example so far, the second banking Directive, the increased opportunity for banks from third countries to exercise activities throughout the Community on the basis of establishment in one single country was initially linked to equivalent access for Community banks in the country of the bank seeking access (reciprocity). In the final version of the Directive, on which the Council reached a "common position" in July 1989, the lack of effective market access for banks from Community countries in a third country comparable to that granted by the Community to banks from that third country is no longer an impediment for access of the latter, but could be a reason to open up negotiations with a view to obtaining comparable competitive opportunities. Only if the absence of effective market access is accompanied by the absence of national treatment this could be a reason, in addition to opening up negotiations, to temporarily limit or suspend any pending or future applications for a banking licence. Moreover, there would not be any measure with retro-active effect. This last clause and the more prudent approach towards the problem of mutual benefits have taken away a considerable amount of fear with respect to possible increases in outside NTBs alongside internal liberalisation.

## 6. DYNAMIC EFFECTS

One of the possible sources of underestimation of the welfare gains as calculated for the Cecchini report are the dynamic effects, such as the effects of increased competition on innovation and technological progress. Another dynamic effect, in the context of the neoclassical growth model of Solow, is that the increases in efficiency which form the basis of the welfare gains in the partial equilibrium analysis exert a positive influence on savings and investment and therefore on the steady-state level of the capital stock. This implies that the initial, comparative static, effect on output will be supplemented by an indirect effect through the increase in the steady-state level of the capital stock. Baldwin (1989) has attempted to quantify these additional output increases, starting from (comparative) static increases, which were calculated in the Cecchini report to lie between 2.5% (direct cost of barriers) and 6.5% (direct cost plus integration effect).

The factor by which the static output increases have to be multiplied in the models used by Baldwin depends on one crucial parameter: the elasticity of output with respect to the capital stock in a Cobb-Douglas type production function with non-constant returns to scale. The more this elasticity exceeds the value of the traditional capital share from the growth-accounting literature (say 0.3), the higher is the multiplier. As long as the output-capital elasticity is smaller than one, there is no influence of the efficiency gains from the internal market on the long-run growth rate. The dynamic effects simply multiply the static gains until the new steady-state level is reached. This additional effect is what Baldwin calls the "medium-term growth bonus". In the special case that the output-capital elasticity equals one, there is however an increase in the long-run growth rate of the economy.

Baldwin shows that even if the capital-output elasticity equals the capital share from growth-accounting literature (this corresponds to the absence of economies of scale), the static output effect has to be increased by at least something like 30%. This conclusion is reached on the basis of a

calculation of dynamic effects for five Community countries. The ranges for these medium-term growth bonuses are given in Table 10. Applying these ranges to the static gains for the Community as a whole, the total (static + dynamic) welfare gains of the completion of the internal market may be seen to range from 3.1% (2.5% multiplied by 1.24) to 15.3% (6.5% multiplied by 2.36). On the basis of alternative estimates, Baldwin even finds an upperbound well above the latter figure.

In the special case of the output-capital elasticity equal to one, Baldwin obtains possible increases in the long-run Community growth rate between 0.28 and 0.92 percentage points.

It should be stressed that the Baldwin results have been derived in the context of the neoclassical growth model which assumes full utilisation of resources in steady state. Consequently, they must be seen as adding to the "potential" effects of the internal market, and more particularly in a medium term context as the adjustment towards a higher steady-state level of output. But even when sticking to the lower bound of these estimates, they seem to make a good case for saying that the Cecchini results are an underestimation of the total (static plus dynamic) effects.

**Table 10:** Increase in static effect on GDP needed to reach new steady-state level (medium-term growth bonus), percentages

	B	D	F	NL	UK
Lower bound	38	36	30	35	24
Upper bound	136	129	80	124	93

**Source:** Baldwin (1989).

## 7. CONCLUDING REMARKS

Should it be concluded, as suggested by Kay (1989), that the real significance of 1992 lies in the hype, rather than in the programme itself? Obviously, the internal market programme is a supply-side rather than a demand-side programme. Contrary to the latter case, its effects are therefore to be brought about by the private sector rather than the public sector (except in its role as purchaser of goods), with an emphasis on the opportunities offered to firms through improved market access and enhanced competition. In order for the private sector to react according to the lines spelled out in the Cecchini report, the internal market programme needs credibility. Only in that case will economic agents adapt their expectations and change their behaviour accordingly. The credibility of the programme depends on the determination with which it is implemented and the economic implications which it embodies. The strong political will expressed in the Single European Act for a successful completion of the internal market and the results achieved therein over the past 18 months are sufficient proof of the determination with which the implementation of the project proceeds. The "Post-Cecchini" literature as reviewed in this paper has demonstrated that even if "realistic" rather than "potential" economic effects are calculated, they continue to have macroeconomic significance. Combined with the fact that 1992 seems to have had non-negligible influence on the behaviour of economic agents both in 1988 and 1989 the conclusion seems warranted that the programme itself has gained credibility over the last year-and-a-half.

This conclusion is not meant to say that the full potentiality of the internal market has yet been transformed into reality, nor that the implications of the internal market are the same for each sector or for each country, be it inside or outside the Community. This points to the importance of the role of accompanying policies. At the microeconomic level, the proper functioning of product and factor markets should be guaranteed by a strong competition policy, the development of the social dimension of the internal market and measures to combat capital movements purely induced by motives of tax evasion. At the macroeconomic level, the

progressive steps towards Economic and Monetary Union provide room for an increased zone of monetary stability and offer the perspective, through increased co-ordination, of a further move towards a situation of full employment of resources, thus adding to the dynamic gains of the internal market. On the distributional side, the poorer regions of the Community could be supported in obtaining a fair competitive position and the restructuring processes could be facilitated through the use of the doubled structural funds. At the international level, the Community's liberalisation programme may contain elements (e.g. national treatment for services) that could serve as examples in multilateral negotiations, such as in the Uruguay round of the GATT. Furthermore, it may provide a stimulus for further integration with the Community's main trading partners. Seen in this way, the internal market would rather contribute to international trade liberalisation than pose a threat to it. Given its high degree of interdependence with the rest of the world, this role of the Community seems not only to be its own choice, but also its own interest.

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