THE POTENTIAL ECONOMIC EFFECTS OF THE EUROPEAN ECONOMIC COMMUNITY

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Economists have always equivocated in their evaluation of the potential economic effects of the establishment of the European Economic Community (EEC). Beginning in 1950 with simultaneous writings on the subject by Maurice Bye, Herbert Gierch, and Jacob Viner,[1] a body of literature has developed which recognizes that from a world viewpoint as well as from the outlook of the participants, an economic union has potential both for adding to and for lessening economic welfare.

The basic fact about the structure of economic unions that leads to this ambivalence is that tariffs are removed between member countries but are retained between the union and the rest of the world. The result is that while discrimination is eliminated between domestic producers and producers in the other countries in the union, discrimination is created between producers in the member countries and producers outside the union. Production is allocated optimally throughout the world if goods are produced by the lowest cost suppliers.[2] If the lowest cost suppliers are within the economic union, then the formation of the union is advantageous, since these lowest cost suppliers now can sell in other member countries, displacing any producers there who were previously maintained by tariff protection.[3] If, however, the lowest cost producers are outside the union, but were able to sell to some of its members over their tariff barriers before the union was organized, after the formation of the union these lowest cost producers may find themselves displaced by producers within the union whose costs are less than theirs plus the tariff.

Any comparison of costs must allow for decreases in production costs within the union due to its formation. One of the most widely mentioned potential values of an economic community is that it extends the size of the market, and, by so doing, allows for realization of economies of scale. Since the producers in each of the member countries face no higher duties outside the union[4] and lower duties within it, the potential market for their output is larger. This will allow the more

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[1] For a brief description of the contribution of each and full bibliographical references, see Balassa, The Theory of Economic Integration 22 (1961).

[2] Because then it is impossible to shift output among producers without increasing total production costs.

[3] For an elaboration of the various possibilities see Balassa, supra note 1, at 25-26.

[4] This assumes that there is no retaliatory action by those outside the community.

efficient and better financed firms to expand. If they have not already fully realized any economies of scale, their costs will fall. Therefore, the formation of a union can lead to the replacement of an outside producer by a member producer that has become the lowest cost supplier.

In considering whether the formation of the European Economic Community has greater potential for moving trade away from or towards the lowest cost producers, it is useful to look first at three points which have been elaborated by Bela Balassa.[5] The first is the economic size of the union; the second, the transportation costs within the area as compared with those between it and the rest of the world; the third, the original competitive or complementary nature of the economies within the union.

It can be argued that the larger its economic size, the more likely an economic union will promote economic welfare, since the larger the proportion of world production within the union, the greater the likelihood that it will contain the lowest cost producer. An economic union will also tend to be advantageous if transportation costs are low among its members compared to their level in the area's trade with the rest of the world. If this is the case, then the chances are greater that after taking account of transportation costs, the lowest cost supplier is within the union. Pre-union competitiveness of the exports of the several members is also likely to lead to gains because this indicates similarities in composition of output of the several countries and, therefore, greater possibilities that lower cost producers in one country will displace higher cost producers in other Member States.

In terms of each of these three considerations, the European Economic Community would seem to score quite high. First, it is economically large. Its gross national product (GNP) in 1962 was 227 billion dollars.[6] Second, except for Italy its six members are separated by minimum transportation costs, although there are also very low transportation costs between the EEC countries as a group and the non-Member States of Austria, Switzerland and Great Britain. Third, the Six were quite competitive before union and so should provide opportunities for displacement of high cost by low cost producers.[7]

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[5] Balassa, supra note 1, at 29-44.

[6] This compares with the United States GNP in 1962 of $556 billion and a GNP for all the European members of the OECD (which includes the EEC countries) of $379 billion. Organization for Economic Co-operation and Development, General Statistics (Supp., National Accounts) 12, 14, 37 (March 1964).

[7] The former overseas dependencies of the six European countries are also included in the union, however. Their economies were largely complementary to those of the Six with their competitors outside the union. The EEC is expected in a number of cases to discriminate against the lowest cost suppliers in favoring these former dependencies. Balassa, supra note 1, at 33.

Two other important considerations are the height of the original tariff and the height of the external tariff of the union.[8] The higher the original tariffs of the member countries, the greater the potential gain from their elimination. The higher the ultimate tariff imposed by the union, the greater the potential loss because of discrimination between producers within and without the Community. Finally, if the common external tariff is above or below the pre-union tariffs of the Member States, discrimination will be increased or decreased between each country's producers and those outside the union.[9]

However, although the great significance of tariff levels is very apparent, it is extremely difficult to say much about their effect in any particular case. First, there is a problem of measurement. There is not one rate of duty but a large number of duties which must be averaged. Probably the most satisfactory set of weights that could be used in constructing this average are the quantities which would be traded in the absence of any tariff barriers. These quantities, however, are not known. Second, if the averaging problem can be somehow resolved there is still no absolute standard by which to ascertain whether the original tariffs and the common external tariff are high or low.

In the case of the tariff of the European Economic Community for other than agricultural products, it has been shown that under a number of different weighting schemes the common external tariff which will fully come into effect in 1967[10] does not differ greatly from the present United States tariff.[11] This common external tariff is (with some exceptions) the average of the 1957 tariffs of the six member countries. To reach the common level, the French and Italian tariffs will generally have to be lowered and the German and Benelux duties raised. The difficulties of evaluating the height of this tariff is suggested by an argument which has been put forth by Lawrence Krause. He maintains that the German producers are generally those within the Community with the lowest costs, and that since the German duties will rise, the degree of protection against outside producers will increase although the common tariff was set

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8 For a discussion of the significance of the height of tariffs, see Balassa, supra note 1, at 44-49.

9 In the case of a free trade area, such as the European Free Trade Association, this last is not a consideration, since each country maintains its previous tariff on goods from outside the area.

10 The original date for the complete achievement of a common external tariff was January 1, 1970, but now it is expected that the actual date will be July 1, 1967.

11 See Committee for Economic Development, Trade Negotiations for a Better Free World Economy 67-85 (App. B) (May 1964). This was prepared by the CED Research Staff.

at the pre-union average.[12] Despite the difficulties of precise evaluation of the impact of the non-agricultural tariffs, it has nonetheless been quite widely concluded that the common tariff schedule of the EEC is not particularly high and that there are significant indications that the Community is willing to lower it further through trade negotiations.[13] The Community's policy on agricultural protection is, however, another matter.

The member countries of the Community, like the United States, have given special aid to their farmers to support their prices and their incomes. Unlike the United States, however, the Community tends to have high cost producers and to be a net importer of agricultural products. In the Treaty of Rome[14] the member countries agreed to set up a special treatment for agricultural products. Under a subsequent agreement reached in January 1962, it was decided that the duties levied on agricultural goods from outside the area will be variable. They will change sufficiently so that products from outside will cost, inclusive of duty, as much as the support price set for Community farm products plus a small premium.[15] This will guarantee that all of the demand for agricultural products at the floor prices which can be supplied by the Community's producers will be so met. The only market left for producers from outside the area will be for any excess of Community demand over Community supply at the floor price. Should, on the other hand, the Community's farmers supply more than is demanded, the surplus will be sold on world markets at the world price with an export subsidy paid by the Community.

The effect of such a policy hinges, of course, on the height of the floor price. If it is low relative to production costs within the EEC, Community farmers will supply little and much will have to be imported to satisfy demand at the support price. On the other hand, if the price is set high enough, all the demand in the Community will be met by its own producers and there may even be a surplus to be sold abroad. In the Common Market's agricultural support program, the pivotal price is that for wheat. All other prices will be adjusted

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12 Salant et al., The United States Balance of Payments in 1968 101-102 (1963).

13 In both 1962 and 1963 the EEC members moved their tariffs towards the eventual common external tariff as if reductions had been made in this tariff. These EEC moves are conditional on their being reciprocated. For further discussion of this point see Committee for Economic Development, supra note 11, at 25-26.

14 For a useful summary of the provisions of the treaty see Committee for Economic Development, The European Common Market & Its Meaning to the United States 92-113 (May 1959). This was prepared by the CED Research Staff.

15 Committee for Economic Development, supra note 11, at 28-29, explains the variable levy in more detail.

to it. In December 1964, agreement was reached on a wheat price, part way between the higher German and the lower French prices. With the wheat price so set and the other prices established in relation to it, it is expected that the EEC will greatly reduce its imports of temperate zone food products and will eventually have considerable export surpluses in a number of agricultural products.[16]

The potential economic effects of a union like the EEC are, however, considerably more extensive than has been indicated thus far. When the markets for many products have been dominated by a limited number of sellers who have tended to collude, either explicitly through overt agreements or implicitly by recognizing their mutual interdependence, one of the more important results of such a union may be that it increases or decreases the amount of effective competition among the sellers. There are a number of possibilities. The elimination of intra-area trade barriers tends to increase the number of potential competitors and, therefore, to decrease the likelihood of effective collusion. Any increase in external barriers, however, has the opposite effect. With a given technology, the changes in the amount of competition will be associated with changes in the levels of prices and of output. If collusive patterns weaken, output will increase and prices will fall. This will result in an improvement in economic welfare as resources are drawn away from industries where they were being used to produce goods with lower value to the consumer. If competition declines, the allocation of resources will worsen as the monopolistic industries raise prices and contract output.[17]

It cannot be assumed, however, that changes in the degree of competition will leave the level of technology unchanged. Again, there is more than one possibility. Greater competition could retard the rate of technological change if, as it is sometimes argued, high profits are necessary to provide firms with funds to finance the research which leads to technological innovations. On the other hand, in-

[16] Balassa, European Integration: Problems and Issues, Am. Econ. Rev., May 1963, at 181-82.

[17] The assumption made here is that where collusive patterns are stronger, prices and outputs are closer to those which would be chosen by a monopolist. A monopolist, knowing he will have to charge a lower price in order to sell a large quantity, will tend to keep his prices higher and output lower than those which would prevail if competition expanded output and pushed prices down. Because of the restricted output, the marginal unit produced by the monopolist will sell for a price above the marginal cost of producing the goods, while the price of goods sold under conditions of perfect competition will just equal the marginal cost of production. Expansion of output of monopolistic industries and contraction of the output of the more perfectly competitive firms, therefore, results in resources being moved into the production of goods where their value (as measured by the price of the goods they produce) is higher relative to their cost.

creased competition may, by cutting profit margins with any given level of technology, force firms into greater research in search of lower cost methods. It also may compel firms to introduce new methods more rapidly than they would if they had greater market power. The latter may be the most important point. Monopolistic producers may find it advantageous to collude on the rate of innovation as well as on prices and output. The introduction of a new method of production or a new product might be postponed because it would make old machines obsolete. If no one introduces the new technology until the old machines have fully depreciated, all may make higher profits. If, however, one firm in a more competitive market adopts a cost-saving innovation at once, this will force the rest of the producers to follow suit.

In Articles 85 and 86 of the Treaty of Rome the member countries commited themselves (with some reservations) to the elimination of private barriers to freedom of trade. Although the implementation of these articles is still largely in the future and, therefore, their effect is quite uncertain, it is significant that such a policy was agreed to by countries that have previously permitted, encouraged, or required cartelization in a number of industries.[18] Such a policy of opposition to private restraints on competition combined with the lowering of tariff barriers within the market would seem likely to lead to an increase in competition with resultant gains both from lower prices and larger outputs of previously cartelized products and from more rapid rates of innovation.

Finally, we must consider the possibility that the formation of an economic union affects the rate of utilization of the productive capacity of the area as distinct from its effects on the size of that capacity. If without the union the relationship between aggregate demand and aggregate supply is such that the economies of the members tend to operate at less than full capacity, the institution of the union could improve economic welfare if it leads to increases in demand. This could result from increases in investment due to the expansion of markets and the acceleration of technological change. If this should occur, it is possible that the fuller use of capacity could lead to a net increase in welfare even if there are unfavorable effects on welfare due to reallocation of production from lower cost to higher cost producers or because of tighter monopolistic controls over markets.

It can be argued that there were some signs of a slowing down

[18] The fact that this reflects a radical change in policy is discussed in Markham, Competition in the European Common Market, in Factors Affecting the United States Balance of Payments 139 (1962), a compilation of studies prepared for the Subcommittee on International Exchange and Payments of the Joint Economic Committee.

of the growth of economic activity prior to the formation of the EEC and that the reactions of business to its establishment kept such a deceleration of growth from occurring.[19] It is most likely, however, that if private demand had become inadequate to keep these economies at full employment their governments would have acted to maintain aggregate demand. The post-World War II record of these nations indicates that their governments are both willing and able to use monetary and fiscal policies to prevent any substantial underutilization of capacity. It cannot be concluded, therefore, that the net effects on aggregate demand of the formation of EEC are of any great significance.

It is certainly much too soon to draw any very definite conclusions about the ultimate impact of the EEC on the allocation of world resources and the rate of growth of output. The result depends in part on the way the anti-cartel policy is implemented. Even more important is the future course of the negotiations between the EEC and the rest of the world on the lowering of trade barriers. If the "Kennedy Round" of negotiations under the General Agreement on Tariffs and Trade (GATT), which is now under way, should lead to substantially lower tariffs, the amount of discrimination against outsiders would be decreased and the chances that gains will outweigh losses enhanced. But, as United States negotiators have emphasized, the position of the EEC on agricultural duties will be very central to the success of present and future GATT deliberations. If the EEC should persist in maintaining floor prices which will make the area increasingly self-sufficient, then even a very liberal policy on other products may not be adequate to lead to a net liberalization of the tariff barriers. What position the EEC will take in the GATT negotiations must depend in part on the positions taken by the United States, the non-Common Market countries, and the other nations involved, and also upon a complex series of domestic economic and political considerations within each EEC country. But, finally, it will also be importantly influenced by all of the political relationships among the Six. It must always be remembered that the EEC was and is an economic mechanism for achieving a political end.

It should be clear that the results of the GATT negotiations are very important to the trading partners of the EEC. It should not be concluded, however, that their successful completion will eliminate all of the actual or potential difficulties created for other nations by the formation of the Community.

From the viewpoint of the United States, a substantial lowering

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19 Balassa, supra note 16, at 176-77 considers evidence for and against this conclusion. On balance, he tends to accept the proposition.

of the EEC external tariff would be desirable, because it would make it easier for the United States to sell in the European market. As a result, the United States balance of payments would become more favorable on current account. Lowering EEC tariffs would also lessen the advantages to United States firms of going into Europe to set up factories inside its tariff walls. This would mean a smaller outflow of direct investment, a debit item in the balance of payments. However, successful completion of the GATT negotiations might very well tend to strengthen the already considerable dynamism of the European economies and lead to an increase in their rate of innovation of new products and new methods of production. Such innovational activity is a source of unfavorable pressures on the United States balance of payments because American producers face increasing competition from newer and lower cost goods at home, in the EEC, and in other markets. It also tends to increase the attractions of the EEC to American capital. A discussion of the possible methods of dealing with any resulting balance of payments difficulties goes well beyond the scope of this paper. There are, however, basically two alternatives: (1) an increasing dynamism in the American economy so that the United States can maintain its innovational position; (2) devaluation or relative deflation, either of which would entail a decline in America's relative economic position.