

RESEARCH ON THE “COST OF NON-EUROPE”

BASIC FINDINGS

VOLUME 7

199192



THE “COST OF NON-EUROPE”
OBSTACLES TO TRANSBORDER
BUSINESS ACTIVITY

Document

COMMISSION OF THE EUROPEAN COMMUNITIES

This publication was prepared outside the Commission of the European Communities.
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by

European Research Associates

&

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The "Cost of Non-Europe":
Obstacles to Transborder Business Activity
European Research Associates & Prognos

**THE "COST OF NON-EUROPE":
OBSTACLES TO TRANSBORDER
BUSINESS ACTIVITY**

Executive Summary

EUROPEAN RESEARCH ASSOCIATES
&
prognos

**THE "COST OF NON-EUROPE":
OBSTACLES TO TRANSBORDER
BUSINESS ACTIVITY**

Executive Summary

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Chapter I Introduction

Our task was to analyse in qualitative and, if possible, quantitative terms the economic costs incurred in transborder business activity (TBA) in the Community which are caused by **divergent and/or discriminatory laws and regulations**. Our brief was limited to manufacturing industries.

We use the term "transborder business activity" in contradistinction to arms-length trade and define it as any relationship between two firms in different countries linked in a long-term contractual relationship, and each of which carry out at least two functions with some autonomy from each other (e.g. selling; production; research). Only one of these functions need to be the object of a special contract.

The link is often, but not necessarily, accompanied by equity holdings, e.g. a subsidiary or a joint venture. Our empirical sample was largely limited to these two forms of TBA.

In identifying obstacles to TBA we did not limit ourselves to company law and related issues, but tackled the problem from the standpoint of enterprises. The broader question therefore became: in what way does regulatory diversity in Europe either discourage firms from engaging in TBA; or cause significant extra costs, relative to purely national operations, when they do.

Methodology

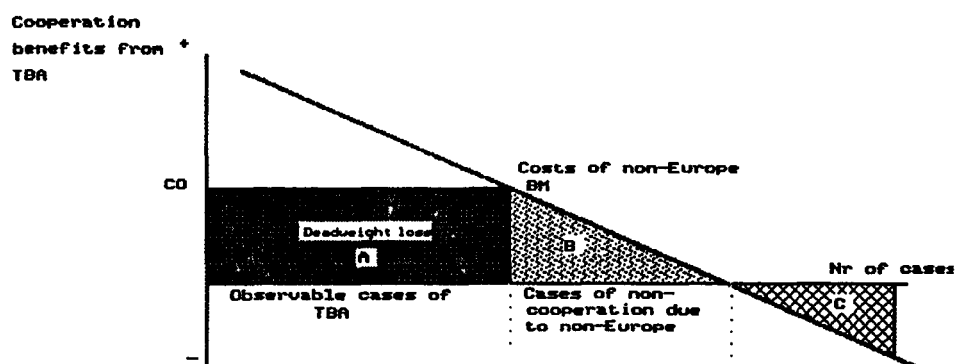
Our methodology required the scaling up of micro-economic insights to macro-economic consequences. These insights were derived from actors (both first hand through interviews; and second hand from academic surveys of business behavior); and from academic analysis on the nature of modern industrial organisation. Only at one level, i.e. the costs of "Non-Europe" to firms engaging in transborder business, was direct observation conceivable. Even here, given the time constraint, we relied on estimates of business executives interviewed. Interviews

also served to identify the chief obstacles to TBA, and their micro-economic effects on company performance.

Our empirical work was based on a standardised interview of some 70 companies in four countries (D, GB, F, I) which (collectively) had subsidiaries (or parents) in most Member States. In addition, we interviewed experts in national and EEC industrial federations and others with a working experience of our area of enquiry.

The key to our analytical approach is contained in Figure 1, which we re-use, with variants, throughout this report. We start from the assumption that the potential benefits of a contractual link between two Community firms vary from very high to negative. This is the sloping curve on the Y-axis.

Figure 1



These potential benefits are reduced by diseconomies in management and production which are caused by non-Europe. This is the part of reality one can actually observe (Chapter II), and which we tried to "measure" (point Co). Multiplied by the number of TBA cases actually existing in the Community, these costs are represented by the integral A in our graph. Chapter III presents the results of our attempts at quantification.

There is a point - BM - where these Euro-caused costs become larger than the benefits of what would otherwise be profitable cases of TBA. This creates integral B, a theoretical construct which we cannot directly observe although we

3 --

have ample empirical evidence that it exists. Integral B contains the "might-have-beens" of European industrial cooperation which were discouraged by non-Europe. To measure the cost of this loss we have developed a "theory" of the benefits of TBA adapted to the concrete situation of the Community today, defining the costs as the reciprocal, i.e. non-realised benefits. We discuss these opportunity costs in Chapter IV.

Integral C represents that part of industry where TBA would not make sense even in a Europe with uniform regulations for business. These are firms, or activities, with local markets and no need for outside technology or components, e.g. brick making; or small and very specialised firms who are in effect global monopolists in their particular niches: certain machine tool and instrument makers for instance.

Chapter II Findings from the business survey

Interviews were conducted in four major countries on the basis of a standardised interview. They were conducted between September 3 and November 11, 1987, and lasted from 1 1/2 hours to seven hours. They usually involved several of the following executives:

Chief executive Head of the legal department
Acquisitions manager Export manager
Finance manager Logistics manager

In order to increase the chance of making valid comparisons even with very small samples (15-20 companies in each country), we tried to set up interviews with companies from a limited number of sectors:

automobiles machinery/machine tools
pharmaceuticals telecommunication
textiles

In addition we interviewed several companies from the food industry, two computer manufacturers, a chemical company, a major rubber producer, and producers of professional and consumer electronics.

A third break-down planned in our sample, in addition to the sectoral and national one, was that between large companies and SMEs. Here, too, we obtained robust findings of significant differences.

1. Individual obstacles

1.1 Industrial policy

In this first item we strayed furthest from our brief to examine **regulatory** obstacles, as we are dealing here above all with the **discretionary** application of national regulation. We were interested in such things as cut-off from (para-)statel credit lines; discrimination in R&D support and in access to procurement markets for "foreign" subsidiaries; pressures to increase local content; etc. Our findings can be summarised as follows:

There was little hard evidence that governments discriminated widely against subsidiaries with foreign parents as regards access to R&D funds. However, gaining access to national programmes sometimes necessitated an extra effort to persuade authorities of the contribution to employment and exports; and the discretionary nature of decision-making left an (only slightly discouraging) margin of uncertainty.

However, national R&D programmes may be discontinued altogether if a whole sector passes into "foreign" hands (consumer electronics in Germany). On the other end of the scale, a country building up a strategic technology from scratch, i.e. one previously dominated by foreign technology, may practise outright discrimination against foreign-owned subsidiaries (telecom in Italy).

Some countries with inward investment controls (e.g. Spain) may make the take-over of attractive companies conditional on the simultaneous take-over of a lame duck.

As regards procurement, local content (employment) considerations were more important than ownership. Exceptions are newly established subsidiaries (often in hi-tech areas) who have not yet acquired a national "smell" and established working relationships with the bureaucracy.

Odd cases of "local content" maximisation could be found in the pharmaceutical industry, where price controls can be manipulated to that end. In Belgium, it was charged, authorities "rewarded" local production with higher prices. In Britain, it was suggested by non-British companies, price controls are related to total investment, including R&D. This led European companies to "overinvest" in British R&D activities: with 4% of the world market, Britain accounted for 10% of world research.

Non-Europe's competitive national industrial policies encouraged otherwise non-economic local production not just in these cases, and in the procurement case mentioned earlier, but also because of export credits. Thus German firms may upgrade local content in France in order to benefit from more generous export finance. On the other hand, products from truly integrated operations may fall below the local content barrier in any country, and hence be excluded from export credits, causing a competitive disadvantage from being "European".

More generally, some companies complained bitterly of the political risk involved in "going European" without the support of a "government" at that level. In one case, a company instituted an across-the-board cut of employment of 10% in all its subsidiaries to forestall charges of "job-killing". This economically inefficient step is the politically induced cost of the private sector doing on its own what the EC is trying in rationalising the steel sector.

1.2. Company law and taxation

Non-Europe in the field of company law, including accounting standards and fiscal law, were the single most important source of both high start-up costs and, more importantly, of dead-weight administrative costs and sub-optimal location of plant and use of resources in general.

Most broadly we can distinguish between:
different **accounting** practices, with considerable administrative costs of "translation" and integration for central management control; and the administrative costs, and effects on company flexibility, of "**fiscal suspicion**" which sees any transfer of assets and current payments, and of profits themselves, as "hidden profit distribution", i.e. an opportunity for tax evasion.

Auditing

Different auditing standards (e.g. historical cost vs. replacement cost accounting, adjustments for currency changes, etc.) are mainly a problem for integrated European multinationals (EMs). The administrative problem is magnified by the fact that companies' internal accounting (controlling) is coloured by existing legal auditing systems. Most large companies therefore have to produce three sets of figures: those conforming to the national requirements of the parent company, and which include the consolidated (i.e. "translated") accounts of subsidiaries; national accounts for each subsidiary; and a standardised, firm-specific system used by all units for controlling purposes. The work involved in producing legally required accounts is sometimes complicated by different reporting dates and periods in different Member States.

While some of the cost of "translation" can be handled by the appropriate software, experts are needed in both subsidiaries and parent companies to fine tune the system. Fees for legal consultants and, of course, external auditors, are substantial. The Fourth Company Law Directive dealing with accounting standards was mentioned only by one company as having improved the situation.

Taxes

The problems caused by "fiscal suspicion" and beggar-thy-neighbour attempts by national tax authorities to maximise their share of an EMs total tax liability have much graver consequences. They do not only cause administrative costs but influence locational decisions regarding group administration, R&D, and production.

The root cause of fiscal suspicion are above all differences in **profit taxes**, including structural elements such as R&D allowances etc. Companies are suspected to use **transfer prices** to maximise tax liability in the most favorable country. There is no doubt that this suspicion is sometimes justified, although even then there is a cost (of manipulation) to the firm; and a dead-weight loss to the economy.

Responses, notably regarding the desirability of a unified European company law, differed according to whether one talked to the tax specialists (notably external consultants) who rather enjoyed the game of "arbitrage"; and executives, notably of large companies, who recognised the cost to company management and planning imposed by fiscal suspicion. Moreover, a large part of the energies of tax lawyers were simply devoted to avoiding double taxation.

Thus, one French EM had to institute a complex system of cost-accounting at the production level to satisfy German authorities of the bona-fides of the prices charged to its German subsidiary. Ditto a large German electronics company to satisfy Italian authorities. In addition, companies complained about the periodic and prolonged (up to 8 months) presence of controllers on the premises of especially German subsidiaries.

Another company pointed out that national requirements on transfer prices were inconsistent (e.g. as regards short-term variations of exchange rates), so that the company had to be in an illegal situation somewhere. In fact, "Europe would grind to a halt if national legislation were fully applied". Living with such ambiguities, however, is both costly and highly unnerving to executives.

The problem of transfer prices sometimes intersected with that of different product standards, since "home" and "export" prices for the same product could differ because of different specifications.

Many companies complained of the difficulty of charging its subsidiaries for **central R&D expenditure**. This is particularly awkward in view of the fact that, from an economic point of view (see chapter III below), technology transfer and R&D scale economies are among the most useful features of TBA.

Particular scrutiny (including at customs) is reserved for the **transfer price of software**. It was much easier, our respondents claimed, for an independent firm to "export" software at its just value than for an integrated TBA. Software makes up significant proportions of the value of an increasing number of products (machine-tools + -30%; telematics (50% +)); it is also the form in which production know-how is often transferred. If the full value of this "component" cannot be charged by the main technology holder in an integrated company or a joint venture, serious distortions result. I.a. a firm may choose to sell "embodied" software, i.e. a hard product, rather than utilising local production opportunities.

Yet a third consequence of suspicion towards "immaterial" transfers was the difficulty for central management companies to level a **management charge** on their subsidiaries. This again inhibits economies of scale in administration; and the development of Euro-centric rather than national loci of planning and know-how.

As regards Italy, many of these problems were accentuated by a second motive for suspicion, i.e. the circumvention of capital controls. This not only influenced current TBAs, but also business expansion (i.e. acquisitions; for more detail see the notes on individual countries, below).

In all, the extra administrative costs imposed by different auditing and fiscal systems was estimated at 10-30% of the relevant departments. This, to us, surprisingly high figure was cited by all large European companies. A partial exception were British companies which did not, by and large, engage in truly integrated operations. (See also section 3, below).

Many companies cited the impossibility of reducing tax liability by off-setting losses in one branch by profits in another as very costly to their operations.

One particularly serious obstacle to business expansion is the practice of tax authorities to levy capital gains taxes on firms taken over or merged, i.e. treating this as a case of "realised assets". The holding company, with both partners remaining legally in existence, is a clumsy substitute for a true merger. An exception are the Netherlands, where (foreign) companies can obtain a "ruling" before

a merger. That still leaves the problem of negotiating their exit from the previous tax residences.

A last item under the heading of company law and fiscal suspicion relates to the rigidity of many national company statutes. The growing preference of European multinationals to choose the Netherlands as headquarters had less to do with tax advantages (dividends), and more with the flexibility and pragmatism of Dutch laws, not least as regards the ability of holding companies to levy and transfer immaterial income, e.g. from royalties, trade marks, etc. Some firms have transferred from tax-friendly Luxemburg for this reason. Flexibility also extends to such things as voting rights - important in joint ventures - where tailor-made agreements between partners are accepted, provided they are spelled out in writing.

1.3. Product/production standards

While this problematique is the object of specialised studies in the Cost of Non-Europe project, our interest related particularly to its effect on integrated business planning in Europe.

We found that some large firms devoted 1/3 of their R&D budgets to the adjustment of their technology to different national settings. This obviously reduces the scale advantages from R&D which would otherwise accrue to integrated European companies. Alternatively, the innovative output of a given R&D effort would be greater. This problem applies particularly to telecommunication on the one hand and mass-produced electronic components on the other. It has little relevance in industrial plant and machinery made to customer specifications.

As regards product standards, even the most marginal divergences (e.g. labelling requirements) prevented, at the very least, efficient, i.e. centralised and flexible, stock management. Stock management, including the option to have a central European warehouse in a post-"1992" world, was particularly important to relatively small multinationals with specialised products (e.g. hospital supplies).

As regards regulations of production, the piecemeal introduction of pollution standards in Europe caused major uncertainties in investment planning and/or led to distorted locational decisions.

It is worth noting that all problems under this heading caused costs to EMs and rather discouraged them to increase the level of internal integration; while some of the same problems encouraged SMEs to seek local production partners to adapt their product to local standards; get type approval, etc.

1.4. Trade Obstacles

Again we limit our remarks to their impact on integrated business strategies.

Border delays and uncertainties are becoming increasingly relevant as just-in-time management of components is gaining in importance. TBA by EMs, with their tight logistics planning, is hampered by this even more than arms-length trade. While customs are one source of the problem, divergent social and technical regulation of the transportation industry was cited as an additional risk factor.

Intra-EEC applications of COCOM controls were mentioned by many firms in the electronics and advanced engineering sectors. The problems were hold-ups at the border; difficulties in carrying out speedy repairs (spare-parts); and differences in national COCOM lists.

Together with the familiar deadweight administrative and resource cost of border-crossing (1% of value in our estimate), uncertainty penalises otherwise efficiency-enhancing forms of integrated TBA which would allow large scale economies through decentralised components manufacture.

A particular problem is posed by Italy, which prohibits temporary imports of components for re-export in a chain of value-added, necessitating the administrative (fiscal, customs) registration of two sales. Dito for demonstration machines, test equipment and other temporary exports.

Non-Europe was also said to hamper business planning due to the discretionary and varied national administration of the common external policy by different countries (quota enforcement).

1.5. Social Policy

TBA, especially within integrated businesses, requires the exchange of some managerial and technical personnel. This raises the question of the "portability" of social security benefits, notably pension schemes, which are tailored to national fiscal systems and/or related to public schemes. In practice, the firm must pay twice, raising salary costs by 10 - 15%. Lack of "mutual recognition" of secondary and other school diplomas by dependents also reduced flexibility of technical and managerial staff.

A different problem is posed by differences in technical training in Europe. Man/machine interfaces and production in general are designed with particular skill combinations in mind. Some firms spend considerable sums to train the workforces in their subsidiaries to conform to a particular standard, and to make communication at the various technical levels possible.

1.6. Capital and Current Transfers

Here there were few general problems: most were country specific. One general problem, however, was the difficulty of gaining access to local stock-exchanges to finance a new subsidiary for medium-sized companies.

Italy, among the major countries, continues to be a special case. We deal with it under point 3 below. The main point to make is that only large and very sophisticated companies can engage in genuine TBA.

Currency risks were cited by virtually all French EMs, some of which are considering introducing the ECU as internal accounting unit. Complaints about currency risks were also occasionally made by companies in other countries. The extra problem raised for transfer prices has been mentioned. One German hi-tech

EM called for the speedy introduction of the ECU as an official means of payment.

2. Large and small companies

While there were important exceptions, TBA by European multinationals (EMs) on the one hand, and small and medium-sized enterprises on the other, could be clearly distinguished as follows:

1. Large companies always engage in some form of TBA. SMEs rarely do so.
2. SMEs are above all interested in marketing, with local production an unplanned afterthought when it occurs, e.g. via a gradual expansion of after-sales service; adaption of products to local standards; or co-production with a former sales "agent".

Large companies are more likely to systematically exploit cost advantages, notably labour and transport, and scale advantages; they are also driven by formal or informal local content considerations; more rarely by political diversification of supply risks (strikes). They also exploit investment and export incentives.

3. SMEs tend to have a relatively arms-length relationship with their production subsidiaries abroad, using long-term contracts not very different from those concluded with third parties. This reflects their relative scarcity of management resources and, in particular, international expertise.

Most EMs prefer a hands-on approach to management, not only in order to exploit all manner of technical and economic cost advantages (of which SMEs may be only vaguely aware); but also in order to pursue market strategies which are directed not only at the customers (as in the case of SMEs) but at competitors. Sophisticated financial management, including tax minimisation; use of capital markets; currency portfolio management, etc. is scarcely practised by firms with less than 2000 employees.

This makes sense in terms of relative management cost; but suggests untapped opportunities for external service providers, e.g. banks, with the requisite economies of scale.

3. Country variations

United Kingdom

The most striking peculiarity of UK companies is the extreme arms-length approach to management. Even world-sized companies seemed to look at their European subsidiaries more in terms of investment diversification than in exploiting the opportunities of continental integration. Thus, for example, the expatriation of staff was not an issue in any of our twenty interviews. R&D was pursued in parallel (duplicated) by closely related subsidiaries. "The first time we saw our colleagues was in the BRITE programme", according to an executive of a hi-tech Italian British-owned engineering subsidiary. Subsidiaries were often managed by special holdings with a handful of staff, headquartered in London - far from the manufacturing headquarters in the provinces, again confirming the financial over the industrial interest.

Given the low level of integration, non-Europe was not perceived as a great problem for British companies engaging in TBA.

France

In France, hands-on management was typical even for medium-sized enterprises. "Expatriation" of management staff was common. There was great pride in being "European". In contrast to the other three countries, being merely French was considered provincial. Like Italy, companies in mature sectors threatened by both German and extra-European competition saw the European "home market" as the only chance for survival through economies of scale. High levels of production integration brought out the problems of non-Europe more sharply than elsewhere.

Germany

German firms are reluctant players in the game of TBA. Direct exports are generally preferred over local production, except when it comes to exploiting labour-cost advantages in Britain, Spain, and Portugal. Formal and informal local content pressures also provide an incentive to produce abroad.

Machine-tool makers were particularly harsh in their comments about TBA with France, where a combination of government interference and unreliable delivery has produced a legacy of distrust. While state interference was a problem in Italy, the fact that there was not actually a government industrial policy made such interference less of a problem than in France.

Italy

Italian TBA fully confirms to the overall image of Italian industry, i.e. a private sector struggling to thrive in spite of the State.

As mentioned for France, large companies in the more traditional sectors see the extension to "Europe" as the only chance of remaining competitive. In other words, moves to rationalise European industry will not be spearheaded by the strongest country, Germany, but by relatively weaker competitors.

The major problem for Italian companies were capital controls which effectively prevent smaller firms from engaging in TBA. Getting permission to invest in a productive facility abroad is not a problem - it just takes time (3 months). Permission for an increase in capital already involves more difficult negotiations. Most difficult of all is to get permission to create a holding abroad. Only very large companies can assume the cost of "negotiating" such a permit with the relevant ministries; and to prepare lengthy annual reports to those ministries, which go well beyond normal audit requirement.

The combination of capital controls with controls on tax evasion, and hence the need to negotiate acceptable business plans with both the Finance and the Foreign Trade Ministries, was particularly felt to complicate life, even for large companies.

The extra-territorial application of Italian controls is another interesting feature: further investments by Italian subsidiaries (i.e. legally French etc. companies), need approval from Rome.

Chapter III Measuring the costs

The following table serves to illustrate the methodology we used to get orders of magnitudes of the costs of individual obstacles to TBA expressed in a comparable unit, i.e. total turnover.

Table 1

ONE FIRM'S COST

(case study)

Obstacle	interview data	published data	assumption	% of turnover
Fiscal administration	30 % due to NE		fisc admin = 15% of all admin; hence NE = 5% of all admin. white collar = 50% of salary costs; all salary = 25% of turnover $25 : 2 \times 5\%$	0.625
Training	10 million ECU for systemic integration	turnover = ?	1/3 for diversity (NE)	0.07
R&D	25% of total for NE	Total R&D = 6.5% of turnover		1.6
Location optim.	5% savings poss.		divide by 2	2.5
Transport	10 - 15 of total due to NE		transport = 1 - 2% of turnover	0.2

Sum 4.995

Special case

Unused economies of scale	loss of 10% of \$ market	\$ market = 1/2 of turnover	reduce by half (resource saving)	2.5
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Sum 7.495

The figures, which incidentally refer to an advanced auto components manufacturer, are surprisingly high; but yet higher figures could be found in state-dominated sectors (see below). The high figures reflect

- the very high "service" content of contemporary industrial production, i.e. administration, technology exchange, marketing, etc.;
- the considerable - and only partially realised - economies-of-scale opportunities which lead many companies to engage in TBA in the first place.

Of course, precise quantitative estimates were the exception, as most executives found it difficult to quantify e.g. hypothetical economy-of-scale gains. When they did quantify, however, the answers were surprisingly consistent. With these elements in hand we needed to make a series of - increasingly heroic - estimates to scale up our results to some level of sector, groups of sectors, and GNP.

The first step was to estimate an average level of cost for each obstacle and each industry for each country separately. The results are not reproduced here. The second step involved aggregating the country results, taking into account the peculiarities of our not always representative samples. This was done in an iterative round-table discussion among the principal interviewers. The rankings of the importance of various obstacles correspond roughly to 1 = less than 1% of turnover to 4 = 4% and above of turnover. (see table 2 overleaf)

These figures aggregate not just apples and pears but apples and cheese. Thus the cost of "company law" sums both the administrative cost, and induced scale-diseconomies. Both averages would be higher if there had been more truly integrated companies in our sample. Or, taking the example of trade-barriers, the figures may refer to actual transport costs; difficulties for just-in-time production-integration; or COCOM- induced problems for supplying and servicing advanced machine tools - problems which do not arise for more conventional producers.

Table 2

	pharma	telec	auto	textiles	machinery
industrial policy	4	3-4	3	0-1	1
company law (1)	2-3	2	3	0-2	2
"social"regul.(2)	2	1-2	2	0-3	0
techn. standards	4	4	2-3	1	1-3
other trade barr.	2	3	2	1	1-3
technology trade	2	1-2	0	0	0
int. payments	*	*	*	*	*

(1) includes administrative costs and sub-optimal production

(2) includes lay-off regulations, education, and "expatriation"

* taken in isolation, payments restrictions ranked high only in Italy

Leaving these caveats aside, we felt that our sectors fell into three broad groups:

I Pharmaceuticals and telecommunications

These were highly regulated and protected industries with a high incidence of obstacles of almost all kinds, especially "industrial policy" and "technical standards". We estimated the total cost of non-Europe to firms in this group engaging in TBA at 9% of turnover.

II Automobiles

This group, together with firms in consumer electronics, a large rubber manufacturer and food processors, were hampered by industrial protection; difficulties to adjust the labour force in response to market shifts; economy-of-scale losses

due to quite marginal differences in technical standards; and substantial "administrative" costs if they were highly integrated. Total cost of TBA was estimated at 6% of turnover, i.e. higher than both average profits, or average R&D expenditure of firms in these sectors.

III Textiles and machine tools

This group had in common: high specialisation; a relatively low integration at the component level; subsidiaries which either served marketing and service purposes; or produced fairly independently parts of the product range; few problems with technical standards. Total cost of TBA = 1.7% of turnover.

Estimating costs by sector

Our next step was to estimate, "on the back of an envelope", the points on the X-axis of our graph, i.e. the proportion of turnover in each group which was generated in a TBA context forming the base-line for integral A ; the proportion potentially suited to TBA but discouraged by non-Europe (base-line B); and the proportion which would remain "local" under any circumstances (C). This latter category included local component suppliers as well as local repair and other services.

Table 3: Cooperation and potential

Industry	TBA	potential TBA	efficient local
pharma	30%	40%	30%
telec.	40%	40%	20%
auto	30%	40%	30%
auto (US owned)	60%	10%	30%
textiles,			
machinery	10%	30%	60%

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THE COST OF NON-EUROPE: OBSTACLES TO TRANSBORDER BUSINESS
ACTIVITY

CHAPTER I : Introduction

1. Objectives of the study

The White Paper on Completing the Internal Market is largely concerned with the removal of remaining barriers to trade in goods and services, and of remaining competitive distortions to such trade. But other agenda items raised in the Paper - financial services, capital movements, the free movement of people, and what is referred to as "business cooperation" - suggest that the concept of the Internal Market, like that of the 1958 Treaty itself, goes well beyond liberalising trade of final output. The objective is "an integrated economic space", or, more technically, one of free factor movements. As the White Paper puts it, the aim is a Community where

"resources, both of people and materials, and of capital and investment, flow in areas of greatest economic advantage".

While people, capital, and the technical knowledge imbodyed in both, are exchanged between economic agents in arms-length transactions, i.e. "trade", long-term contractual relations between firms are generally credited with improving certain factors flows, notably of technology, and indeed of trade itself. We refer to these contractual links, especially if they are associated with some form of equity participation as "transborder business activities", or TBA.

As technology-based competition has intensified world wide, TBA has grown to historically unique levels.¹ Yet such business cooperation is notoriously difficult to arrange across

frontiers.

Part of the difficulty for cooperation lies in regulatory discrimination of extra-national links, stemming from company law, fiscal law, and even social security systems.

The Commission of the European Communities has, for more than two decades, developed Directives intended to remove or mitigate the effects of such obstacles, with the aim of creating an economic space where business can optimise its strategic mix between arms-length and cooperative relationships. These efforts have been consolidated and expanded in the White Paper.

This report seeks to lay the groundwork for an appreciation and a clearer identification of the obstacles to transborder business activity in Europe, and their costs.

The question to be answered could be re-formulated more narrowly: what difference would it make to Europe's economic performance if the White Paper's agenda, headed "Creation of suitable conditions for industrial cooperation" were fully implemented? That question proved to be inadequate for our purpose.

First, other parts of the White Paper, notably the chapter dealing with capital markets, but also the liberalisation of trade in goods and services are part of the relevant regulatory setting for doing transborder business in Europe. Secondly, aspects of national business regulation which have not yet been tackled by the White Paper, but which are seen as part of non-Europe by businessmen, have to be included in a study which relies heavily on a survey of business executives. Thirdly, the White Paper chapter on "business cooperation" pursues more than the goal of easing transborder business: some directives pursue

social control objectives which are often rejected by businessmen.

2. Why European business cooperation: first questions

The case for business cooperation is not easy to demonstrate in traditional, i.e. fairly narrow, economic terms. And, apart from a shortage of theoretical arguments, the empirical evidence of actual business behavior suggests a certain caution. The fact that the overwhelming number of cooperation agreements exists in either the national or the non-European "global" context must indicate the presence of economic forces a great deal more fundamental than the presistance of legal and fiscal obstacles within the EEC.

Indeed, much of what is best, specialised, and competitive in European industry is developed within strong cooperative networks which are not even national but (sub-)regional: metal working in Baden-Württemberg; fabrics in the Arno valley; steel around Brescia; electronics in Flanders, industrial agriculture a round Westland (NL), etc. These vertical and horizontal cooperation networks work in the context of a local infrastructure, man-power pool, technology/research infrastructure, marketing and procurement cooperation, the provision of specialised services and material inputs, and with local political/administrative support which is close enough to business to know what it is doing.

Where regional networks are not sufficient, business cooperation in the national context has significantly lower information and transaction costs than cooperation with foreigners of all kinds - independently of the kind of discriminatory regulations which could be tackled by the Community. If such extra-national cooperation is needed,

according to the consensus of all academics and business sources interviewed, global cooperation has much to recommend it - in fact is seen as a key to the survival of first rate, world-competitive industries and services in Europe.

Indeed, both academics ² and industrialists interviewed agreed that it is an old-fashioned view of European welfare and competitiveness to cheer each time European firms link up, and to see it as a defeat when alliances with foreign firms are entered into. Olivetti, Philips, Siemens are successful "European champions" because of their global presence. Virtually all medium-sized world-competitive firms, and many small ones, exhibit the same pattern.

No trade integration without business integration

Yet, the ease or otherwise with which European firms can cooperate must remain a matter for concern. At the simplest level, because, as noted above, transborder business activity is a key transmission element in the perfection of factor markets: of technology and know-how above all, but also of capital. In addition, as all empirical studies show, TBA is a precondition even for efficient markets in goods, notably intermediate goods, components, and investment goods; and of services.

If the integration of the Third World industrial producers into the world economy in the 1960s owed everything to the substitution of direct business links for arms-length trade ³, today TBA can help to avoid a drifting apart of high-tech Europe from less industrialised regions. European economic integration cannot thrive on arms-length trade alone.

Secondly, TBA remains an essential, if second best and partial, remedy against the distortions in those European product and

factor markets which are caused by direct (national) government intervention, e.g. in procurement markets, and which will persist even under the most optimistic assumptions on progress in the Internal Market agenda. The de-nationalisation of ownership is a pre-condition for the de-nationalisation of certain markets.

Thirdly, TBA is a precondition for the restructuring of those European industries which so far have been locked in a sub-optimal pattern by remaining intra-Community protectionism, and which will have to adjust to the larger market by 1992. Trade alone, we will argue, is an uncertain and slow agent of structural change.

Fourthly, and perhaps uppermost in the mind of many European policy makers, Community firms do not only compete in a neutral competitive world environment, but one characterised by a strategic struggle for market power, by (some) giant firms and/or by the two other leading world economic powers. The agnostic attitude of economists with regard to the international pattern of business cooperation is seen as naive in this view.

Problems of measurement

Taking only the first three and fairly straightforward elements of an economic case of supporting European business cooperation poses serious problems of measurement.

As regards the first argument (the role of TBA in perfecting the flow of factors and final output) the cost-reductions achieved by contractual relative to arms-length inter-firm relations would have to be measured - a daunting enterprise in its own right - and off-set by efficiency losses due to reduced competition. The anti-competitive effect takes in fact pride of place in most academic treatments of the subject⁴. To get from

there to the macro-economic effects compounds complexity.

The second argument, which sees TBA as a way around NTBs, is in a sense a subset of the first even if it deals with political rather than economic/organisational constraints on public markets. While this role of TBA emerges strongly from many empirical studies, including our own, of the reasons for engaging in trans-European business activities, precise measurement would need to address three elements: the extent of market imperfections; the gains from trade foregone; and the extent to which TBA can remedy the situation.

The third argument: TBA as a means of restructuring industry to a continental dimension is controversial, as both liberal economists (competition) and socialist critics (power) see it as inherently negative.

TBA as the basis for a European industrial policy?

The fourth argument which sees European TBA as an essential corrective in the global distribution of market power fully escapes any quantitative assessment. For this would require a long-term assessment of the intentions of the players on the one hand, and of the ability of (the remaining) spontaneous market forces in the world economy to off-set domination strategies on the other.

If one sticks to the task of an objective assessment of the Cost of Non-Europe, it is not easy to find an academically respectable place for what one might call geostrategic market power. The phenomenon is increasingly noted⁵ of course, but difficult to translate into macro-economic/welfare propositions which go beyond common sense. If the discussion is simply about the threat of specific monopolies headquartered abroad - IBM, Boeing - there is an established case for (public) support

of countervailing power.

In a purely national context, SMEs have long been supported in even the most liberal countries for similar reasons. But arguments for European business cooperation found in COM documents, and much of French academic literature, go beyond this and reveal two political lines of thought.

The first runs as follows. TBA, by itself, is not a remedy against Europe becoming the passive object of other people's strategies (except in such sectors as aerospace and telecommunications where vulnerability is the result of almost deliberate fragmentation of the industry through national public policy. This must be remedied an equally deliberate, state-led effort of cooperation). As a recent study puts it, the international phenomenon of business cooperation

pose, en premier lieu, la question de la validité et de la viabilité de la notion même d'espace économique européen. Sa cohérence dépend, en effet, de la mise en place de liaisons des firmes européennes./Sans/ la constitution d'un réseau structuré d'interrelations des activités industrielles à l'échelle européenne, les tentatives de définitions et d'applications d'une politique industrielle communautaire par les pouvoirs publics européens sont dénuées de sens et d'efficacité.⁶

It is obvious that for the purposes of objective measurement of the "Cost on Non-Europe" the normative goal of (laying the basis for) a Community industrial policy can not serve as a yardstick. Not only is there deep political disagreement about the desirability of such a policy, or at least its extent; but any strictly economic assessment of the cost of not having such a policy would raise impossible methodological problems of assessing its future efficiency.

Some empirical results

In the following we present the results of several large-scale investigations (most as yet unpublished) into the motives for business cooperation. They illustrate growing academic interest in the subject, but also great methodological diversity. Some studies include publically sponsored cooperation (aerospace), other exclude it. Some use data bases constituted from press reports; others use more or less representative samples. Some use questionnaires; others interviews, which again may be of the open kind or (sometimes dangerously) pre-structured. Some deal with individual country couples, others with Europe, and others again with the world. Thus the results, for the purposes of our subject, are at best illustrative. They do, however, provide a glimpse of the "state of the art" - and of the methodological and organisation problems to be solved if one were to attempt a truly comparative, Europe-wide study.

The following table gives the results of the Prognos study cited earlier, an empirical investigation of the motives for cooperation of 114 French and German firms. Aerospace and defense cooperation is excluded.

Table 1

Motives for Cooperation between French and German companies
(frequency of motive in % of cooperation cases)

Motive	F-initiated	D-initiated
Securing sources of supply	4	2
Improving market access	70	60
Securing market access, incl. to third markets (LDCs)	10	35
Overcoming NTBs, of which standards, customs procurement/local content	4 10	6 20
Completing product range, systems solutions	18	25
Cost/efficiency criteria: economies of scale exploit prod.cost differentials	4 -	10 5
Access to new prod./technology	20	15
Joint R&D	2	2

Source: Prognos op.cit.,p.46 (translated and re-arranged by ERA)

The striking result of the Prognos study is that market access for the main, or a very important, motive in 2/3 of all cooperation cases examined (motives (1), (2), (7) of the above table). R&D cooperation - one of the major thrusts of the Community's "promotional" policies - hardly figures at all. On the other hand, gaining access to technology, embodied or otherwise, does play a respectable role in motivating cooperation.

Another conclusion to draw from this table, made more explicit below, is the fact that a great proportion of the motivation for cooperation would disappear if the rest of the White Paper agenda would be successfully implemented. This finding, incidentally, causes serious methodological difficulties when we try to measure the Cost of Non-Europe in relationship to a better "anti-monde" a completed national market where, with reduced obstacles to cooperation, many of the reasons for cooperation must be assumed to be reduced as well.

Another study on Franco-German business cooperation comes to strikingly different conclusions. Although the study - "Entreprises Allemandes et Coopération Industrielle à l'Echelle Européenne" by a team from Strasbourg University ⁷ stresses throughout the importance of the EEC as a market, market access does not figure among the main reasons for cooperation given by a sample of 188 German firms. This is explained, i.a., by the fact that high quality marketing (delivery, service) is one of the competitive trumps of German industry, which leads German enterprises

à ne pas saboter cet atout et donc à rejeter des formes de coopération qui se situent près de la phase de commercialisation des biens et services.⁸

According to the Strasbourg study, the preferred mode of cooperation were 1. R&D; 2. finance (in a large sense almost identical with scale economies); 3. Know-how. We note these contradictions between the two studies to illustrate the difficulties of empirical research in this area.

It is only when summarising the advantages of cooperation that the Strasbourg study comes closer to the Prognos results. We cite this list, because it corresponds well with other sources, including our own interviews; and because we can equate, with a negative sign, the Cost of Non-Europe with the advantages of

cooperation as seen by business.

Advantages from Cooperation (Strasbourg findings)⁹

- * cost savings: economies of scale; shorter learning curve
 - * time savings: speedy introduction of new technologies
 - * risk sharing
 - * increased market power against foreign competitors
 - * access to public procurement markets
 - * overcoming NTBs
-

A careful study undertaken by Prof. Balyiss and his team from the Centre for European Industrial Studies, University of Bath, on British-led joint ventures and subsidiaries in Europe¹⁰ broadly supports the Prognos conclusions as regards the weight of marketing; and the Strasbourg conclusions as to R&D. Taking a representative sample of 812 manufacturing companies (PLCs), Balyiss found that half had either JVs or subsidiaries with other EEC companies (and only 4% did not even export) - itself a valuable indication of the extent of intra-European business links.

Marketing was identified as a "function" in 96% of the JVs, and 100% of the subsidiaries.

"Functions" of British-EEC business links in %

Function	Joint ventures	subsidiaries
Solely marketing	22	33
Solely R&D	6	0
R&D plus prod./mark.*)	39	43
Production (plus*)	39	67

Source: Centre for European Industrial Studies, Bath

* The JV break-down is not in mutually exclusive categories: plus means production plus either marketing and/or R&D. For subsidiaries 33 + 67 equals 100.

The Balyiss findings also support Prognos on the low importance of production costs in location decisions. Firms produced locally for local markets because arms-length sales were impossible. The more "difficult" the market, the more the choice tended towards JVs rather than subsidiaries: having a (more independent) local partner was indispensable. Thus 1/3 of all British JVs were in Italy, but only 1/20th of the subsidiaries!

This finding cannot be checked against the result of another study, by CEREM (Nanterre) study which provides a breakdown of functions not according to "target" countries, but to target regions (EEC, US, Japan). The table does, however, show the great variance as regards the cooperation behavior of different Community countries, both in their general preference and according to partner region. The data are based on a reading of the specialised press, and only concern four sectors/technologies: biotechnology; new materials; informatics; and aerospace. The period covered is 1980-85.

Table 2.

FUNCTIONS OF COOPERATION AGREEMENTS
in % of total of country of origin

Partner	Domestic	Other EEC	US	Japan	Total
France					
Knowledge	07%	37%	15%	33%	22%
Production	02%	14%	16%	33%	14%
Market	22%	42%	53%	66%	49%
Global	67%	31%	37%	00%	45%
No. of agreements	44	33	73	06	165
Great Britain					
Knowledge	19%	40%	00%	42%	29%
Production	19%	10%	21%	14%	16%
Market	50%	38%	45%	42%	45%
Global	19%	25%	43%	00%	31%
No. of agreements	10	18	18	7	62
F.R.G.					
Knowledge	00%	39%	12%	57%	35%
Production	00%	23%	20%	28%	20%
Market	51%	42%	57%	42%	45%
Global	48%	23%	10%	00%	20%
No. of agreements	4	15	9	7	40
Italy					
Knowledge	00%	36%	17%	42%	27%
Production	19%	04%	29%	28%	22%
Market	21%	39%	57%	57%	53%
Global	58%	37%	38%	28%	39%
No. of agreements	5	19	23	7	59
Benelux					
Knowledge	00%	60%	40%	50%	50%
Production	00%	40%	13%	50%	25%
Market	00%	30%	13%	50%	25%
Global	00%	10%	40%	00%	25%
No. of agreements	00	09	15	02	28

Source: CEREM, Les Strategies d'Accord, op.cit., p.50.

Mixed motives in imperfect markets

One reason for different results in different empirical studies is that the form of cooperation, and its object, are often confused. Thus the vast study by Porter, Fuller, and Rawlinson on 1.444 international cooperation agreements reported in 1980 in the Wall Street Journal¹¹, uses the term "which were areas" of cooperation where object and form are intermixed. It is entirely possible that R&D cooperation or local production really has market objectives, i.e. they would not take place without market imperfections. R&D cooperation may also exist simply to shelter expenditure from the tax authorities. Local production may also be a means of (inward) technology transfer, as may be a simple participation in capital,¹² etc. We reproduce one table from the Harvard Study not least because of the interesting sectoral results.

TABLE 3

Sectors	R&D Exploration %	Production %	Distribution %	Marketing/ Sales %	Multiple/ others %
Agribusiness	12	47	03	14	19
Metals and minerals	41	44	02	08	06
Energy	65	29	01	02	03
Construction	07	75	00	09	09
Textiles & clothing	00	40	07	18	36
Paper and wood	10	69	10	00	10
Chemicals	09	58	03	20	10
Computers	17	31	13	12	28
Other electronics	05	35	16	17	29
Other electrical	10	40	15	21	17
Automobiles	05	65	04	13	16
Aerospace	31	35	00	19	15
Other machinery	04	39	03	24	26
Other manufacturing	08	59	01	16	16
Transportation	00	41	31	19	10
Communications	22	35	17	00	28
Distribution	00	24	18	42	16
Finance	09	16	30	23	23
Services	13	38	14	24	12
All parents					
Percent	20%	45%	07%	15%	15%
Number	423	929	154	321	328

3. Cooperation as a remedy for market imperfections

Given the conflicting and inconclusive evidence on motives for cooperation we have tried to come to a general view of its place in business strategy so as to arrive at least at a qualitative statement regarding its economic value. Actually, we had to settle for two "perspectives" under which to subsume the varied logic of cooperation: "market imperfection", and "network". The first perspective allows us to remain within familiar terms of economics; the second takes us to a more interesting level of complexity.

As regards the first, we find it striking that in many cases cooperation seems to be is either a response to market imperfections - or an attempt to create them. Thus the results of the Prognos study on business motivation can be restated, for analytical purposes, as follows/

Re-ordering the Prognos list according to analytical criteria we can distinguish between cooperation motives related to

a. private market imperfections, of which

- information (lack of knowledge of local markets is, however, more often a motive for extra-European cooperation); and
- technological monopoly
- established local market power(?)¹³

b. administrative/political market imperfections

- trade controls at the border, including standards;
- national discrimination: procurement/local content
- "political" access to third markets

c. other factor market imperfections

- production cost differentials

d. economies of scale/scope

- in production
- in research
- in marketing : customer preference for one-stop suppliers/solutions.

Of the items mentioned, imperfect information is perhaps the most innocent of all market imperfections but, as we shall paradoxically see also in the chapter on obstacles to cooperation, one of the most pervasive. What is meant here is that a local partner needed e.g. may be to keep abreast of local technology, help finding marketing outlets, raise capital, etc.

Imperfect markets in technology are also fairly innocent, since they reflect a very real and widely recognised problem, i.e. the conflict between a firm's desire to retain the competitive edge it has by virtue of its own R&D, and the general economic interest in the spread of that technology. Cooperation represents a half-way house which allows a firm continued control over its technology, e.g. temporary monopoly rents in its main markets, while allowing the technology to be used in other markets - for a price. This mechanism clearly gains in importance at a time where product cycles shorten and firms cannot hope (or risk) to reap the benefit of a breakthrough via expanding their own production.

Arms-length trade in patents is less adapted to this world of accelerated technological competition. It is a slow means of transfer, both because of registration delays, and because the buyer needs an additional period of R&D to obtain a commercial product. Moreover, patents only partially solve the problem of control.

The ease of otherwise with which cooperation can contribute to

creating a European technology market is therefore important. That importance is arguably greater for the seller of technology who may be unable to draw the full benefits from his R&D successes, than for the buyer, especially if its a large company which can meet his requirements from the vast storehouses of the US and Japan (at a balance of payments cost). The underutilisation of Europe's own stock of technology, and the lack of incentive (finance) for new R&D is a major danger.

Insufficient access to technology, i.e. the buyers interest, is however a greater problem for smaller firms. While some highly specialised SMEs engage in global technology acquisition, others are constrained to look for partners closer to home. This applies especially to forms of technology cooperation which require frequent contacts between limited managerial and technical staff.

Lastly one must point to the possible negative impact of cooperation between firms with strong market power, as argued by Prof. Jaquemin in his study for DG IV:

"il faut envisager la possibilité que l'accord de coopération en R&D facilite la coordination des décisions au niveau des prix et des quantités, et favorise des profits monopolistiques."¹⁴

This brings us to the next item on our list, market power. Here cooperation is particularly Janus-faced from the point of view of raising efficiency. On the one hand, a competitor's established distribution network, good-will, etc. may represent insurmountable barriers for a new entrant. He therefore engages in some joint marketing and even production activity with the local powerholder. While there are by definition gains to both partners, the general economic benefits depend on the circumstances. As the OECD report on Joint Ventures puts it:

"the establishment of a joint venture may eliminate competition between /the partners/ in the areas of activity covered by the joint venture", and
"the joint venture gives them opportunity to collude in areas other than that covered by the joint venture".¹⁵

REFERENCES

1. See for example "Les Stratégies d'accord des Groupes de la CEE: Intégration ou Eclatement de L'Espace Industriel Européen", Laboratoire de Recherche en Economie Appliquée (L.A.R.E.A.), CEREM, Nanterre, Octobre 1986, p.4-5.
2. Most strongly Albert Bressand in his introduction to a workshop on "Economie mondiale: quel rôle pour l'Europe" of the conference "Europespective", Paris 23-25.4; 1987.
3. Pessimism about the Third World's ability to industrialise, so prevalent in the 'sixties, was based on "arms-length" assumptions: no access to capital markets; technology and know-how; final markets. All these were supplied by MNCs.
4. See on this point A. Jacquemin et.al., "Compétition Européenne et Coopération entre Entreprises en Matière de Recherche-Développement", EEC "Collection Document de Travail", IV/761/85-FR, 1985
5. One system of change in this respects is the rise of a new research line in Anglosaxon economics called "strategic trade theory", which much against the preferences of its practioners not only proves the existence of stratgepic trade behaviour, but shows substantial gains for nations which "cheat" against the GATT/competitive norm. For a summary of the recent literature see "Strategic Trade Policy: Is There a Case for Intervention ?", CEPR Bulletin; February 1987, pp 3ff. See also the earlier survey by A. Jacquemin: "Imperfect market structure and Internal Trade, some Recent Research", Kyklos, no. 35, 1982.

In the field of cooperation research proper, the strategic

elements have been brought out very sharply by D. Turck, "La Tunique de Nesseus: les stratégies d'accords internationaux des entreprises japonaises." Cahier d'Etudes no. 85-87, ESCP, Paris, 1985.

6. L.A.R.E.A., 1986, op.cit.p.2.

7. Etude réalisée par Sabine Urban et Serge Vendemini, Université de Strasbourg 3 pour le Commissariat Général du Plan, La Documentation Française, Paris 1986.

8. Urban, et. al., op.cit. p. 122 - 23. The study is based on 188 completed questionnaires, supplemented by 34 in depth interviews.

9. Urban, op.cit.p.29

10. Prof. Brian Bayliss kindly let has have some the results of an as yet unpublished, and untitled research project supported by the British Economic and Social Research Council.

11. M. Porter, M. Fuller, R. Rawlinson, Coalitions and Global Strategies, Harvard Business School, 1984. Cited in Jaquemin, Lammerant, et.al., Compétition Européenne, op;cit. p. 16.

12. CEREM, Les Stratégies d'Accord, op.cit. p. 29.

13. Since the Prognos table reports answers to a questionnaire by business representatives, certain phenomena (notably oligopolistic and other anti-competitive behavior) are unlikely to be mentioned explicitly.

14. Jaquemin, Compétition européenne, op.cit., p.10.

15. OECD, Competition Policy and Joint Venture, Paris 1986, p. 24.

CHAPTER II : MEASURING THE COSTS OF OBSTACLES

1. Methodology

By any academic standard our task of estimating micro- and macro-economic welfare losses incurred by Euro-wide operating business due to regulatory diversity was impossible especially in a period of three months. Thus

- We did not, and do not know the proportion of manufacturing value-added which is generated in Europe within a TBA context.
- We did and do not know for certain what economic benefits are derived from TBA.
- We did and do not know what difference the implementation of the White Paper agenda, and of a more farreaching creation of a Euro-wide regulatory context for business would make.

What we could do is to make estimates; to report estimates made by others on as disaggregate level as possible; and to aggregate these with a methodology which is as explicitly stated as possible.

Given our experience with drafts circulated earlier we ask the reader to respect the distinction between empirical observation, survey-derived estimates, measurement, educated guesses on quantitative relationships, "hard" published data multiplied with all of the foregoing assumptions and estimates; and theory - all of which had to be combined to arrive at least at a more differentiated understanding of the phenomenon, and at best at orders of magnitude which have the character of a reasoned hypothesis.

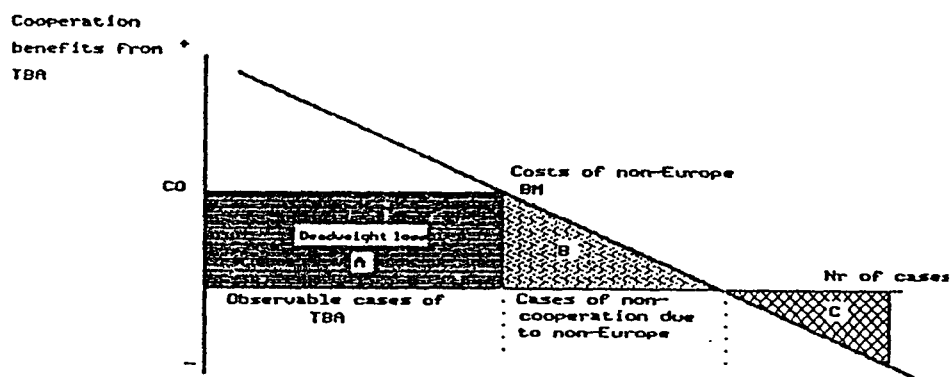
Working in an area where relevant academic theory was hard to find required some bold innovation. We partially circumvented

the problem of estimating the welfare benefits of TBA - and hence the cost of obstacles - by relying on the views of business executives. This worked for precisely defined areas, notably of business administration and management, but would not allow us to capture the wider macro-structural significance of the phenomenon we were studying. For this we had to invent what amounts to a "positive" theory of European TBA, albeit on the basis of some new academic thinking and research in industrial economics.

Since our task was, ultimately, to aggregate what had to be little better than anecdotal evidence, we had to first bring some structure to the universe we were studying.

The key to our analytical approach is contained in Figure 1, which we re-use, with variants, throughout this report.!

Figure 1



1. We start from the assumption that the potential benefits of a contractual link between two Community firms vary from very high to negative. Each of the actual and potential cases of TBA are plotted on the y-axis, with a value of the benefit of TBA assigned to each case. This is the downward sloping curve in the diagram.

2. Potential benefits are reduced by diseconomies in management and production which are caused by Non-Europe. This is the part of reality one can actually observe and which we tried to estimate via the business surveys. Multiplied by the number of TBA cases actually existing in the Community, these directly observable costs are represented by the integral A in our graph. Here we have attempted to quantify our estimates.

3. Integral B contains the "might-have-beens" of European TBA which were discouraged by Non-Europe. We have assessed this "opportunity cost" in qualitative terms. There is a point - BM^1 - where the costs of Non-Europe become larger than the benefits of what would otherwise be profitable cases of TBA. At this point TBA does not take place. This creates integral B, a theoretical construct which we cannot directly observe although we have ample empirical evidence that it exists.

4. Integral C represents that part of industry where TBA would not make sense even in a Europe with uniform regulations for business. These are firms, or activities, with either local markets and no need for a contractual supply of outside technology or components, e.g. brick making; or small and very specialised firms who are in effect global monopolists in their particular niches: certain machine tool and instrument makers for instance.

That last remark makes clear that each industrial sector will have its own pattern. The size of A and B is not only a function of the structure of an industry, its markets, the way technology is generated, etc. and hence of the "inherent" advantages of TBA for that industry; but also of the incidence and costs of obstacles. We have tried to take account of these

differences in our analysis and estimates.

2. The Business Survey

As stated, our main empirical task was to "measure" the costs of regulatory diversity to existing TBA; and, to a lesser degree, to determine the point at which TBA was discouraged altogether.

Under the circumstances (including the time constraint) relying on a direct business survey, as specified in the terms of reference, proved the only feasible route. The alternative would have been a detailed audit at each firm to bring out, e.g. the extra administrative costs caused by different fiscal systems; and an independent assessment of the economic gains which could be achieved by better plant location; specialisation; R&D simplification etc. which would become possible if obstacles were removed, etc.

Our empirical work was based on a standardised interview of some 70 companies in four countries (D, GB, F, I) which (collectively) had subsidiaries (or parents) in most Member States.

In addition, we interviewed experts in national and EEC industrial federations and others with a working experience of our area of enquiry.

Interviews conducted between September 3 and November 11, 1987, and lasted from 1 1/2 hours to seven hours. They usually involved several of the following executives:

Chief executive	Head of the legal department
Acquisitions manager	Export manager
Finance manager	Logistics manager

The broad technical range of our interview questions, which

covered such diverse areas as fiscal administration; R&D ; industrial policy; and social insurance required specialist knowledge which few single individuals could possess. This led, at least in the larger companies, to a lengthy internal decision making process to designate and coordinate interview partners. The sensitivity of some of the questions, e.g. on fiscal fraud or national discrimination further complicated access. Last but not least, most major companies had been contacted by at least one other team of the Cost of Non-Europe project. In all, therefore, a major part of the time and energy of our research team was spent in setting up interviews. In smaller companies with scarce management resources and a pragmatic, non-numerate approach to cost control, we had to be content with partial interviews and/or impressionistic estimates.

In order to increase the chance of making valid comparisons even with very small samples (15-20 companies in each country), we tried to set up interviews with companies from a limited number of sectors:

automobiles	machinery/machine tools
pharmaceuticals	telecommunications
textiles	

In addition we interviewed several food processors, two computer manufacturers, a chemical company, a major rubber producer, and several producers of professional and consumer electronics. This departure from our original sample restrictions - forced by the vagaries of access - proved extremely useful to confirm the existence of patterns which allowed all manufacturing sectors to be allocated to three groups.

A third break-down in our sample, in addition to the sectoral and national one, was that between large companies and SMEs.

Here, too, we obtained robust findings of significant differences.

3. The standardised interview

Previous to the oral interview companies had normally received a one page outline of the broad areas of questioning. The interviews started with an open-ended question of what seemed to be the most important obstacle to doing cross-frontier business in Europe.

We then went through our standardised interview. This was divided into six policy areas, namely

- Industrial policy
- Company law, incl. fiscal problems
- Social legislation
- Product/production regulations
- (Other) Trade impediments
- Technology Exchange

In order to have as large an element of standardisation as possible we asked an identical set of detailed question for each of the six regulatory/policy areas. This so-called "Repeat Module" is reproduced only once in this presentation, although in practice it formed the bulk of the interview.

INDUSTRIAL POLICY

Governments tend to support their national industries. They do this by granting subsidies to general costs or to R&D; preferential access to procurement markets; informal suasion etc.

Have you felt that this has caused difficulties in running your JV/subsidiary? In particular:

Did your partner, by cooperating with you, jeopardize his chances to get subsidies for R&D; access to national procurement markets?

Was there informal pressure on that partner, or on yourself by your own government, to look for a partner of the same nationality; or to limit cooperation in the interest of national control?

REPEAT MODULE

1. How has this concretely influenced your operation?

(Room for open response to be registered where and if appropriate in scheme below. Then continue questioning to check/encourage recall).

(space)

2. Did it cause you to limit the intensity of TBA or to desist from engaging in it altogether

limit forego

- joint R&D	()	()
- joint marketing	()	()
- joint input procurement	()	()
- joint (integrated) production strategy	()	()
- exchange of personell/ cross-frontier use of specialists	()	()
- centralising administrative functions	()	()

other comments:

3. Did it cause you additional costs ?
(quantify as much as possible)

a. Overheads:

Personnel: extra numbers (); transfer costs (); extra training ()

Hardware (extra testing equipment; other duplication)

Financing costs

b. Running costs of production:

Cost of raw materials, semi-finished, components

Other production costs: efficiency of plant use etc.

Stock management

Extra costs of trading between the partners; to outside markets?

4. Other

Did the need to gather adequate information, in addition to personnel costs cause delays in production; cause you to make investment mistakes?

----- END OF REPEAT MODULE -----

COMPANY LAW

When setting up your foreign venture, or while running it, did you have particular legal difficulties? Was it hard to find a mutually satisfactory form of legal contract (JVs) or form of incorporation?

Was it difficult to avoid problems of double taxation?

Did your subsidiary/JV experience problems to get tax relief for R&D expenditures? Was competition law a problem?

Did different auditing standards and traditions cause costs?

REPEAT MODULE

SOCIAL LEGISLATION

Many social protection agreements have to be negotiated at plant level with local unions and local authorities. This is true even within your own country and thus interests us less in this context. But did you find (your own, or your partner's) national regulations on social insurance inhibiting transfer of personnel ("expatriation")? Ditto the need for professional certification of certain technical personnel?

What about legal restrictions on lay-offs?
Trade union role in co-determination?

REPEAT MODULE

PRODUCT: PRODUCTION REGULATIONS

In planning and executing your joint operation did you find national regulations on product and production standards, and the procedures to enforce them, a handicap? E.g.

- safety rules for machinery (including noise, ergonomics);
- other conformity rules, and their certification?
- environmental standards for production; and products ?
- product liability; insurance.

We would like you to distinguish between trade problems as such

which may arise from some of these regulations; and their cost in terms of a rational and efficient joint production planning, specialisation.

REPEAT MODULE

(OTHER) TRADE IMPEDIMENTS

Trade between EEC Member States continues to be hampered by obstacles other than different norms and standards; notably VAT administration; "customs" administration (paper work); costly delays at the border, etc.

Has this been a significant factor for you?

REPEAT MODULE

TECHNOLOGY EXCHANGE

Was patent protection an issue?
Did you find difficulties to exchange technology with your partner due to the fact that his or your technology had been developed within some national support programme?
Have COCOM regulations hampered your technology cooperation, component exchanges, etc.?

REPEAT MODULE

CURRENCY/CAPITAL TRANSFER PROBLEMS

Did you find restraints on

- direct foreign investment (access)
- access to the partner's capital market
- transferring of your own capital abroad (Italy, France only)
- currency transfers for current operations?

REPEAT MODULE

Other essential information

(note and/or ask if not yet emerged from interview:)

1. Nature of the TBA

Joint venture () ; subsidiary (); other ()

2. Product sector

3. Nationality of respondent company partner
company

4. Turnover of the company (specify unit referred to):

4. Verbal summary of results of the business survey

4.1. Individual obstacles

Industrial policy

In this first item we strayed furthest from our brief to examine regulatory obstacles, as we are dealing here above all with the discretionary and discriminatory application of national regulation, or its de facto discriminatory effect. We were interested in such things as cut-off from (para-)statal credit lines; discrimination in R&D support and in access to procurement markets for "foreign" subsidiaries; pressures to increase local content; etc. Our findings can be summarised as follows:

There was little hard evidence that governments discriminated widely against subsidiaries with foreign parents as regards

access to R&D funds. However, a foreign-owned subsidiary seeking access to national programmes sometimes needed to engage in an extra effort to persuade authorities of its positive contribution to employment and exports; and the discretionary nature of decision-making left an (only slightly discouraging) margin of uncertainty.

However, national R&D programmes may be discontinued altogether if a whole sector passes into "foreign" hands (consumer electronics in Germany). On the other end of the scale, a country building up a strategic technology from scratch, i.e. one previously dominated by foreign technology, may practise outright discrimination against foreign-owned subsidiaries (telecom in Italy).

Some countries with inward investment controls (e.g. Spain, but also Greece and even France) may make the take-over of attractive companies conditional on the simultaneous take-over of lame ducks.

As regards procurement, local content (employment) considerations were more important than ownership. Exceptions are newly established subsidiaries (often in hi-tech areas) who have not yet acquired a national "smell" and established working relationships with the bureaucracy. (Here as elsewhere, local content based discrimination provides an incentive to TBA which, for the company, is inefficient.)

Odd cases of "local content" maximisation could be found in the pharmaceutical industry, where price controls can be manipulated to that end. In Belgium, it was charged, authorities "rewarded" local production with higher prices. In Britain, it was suggested by non-British companies, price controls are related to total investment, including R&D. This led European companies to "overinvest" in British R&D

activities: with 4% of the world market, Britain accounted for 10% of world research.

Non-Europe's competitive national industrial policies encouraged otherwise non-economic local production not just in these cases, and in the procurement case mentioned earlier, but also because of export credits. Thus German firms may upgrade local content in France in order to benefit from more generous export finance. On the other hand, products from truly integrated operations may fall below the local content barrier in any country, and hence be excluded from export credits, causing a competitive disadvantage from being "European".

More generally, some companies complained bitterly of the political risk involved in "going European" without the support of a "government" at that level. In one case, a company instituted an across-the-board cut of employment of 10% in all its subsidiaries to forestall charges of "job-killing". This economically inefficient step is the politically induced cost of the private sector doing on its own what the EC is trying in rationalising the steel sector.

Company Law and taxation

Non-Europe in the area of legal and fiscal regulation of company management was the single most important source of costs in engaging in TBA. These cost occurred both a the administrative level; and at the production level through suboptimal plant and resource location.

The root cause of problems is not so much company law itself, i.e. legal differences regarding the rules of setting up and running limited companies. These have been reduced through decades of EEC harmonisation efforts. Rather, it lies in

different fiscal systems: the level of profit taxes; and differences in treatment of capital write-off; retained or distributed dividends; allowances for R&D expenditure, etc. These differences in turn effect two areas of management: auditing on the one hand; and the (related) problem of transfer pricing. Legitimate attempts by companies to limit tax liability clash with a no less legitimate attempt by governments to collect their due; and the common practice (non-Europe!) to maximise their share of the total tax take relative to other countries.

Auditing

While minimal common auditing standards exist in the EEC, three elements cause significant divergences: different national traditions and legal differences on "details" (e.g. adjustment for currency changes); different purposes for presenting accounts, notably the relative weight of stock markets; and different fiscal implications of treating items like "extraordinary" profits and losses etc. Occasionally the work of harmonising parent and subsidiary accounts is complicated by different reporting dates.

The administrative problem is magnified by the fact that companies' internal accounting (controlling) is coloured by existing legal auditing systems. Most large companies therefore have to produce three sets of figures: those conforming to the national requirements of the parent company, and which include the consolidated (i.e. "translated") accounts of subsidiaries; national accounts for each subsidiary; and a standardised, firm-specific system used by all units for controlling purposes.

While some of the cost of "translation" can be handled by the appropriate software, experts are needed in both subsidiaries

and parent companies to fine tune the system. Fees for legal consultants and, of course, external auditors, are substantial. The Fourth Company Law Directive dealing with accounting standards was mentioned only by one company as having improved the situation.

The foregoing remarks refer to current costs of operating TBAs. A substantially larger cost is incurred at the moment of takeover, i.e. a once only investment to adapt company systems to each other, and to train personnel in the new subsidiary in the use of the system. Moreover, the true profitability of the new company may only become apparent to central management after this process is completed. Both costs: financial and uncertainty, may constitute obstacles to transborder business expansion.

Taxes

The problems caused by "fiscal suspicion" and beggar-thy-neighbour attempts by national tax authorities to maximise their share of an EMS total tax liability have much graver consequences. They do not only cause administrative costs but influence locational decisions regarding group administration, R&D, and production.

Companies are suspected to use **transfer prices** to maximise tax liability in the most favorable country. There is no doubt that this suspicion is sometimes justified, although even then there is a cost (of manipulation) to the firm; and a dead-weight loss to the economy.

Responses, notably regarding the desirability of a unified European company law, differed according to whether one talked to the tax specialists (notably external consultants) who rather enjoyed the game of "arbitrage"; and executives,

notably of large companies, who recognised the cost to company management and planning imposed by fiscal suspicion. Moreover, a large part of the energies of tax lawyers were simply devoted to avoiding double taxation.

Thus, one French EM had to institute a complex system of cost-accounting at the production level to satisfy German authorities of the bona-fides of the prices charged to its German subsidiary. Dito a large German electronics company to satisfy Italian authorities. In addition, companies complained about the periodic and prolonged (up to 8 months) presence of controllers on the premises of especially German subsidiaries. Another company pointed out that national requirements on transfer prices were inconsistent (e.g. as regards short-term variations of exchange rates), so that the company had to be in an illegal situation somewhere. In fact, "Europe would grind to a halt if national legislation were fully applied". Living with such ambiguities, however, is both costly and highly unnerving to executives.

The problem of transfer prices sometimes intersected with that of different product standards, since "home" and "export" prices for the same product could differ because of different specifications - an argument difficult to explain to tax authorities.

Many companies complained of the difficulty of charging its subsidiaries for central R&D expenditure. This is particularly awkward in view of the fact that, from an economic point of view technology transfer and R&D scale economies are among the most useful features of TBA.

Particular scrutiny (including at customs) is reserved for the transfer price of software. It was much easier, our respondents claimed, for an independent firm to "export" software at its

just value than for an integrated TBA. Software makes up significant proportions of the value of an increasing number of products (machine-tools +-30%; telematics (50% +)); it is also the form in which production know-how is often transferred. If the full value of this "component" cannot be charged by the main technology holder in an integrated company or a joint venture, serious distortions result. For example, a firm may choose to sell "embodied" software, i.e. a hard product, rather than utilising local production opportunities.

Yet a third consequence of suspicion towards "immaterial" transfers was the difficulty for central management companies to level a management charge on their subsidiaries. This again inhibits economies of scale in administration; and the development of Euro-centric rather than national loci of planning and know-how. However, abuses are not uncommon.

As regards Italy, many of these problems were accentuated by a second motive for suspicion, i.e. the circumvention of capital controls. This not only influenced current TBAs, but also business expansion (i.e. acquisitions; for more detail see the notes on individual countries, below).

In all, the extra administrative costs imposed by different auditing and fiscal systems was estimated at 10-30% of the relevant administrative departments. This, to us, surprisingly high figure was cited by all large European companies. A partial exception were British companies which did not, by and large, engage in truly integrated operations. (See also section 3, below).

Many companies cited the impossibility of reducing tax liability by off-setting profits in one branch by losses in another as very costly to their operations, and a clear disincentive to diversify production outside national borders.

One particularly serious obstacle to business expansion is the practice of tax authorities to levy capital gains taxes on firms taken over or merged, i.e. treating this as a case of "realised assets". The holding company, with both partners remaining legally in existence, is a clumsy substitute for a true merger (inter alia necessitating three tax and auditing systems). An exception are the Netherlands, where (foreign) companies can obtain a "ruling" before a merger. Even then companies still face the problem of negotiating their exit from the previous tax residences.

A last item under the heading of company law and fiscal suspicion relates to the rigidity of many national company statutes. The growing preference of European multinationals to choose the Netherlands as headquarters had less to do with tax advantages (dividends), and more with the flexibility and pragmatism of Dutch laws, not least as regards the ability of holding companies to levy and transfer immaterial income, e.g. from royalties, trade marks, etc. Some firms have transferred from tax-friendly Luxemburg for this reason. Flexibility also extends to such things as voting rights - important in joint ventures - where tailor-made agreements between partners are accepted, provided they are spelled out in writing.

Product/production standards

While this problematique is the object of specialised studies in the Cost of Non-Europe project, our interest related particularly to its effect on integrated business planning in Europe.

We found that some large firms devoted 1/3 of their R&D (with the stress on "D") budgets to the adjustment of their technology to different national settings. This obviously

reduces the scale advantages from R&D which would otherwise accrue to integrated European companies.

Alternatively, the innovative output of a given R&D effort would be greater. This problem applies particularly to telecommunication on the one hand and mass-produced electronic components, automobile components and standardised machine tools. It has less relevance in industrial plant and machinery made to customer specifications.

As regards product standards, even the most marginal divergences (e.g. labelling requirements) prevented, at the very least, efficient, i.e. centralised and flexible, stock management. Stock management, including the option of having a central European warehouse in a post-"1992" world, was particularly important to relatively small European multinationals with specialised products (e.g. hospital supplies).

As regards regulations of production, the piecemeal introduction of pollution standards in Europe caused major uncertainties in investment planning and/or led to distorted locational decisions.

It is worth noting that all problems under this heading caused costs to EMs and rather discouraged them to increase the level of integration (i.e. some of their activities remained in our integral B; while some of the same problems encouraged SMEs to seek local production partners to adapt their product to local standards; get type approval, etc., i.e. to engage in TBA in the first place.

Trade Obstacles

Again we limit our remarks to their impact on integrated

business strategies.

Border delays and uncertainties are becoming increasingly relevant as just-in-time management of components is gaining in importance. TBA by EMs, with their tight logistics planning, is hampered by this even more than arms-length trade. While customs are one source of the problem, divergent social and technical regulation of the transportation industry was cited as an additional risk factor.

Intra-EEC applications of COCOM controls were mentioned by many firms in the electronics and advanced engineering sectors. The problems were hold-ups at the border; difficulties in carrying out speedy repairs (spare-parts); and differences in national COCOM lists.

Together with the familiar deadweight administrative and resource cost of border-crossing (1% of value according to our respondents) uncertainty penalises otherwise efficiency-enhancing forms of integrated TBA which would allow large scale economies through decentralised components manufacture.

A particular problem is posed by Italy, which prohibits temporary imports of components for re-export in a chain of value-added, necessitating the administrative (fiscal, customs) registration of two sales. Ditto for demonstration machines, test equipment and other temporary exports.

Non-Europe was also said to hamper business planning due to the discretionary and varied national administration of the common external policy by different countries (quota enforcement).

Social Policy

TBA, especially within integrated businesses, requires the exchange of some managerial and technical personnel. This raises the question of the "portability" of social security benefits, notably pension schemes, which are tailored to national fiscal systems and/or related to public schemes. In practice, the firm must pay twice, raising salary costs by 10 - 15%. Lack of "mutual recognition" of secondary and other school diplomas by dependents also reduced flexibility of technical and managerial staff.

A different problem is posed by differences in technical training in Europe. Man/machine interfaces and production in general are designed with particular skill combinations in mind. Some firms spend considerable sums to train the workforces in their subsidiaries to conform to a particular standard, and to make communication at the various technical levels possible.

Capital and Current Transfers

Here there were few general problems: most were country specific. One general problem, however, was the difficulty of gaining access to local stock-exchanges to finance a new subsidiary for medium-sized companies.

Italy, among the major countries, continues to be a special case. We deal with it under point 3 below. The main point to make is that only large and very sophisticated companies can engage in genuine TBA.

Currency risks were cited by virtually all French EMs, some of which are considering introducing the ECU as internal accounting unit. Complaints about currency risks were also occasionally made by companies in other countries. The extra problem raised for transfer prices has been mentioned. One

German hi-tech EM called for the speedy introduction of the ECU as an official means of payment.

5. Large and small companies

While there were important exceptions, TBA by European multinationals (EMs) on the one hand, and small and medium-sized enterprises on the other, could be clearly distinguished as follows:

Large companies always engage in some form of TBA. SMEs rarely do so.

Large companies are almost always growth oriented, with a tendency for expansion to spill over to Europe; smaller companies tend to seek value-added rather than volume growth.

SMEs are above all interested in marketing, with local production often an unplanned afterthought when it occurs, e.g. via a gradual expansion of after-sales service; adaption of products to local standards; or co-production with a former sales "agent".

Large companies are more likely to systematically exploit cost advantages, notably labour and transport, and scale advantages; they are also driven by formal or informal local content considerations; more rarely by political diversification of supply risks (strikes). They also systematically exploit investment and export incentives.

SMEs tend to have a relatively arms-length relationship even with wholly-owned production subsidiaries abroad, using long-term contracts not very different from those concluded with third parties. This reflects their relative scarcity of management resources and, in particular, international

expertise.

Most European multinationals prefer a hands-on approach to management, not only in order to exploit all manner of technical and economic cost advantages (of which SMEs may be only vaguely aware); but also in order to pursue market strategies which are directed not only at the customers (as in the case of SMEs) but at competitors. Sophisticated financial management, including tax minimisation; use of capital markets; currency portfolio management, etc. is scarcely practised by firms with less than 2000 employees.

This makes sense in terms of relative management cost; but suggests untapped opportunities for external service providers, e.g. banks, with the requisite economies of scale.

6. Country variations

With the exception of Italy, variations in responses seemed to owe less to objective differences in regulations than to differences in "industrial culture" and general attitudes towards "Europe". At any rate, they confirmed stereo-types.

United Kingdom

The most striking peculiarity of UK companies is the preference for arms-length management of TBAs. Even world-sized companies (unless owned by Americans) seemed to look at their European subsidiaries more in terms of investment diversification than in exploiting the opportunities of continental integration in production, research, and marketing. Thus, for example, the expatriation of staff was not an issue in any of our twenty British interviews. R&D was pursued in parallel (duplicated) by closely related subsidiaries. "The first time we saw our colleagues was in the BRITE programme", according to the

Italian executive of a hi-tech British-owned engineering subsidiary. Subsidiaries were often managed by special holdings with a handful of staff, headquartered in London - far from the manufacturing headquarters located in the provinces, again confirming the financial over the industrial interest.

Given the low level of integration, Non-Europe was not perceived as a great problem for British companies engaging in TBA.

France

In France, hands-on management was typical even for medium-sized enterprises. "Expatriation" of management staff was common. There was great pride in being "European". In contrast to the other three countries, being merely French was considered provincial. Like Italy, companies in mature sectors threatened by both German and extra-European competition saw the European "home market" as the only chance for survival through economies of scale in production, marketing, and R&D. High levels of production integration made French companies more sharply aware of the problems of non-Europe than those of other countries.

Germany

Although they are in fact active practitioners, German firms are often reluctant players in the game of TBA. Direct exports are generally preferred over local production, except when it comes to exploiting labour-cost advantages in Britain, Spain, and Portugal. But formal and informal local content pressures provide an incentive to produce abroad, as may the relative strict limits on national expansion imposed by the Kartellamt.

But, paradoxically, the strong industrial export orientation of

German industry, with its consequent large and sophisticated presence on neighbouring markets, also means that German (medium-sized) firms are often more likely than those of other countries to discover the limits of direct exports and to complement these with TBA. For some large firms, like chemicals and electronics, "multinational know-how" acquired through a global presence has lately been transferred more wholeheartedly to the Community Market.

Italy

Italian TBA fully confirms to the overall image of Italian industry, i.e. a private sector struggling to thrive in spite of the State.

As in France, large companies in the more traditional sectors see the extension to "Europe" as the only chance of remaining competitive. In other words, moves to rationalise European industry will not be spearheaded by the strongest country, Germany, but by relatively weaker competitors.

The major problem for Italian companies were capital controls which effectively prevent smaller firms from engaging in TBA. Getting permission to invest in a productive facility abroad is not a problem - it just takes time (3 months). Permission for an increase in capital already involves more difficult negotiations. Most difficult of all is to get permission to create a holding abroad.

Only very large companies can assume the cost of "negotiating" such a permit with the relevant ministries; and, subsequently to prepare lengthy annual reports to those ministries. For these go well beyond normal audit requirements.

The combination of capital controls with controls on tax evasion, and hence the need to negotiate acceptable business plans with both the Finance and the Foreign Trade Ministries, was felt to complicate life, even for large companies.

The extra-territorial application of Italian controls is another interesting feature: further investments by Italian subsidiaries (i.e. legally French etc. companies), need approval from Rome.

CHAPTER III : Obstacles and the White Paper agenda

As stated earlier, we were encouraged to define the Non-Europe of business regulation more broadly than the White Paper section dealing with "business cooperation". Indeed, this corresponded to business views. On the other hand, the often sceptical reactions of business to Commission proposals in the narrow area of business cooperation (see point 2 below) is more than counterbalanced by the relevance of the agenda as a whole for promoting TBA.

In the following we sometimes go over the same ground covered in our business survey; but this time we look at the relevance of the remedies proposed by the White paper, rather than the cost of obstacles to TBA as such.

1. Non-company law initiatives

Trade

An important part of reforming the environment for doing business in Europe is, of course, trade. TBA, as we saw, is to some extent a substitute for trade and, more particularly, a way around trade barriers. Hence some of the latter motivation would disappear with the full implementation of the White Paper agenda on trade liberalisation. But other reasons for TBA would remain and even be re-inforced. As we saw in the chapter on "networking", the efficient organisation of exchanges tends to involve a mix between arms-length and contractual relationships, and both of these involve moving goods across borders.

One particular item on the trade agenda is standards. Again, as we saw, TBA may be positively encouraged rather than hindered, by differences in national standards, certification procedures,

etc. But the type of business cooperation which really changes the efficiency of the European economy, i.e. which realises a sophisticated division of labour through networks and/or integrated management of production, is obviously much easier if the various pieces can fit together and are acceptable on the whole market.

Services

Another item is the liberalisation of services. Most businesses have established relations with a house bank, their own insurance company, and even law and public relations firms. Building up such relationships in a foreign country is costly. Again, horizontal TBA is sometimes a second best response to this problem, i.e. a firm acquires a partner who, with his established relationships, takes care of the problem of financial and other services. On the other hand, and especially for TBA involving substantial capital participation and hence control, having access to familiar service providers is clearly seen as an asset by business. The way American banks, advertising agencies etc. followed the expansion of US direct (productive) investment in Europe in the 'sixties illustrates this point.

An indirect effect of creating conditions for cross-border trade in services is national de-regulation: there can be no Community market until there are genuine national markets. De-regulation has the effect of improving services to manufacturing industry, notably by increased flexibility and lower costs. The degree to which the Internal Market is seen as a "natural" space for business expansion will greatly depend on the liberalisation of services.

Apart from financial services, transport services are of particular interest for TBA. The fact that it may be cheaper to

fly from London to New York than to Athens is only one aspect. Another is protectionist regulation of trucking. In many countries the only way firms have of avoiding the outrageous rates and limits on cabotage imposed by regulation is through company-owned trucking fleets. But these often may not be used freely even among wholly owned, but legally independent, subsidiaries; much less with "foreign" cooperation partners. Although this problem arises both within and among Member States, the greater distances associated with trans-border cooperation, and the prevalence of looser forms of cooperation, multiply the negative effects in Europe.

One particular service requires special mention: telecommunications. As the Commission's recently approved Green Paper shows, creating an integrated European market for telecoms services is a complex affair, requiring national liberalisation; cross-border liberalisation and non-discriminatory rate setting; technical harmonisation; and the creation of a jointly developed, high-capacity infrastructure. The importance for business cooperation in Europe is crucial: the creation of a network for networks.

Capital markets

Although not unrelated to services liberalisation, capital market liberalisation is, rightly, dealt with separately in the White Paper. Different rules and regulations governing securities markets do present a real obstacle to business cooperation, notably when it involves the acquisition of shares.

Among the remedies proposed in the White Paper are:

- an extension (agreed by Council in November 1986) of earlier EEC directives on liberalisation of capital movements (early 1960s) to include the acquisition and sale of unlisted securities; and the issuing and placing of the securities of non-resident companies;

- a proposal to coordinate EEC rules on the contents of prospectuses to be published when listing securities;
- a proposal (made April 1987) for the abolition of stamp duty on transactions in securities;
- initiatives to coordinate disciplines regarding trade in securities :
 - a proposed directive (COM (87) 111) aligning laws for combatting insider trading;
 - a draft proposal (now at stage of a consultative document) for a directive requiring minimum guarantees on information to be given to those involved in take-over operations; and
 - a proposed Directive (October 1987) abolishing dual exchange markets which discriminate against capital transfers.

Competition policy

Competition policy, both in the sense of anti-trust and in the form of control of state aids (subsidies), does of course play a major role in setting the conditions for TBA. Since this is a complex subject in itself, we limit ourselves to a few remarks resulting directly from our interviews.

The first obstacle mentioned by respondents is the existence of double jeopardy, i.e. the co-existence of (especially the German) national with EEC controls. The fact that EEC controls are applied ex-post (in the absence of a German-style prior notification procedure) does provide a particularly awkward disincentive. Proposals to change this state of affairs have therefore been welcomed by business.

In the field of cooperation in the narrow sense, notably where it serves technology promotion, the Commission has sought to reduce uncertainty by "block-exceptions" for R&D cooperation and joint ventures. The latest candidate are inter-company licensing agreements which may enter into force in 1988.

So far block exceptions are restricted to small and medium sized companies. But, according to some of our academic and business respondents, these companies are frequently not even aware that Community law might have created a problem ⁷, i.e. were not deterred from exploring cooperative opportunities even without block exceptions.

As regards state subsidies, it is clear that tougher EEC controls of these subsidies would remove one important obstacle to rationalisation of whole industrial sectors, and hence create strong incentives for trans-European business links.

2. Agenda items related directly to "business cooperation"

Discussing the contribution of the White Paper initiatives in favour of business cooperation faces two preliminary difficulties. The first is that the proposed Directives pursue multiple goals, such as transparency, for complex reasons of industrial and even social policy which go beyond "cooperation". Secondly, many proposals do either not exist at all, or will be presented in substantially modified form. In this situation an assessment already burdened with an excessive amount of "hypotheticals" becomes even more difficult.

Part II, Chapter VI of the White Paper on "Creation of Suitable Conditions for Industrial Cooperation" has three parts:

- company law
- intellectual property
- taxation.

Intellectual property has been excluded from our terms of reference. We reproduce below the timetable for initiatives under the other two chapters.

	Doc. no.	proposed	adoption ?
COMPANY LAW			
Proposals for a Regulation for an European Economic Interest Grouping	Com (73) 2046	1973	
	Com (78) 139	1978	1985
Proposal for a Fifth Company Law Directive (structure of public limited companies)	Com (72) 887	1973	
	Com (83) 185	1983	1988
Proposal for a Tenth Directive concerning cross-border mergers	Com (84) 727	1985	1987
Proposal for an Eleventh Company Law Directive to dispense branches of companies from publishing separate accounts		1986	1988
Proposal for a Directive on the liquidation of companies		1987	1989
Proposals for a Directive on take over bids		1987	1989
Proposal for a Directive on the relationship of undertakings in a group		1988	1990
Amendment to proposal for a Regulation on the Statute for a European Company		1970	
	Com (70) 600 Com (75) 150	1975 1988	1990
TAXATION (Removing tax obstacles to cooperation between enterprises in different Member States)			
Arbitration procedure concerning the elimination of double taxation	Com (76) 611	1976	1985
Common system of taxation applicable to parent companies and their subsidiaries	Com (69) 6	1969	1985
Common system of taxation of mergers, division and contribution of assets	Com (69) 5	1969	1985
Harmonization of taxes on transactions in securities	Com (76) 124	1976	1986

2.1 COMPANY LAW

Since the early 1960s the EEC has pursued a policy of encouraging TBA by reducing diversity and increasing transparency. Both approaches ease access and reduce the risks of "foreign" market operators. While the first company law directives have long since become part of national legislation, more recent proposals - notably the 5th Directive on Boards, including worker participation, have created a climate of considerable business resistance to further harmonisation. More generally, company law harmonisation based on Article 54, 3g of the Treaty aims to provide equivalent economic and legal protection throughout the EEC (to shareholders, creditors and workers) as a counterweight to the freedom for firms to establish anywhere in the EEC. This explains the sceptical attitude of some business circles to Commission proposals.

At the same time, since the end of the transitional period Article 58 of the Treaty has guaranteed directly the right of establishment for companies on a non-discriminatory basis. So there is no absolute legal bar against companies seeking to set up cross-frontier subsidiaries which would need to be removed by harmonisation. Hence political and economic fears of reduced management flexibility and control tend to balance positive expectations of reduced administrative costs through further company law harmonisation.

Obstacle 1: Differences in laws on company structure, powers and administration

By and large, these differences are seen only as an irritant by large companies, particularly when contrasted to the major problems these companies fear they would face as a result of EEC attempts to remove such differences through harmonisation. Indeed, for many Euro-wide operating companies the negative

reaction to any 'foreign' meddling with national company law appears by far to outweigh the enthusiasm raised by the prospect of a levelling of legal divergencies with other EEC countries.

Yet, the Commission has argued strongly - and our survey among integrated European companies confirms - that cross-frontier establishment for a company in a non-harmonised environment is "complex, costly and inefficient".⁸ While some basic alignment - e.g. of capital requirements (the second company law directive) and of financial reporting (the fourth and seventh) - has now been achieved, the detail of accounting practices etc. remains different enough to cause costs.

Remedies

In the area of harmonisation of company structure, the principal instrument set out in the White Paper is the amended fifth directive (COM (83) 185), which seeks harmonised board structures and an 'equivalent' measure of worker participation in company structures throughout the EEC. Given business resistance, this proposal is likely to be amended.

The draft eleventh directive, proposed in July 1986, seeks to simplify disclosure obligations by harmonising the reporting requirements imposed on branches of foreign companies. A point worth noting here is that the fifth and eleventh directives harmonise in quite different ways - the fifth by extending similar obligations to all 12 Member States; and the eleventh by removing these obligations where they exist.

Obstacle 2: National vs. group management

National laws in all Member States contain provisions which de facto prohibit subsidiaries to be managed in ways which optimise

the performance of the company as a whole. These provisions essentially serve to protect the rights of minority shareholders. Only German law allows the conclusion of a so-called "Beherrschungsvertrag" which, in effect, guarantees the income of minority shareholders in return for a free hand by management. In practice, political and legal obstacles to damaging employee interests - outside company law - are a more serious obstacle to management in the Group interest.

Remedy

In the area of group law, the Commission has circulated a draft proposal for a ninth company law directive which seeks to enable a group to act on a group basis while harmonising the safeguards required for the individual company which is a member of the group.

Obstacle 3: Absence of legal framework/vehicles for promoting cross-frontier cooperation.

Remedy

- The adoption in 1985 of the European Economic Interest Grouping (EEIG), which comes into force in 1989, is the first example of a company legal entity under Community law: it provides a common vehicle for numerous forms of joint activity between companies who fully retain their legal independence.

- The proposed tenth company law directive (COM (84) 727), which would enable full asset mergers between firms from different Member States (involving the disappearance of one of the firms), and also simplify procedures for restructuring a group.

- The European company statute (COM (75) 150), would provide a single legal structure which companies could adopt for the conduct of business throughout the Community.

Residual obstacles

None of the proposals deal specifically with the problem of speeding up company registration, e.g. in the incorporation of new collaborative ventures like ESS, and removing administrative delays. However, on issues such as these, what is the proper role of the EEC and the national legislator?

2.2 TAX OBSTACLES

Fiscal experts at most of the companies we interviewed expressed scepticism bordering on outright rejection towards a genuine European company statute incorporating fiscal provisions. Their reasoning can be explained as follows. Assume that the total fiscal burden on companies in each of the Member States is equal. However, the structure of taxation differs widely among countries (i.e. the extent to which tax liability is reduced for R&D, other investments, dividends, jobs created, etc.) In addition, of course, there is reverse taxation: national subsidies for everything from exports to capital and infrastructure.

By a combination of clever location, the use of holdings, and of transfer prices, companies can minimise their tax liability and maximise their take of subsidies to the point where they are better off than any purely national company. This may compensate for the cost of operating in a fragmented Europe. This means that, to be attractive, any EEC fiscal regime would have to set significantly lower tax rates overall to compete with the effective rates achieved by exploiting national

diversity.

Given the difficulties of introducing a single EEC profit tax regime - which alone would relieve many of the problems cited in our business survey, the Commission nevertheless has developed a whole range of proposals which would effectively deal with TBA-inhibiting iniquities.

Obstacle 4: Capital gains tax levied on mergers and take-over operations

- in the case of an asset merger (i.e. where the absorbed company's assets are taken over by a company in another country), capital gains (levied by the authorities in the absorbed company's country) hit the difference between the book value of the absorbed assets and their current value, even though this value is not realised (turned into cash);
- in the case of share-exchange operation between companies, capital gains tax liability arises from the difference between the value of the shares carried in the books and that at which the transaction is carried out;
- in the case of purchase of a permanent establishment (e.g. factory) belonging to a company in country B by a company in country A via the latter's issuing shares to the former, the company in country B faces capital gains on the difference between the current value and book value of the permanent establishment which has been acquired from it via the share transaction even though it does not realise the monetary value of the shares.

Remedy

The proposed directive on "a common system of taxation of

mergers, divisions and contributions of assets" (COM (69) 5) would :

- as regards full-blown asset mergers, defer capital gains assessment and tax until the moment when the absorbed assets or contributions are actually realised. However, the directive would not in itself make such mergers possible - for that, the tenth directive on company law harmonisation would have to be adopted;
- as regards share exchange operations resulting in the acquisition of a 'qualifying majority' (= majority of voting stock), not levy capital gains on the transaction unless the shares were realised; if the directive is adopted and implemented, such operations - which constitute a widespread method of cross-frontier cooperation - would immediately benefit (i.e. this benefit does not have to await the adoption of the tenth company law proposal);
- as regards exchange of shares against a permanent establishment, defer capital gains on increased asset value until realisation. Adoption of the directive would also have immediate benefits in this case.

Obstacle 5: Double taxation

Liability, in the tax territory of a foreign subsidiary, of withholding tax on dividends distributed by the subsidiary back to the parent.

Remedy

The proposed directive on "a common system of taxation applicable to parent companies and their subsidiaries" (COM (69) 6) seeks to solve this by abolishing withholding tax on dividends distributed to a parent by a foreign subsidiary. An exception is envisaged for Germany, allowing it a residual level of withholding tax to compensate for the relatively low level of tax it currently levies on distributed profits (36%). In the absence of this directive, cross-frontier situations within the EEC are handled by bilateral double taxation conventions. The OECD's 1977 Model Convention on double taxation recommends that withholding tax should not exceed 5%, but this level is exceeded in many instances.

Obstacle 6: Double taxation (transfer pricing)

In our business survey we discussed the pervasive impact of "fiscal suspicion" on the cost and freedom of management. Current EEC proposals deal with a more limited problem: Tax authorities can carry out ex-post assessments of inter-company prices (i.e. legitimate, not fraudulent, transfer pricing). This can result in double taxation.

An example of this is where a company in country A transfers to its sales office in country B, at a price of 100, goods which the sales office then markets at 120 in country B. Country B's tax authorities use the 120 figure for calculating profits tax. But country A's tax authorities may also audit company A and reassess the national market price of the products (in country A) at, say, 110. So tax is levied twice on the same goods.

Remedy

The arbitration procedure (COM (76) 611) concerning the elimination of double taxation seeks to give the force of EEC law to the toothless OECD Model Convention provisions on arbitration of double tax disputes. The OECD arrangement exhorts the tax authorities concerned by a firm's complaint against double taxation to come together in view of a settlement, but this can take years and even then the issue may not be resolved.

The EEC arbitration procedure says that if, after two years, the two tax authorities do not agree, then the problem should be put to the committee provided for in the directive which would then issue a recommendation. One or other of the two tax authorities could still block the recommended solution for 6 months but, after that, in the absence of an agreement, the Committee's recommendation would be applied.

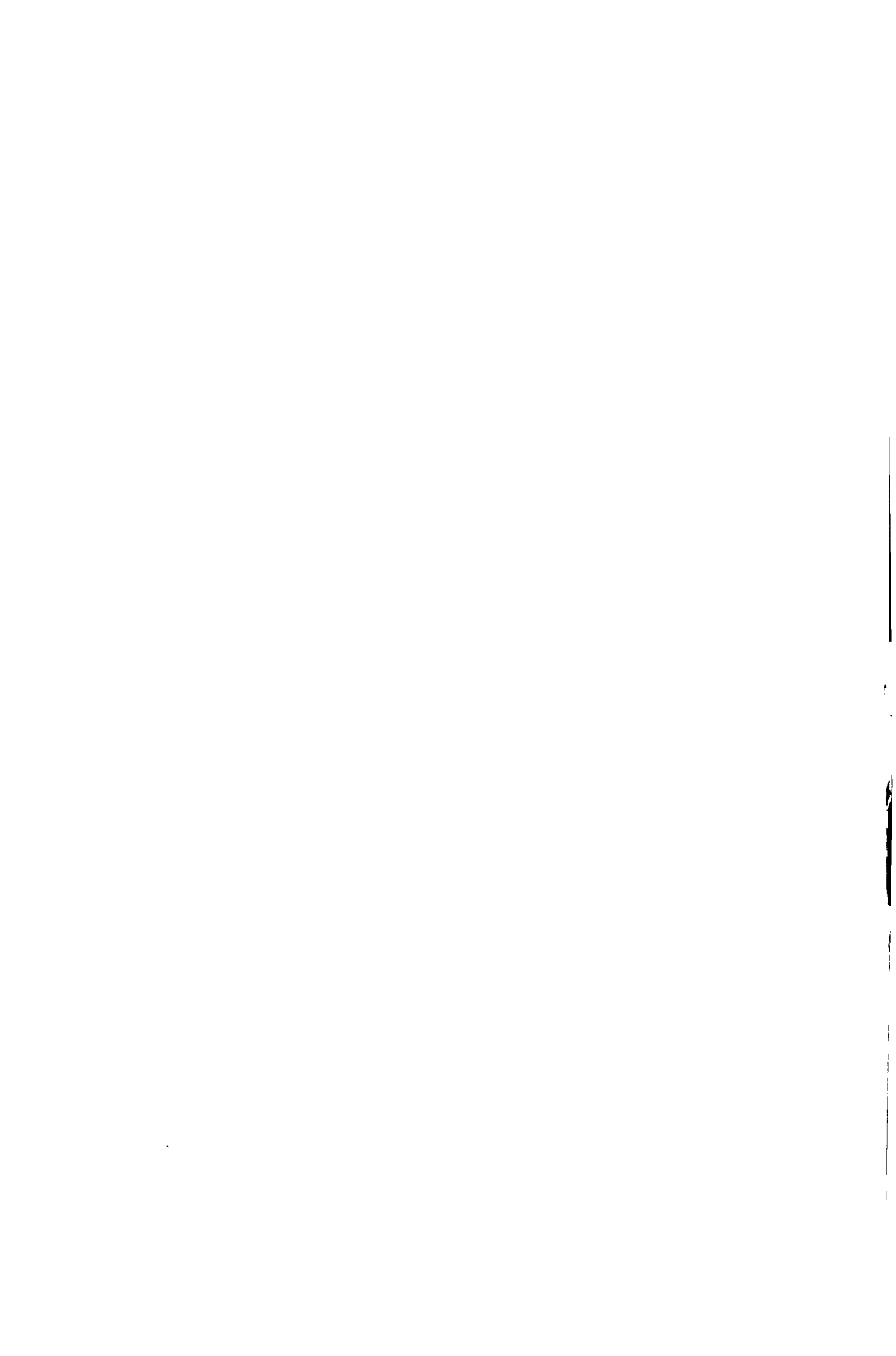
Obstacle 7: Tax assessment

It is at present impossible to offset losses made by foreign permanent establishments against profits made by a home country company.

Remedy

None as yet, but at the pre-conceptual stage.

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CHAPTER IV : Quantification

1. Finding a unit of measurement

The following table serves to illustrate the methodology we used to get quantitative orders of magnitudes of the costs of individual obstacles to TBA expressed in a comparable unit, i.e. per cent of total turnover. Essentially, it consisted in relating an interview estimate, whether expressed in money terms, a fraction, or a percentage of that part of the company's activity which was familiar to the interview respondent to published data in the company's annual statement and/or assumptions about the expenditure pattern of companies of this type.

ONE FIRM'S COST

(case study of European multinational)

Obstacle	interview data	published data	assumptions	% of turnover
Fiscal administration	30 % due to NE		fisc admin = 15% of all admin; hence NE = 5% of all admin. white collar = 50% of salary costs; all salary = 25% of turnover 25 : 2 x 5%	0.63
Training	5 million ECU for systemic integration	turnover = 6.4 bio ECU	1/3 for diversity (NE)	0.07
R&D	25% of total for NE	Total R&D = 6.5% of turnover		1.6
Unrealisable Location optimisation	5% savings possible		Total costs = 50% of turnover	2.5
Transport	10 - 15% of total costs due to NE		transport costs = 1 - 2% of turnover	0.2

Sum 5.0

Special case

Unused economies of scale	loss of 15 - 20% of current \$ market	Current \$ market = 15% of turnover		2.5
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Sum 7.5

The figures, which incidentally refer to an advanced auto components manufacturer, are surprisingly high; but yet higher figures could be found in state-dominated sectors (see below). The high figures reflect

- the very high "service" content of contemporary industrial production, i.e. administration, technology exchange, marketing, etc.; it is here that more narrow technical analysis of trade barriers as such are likely to yield much lower figures and
- the considerable - and only partially realised - economies-of-scale opportunities which lead many companies to engage in TBA in the first place. Note that we are talking here of that 1/5th of manufacturing industry which is actually involved in TBA (integral A), not an industry average.

Of course, precise quantitative estimates were the exception, as most executives found it difficult to quantify e.g. hypothetical economy-of-scale gains. When they did quantify, however, the answers were surprisingly consistent.

With these elements in hand we needed to make a series of - increasingly heroic - estimates to scale up our results to sectors, groups of sectors, manufacturing industry as a whole and GNP.

The first step was to estimate an average level of cost for each obstacle and each industry for each country separately. This was done in a meeting of the four interview teams on the basis of the raw interview data and the summary interview reports which we do not reproduce here.

This iterative round-table assessment provided a minimum of "calibration" of the various estimates. It also allowed a combination of the fragmentary quantitative data with more impressionist assessments of respondents to some sort of common unit. We limited ourselves to only four cost levels, with "1" corresponding roughly to a cost of less than 1% of turnover, experienced as a significant but not prohibitive nuisance by respondents, and "4" equalling a cost of 3% and above of turnover, i.e. the level at which respondents became angry with Non-Europe.

A second step involved aggregating the country results to single "Euro" magnitudes, taking into account the peculiarities of our not always representative samples. This again was done in an iterative round-table discussion among the principal interviewers (Table x).

These figures aggregate not just apples and pears but apples and cheese. Thus the cost of "company law" sums up both the administrative cost, and induced scale-diseconomies. Both averages would be higher if there had been more truly integrated companies in our sample. Taking the example of trade-barriers, the figures may refer to actual transport costs; or to difficulties of border problems for just-in-time production-integration; or to COCOM- induced problems for supplying and servicing advanced machine tools - problems which do not arise for more conventional producers.

Table 2

pharma telec auto textiles machinery

industrial policy	4	3-4	3	0-1	1
company law (1)	2-3	2	3	0-2	2
"social"regul.(2)	2	1-2	2	0-3	0
techn. standards	4	4	2-3	1	1-3
other trade barr.	2	3	2	1	1-3
technology trade	2	1-2	0	0	0
int. payments	*	*	*	*	*

(1) includes administrative costs and sub-optimal production

(2) includes lay-off regulations, education, and "expatriation"

* taken in isolation, payments restrictions ranked high only in Italy

Leaving these caveats aside, we felt that our sectors fell into three broad groups:

I Pharmaceuticals and telecommunications

These were highly regulated and protected industries with a high incidence of obstacles of almost all kinds, especially "industrial policy" and "technical standards". We estimated the total cost of Non-Europe to firms in this group engaging in TBA at 9% of turnover.

II Automobiles

This group, together with firms in consumer electronics, a large rubber manufacturer and food processors, were hampered by industrial protection; difficulties to adjust the labour force in response to market shifts; economy-of-scale losses due to quite marginal differences in technical standards; and substantial "administrative" costs if they were highly integrated. Total cost of TBA was estimated at 6% of turnover, i.e. higher than both average profits, or average R&D expenditure of firms in these sectors.

III Textiles and machine tools

This group had in common: high specialisation; a relatively low integration at the component level; subsidiaries which either served marketing and service purposes; or produced fairly independently parts of the product range; few problems with technical standards. Total cost of TBA = 1.7% of turnover.

2. Estimating costs by sector

Our next step was to estimate the points on the X-axis of our graph, i.e. the proportion of turnover in each group which was generated in a TBA context forming the base-line for integral A; the proportion potentially suited to TBA but discouraged by Non-Europe (base-line of B); and the proportion which would remain "local" under any circumstances (C). This latter category included local component suppliers as well as local repair and other services.

Our methodology here was to make a detailed analysis of structural elements of each sector which tend to "allocate"

portions of the total activity of these sectors on our A, B, and C dimensions. In the following we combine information gained in our interviews with our assessment of industry characteristics to draw a differentiated picture of motives for engaging in TBA and the likelihood (evidence) of doing so.

3. Sector characteristics and propensity to engage in TBA.

We look at four industries namely

- * automobiles
- * textiles
- * telecommunications
- * machine tools

to assess what, if anything, pushes them to engage in TBA.

The structural elements which are singled out are

- * economics of production
- * market and marketing
- * research and development
- * industry structure (concentration etc.)

The effects of structural industry characteristics on TBA behavior have been coded in terms of the basic graph, i.e.

- A = TBA despite cost of Non-Europe
- B = TBA worthwhile but discouraged by Non-Europe
- C = TBA not worthwhile

1. Automobiles

Production

a. Global overcapacity (+- 5 million units); ditto in EEC (+- 2 million); strong competitive pressures on European mfs; stagnant/declining demand prospects, hence no pressure for capacity expansion via TBA.

b. Great importance of economies of scale. Rationalisation in the sense of elimination of overcapacity can be linked with rationalisation of production lines, use of common components, etc. Hence TBA in the network sense exists, but internalising costs of Non-Europe.

Non-Europe in company law and industrial policy prevent rationalisation-type TBA.

c. Exploiting factor cost differentials no longer motive for TBA in Europe; there is even a slight bias towards high-wage countries except for low-tech components.

Marketing

TBA to overcome nationalist NTBs of little importance except in Iberia. But also in Britain fleet-buying creates some bias towards local production.

R & D

a. Genuinely innovative, high-risk and high-cost research rather rare; hence little pressure for TBA from this quarter for mass producers.

b. Development costs very high to optimise package of known, or bought-in new technologies. On the other hand, autos still have recognisably "national" characteristics. Moderate pressure for TBA likely to rise.

	A	B	C
a.			X
b.	X		
Non-Europe		X	
c.			X
Marketing	(X)		X
R & D a.			X
R & D b.		X	

c. Innovations come largely from suppliers (new materials; production technology; electronic regulation.
 Considerable, but non-integrated, R&D cooperation.
 Non-Europe prevents more intensive TBA/rationalisation.

Industrial Structure

a. Automobile industry characterised by very large firms with management resources to engage in Europe- (and world-wide) TBA. But cooperation limited to suppliers, or component-specific cooperation with competitors, internalising heavy costs of Non-Europe.

b. Dominance of one, or at most two nationally owned mass producers in each Member States leads firms themselves, and public authorities to avoid cross-frontier mergers.

(Note that the situation is slightly different in the trucking industry where one integrated European multinational - IVECO - exists.)

2. Textiles

Production

a. World-wide, and, to a lesser degree, EEC-wide overcapacity; poor profitability because of competition; hence no motive for expansion-motivated TBA.

b. Economies of scale important in industrial and other non-fashion textiles; with added need to reduce overcapacities this has led to fair degree of Europe-wide TBA.

High proportion of specialised, highly productive SMEs with at most local business links and OECD-wide markets; for these no reason for Euro-wide TBA.

c. Rising capital intensity diminishes importance of factor price differentials,

	A	B	C
(c)	(x)	x	
(a)	x		
(b)		x	
(a)			x
(b)	x		
(c)			x

except in extreme cases (Portugal). On the other hand, the re-location process from NICs to fully industrialised countries, encouraged by a combination of protectionism (MFA) and increasing capital intensity, suggest untapped TBA potential by parents in high-wage countries (D, B, NL). These marginal advantages sensitive to the cost of Non-Europe.

Marketing

Access to customers (industrial users; wholesalers) well established. Low incidence of NTBs. Direct exports possible, with at most marketing subsidiaries required; hence weak incentives for TBA.

Research and Development

Innovations tend to come from capital goods suppliers. Hence few incentives for producers themselves to reap economies of scale with other producers.

Some incentives for TBA between manufacturers and capital goods suppliers.

Industrial structure

The Community textiles industry is characterised by a dualist structure with large companies (mostly for industrial textiles, carpets etc. on the one hand, and a number of specialised medium-sized (Germany) and even small (Italy) firms on the other.

Large companies have the resources to engage in TBA;

small companies have little incentive.

A	B	C
	x	
		x
		x
(x)		
x		
		x

Telecommunications
(incl. office automation)

Production

a. Strong global growth of demand with matching growth of capacity. Little overcapacity as such (except in central switching), but prospect of NIC, US, and Japanese inroads in global market provide few incentives for capacity expansion in Europe through TBA.

b. Economies of scale on the one hand, and trend towards systems solutions (hard & software) provide strong incentives for cooperation. Cost of Non-Europe very high (standards; type approval; border controls; COCOM).

NTBs, notably in the procurement market provides incentives for TBA, but nation-specific product development, on balance discourages TBA.

Marketing

a. Trend towards systems-solutions for both private and public customers requires local presence. Thus in spite of high costs of Non-Europe clear evidence of growing TBA.

b. Procurement discrimination continues to favour companies which have not lost their national character; hence Non-Europe presents risks of forming truly integrated companies.

Research and Development

High speed of innovation. R&D both expensive and risky. Includes "basic research". Hence very strong pressures towards TBA.

On the other hand, R&D cooperation still too much at the long end of the market ("basic") with

unused potential for rationalisation (TBA) in product development

	A	B	C
			X
	X		
		X	
	X		
		X	
	X		
		X	

Industrial structure

Large companies predominate, hence management resources allow TBA

but most have formal or informal role as national champions hampering farreaching integration/rationalisation.

Mechanical engineering

Production

a. Moderate growth of global demand; European industry competitive in world markets. Few economies of scale in specialised plant and machine tool market can be obtained in production as such. (D, I).

Even in the standard end of the market (F, GB) plant economies of scale not very important. Hence few incentives to enlarge production units through TBA.

b. Improved production economies can be reached by vertical cooperation with component suppliers; and by completing product ranges by exchanges/specialisation with competitors; hence some (and growing) trend towards TBA.

But high sensitivity to Non-Europe (norms; border problems) lead to unused potential for TBA.

Specialised producers of customer specific products form a large proportion among both large and small firms in the industry with little incentive for TBA.

Marketing

Strong element of "service" in industry offering "solutions" rather than products alone. Hence TBA needed for finishing products locally; adapting it to local standards; and after-sales service in general. Hence incentives for TBA.

	A	B	C
Industrial structure	X		
Mechanical engineering		X	
Production			X
a.			
b.	(X)		
But high sensitivity to Non-Europe		X	
Specialised producers			X
Marketing	X		

Research and Development

a. Short-term, planned product development adapting new but known technology predominates over lengthy and risky "basic" research (which is often done in public laboratories). Hence

weak incentives for TBA within the industry itself. This may change, however, if innovation goes beyond electronics to incorporate lasers, new materials, bio-technology.

b. Usual cooperative links between either machinery manufacturer and customer; or with component suppliers (sensors; chips, software). Here are

potential incentives of Euro-TBA, although strictly speaking not within sector itself.

Industry Structure

Company size ranges from small to medium-large. Given absence of standardised production runs even for larger firms supplying industrial plant, TBA would involve very considerable management costs. The smaller companies, which predominate, lack management resources altogether. Uncertainty as to quality and delivery discourage pre-TBA contractual experiments.

A	B	C
		X
(x)		
	X	
		X

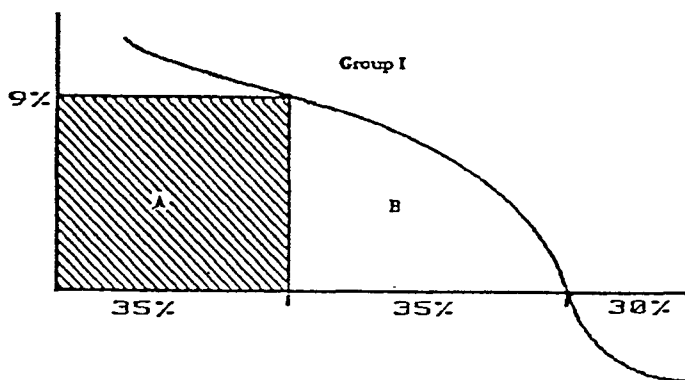
Given our ultimate objective to reach some numerical estimate of integral A we had to turn the qualitative assessments in the above sector analyses into quantitative estimates. These estimates, and the later multiples based on them, should be treated with the greatest caution: they can do little more than structure our understanding of diversity and prevent us from making blanket assertions on the role of TBA "for industry".

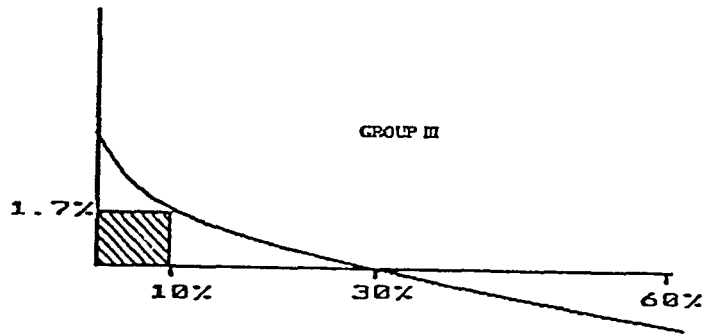
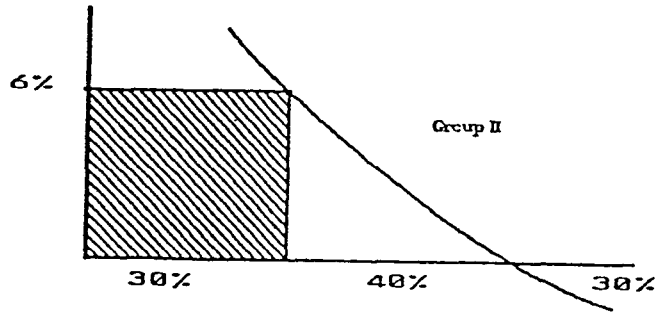
Table 3: Cooperation and potential

Industry	TBA	potential TBA	efficient local
pharma	30%	40%	30%
telec.	40%	40%	20%
auto	30%	40%	30%
auto (US owned)	60%	10%	30%
textiles, machinery	10%	30%	60%

With these assumptions our standard graph can be drawn in three illustrative versions.

Cost of non-Europe : sectoral profiles





We can now quantify more precisely the contents of integral A, which is

cost of TBA x total turnover x % of turnover involved in TBA

Since we are ultimately interested in the costs for industry as a whole, we do not make this calculation separately for our five sectors, but for three groups, "assigning" each two to four-digit industry to one of the three groups. Since the EEC does not yet publish very detailed industrial statistics, and only on a country basis, we took our data from the OECD's Industrial Structure Statistics 1984 (1986). That, however, omits countries such as France, so that we make our

calculation for a single country, Germany.

Group I

3522 pharmaceuticals	19 billion DM (rounded)
3825 Office & computing machin.	15
3832 Communications equipment	55
3841 shipbuilding	8
3842 railroad equipm.	1
3845 aircraft	9
Total	107

Group II

31 Food etc.	172
35 Chemicals (exc.351,3522)	200
3833 Electrical appliances	15
384 Transport (exc.see I)	152
Total	539

Group III

32 Textiles etc.	66
33 Wood products	36
34 Paper etc.	57
351 Industrial chemicals	106
36 Non-Metalic Min.Prod.	40
37 Basic Metal Ind.	90
381 Metal products	80
382 Machinery (exc.3825)	142
383 Elec.machinery (exc.3832) and 3833)	63
385 Professional goods	16
39 "Other"	8
Total	704

The integrals A thus become:

Group I

$35\% \times 107 = 37$; $37 \times 9\%$ (cost of TBA) = 3.4 billion DM

Group II

$30\% \times 539 = 162$; $162 \times 6\% =$ 9.7 billion DM

Group III

$10\% \times 704 = 74$; $74 \times 1.7\% =$ 1.3 billion DM

Total manufacturing 14.5 billion DM

Scaling up these results to the Community level needs taking account of the relatively large share of manufactures in German output; the relative strength of specialised (group III) sectors and weakness of some group II industries like electrical appliances, etc. In addition, the "military industrial complex", which belongs into the high-cost group I, is largely hidden in groups II and III. On the other hand, making more precise calculations on the four-digit level for all countries would be tantamount to creating a false illusion of precision for what are, after all, pyramidal guesstimates.

Nevertheless, we feel that a loss of 30 billion ECU for the Community as a whole is a conservative estimate of losses incurred in that part of manufacturing industry engaged in TBA. To this must be added the contents of integral B, i.e. the non-realised TBA benefits to which we turn in the next chapter.

Before doing so it may be useful to calculate from the given German statistics the implications of our judgement regarding

sectoral involvement in TBA; i.e. to estimate which proportion of manufacturing industry is

- actually engaged in TBA (the Y-axis of integral A,
- prevented from doing so (y-axis of integral B); and
- for whom this aspect of Non-Europe is irrelevant (C).

This calculation suggests that from a total manufacturing turnover of 1350 billion DM

256 billion, or 19% are actually engaged in TBA;
472 billion, or 35% are prevented from doing so; and
621 billion, or 46% are not candidates at all.

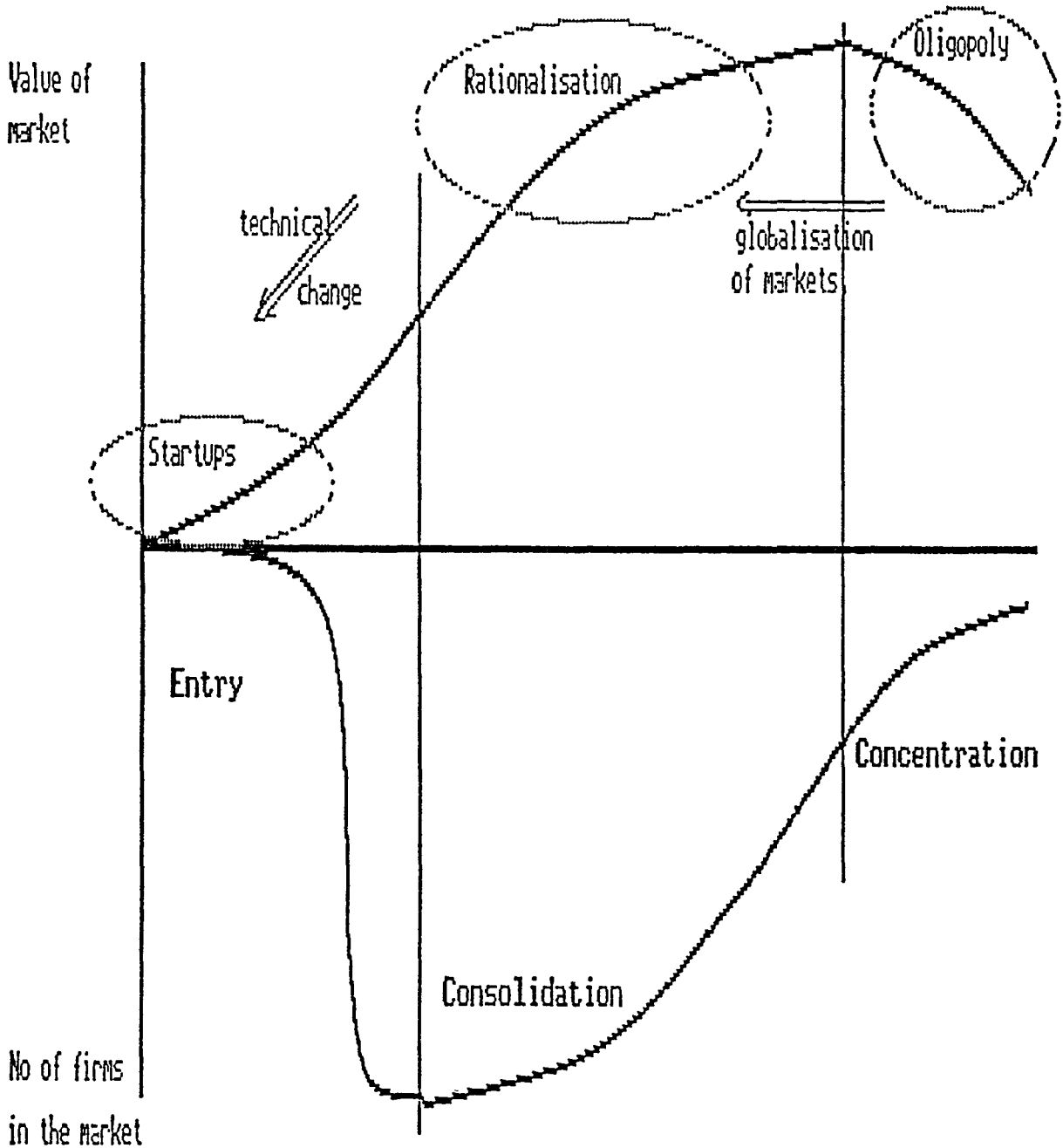
Chapter V THE COST TO THE EUROPEAN ECONOMY

We turn in this last chapter to integral B in our basic graph, i.e. the cost to Europe of transborder business activity which is discouraged altogether because of obstacles. This (opportunity) cost must be some inverse function of the benefits of transborder business activity. So the more upbeat formulation of the question asked in this chapter could be: If more obstacles were removed, what (further) contribution could TBA make to the prosperity and integration of the European economy?

In what follows we stress mainly the benefits of TBA. This does not imply that the "classical" objections to business cooperation which were stressed in the introduction are presumed to be invalidated: collusion and other forms of anti-competitive behaviour may reduce welfare; slow down technological innovation; and lead to firms which are too large to respond quickly to the economic environment. If we ignore these dangers here we do so partially in order to simplify exposition; and partially because - irrespective of what theory and past empirical evidence suggest - we are persuaded that the contemporary context of industrial evolution is rather unique:

First, as we will suggest in our analysis below of "networking", industry is experimenting with new forms of organisation which overcome many of the drawbacks of large size. Secondly, we will argue, only TBA can break down certain structural and political obstacles to the Completion of the Internal Market, without which mere liberalisation will partially fail. Thirdly, Europe is exposed, as never before, to competition from world-scale firms. Fourthly, technical change is pushing portions of the activities of mature industries in the infant industry category. The significance of this latter

point will become clearer in the following analysis. The graph below illustrates two dimensions of change.



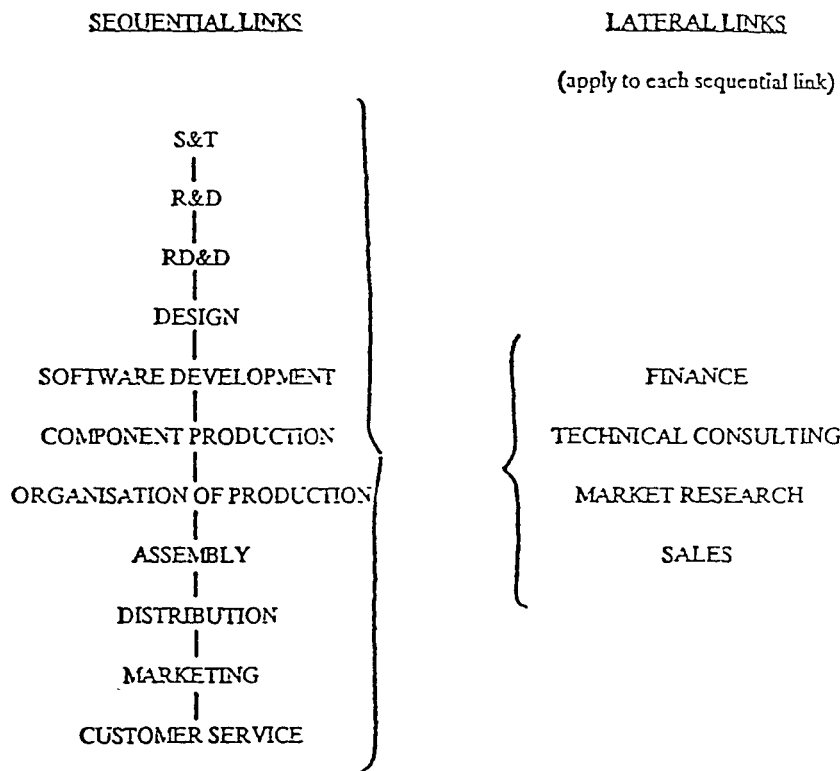
1. Networking: from market to contract

The following analysis may seem to shift the ground of the study which, so far, has stressed the cost of non-Europe to (tightly) integrated European management. But the looser forms of TBA which will be discussed here share many of the problems of integrated operations. For one thing, the legal/financial links between networking companies are often indistinguishable from those of integrated operations: equity links are common, even if their function is different.

To understand the contemporary significance for the modernisation of the European economy of certain forms of transborder business activity we need to make what may seem an overly academic digression on new emerging pattern of "industrial" organisation. The word "industrial" is set in quotationmarks, because the "soft" inputs into the generation of value-added are increasingly marginalising the "hard" inputs.

The exchange of goods and services on an arms-length and ad hoc basis, i.e. "trade" in a text-book sense, between independent firms in two different countries, is becoming the exception rather than the rule: Contractual relationships between links in the "chain of value added" are becoming an essential feature of the modern economy. An abbreviated illustration of the concept of the chain of value-added (used mostly in French writings) is given below.

THE CHAIN OF VALUE ADDED



The links between these elements of the "production" process are conventionally assumed to be either formed by the hierarchic/bureaucratic organisation internal to the firm; or through ad hoc, arms-length market relations between firms.

This pattern is fact being replaced by a new flexibility in which the distinction between the internal and the external division of labour in enterprises is blurred. At its most extreme, for instance, a component supplier or software department within a firm may have very similar relationships with either other departments of the same firm, its own suppliers of inputs, its (own) outside clients and indeed with competitors to the firm. What is left is an interactive network where specific functions, or tasks, are carried out under conditions of (reciprocal) control which may vary for each technology, product, market, or input, whether material or of services.

Some, like Bressand, have linked this phenomenon predominantly to the informatics/telematics revolution which suppresses traditional constraints of time and distance.¹ Others stress the globalisation of markets on the one hand, and increased international competition on the other.

On the one hand, globalisation opens opportunities of access to resources - technology, manpower, finance - which overtax a centralised firms capacity. Frequently, firms can neither internalise the new opportunities within their own direct control, nor manage the information needed for operations in a complex and multifaceted environment. A recent OECD report speaks of the "rising marginal cost of internal coordination" when firms venture into new areas.²

Global competition forces firms towards (real) product differentiation, thus breaking the mold of mass production; it forces them into a technology race where they must settle for partial monopolies within alliances; and it forces them to be "present" in many markets at the lowest cost. In short, firms have to optimise the conflicting claims of flexibility and control; and of differentiation on the one hand and global market power and economies of scale on the other.

Prof. Bianchi of Nomisma, Bologna, makes many of these points in an as yet unpublished comparative study of the re-organisation of FIAT on the one hand, and small-firm industrial networks of the Prato type - as complemented by the global marketing function of Benetton on the other.³

In both cases, the distinction between the firms's external and internal division of labour is blurred, with more or less autonomous units agreeing on the specifications of their respective jobs (interfaces) and left to get on with it. This may mean that components suppliers make suggestions for the

design of the final product; independent technology centers are used by units at all stages of production, and even marketing. Typically, the equivalent of agents, brokers, or franchisers organise relationships in the design-production-marketing process, whether inside a firm, within "industrial districts", or among firms operating globally.

The place of transborder business activity (TBA) in this flexibility can be represented in the following table: the international dimension appears if we replace the general term "cooperation" with "networking-type TBA", and "armslength" with the term "trade". Read in this way the table suggest that for each of hundreds of elements a firm must make an optimising decision of the type suggested above, i.e. control vs flexibility.

Table 4

COOPERATION IN COMPANY STRATEGY

Preferred mode of operation

FUNCTION	in house	cooperation	arms length
Technology acquisition			
T ₁ (basic)	R,D&D		
T ₂		R&D	
T ₃			patent/licensing
PT ₁ (product technology)	R&D		
PT ₂ (production technol.)		R&D	
Production			
P ₁₋₃₄₅	traditional		
P ₃₄₆₋₃₅₀		joint venture	
P ₃₅₁₋₃₅₄		subsidiary	
P ₃₅₆₋₃₅₇		supply contract	
Input procurement			
Raw materials			
R ₁	(vertical integration)		
R ₂		joint purchasing	
R ₃		longterm contract	
R ₄			open market
Semi finished		joint purchasing	
Capital goods			
C ₁	(e.g.; steel, auto:robots)		
C ₂		joint development	
C ₃		subsidiary	
C ₄			off shelf
Services			
S ₁ (finance)	own cash flow		
S ₂		house bank	
S ₃		venture capital	
S ₄			capital market
Marketing			
P ₁	own distribution		
P ₂		marketing agreement	
P ₃		joint venture	
P ₄		marketing subsidiary	
P ₅		franchising	
P ₆			agent
T ₁		licensing	
T ₂			patent

The table illustrates the fact that a firm may choose a different organisational solution to the acquisition of each basic technology (T1, T2) or production technology (PT3, etc.); may choose to produce most goods in house (P1 - P 345), but choose to produce some in cooperation with others; buy its inputs on the open market, or integrate vertically (e.g. a computer company buys a software house; an aluminium processor a bauxite mine), or again have a long-term relationship with producers of inputs (e.g. an automobile company with car component suppliers); develop its production machinery itself (robots made by car companies; plant produced by chemical companies), buy it of the shelf (typical for textile producers), or develop it jointly with a supplier (advanced industrial textiles); procure finance capital on the open market or through an organic link with a holding, house, bank, etc.

Academic studies of international cooperation are full of illustrations of networks between different firms, looking ominously like giant spiderwebs. ⁴ Representations of this kind are often taken as proof of concentration, with the networking company appearing to have acquired vast influence. This is at least in part a misunderstanding, since weak control is a precondition for obtaining the benefits of networking: for these benefits depend on independent market responses by the constituent parts.

What does this view of an emerging new industrial organisation tell us about the value of cooperation - and hence the cost of obstacles?

Clearly, business cooperation, and by extension TBA, emerges as the single most important "institutional" instrument, without which the new dynamic flexibility made possible by "networking"

remains limited to intra-firm reforms. The economic loss to the firm for being deprived of the cooperation option in its strategic mix is not adequately circumscribed with the term efficiency.

Flexibility is not only a low-cost, low-risk option, but may be an indispensable precondition for staying in the market at all: for gaining speedy access to technology, information, and know-how; for the speed of reacting to change; for a competitive presence in ever more specialised markets and market segments.

One of the consequences may be the demise of the classic multinational. As Olivetti's de Benedetti puts it

"le concept de multinationale est dépassé. Le succès ne peut aujourd'hui être atteint que par des alliances qui vous donnent simultanément accès en toute part du marché global."⁵

To sum up this general point: Cooperation between fairly autonomous, geographically and functionally specialised economic units in "networks", provides a combination of strategic control and flexibility, and hence efficient short-term market responsiveness which is becoming the essence of modern business organisation. As an alternative to both centralised management and arms-length trade, it is an instrument for coping with two features of the contemporary economy: the globalisation of markets; and the speed of technological change.

Both lead to information overload. Thus it may become difficult for central management to know what technology is available at the production and product level in each of its hundreds of specialities; and where to sell "surplus" technology which is generated internally.

The information problem caused by technological and geographic (market) complexity is directly reflected in another cost, i.e. transaction costs. Although networking, even among equity linked firms, always involves negotiation on prices and specifications, these can be routinised in long-standing relationships with built-in elements of mutual trust. In this latter context one sometimes speaks of the "hostage function" of minority share-holdings.

Another, frequently observed, pattern is for two large firms to pool risks, and achieve economies of scale by developing or producing a component or other input, or sharing a service such as marketing. This form is often referred to as "strategic alliances". While it may have more than its share of anti-competitive dangers, it does provide a highly capital-saving way for firms to achieve world-competitive technology and scale; and to extend their market presence geographically so as to reap general economies of scale.

Last but not least, given the known hesitations of companies to engage in arms-length technology transfer (patent sales; licensing) which would compromise monopoly rents, cooperation - which allows such transfers (often on a barter basis) - tends to increase the diffusion of technology.

Quid of European-wide cooperation? External networking is particularly important in cases where

- * central management lacks the information for dealing with all productive assets directly;

- * would otherwise be discouraged by the risks (uncertainty) of a full-scale presence to go beyond arms-length market relationships, but

* needs to have the security, and minimal control required for a long-term and effective presence in a "market" which it cannot achieve through arms length ad hocery.

While these remarks are valid for any international "presence", they are particularly relevant for Europe.

For one thing, the "information" needed to operate in Europe is particularly costly to acquire relative to the pay-off for each individual country, especially as regards the smaller ones. The same "investment" in learning to cope with a "foreign" business environment made for the US yields a much larger pay-off in terms of market access for both sales and acquisition (technology). Moreover, the technology "gradient" tends to be larger when cooperating with both Japan and the United States, creating larger incentives to overcome the threshold of heavy front-loaded entry costs. From an economic point of view, however, the sum of the literally tens of thousands of more marginal technological improvements which are available, but remain unused, within the European market, may be as decisive for competitiveness as the publicised hi-tech deficiencies in selected areas of micro-electronics etc. remedied by transatlantic or pacific TBA. Yet given the lower technology gradient in Europe, even small obstacles to TBA may discourage companies from diversifying sources of, and markets for, their technology.

At the same time, given the globalisation of competition, meeting that competition successfully on the most favourable ground, the European home market, is a precondition for success. This familiar argument - for a trading market - is doubly valid for transborder business cooperation in Europe: networking can add the element of flexibility and accurate market response on which dynamic competitiveness depends.

The micro-level effects of network-type TBA are linked to specific macro effects. Information cost reduction and risk reduction combine to increase potential investment opportunities, hence raise total investment in the economy. This, at least, would be the conclusion of applying Schumpeterian growth theory, with its stress on opportunities for new products and/or new production technology as the true long-term motor of growth to our analysis of the benefits of networking.

More narrowly, capital saving increases the overall productivity of capital. Capital saving, we saw, results from several properties of networking-type TBA. On one level, it results from the de-coupling of "dedicated" input-output relations on the chain of value-added: peaks and troughs of demand and supply can be evened out by recourse to alternative markets and suppliers. Networking can also save heavy front-loaded capital investment associated with developing a new technology or product from scratch; or to expand into a hitherto unfamiliar market. These cost-saving properties again translate into a behavioral, Schumpeterian variable, i.e. innovative behavior, since cost reduction equals risk reduction, making otherwise marginal opportunities more attractive.

2. Business expansion

While virtually all larger businesses today engage in some form of networking, the creation of an integrated European economy also requires more robust forms of TBA. These involve the extension of direct control from the management in the firm in one country over productive resources in another.

The wholly-owned subsidiary, whether greenfield or the result of a take-over, is the typical instrument of expansion. Mergers are either a polite circumlocution of the same thing; or, more rarely, involve a genuine centralisation of two centers of control.

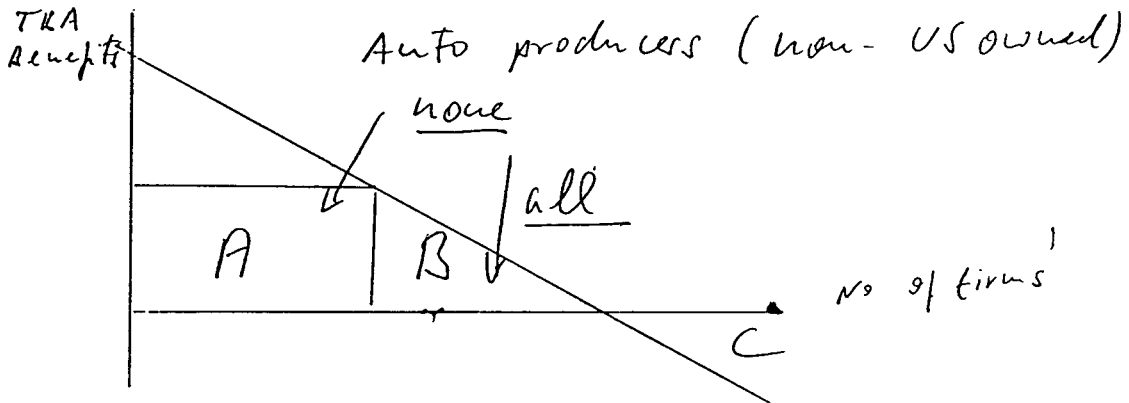
Business expansion is economically beneficial if it asserts competitive advantages of a firm more quickly and more effectively than is possible by trade alone. These competitive advantages may lie in technology and/or production know-how; management know-how; marketing skills, etc.

In theory trade, i.e. exports by firms having such advantages, will also serve to deplace inefficient competitors, with the winner reaping the economies of scale of the large market. In practice, however, this process is slow, with the eventual losers staying in the market while running down their financial and technological assets. More importantly, adjustment may be inhibited by countervailing national subsidies and other forms of local protection.

This points to the single most important task of transborder "business expansion" for the completion of the Internal Market: the rationalisation of industry. Overcapacity is a typical feature of too much of European industry. It exists both in mature industries whose adjustment is delayed by national policies; and, occasionally, in high-tech industries fostered by other national policies. Equally, the two ills of Europe's R&D effort: duplication of national programmes; and preferential national procurement, will not disappear with legislation, but only when the nationality of the firms themselves will be sufficiently confused to make nonsense of national preference. No one in Europe can buy a national Airbus.

The difference between networking and business expansion is illustrated by the automobile industry. All manufacturers and component suppliers are cooperating; i.e. they are situated in the upper triangle of figure 3. Partial economies of scale in R&D and manufacture (e.g. engines) are achieved. But virtually all are in the lower triangle as regards business expansion. Rationalisation has taken place within the national context.

Figure 3



In practice, "networking" and expansion are often present simultaneously in business links, with the relative emphasis on de-centralisation and control shifting according to the strategic necessities of a technology (maturity) and a market. Note that the nature of the equity link between two units is not the criterion for judging whether we are observing "networking" or "expansion". In the former case, equity serves a "hostage" function to re-assure both partners that contracts are carried out faithfully; and stable over the medium term. It also increases their overall level of information about the partner. In "expansion", on the other hand, the potential for equity to exercise full control are being used.

To sum up, transborder business activity is a pre-condition for the functioning of a modern exchange economy. Its relationship to the overall 1992 project is therefore one of an accelerator

or inhibitor of the positive effects, both static and dynamic, expected from trade and services liberalisation in general. As such it is a parameter to be put before the entire welfare function established for the 1992 project.

In turn, the likelihood of TBA increasing beyond present levels not only depends on the realisation of the White Paper's targets for company law, but on advances in the liberalisation and de-regulation of trade and services.

Some readers of earlier drafts of this study have interpreted its results as proving the socially regressive nature of easier TBA in Europe. Rationalisation, an obvious primary effect of TBA, means increased unemployment; moreover firms will grow bigger and more powerful within a relatively weak context of socio-political control. Both fears are to some extent justified. But resource saving - including labour - is at the heart of the economic "welfare" benefits of any liberalisation, including trade itself. One cannot be in favour of the trade-liberalisation part of the Internal Market agenda without welcoming TBA which is, as we argued, an institutional precondition for the effectiveness of market integration.

Moreover, much of the rationalisation effect concerns deadweight administrative costs, and the R&D sector of firms, binding highly skilled (and high-cost) resources which could be put to more productive use.

As regards the fears of weak socio-political control (which dominated EEC rule making for business in the 1970s), that control is bound to be stronger, and have a chance to grow, in a European context. The alternative to Euro-wide TBA is not the status-quo, but weak "national" firms linking up with strong non-European partners which can exploit residual national protectionism, including subsidies, in a Europe which remains

economically and technologically balcanised.

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