OCCASIONAL PAPER
74

# The Impact of the European Community's Internal Market on the EFTA

By Richard K. Abrams, Peter K. Cornelius, Per L. Hedfors, and Gunnar Tersman

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The following symbols have been used throughout this paper:
. . . to indicate that data are not available;
— to indicate that the figure is zero or less than half the final digit shown, or that the item does not exist;
– between years or months (e.g., 1984–85 or January–June) to indicate the years or months covered, including the beginning and ending years or months;
/ between years (e.g., 1985/86) to indicate a crop or fiscal (financial) year.
"Billion" means a thousand million.
Minor discrepancies between constituent figures and totals are due to rounding.



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# Preface

The member states of the European Community (EC) and the European Free Trade Association (EFTA) have a special relationship reflecting a shared history and common values.[1] They are also each other's most important trading partners. For all of the EFTA countries, the EC is of overriding economic importance. Since the EC launched its internal market program, relations between the EC and EFTA have intensified. In order to enable the EFTA countries to participate in the economic aspects of the European integration process, the EFTA and EC are seeking to establish a European Economic Space (EES), providing for the free movement of goods, services, labor, and capital—the "four freedoms." This paper provides an overview of the effects of an EES agreement on the EFTA countries. The emphasis is on the four freedoms. However, issues related to monetary cooperation and tax harmonization are examined as well.

This paper was prepared in the Northern European Division of the European Department. Its authors are Richard K. Abrams, Peter K. Cornelius, Per L. Hedfors, and Gunnar Tersman. Contributions were also received from Tilman Ehrbeck, Sami Geadah, and Thomas H. Mayer. The authors are most grateful for comments received from the EFTA secretariat and several IMF staff. In particular, we would like to thank Jukka Leskela, Steinar Juel, Sven Norberg, and Helmut Spindler of the EFTA secretariat, as well as Krister Andersson, Jagdeep Bhandari, Adalbert Knöbl, Donald Mathieson, Duncan Ripley, and Horst Ungerer, and colleagues from the Exchange and Trade Relations Department and the Western European Division of the European Department. The paper was edited by David M. Cheney of the External Relations Department. The opinions expressed in this paper are those of the authors and do not necessarily reflect the views of the IMF.

[1]Current members of the EC include Belgium, Denmark, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Spain, and the United Kingdom. The EFTA includes Austria, Finland, Iceland, Norway, Sweden, and Switzerland.



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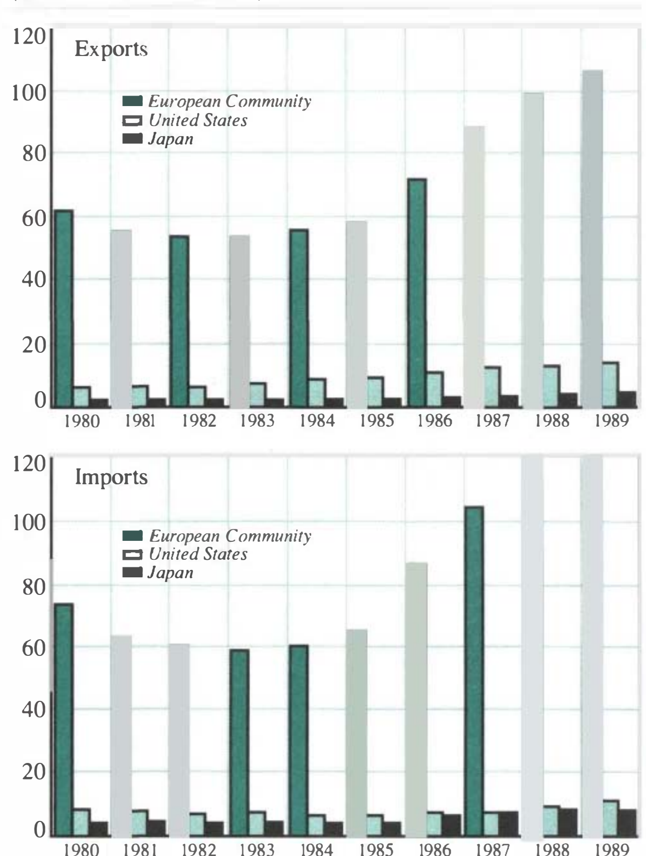
# I Introduction

The member states of the European Community (EC) and the European Free Trade Association (EFTA) have a special relationship based on geographic proximity, a shared history, common values and—as many see it—a shared destiny.[1,2] They are also each other's most important trading partners (Charts 1 and 2). The EC countries account for over 50 percent of the EFTA countries' exports and more than 60 percent of their imports. Indeed, the EFTA countries trade as extensively with the EC countries as the EC countries trade among themselves. On the other hand, the EFTA countries by themselves do not constitute a cohesive area. Intra-EFTA trade is—with the exceptions of trade between Switzerland and Austria and between Finland, Norway, and Sweden—insignificant relative to the trade of individual EFTA countries with the EC.

Despite the small economic size of the EFTA countries—the foreign trade of the EFTA is one sixth that of the EC—together they are the EC's largest trading partner outside the Community. However, the EC is still a far more important trading partner for the EFTA countries than the EFTA countries are for the EC. While EFTA exports account for only 2 percent of domestic demand in the EC, exports from the EC account for more than 15 percent of domestic demand in the EFTA countries.

Although the EC and EFTA have had close relations, the two organizations have different characters. EC members sought from the beginning to move toward a broadly based economic, social, and political union, ceding increased authority and power to their central governing bodies. The EFTA, on the other hand, has remained loosely knit because of its members' desire to preserve their national sovereignty.

**Chart 1. EFTA: Trade with Selected Partners**
(in billions of U.S. dollars)




Source: IMF, *Direction of Trade Statistics*

EC-EFTA relations have evolved rapidly in recent years. A major step was taken in 1984, when ministers of the EC and EFTA agreed that renewed efforts were needed to deal with the changing global economy. The jointly issued "Luxembourg Declaration" envisaged intensified and expanded cooperation between the two organizations, including the creation of a dynamic European Economic Space (EES)—which at the time was left undefined.

[1]The EC member states include Belgium, Denmark, France, Greece, Germany, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Spain, and the United Kingdom, while the EFTA is made up of Austria, Finland, Iceland, Norway, Sweden, and Switzerland. The United Kingdom and Portugal were EFTA members, but they left the EFTA to join the EC in 1973 and 1986, respectively.

[2]The preambles to many statements on relations between the two organizations, including joint declarations, emphasize this commonality; see "EFTA Summit . . ." (1989) and European Community (1989).



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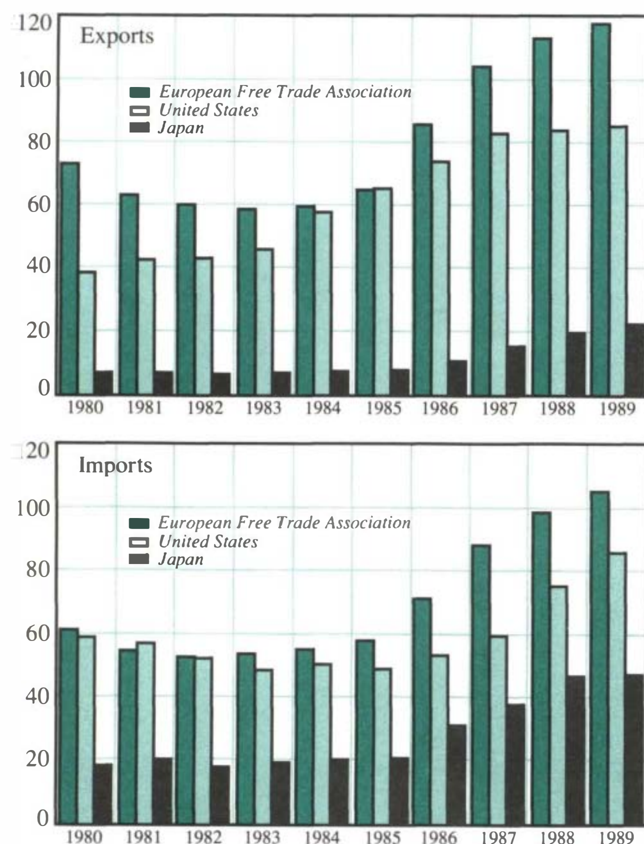
**Chart 2. EC: Trade with Selected Partners**
(in billions of U.S. dollars)




Source: IMF, *Direction of Trade Statistics*

Views toward integration in Western Europe began to crystallize following the EC Commission's publication in 1985 of the White Paper, *Completing the Internal Market*, and the adoption of the Single European Act in 1986 (EC Commission, 1985 and 1986c). The White Paper laid out the full legislative agenda and a timetable for the internal market program, which was to clear the way for the free circulation of goods, services, persons, and capital—the "four freedoms"—within the EC. The Single European Act made the internal market program possible by modifying EC rules in a number of areas, including the replacement of unanimity rules by qualified majority requirements for voting in a number of pivotal areas.[3]

While EFTA members do not appear worried that the internal market program will cause the EC to become more protectionist, they have become increasingly concerned about their competitive position vis-à-vis the EC as the program has advanced and gained momentum.[4,5] Efforts to clarify EC-EFTA relations intensified in 1989. Much of the impetus came from a speech by Jacques Delors, President of the EC Commission, to the European Parliament in January 1989, in which he invited the EFTA to form a more structured relationship with the EC, later known as the Delors Initiative. Not only did the EFTA agree to such talks, but working groups were formed to study cooperation in a number of areas, including the institutional and legal changes needed to permit a more structured relationship—the start of the so-called Oslo-Brussels process. In December 1989, ministers of the EC and EFTA met and agreed to hold negotiations on forming this more structured relationship. Formal negotiations began in June 1990.

## Outline of the Study

This paper provides an overview of the likely impact of the creation of the EC's internal market on the EFTA members. The focus is on the four freedoms and the institutional and legal changes required for increased economic cooperation between the EC and EFTA. Although not formally part of the negotiations, certain tax issues are also raised.

The paper is in ten parts and includes a summary and glossary. The first part discusses the origins of the EC and EFTA and the history of their relationship. It focuses on events since the Luxembourg Declaration, especially since the Delors Initiative. The paper goes on to discuss the institutional and legal changes that may prove necessary for greater EC-EFTA cooperation and the implications of the internal market for trade, production, and resource allocation in the EFTA countries. It examines issues related to trade in goods—mainly industrial goods—and transport services and considers issues of labor mobility and trade in financial services. The paper then examines the potential impact of EC plans for monetary unification on the EFTA countries and the implications of EC efforts at tax harmonization. It ends with a summary

[3]For the definition of qualified majority, see Article 148 of the EEC Treaty.

[4]By the end of 1988, the halfway point to the start of the internal market, the EC Commission had submitted to its Council of Ministers more than half of the 279 legislative proposals envisaged in the White Paper, and the Council had adopted 45 percent of the proposals. By the end of 1989, the Commission had submitted virtually all of its proposals and the Council had adopted almost two thirds of them.

[5]Concerns about the internal market seem to be the primary reason for Austria's application for EC membership in 1989 and the Swedish Parliament's decision in December 1990 to apply for membership in 1991. Serious concerns have been voiced in other EFTA countries as well.



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and set of conclusions. The paper covers the period through mid-1990. However, in some areas, notably monetary unification, it is more current as important changes have taken place since then.



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# II Background

## Origins of the EC and EFTA

The issue of economic and political integration has been on the Western European agenda since the end of World War II (Siegler, 1961). The first step toward forming the European Communities (EC) was taken in 1951, when Belgium, France, Germany, Italy, Luxembourg, and the Netherlands formed the European Coal and Steel Community (ECSC) with a supranational administrative body, the High Authority.[6] In 1955, following the failure of plans to form a European Defense Community and a European Political Union, the same six countries agreed in principle to form a common market, which envisaged the free movement of goods, services, labor, and capital—the "four freedoms." The founding document of the European Economic Community (EEC)—the EEC Treaty, signed in March 1957—embodied a vision for broadly based economic integration going well beyond simple cooperation on trade issues.

Talks on a larger Western European free trade zone—instigated by the United Kingdom—failed in 1958, partly because of British insistence on preferential treatment of its Commonwealth ties and its special relationship with the United States, and partly because the EC Commission in Brussels—as well as several EC member countries—feared an undermining of the EC consolidation process. In reaction, Austria, Denmark, Norway, Portugal, Sweden, Switzerland, and the United Kingdom formed the European Free Trade Association (EFTA) in January 1960. Finland joined in 1961, and Iceland in 1970.[7]

## Free Trade Agreements of 1972–73

From the outset the EC was more cohesive than the EFTA.[8] The EFTA countries tried to bridge the opening gap between the two blocs. However, it did not take long before the EFTA countries realized that they needed to forge closer links with the Community. As early as 1961, the United Kingdom, Denmark, Norway, and Sweden applied bilaterally to the EC, either for association or membership. However, the political climate in Western Europe and setbacks in the EC's internal integration delayed new accessions to the EC in the 1970s. Negotiations between four countries—Denmark, Ireland, Norway, and the United Kingdom—and the EC began in June 1970 and resulted in Danish, British, and Irish membership in 1973. Denmark and the United Kingdom left the EFTA concurrently. Norway elected not to join following a national referendum on membership.

The remaining EFTA members, including Norway, concluded parallel bilateral Free Trade Agreements (FTAs) with the EC in 1972–73. In the FTAs, the EC and each EFTA member bilaterally agreed on a timetable to abolish tariffs on most industrial goods in five cuts of 20 percent by the end of 1977. For some sensitive products, such as paper and steel, temporary quotas remained and tariff removal was delayed until 1984. Special declarations covered certain goods such as Swiss watches, Austrian cheese, and Icelandic fish. Joint committees were also set up to monitor trade relations.

To help solve problems caused by differing trade policies regarding third countries, a system of rules of origin was developed. The initial bilateral provisions of

[6] The European Communities of today comprise the European Coal and Steel Community (ECSC), the European Economic Community (EEC), and the European Atomic Energy Community (EURATOM). For a review of EC institutions, see Noel (1988).

[7] Finland became an associate member of the EFTA in 1961. The agreement gave Finland essentially the same rights and obligations as other EFTA members. Finland became a full member in 1986.

[8] Bilateral trade flows hint that political rather than economic considerations governed many countries' decisions on which organization to join. Wijkman (1988) presents data on trade flows between EFTA and EC countries that show that Germany was a major market for all EFTA countries, while some EFTA countries, for example, Sweden and Switzerland, were more important for Germany than some of its fellow EC members. Trade between the Nordic and Alpine members of the EFTA was minimal.



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the FTAs treated the EC as one country and did not allow for cumulation of processing by EFTA members.

The Free Trade Agreements of 1972–73 helped to integrate the Western European market for industrial goods. For the EFTA countries, the FTAs still provide the legal framework for more than half of their foreign trade.

## Luxembourg Declaration and Its Initial Follow-Up

In April 1984, ministers from all 18 members of the EC and EFTA agreed on a second generation of EC-EFTA initiatives in the so-called Luxembourg Declaration (EFTA, 1987a, pp. 106–11 and 159–61). Faced with a changing global economy, Western European countries saw a need for increased cooperation, including the creation of a "dynamic European Economic Space" (EES). The accord focused on three issues. First, it supported continued efforts to combat protectionism and encourage free trade in Western Europe. Second, it stressed continued pragmatic and flexible cooperation beyond the framework of the FTAs, including joint research and development projects. Third, it encouraged increased consultations and exchanges of information to help find equitable solutions between trading partners and to foster an open and multilateral trading system.

In September 1984, the High Level Contact Group, representing the member countries of the EFTA and the EC Commission, began holding semiannual meetings to monitor progress toward implementing the Luxembourg Declaration. At its first meeting, it agreed that major areas of focus should be on EC-EFTA cooperation in eliminating technical barriers to trade, particularly in the areas of technical regulations and in simplifying rules of origin and border formalities.

In May 1985, the EC Commission reconfirmed its commitment to the Declaration and set four criteria for further cooperation (EC Commission, 1986b, p. 1). First, the EC's independent powers of decision were not to be affected. Second, eliminating technical barriers to trade and simplifying administrative formalities at EC-EFTA frontiers would be pursued in parallel with the progressive integration of the EC's internal market. Third, no field was to be excluded a priori. Fourth, to discourage a pick-and-choose policy, the EES could only be achieved if the costs and benefits were shared fairly, requiring real reciprocity among the partners.

## White Paper and the Single European Act

A turning point came when the EC Commission issued the White Paper, *Completing the Internal Market*, in 1985 (EC Commission, 1985). The White Paper was a comprehensive document that laid out a step-by-step plan to create an integrated, coherent economic framework for all of the EC by January 1, 1993. The plan contained some 300 legislative proposals—later cut to 279—designed to eliminate all man-made physical, technical, and fiscal barriers that could hinder the free functioning of a single market in the EC. The program was also seen as requiring a harmonization of laws needed for the functioning of a common market. The White Paper also set a timetable, calling for some actions to be taken as early as 1985. However, in 1987 the Commission moved up the timetable for drafting proposals, with the goal of drafting all proposals by the end of 1988 to allow four years for their adoption and implementation.

The internal market program required certain amendments to the EEC Treaty. These were set out in the Single European Act, signed by the 12 EC governments in 1986, with effect from July 1987 (EC Commission, 1986c). The most important change was replacing the requirement that decisions be reached unanimously with one allowing decisions to be made with a qualified majority in all areas regarding the internal market with the exception of fiscal provisions, provisions relating to the free movement of persons, and the rights and interests of employed persons. It also enhanced the role of the European Parliament in the decision-making process and made foreign policy cooperation a formal part of the EC's activities. The Act was seen as important because it provided the political impetus and the legal framework needed to achieve a truly unified market by 1992.

## EFTA's Response to the White Paper

While the need for joint cooperation was increased by the adoption of the White Paper, progress was initially slow. The first step was taken in 1986 when the EC Council of Ministers encouraged the EFTA to take concurrent measures aimed at creating the EES. In response, EFTA ministers stressed the need for parallelism with the internal market program and joint cooperation. Since then, semiannual meetings between representatives of the EC Commission and EFTA member states have identified some 20 potential areas of cooperation. The High Level Contact Group also set up working groups to transform these statements into actions. Prior to 1989, the EFTA agreed to the joint use of the EC's unified custom documents (the "Single Administrative Document"), and the EC agreed that cumulation rules for EFTA products would include all inputs by EFTA members from January 1989. Cooperation to harmonize standards has also advanced



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through the European standardization bodies, particularly in information technology and data processing.

Although progress was made, the EFTA countries were divided in their negotiation strategy with the EC. While aware of the potential gains from negotiating as a bloc, they were not formally committed to this path. Individual members sought bilateral talks in areas they saw as either especially important to them or as likely to yield concessions from the EC. For example, Iceland sought bilateral talks on fishing rights and trade in fish, and Switzerland on financial services, labor mobility, and road transport.

## Recent Developments

Cooperative efforts between the EC and EFTA accelerated following a speech to the European Parliament by EC Commission President Delors on January 17, 1989. In his speech, Mr. Delors said that progress in the pragmatic, step-by-step cooperative process that had begun with the Luxembourg Declaration had become increasingly difficult. He saw two options for future relations. Either the present pattern of bilateral relations could continue, with the aim of creating a free trade area encompassing the Community and EFTA, or the two blocs could strive for ". . . a new, more structured partnership with common decision-making and administrative institutions to make our activities more effective and to highlight the political dimension of our cooperation in the economic, social, financial and cultural spheres" (Delors, 1989).

In pushing for a more structured relationship—the Delors Initiative—he said that if the EFTA strengthened its institutional structure, "the framework for cooperation would rest on the pillars of our organizations." He voiced doubts about whether the EFTA countries could continue their pick-and-choose strategy, adopting only EC rules that suited them. While EFTA members were attracted by the EC's large unified market, the internal market was to be more than this. It was an economic and social area on its way to becoming a political union, requiring greater cooperation on foreign policy and security.

EC-EFTA cooperation was the main topic of the meeting of EFTA heads of state in March 1989. At the meeting they reaffirmed their commitment to the EES and voiced support for the Delors Initiative ("EFTA Summit . . .," 1989). They proposed a two-track approach to future talks, with the follow-up to the Luxembourg Declaration focusing on specific topics and an examination of forms of cooperation to achieve a more structured relationship. This showed that the EFTA could agree on a political platform going beyond the lowest common denominator and that the ambition of EFTA governments was greater than earlier believed ("Editorial—Two Tracks . . .," 1989).[9] Soon after, at an EC-EFTA ministerial meeting in Brussels, further support was given to this new cooperative process—called the Oslo-Brussels process—when most EC ministers also confirmed their support of the Delors Initiative.

In April, a joint High Level Steering Group was set up and working groups formed to examine the potential for cooperation in five areas: free trade in goods; free trade in services and capital movements; free movement of labor; joint cooperative projects; and institutional and legal changes. While the first four groups examined issues relating to the White Paper, the fifth explored institutional and legal changes needed to secure broader, institutionalized cooperation. In these working groups, common positions were achieved by consensus, not by vote.

The High Level Steering Group met in October 1989 to discuss the findings of the working groups and to decide whether to propose formal negotiations on intensified cooperation. While details were not disclosed, the meeting was considered a success. However, the EC restated its unwillingness to allow changes that would interfere with its autonomous decision-making process. EFTA members, while expressing a wish to participate in the four freedoms, also wanted to remain independent from the EC and to retain autonomy in their relations with third countries. The EC and EFTA were not aiming at a Common Agricultural Policy (CAP) and did not favor the removal of borders between the blocs, as was envisaged within the EC.

At their meeting in December, EC and EFTA ministers decided to start negotiations on expanded cooperation in the first half of 1990, with the aim of concluding them as rapidly as possible. In their statement, they noted a convergence of views on determining the scope and content of a renewed framework for EC-EFTA relations. Three objectives were cited:

(1) to achieve free movement of goods, services, capital and persons on the basis of the relevant *acquis communautaire*, to be identified jointly; exceptions, justified by considerations of fundamental interests, as well as transitional arrangements, could be matters of negotiation; equal conditions of competition should be ensured;

(2) to strengthen and to broaden cooperation in the context of the Community's actions in other areas, such as research and development, the

[9] It has been argued that the primary considerations holding the EFTA together are that its members were not EC members and have similar FTAs. The statement appeared to show that the group was now united with a common purpose.



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environment, education, working conditions and social welfare, consumer protection, programs for small and medium-sized enterprises and tourism; and

(3) to reduce economic and social disparities between their regions (“EC and EFTA . . .,” 1989).

While ensuring the decision-making autonomy of the two blocs, EC and EFTA ministers agreed that efforts would be made to facilitate a consensus on decisions relating to the EES. They also agreed that steps be taken to permit “appropriate formulae to ensure the direct effect of common legislation, surveillance of its implementation as well as judicial monitoring.” The ministers envisaged the full implementation of the four freedoms, with only limited scope for exemptions, and a broadening of EC-EFTA relations, possibly including significant legal and institutional actions that could require changes in the relationship between the two blocs and in the structure of the EFTA.[10]

[10]In his address to the European Parliament in January 1990, Mr. Delors noted that major problems remained concerning the decision-making process. While the EFTA's interests needed to be taken into account, it would have to be by “osmosis” for major Community decisions; decision making could only be shared with EC members. Therefore, “a delicate balance will need to be struck” (Delors, 1990, p. 13).

While EFTA members favored a rapid conclusion of the discussions—ideally by the end of 1990—EC representatives noted that the discussions should be concluded early enough to allow the agreement to become effective on January 1, 1993.[11] Under the circumstances, the latter date would seem more likely, since EC-EFTA agreements cannot be concluded in many important areas before the EC formulates its own position.

Formal negotiations began in June 1990. At present, there appear to be three key problem areas:

(1) the extent to which the EFTA will be allowed to participate in decision making for laws and regulations governing the EES;

(2) the degree to which the EFTA must strengthen its institutional structures as part of the EES; and

(3) the extent to which EFTA countries will be granted exemptions—permanent or temporary—from implementing EC laws in the areas covered by the EES agreement.

[11]In January 1990, it was agreed that the EFTA's Council of Ministers should meet more often to help assure that the EFTA presented a united front in its negotiations with the EC.



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# III Institutional and Legal Issues

A number of institutional and legal issues arise as a result of efforts toward intensified EC-EFTA cooperation. There is a need for increased mutual recognition in civil law, particularly with regard to commercial judgments, and the institutional changes that may be required as part of the creation of the EES. Other relevant issues include corporate law and industrial and intellectual property.

## Mutual Recognition under Civil Law and Institutional Issues

As talks between the EC and EFTA progressed, it became clear that closer ties would require an extension of cooperation into the legal sphere. Most members of the EC and EFTA support the concept of mutual recognition in the areas of civil and commercial law. However, currently many countries neither recognize nor enforce the judgments of foreign courts unless required to do so under an existing agreement. Within the EFTA, there are agreements on the recognition and enforcement of civil judgments covering the Nordic members and Austria, while the EC's 1968 Brussels Convention allows for reciprocal recognition and enforcement of court decisions in civil and commercial law, as well as for the enforcement of a court judgment in another member state. In September 1988, an accord designed to parallel the Brussels Convention was presented to the EC and EFTA countries in Lugano, Switzerland. However, at the time, only 10 of the 18 delegations were empowered to sign.

Talks on legal cooperation were raised to a new level by the Delors Initiative and the Oslo-Brussels process. In December 1989, ministers of the EFTA and EC member states agreed that negotiations should permit surveillance of the implementation of agreed measures and regulations, as well as judicial monitoring and enforcement. This, in turn, appeared to require changes that would involve at least some form of common decision-making and administrative institutions.

Allowing judicial monitoring and enforcement of joint agreements, as well as creating common decision-making institutions, would require changes both within the EFTA and in EC-EFTA relations. Some of these changes could prove difficult to implement. At present, the EFTA has no supranational power over its members. Decisions are by consensus and the EFTA has only limited facilities for monitoring its membership and no coercive powers. Institutions with these powers may be needed to enhance cooperation both within the EFTA and between the EC and EFTA. In fact, the EC is insisting that the creation of such institutions is a precondition for the successful conclusion of the EES negotiations. However, EFTA members will probably seek to minimize the powers of any such institutions to preserve the greatest possible degree of national sovereignty.

Perhaps the most difficult issue in EES negotiations involves EFTA participation in the legislative process on issues relating to the EES. Although it will allow the EFTA countries to express their views on legislative issues, the EC will not compromise its control over its legislative process.[12] EFTA members, on the other hand, are insisting on a "genuine" joint decision-making mechanism on issues relating to the EES. The EFTA countries may accept a junior status, if they are permitted to present proposals and if they are assured that attempts will be made to reach a consensus on decisions affecting the EFTA before the EC votes on the issue. However, in general, it appears that the laws of the EES will be based on EC legislation, with the EFTA countries incorporating this legislation into their own laws. The number and type of exceptions, and whether they will be temporary or permanent, provide

[12]The EC has long held firm on its unwillingness to compromise its own sovereignty. In January 1990, Mr. Delors, in a speech to the European Parliament, said that in EC-EFTA negotiations "the crux of the current debate is on the decision-making process. There will have to be some sort of osmosis between the Community and EFTA to ensure that the EFTA's interests are taken into account in major Community decisions. But this process must stop short of joint decision making, which would imply Community membership...a delicate balance will have to be struck during the negotiations" (Delors, 1990, p. 13).



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the basis for special negotiations that started in the second half of 1990.[13]

The EC may also not wish to give up full control over judicial oversight and enforcement of judgments. On the other hand, the EFTA countries may be unwilling to give the EC full power over inter-bloc disputes. They may insist that such disputes be settled by a new judicial institution, which would presumably be an expanded version of the EC's Court of Justice.[14] However, a compromise seems possible, if, as noted, such a court bases its decisions on EC legislation, rulings, and principles of law.

These areas are being examined as part of the Oslo-Brussels process, but so far there is no final solution. If key decisions are to be made jointly, some form of joint Council of Ministers would help to advance those decisions. However, it is not likely that such a group would be given any direct power over the EC legislative process.

## Corporate Law

EC laws on company establishment and merger policy are of vital interest to EFTA members. However, while talks within the EC have centered on details of trans-Community corporations and limits on intra-Community mergers, EFTA members are more concerned about being "able to conduct mergers, acquire subsidiaries and establish business throughout the European Economic Space on an equal footing with companies in the EC countries" (Council of State, Report to Parliament . . ., 1989, p. 38). While EC member states must allow citizens and firms of other member states the same rights and privileges to engage in business activities as their own citizens, rules differ regarding third countries. Most members permit companies of third countries to establish economic enterprises and acquire domestic firms in most sectors. However, France, Greece, Ireland, Portugal, and Spain require official approval. Thus, a key issue is whether the EC will apply uniform rules to all third countries and, if so, whether these will be based on reciprocity.

The outcome for third countries is not yet clear. While a number of directives have been passed, many important issues remain unresolved. The focus will probably not shift to third countries until most internal issues have been settled. Few predict a protectionist outcome. However, there have been calls for fair or similar treatment as a means of ensuring nondiscrimination. A major agreement on merger policy in December 1989 did not have a reciprocity clause, but it did permit the Commission to negotiate with third countries that discriminate against EC firms in takeovers or mergers.[15] In March 1989, an EC-EFTA experts meeting was held to discuss EC directives that had been passed. The EFTA representatives examined how the directives differed from the EFTA countries' company law, and they planned a meeting to define the areas requiring further cooperation. Further discussions were presumably held by joint working groups under the Oslo-Brussels process, although their findings remain confidential.

One potential problem area concerns regulations governing foreign ownership of domestic firms. In the EC, these rules are currently set by individual member states and are highly variable. However, the EC plans to harmonize this legislation. This could put several EFTA members in a difficult situation. At present, all EFTA members except Austria limit foreign ownership of private, nonfinancial joint stock companies to keep strategic industries—or all industries—under domestic control. The Nordic EFTA members have laws limiting both foreign ownership of domestic firms and the creation of joint stock companies by foreign firms with special permission required for exemptions. Swiss firms, while not subject to legal limits, have a gentlemen's agreement on the sale of registered stock in domestic firms to foreigners, and until late 1988, none was sold.[16]

EFTA members are aware that the price for equal treatment within the EC will be reciprocity, including liberalizing and harmonizing rules on foreign investment. This may partly explain why some EFTA members have eased their rules on foreign ownership. In 1987, Finland raised its limit on foreign ownership of domestic corporations from 20 percent to 40 percent, while in 1989 Norway raised its limit from 20 percent to 33 1/3 percent. Sweden is preparing similar

[13]Negotiations about these exemptions have proven difficult. The EC Commission seems to have taken the position that the EFTA is requesting too many exceptions, while the EFTA has emphasized the brevity of the list. Factions within the EC—including the Foreign Affairs Committee of the EC Parliament—have argued that no exceptions should be granted, even temporarily.

[14]Some prescreening system would also be needed to avoid the awkward situation in which the broader court could be asked to overrule a decision by the EC's Court of Justice.

[15]The regulation, approved after 16 years of negotiations, with limited exceptions, gave the Commission sole power to block or permit mergers involving companies with combined turnover of over 5.0 billion European currency units (ECUs), of which ECU 250 million of each company was within the EC. Smaller mergers remained under the jurisdiction of national authorities. Certain revisions suggested by the European Parliament will need to be considered before the regulation takes effect.

[16]Until recently, only bearer stock, which usually has reduced voting power, was sold to foreigners. Between November 1988 and June 1989, four Swiss firms began to permit foreigners to hold registered shares.



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legislation. The Finnish Parliament has set up a committee to study the further liberalization of foreign ownership rules. However, new legislation is not likely to be enacted before 1992.

There is also much interest in the trans-EC corporations that are being developed: the European Economic Interest Grouping (EEIG) and the European Company. EEIGs were introduced in July 1989 to expedite joint ventures between Community members. They are partnerships whose legal form depends on the contract among its participants. Such partnerships have no capital requirements and the liability of the partners is unlimited. EEIGs may not employ over 500 persons and must have participants from more than one member state, although a subsidiary of a multinational firm would fulfill this requirement. All profits must be transferred to its owners. Once registered in a member state, an EEIG may operate throughout the EC without further registration requirements. Permitting participation by subsidiaries of multinational firms largely precludes discrimination against third countries.

Proposals regarding European Companies were put forward in July 1989. Such entities are EC-chartered, limited-liability, joint-stock companies, headquartered in a member state, with capital exceeding ECU 100,000. While not receiving preferential treatment under national law, European Companies are to be free of many of the constraints of functioning within 12 distinct national legal systems by dint of their EC charter. Rules governing foreign participation are to be developed. However, should EES discussions be sufficiently successful to include competition policy, this legislation, as well as the EEIG, may also cover EFTA members.

## Industrial and Intellectual Property Rights

Industrial and intellectual property rights cover a range of issues including counterfeiting, trademarks, copyrights, and patents. Both within the EC and between the EC and the EFTA, progress has been slow in most of these areas. However, progress is being made on counterfeiting. In January 1988, legislation was enacted preventing imports of copies of items with valid EC trademarks. In June 1988, EFTA ministers agreed to consider similar national legislation and the preparatory work has begun. In April 1989, EFTA and EC experts discussed a draft of a multilateral accord prepared by the EFTA and laid out a range of possible alternatives.

Progress also appears to be taking place in trademark legislation. After more than ten years of talks, the first directive was passed by the Council in December 1988. Its aim was to harmonize the essential points of trademark laws of the member states. In April 1989, EFTA and EC experts met on this topic. Apparently, the talks focused on modifying the multilateral Madrid Agreement on trademarks—to encourage the Nordic countries to sign—and on making the EC directive compatible with the revised agreement.[17]

Progress on copyright legislation has been slower. The EC issued a preliminary draft of a uniform set of regulations in 1988. However, the area is complex and finalizing the directive will take time. The Commission has sought feedback from the members of both the EC and EFTA. An EFTA expert group has forwarded its reactions. Harmonizing legislation on copyrights is also a priority within the Nordic group, which cooperated in drafting national legislation in this area. In 1984, an EFTA ad hoc group informed the Commission of its support of the principle of harmonized legislation. However, joint progress will probably have to await the outcome of EC discussions.

The EC is deadlocked on patent legislation. A Community Patent Convention (CPC) was agreed on in 1975 and ratified by seven member states. However, implementation required unanimity and several members were slow to agree while Denmark and Ireland were constitutionally barred from signing. In December 1989, nine members agreed to a revised CPC, while a tenth gave conditional approval, but Denmark and Ireland could still not sign.[18] The CPC may be revised to allow only signatories to use the patent. Four EFTA members have ratified the 1977 European Patent Convention, which is similar to EC legislation. Norway signed the agreement but did not ratify it, while Finland, the only EFTA member not to sign, has harmonized its legislation with the convention. EC-EFTA talks must probably await a unified EC position.

Should the Oslo-Brussels process succeed, talks in all of the above areas could come under it. Otherwise, they will likely be handled on a case-by-case basis, generally involving either bilateral or inter-bloc talks. However, in some cases, for example, the Nordic group in copyright legislation, subgroups of EFTA members could become involved.

[17]Twenty-eight countries, including most EC countries and Austria and Switzerland, have signed the Madrid Agreement.

[18]Passage may be academic, since the costs of registering patents under this convention are expected to be high, perhaps prohibitively so.



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# IV Effects of Integration

The EC internal market program has potential effects on the allocation of resources not only within the EC but also in countries with close ties to the Community, such as the EFTA countries. Increased integration in the EC is widely expected to stimulate the EC economies and to contribute to a better use of their resources. For the EFTA countries, the principal issue is whether participation in the EC integration process—assuming that the EC would agree—would yield substantive economic gains; and whether the decision not to join would entail substantive losses.

The implications for the EFTA countries will depend on both the form of the internal market and the future relations between the EC and EFTA countries. Although many institutional arrangements may be possible, it is convenient for analytical purposes to concentrate on two highly stylized cases: a nonintegration case, in which the EFTA countries do not integrate further with the EC; and an integration case, where EFTA members fully participate in the economic dimension of EC integration (which does not necessarily imply that they must become full Community members). Arrangements in between, which appear most likely, may be viewed as a combination of these two cases.

## Structure of EFTA Foreign Trade

The EC has long been the EFTA countries' most important trading partner (Chart 3). This is particularly true of Austria and Switzerland, which traditionally have been more closely linked to the EC core than the Nordic EFTA countries. Among the Nordic countries, Finland still trades relatively little with the EC, a reflection of traditionally extensive commercial relations with the U.S.S.R. and Sweden. Norway is the only country whose trade with the EC has generally decreased in recent years. However, in relative terms, it still exports more to the EC than any other EFTA country. In both Iceland and Sweden—the smallest and largest exporters, respectively, within the EFTA—the Community accounts for more than half of both exports and imports.

The trade of the EFTA countries is heavily concentrated in manufactures, which account for over four fifths of total EFTA exports (Table 1). Reflecting the dominant role of industrial products, EFTA trade is of the intra-industry rather than the inter-industry type. There are, however, important differences within the group of EFTA countries. Iceland and Norway are highly dependent on primary products. While the bulk of Iceland's exports consist of fish products, Norway is a major exporter of crude oil and natural gas. Although these are the most obvious cases of inter-industry specialization, there are other examples as well. Largely because of the availability of low-cost hydroelectric power, a significant part of Norway's non-oil exports consists of such energy-intensive products as aluminum. Similarly, reflecting an abundance of raw materials, Finland and Sweden are large exporters of forestry products, which account for a considerable portion of exports. However, with the exceptions of Iceland and Norway, the EFTA countries are essentially exporters of differentiated industrial products. In this respect, they are similar to the most advanced EC countries.

## Nature of Remaining Barriers in Western Europe

European markets appear to remain fragmented despite the fact that trade in manufactures within the EC and EFTA is free from all tariffs and quantitative restrictions. The existence of large price differences for most commodities among national markets clearly supports this view (Wieser, 1989). Judging from these price differences, in general, the original six EC countries appear to constitute the most integrated area in Western Europe (Table 2). The degree of price dispersion is higher when Denmark, Ireland, and the United Kingdom are included. As perhaps can be expected, the area that includes all the current EC members and the EFTA countries appears to have achieved a much lower degree of integration than the six original EC members. The Nordic EFTA members stand out as the high-cost countries of Europe (Table 3). Of course, this



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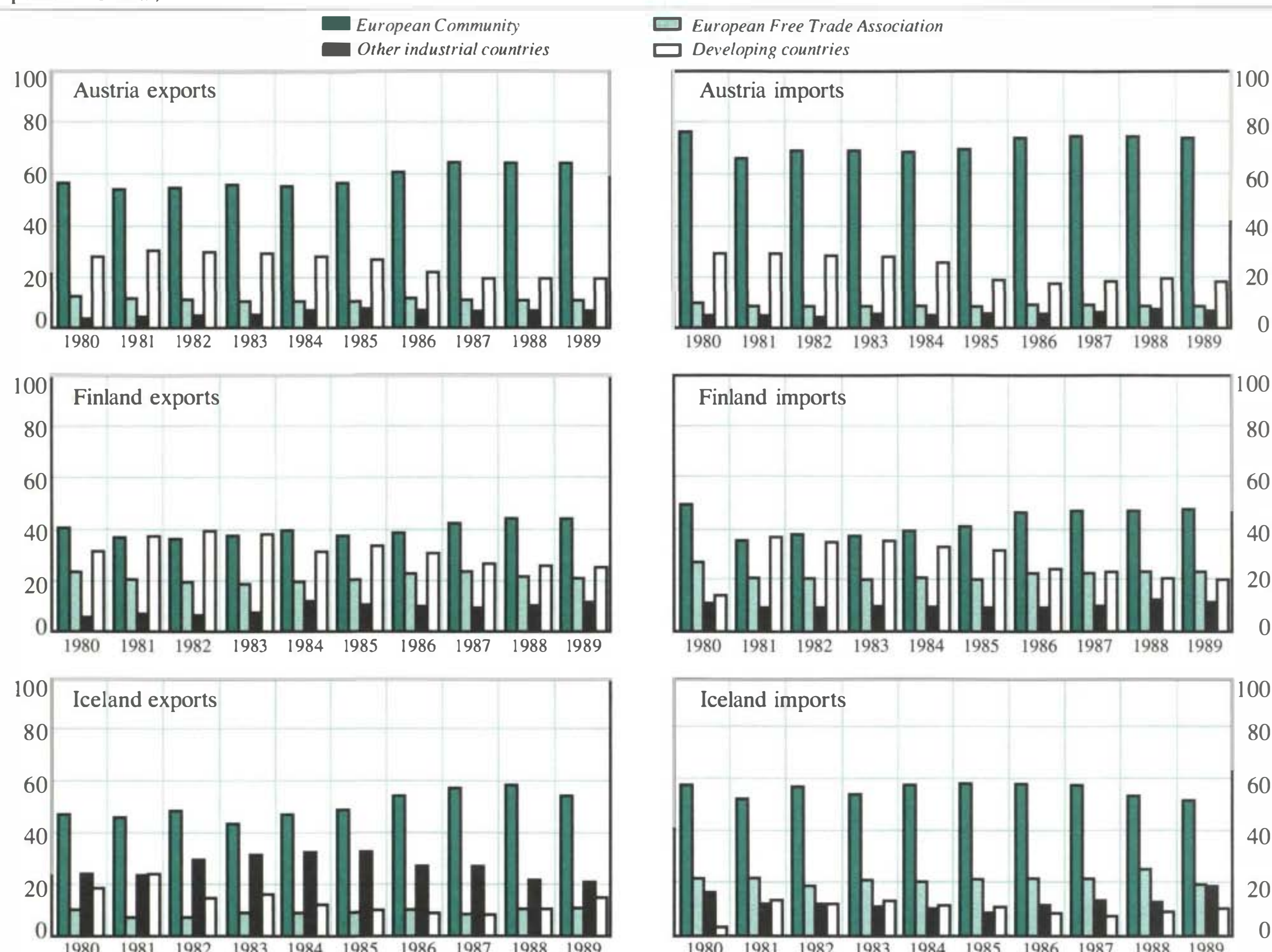
**Chart 3. EFTA: Direction of Trade**
(in percent of total)




Source: IMF, *Direction of Trade Statistics*

may partly reflect such variables as higher real per capita incomes, higher indirect taxes, higher transport costs, and (perhaps to some extent) currency valuation. However, smaller home markets—implying both less competition and scale disadvantages—may also be important.

Although tariffs and quantitative restrictions on trade within Western Europe have largely been abolished, other obstacles remain. These can be divided roughly into two different groups. The first group includes various administrative procedures such as border controls. These give rise to trade costs in much the same way as transportation does. Unlike tariffs and quotas, which either generate government revenues or rents to private companies, border controls impose net resource costs both on governments and companies. The second group includes such government practices as public procurement rules, technical standards and regulations, barriers to entry, and public monopolies. These act as import quotas in that they tend to generate rents both to foreign and domestic firms. As argued by Baldwin (1988), the benefits of eliminating factor market barriers may well be as important as other trade liberalization measures.

Although all of these obstacles do not generate any government revenues or perhaps are not as direct as quotas, they may still be as harmful as conventional barriers. First, they entail trade costs and are therefore trade-decreasing. Second, by restraining foreign competition and preventing arbitrage between different national markets, they encourage market segmentation and effectively serve to create local markets. While barriers resulting from government regulations may be the most obvious obstacles to less-than-full integration of European markets, other elements may also contribute. The most important are private anti-competitive strategies aiming at exploiting market power and differences in buyer preferences among different markets. It



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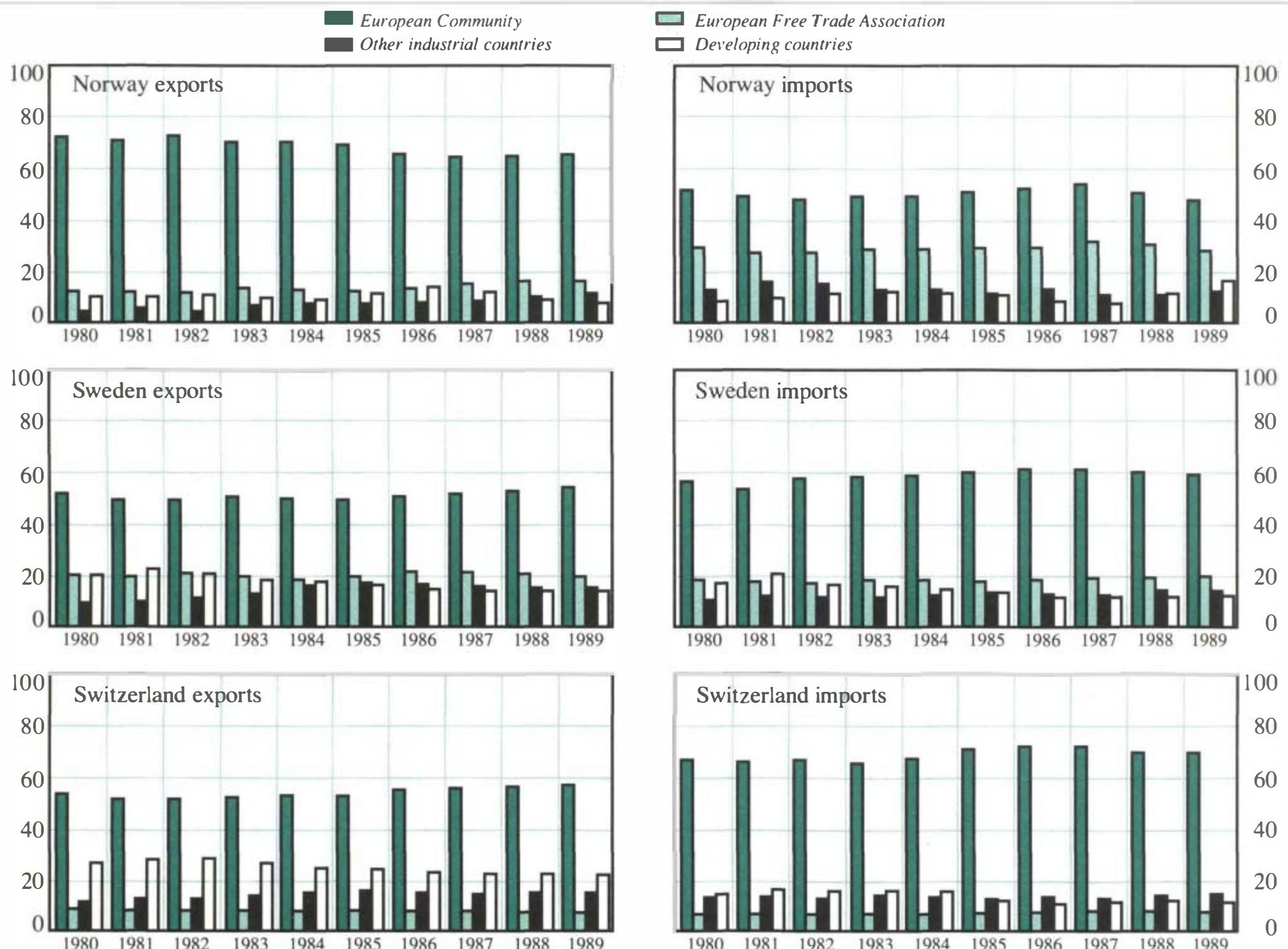
**Chart 3. EFTA: Direction of Trade (concluded)**
(in percent of total)




Source: IMF, *Direction of Trade Statistics*

is unclear whether or not the internal market program will eliminate these more subtle obstacles.

## Economics of the Internal Market

The EC is seeking to remove all artificial barriers that inhibit trade within the Community. To better understand the likely effects of the internal market, it is useful to review the determinants of the pattern of international trade. Economic theory identifies three benefits of trade: it allows specialization according to comparative advantage; it results in a better use of scale economies; and it increases competition.

According to the theory of comparative advantage, gains from trade arise because countries differ in some respect. The most common explanation is that countries differ in factor endowments as in the so-called factor proportions model (Helpman, 1984).[19] However, the fact that the Western European countries are at similar levels of economic development and that trade costs are already quite low suggests that the theory of comparative advantage can explain only the relatively small fraction of total trade among these countries, which comprises products based on natural resources.[20]

Greater integration in Western Europe may yield important gains from further specialization based on

[19]Another, perhaps less likely, possibility is that countries have access to different technologies. For a survey of tests of different trade models, see Deardorff (1984).

[20]As already indicated by the structure of EFTA foreign trade, products in which the EFTA countries are likely to have a comparative advantage include forestry products in the case of Finland and Sweden, fish in the case of Iceland, and energy-intensive products for Norway. For a study of comparative advantage between the EC and EFTA, see Haaland and Norman (1987).



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**Table 1. EFTA: Merchandise Exports by Commodities[1]**
(in percent)

| | 1977 | 1987 |
|---|---|---|
| Austria | | |
| Food and beverages | 3.6 | 3.4 |
| Raw materials | 8.6 | 5.4 |
| Fuels | 1.9 | 1.8 |
| Manufactures | 85.9 | 89.4 |
| Finland | | |
| Food and beverages | 4.0 | 2.2 |
| Raw materials | 16.4 | 12.7 |
| Of which: | | |
| Wood | 8.6 | 5.4 |
| Paper pulp | 5.1 | 4.6 |
| Fuels | 2.1 | 2.2 |
| Manufactures | 77.5 | 82.8 |
| Of which: | | |
| Paper products | 22.8 | 25.8 |
| Iceland | | |
| Food and beverages | 70.9 | 77.9 |
| Of which: | | |
| Fish | 56.4 | 72.5 |
| Raw materials | 8.0 | 3.1 |
| Fuels | — | — |
| Manufactures | 21.1 | 19.1 |
| Norway | | |
| Food and beverages | 10.0 | 7.7 |
| Raw materials | 5.9 | 4.4 |
| Fuels | 20.1 | 40.5 |
| Of which: | | |
| Crude oil | 18.5 | 28.3 |
| Natural gas | — | 11.9 |
| Manufactures | 64.0 | 47.3 |
| Of which: | | |
| Nonferrous metals | 10.6 | 9.1 |
| Sweden | | |
| Food and beverages | 2.1 | 1.8 |
| Raw materials | 13.9 | 9.4 |
| Of which: | | |
| Wood | 4.7 | 3.5 |
| Paper pulp | 5.8 | 3.7 |
| Fuels | 1.8 | 2.9 |
| Manufactures | 82.2 | 85.9 |
| Of which: | | |
| Paper products | 9.0 | 11.7 |
| Switzerland | | |
| Food and beverages | 4.0 | 3.0 |
| Raw materials | 1.7 | 1.2 |
| Fuels | 0.1 | 0.1 |
| Manufactures | 94.2 | 95.6 |
| EFTA | | |
| Food and beverages | 4.7 | 3.9 |
| Raw materials | 8.9 | 6.1 |
| Fuels | 3.9 | 6.9 |
| Manufactures | 82.5 | 83.1 |

Source: OECD, *Foreign Trade by Commodities.*
[1]According to SITC Rev. 2. Product classification as follows: food and beverages: 0–1; fish: 03; raw materials: 2–4; wood: 24; paper pulp: 25; fuels: 3; crude oil: 33; natural gas: 34; manufactures: 5–9; paper products: 64; and nonferrous metals: 67.

comparative advantage. Are there any costs involved? As far as trade arrangements are concerned, the EC is at present essentially a customs union. This means that internal tariffs and quotas within the Community have been eliminated while each country has to conform to a common external trade policy. When union members reduce barriers among themselves and coordinate their external trade barriers, there are two conflicting effects: the first tends to increase welfare of the participating countries while the second tends to decrease it.[21]

As internal barriers within a customs union are eliminated in each country, domestic goods are substituted for by goods from its union partners. This is the trade-creation effect that tends to increase welfare. However, another effect works in the opposite direction. As goods produced within the customs union become cheaper relative to goods from the rest of the world, there is a tendency to switch demand to relatively more expensive union goods from more efficiently produced goods from outside the union.

It is in principle not possible to exclude the possibility that a customs union could cause trade-diversion effects sufficiently large to reduce welfare in the union as a whole. Also, even if the union as a whole would gain, some members may be hurt. In the case of Western Europe, the fact that conventional tariff-type barriers are already low suggests that the trade-diversion effects of further integration may be rather limited. However, a harmonization of nontariff barriers may clearly have some damaging effects.

The recognition that most trade among industrial countries is in similar but differentiated products has in recent years resulted in alternative theories that explain trade mainly in terms of scale economies and imperfect competition (Helpman and Krugman, 1985). With differentiated goods subject to increasing returns to scale and with consumer preferences for diversity, gains from trade arise that have nothing to do with comparative advantage. The basic proposition is that if each country concentrates its resources on a limited range of goods, it can produce them on a larger and more efficient scale while the variety available for domestic use is increased through imports.

The traditional analysis of trade liberalization is based on a framework similar to the neoclassical growth model in which the equilibrium growth rate is determined by the growth of labor supply and technical progress. The latter is usually assumed to be invariant to policy changes. In conventional models, because of the assumption of constant returns to scale, trade liberalization has no permanent effects on growth. If barriers to trade are lowered, output will grow faster

[21]The traditional literature on customs unions has concentrated on the case of trade under perfect competition and constant returns to scale. Surveys of this literature are included in Corden (1984) and Pomfret (1986). For more recent theoretical studies, see Ethier and Horn (1984); Venables (1985); and Winters (1988).



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**Table 2. Price Dispersion in the EFTA and EC in 1985**
(standard deviations from EC average)

| | EC-6 | EC-9 | EC-12 | EC-EFTA[1] |
|---|---|---|---|---|
| Food | 4.9 | 10.7 | 12.7 | 30.7 |
| Beverages | 9.7 | 32.0 | 34.6 | 84.2 |
| Tobacco | 21.9 | 41.5 | 43.9 | 47.2 |
| Nontraded goods and services | | | | |
| Gross rent | 37.9 | 33.2 | 42.9 | 46.3 |
| Medical and health services | 17.0 | 22.2 | 26.7 | 24.1 |
| Public medical and health care | 19.0 | 20.8 | 25.5 | 23.4 |
| Operation of transport equipment | 7.8 | 10.5 | 16.7 | 17.3 |
| Transport services | 23.9 | 31.6 | 37.7 | 46.5 |
| Communication | 35.7 | 39.1 | 38.2 | 41.6 |
| Education, recreation, and culture | 15.0 | 14.1 | 26.8 | 26.9 |
| Government consumption | 17.7 | 12.6 | 26.9 | 29.3 |
| Construction | 7.6 | 12.5 | 17.6 | 18.5 |
| Traded goods and services | | | | |
| Clothing and footwear | 10.8 | 14.0 | 11.6 | 23.1 |
| Fuel and power | 10.8 | 13.6 | 17.6 | 19.1 |
| Household equipment and operation | 5.3 | 9.5 | 13.5 | 15.3 |
| Recreation equipment and repairs | 10.0 | 13.1 | 12.5 | 18.1 |
| Medical and pharmaceutical products | 29.3 | 28.3 | 30.7 | 31.5 |
| Transport and communication | 10.5 | 16.4 | 21.1 | 23.7 |
| Transport equipment | 12.0 | 23.7 | 26.1 | 32.4 |
| Books, magazines, and newspapers | 21.4 | 25.7 | 32.6 | 53.4 |
| Business fixed investment | 6.2 | 12.0 | 11.5 | 13.3 |
| Machinery and equipment | 9.9 | 14.6 | 8.2 | 12.9 |
| Transport equipment | 19.6 | 23.5 | 23.3 | 31.9 |
| Non-electrical equipment | 5.3 | 11.5 | 4.9 | 7.9 |
| Electrical equipment | 6.2 | 14.0 | 9.3 | 19.1 |

Source: Wieser (1989).
[1]All current EC members plus Austria, Finland, Norway, and Sweden. Data for Iceland and Switzerland are not available.

**Table 3. Price Levels in the EFTA in 1985**
(EC = 100)

| | Austria | Finland | Norway | Sweden |
|---|---|---|---|---|
| Household consumption | 112 | 137 | 143 | 127 |
| Food, beverages, and tobacco | 116 | 172 | 183 | 172 |
| Food | 116 | 162 | 169 | 165 |
| Beverages | 109 | 291 | 296 | 255 |
| Tobacco | 132 | 133 | 191 | 145 |
| Clothing | 116 | 146 | 143 | 152 |
| Gross rent | 119 | 118 | 128 | 135 |
| Household equipment and operation | 98 | 134 | 120 | 105 |
| Medical and health care | 98 | 116 | 114 | 100 |
| Medical and pharmaceutical products | 145 | 132 | 139 | 102 |
| Medical and health services | 81 | 93 | 98 | 81 |
| Public medical and health care | 111 | 122 | 120 | 104 |
| Transport and communication | 115 | 139 | 143 | 107 |
| Personal transport equipment | 100 | 168 | 163 | 102 |
| Operation of transport equipment | 126 | 124 | 103 | 112 |
| Transport services | 105 | 155 | 202 | 164 |
| Communication | 116 | 121 | 189 | 61 |
| Education, recreation, and culture | 116 | 128 | 137 | 122 |
| Miscellaneous | 105 | 141 | 162 | 127 |
| Government consumption | 113 | 126 | 149 | 143 |
| Gross fixed capital formation | 98 | 112 | 119 | 127 |
| Construction | 96 | 109 | 108 | 140 |
| Machinery and equipment | 98 | 120 | 137 | 108 |
| Transport equipment | 106 | 169 | 164 | 129 |
| Non-electrical equipment | 95 | 114 | 121 | 93 |
| Electrical equipment | 100 | 110 | 121 | 165 |
| Gross domestic product | 108 | 130 | 135 | 128 |

Source: Wieser (1989).



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for some time but will eventually return to its steady state growth path. This result does not necessarily hold in models with increasing returns to scale.[22] In such models, trade policy may permanently affect the rate of growth of output through its effects on investment. For example, Baldwin (1989) argues that the internal market may significantly raise the equilibrium growth rate in the EC. It is thus important to distinguish between the static and the dynamic effects of trade liberalization.

With increasing returns to scale, markets will be imperfectly competitive. A common assumption is that of monopolistic competition, implying that there are many firms producing differentiated products of the same variety. However, despite their monopoly power, firms will earn only normal rates of return. Although the model of monopolistic competition is attractive in its simplicity and has provided valuable insights, most markets are probably oligopolistic in that firms take each other's actions into account and consistently extract monopoly rents. In this case, the possibility of international trade may induce a more competitive behavior and make oligopolistic pricing strategies less likely.[23]

In conventional models based on perfect competition, measures that distort free trade generally tend to decrease welfare. This is, however, not necessarily the case once oligopolistic behavior is present. Beginning with Spencer and Brander (1983) and Dixit and Kyle (1985), recent theoretical studies have shown how discriminatory actions by governments—"strategic trade policy"—could be beneficial by helping firms exploit market imperfections. It remains to be seen how important the arguments of strategic trade policy really are. Nevertheless, the internal market program has some elements reminiscent of strategic trade policy. One of the most important motives behind the new initiatives has apparently been to improve the ability of EC firms to compete with firms in other countries, notably in Japan and the United States.

The existence of scale economies and imperfectly competitive industries argues for greater integration. Nonetheless, although the creation of the internal market in general can be expected to be beneficial, a formal analysis is complicated by second-best problems. In a typical imperfectly competitive industry, the elimination of internal barriers is likely to stimulate firms both to reduce prices and to raise production. This tends to increase welfare. From a general equilibrium perspective, however, the net effect on welfare may be smaller. For example, if factor prices are distorted, an expansion in one particular industry may adversely affect resource allocation elsewhere in the economy.

The expectation that the internal market will lead to improvements in economic conditions within the EC is based on all three trade-benefit principles. Trade will result in some further specialization based on comparative advantage; some increase in the scale of production in certain industries; and some increase in competition. However, although comparative advantage is important, most of the potential gains will probably derive from a better use of scale economies and increased competition in the larger united market. This is illustrated in several model simulations, for example, in Venables and Smith (1988), who studied the effects of a reduction in trade costs and an elimination of market segmentation within the framework of a partial equilibrium model in ten EC industries. In a similar exercise for Norway and Sweden, Norman (1989) reached the same conclusions.

There seems to be little doubt that the internal market program, if implemented successfully, will yield substantial gains for the Community. However, an accurate calculation of the magnitude of these gains is difficult if not impossible to achieve.[24] Several theoretical and empirical considerations underlie this pessimism. In principle, the effects of the internal market could be simulated with the help of a computable general equilibrium model. The basic problem with this approach is the lack of a general theory of imperfect competition. The model builder is thus forced to make a series of arbitrary choices among a number of more or less equally plausible assumptions concerning in particular the interaction of firms in oligopolistic markets. Unfortunately, these assumptions typically prove

[22]The existence of economy-wide increasing returns to scale may not only reflect scale advantages at the level of the individual firm but also externalities. Technological advances in one industry may, for example, have spillover effects in other industries. In addition, profit-motivated technological improvements may be as important as investment in real capital. For a discussion of the link between growth and increasing returns, see Romer (1987).

[23]It is theoretically possible that a reduction of trade barriers in this case could have adverse effects on welfare. According to the so-called reciprocal dumping model by Brander and Krugman (1983), oligopolistic firms may have an incentive to discriminate between different markets and charge higher prices at home than abroad. This implies a waste of resources both because prices are different in different markets and because of the transportation costs. Although not likely, lower trade barriers may further reinforce this tendency.

[24]The EC Commission (1988b) has tried to do this through a combination of judgmental methods and model simulations. The calculations were made in two steps. The first step was to estimate the direct cost savings resulting from the elimination of the existing barriers. The second step was to calculate the relationship between direct effects on the basis of a partial equilibrium model with imperfect competition and economies of scale developed by Venables and Smith (1988). This model was calibrated to data on only ten industries, which is why the exercise may provide little guidance on the overall effects. See also Flam and Horn (1989).



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to be crucial for the results. In addition, as soon as imperfect competition is present, second-best effects make any comparisons of alternative nonoptimal situations difficult.

There are also empirical problems. The observed price differences among Western European markets may not only reflect barriers imposed by governments but also an important element of price discrimination. It is not clear to what extent the observed price differences are the result of obstacles that the internal market program is supposed to remove. As a consequence, it is difficult to predict the degree of price convergence. Although a number of plausible arguments may explain why firms will be less able to discriminate between different national markets—in particular, it may be easier to engage in cross border arbitrage—it is unlikely that the internal market program will end all such practices. This is crucial since most of the gains from the internal market program are expected to come from an elimination of market segmentation rather than from a reduction in trade costs (Venables and Smith, 1988; and Norman, 1989). Also, to take advantage of scale economies, the number of domestic competitors in each country must decrease. This can only be compensated for by an increase in competition at the European level. There is, of course, a risk that the current stream of mergers and acquisitions in Europe may prevent such an increase from materializing.

## Benefits and Costs for EFTA Countries

The EFTA countries would share in the gains from the internal market program, if they decided to and were permitted to participate fully in the EC integration process. First of all, there would be scope for further specialization along the lines of comparative advantage. A de facto integration would also neutralize the possible negative effects on the EFTA countries from trade diversion in the EC.

Since this strategy would amount to nothing less than the formation of a customs union, it would not be costless. The creation of an internal market encompassing both the EC and EFTA would require a complete coordination of trade policies. As trade between the EFTA and EC would be liberalized while barriers to trade with the rest of the world would remain, trade diversion effects could arise, which would tend to decrease welfare in the EFTA countries. The importance of these effects depends to a great extent on the future course of EC trade policy, which may be hard to predict. With notable exceptions, tariffs do not seem to differ substantially between the EC and EFTA countries (Herin, 1986; and Pintado and others, 1988). However, quantitative restrictions may be a more serious issue.[25] In any case, the EC's willingness to be more restrictive with respect to third countries—or to be more restrictive in the future—suggests that the problem of trade diversion cannot be completely dismissed.

Although a further inter-industry specialization may yield some benefits, most gains would probably derive from a better use of scale economies and increased competition. In a typical noncompetitive industry producing a differentiated good subject to increasing returns to scale, there would be both a downward pressure on prices and an expansion of production. The elimination of internal barriers within the EC and EFTA would tend to shift demand in each country from domestic sources to imports. Since total domestic demand and production would be likely to increase, this would not necessarily imply that the demand for domestic goods in domestic markets would need to decrease. On balance, however, the expansion would likely take place mainly in export markets.

How would welfare be affected? Transfers from domestic producers to domestic consumers that result from the fall in prices charged in domestic markets are welfare-neutral from the point of view of the economy as a whole. Any gains must therefore come from the effects of increased competition on domestic resource allocation, which are normally positive, or from the effects on terms of trade, which are unclear. Although it seems reasonable to assume that the positive effects would dominate, on a theoretical basis, the effects on welfare are ambiguous. Furthermore, in a general equilibrium perspective, it is even more difficult to assess the effects on welfare. As already indicated, if factor prices are distorted, an expansion of certain sectors may come at the expense of other sectors where resources could be used more efficiently.

While the effects on the EFTA countries are qualitatively the same as those on the EC, the EFTA countries may have more to gain from participating in the internal market than the EC on average. The EFTA countries have considerably smaller home markets than most countries in the EC. As is formally illustrated in model simulations by Norman (1989), this generally implies a more severe trade-off between scale advantages and competition.

If the EFTA countries would fail to integrate further with the EC, they would not be able to reap the gains accruing to EC members. Are there additional costs? It is reasonable to argue that some economic losses are involved, although their magnitude is uncertain. To

[25] The automobile industry is a good example. Several EC countries impose quantitative restrictions on imports of Japanese cars in the form of voluntary export restraints (VERs). As a result, market shares of Japanese car producers differ substantially both within the Community and within Europe as a whole.



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determine the effects on the EFTA countries, consider first the current situation. As far as manufactures are concerned, the EC and EFTA constitute a free trade area. No tariffs or quantitative restrictions restrict the free flow of these goods within Western Europe. The remaining barriers to trade affect the EC and EFTA countries more or less equally.

The internal market program aims at the complete elimination of existing trade barriers within the EC. As a result, each country within the Community will experience a fall in import prices and an improvement in terms of trade. This will tend to shift resources away from the production of import substitutes into the production of exportables while the composition of demand will undergo a similar shift but in the opposite direction. The exploitation of scale economies and increased competition will further contribute to the expansion of demand and output.

In the nonintegration case, as trade barriers are eliminated within the EC, demand will tend to shift from EFTA products to EC products both within the EC and EFTA. As EFTA terms of trade fall, a reallocation of resources from export industries to import-competing industries will take place, resulting in a less efficient use of available resources. However, to the extent that prices in the EC would fall, possibly reflecting a better use of scale economies and a decrease in monopoly power, there would also be an offsetting tendency for EFTA terms of trade to improve. Without a detailed knowledge of how these price changes are distributed over different industries, it is difficult to calculate the net effect.

The adverse effects stemming from the reduction in demand for EFTA products are likely to be reinforced by a less efficient use of scale economies. In a typical industry operating under increasing returns to scale and imperfect competition, the more competitive environment in the EC would force EFTA firms to make both price and quantity adjustments. The reaction of EFTA firms depends, among other things, on their competitive position on foreign and domestic markets and the relative importance of these markets.[26] EFTA firms probably have a stronger position in their domestic markets than in foreign markets. They may therefore partly resist lowering their prices on domestic markets or in any case lowering their prices less than their EC competitors.[27] Nevertheless, in contrast to the integration case, prices and volumes of EFTA firms are both likely to decrease as barriers within the EC are eliminated. As in the integration case, the fall in prices on EFTA and EC products will boost the welfare of consumers while decreasing that of producers. However, on balance, the negative effects are likely to dominate.

Reflecting the adverse shift in demand for EFTA products, the EFTA countries' trade balance is likely to deteriorate. With less demand for EFTA products, firms would cut back production, resulting in reduced demand for labor and higher unemployment. The only way that production and employment would be unaffected is through a decrease in production costs. This can be achieved only through an offset in labor costs. In order to maintain employment, wages in EFTA countries would need to decline relative to wages in the EC. With such a decline, EFTA employment and production would again rise, thereby restoring demand for EFTA products through a decline in EFTA relative prices. While general equilibrium considerations may complicate the picture, we can conclude that with unchanged relative wages, the deterioration in the EFTA countries' relative position will show up in higher unemployment and reduced competitiveness. On the other hand, if relative wages are allowed to decline, EFTA terms of trade will fall further. Both possibilities imply a reduction in EFTA purchasing power.

A failure to integrate further with the EC may also have important consequences for firms' locational decisions. In order to avoid the deterioration in external competitiveness that is likely to take place in the nonintegration case, EFTA firms may be tempted to move some of their production facilities into the Community. This possibility may be attractive for several reasons. First, with increasing returns to scale and transport costs, it makes sense to concentrate production facilities as close as possible to the most important market (Krugman, 1988). This trade-off is particularly stringent in the case of the EFTA countries, which all possess small domestic markets. Second, establishment in the EC may help EFTA firms compete for public procurement under the same conditions as EC firms and also avoid restrictions related to rules of origin and technical standards. Third, the internal mar-

[26]Assuming that firms are unable to discriminate between different markets, the same price will be charged in each market. This price will then be a weighted average of the hypothetical prices that would prevail in each market if price discrimination were possible.

[27]If firms were able to discriminate between different markets, prices in the EFTA countries might rise while prices in the EC would decline. Since the completion of the internal market may result in reduced production of EFTA firms, average costs could rise, forcing these firms to increase their prices in EFTA markets. This may also allow EC firms to charge higher prices in EFTA markets than in the EC. The implications of different assumptions about segmentation for the effects of trade policy are discussed in Markusen and Venables (1988).



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ket may give rise to external effects that make establishment there more profitable. All three factors suggest that EFTA terms of trade would decline and that relative wages would have to compensate for the shortfall. Most disadvantages obviously disappear if the EFTA countries would become fully integrated with the Community. However, a complete integration is likely to reduce the costs of establishment in the EC. If the external effects from the concentration of economic activities in the EC are sufficiently strong, establishment in the EC is likely to become more attractive even with full integration.



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# V Trade in Goods

Most of the trade in goods between the EC and EFTA is in industrial products, which account for more than 90 percent of EFTA exports. Although fish products account for only a small percentage of total EFTA exports, they are the main source of export revenue for one EFTA member, Iceland. Since the EC and EFTA are not aiming at a common agricultural policy, the impact of the internal market on inter-bloc trade in agricultural products is likely to be small.

The main issues in the prospective trade in goods between the EC and EFTA will depend on the nature of their trading relationship. This relationship could take on a variety of forms, ranging from the status quo to a common market that includes all 18 countries. While a common market may have important benefits, the requirement of a common trade policy toward third countries would pose major difficulties for several EFTA members. Therefore, this chapter will not address issues associated with the creation of a common market.

Since the FTAs already assure free trade in industrial goods, the main issues from the EFTA's perspective are how changes arising from the internal market may influence inter-bloc trade and what may be done to mitigate any negative side effects. The main areas of interest—although several extend well beyond goods trade—include the elimination of internal border controls and other physical barriers, the harmonization of technical standards and regulations, the liberalization of public procurement policies, the administration of rules of origin and anti-dumping rules, and state aid policies.

## Border Controls and Other Physical Barriers

Border controls inhibit the free movement of individuals and constitute a costly impediment to the free flow of goods and services. These controls are motivated by a number of considerations, including commercial, fiscal, economic, health, statistical, and security ones. While both the EC and EFTA have eliminated customs duties and quantitative restrictions on their internal trade, border checks remain to assure compliance with national rules on indirect taxation and to enforce quota agreements with third countries. They also protect against terrorism, drugs, the entry of unwanted goods and individuals, and the enforcement of national and Community policies in such areas as agriculture and trade, and for various safety and health checks.

Border controls are costly to both firms and governments. The direct costs are mainly administrative. For importers and exporters, these involve the expense of staff and computing and processing for the additional paperwork needed for foreign trade. Governments must bear the costs of this paperwork and of manning internal borders. Additional costs also arise from shipping delays at border checks.[28]

The White Paper envisaged the elimination of all internal frontier controls within the EC, requiring that policies restricting the flow of goods, services, and individuals among member states be relaxed and eventually abandoned. In addition, policies regarding the EC's external borders needed to be unified so that any individual or commodity entering one member state from outside the EC would be free to enter any other member state. This required harmonization of national regulations for the entry and exit of goods and individuals as well as confidence that these regulations would be effectively enforced.[29]

Ending internal border controls would affect the competitiveness of firms in non-EC countries in several

[28]An EC-financed study estimated the total cost of border controls at about 0.3 percent of Community GDP, mostly administrative costs to firms. In addition, importers estimated the rise in intra-EC trade from eliminating internal border controls at 1 percent, while exporters estimated the rise at 3 percent. See Ernst and Whinney (1988).

[29]The White Paper envisaged the complete dismantling of all border controls and other physical barriers within the EC by 1993. However, progress has been slower than hoped. In December 1989, the Schengen Agreement was to be signed by Belgium, France, Germany, Luxembourg, and the Netherlands, removing all border controls and allowing people to travel freely within the five-country region. The agreement was delayed until June 1990 because of a dispute between the Federal Republic of Germany and its partners regarding the status of East Germany. The accord still must be approved by the parliaments of the five-country signatories.



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ways. Reducing shipping and administrative costs for EC-based firms' intra-Community trade would bring an autonomous improvement in their terms of trade vis-à-vis outside firms. However, non-EC firms trading within the EC would gain some benefits in cases where their goods were transshipped within the EC, or where firms had previously shipped goods into the EC by indirect routes to avoid costs associated with crossing internal frontiers. EC firms exporting to nonmember countries could also benefit from reductions in the cost of shipping goods across the EC.

Differing trade policies toward third parties are likely to force the retention of some form of border controls between the two blocs. Therefore, the competitive position of EFTA firms within the EC will partly depend on the administrative costs of these controls and the time involved in crossing protected borders.[30] Much progress has been made in cutting the administrative costs of border crossings. In January 1988, the Single Administrative Document (SAD) and Common Transit Conventions came into force, greatly simplifying the administrative procedures associated with the goods trade between the EC and EFTA.[31] In the conventions, the EC and EFTA agreed to replace most customs documents used in EC-EFTA trade with the single document used in intra-EC trade. The agreement also provided that the EC and EFTA countries would fully computerize their customs data and customs procedures by 1992, helping to minimize the relative cost disadvantage of EFTA exporters to the EC, while placing EC firms on an equal footing with EFTA firms trading in EFTA.

The potential savings from faster border crossings may vary depending on the countries involved. The impact of more uniform border formalities at the EC's external borders will differ from country to country within the EC. Additional savings may arise by shifting some customs officials freed from working on the intra-EC borders to the EC's external borders. However, the savings from eliminating intra-EC border crossings should also yield significant benefits for EFTA countries but, in any case, they are likely to be smaller than the savings on administrative costs.

Consumers in the EC and EFTA should benefit from lower transport costs within the EC, as well as from reduced administrative costs in inter-bloc trade. However, the impact on EFTA consumers partly depends on what action, if any, is taken by EFTA firms and domestic authorities to offset the negative terms-of-trade effects of the relative decline in transportation costs within the EC. Improved customs procedures should also reduce the administrative costs to EC and EFTA governments, while the elimination of internal border controls within the EC would result in further administrative savings for EC governments.

## Technical Standards and Regulations

A producer wishing to sell a good within the EC or EFTA may be subject to a different set of rules governing the product in each of the 18 countries. These rules fall into four categories: technical standards, which are formally voluntary but may have quasi-legal status by government decision or commercial practice; regulations, which are legal requirements set by the EC governments; testing procedures; and certification that the product conforms to the regulations or standards (Calingaert, 1988, pp. 25–26). In the EC and EFTA, standards, testing, and certification procedures are normally set by private groups, which may be national or multinational. The two main multinational groups, CEN and Cenelec, include all members of the EC and EFTA.[32] EC firms consider these rules the single most important barrier to the internal market (Cecchini, 1988, p. 28). However, ending these differences will be difficult and complex because of their sheer volume. There are an estimated 100,000 different technical regulations and standards within the EC alone (EC Commission, 1988b, p. 43).

Divergent regulations and standards may distort firms' behavior in several ways. By raising the costs of doing business in a larger market, firms may seek only to fill the niche created by their national regulations, instead of competing more broadly. Problems associated with divergent regulations and standards are especially severe for transport equipment and certain other investment goods, precision and office equipment, pharmaceuticals, food, and tobacco (EC Commission, 1988b, pp. 51–53). Domestic orientation not only reduces trade, but the resulting market fragmentation may also hinder research and development, especially in areas with major scale economies. Additional costs may include duplication of research and development

[30]Some relaxation of border controls is possible. For example, from July 1991, customs checks will be randomized for goods being transported between the EC and Switzerland. However, the benefits to the Nordic countries from such an initiative would be limited.

[31]This was a top priority item of the High Level Contact Group working on implementing the Luxembourg Declaration. This agreement was the first EC-EFTA accord to come out of the Luxembourg Declaration.

[32]CEN and Cenelec are French acronyms for Committee for European Standardization and Committee for European Electrotechnical Standardization, respectively. A third body, the European Telecommunications Standards Institute (ETSI), sets standards in the area of telecommunications. For details on the design of technical regulations and standards in the main European standardization organizations, see Nicolas (1988).



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and higher inventory and distribution costs. Public expenditures may also rise as a result of the duplication of testing and certification of products, while consumers must bear the direct costs passed on by firms and governments and the indirect costs of reduced competition and less rationalization of production and marketing.

The cost of technical barriers is believed to be high. However, they are difficult to quantify because they tend to be industry-specific and are often intertwined with other barriers, including content requirements and restrictive government procurement practices. [33]

The White Paper proposed to reduce and eventually eliminate divergent regulations and standards using a three-part strategy of selective harmonization, mutual information, and mutual recognition. Selective harmonization requires legislation on the essential product characteristics. However, the passage of binding legislation is difficult, requiring Council unanimity.[34] Thus, it will only be required when national regulations differ in essential characteristics in terms of health, safety, or consumer or environmental protection. In these cases, the EC standard—expressed in fairly general terms—will first be defined. These requirements are sufficient to allow the product to circulate freely within the EC. When no major disparity exists, mandated groups, mainly CEN/Cenelec, will be charged with establishing the detailed technical specifications of the European or EC standard. Once the standard is set, these groups will also set the final specifications that would conform to the standard.[35] EFTA members are in a special position in this regard, since they not only participate in setting EC standards, they are also subject to the standards once they are passed.[36]

To ease replacement of national standards by EC standards, the Commission is working to strengthen the standard-setting bodies. However, while industry bodies will be charged with setting EC standards, the Commission has insisted that the interests of all sectors affected by the standards—including both sides of industry, commerce, and consumers—be taken into account. The Commission may also withdraw a mandate from any body that is not effectively and fairly fulfilling its task. The EFTA has worked closely with the EC both in helping to set the EC standards and in setting work priorities.

Much progress has also been made in the area of mutual recognition of technical regulations and standards within the EC. In the Cassis de Dijon decision of 1979, the European Court of Justice held that products lawfully produced and marketed in one member state must, in principle, be admitted into every other member state. Mutual recognition is to be accepted when harmonization is not essential or has not yet been introduced. Barriers are to be permitted "only when they are *necessary* to satisfy mandatory requirements, serve a purpose *in the general interest* and are *essential* for the purpose to be attained" (EC Commission, 1989b, pp. 39–40).

To help prevent the erection of new barriers in the interim, member states must give the Commission advance notice of all draft regulations and standards involving technical specifications. Implementation must then be delayed for up to one year to allow the Commission and other member states to determine if any elements are likely to create trade barriers and, if so, to take remedial action. Similar legislation was passed by the EFTA in 1987. Members of the EC and EFTA also have agreed to provide CEN/Cenelec drafts of all new regulations and standards as soon as possible to allow other members to comment and request changes.

Efforts are under way to use mutual recognition to avoid duplication of testing and certification procedures. However, countries have more faith in their own certifying systems than in foreign ones. To overcome this bias, the EC Commission and most EFTA members favor centering efforts in CEN/Cenelec. A major step was taken in June 1988, when EFTA and EC members signed a framework on the mutual recognition of test results and certification. While presupposing common guidelines for testing procedures, it was seen as a necessary first step toward EC-EFTA negotiations on framework and sectoral agreements ("Joint Conclusions . . . ," 1988). However, this agreement is yet to be finalized.

Fears have been voiced that EC standards may be drafted to discriminate against nonmembers, but EFTA members discount this. Unifying regulations for 12 EC countries—18 including the EFTA—are sufficiently complex to discourage such efforts. Discrimination

[33]The Cecchini Report estimates the costs of the EC's internal barriers for seven industries, accounting for 43 percent of EC industrial output. The estimated savings from the removal of barriers from technical regulations, import restrictions, and restrictive government procurement policies is equivalent to about 0.3 percent of EC GDP. Half are in telecommunications equipment and result from the ending of restrictive government procurement practices. Cecchini (1988), pp. 25–27 and 50–68.

[34]On the other hand, passage of technical standards by CEN/Cenelec requires only a qualified majority.

[35]While the EC standards are not mandatory, goods meeting the standards are assumed to fulfill the essential requirements test. A manufacturer not meeting the EC standard must be able to prove that the products meet the essential requirement.

[36]Voting in CEN/Cenelec requires a two-thirds majority, but efforts are made to achieve unanimity. EC country institutions' voting weights are based on the EC treaties, while EFTA members' weights are negotiated. EC institutions have special rights in the implementation of new documents. If a document does not receive a qualified majority, a count is made of only the EC institutions. If a qualified majority of this group is in favor, EC institutions must implement the decision along with EFTA institutions voting for it. EFTA institutions voting against the document are theoretically not required to implement it.



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would also be against the interests of distributors and consumers in the EC and contrary to the Commission's mandate. In addition, gains from discriminatory standards would be short-lived, since outsiders would modify production methods to meet the standard.

As members of CEN/Cenelec, EFTA countries generally are obliged to accept EC standards as they are enacted. However, closer EC-EFTA cooperation should bring increased efforts to remove technical barriers between the blocs, including efforts by EFTA members to incorporate virtually all EC standards as they are passed. One potential issue is whether EFTA members will be allowed to retain or enact tougher standards than those in the EC, notably regarding the environment. This could cause problems, since it could result in situations where goods produced by the EFTA member meet the EC standard, but goods meeting the EC standard do not meet the domestic standard of the EFTA country. No matter what the rationale, this could be seen as discriminatory.

While eliminating technical barriers to trade will involve a major effort for the EC and EFTA alike, the EFTA is well positioned to move in step with the EC. The outlook is good for several reasons. First, as members of CEN/Cenelec, EFTA members already participate in the decision-making process in these organizations. Second, most EFTA countries already use EC standards whenever possible. In cases where there is no standard, the only requirement for sale in the EC is that the product meet the standards of some member state; if it does not meet the standards in the country in which it is sold, the product must be shipped through a member state where it does meet the standards.[37] Third, increased EC-EFTA cooperation is likely to result in an agreement to eliminate technical barriers between the two blocs, which will probably follow along the lines of the measures being taken in the EC.

In May 1990, the EC and EFTA also agreed to create an institution called the European Organization for Testing and Certification (EOTC). The EOTC will work to harmonize testing and certification throughout Europe, including eliminating the need to retest goods when they cross national frontiers. The EOTC will have a standing on par with CEN/Cenelec and will be formed in three stages, the last taking effect on January 1, 1993.

## Procurement Policy

Public sector purchases of goods and services by all levels of government and public enterprises accounted for roughly 15 percent of Community gross domestic product (GDP) in 1986.[38] While much of this involved purchases that were noncompetitive, nontradable, or in quantities too small to be covered by EC rules on contractual procedures, contractual purchases by the public sector—public procurement—were equivalent to 7–10 percent of Community GDP. Public sector purchases in the EFTA countries are estimated at about 10 percent of GDP, implying public procurement in the range of 4.5–6.5 percent of GDP (Pintado and others, 1988, p. 27).

Public procurement has remained largely closed, despite legislation that was to open up public works contracts in excess of ECU 1 million (1971) and public supply contracts of over ECU 200,000 (1977). In 1986, about 20 percent of the tenders covered by the directives were published, while 2 percent went to bidders from other member states. This was caused mainly by two factors. First, energy, transport, telecommunications, and water supply were exempt from the rules. Second, EC legislation has been bypassed and ignored, showing "that the Community legislator has proved no match for national and local purchasing bureaucracies" (Cecchini, 1988, p. 18).

The costs of nationalistic procurement policies are high.[39] The savings may be divided into three categories: the static trade effect of buying from the cheapest EC supplier; the competitive effect of opening closed sectors; and the restructuring effect of forcing small firms in protected sectors to grow to take better advantage of scale economies. The savings would be even greater if procurement were fully open to non-EC bidders. In addition, the savings to private buyers from less restrictive trade practices and the dynamic effects of greater competition, innovation, investment, and growth may also be large.

The White Paper laid out a three-part strategy for opening public procurement. First, legislative loopholes would be closed and efforts made to increase the transparency of public tenders to encourage greater participation by other member states. Second, losing bidders would be given improved legal redress and the Commission would be given greater powers to police and enforce compliance. Third, procurement rules would be extended to energy, transport, telecommunications, and water supply, and later to the services sector.

[37]Presumably, EFTA states will be required to give reciprocal rights to EC member states and probably to other EFTA members as well.

[38]For a summary of the costs of restrictive procurement policies, see Cecchini (1988), pp. 16–23, or EC Commission (1988b), pp. 54–59. This discussion is largely based on these two reports.

[39]Atkins (1988) studied Belgium, France, Germany, Italy, and the United Kingdom, using some 40 product categories and 1984 data. The estimates, extrapolated to the EC-12, showed a potential saving of about ¾ of 1 percent of EC GDP, about one fifth from defense. About half the savings were in telecommunications, power turbines, and data processing.



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Efforts to implement these plans have begun, but progress has been slow. A program of action was set by the Commission in mid-1986. In 1988, three directives were tabled before the Council of Ministers: one opening the energy, telecommunications, and water supply sectors to international tender, and two others designed to ensure compliance with existing public procurement directives. In April 1989, a revised report on opening protected sectors was presented to the European Parliament for supply contracts worth over ECU 750,000 and works contracts over ECU 5 million (Committee on Economic and Monetary Affairs . . ., 1989). In February 1990, after some delays, the directive was passed.[40] One change—which caused the delays—was a "buy European" clause that gave bidders from member states a 3 percent margin of preference relative to bidders outside the EC, unless the outside bids contained at least 50 percent "European content." The ministers also stated that the content requirement would be waived if a worldwide agreement to drop such requirements could be made under the General Agreement on Tariffs and Trade (GATT). Discussions on public procurement of services are next on the agenda.

The Luxembourg Declaration listed public procurement as a primary area where EC-EFTA cooperation was desirable, but advanced no proposals. Discussions began in 1986. Efforts have focused on gradually opening up public works contracts at all levels of government. EFTA ministers have also agreed to provide copies of tender requests in accordance with the GATT agreement for publication in the EC's official paper and inclusions in data banks regarding public procurement. Plans have also been discussed to revise EFTA rules on surveillance and enforcement (EFTA, 1989, pp. 2–3). These rules, which must be enacted at the national level, are equivalent to those in the EC.

While the level of concern about opening public procurement varies among EFTA members, progress is possible in this area.[41] As noted, agreement at the EC-EFTA meeting in December 1989 was based on the principle of free movement of goods and services and that, with limited exceptions, EFTA members would follow actions taken by the EC. This implies that joint agreements may eventually have to be reached on opening procurement policies on equal terms to bidders throughout the two blocs. However, while the accord grants EFTA members greater input in the EC's own discussions on this topic, joint progress is likely to be slow until the EC completes its own work in this area.

## Rules of Origin and Anti-Dumping Rules

The EC has two sets of origin rules.[42] Preferential rules are used to determine if a product originates in a particular country and is eligible for preference under special agreements, including the FTAs and the Generalized System of Preferences. These normally require that the product undergo sufficient processing to change the product's tariff heading. Other tests may also be used, such as the form of processing or the percent of value added. Nonpreferential rules relate to commercial policy measures and rules, including anti-dumping measures. They are based on the "last substantial operation" rule, which may be based on either a technical test on change in product properties, an assessment of the importance of the last operation in the totality of the manufacturing process, or a value-added criterion.[43]

Until 1989, a major concern for EFTA members was the cumulation rules in their FTAs with the EC. These rules were originally bilateral between each individual EFTA member and the EC, so that a good produced by one EFTA member would only qualify for duty-free status under its FTA if the proportion of the final price added by its own inputs plus those added by EC members exceeded the minimum requirement. Thus, the contribution of other EFTA members was not counted. However, in January 1989, this rule was changed so that all materials and inputs originating in EFTA and EC countries now count against the minimum.

Under EC procedures, the definition of dumping is based on the price in the exporter's home market. However, if this is not considered representative of costs, prices in third countries may also be used (Kelly and others, 1988, pp. 95–96). If dumping is detected, GATT provisions permit the imposition of a countervailing duty if injury is found and if the dumping is attributable to state subsidies. Anti-dumping regulations are not applied to intra-Community trade, since the maintenance of price differentials is, in principle, not possible within a free market.

[40]In December 1989, the Ministers also reached agreement on recourse rules for firms that were unjustly excluded from public works or supply contracts. It is scheduled to take effect in January 1993 for all member states except Greece, Portugal, and Spain.

[41]For example, Finland, which sees its policies as open, argues that competition should be as free as possible; see Council of State, Report to Parliament . . . (1989), p. 34. A Swedish bill on the internal market did not list procurement as a major policy goal; see Swedish Ministry of Foreign Affairs (1990), p. 24.

[42]In October 1989, the EC Commission adopted a directive on rules of origin stating that the EC would apply these rules in a way that would not affect trade or investment. See European Community (1989), pp. 1–3.

[43]As set out in the EC Council's Regulation No. 802/68, June 27, 1968, and incorporated in the 1973 Kyoto Convention, which laid out the general principles of an international system of rules of origin.



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EFTA members have sought exemption from the EC's anti-dumping regulations, arguing that they discriminate against EFTA-based firms since large price differentials exist within the EC. EFTA members also fear that, after the start of the internal market, price cuts will be necessary to maintain market share within the EC, making EFTA-based firms vulnerable to anti-dumping actions. The Commission has stated that the EC would be prepared to drop anti-dumping rules with regard to the EFTA, if they were replaced by uniform competition rules. The negotiations following up the Oslo-Brussels process could lay the groundwork for progress in this area.

## State Aid

The White Paper states that a strong-competition policy requires that "discipline on state aid be rigorously enforced" (White Paper, para. 158). EFTA members stress the need for this discipline to the EC and report lapses they detect (Council of State, Report to Parliament . . ., 1989, pp. 32–33). These protests are usually based on the FTAs, which state that "any public aid which distorts or threatens to distort competition by favoring certain undertakings or the production of certain goods" is incompatible with the functioning of the FTAs (EFTA, 1987a, p. 100). The EFTA convention has a similar prohibition covering trade between EFTA members. While disputes may be brought before the GATT, EFTA and EC members generally seek to avoid settling their differences in this way.

Talks on state aid have begun. The first goal is to develop a system for reporting all state aid in EC and EFTA countries and a consultation procedure for problem cases. Preliminary proposals in both areas were advanced in November 1988 and are under study. One problem is that the EFTA countries do not have a monitoring and enforcement mechanism enjoying the same legal status as the EC's. Work has also begun within the EFTA to strengthen its internal procedures; progress is thought to be a precondition for successful inter-bloc discussions. It is hoped that an enforcement mechanism may be developed as part of the institutional changes associated with the Oslo-Brussels process.

## Fisheries and Trade in Fish

Within the EFTA, only Iceland views the discussions regarding fisheries and trade in fish as important.[44] In Iceland, fisheries and fish processing account for one sixth of GDP and about three fourths of merchandise exports, half of which go to the EC. While the FTAs did not cover fish, Iceland was given favorable terms on its sales of fish and fish products to the EC, with about 50 percent of its fish exports enjoying special preferences (Gislason, 1987).[45]

The current version of the EC's Common Fisheries Policy (CFP) will remain in effect until 1991. This policy uses catch quotas to help conserve fish stocks, while seeking to modernize the fishing industry to increase competitiveness. To assure a sufficient supply of fish within the EC, fishing rights are bought from third countries or negotiated in exchange for access to markets. To protect the fishing and fish processing industry, tariff barriers and quotas are imposed on fish imports. While fishing within EC waters has been limited to conserve the fish stocks and because of pollution, fish catches outside EC waters have also decreased. Falling catches, however, have meant that the EC's fish processing industry has had to import more fish from outside sources.

In 1988, 5 percent of EC imports of unprocessed fish came from Iceland. While Iceland's fish exports to the EC have gradually risen, EC policy on processed fish has caused problems for Iceland, particularly for its trade in salted fish. The principal customers for salted fish are Greece, Italy, Portugal, and Spain. When the FTAs were signed, Greece, Portugal, and Spain were not members of the EC. Their accession to the EC has made their imports of salted fish subject to the same restrictions under the CFP as the other imports of EC member states. As a result, the share of Icelandic fisheries exports that enjoy preferential treatment in the Community fell by about 15 percent (Olafsson, 1989).

Icelandic exporters have been forced to make price concessions to maintain market shares. Partly to offset the fall in revenue from salted fish, more unprocessed fresh fish is exported. Recently, the Icelandic Government imposed temporary export restrictions on fresh fish to protect employment in the fish processing industry. Further measures may be taken if the trend continues. Icelandic firms may have to move their processing operations to the EC to evade trade barriers and to furnish traditional southern European markets.

In its negotiations with Iceland, the EC Commission insisted on access to Icelandic fishing grounds as the price for freer access to the EC. Because of its heavy dependence on fisheries and the fact that Iceland's fishing zones are already fully used, such an agreement

[44]Norway and Sweden both share their fishing rights with the EC in exchange for preferential treatment for their fish exports.

[45]Although the Free Trade Agreements were reached in 1972, the dismantling of EC duties on certain fish products came into force only in 1976, when the "cod war" between Iceland and the United Kingdom was settled.



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is not considered a feasible option for Iceland. There is also a political consensus in Iceland in support of this position.

The question then becomes what is the most appropriate strategy for negotiating with the EC. At present, the EFTA is being given a central role in the talks. This became possible when intra-EFTA trade in fish was freed in March 1989. While this agreement had little economic significance for the EFTA, it was seen as a key precedent for inter-bloc negotiations. However, it is still not clear whether negotiating through the EFTA will give sufficient weight to Iceland's interests. If an extension of the free trade arrangements to processed fish cannot be achieved, Iceland may have to look elsewhere for markets if it remains unwilling to increase its fresh fish exports. Neither the Luxembourg Declaration nor the Oslo-Brussels accords indicate the course these negotiations are likely to take.



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# VI Transport Services

Liberalization of the EC's transport sector is important not only because of its size, but also because extensive restrictions in the sector are thought to have had a negative impact on trade and industry. The White Paper laid out conditions for establishing a free internal market in road transport of goods, road transport of passengers, international inland waterway transport of goods, sea transport, and air transport. This chapter focuses on three areas, road transport of goods, sea transport, and air transport, since the other areas were considered less important for the EFTA countries (Table 4).

## Road Transport of Goods

Since over 80 percent of intra-Community goods trade is by road, the White Paper was more ambitious in the area of road transport of goods than in other transport areas (Pelkmans and Winters, 1988, p. 51). The main goals were to abolish internal border checks, phase out quotas on inter-country hauling, and allow nonresident carriers to provide road transport services between other member states (cabotage). Technical standards, vehicle taxation, and working conditions were also to be harmonized.

At present, rules and restrictions governing trucking operations, safety standards, market entry, and price regulations all differ among EC and EFTA countries. The methods of taxing trucking operations and the level of taxation also vary, causing large differences in a firm's cost structure depending on where it is incorporated and where it operates.[46] In addition, rules governing nonresident carriers are set by bilateral negotiations with over half of cross-border trips rationed by bilateral permits ("Europe's Internal Market," 1988, p. 36).

Liberalization efforts began slowly, as member states with more heavily taxed and regulated trucking sectors sought to protect the competitiveness of their firms, while maintaining adequate safety standards in the face of deregulation. The first major pact was made in June 1988, when it was agreed that the number of EC licenses for inter-country transport would be raised by 40 percent immediately and by another 40 percent in 1989.[47] It was also agreed that by 1993, all remaining restrictions would be scrapped; an EC-wide truck drivers' license would be introduced to give haulers freedom to trade if they meet a set of professional

[46]Within the EC, some countries—for example, the United Kingdom and Germany—rely on direct taxes on trucking operations, while others—such as France and Italy—make little use of these taxes. In 1986, the annual tax for a large truck varied from ECU 345 in Italy to ECU 4,870 in the United Kingdom. In addition, countries with high direct taxes make little use of road tolls, while countries with low direct taxes use them heavily. Fuel taxes also vary sharply; see EC Commission (1986a).

[47]In December 1989, a further quota increase of 40 percent was tentatively agreed for 1990–92. However, the measure has not yet been allowed to take effect.

**Table 4. EFTA: Mode of Transportation of Foreign Trade in 1985[1]**
(in percent)

| Mode of Transportation | Austria | | Iceland | | Finland | | Norway | | Sweden | | Switzerland | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Import | Export | Import | Export | Import | Export | Import | Export | Import | Export | Import | Export |
| Road | 25.2 | 49.1 | — | — | 3.3 | 2.8 | 12.4 | 2.4 | 11.4 | 13.7 | 39.8 | 54.3[2] |
| Rail | 39.8 | 41.9 | — | — | 11.8 | 10.4 | 5.4 | 0.7 | 5.8 | 33.5 | 24.0 | 38.1 |
| Maritime | — | — | 99.7 | 99.8 | 81.8 | 86.7 | 81.4 | 51.3 | 81.6 | 52.8 | 16.3 | — |
| Inland Waterways | 11.2 | 8.7 | — | — | 1.2 | 0.1 | — | — | — | — | 19.9 | 6.3 |
| Air | — | 0.1 | 0.3 | 0.2 | — | — | — | 0.1 | 0.1 | 0.1 | 0.1 | 1.0 |
| Pipeline | 23.7 | — | — | — | 1.9 | — | — | 45.5 | — | — | — | — |
| Other[2] | — | — | — | — | — | — | 0.8 | — | 1.2 | — | — | 0.3 |

Source: EFTA, *The Transport Study,* Annex II.
[1]Including transport by pipeline.
[2]Includes unallocated.



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standards; and member states would harmonize their rules on road taxes and drivers' working conditions.

Opening borders and liberalizing the trucking industry should reduce transport costs. Border delays cause international shipments to take as much as 50 percent longer than comparable domestic shipments, while the permit system forces trucks to return empty on many international hauls.[48] These factors, along with rationalizing the structure of the sector, could result in marked reductions in intra-Community transport costs.[49]

Lower trucking costs in the EC may, however, have a relatively small impact on inter-bloc trade. The savings in transport costs within the EC for manufactures—which account for most inter-bloc trade—are likely to be small relative to the total cost of the goods. Furthermore, as noted, EC-EFTA trade will also benefit from the introduction of the Single Administrative Document and the planned computerization of customs data, as well as the decontrol of the EC's internal borders. In addition, most of the trade between the Nordic countries and the EC is by sea.

Liberalization may still have an impact on firms hauling goods between the EC and EFTA. The demand for their services will vary with the level of trade and with inter-bloc road transport policies. The existing bilateral pacts will be scrapped by 1993, since they discriminate against third-party EC members, and new agreements will be needed by that time to avoid risking interruptions in inter-bloc transport. However, the outlook for EFTA firms is not clear.[50]

Within the EFTA, there appears to be a desire to reach an agreement on road transport with the EC. The EFTA's Transport Committee has a goal of "non-discriminatory access to the market for carriage of goods by road between the Community and the EFTA countries, meaning in practice an extension of the common road haulage market to the EFTA countries . . . to achieve a common West-European transport market" (EFTA, 1988, pp. 16–18). This would require at least partial harmonization of rules on road transport, taxation of commercial vehicles, and market access. EFTA members are expected to mirror EC regulations in all areas, except perhaps vehicle weight. While a joint EC-EFTA agreement is favored—perhaps as part of the EES negotiations—divergent interests and bargaining power could result in bilateral solutions.

[48]Border delays are also estimated to cost about ECU 0.4–0.8 billion annually (Cecchini, 1988, p. 12). Empty return hauls are estimated to cost another ECU 1.2 billion annually (EC Commission, 1988a, p. 97).

[49]A 5 percent saving was estimated in EC Commission (1988b), p. 95.

[50]EC demand for non-EC transport services is estimated to fall by almost 8 percent; see EC Commission (1988b), p. 182.

EC trucking regulations have also led to disputes with two EFTA members, Austria and Switzerland, which are both on key trucking routes between EC member states. Negotiations are taking place on a bilateral basis. For Austria, the issues include taxation, investment in better routes, quota and border controls, and limits on traffic and noise levels. Tensions rose in December 1989, when Austria banned night driving by large, high-noise trucks on several transit routes. However, these problems appear manageable. For Switzerland, the key issues are road taxes and size limits on trucks. Size limits are especially contentious. The EC objects to the Swiss prohibition on trucks over 28 tons, because the EC permits trucks of up to 40 tons, while the Swiss argue that the larger trucks would crowd its highways, cause excessive noise, and damage the fragile mountain environment. Neither side has shown signs of yielding, and the discussions may spill over into other areas.

## Sea Transport

EC policy on maritime transport is evolving. While the White Paper envisaged a phasing out of restrictions among member states and the creation of conditions under which these services could be freely provided, there was no EC-wide legislation in this area. In 1986, four regulations were passed. The first sought to counter discrimination by third countries against EC-owned vessels. The second condoned the principle of cabotage for EC-owned vessels. The third made certain maritime activities subject to monopoly regulations, and the fourth set procedures to combat dumping in international shipping. The first regulation was to enter into force in 1993, while the others took effect in July 1987. These were seen as first steps toward a comprehensive shipping policy, with issues such as the decline of the EC's shipping fleet left for future discussions. Also envisaged were plans to harmonize national maritime policies regarding crew regulations, taxation, and technical standards.

The regulations were generally well received within the EFTA. The main concern was that cabotage was only favored for EC-owned ships. The EFTA committee on transport issues proposed that the rules be broadened to include EFTA members (EFTA, 1988, pp. 29–30). However, some EFTA members thought problems could be avoided by using EC-based subsidiaries.

While no new regulations have been enacted by the EC since 1986—and progress on cabotage has been minimal—a proposal for a European Ship Register was advanced in May 1989. Under the plan, EC-based shipowners could register their ships under the EC flag



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(Euros). Euros would be subject to high technical and safety standards, and all officers and at least part of the crew would have to be EC nationals. In exchange, only Euros would be granted cabotage within the EC. Minimum safety and labor standards were also proposed for non-EC ships using EC ports, although this is unlikely to affect ships flying EFTA flags.

EC measures, those taken and proposed, may have little impact on inter-bloc shipping. While shippers from EFTA countries would like the right of cabotage within the EC, this would have to be negotiated based on reciprocity. However, little progress is likely in inter-bloc talks in this area until the EC sets its own policies. Should EES talks go well, mutual concessions may be granted and EFTA shipping firms could be made subject to the same rules as EC firms. If this is not handled under the EES, the position of EFTA members will probably depend on EC policies regarding third countries, which are yet to be established. In any case, EC-based subsidiaries of EFTA firms may be permitted to register as Euros.

## Air Transport

Until recently, every state in the EC had full sovereignty over its air space. In addition, perhaps because most airlines were largely or wholly state owned, air transport was exempted from the competitive statutes of the EEC Treaty. A report by the EC Commission found that the system of air services in Europe had become mainly one of licensed duopolies, with "some 200 separate bilateral agreements between 22 countries . . . in which designated carriers provide services whose cost, capacity and conditions are directly or indirectly regulated. Rights by a Community carrier to offer services between two other Member states, so-called fifth freedom rights, are effectively prohibited . . . . In 1987 only 5 % of European routes had multiple designation, i.e., more than one airline per State per route. In a number of cases the revenues on city pair routes are pooled and split 50:50 between both carriers. Price competition is limited" (EC Commission, 1988b, p. 97).

The cost of these arrangements appears high. During 1978–82, the average cost of international air services in Europe was 60 percent higher than similar services in North America, while the cost of air shipment per ton or kilometer was 50 percent higher (EC Commission, 1988b, p. 97). In addition, the variable costs of flying routes of similar lengths were 20 percent higher in Europe than in North America, while ticket costs were on average 35–40 percent higher ("Europe's Air Cartel," 1989).

Liberalization has progressed slowly. The first proposals were made in 1974, but none were enacted until 1983, when a measure easing inter-regional air service was passed. The White Paper discussed liberalizing the sector in general terms, so the Commission was freed to set its own strategy. By 1987, it aimed to allow greater freedom to provide air services between member states by changing the system of setting and approving tariffs, and by limiting governments' rights to restrict capacity and market access. No mention was made of policies toward third parties. By 1992, the Commission had hoped to increase competition within the EC by ending block exemptions from competition rules for the intra-EC operations of airlines owned by nationals of EC member states and by allowing these airlines full fifth freedom rights within the EC. It was hoped that these efforts would not be undercut by increased concentration in the sector. However, mergers, joint ventures, and cooperation agreements are all up sharply.[51]

In December 1987, an agreement was made limiting the freedom of authorities at one end of a route to reject lower fare proposals by carriers at the other end and setting conditions for offering discount fares. It also set a three-year timetable for expanding the minimum range for capacity sharing from a 50:50 to a 40:60 range; allowed more airlines to compete on crowded routes and regional hubs; and gave certain fifth freedom rights to carriers within the EC. While route sharing and fares have fallen on the busiest routes, the benefits of this agreement are seen as limited, with no major impact on non-EC carriers.[52]

The next step was taken in April 1989, when the European Court stopped an attempt to prevent sales of certain discount tickets—pursuant to the Commission's power to use EC regulations on anti-competitive agreements to challenge price fixing agreements involving member states—both on intra-EC routes and on routes to non-EC countries. This implied that the Commission could challenge air fare agreements on international routes made through the International Air Transport Association.

A major accord was reached in December 1989 when EC transport ministers approved in principle guidelines for three reforms. First, all capacity and revenue sharing arrangements between governments should end by

[51]For example, British Airways has taken over British Caledonian. Increased concentration in the sector may act to undercut the potential competitive gains from the EC's open skies policy. The EC Commission is concerned about these developments. In February 1990, the Commission issued a statement objecting to Air France about its planned takeover of UTA.

[52]In June 1989, the Commission proposed to expand this accord to cover regional air service by ending exclusions based on distance and aircraft size. These talks are still under way.



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January 1993. Second, governments should lose the right to reject unilaterally nonpredatory changes in air fares by January 1993. Third, governments should end discrimination against smaller domestic airlines by July 1992. In June 1990, the EC transport ministers formally approved the timetable. However, it is not yet decided how these rules will be applied to carriers from third countries flying to Western Europe.

Liberalizing intra-EC air service may have an impact on airlines owned by EFTA nationals and governments—particularly SAS, which is jointly owned by interests in Denmark, Norway, and Sweden.[53] The EFTA committee on transport issues argued that air transport rules were best suited to a region covering all of Western Europe, with EFTA members included in the EC's air transport regime. The key issue for the committee was whether mirroring or comparable legislation should be adopted by the individual members or by EFTA as a bloc. However, so far, talks have only been bilateral. Negotiations have started with Norway and Sweden.[54] The outcome is not clear. While accords with Norway and Sweden seem likely, a multilateral accord is possible if the EES talks succeed.

[53]SAS is treated as an EC carrier because of Danish participation.

[54]The joint talks may allow Norway and Sweden to be treated separately from other EFTA members.



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# VII Labor Mobility

The free movement of labor is one of the four freedoms viewed by the EC as essential to the success of the internal market program. It requires that citizens of the member states be free to engage in their professions throughout the EC without discouraging restrictions. As in the case of trade in goods, free labor mobility requires the elimination of border controls and technical barriers—with technical barriers posing the greatest problem. Within the EC, the primary technical barriers relate to differences in national rules on professional and vocational qualifications.

Although the EC Court of Justice has restricted the right of officials in member states to reserve posts in private firms for nationals and much effort has gone into harmonizing national qualifications, Community-wide standards have not been established for many professions. Somewhat more progress has been made in formulating comparable vocational training qualifications. As with trade in goods, the Commission has applied the Cassis de Dijon principle of mutual recognition, implying that any person practicing a vocation in one member state should in principle be able to practice it in another. However, obstacles to the free movement of labor remain, including complex administrative procedures for residency permits and rules on the taxation of wage earners residing in one member state and earning their income in another.

Restricting labor mobility in the EC implies a less-than-optimal factor allocation, leading to efficiency losses and lower overall welfare (Pintado and others, 1988, p. 51). On the national level these effects have long been recognized, and labor mobility within countries is usually encouraged. However, at the Community level, protecting insiders' positions vis-à-vis outsiders—particularly if domestic unemployment is high—and pride in national traditions and institutions may still lead to segmented labor markets. The importance of cultural and linguistic differences should also not be underestimated.

Labor mobility is driven by similar considerations as is goods trade (Krugman, 1987, p. 129). Labor migration from one country to another—one-way migration—corresponds to inter-industry trade in goods. When labor moves from a low-wage to a high-wage country, world income rises because labor is allocated more efficiently. On the other hand, two-way migration—which corresponds to intra-industry trade—can occur for a number of reasons, mainly mismatches in the supply and demand for specific skills in particular labor markets and movements within multinational firms. This may also have a beneficial effect on labor allocation.

One-way migration has been the main form of labor movement within the EC. In the 1960s and early 1970s, unskilled workers moved from the south of Europe to the strong labor markets in the north. However, wage disparities have continued. A recent study showed that industrial labor costs in Europe range from 25 percent of the EC average in Portugal to 30–40 percent above the average in some of the urbanized regions of the north, mainly Germany and the Netherlands (Begg, 1989). However, a rise in unemployment in the north has caused a fall in one-way migration, despite continued wage differentials.[55,56]

The EFTA countries generally require foreigners to obtain a work permit before permitting them to work in their domestic market. Since 1954, however, all Nordic citizens have the right to work in another Nordic country without a work permit; although movement is made difficult in certain professions, for example, the legal and medical professions. Nordic citizens also enjoy the same social security and social rights as the host country's own citizens.

EC-EFTA cooperation regarding labor mobility is still at an early stage. Some progress has been made,

[55]Helm and Smith (1989) argue that this also reflects the power of trade unions in the northern EC countries.

[56]One-way migration may continue to slow even if existing barriers to labor mobility are completely removed. With the envisaged harmonization of working conditions and a common social policy in the EC—the "social dimension of the internal market"—some of the pressures that have in the past led to internal migration of labor may be reduced ("The Social Dimension of the Internal Market," 1988). It has been argued that a harmonization of social standards would run counter to the aim of increased labor market flexibility and even development within the EC. See "Sachverständigenrat zur Begutachtung der gesamtwirtschaftlichen Entwicklung" (1989), pp. 194–200.



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for example, the mutual recognition of higher education diplomas and participation in European Community Action for the Mobility of University Students (ERASMUS). However, there appears to be a growing awareness within the EFTA that efforts must be intensified to benefit fully from the creation of the EES.

In October 1989, the EC-EFTA High Level Steering Group stated that the free movement of persons would be an important supplement to the three other freedoms. Employees, the self-employed, and their families should be allowed to move freely within the EES on the basis of mutual recognition, nondiscrimination, and reciprocity. However, recognizing the special situation in some EFTA countries, the EFTA emphasized that special agreements were required to guide negotiations in this area ("Schlussfolgerungen der EG-EFTA-Steuergruppe," 1989). On the other hand, a major accord in this area would apparently not be reached outside of EES negotiations.

The EFTA's Consultative Committee—which includes representatives of employers, labor, and other economic interest groups—favored the free flow of labor at its October 1989 meeting. In its final document, the Committee supported the creation of a Western European social space and recommended EC-EFTA negotiations on removing physical border controls under the principles of nondiscrimination, reciprocity, and mutual recognition. The Committee's recommendations were endorsed by the EFTA's ministerial meeting on October 27, 1989.

While concerns persist about a large one-way migration from EC countries with high unemployment rates, it appears that EFTA countries attach greater importance to the potential gains from two-way migration.[57] It is also believed that, with rapid technological change, growth may be hampered by bottlenecks in specific skills and that barriers to labor mobility may slow technological development. Free labor mobility within the EES would also tend to reduce labor market pressures in countries with low unemployment and help contain wage drift.

Switzerland apparently still has reservations about allowing free labor mobility within the EES, although it has not raised objections to the recommendations of the EFTA's Consultative Committee ("Officials Agree on Framework . . . ," 1989). Switzerland is already a substantial net importer of labor[58] and the size of its foreign work force is a sensitive political issue. On the one hand, it is feared that the free flow of labor within the EES could cause the foreign work force to increase sharply after 1992. On the other hand, inhibiting labor mobility could cause difficulties in hiring much needed skilled labor from EC countries (Hauser and others, 1988, p. 71). Thus, it remains uncertain whether Switzerland will go along with the EFTA decision to endorse free flow of labor across frontiers.

[57]While few official statements have come out against free labor mobility, the press in several EFTA countries has reported concerns. For example, there is a fear that foreign workers could flood Iceland's small domestic labor market, while an inflow of new workers could raise the already high unemployment rate in Norway. In addition, there has always been a reticence to allow foreign workers in Finland.

[58]In 1987, one fourth of all workers were foreign, with three fourths coming from EC countries; see Conseil Fédéral Suisse (1988).



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# VIII Financial Services and Capital Movements

The Community's efforts to create a European financial area[59] are two-pronged: the removal of all barriers that inhibit cross-border trade in financial services and the establishment of EC firms in other markets within the EC; and the removal of all exchange and capital restrictions within the Community. Formal discussions between the EC and EFTA, which started with the Luxembourg process, are now being carried out in the working group on services and capital movements, which was created as part of the Oslo-Brussels process. The prospects for closer cooperation are generally good. However, certain policies—mainly related to the access of EC firms to EFTA markets—may still pose problems for some EFTA countries.

## Implications of Financial Integration

The liberalization of trade in financial services and capital movements is a key component of the internal market program for several reasons. First, the financial sector accounts for a substantial share of output and employment in the Community. Second, trade in financial services is still subject to considerable protection, particularly in the retail sector. Third, financial services are used as inputs in other economic activities, implying important spillover effects throughout the economy. The gains from a unified financial market should be substantial.[60] However, they may not accrue equally to all member states. The gains may be particularly large in the southern member states, which are relatively less integrated with world capital markets.

The economic effects of liberalizing trade in financial services are similar to those of liberalizing trade in other products. First, liberalization may help achieve a more efficient resource allocation within the financial services sector. Since trade in financial services is essentially of the intra-industry type, the main benefits should come from economies of scale and from increased competition. Second, liberalization may also help improve resource allocation across different sectors of the economy. Although the economic effects are similar to those in other sectors—since the provision of financial services usually requires a physical presence—there is likely to be more cross-border establishment than in nonservice industries.

The current variation in retail prices for financial services in Western Europe provides significant incentives for further cross-border expansion.[61] In the retail sector, strong local networks in many countries suggest that the expansion will take place through mergers and acquisitions rather than through new establishments. Indeed, this process is already under way. The wholesale sector has long been more exposed to foreign competition and is less limited by the need for a physical presence. Cross-border trade may therefore play a more prominent role in the wholesale than in the retail sector.

The benefits of liberalizing capital movements are somewhat different from those of liberalizing trade (see Krugman, 1987). Free capital movements allow for an efficient allocation of savings and investment. In this respect, one-way capital movements are similar to inter-industry trade, that is, trade driven by comparative advantage. However, even without net resource transfers, important benefits can result. Two-way capital flows, often short-term, give rise to gains for much the same reasons as intra-industry trade. With free access to foreign financial markets, investors can diversify their portfolios and achieve a more efficient asset composition. Free capital movements will also help to increase competition in financial markets.

While the free movement of capital can generally be expected to be beneficial, this may not always be the

[59]The EC Commission's original proposals are in its 1985 White Paper. In the course of implementing the internal market program, certain proposals have been withdrawn and others have been added. For a recent overview of the legislation covering financial services and capital movements, see European Documentation (1989).

[60]The EC Commission (1988b) has estimated that the creation of a common market in financial services may raise GDP in the Community by 1.5 percent as compared with a cumulative gain of 4.5 percent for the internal market program as a whole.

[61]Data on price differences for financial services within the EC are presented in the EC Commission (1988b).



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case. If other distortions are present, liberalizing capital movements may actually reduce welfare. The most obvious example is the existence of different tax systems. Although free capital movements may equalize the real after-tax rates of return in different countries, real rates of return before taxes may still differ, implying an inefficient allocation of capital. However, it is generally better to remove the original distortions than to introduce additional ones. As Basevi (1988) argues, the internal market program turns the second-best argument around in that the removal of regulations and restrictions in the financial sector may make the underlying distortions more transparent. Particularly, in the area of taxation, there may be pressures for harmonization of the tax treatment of capital income (Bovenberg and Tanzi, 1990).

The effects on EFTA countries depend on several considerations.[62] A complete integration—implying both the harmonization of rules and regulations and the elimination of all remaining capital controls—would enable the EFTA countries to share fully in the gains from financial integration in Western Europe.[63] EFTA customers would benefit both from lower prices and access to other European markets. EFTA financial institutions would gain improved access to foreign markets, but they would also face more competition in their domestic markets. The effects of allowing more foreign competition may be different for different EFTA countries. Switzerland appears to have the strongest and most developed financial sector among the EFTA countries. Financial institutions in Norway, and in particular in Iceland, may face difficult challenges. Financial institutions in the EFTA countries are already preparing for the more competitive environment of the 1990s. In the Nordic countries, several banks and insurance companies have either merged or formed strategic alliances in order to build a stronger market position.

A decision not to participate in a European financial area is likely to imply some costs. The benefits of creating a common market for financial services in the EC would then accrue mainly to large customers—multinational firms and institutional investors—which already have access to foreign markets. EFTA institutions may find it harder to compete both for foreign and large domestic customers. This would probably contribute to a greater expansion of EFTA subsidiaries abroad than otherwise. At the same time, smaller EFTA customers would not benefit from the lower prices and greater diversity associated with a unified European market.

[62]The effects on EFTA countries are discussed in EFTA (1989) and Gardener and Teppett (1990).

[63]Estimates by Pintado and others (1988), based on the same assumptions as those employed by the EC Commission (1988b), suggest that the EFTA countries would have more to gain than the EC.

## Banking

The EC's approach to liberalizing trade in financial services rests on three fundamental principles, which go back to the Cassis de Dijon judgment by the EC Court of Justice in 1979: home country control, mutual recognition, and harmonization of essential laws and practices. The first principle stipulates that supervision of a financial institution, including all of its branches, should be handled by the authorities in its home country, which implies that authorities in host countries must accept the judgments of the authorities in the home country.[64] The second principle requires each member state to recognize the supervisory bodies of other Community members. If a financial institution is authorized by one member's authorities, it should be permitted to operate in the other member states. The third principle calls on the EC Commission to establish certain minimum standards for prudential supervision of financial institutions with which all member states must comply. Since business is likely to flow to the least regulated areas, the EC hopes to stimulate regulatory convergence through competition among the regulatory frameworks of different member states. Community-wide minimum standards provide a floor to this process.

The centerpiece of the Community's plans for an integrated banking market is the Second Banking Directive, which was adopted in December 1989 and will come into effect on January 1, 1993. This directive provides for a single banking license that will be the only authorization needed for a bank to operate in the Community. If a bank is authorized to operate in its home country, it will automatically be authorized to operate in other member states without prior permission from its host country authorities. However, host countries will continue to be responsible for the control of bank liquidity.

The single banking license is based on a universal banking model. It therefore allows banks to participate in a broad range of activities including leasing, portfolio management, and securities trading. Once a bank has been authorized by its home country authorities to undertake a certain activity, it is free to undertake that activity throughout the Community regardless of whether banks in other countries are authorized to do so. To safeguard the interests of depositors and investors—and the stability of the financial system—each

[64]However, supervision of a subsidiary is the responsibility of the authorities in the country in which it is chartered.



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member state must comply with certain basic standards with respect to capital requirements, the range of permissible nonbanking activities, and supervisory control of its main shareholders.

The Second Banking Directive is complemented by a number of directives on the harmonization of prudential standards and banking supervision. Common standards for the own funds of credit institutions were established with the adoption of a directive in April 1989. A solvency ratio directive adopted in December 1989 requires banks and credit institutions to limit their lending and financial exposure to a fixed multiple of their capital. These two directives constitute the harmonized prudential requirements necessary to implement the single banking license. Both follow closely the recommendations on capital standards by the Committee on Banking Regulation and Supervisory Practices of the Bank for International Settlements (known as the Cooke Committee or the Basle Committee).[65] A number of other directives and recommendations deal with similar prudential issues and with accounting standards.[66]

According to the Second Banking Directive, subsidiaries of foreign banks will generally be able to operate under the same conditions as EC banks. They may engage in all of the activities authorized in the EC country in which they were first established and where they are supervised. While existing EC-based subsidiaries will be covered by a grandfather clause, newly established subsidiaries will be subject to a reciprocity requirement.[67] Banks from non-EC countries may establish subsidiaries in any EC country if their home countries treat EC banks similarly to domestic banks. Branches of banks not headquartered in the EC may not have the right to provide services throughout the EC. The rules for establishing branches of non-EC-originating institutions have not been set on an EC-wide basis and are likely to remain subject to the discretion of each member state.

The original draft of the Second Banking Directive called for reciprocity based on equivalent treatment. This would have implied that non-EC countries would be required to grant EC banks the same treatment as that granted by the EC. Since Europe has a universal banking tradition, while the United States and Japan still impose a legal dividing line between banking and securities operations, this approach was heavily criticized both within and outside the Community. The directive was subsequently modified and the EC has indicated that it will apply the principle of national treatment. This implies that foreign banks will have access to the EC if their home countries do not discriminate between EC banks and domestic banks. However, the Commission will continue to use equivalent access as a bargaining tool. If the Commission finds that a non-EC country is not granting EC banks treatment comparable to that granted by the EC to non-EC banks, the Commission can initiate negotiations.[68] Licenses can be denied in cases where non-EC countries do not grant national treatment to EC banks. Subsidiaries of non-EC banks established in the Community prior to the implementation of the directive are subject to grandfathering provisions and will be treated as Community banks.

The EFTA countries all have a strong interest in participating in a Western European market for banking services. The prospects for further cooperation between the EC and EFTA are generally good. Initially, the talks between the EC and EFTA focused mainly on proposals regarding solvency and equity requirements, deposit insurance schemes, and accounting standards. All EFTA countries are currently revising their legislation and practices to conform more closely with internationally accepted standards, as well as with EC standards. However, if EFTA banks are to take full advantage of the EC's liberalization efforts, EFTA countries must satisfy EC reciprocity requirements. This may call for changes in the legislation of some EFTA countries with respect to current limitations on foreign ownership and establishment.

In Austria, foreign banks may establish subsidiaries and acquire shares in Austrian banks. Subject to authorization, they may also establish branches. The Nordic countries all have restrictions on foreign ownership and establishment. However, all countries have recently taken important steps to liberalize these restrictions. Although the existing legislation in Finland limits foreign ownership to 20 percent of Finnish banks,

[65]Committee on Banking Regulation and Supervisory Practices, "International Convergence of Capital Measurement and Capital Standards," July 1988. Among the signatories were Belgium, Canada, France, the Federal Republic of Germany, Italy, Japan, Luxembourg, the Netherlands, Sweden, Switzerland, the United Kingdom, and the United States.

[66]At the end of 1985, the EC Commission proposed a directive on the liquidation and reorganization of credit institutions. In December 1986, the EC Commission issued two recommendations on the supervision of large exposures to single customers and groups of customers and deposit guarantee schemes. A proposal for a directive on mortgage credit was issued in 1987. A 1986 directive and a 1989 directive seek to harmonize accounting standards.

[67]Key (1989) discusses different reciprocity concepts and their implications for third countries.

[68]It remains unclear whether the EC could insist on equivalent treatment given legal commitments by several member states. The Organization for Economic Cooperation and Development code on capital movements generally prohibits discriminatory measures between OECD countries. The only exceptions relate to countries forming a customs or monetary union or to countries that have made an explicit reservation for reciprocity. However, some EC countries have not lodged such a reservation.



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foreigners can acquire up to 100 percent with special permission. Finland is considering allowing foreign banks to establish Finnish branches. In Iceland, while foreign participation in nonbank financial institutions is already permitted, banks may have only representative offices. However, Iceland recently declared its interest in opening its banking industry to limited foreign competition, and new legislation has been prepared to allow foreign ownership of up to 25 percent of shares in Icelandic banks. Norwegian banking legislation generally limits foreign ownership in Norwegian institutions. However, the limit was recently raised to 33⅓ percent and foreign banks can now establish branches. Beginning July 1, 1990, Sweden lifted the special ban on foreign ownership of Swedish banks, securities firms, and consumer-oriented finance companies, although the general provisions limiting foreign participation in Swedish companies still apply to banks. Foreign banks will also be able to establish branches. All countries are considering further liberalization measures. EC reactions to these moves have been positive. Provided that certain key provisions are adopted, the EC seems to be willing to include the EFTA countries in the internal market for banking services.

## Insurance

The insurance industry in the Community already enjoys freedom of establishment. The EC has long had a body of legislation that coordinates national laws both on the establishment and the operation of insurance companies. Community laws cover the setting up of new companies, the opening of new branches, and supervision. However, reflecting considerable differences in national regulations, a number of obstacles remain that limit the freedom of an insurance company in one member state to cover risks in others.

The basic initiatives covering non-life insurance are included in the Second Non-Life Insurance Directive, adopted in June 1988. Any insurance company based in the EC will be able to cover large risks throughout the EC without having to establish itself in other than its home country. The directive is the follow-up to a 1986 decision by the European Court of Justice, which found that the freedom to provide insurance services already existed on the basis of the Treaty of Rome. However, the Court also declared that, in some areas, certain restrictions against insurers from other member states were compatible with the Treaty. The Court saw a particular need to protect small clients. As a consequence, the ruling distinguishes between large risks, which relate to larger commercial and industrial clients, and mass risks, which relate to small businesses and individuals. For large risks, only simple notification is required for providing services in other member states. The access procedure for mass risk insurance is more complicated. Since national supervision and control is considered more important in this area, some retention of host country control has been deemed necessary. Therefore, in order to realize a common market for mass risk insurance, the EC may have to take further action to harmonize national regulations. A proposal for a directive on these matters was tabled by the Commission in July 1990.

In contrast to the Second Banking Directive, the Second Non-Life Insurance Directive deals only with cross-border provision of services and does not provide for Community-wide branching of insurance companies under home country control. Therefore, the EC is considering a framework directive for non-life insurance that will introduce a single license and home country control for all insurance risks. A similar directive is to be proposed on life insurance policies. This directive also will deal with technical reserves, the choice and content of laws applicable to insurance contracts, and administrative procedures regulating the activities of insurance companies outside their home state.

The EC took a further step toward a unified market in life insurance policies by adopting the Second Life Insurance Directive in December 1989. This directive essentially frees Community citizens to take out life insurance policies in any member state. However, it distinguishes between the case where an individual wishes to take out a policy in a country other than his resident country—in which case he would have to accept the degree of protection in the country of the insurer—and the case where an insurance company wishes to conclude an agreement outside its resident country—which requires the insurance company to accept the provisions of the country in which the risk is located. This is an exception to the principle of home country control. Further harmonization efforts are being considered to achieve a common market for life insurance policies.

The EC's policy with respect to insurance companies from nonmember countries is similar to that in the banking area. Subsidiaries of EFTA insurance companies operating in the EC will be subject to the same treatment as EC companies. Once a subsidiary is established in any member state, it is free to compete with EC companies on an equal footing. However, the Second Life Insurance Directive includes a reciprocity clause that follows the wording in the Second Banking Directive. Moreover, the 1973 First Non-Life Insurance Directive and the 1979 First Life Insurance Directive both seem to imply that branches of non-EC companies would be subject to certain provisions requiring them to deposit assets relative to their commitments in each member state. Most member states have also filed



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exceptions to the Organization for Economic Cooperation and Development (OECD) code on capital movements, which would allow them to apply reciprocity requirements on non-EC countries. Finally, as in banking, the freedom of non-EC insurers to provide services does not apply to branches or operations of companies headquartered outside the Community.

The possibility of concluding agreements between EC and non-EC countries on insurance was established both in the First Non-Life Insurance Directive and in the First Life Insurance Directive. Switzerland was the first country to do so. Under an agreement concluded in October 1989, which may serve as a model for similar agreements in the future, Swiss and EC insurers will have access to each other's markets for non-life insurance on a reciprocal basis. Swiss companies will be able to operate in the EC through agencies or branches provided that Switzerland grants EC companies equal rights. The agreement introduces minimum standards based on the First Non-Life Insurance Directive. It is valid only as long as Switzerland keeps its legislation in line with that of the EC.

All of the EFTA countries want their insurance companies to have sufficient scope to operate abroad. The talks between the EC and EFTA have so far been rather general in nature. In the Nordic countries, the insurance industry has been highly regulated, with prohibitive restrictions on foreign establishment and ownership. In line with the general trend of financial deregulation in other countries, efforts to liberalize the insurance sector are now being considered. An EES agreement is expected to provide for an integration of the insurance markets between the EFTA countries and the EC; it will imply removal of existing restrictions on establishments from other EES countries.

## Investment Services

The White Paper envisaged the creation of a unified European securities market system that would link the existing stock exchanges in the Community. A number of directives have been proposed or enacted, aimed at breaking down barriers between national markets. A major step was taken by the Council of Ministers in November 1985 with the adoption of a directive establishing the free marketing of units issued by investment funds.[69] It was the first directive establishing the freedom to market a financial product throughout the Community on the basis of the principles of mutual recognition, home country control, and harmonization of essential standards. Several directives have focused mainly on harmonizing listing and information requirements.[70] In the area of mergers and acquisitions, a proposal for a directive on public takeover bids was put forward in 1988, while a directive on insider dealing was adopted in the fall of 1989.

The Commission has also proposed a directive on investment services that would provide for a single authorization procedure for firms wishing to engage in investment advice, brokerage dealing, market making, and portfolio management in the Community. This directive gives securities houses the same freedoms as banks. It also contains reciprocity provisions similar to those in the Second Banking Directive.

Foreign investment houses have already been able to operate in most EFTA countries for several years. These companies have worked almost exclusively in the wholesale market. The talks between the EC and EFTA have dealt primarily with issues such as insider dealing, requirements for stock exchange registration, and the activities of investment funds.

## Capital Movements

Since a complete integration of financial markets is impossible without free movement of capital, the EC has made rapid progress in this area. In June 1988, the Council of Ministers adopted a directive that called for a complete removal of all remaining capital controls in most EC countries by July 1, 1990. Several countries implemented the directive well in advance of the deadline. While France and Italy abolished remaining restrictions in January and May, respectively, Belgium and Luxembourg abolished their two-tier exchange market in March. However, Ireland and Spain have been authorized to maintain certain restrictions until the end of 1992 and through the end of 1995 in the cases of Greece and Portugal. The directive contains safeguard clauses that allow member states to reintroduce restrictions on short-term capital movements in the event of disturbances to monetary and exchange rate policies. Such restrictions must be authorized by

[69]The directive refers to unit trusts or "undertakings for collective investment in transferable securities," which are legally similar but not identical to mutual funds.

[70]Early initiatives included a 1979 directive coordinating the conditions for the admission of securities to official stock-exchange listing and a 1980 directive coordinating the requirements on listing particulars to be published for the admission of securities to official stock-exchange listing. These were followed up by a 1982 directive on the regular publication of information on listed companies. The Council took a further step in 1988, when it adopted a directive on the information to be published when major changes in the ownership of a listed company take place. In 1989, the Council adopted a directive coordinating requirements on the prospectus to be published when transferable securities are offered to the public.



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the Council and may be maintained for a period not to exceed six months.

The 1988 directive recommends the application of the ''erga omnes'' principle. This implies that the liberalization of capital movements be accomplished unilaterally, on a worldwide basis. However, this does not prevent the application of any reciprocity requirements in other areas. In this connection, direct investment, the provision of financial services, and the admission of securities to capital markets are explicitly mentioned.

The EFTA countries have gone through a similar liberalization process. Switzerland was the first EFTA country to free capital movements, followed by Austria. However, until recently, all the Nordic countries maintained tight capital and exchange controls. Sweden removed all remaining restrictions in July 1989. Norway removed most of its existing restrictions on the corporate and institutional sectors in December 1989. Effective July 1, 1990, Norway abolished nearly all remaining restrictions, including those affecting individuals. Finland has taken similar steps. Iceland still retains a rather comprehensive system of restrictions, but the Government intends to implement extensive liberalization measures by 1993.

The freedom of capital movement raises a number of fiscal issues with respect to the scope for tax harmonization and its realization (Bovenberg and Tanzi, 1990). The EC Commission has so far considered three options: increased cooperation and exchange of information among national tax authorities; stepped-up reporting requirements; and a minimum withholding tax imposed on dividends and interest income imposed at the source on all EC residents. Initially, the Commission opted for the third approach as it proposed a minimum withholding tax of 15 percent on interest income in February 1989. After much opposition from some member countries, the Commission shifted the emphasis in the direction of enhancing the exchange of information to assist member governments in enforcing taxation of their respective residents. The final solution remains unclear. Taxation is outside the scope of the Oslo-Brussels process. However, as in the EC, the EFTA countries will have to reconsider their tax systems in the process of liberalizing capital movements.[71]

[71]Finland, Norway, and Sweden are currently carrying out major tax reforms. Reform efforts in all three countries have been guided by the need to conform with international trends. However, it is premature to predict the extent to which further adjustments will be needed.



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# IX European Monetary Unification and the EFTA

Although the establishment of an economic and monetary union (EMU) is not part of the internal market program, its completion is sometimes seen as a precondition for the program's success because of the far-reaching implications of complete financial integration (Schinasi, 1989). At the same time, the increased likelihood of EC-EFTA free trade in financial services has raised the issue of whether this will also require EFTA countries to participate in the EC's arrangements on monetary and economic cooperation. This would entail joining the European Monetary System (EMS), which in turn would have major implications for the conduct of economic policies in the EFTA countries. The benefits and costs of joining the EMS would, to a large extent, depend on the policy adjustments membership would require.

## Evolution of Monetary Integration in the EC

The EEC Treaty does not include precisely defined commitments regarding monetary and exchange rate policies. Monetary unification is not a stated objective, although the Treaty does cover most of the conditions necessary for monetary integration (Emerson, 1979, p. 23). However, when the fixed exchange rate system came under pressure in the late 1960s, the Heads of State and Government of the EC decided to seek the creation of an EMU in Europe. The Werner Plan, presented in 1971, envisaged fixed exchange rates, free movement of capital, and coordinated monetary policies supervised by a common monetary institution. It also favored harmonized economic policies, especially in the fiscal field. However, events in the world economy prevented the Plan's implementation.

In April 1972, after the suspension of U.S. dollar convertibility and the Smithsonian Agreement of December 1971, EC member states concluded a common margin agreement in Basle aimed at reducing the fluctuations between their currencies. Under this agreement, the EC central banks set up an arrangement known as the "snake in the tunnel," because the allowed margin in the arrangement was only half the 4.5 percent allowed under the Smithsonian Agreement.[72] In May 1972, the Norwegian krone became associated with the snake. In March 1973, pressure from speculative capital flows forced the participants to jointly float vis-à-vis the dollar, causing the tunnel around the snake to disappear. Both Norway and Sweden participated in this new arrangement. However, conditions in the snake remained unstable, causing several currencies—including the British and Irish pounds, the Italian lira, and the French franc—to leave. Sweden and Norway left the snake in August 1977 and December 1978, respectively, as they regarded monetary policy in the other participating countries as too restrictive and incompatible with the overriding domestic objective of high employment (Gylfason, 1990, p. 5). Although limited progress was made toward monetary integration during this period, the snake arrangement served as a useful framework of cooperation for the remaining countries and laid the foundation for the EMS.

In December 1978, a resurgence of interest in monetary cooperation led to the adoption of the resolution of the European Council, which formed the basis of the EMS. In the hope of creating a zone of monetary stability in Europe, the EMS was based on three cornerstones: the exchange rate mechanism (ERM); the ECU; and several credit facilities (Ungerer, 1979).[73] The EMS, which became operational in March 1979, has shown much flexibility as well as the ability to evolve gradually over time (Ungerer, 1990; and Ungerer and others, 1983, 1986). The success of the EMS in fostering monetary convergence to secure increasingly stable exchange rates within the ERM has created favorable conditions for further European economic and monetary integration (Giavazzi and others,

[72]The Smithsonian Agreement re-established fixed exchange rates, with margins of ±2.25 percent, instead of ±1 percent under the Bretton Woods agreement.

[73]When the EMS became operational in 1979, all nine members but the United Kingdom participated in the ERM. Greece, Portugal, and Spain joined the EMS after acceding to the EC. Greece and Portugal have stayed out of the ERM, while Spain and the United Kingdom became participants in June 1989 and October 1990, respectively.



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1988; Gros and Thygesen, 1988; and DeCecco and Giovannini, 1989).

As the initial goals of the EMS have progressively been achieved with full capital liberalization ahead of schedule, there are concerns that the demands on the EMS may eventually exceed the system's capabilities.[74] At the Hanover summit in June 1988, the European Council appointed a committee chaired by EC Commission President Jacques Delors to propose steps leading to monetary unification within the EC. The Delors Committee presented its report in April 1989 (Committee for the Study of Economic and Monetary Union, 1989). The report proposed a three-stage process to achieve a monetary union based on total and irreversible convertibility of currencies, completely free capital movements, fully integrated financial markets, and irrevocably fixed exchange rates.

In the first stage, economic and monetary coordination would be strengthened to secure greater convergence of economic performance. New forms of multilateral surveillance would be used where policy corrections were of joint interest, and Community-level consultations would lead to proposals for changes in national policies. Member states would also be expected to consult with the Community before adopting key monetary targets or policies. A single financial area would be formed, and all EC member currencies would participate in the ERM.

In the second stage, a European System of Central Banks (ESCB) would be established and would gradually absorb the functions of the present European Monetary Cooperation Fund, and the Committee of Central Bank Governors and its subcommittees (which were established in the first stage). Budgetary coordination would be further tightened, and exchange rate realignments would be permitted only in exceptional circumstances.

The third stage would entail the transition to a single currency. At this point, the ESCB—which would already be implementing Community exchange rate policy—would assume control over exchange market intervention in third currencies. Within the Union, Community bodies would be given enforceable powers in such areas as the binding coordination of members' budget policies and, if necessary, conditional use of EC resources to secure structural and regional policy objectives or to intensify members' adjustment efforts. At this stage, the Community would assume its full role in international policy coordination and international monetary negotiations.

At its Madrid meeting in June 1989 the European Council endorsed the Delors Report. Restating that the EMU would be indispensable for the completion of the internal market, the EC decided that the first stage would begin on July 1, 1990. For the second stage, the EC has set a target date of January 1, 1994. As this stage would include the transfer of monetary sovereignty—thus requiring adjustments of the Treaties of Rome—it was agreed to set up an inter-governmental conference for negotiating the exact terms of these adjustments. While this conference resumed its work in December 1990, the start of the third stage is still under consideration.

## Exchange Rate Arrangements in EFTA Countries

In contrast to the EC, where national monetary and exchange rate policies aim at convergence, exchange rate policies in the EFTA countries differ markedly, especially between the Alpine and Nordic member countries. Austria has pegged the external value of the schilling to the deutsche mark, requiring the authorities to use monetary policy exclusively to maintain exchange rate stability.[75] Switzerland has adopted similar monetary targets as in Germany, leading to a de facto harmonization of monetary policies.[76] It has not set a formal exchange rate target, but since the monetary policies of the Deutsche Bundesbank and the Swiss National Bank have been guided by similar targets, the deutsche mark/Swiss franc exchange rate has remained remarkably stable.[77]

In contrast to the Alpine EFTA countries, all Nordic EFTA countries but Norway peg their currencies against baskets of currencies in which the ERM

[74]With full capital mobility, speculation could lead to excessive swings in exchange rates and interest rates. Since financial integration is likely to increase the sensitivity of capital movements to changes in these variables, increased coordination of monetary policies may be necessary; see Russo (1988).

[75]Until 1978, Austria's exchange rate policy was based on a currency basket, with the deutsche mark dominating. In 1981, the exchange rate was determined primarily by the deutsche mark. Austria's strategy of pegging the schilling is often described as a "hard currency policy." For details, see Genberg (1986) and Haltunen (1984).

[76]As did Germany, Switzerland switched to floating exchange rates in January 1973 in order to achieve effective monetary control. Monetary targeting was introduced in 1975 with the adoption of a target for $M_1$. This policy was temporarily abandoned in 1978 in the face of strong demands to prevent an already poor competitive position from deteriorating. Instead, an explicit exchange rate target vis-à-vis the deutsche mark was set. However, monetary targeting was reintroduced in 1980 and targets have since been announced for the monetary base. This switch from $M_1$ to the monetary base was related to exchange rate expectations and instabilities of the demand for $M_1$.

[77]Although the external value of the Swiss franc is, in principle, endogenous, the Swiss National Bank occasionally modifies its policy of base money control by using the Swiss franc/deutsche mark exchange rate as a secondary intermediate target for monetary policy; see Genberg (1990).



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currencies have a substantial weight. Currencies included in the baskets generally reflect the relative importance of trade with other countries (Table 5). However, in the case of Sweden, the U.S. dollar has been given double weight since a substantial share of Swedish exports is denominated in dollars. The dollar has also a disproportionately large weight in the Icelandic currency basket, reflecting the importance of the dollar for capital account transactions. The currency weights in the baskets are reviewed periodically.

Until recently, Norway too pegged its currency to a basket. However, shortly after the United Kingdom decided to join the ERM, Norway decided to peg the krone to the ECU. The central value of the krone was set at NKr 7.9940 per ECU. As before, the Bank of Norway will keep the value of the krone within a fluctuation range of 2.25 percent around its central value.

**Table 5. Currency Basket Arrangements in the Nordic EFTA Countries**[1]

| | Finnish markka | Icelandic króna | Swedish krona |
|---|---|---|---|
| Composition of the basket[2] | | | |
| Austrian schilling | 1.6 | 0.4 | 1.3 |
| Finnish markka | — | 2.1 | 6.7 |
| Norwegian krone | 3.8 | 5.2 | 8.7 |
| Swedish krona | 19.1 | 5.3 | — |
| Swiss franc | 2.4 | 2.3 | 2.1 |
| Total weight of EFTA currencies | 26.9 | 15.3 | 18.8 |
| Belgian franc | 3.1 | 1.7 | 3.7 |
| Danish krona | 4.4 | 7.0 | 7.6 |
| Deutsche mark | 19.1 | 13.4 | 16.4 |
| Netherlands guilder | 4.8 | 4.7 | 4.6 |
| French franc | 6.5 | 4.7 | 5.2 |
| Italian lira | 5.0 | 3.2 | 3.8 |
| Spanish peseta | 1.9 | 2.2 | 1.5 |
| Total weight of ERM currencies | 44.8 | 36.9 | 42.8 |
| Canadian dollar | — | 0.4 | 1.2 |
| Japanese yen | 6.3 | 7.9 | 3.6 |
| Portuguese escudo | — | 4.5 | — |
| Pound sterling | 13.6 | 15.2 | 11.1 |
| U.S. dollar | 8.4 | 20.0 | 22.5 |
| Organized foreign exchange market | Yes | No | Yes |
| Weighting scheme[3] | Bilateral[4] | Bilateral[5] | Bilateral[6] |
| Margins | ±3.0 | ±2.25 | ±1.5 |
| Adjustment frequency | quarterly | annually | annually |

Sources: National authorities.

[1]As of October 31, 1990.

[2]Weights in percent of total.

[3]In percent of the basket index.

[4]The index includes all convertible currencies of those countries accounting for at least 1 percent of Finland's foreign trade in commodities during the previous three-year period.

[5]The trade index contains 15 currencies of those countries that are most important for Iceland's foreign trade.

[6]The index includes all convertible currencies of those countries that account for at least 1 percent of Sweden's foreign trade during the previous five-year period.

## EFTA's Interest in Monetary Consultations with the EC

The EFTA's countries—while willing to participate in financial integration in Western Europe—recognize the implications of free trade in financial services, particularly as they relate to monetary independence, currency substitution, fiscal policy, and the ability to deal with country-specific shocks (Folkerts-Landau and Mathieson, 1989). There is growing concern whether the EFTA countries—with the EC as their largest trading partner—can achieve full integration of financial services without participating in the EC's economic and monetary arrangements. For example, the report of the EFTA's Consultative Committee on the Creation of a European Financial Area states:

> Having in mind the interdependence of the EFTA and the EC countries and the goal of the European Economic Space, the avoidance of divergent exchange rate developments between the countries is an important task . . . Instabilities . . . will undermine the creation of a European Financial Area (EFTA, 1989, p. 20).

Reflecting these concerns, the EFTA heads of state, in March 1989, expressed an interest in intensified consultations with the EC on economic and monetary policy ("EFTA Summit . . . ," 1989, para. 12). However, they did not say whether the talks should be informal or within the framework of the EMS. This aim, stated even before the Delors Report, has been interpreted as being "not far from what is foreseen as part of the first step of the EMU" (Kleppe, 1989). Some have argued that—considering the challenges arising from financial integration—there is no alternative but for the EFTA countries to join the EMS, since only through formal economic and monetary cooperation with the EC can the EFTA countries hope to defend their interests within the European Economic Space.[78]

[78]See "Keine Alternative zu EWS Beitritt . . ." (1988). Full membership in the EMS, with access to all credit facilities, seems only possible if the EFTA joins the EC. In contrast, accession to the ERM alone—where support through the very short-term facility for financing obligatory interventions is automatic—is also conceivable for non-EC members (Ungerer, 1986, pp. 5–6). Apart from this, the EFTA countries could also become associate members of the EMS. Such an association would, for example, consist of participation in the ERM, so that the associate member would undertake to keep its exchange rate within specified fluctuation limits fixed in relation to both the ECU and individual EMS currencies. However, in contrast to ordinary members, an associate member may not even have access to the very short-term facility of the ERM. This disadvantage could be offset through borrowing arrangements between central banks.



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Mr. Duisenberg, head of the Dutch central bank, has also argued that having the EFTA countries join the EMS might be in both their interest and that of current EMS members:

> Coherence within [the EMS] has grown and will continue to grow now that policies are increasingly converging and the planned full liberalization of capital markets is gradually coming nearer. This raises the question whether it would perhaps be better if all European countries, and that includes all EFTA countries, were to assign greater significance to the stabilization of intra-European exchange rates. This would create a broader 'base of stability' against the non-European currencies, such as the U.S. dollar. This would be in perfect harmony with EFTA's declared intention to seek participation in the formation of the EC internal market (Duisenberg, 1988, pp. 40 and 42).

These arguments appear to assume that the formation of the EES would create an optimum currency area for the EC and EFTA. If this is the case, the enlargement of the EMS and EFTA's participation in the Delors Plan toward complete monetary unification in Western Europe could indeed be beneficial for both blocs.

## Concept of the Optimum Currency Area

There is considerable debate as to what constitutes an optimum currency area,[79] with the literature going back to a classic study by Mundell (1961). In this study, Mundell argued that an optimum currency area must have a high degree of mobility of factors of production requiring a large measure of openness for both labor and capital. McKinnon (1963) also viewed openness as an essential feature of a currency area. However, he focused on goods and services, arguing that openness should be measured by the size of the tradables sector. Kenen (1969) argued that the degree of diversity of the product mix in an economy was also important in determining a currency area. Finally, shifting the emphasis from the goods to the capital markets, others have argued (Ingram, 1969) that an optimum currency area requires a high degree of financial integration. Capital mobility alone, as suggested by Mundell, would not be a sufficient condition.

All these approaches seek to establish objective criteria for the formation of a currency area. The extent of factor mobility, product diversification, and financial integration—as well as the share of tradables in production—are all seen as indicators of whether a country's economic policy interests would be furthered by joining a given currency area. Based on these criteria, the EES—with the EFTA countries fully participating in all four freedoms—may indeed form an optimum currency area.[80] As observed earlier, the formation of the EES, combined with the internal market program, would imply free movement of capital and labor between the EC and EFTA. With the removal of capital controls and the deregulation of cross-border restrictions on the provision of financial services, financial markets would become integrated. Moreover, all EFTA countries are very open economies and most have a relatively high degree of product diversification.

In addition to the approaches that emphasize objective criteria, other literature focuses on "subjective" criteria. This approach can be divided into two broad categories, one focusing on commonality of aims and one on similarity of policy attitudes. The former includes Haberler (1970) and Fleming (1971)—who stressed the importance of broadly equivalent rates of inflation—and De Grauwe (1975), who emphasized the need for similar inflation-output or inflation-employment trade-offs. The latter category includes Tower and Willett (1976), who argue that an optimum currency area requires a high degree of policy integration.[81]

The "subjective" approaches are not very different from a third approach that focuses on the costs and benefits of participating in a currency area. Although the cost-benefit approach takes a different perspective, there are obvious similarities with the subjective approaches. In principle, it can be assumed that if differences between national economic policy objectives and attitudes exist, the costs of joining an existing currency area will depend on the degree of necessary policy adjustments. The more economic priorities align with those in the area, the less the need for adjustments and hence the lower the costs of joining (and vice versa).

Based on this approach, Canzoneri and Rogers (1990) and Végh and Guidotti (1990) discuss the issue from a fiscal point of view. Given that optimal taxation requires that the marginal disutility from different forms of taxation including the inflation tax is equalized, they argue that an optimal currency area would include countries with the same level of inflation. However, if national tax structures differ, requiring divergent inflation rates, the harmonization of inflation rates necessary to preserve stable exchange rates would be a sub-optimal solution. The welfare costs involved have to be weighed against the benefits of having a single currency, especially the absence of valuation and

[79]This overview largely follows Guitián (1988), pp. 4–5.

[80]The position of Iceland, however, would appear somewhat tenuous.

[81]Of course, there is a close relationship between common aims and the degree of policy integration.



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currency conversion costs, which may impede trade between regions.

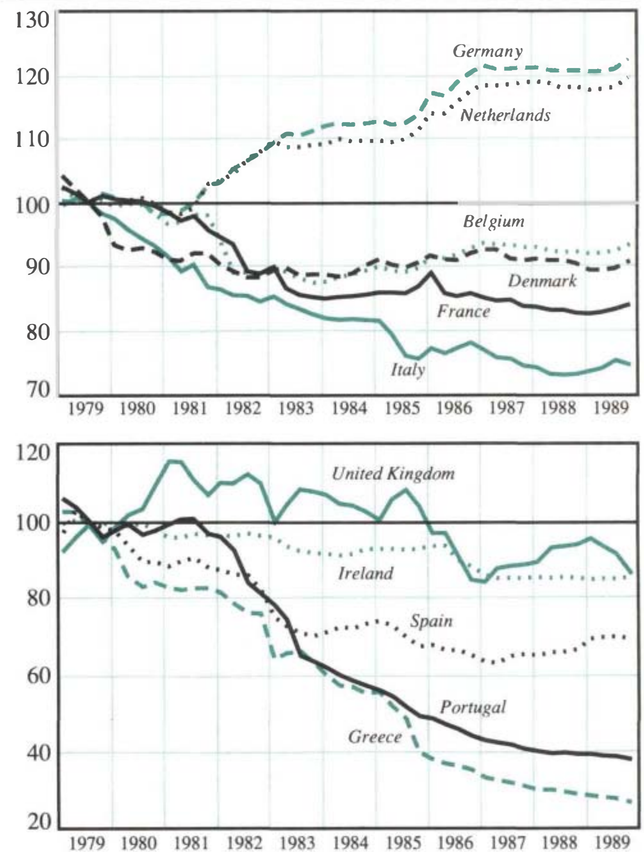
Despite similarities between the subjective approaches and the cost-benefit approach, they may result in different conclusions. Assume, for example, that economic policies differ sharply in the countries concerned. The subjective approaches imply that these countries would not form an optimum currency area. In contrast, the cost-benefit approach may achieve the opposite result, if the benefits of adjusting economic policies exceed the cost associated with these adjustments. Since not only the cost but also the benefits of forming a currency area may rise with the adjustments, sharp differences in economic policies do not preclude the possibility of an optimum currency area. In turn, relatively similar policies do not necessarily imply formation of a currency area. Although the costs may be relatively small, they may still exceed the benefits.

## Exchange Rate Behavior, Monetary Growth, and Inflation

A close examination of the EFTA countries' exchange rate and monetary policies yield several conclusions. First, the short-term exchange rate variability of the currencies of the Alpine states against the ERM currencies is remarkably low (Guitián, 1988, p. 20). In fact, the variability of the Austrian schilling is lower than for the currencies in the ERM. While relatively limited exchange rate movements vis-à-vis the ECU can be observed for the Finnish markka, the Norwegian krone, and the Swedish krona over the medium and long run, the movement of the frequently devalued Icelandic króna differed markedly from all ERM currencies (Charts 4 and 5). The Alpine EFTA states' currencies, on the other hand, have maintained their values vis-à-vis the ECU at least as well as most of the de jure ERM participants. Over time, both currencies have followed the appreciation of the deutsche mark and the Dutch guilder against the ECU.[82]

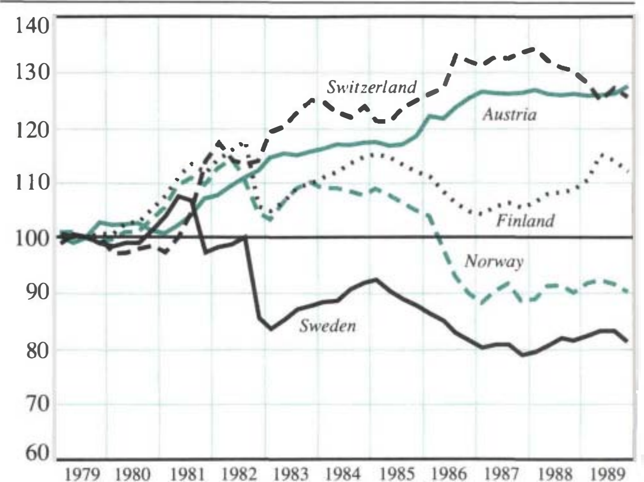
The differing exchange rate developments in the EFTA countries may to a large extent be explained by differing monetary growth rates. For example, monetary growth rates in the Alpine members of the EFTA seem to have followed developments in the EMS relatively closely (Table 6). A tendency toward lower money growth is also observed in Sweden, while monetary growth in Finland and Norway has remained faster than in the EMS. However, the more rapid monetary growth may be partly explained by the financial reform that took place in these countries during the mid-1980s.

**Chart 4. EMS: Exchange Rates Against the ECU**
(third quarter, 1979 = 100)




Source: IMF, *International Financial Statistics*

**Chart 5. EFTA: Exchange Rates Against the ECU**
(third quarter, 1979 = 100)




Source: IMF, *International Financial Statistics*

[82]According to Russo and Tullio (1988), the EFTA countries behaved as if they belonged to the EMS at least since 1983. However, the study does not include Finland or Iceland. In the Icelandic case, their findings would probably not apply.



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**Table 6. Monetary Growth in the ERM and in EFTA Countries[1]**

| | 1979 | 1980 | 1981 | 1982 | 1983 | 1984 | 1985 | 1986 | 1987 | 1988 | 1989 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| ERM countries[2] | | | | | | | | | | | |
| Average increase[3] | 13.0 | 8.7 | 10.4 | 9.5 | 13.2 | 10.4 | 8.2 | 8.9 | 8.7 | 7.6 | 7.4 |
| Average deviation from mean[4] | 5.9 | 2.9 | 3.7 | 2.3 | 5.1 | 7.0 | 4.5 | 3.0 | 2.9 | 2.0 | 2.0 |
| Average deviation from lowest[4] | 5.2 | 4.9 | 5.7 | 3.9 | 8.0 | 5.7 | 3.7 | 3.2 | 4.7 | 4.4 | 2.9 |
| EFTA countries | | | | | | | | | | | |
| Austria | | | | | | | | | | | |
| Increase[3] | 11.1 | 9.5 | 11.4 | 11.0 | 8.6 | 3.9 | 6.7 | 6.9 | 8.8 | 6.7 | 7.0 |
| Deviation from ERM mean[4] | 4.3 | 0.7 | 0.6 | 1.5 | 5.4 | 10.7 | 3.6 | 3.5 | 0.3 | 1.4 | 1.1 |
| Deviation from ERM lowest[4] | 4.0 | 6.0 | 6.6 | 4.9 | 3.4 | 0.9 | 2.2 | 1.2 | 5.0 | 3.5 | 2.5 |
| Finland | | | | | | | | | | | |
| Increase[3] | 15.9 | 16.0 | 15.4 | 15.0 | 13.7 | 13.4 | 17.3 | 13.5 | 10.7 | 14.1 | 18.3 |
| Deviation from ERM mean[4] | 0.5 | 7.2 | 3.4 | 5.5 | 0.3 | 1.2 | 7.0 | 3.1 | 2.2 | 6.0 | 10.2 |
| Deviation from ERM lowest[4] | 8.8 | 12.5 | 10.6 | 8.9 | 8.2 | 8.6 | 12.8 | 7.8 | 6.9 | 10.9 | 13.8 |
| Iceland | | | | | | | | | | | |
| Increase[3] | 55.5 | 55.2 | 78.5 | 58.0 | 76.9 | 49.2 | 41.6 | 43.9 | 36.1 | 26.3 | 26.0 |
| Deviation from ERM mean[4] | 40.1 | 46.4 | 66.5 | 48.5 | 62.9 | 34.6 | 31.3 | 33.5 | 27.6 | 18.2 | 18.1 |
| Deviation from ERM lowest[4] | 48.4 | 51.7 | 73.7 | 51.9 | 71.7 | 44.4 | 37.1 | 38.2 | 32.3 | 23.1 | 21.5 |
| Norway | | | | | | | | | | | |
| Increase[3] | 13.1 | 12.1 | 12.7 | 10.7 | 10.3 | 14.1 | 16.2 | 9.0 | 21.0 | 5.5 | 5.5 |
| Deviation from ERM mean[4] | 2.3 | 3.3 | 0.7 | 1.2 | 3.7 | 0.5 | 5.9 | 1.4 | 12.5 | 2.6 | 2.6 |
| Deviation from ERM lowest[4] | 6.0 | 8.6 | 7.9 | 4.6 | 5.1 | 9.8 | 11.7 | 3.3 | 17.2 | 3.3 | 1.0 |
| Sweden | | | | | | | | | | | |
| Increase[3] | 15.4 | 9.7 | 9.7 | 13.6 | 21.8 | 4.0 | 3.7 | 13.3 | 10.6 | 8.4 | 10.9 |
| Deviation from ERM mean[4] | — | 0.9 | 2.3 | 4.1 | 7.4 | 10.6 | 6.6 | 2.9 | 2.1 | 0.3 | 2.8 |
| Deviation from ERM lowest[4] | 8.3 | 6.2 | 4.9 | 7.5 | 16.4 | 0.8 | 0.8 | 7.6 | 6.8 | 5.2 | 6.4 |
| Switzerland | | | | | | | | | | | |
| Increase[3] | 9.5 | 6.8 | 4.3 | 3.3 | 8.6 | 7.4 | 5.9 | 2.5 | 9.3 | 8.3 | 5.7 |
| Deviation from ERM mean[4] | 4.9 | 2.0 | 7.7 | 6.2 | 5.4 | 7.2 | 4.4 | 7.9 | 0.8 | 0.2 | 2.4 |
| Deviation from ERM lowest[4] | 2.4 | 3.3 | 0.5 | 2.8 | 3.4 | 2.6 | 1.4 | 3.2 | 5.5 | 5.1 | 1.2 |

Source: IMF, *International Financial Statistics;* and IMF staff calculations.
[1]Monetary growth (changes over preceding year) refers to broad money.
[2]During 1979–88, ERM countries include Belgium, Denmark, France, Germany, Ireland, Italy, Luxembourg, and the Netherlands. While Spain is included for 1989, the United Kingdom has been omitted as it joined the ERM only in October 1990.
[3]In percent.
[4]In percentage points.

On the other hand, money growth in Iceland greatly exceeded that in the EMS.

Since a currency area with fixed exchange rates requires converging inflation rates at least over the medium run, it is useful to consider the extent to which price developments in the EFTA countries have deviated from those in the EMS (Table 7). Inflation in the EMS also seems to have converged at a lower level.[83] Again, Austria and Switzerland exhibit relatively low inflation rates, whereas rates in the Nordic countries have remained higher.

These findings imply that, at present, the subjective approaches do not support the view that the EMS is an optimum currency area for the Nordic EFTA countries, whereas Austria and Switzerland have behaved

[83]This did not necessarily occur because of the EMS. However, most empirical studies concluded that the EMS has provided a framework in which anti-inflationary policies could be pursued more effectively by entailing a binding constraint for high-inflation countries; see Russo and Tullio (1988).



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**Table 7. Inflation in the ERM and EFTA Countries[1]**

| | 1979 | 1980 | 1981 | 1982 | 1983 | 1984 | 1985 | 1986 | 1987 | 1988 | 1989 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| ERM countries[2] | | | | | | | | | | | |
| Average inflation rate[3] | 8.2 | 11.2 | 11.7 | 10.6 | 8.0 | 6.3 | 4.8 | 2.2 | 2.0 | 2.4 | 4.1 |
| Average deviation from mean[3] | 3.8 | 5.3 | 5.0 | 3.6 | 2.9 | 2.0 | 1.8 | 1.9 | 1.7 | 1.5 | 1.4 |
| Average deviation from lowest[4] | 4.1 | 5.9 | 5.4 | 5.3 | 5.2 | 3.9 | 2.5 | 2.4 | 2.7 | 1.7 | 3.0 |
| EFTA countries | | | | | | | | | | | |
| Austria | | | | | | | | | | | |
| Inflation rate[3] | 3.7 | 6.4 | 6.8 | 5.4 | 3.3 | 5.7 | 3.2 | 1.7 | 1.4 | 1.9 | 2.6 |
| Deviation from ERM mean[4] | 5.8 | 6.9 | 6.4 | 5.8 | 5.5 | 0.9 | 2.5 | 1.4 | 0.6 | 1.0 | 3.0 |
| Deviation from ERM lowest[4] | 0.4 | 1.0 | 0.5 | 0.1 | 0.5 | 3.3 | 1.0 | 1.9 | 2.1 | 1.2 | 1.5 |
| Finland | | | | | | | | | | | |
| Inflation rate[3] | 7.5 | 11.6 | 12.0 | 9.6 | 8.4 | 7.1 | 5.9 | 2.9 | 4.1 | 5.1 | 6.6 |
| Deviation from ERM mean[4] | 2.0 | 1.7 | 1.4 | 1.6 | 0.4 | 0.5 | 0.2 | 0.2 | 2.1 | 2.2 | 2.6 |
| Deviation from ERM lowest[4] | 3.4 | 6.2 | 5.7 | 4.3 | 5.6 | 4.2 | 3.7 | 3.1 | 4.8 | 4.4 | 5.5 |
| Iceland | | | | | | | | | | | |
| Inflation rate[3] | 45.3 | 58.6 | 50.9 | 51.0 | 84.3 | 29.2 | 32.4 | 21.3 | 18.8 | 24.7 | 20.8 |
| Deviation from ERM mean[4] | 35.8 | 45.3 | 37.5 | 39.8 | 75.5 | 22.6 | 26.7 | 18.2 | 16.8 | 21.8 | 16.8 |
| Deviation from ERM lowest[4] | 41.2 | 53.2 | 44.6 | 45.7 | 81.5 | 26.8 | 30.2 | 21.5 | 19.5 | 24.0 | 19.7 |
| Norway | | | | | | | | | | | |
| Inflation rate[3] | 4.8 | 10.8 | 13.7 | 11.4 | 8.4 | 6.3 | 5.7 | 7.2 | 8.7 | 6.7 | 4.6 |
| Deviation from ERM mean[4] | 4.7 | 1.5 | 0.3 | 0.2 | 0.4 | 0.3 | — | 4.1 | 6.7 | 3.8 | 0.6 |
| Deviation from ERM lowest[4] | 0.7 | 5.4 | 7.4 | 6.1 | 5.6 | 3.9 | 3.5 | 7.4 | 9.4 | 6.0 | 3.5 |
| Sweden | | | | | | | | | | | |
| Inflation rate[3] | 7.2 | 13.7 | 12.1 | 8.6 | 8.9 | 8.0 | 7.4 | 4.2 | 4.2 | 5.8 | 6.4 |
| Deviation from ERM mean[4] | 2.3 | 0.4 | 1.3 | 2.6 | 0.1 | 1.4 | 1.6 | 1.1 | 2.2 | 3.9 | 2.4 |
| Deviation from ERM lowest[4] | 3.1 | 8.3 | 5.8 | 3.3 | 6.1 | 5.6 | 5.2 | 4.4 | 4.9 | 5.1 | 5.3 |
| Switzerland | | | | | | | | | | | |
| Inflation rate[3] | 3.6 | 4.0 | 6.5 | 5.7 | 3.0 | 2.9 | 3.4 | 0.8 | 1.4 | 1.9 | 3.2 |
| Deviation from ERM mean[4] | 5.9 | 9.3 | 6.9 | 5.6 | 5.8 | 3.7 | 2.3 | 2.3 | 0.6 | 1.0 | 0.8 |
| Deviation from ERM lowest[4] | 0.5 | 1.4 | 0.2 | 0.4 | 0.2 | 0.5 | 1.2 | 1.0 | 2.1 | 1.2 | 2.1 |

Source: IMF, *International Financial Statistics;* and IMF staff calculations.
[1]Changes in consumer prices (over preceding year).
[2]During 1979–88, ERM countries include Belgium, Denmark, France, Germany, Ireland, Italy, Luxembourg, and the Netherlands. While Spain is included for 1989, the United Kingdom has been omitted as it joined the ERM only in October 1990.
[3]In percent.
[4]In percentage points.

as if they had already belonged to the EMS.[84] This suggests that if the EFTA countries were to join the EMS, major policy adjustments could probably be avoided only in the two Alpine countries. In the Nordic countries, however, joining would require—to varying degrees—changes in their economic policies. From the view of the cost-benefit approach to optimum currency areas, does an accession of the EFTA countries to the EMS appear desirable?

[84]Whether the EMS is an optimum currency area for all participants in the system is not addressed here. However, Russo and Tullio (1988) found that some countries that are formally members of the EMS did not behave as "good" members by reason of their use of large margins of fluctuations, frequent realignments, or divergent economic policies.

## Cost and Benefits of Joining the EMS

With perfect capital mobility and fixed exchange rates, there is little scope for an independent monetary policy. The central bank controls neither the domestic



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interest rate nor the money stock. The only effect of an open-market operation is a change in the composition of its balance sheet. The speed with which central banks purchase bonds determines the speed of their loss of reserves. This is one of the main conclusions of the literature on the Mundell-Fleming model (Mundell, 1968; Fleming, 1962; Frenkel and Razin, 1987; Genberg, 1989; and Kenen, 1985).

The experience with the EMS—where capital mobility has been less than perfect and exchange rates not completely fixed—has shown that such a system severely limits autonomy in policy formulation (Guitián, 1988). Under present arrangements, monetary coordination involves using the Deutsche Bundesbank's policy as a reference for the conduct of monetary policies in the other ERM member countries (Schinasi, 1989). However, with full financial integration and irrevocably fixed exchange rates as envisaged in the Delors Report, any remaining independence would be lost, requiring complete monetary coordination among the EMS members.[85]

All EFTA countries except Switzerland pursue exchange rate targets. These countries are aware of the constraints that fixed exchange rates impose on economic policymaking.[86] Joining the EMS would not imply a change from a flexible exchange rate regime to a fixed rate regime, but one from a fixed but adjustable exchange rate regime to another.[87] The important difference would be that under existing arrangements discretionary exchange rate changes are the Government's decision, while, in the EMS, agreement must be reached with other participants. With exchange rate realignments in the EMS depending on a joint decision by all participants, the authorities are forced to follow the monetary policy stance in the other member countries, which, in effect, has been dominated by the anti-inflationary policy of the Bundesbank. This additional constraint on policy autonomy becomes more severe, the more monetary policy and inflation rates deviate from those in the EMS.

The further loss in monetary autonomy would constrain the authorities' ability to reduce the cyclical, or "demand deficient," component of unemployment with an expansionary monetary policy.[88] As a result, the reliance placed on structural and fiscal policies would increase. However, a reduction in monetary autonomy may also reduce the extent to which fiscal deficits can be financed by seigniorage from money creation (Table 8). As noted by Dornbusch (1988), part of this loss would come from a reduction in monetary expansion to a rate compatible with lower inflation rates. In addition, financial integration would bring pressure to harmonize reserve requirements for commercial banks. Those countries with relatively high reserve requirement ratios face, other things being equal, the largest prospective loss of seigniorage.[89] Although the effects on financing fiscal deficits may be relatively small, it may still increase the burden on stabilization policies.

In addition, the harmonization of revenues from seigniorage could lead to a sub-optimal increase in tax distortions. Assuming that current inflation rates are consistent with optimal taxation, implying that the mar-

[85]As argued, for example, by Giavazzi and Giovannini (1989), the present form of coordination—where monetary policy is set by Germany and the other countries may either go along with German monetary targets or realign—is inconsistent with fully integrated financial markets. Pointing to the Italian experience, where there was a major speculative attack when administrative controls on export credits were removed in May 1987, the authors emphasize the need for setting monetary targets by a supranational institution. Otherwise, speculative attacks could cause realignments that may be regarded as inconsistent with economic fundamentals.

[86]Capital controls in the EFTA countries have been almost completely removed and the remaining controls do not appear very effective. Akerholm and Tarkka (1987) argue that the Nordic EFTA countries could not conduct an independent monetary policy even when all controls are in effect. For empirical evidence, see Virén (1989).

[87]However, the degree of adjustability in the ERM may be open to dispute and, as noted, the Delors Report envisaged making ERM exchange rates irrevocably fixed.

[88]At the same time, financial integration may make it easier for European residents to switch among monetary assets denominated in different currencies so that the demand for key monetary aggregates may become less stable than in the past, which might complicate monetary control.

[89]The loss of revenue from money creation could be offset partly by two effects working in the opposite direction. First, lower inflation rates may lead to a greater willingness of the public to absorb money, thus reducing real interest rates. This effect will be particularly large in countries where the stock of interest-bearing public debt is large relative to the stock of base money. Second, "external" seigniorage gains could arise if assets were denominated in ECUs and grew in proportion to world trade; see Cohen and Wyplosz (1989).

**Table 8. Seigniorage in the EFTA Countries, 1980–87[1]**

| | In Percent of GDP | In Percent of Total Government Revenues |
|---|---|---|
| Austria | 0.4 | 1.2 |
| Finland | 0.8 | 2.9 |
| Iceland[2] | 2.0 | 6.3 |
| Norway | 0.4 | 0.9 |
| Sweden | 0.4 | 0.9 |
| Switzerland | 0.4 | 4.2 |

Source: IMF, *International Financial Statistics;* and IMF staff calculations.

[1]Seigniorage is measured as the December-to-December change in reserve money.

[2]Since required reserves have been indexed in Iceland, seigniorage is calculated as the increase in the nonindexed part of reserve money.



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consistent with optimal taxation, implying that the marginal disutility of raising taxes is the same for all revenue sources, the harmonization of inflation rates may be welfare-decreasing (Canzoneri and Rogers, 1990). The harmonization of conventional taxes could aggravate this problem as revenue losses in some countries could lead to a heavier reliance on revenues from money creation (Végh and Guidotti, 1990).

A loss of monetary autonomy can be seen as a disadvantage for economic policymaking. However, by joining a fixed exchange rate system under German leadership, more inflation-prone countries can gain credibility in the disinflation process, provided that realignments are not frequent and entail political as well as economic costs.[90] This gain in credibility arises from the fact that maintaining fixed exchange rates requires the authorities to keep their policies in line with the policy stance in the EMS. In this case, participation in the ERM has a disciplinary effect and thus allows a country more easily to "buy" the anti-inflationary reputation of the Deutsche Bundesbank.[91]

The need for discipline concerns not only monetary policy, but also the labor market. Where cost-push factors are dominant in determining the inflation rate, moderate wage settlements are needed to maintain exchange rate stability. On the other hand, fixed exchange rates may provide a nominal anchor for inflation expectations and may thus contribute to moderate wage demands.

However, competitiveness will deteriorate if discipline is less than perfect—and differences between the anti-inflationary policy stance in Germany and in the country concerned remain—and if needed realignments are postponed.[92] To determine the net impact of ERM participation, the credibility gains have to be weighed against the output loss caused by the real appreciation of the exchange rate.[93] While this is a difficult task—requiring intertemporal judgment—it cannot, a priori, be excluded that ERM participation may reduce welfare.[94]

It should also be remembered that the present currency basket arrangements in Finland, Iceland, and Sweden are designed to provide the maximum average stability in the effective exchange rate. This implies that the adverse effects of global exchange rate fluctuations on competitiveness are minimized, which would no longer be the case if they joined the ERM. However, the basket arrangements do not appear so different from the ERM that this effect would be of dominant importance. In fact, with the accession of the pound sterling in the ERM in October 1990, the similarity between the basket arrangements and the ERM has become even greater. Presumably, this development has been a major contributor to Norway's decision to peg the krone to the ECU.[95]

It has also been argued that financial integration—especially the removal of all existing capital controls—may increase the risk of large and destabilizing capital movements. However, as noted by Kleppe (1989), joining the ERM would have the advantage of having access to unlimited very short-term support when the currency is under pressure.

## Views of Individual EFTA Countries

The preceding discussion does not provide a clear answer about whether participation in the ERM would yield benefits that would unambiguously exceed its costs. Such a judgment would depend on economic preferences in the country concerned, as well as their weighting of the potential costs and benefits. While the EFTA as a whole recognizes the need for closer economic and monetary cooperation with the EC, the views of individual member states vary as to whether this requires a formal accession to the EMS.

Having applied for EC membership in 1989, the *Austrian* authorities recognize that accession to the EC would also imply participation in the EC's formal monetary arrangements. Consequently, Austria has initiated concrete steps toward an association with the EMS according to Article 5.2 of the EMS agreement ("Dr. Klauhs Presents an Austrian View . . . ," 1989). However, even before the Austrian National Bank was authorized to enter into detailed exploratory talks on Austria's association with the EMS, several preliminary steps had been taken. At Austria's request, the

[90]See Giavazzi and Pagano (1986) and Giavazzi and Giovannini (1989). However, as Lane and Rojas-Suàrez (1989) have shown, the gain in credibility depends also on the degree of capital mobility and the margin within which the exchange rate is allowed to fluctuate.

[91]According to Kremers (1990), this could be observed for Ireland, where before 1979 Irish inflation expectations mainly followed expected movements in the United Kingdom. Upon entry into the EMS, Irish expectations converged toward the expected price behavior of ERM partners.

[92]If under these circumstances realignments are postponed, the currency of the country concerned will appreciate in real terms. As Russo and Tullio (1988, p. 49) argue, the size and duration of the real appreciation could be considered a measure of the extent to which the monetary authorities concerned have not been able to "borrow credibility" from the Bundesbank.

[93]Of course, the effects of the appreciation can be temporarily delayed by devaluing the exchange rate prior to entry in the ERM.

[94]Melitz (1988) argues that this may have been the case for France.

[95]Until recently, the Norwegian authorities maintained that EMS membership would hinge on that of the United Kingdom; see Skånland (1988), p. 46.



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Austrian National Bank was granted the status of "other holders of ECUs" in July 1989. The Bank has also participated in the daily consultations of EC central banks, while the ECU has been quoted on the Vienna Foreign Currency Exchange since 1986.

The Swiss National Bank was the first central bank outside the EC to be granted the status of "other holders of ECUs" by the European Monetary Cooperation Fund. However, *Switzerland* does not plan to join the EMS, mainly for two reasons: First, President Lusser of the Swiss National Bank believes that the additional discipline provided by fixed exchange rates is not necessary to achieve price stability. EMS membership would hardly improve Switzerland's situation.[96] Second, it has been argued that the EMS is not an optimal currency area for Switzerland.[97] Such an optimal currency area would exist if labor and capital were mobile. Unlike Austria, however, Switzerland has objected to removing labor mobility restrictions vis-à-vis EC members.

Among the Nordic countries, so far only *Norway* has indicated that it may seek to join the EMS.[98] Recently this interest has intensified, as indicated by the pegging of the krone to the ECU. A report published in 1989 by a government committee on monetary policy suggested that EMS membership would be advantageous mainly for two reasons (Norges Offentlige Utredninger, 1989). First, the ERM would provide Norway with better protection against speculation than the current basket arrangement, by giving access to unlimited short-term support when the krone came under pressure. Although the krone has been quite stable since it was last devalued in 1986, there have been isolated incidents of speculation. Thus, the gains from access to the very short-term financing facility may outweigh the losses—in terms of exchange rate stability—from abandoning the present basket arrangement. Second, EMS membership may, it is argued, add credibility to Norway's stabilization policies. Although participation in the EMS would also result in a loss of monetary autonomy, the overall benefits would still be positive.[99] Therefore, Norway might seek accession to the EMS, even if its fellow EFTA members decide not to.

*Finland, Iceland,* and *Sweden* do not at present plan to join the EMS nor to forge closer links with the EC's exchange arrangements. Although the authorities in these countries are aware that closer financial integration with Western Europe reduces policy autonomy—irrespective of whether they join the EMS—they are not yet willing to surrender the exchange rate instrument and to subordinate monetary policy to exchange rate stability (Moe, 1990). As Mr. Franzén, the Deputy Governor of the Bank of Sweden, has put it: "A necessary condition for seriously raising the issue of a Swedish association to the EMS is that there are clear indications showing that the overall domestic policy forcefully strive to reduce inflation. Today there are no such convincing indications. Consequently, a Swedish EMS association is not on the agenda today" ("Some Aspects of the EMS," 1990). However, Mr. Franzén also stressed that a future Swedish EMS association was not to be ruled out. If other EFTA countries were to join or become associated with the EMS, closer ties might become more attractive. As Kotilainen and Peura (1989) have argued, this would also apply to Finland. In this respect, any step by Norway toward joining the EMS might lead to a change in the others' position. As far as Iceland is concerned—which is subject to frequent supply shocks attributable to its heavy reliance on fisheries—participation in the EMS appears difficult at this time. Since Iceland's overriding economic policy goal has been to maintain full employment, the costs of subordinating monetary policy to exchange rate stability would probably far exceed the benefits of EMS membership.

[96]See "Dr. Lusser warns against exaggerated expectations . . . " (1988) and "Schweizerische Notenbank: Absage an Beitritt zum EWS" (1988). However, as Dr. Lusser also stressed, Switzerland's stabilization policy may nevertheless be beneficial for the monetary integration process in Europe as it enlarges the stability-oriented core of the EMS. See "Der Schweizer Beitrag zur Europäischen Währungsunion (1990).

[97]See "Das EWS als Währungspolitische Alternative," 1988.

[98]See "Norwegians May Seek EMS Entry" (1989) and "EC Outsiders Pursue Connection with the EMS" (1990).

[99]The Norwegian authorities recognize that the resulting loss in monetary autonomy may be particularly important for their country, which, as a major oil exporter, is subject to shocks that may be seen as country-specific relative to its trading partners. This has been one of the major reasons why the United Kingdom until recently has refused to join the ERM. See Ungerer and others (1986), p. 4.



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# X Tax Harmonization

With the implementation of free mobility of commodities and factor inputs, the EC Commission has stressed the need for tax harmonization. The Commission has given top priority to harmonizing indirect taxes, since, at present, the administration of these taxes depends crucially on the existence of border controls, which are to be removed with the start-up of the internal market. As no removal of border controls between the EC and the EFTA is currently envisaged, the implication for the EFTA of indirect tax harmonization in the EC is limited. Moreover, the EC countries have tended to postpone decisions relating to tax harmonization. While an alignment of taxes may still result spontaneously through competitive pressure, it would proceed more slowly than a centrally administered harmonization. Harmonization of corporate and capital income taxes is potentially a more urgent problem because these taxes fall on a highly mobile base. However, at this point, the Commission has no plans for a general harmonization of taxes on labor income, reflecting the fact that the psychological and cultural barriers to international mobility of labor remain high.

## Indirect Taxes

At present the EC and EFTA countries maintain widely different value-added tax (VAT) rates (Table 9).[100] Since the VAT systems are operated according to the "destination principle," under which goods are taxed in the country of final consumption, adverse effects on any country's competitiveness or tax base are avoided. Thus, a product carries the domestic tax rate whether it is produced domestically or imported, while exported products leave the country free of any VAT. In order to ensure that the domestic VAT is charged on imported products and that goods for which zero-rating is claimed are being exported, countries rely on tax adjustments at the border. Border controls are also used to monitor cross-border trade, so that consumers making direct purchases abroad are subject to the domestic VAT on purchases in excess of the personal exemption. Thus, the frontier formalities permit a member country to set its own tax rates without imposing adverse externalities on others.

If the VAT system is to remain neutral after border controls are eliminated, an administrative substitute for fiscal checks at the frontier has to be devised. In addition, member states with higher rates of indirect taxation may have to reduce their tax rates in order to avoid a diversion of retail business (and tax revenue) to lower-tax member states. For the former purpose, the Commission has proposed that the system of zero-rating of exports from one member country to another

**Table 9. EC and EFTA: VAT Rates[1]**
(in percent)

| Country | Lower Rate | Standard Rate | Higher Rate |
|---|---|---|---|
| EC | | | |
| Belgium | 1–6 | 19 | 25–33 |
| Denmark | — | 22 | — |
| France | 5.5 | 18.6 | 25 |
| Germany | 7 | 14 | — |
| Greece | 3–6 | 16 | 36 |
| Ireland | 2–10 | 25 | — |
| Italy | 4–9 | 19 | 38 |
| Luxembourg | 3–6 | 12 | — |
| Netherlands | 6 | 18.5 | — |
| Portugal | 8 | 17 | 30 |
| Spain | 6 | 12 | 33 |
| United Kingdom | — | 15 | — |
| EFTA | | | |
| Austria | 10 | 20 | 32 |
| Finland | — | 19.5 | — |
| Iceland[2] | 14 | 24.5 | — |
| Norway | — | 20 | — |
| Sweden | — | 23.46[3] | — |
| Switzerland[4] | — | 16 | — |

Sources: "Rates of VAT in the EC on January 1, 1989," *European Report,* December 14, 1989, p. II, 4; "Value Added Taxation in Europe," *Guides to European Taxation,* Vol. IV; and country authorities.
[1]January 1, 1989, unless specified otherwise.
[2]January 1, 1990.
[3]Reduced rates are applied for construction and certain other services. A temporary increase to 25 percent took effect on July 1, 1990; it will expire on December 31, 1991.
[4]No VAT. Turnover tax levied at 6.2 percent on consumers and 9.3 percent on retailers. Imports are taxed at 9.6 percent unless they are imports of a registered enterprise.

[100]Switzerland has a turnover tax instead of a VAT.



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be ended, that is, transactions between countries be treated as those within countries. Thus, exports would carry the exporting country's VAT, which would be reimbursed as input VAT to the importer. Such a change would have implications for the international distribution of tax revenue.[101] Accordingly, a clearing system would be set up to redistribute VAT revenues, so that they continue to accrue to the country consuming the products. In relation to nonmember countries, the EC would continue to operate a traditional system based on fiscal documentation at the border. Thus, the administrative aspects of the proposed VAT reform would have no consequences for the EFTA as long as border controls are maintained between the two blocks.

The issue of harmonization of tax rates arises primarily in the context of cross-border shopping. There is already a considerable amount of cross-border shopping in the EC (for example, between Denmark and Germany), and it is likely to increase with the removal of border controls. This may lead to competitive downward pressure on tax rates. Instead of such a market-driven alignment of rates, the Commission proposes harmonization by agreement, whereby the burden of adjustment is shared between high-tax and low-tax countries.

At present, all member countries except Denmark apply at least two VAT rates: a reduced rate for such necessities as food and medicine, and a standard rate for other goods. The Commission has proposed retaining a dual rate structure, while leaving the member countries some freedom in setting the tax rates in each category. According to the initial proposal announced in 1987, the standard rate should be set between 14 percent and 20 percent, with the reduced rate between 4 percent and 9 percent. The width of the bands was determined on the basis of the U.S. experience, suggesting that differences of about 5–6 percentage points in tax rates between neighboring states can be sustained without serious border trade problems.

Some countries objected to the Commission's proposal because of the large changes in tax rates or tax coverage that it would have required. The United Kingdom would have had to eliminate the zero rate it uses on a variety of goods and services, while Denmark would have suffered a sharp cut in revenue from its VAT. In May 1989, therefore, the Commission modified its proposal, adopting a "pragmatic" approach to VAT harmonization. The modified proposal entailed, among other things, rescinding the upper limit on the standard rate. The Commission also accepted a zero rate for a limited number of commodities in countries that already provide for a zero rate. However, it retained the proposed band for the reduced rate.

Along with its proposals to align VAT systems, the Commission has also suggested harmonizing excise taxes. Excise tax systems of the EC countries are even more divergent than VAT systems, for example, in the treatment of manufactured tobaccos, alcoholic beverages, and mineral oils.

The Commission's initial proposal was quite radical, involving complete harmonization of tax rates as well as of the tax base of excises. Full harmonization was justified on the grounds that the VAT is calculated on a product's price including excise duty, so that any differences in excise duty rates would magnify the differences in effective VAT rates. Full harmonization was probably also considered essential to reducing the scope for indirect protection of national production of such products as tobacco and alcoholic beverages. On the other hand, the proposal has been criticized for not paying adequate attention to health, environmental, or other legitimate concerns of member countries. In May 1989, the Commission modified its proposal by setting only minimum rates for tobacco products and alcoholic beverages. For the longer run it also defined target rates of taxation; these target rates are 10 percent higher than the rates proposed in 1987. To administer excise taxes after lifting border controls, the Commission has proposed establishing a system of linked bonded warehouses. This involves suspending the excise duty until goods leave a warehouse to be sold on the domestic market.

Assuming that border controls between the EFTA and the EC are maintained, tax harmonization would not have important consequences for the EFTA. However, all the EFTA countries except Switzerland have tax rates in excess of the top rate originally proposed by the Commission. Since harmonization in the EC—whether by prior agreement or by competitive pressure—is bound to lead to a lowering of the higher rates, the incentives for cross-border shopping by EFTA nationals in the EC will increase. Thus, the Danish VAT rate is likely to fall, providing opportunities for profitable cross-border shopping by Swedish nationals. However, the difference in rates between the two countries is unlikely to exceed 5–6 percent, which is considered the maximum sustainable difference in the absence of border controls. On the other hand, Austria's VAT rate on luxuries (32 percent) is likely to look very high following harmonization in the EC and would probably have to be brought closer to the EC standard rate. Iceland has the highest VAT rate in the EFTA, but the scope for cross-border shopping is limited, given Iceland's geographic location.

[101]Under this proposal, exporting countries with relatively high rates of VAT would gain, as would countries with export surpluses.



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While Switzerland's dependence on its turnover tax is comparatively modest, most EFTA countries rely heavily on VAT revenue (Table 10). A removal of border controls between the EFTA and the EC and a concomitant harmonization of VAT rates would thus lead to sizable revenue losses for the EFTA countries. The latter may therefore opt to follow Denmark's approach to harmonization, which is to give priority to the lowering of rates on goods that are important in cross-border trade.

## Capital Income Taxation

The liberalization of capital movements now in progress in the EC raises the issue of harmonization of corporate and portfolio income taxation. With capital liberalization in the EFTA countries also progressing at a rapid pace, the issue is equally important in their case. Indeed, the EFTA countries could be vulnerable to any major changes in EC capital income taxation. In practice, however, although capital income taxation has been on the EC agenda longer than the internal market, consensus has been particularly elusive.

At present, EC countries' methods of taxing capital income differ widely. Calls for harmonization have been prompted by the fact that with full capital mobility in prospect, these differences are creating considerable scope for tax arbitrage and tax evasion. Moreover, when capital is free to flow to countries with a favorable tax regime or where it can escape taxation altogether, the capital will not necessarily be used to finance the most efficient investments.

The Commission has made a number of proposals in the area of corporate income taxation, with the first back in 1969. The proposals address such issues as harmonization of company tax systems, elimination of double taxation of foreign source company income, and crediting of shareholders for the tax on company profits. Thus, the main features of a directive proposed in 1975 included a single statutory rate of corporate income tax set in an interval between 45 percent and 55 percent; a common imputation system for distributed dividends with a single rate of tax credit to shareholders; and a common approach to the taxation of dividends crossing borders. The proposal was never adopted; it was officially withdrawn in April 1990.

On July 23, 1990, EC finance ministers adopted a package of three corporate tax directives that had been blocked at the Council level for several years. The directives aimed at eliminating most risks of double taxation for firms operating across borders within the Community. The package included a directive to prohibit member states from imposing a withholding tax on profits distributed by a subsidiary in its territory to a parent company located in another member state.

The Commission has formed a special group of experts to review the whole area of corporate taxation. It will analyze such issues as whether the differences in corporate taxation distort investment decisions, whether market forces and competition among national fiscal systems will suffice to eliminate these differences or whether Community legislation will be necessary, and so forth.

Interest income from foreign bank deposits or securities is potentially an easy conduit for tax evasion following removal of capital controls. Thus, a Commission proposal issued in February 1989 calls for a minimum 15 percent withholding tax on interest income of EC residents. In view of the risk of inducing capital outflows to third countries with adverse effects on interest rates in member countries, the proposal provides for numerous exemptions. Nevertheless, it has run into considerable opposition. As a result, the Commission has shifted the emphasis of its proposal from the withholding tax toward agreement on adoption of minimum reporting agreements and exchange of information on EC residents' interest income.

Progress toward concerted harmonization of capital income taxes in the EC will apparently be slow, which may not give great comfort to the EFTA countries. First, with increasing capital mobility, the EFTA countries may be just as exposed as the EC countries

**Table 10. EC and EFTA: Revenues from VAT and Excise Taxes[1]**
**(in percent)**

| | VAT | | Excise Taxes | |
|---|---|---|---|---|
| | of Revenue | of GDP | of Revenue | of GDP |
| EC | | | | |
| Belgium | 16 | 7 | 5 | 2 |
| Denmark | 23 | 10 | 11 | 5 |
| France | 21 | 9 | 6 | 3 |
| Germany | 13 | 4 | 8 | 2 |
| Greece | 20 | 7 | 14 | 5 |
| Ireland | 20 | 8 | 10 | 4 |
| Italy | 14 | 5 | 7 | 3 |
| Luxembourg | 13 | 6 | 9 | 4 |
| Netherlands | 16 | 8 | 5 | 3 |
| Portugal | 18 | 7 | 16 | 6 |
| Spain | 17 | 5 | 6 | 2 |
| United Kingdom | 16 | 6 | 12 | 4 |
| EFTA | | | | |
| Austria | 18 | 6 | 7 | 2 |
| Finland | 33 | 10 | 14 | 4 |
| Iceland | 34 | 9 | 7 | 2 |
| Norway | 22 | 10 | 15 | 7 |
| Sweden | 17 | 7 | 10 | 4 |
| Switzerland | 15 | 3 | 3 | 1 |

Sources: IMF, *International Financial Statistics*, March 1990; and IMF, *Government Finance Statistics Yearbook*, 1989.
[1]The data refer to the most recent year for which data are available. In most cases the year is 1987 or 1988.



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to the risks of tax arbitrage, tax evasion, and distorted investment incentives posed by the current EC system. Second, concerted action may be replaced by harmonization through uncontrolled competitive pressure. The proliferation of tax reforms in both the EC and the EFTA in recent years may be an indication that this process is already under way. One problem with such a process is that the competition may in the long run drive tax rates down to suboptimal levels or create tax systems that are less efficient than if they had been the result of coordinated effort. In any event, the hardships are likely to be particularly great for such high-tax countries as Norway and Sweden, where substitute revenue sources may be difficult to find.



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# XI Summary and Conclusions

EC-EFTA relations received a major push in 1984, when the EC and EFTA jointly issued the Luxembourg Declaration aimed at creating a dynamic European Economic Space (EES) and signaling the political will to extend cooperation beyond the FTAs. Relations developed a new sense of urgency—particularly on the EFTA side—following the EC Commission's issuance of its White Paper, *Completing the Internal Market*, in 1985, and adoption of the Single European Act in 1986. As the internal market program gained momentum, the EFTA countries grew increasingly concerned about being left out.

In January 1989, efforts to improve cooperation gained new momentum from an invitation to the EFTA by Jacques Delors, President of the EC Commission, to form a more structured relationship with the EC. The EFTA responded in March 1989 with the so-called Oslo Declaration, in which EFTA heads of state expressed their willingness to explore the "ways and means to achieve a more structured partnership. . . ." This put the EES negotiations on a two-track course. The legal and institutional changes required by greater cooperation were to be covered under the so-called Oslo-Brussels process, while issues related to laying the basis for the free movement of goods, services, capital, and labor within Western Europe—the four freedoms—continued to be addressed in the follow-up to the Luxembourg Declaration. Since launching the Oslo-Brussels process, the EFTA's relationship with the EC has changed considerably as the EFTA has sought to present a more united front. Ministers from EC and EFTA countries agreed in December 1989 to begin formal negotiations on forming a more structured relationship and began negotiating in June 1990. While the EES appears to be gaining momentum, the possibility of little or no change in EC-EFTA relations cannot be excluded.

The success of the EES hinges on progress on a number of legal and institutional issues. Under any circumstances, relations could benefit from improved mutual recognition in civil and commercial law. Both organizations have made internal progress in this area, but only half of the countries have signed a multilateral accord on the subject.

The EFTA countries have also expressed a desire to have a say in the EC's decision-making process on legislation and other issues that also affect the EES. The EC has repeatedly said that, while it would allow the EFTA countries to voice their opinions, it would not allow them to vote, a right reserved only for EC member states. The EFTA has accepted that EES legislation will be largely based on EC law. However, it is still seeking a genuine joint decision-making mechanism on matters relating to the EES. Beyond this, the EES implies the creation of new institutions for judicial monitoring and enforcement, both in the EFTA and in a joint EC-EFTA body. It would require the EFTA to create a judicial body of its own with enforcement powers over its members. While a joint judicial body would also appear desirable to handle inter-bloc disputes, the EC may resist this as an infringement on its sovereignty. On the other hand, proceeding without a joint body would probably force the EFTA states to accept unilateral decisions of the European Court of Justice, which could be politically difficult. A compromise is possible, however, since the EFTA countries appear willing to accept that the EES will be based on EC law.

While the EC has made progress in creating various types of trans-Community corporate entities and in formulating an EC-wide merger policy, EFTA firms are more concerned about receiving equal treatment within the internal market. Highly discriminatory policies are not expected. But the outlook for third countries is not clear and may not be settled until the EC has clarified its own position on these matters. Equality of treatment may be addressed in EES discussions. A possible sticking point is the EFTA countries' laws on foreign ownership of domestic firms. At present all EFTA members, except Austria, limit foreign ownership of private nonfinancial joint stock companies. However, several EFTA countries have liberalized legislation in this area and further liberalization is being contemplated. The EC Commission, for its part, has been insisting that the EFTA countries strictly limit the list of exceptions to EC legislation.

Changes would also appear desirable in the areas of industrial and intellectual property rights—notably



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counterfeiting, trademarks, copyrights, and patents. Although progress has been made both within the EC and in joint talks on counterfeiting and trademark legislation, the EC is moving slowly in copyright legislation and is deadlocked on patents. Progress is not likely until the EC resolves its own differences in these areas. Joint progress will likely be made on either an inter-bloc basis, probably under the Oslo-Brussels process, or through bilateral talks. However, in some cases, such as the Nordic group on copyright legislation, subgroups of the EFTA could get involved.

While most trade within and between the EC and EFTA is free from conventional barriers, Western European markets remain fragmented. Although tariffs and quantitative restrictions on trade in the region have largely been abolished, other obstacles remain. Some are imposed by governments, such as border controls, technical standards, and public procurement rules. However, private anti-competitive strategies aimed at exploiting market power may also be important. It is unclear whether the internal market program will eliminate all of these more subtle obstacles.

Integration is seen as beneficial for several reasons. It allows specialization based on comparative advantage; it allows greater scale economies; and it encourages competition. However, since trade costs in Western Europe are already low and factor endowments are relatively similar, the gains from comparative advantage may be quite small. The gains from increased scale economies and greater competition are likely to be much larger.

There seems to be little doubt that the internal market will bring gains to the EC. However, these gains are difficult to quantify. First, there is no general theory of imperfect competition, and empirical estimates tend to be highly sensitive to the underlying assumptions. Most of the gains are likely to result from the effects of market integration rather than reduced trade costs. However, while firms may be less able to discriminate between markets, it is difficult to predict the extent to which the internal market program will end such practices. Second, comparisons of second-best solutions are difficult.

If the EFTA countries fully participate in EC integration, they will also share in the gains from the internal market program. While the effects are similar to those on EC countries, the smaller home markets of EFTA countries may imply greater potential gains than in some EC countries. However, the EFTA countries may also have to bear some costs, if they are required to coordinate their external trade policies with those of the EC.

A decision not to integrate further with the EC is likely to result in some losses for the EFTA countries, both relative to the current situation and relative to full integration with the EC. These losses would arise because EFTA firms would become less competitive vis-à-vis their EC counterparts. As trade barriers are eliminated within the EC, demand will tend to shift from EFTA products to EC products, which will depress production in the EFTA. To avoid a deterioration in competitiveness, EFTA firms may be tempted to shift production to the EC. In order to maintain employment within the EFTA, the deterioration in EFTA terms of trade would need to be offset through reduced relative labor costs.

An examination of the economic objectives of the internal market program and the outlook for EC-EFTA relations suggests that—while concessions may be needed from the EFTA—the internal market should have a generally positive impact on the EFTA economies. Prospects for goods trade appear quite favorable. The costs of border controls are falling. While it may not be possible to end inter-bloc border controls—which will put EFTA firms at a slight disadvantage relative to EC firms—the costs of the remaining barriers have declined because of the Single Administrative Document (SAD) for customs clearance. Costs should decline further following the planned computerization of customs data and customs procedures. In addition, EFTA firms will benefit from the free movement of goods within the EC.

The outlook for harmonization and mutual recognition of technical standards and regulations is also favorable. The EC and EFTA are both members of CEN/Cenelec—the two major multinational standards-setting groups in Western Europe—and the EC has agreed to take the EFTA's views into account when formulating its positions. Progress in joint recognition of certification and testing is also likely. However, several EFTA members have strict industrial standards, notably on the environment, and retaining these standards may be seen as discriminatory by the EC.

The chances for a pact on public procurement are less certain. Progress is most likely to come under the umbrella of the EES. So far, the only agreements have been on strategy and on exchanges and publication of data. The EC has recently made some progress, but serious talks with third parties may have to await further progress within the EC, for example, on government procurement of services. However, the EFTA may also face problems formulating a unified position on this topic. Successful inter-bloc talks may depend on the momentum of the whole EES process. If joint progress is not achieved, the EFTA countries are likely to be subject to the same rules as other third countries. The recent EC directive on public procurement in formerly protected sectors allows EC countries to discriminate against firms from non-EC countries



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unless the bids meet minimum "European content" requirements.

Much progress has been made regarding rules of origin, but difficulties remain. For some time, the key problem for the EFTA countries was that their FTAs with the EC were bilateral, with no cumulation rules for inputs from other EFTA members. These rules were broadened in January 1989. However, concerns remain about the EC's anti-dumping laws. There is some fear that preserving market shares in the EC after the start-up of the internal market may require price cutting, which could be treated as dumping. The EC has said it will not exempt EFTA members from these rules unless they agree on a uniform set of competition rules. Previously, such an accord did not seem likely, but a solution may be found as part of the talks relating to the EES.

Inter-bloc talks on state aid are under way. The initial goal is to develop a joint reporting system and a system for consulting on problem cases. One difficulty is that the EFTA has no monitoring or enforcement procedures. Work on monitoring has begun, but an enforcement mechanism is not likely to be developed except as part of a broader EES agreement.

Talks on fishing rights and trade in fish are problematic. The EC seems divided on allowing a country's fish exports free access to EC markets without its granting the EC access to its fisheries. Iceland is the only EFTA country that views fisheries as a major concern. Fishing is the backbone of Iceland's economy and there is a political consensus that this issue is non-negotiable. However, Iceland needs to retain its access to the EC and hopes to improve it. Therefore, it may be willing to support other aspects of the EES in exchange for concessions in this area.

Most talks on transport issues are still preliminary. While the EFTA committee on transport has begun discussions with the EC, the outlook is not likely to become clear until the EC formulates its own position in this area. The outcome is likely to take one of two paths: an accord will either be made on an inter-bloc basis—possibly as part of the EES—or between individual EFTA countries and the EC on a case-by-case basis.

Both the level of interest and the negotiating positions of EFTA members vary across issues. Austria and Switzerland are highly interested in road transport. They are also located on key intra-EC transport routes, so their bargaining position is strong. On the other hand, the Nordic members of the EFTA have relatively limited interest in road transport issues, since they are physically separated from the continent. Marine transport is important to the Nordic EFTA members but not to the Alpine members. However, little firm progress has been made in either of these areas.

All EFTA members are interested in air rights and have been invited to negotiate on this issue with the EC. Norway and Sweden are likely to receive favored treatment since their main carrier, SAS, is partly owned by interests in Denmark and is being treated as an EC carrier. The EFTA's argument that air transport rules are best handled on a Western European basis appears well founded, but the success of these talks—beyond a likely accord between the EC and Norway and Sweden—could hinge on the success of the EES. Otherwise, a basis may be found by examining a range of transport issues together.

Prospects for liberalization of the movement of people within Western Europe are not yet clear. The EC views labor mobility as essential for the efficiency of the internal market. The EFTA countries have agreed in principle with this objective for the EES, and some progress has been made in reducing technical barriers to mobility in Western Europe. While there are concerns about labor mobility in several EFTA countries, only Switzerland has publicly raised official objections. It appears likely, however, that political support can be raised within the EFTA countries for such an accord unless it is part of a wider agreement on the EES. Even in this case, Switzerland may seek a partial exemption, and some EFTA countries may retain the right to introduce restrictions under certain circumstances. However, as noted, the EC has been taking a firm line on such exceptions.

Financial integration is central to the internal market program. Free capital flows and trade in financial services are expected to yield substantial gains for the EC. Similar gains would accrue to EFTA members if they integrate further with the EC in this area. The EFTA countries share many of the EC's objectives in this field, and prospects for greater cooperation appear favorable. The EFTA countries have all deregulated their domestic financial markets and most have liberalized capital movements or are in the process of doing so. They are also revising their legislation and practices for financial institutions to conform more closely with internationally accepted standards and with those of the EC. Restrictions on foreign ownership may pose problems, however, notably among the Nordic countries.

Closer financial integration with the EC would give the EFTA countries' financial institutions improved access to EC markets, but they would also face increased competition at home. The effects of this may vary among countries. Switzerland seems to have the most developed financial institutions in the EFTA. Norway, and particularly Iceland, may face greater challenges. However, a decision not to integrate is also likely to incur some costs. Larger EFTA customers would tend to turn abroad for financial services, while



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smaller customers would be deprived of this potential benefit.

With respect to the possible participation of the EFTA countries in the EC's formal monetary and exchange arrangements, a central question is whether or not the EES forms an optimum currency area. One approach, based on necessary preconditions, seems to support the EFTA countries joining the EMS. However, a second approach, which argues that an optimum currency area requires similar policies and objectives in the member countries, would suggest that only Austria and Switzerland should join. A third, the cost-benefit approach, which examines the effects of joining a different exchange rate regime, does not yield a clear answer. It finds that the decision must be based on key value judgments, for example, whether the loss in policy autonomy is compensated for by gaining credibility through exchange rate commitments. The fact that—apart from Austria—only Norway has expressed an interest in EMS membership shows that there is no homogeneous opinion within the EFTA. However, increasing financial integration in Europe strengthens the need for policy cooperation with the EMS, either formal or informal.

Tax harmonization has emerged as an internal market issue primarily with respect to indirect taxation. With the elimination of border controls, the fiscal checks required for the operation of the present VAT system will disappear, while the scope for cross-border trade increases. The EC Commission has proposed administrative reforms, permitting the VAT system to continue to operate according to the "destination principle." It has also called for a degree of harmonization of VAT and excise tax rates so as to reduce the potential gains from cross-border trade. In both respects, the implications for the EFTA are limited as long as border controls remain in effect between the EC and the EFTA. To the extent that harmonization in the EC—whether by agreement or by competitive pressure—leads to a lowering of tax rates, the incentives for cross-border shopping by EFTA nationals in the EC will increase (for example, between Denmark and Sweden), but such shopping will remain subject to border checks.

Harmonization of capital income taxation is a long-standing issue in the EC, and one that has become increasingly urgent with the liberalization of capital flows. However, relatively little progress has been made toward concerted initiatives in this area. The issue is important for the EFTA countries as well, since they too are rapidly achieving full capital mobility. At present, it appears that in both blocks harmonization will be propelled by competitive, downward pressure on tax rates rather than by agreement, and the proliferation of tax reforms suggests that this process is already under way. Such a process may impose particular hardships on such high-tax countries as Sweden and Norway, where substitute revenue sources may be difficult to find.



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# Glossary[1]

*Aquis communautaire:* The accomplishments of the European Community to date. In this paper, it refers to the question of which EC laws and legislation will be integrated into the common legal basis of the EES.

*Cabotage:* Allowing a nonresident carrier to provide transport services between other states. (Usually refers to a carrier from one EC member state providing services between other member states.)

*CAP:* The EC's Common Agricultural Policy.

*Cassis de Dijon ruling:* A 1979 decision by the European Court of Justice that established the rule that products made and marketed according to the legal requirements of one member state must circulate freely throughout the Community.

*CEN/Cenelec:* French acronyms for the Committee for European Standardization and the Committee for European Electrotechnical Standardization, respectively. These are the two main multinational standardization bodies for the EC and EFTA, to which all EC and EFTA member states belong. Voting is by qualified majority; however, both strive to reach a consensus before voting. EC institutions currently have special rights on the implementation of new documents. Recently, the EC and EFTA agreed to create a third, related institution; see the European Organization for Testing and Certification.

*CFP:* See Common Fisheries Policy.

*Commission of the European Communities (or EC Commission):* Executive and policy-proposing body of the Communities; its members must act independently of both the member governments and the Council of Ministers.

*Committee of Central Bank Governors:* Committee composed of central bank governors that makes certain decisions regarding the operations of the EMS, and that is involved in preparing all decisions and resolutions of the Council of Ministers on monetary policy.

[1]Primary sources used in this glossary are Folkerts-Landau and Mathieson (1989), pp. 21–22, and Noel (1988).

*Common Fisheries Policy (CFP):* The EC's fisheries policy. It seeks to conserve fish stocks, while trying to enhance the competitiveness of the fishing industry. The CFP works to assure a sufficient supply of fish within the EC, either by buying fishing rights from third countries or by negotiating access to fishing grounds in exchange for providing market access in the EC.

*Community:* See European Communities.

*Council of Ministers:* The only Community institution whose members directly represent the member governments at the ministerial level. It reaches decisions in one of three ways: unanimously, by simple majority, or by a weighted majority according to various rules laid down in the Treaties.

*Delors Initiative:* In a speech to the European Parliament in January 1989, Jacques Delors, President of the EC Commission, presented the EFTA with the option of either continuing the step-by-step process of cooperation started by the Luxembourg Declaration or to strive for ". . . a new, more structured partnership with common decision-making and administrative institutions. . . ." This later alternative became known as the Delors Initiative.

*Delors Report:* Report on the Economic and Monetary Union in the EC, submitted by a committee chaired by Jacques Delors, President of the EC Commission, to the European Council in April 1989. The report, endorsed by the Council, contains an outline of the main features of the monetary and economic union and a description of the stages that could lead to the union.

*Directives:* Issued by the Council of Ministers and binding as to the result to be achieved. Each member state may decide how to achieve that result, and may have to amend its own national laws or administrative practices to bring them into line with Community law.

*EC:* European Communities or European Community; in practice the two terms are used interchangeably.

*EC credit facilities:* See medium-term financial support facility, short-term monetary support facility, and very



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short-term financing facility (the latter limited to participants in the ERM).

*Economic and monetary union (EMU):* The Delors Report envisaged the EMU as including total and irreversible convertibility of currencies; the four freedoms; irrevocably fixed exchange rates, with no fluctuation margins; sufficient coordination of macroeconomic policies including binding rules for budgetary purposes and a joint competitive policy; and common structural and regional policies.

*EEC:* European Economic Community.

*EEC Treaty:* Founding document of the EEC, signed in March 1957; often called the Treaty of Rome.

*EEIG:* See European Economic Interest Grouping.

*EES:* European Economic Space.

*EFTA:* European Free Trade Association.

*EMCF:* European Monetary Cooperation Fund.

*EMS:* See European Monetary System.

*EMU:* See economic and monetary union.

*EOTC:* See European Organization for Testing and Certification.

*Equivalent treatment:* One of two interpretations of the concept of reciprocal treatment. In the case of the EC, the demand for equivalent treatment means that in order for a foreign company to operate freely in the EC, its home country must extend identical treatment to EC companies as its firms receive in the EC. See also national treatment.

*Erga Omnes:* Principle stipulating a certain liberalization measure to be automatically applied to all other countries.

*ERM:* See exchange rate mechanism.

*Essential characteristics:* General characteristics in terms of health, safety, or environmental standards required for goods to be sold within the EC.

*Essential harmonization:* Calls on the EC to establish minimum standards for the conduct of given types of business.

*European Commission:* See Commission of the European Communities.

*European Common Margins Arrangement:* Also known as the "snake," it was the predecessor of the European Monetary System. Under this arrangement, which prevailed from April 1972 to December 1978, the EEC central banks agreed on a maximum margin of 2.25 percent among their currencies.

*European Communities:* Consists of the European Coal and Steel Community (ECSC), the European Economic Community (EEC), and the European Atomic Energy Community (EURATOM). The ECSC was established by the Treaty in Paris in 1951. In 1951, the EEC was established by the Treaty of Rome. At the same time, the EURATOM was established by a separate treaty. The institutional structure of the EC (organized along the lines of a national administration) consists of the EC Commission, the Council of Ministers, the European Parliament, and the European Court of Justice. Its member states include Belgium, Denmark, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Spain, and the United Kingdom.

*European Company:* Proposed in July 1989 as a form of EC-chartered firm. It is envisaged as a limited liability, joint stock company, headquartered in a member state, with capital exceeding ECU 100,000. While not receiving preferential treatment under national law, it is to be free of many of the constraints of functioning within its 12 distinct national legal systems by dint of its EC charter. Rules governing foreign participation are to be developed.

*European Council:* The heads of government of the member countries at a Paris meeting in December 1974 decided to meet regularly, accompanied by their ministers of foreign affairs, normally twice a year. These meetings have become known as the European Council.

*European (or EC) Court of Justice:* Assures that implementation of the EC Treaties is in accordance with the law, and assures that Community legislation is good law. It may also give preliminary rulings on questions referred to it by national courts.

*European currency unit (ECU):* A composite unit consisting of specified amounts of the currencies of all EC member countries. It serves as the numeraire for the ERM, as the denominator for operations in both the intervention and the credit mechanisms, as a reference point for the divergence indicator, and as a means of settlement and a reserve asset of EMS central banks. It is also used as the unit of account in other areas of the EC, for example, the budget.

*European Economic Interest Grouping (EEIG):* A trans-EC partnership created in 1989 to expedite joint ventures between EC firms. Its legal form may vary, it has no capital requirements, and partners' liability is unlimited. It may not employ over 500 persons and must have participants from more than one member state, although a subsidiary of a multinational firm may count toward this requirement. All profits must be



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transferred to its owners. Once registered in a member state, it may operate throughout the EC without further registration requirements.

*European Economic Space (EES):* This concept originated as part of the 1984 Luxembourg Declaration, although at the time it was left undefined. The term now refers to a zone of Western European cooperation where, to the extent possible, the four freedoms are permitted and where the institutional and administrative facilities allow a structured relationship with far-reaching and legally binding agreements. It is hoped that the agreement will extend beyond economic issues, into the areas of consumer protection, education, environment, research and development, and the social dimension. The EES originally included the EC and member states of EFTA, but recently Liechtenstein has also joined the talks (as a contracting party on the EFTA side).

*European Free Trade Association (EFTA):* Free trade association founded in 1960. Its membership includes Austria, Finland, Iceland, Norway, Sweden, and Switzerland. The United Kingdom and Portugal were founding members, but they left the EFTA and joined the EC in 1973 and 1986, respectively.

*European Monetary Cooperation Fund (EMCF):* A fund set up in 1973 to serve as the embryo of a reserve system of the Community central banks, and to have operational responsibility in a Community currency exchange system. Its governors are those of the member states' central banks. It uses the Bank for International Settlements as its agent.

*European Monetary System (EMS):* The successor of the European Common Margins Arrangement, which became operational in March 1979. Aiming at establishing a zone of monetary stability in Europe through a lasting and effective system of close monetary policy cooperation, the EMS rests on three pillars: the exchange rate mechanism, the European currency unit, and several credit facilities.

*European Organization for Testing and Certification (EOTC):* In May 1990, the EC and EFTA agreed to create a new testing and certification organization to work alongside the CEN/Cenelac. It will be formed in three stages, with the last taking effect on January 1, 1993.

*European (or EC) Parliament:* Elected by popular vote within the EC, it has advisory powers under which it delivers to the Council nonbinding opinions on Commission proposals and has supervisory powers over the Commission. It is also responsible for final approval of the EC budget, although with limited power to amend it. More recently, the Parliament acquired the power to reject or amend Council decisions pertaining to the unification of the EC market under the Single European Act.

*European (or EC) Standard:* Product standard set legislatively or by mandated body assuming that a product meets the essential characteristics test. A product not meeting the European Standard may still be sold within the EC if the producer can show that the product meets the essential requirements test.

*Exchange rate mechanism (ERM):* This mechanism has two components: The first is based on maintaining limits of fluctuations around bilateral central rates between participating countries by means of unlimited intervention on the exchanges. The second is based on the divergence indicator, whose purpose is to establish a basis for action on the part of the authorities when a currency's rate exceeds certain limits that are fixed in terms of the ECU and that—because they are narrower than those demarcating the bilateral margins of fluctuation—will be reached before the latter.

*Four freedoms:* The free movement of goods, services, labor, and capital.

*Free Trade Agreements (FTAs):* Bilateral trade agreements signed by the individual members of EFTA and the EC in 1972–73. In the FTAs, the EC and each EFTA member agreed gradually to abolish tariffs on most industrial goods, although temporary quotas were permitted on certain items and the removal of tariffs on these items was delayed. Special declarations covered selected single items, such as Austrian cheese, Icelandic fish, and Swiss watches.

*FTAs:* See Free Trade Agreements.

*High Level Contact Group:* Formed by senior officials of EFTA member states and the EC Commission in September 1984 to supervise informally progress in implementing the Luxembourg Declaration.

*High Level Steering Group:* Formed by high-level officials of EFTA member states and the EC Commission in April 1989 to oversee the progress of the working groups created as part of the Oslo-Brussels agreements. Four of the working groups examined areas relating to the Luxembourg Declaration, including the potential for cooperation in the areas of free trade in goods, free trade in services and capital, free movement of labor, and joint cooperative projects. The other working group was a direct outgrowth of the Oslo-Brussels process and explored the institutional and legal changes needed to secure broader, institutionalized cooperation.

*Home country control:* Principle calling for supervision and enforcement of legislation by the authorities in the



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country in which a company is incorporated, rather than in the countries in which it operates. For example, a British bank operating in Italy is under the control of British rather than Italian authorities. Home country control, mutual recognition, and essential harmonization are the three principles underlying much of EC integration efforts in areas ranging from technical standards to financial services.

*Internal market program:* Program designed to create a single market encompassing all of the member states of the EC, to ensure the full implementation of the four freedoms. The details and timetable for completing the internal market were set out in the EC Commission's White Paper in 1985; certain modifications have since been made.

*Luxembourg Declaration:* In April 1984, member states of the EC and EFTA agreed on a series of initiatives, including increased cooperation through the creation of the European Economic Space. While the EES was initially left undefined, the accord called for continued pragmatic and flexible cooperation beyond the framework of the FTAs, as well as fostering an open and multilateral trading system and combatting protectionism and encouraging free trade in Western Europe.

*Medium-term financial support (MTFS) facility:* Medium-term financial assistance granted by the Council to any member state experiencing or seriously threatened with balance-of-payments difficulties. Assistance is conditional, with the borrowing country having to agree to certain economic and monetary conditions. It is denominated in ECUs and repayable within a period of between two and five years.

*Mutual recognition:* Principle calling for all national authorities in EC member states to accept the ruling of the authorities in which a company is incorporated. See also home country control.

*National treatment:* A less stringent interpretation of demands for reciprocity. It calls on authorities in nonmember countries to treat EC companies in a nondiscriminatory fashion in return for access to EC markets. For example, in order for U.S. banks to operate in the EC, the EC may require that the U.S. authorities treat EC banks in the same way as they treat U.S. banks. See also equivalent treatment.

*Oslo-Brussels process:* Started in March 1989 as a result of the Delors Initiative. It is seen as a second track for the EES negotiations, focusing on the institutional and administrative changes needed to secure a more structured relationship between the EC and EFTA as a basis for forming the EES.

*Oslo Declaration:* Statement by the EFTA heads of state in March 1989 reaffirming their commitment to the EES and expressing support for the Delors Initiative.

*Reciprocity requirement:* Calling for nonmember countries to apply nondiscriminatory treatment of EC companies in exchange for access to EC markets. The practical significance of this requirement depends on whether it calls for equivalent or national treatment.

*Schengen Agreement:* An agreement signed in June 1990 by Belgium, France, Germany, Luxembourg, and the Netherlands to remove all border controls and allow people to travel freely within the five-country region. Its implementation requires parliamentary approval by each of the five signatories. Schengen is a city in Luxembourg.

*Short-term monetary support (STMS) facility:* To help meet financing needs arising from temporary balance-of-payments deficits caused by unforeseen difficulties or cyclical divergences. The mechanism is based on a system of debtor and creditor quotas that determine each Community central bank's borrowing entitlement and financing obligations. These credits are granted by central banks for three months and are twice renewable.

*Single Administrative Document (SAD):* Agreement to replace all customs documents used in EC-EFTA trade with the single document used in intra-EC trade. The agreement came into force in January 1988.

*Single European Act:* Amendments to the Treaties establishing the EC seen as necessary for the implementation of the internal market program. The Act was signed by the EC member states in 1986, and took effect in July 1987. It replaced the requirement that decisions be reached unanimously with one allowing decisions to be made with a qualified majority in all areas regarding the internal market, with the exception of fiscal provisions, provisions relating to the free movement of persons, and the rights and interests of employed persons. It also enhanced the role of the European Parliament and made foreign policy cooperation a formal part of the EC's activities.

*Snake:* See European Common Margins Arrangement.

*Treaty of Rome:* See EEC Treaty.

*Value-added tax (VAT):* Indirect tax levied on value added excluding the tax paid at previous stages in the production process. Thus, unlike in the case of the sales tax, cumulation of tax liability is avoided.

*Very short-term financing (VSTF) facility:* A very short-term credit facility that central banks participating in the ERM may grant to each other through the



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EMCF to permit interventions in Community currencies. Such operations are denominated in ECUs, and the debtor and creditor interest rates are equal to the rates applicable to net users and holders of ECU assets. The duration of such financing is 45 days and can be extended by three months.

*White Paper:* Paper issued by the EC Commission that laid out a step-by-step plan to create an integrated, coherent internal market based on the four freedoms for all of the EC by January 1, 1993. The plan contained a full set of legislative proposals designed to eliminate all man-made physical, technical, and fiscal barriers that could hinder the free functioning of a single market in the EC. It also set out a full timetable for the implementation of these measures; the timetable has since been accelerated.



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