COMMISSION OF THE EUROPEAN COMMUNITIES

SEC (88)524 final

Brussels, 13 April 1988

E U R O P E 1 9 9 2

THE OVERALL CHALLENGE

Economic gains from the 1992 programme could rise to 200 billion ECU or more, together with a substantial boost to employment.

The Commission today revealed the results of a major study which it commissioned to evaluate scientifically the benefits of the single market. This study which will shortly be published in book form provides the hard evidence, the confirmation of what those who are engaged in building Europe have always known: that the failure to achieve a single market has been costing European industry dearly in unnecessary costs and lost opportunities; that the completion of the internal market will provide the economic context for the regeneration of European industry in both goods and services; and that it will give a permanent boost to the prosperity of the people of Europe.

The study not only quantifies the heavy cost that we now pay because of the many barriers which fragment the Community's economy into twelve separate markets; it also calculates the value of the immense opportunities which the completion of the internal market will open up: opportunities for growth, for job creation, for economies of scale, for improved productivity and profitability, for healthier competition, for professional and business mobility, for stable prices and for consumer choice.

The total potential economic gain to the Community as a whole is estimated to be in the region of ECU 200 billion or more expressed in 1988 prices. This would add about 5% to the Community's gross domestic product. This calculation includes not only the savings made by removing the barriers which directly affect intra-EC trade (essentially frontier formalities and related delays) but also, and more significantly still, the effects of removing barriers which hinder new market entrants and thus the free play of competition. To that we must add the cost savings which businesses can achieve through exploiting more fully the potential economies of scale which a single market offers. These gains will already start to arise in the short-run, as increases in production allow fixed investment costs to be covered by larger sales volumes. To a much more important extent, however, they will accrue in the longer run as companies and production units are restructured and get closer to the most efficient possible scales of production. Finally, the estimate includes other gains in efficiency due to intensified pressures of competition affecting administrative overhead costs and over-manning at all levels.

The study further shows that the predicted effects of EC market integration through removal of customs barriers, opening up public procurement, liberalisation of financial services, and other supply-side effects will in the medium-term

- in addition to boosting output, employment and living standards simultaneously cool the economy, deflating consumer prices by an average of 6%;

- relax budgetary and external constraints, improving the balance of public finances by an average equivalent to 2.2% of GDP and boosting the EC's external position by around 1% of GDP.

(1) The study.

In 1986 Lord Cockfield, on behalf of the Commission, invited Mr Cecchini to organise a comprehensive enquiry into the likely economic impact of completing the programme of actions set out in the 1985 White Paper on the internal market.

A larger number of independent economic experts, consultants and research institutes contributed to the project, fully supported also by the services of the Commission.

The methods of work included:

- studies of individual categories of market barriers (e.g. frontier delays);

- studies of how individual manufacturing industries are affected (e.g. food-processing, pharmaceuticals, automobiles, telecommunications equipment ...);

- studies of how individual service sectors are affected (e.g. financial and business services, telecommunications...);

- studies of the main economic phenomena that are relevant (e.g. economies of scale, structure of industries, the incidence of competition on corporate behaviour...)

- a survey of the opinion of 11,000 industrialists, covering all countries and branches of industry;

- econometric modelling work for integrating the results of the microeconomic data into overall macroeconomic results.

The results of the study will be set out in a book by Mr Paolo Cecchini and his colleagues. This book will appear in all Community languages, and will be distributed by private publishers in the Member States. The first editions will begin to become available in one month's time. Details of the underlying economic analysis will be made available in a special number of "European Economy" by the Directorate-General of Economic and Financial Affairs of the Commission, also to be published in a month's time.

In addition, three volumes of working papers, to be published by the Commission, will set out the summary findings of the numerous sectoral studies and business surveys. Finally, the complete reports of the main consultants' studies will also be published as documents by the Commission.

(2) The results

a) Microeconomic estimates

The direct costs of frontier formalities, and associated administrative costs for the private and public sector are estimated to be of the order of 1.8% of the value of goods traded within the Community. To this must be added the costs for industry of other identifiable barriers in the internal market, such as technical regulations and other barriers, which are estimated, in opinion surveys of industrialists, to average a little under 2% of those companies' total costs. The combined total then represents about 3 1/2% of industrial value-added.

These figures reflect the direct cost of identifiable market barriers. The total gains that are to be expected from competitive integration of the product markets are much greater.

In particular, industries and service sector branches, at present subject to market entry restrictions, could experience considerably bigger percentage cost and price reductions. Examples include branches of industry for which government procurement is important (energy generating, transport, office and defence equipment), financial services (banking, insurance and securities) and road and air transport. In these cases cost and price reductions often of the order of 10 to 20%, and even more in some cases, are expected.

4

The study shows that there are substantial unexploited potential economies of scale in European industry. In more than half of all branches of industry, 20 firms of efficient size can co-exist in the Community market whereas the largest national markets could only have 4 each. As a result, only an internal market on a truly European scale can combine the advantages of technical and economic efficiency, 20 Community-wide operating firms being more likely to assure effective competition than 4 firms in a domestic national market. Comparing the present industrial structure with a more rationalised but still less than optimal one, it is estimated that about one third of European industry could profit from cost reductions of ranging from 1 to 7%, depending on the branch concerned. The aggregate cost saving from improved economies of scale would amount to something in the order of 2% of GDP. There are other gains in efficiency due to intensified pressures of competition. These gains may, for example, concern overhead costs, over-manning and inefficient management of inventories. Evidence from a variety of sources suggests that these kinds of efficiency gains can be of considerable importance. In addition, where monopoly profits exist as a result of market protection, they will be reduced or eliminated, and thus offer gains for consumers through price reductions. Indeed, while a significant part of these consumer price differences between countries is accounted for by indirect taxation and excises much of the remainder is indicative of inefficiency and non-competitive market segmentation.

In the aggregate, for all sectors and all types of cost-saving and potential price reductions, the study suggests total economic gains of the order of 4 1/4% to 6 1/2% of GDP for the Community as a whole. At 1988 prices, for the twelve Member States, this amounts to a range of around 170 to 250 billion ECU. (The 200 billion ECU quoted above is a rounded mid-point in this range).

The study did not systematically estimate the distribution of these gains by Member States. However, the evidence is that all stand to gain. Since many of the potential benefits arise from lower achieving costs and more efficient productions methods, the newer Member States could register above average gains, especially if account is also taken of the decision to double the Community's structural funds.

b) <u>Macroeconomic simulations</u>

The study also includes a series of macroeconomic simulation exercises whose purpose was to give some idea of the possible time-profile of the impact of the 1992 programme, and also express the results in terms of other economic variables such as employment and inflation. For this purpose, the effects of the internal market programme (obtained from the foregoing microeconomic estimates) were grouped under four major headings, each having a different type of macroeconomic impact:

(a) the removal of frontier delays and costs,
(b) the opening of public markets to competition,
(c) the liberalisation and integration of financial markets, and
(d) more general supply-side effects, reflecting changes in the strategic behaviour of enterprises in a new competitive environment.

The results are in part dependant on the macroeconomic policy accompanying the 1992 programme. The results show that the first and immediate effects will be in terms of downward pressure on prices and costs. Increases in output would follow with a modest time-lag. After about 5 to 6 years, a cumulative impact of + 41/2% in terms of GDP and - 6% in terms of the price level could be expected. The positive impact on employment could in the medium-term amount to about 2 millions jobs, even after absorbing the significant productivity and restructuring effects, attributable to the integration of the market.

If a specific macroeconomic policy that recognized the potential for faster growth is pursued; as would be reasonable to expect also in view of the lessening of inflation, balance of payment and budget deficit constraints, the gains could mount to 7% in terms of GDP and a 5 million increase in employment.

c) <u>The overall results</u>

The results of the two sets of calculations, microeconomic and macroeconomic, are thus mutually supporting. The range of figures may well be an underestimate since they excludes certain types of dynamic continuing benefits that market integration is likely to confer, which are thought to be important but which are very difficult to quantify.

Three examples:

- Firstly, there is increasing evidence that the trend rate of technological innovation in the economy depends upon whether or not there is competition; only an integrated market of European dimensions can offer the benefits both of scale of operation and of competition.

- Secondly, there is evidence in fast-growing high technology industries of dynamic or learning economies of scale, whereby costs decline as the total accumulated production of certain goods and services increase; market segmentation gravely limits the scope for these benefits and damages performance in key high-growth industries.

- Thirdly, the business strategies of European enterprises are bound to change: indeed, there is evidence of this already happening. A full integration of the internal market will foster the emergence of truly European companies, with structures and strategies that are better suited to securing a strong place in world markets.

6

The study further makes the point though that the benefits of the single market will develop gradually, they will multiply as they grow. In the first phase the removal of barriers will produce narrow, technical and short term gains but as market integration will begin to impact on structures, the benefits will become much bigger.

(3) Realizing the full potential gains

The study confirms that if Europe is to get the most out of its large home market the internal frontiers must truly disappear and be free of administrative complications between Member States. All barriers have to be removed, otherwise the last remaining barriers may on their own be sufficient to keep the markets segmented and to smother competition.

The challenge is political and social as well as economic. To succeed the programme requires changes which will affect protected positions: those of regions as well as nations of companies and industries and of their workforce. The road to market integration, however paved with good intentions, leads to 1992 by way of hard decisions rather than easy options. These will be made easier under the following circumstances:

- Business must respond to the challenge and seize the new opportunities on offer. Corporate management should also seek to make industrial relations less conflictual, encourage employee involvement in the life of the enterprise, and ensure that workers share in the jointly achieved productivity gains.

- Competition policy must be effectively enforced by both Community and national administrations, to guarantee that the barriers which have just been removed are not replaced by other anti-competitive devices. Those who wish to compete must be certain that they will be allowed to do so. Firms should be able to compete fairly with known commercial rivals, but they cannot be expected to compete with governments standing behind these rivals. Equally the business world must understand clearly that commercial practices which tend to protect markets, or lead to the abuse of dominant positions, must be vigorously countered. At present, price discrimination between national markets is widespread and substantial, to the considerable detriment of consumers. Competition policy must, for the market to be fully integrated, ensure, for example, that parallel imports are to be welcomed wherever undue price differences are seen to exist.

- The distribution of gains must be fair, as must be the distribution of the costs. It should not be taken for granted that the distributional impact will be excessively problematic. Experience for example with the removal of intra-EC tariff barriers indicated only a modest redistributive effect. The accession of new members has confirmed the potential for the stimulation of investment and economic growth. Undoubtedly however assistance will be needed for the Community's disadvantaged and declining regions and labour affected by restructuring. So long as the potential gains from market integration are used to reinforce consens around the 1992 programme, its success can be assured.

4

- Economic policy must be supportive. The survey undertaken for the study revealed that business opinion was optimistic that the 1992 programme is expected to result in increased sales and output. These favourable expectations will need to be backed by a well co-ordinated, growth-orientated macroeconomic policy.

- Monetary policy must continue to promote a zone of stability within Europe. Removing the barriers between financial markets and fully liberalising capital movements will increase the risk of exchange rate instability. This must be countered by increased monetary policy co-operation through a strengthened EMS.

(4) The main conclusion.

Today's fragmentation of the European economy and its weak competitiveness in many markets means that there is large potential for the rationalisation of production and distribution structures, leading to improvements in productivity, and reductions in costs and prices. The completion of the internal market will, if appropriately reinforced by the competition policies of both the Community and Member States, have a significant and positive impact on economic performance and employment. The size of this impact, in terms of the potential for increased non-inflationary growth - an economic bonus of ECU 200 billion at 1988 prices and the creation of millions of new jobs - should be sufficient to transform the Community's economic performance from a less than brilliant one to an outstanding one.

8

Note on Tables

The two tables summarise, respectively, the microeconomic and macroeconomic estimates of the impact of completing the internal market.

Two sets of calculations were undertaken because the microeconomic method permits the results to be assembled according to different microeconomic concepts and in considerable sectoral detail, whereas the macroeconomic method allows the aggregate results to be expressed in terms of more macroeconomic variables (GDP, inflation, employment etc.). The two sets of calculations are based on the same basic sectoral information, and are therefore consistent. However the final results offer somewhat different ranges for each of the two methods since they explore various hypotheses of different kinds (of a policy or methodological character).

Table 1

Microeconomic estimates of potential economic gains for the EC resulting from completion of the internal market

		Billions ECU	% of GDP
1.	Gains from removal of barriers affecting trade	8-9	0.2-0.3
2.	Gains from removal of barriers affecting overall production	57-71	2.0-2.4
3.	Gains from removing barriers (sub-total)	65-80	2.2-2.7
4.	Gains from exploiting economies of scale more fully	61	2.1
5.	Gains from intensified competition reducing business ineffectiveness and monopoly profits	46	1.6
6.	Gains from market integration (sub-total)	62*-107	2.1*-3.7
7.	Total Gains		
	- for 7 Member States at 1985 prices	127-187	4 1/4 - 6 1/2
	- for 12 Member States at 1988 prices	170-250	4 1/4 - 6 1/2

Source: Commission of the EC.

ALL FIGURES EXCEPT IN THE LAST LINE ARE EXPRESSED AT 1985 PRICES AND RELATE TO 7 MEMBER STATES. THE AGGREGATE RESULT IS SCALED UP IN TERMS OF THE 12 MEMBER STATES' 1988 GDP ONLY IN THE LAST LINE.

The ranges for certain lines represent the results of using alternative sources of information and methodologies. The seven Member States (Germany, France, Italy, United Kingdom, Benelux) account for 88% of the GDP of the EC twelve. Extrapolation of the results in terms of the same share of GDP for the seven and twelve Member States is not likely to over-estimate the total for the twelve. The detailed figures in the table relate only to the seven Member States because the underlying studies mainly covered those countries.

*This alternative estimate for the sum of line 6 cannot be broken down between the two lines 4 and 5.

Table 2

<u>Macroeconomic consequences of EC market integration accompanied by economic policy measures</u>

Nature of economic policy	Economic consequences				
	GDP as %	Consumer prices as %	Employment (in millions)	Public deficit as % point of GDP	External balance as % point of GDP
Without accompanying economic policy measures	4.5	-6.1	1.8	2.2	1.0
With accompanying economic policy measures	7.0	-4.5	5.0	0.4	-0.2
Margin of error:			± 30%		

<u>Source</u>: Commission of EC. Simulations conducted on the HERMES and INTERLINK economic models.

<u>Note</u>: The economic consequences of the magnitudes indicated are estimated to accumulate over a <u>medium-term</u> period.

The accompanying economic policy measures (increased public investment, income tax reductions) are calibrated so that the room for manoeuvre created by internal market integration for the budget balance or external balance are largely used (i.e. these variables return close to their initial situation).