

I

**ECONOMY**



# 1

## Competitiveness

### 1.1 Introduction

European economic integration has come a long way in recent years but is still far from completion. The late twentieth century and early twenty-first century have seen the onset of the Single Market and of the single currency. Yet, total economic integration will not be completed without a much greater degree of economic harmonization and political integration. Reaching the present level of economic integration in the European Union (EU) has been a slow and somewhat spasmodic process. Despite being commonly known as the Common Market throughout much of the 1970s and 1980s, the European Community (EC) was only a customs union during much of its existence. The pace of economic integration increased during the 1990s. The EC became a real common market, in which free mobility of factors of production is allowed, on 1 January 1993. The introduction in January 1999 in eleven of the fifteen member states of the Euro—the common European currency—represented a further step towards full economic integration.

The acceleration of the process of European integration during the 1990s has been mainly driven by the desire to make the EU more competitive in a globalized economy. But to what extent has this been achieved? This chapter looks at the evolution of the EU economy as a whole, and compares it with the evolution of other world economies. The first section is devoted to the stages of economic integration and economic integration in the EU. The second section deals with economic integration as a means to achieve competitiveness and studies the expected benefits of economic integration. Finally, the last section examines the impact of European economic integration on trade, economies of scale, productivity, and growth.

## 1.2 The stages of economic integration

Economic integration among different nations or regions rarely happens overnight. The progressive removal and ultimate eradication of economic barriers between different states is often a lengthy and winding process, whose rhythm is determined by economic as well as political bargaining and compromise. Political resolution also determines the intensity of economic integration. From the simple elimination of trade tariffs to the total unification of monetary and fiscal policies and institutions, there are numerous stages of economic integration. These stages, first described by Balassa in 1961, represent the different levels which may be adopted in the process towards full economic integration. Most processes of economic integration however rarely go beyond the two initial stages of integration.

The simplest level of integration is the **free trade area**. In a free trade area, free movement of goods is allowed among its members. This implies the abolition of tariffs and quotas for imports from area members, although members of the area keep their own quotas and tariffs *vis-à-vis* third countries. In essence the free trade area is a preferential trade agreement, which may include just a series of products or expand to the whole manufacturing sector and even services. One of the disadvantages of the free trade area is that since members maintain their own tariffs and quotas *vis-à-vis* third parties, countries outside the area may redirect their trade and target the country with the lowest tariffs or highest quotas in order to access the markets within the area. In order to prevent this and other problems, which may ultimately lead to tensions among members of the free trade area and to the demise of the agreement, most free trade areas go beyond the simple elimination of tariffs and adopt some timid form of policy integration or institutional co-ordination.

A more advanced stage of economic integration is the **customs union**. In a customs union, the eradication of internal tariffs and quotas is accompanied by some common external trade restriction and/or the harmonization of external tariffs and quotas. The establishment of common external tariffs and quotas necessarily implies a much greater level of institutional co-ordination than in the free trade area. Members of the customs union not only have to give up their capacity to set up external tariffs, but often also harmonize and make compatible other aspects of their respective national trade policies. Custom unions frequently result in the creation of common regulatory bodies and institutions which police and control trade within the union and, in some cases, even implement policies whose main aim is to foster and to regulate trade within the union.

The **common market**, also known as **single market**, is usually the next stage of economic integration. The common market shares with a customs union the eradication of internal and the harmonization of external tariffs, but it also implies the removal of all non-tariff barriers to free factor mobility. The outcome is the free mobility of goods, capital, labour, and services across the territory of the common market. The eradication of all obstacles to free factor and asset mobility usually requires a much greater level of regulation than in customs unions. Institutions are set up in order to monitor and guarantee that decisions adopted by the authorities of the member states do not affect competition and the free mobility of factors across the common market.

A further stage of integration occurs when members of a common market begin to harmonize their economic policy. At this stage the common market starts to become an **economic union**. National economic authorities of the member states, under the aegis of a common or a series of central institutions, resort to coordinating certain areas of economic policy until they ultimately give up their national control over them to a supranational body. The harmonization of economic policy generally occurs in the fields of monetary and/or fiscal policies.

When all areas of economic policy in the member states are harmonized the economic union gives way to the stage of **complete economic integration**. In this final stage of the process of economic integration the capacity of individual states to implement their own independent economic policies disappears completely. Central institutions substitute national ministries of the economy and national central banks as the centres of economic decision-making. In a complete economic integration the economies of the member states are regulated as if they were the economies of a unified nation: there is a common currency and common fiscal and financial system and national economic institutions become mere branches of the central institutions.

### 1.2.1 Economic integration in the EU

Any process of economic integration is difficult to achieve and requires not only an economic rationale, but also a strong political will. The fact that free trade areas only include the abolition of tariffs and quotas among member states and demand little or almost no economic harmonization make them attractive for groups of countries willing to share some of the benefits of free trade, but wary of giving up their economic independence. Indeed, most processes of economic integration in the past have been limited to the free trade area stage. This is the case, for example, of the European Free Trade Association (EFTA) and of many of the current multinational regional economic associations such as the North American Free Trade Association

(NAFTA), the Australia and New Zealand Closer Economic Relations and Trade Agreement (ANZCERTA), or the Association for Latin American Integration (LAIA). The original EC, at the time of the signing of the Treaty of Rome in 1957, was also a free trade area which gradually developed into a customs union as common foreign tariffs and quotas were agreed and common policies implemented in the early years of its existence (Table 1.1).

Few free trade areas lead to the establishment of customs unions. The fact that customs unions usually imply a much greater degree of institutional coordination than free trade areas and that the former are often regarded as a significant step towards economic union deters many nations from venturing into further integration. Only when one of the members with economic and political ascendancy in the free trade area pushes the others in that direction or when there is the political will in all member states to strengthen economic ties, are customs unions completed. The German *Zollverein* is an example of the former. In 1834 a series of German states set up a customs union which became the embryo of what was to be full economic integration a few decades later. The *Zollverein* was however a union of unequals. Prussia's political, military, and economic might in nineteenth century Germany allowed it to shape the *Zollverein* according to its own economic and political interests. The EC represented a form of customs union in which economic and political determination by all member states played a capital role. The signature of the Treaty of Rome in 1957, by which the EC was established, represents a negotiated agreement among equals to set up a customs union. However, the EC is the exception to the rule.

More often than not, free trade areas fail to make the passage to a customs union. Outside the EC, few economic associations have succeeded: MERCOSUR in Latin America is one of them, and NAFTA in North America has held discussions on the introduction of features of a customs union. But the transfer of powers and the loss of sovereignty to supranational bodies inherent in the formation of a customs union means that this stage of economic integration has seldom been achieved.

The even greater surrender of national economic sovereignty needed in order to establish common markets makes this form of economic integration rarer than customs unions. The EU was the first example of a common market freely agreed among sovereign nations. Yet, and despite being commonly known as the European Common Market throughout the 1970s and 1980s, it took the EC more than thirty years to become a real common market. Free mobility of goods, services, capital, and labour was only implemented—and still with restrictions and transition periods with regards to certain products and sectors—with the introduction of the Single European Market on the 1 January 1993 (Table 1.1).

But since then the new EU has burnt stages of economic integration much

**Table 1.1** The stages of economic integration in the EU

Level of integration	Main features	Period
Free trade area	Free trade among members	From 1958 to the early 1960s
Customs union	Free trade with a common external tariff	in theory from 1958, in reality from the early 1960s until 1993
Common market	Free mobility of factors and assets across member states. No internal invisible trade restrictions	1993–1999
Economic union	Harmonization of economic policy	Early stages in 1993. Partial economic union in 1999
Economic integration	Completely unified economic policy	Not yet achieved

faster than before. As the Single Market was about to be implemented, the member states of the EU were already negotiating in Maastricht further forms of integration leading towards the establishment of an economic union. The agreement to proceed towards Economic and Monetary Union (EMU) was reached in this period and the early stages of harmonization of monetary policies and other economic policies aimed at preparing EU member states for EMU began to be implemented almost at the same time as the common market for certain goods, products, and services was being completed (Table 1.1). The new common currency—the Euro—was adopted by eleven member states of the EU on 1 January 1999. Greece joined two years later. And the process of economic integration—as well as that of political integration—is still under way. Negotiations in order to achieve a greater harmonization of fiscal policies are a sign that complete economic integration may be getting closer.

### 1.3 Economic integration as a means to achieve competitiveness

What are the reasons for the dramatic increase in momentum of economic integration during the late 1980s and 1990s? Why has a customs union which had experienced relatively little transformation during the first twenty-five

years of its existence become first a common market and later an economic union in less than a decade?

There are many reasons that explain the gathering of pace of European economic integration during the last few years of the twentieth century, but all of them are linked to the process of economic globalization. Proponents of globalization underline that since the 1970s a new world economic system has emerged. The main feature of the new global economic system is the high mobility of capital, goods, labour, and, to a lesser extent, services across the world, marking a radical break with the post Second World War past of strong national economies (Gray, 1998; Beck, 2000). Firms and nations around the world compete for capital, customers, and labour in what is regarded to be an increasingly technology-led and volatile market (Dicken, 1998). If firms and nations are to be successful in this increasingly globalized market they have to adapt to the new economic environment and to be able to produce better quality products and services at lower prices. In other words, they have to learn to be competitive.

### 1.3.1 The limits of European competitiveness

But, were (and are) European firms competitive? Could an economically divided Europe compete and succeed in a globalized world? Across western Europe there was a widespread perception throughout the 1980s and early 1990s that the presence of nationally divided markets was seriously limiting the competitive capacity of European nations and firms in the global marketplace. Whereas the US and Japan—the main competitors of the EC in a globalized economy—were large, unified, and relatively cohesive markets, the European market was extremely fragmented. Before the establishment of the Single Market, there were fifteen nationally divided markets within the EU, whose existence generated a series of costs which limited European global competitiveness. Member states, aware of the problem of increasing lack of competitiveness, gave the European Commission the task of solving the structural bottlenecks and of preparing the EC for the creation of a single market. The response from the European Commission to this challenge came in the form of a White Paper entitled *Completing the Internal Market* (1985). The White Paper set the bases for the establishment of a single market and led to the commissioning of a series of reports on different aspects of integration. The best known of these reports is the Cecchini report (1988), which evaluates the costs of having nationally fragmented markets—also known as the costs of the ‘non-Europe’—and estimates the possible benefits of the Single Market. According to this report the existence of nationally fragmented markets generated three types of barriers to trade:

- a) *Physical barriers*: linked to the presence of intra-EC border stoppages, controls at border checkpoints, red-tape, and the existence of different currencies;
- b) *Technical barriers*: related to the use of different national product standards and technical regulations in every member state, to the presence of conflicting business laws, and of protected public procurement markets;
- c) *Fiscal barriers*: linked to the lack of fiscal harmonization, ranging from contrasting income and corporate tax rates to differing value-added tax (VAT) rates and excise duties.

The following sub-sections elaborate on each of these types of barrier.

### Physical barriers

Until recently intra-EU national boundaries not only delimited the borders between member-states, but also represented a series of barriers to trade and additional costs. The first of these physical costs were the customs related costs. Existing customs controls, border stoppages, as well as the paperwork and red tape associated with them represented a hefty penalty for the free mobility of goods within the EC. Intra-EC trade, and especially the exchange of low value-added and perishable goods, suffered as a result.

The presence of fragmented markets was also linked to high administrative costs and regulatory hassles. Companies willing to engage in trans-border trade had to deal with different national regulations and often with a significant amount of red tape in order to be able to sell their products in other western European countries. For large companies trading large volumes of goods and/or services this implied additional costs. But it was mainly the small and medium-sized (SMEs) companies which suffered the most from these administrative costs, since the costs of engaging in trans-border trade were a higher proportion of their volume of business. In addition, many SMEs lacked the expertise, the time, and adequate human resources to cope with the administrative costs of trade in fragmented markets, a fact that frequently prevented their international expansion.

Together with customs and related administrative costs, nationally fragmented markets brought about protected markets and protectionist procurement (Cecchini, 1988). Until recently countries in Europe had policies for protecting and subsidizing key industries. Fear of foreign dependence in sectors considered essential for the development of the country led to the setting up of the policy of national champions. Every country needed to have at least one public or private industry in every sector deemed to be of 'national strategic interest' and many sectors fell under this broad definition. These

generally included petrochemical industries, shipbuilding, the iron and steel industry, car manufacturing, tobacco, telecommunications, air transport, military equipment, and often even chemical industries, information technology, and maritime transport. In some cases, basically in the telecommunications, air transport, and tobacco sectors, this was achieved by the establishment of protected markets and national monopolies. In other sectors national industries were set up and allowed to 'compete' in heavily protected national markets. A third option was to encourage the private sector to develop the industry, although private companies benefited from oligopolistic practices, large subsidies, and protectionist procurement practices by the state. The consequence of these policies of national champions was the emergence of monopolies in telecommunications (BT, France Télécom, Deutsche Telekom, SIP, Telefónica), air transport (British Airways, Lufthansa, Air France, Alitalia, Iberia, Olympic Airways, TAP), and other sectors, and of relatively large public and private companies in many others.

In spite of the fact that many of these companies managed to survive and even to prosper in nationally protected markets, excessive market fragmentation came at a price. The overall consequences of the presence of protected markets and industries were negative to Europe as a whole. Since economic protection meant that many of these companies faced no real external competition and did business in captive markets, there was no pressure for the majority of these firms to develop and/or use state-of-the-art technology or to produce according to international standards, or at internationally competitive prices. In certain sectors, such as shipbuilding and iron and steel, this resulted in underperforming industries, which often relied on subsidies and public contracts to remain in business. In other sectors, such as telecommunications or information technology, the situation contributed to a certain technological backwardness. And in all cases the existence of protected markets led to the excessive fragmentation of sectors in Europe in comparison to its American or Japanese competitors. The differences in the structure of the automobile sector between the US and the EC a couple of decades ago were a paradigmatic example of the effects of fragmented national markets with national champions policies. Although the car markets on both sides of the Atlantic were roughly similar in size, the American market was dominated by two large companies (General Motors and Ford) with a smaller third company (Chrysler) struggling to survive. Such a level of concentration allowed American companies to benefit from economies of scale and to develop larger technology projects. In contrast, the European panorama was much more divided. Each country had one or several national champions: Volkswagen in Germany; Fiat in Italy; Renault, Peugeot, and Citroën in France; Volvo and Saab in Sweden; Rover in Britain; Seat in Spain. If we add the many companies specialized in specific market niches (Daimler-Benz, BMW, and Porsche in

Germany; Alfa Romeo, Lancia, or Ferrari in Italy; Jaguar in Britain) and the numerous truck and van producers at the time, almost every country in Europe—bar the smallest ones—had its own national motor-vehicle industry. And even though excessive fragmentation did not prevent the automobile industry from competing outside European markets (especially in the luxury car sector), this was not the case in other sectors. In the computer hardware industry, for example, the attempts by governments to foster their own national champions ended in almost universal failure. By the mid-1980s many western European countries were trying to promote their own computer companies. Sweden had Ericsson, Germany relied on Siemens, Italy on Olivetti, France tried with Thomson, and even Greece had plans for its own computer industry. Even if all of these companies still exist—Ericsson is a formidable player in the mobile telephones industry, Thomson in the micro-electronics sector, and Siemens and Olivetti are powerful industrial conglomerates—none of them is nowadays a major actor in the computer hardware industry.

Policies to promote national champions also resulted in the duplication and excessive fragmentation of public and private R&D efforts. Whereas American research programmes were highly concentrated and enjoyed large funding, European research programmes were conducted on a national basis and often competed against one another. The consequences were research redundancies and a suboptimal outcome of research investment in Europe, especially in comparison to the US or Japan (Emerson *et al.*, 1988).

As a whole, consumers bore most of the costs of the existence of nationally fragmented markets. The existence of physical barriers to trade, red tape, protectionist and national champion policies generally resulted in higher prices for goods and services in the European markets than in larger markets, and fundamentally than in the US. This was especially the case in services, where restrictions to competition were higher. In the telecommunications market, fragmentation and national monopolies meant that European consumers had to pay higher telephone bills than their North American counterparts. Differences within the EC were also important and often related to the different policies adopted in each country. Countries such as Italy and Spain tended to subsidize local calls by increasing the cost of long distance calls, whereas an early liberalization of the telecommunications markets brought the cost of long distance calls in Britain to the lowest levels in Europe. Higher telephone costs than in the US affected not only the consumers' pockets, but also the competitiveness of European companies in a global marketplace, and contributed to a relatively slow European start on the internet. Another market where consumers and companies were penalized by high prices was the air transport market. The control of European skies by national governments and air carriers until the mid-1990s was translated into higher air fares for

passengers, as a result of the absence of real competition. Many other sectors, such as the car, home, and health insurance sector, or road and railway transport, had similar problems. In addition, European consumers also had to bear an enhanced cost of commodities and manufacturing products generated by protected industries.

The final physical barrier was the existence of different national currencies, which represented additional costs for the development of economic activity. Most of these costs were transaction costs, that is the cost of exchanging currencies. The transactions costs involved in exchanging currencies were deadweight losses for consumers and firms (De Grauwe, 1997). Apart from direct transaction costs, the existence of different national currencies had other additional costs like the presence of price discrimination between national markets or the higher cost of holding higher international reserves. In addition, the existence of different national currencies had extra costs in the form of higher interest rates and lower FDI for peripheral nations, as a consequence of their exchange rate volatility, their greater market instability, and the greater risk of devaluation (Hitiris, 1998; Darby *et al.* 1999). Finally, the existence of different currencies and the transaction costs of exchanging currencies and having to deal with different regulations and bureaucratic practices contributed to deter consumers and firms from purchasing cheaper goods and services in other countries.

### Technical barriers

The second sort of barriers for European consumers and firms were divergent national product standards, different technical regulations, and conflicting business laws. Although originally designed for other purposes, such as to increase health and safety, technical regulations and national product standards became powerful instruments for market protectionism. The implementation of incompatible technical regulations and product standards in a fragmented market led to the establishment of different electricity systems for home appliances, different television systems, different telephone systems, and even to driving on a different side of the road in different European countries. The implementation of these non-tariff barriers not only represented problems for consumers, who could not take their television sets from Italy to the UK, or who had to buy different plugs or adapters for their electric razors when on holiday or moving across countries, but also added considerable costs for European firms which had to adapt their products to the different national standards (Cecchini, 1988). In contrast, American firms could profit from the economies of scale of having to service a large market with homogeneous technical regulations and a single national standard. Once again, SMEs were the prime victims of this sort of non-tariff barriers, since they were

more vulnerable to the costs of coping with changing standards across borders and of the duplication of product development related to them than large firms.

Another technical barrier was the existence of protected public-sector procurement and construction markets. In most European countries government supply and construction contracts were restricted to national firms, and, whenever there were no legal restrictions for foreign bidders, technical regulations often discriminated against them. This situation closed large sections of the public sector market to international competition.

### Fiscal barriers

The third set of barriers which limited the competitiveness of European firms were of a fiscal nature. The lack of fiscal harmonization within the EC meant different fiscal regimes within the EC for individuals and firms and different rates in indirect taxes, such as VAT. The result of such a variegated panorama was that companies had to cope with and adapt to different fiscal regimes and accounting standards across countries. Subsidiaries of multinational firms often had to duplicate or triplicate their accounting standards in order to cope with the demands of the parent company and the national system of each branch's host country. In addition, as the Cecchini report (1988) underlines, the transnational daily exchange of goods, assets, and know-how between the parent company and the branch or among branches often aroused the suspicion of national authorities trying to prevent tax evasion. This 'fiscal suspicion' limited the flexibility of companies and provoked additional costs in order to respond to national fiscal legislation and the demands of national tax authorities (Cecchini, 1988).

The combination of physical, technical, and fiscal barriers represented an important burden for all those economic actors willing to engage in international trade. The additional costs incurred by companies and individuals doing cross-border deals were a deterrent for many companies, which were thus confined to their national markets. The costs associated with market fragmentation were related both to the size of the actors and the size of the market. In terms of the size of the economic actors, individuals and SMEs stood to lose most from market segmentation, since they had to bear a higher percentage of the costs of engaging in trans-border deals. Large companies were also disadvantaged, especially *vis-à-vis* similar companies trading in the American or Japanese markets. However, thanks to economies of scale, their burden was relatively smaller than that of SMEs.

In terms of the size of markets, firms located in smaller markets were the most vulnerable to fragmented markets. Companies in Ireland, Portugal, or Greece could not rely exclusively on the dynamism of their internal markets

and needed to expand internationally if they were to prosper. With national markets that barely exceed 1 per cent of the European market (Table 1.2), their internal markets lacked the scale to allow for long-term expansion, especially in sectors which needed advanced technology or large investments. German, French, or even firms from the integrated market of the Benelux were, in contrast, in a much better position to compete. Their much larger internal markets allowed for greater expansion. However, taken individually, the size of the different European national markets had become too small to compete in a globalized world. Table 1.2 compares the size of national economies in the EU with those of the US and Japan in the year 2000. Although the strength of the US dollar with respect to the Euro in that year led to an overvaluation of the size of the US economy, the Table gives a clear indication of the difference in size between the American and Japanese economy and that of individual EU countries. In 2000 the US economy was 26 per cent larger than those of all the EU member states put together. The size of the Japanese economy was roughly half that of the US and 40 per cent below the size of the total size of the EU economy (Table 1.2). Taken individually, every single economy in the EU was too small to rival that of the US or Japan. The size of the German economy—by far the largest in Europe—was less than one fifth that of the US (Table 1.2) and two and a half times smaller than that of Japan. The UK, the second largest European economy when measured in a common currency, only represented one seventh, and that of France around 13 per cent of that of the US (Table 1.2). Nine of the fifteen EU national economies did not even reach 5 per cent of the size of the US economy (Table 1.2).

In sum, the existence of nationally fragmented markets represented a serious competitive cost for the European economy in terms of its capacity to reach the adequate economies of scale to compete with large integrated markets such as the US or the Japanese market.

### 1.3.2 The expected benefits of economic integration

If the existence of fragmented markets posed a serious threat for European competitiveness in a globalized economy, many believed—with the European Commission among them—that economic integration offered a solution to the problem. The increasing globalization of the world economy and the simultaneous transformation of developed nations from mass-production to increasingly technology-driven flexible production economies had led to widespread concern about the possible loss of competitiveness of European firms and nations. The basic tenet was that excessive market fragmentation within the European scale was reducing economies of scale and thus obstructing the structural reforms needed to adjust to global challenges. Market integration was thus a response to the recognition of the necessity of greater

**Table 1.2** Total GDP in the EU, the US, and Japan, 2000

Country	Total GDP in 2000 (billions of €)	% of the EU economy
Austria	205.5	2.42
Belgium	244.0	2.87
Denmark	174.2	2.05
Finland	131.2	1.54
France	1 399.2	16.47
Germany	2 036.0	23.97
Greece	120.7	1.42
Ireland	101.1	1.19
Italy	1 152.3	13.57
Luxembourg	19.9	0.23
Netherlands	399.1	4.70
Portugal	112.3	1.32
Spain	605.7	7.13
Sweden	248.8	2.93
United Kingdom	1 543.0	18.17
European Union	8 493.0	100.00
United States	10 738.7	126.44
Japan	5 163.2	60.79

Source: EUROSTAT data.

European competitiveness, since integration would have triggered an increase in the size of the European market, a reduction of the costs of trade, a removal of structural bottlenecks, and economic restructuring. Hence from the mid-1980s the EC embarked on a process of economic integration—still under way—which reached its high points in 1993 with the implementation of the European Single Market and in 1999 with the introduction of the Euro, the European single currency.

According to many *ex ante* studies carried out by the European Commission and independent economists, market integration would have led to important cost-saving effects. The Cecchini report (1988: 17) identified three major areas for cost savings resulting from market integration:

- a) the 'static trade effect': the benefits reaped from allowing public authorities to buy from the cheapest (i.e. foreign) suppliers;
- b) the 'competition effect': the introduction of greater international

competition was expected to provoke downward pressure on prices charged by domestic firms in sectors where competition was previously restricted, as a result of the entry of foreign firms in the market;

- c) the 'restructuring effect': resulting from the reorganization of industrial sectors and companies under the pressure of the new competitive conditions, which generate economies of scale and greater efficiency.

Other possible benefits of market integration identified by the Cecchini report included the 'savings for private sector buyers who pay less for goods . . . whose prices have been reduced by the break-up of restrictive trade practices in the public sector' (1988: 17) and the dynamic effects of greater competition on innovation, investment, and growth. In addition, market integration was expected to generate significant savings for the public sector. These savings included cuts in government subsidies, especially in the support for inefficient firms, and a European-wide rationalization of R&D expenditure.

The combination of all these cost-saving effects was expected to lead to two different kind of benefits: the direct benefits of the eradication of economic frontiers and the indirect benefits resulting from the process of economic restructuring, increases in trade and competition, and greater economies of scale (Tsoukalis, 1993; El-Agraa, 1998). Although, in the short term the direct benefits were expected to outstrip the indirect benefits, in the long run the indirect effects would contribute to the emergence of virtuous cycles of innovation and competition (Tsoukalis, 1993). Together with the micro-economic consequences of the completion of the Single Market, important macroeconomic benefits could also be expected. These benefits would be generated by the opening up of the national public procurement markets and the liberalization of services.

The expected outcomes of the Single Market were thus a lowering of prices as a consequence of greater competition and a greater concentration of resources which would ultimately lead to an increase of consumer purchasing power, a rise in investment, greater job creation, and an improvement in the competitiveness of European firms and companies.

The setting up of the single currency is aimed at bringing additional cost-saving effects, ranging from substantial direct savings derived from the elimination of transactions costs, to indirect benefits related to the better functioning of the internal European markets. The Euro is also likely to generate welfare gains and greater growth from eliminating uncertainty and currency exchanges risks. On the whole the expected benefits of the single currency include positive effects on trade and investment and the possibility of reinforcing Europe's economic role in the world.

Some authors—especially those involved in the early stages of the Single Market—have tried to estimate the potential gains of economic integration in

Europe. The Cecchini report (1988) predicted the gains from the completion of the Single Market to be in the range between 174 to 258 billion €, which, at the time of the report, represented approximately 4 to 7 per cent of the EC's GDP. Emerson *et al.* (1988) calculated gains between 4 and 6 per cent of GDP. Most of these gains would have been accrued as a consequence of the effects of the Single Market on production costs. Additional benefits would come in the form of trade costs, economies of scale, and competition effects (Emerson *et al.*, 1988). Baldwin (1989) was even bolder than Cecchini and Emerson and estimated that the gains from the Single Market could be between three and a half and five times larger, as he considered not just the possible rise in output, but also the long-term effect on growth as a result of increasing the stock of capital. Researchers analysing the possible impact of EMU have been, in contrast, much more reluctant to give estimations of the expected benefits.

## 1.4 The impact of economic integration

Has European economic integration delivered the benefits predicted by its proponents? Has the EU experienced since 1993 the increases in trade, the more efficient allocation of resources, and the greater growth and welfare gains expected from economic integration? Have European nations and firms become more competitive?

This section of the chapter gives an overview of the recent economic evolution in the areas of trade and foreign direct investment (FDI), economies of scale, productivity, and growth in the EU in order to try to identify if the optimistic predictions of the *ex ante* analyses have been fulfilled.

### 1.4.1 Trade and FDI

During the 1990s trade has experienced a sizeable increase across the European Union. Exports of goods and services rose from levels of 26.8 per cent of EU GDP in 1988 to 31.73 per cent in 1997 (Table 1.3). Similarly, imports went from representing 26.06 per cent of European GDP in 1988 to 29.25 per cent in 1997.

The 5 point rise in the share of exports as a share of the EU's GDP and the three point expansion in imports represent a greater level of trade creation in absolute terms than in any other developed area of the world. Export expansion in the US in the same period was 3.10 per cent of GDP, whereas in Japan a mere 1.09 per cent (Table 1.3). Import expansion in the US and Japan was 2.2 and 2.15 per cent of GDP respectively. However, if we take into account the relative change in trade creation rather than the expansion in

**Table 1.3** Exports of goods and services as a share of GDP

	1988	1991	1994	1997	Change 1988–97	% Change
EU	26.80	26.26	27.79	31.73	4.93	18.40
US	8.99	10.37	10.54	12.09	3.10	34.48
Japan	10.02	10.19	9.27	11.11	1.09	10.88
OECD	17.31	17.89	17.92	21.02	3.71	21.43

*Source:* EUROSTAT data.

absolute terms, the picture changes. Exports in the US grew at a greater pace than in the EU (Table 3.1) and both the US and Japan experienced greater growth than the EU in imports. As a whole, during the 1990s trade creation in the EU was greater than in other European countries, such as Switzerland, Norway, or Iceland, which did not participate in the process of economic integration. Export growth in the EU—but not import growth—also exceeded that of the countries of central and eastern Europe, with the exception of Hungary. Overall, it can be said that the evolution of European trade in a world context has been rather disappointing, especially in comparison with that of countries like Canada or Mexico which have undergone a much milder process of regional economic integration.

At the national level no clear pattern seems to emerge. Some countries with already open economies at the end of the 1980s, such as Ireland, have experienced a significant increase in trade. Less open countries, like Finland, Sweden, Spain, or Italy have also witnessed considerable trade creation. Yet, not all economies in the EU have benefited equally from the removal of trade barriers. The ratio of exports as a share of GDP has declined in four countries—Germany, Greece, Luxembourg, and Portugal—between 1988 and 1997. Luxembourg, Greece, and Portugal have also seen their share of imports decline. This lack of a clear pattern in the evolution of trade suggests that the supposed greater territorial specialization associated with greater economic integration has not yet happened. European integration has been accompanied by an increase in intra-industry trade. In contrast, the expansion of inter-industry trade has been less important (CEPII, 1997). The relative stability of inter-industry trade has prevented a further concentration of capital intensive industries in core countries to the detriment of the European periphery. In fact, former lagging countries such as Spain and, above all, Ireland have profited from economic integration to expand trade and attract capital-intensive industries. Portugal and Greece have been less successful. However, the level of intra-industry trade suggests that the expected special-

ization within the EU may be starting to happen within sectors rather than across sectors (CEPII, 1997).

Although often trade and foreign direct investment go hand in hand, economic integration during the 1990s seems to have had an even lower impact on FDI trends than on trade. Net inflows of FDI into EU countries have tended to oscillate more with economic cycles than as a result of reform and economic integration. Table 1.4 reports the FDI net inflows into the EU, the US, and Japan as a percentage of GDP. All other factors being equal, the Single Market does not seem to have led to an increase in the inflows of FDI to the EU. Inflows of FDI reached their peak at the apex of the economic cycle around 1990, just before the implementation of the Single Market, and have since followed a downward trend. When compared to the US, relative the net inflows of FDI into the EU have declined with respect to the period before 1993. FDI represented 1.46 per cent of GDP in the EMU area in 1990 and fell to only 0.83 in 1997. Inflows of FDI into the US have followed an opposite trend rising from 0.86 per cent in 1990 to 1.19 per cent in 1997 (Table 1.4).

**Table 1.4** FDI net inflows as a percentage of GDP

Country	1980	1985	1990	1994	1997
Austria	0.30	0.26	0.41	1.08	1.20
Belgium	—	—	—	—	—
Denmark	—	0.19	0.85	3.31	1.70
Finland	0.05	0.21	0.60	1.53	1.78
France	0.49	0.50	1.10	1.19	1.65
Germany	—	—	—	0.09	-0.02
Greece	1.38	1.10	1.21	0.99	0.86*
Ireland	1.43	0.83	1.38	1.55	3.63
Italy	0.13	0.25	0.59	0.21	0.32
Luxembourg	—	—	—	—	—
Netherlands	1.33	1.17	4.35	2.23	2.42
Portugal	0.55	1.16	3.78	1.44	1.68
Spain	0.70	1.19	2.84	1.94	1.04
Sweden	0.20	0.39	0.86	3.16	4.33
United Kingdom	1.88	1.20	3.33	0.90	2.96
EMU area	0.50	0.56	1.46	0.75	0.83
United States	0.62	0.49	0.86	0.66	1.19
Japan	0.03	0.05	0.06	0.02	0.08

\*Data from 1996. Source: World Bank World Development Indicators (2000).

The evolution of FDI has varied enormously across European countries. Only in Austria, Denmark, Finland, Ireland, and Sweden have inflows of FDI experienced a significant increase during the period since the implementation of the Single Market. In the Austrian, Finnish, and Swedish cases, the increase in FDI—as was the case in the previous decade for Portugal and Spain—may be more related to EU membership than to the effects of economic integration. In contrast, in all other EU countries, bar France, net inflows of FDI as a percentage of GDP have declined. The highest declines have occurred in the Netherlands, Portugal, and Spain (Table 1.4).

The 1990s have also brought about a change in FDI. FDI flows among EU member states, which dominated before the completion of the Single Market, have lost some of their previous importance. For the first time in 1996, FDI outflows from the EU to the rest of the world exceeded those within the EU. This may be a sign of the pressures of globalization and of the need to get positions in world markets, but also a symptom of an early waning of the effects of economic integration. Economic recovery and EMU led to a new upturn in FDI in the late 1990s, but it is still early to see if this reversal of trends will be sustained in the long run.

#### 1.4.2 Economies of scale

Another area where economic integration was predicted to have a clear impact is that of economies of scale. *Ex ante* reports frequently highlighted that economic integration was expected to bring about a more efficient concentration of resources, preventing duplication and thus generating economies of scale. European firms were supposed to be the main beneficiaries of these trends.

Competition linked to the Single Market and the establishment of the single currency was supposed to trigger a restructuring effect leading to economies of scale, technology transfers, employment creation, and greater efficiency by European companies. This restructuring effect seems to be taking place. The number of mergers and acquisitions (M&As) in the EU increased by more than two and a half times between 1987 and 1998, from 2775 to 7600 (Table 1.5). The bulk of this increase happened however in anticipation of the Single Market and was partially related to the evolution of the economic cycle. The economic boom of the late 1980s and early 1990s contributed to the wave of mergers and acquisitions which lasted until 1990 (Table 1.5). Since 1990, the total number of mergers and acquisitions in the EU has remained relatively stable, closely following the economic cycle (European Economy, 1999).

However, the stability in the numbers of mergers and acquisitions throughout much of the 1990s hides two profound transformations: the internationalization and the increasing total volume of M&As (European Economy, 1999).

**Table 1.5** Total number and percentage of national, European, and international mergers and acquisitions, 1987–1998

	1987	1990	1993	1996	1998
Number	2775	7003	5740	6327	7600
% National	71.6	60.7	63.4	55.7	50.1
% EU	9.6	21.5	15.9	17.4	16.5
% International	18.8	17.8	20.7	26.9	33.4

*Source:* AMDATA in European Economy (1999).

Whereas in 1987 M&As involving companies from the same European state represented more than 70 per cent of the total, by the end of the 1990s the percentage of national mergers had fallen to slightly above 50 per cent (Table 1.5). The emergence of cross-border M&As has taken place in two stages. The first stage happened during the late 1980s in anticipation of the Single Market and mainly involved companies from two different European member states. The percentage of intra-EU M&As increased from levels of 9.6 per cent in 1987 to 21.5 per cent in 1990. Meanwhile, the percentage of M&As involving a company from outside the EU remained stable and even declined slightly (Table 1.5). The second wave of internationalization—or, in this case, globalization—of European companies has taken place in the wake of EMU. Whereas the level of European M&As hovered at around 16 per cent of the total between 1993 and 1998, the percentage of M&As involving at least one overseas company almost doubled between 1990 and 1998. In that year, one third of all M&As involved at least one non-EU partner (Table 1.5).

The second feature of the process during the 1990s has been the increasing volume of the deals. The total volume of inward cross-border M&As involving companies in the EU has been multiplied by almost six between 1991 and 1998. An even greater expansion has occurred in EU outward cross-border M&As (Table 1.6). Cross-border M&As picked up pace towards the end of the 1990s, with the volume of inward cross-border M&As almost doubling between 1997 and 1998 and that of outward M&As almost tripling in the same period (Table 1.6). The spiralling of the process in Europe may be related to the expected economies of scale linked to the launch of the Euro. However, it may also be propelled by the emergence of new global economic actors, resulting from the merger of large transnational companies (TNCs), which increasingly drive other companies to look for partners or acquisitions or to move towards restructuring, in order not to lose their market share and to increase their competitiveness (Kang and Johansson, 2000). Europe has not been isolated from this process. Despite the fact that many of the M&As still

involve companies from just one country, such as in the case of the merger of the British chemical firms SmithKline Beecham and Glaxo Wellcome, or the Italian firms Telecom Italia and Olivetti or Pagine Gialle and Tin.it, an increasing number of the largest mergers since the late 1990s have involved firms from different EU member states (Orange and Mannesman, Vodafone and Mannesman, Zeneca and Astra). And European firms are becoming more aggressive in the overseas market, as the deals between Terra and Lycos, or the takeovers of Chrysler by Daimler-Benz and of Amoco by British Petroleum indicate. M&As are becoming so important that they have started to dominate FDI flows in Europe.

Does this mean that European integration has been the driving force behind the increasing concentration of European companies? If we compare cross-border M&A activity in Europe and the US the figures point in other directions. Notwithstanding their recent boom, the growth of M&A activity in the EU has lagged behind that of the US. Growth of cross-border M&As in the US—despite still being lower in volume than in the EU—has clearly

**Table 1.6** Volume of cross-border M&As (billion US\$)

	Inward				
	1991	1994	1997	1998	Multiplier 1991–8
EU	38.7	58.4	133.6	223.4	5.8
Rest of Europe	4.1	7.4	14.6	17.6	4.3
North America	26.1	62.9	76.3	218.1	8.4
Rest of the World	16.4	67.7	116.5	98.9	6.0
Total	85.3	196.4	341.0	558.0	6.5
	Outward				
	1991	1994	1997	1998	Multiplier 1991–8
EU	50.5	75.3	127.5	330.6	6.5
Rest of Europe	3.4	18.2	42.1	14.4	4.2
North America	15.7	52.0	106.4	175.2	11.2
Rest of the World	15.7	50.9	65.0	37.8	2.4
Total	85.3	196.4	341.0	558.0	6.5

*Source:* KPMG Corporate Finance in Kang and Johansson (2000).

outstripped that of the EU during the 1990s (Table 1.6). The greater dynamism of North American firms becomes manifest when the regional share of inward and outward cross-border M&As, rather than absolute numbers, are considered (Table 1.7). During the 1990s, North American firms are the only ones that have gained ground both in inward and outward M&As. They increased their share of inward cross-border M&As between 1991 and 1998 by 8.5 per cent and that of outward M&As by 13 per cent. Most of this relative expansion has been at the expense of Japanese and South East Asian firms, countries that until the Asian crisis of 1997–98 were among the most aggressive in the field (Table 1.7). However, European firms have also lost out to North American firms: the EU share of outward M&As remained stable in that period, and that of inward M&As declined by 5.4 points (Table 1.7).

Moreover, the process of economic concentration and rationalization, to which economic integration has contributed, has not sufficed to hoist more

**Table 1.7** Volume of cross-border M&As (billion US\$)

	Inward				
	1991	1994	1997	1998	Change 1991–8
EU	45.4	29.7	39.2	40.4	–5.4
Rest of Europe	4.8	3.8	4.4	3.1	–1.7
North America	30.6	32.0	22.4	39.1	8.5
Rest of the World	19.2	24.5	34.0	17.8	–1.4
Total	100.0	100.0	100.0	100.0	0.0
	Outward				
	1991	1994	1997	1998	Change 1991–8
EU	59.3	38.4	37.4	59.3	0.0
Rest of Europe	3.9	9.3	12.4	2.5	–1.4
North America	18.4	26.5	31.9	31.4	13.0
Rest of the World	18.4	24.8	18.3	6.8	–11.6
Total	100.0	100.0	100.0	100.0	0.0

Source: KPMG Corporate Finance in Kang and Johansson (2000).

**Table 1.8** Location of the world's largest fifty corporations

	United States	Europe	Japan	Other
1960	42	8	0	0
1970	32	14	4	0
1980	23	19	5	3
1990	17	21	10	2
2000	15	16	19	0

*Source:* Fortune Global 500.

European firms into the group of the world's largest companies. In 2000 the EU had fewer companies among the top fifty in the world than in 1990 (Table 1.8) and only one European company (Daimler-Chrysler) was in the top ten. It seems somewhat ironic that the expansion of the number of European companies among the world's largest fifty occurred fundamentally during the 1960s and 1970s, a period of strongly fragmented national markets, and that it decreased during the peak of integration (Table 1.8).

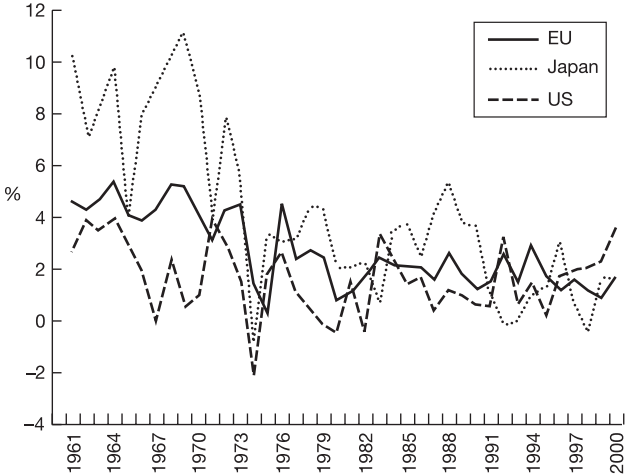
The economies of scale resulting from the increasing concentration of European firms can thus be attributed more to the process of globalization and to macroeconomic, industry-level, and technology-related factors than to European integration. The Single Market and EMU may be triggering a restructuring of firms and may have fostered the increasing numbers of cross-border M&As that the EU has witnessed during the 1990s, and especially since 1997 (Kang and Johansson, 2000). But then again, the process is not dissimilar to what has been experienced in other parts of the world, and especially in the US.

### 1.4.3 Productivity

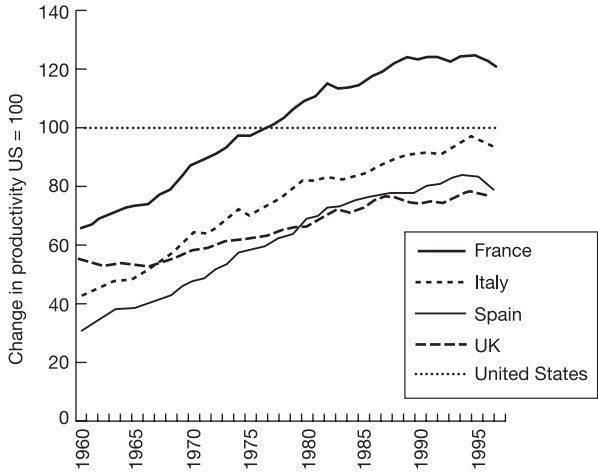
Another area where European integration is supposed to yield benefits is that of labour productivity. Greater competition, the restructuring of firms, and the benefits of greater economies of scale and agglomeration are expected to deliver an increase in labour productivity and make workers in the EU more competitive with respect to their American and Japanese counterparts.

For much of the period since the end of the Second World War, labour productivity in western European countries has been below that of the US and Japan. However, and despite the existence of fragmented national markets, European countries have managed to close the productivity gap with the US during much of the period. Figure 1.1 represents labour productivity growth in the EU, the US, and Japan between 1960 and 2000. Labour productivity

growth in the EU during much of the early stages lagged behind that of Japan, but was clearly above that of the US. As a result, labour productivity in the EU converged on that of the US during the 1960s, 1970s, and early 1980s. Productivity convergence is also observed at the national level. Productivity in France outstripped that of the US as early as 1980 (Figure 1.2). Italy and Spain



**Figure 1.1** Labour productivity growth in the EU, the US, and Japan, 1960–2000  
 Source: EUROSTAT data.



**Figure 1.2** Evolution of labour productivity in selected European countries with respect to the US  
 Source: World Bank World Development Indicators (2000).

also closed the gap significantly. In the Spanish case labour productivity, which was barely more than one quarter of that of the US in 1960, rose to levels above 80 per cent of in the early 1990s. The UK also managed to close the productivity gap, albeit in a rather less spectacular fashion (Figure 1.2).

Labour productivity convergence on US rates came, however, to an end around 1985 (Figures 1.1. and 1.2). Several factors contributed to the halt in convergence. The first one was the increasing technology gap between the US and Europe. The personal computer and the internet revolutions have been led from the US. The US government and large US corporations were able to spend more than their European counterparts on R&D, a factor that contributed to give the US a technological edge with respect to Europe. Fragmented markets, national monopolies or oligopolies, or simply national champions facing relatively little competition within their national markets often prevented the development of new technologies or even access to them in Europe. As a result, the diffusion across Europe of some of the technologies behind recent trends in economic growth, such as computers and the internet, was slower than in the US. A third factor in the productivity slowdown in western Europe was the rigidity of European labour markets (see Chapter 5). Rigid labour market conditions and strict and costly regulations on hiring and firing employees not only resulted in high levels of structural unemployment, but also kept much of the young innovation-prone European talent out of the labour market for long periods of time. The US, in contrast, based their productivity growth during the same period on the capacity to generate and assimilate innovation of a younger labour force.

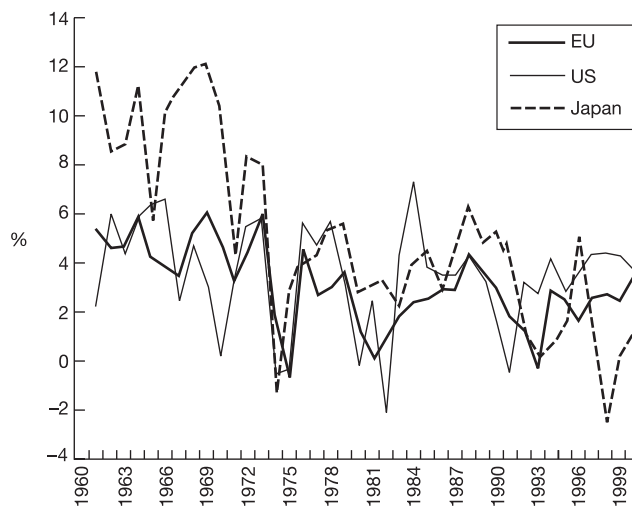
European integration and national reforms have tried to address some of the inefficiencies at the bottom of the productivity slowdown in Europe. As we will see in Chapter 5, labour market reforms throughout the 1990s have made labour markets in Europe more flexible. The Single Market and EMU are also contributing to solve some of the problems that besieged innovation in Europe prior to the 1990s. The results are starting to be felt. During the 1990s and despite lower growth rates, European productivity levels have remained close to those in the US. Some so-called 'old economy' countries, such as Germany, have performed well in productivity terms. But even in high tech, Europe is becoming more competitive. Since the completion of the Single Market there has been a greater concentration of the R&D effort in a few areas of Europe. Southern England, Southern Germany, and the areas surrounding Paris, Stockholm, and Helsinki are becoming the main technology poles in Europe (Quah, 2001). And this concentration is starting to bear fruit. In mobile communications—which many perceive as the motor of growth in the future—Europe now has the edge. Most mobile technology is European. The largest mobile phone manufacturers are Nokia (Finnish) and

Ericsson (Swedish), whereas the majority of mobile phone microprocessors are manufactured by ARM (a British company) (Hauser, 2001).

Although it is still relatively early to say whether European labour productivity is, once again, going to start growing faster than American productivity, European integration and labour market reforms seem at least to be contributing to allowing Europe to become more competitive in this realm than it was in the 1980s.

#### 1.4.4 Economic Growth

But perhaps the most important question is to try to assess whether European economic integration will allow Europe to keep up with the pace of its competitors and, perhaps, outgrow them. The main objective of European integration is to achieve greater economic competitiveness in order to rival the economic might and dynamism of the US and Japan. The success of this objective should ultimately be reflected in economic growth rates. But, as in the case of trade, economies of scale, and productivity, the empirical evidence is far from clear. In the post-war era, the EU has not been a star performer among the developed economies. As in the case of productivity growth, economic growth in the EU has lagged behind that of Japan during the post-war decades, and, although since the 1960s growth in the EU slightly outstrips that of the US, most of the difference in favour of Europe dates back to the 1960s (Figure 1.3). Growth in the EU has been lower than at least in one of its



**Figure 1.3** Economic growth in the EU, US, and Japan, 1960–2000

Source: EUROSTAT data.

competitors in every decade since the 1960s. The 1960s, 1970s, and 1980s were Japanese decades; the 1990s has been the decade of the US (Figure 1.3). The economic gap in favour of the US has grown since the 1970s (Table 1.9).

And the growth gap between the US and the EU has reached its highest level since the implementation of the Single Market. Between 1993 and 2000 growth in the US outpaced growth in the EU by more than 70 per cent (Table 1.9). This gap is, however, significantly reduced when GDP per capita growth instead of real GDP growth is considered.

If there is one feature that describes European national economic performance since the implementation of the Single Market and during the early stages of EMU, it is its heterogeneity. Some countries have performed extremely well. Growth in Ireland—recently dubbed the ‘Celtic Tiger’—has more than doubled that of the US between 1993 and 2000 (Table 1.9). Finland and Luxembourg have also outpaced the US. Yet, the nations that make up the European core have had a dismal relative economic performance during the same period. Growth rates in Germany and Italy have been less than half those of the US. France barely exceeds that threshold and, among the four largest economies in the EU, only growth in Britain has exceeded the EU average (Table 1.9).

## 1.5 Conclusion

The acceleration of European economic integration that took place during the late 1980s and especially during the 1990s has basically been aimed at making the EU more competitive in an increasingly globalized world. The development of the Single Market and EMU were intended to tackle some of the structural bottlenecks which were at the root of the relatively poor European economic performance since the process of globalization started. However, this thorough transformation of the European economic environment has not produced the immediate and spectacular economic benefits predicted by some of the *ex-ante* studies (Vanhoudt, 1999). By some indicators the early results are somewhat disappointing: the gap between the US—always regarded as the main economic competitor—and the EU has increased in terms of GDP and productivity and America has had a better relative performance in trade, FDI, and M&As. In many areas, such as productivity or FDI, European economic integration seems to have played second fiddle to the evolution of the economic cycle. To a certain extent, it could be said that a more economically integrated EU has been reacting to the forces of globalization rather than guiding and anticipating them, as the US economy seems to have done during much of the 1990s.

It is, nevertheless, too early to conclude that European economic

**Table 1.9** Average growth rates in the EU, the US, and Japan, 1960–2000

	Average growth rates per period				
	1960–70	1970–80	1980–90	1990–2000	1993–2000
Austria	4.72	3.64	2.31	2.09	2.03
Belgium	4.91	3.39	2.05	2.08	2.15
Denmark	4.50	2.18	1.58	2.17	2.50
Finland	4.84	3.50	3.09	2.08	3.80
France	5.57	3.31	2.47	1.81	1.95
Germany	4.47	2.74	2.26	1.90	1.48
Greece	8.55	4.71	0.70	2.32	2.43
Ireland	4.21	4.74	3.59	6.62	7.63
Italy	5.72	3.62	2.23	1.49	1.59
Luxembourg	3.56	2.65	4.51	5.56	5.63
Netherlands	5.08	2.98	2.20	2.88	3.06
Portugal	6.48	4.80	3.19	2.55	2.59
Spain	7.36	3.55	3.01	2.44	2.68
Sweden	4.65	1.98	2.02	1.69	2.43
United Kingdom	2.92	1.97	2.69	2.18	2.90
European Union	4.86	3.02	2.42	2.02	2.16
United States	4.25	3.28	3.20	3.21	3.69
Japan	10.17	4.47	4.01	1.27	0.99

*Source:* EUROSTAT data.

integration is not yielding the expected positive economic effects, first, because the differences in the economic cycle may be at least partially responsible for the observed differences in economic performance between the US and Europe. At the time of the completion of the European Single Market, the US economy was beyond the trough of the economic recession of the early 1990s, whereas most western European economies were only entering it. At the beginning of the twenty-first century, the economies of the EU seem, in contrast, in better shape than the American economy. A second factor to take into account is the time frame. European economic integration may be setting the foundations for a quicker future adaptation by the EU to global economic challenges. There are already some encouraging signs and the real effects of integration will only come to light in the near future. If these effects are broadly positive, the first decade of the twenty-first century may well be a European decade.