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Internal and External Liberalisation for Faster Growth

Herbert Giersch *

Internal Paper

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Internal Paper

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I Introduction and Summary

1. Macro-economic policies tend to be discussed and planned on the premise that potential output and its future growth path are given or can only be influenced by mainly macro-economic policies such as

- a demand pull for unsustainable growth (Layard et al. 1984),
- a two-handed approach, expanding supply as well as demand, with emphasis on incomes policies (wage moderation) for higher employment (Blanchard et al. 1985), or
- a two-handed approach with emphasis on a policy mix favouring capital formation (Modigliani et al. 1986).

Trade policies are hardly mentioned in this context; belonging to a different academic discipline or to a different department or ministry in national administrations, they do not receive much attention from experts in the monetary-fiscal field. This paper argues that they are most important.

2. Trade theorists and trade negotiators, on the other hand, often take effective demand as given. While theorists tend to assume that relative prices are flexible enough to permit a full (or optimal) use of resources, including labour, practitioners and trade negotiatiors are impressed by the reality of unemployment and the mercantilist views of businessmen (and labour leaders) who believe the demand for output (or labour) to be inadequate most of the time and, therefore, fear that the gains from trade will transform themselves into output losses (and unemployment). Unilateral steps to freer trade are therefore completely ruled out in

practice even by experts who feel committed to the general welfare.

3. This paper is an attempt to bring the two sides together. It will demonstrate, on the one hand,

- that internal and external liberalisation of trade in goods and services does substantially raise potential output and its growth path and
- that it, therefore, pays to anticipate these gains in conceiving and conducting macro-economic policies.

On the other hand, it will be argued that a macro-economic policy that is trade oriented and forward looking in this sense would allow trade negotiators and deregulators to deemphasise the direct losses of output and employment expected from removing restrictions and to anticipate a pull of demand that will facilitate the transfer of resources to alternative uses.

4. In dealing with both internal and external liberalisation, the paper will attempt to demonstrate that the two are complementary to a considerable extent and that it is, therefore, advantageous to combine both efforts into one strategy.

a) One chain of reasoning is
   - that external liberalisation requires domestic adjustment which is likely to be easier where markets for alternative uses offer an unrestricted entry;
   - that in the extreme case of regions dominated by declining industries, nothing short of experiments with "Free Enterprise Zones" will provide sufficient facility for coping with severe adjustment problems;
   - that alternative uses are not limited to manufacturing and that for the advanced countries of Europe the internal deregulation of service activities is almost a prerequisite for the full liberalisation, internal and external, of trade in goods;
   - and that the external liberalisation of trade in services as well as in goods will meet with great complications unless it is accompanied by internal liberalisation, deregulation and, perhaps, privatisation.

b) The other reason for combining internal and external liberalisation stems from the consideration that the completion of the E.C. Internal Market by 1992 is an agreed objective. If it is to be achieved in time, it will involve a speeding up of structural adjustment in many areas. An inward-looking reorientation of production is likely to cause the same costs but to offer much less scope for static and dynamic gains from trade than a reorientation that simultaneously exploits Europe's opportunities in a regime of free(r) trade on a worldwide scale. This becomes most plausible if one considers that free(r) trade will allow the world economy to raise output and employment without inflation and to speed up its growth of potential output by a significant margin.

II Openness and Growth: General Principles and Prospects

5. The case for liberalisation, external as well as internal, rests on the case for individual freedom and competition in open markets. When markets are open in the sense that barriers to entry for new suppliers are low, customers and ultimate consumers can safely expect to be served at the lowest possible price, at least in the medium run. This is because suppliers are under the control of potential as well as actual competition. Artificial barriers to entry built by governments or trade associations raise actual prices above competitive prices thus permitting producers' rents at consumers' expenses. Moreover, they worsen the economic opportunities of those who are excluded. If this sounds trivial, why is it so often ignored in practice?

6. The economic rent obtained by closing the market is at least partly consumed on the spot. It is transformed into unnecessary expenses and sheer waste, slack and sluggishness, a lack of innovative activities, a failure to quickly learn from other people's experience or research. Where such rents are in potential supply, they will invite rent-seeking activities. Intelligent people who might do better elsewhere offer their specialised services for lobbying and vote selling in the political arena. Such activities distort the public discussion of economic policies. They also push governments to further intervene, both to protect the rents from erosion and to support groups suffering from their discriminatory side effects.

7. Most harmful, perhaps, are the discouraging effects on outsiders. The latter include potential entrepreneurs and employers and the long-term unemployed at home and abroad, particularly in less developed countries (LDCs). The loss of dynamism on this account must be considerable, given the fact that protection is mostly sought by and given to established firms and employees, probably discriminating against the young, at least indirectly. In the same vein, there is reason to think that restrictions are particularly harmful for people with a high motivation level, e.g. in countries where the incentive system is not impaired by high marginal taxes or otherwise. Hence efforts to improve the incentive system will bear their full fruits only if they are accompanied by steps towards more open markets.

8. Openness refers to future opportunities as well as to opportunities in alternative markets. The avenue towards the future is technical progress; and investment is the means to exploit these opportunities. Obstacles to innovative investment must slow down the process of structural change. They are particularly harmful in advanced countries where large parts of manufacturing are under the pressure of competition from catching-up countries. Indirectly, these obstacles give rise to protective measures that often merely slow down the process of structural adjustment. In the final analysis, such protection is often only protection for defensive investments which involve a substitution of capital for labour without much genuine innovation. Therefore, a lack of openness vis-a-vis the future leads to what trade theorists call a "reversal of factor intensities". From a cosmopolitan point of view this amounts to a waste of capital in a world short of it.

9. Resistance against technical progress and against internal and external liberalisation must be expected from labour when (i) technical progress has a labour saving bias (saving more labour than capital) and (ii) unemployment rates are high.
Both sources of resistance have a common ground: an overpricing of labour. This is why wage moderation is of central importance. The role of wages in creating and fighting excessive unemployment need not be elaborated here as it has been well emphasised in the E.C. Commission's "Cooperative Growth Strategy" (1985). The influence of wage pressures on the nature of technical progress, however, is

less well understood. This is because the advance of technology is often tacitly assumed to be an exogenous factor, unrelated to relative scarcities. But just as they influence the decision to substitute capital for labour in investment decisions, distorted factor prices (excessive wages relative to interest rates, depressed interest rates relative to wages) lead to a preference for labour saving over capital saving options in new technologies. And even if research workers are not explicitly told what to search for, they will tend to pursue paths of inquiry that are expected to produce results meeting the test of market efficiency. The time lag involved is presumably long, given the fact that fundamental research is often remote from applied R&D and hence from economic considerations. A redirection of technical progress in favour of capital saving can, therefore, take quite a while during which resistance against technical progress as such may remain popular.

10. Popular resistance against imports and import liberalisation comes from the same source. The reason is

- that advanced countries are expected to take the lead in liberalisation,
- that these countries - apart from trading among themselves - largely import standardised products from countries with an ample supply of labour and correspondingly low wages, and
- that imports, therefore, tend to weaken the relative position of labour against capital.

11. Only when labour is in excess demand so that there is an inflow of foreign workers, will free(r) imports from low wage countries be generally welcome - as a substitute for foreign workers. Free(r) imports will then not only benefit consumers but also producers: entrepreneurs and firms using labour intensive import goods as inputs, exporters of capital and capital goods, skilled workers who are complementary to unskilled labour, and unskilled workers who dislike their direct foreign competitors. These circumstances prevailed in the 1960s in the E.C. of the Six.

12. In present circumstances - high unemployment among less skilled workers - there is only a much more limited but potentially expanding group of people who can - apart from consumers - expect to clearly benefit from, and hence to support, internal and

external liberalisation and the faster growth that will go along with it. This group includes all those who are actually or potentially complementary to unskilled labour, domestic or foreign. Examples are: savers, suppliers of capital and of capital goods (both to the domestic market and to foreign markets), skilled workers, persons supplying and acquiring technical knowledge and human capital. In a longer perspective, the importance of potential complementarity should not be underrated: unskilled workers may make themselves complementary to the labour embodied in imports or replaced by them, i.e. they can acquire the skills that face a high income elasticity of demand in the prospective growth process.

13. This has an implication for wage policy. Faster growth, in the same way as it raises the demand for savings and physical capital, can be expected to require a much more expanded supply of human capital. Hence, the skill differentials in the wage structure will have to increase. Indeed, in order to facilitate liberalisation for faster growth, these differentials should increase at an early stage of the process, perhaps even in anticipation of its start. This is most acute in structurally weak regions. If they want to become more competitive, they have to lower real wages for immobile unskilled labour so that their locations are more attractive to physical capital. And, at the same time, they have to offer higher salaries to experts and mobile skilled workers in order to attract more of them for faster productivity growth. This divergence is likely to strain interpersonal relations and traditional notions of equity.

14. Liberalisation for faster growth thus requires a social atmosphere tolerant towards changes in relative prices and income differentials. Growth will be delayed and liberalisation resisted if people have static or backward oriented notions of equity, justice, and fairness. This point is important enough in the European context to warrant a digression.

- Static notions of justice and equity, as they governed for centuries in Europe's history, implicitly refer to a point in time or to a group reproducing itself in the course of time. Think of a tribal community (on a subsistence level), a caste system or a stationary guild society and ask yourself – behind the veil of ignorance about your own position - what rule of fairness you would want to approve in order to limit the maximum economic risk, i.e. premature death. The answer most probably would be: equality to the extent necessary for satisfying basic needs. The poorer the society, the more equality will be called for.

- A society which has risen above subsistence levels without understanding why, will still instinctively approve of this rule of fairness as a matter of precaution or cultural lag. Income differentials, as they can exist in wealthier societies, will then have to be defended in a different way, e.g. by recourse to god's will or tradition. A materialistic interpretation of history - like Marxism - shatters these normative foundations unless society does learn to understand why it has become rich.

- A notion of fairness and equity that allows a dynamic interpretation has been offered by John Rawls (1971). This interpretation can be presented as follows: one may feel justified to earn more than the social minimum and even more than the average if one's moving ahead somehow benefits the poorest members of the group. Charity is the altruistic way, tax loyalty the legalistic way of paying tribute to this fairness principle. In a market system the right focus will be on actual and prospective relative prices. As indicators of useful social behaviour, relative prices correctly tell: make yourself complementary to the poor. By purchasing their products and by hiring their services you improve the poor fellows' terms of trade; by saving and investing you augment the capital stock and contribute to raising labour productivity; and by performing the entrepreneurial function you pave the way to new opportunities for your collaborators, your customers, and even your imitators. In the tribal community, the chief is supposed to deserve a better living as a reward for his lifetime leadership in the war against the enemy, human or ecological. In a dynamic society, the heroes are economic frontrunners, including entrepreneurs who earn (transient) extra profits for being (temporarily) ahead of other people. They benefit the latter by pulling them along or by inspiring them to follow suit.

15. Apart from equity, Europe is strongly concerned with social security. It is true that faster growth, once achieved, allows improvements in the social security net, thus benefitting those unable to adjust; but extended notions of social security - once embodied in institutions - must sooner or later be expected to produce moral hazard, i.e. to reduce the incentive or pressure to adjust and to induce more reliance on external protection and subsidies. The welfare state may not be observably harmful when adjustment requirements are relatively small under conditions of fast straightforward growth - as in the 1960s; but this no longer holds when growth slows down while structural change accelerates - as in the 1970s under various supply shocks and increasing competition from the NICs. Moreover, it probably takes time for behaviour to adapt to a different incentive system. This is as important for the future, should incentives be improved, as it was for the past when incentives for economic achievement and growth were impaired by the expansion of the welfare state.

16. Protectionism, internal and external, is an outgrowth of a security-minded mentality: nobody is ever to lose. But then there will be few to gain. In the framework of Paretian welfare economics, the gainers are supposed to compensate the losers. But compensation in actual practice may have prohibitive costs. A compensating society may thus be quite stagnant. A way out is to adopt a longer perspective. Hicks once suggested the principle that in the longer run everybody will be faced with opportunities to gain from change. To be widely acceptable this, however, requires that individuals

- have a life expectancy high enough to warrant such hope and
- have accumulated sufficient savings to survive during the interval
- or can rely on the family or on government support.

A young and wealthy population with strong family ties will accept more change and growth without actual compensation. This suggests that governments would be well advised to concentrate their offer of help to those elderly who are poor and cannot rely on the family. The latter could, if faced with severe income losses from external and internal liberalisation, be pensioned off, often at less cost to society than the customary maintainance subsidies. Apart from this, private savings and private property deserve promotion as means of protecting individual livelihood in a period of fast change. Transforming the income tax into an expenditure tax, e.g., would go into this direction. So would the privatisation of socialised enterprises.

17. Recent shifts in public opinion in many parts of the world are an indication that individualism and self-responsibility have improved prospects. Many small countries in Asia successfully changed from inward-looking to outward-looking policies. The People's Republic of China shows strong tendencies of domestic and international liberalisation - paralleled by a switch to deregulation, privatisation and market orientation in a number of countries in the West. Similar trends are observable in large firms which lay greater emphasis on the decentralisation of decision making and on profit participation. Even the Soviet system, under new leadership, seems to enter a period of reform. Such changes may be temporary and subject to a partial rollback. But the information revolution which is pushing towars decentralisation - despite Orwell - is irreversible. It definitely lowers the costs of communication and should, therefore, give a lasting impulse to a process of growth acceleration cum liberalisation.

18. After more than fifteen years of relative stagnation, Europe in the second half of the 1980s should find itself ready for a programme that would greatly help to initiate a new spurt in economic development. At the time of writing (1986), the cyclical position of its economy warrants the new optimism that has gained ground despite worsened export prospects. Based on the success of past anti-inflation policies in all countries and of fiscal consolidation in some of them, confidence in relative price level stability in the near future is strong. It could be maintained for a longer period of time, even with stronger demand, if a policy of moral suasion for wage moderation were combined with an incomes policy of liberalisation and market flexibility. Never during the last 15 years have prospective conditions for such a programme been better than now.

III Openness and Growth: The Empirical Evidence

19. A 4-5 per cent growth of industrial economies in the 1950s and 1960s went along with the opening of markets, while a 2-3 per cent growth in the 1970s and 1980s was paralleled by rising protectionism, both within and among countries. Before the background of the preceeding discussion, this is no surprise. It gives an indication of the magnitude involved: the subject of this paper is a difference of two percentage points per annum in real economic growth. Up to a degree, mutual causation seems to have been at work: a virtuous circle in the first period, a vicious circle in the second one.

a) The virtuous circle could be observed in West Germany, when the dismantling of many controls after 1948 created room for an unexpected rise in productivity that left real wages behind, thus increasing the demand for labour and promoting a positive sum game mentality in favour of (i) open product markets, (ii) convertibility on capital account, (iii) a free inflow of guest-workers and (iv) a technology transfer from the U.S. uninhibited by fears of technological unemployment. Germany took several unilateral steps towards import liberalisation and lower tariffs - ahead of schedule - for inviting competition as a means to maintain price level stability. This helped to accelerate the formation of the E.C. Common Market.

b) The vicious circle dominated in the 1970s and 1980s in most industrial countries. Its trade component was the New Protectionism of non-tariff-barriers (NTBs) (comprising the Multi-Fiber-Arrangement (MFA), bilateral import quotas, import licensing, orderly market arrangements (OMAs), voluntary export restraint agreements (VERs), safeguard measures, the restrictive application of standards, anti-dumping quarrels, and the (competitive) granting of subsidies to domestic producers). The products mainly covered were exports from countries (NICs) which have embarked upon an outward looking catching-up process. The purpose was to prevent or delay the displacement of domestic labour, primarily in old industrial regions on the European continent. Protectionism, it could be observed, tended to feed on itself. By permitting more sluggishness (X-inefficiency) it impaired the growth of productivity and output, while less growth reduced the dynamic margin where structural change can take place without pain. This in turn raised the demand for protection in the political arena.

20. The strongest statistical evidence for a negative impact of external protection on growth is supplied in a comparative study covering 32 developing and 5 industrial countries by Heitger (1986). The mean effective rate of protection of this sample (which includes the E.C. 6 as one country) accounts for a retardation of economic growth by 1.9 percentage points (on average per annum in the 1960s and 1970s). This finding is based on a production function-type analysis employing - as variables explaining economic growth -

(i) the adult literacy rate as a proxy for human capital,
(ii) the share of investment in GDP,
(iii) the rate of population growth as a proxy for labour,
(iv) per capita income relative to that of the U.S. as a proxy for the technological adaptation potential, and
(v) the effective rate of protection.

As technology transfer goes along with trade and as it is more important for developing than for developed countries, one may conclude that openness is even more beneficial for the former than for the latter - as it was for Europe during the postwar process of catching-up in relation to the U.S.A. .

21. Other studies point in the same direction:

a) For a sample of 41 developing countries in the 1950s and 1960s, Michaely (1977) demonstrated that a higher share of exports in GDP was positively correlated with per capita income growth.

b) Applying a production function-type relationship in a study of ten semi-industrialised countries, Balassa (1978) found that export growth for the 1966 to 1973 period matters in explaining why growth rates differ. Per capita growth in South Korea, e.g., would have been 42 per cent less had this country achieved merely the average export growth rate of the sample.

c) Michalopoulos and Jay (1973) and Krueger (1978) provide additional evidence for a positive correlation between export expansion and income growth.

d) Finally we know from case studies that trade liberalisation in developing countries went along with faster growth. Krueger (1983) and Donges and Müller-Ohlsen (1978) report that a change from import substitution to outward-looking policies led to higher rates of economic growth in many cases. Even after the oil shocks of 1973 and 1979, outward oriented developing countries had a much better growth performance than those LDCs which pursued a strategy of import substitution (Balassa 1981; Lal and Rajapatirana, forthcoming).

22. A clue to the question why import liberalisation has favourable effects on growth can be inferred from studies (Heitger 1983) which show that a country's international sector usually has a higher productivity growth rate than the domestic sector. The traditional view equates the international sector with industry and identifies the mechanism behind its produtivity performance as the exploitation of scale economies. Instead, the present author suggests to focus on competition as the explanatory factor as will be explained below (para 32). This competition is the driving force, whether or not substantial economies of scale exist. With import liberalisation, the sheltered domestic sector will shrink, and firms exposed to international competition will speed up their productivity growth. The same can be expected from an increase in competition due to deregulation.

IV Internal Liberalisation: Comments on the E.C. White Paper

23. "The probability of forced efficiency under the pressure of foreign competition has become one of the weightiest arguments for the formation and extension of custums unions. Not that world-wide free trade would not be far more effective in removing domestic restrictions on competition; but political resistance to it seems insuperable. But the same vested interests as are fiercely opposed to global free trade are willing to 'cope' with regional free trade, and some loosening of monopoly positions can be expected also from a regional common market. It is not forgotten, however, that many politically influential industrial groups have accepted the establishment of the common market only in the hope that cartels and mergers will succeed in averting the outbreak of unlimited competition among producers". This statement by Fritz Machlup, then President of the International Economic Association during its Fourth Congress in 1974 (Machlup 1976), perfectly describes the present author's position as an economist, on the relative importance of the European Council's determination since 1982, to complete the internal Common Market in the near future, specified in 1985 to be the period until 1992.

24. In commenting on the E.C. Commission's White Paper of June 1985, the subsequent paragraphs will continue the preceeding line of reasoning and stress the dynamic rather than the static aspects of competition. The judgements, factual or value oriented, underlying this reasoning can be set out as follows:

(i) Competition, in a world of uncertainty and limited knowledge, is "a process of discovery" (Hayek 1968); we do not know a priori what situation is superior, but producers engaged in competitition will make experiments (i) to reveal their customers' preferences, (ii) to improve products and (iii) to lower their costs. Those who have better hypotheses will see them corroborated (Popper 1959) in the market; others will imitate them or launch improved hypotheses if their previous tests have failed; competition, just as research, never reaches a stage that could be called "perfect".

(ii) While product innovations (including product differentiation) are a means of sensing consumers' preferences, process innovations raise total factor productivity (X-efficiency) by exploiting new knowledge, technical and organisational. As the stock of this knowledge is growing all the time, competitive pressures to exploit it should, in principle, be maintained even if this were at the expense of short run gains from monopolisation (mergers) and cartelisation (cooperation).

(iii) In a European context, mergers and inter-firm cooperation are the less tolerable, the greater is the protection against competition from third countries (external protection) and vice versa.

(iv) Competition cannot be fair to producers without being unfair to consumers or to those whom rules of fairness exclude from the market. Severe competition which eliminates participants is mostly the result of repressed competition: previous cartel arrangements, regulation, or outside protection. It should, therefore, not be blamed on the principle of liberal markets.

(v) Subsidies from governments distort or weaken competition, but they do not lead to genuine discoveries (that would not have been made anyway. This holds for maintenance subsidies which merely slow down adjustment, but often also for R&D subsidies which fail to create a corresponding research capacity.

(vi) Norms imposed by governments limit the process of search for better products and processes in compliance with consumer preferences and should, therefore, not be established as European norms except perhaps as minimum requirements necessary to prevent negative non-pecuniary externalities. Scale economies from norms stimulate competition or agreements among firms and will, therefore, be fully exploited by the market.

(vii) Norms and standards for products established in one member country should be considered sufficient in all other member countries, particularly if consumers receive information about the standard prevailing in the country of origin (Cassis de Dijon doctrine).

(viii) This country of origin-principle which is applicable to goods should also cover services. There is nothing inherent in the nature of services that could warrant a different treatment.

(ix) As regards taxation, the country-of-origin principle already applies to direct taxes; it should equally apply to indirect taxes. Then entire national tax systems would compete with each other.

25. There is common ground between the propositions advanced in this paper and the White Paper where the latter states
- that all controls at the internal borders should be abolished by 1992 (para 1, para 27);
- that this requires the removal of all national (and regional) import quotas (para 35) and that if such quotas would still be allowed according to Article 115 of the EEC Treaty they should no longer be administered at the frontier (para 36);
- that all restrictions on imports imposed under Article 108 EEC Treaty for balance of payments reasons that are applicable at internal frontiers will have to be renounced (para 37);
- that the CAP (Common Agricultural Policy) has to be adjusted to the effect that border controls become unnecessary (para 38);
- that, in order to avoid border controls, trucking should be deregulated (para 44, para 109);
- that domestic authorities should have less power to regulate prices, capacities and entry in the field of civil aviation (para 109);
- that national regulations should be harmonised with the proviso that they are limited to what health and security considerations compellingly require (para 65);
- that the "Cassis de Dijon Principle" (according to which all goods complying with the legal requirements of the country of origin should have free access to all countries of the Community) should be widely applied (para 58, para 77);
- that this same principle should also be applied to financial services (para 102, para 103);
- that freedom of professional services should be accomplished for doctors, lawyers and others who want to settle in countries which require permission on the basis of professional and academic qualifications (para 91);

- that factual discrimination of foreigners in public procurement procedures should be abolished (para 85);
- that national exchange control measures, if any, should not be administered at the border (para 132).

27. There are three major points of possible disagreement. The White Paper pleads for European industrial norms (para 65), although admitting that a mutual recognition of national norms would provisionally do. This assumes that common technical norms are advantageous independent of how they are established. It ignores that norms, apart from promising economies of scale and having an information content, tend to close opportunities for technological advance and definitely reduce the variety of products available on the market. These advantages come into full consideration and are sufficiently weighed against the advantages flowing from scale economies only when norms arise from a process of trial and error under conditions of competition among many or even few suppliers. It is true that the selection of norms by the market may not be perfect. But if committees of technicians decide (or merely suggest for decision by authorities), technical considerations are most likely to override consumers' preferences and the aspect of opportunity costs. This danger is presently enhanced by two trends:

(i) Strict product liability is becoming a major concern under the influence of American legal practice; it may lead to an excessive caution on behalf of technicians and producers without regard to the moral hazard effect that is likely to arise if consumers are made to believe that consumer goods are guaranteed fool proof.

(ii) The Tschernobyl nuclear energy accident is likely to raise emotional concerns about security in many other fields. If authorities become more and more involved in fixing standards, the security associated with them will be considered a public good that has benefits without any costs. In these circumstances politicians and bureaucrats as well as the technical experts advising them will push for excessive rather than minimum standards thus unintentionally closing the market to new entrants or competitors from other countries.

28. The White Paper also goes too far in calling for a policy to promote industrial cooperation (para 133). It ignores the general tendency among producers of the same trade to form implicit or explicit cartels at the expense of customers and final consumers. The language of the Book in this section - with appeal to small and medium-sized enterprises - allows this interpretation. Even different mentalities and habits are seen as obstacles to cooperation, as if maximum cooperation rather than optimum competition were the goal.

29. The greatest difference of opinion or judgement exists with regard to indirect taxes, notably VAT levels. The White Book pleads for an almost complete harmonisation of these levels (para 175) thus implicitly endorsing the principle of the country of destination as it is presently applied in intra-European and international trade. It ignores the alternative principle of the country of origin which - for other features of the product - is embodied in the Cassis de Dijon decision. This alternative principle takes all taxes, direct and indirect, as producers' taxes or as an equivalence for the government's supply of public goods that improve economic conditions prevailing in the producer's country or location (Giersch 1962, Sievert 1964, Wissenschaftlicher Beirat beim Bundesministerium für Wirtschaft, 1986). It leaves the mix in the financing of these public goods (the mix between direct and indirect taxes) to the country of origin which can fully take into account the specific tax mentality and the traditions of the population. Under this alternative principle border controls can be removed without a harmonisation of VAT levels.

The switch, however, requires an adjustment of exchange rates. This is so because the present system contains an apparent element of protection for producers in countries with relatively high VAT levels: imported substitutes for domestic products are subject to high VAT rates at the border while goods exported are free of them. The protection involved is apparent only since it is (largely) matched by a correspondingly higher valuation of the exchange rate. To put it differently: the exchange rate effect means that countries with relatively high VAT levels are relatively expensive countries for tourists who pay the same prices as domestic consumers. The present system thus discriminates against tourism in countries with relatively high VAT levels. The exchange rate adjustment that will go along with the switch is thus a devaluation. Apart from benefitting tourism, it serves as a compensation for the withdrawal of the apparent element of protection. In a similar way, countries with relatively low VAT levels would have to upvalue their currency. Apart from becoming less attractive for tourists, these countries offer practically the same locational advantages (or disadvantages) as they do now: the tax switch that appears to benefit their producers is matched by a revaluation that withdraws this benefit. But note that exchange rate adjustments can cope only with differences in VAT levels; they do not affect differences in the structure of tax rates. Some harmonisation of the structures will therefore be inevitable even under the country-of-origin-principle. The same applies to specific national taxes on consumers's goods. Fixing the rate for these taxes would remain a national prerogative, albeit limited by the market (smuggling) except for goods to be registered (e.g. cars).

30. Nevertheless, the principle of destination can be applied, even without border controls, albeit with some imperfections, even if levels of VAT rates remain different. Technically, the procedures of payment would be shifted from frontiers to the locations of the importers, as the White Paper suggests. The importer would inform the exporter, certified by his tax authorities, that he paid his VAT. This declaration would allow the exporter's tax authority to reimburse the VAT, and knowing this, the exporter would contract for a price without VAT to begin with. Difficulties would arise in the case of direct consumer purchases (mail order, tourism) if VAT rates are substantially different; here the principle of the country of origin would have to apply for simplicity's sake. It would be a competitive element welcome as a brake for the national governments' propensity to raise VAT rates.

31. Apart from border controls, the internal market for industrial products is still fragmented by

(i) discriminating public procurement,
(ii) public aid to industry,
(iii) favouritism: special treatment of public enterprises (according to Article 90).

The economic costs of this fragmentation have not yet been carefully assessed, but they must be enormous in terms of the welfare of consumers and taxpayers. Pelkmans (forthcoming) gives a rough indication of the order of magnitude of direct costs:

- something like ten per cent of the ECU 400 billion annual procurement expenditure - i.e., ECU 40 billion - (Albert and Ball, 1983),
- a similar amount (ECU 32 billion in 1981) of sectoral, regional, industrial, export and fiscal aid, mostly for steel.

In addition, there are indirect costs from a distortion of competition due to the fact that trade and competition in medium-tech and high-tech products are hampered and distorted because countries usually do not yet mutually recognise national test certificates and because governments or public agencies discriminate against foreign suppliers. In the field of low-tech products (steel, textiles, clothing, ceramics, glass) internal competition is distorted because external protection is combined with internal impediments to trade and adjustment (subsidies).

32. It is worth repeating in this connection that these impediments to trade and adjustment not only involve costs on static allocation account; more important is that they slow down the productivity advance. This we can infer from a study already quoted (Heitger 1983) which compares the superior productivity performance of the international sectors of national economies with that of the domestic and sheltered sectors. The usual explanation for the different productivity performance is that the international sector largely comprises industrial activities which are associated with increasing returns. The present writer, in contrast, maintains that the essential difference is the strength of the challenges from competition. Increasing returns to scale are no free lunch, no mannah from heaven. They must be paid for in the form of heavy initial investments due to indivisibilities. It is, so to speak, only after having driven an uphill road that one can exploit the cost advantages of a downhill ride. Whether there is any net saving of gasoline or time by riding up and down in comparison to driving on a plain is highly doubtful; but driving in competition will certainly result in a higher performance level, either in terms of time or cost saving. The association of

industry and long run increasing returns appears to be a false generalisation from the historical episode of industrialisation when new knowledge, which is really what matters, found its way into the economy mainly via industrial investment. This is no longer the case.

33. It is the function of competition from the NICs (from "below") to push European producers into product and process innovations – as an alternative to decay – or into a move to low wage countries (locational innovations) within and outside the E.C.. External protection and intra-E.C. fragmentation offer only some additional time for adjustment. But whatever time European firms gain in this way, they are likely to lose when they meet with barriers to entry in the new environment or in the more sophisticated markets. Fragmentation and protection thus reduces the speed in which resources can move from low-tech to medium-tech and from there to high-tech activities. This speed will determine Europe's overall technological competitiveness in the next decades. It is in this sense that the completion of the Internal Market as a competitive market will be decisive for Europe's role in the world economy.

34. The White Paper is a milestone in the development of the Community. It deserves more publicity than it so far received. It is not only comprehensive but also specific enough to catch the citizens' imagination. The timetable it contains could well become an instrument of public pressure. Nevertheless, it is weak or vague in several respects, e.g. on aid to industry (only an inventory of state aid is foreseen by 1986), on regional policy, on public procurement, and on the deficit financing of public firms. Hope, however, is warranted that the actual removal of border controls will induce further steps towards liberalisation in the fields of agriculture (where monetary compensatory amounts would become impossible), transportation and imports from external sources (where it would become impossible to apply national quotas under the Multi-Fibre-Arrangement or to effectively protect national industries by means of Voluntary Export Restraint arrangements.

35. Agriculture and external liberalisation will be treated in subsequent parts of the paper. This brings us to the problems of transportation and other services. Services cover the field of

invisible trade. This trade is so difficult to liberalise because services are mostly subject to regulation by national authorities. In transport, as in other fields, the deeper reason for regulation is protection, i.e. the opposite of the competition that we consider vital for prosperity and faster growth in the Community. Such protection is often demanded in the name of consumers but it usually serves the purposes of producers who are eager to capture the rents, pecuniary and non-pecuniary, which protection is offering. In defence of these rents, numerous reasons are being invoked - from military security in NATO to employment security in individual jobs. The nucleus of resistance are often public enterprises (railways, P.T.T.) and their labour unions. Their arguments have some appeal in Europe's public as long as governments stick to old European traditions which made people believe that public enterprises are public because they are supposed to produce public goods which markets would fail to supply adequately. This old view has turned out to be wrong.

36. Liberalisation and deregulation may, therefore, require privatisation. Resistance against privatisation comes from politicians in office who are keen on defending their power and influence and the rents associated with them. It also comes from the employees of public enterprises. British experience seems to show that it is possible to overcome these resistances by giving adequate compensation. The forms of compensation must be somehow disguised since few beneficiaries would be prepared to quite openly admit that they previously opposed privatisation for quite selfish (and pecuniary) reasons. This certainly raises the danger of overcompensating interest groups at the expense of the general public but there are no foolproof recipes for avoiding it. The most important form of compensation is to sell an adequate number of shares at a discount price to the employees and the management of the enterprise to be privatised. This gives the whole issue a flair of being a step towards workers' participation and people's capitalism. Apart from this, there must be ideological commitment - or political will - on the part of leading politicians. Otherwise the privatisation of public enterprises is likely to get stuck over the details of each and every case. However, successful moves in one country (like Britain) can inspire imitation in other countries of Europe, just as truck and airline deregulation in the U.S. are examples worth to be closely examined in the E.C..

37. Liberalisation of intra-EC trade in services without deregulation means competition between different regulatory systems. Here only the principle of the country of origin (or the Cassis de Dijon doctrine) can apply. An insurance company situated in the U.K. will remain subject to the U.K. regulation and will sell a product with the trademark "made in Britain", competing with insurance companies subject to a different regulatory standard. This kind of competition is exactly the same as the competition among suppliers of goods with different quality standards. As a process of discovery, it will give a clue to what types of standard European buyers prefer in the field of services. Common standards for different service activities may be elaborated after a while as European trademarks, but then they should be designed also with regard to Europe's competitiveness in world markets for services.

38. The position taken here goes against the view dominant among Member States who hold that they need not permit the free import of insurance services before coordination has taken place (Pool 1984). The reason given for the need of prior coordination is that competition otherwise would be distorted. This again ignores the role of competition as a search process; it is also unrealistic because our diversity would never allow real competition to start from equal conditions or opportunities. It is from diversity rather than equality of conditions that a division of labour emerges; a process of competition and trade may bring about an equalisation of some sort (product prices, factor prices) if impediments to trade (transport cost, transaction costs, tariffs etc.) are low. Governments must let competition operate first so that they obtain information about how (in what direction) the public wants to see the regulations harmonised. After all, governments of Member States are not the masters but the servants of their people. If the E.C. Commission is not strong enough to convince governments, it will have to take the case to the Court of Justice in order to question how strong the grounds of general interest really are that are thought to justify impediments to cross-border traffic in services.

39. The argument most often put forward in defence of protective regulations is paternalistic: individuals, given the freedom of a wider choice, would be likely to make more mistakes as

many buyers have less than full information. However, mistakes are unavoidable in any market, and if the argument were generalised we should not have the completion of the internal markets for goods either. In the Cassis de Dijon case the Court's view was that the German requirement (of a minimum alcohol content of 25 per cent for fruit liqueurs that excluded foreign suppliers) was not essential since the information it contained could be easily "conveyed to the purchaser by requiring the display of an indication of origin and of the alcohol content on the packaging of products" (E.C. Court of Justice, 1979, p. 664). Surely in insurance and banking the information problem may be less trivial than in the liquor case, but consumers are also more aware of it. Moreover, consumers can learn; they need not - and will not - remain so uninformed as they can afford it under a paternalistic regulatory system. Finally, if national governments think that their own regulatory system is superior to that of their competitors they are free to have it advertised to their own obedient citizens - and to those in other member countries.

39.a) At this point, it is tempting to raise a general objection against the assimilation of financial products to goods: in goods markets it is the product which has to meet the quality standard, in service markets it is the producer. However, the issue is not control or regulation itself but whether control exerted by the country of origin can be taken by the country of destination as rendering enough protection to its residents. Even if these residents are considered to be badly informed or if their government is strongly paternalistic, liberalisation may take place without prior harmonization of controls since liberalisation merely amounts to removing a prohibition for residents or a legal discrimination of foreign suppliers; it does by no means exclude informing residents about the merits and de-merits of the domestic and foreign regulatory standards.

Against this line of reasoning one may argue that information is not enough to guarantee consumer protection; in additon, supervision of the providers of financial services is required. This argument implies that some E.C. members have no supervision at all. If true, do their citizens suffer badly? Would their suffering not be the most alarming information to be disseminated in the process of liberalisation and a strong motivation to enjoy the free access to the (supposedly better) foreign services?

The ultimate defense of the need for harmonization usually invokes some public good argument referring to the "stability of the system as a whole". The idea of a "system" that has to be safeguarded is, of course, diametrically opposed to the notion of competition as applied in this paper. "System" in this sense is either a cartel or a hierarchical order with a central governing body - or perhaps both. But then the question arises whether completing the internal common market does really aim at a market or rather at a highly complex bureaucratic arrangement.

V External Liberalisation: Recent Trends

40. The recent record of worldwide liberalisation is disappointing as recent assessments show (Donges 1986). It is true that the Tokyo Round of negotiations conducted in the framework of GATT and completed in 1979 produced an agreement of tariff reductions (by one third for the nine major industrial markets combined) and established several "Codes of Conduct" with the aim of stopping the proliferation of non-tariff barriers (NTBs). But the subsequent GATT Ministerial Meeting of November 1982 failed to come out with a credible commitment to cut import restrictions and export subsidies, and the U.S. Administration since then has had an increasingly hard stand against mounting protectionist pressures.

41. Tariff rates, it is true, are still substantial in industrial countries for finished manufactures (almost 7 per cent in the E.C., 6 per cent in Japan, 5.7 per cent in the U.S.), and they operate mainly to the disadvantage of developing countries. It is also true that in developing countries they are higher than in the industrial countries and continue to be non-binding to a large extent. But the main obstacles to freer trade are NTBs. They include:

- import quotas,
- "voluntary" export restraints (VERs),
- orderly market agreements (OMAs),
- anti-dumping measures based on extended definitions of dumping,
- variable import levies,
- administrative guidance,
- subsidies.

These NTBs are applied discriminately

- in favour of specific domestic sectors, (agriculture, textiles and clothing, footwear, leather products, ceramics, steel, shipbuilding, consumer electronics, watches, automobiles, machine tools) and
- against the most competitive suppliers (Japan and the NICs).

42. The share of manufactured imports subject to NTBs in 1980 was 10.8 per cent in the E.C., 7.2 per cent in Japan and 6.2 per cent in the U.S. according to Balassa and Balassa (1984) who also indicate – for the 1981–83 period in the U.S. and the E.C. – an extension to other products that had made up 6.5 and 4.1 per cent respectively of total imports in 1980. More recent calculations (Nogues et al. 1986) show for 1983 that

- the E.C. had NTBs on 22 per cent of its total imports,
- the U.S. on 43 per cent and
- Japan on 12 per cent.

With regard to manufactures, the E.C. and the U.S. in 1983 seem to have been more protectionist than Japan according to these calculations.

43. Apart from agriculture, which is subject to the E.C. Common Agricultural Policy (CAP) covering now 90 per cent of farm output (50 per cent in the early 1960s), the two sectors most heavily protected in Europe are textiles and steel. Textile imports are subject to the Multifibre Arrangement (MFA) that originated in 1973 as a temporary measure and was recently (1986) renewed for the third time. The MFA has been tightened up, previously under pressure from the E.C. (MFA II and III), recently at the request of the U.S. (MFA IV). Its effect has been

- to give relief from import competition, previously only from actual imports, now also from future import growth,
- to penalise the most efficient suppliers among developing countries,
- to discourage others from imitating the frontrunners by creating uncertainty about market access conditions.

Several E.C. member states invoked Article 115 of the Treaty to derogate from the common external tariff, thus eroding the internal common market for textiles.

44. As to steel, the regulatory interventions of the E.C. Commission initiated in 1977 to reduce overcapacities in an orderly manner (Davignon Plan), later supported by mandatory production quotas and subsidies (explicitly forbidden under Article 4 of the Treaty of Paris), have been supplemented by protective devices applied against third countries. They include minimum import prices, anti-dumping procedures and VERs for about 80 per cent of steel imports. Scheduled to be phased out by 1985, this regulatory system has been prolonged - until the end of 1987 for production quotas and import protection, until 1990 for subsidies. As in textiles, we observe that temporary relief by protection tends to become permanent, leads to a moral hazard phenomenon.

45. The U.S. protectionist steel policy, which started in 1978 with the trigger price mechanism has gradually changed. Its present emphasis is on anti-dumping procedures, VERs (with the E.C.) and safeguard measures under Article XIX of GATT with a view to limiting the import share to 20.5 per cent.

46. An increasing protectionist drift can also be recognised by focussing on the spread of VERs to consumer electronics, automobiles, and machine tools. VERs are the governments' devices for circumventing the rules they themselves laid down and agreed upon in GATT. They are now applied beyond mature and declining industries to ventures in the medium-tech and high-tech areas. If we consider that governments also intervene at the upper end to pick the winners and even to "create" them we come to wonder where the market is left to work for the benefit of consumers without governments supporting domestic producers at high costs.

47. Contrary to widespread perceptions, Japan actually seems to be less mercantilist on these accounts than either Europe or the U.S.. With the exception of agriculture and food processing, Japan's GATT record is fairly clean, even with regard to textiles. There may be clandestine protectionism in Japan, but it is difficult to believe that it has measurably expanded in recent years,

when information costs declined and American and European firms increased their presence.

48. Comparing the E.C. and the U.S., one has to consider that trade policy over here is less noisy than in the U.S. where Congress is much more involved than parliaments are in Europe. With more publicity, European protectionism might have been more restrained in the public interest.

VI External Liberalisation: The New GATT-Round

49. The GATT can be described as a cartel of governments directed against domestic producers' groups, including cartels that want to improve their terms of trade by preventing their customers from having free access to foreign competitors. As a "cartel against cartels", it has a function similar to that of competition policy. The New GATT-Round following the Punta del Este Meeting - the Uruguay Round - is an opportunity for reasserting this role of GATT. Hence it deserves the full support of the E.C. Commissioner responsible for competition policy.

50. Like a cartel, GATT is not very powerful by itself. It can hold the line by preventing some protectionist mistakes. But dynamism towards freer trade for faster growth will not be generated in GATT-Rounds. This is why proponents of free trade so often call for leadership. The U.S. does not appear to be ready for such leadership, given the overwhelming protectionist pressures that prevailed when the dollar was strong in foreign exchange markets. This may have changed with the decline of the dollar. A lower exchange rate always improves the short term outlook of the business community. Perhaps, the Uruguay Round would hardly have been initiated, had not been this change in U.S. competitiveness.

51. For Europe, this Round is a challenging opportunity for the following reasons:

(i) The E.C. can assert itself as an identity in world wide negotiations.

(ii) The Commission will gain prominence over national governments as the main actor, once Ministers have agreed on seeing the Community as a locomotive in the negotiations. The Commission can demonstrate to the population that it is more aware of the general welfare of consumers and less dependent upon specific interest groups than some member governments, notably before elections.

(iii) There is new scope for leadership within the Commission because external liberalisation is a worthwhile endeavour to be coordinated with the completion of the Common Internal Market and with the Commission's co-operative growth strategy.

(iv) In the field of agriculture, the external and the internal pressures for a fundamental reform could be combined so that a historical leap forward might become politically feasible, facilitated by the faster growth of Europe's non-agricultural sectors and their absorptive capacities under a more liberal trade regime.

Subsequent paragraphs will concentrate on the last two points.

52. The completion of the Common Internal Market will have to be co-ordinated with external liberalisation in the field of services, wherever external suppliers matter and complain. The reason is what in the customs union issue was called "trade diversion". In the present context we may speak of "service diversion". As is widely known, such diversion results when two or more countries grant each other freer entry for their goods but not for goods from third countries. The latters' exports thus suffer from discriminatory treatment. Other things remaining equal, imports from third countries will decline. In the E.E.C. case this discrimination was perhaps outweighed by an induced acceleration of economic growth which brought about faster import growth. The combined effect helped to convince third countries that it would be worthwhile to join the E.C. .

53. There is a parallel case resulting from the internal liberalisation of trade in services. Two forms of such liberalisation can be distinguished. One form is the freedom to establish a subsidiary in another member country, subject to the rules and regulations which the host country applies to its own nationals. A British insurance company's subsidiary in Germany can then do business in Germany as if it were a German company. The same would hold for a German company's subsidiary in Britain. If this

arrangement is limited to E.C. members, U.S. companies might be at a disadvantage. Their European competitors would receive additional scope for what in the trade field has been called "intra-industry" specialisation, a scope that is denied to them. The envisaged complaint is about a denied opportunity. This loss of competitiveness may induce them to press their own government to participate in the arrangement. In practice, such participation will mean a move towards the formation of a kind of "GATT for Services". It would be wise for E.C. Europe to join such efforts right from the start.

54. The other form of liberalising internal competition in services is freeing cross-border trade. Here the principle of the country of origin has to be applied. Every E.C. country would permit companies operating in other member states to freely offer their services in its own market, perhaps with the proviso that the service supplied - say an insurance contract - is explicitly characterised and advertised as "British" or "according to French regulatory standards". Companies operating from third countries would be denied this kind of free access. Again, the U.S. government would feel increasing pressure to obtain the same concession for its companies in exchange for the concession of a free sale of European company's services on the U.S. market. The difference to traditional trade diversion again stems from the fact that the non-European companies had no access whatsoever before; they are being denied an opportunity that their European competitors gain.

55. The liberalisation of air transportation services, to the extent that it is foreseen in the White Paper, is a different case for a deplorable reason: in this field, Europe has a very long way to go - with much adjustment - before it could be said to have a market comparable to the U.S. in both scope and degree of competition. It is true that the same seems to hold for insurance services but airlines, other than insurance, are mostly subject to government ownership or to national security considerations (at least in rhetoric). Moreover, the deregulation of airline services in the U.S. was limited to U.S. carriers, and Europe and its airlines - for obvious reasons - never seriously asked to have access to the U.S. market on the same conditions as U.S. carriers. The U.S. would have immediately demanded reciprocity; this reciprocity could have never been granted without internal

liberalisation. Nevertheless, it seems that steps towards internal liberalisation would increase Europe's bargaining power: with a more liberal internal regime, Europe would have more to offer and could, therefore, hope to make substantial gains in terms of freer access for its airline services in world markets. This gain would be of substantial value, given the high income elasticity of demand for these services. The E.C. Commission might wish to induce economists to have a closer look at this subject which is complicated and, therefore, dominated by insiders who may not be able to completely detach themselves from the influence of vested interests. An alternative would be to urge for a sweeping political decision in favour of airline deregulation and worldwide competition on the grounds that such a move would be essential - and a test - for Europe's economic dynamism.

56. Agriculture, to many economists and laymen alike, appears to be hopelessly unsuitable as a subject of liberalisation efforts. Atavistic anxieties about basic needs merge with vested interests of a well organised political pressure group. Everything in this field seems to have been overdone to an extent that it is turning into its negative: overproduction instead of starvation, wasting instead of economising resources, deterioration of quality instead of product improvement, peasant revolts instead of appeasement. Some economists have warned against this decades ago. Now the agricultural perversities are spoiling Europe's image among the population within and outside the E.C.. Financially, a good European is to be taxed as a notorious "Europayer." In the Uruguay-Round, the issue of the Common Agricultural Policy will come up again and again, surely with detrimental effects on other fields. A financial breakdown internally and a breakdown of trade negotiations internationally have become imminent threats. The time of complacency has run out. A stumbling bloc is to be removed. Most people agree. But they also stick to the defeatist belief that the sensible is impossible. This is a situation where nothing short of a deep crisis can produce a turnaround. It may endanger the GATT negotiations. No subject for macroeconomists? Surely, it is a macro-problem similar to that of the labour market: The level and structure of agricultural prices do play the same distorting role in product markets as the level and structure of wages in factor markets.

57. There will be no other lasting solution to the agricultural problem than a compliance with the dictates of the world market. And if governments believe that incomes presently earned by agricultural producers should be protected, to the extent they are rents measured against the background of world market prices, direct income support could be offered to those incapable of adjusting their activities. The technical issues involved cannot be discussed in this context. Nor is it possible to present - and evaluate the costs of - alternative schemes. But it is worth repeating what so often has been stated, i.e. that direct income subsidies are a cheaper form of incomes policy than any scheme involving prices and hence a misallocation of resources in addition to what the consumer has to pay. It would be irresponsible if Europe added to these wastes the loss of growth opportunities that would arise should its stubbornness in agricultural policy lead to a breakdown of GATT negotiations.

VII Liberalisation and Macro-Economic Policies

58. A liberalisation of trade in goods and services, internal and external, would be a positive supply shock. The empirical evidence referred to above (para 20 et seq.) indicates what the order of magnitude is likely to be: Europe could expect an increase in the rate of growth of potential output in the range of two percentage points. The figure may be higher for some countries and regions with a high potential for catching-up; it may be lower for the more advanced and prosperous regions and for countries that are ahead of others.

59. What also matters for policy formation is the time profile of the improved growth prospects. For lack of evidence we have to speculate. One factor is the static allocation - or integration - effect: bits and pieces of the sheltered (domestic) sector will become part of the international sector; in the process of transition, their productivity will increase. This is the counterpart of the pains arising from the induced structural adjustment. This effect will peter out after the transition period when the liberalisation process has come to an end. Then there is another effect which will appear less plausible to non-evolutionary economists. It is not the effect of reallocation, or of the competitive pressure bringing about reallocation, but the result

of the higher competitive pressures that are permanently at work in what we call the international sector in contrast to the domestic or sheltered sector. Included in this competition is a lot of what is sometimes called "unfair" competition or "dumping" at prices equalling short term marginal costs or what Schumpeter seemed to mean by the "gales of competition". Although governments will be hard pressed to tame this kind of competition, we can trust that participants in a market that is as anonymous as the world market - with new NICs coming up all the time - will always attempt to circumvent the written and unwritten rules of explicit and implicit protectionism. This point supports the view that some growth acceleration will be permanent. On the other hand, it has to be admitted that such circumvention is going on all the time and that the protection we measure may not be as effective as it appears at first sight. However, the evidence quoted refers only to the protection as we measure it and it relates to the growth performance. In this sense the two sides are likely to balance. There is perhaps a more important qualification: were the effective rates of protection that prevailed in the past and that underly the calculations not possibly higher than those we are going to tackle in the future? Without further research we have to admit ignorance. Apart from this, the actual acceleration of growth will also depend upon how far towards free trade Europe - and the world - will be actually prepared to go.

60. This paper is a plea for moving ahead courageously and on a broad front.

(i) The courage for the internal liberalisation measures and for E.C. leadership in the Uruguay-Round can be safely based on the recognition that Europe has a growth potential to exploit.

(ii) This growth potential can be widened by early measures to make markets more flexible and responsive to relative scarcities - the labour market and the agricultural markets not excluded.

(iii) Tax reforms in imitation of the present U.S. example will greatly help to improve incentives and to raise supply responsiveness.

(iv) Decision makers and negotiators on the liberalisation front will have to operate on the assumption that overall demand is certain to develop along with supply responsiveness - in upswings ahead of supply, in unavoidable slowdown periods with a short time lag; and monetary-fiscal policy should allow for the increased supply responsiveness in a way that makes freer imports and more import competition a welcome public good for maintaining price level stability.

(v) Leadership is required for such a movement on a broad front because each segment (or sector) will go ahead only if there is enough certainty that others will make the complementary steps. Partial steps are futile, at best they are second best. An important implication for econometric modelling and policy simulations is that changing a single policy variable (ceteris paribus) is inferior to comparing well composed strategy alternatives (mutatis mutandis). In this sense the above considerations fill a lacunae in the Commission's "Co-operative Growth Strategy".

Without a coordinated policy, Europe may still have faster economic growth and less unemployment sometime in the future; but we can definitely have it a couple of years earlier if we succeed in mutually convincing ourselves that concertation along these lines is possible and worth the effort.

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