

PART III

COMPLETING THE INTERNAL MARKET: THREATS AND OPPORTUNITIES

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In this part of the report we turn from study of past experience in the EC to the examination of the threats and opportunities likely to arise from the completion of the European internal market by 1992. In order to identify these we begin, in Chapter 8, with presentation and explanation of a framework for analysis of the effects of market completion on the Irish economy. This analytical framework is based on identification of the direct and indirect effects of the removal of non-tariff barriers. We believe that Chapter 8 provides a framework which can be used by those who wish to study the implications of 1992 for the particular sectors with which they are concerned.

While this report is *not* intended to be a detailed study of the *sectoral* implications of market completion we do apply our analytical framework to selected sectors. In Chapter 9 we consider which parts of manufacturing industry face threats and which parts face opportunities — and whether these arise from the completion of the internal market or from other sources.

In Chapter 10 we examine the services sector. It is widely agreed that 1992 will be more significant in services than in manufacturing — given the present highly segmented European market for most services. Our analysis confirms that distribution, transport and financial services will all experience profound changes in the coming years. In general, Part III of the report examines only the *effects* of market completion; however, for ease of presentation, Chapter 10 also considers the *responses* which are required at corporate and government level if the Irish services sector is to meet the enormous challenge of 1992.

Chapter 11 asks the important question: how will market completion affect the regions of Europe? We explain and evaluate arguments concerning regional convergence and divergence and consider some of the empirical evidence on this question. Our conclusion is that the costs and benefits of the completion of the market are likely to be distributed unevenly — and, consequently, it should not be expected to narrow the disparities between regions, let alone bring about convergence. This is a fundamental conclusion which informs the rest of the report.

Part III of the report concludes with Chapter 12, which studies the issue of the removal of frontiers — and the approximation of indirect tax which is considered necessary to achieve it. Both the need for the removal of frontiers and the effects of indirect tax approximation on Ireland are evaluated.

COMPLETING THE INTERNAL MARKET: A FRAMEWORK FOR ANALYSIS

1. THE STATE OF EUROPEAN ECONOMIC INTERGRATION

The idea of completing the internal market was outlined briefly in Chapter 1. There it was noted that in its 1985 White Paper *Completing the Internal Market* the Commission listed the measures necessary for completion as:

- (a) removal of physical barriers;
- (b) removal of technical barriers;
- (c) removal of fiscal barriers.

Its categorisation of the 300 proposals under these three headings is somewhat artificial. Physical barriers refer to frontier controls on goods and persons. Fiscal barriers comprise all obstacles and significant distortions among member states that derive from differences in the base and rates of indirect taxes. Any other obstacles are grouped into the remaining category of technical barriers.

An alternative, though complementary, approach is to ask what omissions in negative and positive integration of the EC exist which prevent it from being a unified market.* Even if we initially confine this search for omissions to the market for *industrial* products we find a remarkable list of measures needed to obtain one internal market.** These omissions in integration can be categorised under two headings: omissions in formal market access and omissions caused by domestic interventions.

(i) Omissions in Formal Market Access

Clearly, the continued existence of *national customs* with diverse procedures limits market access. There are clear omissions in *technical harmonisation* resulting from national technical standards. For many years the Commission has been trying to follow an ambitious harmonisation programme — but until 1983 the tempo of national regulation was higher than the yearly output of EC

*Negative integration is the removal of obstacles to market access. Positive integration is the establishment of institutions and co-ordination of policies. Formal market access is what results from negative integration. Completion of the internal market involves both negative integration (e.g., removal of customs barriers, etc.) and positive integration (e.g., co-ordination of transport or technology policy).

**This section draws heavily on Pelkman's (1986) report to the Commission *Completing the Internal Market for Industrial Products*.

harmonisation directives. Other omissions in formal market access also exist. Both patents and trade marks are still national and this certainly induces fragmentation of the market. Disparities in *indirect tax* rates in the Community greatly increase the significance and cost of customs at internal EC frontiers. *Exchange controls*, besides giving member states an incentive to maintain customs controls, also create a general perception that the risks and thresholds for intra-EC exchange are fairly high, so that small enterprises and new entrants may be discouraged from exploiting the internal market. Of course, exchange controls are a consequence of macroeconomic policy differences and consequently their removal has serious implications for national macroeconomic policies.

Despite the general freedom of trade in products of Community origin, some products from third countries are subject to *national trade policies*. Important examples are virtually all textile and clothing products under the Multifibre Agreement, motor cars from Japan, and various consumer electronics and leather and sporting goods from several East Asian countries such as Taiwan, Hong Kong, South Korea, and Singapore.

A final omission in formal market access arises because serious discriminations in *transport* exist — particularly in road haulage and air transport. Once it is recognised that transport is, and is likely to remain, a highly regulated sector then it is clear that freedom to supply transport services throughout the internal market will depend on *agreement* about the *common regulation* of the sector.

(ii) Omissions Caused by Domestic Interventions

Even where formal market access exists, interventions by national governments may cause distortions of competition which create a second group of omissions in the Community economic system. This important observation has been well explained by Pelkmans and Robson: “if markets are not subjected to harmonisation of public policy interventions that significantly affect competitive conditions in member states, the benefits from a common market will remain smaller than is technically feasible, and the operation of the market itself could be seriously impaired. In its absence, movements of goods, factors and services within the Community would respond to distorted price signals and the outcome would be an inferior allocation of resources” (1987). The main interventions which affect the market for industrial products are national aids to industry, public enterprises, and public procurement practices. In addition, it is almost certainly the case that the vast array of public interventions in market regulation, social policy and even macroeconomic management also significantly affect competitive conditions.

Problems arise from *national aids to industry* because, during the 1970s and early 1980s, a divergence grew between the Commission’s surveillance of public

aids to industry, on *paper*, and the actual distortions of the internal market. On paper, aid surveillance in the EC appears to aim to facilitate rationalisation processes in industry. Aid is strictly conceived so as to strengthen the adaptive capacity of firms and lower the tangible and intangible social costs of transition. In these circumstances any problem of a possible distortion of competition in the internal market would seem bearable. In reality, however, aid packages multiplied after 1973, such that in shipbuilding, textiles, clothing, steel and the car industry, so called ‘crisis aid’ has come to be accepted as normal. In recent years, the Commission has become more strict in using its powers.

In theory, Community law, including the rules of competition, applies to the way in which national governments regulate and finance their *public enterprises*. However, serious worries about distortion of internal market competition arise from the practice of automatic underwriting of losses of some public firms in countries such as Spain, Portugal, Italy, France and Greece and, for public steelmills, in all relevant member states. In 1980, the Commission introduced the ‘transparency directive’ in order to establish surveillance of public aid to public enterprises but, despite some notable successful challenges in recent years, the problem of making this surveillance effective remains.

Another major omission in formal market access arises because Community competition policy does not fully apply in factor and service markets. As a result, domestic regulatory regimes and a myriad of domestic interventions maintain the fragmentation of these markets. This causes divergent competitive conditions in the markets for labour, financial capital and services (such as insurance, telecommunications, distribution systems and transport) and also, indirectly, in the markets for industrial products.

The final omission in industrial and service market integration caused by domestic interventions is that arising from *public procurement*. Two things can be said about this. First, in the view of Pelkmans and many others, “the failure to remove discrimination in public procurement amounts to a cardinal omission in the internal market” (Pelkmans, 1986). Second, the failure of an internal market in this area exists despite the formal prohibition of discriminatory public procurement in 1969 and the harmonisation of procurement and tendering procedures in 1971 and 1977.

Identification of these ways in which the internal market is not complete tends naturally to produce a list of gaps and a list of policy measures to fill them. However, this may obscure the fundamental nature of the problem. The fundamental problem is that many aspects of Community economic policy are not coherent. This reflects an unwillingness to recognise the full implications of genuine economic integration and, in particular, the way in which

Community and member state policy in one area affect the functioning of the economic and social system in many other areas. This unwillingness to recognise the real implications of integration may, in the past, have reflected a lack of integrative ambition (Pelkmans, 1986). On this view the task facing the Community is to identify and establish a combination of formal market access, trade policy, competition policy, industrial policy, monetary policy, budgetary policy and social policy which can sustain complete market integration in the economic sense.

2. THE INTERNAL MARKET PROGRAMME

The eventual response to these serious omissions in European economic integration was the formulation and adoption of the internal market programme. The format of the programme follows closely that laid out by the Commission in its 1985 White Paper *Completing the Internal Market*. The many measures proposed are listed under the headings (i) removal of physical barriers (ii) removal of technical barriers and (iii) removal of fiscal barriers. It is most important to appreciate that while completion of the market requires removal of many obstacles to trade (negative integration) it also depends on the establishment of many new common policies, policy procedures, and institutions (positive integration). This is partially recognised in the internal market programme and accounts for the immense amount of detailed work involved in executing the programme.

(i) Removal of Physical Barriers

These physical barriers consist of controls on the movement of goods and controls on the movement of people. To remove controls on goods the Community intends to abolish completely frontier controls and customs. This implies that individual member states can no longer pursue any independent commercial policy such as import quotas or quotas on transport. Likewise, parts of Community policy, such as MCAs will have to be altered. Finally, if these separate national policies are abolished then new Community policy will be needed in certain areas. An obvious example is veterinary and plant health policy. A less obvious example is the need to agree on the social element in certain types of transport, e.g., railways.

Likewise, the removal of controls or checks on the movement of persons will require the creation of common European policies for the control of terrorism and drug trafficking.

(ii) Removal of Technical Barriers

A great many measures are planned under this heading and they can be usefully grouped as follows.

Free Movement of Goods

At present, the free movement of goods is inhibited by the existence of different national technical standards. A key element of the internal market programme was the adoption in the Spring of 1985 of the so-called 'new approach' to technical harmonisation. This involved mutual recognition of technical standards, rather than lengthy negotiation of a detailed new Community standard. At the same time, the White Paper contains a long list of draft directives for technical harmonisation that are to be implemented under the 'old approach'. The 'new approach' extends to financial services as well as to manufactured goods, where it is encapsulated in the principle of home, rather than host, country recognition and regulation of financial institutions.

Public Procurement

The Commission proposed to open up the tendering for public contracts, by improving existing Directives and extending their coverage to energy, transport, water, telecommunications and public services.

Free Movement of Labour and the Professions

The Commission aimed to remove many of the obstacles which still exist in this sphere by creating mutual recognition of educational and training qualifications and, where necessary, establishing Community standards. It is also intended to remove some of the administrative and taxation provisions which limit choice of residence within the Community.

Common Market for Services

One of the most striking omissions in economic integration is the fact that Community competition policy applies only very imperfectly to services. Completion of the internal market will involve a considerable opening up of the markets for financial services (banking, insurance, and transactions in securities), transport, and the new services (information technology and broadcasting). Making the market for financial services more open will involve not only allowing more competition between institutions but also removal of restrictions on capital movements. This has profound implications for other aspects of Community and member state policy, such as macroeconomic policy co-operation, taxation and social security (Pelkmans, 1982). In transport, the proposals consist of a combination of enforcement of the Common Transport Policy, that is set out in the Treaty of Rome, and a set of new measures to promote competition. In the area of new services it is intended to devise an approach which will create a pan-European mobile telephone system — and this is being actively discussed at present. It is not intended to abolish national regulatory systems in broadcasting but it is hoped to devise a common policy within which these national systems will be 'transparent'.

Capital Movements

The Commission's White Paper argued that free movement of capital is an

integral part of completion of the internal market for goods and services. But it also noted that, quite separately from that, monetary stability is an essential precondition for the proper operation and development of the internal market. Therefore, action to achieve greater freedom of capital movements would need to move parallel with the steps taken to reinforce and develop the EMS.

Creation of Suitable Conditions for Industrial Co-operation

The proposals under this heading consist first of a set of alterations to company law to facilitate cross border co-operation and merger, and ultimately to allow the formation of a company at Community rather than national level. Secondly, a number of Directives have been proposed to greatly simplify the current legal position on trade marks and patents. In addition, recent and likely future technical changes throw up a number of new problems in ownership and control of intellectual property, and the provision of a legal framework must be primarily at the Community rather than the national level. Finally, there are a number of tax obstacles to co-operation between enterprises in different member states which it is intended to remove. A related issue which naturally arises in this context is the question of the nature and level of taxation of enterprises in the Community. Though this question will almost certainly be studied with increasing interest in the coming years, harmonisation of corporate tax is not included in the internal market programme.

Application of Community Law

Perhaps one of the most important parts of the internal market programme is not the *passing* of new Community legislation but the vigorous *enforcement* of existing legislation. This is so, because many of the omissions in integration identified above arise from violation of provisions included in the Treaty of Rome or subsequent Community legislation. The backlog of cases requiring judgement benefits the infringing state and creates an incentive to further illegal actions.

Two other aspects of Community law enforcement are included in the internal market programme. One is the development and enforcement of Community competition policy including a new merger control regulation. The second is monitoring and strict control of state aids to industry. Stricter application of the Community powers of surveillance and supervision is a matter of *negative* integration. But that will not be enough. States provide aid to industry to deal with industrial crises, to assist restructuring, to promote regional development and to assist the emergence of new high-tech sectors. Harmonisation of these aids, that significantly affect competitive conditions between countries, poses the Community a number of questions which must be resolved at the same time. These concern the Community's approach to industrial restructuring, regional development and R+D policy. A considerable amount of *positive* integration would seem to be a necessary precondition to achieving the stricter Community control of state aids. To some extent provision for these necessary

accompanying measures is made in the Single European Act which, besides the internal market, contains important Treaty articles on research and technological development, economic and monetary union, social policy, the environment and economic and social cohesion.

(iii) Removal of Fiscal Barriers

The removal of fiscal barriers is closely related to the removal of physical barriers. The Commission's proposals in this area are outlined and discussed in Chapter 12 of this report.

(iv) Summary and Conclusions

First, to summarise, the internal market programme consists of a set of measures to make international trade easier between the member states, to remove some of the many non-tariff barriers to the movements of goods, services, capital and labour, and to open up much of national public procurement to tenders from throughout the Community.

Second, the programme to complete the internal market, as set out in the Commission's 1985 White Paper and as spurred on by the provisions of the Single European Act, can be seen to be 'breathtakingly ambitious' — when considered in the light of the history of the Community from the mid-seventies to the mid-eighties (Pelkmans and Robson, 1987).

Third, having said that, it must be noted that there is nothing comprehensive about the internal market programme. We mean this in two senses. First, the fact that a practice or a regulation inhibits or distorts trade, or the movement of labour or capital between member states, does *not* necessarily mean that there is an existing or planned proposal to eliminate or modify it (Kay, 1989). Second, the Commission's White Paper, and the internal market programme *per se*, considers measures *only* from the standpoint of the promotion of an efficient use of resources. As Pelkmans and Robson stress, the impact of the measures proposed on other policy objectives is not taken into account. Nor is there any consideration of the implications of market completion for the development of other Community policies, such as regional, social, industrial, budgetary and monetary policies, even though these are many and significant (Pelkmans and Robson, 1987). These wider aspects of European economic integration are considered in later chapters of this report.

3. A FRAMEWORK FOR SECTORAL ANALYSIS OF THE IMPACT OF 1992

(i) Identifying the Processes of Integration

In order to identify the processes which economic integration sets in train it is necessary to consider the theory of international trade and integration. In

recent years, there has been considerable change in the theories of trade and integration and it is desirable that new as well as traditional approaches be taken into account. In Chapter 2 we have contrasted the traditional theory of international trade with modern approaches. In Chapter 3, as a prelude to investigating Ireland's experience since accession, we outlined some hypotheses about the effects of removing tariff and non-tariff barriers to trade (NTBs).

Both the theories discussed in Chapter 2 and the hypotheses set out in Chapter 3 are relevant in formulating a framework for analysis of the effects of market completion on the Irish economy. Using the processes of integration as identified in these theories, we derived a framework which was similar in many respects to that used in what has become known as the 'Cecchini Report'.^{*} Consequently, in setting out a framework for analysis we use the basic format found in the 'Cecchini Report', which will be familiar to many readers, and develop it somewhat where necessary.

(ii) Direct Effects of Market Completion

Completion of the internal market will have both direct and indirect effects. Indeed, two distinct *direct* effects can be identified.

Cost reduction will result from removal of non-tariff barriers (NTBs). For example, firms should be able to find cheaper inputs, transport, insurance, packaging and labelling costs should fall, the cost of goods traded should be reduced by the removal of bureaucratic obstacles, etc. These cost reductions should facilitate price reductions and, consequently, increased demand and output.

Increased competition will result from the improved market access of firms in all countries. Firms which can currently operate high price-cost margins or price discrimination should find this ability curtailed by increased competition. In short, firms will find it less easy to practice market segmentation. In addition, measures such as the liberalisation of public procurement should encourage market entry by other EC producers and, consequently, increased competition.

The relative strength of these two direct effects will differ from industry to industry. It is, however, possible to identify some of the factors which determine the strength of the two direct effects.

^{*}The 'Cecchini Report' refers to the studies undertaken in a major Commission project directed by Paolo Cecchini. The overall results of the project are available in two complementary reports. The first, issued under the responsibility of the European Commission's Directorate-General for Economic and Financial Affairs, contains detailed economic analysis and is entitled *The Economics of 1992*. It is available as Issue Number 35 of the Commission's journal *European Economy* or in book form edited by Michael Emerson (Emerson, *et al*, 1988). The second report available is a book by Paolo Cecchini, *The Challenge of 1992*, addressed to a general readership (Cecchini, 1988). Our references are invariably to the first, more detailed, report (Emerson *et al*, 1988) and in the text we refer to this as the Cecchini Report or *The Economics of 1992*.

First Direct Effect: Cost Reduction

The extent of immediate cost reduction clearly depends on the height of NTBs in different industries. Some NTBs affect all industries which produce tradable products — the most obvious example being customs costs. Others affect only some industries — for example, national packaging, labelling or technical standards and national government procurement practices. But, even when a NTB has an effect, it will not affect all industries equally. For example, costs arising from customs delays or restrictive transport practices will affect products with low value to weight ratios disproportionately. It is agreed that in general NTBs are relatively less in low-technology products than in high-technology markets. But customs delays or road transport quotas may impose a much greater cost penalty on low-technology products since they will be a higher proportion of the value of the product. The proportion of output which is currently traded is clearly an important determinant of the extent of cost reduction and should be referred to in assessing the probable immediate impact of completion of the market. Likewise, the frequency and height of non-tariff barriers will differ between intermediate and final goods and will depend in part on the nature of the relationship between the exporting and importing firm. For an evaluation of the significance of NTBs in different industries see the supplementary volumes produced as background to the 'Cecchini Report' (*Research on the 'Cost of Non-Europe' — Basic Findings Volume 1* and the summary in Part C of *The Economics of 1992*).

Second Direct Effect: Increased Competition

Price reductions resulting directly from increased competition are a function of the current degree of concentration of an industry. Despite the presence of NTBs, many industries still contain a considerable number of firms and, therefore, competition ensures that price cannot depart excessively from costs (inclusive of those arising from NTBs). Commonly cited examples include textiles, clothing and footwear. By contrast, other industries are highly concentrated, or market entry is restricted, and firms in individual national markets have scope for monopoly pricing, price discrimination and x-inefficiencies.^{*} Examples are pharmaceuticals, man-made fibres, office machinery, domestic electrical appliances and motor vehicles.^{**}

(iii) Indirect Effects of Market Completion

These two direct effects may be the start of two chains of causation which create substantial *indirect* effects. These have been labelled 'size' and 'competition' in the 'Cecchini Report' and are depicted schematically in Figure 8.1 and listed in Table 8.1.

^{*}Where total costs of production are not minimised, due particularly to monopoly power, the resulting poor performance is labelled x-inefficiency.

^{**}For further details see Part C, Part D.7, and Part D.9 of *The Economics of 1992*, and *Basic Findings*, Volume 1.

First Indirect Effect: Market Size

The *direct* effect of removal of NTBs may be to reduce costs and, consequently, price. As the quantity demanded and supplied increases, the firm may find costs of production falling again because of *economies of scale* (EOS). This facilitates further price reductions and output growth. But this is not the end of the indirect effects. The process of increasing output and exploiting economies of scale involves larger, low-cost, producers eliminating smaller high-cost firms and can, consequently, initiate a major restructuring of industry — in particular, but not only, rationalisation. This is one very important possible indirect effect of market completion.

Figure 8.1
Schematic Presentation of the Two Channels of Direct and Indirect Effects of Market Completion

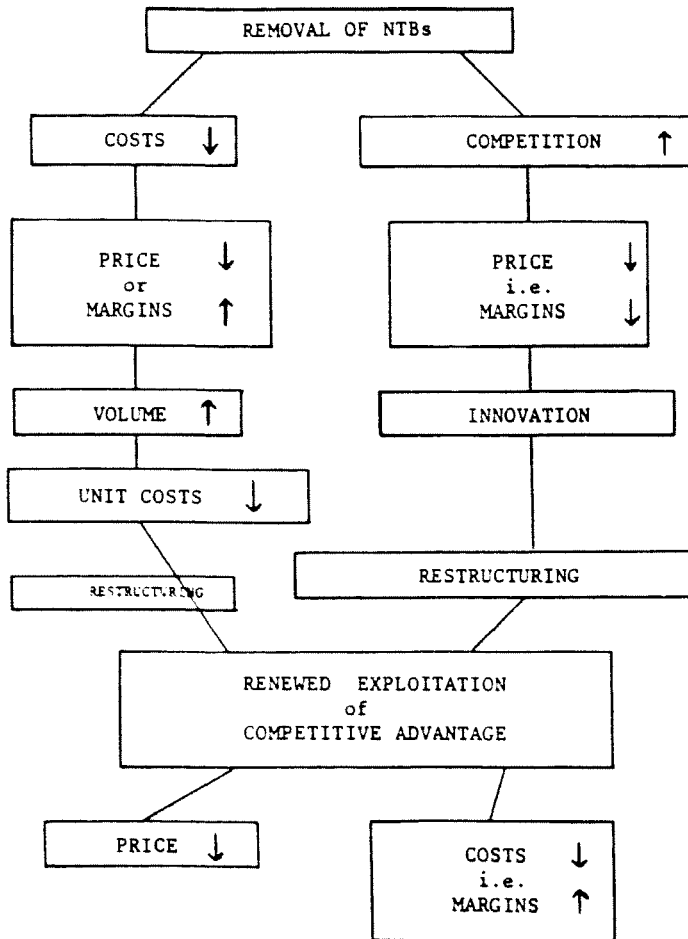


Table 8.1
Direct and Indirect Effects of Market Completion

Direct Effects		Indirect Effects	
<i>Direct Cost Reduction</i>	<i>Output Increase</i>	<i>Cost reduction</i>	<i>Restructuring</i>
1. <i>Direct Cost Reduction</i> a function of: proportion of output traded importance of NTBs	<i>Output Increase</i> a function of: market structure product differentiation	<i>Cost reduction</i> a function of: EOS in production EOS in distribution EOS in financing EOS in R + D EOS in innovation learning effects	<i>Restructuring</i> form of restructuring depends on pattern of EOS, strategic response to this by other firms, and pattern of demand
2. <i>Price reduction</i> due to competition a function of: market structure	<i>Technical Change and innovation</i> a function of: level of technology market growth	<i>Strategic interplay</i> leading to restructuring. Strategies adopted and consequent changes depend on specific structural characteristics, e.g., mass-production environments, differentiated product environment, fragmented environment.	

But this may, in turn, stimulate further indirect effects which considerably alter the competitive environment for Irish firms. Firms which find themselves threatened by the low cost of the dominant producers will presumably search for counterstrategies, such as product differentiation, product innovation, process innovation and mergers or take overs. Thus a further and more important indirect effect of market completion may be the production of a wider variety of goods and services (Kay, 1989; Geroski, 1989). However, besides posing new challenges, most of these strategies still imply “a slow but steady reorganisation of industry towards large scale production with weeding out of fringe producers” (Pelkmans, 1984, p.79).

How important will this indirect effect be and how will it influence firms in Ireland?

A major restructuring of industry with further growth in firm size depends first and foremost on the extent of economies of scale and the degree to which firms in the EC are currently below the minimum efficient scale. It also depends on the relative strength of demand for mass-produced or differentiated products (Geroski, 1989). In assessing the extent of economies of scale in any given industry it is important to distinguish between:

- economies of scale in production
- economies of scale in distribution
- economies of scale in financing
- economies of scale in R + D
- economies of scale in innovation
- cost reductions due to experience and learning.

It is fairly widely agreed that economies of scale in these activities differ considerably (Pratten, 1987). For example, in many industries there are large economies of scale in production (Bailey and Friedlaender, 1982). Recent developments seem to reveal considerable scale economies in distribution, but little or none in the innovation process (Emerson *et al* 1988, Geroski, 1988). It follows that the overall importance of economies of scale and, consequently, the extent of restructuring, will depend in large part on which activity is important in a given industry at a given time.

The size of economies of scale will determine what kinds of firms will reap the greatest medium- to long-term benefit from completion of the European market, and also what kinds of firms will emerge in Europe after completion of the market. If economies of scale, of whatever sort, are very substantial, then larger firms will have an initial advantage and very large firms will ultimately emerge. If economies of scale are not so significant then small to medium size enterprises (SMEs) will benefit, and competition will take some other form than scale-based cost reduction.

The questions which arise in analysing this first path of direct and indirect effects are presented schematically in Figure 8.2. Some of the considerations necessary to answer them have been set out in Table 8.1. For example, the first question must be: will costs in the industry be reduced? (see Figure 8.2). Table 8.1 shows that the extent of cost reduction is a function of the proportion of output traded and the importance of non-tariff barriers in the industry. If costs do fall, a second preliminary question arises: is this likely to be reflected in price reductions? This depends on the degree of competition in the industry. A further question is: will reductions in price induce increased output? In Table 8.1 it is noted that this depends on the structure of the industry and the extent of product differentiation. For example, where there is a high degree of product differentiation changes in price tend to induce relatively small changes in demand.

Whether the product is mass-produced or differentiated the completion of the internal market should increase the *size* of the market — though the extent of increase will depend on this and other factors. It is this increase in the size of market which is the basis of this first indirect effect of market completion. The significance of the subsequent indirect effect depends on the answer to the central question: are there economies of scale (EOS) in the industry? In Figure 8.2 we explore some of the implications of a positive answer to this question. The implications depend on whether the economies of scale are in production, distribution, financing, research and development, innovation or arise from some learning process* These implications are mainly illustrative — specific situations will be amenable to much more detailed analysis by experts in different industries.

In studying Figure 8.2 one important point should be noted. In a simple diagram of this sort it is only possible to answer the question — are there economies of scale in the industry? — with a ‘yes’ or a ‘no’. This will be adequate in identifying whether the *key* competitive advantage is scale or one of the other properties listed: access to natural resources, labour intensity, product differentiation, or the application of scientific knowledge. Clearly there are many industries where product differentiation or scientific application, rather than scale, is the *key* competitive advantage, but where *some* economies of scale still exist. If some of these economies of scale remain unexploited in the European market then we can expect an increase in firm size as a result of larger firms eliminating smaller ones. Therefore, the question of scale economies should not be considered as relevant only to industries where scale or mass production is the *main* source of competitive advantage.

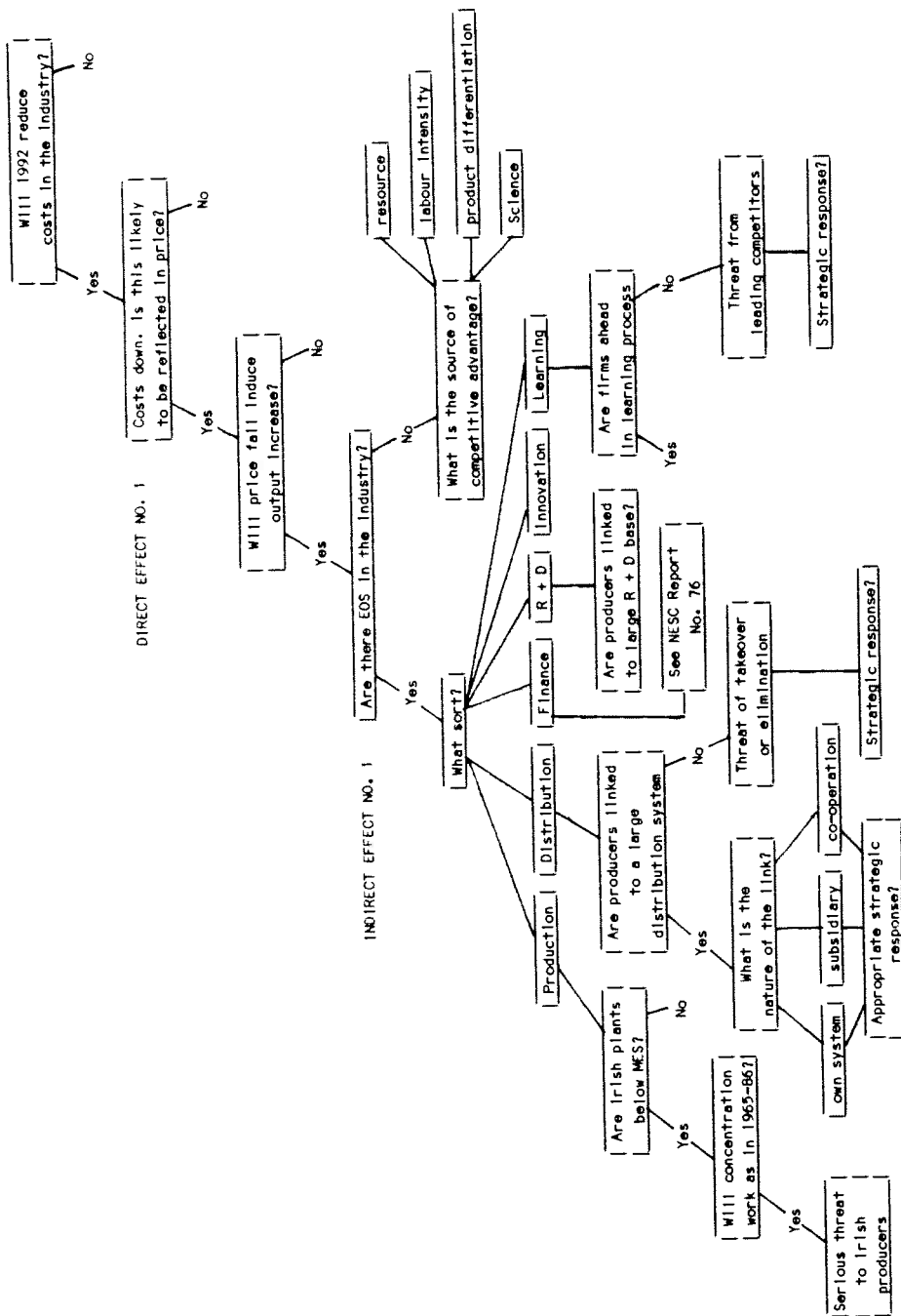
Second Indirect Effect: Competition

The direct effect which increased *competition* has on price-cost margins may be expected to stimulate two indirect effects of possible significance. The first

*In Figure 8.2 MES is an abbreviation of minimum efficient scale.

Figure 8.2

Analysing One Channel of Influence of Internal Market Completion



is an increase in the internal economic efficiency of firms; the second is a spur to innovation.

Removal of Inefficiencies

Where some degree of monopoly power exists, then total costs of production may not be minimised or, put another way, more inputs are being used than is really necessary to achieve the given output. This waste or poor performance is known in economics as 'x-inefficiency'. Sharper competition can bring about the removal of these 'x-inefficiencies'. It should be noted that these inefficiencies arise not only from slack in production processes but also from the use of inefficient decision-making practices. Consequently, their removal can involve substantial rationalisation of an enterprise* It is likely that where a firm has some monopoly power, this will be used partly to generate monopoly profits from a higher than average mark-up and partly to make life easier for various people in the firm, i.e., x-inefficiencies. Consequently, increased competition as a result of removing non-tariff barriers to trade should induce both a reduction in mark-up and increased internal efficiency.

Increased Innovation

Increased competition, resulting from a reduced ability to segment markets and easier market entry by EC rivals, is likely to have another important indirect effect. Firms faced with more aggressive competition will seek not only to *match* the competition by cost reductions but also to *evade* it by repositioning themselves (Geroski, 1989). They can do this by *differentiating* their product from that of their rivals. Product differentiation usually requires innovation of some sort and so completion of the internal market will induce firms to innovate. A view emerging from some recent work on industrial economics is that increased competition will have a positive impact on technical progress and the diffusion of innovation. This is at variance with a traditional idea that monopoly, despite its attendant costs, was more conducive to R + D and innovation. The new view denies that large firm *size* is conducive to innovation and argues instead that rapid market *growth* strongly stimulates innovation in industry (Geroski, 1988). This view leads to the expectation that completion of the market, by increasing competition, will have a major dynamic impact on those sectors in which current NTBs are high, technological development is significant, and the outlook for market growth is good. Clearly this dynamic process would initially be much stronger in some sectors than in others.

*As we noted in Chapter 3 there is no reliable way for anyone outside an industry to measure this kind of inefficiency. The existence of substantial price variation between national markets in the Community may provide some clue, so long as these price variations reflect differences in costs due to differences in efficiency. The price differences may reflect differences in mark-up over costs rather than differences in costs. Evidence on the extent of price variation between national EC markets and industrial structures in various industries can be found in Parts D.7 — D.9 of *The Economics of 1992*, Emerson *et al*, 1988.

This effect of increased competition on innovation is given considerable emphasis in the 'Cecchini Report' on the effects of completion of the internal market. The reason for this emphasis is readily grasped once it is recalled that a major motivation for completing the internal market is the failure of Europe's high-technology industries to match the performance of the Japanese and the Americans. If increased competition causes more innovation then it would seem to be exactly what is required to address the key problem of the European economy (Geroski and Jacquemin, 1985). Furthermore, if increased competition stimulates Europe's high-technology industries there is likely to be a further possible *indirect effect* of market completion. A revitalisation of Europe's high-tech sectors, and an increase in their rate of technical change and innovation, may ultimately affect other sectors. When high-tech products are capital goods, or intermediate goods or services for use in other sectors, then sectoral interdependence will cause the effects of changing technology to spread across product markets. In medium or low-tech sectors dramatic changes in products and processes would occur. Of course, independent of market completion in Europe, a tremendous wave of technical change is occurring and this is clearly affecting not only those high technology sectors which generate innovation and produce high-technology products, but also many industries producing traditional products.

Conclusions on Direct and Indirect Effects

In using this framework for analysis there are three propositions which are of considerable significance. First, the indirect effects of market completion are likely to be more substantial than the direct effects. Second, and most significantly, the relative size and nature of the direct and indirect effects will differ between sectors of the economy. Indeed, Kay goes as far as to say that "there are almost no useful generalisations about the probable effects of the attack on non-tariff barriers contained in the 1992 programme. Industry-specific analysis is required" (Kay, 1989).

Furthermore, the indirect effects — restructuring, technical change and innovation — are likely to interact in complicated ways. In particular, even where the direct effects on a particular industry (cost reduction and/or price reduction) are small (because NTBs are low and the market is already competitive) significant indirect effects are possible if the competitive environment, or firms' perception of it, is changed in such a way as to stimulate strategic responses by firms.

This brings us to a third proposition. Even where analysis, using a framework such as that outlined above, indicates that the 1992 programme should have few effects on a given industry, account must be taken of the *perception* of firms and, more generally, of the very significant *psychological* effect of the internal market programme (Kay, 1989).

4. FIRM SIZE IN THE INTERNAL MARKET

(i) **Conflicting Views on Economies of Scale**

In proposing a framework for analysis of the effects of market completion on the Irish economy we have outlined the two channels of causation — size and competition — as discussed in the 'Cecchini Report'. While exploitation of economies of scale and increased competition are not necessarily inconsistent — so long as the market can sustain enough firms — there are, in fact, considerable differences in thinking between those who stress *economies of scale* and those who emphasise *competition* and *innovation*. This is reflected in the 'Cecchini Report', which was assembled from the research of many different economists. In the report there is a clear tension between the view that further concentration of industry is likely (because significant economies of scale remain to be exploited) and the view that the larger market will increase the *variety* of products available, and hence that small and medium sized enterprises will benefit most (because they currently suffer most from non-tariff barriers and, most importantly, because they have the characteristics, in particular, the ability to innovate, which are most important for success in a unified internal market).

The significance of this issue for Ireland arises from the fact that — as revealed in our analysis of the changes in the manufacturing sector since accession — very few large-scale internationally-traded activities undertaken by indigenous firms have survived Ireland's integration into the European economy. If a significant part of the increased competition created by completion of the market was to take the form of cost reduction based on scale expansion then the fear naturally arises that Irish firms would find it very difficult to compete. Furthermore, if completion implies increased firm size, then *barriers to entry* of various sorts may increase — even though market completion also means increased competition *between these dominant firms* in a given industry (Venables, 1985). If, on the other hand, those who stress competition and innovation are correct then the increased competition resulting from market completion will be based only to a small extent on exploitation of scale economies and will take a number of other forms, such as technological activity aimed at product and process development, product differentiation, market segmentation, and redefinition of firms' specialisation (Ergas, 1984; Geroski and Jacquemin, 1985). It might be concluded that in this case the prospect for Irish firms are somewhat better.

The argument between these two views turns on a number of theoretical and empirical points and, given the significance of the issue, it may be worthwhile to consider these in a little detail.

(ii) **Predictions of the New Trade Theory: Increased Firm Size**

We may note first what is known theoretically. We have seen in Chapter 2 that the theory of trade with imperfect competition and increasing returns to scale

provides fairly clear cut predictions about the effect of multilateral reductions in barriers to trade. It predicts that such reductions will lead to increased competition in each market, reducing firms' price-cost margins, and lowering price in each country. The total number of firms producing in each country is likely to be reduced by the trade liberalisation, but remaining firms will operate at increased scale and, with increasing returns to scale, at lower average cost (Venables, 1985).

The argument that stresses the beneficial effect of competition on innovation is quite different from this, but what is of interest is the grounds on which the above theory is rejected. For, as Venables has pointed out, acceptance of the theory, as outlined above, would lead to the following conclusion. The integration of the European market is essentially a once-off change. The change involves firms entering or expanding their sales to foreign markets and leads to increased competition. But it is unlikely that following this change the entry of new firms to the industry will be easier than prior to the change. The removal of barriers to trade will increase firm size and lead to fuller exploitation of economies of scale. To the extent that barriers to entry are associated with economies of scale or with absolute financing requirements, entry barriers may be *greater* in an integrated European market than in segmented national markets. It therefore seems possible that while further market integration may initially increase competition, it might not reduce entry barriers.

It would seem that those who stress the impact of market completion on innovation, and play down the role of scale, do not reject this theoretical approach but simply differ on two important *empirical* issues*:

- They doubt that economies of scale are, or have been, very significant.**
- They believe that small firms in competitive markets create significantly more innovation than large firms and/or firms with monopoly power.***

These are two issues on which much empirical research has been done. The first of them is the more important to shaping and using a framework for analysis in the Irish situation and, while a comprehensive discussion is impossible, a number of observations can be made.

*For example, subsequent to the publication of the 'Cecchini Report' Geroski has criticised its emphasis on economies of scale, but he agrees that "If increasing market size opens up the possibility of exploiting scale economies through a large scale rationalisation of production, this can *only occur at the cost of reducing competition*" (Geroski, 1989, emphasis added).

**See Geroski and Jacquemin 1984 and 1985; Kay, 1989; Geroski, 1989.

***See Geroski, 1988.

(iii) How Large are Economies of Scale?

When assessing the significance of economies of scale two aspects are relevant. First, the size of scale economies in the *past* development of the European, American and Japanese economies and, second, the likely future trends in economies of scale. Bearing in mind that many possible types of scale economies exist it is not surprising that strong and general conclusions are hard to find. Much the easiest type to measure are technical economies — the impact of plant size on cost of production. Most research on this and other dimensions reveals significant production economies of scale in manufacturing and economies of various kinds (for example, economies of firm size, economies of distribution) in manufacturing and services.* The 'general scepticism about scale economies' of those who stress innovation would seem to be largely based on a different reading of the evidence: they consider that much of the growth in the size of firms in the 1960s and 1970s reflected not scale economies but the pursuit of a strategy of merger and conglomeration by firms and governments — a strategy which, incidentally, they consider to have been unwise (Geroski and Jacquemin, 1985; Kay, 1989; Geroski, 1989). Others are unconvinced by this and therefore consider that the dismissal of size might be premature (Krugman, 1985). In our view also the burden of proof lies with those who reject the significance of scale economies in the growth of western economies and firms, and we remain to be convinced of this view.

(iv) Effect of Technical and Organisational Change on Scale Economies

The second aspect of the size of scale economies is the likely future trend. There is no doubt that technological change alters scale economies. However, technological change and the way it influences firms' strategies is a highly complex phenomenon which is only beginning to be understood.

To some, the trends in technology and the resurgence of small firms are seen as confirmation of the role of innovation, rather than scale, in the completion of the internal market. They argue that the "root cause of the current industrial crisis in Europe is not the small scale of European firms but rather that they have been too slow in initiating and responding to change" (Geroski and Jacquemin, 1985). This view reflects a general scepticism about scale economies and is based on the idea that the current challenge facing European industry requires a different response from that of the 1960s (Geroski and Jacquemin, 1984). In particular, the corporate strategies which will be successful are unlikely to be those of wide diversification and merger activity. Instead, product differentiation and diversification closely related to the firms' existing expertise and strengths are indicated.

Recent studies of corporate strategies tend to the view that the changes in the economic environment are such as to encourage firms to undertake less

*See Pratten, 1988; the Cecchini Report, 1988; Baily and Friedlaender, 1982; and, in an explicit international trade context, Chichilnisky and Heal, 1986.

functions 'in-house'. These trends, which are greatly strengthened by technical changes, are such as to offer *smaller optimal sizes*. Changes in the technical and business environment seem to increase the risks involved in vertical integration and capacity expansion and, as a result, new corporate strategies place less emphasis on firm size (Ergas, 1984; Martin, 1989).

There can be no doubt that earlier literature may have concentrated too much on the technical advantages of large scale, without examining just how scale fitted into firms' *strategies*. Recent work, much of it undertaken by those who stress innovation, certainly takes a more sophisticated view of the competitive position of firms making decisions about scale, products and processes. However, there are reasons why scale economies should not be dismissed. This view is adopted partly because of our reading of the analytical and empirical issues involved and partly because of the particular situation of Irish firms in the integrated European market.

The emerging pattern of firms in manufacturing and services will be determined by a very complicated interaction of technical, organisational and spatial forces. Though the impact of technical change has been to reduce the efficient size of plant in many sectors — as stressed in the argument outlined above — it would be a mistake to infer that economies of scale have disappeared or ceased to play any role in competition. While technical developments may have reduced the minimum efficient scale of plants in many industries — where size of plant is measured by the number of *employees* — they may not have reduced the economies of scale for large *product volumes* (Pratten, 1988). More generally, technical change seems capable of generating opposite effects. There is evidence that the current wave of technical change is *undermining* scale economies in *mass-production*, but *injecting* scale economies at the *batch* production end of the size spectrum.* In rejecting the emphasis on scale economies, in many discussions of the internal market programme, Geroski emphasises the possibility that increased market size will induce the production of a *wider variety* of products, rather than prompt increased scale in the production of mass-produced homogeneous products (Geroski, 1989). But this would seem to implicitly link size of plant and size of firm to size of the market for one product.** But Perez points out that the new flexible technologies, in the erstwhile less productive 'craft' industries, "allow enormous increases in scale, where size of plant is not necessarily equivalent to size of market for one product but for a large, changing family of products" (Perez, 1983). Indeed, one of the most remarkable features of the

new technology is that it allows product differentiation and the low costs of large automated production *to be combined*. While this certainly allows small firms produce at low cost it also reduces the cost of small batch production in large plants and large firms.

The presence of conflicting effects of technical change can also be seen when a distinction is made between firm-, plant-, and product-economies of scale. Economies of scale in production may be diminishing in the mass-production industries, but firm-economies show signs of being enhanced, given the higher indirect costs of production associated with the development and utilisation of software-intensive industry (Kaplinsky, 1984). Likewise, while technical changes seem to be reducing the minimum efficient scale of some plants — thus giving smaller specialised companies a greater chance of survival — in some industries there is evidence that the costs of *developing new products* is of increasing significance — thus conferring greater advantages on larger firms (Stopford and Turner, 1986). In addition, economies of scale in *distribution* are rising not falling. As Stopford and Turner say the "conclusions from these conflicting dynamics are far from clear". But, it seems certain that the effects of technical change on scale economies, and hence the future trend on scale economies, is sufficiently complex to warrant considerable further investigation before scale economies and innovation are contrasted as opposite forces (see Dosi, 1988).

Having considered all the above arguments we are inclined to conclude that economies of scale remain relevant and will play a significant part in the competitive response to completion of the internal market.

(v) The Role of Small Firms

This general conclusion is reinforced by a number of specific ones. Regardless of the relative merits of the conflicting arguments about the significance of increased scale and innovation in the wake of market completion, there remain reasons why scale may be a concern to Irish firms and policy makers. Study of the nature of the resurgence of small firms internationally shows that these are frequently in the service sector, and exist both in close proximity to leading large firms in manufacturing, and in close proximity to one another. The close proximity of a large number of small firms in high technology fields creates agglomeration economies. Given these trends the absence of large firms in many branches of the Irish economy, especially manufacturing, would still seem to be a problem. Paradoxically, the absence of *large* firms may make it difficult to achieve the very proliferation of small firms highlighted by those who are sceptical of the role of scale economies.

Secondly, even if those who emphasise the second indirect effect of market completion (increased competition and innovation), and play down the first indirect effect (exploitation of economies of scale), are correct in general, it

*Kaplinsky, 1984. He notes that "In both cases, there are substantial implications for the location of industry and hence for the viability of production in peripheral production sites". The implications of technical change for the *location*, as opposed to the *scale*, of industry are discussed in Chapter 11.

**For example, Geroski says "the benefits of scale economies can only be realized by product standardisation, and this, in turn, means a reduction in the variety of goods offered for sale and in their degree of customization" (1989).

does not follow that disadvantages of small scale will not arise for Irish firms. This is because many firms in Ireland are small by European standards and, therefore, may experience pressure from larger rivals — even if those rivals are not increasing their scale significantly.

All of these judgements concerning the relevance of economies of scale are reflected in Figure 8.3, which analyses the possible effects of market completion by posing and answering a number of questions. (1) Will the effects of market completion be confined to high-technology sectors? Our answer is that the effects will spread across manufacturing and services, but that the precise effects will depend on industry-specific characteristics. (2) What kinds of firms will emerge after market completion? If there were *very* large economies of scale in many sectors then this would encourage the formation of giant corporations. While this has occurred, and will occur, in some sectors, we do not see it as a general phenomenon. Consequently, we answer the question by saying: small and medium sized enterprises (SMEs). However, the implication of all we have said above is that these SMEs may have the chance to exploit *some* economies of scale and, consequently, a second question about scale economies has to be asked: (3) Will such firms experience concentration? In the remainder of the table we explore the implications of the two possible answers to this question. The final question concerns the *spatial* forces at work and is discussed in detail in Chapter 11.

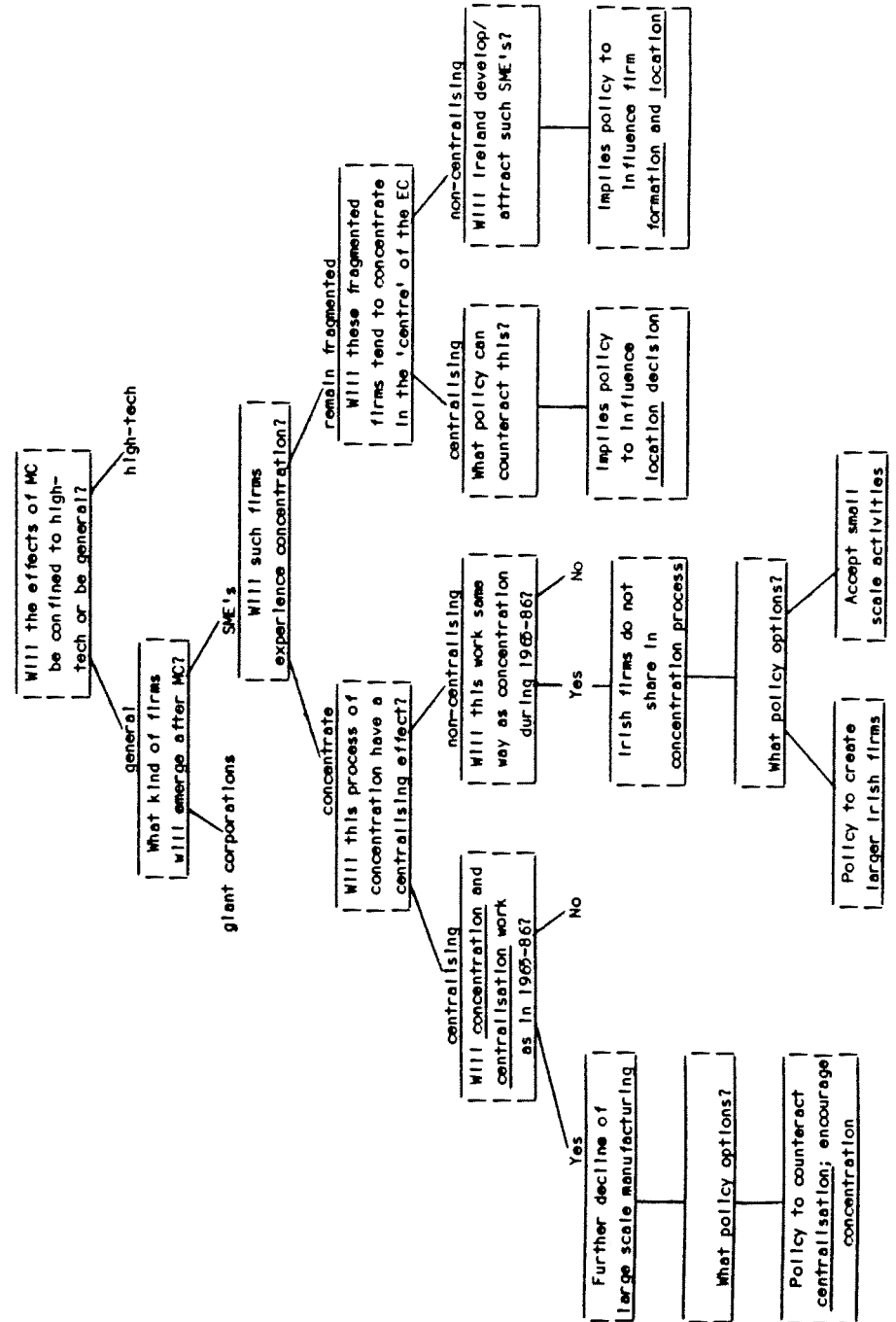
(vi) Implications of the Indirect Effects of '1992' for Ireland

Finally, consideration of the competitive strategies open to small firms suggests that we re-evaluate the *implications* of this dispute concerning which indirect effect of integration will be more significant. We prefaced our evaluation of the two positions by saying that if completion of the market led to an increase in firm size, because of economies of scale, then, on the evidence of the past, Irish firms may experience difficulties. We said also that if, instead, increased competition stimulated innovation, especially by small and medium sized firms, then it might be concluded that the prospects for Irish firms are better. However, this latter conclusion may need to be revised.

If there are any significant advantages of scale then in their attempt to survive small firms are constrained to adopt very particular strategies.* For example, small or medium sized firms can prosper so long as they can acquire some competitive advantage over their bigger rivals. One frequently cited advantage is the ability to respond more rapidly to change. Indeed, the innovativeness of small and medium sized firms, highlighted by those who stress the second channel of causation, is a perfect example of this. But a strategy of being more innovative than larger competitors is a highly *demanding* one; it requires considerable management ability, technical skills and, probably, technology.

*These strategies are discussed in a little more detail in Chapter 14.

Figure 8.3
Analysing the Possible Effects of Market Completion (MC) on the Irish Economy



Consequently, an internal market with increased competition stimulating innovation by small and medium sized firms, may be *different* from increased competition based on scale economies, but may be only marginally less difficult for Irish firms.

THE MANUFACTURING SECTOR

1. INTRODUCTION

In this chapter the framework for analysis developed in Chapter 8 is applied to selected sectors of manufacturing industry in Ireland. Manufacturing industry in Ireland has already experienced the removal of tariff protection and tariff-free access to the markets of the EC. The completion of the internal market by 1992 is intended to remove many of the non-tariff barriers to trade, and to the movement of capital and labour, which remain in the Community. This chapter, when combined with the framework set out in Chapter 8, suggests one way in which the likely impact of the removal of non-tariff barriers (NTBs) might be analysed. Such analysis is vital if successful public, corporate and individual responses to the threats and opportunities are to be devised.

We begin this analysis with a general assessment of the implications for three broad categories of manufacturing industry. The three categories used are those which emerged from our study, in Part II of the report, of the performance of manufacturing industry since reduction of tariff protection in the mid-sixties. In subsequent sections we consider the likely implications of 1992 for a number of individual sectors. We stress that this report is not fundamentally a *sectoral* study of 1992 and, consequently, the analysis of individual industries in this chapter must not be seen as comprehensive industry-specific studies. Such analysis was not the task given to the Council in this instance and, furthermore, such analysis requires, among other things, the deep industry-specific knowledge of those involved in each sector of manufacturing.

There are three general points which recur in our examination of various categories of manufacturing and it may be helpful if they are stated at the outset. First, manufacturing industry, both in Europe and worldwide, is undergoing some remarkable and profound changes which have little if anything to do with completion of the internal market. These arise not only from technical change but also from organisational rearrangements and global macroeconomic and trade imbalances. In some industries these changes will be more significant than the completion of the EC internal market. In all cases they provide the context in which market completion is occurring.

Second, the terms 'completion of *the* internal market' and 'single European market' are unavoidable but may create the misleading impression that after 1992 there will be a single or unified European market of 320 million people

for almost all manufactured goods. But the fragmentation of the European market is only partly a result of the trade barriers which are to be removed in the 1992 programme. Much of the fragmentation of the market arises from the diversity of cultures, traditions and consumption patterns in Europe and, consequently, will remain after 1992 (Kay, 1989). Conversely there is already a unified European market for some commodities, such as aircraft and oil. The extent to which the 'completion of the internal', in the sense of the current internal market *programme*, will create a unified European market in each product, or improve access and entry to a series of fragmented markets, is one of the most important questions for expert industry-specific analysis.

Third, economic analysis cannot predict the precise effects of market completion on each industry. In attempting to identify the effect of completion on specific parts of the Irish economy we are in effect in the same position as a government attempting to inform its industrial policy with an analysis of its country's comparative advantage. Even if we were content to apply the traditional factor proportions theory of trade, or a modified version of it taking account of human capital, etc., we are faced with the problem identified by Pelkmans: "variants of this theory always explain comparative advantage at a high level of aggregation; not at the level relevant for deciding industrial production and marketing" (Pelkmans, 1984). If the *new* approach to understanding trade, with its emphasis on intra-industry trade, is considered relevant, then this problem is even more acute. As Ergas says "it has to be conceded that intra-industry trade is a more complex phenomenon which does not lend itself as readily as the inter-industry trade model to predictions of shifts in competitiveness and comparative advantage" (Ergas, 1984).

(i) General Assessment: Three Categories of Manufacturing Industry

Industries can be classified in many different ways depending on the purpose for which the classification is required. Here we use a classification which emerged from our study of the experience of manufacturing industry since the mid-sixties, and which is similar to that previously used by O'Malley (1987) and Blackwell and O'Malley (1984). In our analysis of the performance of industry and in Part II we identified three groups of industries and sub-sectors:

1. Foreign owned, grant-aided, export oriented
2. Naturally protected (i) large scale
(ii) fragmented
3. Internationally traded, relatively large scale.

Each of these groups exhibited a very different response to removal of tariff protection. Very briefly, the first group increased both output and employment rapidly during the 1970s and continued output growth in the 1980s. The second group could increase output and maintain, or slightly increase, employment so long as domestic demand was buoyant, but experienced difficulties in the

1980s. The third group consists of those industries which showed almost continuous decline once they were exposed to international competition.*

1. Foreign-Owned, Grant-Aided, Export-Oriented

The first of the direct effects of market completion — the reduction in costs following removal of NTBs — is likely to be favourable to foreign-owned firms in Ireland. This is because they are not protected, but are hampered by customs barriers, technical standards, and government procurement, and are disadvantaged by the high cost of transport, insurance and financial services. Therefore, exports from such firms should increase. If the profitability of a multinational firm exporting from Ireland increases then, other things being equal, this should increase the attractiveness of Ireland to new foreign direct investors. The only *direct* measures which may benefit the European competitors of these firms is the development of EC assistance towards R + D. This is likely to aid R + D activities of European firms relative to their US and Japanese competitors located in Ireland (Padoa-Schioppa, 1987).

However, the second of the direct effects — price reduction following increased competition — is likely to be significant for a number of these firms, since several of them are in highly concentrated industries.

These *direct* effects of the measures adopted between now and 1992 are likely to be less significant than the *indirect* effects. By the *indirect* effects we mean the restructuring that arises as firms adopt survival strategies; here the effects of market completion become linked to the effects of technological change, and the competitors to be considered are not only European firms but American and Asian also. The grant-aided, mostly foreign-owned, sector in Ireland contains at least two types of firms: those that qualify as *mass-production* or *scale-intensive* firms, and those which are specialised or differentiated. The restructuring that occurs in each of these types of industry are likely to be somewhat different.

In mass-production or scale-intensive industries (such as office machinery, telecommunications machinery, basic chemicals) it is likely that concentration and co-operation at the EC level will be necessary for competitiveness. It is likely that mergers and take-overs will occur in order to allow the exploitation of economies of scale. Mergers and take-overs between European firms have already occurred. By contrast, to date, *co-operation agreements* have been mainly with non-EC firms (Jacquemin and Buiges, 1988). It is, of course, very

*In a recent discussion of the effects at the European level of completion of the market, Jacquemin and Buiges (1988) adopted the following classification: mass-production; specialised/differentiated; fragmented; impasse. The OECD, in a recent analysis of international adjustment and trade, proposed that the distinction between high-tech, medium-tech and low-tech industries be replaced by the following categories: resource-intensive; labour-intensive; scale-intensive; differentiated goods; science-based. We make some use of each of these classifications in the analysis which follows.

difficult to say how Ireland will be affected. Four categories of firm or project are relevant; existing and potential foreign investors, and EC and non-EC. We would like to be able to put a sign representing

	EC	non-EC
existing		
potential		

increased or decreased investment and employment in each of the boxes above. Two broad scenarios can be envisaged. In the optimistic one the Irish plants of EC and non-EC firms would play a significant part in their strategy and, most importantly, Ireland would play a part as a location for non-EC firms in their strategic response to completion of the market and the benefits it brings to their EC rivals. In the pessimistic scenario the restructuring which occurs would involve attempts to exploit agglomeration economies, or other sources of advantage, such that Irish plants would be discarded, and the strategic response of non-EC firms would involve location of production units linked with their R + D centres. It can be seen that changes in production processes, more than changes in products, are a crucial determinant of which of these scenarios, if any, occurs.

In specialised or differentiated product industries the structure is different and the strategic responses are likely to be also. These industries contain large firms and small firms occupying niches. The emerging industries such as micro-processors, lasers, and medical and surgical equipment fall into this category. Technical change is an important determinant of competitiveness. Firms will mostly continue to occupy niches as the internal market is completed, but the available niches will become bigger. It is hard to see that current producers in Ireland in this category are protected by non-tariff barriers, but some of their competitors in Europe probably are. Consequently, these competitors will experience increased competition. But their *response* to this may include a more aggressive attack on other firms' existing market share. Against this, the response may be further product *differentiation*. Although scale economies in *production* are less important in these industries, *other* economies of scale and scope can be significant and, if so, they will be brought into play in strategic manoeuvring. Overall, the restructuring of these specialised or differentiated industries in response to market completion would seem to pose less of a threat, but technology, in its various forms, seems crucial to survival.

2. Naturally Protected (i) Large Scale

We noted in our earlier work that the source of natural protection differs in food, drink and tobacco, paper and printing, wood and furniture, and non-metallic minerals (see Chapters 4 and 7). Consequently, the direct impact of the measures to be adopted will differ. Also the *degree* of purely *natural* protection differs and, more importantly, is almost certainly changing. For example, in the food industry access to material inputs as a source of competitive advantage would seem to be declining in significance, and application of scientific advances to products and processes increasing as a source of advantage. Presumably, similar changes are occurring in the other industries.

We may analyse such industries using the framework outlined in Chapter 8. What will the *direct* effect of market completion be? The first direct effect will be a *reduction in costs* arising from reductions in transport costs, access to cheaper inputs, removal of customs barriers, a more competitive insurance industry, etc. Producers in Ireland and in other countries should both experience a reduction in costs — with costs to the Irish producers perhaps falling somewhat more. The second direct effect of market completion is *increased competition*. By curtailing the market power of dominant Irish producers this will certainly exert downward pressure on the prices they can charge. If equivalent firms in other countries also currently benefit from a degree of natural protection (as they probably do in industries like food, drink, tobacco, paper, etc.) then they too will experience increased competition. We would expect some mutual inter-penetration of markets. Without considering the *indirect* effects of market completion (exploitation of scale economies and innovation) it is impossible to predict which firm would achieve the greater penetration of the other's market.

If exportable products are developed, then further import penetration would not necessarily be a cause for concern; it would simply be a by-product of intra-industry specialisation and trade. However, the development of exportable products, and the retention of the home market in the face of competition, will probably imply different strategies in different industries and, indeed, in different sub-sectors of each industry. For example, in some lines, exports may require a degree of product differentiation and consequently, branded products can be exported. In others, the strategic market structure and/or the technology may dictate that such product differentiation would be very difficult (costly) to achieve and other sources of competitive advantage, like scale economies in processing, must be exploited in capturing exports for non-branded products.

2. Naturally Protected (ii) Fragmented

One of the main trends in indigenous manufacturing since accession has been the increasing size of these sectors (metal articles, mechanical engineering, carpentry workshops) as a proportion of total manufacturing employment. At the same time other fragmented industries, such as soft drinks, were

restructured after accession to the EC and have become much more concentrated. This serves to show that these industries are not immutably fragmented.

In general, it is thought that non-tariff barriers are not very significant in these industries. Consequently, it is thought that 1992 will have little if any impact on the markets which they supply. However, it must be the case that there are products which are at the margin of being worthwhile to trade. And since 1992 will generally undermine market segmentation and encourage market entry a reduction in customs and transport costs will tip the balance and may cause import competition. A more significant threat (and opportunity) arises from changes in process and product technology and consumer tastes. For example, DIY products replace the work of firms in fragmented industries. The difference is that the new products are highly tradable. The key feature of fragmented industries is the tailoring of the product to particular local or regional requirements. Where changes in materials or design can *retain this flexibility but centralise production*, then all sorts of economies can be exploited. In addition, standardisation of consumer tastes or producers' equipment may undermine the competitive advantage of small local firms in these industries. It would seem that, by and large, the innovations required in this area do not require substantial R+D outlays, but depend more on imaginative use of new materials developed elsewhere. Firms identifying opportunities in these areas are unlikely to be exporting initially and, consequently, exports as a criterion for assistance from state agencies would be inappropriate.

A major determinant of employment and output in fragmented industries is the *level of domestic demand*. In the long-run these industries would gain significantly from implementation of the EC's co-operative growth strategy for more employment, which would permit a faster rate of growth of domestic demand.

3. *Internationally-Traded, Relatively Large-Scale*

The industries which have been in long-run decline, such as clothing, footwear, textiles, transport equipment, indigenous electrical engineering and chemicals, and some parts of food, are characterised mainly by having had little protection once tariff barriers were removed. It follows, of course, that they are in no way protected by the non-tariff barriers which are to be removed by 1992. Some of their competitors in many EC states do receive protection from these NTBs — particularly state aids to industry and voluntary export restraints. To that extent the Irish industries will receive some boost from completion of the market.

It is of interest that in presenting an illustration of gains from market completion the 'Cecchini Report' cites these as industries in which the ultimate fall in production costs would be relatively small, but the proportion of this fall

which is a *direct* effect of removal of NTBs would be large — reflecting the fact that not many economies of scale remain unexploited and price competition is already fierce.

But the significant developments in these industries would seem to lie elsewhere. The output of the Danish textile, clothing and footwear industries, and of British clothing, have *increased* in the 1980s. These industries are the heart of the intra-industry trade argument. Their initial survival in each of the EC-6, and their ultimate survival in the EC at all, is the biggest single argument against the traditional factor proportions theory of trade. This survival, where it has happened, would seem to be based on European firms, and states, *transforming these industries from labour-intensive ones to some other sort*. The competitive advantage of these industries would seem to depend on various combinations of product differentiation (design and quality), production technology, and information and marketing systems.

This group of industries is one where it is important to note that the population of firms in Ireland now is very different from the population that existed as tariff barriers were reduced after 1965. It could be said of that earlier population that, because they had grown up under tariff protection and served a small market, they were in all probability, less efficient and less cost effective *in an absolute sense* than their potential competitors in other countries. It does not seem possible to say the same thing now. To this extent we would not expect the next round of integration to have the same effects as the first round did.

At the same time, while a large proportion of the output of these industries is exported, output continues its long-run downward path. This contrasts with similar industries in some other member states. This would suggest that the Irish firms, or at least a significant proportion of them, do lag behind in those activities which are the key to real competitive strength. If this is so, then at best, they will be confined to the least dynamic and profitable segments and, at worst, new competitive threats await them.

2. THE FOOD PROCESSING INDUSTRY

(i) Introduction

In Part II of the report we saw that a food processing as a whole has consistently accounted for a very substantial percentage of manufacturing employment in Ireland. This high and fairly stable share masks two kinds of change. The roughly static total employment level was the result of significant job losses matched by job gains. In addition, there was very considerable change in the pattern of output and employment between sub-sectors. Finally, in the period since accession, taken as a whole, output of the food industry has not grown rapidly (see Chapter 4).

As noted above our study of manufacturing revealed three distinct patterns of response to EC entry. The food industry, which contains very different sub-sectors, falls into two of those categories.

Some sub-sectors of the industry belong in our third category — internationally-traded goods in which there are some advantages to relatively large-scale production. In these sectors (e.g., fruit and vegetable processing) Irish producers were in decline in the face of international competition. Other parts of food were characterised by small scale and heavy reliance on the domestic market. These sub-sectors increased employment during the transition period but fared very poorly during the 1980s.

Changes in the size-structure of both the indigenous and foreign segments of the industry over the period 1973-87 created a reduction in the proportion of employment in the largest size categories, and increased concentration in the medium sized establishments. Given the mixed pattern of declining and growing sectors, general conclusions on the evolving industrial structure are difficult to draw. However, as stated in Chapter 6, it does seem that the Irish food industry is one that has conformed to the pattern predicted by some new theories of integration, viz. relatively large firms having distinct advantages over smaller ones and pressing these advantages home. In particular, the change in size-structure in food processing in Ireland is much less dramatic than the transformation in the size-structure of other sectors of manufacturing.

(ii) Trends in the Food Processing Industry Internationally

In most OECD countries the food processing industry is the single largest contributor to manufacturing output and employment. The share of the industry in most countries has remained relatively stable over the past 20 years, accounting on average for 10 per cent of output and 8-9 per cent of employment. Ireland is a clear outlier in the importance of the industry to the economy, since it accounts for 37 per cent of production and 22 per cent of employment. In almost all OECD countries the growth of food output has been below that of manufacturing as a whole. Approximately one-third of total agricultural and food trade in the OECD area is in *processed* foods, and this has been increasing. Intra-industry trade is a feature of international trade in food products, with many countries being significant exporters and importers of processed foods.

Many of these features serve to shape the nature of competition in the industry. In most OECD countries the food processing industry is oligopolistic, (i.e., a small number of firms supplying the major share of output). In all countries and sectors of the industry concentration has been increasing over time. Studies show that the degree of concentration varies across countries, being particularly high in the UK, Australia, Canada and Denmark and less so in Italy, France, Germany and Ireland. The increase in concentration has been fuelled

by many mergers and acquisitions. Some of these have involved very large companies, and have altered the structure of the industry radically. In addition to being a concentrated industry at the national level, it also tends towards oligopoly at the international level, with many of the large firms producing a highly diversified range of products.

The dominant motive for most mergers is expansion. The food industry is a mature slow-growth industry (real growth of approximately 1 per cent per annum). This results from low rates of population growth and the low responsiveness of food demand to increases in income. Mergers and acquisitions allow firms to capture larger *shares* of static markets, through acquiring existing companies and particularly their *brands*. While the total market may be slow growing, different segments exhibit divergent growth rates, influenced by such factors as shifts in the structure of population and labour force participation, household size, consumer concern for health and diet and domestic appliance technology. Increased income has led to a trend away from low priced food commodities to products with higher value added, and consequently higher margins.

The growth of concentration in the food *processing* industry has also been motivated by the need to counter greatly increased concentration in the food *retailing* sector. Increased concentration in the retailing sector allows the retailers to place demands on the processors concerning content, packaging and pricing, with a consequent squeeze on processor's margins. The strategic response of many producers to this shift in relative power has been to increase concentration in order to exercise some countervailing power.

Since demand is relatively unresponsive to price changes, competition in this industry, as in other oligopolistic industries, is based largely on *products* rather than prices. The main strategies utilised to increase and defend market shares are product proliferation and product differentiation through brand names. These competitive strategies result in high barriers to entry in the industry. Due to its oligopolistic structure, its highly developed product differentiation and its barriers to entry, the food sector has enjoyed higher than average rates of return in the major OECD countries. Diversified food manufacturers with large market shares are consistently among the most profitable firms.

A final feature of the food industry, as of many others, is the increasing trend for companies to operate across national frontiers (with the exception of European companies — as will be seen presently). Indeed, it can be argued that we are in an era of *global competition*. As national tastes become more standardised, products are emerging which can be sold in many countries with minimal modification, thus paving the way for greater economies of scale and low costs. There is a debate about precisely how far such homogenisation of taste and convergence of demand will go. Some argue that only a small

proportion of the world's products will be globally branded. Whatever the ultimate extent of convergence, successful businesses seem able to identify ranges of product needs which are reasonably standard between countries of similar income levels. Products developed to satisfy these needs may require few variations to make them marketable in each national market.

(iii) Impact of 1992 on the Industry

The food industry is more heavily regulated than most other sectors and is affected by an array of government policies with various objectives. Examples are food subsidies and price controls, regulation of food standards and tariff and non-tariff barriers to trade. Indeed, many OECD countries levy import duties on processed foods and grant export refunds to food producers, in an attempt to protect both farmers and the processing industry from foreign competition. In the 'Cecchini Report', five different barriers to trade in food processing were identified: restrictions on the use of specific ingredients; regulations governing content and its description; packaging and labelling — such as compulsory use of recyclable containers; tax discrimination — such as mix of specific and *ad valorem* taxes; specific import restrictions. Other non-tariff barriers contributing to the protection of domestic markets are restrictions on vegetable fat in chocolate and ice cream, and beer and pasta purity laws (*The Economics of 1992*). The removal of these latter barriers is unlikely to have a significant impact on the Irish food processing industry.

The *direct* economic benefit of removing non-tariff barriers is an immediate *reduction in costs*. In the case of the food industry this benefit will come from three different sources: the use of less expensive ingredients; the reduction in packaging and labelling costs; and the removal of bureaucratic obstacles to imports.

Indirect economic effects will stem from the increase in competition, any consequent restructuring, and the wider choice of products available to consumers. While the 'Cecchini Report' did not quantify the likely effects of restructuring of the food industry, it did argue that the removal of non-tariff barriers should lead to appreciable changes in the strategies of food-processing companies. At present US companies are very dominant in the sector (accounting for 8 of the largest 10 companies). This has been achieved through specialising in products for which they have the largest market share and exploitation of economies of scale through geographical diversification. The EC study contrasts this with the much more limited geographical scale of European companies: of the 46 largest European companies in the food-processing sector, 44 per cent operate in only one Community country other than their country of origin, while only 16 per cent operate in at least four of the largest Community countries. The major European groups are, therefore, very largely oriented towards their *national* markets alone. The completion of the internal market may allow European firms to develop into global players.

Table 9.1
The Food Processing Industry: Employment,
Production and Labour Productivity by Sub-Sector, 1987

	Number Employed (000s)	Employ- ment Share	Pro- duction 1980=100	Employ- ment 1980=100	Labour Produc- tivity 1980=100
Slaughtering	10.0	26%	122.3	87.7	139.4
Dairy Products	7.6	19%	122.3	75.2	162.4
Grain Milling	3.2	8%	104.7	71.1	147.2
Bread and Biscuits	7.0	18%	86.2	74.5	115.8
Sugar, Cocoa, Chocolate and Sugar Confectionery	5.0	13%	107.9	75.8	142.4
Other Foods	6.0	16%	212.9	105.3	202.3

Sources: *Industrial Employment, Earnings and Hours Worked*, and *Census of Industrial Production*, CSO.

(iv) Implications for Food Processing in Ireland

In studying the health of the Irish food processing industry it is noteworthy that in the eighties Ireland's productivity growth has been very favourable relative to other OECD countries. However, much of this increased productivity was due to labour shedding; the volume of output increased quite slowly. While a reduction in employment was experienced in the industry internationally, the proportionate contraction was greater in Ireland.

Table 9.1 gives a profile of the Irish food processing industry in 1987. It shows that consistent with the trends in agriculture and manufacturing since accession, meat processing and dairy products are now the most significant parts of the food industry. Table 9.1 also shows a breakdown of productivity growth by sub-sector. The growth of productivity in the bread and biscuit sub-sector is very significantly below average, while that of 'other foods' is substantially above average. Productivity trends are, of course, only a partial indicator of sector performance. They are useful where the key to competitive success lies in *price competition*, and where labour costs are, in turn, a prime determinant of price competitiveness.

In the food processing sector one of the major sources of competitive advantage is the price and quality of the raw material. Raw materials generally account for two-thirds to three-quarters of total industry costs (Cox and Crossley, 1983). The cost and availability of raw materials is, therefore, of crucial importance to the success of this sector. But this has for many years been one of the major problems facing the Irish industry. In the Council's

report *Strategy for Development* (NESC Report No. 83) the most important requirements for expansion of the industry were identified as:

- (a) the securing of better synchronisation between food industry supplies and market needs;
- (b) redressing the problems of seasonality among primary producers;
- (c) the introduction of long-term supply contracts between primary producers and processors.

However, cheapness and reliability of raw material supplies, though necessary, are not a guarantee of success in the industry. Since *price competition* is not significant, producers are unlikely to be rewarded for cutting prices. Other means of competing in the market exist and must be exploited *in order to capitalise on the raw material advantage*. This involves product proliferation, product differentiation and other non-price market conduct. The costs of product differentiation (through advertising and promotion) constitute a very high barrier to entry to the industry, and to OECD markets, and explain the importance of scale to businesses in this industry. Food sales account for about 14 per cent of disposable income in the US, but the food system (including retailing) accounts for about 28 per cent of all advertising expenditure.

It is, therefore, marketing and distribution scale which are the important keys to competitive success. The completion of the EC internal market is another factor facilitating global consolidation, through allowing European firms, currently oriented towards their domestic markets, to develop into global players. Scale therefore becomes one of the keys to competitive success.

(v) Conclusions

The following are the main points which are significant in an assessment of the implications of 1992 for the food processing sector in Ireland.

First, in contrast with most of indigenous manufacturing, the food industry retained large Irish producers and, has, in recent years, seen a wave of concentration. From a *production* perspective the scale of Irish food processing plants was found to be on a par with the best in Europe in NESC Report No. 64. However, it is scale in *distribution* which is now crucial for successful participation in the industry. To the extent that the unification of the internal market accentuates the current trend towards scale, which it is likely to do, it must be considered a threat.

Secondly, in terms of productivity growth, the industry in Ireland has outperformed its OECD rivals since 1980. While acknowledging that this has been achieved through labour shedding, and that it would have been preferable had it been achieved through increased output, it none the less provides part of a competitive platform with which to ensure survival in the internal market.

Thirdly, in terms of *value-added-per-employee*, the industry has tended to be significantly below the European average (see NESC Report No. 83). This feature of the Irish food processing industry has implications for its competitiveness and for its future prospects. The most significant of these is that Irish food processors have relatively low market shares in the high value-added and high-growth segments of the industry. Attempting to build market share against well established competitors in oligopolistic markets is extremely difficult.

Fourthly, the existence within Ireland of the principal raw material resource *should* provide another element of a competitive platform. We have restated the *necessary* conditions which must exist, in the relationships between raw material suppliers and processors, if Ireland is to capitalise on this raw material advantage. We emphasise, however, that the raw material availability is a necessary but not a *sufficient* condition for competitive success.

Because of the domination of a few US and European firms in many food segments, smaller European firms are beginning to form alliances to establish world-wide brand names and underwrite research and advertising costs to compete with the supergroups. The scale of the firms in the Irish food processing industry suggests that this route may be worth exploring. Building scale is also possible through domestic merger and rationalisation.

3. METALS AND ENGINEERING

Metals and engineering employed around 60,000 people in 1987 and this constitutes almost 30 per cent of total employment in manufacturing. However, the sector includes very diverse kinds of activities which are liable to be affected in very different ways by completion of the internal market. Table 9.2 shows employment in each of the subsectors and gives an indication of the extent to which employment is in foreign-owned firms.

(i) Electronics (NACE 33 and 34)

We consider first the electronics sub-sector of metals and engineering. This consists of office and data processing machinery (NACE 33) and parts of electrical equipment (NACE 34). Electronics has experienced rapid growth of output and productivity with slow growth of employment in the 1980s. It has been shown that an important feature influencing the behaviour of foreign firms is the life cycle of their products. It is relevant therefore to note that most of the firms in electronics in Ireland came to Ireland during the seventies and that they came relatively early in the life-cycle of their product. Other relevant features of these firms is that they are largely non-European (most from the US) and tend to be small by the standards of multinational corporations (O'Malley, 1987).

Table 9.2
Employment in Metals and Engineering, 1987

	Total Employment 1987	Foreign as per cent of total
NACE 22 Metals	1,600	68
NACE 31 Metal Articles	11,600	0
NACE 32 Mechanical Engineering	7,700	52
NACE 33 Office and Data Processing Machinery	6,700	90
NACE 34 Electrical Equipment	18,200	74
NACE 35 Motor Vehicles including Parts	2,700	58
NACE 36 Manufacture of Other Means of Transport	4,100	—
NACE 38 Instrument Engineering	6,900	94
NACE 22, 31-37 Metals and Engineering	59,600	61

Source: E. O'Malley, (1987) *The Irish Engineering Industry: Strategic Analysis and Policy Recommendations*, Dublin: ESRI. General Research Series, Paper No. 134.

The grant-aided foreign-owned sector in Ireland contains at least two types of firms: those that qualify as *mass-production* or scale-intensive firms and those that are specialised or *differentiated*. In mass-production or scale-intensive industries the direct effects of market completion would seem likely to be the following. The firms in Ireland are protected by few NTBs (apart from the incentives provided by Irish state agencies) whereas their competitors in the rest of Europe probably receive considerable protection — particularly through preferential government procurement. While all firms should experience an initial reduction in *costs* because of the removal of various NTBs, those which are currently protected by other NTBs will also experience pressure to reduce *price*. Indeed, the second direct effect of market completion identified in our framework for analysis — increased competition — is likely to be experienced quite widely. This is because much of the electronics industry, for example, office machinery and data processing equipment, is fairly concentrated, allowing firms high price-cost margins ('Cecchini Report', 1988).

However, electronics is one sector where these *direct* effects on costs and price-cost margins are likely to be small relative to the indirect effects. These indirect effects consist of exploitation of economies of scale and increased innovation. In outlining the possible effects of market completion we noted that four categories of firm or project are relevant: existing and potential foreign investors, and EC and non-EC firms.

Existing Projects

Most of the existing electronics manufacturers in Ireland are non-European firms. Assessment of the impact of market completion therefore boils down to

an assessment of the prospects of these firms. Electronics is one sector where it is especially true that the impact of technical change is likely to be more significant than the impact of market completion *per se*. The electronics sector is likely to continue to experience rapid, though sometimes erratic, growth of demand. A number of likely trends in the sector have been identified and their implications for producers located in Ireland need to be evaluated. *First*, the pattern of demand is likely to shift, with increased use of information technology in manufacturing and retailing, whereas to date much of the demand was from the financial services sector. *Second*, a number of technical trends in the industry are expected, or certainly hoped, to improve the prospects of European firms relative to the industry leaders from the US and Japan.* *Third*, the existence of economies of scale at the level of the product are expected to lead to considerable organisational change as firms form mergers, co-operative agreement, or pursue takeovers, in order to spread the costs of development and gain access to new markets.

Two considerations are relevant to the existing electronics industry in Ireland. First, what will happen to the market share of the producers located in Ireland? Second, how will the reorganisation of the industry into larger units affect the industry in Ireland? There are forces working in opposite directions. The major positive force is the opening of government procurement. Public procurement represents up to 60 per cent of information technology purchases in the EC. Opening of public procurement should both increase the market share of firms located in Ireland and decrease the disadvantages of being located in Ireland. On the other hand, if the measures taken to improve the competitive position of European firms actually succeed, then producers in Ireland, being mostly non-European, must experience more competition.

Some parts of the electronics industry are in specialised or *differentiated* environments. These environments contain both large firms and small firms occupying niches. The emerging industries such as micro-processors, lasers, and data processing software fall into this category. Technical development is an important determinant of competitiveness. It is expected that on completion of the market firms will continue to occupy niches, but the available niches will become bigger. Some currently differentiated product industries are likely to eventually become mass-production industries while others will remain highly specialised.

For example, opinions differ on whether the software industry is destined to evolve like other industries — a few volume suppliers and many niche

*These technical trends are the following: (1) Continued downsizing will threaten producers of mini-computers and mainframes; (2) the emergence of standard operating systems will allow an escape from IBM proprietary systems; (3) increased emphasis on software; (4) the emergence of 'open' systems which allow communication between systems produced by different manufacturers.

companies. Some consider that it cannot remain a 'cottage industry' and, once suitable distribution systems develop, volume suppliers will inevitably emerge. Others consider that the industry is unavoidably specialised and therefore will remain highly fragmented. Since Ireland has a number of indigenous firms in the software sector the strategic choices concerning product range and geographical area to be served will be significant.

New Foreign Direct Investments

A number of forces will determine the future flow of foreign investment in electronics in Ireland; the completion of the internal market is but one of these. First, there are strong autonomous trends in the pattern of foreign direct investment on a world scale. After several decades of sustained growth, US manufacturing investment in Europe peaked in 1980. Japanese foreign direct investment has increased in recent years but has been concentrated in the US. There are global macroeconomic reasons why this pattern cannot continue and many expect Japanese investment in Europe to increase. Indeed, there is some evidence that both Japanese and US foreign investment in Europe has increased in recent years (Duffy, 1988). Technical change is influencing the attractiveness of foreign investment in manufacturing in complicated and, as yet, unknown ways. The enormous growth of inter-firm collaboration in high-technology sectors, and its active encouragement by the Community, must influence the attractiveness of foreign direct investment. To date much of the collaboration between European firms has been in research. Eventually, decisions about the location of facilities for *production* of new products will be made by the emerging European firms. Shortening product cycles and other developments are changing the criteria upon which location decisions are being made (see Chapter 11 below).

It is in the context of these trends that the effect of market completion on the flow of foreign direct investment into Ireland must be considered. There is reason to believe that completion of the market will increase non-European foreign direct investment in Europe since fragmentation of the European market seems to have limited such investment. Japanese and other firms note that to date European governments have been able to apply pressure to have plants located nationally, thus greatly limiting the exploitation of scale economies. While this increase in investment in Europe is likely to increase investment in Ireland, two other factors should be noted. First, the Community is strengthening its anti-dumping measures by imposing mandatory local-content rules in order to crackdown on far-eastern 'screwdriver' plants which merely assemble imported components. This measure may *increase* rather than decrease investment in Europe, but it is difficult to say what share of this might come to Ireland. The ability to provide local sub-supply of parts and services may be an important factor in influencing the location of these investments. Secondly, competition between EC countries for foreign investment has become intense. Even if state aids by richer member states were curtailed,

Ireland will experience increased competition with Greece, Spain, Portugal and the UK. The recent flow of foreign investment generally into Spain, and of Japanese investment into the UK is evidence of this.

(ii) Electrical Engineering (NACE 34 and 38)

In industries such as domestic electrical appliances there is evidence that European plants are below minimum efficient scale due to fragmentation of the market. This applies both to European firms and non-European producers and arises largely from the power of states to influence the location of plants, and from a host of non-tariff barriers. As a result large companies like Philips have far more plants in Europe than would be efficient (De Jonquieres, 1988). As in the industries considered earlier, most existing plants in Ireland are already oriented to the export market and it is their competitors who should experience the price-cost squeeze when NTBs are removed. However, this is also an industry in which these direct effects on costs and prices are likely to be small relative to the indirect effects of scale economies and increased innovation. The impact of these indirect effects on firms in any individual country is difficult to predict as it depends on the strategic restructuring undertaken by firms.

The indigenous segment of electrical engineering consists of a small number of relatively large firms and a fringe of smaller firms serving local markets. Several of the larger firms rely on public sector purchasing of telecommunications equipment. It is not clear what the future growth of demand will be and, in addition, the opening of public procurement will create opportunities and, perhaps, more significantly, threats.

(iii) Manufacture of Metal Articles and Mechanical Engineering (NACE 31 and 32)

In Ireland these sub-sectors consist of a large number of very small firms serving local markets with products differentiated to the customer's requirements. Such a structural environment is best described as *fragmented* (Jacquemin and Buiges, 1988). The features of this environment are very low exit and entry costs and few economies of scale, so that many small firms exist with varying and unstable margins, which often depend on the quality of their management. The analytical framework developed in Chapter 8 suggests that there are likely to be few effects from completion of the internal market. The fortune of these sectors depends on the growth of domestic demand as is apparent from the slow growth of output and substantial decline in employment since 1980.

However, the emerging pattern of technical change may have some implications for the manufacture of metal articles and of mechanical machinery. A notable feature of the flexible manufacturing made possible by the use of computers in design and manufacturing is the emergence of two opposite trends. There is evidence that the current wave of technical change is *undermining* scale

economies in mass-production, but injecting scale economies at the batch production end of the size spectrum.* As a result it may be possible for large producers to achieve the extreme product differentiation previously available only to the fragmented producers in metals. This combination of product differentiation and economies of scale may make it difficult for small-scale machinery suppliers, using conventional technology, to compete with machinery produced with automated flexible manufacturing systems (Kaplinsky, 1984).

(iv) Production and Preliminary Processing of Metals (NACE 22)

This sector is dominated by Irish Steel Ltd, a state owned company. Its production of steel benefits from national aid permitted by the EC to the industry in the Community. Consequently, its future depends in part on what Community regime emerges for the steel industry rather than on the completion of the internal market *per se*. However, it also depends on what kinds of economies of scale are operative and on whether some of these can be circumvented by creating a partnership with a significant European producer.

(v) Manufacture of Motor Vehicle Parts (NACE 35)

This sector comprises 115 companies employing about 2,700 people. Developments in the motor industry internationally mean that components suppliers will be more than ever under the control of their customers, the motor manufacturers. In addition to closer collaboration between car manufacturers and components manufacturers there is evidence of a process of concentration in the sub-supply sector. Ford has announced plans to encourage the establishment of components plants next to its major European assembly plants, while General Motor's strategy is to have all component suppliers within 100 miles radius of its final assembly plant (Griffiths, 1988). On the evidence of the past this increased scale will tend to put pressure on producers in Ireland.

As in several other industries the completion of the internal market is likely to speed up developments which are occurring in any case. One of these is the introduction of new organisational procedures such as 'just in time' production. This is designed to minimise the amount of capital tied up in car manufacturer's inventories and, other things being equal, will tend to induce producers to buy components from firms located *near* their final assembly plants. At the same time, in certain sectors, information technology is being used to greatly increase the efficiency of decentralised networks of manufacture, supply and distribution (Parkes, 1988; Lorenz, 1987). The overall spatial effects of these new technologies is a highly complex phenomenon which is only beginning to be understood (see Chapter 11).

*The implications of technical change for the *scale* of firms and plants is discussed in Chapter 8, while its implication for the *location* of firms and plants is examined in Chapter 11.

4. CLOTHING (NACE 453-456)

The clothing industry in Ireland consists of about 350 companies of which over 80 per cent are in the small industry category — i.e., employing less than 50 people. Over half of the companies employ fewer than 15 people. There are only about 12 clothing companies employing more than 200 persons on one site. Of these, 10 are foreign owned. Employment in the industry has fallen by almost 20 per cent since 1980, but output in 1987 was slightly lower than in 1980. This implies an increase in productivity of only 20 per cent over the seven year period. About 60 per cent of the industry's output is exported, with sales to the UK accounting for over half of this amount. Nevertheless, nearly half of Irish clothing companies rely exclusively on the domestic market.

The long-term development of the clothing industry in all EC countries is conditioned by one fact. The industry has remained labour intensive because of the difficulty of automating the key stage of production — the sewing of cloth. The effect of this is that labour costs have remained an important influence on competitiveness, and, in particular, that all EC countries have been threatened by producers in low-wage economies (OECD, 1988). One of the implications of this has been the adoption by the Community of quotas on the importation of clothing from certain low cost sources under the Multifibre Agreement (MFA). Indeed, it is a feature of both the clothing and textile industries that government measures to support the industry typically take the form of trade rather than industrial policy measures. Otherwise the industry is highly competitive internationally. The only NTBs inhibiting trade within the Community are those which apply to all products, such as the costs of border checks or the indirect effects of NTBs in other sectors, such as insurance and transport. Completion of the internal market should even out these costs. Clothing is one industry in which the *direct* effect of market completion may worsen the position of Irish producers relative to their EC competitors. Unlike many other industries, producers in other member countries are not protected by NTBs such as technical standards and regulations or preferential government procurement. In addition, completion of the internal market may sharpen the competition from non-EC low-cost countries. This will occur if abolition of border controls ends quota restrictions on movement *within* the EC of clothing imported from non-EC producers.

The inability to mechanise the chief assembly function, sewing, does not imply that there are no technological opportunities in the industry, nor that scale is of no competitive advantage. The paradox of technical change in the clothing industry is that it is in the *high-skill* operations such as design, engineering and cutting that technological developments have so far taken place, while the low skill functions have resisted automation. The introduction of computer aided design (CAD) has transformed the design, grading and cutting stages. It is significant that use of these technologies allows only small savings in *labour* costs but considerable savings on materials and increased flexibility. In

addition, such systems are highly expensive and require considerable reorganisation, which makes high demands on managerial skills. For all these reasons these new technologies are much more easily adopted by large firms than by small. This is an example of how new technology can make *scale* and *flexibility*, traditionally conflicting with one another, into complementary advantages within a firm (see Chapter 11).

Faced with the limited potential for automation, clothing producers in many countries have developed other strategies to secure or retain competitive advantages. The first and perhaps the most important of these is *product innovation*. This term covers a wide array of actions all of which are intended to escape the area of fierce price competition. This may involve the constant development of new varieties of clothing items or upgrading marketing strategies by *creating* labels, or working for those who already hold such labels. Another way of differentiating the product is to increase the quality of service rendered to the ultimate consumer. This requires close co-operation with the wholesaler and retailer and may require close ties with textile manufacturers. Note that most variants of this strategy of product innovation imply the need to use the new technology and to reorganise, because otherwise the shorter production runs involved will increase costs. So investment in new technology and product innovation cannot be seen as *substitute* strategies.

A second strategy is designed to circumvent the implications of the high labour-intensity of the sewing operation and consists of 'outward processing'. This involves the export of the cut clothing parts, for assembly by a sub-contractor in a country with low wage rates, and reimport of the assembled garment — paying import duty only on the value-added to the cut pieces. The clothing industries in the US, Germany, the Netherlands and France are reported to make heavy use of this strategy. This procedure is concentrated on low and middle-priced items which are not subject to fast change in market demand and can, therefore, be produced in long production runs.

Thirdly, a number of *organisational* changes are occurring in the clothing trade which are of major significance to clothing manufacturers. The first of these is one that can be seen in retailing generally and consists of the growth of multiple outlets at the expense of small retail shops. This suggests that there are some economies of scale at the distribution and marketing stage of the industry. As a result access to the multiples can be crucial to survival, even in the home market. But if access is achieved this will provide the manufacturer with continuous contact with the consumer. Secondly, in some cases clothing firms themselves are undertaking organisational changes which give them access to the consumer and a highly flexible production facility. This may consist of establishment of retail outlets, as in the case of the Italian company Benetton, or formation of trading houses which constitute combinations of competitors. These organisational changes also seem to involve the extensive use of information technology.

These technical developments and strategies illustrate some of the threats and opportunities which will face clothing manufacturers in Ireland. We may start by noting that some of the larger Irish producers are already taking advantage of the opportunities to introduce information technology into the design and pattern making procedures and intend to automate the cutting stage. The case of Magee's of Donegal also illustrates the advantages which stem from joint textile and clothing manufacture. But this successful response of a relatively large scale producer highlights the difficulties faced by much *smaller* firms. Almost all aspects of the strategies outlined above will be significantly more difficult for the small and very small firms to adopt, and will tend to favour the large over the small. Where expensive new investment or product innovation are not possible, cost will continue to be a key determinant of competitive advantage. In these areas, low-cost competition will continue to be experienced not only from non-EC producers but also from some UK firms where very low wages are paid.

One segment of the clothing industry which has the potential to escape extreme price competition through product innovation is the fashion or designer end of the market. Yet a number of high profile designers in both Ireland and the UK have experienced difficulty in recent years. In the UK this has been attributed to a lack of *venture capital* and to problems in finding suitable sources of *production* — the large manufacturers cannot provide the small quantities that the designers need, while the 'sweatshops' cannot deliver the right quality. As a result, UK designers have turned to Italian producers who have close liaison with designers and are capable of dealing with small quantities. Given that designers are potentially capable of providing one of the most valuable competitive advantages to the clothing industry — market related design and product differentiation — the source of business failure among this group and of the remarkable success of the French and Italian industries could repay investigation.

5. TEXTILES (NACE 43)

The Irish textile industry consists of about 200 firms, the majority of which are indigenous. However, many of the larger firms are foreign owned and these account for around 60 per cent of employment. The industry has seen a long-run decline of both employment and output — with a particularly sharp contraction in employment since 1980.

In assessing the threats and opportunities it is important to note some features of the industry internationally. This is an industry in which there has been fierce international competition for many years. The traditional methods of production were readily adopted in many less developed countries (LDCs) and newly industrialising countries (NICs) and, given their low wage costs, they became highly competitive in this labour-intensive industry. Initially the response in more developed countries was *concentration*, in order to create

firms sufficiently large to undertake big investments in labour-saving technology. However, one of the characteristics of textile technology is that there are few obstacles to its diffusion to developing countries. The adoption of mechanised spinning and especially weaving in LDCs led to a re-orientation of the industry in developed countries towards higher value-added goods, and this revealed the advantages which small and medium-sized firms possess. At the same time the use of modern textile technology in developing countries has tended to narrow or even wipe out the competitive edge which these countries traditionally derived from their low wage costs. Consequently, in the modern textile industry worldwide, both capital and energy costs are major factors (OECD, 1988).

This thumbnail sketch indicates that the experience of the industry in Ireland is in fact similar to that of textile producers in many developed economies. Indeed, the modernisation of the Irish industry seems to be more advanced than in several other OECD countries. Thus, while the absolute contraction of the industry will be very difficult to reverse, we would look for increased productivity as evidence that investment in new technology has stabilised the industry. This will be necessary to maintain a share of even the Irish and British market against the highly productive West Germans and Italians who now dominate the European industry.

Given the existence of fierce international competition in textiles it is unlikely that completion of the internal market will greatly alter the competitive climate in the industry. The removal of NTBs such as customs delays will probably just magnify prevailing sources of competitive advantage and disadvantage. High capital costs seem to be a feature of the industry in general, and the scope for further technical change and automation implies that capital requirements will continue to grow. This would tend to give large and well capitalised companies an advantage over others. The production of synthetic fibres is a large-scale and highly energy-intensive process and relative energy costs are an important determinant of competitiveness.

However, in other parts of the industry the high productivity achieved by automation and large-scale production tends to reduce product flexibility. Smaller firms can gain the competitive advantage of flexibility and product innovation in high-value product niches. These are also the high-growth markets in an industry which has in general experienced slow growth of demand for many years.

However, if pursuit of a niche strategy does not demand scale, it does make demands on management and other skilled labour inputs. While pursuit of a niche strategy will allow some escape from price competition, and the attendant need for large-scale capital outlay on automation, it will not permanently remove cost as a competitive advantage or disadvantage. Future technical

change in the textile industry is likely to focus on reconciling cost reductions with small volume output.

Finally, a more liberal trading regime may follow the expiry of the Multifibre Agreement in 1991. However, it is not possible to forecast what arrangements will apply. Even if the new regime exposed Europe to greater competition from LDCs it should be noted that, on the evidence of the past, this competition would be very different in the various segments of textiles. Import penetration of OECD markets by LDCs has been particularly important in the field of woven fabrics, especially cotton, much less in the field of yarns, and almost non-existent in knitted fabrics.

6. PRINTING AND PUBLISHING (NACE 473-474)

This sector of manufacturing consists of about 300 establishments, most of them Irish-owned, employing around 10,000 people. Employment in the sector has fallen by about 14 per cent since 1980 — which is a smaller fall than was experienced in most other branches of manufacturing (see Chapter 4). Output has remained constant since 1980, having grown slowly during the 1970s. These developments contrast somewhat with the performance in other OECD countries, where employment fell quite sharply in both the 1970s and 1980s, but output has nevertheless increased relatively rapidly — indicating strong productivity growth (see Chapter 5).

Printing and publishing is not a highly traded activity. For the most part, the major exporters of printed matter are also the largest importers. Import penetration of the Irish market is relatively high at around 30 per cent and exportation of about 12 per cent of Irish production is also high by international standards. On a world scale, Europe is the historical centre of the world printing and publishing industry and accounts for well over half of world trade. However, language plays a large part in governing the pattern of trade, and trade in English language material is much the most important. Despite these historical patterns two new trends in the industry should be noted: growing imports from non-OECD countries and the internationalisation of production. The latter trend is continuing unabated with multinational publishing houses engaging in foreign investment, mergers and acquisitions.

A remarkable feature of the print era was the use of one basic technology for over 500 years. However, the past 25 years have been a period of rapid technological change in printing, largely due to computerisation. Much of the most far reaching technical change in printing and publishing has been the application of computers and microprocessors to the pre-press or composition stage of production. This, and changes in other parts of the overall process, have lowered costs and greatly reduced barriers to entry. As a result the industry is less concentrated and is comprised of smaller firms than most other OECD

manufacturing sectors (OECD, 1988). This is more true in printing than in publishing, where there are economies of scale and there have been a substantial number of mergers and acquisitions, and diversification from book publishing to telecommunications media.

The impact of new facsimile equipment, which allows composition work done at one location to be transmitted electronically to another for printing, is difficult to predict. On the one hand it would seem to contribute to greater concentration of sales in a smaller number of firms. But looked at geographically it may facilitate a wider dispersal of actual printing and publishing activity. For example, in Japan facsimile installations are used to transmit newspaper text from central newsrooms to provincial centres. Conversely, this technology will enable Irish firms to tender for foreign pre-printing contracts with the actual printing being done in the relevant markets. The pattern of sales and purchases will depend on technical ability and the relative costs as determined by economies of scale in print runs and the price of transportation and telecommunications. We stress technical ability along with costs of transportation, etc., because the technical changes of recent years have changed the competitive basis of the industry from wage costs to the rate of technological innovation.

In fact, in the major OECD economies the diffusion of electronics technology has been greater in printing and publishing than in any other manufacturing sector. This would not seem to be the case in Ireland where the introduction of new technology has been slow in many segments of printing and publishing. Also, in many countries the introduction of new technology in the ten years since 1975 coincided with increased output growth, and faster growth than in manufacturing in general. Both the UK and Ireland seem to be exceptions to this trend and there remains significant overcapacity throughout the traditional sector of Irish printing and publishing.

Further technological change seems likely and may cause job losses in newspaper, magazine and book printing but not in publishing or in commercial printing. This trend will be reinforced by the formation of larger book publishing and printing firms through mergers and take-overs.

Given the existence of economies of scale in book publishing and printing, but smaller economies and fewer barriers to entry in commercial printing and publishing, it would seem that the state agencies' efforts should concentrate on those companies with the potential to produce and sell into expanding market niches such as the highly successful computer manual business.

7. CHEMICALS AND PHARMACEUTICALS (NACE 25-26)

Chemicals and pharmaceuticals is one of the top performing sectors of Irish manufacturing since 1980. It employs around 12,000 people, mostly in foreign-

owned firms, and has achieved rapid growth of output — mostly for export. Although some firms are involved in both chemicals and pharmaceuticals the market situation in the two sectors is so different in the EC that the effects of market completion should be considered separately.

(i) Chemicals (NACE 25 and 26 except 257)

The European chemicals industry is characterised by heavy cross-border trade already. Thus there virtually exists a European-wide market despite the continuation of certain non-tariff barriers. Indeed, chemicals is one of the few areas of European manufacturing able to compete effectively with the US and Japan. It is an industry in which there are considerable economies of scale — but most of these would seem to have been exploited already. Consequently, the industry is dominated by very large multinational firms.

The NTBs in chemicals arise because of customs delays and costs and national regulations governing health, safety and product quality. These certainly restrict trade to some extent. They also induce a certain duplication of R + D as firms must develop products which satisfy varying technical requirements in individual EC countries.

Therefore, the main direct effect of completion of the market is likely to be a reduction of costs and an increase in competition. When we consider the indirect effects there seems little basis for significantly increased scale. The impact of the initial price and cost reductions is likely to differ between highly differentiated products and bulk industrial chemicals. Firms producing differentiated products should be able to avoid greatly increased competition. Others may experience competitive pressure on their profit margins. It is possible that this will stimulate innovation as outlined in the second channel of causation in the framework for analysis set out in Chapter 8.

The chemical industry in Ireland is dominated by foreign-owned firms. In the other sector of manufacturing where foreign firms are important, metals and engineering, we said that there was a possibility that these firms would rationalise their European plants, and this presented possible threats and possible opportunities for Ireland. Does a similar outcome seem possible in the chemicals sector? In our view a major restructuring is unlikely. To see this it is worthwhile considering research and production separately.

In the case of *research* activities very few of the foreign companies have located significant R + D in Ireland, tending generally to rely on the parent company for both this and marketing. Indeed, in the chemical industry generally research tends to be much more centralised than production. However, there is recent evidence of a tendency to decentralise R + D. However, the purpose of this is to ensure that more R + D is done in harmony with the marketing and operations divisions of the company. But, since Ireland is not a major *market*

for chemicals, it seems unlikely that decentralisation of research would include this country. Indeed, much of this decentralisation of research is to the US and Japan and reflects the *global* scale of the major European firms.

When we consider the locations of *production* capacity it is seen that 1992 is unlikely to induce major relocations. We mean this in two senses. It seems unlikely that firms will wish to centralise or rationalise their European operations into fewer sites, as might occur in electronics or electrical appliances. Consequently, there seems to be little threat to the industry in Ireland. But it seems equally unlikely that firms would relocate their final or other stages of production alongside their plants producing intermediary products in Ireland. The reason for this is that in the chemicals industry there are a number of motivations, quite apart from those created by non-tariff barriers to trade, for establishing and maintaining *local* manufacture in many countries — and particularly in major markets.

As far as the indigenous firms are concerned it should be noted that, despite the dominant role of giant corporations, there are niche markets which could be served. However, there are high entry costs, and small firms can experience both production and marketing difficulties. These difficulties of small scale are barriers to entry which exist now, rather than effects of economies of scale which will be exploited by larger producers after 1992.

(ii) Pharmaceuticals (NACE 257)

The pharmaceuticals sector presents a remarkable picture. In one respect it is a highly international sector dominated by a relatively small group of large multinational companies. At the same time it is the sector in which the national markets are, perhaps, most controlled by national authorities and consequently highly segmented. This national regulation arises from the fact that the major purchaser tends to be the national health care authority and the usual public procurement practices apply. In addition, there are very different and costly national product registration and approval procedures and there is a complicated set of national price-control systems. The manufacture of active ingredients is confined to a limited number of sites, including Ireland, but their conversion into dosage forms is highly decentralised.

A vigorous implementation of the internal market programme *could* have an enormous impact on the European pharmaceuticals industry. Most aspects of these changes would tend to be favourable to the pharmaceuticals sector in Ireland.

A more harmonised acceptance of standard specifications and registration procedures could alter the location of 'finishing plants'. Foreign firms may reap considerable economies of scale by reducing the number of finishing plants and locating these at a limited number of sites. Ireland should be a strong candidate

for the location of these plants. However, opinions differ on the likelihood of multinationals actually closing down a number of plants, as this may be both politically difficult and commercially damaging. To say that it could be politically damaging is to implicitly admit that discriminatory government procurement of drugs will continue after 1992. Firms may not close finishing plants for *commercial* reasons because the nature of the pharmaceuticals market is such that firms must maintain a presence, at least in the form of a distribution system, in many countries.

The harmonisation of product approval would help Irish indigenous producers of generic drugs to achieve access to various European markets.

The existing complicated set of national price control systems tends to favour locally based suppliers. For example, Britain has used its freedom over price setting to establish a price-control scheme that lets UK-based companies charge relatively high sums for their products in their home market. This has given the UK industry a high degree of stability and a base from which to attack overseas markets. While Ireland is a high-price country the small size of the Irish market means that this high price can do little to support or attract pharmaceutical producers. Consequently, movement towards a more harmonised approach to price setting would benefit the industry in Ireland by putting pressure on producers in other countries.

However, it is possible that harmonisation of prices would involve a reduction of the average price received by the industry in Europe generally. If this were combined with greatly increased access to markets, resulting from common approval guidelines, then it could have very substantial impacts on the industry in Europe. These could induce substantial restructuring — including the possibility of greater concentration of the industry. The impact of such a substantial restructuring on the Irish pharmaceuticals industry is difficult to predict.

Finally, all of the above was a consideration of a vigorous implementation of internal market measures. In general, in this chapter and, indeed, throughout this report, we have analysed the likely effects on the assumption that the market completion programme will be implemented. However, in the case of the pharmaceuticals industry there seems to be more than average doubt about two key harmonising measures. First, agreement of common approval of guidelines by the health authorities of the member states would be a considerable diplomatic and administrative achievement. Kay considers that it is "difficult to believe that national governments will be willing to cede real authority in this area to any European agency in the foreseeable future" (Kay, 1989). Secondly, differences in registration requirements are not the only, and perhaps not even the main, reason for the continued existence of market segmentation. This can also be attributed to the reluctance of all parties,

particularly the ultimate purchaser in large member states, to stimulate parallel trade — even where this would be legally possible (Kay, 1989). Consequently, the 'Cecchini Report' points out that no harmonisation of prices is expected in the Community in the immediate future. These reservations serve to qualify the expectations outlined above.

8. CONCLUSIONS

(i) '1992' and The Changing Economic Environment

One of the most important general points to emerge from our analysis is that 1992 must be seen in the context of other changes in the general economic environment affecting businesses. This is true for all countries but especially so for Ireland. The reason for this is that large parts of the Irish economy are highly oriented to the international economy and are protected by few non-tariff barriers. The important aspects of the general economic environment are technical change, organisational change, macroeconomic conditions (including the level of demand, exchange rate movements, the prices of credit and raw materials) and the emergence of important new producers, in particular from Japan and the newly industrialised countries. Much the most important of these would seem to be the phenomenal wave of technical change which is sweeping the world economy. Indeed, it might be seen as largely the cause of the rapid change in the ownership and organisation of companies. The importance of technical and organisational change was confirmed in the application of our framework for analysis to Irish manufacturing industry. In several sectors the dominant threats and opportunities seemed to be those created by technical and organisational change rather than the removal of non-tariff barriers.

The current wave of technical change can be seen as an autonomous event — independent of the completion of the European market. Yet the two events are not fully independent. This is because one of the most significant features of the current wave of technological change and associated organisational restructuring is that it seems to be *inherently international* or, perhaps more accurately, supranational (Perez, 1983). This international dimension probably arises in part from the provision of unprecedented data-management capabilities and telecommunications infrastructure, which allows the efficient management of transnational firms. In addition, the radical productivity increases made possible by computer-aided design and manufacturing mean that for businesses to reach viable size the volume of output and the range of products of a given plant must serve an international market. The same applies in the production of services such as information and telecommunications. In short, national markets, particularly small national markets, would be a hindrance to the full deployment of the new technologies.

Recognition of these facts allows us to see 1992 in a new light. The move to

complete the internal market can be seen as partly a response to a set of changes which are occurring in any event and which will inevitably increase the international aspect of economic life. In this context the decision to complete the internal market would seem to do two things. It helps to ensure that these new developments in business occur fully in Europe, rather than influencing Europe but partly passing it by. Secondly, it allows the Community to influence the process of economic and social change. Some features of the technology and new organisational patterns are indeed inherent and therefore inevitable — an example would be its internationalism — but many others are not. For example, while the new trends in technology and business undoubtedly demand *changes* in social relationships within the firm, and between groups and individuals in society, the exact new pattern of social and distributional arrangements is not determined rigidly by the new economic environment (Perez, 1983). While no single national government in Europe can greatly influence the economic environment, or fashion the social developments which a rapidly changing economy produces, there seems little doubt that the European Community can.

(ii) Threats and Opportunities facing Irish Manufacturing Industries

Given the connection between 1992 and the autonomous changes in the world economy we have adapted a fairly broad view when assessing the threats and opportunities facing Irish firms. Thus we consider it appropriate that we mention threats and opportunities which arise from technical or other business developments. However, as far as possible we have mentioned whether a particular threat or opportunity is a direct result of market completion or not.

One general observation can be made about the threats and opportunities facing manufacturing industry in Ireland. Most manufacturing sectors in Ireland are hindered rather than helped by the sort of non-tariff barriers which fragment the European market. The clearest examples of this are the extra costs imposed by customs checks and the imposition of national technical standards. The first falls heavily on Irish manufacturers because a high proportion of their output is exported, and access to European markets can involve crossing several borders. Indeed, some commentators on 1992 have generalised this and concluded that small countries will gain most from completion of the market because a higher proportion of their production is traded.

However, given this general observation that there are few non-tariff barriers protecting Irish manufacturing industry, it is important to think clearly about how this will translate into threats and opportunities after 1992. The completion of the internal market can benefit a firm only by lowering costs and giving it access to markets from which it was previously excluded.

In order to assess the extent of this beneficial effect it is necessary to assess the

nature and extent of the non-tariff barriers which inhibit Irish industry. Manufacturing firms in Ireland are constrained by NTBs, in the form of high costs, not only because of the frontier delays, foreign technical standards and foreign government procurement, but also because of the fragmentation of the European insurance, banking and transport industries, and relatively high indirect taxes on motor vehicles and fuel.

Application of our analytical framework to manufacturing industry revealed that the *direct* effects of market completion are likely to be positive for most sectors. Possible threats came to light when the *indirect* effects were considered and when other factors like technical change were taken into account.

- In the food processing sector the small scale of the Irish businesses relative to their European and especially US competitors was identified as a possible cause for concern.
- In electronics existing plants and the future flow of foreign direct investment were considered separately. Existing producers should find the *direct* effects beneficial, but these are likely to be small relative to the indirect effects. But in this industry the *indirect* effects are very difficult to predict since they depend on firms' strategies, as much as on objective economic conditions. The flow of new foreign investment to Ireland is likewise hard to predict. While foreign direct investment in Europe certainly seems to be reviving, Ireland will experience increasing competition from new member states Greece, Spain and Portugal and from countries with large markets, such as the UK.
- In electrical engineering a threat exists because large firms, both European and non-European, seem likely to reduce the number of plants they operate in Europe and this process contains potential dangers.
- In metal articles and mechanical engineering a possible threat to Irish producers is presented by technical change; current trends in technology allow large producers to meet highly specialised needs with differentiated products.
- The processing of metals may be threatened by changes in the Community steel regime.
- In the automotive components sector, possible threats arise from the impact of technical and organisational change on the location of plants supplying the major motor manufacturers.
- Clothing is one sector where the *direct* effects of market completion may not be positive because, unlike most other industries, producers in other member states receive little extra protection from non-tariff barriers. In addition, the indirect effects of market completion may contain threats since the technical and organisational requirements for competitive success seem to be more easily acquired by larger firms.
- In textiles what threats exist seem to arise from the high and rising capital costs which are created by technical change. This tends to give large and well capitalised companies an advantage over others.

- Printing and publishing is a sector in which threats arise for different parts of the industry from technical change and from economies of scale.
- In chemicals 1992 seems likely to create few threats and few opportunities.
- In pharmaceuticals a vigorous completion of the internal market would probably cause a radical restructuring of the industry in a direction which could, on balance, favour Ireland. However, it is unlikely that the segmentation of the European market will be undermined by 1992.

However, in our view these threats do not define the inevitable outcome of completion of the internal market. There are two reasons for saying this. First, as well as threats there are considerable opportunities — as indicated by the generally beneficial *direct* effects of market completion which we expect. Second, many of the threats outlined above can be overcome, and the opportunities seized, if the correct corporate and public policy response can be devised. But a prerequisite for formulation of these responses is realistic analysis of the process of economic integration, and other processes of economic change, and application of these to each industry by those with deep industry-specific knowledge. The Council sees its role as providing the analysis of integration and suggesting how the industry-specific analysis might proceed.

IMPLICATIONS FOR THE SERVICES SECTOR OF COMPLETION OF THE INTERNAL MARKET

1. INTRODUCTION

As indicated earlier, completion of the internal market has three main components: the removal of physical, technical and fiscal barriers within the Community. The removal of technical barriers covers the free movement of goods, the free movement of labour and the professions, liberalisation of capital movements, the opening up of public procurement and the creation of a common market for services. The Commission views the last as one of the main preconditions for a return to economic prosperity.

This Chapter deals with the implications for Ireland of the creation of a common market for services. Before addressing the implications, it is necessary to first of all take a brief look at the composition of the services sector, the division between traded and non-traded services, how international trade in services has been evolving and how Irish trade in services measures against international trends.

2. THE SERVICES SECTOR: DEFINITIONAL CONSIDERATIONS

A useful classification system for the services sector is one which distinguishes between four categories of service activities, labelled distributive, producer, social and personal services*. The producer and distributive services are primarily concerned with the production, servicing and distribution of material goods. *Producers services* provide finance, design, management, legal and similar services to other industries. *Distributive services* provide transport and communications, sales and storage facilities to other industries. The distinction between producer and distributive services is based on the stage of the production process at which they intervene: distributive services at the final stage, and producer services at an intermediate stage. *Social services* provide collectively for needs such as health, education and welfare and are to a large extent provided by the State. *Personal services* cover hotels, eating and drinking establishments and are, in general, provided for individual consumers.

The classification of services is reasonably straightforward on a national basis. There are, however, complications in showing the extent to which services are internationally tradable. The consumption of some services is often nearly

*This is known as the Browning-Singleman classification.

simultaneous with its production, while manufactured goods can be produced, put into inventory and consumed later. Other services, however, are closer to manufacturing. These features provide a basis for the following classification:

- (i) foreign-tradable services which create a product which is distinct from the productive process itself and which thus lend themselves to exporting, i.e., where production and consumption are separable;
- (ii) location-bound services that involve a 'foreign' presence, generally because consumption cannot be separated from production.*

In case (i), it is possible to produce the service in Ireland and export it to other countries without having to set up an establishment in another country. Software is a good example. In case (ii), if an Irish producer wished to sell the service abroad, then a foreign establishment would be necessary to produce the service, i.e., staff and possibly full branches of the business need to be established in the importing country. For many service companies therefore the right of establishment is crucial.

Linking the classification system for domestic purposes and that for trading purposes is difficult but nevertheless worthwhile. In general, personal services and social services fall into category (ii). Examples, are hotel accommodation, haircuts, etc. Producer services on the other hand tend to fall into category (i) where, depending on the circumstances, service products can be traded or can be provided through establishment in the foreign market. This latter situation characterises the financial services sector (banking, insurance, etc.) with which we will deal in more detail later.

The most readily available source of information on international trade in services comes from balance of payments data. The current account of the balance of payments is composed of a merchandise account and an invisibles account. The total of these two accounts gives the net balance on current account. Within the invisibles account, a distinction is made between factor incomes, services and transfers. Factor income refers to trading and investment income (including profits, dividends, royalties and interest payments abroad on the national debt) and payment for work abroad. Transfers refer to remittances of emigrants, subsidies from and taxes paid to the European Communities. The final category, and the one with which we are concerned, is that of services. It is disaggregated into four main categories: (i) international freight; (ii) passenger fare receipts and 'other transportation'; (iii) tourism and travel; and (iv) other services. A brief description of each of these items follows.

International Freight: This includes the total receipts of Irish sea and air carriers for the importation of goods to Ireland and the total receipts of these

carriers from non-residents for all other international shipments of freight (other than time charters).

Passenger Fare Receipts: This includes the total foreign receipts of Irish sea and air carriers from non-residents for the carriage of passengers.

Other Transportation: This includes the time charter receipts and payments of Irish sea and air carriers and expenditures in Ireland of non-resident carriers.

Tourism and Travel: The credit item (export equivalent) represents all receipts by residents from non-resident visitors; the debit item (import equivalent) represents all foreign expenditure of Irish residents in connection with foreign travel (including expenditure for carriage by non-resident carriers).

Other Services: Included are military and diplomatic expenditure;* foreign payments of Irish residents for the renting of cinema and TV film; payments for professional and technical services, consultancy, advertising and sales promotions and receipts in respect of non-financial services, etc.

3. INTERNATIONAL TRADE IN SERVICES

International service transactions are increasingly significant in international trade. The share of invisibles in total trade rose from 23.4 per cent in 1960 to 26.2 per cent in 1982. Notwithstanding this increase, international market penetration in services is still quite low by comparison with penetration in goods. One of the main reasons for this is the existence of barriers to trade in services and the failure to reduce these barriers in line with the reduction of barriers to trade in goods. Services were not included in the various multi-lateral trade agreements conducted under the aegis of GATT. It is only in the most recent Uruguay Round that trade in services has been included in what is described as "a parallel track" to the main GATT negotiations.

The barriers to trade in services are quite high and countries have adopted different devices for protecting domestic suppliers of services from foreign competition. Examples include situations whereby a countries' imports can be insured only by that countries' insurance companies or where foreign communications firms are prevented from providing enhanced communication services by being refused use of state owned lines. Other general barriers include visa requirements, investment regulations, restrictions on the ability to repatriate earnings, etc.

Interest in the services sector has increased and particular attention has been

*Technically speaking, military/diplomatic expenditure is a government transaction and refers to non-commercial products.

*See Boddeyn (1987).

devoted to a liberalisation of trade in services through the removal of these barriers. There are a number of reasons for this.

First, the service sector is now the main source of employment, accounting for about 60 per cent of total employment in 16 countries recently surveyed by the OECD; employment in almost all service activities has been growing more rapidly than in the economy as a whole.

Second, the changing nature of the relationship between the manufacturing and service sectors, with technical progress giving rise to a growing service content of manufactured goods. For example, software accounts for a growing share of the purchase price and installation cost of a lot of equipment incorporating new technology.

Third, innovations in microelectronics and communications technology have greatly enhanced opportunities for trade in services, making possible international exchange of electronically encodeable data. Also the conjunction of communications, information processing and storage technologies enable both locational and temporal separation of service production and consumption.

Fourth, the contracting out of service functions by manufacturing businesses allowing the establishment of specialist firms in these areas.

It was indicated earlier that whether a service is traded in the same way as a product or whether a physical presence is required depends in the main, on technological possibilities and national regulatory requirements. As indicated in the third point in the above such inherent technical obstacles to trade are diminishing rapidly. However, many obstacles in the form of regulatory requirements remain, with many countries protecting their domestic service sectors through tight regulatory regimes.

The data on the evolution of Irish trade in services are now presented and address the following points:

- (i) how have services evolved in the context of the overall invisibles account?
- (ii) how has trade in services evolved relative to merchandise trade?
- (iii) what are the relative growth rates of the various categories within services?
- (iv) how does our pattern relate to international developments in this area?

Table 10.1, which shows the invisibles account of the balance of payments, answers the first question. Both the Services and Transfer components of the Invisibles account have remained in surplus during the period presented in the table. Net Transfers have shown a degree of volatility around an increasing

Table 10.1
The Invisibles Account of Ireland's Balance of Payments (£m) 1978-87

	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	
Services	Cr	452.2	541.2	634.2	714.4	841.4	939.0	1074.0	1211.6	1167.0	1337.0
	Db	-387.1	-474.1	-553.8	-630.3	-702.2	-830.0	-922.5	-1006.4	-1114.0	-1324.0
	Net	65.1	66.5	80.4	84.1	139.2	109.0	151.5	205.2	53.0	13.0
Factor Incomes	Cr	285.1	346.3	474.0	578.5	595.2	561.5	704.1	807.2	748.0	771.0
	Db	-513.3	-629.3	-832.1	-1083.1	-1522.9	-1745.4	-2432.9	-2772.9	-2705.0	-2717.0
	Net	-228.2	-283.0	-358.1	-504.6	-927.7	-1183.9	-1638.8	-1965.7	-1957.0	-1946.0
Transfers	Cr	532.8	648.2	696.0	660.9	765.9	901.8	1071.3	1319.3	1366.0	1322.0
	Db	-79.2	-92.3	-114.5	-137.4	-172.7	-230.6	-332.8	-345.5	-409.0	-436.0
	Net	453.6	555.9	581.5	523.5	593.2	671.2	738.5	937.8	957.0	886.0
Total Invisibles Account	290.5	339.4	303.8	103.0	-195.3	-403.7	-748.8	-786.7	-984.0	-1047.0	

Source: Statistical Bulletin, June 1988.

trend. Notwithstanding the surplus on these two accounts, the overall invisibles account has gone from a surplus in the late 1970s and early 1980s to a deficit of over £1 billion in 1987. This is due entirely to the Factor Incomes account which exhibited an increasing deficit from 1978 on, with a significant acceleration being experienced after 1980. This deficit is attributable to an outflow of profits, dividends and royalties, and national debt interest. The Services account experienced increasing surpluses up to 1985, but these have almost disappeared in 1986 and 1987.

Service exports and service imports have shown different trends in relation to their merchandise counterparts, with service exports growing somewhat less than merchandise exports but service imports growing more rapidly than merchandise imports (Table 10.2). As a result, service trade as a percentage of merchandise trade has fallen in the case of exports from 15.5 per cent to 12.8 per cent and increased in the case of imports from 10.6 per cent to 14.5 per cent.

What is the relative performance of the various sub-sectors within the services sector? Table 10.3 presents the details. The most rapidly growing sub-sector is that of 'other services', which increased its share of services exports from 13.4 per cent to 16.6 per cent and its share of service imports from 31.3 per cent to 37.6 per cent (Table 10.4). An interesting feature of these increased shares is that they have occurred entirely in the period 1984-87 on the exports front, while in the case of imports the increase was very marked between 1981 and 1987, following a very marked fall between 1978 and 1981. Both the export and import components of tourism and travel are below the average growth rate for the sector.

Irish trade in services must be examined in the context of relevant international developments. In 1982, trade in services for the EC countries represented on average one quarter of the trade in goods, which is the same proportion as in 1973, indicating similar growth rates for the two sectors. This, however, hides different patterns of development for different types of services. In general, transport and travel services have grown less rapidly than trade in goods while 'other services' have grown considerably faster. In the international data, many of these services are of a specialised nature, covering items such as management, engineering, communications, financial, business and insurance services, provided mainly to firms. For the EC countries, 'other services' represent 11.2 per cent of exports of goods and 8.3 per cent of imports (1982); the comparable figures for Ireland are 2 per cent and 5.4 per cent respectively (1987 data).

The trade category 'other services' is the closest in definition to the domestic category 'producer services'. It is therefore not surprising that in the OECD area as a whole the most rapidly growing area of service employment has been financial and business services in which an annual average growth rate of over

Table 10.2
Irish Service and Merchandise Trade (£m) 1978-87

	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987
Merchandise ¹	Cr 2921.6	3385.1	4004.4	4789.2	5591.9	6812.7	8696.0	9526.8	9181.0	10447.0
	Db -3656.3	-4760.4	-5346.1	-6486.9	-6712.3	-7334.2	-8892.6	-9390.2	-8746.0	-9137.0
Services ²	Cr 452.2	541.2	634.2	714.4	841.4	939.0	1074.0	1211.6	1167.0	1337.0
	Db -387.1	-474.1	-553.8	-630.3	-702.2	-830.0	-922.5	-1006.4	-1114.0	-1324.0
Services as % of Merchandise	Cr 15.5	15.9	15.8	14.9	15.0	13.8	12.3	12.7	12.7	12.8
	Db 10.6	9.9	10.3	9.7	10.5	11.3	10.4	10.7	12.7	14.5
Memorandum Item										
Average annual nominal growth 1978-87 of:										
Merchandise Exports					15.2					
Service Exports					12.8					
Merchandise Imports					10.7					
Service Imports					14.6					

Sources: ¹National Income and Expenditure, various issues, CSO.

²Table 10.1.

Table 10.3
Components of Ireland's Service Trade (£m) 1978-1987

	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	Av. An. Rate of growth
International Freight	Cr 34.0	39.7	54.3	61.0	86.0	86.7	98.0	104.2	89.0	93.0	11.8
Other transportation	Cr 141.8	182.9	219.3	251.3	288.6	335.3	391.0	424.7	423.0	460.0	14.0
	Db -82.2	-100.1	-143.8	-165.4	-194.9	-246.0	-271.0	-267.0	-271.0	-279.0	14.5
Net	59.6	82.8	75.5	85.9	93.7	89.3	120.0	157.7	152.0	181.0	—
Tourism and Travel	Cr 215.9	257.4	281.9	308.3	355.0	390.0	442.0	518.0	492.0	562.0	11.2
	Db -183.8	-251.4	-283.4	-318.5	-346.9	-363.0	-378.0	-401.7	-510.0	-547.0	12.9
Net	32.1	6.0	-1.5	-10.2	8.1	27.0	64.0	116.3	18.0	15.0	—
Other Services	Cr 60.5	61.2	78.7	93.8	111.8	127.0	143.0	164.7	163.0	222.0	15.5
	Db -121.1	-123.2	128.6	-146.4	160.4	-221.0	-273.5	-337.7	-333.0	-498.0	17.0
Net	-60.6	-62.0	-49.9	-52.6	-48.6	-94.0	-130.5	-173.0	-170.0	-276.0	—
Total Services	Cr 452.2	541.2	634.2	714.4	841.4	939.0	1074.0	1211.6	1167.0	1337.0	12.8
	Db -387.1	-474.7	-553.8	-630.3	-702.2	-830.0	-922.5	-1006.4	-1114.0	-1324.0	14.6
Net	65.1	66.5	80.4	84.1	139.2	109.0	151.5	205.2	53.0	13.0	—

Source: *Statistical Bulletin*, various issues, CSO.

Table 10.4
Components of Ireland's Service Trade: Percentage Shares (%), 1978-1987

	1978	1981	1984	1987
International Freight	Cr 7.5	8.5	9.1	6.9
Other Transportation	Cr 31.3	35.2	36.4	34.4
	Db 21.2	26.2	29.4	21.1
Tourism and Travel	Cr 47.7	43.1	41.1	42.0
	Db 47.5	50.5	41.0	41.3
Other Services	Cr 13.4	13.1	13.3	16.6
	Db 31.3	23.2	29.6	37.6

Source: Table 10.3.

5 per cent was achieved between 1976 and 1982, compared with just over 2 per cent for services as a whole. However, the rate of employment growth in financial and business services in Ireland was four times the OECD average and was higher than that of any other OECD member state. Allowing that this service area started from a relatively low base in Ireland this must be accounted a remarkable achievement.* What it highlights, of course, is the importance for Ireland of forthcoming changes in the regulatory framework governing the provision of financial services.

4. THE COMMISSIONS'S PROPOSALS

The Commission, in the White Paper *Completing the Internal Market*, sees the establishment of a common market in services as one of the main pre-conditions for a return to economic prosperity. In general, progress on the freedom to provide services across internal frontiers has been much slower than the progress achieved on the free movement of goods. In emphasising the importance of trade in services, the Commission appeals to (i) the growing contribution of market and non-market services in total value-added in the Community, relative to industry's contribution and (ii) the steady decline in industrial employment and the job creation record of the Community's market services sector.

Against this background, the Commission suggests opening up the whole internal market for services: covering new service areas such as information, marketing and audiovisual services and the traditional services such as transport, banking and insurance. In the case of transport, the opening up of the market requires:

*The extent to which this growth represents a net increase in employment depends, for example, on the extent to which it represents manufacturing firms contracting out some of their service functions.

- (i) the phasing out of quantitative restrictions (quotas) for the transport of goods by road between member states, and the establishment of conditions under which non-resident carriers may operate transport services in another member state;
- (ii) freedom to provide services for the transport of passengers by road;
- (iii) greater freedom in air transport services, in particular, changing the system for the setting and approval of fares and limiting the rights of governments to restrict capacity and access to the market.

(i) Road Haulage

A major step was taken in June 1987 in the liberalisation of the European *road haulage* system. It was agreed that all quantitative restrictions on the operation and movement of vehicles would be abolished by 1 January 1993. The level of authorisations for multilateral road haulage increased by 40 per cent in 1988 and a further increase of the same magnitude is expected in 1989. Liberalisation of the road haulage sector will also involve the introduction of cabotage operations (i.e., point to point haulage within one State by the resident of another). At present, this type of operation is not permitted within the Community.

The increase in competition, which is implied by the introduction of cabotage operations, should prove beneficial for users of such transport services. The implications for the road haulage industry depends upon the competitiveness of that sector. As with the financial services sector, these are issues which the individual firms within the industry must address. However, there is also the domestic cost and regulatory environment within which the firms operate, which will crucially determine the success of these businesses. There is a view that the implementation of cabotage would lead to the penetration of the Irish domestic market by Northern Ireland hauliers, who are perceived to enjoy cost advantages. From a public policy perspective, this raises issues concerning vehicle tax rates, excise duty on fuels, infrastructure costs, motorway charges.* It implies that if domestic haulage companies are to compete with international competitors, the domestic environment which impinges directly on their competitiveness must be critically examined and any competitive handicaps identified should be immediately rectified.

(ii) Distribution

While the Commission has not made any specific proposals in relation to the *distribution sector*, its proposals in relation to tax approximation and the abolition of economic borders together with changes in competition policy will have a major bearing on the evolution of that sector. The general issues surrounding tax approximation are discussed in Chapter 12. The indirect tax differentials which will ultimately prevail could, in the absence of economic

*An issue which would arise from any changes in this area is that of the environmental implications. The issue is not addressed here.

borders, considerably influence the purchasing patterns of consumers and hence create major problems for the distribution sector in Ireland. In more general terms, the absence of economic borders will permit consumers to shop unhindered in the various Community countries. Competition policy will impact on the distribution sector through, for example, the regulation of exclusive distribution agreements. FitzGerald (1988) has examined these issues. He concludes that the effects of 1992 on the distribution sector will arise initially from its effects in promoting the harmonisation of prices in the EC. The possible reasons for differences in prices between EC member states are the following:

- (i) differences in indirect taxes;
- (ii) exchange rate changes;
- (iii) costs of transport;
- (iv) differences in distribution efficiency across countries;
- (v) market segmentation by manufacturers.

In an evaluation of the higher net-of-tax prices observed in the Republic during periods of the 1980s, FitzGerald concludes that they were probably primarily due to differences in the price charged by manufacturers in the North and the Republic. This scope for price discrimination between national markets will be greatly curtailed as a result of the unification of the internal market.

FitzGerald also concludes that the major area in the distribution sector where 1992 can be expected to lead to reorganisation and a loss of employment is among importers/wholesalers. For UK firms supplying the Irish market, they will find it considerably easier to dispense with agents and deliver direct to retailers. There may also be a trend for rationalisation of the distribution system on the island by the appointment of a single distributor covering the Republic and the North. The major factor making for change in this area is the fact that an Irish importer cannot, under EC competition policy, prevent Irish retailers from going to the UK to obtain better terms available there. Economies of scale in importing means that a UK importer could be in a much stronger competitive position than his Irish counterpart. This, together with the absence of border formalities, will make the post-1992 situation radically different.

Businesses where after sales service is important may have some protection from these tendencies. FitzGerald also concludes that for the retail sector the initial impact of 1992 should be confined to a harmonisation of prices, without directly affecting profit margins. He also expects that for consumers in the Republic 1992 should mean some limited reduction in net-of-tax prices over and above the effects of tax approximation.

(iii) Air Transport

In moving to a more liberalised *air transport* regime, three main areas are

affected — tariffs, capacity controls and access to the market. The EC made considerable progress towards the introduction of a more liberalised regime when the Transport Council adopted an initial 3 year package of measures in December 1987, covering air fares, capacity, access to the market and the application of the competition rules of the Treaty of Rome to civil aviation.

Many of the concepts which were discussed in the context of manufacturing industry are also applicable in the aviation sector. The difficulty of achieving economies of scale in the context of a small home market implies that businesses which confine themselves to the domestic market can face significant cost penalties. In order to compete on equal terms with their larger foreign rivals, Irish airlines must not be confined to Irish markets exclusively. It is vital that they be allowed to serve other markets in Europe, especially the major markets so as to achieve the economies of scale necessary to be competitive.

In spite of the set of liberalisation measures adopted in 1987, protection of carriers from open market conditions by member states is still possible. For example, there exists an EC regulation which permits a government to intervene and prohibit capacity increases where the share of its flag carriers has fallen below 40 per cent. This, in effect, means that Irish carriers do not have the right to provide more than 60 per cent of total airline seats in any particular market. Other features of the EC's 1987 'liberalising' measures which could adversely affect Irish airlines operating Fifth-Freedom services (i.e. services between non-domestic destinations) are the limitation of sales to 30 per cent of capacity and the requirement that all flights must begin and end in Ireland. The removal of all these constraints should be a major objective of Irish policy in the next phase of negotiations due to begin in 1990.

Because of the constraints on market entry and the cost penalties associated with small size and limited networks the ability to forge strategic alliances is an important element in the strategies of smaller carriers. It is important that such carriers be allowed to co-operate commercially with other carriers so as to be in a position, jointly, to offer passengers a more extensive range of services than they can individually. It is important, therefore, that the application of Community competition policy should not discourage such strategic alliances between carriers (including investment in equity).

Up to now we have briefly adverted to transport issues in the areas of road transport and aviation against the background of regulatory changes emanating from the European Community. However, this is only one dimension of the relevant background. Another equally important dimension is that of access transport. The degree of openness of the Irish economy and its island nature ensure that the overall transport system is vital in the link between the business and its market. The overall transport system is a chain of

sub-transport operations. This means that the internal transport system must be efficient and effective. It means that the internal arteries of transport must dovetail with access ports — both air and sea. Those access ports must have the capacity to handle the freight and passenger movement efficiently and competitively. Sea and air capacities must also be sufficient to move goods competitively and speedily. The access transport dimension is picked up later in Chapter 15. Related to this issue also are the implications of tax harmonisation for access transport. Implications arise in two main ways: (i) the indirect tax approximation proposals of the Commission imply the imposition of VAT on passenger transport and on freight; (ii) the abolition of duty free sales within the Community. This has implications for the major air and sea carriers as well as for Aer Rianta.

(iv) Banking

For *banking* the most important development is the attempt to create a common financial market through the Second Banking Co-ordination Directive due to be adopted by the Council of Ministers in 1989. Under the terms of this Directive, a bank once authorised in any member state, will be free to do banking business in any other member state without the need for additional authorisation in those member states. The Home State licencing authority will be responsible for the authorisation and prudential supervision of that bank, wherever it operates within the Community. This contrasts with the situation prior to this whereby a bank in any member state had to seek a licence from the licencing authority of any other member state where it wanted to do business.

The single licence allows a bank to provide a range of banking services anywhere in the EC. Banking services are defined very widely in the Directive and are based on the 'universal banking' model. In this model, a bank can be active in lending and deposit-taking services, financial leasing, the underwriting and trading of all forms of securities (both for its own account and for customers), the management of portfolios etc. The Directive, once adopted, will establish the 'universal bank' as the standard type of banking institution in Europe and finalise the trend away from the separation of banking businesses to the creation of one-step shopping in financial services.

Acceptance of home state authorisation requires an EC role regarding minimum standards. If a member state foregoes its right to supervise a banking institution operating in its territory, it will require some assurance that its depositors are not placed at risk by lower standards and that its home banks are not at a competitive disadvantage by having to comply with higher financial standards than their competitors from other member states. The requirement for minimum standards are contained in two directives. The first of these, the Own Funds Directive, defines, what is meant by "own funds" or capital for the purposes of calculation of ratios and for other supervisory purposes. The

second one, the Solvency Ratios Directive, will lay down various solvency ratios based on risk situations and governing off-balance sheet items.

According to Welch (1988) some problems remain. Firstly, the skills and the financial resources to manage the wide range of activities of a universal bank are quite different from those required in a banking institution narrowly defined. The Directive does not specify that an institutions's competence to engage in each activity be assessed by the licencing authority in its home state. Furthermore, the Draft Directive proposes that the host state should be empowered to require banks from other member states to make sufficient provision against market risk in respect of operations on securities markets in their territory.* This runs counter to the overall thrust of the Directive, i.e. that the Home State licencing authority should be the sole body responsible for authorisation and prudential supervision of the bank. Similar remarks apply to other issues such as Conduct of Business Rules which remain within the host state's discretion.

The single licence establishes a very liberal framework. However, the transformation of the twelve countries banking systems into a single market requires the harmonisation of many national regulations to ensure a proper competitive environment. A number of other proposals and directives have been issued by the Commission to deal with these issues. In the area of mortgage lending, the proposals provide for the freedom of establishment and the freedom to supply services in the field of mortgage credit in a host country in accordance with the financial techniques permitted in the home country.

Transactions in unit trusts and equivalent products will only require home country authorisation and may be freely marketed within the EC. The directive covering this is UCITS (Undertaking for Collective Investment in Transferable Securities) and will come into force in 1989. While a member state can place more severe requirements on funds than the requirements specified by the Directive these can apply only to those funds run by domestic companies and not to those being offered by foreign competitors. No fund may transact business unless it has been authorised by a member state. One provision which departs from the concept of home country authorisation is that member states can place any rules they like on matters not covered by the UCITS Directive — such as marketing and advertising.

A further Directive, which the Commission submitted to the Council early in 1989, covers investment services in the securities field. The Directive provides a system of authorisation for anybody wishing to carry out a range of investment services in respect of transferable securities covering investment advice, broking, dealing and portfolio management. The Directive provides for home country authorisation and supervision, subject to harmonised minimum

*The Commission is presently working on a separate directive to cover this issue.

requirements and, once authorised, for freedom to provide services throughout the Community.

(v) Insurance

For *insurance* there were some developments in the 1970s which served to open up the insurance market throughout the Community. Through the non-life and life establishment Directives of 1976 and 1984, insurance companies with a head office in one member state are free to establish branches in other member states subject to certain conditions. Directives in 1973 and 1979 established supervisory rules and minimum solvency ratios for non-life and life assurance respectively. This freedom has been exercised by many insurers who now conduct business in Ireland. Approximately half of the 40 non-life insurers now operating in Ireland are new entrants since our accession to the Community. In the case of life assurance, there are now 26 undertakings compared to just 15 in 1972.

While the right of insurance companies to become established in other member States was enshrined in directives, such freedom did not extend to companies to market their products throughout the Community without necessarily having an office or branch in every member state. In December 1986 the Commission opened proceedings against a number of countries on the issue of freedom to trade services across borders. The European Court of Justice ruled in the Commission's favour but with important provisions. The guidelines laid down were:

- (i) member states may not insist that an insurer be established in their territory in order to cover risks there;
- (ii) an insurance company which has a permanent residence in a member state is considered as being established there, even if the presence does not take the form of a branch or agency but consists merely of an office managed by the Company's own staff or by an independent person who is authorised to act on a permanent basis.

In spite of these liberal guidelines, the Court indicated that member states may require authorisation of insurers who cover risks situated in their territory and insurers must observe any local rules about policy conditions and keep reserves in the national territory. This was considered necessary to ensure adequate protection of consumers. In effect, the Court indicated that significantly more harmonisation of regulatory conditions would be needed before the principles of home country control could be achieved in those cases where the policyholder stands in particular need for protection. Cross-border selling would thus be limited to customers big enough to form a professional view of whether a foreign insurance company was sound or not.

The non-life Directive which followed this Court ruling lays down rules under which insurance businesses authorised in member states will be able to transact

business in other member states on a service basis. The Directive provides a more liberal regime for large risks (substantial industrial and commercial enterprises including all marine, aviation and transport business) which by their nature require less supervisory protection. For "mass risks" (i.e., the smaller type risk such as house and house contents insurance) a more stringent regime will apply with a continuing important supervisory role for the regulatory authorities in the country where the insurance is being sought. A similar directive for life assurance is expected to provide freedom to sell life assurance across frontiers though it is expected that the directive will not be adopted before 1991. Ireland, along with Greece, Portugal and Spain, has been afforded special transitional arrangements regarding implementation of the directive.

The removal of obstacles to trade in financial services across the Community is only one aspect of the environmental change facing financial service institutions. Financial markets are undergoing extensive structural change. The strategic response to completion of the internal market must be fashioned in the context of the wider changes. The next section considers these structural changes, their source and nature.

5. INTERNATIONAL TRENDS IN FINANCIAL MARKETS

Financial markets in major industrial countries during the past decade have expanded rapidly and have undergone extensive structural change. Factors ranging from increased uncertainty about macroeconomic developments to technological advance have fuelled this growth and structural change. The changes can be examined under four broad headings:

- (i) growth of financial markets;
- (ii) internationalisation of financial markets;
- (iii) development of new products and evolution of new financial institutions;
- (iv) the liberalisation of financial markets.

(i) Growth of Financial Markets

During the period 1976-86 real activity in the major financial markets has expanded more rapidly than real output in the major industrial countries. For example, international bank lending and net international bond issues grew 2½ times faster than real GNP in the industrial countries during 1976-86. The securities and equity markets have also experienced similarly rapid growth rates.

These trends are reflected in employment and value added data for the sector. The OECD has shown that this particular branch, from among 18 other manufacturing and service sectors, has experienced the most rapid growth from 1975 to 1983.

The expansion of financial markets has been accompanied by major shifts in the flow of funds among sectors in the major countries. In Ireland, the late seventies and first half of the 1980s was dominated by the flows set up as a result of the exchequer's demand for funds and the associated balance of payments flows. In the last two years the financial system has been adjusting to a reversal of these flows with the public sectors' appetite for funds declining and the balance of payments moving into surplus.

(ii) Internationalisation of Financial Markets

The growth of the industry has encouraged many financial enterprises to become international. Where regulations have permitted, commercial and investment banks have extended their networks internationally. The number of foreign banking firms in the major industrial countries increased sharply and accounted for a considerably greater share of total bank assets. The growth of investment funds has also brought foreign markets within reach of domestic savers, allowing them to diversify their risks.

The growing importance of external financial transactions for domestic banks has been reflected in the rise in the proportion of total bank business accounted for by foreign loans or foreign security purchases. For the OECD as a whole, the relative importance of foreign business of deposit money banks has grown from 12.1 per cent of assets in 1970 to 23.7 per cent in 1981 and in the case of liabilities for 11.3 per cent to 23.4 per cent. The respective figures for Ireland are: from 36.0 to 47.1 in the case of assets and from 29.8 to 49.2 in the case of liabilities.

(iii) New Products/New Financial Institutions

The emergence and spread of new financial instruments has been a feature of the evolution of financial markets. This development facilitates the break up of established markets, the evolution of new market segments and the growth of new institutions or the re-orientation of existing institutions to satisfy these segments. The development of such products has itself contributed to the growth of markets.

The evolution of new financial products is a response to the requirements of consumers of financial products. For example, the volatility of interest rates on capital markets made it particularly risky to enter into long-term contracts to lend and borrow at fixed nominal rates. This led to the development of products such as floating rate loans, floating rate bonds, interest rate options and interest rate futures as a means of hedging against such risks. Financial instruments have been developed to spread and transfer the credit risks associated with industrial investment. Examples are options and futures contracts relating to industrial securities, subordinated loans, non-voting shares. Products have also been developed to cope with increased exchange rate risk.

One of the most far reaching innovations in the financial services market has been the shift of credit flows from bank lending to securities markets.* Unlike direct bank loans, these securities allow risks to be split among a large number of investors. This innovation also provides much greater liquidity of financial assets.

There have been significant changes in the composition of household and non-financial enterprise financial portfolios across the major industrial countries. It reflects the increased competition between various deposit-collecting institutions and highlights the competitiveness of non-bank financial enterprises. In the major industrial economies (US, Germany, UK, Japan, Canada) the share of the household and business sector savings held in deposits has fallen and that in 'institutional investment' has increased.** By institutional investment is generally meant mutual funds, pension funds, asset management funds and insurance company funds.

A roughly equivalent table can be constructed for Ireland showing the structure of personal sector savings by institution.*** The following shows the percentages taken by each institutional type for 1965, 1975, and 1985:****

	1965	1975	1985
Life Ass/Pension Funds	27.6	14.3	51.6
State Agencies	31.7	25.9	20.7
Building Societies	7.5	12.0	16.3
Banks	33.2	47.8	11.4

The changes between 1965 and 1985 are striking: life assurance and pension funds and building societies doubled their share and banks lost two-thirds of their share. The competitiveness of non-bank financial enterprises is again highlighted. The source of their competitive advantage is addressed in Section 6.

(iv) Liberalisation of Financial Markets

Financial markets are the most regulated of all economic activities in OECD countries. The regulatory framework was initiated in the wake of the 1929 crisis and was built upon in the 1940s and 1950s. The OECD has described the situation existing in the 1970s as follows:

“...most financial institutions had tight constraints on the structure of their liabilities (sources of finance) and assets (investment areas). The rates

*Before this innovation, an intermediary (such as a bank) held a non-tradable loan asset and the saver held a liability (which may be tradable) of the intermediary. With the innovation — labelled 'securitisation of credit' — the lender holds a tradable direct claim on the borrower.

**Structural Adjustment and Economic Performance OECD 1987.

***The Flow of Funds 1960-85 T. O'Connell *JSSIS* 1986.

****These figures refer to shares of flows in the particular years as opposed to stock of savings.

applied by these institutions — including deposit and borrowing interest rates and their service commissions — were also highly regulated. Consequently, the majority of financial enterprises were specialised in administratively protected market segments, where a type of oligopolistic competition based on fixed rates and service differentiation used to operate ... Taken as a whole, the capital market was no longer functioning as a comparative selection system for ... optimal investment projects, but instead as a number of more or less watertight fund collecting and allocation circuits under regulatory control.” (OECD, 1987, p. 156).

Such a regulatory environment affected the individual markets — particularly by giving incentives to particular types of behaviour. In some cases, restrictions limited the ability of certain types of financial institutions to diversify their portfolios. This exposed such institutions to certain geographic or sector-specific stocks and to the growth of competitor institutions not covered by the regulatory framework. Institutions so affected attempted to undertake restricted operations in off-shore markets (e.g., Eurocurrency markets) or through domestic operations under alternative corporate forms. Prudential regulations frequently induced institutions to adjust the location or type of their activities (e.g., off-balance sheet activity). Differences in the taxation of various institutions conferred competitive advantage unrelated to the competitive ability of the respective institutions.

The rigidities produced by such a regulatory environment have forced governments to examine their policies towards the financial sector. This has produced a number of quite significant changes which have radically altered the direction of policy towards the financial services sector.

The OECD has categorised these changes under four headings:

- (i) deregulation of interest rates;
- (ii) deregulation of financial service prices;
- (iii) integration of markets;
- (iv) opening up of markets to foreign competition.

The first and second headings refer to the dismantling of interest rate and price cartels in domestic oligopolistic markets, including brokerage commissions (the Big Bang). Opening up of markets to foreign competition includes the admittance of international institutions into the local financial markets and the liberalisation of cross border financial flows. In many countries, commercial banks, investment banks, insurance companies, pensions funds and sectoral banks tended to collect and allocate their funds in rigidly confined markets. Regulatory changes have allowed the various institutions to compete against each other in more integrated financial markets.

In this section we have examined changes in the financial services sector under four main headings:

- (i) the growth of financial markets;
- (ii) the internationalisation of financial markets;
- (iii) development of new products/new institutions
- (iv) liberalisation of financial markets.

From the brief sketch of developments under those four headings it is clear that all of the participants in the financial services market are faced with a rapidly and radically changing environment. The changes consequent on the unification of the internal European market are only a part of all the changes now facing financial institutions.

6. IMPLICATIONS FOR IRELAND AND POLICY ISSUES

(i) Implications for Government: General

Before getting into specific parts of the service sector, some general remarks about the services sector as a whole, its role in the process of economic development, and the consequent implications for public policy are addressed. We consider first the indirect or knock-on effects of the liberalisation of trade in services on the remainder of the economy.

It is necessary to very briefly recall the main thrust of *Strategy for Development*, viz. that the key to economic growth lies in the exposed internationally trading sectors. Those sectors of the economy which predominantly serve the domestic market, such as private non-traded service activities, cannot be regarded as an independent source of sustained economic growth. However, such sectors are essential to the smooth and efficient functioning of the exposed sectors of the economy.

The constraints on competitiveness which directly apply in the exposed sectors, either do not apply or apply only indirectly to the non-traded sectors. The non-traded nature of many of the services and hence the source of the protection from foreign competition is often to be found in the regulatory framework governing the sectors rather than in the technical nature of the services. The competitive environment within which many service sector businesses operate can thus be radically altered by a change in the regulatory regime.

In the absence of international competition it is conceivable that the exposed sectors could be placed at a competitive disadvantage in international markets by virtue of the cost and type of services provided by the non-traded sectors. As part of the research into assessing the potential economic effects of completing the internal market, significant differences were found in the cost and range of services across the various member countries; reflecting the different competitive environments in the various countries.* This absence of

*The Economics of 1992, *European Economy*, No. 35 March 1988.

competition provides the rationale for domestic competition policy. However, the Council has previously indicated that competition policy is only a second-best solution. A better alternative is opening up of the non-traded sectors to foreign competition. This should help to ensure the removal of any competitive disadvantage which the exposed sectors may face. The removal of the barriers to trade in services may have short-term dislocation effects, but against these must be set the longer-term detrimental effect of having an uncompetitive services sector. In general, therefore, seeking derogations from the trade liberalisation measures is unlikely to be in Ireland's best interests in the long term. Not only does seeking exemption from the measures preserve an uncompetitive domestic structure but it prevents Irish domestic enterprises from adopting an international orientation and seeking to benefit from the opportunities presented by the liberalisation of regulatory environments.

(ii) Implications for Government: Financial Services

The principles of mutual recognition and home-country control is likely to increase competition, not only among firms across the EC but also between the different national regulatory systems. There will be great pressure on these systems to converge since they are a crucial factor in the ability of the financial service businesses to compete internationally.

The formation of a unified financial market will also require major changes in tax systems in the financial area. At present, the treatment of interest and dividend income, securities transactions, capital gains and bank deposits varies greatly from country to country. Capital gains taxes on individuals range from zero in Belgium to 50 per cent in Denmark. Stamp duties range from zero to 0.5 per cent of the value of stocks and bonds. The variety of practice in regard to the taxation of interest and dividend income is shown in Table 10.5. Ireland is shown to operate a withholding tax of 32 per cent on interest paid to residents and no withholding tax on non-residents. Luxembourg does not apply any withholding tax on interest income accrued by residents of other EC countries and banks do not report interest income to foreign tax authorities.

Another factor which can give rise to differences in competitive conditions is that of liquidity ratios. Financial institutions are generally required to hold primary and secondary liquidity in the form of central bank deposits and government securities. The required holdings and the rate of return on these holdings differ across countries and even between different types of financial institutions in individual countries. These differences have similar effects to taxation differences in generating competitive distortions. The Commission on Taxation has pointed out that liquidity requirements are a form of hidden taxation, to the extent that different liquidity ratios apply and that yields on liquidity holdings are below yields available in the market place.

A major factor facilitating the persistence of these differences in taxation and regulatory requirements is the existence of exchange controls. Prior to 1979 the

Table 10.5
Withholding Taxes in the EC Member States
 (Per cent of Interest and Dividend Income)

	On interest paid to		On dividends paid to	
	Residents	Non-Residents	Residents	Non-Residents
Belgium	25	25	25	25
Denmark	0*	0*	30	30
France	**	0-51	0	25
Germany	0***	0***	25	25
Ireland	32	0	0	0
Italy	12.5-30	12.5-30	10	32
Luxembourg	0	0	15	15
Netherlands	0*	0	25	25
United Kingdom	25	25	0	0
Greece	****	49	42-53	42-53
Portugal	30	30	12	12
Spain	20	20	20	20

Rates indicated are subject to restrictions and exemptions.

*Banks report interest income to the tax authorities.

**Recipients can choose to pay 27% or 47% depending on the savings instrument, or to lump interest income with other incomes. Banks report interest income to the tax authorities.

***Banks do not report interest income to the tax authorities.

****Corporations pay 25%; individuals pay 8% plus an amount linked to graduated rates applicable to income taxes.

Source: Adopted from Arthur Andersen (from J.P. Morgan, *World Financial Markets* 1988, Issue No. 5).

Irish currency was maintained at a fixed one-to-one parity with the pound sterling. There were virtually no restrictions on capital flows between Ireland and the UK. Irish membership of the sterling zone required that controls, similar to those in force in the UK, be applied to capital movements between Ireland and non-sterling countries. At the time of entry into the EMS, exchange controls were extended to the UK. The principal control measures were in respect of capital outflows. The major capital outflows restricted were the investment of new Irish funds on foreign stock exchanges, the holding of foreign currency balances by residents and the lending of Irish funds to non-residents. Residents could continue to hold foreign securities held at the time of the introduction of controls and could finance further purchases with foreign currency borrowing. Insurance companies and pensions funds could also use Irish pounds up to a limit of 10 per cent of their cash flow for investment in foreign currency securities. This was increased to 12½ per cent in January 1988. A number of relaxations have been introduced since then, and in January 1989 all restrictions on purchases by residents of medium and long-term foreign securities were removed.

These relaxations are a prelude to complete removal of exchange controls. The Commission views total liberalisation of capital movements as one of the main planks for completing the internal financial market by 1992. Spain, Greece, Ireland and Portugal have been permitted to delay implementing the final stage of capital control liberalisation until 1992, with Portugal and Greece having the possibility of derogating from the agreement still further. The Taoiseach, at the launch of the government's 'Europen' campaign indicated the government's intention to honour that obligation.

Since exchange controls have permitted significant differences in taxation regimes across the various Community countries, their proposed removal will require changes in these regimes. The EC directive on capital liberalisation required the Commission to produce proposals aimed at "eliminating or reducing risks of distortion, tax evasion and tax avoidance linked to the diversity of national systems for the taxation of savings and for controlling the application of the systems"; The Commission published its proposals in February 1989. They are briefly as follows:

- (i) the application by all member states of a 15 per cent withholding tax to interest income
- (ii) strengthening of mutual assistance between member states' tax administrations so as to facilitate measures to counter tax evasion.

The 15 per cent rate, which represents an approximate average of the national rates, will be a minimum rate, with each member state being free to impose a higher rate (either exclusively for national taxpayers or for all recipients of interest payments). A certain number of exceptions can be made by member states, such as interest paid to third country residents, or on certain types of interest income, e.g., from small saver's schemes or from "Eurobonds".

While this proposal is aimed at limiting the extent to which capital flows will be motivated by differential tax treatment, there are other dimensions to the taxation of financial institutions and their products which could hinder the competitiveness of Irish institutions and lead to capital flows. The *ad hoc* nature of the taxation of financial institutions in Ireland, through a basic regime plus levy in the case of banks, levies on general insurance companies and levies on the products of life assurance companies will have to be replaced by a more rational form of taxation, underpinned by the principles of good taxation practice and designed not to handicap financial institutions in a single financial market. This does not necessarily imply a reduction in their overall burden of taxation, rather the raising of taxation in a manner which does not impair their competitiveness.*

*It should be noted that the bank levy was introduced to compensate for the perceived inadequate corporation tax yield from banks by reference to their profitability, partly resulting from the utilisation of tax-based lending.

A notable feature of the development of the financial services sector in Ireland is the initiative by the government to establish the International Financial Services Centre (IFSC) in the Customs House Docks area in Dublin. The establishment of the centre, together with a fiscal incentive of a 10 per cent corporation tax rate, is designed to attract international financial services to Ireland. This initiative derives from a desire to share in the worldwide expansion of economic activity in the financial services area. It is also linked to the government's policy for the development of inner cities generally and the Customs House Docks area in particular. The package of fiscal incentives for urban renewal is contained in the Finance Act 1986 and the Urban Renewal Act 1986.

Having achieved this rapid response to events in the international financial services sector, the further development of the initiative should give consideration to the following factors. An examination of the evolution of Irish industrial policy indicates that the attraction of foreign business to Ireland through generous fiscal and financial incentives was not, in itself, sufficient to underpin the development of a sector. Attention needs to be devoted to the links which these foreign businesses forge with the remainder of the economy and the spur which they give to indigenous development. It is particularly important that a dual structure is not allowed to develop — as happened in the manufacturing sector. This takes on added significance because of the liberalisation of the European financial market. In the context of home country control and open competition for financial business, the policy measures needed to allow indigenous financial institutions to develop are as important as the attraction of foreign financial institutions to Ireland.

(iii) Implications for Financial Service Businesses

Using the framework which has been developed for sectoral analysis in Chapter 8 it is possible to evaluate the likely consequences of financial market integration in a systematic way and to identify some of the strategic issues facing financial institutions in the unified market. The outline of the framework is as follows:

Direct Effects

- (i) cost reduction from the removal of non-tariff barriers;
- (ii) price reductions resulting directly from increased competition, the magnitude of which depend upon the current degree of concentration of an industry;

Indirect Effects

- (iii) further cost and price reductions as output expands and businesses experience increasing returns to scale. This is likely to give rise to sectoral restructuring;
- (iv) a spur to an increase in the internal economic efficiency of firms and a spur to innovation.

In an attempt to evaluate the direct effects, an EC-wide study was carried out by Price Waterhouse based on the prices of 16 financial products — 7 banking services, 5 insurance services and 4 brokering or securities services. For all financial services together, a price reduction for the EC as a whole of 10 per cent is estimated. While there may be reasons for price differences other than absence of competition (e.g., cost differences), the creation of an integrated financial market will, no doubt, give rise to price reductions. The falls in the prices of financial services to be expected differ significantly from country to country but also from sub-sector to sub-sector within individual countries. While it is not intended to carry out such research for Ireland, price falls of at least the European average are likely, given the degree of concentration in certain sub-sectors of the domestic financial services market.

In discussing concentration in, for example, the banking industry it is important to remember that there are different segments in the industry, with a clear distinction existing between retail and wholesale banking. In the wholesale segment, domestic institutions have faced competition from North American and European financial institutions which have established in Ireland. Irish banking has also been open to external competition from foreign banks that did not have a presence in Ireland, through direct lending from abroad. The reduction in prices on the wholesale market consequent upon unification of the European banking market may thus be more limited than in other segments. These competitive forces would not have been as strong in the retail sector, while institutions serving narrow segments, such as mortgage finance, would not have faced international competition.

The magnitude of the first of the indirect effects mentioned above depends crucially on whether economies of scale characterise the provision of banking services. Economies of scale exist where a scale of operation lowers the unit cost of the product. The concept was generally applied to manufacturing industry. Whether they exist in the service sector is a matter of debate. It is argued, for example, that such economies may elude banks and other financial firms. This is based on the view that labour and interest costs do not fall appreciably with volume and generally dwarf the fixed costs associated with offices, computers, trading floors, branches, etc. It is argued, for example, that US banks seem to exhaust size related economies at a fairly low level of assets (\$50m). In the literature there is some dispute about their existence*.

Another type of economy is that of product range, i.e., the wider the product range, the lower the cost of providing any one product. This gives rise to the concept of the financial conglomerate, designed to market the full range of

*A study by Giligan, Smirlock and Marshall (1984) covering 714 US banks concludes that economies of scale can only be achieved in a small bank (\$25m deposits) and that these economies reach their peak with less than \$100m in assets. However, another study by Murray and White (1983) found increasing returns to scale in the majority of 61 Canadian savings banks.

financial services using common distribution networks, funding facilities, managers and support services. Both studies cited in the footnote stress the existence of economies of product range. Trends in the industry would also indicate that many financial service businesses believe it because they broaden the range of services offered. Traditional demarcations between different financial institutions are being steadily eroded. Banking activity is not now restricted to banks. Joint ventures and partnerships between different types of financial institutions are becoming increasingly common. This is particularly apparent between banks and stockbroking firms. Also, insurance and securities firms are interested in distributing their products through bank branches to banks' traditional customers. However, there are also contrary views on the efficiency of financial conglomerates (see, for example, Llewellyn, 1985).*

Were economies of scale to be very significant in the provision of banking services, then banking concerns with large home markets would be likely to have better cost structures than those with smaller domestic markets. The balance of evidence cited above suggests that economies of scale are not vital to competitive success. It has been found that the variation in average costs between different sized banks is much smaller than the variation in costs across banks in the same size class. This means that efficiency differences are a greater source of cost differences than size.** The ability of Irish banking institutions to compete on the domestic market against foreign products and to offer products in foreign markets against local competition will be crucially influenced by relative efficiency levels between the competing institutions. While the Irish banking sector has not been protected in the same manner as have the sectors of some other European economies, nevertheless the degree of concentration in the industry in a context of limited international competition suggests that scope for efficiency improvements exist. Exploiting such potential efficiency gains is necessary in the bid to be competitive in the unified internal market.

A second key requirement for remaining competitive in the financial services market is product innovation. As was indicated earlier in the review of developments in the industry, the rate of product development and product innovation is very rapid. Irish institutions will not hold market share unless they are to the forefront in this respect.

An alternative to in-house product development is joint-venture arrangements whereby one partner provides the products and the other provides the distribution outlets. Central to the efforts to exploit the scope for efficiency improvements and keep to the forefront in product innovation is the need to rapidly adopt the technological advances taking place in telecommunications and data processing. New developments in such areas as computer technology,

*Berger *et al* (1987) refutes the finding of the existence of economies of product range in banking services.

**See, for example, Humphrey (1987).

computer software and telecommunications permit more rapid processing and transmission of information, completion of transactions and less costly confirmation of payments. In addition, improved computer technology makes possible the development of new instruments for hedging and risk spreading, including options and financial futures.

The recent EC Directives in the financial area expand the options which financial institutions face in penetrating foreign markets. The ways in which individual undertakings can become involved in the provision of services to foreign markets are:

- (a) full representation with branches or subsidiaries, whether *de novo* or by merger or acquisition;
- (b) formation of co-operation arrangements with counterparts or distributors from various countries;
- (c) by operating out of their home base in selling financial products to customers in other Community countries, i.e., direct export of financial services without a physical presence.

The appropriate strategy will depend upon the nature of the market into which the business wants to expand. Breaking into a country's retail banking (including mortgage credit) or life assurance markets is expensive because a retail network of offices or agents is required, providing sales, marketing and customer service, thus making option (c) unattractive.

A network can be established (i.e., option (a)) by opening new branches or purchasing a competitor's. It is very unlikely that establishing in foreign markets through a greenfield branch network will occur. The present branch networks in Community countries, usually dominated by national banking institutions with large market share, generally serve as an entry barrier to the businesses, i.e., competitor firms would find it prohibitively expensive and time-consuming to begin from scratch, building a branch *network*. However, it will only serve as an entry barrier as long as it is necessary to have a branch network to conduct business. As was seen earlier in the domestic environment, the presence of an elaborate branch network did not prevent banks from losing significant market share in the savings market. A vital strategic question is whether the branch network will remain more durable as an entry barrier for the distribution of financial products.

Penetration of foreign markets is more likely to take the form of merger/acquisition or various types of alliances. Alliances can range from co-operation arrangements which is simply a loose amalgamation of community country financial institutions having mutual agreement on certain issues such as cross-selling products to a joint venture which is a more formal arrangement, useful for assaults on new market segments. Cracking a foreign market without a

significant presence on the ground would prove extremely difficult. There is little doubt but that psychological factors, including customer loyalty, could more easily be capitalised upon through a presence in the market.

The keys to competitive success in the *insurance* sector are likely to have much in common with those in banking; in fact much of the preceding section has revolved around the concept of financial institutions rather than banks *per se*. For example, in the area of life assurance a study by Kellner and Mathewson rejects the hypothesis that there exist economies of scale in life assurance but argues that there are economies of product range. Again therefore, size *per se* is not a necessary condition for competitive advantage. Efficiency, product innovation and the exploitation of technological developments are likely to be crucial. The issues in regard to penetration of foreign markets for insurance are similar to those for banking.

7. CONCLUSIONS

The internationally trading sub-sectors of the services sector are an important component of the exposed sector of the economy. It was seen that the 'other services' component (which is predominantly specialised producer services) of the invisibles account of the balance of payments was growing more rapidly than merchandise trade. This trend is confirmed by an examination of the employment trends in this sector.

The effects of market completion are likely to be much more prevalent in the services sector than in the manufacturing sector. This is because international market penetration in services is quite low by comparison with penetration in goods. One of the main reasons for this is the continuing existence of barriers to trade in services throughout the Community. In effect, therefore, service sectors are now going to face what the manufacturing sectors faced in 1973 when Ireland joined the Community.

The barriers to trade in services are quite high and countries have adopted different devices for protecting domestic suppliers from foreign competition. As part of the programme to complete the internal market, the Commission proposes opening up the whole internal market for services, covering such areas as information, marketing and audiovisual services and the traditional services such as transport, banking and insurance.

As an underpinning to the exposed sectors of the economy, the non-traded component of the services sector has a vital role to play in ensuring the competitiveness of these sectors. As a result of the liberalisation measures, many sectors previously defined as non-traded will become traded. Opening up of the non-traded components of the services sector will generate efficiency improvements and price reductions, and should be encouraged, not hindered.

Derogations should not therefore be sought. There may be short-run problems but they must be set against the benefits of a more competitive services sector.

Completion of the internal market in the transport and distribution sectors will give these sectors a totally new competitive environment. In distribution, the scope for price discrimination between different markets will disappear and prices across the Community will tend to converge. The abolition of economic borders is likely to lead to a reorganisation of the sector, particularly in the importing/wholesaling sub-sector, as retailers deal directly with producers and as Ireland as a whole is treated as one region for distribution purposes.

In the road haulage and aviation sectors, the liberalisation measures will also radically change the operating environment of businesses in these sectors. In road haulage, the measures will facilitate entry into the sector and permit point to point haulage within each state by the resident of another state. While the imposition of higher excise duties on such inputs as mineral oils might not threaten the survival of domestic transport companies in the context of a protected home market, the regulatory changes now taking place will require concomitant changes in the taxation of such inputs. This issue is discussed again in the context of tax approximation in Chapter 12.

In aviation, the liberalisation of the regulations, particularly in regard to market access and capacity controls, should serve initially to benefit smaller carriers with small domestic markets — allowing them to achieve scale economies. Major constraints still exist, however, and the objective in the next phase of liberalisation should be to remove these. These initial changes are of a 'direct effect' type as specified in our framework of analysis. However, these measures will impel the industry towards restructuring, which are essentially indirect effects. If smaller airlines are not to lose out in this restructuring, then further changes are required in the regulatory regime to permit airlines to engage in strategic alliances.

One of the sectors undergoing major structural change is that of financial services. Unification of the internal market in financial services will add another dimension to the forces already impelling these changes. The essential feature of the Community's regulatory change is that a financial institution once authorised in its home member state will be free to conduct business in any other member state, without the need for additional authorisation. These regulatory changes will have, as a first direct effect, the intensification of competition.

It is possible to use the analytical framework of direct and indirect effects devised in Chapter 8. With regard to direct effects it is likely that price reductions of at least the European average of 10 per cent will occur, given the degree of concentration in certain sub-sectors of the domestic financial services

market. An exception to this may be the wholesale banking market which has had significant exposure to foreign competition. With regard to indirect effects, it is argued that economies of product range are more important than economies of scale. In addition, efficiency differences are a greater source of cost differences than scale differences. Businesses with smaller home markets are therefore not automatically at a competitive disadvantage.

While concentration has been high in the industry, there has been some penetration in the last decade by foreign institutions. Foreign competition is therefore not unknown. In addition, the Irish financial market has not been as protected as the financial sectors of certain other European countries. Therefore, some opportunities may exist abroad. Having made these general points it is worth noting that certain sub-sectors of the financial services industry, such as building societies, which have generally tended to concentrate on one segment of the market and which have been less exposed to foreign competition may be more vulnerable to the opening up of the market.

Against this background, the ability of Irish banking institutions to compete on the domestic market against foreign products, and to offer products in foreign markets against local competition, will be crucially influenced by relative efficiency levels between the competing institutions. It is argued that some scope for efficiency gains exist in the Irish banking industry; exploitation of such efficiency gains is vital. A second key requirement for remaining competitive in the financial services market, is product innovation. Central to the efforts to exploit the scope for efficiency improvements and keep to the forefront in product innovation is the need to rapidly adopt the technological advances taking place in telecommunications and data processing.

The recent EC Directives in the financial area expand the options which financial institutions face in penetrating foreign markets. The appropriate strategy will depend upon the nature of the market into which the business wants to expand. Breaking into a country's retail banking (including mortgage credit) or life insurance markets is expensive because a retail network of offices or agents is required. Direct export of financial services without a physical presence is therefore unlikely. Establishing in foreign markets through a greenfield branch network may face prohibitive entry barriers. A vital strategic question is whether the branch network will remain durable as an entry barrier for the distribution of financial products. Penetration of foreign markets is therefore likely to take the form of representation through merger/acquisitions or various types of alliances.

Given the heavily regulated nature of the financial services sector, the actions taken by government are as important as the actions taken by the institutions themselves in preparing to compete in this new environment. Ireland's indigenous institutions must not be handicapped in defending their domestic

market or in launching offensives in new markets by the domestic taxation and regulatory environment. Two related issues need to be addressed urgently if the indigenous institutions are to position themselves to meet the full rigours of international competition:

- (i) the nature of the regulatory structure in an international comparative context;
- (ii) the specific taxation of financial institutions and products to ensure a level playing field internally and competitive success externally.

In order to reduce uncertainty, the Council recommends that the government should review and publish its intentions in regard to these issues. While the Central Bank Bill, the Building Societies Bill and the TSB Bill address some of the existing problems, the wider policy issues still remain.

In a situation in which Irish financial institutions are regulated and taxed in a manner which does not impair their international competitiveness, the key to survival rests with the institutions themselves. More general environmental changes in their markets are as important as 1992. We have outlined some general considerations arising from these environmental changes. The development of corporate strategies to cope with these environmental changes crucially depends upon the quality of management in these institutions.

HOW MARKET COMPLETION WILL AFFECT THE REGIONS OF EUROPE

1. INTRODUCTION

Having developed a framework for analysis of completion of the internal market (Chapter 8) and applied it to manufacturing (Chapter 9) and to the services sector (Chapter 10) we now address a wider question: what effects will completion of the internal market have on the regions of Europe? This chapter contains a systematic analysis of the forces making for regional convergence and divergence. In Section 2 we outline various economic theories which predict regional diffusion or concentration of economic activity and assess their theoretical validity and realism. In Section 3 we consider the argument that completion of the internal market, by increasing the rate of growth of the European economy, will greatly assist convergence among the Community's member states and regions. Section 4 summarises the analysis and outlines our general conclusion. Having weighed up these arguments we conclude that the benefits of market completion are likely to be distributed unevenly — with the greatest benefits accruing to regions in which industries with economies of scale and highly innovative sectors are most prevalent.

This conclusion differs sharply from the view found in what has become known as the "Cecchini Report". In Section 5 (and an Appendix) we explain why the few statements in the Cecchini Report on the likely regional effects of market completion are erroneous. Finally, in Section 6 we consider some of the empirical evidence on European regional development. While the studies on the evolution of regional disparities, cited in Section 5, cannot be taken as rigorous tests of the various hypotheses reviewed in Sections 1 to 4 they do provide a background against which to judge the realism of claims that completion of the internal market will narrow or widen regional disparities.

2. TENDENCIES FOR REGIONAL CONVERGENCE AND DIVERGENCE

A crucial consideration must be the impact of completion of the internal market on the disparities between regions in the EC. Approaches to regional policy and to several other policy areas will differ depending on whether further integration of the European economy is expected to bring about convergence of regional economies or a widening of the already considerable gaps between regional incomes. In this section we explain why the disparities between regions will, in all probability, widen, and why the gains from integration may actually

be distributed unevenly. This conclusion is based on consideration of the theoretical arguments and trends in the international economy.

(i) Regional Convergence by Market Forces

Mainstream economic theory, based on the notion of the economy as a self-adjusting mechanism, formulates the regional dimension in a way which stresses the tendency to regional balance. According to this theory, the normal functioning of supply and demand will tend to achieve full utilisation of all resources within each region and, more significantly in the current context, tend to eliminate disparities between different regions. Any disparities between regions which are observed tend to be attributed to regional differences in endowments of factors of production, and to certain imperfections or rigidities in the economic system. Consequently, policies to solve the resulting regional problems concentrate on increasing price and income *flexibility* within regions and *mobility* of capital and labour between regions. Indeed, the very notion of the economy as a self-adjusting mechanism is based on the idea that such movements of prices, incomes and quantities are 'equilibrating' — that is, that they serve to remove the disparities which give rise to them. The predictions of this theory about the regional impact of completion of the internal market are clear: in a regime of genuine free trade, inter-regional movements of products and/or factors of production will lead first, to increased potential welfare for all regions and, second, to convergence of incomes.

This theory of regional convergence is widely considered to be untrue since it is based on some highly unrealistic assumptions (Armstrong and Taylor, 1985). The implication of this is, as Padoa-Schioppa says, that "any easy extrapolation of 'invisible hand' ideas to the real world of regional economics in the presence of market opening measures would be unwarranted in the light of economic history and theory" (Padoa-Schioppa, 1987).

(ii) Forces making for Regional Concentration of Economic Activity

A much more promising approach to understanding the existence and persistence of regional inequalities is that which invokes the 'principle of cumulative causation' (Myrdal, 1957). If there are 'economies of scale in production' (the cost of production of goods falls as output increases) or if there are 'economies of agglomeration' (the cost of production is lower because of the proximity of other firms) then a region which gets an initial advantage will find that advantage reinforced as its level of production increases. Each time output is increased costs fall and other regions find it more difficult to catch up. If the strong region attracts capital and labour from weaker regions this will further enhance its productive potential and, because of the economies of scale and of agglomeration, strengthen its competitive advantage. Hence the label 'cumulative causation'; output growth, by lowering costs, developing skills and know-how, inducing innovation and specialisation, creates a self-sustaining growth process in certain regions. But other regions may equally find

themselves in a cycle of decline (Kaldor, 1970). On this view, economic disparities, far from being self-adjusting, or self-correcting, as in the orthodox vision, tend to be self-reinforcing (see Chapter 2).

Other factors can be added to this account which reinforce the tendency to concentration. A growth centre requires the construction of considerable infrastructure and there are *economies of scale* in its provision; this consolidates the growth centre (Moore and Rhodes, 1987). A crucial difference between this and the mainstream approach is that, in the presence of increasing returns, the movement of labour or capital, or both, in response to wage or profit differentials, instead of re-establishing inter-regional equality, may actually create the conditions which favour *further* resource shifts.*

One of the most fundamental processes of development is the division of labour — and it has implications which seem to strengthen the tendency to geographical concentration. As the market for final output increases, production and other processes become more and more fragmented into specialised activities. This takes the form both of increasing technical division of labour within the individual firm — division of labour in production — and increasing division of labour between firms — the division of labour in society. This latter process means that the inter-firm transactions become numerous and complex: flows of materials, subcontracting relations, face-to-face exchanges of information, and so on. This creates strong pressures for geographical concentration of industry. In recent work on the regional distribution of economic activity access to these information networks is given even more emphasis than economies of scale in production. The pressures for concentration created by the development of an intense labyrinth of inter-plant and inter-firm transactions has been used to explain the development of the Lancashire cotton complex of the nineteenth century, of the semi-conductor

*In specifying how cumulative causation arises, Kaldor (1970) incorporated the idea that productivity growth is a function of output — a relationship that became known as Verdoorn's Law. In Kaldor's formulation a region's output growth is in turn determined by the growth of its 'exports' to other regions. But, if the growth of its export sector depends on its competitiveness, a region with more rapid productivity growth will experience enhanced competitiveness. This explains the virtuous circle of cumulative causation, since the price of a region's exports depends on its productivity growth, which in turn depends on its output (export) growth. This will be recognised as the theoretical basis upon which Ireland, and many other countries, adopted an *export-led* growth strategy.

Formal presentations of Kaldor's cumulative causation theory serve to clarify the role of *structural factors* in determining regional growth. In this theory regional growth rate differences are explained by differences in price elasticity of each region's exports, differences in the income elasticity of each region's exports, differences in rates of autonomous productivity growth, and differences in the rate at which productivity responds to output growth (Dixon and Thirlwall, 1975; Robson, 1987). If the word 'supply' is used in its broadest sense, rather than merely to denote the scarcity of factors, then these structural determinants of regional growth and regional problems can be seen to be partly supply-side phenomena. This view of regional growth has been extremely influential and has had some impact on the design of regional policy. One of the concerns of much of regional policy is to alter the structure of the regional economy so as to increase the share of export industries.

industry in Silicon Valley, California, in the 1960s and 1970s, and Route 128 in Massachusetts in the 1980s (Scott and Storper, 1986).

Another component of the explanation of cumulative centre-periphery differences in growth is the development of advantageous *labour market characteristics* in central regions (Keeble, Owens and Thompson 1982). The massing together in one place of large populations which collectively embody many different skills and attributes is an important agglomeration economy (Scott and Storper, 1986). Furthermore, over time there can develop a long history of age, education and skill-selective migration to central regions which enhances still further the relative advantage of such regions for further investment in the more advanced industries.

Yet another recently studied advantage of concentration is *innovation leadership*. Location in a leading region allows firms achieve *information-maximisation* and *risk-minimisation* and these strongly support innovative activity (Keeble, Owens and Thompson, 1981). Empirical work has revealed evidence of remarkable concentration both of industrial research activity by private and public sector organisations, and of actual manufacturing innovations in core regions.* A recent OECD report *Structural Adjustment and Economic Performance* highlights the significance of manufacturing expertise as a prerequisite for reaping the benefits of innovation. It notes that such expertise “grows by the cumulative effects of learning, scale and sector cross-fertilisation” and is, “contrary to the assumptions of the orthodox theory of comparative advantage . . . geographically concentrated” (OECD, 1987, p.256). Firms and countries that have acquired this manufacturing know-how are well placed to take an even larger share of the value added made possible by technical progress.

This formidable list of arguments would seem to justify the interim conclusion that there are considerable forces making for concentration of advanced economic activity.**

*This work is cited in our discussion of innovation-oriented industrial policy in Chapter 15.

**It should not be inferred from this statement that we accept uncritically the conclusions of a deterministic Myrdal-Kaldor model of regional growth. A number of telling criticisms can be made of such models. First, the model does not explain the *initial pattern* of regional specialisation, but simply traces how a given set of export sectors will respond to changes in variables such as national income growth. Secondly, the model assumes that the region's export sector is the only source of regional output growth. But productivity growth, for example, could occur in other sectors. Third, the relationship between output growth and productivity growth is a very complex one and may be grossly over simplified by Verdoorn's Law. Yet the Verdoorn relationship is central in generating the cumulative causation process in these theories. To the extent that the Verdoorn relationship picks up the influence of *economies of scale*, the precise form of these economies should be investigated in more detail (Armstrong and Taylor, 1985). Finally, it must be noted that regional or national development policy based on the export-led growth theory has not always worked as intended. In particular, though rapid export growth has been achieved, as for example in Ireland, this did not generate the dynamic effects on productivity, innovation, etc., which would be expected

If this is what emerges from *regional economics* it is of interest to ask how consistent it is with what is found in the *economics of international trade* and economic integration. In fact, much of the significant recent literature on trade and *economic integration* is based precisely on consideration of economies of scale, product differentiation and the market power of firms. A study of that literature reveals that the gains from free trade are probably very considerable but may be distributed in a very uneven way between firms, countries and regions.

(iii) The New Trade Theory and the Distribution of Gains from Trade

The central insights of this new theory of trade have been described as follows. If there are important advantages to large scale production or significant ‘learning’ effects then new entry into a given industry may look unprofitable, even though existing firms are making exceptionally high profits (Krugman, 1987a). These above average profits are known as ‘rents’ in economic parlance. Regions which retain or capture industries in which firms can earn rents will gain most from economic integration.

A second reason why the gains from integration may be especially high is ‘external economies’. By an ‘external economy’ economists mean a benefit from some activity that accrues to individuals or firms *other than those undertaking the activity*. Krugman says that the most plausible example is the *diffusion of knowledge* generated in one industrial line to other firms and other sectors. The reason why external economies have become an issue in analysis of trade and economic integration is that study of trade patterns reveals that technological innovation seems now to be a major determinant of trade patterns (Krugman, 1983). Innovation is particularly likely to generate valuable spillovers because it involves the generation of knowledge. If, as has been suggested above, innovating sectors and activities have a tendency to concentrate in certain regions then clearly these external economies will be captured by those regions (see Chapter 2 for a more detailed account).

Strategic Sectors

Trade and integration involve the rearrangement of economic activity in the countries and regions participating. We have seen that the traditional view argues that all regions can gain as they specialise in activities in which they have advantages and, furthermore, the more complete the integration — i.e., the greater is the mobility of labour and capital — the greater will be the tendency to equalisation of incomes. Another way of putting this is that it is a matter

if Verdoorn's Law held. Again this requires that the factors which are summarised in the Verdoorn relationship be re-examined in considerable detail. All attempts to explain the uneven economic development which is the norm in capitalist economies face the task of identifying the location and nature of the *cumulative element* (Harris, 1987). From this general perspective, the approach initiated by Myrdal, and developed by Kaldor and others, should probably be seen as but one possible explanation.

of indifference *what sectors* a particular region specialises in — since no sector or activity is more valuable to the economy than any other. As Krugman says, this is the question on which the old and new thinking about trade differ. The implication of the new approach is that there may be ‘strategic sectors’ after all (Krugman, 1987a). First, the importance now being given to economies of scale, advantages of experience, and innovation in explaining trade patterns implies that ‘rents’ may not be fully competed away — that is, that labour or capital will sometimes earn significantly higher returns in some industries than in others. Secondly, given the role of technological competition it is now more plausible to argue that certain sectors yield important external economies — that producers are not paid the full social value of their production. The existence of strategic sectors in this sense means that “the benefits of trade may not be shared symmetrically . . . with the country exporting the commodities whose production involves greater scale economies typically benefitting more” (Eaton, 1987, p.126; see also Brander, 1987, p.25).^{*} But the theory also gives some indication of what countries and regions are likely to retain or capture industries which involve scale economies. Krugman explains that “theoretical models of strategic trade policy show that in industries subject to increasing returns, the size of the domestic market can be an important determinant of export performance” (Krugman, 1987b). In Chapter 2, we saw that there are strong reasons why industries with economies of scale can be expected to concentrate in countries with large domestic markets.

A Qualification

Although these considerations lead to the expectation that smaller, poorer, less developed, and peripheral regions, including Ireland, will in general benefit less than other regions from economic integration there are features of the immediate situation which require that we qualify this conclusion. The argument outlined above deals with the long-run benefits of integration and seems valid as far as these are concerned. But in the Community as it currently exists the distribution of *immediate* benefits from market completion is likely to be somewhat different. As we have seen in Chapters 8 and 9 the Irish economy, especially manufacturing in Ireland, is supported by very few non-tariff barriers (NTBs); consequently, the removal of NTBs across the Community is likely to place a much sharper price-cost squeeze on producers in other member states. Thus in 1992, in contrast to 1965 and 1973, Ireland may gain a disproportionate share of the immediate benefits and suffer fewer of the immediate costs of integration. It is perhaps *possible* that this initial advantage will stimulate sufficient *output increases* and *external economies* to create a dynamic process which allows Ireland capture a greater share of the long-term benefits than in the past. But, if all the arguments outlined above hold, it is highly doubtful that this will be sufficient to narrow, let alone remove, the disparities in income.

^{*}In Krugman’s judgement “What all this means is that the extreme pro-free-trade position — that markets work so well that they cannot be improved on — has become untenable” (Krugman, 1987a, p.15).

In summary, the concern about regional inequality found in the regional economic literature has recently acquired a direct parallel in the study of trade and integration. Indeed, to a large extent the new approach to trade consists of the belated introduction into trade theory of features of economic reality — economies of scale, external economies and learning effects — long considered essential in the study of regional economies and economic development (Bell, 1987).

In spite of the existence of strong tendencies to concentration of industrial and economic activity it would be very surprising if there were not also counter-tendencies. What tendencies towards diffusion can be identified, and are they sufficiently strong to counteract the forces making for concentration?

(iv) Forces for Diffusion of Manufacturing Industry

A New Spatial Division of Labour

Analysis of the spatial pattern of modern industry has led a number of economists to the view that very substantial diffusion forces are at work. Their basic idea is that the second half of the twentieth century has seen the development of a quite new ‘spatial division of labour’. In the nineteenth century industrial economies showed a *geographical* specialisation which was also predominantly a *sectoral* specialisation. Particular industries seemed to find strong incentives to concentrate all their capacity in the areas most propitious in terms of their requirements of production. This pattern has now given way to a quite different spatial division of labour. The spatial division of labour is no longer a sectoral one. Because of their size and organisational power, corporations can now construct locational hierarchies that place their production activities, which are separable within the firm, at different places in the economic landscape. Of course, reference to the existence of a new spatial division of labour is not itself an *explanation* of the regional pattern of economic activity, it is still purely descriptive. Various explanations can be adduced drawing on increased competition, technical changes, new organisational methods and industrial relations requirements (Massey, 1979).

Whatever explanation is preferred this new spatial division of labour has important implications for the locational patterns found in the modern economy.^{*} These are usually said to be the following. The mass-production and

^{*}It also has interesting implications for the way in which regional inequalities are measured. Many indices of regional economic health measure the *sectoral structure* of the economy and are, therefore, implicitly based on a regional division of labour which is sectoral (Clark, Gertler and Whiteman, 1986). Furthermore, the idea of a new spatial division of labour has the advantage of assisting us in reaching a more accurate assessment of the impact of regional or industrial *policy* (Massey, 1979). Any assessment of the impact of policy involves an implicit or explicit counterfactual hypothesis about what would have happened in the absence of the policy. Frequently, this counterfactual hypothesis is a simple projection of earlier trends. In the case of industrial location patterns this may be mistaken; the idea of the new spatial division of labour draws attention to changes which were happening in the location of industry *independent of regional/industrial policy*, and these should be discounted before inferring the impact of that policy on location patterns.

assembly stages of production, which form the lower order of a locational hierarchy, are usually located in areas where unskilled and semi-skilled labour are available and wages are low. Several different types of areas possess these features and, consequently, no very tidy geography of mass-production and assembly emerges. There is a second stage of production which consists of processes which are not yet standardised. This stage is typically located in old centres of skilled labour. However, this stage of production is of decreasing quantitative importance. Finally, at the top of the locational hierarchy are found the control functions, product research, design and development, technical and managerial strata. These are located in the central metropolises.

How does this view relate to the many arguments for concentration cited above? Essentially, this view accepts that economies of scale, specialisation and division of labour are still at work generating economic growth, but in a somewhat different context. The context has changed in that the operation of these forces no longer requires that producers or consumers be *located close* to one another. This is so because of a number of recent changes in the spatial organisation of production and consumption. First, firms no longer rely on *local* markets to provide the level of demand necessary to exploit economies of scale. Second, the organisation of production has undergone profound changes, including the vertical integration of sequential functions within single firms and, more recently, a multinational arrangement of production (Clark, Gertler and Whiteman, 1986). Note that this vertical integration involves a reversal of the social division of labour — the performance of different functions in separate enterprises — and of the concomitant polarisation tendencies. One feature of the large capital-intensive standardised units of production which emerge is that they have streamlined external transactions in comparison with the firms in the concentrated centres of growth (Scott and Storper, 1986).

To this pressure for diffusion of certain industrial activities may be added the effect of improvements in transport and telecommunications infrastructure which reduce the significance of distance (Camagni and Cappelin, 1982). Another factor limiting regional imbalances is the fact that rapid growth in central areas puts a strain on local infrastructure and creates costs of congestion (OECD, 1989).

These arguments have been used to explain the location of branch plants in many peripheral regions and third world countries and also to account for the perceived 'deindustrialisation' of old industrial regions in advanced economies. There is some evidence that the hierarchy of regions is not as stable as certain versions of the theory of cumulative growth and decline would imply; strong regions can go into decline and weaker regions can surpass them. This new approach has the advantage of being able to take serious account of the

diffusion forces which seem to be at work without, at the same time, reverting to the notion of even development found in traditional economic theory.

Assessment

Do these arguments warrant the conclusion that the forces of diffusion are such that the completion of the internal market may be expected to coincide with a narrowing of the disparities between rich and poor regions in Europe? In our judgement the answer must be: no. There are two reasons for reaching this conclusion. First, the diffusion of industry as a result of the 'new spatial division of labour' is not the only force influencing the pattern of regional development; some of the other forces at work tend to maintain or even reinforce concentration. Second, even where the new spatial division of labour is creating a diffusion of certain manufacturing activities, this diffusion is *not* likely to bring about convergence of regional incomes and economic structures. We briefly explain these two propositions.

Diffusion not a General Imperative

Quite apart from the many reasons for concentration outlined earlier there are a number of features of the international economy which seem to mitigate the diffusionist impact of the 'new spatial division of labour'. A very large, and some would argue increasing, share of foreign direct investment is in *developed*, central, rather than peripheral or third world regions (Amin and Smith, 1985; Sayer, 1986). This implies that the pressures on firms to relocate standardised processes in poorer areas may not be as quantitatively significant or as general as some would argue. The relocation of production away from central regions is not a feature of all industries, but of subsets of industries — in particular US firms. Japanese firms do not seem to feel the same pressure to pursue such a strategy. Indeed, generally, there are social and institutional characteristics of capital and labour which may be very significant, and which therefore undermine the idea that relocation and diffusion is a *general imperative* (Hill, 1987; Marshall, 1987; Sayer, 1986). Likewise, to rely on a general pressure for diffusion would be to ignore the role of national governments and *internal social structures* in influencing patterns of development (Jenkins, 1984; Sayer, 1986; Bagchi, 1987).

However, it has to be said that, even if the general pressure for diffusion of manufacturing through foreign direct investment will not be as strong as was once believed, we cannot infer from this that *Ireland* will not attract such branch plants. There are two closely related reasons for saying this. First, there is considerable evidence that tariffs influence the pattern of foreign direct investment; so long as the EC maintains its external tariff a certain proportion of US and Asian firms will *locate* production units in the EC rather than *export* to it. Second, the concomitant of a weakening of the pressure for diffusion of manufacturing to third world and peripheral regions is increased pressure to locate production in the major markets. In these respects Ireland has a

somewhat ambiguous status — peripheral, and therefore low cost, yet far more developed than third world countries and, most significantly, part of the EC market. It follows that it is difficult to predict how much foreign direct investment is likely.

Technical and Organisational Changes in Industry

Certain trends in international industry are likely to maintain or even reinforce concentration (see Wadley, 1986). In particular, the technological changes underway may have this effect. The new electronic technologies have extreme technological *interdependence*, such that possession of capability in certain products — semiconductors for example — is vital to future competitive advantage in the electronics industry as a whole.* This clearly implies a certain *cumulative* process. Automation reduces the significance of labour costs and hence the attractiveness of peripheral, low-cost, locations; at the same time scarce, and usually centrally located, technical skills have become more significant. In highly innovative activities *direct access* to markets, which may have ceased to matter in standardised products, becomes important again. Indeed, Padoa-Schioppa considers that there “are strong tendencies for high technology industries (such as electronics and informatics) to cluster together” (Padoa-Schioppa, 1987).

Japanese management techniques, with their emphasis on quality and ‘just-in-time’ production, would seem to imply concentration rather than dispersal of production units. It is significant that industry in Japan itself involves integrated factories clustered together as, for example, in Toyota City (Hill, 1987). Indeed, it has been argued that the ‘flexible manufacturing systems’, which Ergas considers an essential part of successful corporate strategies, in general favour agglomerated rather than dispersed production locations (Kaplinsky, 1984).

Furthermore, an important trend in corporate strategies is vertical de-integration or, as Ergas calls it, ‘de-verticalisation’; the increased pace of technological change has greatly increased the risks of vertical integration (Ergas, 1984). Recall that the vertical integration in evidence in the 1960s and 70s was partly what simplified the external transactions of plants, and thereby *facilitated their location away from the growth centres*. Vertical integration is being replaced by co-operative agreements, long-term contracts and joint development projects — the motivation for which is the remaining, and even increased, need for a ‘tap’ into component technology (Ergas, 1984). But these contractual arrangements will probably arise between firms located in

*“The innovation literature indicates that there is usually a substantial degree of interdependence or connectedness between a particular technological change and prior developments in the same technology and complementary or facilitory activities in related technologies. As a consequence of this kind of interdependence successful innovation usually requires that firms be plugged into a whole range of past and contemporary technologies that are related to their R + D efforts” (Borrus, Tyson and Zysman, 1987).

developed industrial centres — though not necessarily in the same country or continent (for example, investment by European firms in innovative firms in the US — Sayer, 1986).

Finally, the increased pace of technological change may undermine another piece of the argument for diffusion based on the ‘new spatial division of labour’. Production tended to be relocated in peripheral regions as the product matured, because, at that stage, cost of production, rather than technological superiority or quality, became the key determinant of competitive advantage. But technological change delays or undoes such product maturity and refocusses the search for competitive advantage on new products and processes (Borrus, Tyson and Zysman, 1987). A classic example of this is provided by the consumer electronics industry; British and US producers tended to treat products like television sets as mature products, whose cost of manufacture could only be lowered by producing in countries with relatively cheap labour. Japanese producers, on the other hand, introduced significant process and product *innovations* which almost wiped out the American and European television industries. Most significantly, for the issue in hand, this ‘dematuring’ of the industry by automation and changes in product design shifted cost advantage back towards production in advanced industrial countries (Sayer, 1986).

Overall then, it seems too simplistic to infer that radical technical, telecommunications and transport improvements, because they *technically* reduce the significance of distance, also reduce its overall *economic* significance, or cause a wider dispersal of activity and a convergence of regional economies. In Chapter 8 we argued that the effects of the new technologies on the *scale* of firms and plants was highly complicated and depended on very *specific* features of the industry. It should come as no surprise that a similar conclusion applies to the effect of technical change on the *location* of activity*.

Conclusion on the Strength of the Force for Diffusion

For all these reasons it has to be concluded that as the internal market is completed the tendency for industrial activity to diffuse from the centre to the periphery of Europe will not be sufficiently powerful to overcome the forces making for centralisation. This was our first argument against the view that the pressures for diffusion, which certainly exist, will emerge as dominant and produce convergence of the regional economies of Europe.

*See Cooke and Imrie, 1989; Perez, 1983; Kaplinsky, 1984; Dosi, 1988; and Stopford and Turner, 1985. In discussing the regional implication of 1992 Pelkmans and Winter note that “Although improved communications reduce the economic distance between the periphery and the core, they also currently generate economies of agglomeration” (1988).

The Effects of Dispersal of Manufacturing Plants

Our second argument against that view is that *even where dispersal of industry takes place*, creating a new spatial division of labour, it does not, in general, bring about *convergence*.

Studies of the relocation of manufacturing industry in peripheral regions and countries show that frequently its impact is small. Wages and skills remain low. Branch plants have few links with the local economy. The investment does not greatly expand the local technical, research and managerial resources. Little R+D is undertaken and, consequently, the likelihood of new local firm formation is not increased. The regional economy becomes an extremely 'open' one. Finally, the remission of profits, interest and dividends is likely to go to the parent company outside the locality. The emergence of an inter-regional hierarchy of functions means that differences between the economic structures of central and peripheral regions are *changed from what they were* — when the centre produced manufactures and the periphery produced raw materials — *but are not removed*. Not surprisingly, the continued difference in structures is reflected in continued disparities in incomes.

It is important to note that to report these facts is in no way to claim that branch plant investment *harms* the economy of peripheral regions or causes actual *divergence* between regional incomes. Such a view has been put forward, but tends to be stated in vague terms which are quite insufficient to make the case (see, for example, Sivanandan, 1987):*

Indeed, in pointing out that branch plant investment in peripheral or poorer regions does not in general initiate the dynamic processes of industrialisation, we note that occasionally it may stimulate substantial development in the region. Location of branch plants requires the provision of transport and telecommunications infrastructure and, given that there are considerable economies of scale in the provision and use of these, then further firms may find the region increasingly attractive, and indigenous firms may reap economies also. In the US a small number of newly-industrialised areas have recently shown signs of becoming growth centres in their own right (Scott and Storper, 1986). To a somewhat lesser extent Scotland, which has the biggest concentration of semi-conductor producers in Europe (over 90 per cent US-owned), had developed a pool of skilled labour and seen the emergence of a number of new small firms providing specialised services to this industry (Sayer, 1986). Recent research has shown that inward direct investment varies considerably in the skill content of its work, the degree of division of labour, purchases from local economy, proportion of managerial occupations, extent of R + D activity undertaken, and introduction of product innovations (Young

*Of course it is quite possible that in *specific cases* the development of a regional or national economy could be *retarded* by the position it acquires in the new spatial division of labour. We are not aware of cases for which this has been convincingly demonstrated.

and Stewart, 1986; Goddard, *et al*, 1986). Consequently, no completely general proposition about the effect of foreign direct investment, or its lack of effects, seem justified.

However, the evidence on branch plant investment in Ireland to date does not suggest that these spin-off effects have materialised. In their survey of multinational firms in chemicals, mechanical engineering and electrical engineering, Young and Stewart found that branch plants in the Republic of Ireland had the 'worst' general profile of all the regions in Britain and Ireland (Young and Stewart, 1986). In research on the regional pattern of R+D, product innovation and technology transfer in Britain, it was found that these growth-inducing, or at least growth-related, factors were most prevalent in the South East and least in evidence in the peripheral assisted areas (Goddard, Thwaites, Gibbs, 1986). Ireland is likely to resemble these assisted areas in this respect.

(v) Conclusion

Drawing on the arguments found in regional economics and the new theories of international trade and integration, we identified the forces making for geographical concentration of advanced economic activity, and reached the interim conclusion that the benefits of completion of the internal market would probably be distributed unevenly. Against these arguments has been thrown the case that emerges from the theory of the 'new spatial division of labour' — that the dispersal of manufacturing activity from the centre to the periphery may create a force for convergence of central and peripheral regional economies. Our evaluation of this tendency towards relocation of manufacturing industry, in the context of other changes in the international economy, has indicated that inward investment from higher income regions is unlikely to occur on a scale sufficient to counteract the tendency towards centralisation which arises from economies of scale, external economies, and recent technological and organisational developments. Consequently, our interim conclusion concerning the regional impact of completion of the internal market moves a step closer to being our final conclusion. One further counter-argument remains to be weighed against it.

3. EUROPEAN GROWTH AND REGIONAL CONVERGENCE

(i) The Effects of Growth on Regional Disparities

A different argument for the existence of forces making for economic convergence as economies integrate must also be considered. Nevin, for example, agrees that the relevant economic theory (such as those discussed above) predicts that integration will lead to an accentuation of regional disparities, but argues that this prediction must be qualified (Nevin, 1985). Qualification is necessary because of the positive effect of economic integration on the growth rate of the *European economy as a whole*. This

makes a difference to regional disparities because, in his view, regional policy intervention, aimed at the improvement of the economic position of peripheral regions, is invariably easier and more effective in the context of a 'national' economy growing at a relatively high rate.

A somewhat similar view is taken by the European Commission in its *Third Periodic Report on the Social and Economic Situation and Development of the Regions of the Community* (1987) and in a study published with its *Annual Economic Report 1988-89*. In these reports it is pointed out that during the period 1960 to 1973 disparities in income per head between EC member states and regions narrowed; but since the onset of recession in 1973 there has been divergence rather than convergence. In the latter document the Commission says: "it is very striking that economic developments in the relatively poorer countries seem to be affected by the aggregate rate of economic growth in the Community." This is seen as supporting the view that regional policy and general economic policy should be seen as complementary (see also Padoa-Schioppa, 1987).

The view that rapid growth of the European economy is generally conducive to reduction in regional disparities almost certainly has some validity. However, we do not see it as capable of supporting the proposition that completion of the internal market will *of itself* start a process of regional income convergence. There are two reasons for this.

(ii) Integration and Growth

First, it is by no means clear that integration *of itself* increases the growth rate of an economic union. There are, indeed, reasons to believe that creation of a larger market can, through its impact on productivity and technological advance, increase the rate of growth of output. However, in considering this a distinction must be made between a *once for all* increase in productivity levels, which is very plausible, and a sustained increase in the rate of growth of productivity, which is conceivable but less likely (Robson, 1987). It would be a courageous student of integration that would attribute the rapid growth of the European economy over the whole period 1958 to 1970, and the associated narrowing of income differentials, to the formation of the EC. Likewise, it is highly speculative to predict that completion of the internal market will, *of itself*, increase the long-run growth of the European economy.* This statement is valid whether or not we accept the now widespread view that the relatively slow growth of Europe in the period since 1979 was *caused primarily* by its fragmented internal market. In fact, many who agree that fragmentation of the market has indeed *inhibited* European growth believe that co-ordinated growth-

oriented macroeconomic policy is a *necessary* adjunct to the market completion policy (Padoa-Schioppa, 1987; Brookings Institute, 1987; EC Commission White Paper, 1985; 'Cecchini Report', 1988). Indeed, this analysis led Professor Dreze of the Centre for European Policy Studies (CEPS) in Brussels to the conclusion that "If the EC's internal market programme is not realised during a period of faster growth then the costs will outweigh the benefits".

(iii) European Growth and Regional Disparities

The second reason why we cannot subscribe to the view that market completion will restart convergence is that even if the European economy re-attains rapid growth we cannot predict that this will narrow regional disparities. The reason is that the relationship between high European growth in the period 1960-73 and an element of convergence of regional and national incomes in those years, on the one hand, and low growth in 1974-86 and slight divergence, on the other, has not been analysed in nearly enough detail. From the simple correlation highlighted by the Commission it is not possible to identify *how* EC growth affects national or regional growth. A research project on the scale of the 'Cecchini Report' would be required before knowledge of the nature and strength of the relationships involved could be confidently acquired.

Evidence of the possible complexity of the relationships involved can be found in an intriguing analysis of the relationship between national/union growth and regional growth formulated by Burns using US data (1987). He argues that national, in this case US or Europe-wide, growth does indeed influence regional growth, but in a *cyclically uneven* way. Specifically, the disparity between central incomes and regional or peripheral ones widens as central/national growth accelerates and narrows as central growth slackens. In the acceleration stage of the cycle the growth-effects are spatially concentrated in the *core* regions; the result is a *widening* of regional differences. As acceleration of growth stops and high growth is achieved, the growing imbalance characterising the acceleration stage begins its reversal. High growth establishes linkages which cause the positive effects to spill over into peripheral regions. As the number of linkages increases the dominance of the core diminishes. When national growth *slackens* and enters a deceleration phase, the gap between the centre and periphery *narrows* most. As deceleration gives way to low-growth the linkages between core and periphery weaken, and the vitality of the peripheral economy disappears. Thus Burns identifies an intergration cycle that follows the national/union growth cycle, but runs *inverse* to it. Note that this hypothesis is consistent with the simple relationship between European growth and convergence highlighted by the Commission.

For these two reasons we cannot accept that the relationship between EC growth and regional growth, as currently understood, can provide the foundation for the idea that completion of the internal market will, through

*In his article '1992: Myths and Realities' John Kay of the Centre for Business Strategy at the London Business School says "it seems unlikely that the economic consequences of 1992 will be macroeconomic, or that we should look for major results from generalised trade liberalisation" (Kay, 1989).

its effects on European growth, reduce disparities between the regions of the Community.

4. MARKET COMPLETION AND CONVERGENCE: A GENERAL CONCLUSION

Our analysis of the likely regional impact of completion of the internal market has proceeded through a number of stages. In common with many others, we were able quickly to dismiss as unrealistic the notion that self-adjusting mechanisms in the economy create an automatic tendency towards full employment of labour and capital in all regions, and equality of regional incomes. Drawing on the theory of regional economic development proposed by Myrdal in 1957, and developed by regional economists since then, we found a formidable list of arguments that advanced economic activity will tend to concentrate in leading regions, causing a cumulative divergence of regional fortunes. The heart of this case is that because of economies of scale, the division of labour, and external economies created by innovation and the development of skills, economic growth in leading regions has a significant self-sustaining element. The realism of these arguments led us to the interim conclusion that there are considerable forces making for concentration of economic activity.

When we asked how this interim conclusion applies to the specific case in hand (the completion of the internal market) we found that the new theories of trade and economic integration — which take account of economies of scale and external economies — predict that the benefits of integration will not be distributed evenly. In the context of European market completion our interim conclusion was thus restated to say that the benefits are likely to be distributed unevenly — with the greatest benefits accruing to regions in which industries with economies of scale and highly innovative sectors are most prevalent. Ireland is not likely to be among these regions.

Against this interim conclusion we weighed the case that there are tendencies towards *diffusion* of economic activity from the centre to the periphery, and towards convergence of regional economies. There has definitely been considerable pressure for dispersal of manufacturing from traditional industrial areas to peripheral regions, and this tendency has been analysed using the concept of a new spatial division of labour. This is without doubt an important contribution to an understanding of the regional patterns found in modern economies, and a useful antidote to the dire predictions of some versions of the theory of cumulative regional growth and decline. However, our immediate concern has been to assess whether the dispersal of manufacturing activity is likely to render invalid our interim conclusion about the distribution of the benefits of completing the internal market. Unfortunately, it would seem unlikely to do so. There are two reasons for this. First, taking account of other

developments in the international economy, it seems unlikely that inward investment from central regions will occur on a sufficient scale in the coming years. Second, even where external direct investment in manufacturing does occur it tends not to have a profound impact on the economic potential of those peripheral regions.

Before our interim conclusion could be installed as our final conclusion one other argument had to be weighed against it. If completion of the internal market increased the growth rate of the European economy as a whole, and if rapid European growth coincided with or was followed by a reduction in regional disparities, then completion of the market would create a tendency to convergence of regional economies. While rapid European growth would probably increase the *possibility* of reducing regional disparities, neither of the two propositions in the argument stated above are sufficiently well established — either theoretically or empirically — for us to place our trust in them. Consequently, after consideration of all the above arguments, our general conclusion must be that the benefits of market completion are likely to be unevenly distributed — with the greatest benefits accruing to regions in which industries with economies of scale and highly innovative sectors are most prevalent. Consequently, completion of the internal market should not be expected to narrow the income disparities between regions in the EC, let alone bring about convergence.

5. THE 'CECCHINI REPORT' AND THE DISTRIBUTION OF GAINS FROM THE INTERNAL MARKET

A different view of the likely regional distribution of gains from market completion can be found in what has become known as the 'Cecchini Report' ('The Economics of 1992' *European Economy* No. 35). In the preparation of that report no attempt was made to estimate, or even to ascertain the broad orders of magnitude of, the relative gains of different regions. Nevertheless, in the 'Summary and Conclusion' it is stated that smaller and newer member states "have proportionately the biggest opportunities for gain from market integration" and it is clearly implied that the distribution of the gains, if uneven at all, is likely to favour these regions in these states. In addition, it is said that recent theories concerning international trade cast doubt on the probability of divergent regional fortunes and point to more balanced or indeterminate outcomes. In our view the arguments developed by Cecchini to support these conclusions are erroneous and they should be seen, therefore, as no more than assertions.

Cecchini's argument is based on the contrast between the traditional or orthodox theory of international trade and the modern approach, which takes account of scale economies and product differentiation. From this it is inferred

that the newer approach predicts a more even distribution of the gains from trade and integration. In our view this is a total misrepresentation of the traditional theory and a highly selective account of the new approach and will leave readers of the 'Cecchini Report' with an inaccurate impression of the trend in economists' thinking about the distribution of gains from integration. Our demonstration of this point turns on the precise differences between traditional and more recent theories of international trade and is, consequently, somewhat technical. For this reason the argument is placed in an appendix to this chapter.

6. EMPIRICAL EVIDENCE ON EUROPEAN REGIONAL DEVELOPMENT

(i) The Context

In this section we complement our discussion of the likely regional effects of market completion with a review of some of the empirical evidence on regional disparities in the European Community in recent years. The reports on the evolution of regional disparities which are cited below cannot, in general, be taken as rigorous tests of the various hypotheses reviewed earlier in this chapter. This is because the period under review, roughly the seventies and eighties, has seen a number of economic changes of major proportions — all of which are likely to have regional impacts. First, the period since the early seventies has been one of severe economic disruption internationally, and this has prompted varied *national* responses. Second, there has been distinct alterations in the international division of labour following the rise of several Asian economies. Third, European economic integration deepened and widened. Finally, but on a scale which is incomparable with these three, there has been a Community regional policy in operation since 1975. All of these will certainly have influenced regional disparities and we cannot hope to disentangle their separate effects. Nevertheless, the broad trends identified in the empirical research on regional development provide a significant background against which to judge the realism of claims that completion of the internal market will diminish or widen regional disparities.

(ii) The Overall Pattern of Regional Disparities

A comprehensive statistical profile of the regions of the Community can be found in the second and third *Periodic Reports on the Social and Economic Situation and Development of the Regions of the Community*, produced in 1984 and 1987 respectively. Our concern here is merely the overall level of regional disparities and the trend towards convergence or divergence.

Income Disparities

The *Third Periodic Report* gave the following summary description of the pattern of *regional income disparities* in the Community after the enlargement to include Spain and Portugal: about half the Community population lives in

regions whose per capita incomes lie within a band of ± 15 per cent around the Community average. *Below* this band, there are some 40 regions, comprising about one quarter of the Community population. Closer examination reveals that this group is made up of *two* very unequal sub-groups. About a dozen regions, accounting for 6 per cent of the Community population, have an income gap of 15 to 25 per cent, this group being a heterogeneous one that includes a number of regions with particular problems in the northern part of the Community. Clear signs of lagging development typify the second and larger sub-group, whose incomes are more than 25 per cent below the Community average. Ireland is one of these regions. These regions comprise just under one fifth of the Community population. They are all regions on the extreme southern and western periphery of the Community, with low average population density, a young and strongly growing population and production that is still heavily geared towards agriculture. If one compares the 10 weakest with the 10 strongest regions in the Community as a whole, the disparity in incomes generated is a ratio of 1:3. There is, however, less homogeneity in recorded unemployment between these backward regions; on the one hand, there are considerable differences due to national structures and policies; on the other, there are forms of underemployment, in some cases substantial, due to agricultural structures and the lack of alternative employment.

A Composite Measure of Regional Problems

The Commission has developed a composite measure of the intensity of regional problems. This measure, known as the 'synthetic index', combines measures of a region's economic strength and its labour market situation.* From its calculation of the synthetic index for the early to mid-1980s the Commission has identified a group of regions with the highest intensity of regional problems. These are Greece, Ireland, the Mezzogiorno in Italy (excluding the Abruzzi), Portugal, Spain and Northern Ireland. A second smaller group of regions, also with relatively high levels of problem intensity was also identified. This consisted of the Abruzzi, six regions in the UK and two in Belgium. The first group of most disadvantaged regions were largely agricultural and are located on the southern and western periphery of the Community. By contrast the second group are confronted with particular industrial adjustment problems.

*In constructing the synthetic index of regional problems two measures of economic strength are used: GDP per head of population and GDP per person employed — the latter intended to indicate the productivity of the region's economy. Likewise two measures of the labour market situation are included — the first is the unemployment rate adjusted for estimated underemployment. Second, in order to include a dynamic or forward looking element, consideration is given to prospective labour force change to 1990. This indicates the job requirements of a region. The above four variables are combined using the following weights: GDP per head of population, 25 per cent; GDP per person employed, 25 per cent; unemployment adjusted for underemployment, 40 per cent; prospective labour force change till 1990, 10 per cent. Finally, in the *Third Periodic Report* the index was calculated for 1981, 1983 and 1985 and an average of these three years taken.

Trends in Regional Disparities

We have seen in Chapter 5 that from 1960 to approximately 1974 disparities between *national* levels of income (GDP) per head narrowed, but from 1975 onwards these disparities widened slightly. By and large, disparities between *regional* income levels followed a similar pattern — though the narrowing of disparities in the early period was fairly limited. The turnaround from convergence to divergence was even more marked when unemployment rates are considered.

Regional Disparities in Europe and the US

It was noted in the *Third Periodic Report* that an international comparison revealed the Community to have relatively large regional differences. Regional disparities in income are at least *twice* as wide in the Community as in the US. Regional differences in unemployment are almost *three times* as wide in the EC as in the US.

(iii) Analysis of Centrality and Peripherality

The EC Commission and the UK Department of Industry jointly sponsored research by Keeble, Owens and Thompson, of Cambridge University, into the pattern of regional development in Europe. Their report *Centrality, Peripherality, and EEC Regional Development* (1982) was designed specifically to assess “whether there exists a significant tendency towards increasing concentration of people and industry in the more central areas of the Community” and, consequently, it forms an important but by no means conclusive test of some of the arguments outlined above. In order to investigate this they were asked to answer three related questions: (1) do significant economic differences exist between the central and peripheral regions of the Community? (2) are these different categories of regions evolving differently over time? (3) how far may observable differences be explained by, or related to, relative location within the Community?

A Measure of Accessibility or Economic Potential

A central device used by Keeble, Owens and Thompson was the construction of a measure of each region's relative *accessibility to economic activity*, as it is actually located in different areas of the EC. This is done by combining data on regional incomes (as measured by GDP) with data on transport costs between a given region and other regions in the Community.* The resulting

*The standard and widely used measure of ‘economic potential’ defines the peripherality, accessibility or potential, P_i , of a given region, i , as

$$P_i = \sum_{\substack{j=1 \\ i \neq j}}^n \frac{M_j}{D_{ij}} + \frac{M_i}{D_{ii}}$$

where M_j is a measure of the volume of economic activity in region j , and D_{ij} is a measure of the distance costs between regions i and j . Examination of this formula will show that, essentially, the economic potential of a region is measured by the volume of economic activity in other regions, M_j, M_k, \dots, M_n , each weighted by the distance, D , between region i and those other regions, D_{ij} . M_i/D_{ii} incorporates the contribution of the regions *own* volume of economic activity (M_i) to its overall peripherality index (Keeble, Offord and Walker, 1986).

index of accessibility for 1977 revealed a wide disparity between the most inaccessible, or peripheral, region in the Community, Calabria, and the most accessible or central region Rheinhessen-Pfalz. Calabria's accessibility index was only 11.7 per cent of the latter's. A further ten regions — seven of them in Italy, plus Corse, Northern Ireland and Ireland — were below 20 per cent of the maximum (see Keeble, Owens, Thompson 1982b).

Comparison of the values of this accessibility index for the regions of the EC nine in 1965, 1970, 1973 and 1979 reveal a clear trend of widening disparities. The reason for this trend was quite clearly a relative concentration of economic growth during this period in the more central regions of the Community. Analysis of the period 1973 to 1977 showed a further widening of disparities — but at a slower rate than in the early 1970s. The authors say “If relative inaccessibility does inhibit economic growth and the development of more advanced sectors of economic activity in the EEC's peripheral regions, then the latter's already marked comparative disadvantage in this respect increased further in this period” (Keeble, Owens, Thompson, 1982b, p. 155).

Analysis of Central, Intermediate and Peripheral Regions

These indices of accessibility were used to classify each EC level-II region as ‘central’, ‘intermediate’ or ‘peripheral’. Regions were also classified as highly urbanised, urbanised, less urbanised and rural. These classifications were then used to investigate regional variations in economic performance and evolution within the EC in the 1970s.

Trends in growth of GDP in the 1970s showed a substantial and continuing concentration of economic activity in the central regions of the Community, relative to the periphery. However, within this general pattern, there was a clear relative urban-rural shift of GDP. Since 1970, other things being equal, the more urbanised the EC region the lower the rate of growth of economic activity, while the more rural the faster the rate of growth. The authors note that since the largest cluster of urbanised regions is to be found in the EC's centre, this finding renders the centre's above average actual GDP growth rate in the 1970s particularly noteworthy. When GDP was related to population and employment, as indicators of regional output per head, the analysis again revealed a clear trend towards widening centre periphery disparities in these years.

Subsequent research by Keeble, Offord and Walker (1986) repeated this analysis using 1983 data. This revealed that, unlike the period 1965 to 1979, between 1977 and 83 the periphery was characterised by slightly *higher* rates of GDP growth than central regions. However, notwithstanding higher growth *rates* in peripheral regions, the absolute gap in *levels* of GDP per head between peripheral and central regions *widened* appreciably during this period.

Differences in Economic Structures

These trends are related to a marked and intensifying centre-periphery difference in *regional economic structures*. After 1973 the demographic trends in the peripheral regions were markedly different than in the central regions, with substantial population growth in the former but virtually no increase in the latter (see Chapter 5 above and the Commission's *Annual Economic Report 1988-89* pp. 117-30). The economies of peripheral regions are significantly more dependent than central regions on agriculture, whereas central regions are significantly more specialised than peripheral regions on manufacturing and producer service industries. In the 1970s manufacturing employment declined in all types of regions, but the decline in the periphery's already lower manufacturing proportion was, in fact, faster than that for the centre. Manufacturing employment in all three types of regions continued to decline in the period 1977 to 1983, but in this period the periphery's rate of job loss was *less* than in the centre. When service sector employment was examined it emerged that central regions were significantly more specialised in *producer services*, while the peripheral region's service sector contains mainly *consumer services* — and these differences intensified between 1973 and 1979. Writing in 1981, Keeble, Owens and Thompson considered that these findings "indicate that the economies of the Community's central and peripheral regions are evolving differently, with a widening gap between centre and periphery in average levels of specialisation on manufacturing, producer services and consumer services".

Analysis of Employment Change

A shift-share analysis of employment change was also undertaken. This revealed that between 1973 and 1979 *total employment* in peripheral regions grew by no less than 1.5 million workers (a 5.8 percentage increase) while total employment in central regions grew by only 135,000 (a 0.4 percentage increase). This was considered surprising — all the more so because the analysis showed that the central regions did indeed possess a sectoral structure of employment which was much more biased towards growing industries and, therefore, might have been expected to do better in subsequent employment growth.

Disaggregating the periphery into Italian, French, and Northern revealed interesting differences. The Italian and French peripheries had unfavourable employment structures but nevertheless managed to increase employment — largely because of a massive increase in consumer services, specifically retailing and distributive trades, in the Italian periphery. By contrast the Northern periphery had a more favourable employment structure but, nevertheless, increased employment at a much slower rate than the Italian — though still faster than the central region.

Keeble, Owens and Thompson argued that these findings support the following interpretation. The central region's relative employment decline "would seem

to reflect not economic weakness and declining industries, but capital-labour substitution, rising labour productivity, and hence increasing efficiency and competitiveness in most sectors of economic activity". Differential employment growth in consumer services in the Italian periphery may be a response to a unique demographic situation — job creation in marginal, low-income services: "It is thus a sign of a weak rather than a strong regional economy."

Detailed analysis of variations in *manufacturing employment change* during the 1970s revealed that, within the context of overall EC decline, the highest rates of loss were recorded by peripheral regions. The intermediate regions recorded the best performance. However, there was considerable heterogeneity among the different peripheral regions. The Italian periphery sustained 20 per cent of the Community's total decline: in contrast the Northern periphery recorded a rate of job loss which was smaller even than the intermediate regions. The authors suggest that this relatively very good performance of the Northern periphery may well be related to national and regional policy.

This research confirms for the first time at a European level the existence of a marked relative urban-rural shift of manufacturing employment. Urbanised regions accounted for a disproportionate amount of job loss between 1973 and 1977.

The Structure of Manufacturing Industry

These studies also investigated changes in the structure of manufacturing industry. This revealed that in the 1970s the manufacturing structure of the Community's peripheral regions differed strikingly from that of central regions — with a marked bias towards more modern, technologically-advanced and research-intensive engineering industries in central areas, but an even more pronounced bias towards older, more traditional labour-intensive industries in the peripheral areas. Furthermore, this structural difference between central and peripheral region manufacturing intensified between 1973 and 1979.

Keeble, Owens, and Thompson considered that this evidence is consistent with the predictions of what is known as 'filter-down theory'. Townroe describes this theory as follows (Townroe, 1979, p. 147). Large urban areas are more than proportionately sources of creative entrepreneurship. Thus urban areas tend to have a concentration of fast-growing industries. But, as a given product ages, mass-production becomes possible, skill requirements fall, and consequently plants filter down the skill and wage hierarchy of urban areas from the large cities to small non-metropolitan towns. It should be noted that this hypothesis, as tested by Keeble, Owens, and Thompson, distinguishes between technologically advanced *industries* or *sectors* and traditional labour-intensive *industries*, rather than between advanced and labour-intensive *activities* within a given industry. Despite a certain similarity it is, consequently, different from,

though not inconsistent with, theories based on the new spatial division of labour.

Unemployment

Although peripheral regions showed much higher unemployment than central regions in 1973, the dramatic *growth* of unemployment within the Community has been relatively heavily concentrated in its central, not its peripheral, regions. However, for young people the opposite applies, with a much more rapid growth of youth unemployment in the periphery than in the centre. Nevertheless, throughout the 1970s, and in 1983, peripheral regions still had much higher *levels* of unemployment of all kinds — total, youth and female — than the central or intermediate regions.

Conclusions of the 1982 Study

In summary, in their 1982 report, Keeble, Owens and Thompson give the following answers to the three questions asked of them. First, “taken as a whole; the results of the Cambridge study demonstrate conclusively that the EC’s central and peripheral regions differ markedly in their economic structure, performance and evolution”. Second, the “analyses clearly suggest that in many cases, central and peripheral regional economies are *evolving* in quite different directions. Thus differences in the structure of both manufacturing (modern : traditional) and service (producer : consumer) industries are widening, not narrowing, over time, while already severe centre-periphery disparities in output per head and youth unemployment rates have intensified, not diminished, during the 1970s”*

The third question posed was: to what extent are these differences *explained by*, or related to, relative location within the Community, or are the observed differences the product of other factors, which happen by chance to yield a centre-periphery pattern of economic disparities? Their conclusion was that the variety and extent of differences seem clearly to rule out the argument that they have developed purely by chance, and are not related to systematic forces of some kind, whether national or Community-wide. Secondly, the precise nature of the differences suggest that while specific *national* factors undoubtedly do influence variations, still “relative peripherality and inaccessibility at the Community-wide level does constitute an underlying determinant of the periphery’s poor economic performance”. Two pieces of evidence are adduced in defence of this proposition. First, a very large proportion of their analyses reveal the existence not just of centre-periphery *differences*, but of a *gradient* of regional economic indicators from central,

*These findings are broadly consistent with those of historical research on the effects of free trade. Research on the impact of free trade in the mid to late nineteenth century on three ‘less developed’ countries (France, Germany and Italy) and one ‘developed’ economy (Great Britain) revealed that it coincided with *divergent* growth rates and hence to a larger gap between development levels (Bairoch, 1972).

through intermediate, to peripheral regions. Second, statistically it seems that, despite national factors, peripherality in very different parts of the EC is consistently associated with different, and nearly always relatively poorer, economic structures and performance, compared with central regions.

This led the authors to three important conclusions.

- (i) “The general conclusion from all the preceding evidence and analysis must be that the economic advantages conferred on relatively central regions of an integrated trading Community such as the EC do indeed as [our discussion of theory] hypothesised, encourage a cumulative concentration there of investment and economic activity, especially of innovative, technologically-advanced and productive activity”.
- (ii) “Even apparently adverse trends, such as poor differential employment performance and a steep rise in central region adult, though not youth, unemployment, seem likely to be associated not with central economic decline but with increasing productivity, efficiency and competitiveness”.
- (iii) In the case of peripheral regions “Even apparent relative improvements in peripheral job opportunities and female activity rates have been related in this study to growth of possibly marginal consumer services as an alternative to even higher unemployment, or to the filtering down to certain peripheral regions of older, traditional manufacturing industries whose long-term prospects are likely to be poor?”

Relative Performance of the Northern Periphery

It is of interest that Keeble, Owens and Thompson qualified this last statement somewhat. They note that when it comes to maintaining manufacturing employment, and to the structural division between modern and traditional industries within manufacturing, there are important differences *within* the periphery, which policy must recognise. Specifically, the Northern periphery succeeded better in maintaining manufacturing employment than the Southern (especially Italian) and, in their view, this suggests that national, and particularly Irish, regional policies have had some impact on the location of mobile manufacturing investment. Secondly, they note that “Ireland has made considerable strides to improve its manufacturing structure” between 1973 and 1979 — something that was found also in Scotland and Northern England. While the general observation of a more traditional industrial structure in the periphery as a whole prompted Keeble, Owens and Thompson to the view that the predictions of filter-down theory are largely confirmed, the movement towards a more modern structure in Ireland, Scotland and Northern England would seem to indicate that the slightly different theory — based on the new spatial division of labour — may be appropriate in explaining the development

of these regions.* This finding of an improved manufacturing structure — in the sense of a higher ratio of ‘modern’ to ‘traditional’ industrial sectors — should be combined with the finding of Young and Stewart, reported earlier, that foreign-owned branch plants in Ireland had the *worst* general profile of all the regions in Britain and Ireland.

Trends in the Early 1980s

The more recent research by Keeble, Offord and Walker (sponsored by the European Commission’s Directorate-General for Regional Policy) confirmed many of the results cited above. In particular the differences in population growth, dependence on agriculture, specialisation in manufacturing and specialisation in producer and consumer services all remained true in the early 1980s. However, the relative rates of *change* in some of these variables were different in the later period. Trends in total employment in the years 1979-83 reveal a clear centre-periphery gradient, with virtually no growth in employment in the centre, but 14 per cent growth in the periphery. (However, the periphery was not homogeneous in this; there was above average growth in the Italian periphery and declining employment elsewhere.) Manufacturing employment decline was slower in the periphery (-2.7 per cent) than that in the intermediate (-6.6 per cent) or central (-11 per cent) regions.

One other new trend of considerable significance emerged. Although the peripheral regions were still found to have manufacturing structures significantly biased towards traditional industries, compared with intermediate or central regions, the *direction of change* in these structures was new. Unlike the situation in the 1970s, in the 1980s central regions have recorded rapidly falling ratios of modern to traditional manufacturing industries, whereas peripheral regions have experienced increasing ratios, albeit from a very low base. In their view “both sets of EUR 10 regions are thus apparently now converging towards intermediate region values and the Community average” (Keeble, Offord and Walker, 1986).

In many respects this is the pattern of sectoral development that is predicted by the theory of the new spatial division of labour. However, analysis of the ratio of employment in ‘traditional’ *sectors* to employment in ‘modern’ *sectors* — which is what Keeble, Offord, and Walker provide — is not sufficient to test the central hypotheses of that theory, namely, that despite *sectoral uniformity* across regions there would emerge a clear *hierarchy of functions*, which would recreate regional inequality and uneven development. The general trends in manufacturing structure revealed in the later Cambridge study, when combined with the specific observation about Ireland, Scotland, and Northern England

*Keeble, Owens and Thompson explain that absence of data made it impossible for them to test this type of theory. Such a test would require a study of centre-periphery differences in manufacturing *organisation*, level of *control functions* and branch plant status. But see Perrons (1981) and (1986).

in the early study, suggest that some dispersal of manufacturing employment, perhaps along the lines of the new spatial division of labour, has been occurring.

An Alternative Interpretation of the Evidence

A very different interpretation of the evidence is adopted by Camagni and Cappellin (1982). They strongly reject the idea that the evolution of the European economy involves a cumulative divergence between centre and periphery, arguing instead that there is a “complex scenario of multiple and diverging forces operating at different spatial levels”. They interpret the divergence of *regional* income levels as resulting from the divergence of the *national* economies. In their view “the increase in disparities is not really a result of diverging employment levels or real productivity levels; rather it stems from increasing differences in exchange rates and sectoral price trends”.

They see the development of European regions as part of a general process of gradual diffusion, and argue that this process has been overlooked in theories of regional growth — most of which were elaborated in order to explain concentration rather than diffusion. Their model concentrates on the endowment of factors of production available in any given region. The fundamental explanation of the diffusion trend is “the long-term equalisation of the general *infrastructure endowment* and the quality of production factors throughout the national territories and ... the general spread of organisational, managerial and technological models”.

Where Keeble, Owens and Thompson draw attention to the divergence of income and output *levels*, despite more rapid growth *rates* in the periphery in the period 1977-83, Camagni and Cappellin stress the emergence of *sectorally* balanced development — especially in intermediate regions. Keeble, Owens and Thompson identified a *gradient* of values from central through intermediate regions to the periphery, and read this as evidence that economic *accessibility* is a determinant of regional performance; Camagni and Cappellin see the same gradient as evidence that the diffusion process spreads spatially, but gradually, in a continuous way along the main transportation and communication networks, touching contiguous areas in sequence. Such an interpretation would be untenable in the face of the increased *absolute* disparity between central and peripheral regions, were it not for their attribution of this increased inequality to differing *national* policies and performance.

Our analysis of theories of concentration and diffusion in the earlier sections of this chapter has suggested scepticism about the existence, or at least the strength, of what Camagni and Capellin call ‘natural diffusion tendencies’. Given this scepticism their interpretation would need to be supported by much more specific evidence in order to be compelling.

(iv) Conclusion

The empirical evidence cited in this section provides evidence of the extent of structural differences between the regions of the Community. It also provides evidence of the possibility of increasing disparities in incomes and unemployment and, at the same time, convergence in relative manufacturing structures. The evidence cited cannot, of course, provide confirmation of any one theory of convergence or divergence. However, our general conclusions concerning the likely regional distribution of gains from the completion of the market are not based on acceptance of any one regional theory. Rather, they are derived from a number of theoretical propositions, assessed in the light of history and current developments in the international economy. In a general sense we consider that the empirical evidence lends support to the conclusions we have reached. But it cannot be said that the regional forces at work in the Community have been definitively analysed, either here or in national or Commission reports.

7. CONCLUSION

We have seen in this chapter that there are a formidable list of reasons why advanced economic activity will tend to concentrate in certain regions. Among the factors making for concentration are economies of scale, economies of agglomeration and the division of labour, advantageous labour market characteristics, innovation leadership and external economies associated with the generation of knowledge. There are also forces for diffusion of manufacturing and other activities. Among these are the emergence of a new spatial division of labour, improvements in transport and telecommunications in peripheral regions and congestion in central regions. However, our analysis suggests that in the coming years these forces, while they will certainly be at work, will not be sufficiently strong, nor sufficiently convergence-generating, to overcome the forces for concentration.

This *general* view of regional developments is one which finds a clear echo in the specific study of European market integration. Robson says that "the formation of an economic grouping is likely to enhance the forces of polarisation at country level" (1987). Eaton considers that "the benefits of trade may not be shared symmetrically ... with the country exporting the commodities whose production involves greater scale economies typically benefitting more" (1987). Krugman tells us that while scale economies and oligopoly increase the *potential* gains from trade "they also open up some possible ways in which trade can have adverse effects" (1987b). Padoa-Schioppa, in his important study of the Community system, considers that "the spatial distribution of such gains is less certain and is unlikely to be even" (1987). Finally, and specifically on the completion of the internal market, Pelkmans and Robson say that the structural problems of the less advanced member states "will almost certainly be accentuated by an approach to fully-fledged industrial market integration" (1987).

After consideration of all the arguments our general conclusion must be that the long-run benefits of market completion are likely to be unevenly distributed — with the greatest benefits accruing to regions in which industries with economies of scale and highly innovative sectors are most prevalent. Ireland is not such a region. Consequently, completion of the internal market should not be expected to narrow the income disparities between regions in the EC, let alone bring about convergence. This is a fundamental conclusion which informs the rest of the report.

Appendix

THE 'CECCHINI REPORT' AND THE DISTRIBUTION OF GAINS FROM THE INTERNAL MARKET

1. THEORIES OF DIVERGENCE AND BALANCE

We have noted in Section 5 of this chapter that the 'Cecchini Report' presents a view of the distribution of gains from market completion which differs from that adopted by the Council in Sections 2, 3 and 4 of this chapter. The 'Cecchini Report' was an attempt to ascertain the aggregate potential gains from completion of the internal market and, as such, did not research the relative gains of different regions. Nevertheless, in its 'Summary and Conclusions' it is stated that smaller and newer member states "have proportionately the biggest opportunities for gain from market integration", and it is clearly implied that the distribution of the gains, if uneven at all, is likely to favour these regions in these states. In addition, it is said that, in general, recent theories concerning international trade cast doubt on the pessimistic idea of regional divergence and point to more balanced outcomes. It is our contention that the arguments developed in the 'Cecchini Report' to sustain these conclusions are questionable and they should be seen, therefore, as no more than assertions.

Cecchini's argument starts from the valid observation that "theories of vicious circles of divergence of regional fortunes resulting from market integration exist, but so do alternative theses that point to more balanced or indeterminate outcomes". The conflicting theories concerning the regional effects of integration are elaborated and it stated that it is the new approach to trade and integration that "points to more balanced or indeterminate outcomes". With good reason, Cecchini places greatest trust in these very interesting developments in the analysis of trade and is, by this logic, led to the conclusion reported above: namely, that the regional distribution of the gains from integration will be fairly balanced — probably favouring regions in the smaller and newer member states.

But Cecchini's elaboration of the conflicting theories concerning the effects of integration is quite misleading. It is said that the *traditional* theory of international trade predicts vicious and virtuous cycles of regional decline and growth, and that the *new* approach predicts a more even distribution of the gains from trade and integration. We will show below that this is a

misrepresentation of the traditional theory and a highly selective account of the new approach. It will emerge from that brief demonstration that almost the exact opposite conclusion is correct: namely, that it is the new approach to trade which makes the more significant allowance for the possibility of an uneven regional and national distribution of gains. If this new approach is to be embraced, as it is by Cecchini, then all its implications should be squarely faced.

2. THE TRADITIONAL THEORY OF TRADE

We have seen in our discussion of theories of integration in Chapter 2 that in the traditional theory, trade is based on each country specialising in accord with its endowment of factors of production (land, labour and capital). On the opening of trade, each country will experience a contraction of some industries and an expansion of others and this process will have redistributive effects. The Cecchini Report describes this, and then says:

In the long term, activities will disappear or will be relocated and certain regions will undergo a cumulative decline. At the same time, the expanding sectors will permit the setting up of new firms and the commitment of factors of production and resources, and the corresponding regions will enter a virtuous circle of expansion. In this way, the rich would become richer and the poor poorer (p. 139).

This is a misleading account of the costs of free trade as understood in traditional trade theory.

First, what is not said, and what is central to that theory, is that in the process of international specialisation, although some individuals will have to change from one line of activity to another, and although they may find their wage lower in this new activity, *they will not be unemployed*. The traditional theory of international trade excludes the possibility of unemployment. This should be made clear when the traditional theory is described as supporting a 'pessimistic view' (p. 139).

Second, Cecchini's statement that traditional trade theory predicts that "certain regions will undergo cumulative decline" while others "enter a virtuous circle of expansion" are very questionable. The following is a more accurate representation of the traditional theory. If, before trade, industries are regionally concentrated, which is plausible, then the opening of trade, which implies the contraction of some industries and the growth of others, will clearly have a differential regional effect. What is involved is a *once for all* reallocation of resources to the expanding industry and region. Furthermore, after that reallocation has been made, incomes in similar occupations will once again be *equal* between both regions — and, indeed, will tend to equality between countries. An *essential* part of the analytical foundation of the traditional

theory of international trade (and of orthodox economics) is that movements and reallocations of labour and capital in search of the highest return will have particular *equilibrating* effects: in this case, will tend to equalise the returns between different regions. The one thing that is categorically not predicted is *cumulative* decline or growth — for, by definition, that could arise only if the movement of labour or capital created the need for a *further movement*. This, although a distinct possibility in the real world, is ruled out by the analytical foundations of the traditional theory of trade. We know of no *general* argument in traditional trade theory which supports the conclusion that as a result of trade “the rich would become richer and the poor poorer”*

Finally, and most remarkably, the ‘Cecchini Report’ makes no reference to the *central proposition* derived from the traditional approach to international trade. In terms of the example of expanding and contracting industries used above it can be stated as follows: the additional production for exports in the expanding industries, resulting from the absorption of resources from the contracting industries, will be able to purchase, through trade, *a larger quantity of those commodities that were previously produced at home*, due to the lower relative price of these commodities under free trade. In other words, *total national real income will be larger in each country under free trade* and every individual in each country can, potentially, be made better off by opening trade. Reading the ‘Cecchini Report’ one would never guess that this is what is said by the ‘pessimistic’ traditional theory of trade. If the theory was as portrayed there, it would be a mystery why it has, for almost one hundred years, been the conceptual basis for most arguments in favour of free trade.

The method adopted in this part of the ‘Cecchini Report’ is to then draw attention to the contrast between the supposedly pessimistic view generated by the traditional trade theory and the view that emerges from alternative theories developed in the very recent past. In our view the subsequent account of what is predicted by these new theories is accurate but incomplete. As a result the contrast drawn between the two theories is quite misleading — and this conveys to the reader an inaccurate impression of the trend in economists’ thinking about the distribution of gains from integration.

3. THE NEW THEORIES OF TRADE

We have seen in Chapter 2 that the new approach to studying trade is based on allowing for the presence of economies of scale and predicts that much trade will be based on specialisation within rather than between industries. There is reason to believe that adjustment in order to specialise on particular products

*Indeed, there is a sense in which orthodox trade theory predicts that within poorer countries the rich would become poorer and the poor richer. In particular, the theory says that, under certain assumptions, trade will not only make such countries better off but will also change income distribution within them in favour of labour (see Chapter 2 above and Chichilnisky and Heal, 1986).

and activities *within* a given industry will be less disruptive than the running down of whole industries or sectors and the building up of others, which is implied in the traditional understanding of trade. Cecchini draws attention to this to suggest that future European integration will have few reallocate and redistributive effects and, consequently, concern about completion of the market may be unfounded.

One definite implication of taking account of increasing returns to scale, and the strong firms which go with them, is that the total *potential* gains from integration are greater (see Chapter 2). Gains of this sort are discussed extensively in the ‘Cecchini Report’ — and, by and large, this seems justified since there is evidence that European firms have not fully exploited economies of scale (though recall from Chapter 8 that this is the subject of some contention).

This account of the new theory is unobjectionable, so far as it goes; but it by no means exhausts the possible affects of integration as enumerated in the new literature. To see this, we may contrast Cecchini’s exclusive emphasis on the *increased* benefits of integration as identified in the new theories, with the discussion of the same question in another recent report to the Commission. In formulating his report *Efficiency, Stability and Equity: A Strategy for the Evolution of the Economic System of the European Community* Padoa-Schioppa (1987) commissioned a background paper from Professor Paul R. Krugman of the Massachusetts Institute of Technology, one of the major authors of the new theory of international trade theory (see Annex A to the Padoa-Schioppa report). In that paper Krugman says:

Unfortunately, while scale economies and oligopoly increase the *potential* gains from trade, they also open up some possible ways in which trade can have adverse effects. These negative aspects have received considerable attention recently, and thus require discussion (Krugman 1987b).

Krugman summarises the new view of the distribution of gains from trade by saying that trade based on economies of scale “probably involves less conflict of interest *within* countries and more conflict of interest *between* countries than conventional trade” (1976b). In Chapter 2, we have provided an extended explanation of the analytical arguments which underlie this statement.

Padoa-Schioppa’s own view is that “the spatial distribution of such gains is less certain and is unlikely to be even”.

The possibility of an uneven distribution of the welfare effects of trade arises mainly because a country, and conceivably a region, could experience a contraction of its increasing returns to scale industries, and an expansion of its decreasing returns industries. In Chapter 2 we explained why this is, in fact,

TAXATION AND INTEGRATION

considered a likely outcome* Industries with economies of scale will tend to concentrate in countries with larger markets, and both economies of scale and external economies can have dynamic or cumulative effects.

In summary, the new theory of trade takes account of those very features of the modern economy — increasing returns, external economies, the advantages of experience, monopoly power and the barriers to entry created by high capital and R+D requirements — which were originally used to explain regional inequality and divergence. Contrary to the impression created by the ‘Cecchini Report’ it is those new theories which include the possibility of cumulative processes of growth and decline.** There is every justification for Cecchini’s Committee drawing heavily on the new approach in identifying and estimating the *aggregate* benefits from completion of the internal market but, having done so, it behoved them to listen also to what the new theories say about the *distribution* of those gains.

1. INTRODUCTION

The creation of a single internal market was part of the original vision of the Community. This unified market was to be free of restriction on the movement of goods and of obstacles to the free movement of persons, services and capital. It also required a system to ensure that competition in the common market would not be distorted, the approximation of laws to ensure the proper functioning of the market and systems of taxation which would not interfere with the freedoms established under other headings. The measures that need to be taken to unify the internal market have been classified by the Commission under three headings:

- the removal of physical barriers
- the removal of technical barriers
- the removal of fiscal barriers.

This chapter is concerned with the removal of fiscal barriers.

In the context of international economic integration, tax harmonisation issues are usually analysed on a range of economic criteria such as resource allocation, adjustment and stabilisation, growth and distributional considerations. The resource allocation criterion has dominated tax harmonisation analysis, reflecting the emphasis of orthodox integration analysis upon improving the allocation of resources. In the case of indirect taxes, the problem is to determine the efficiency impact of tax differences on commodity trade. For direct taxes, the efficiency considerations principally concern the impact of differences in net tax burdens between countries on the international migration of factors, and the implications of this for resource allocation and the fiscal autonomy of members.

In evaluating the rationale for tax harmonisation in economic groupings, considerations other than resource allocation, stabilisation and distribution may have to be taken into account, particularly for forms of international integration that go beyond free trade areas and customs unions. The dominant “other” consideration tends to be administrative. The retention of internal fiscal barriers typically constitutes a substantial physical and psychological obstacle to intra-union trade. In Europe, the procedures used and the formalities required in connection with VAT and excises at intra-Community frontiers are complicated, cumbersome and costly. In a survey of the perceptions of industrialists in all 12 member states on the importance of the different barriers

*However, we also noted that Helpman and Krugman (1985) show that contraction of industries with economies of scale does not *necessarily* imply that a country experiences *net losses* from trade. The possibility of *net losses* from trade is *not* our concern here, or elsewhere in this report.

**Indeed, it is precisely because the new theory links the simple gains from trade with all these dynamic forces that it has been used to develop proposals for *strategic trade policy* — in marked contrast to the traditional theory which says that, in general, countries would do best with complete free trade.

to trade within the Community, frontier formalities ranked third in terms of seriousness. The top two were technical rules and standards, and administrative formalities. There were some differences within the group of industrialists with small and medium sized firms, for example, finding frontier costs more onerous than large firms.

The Commission has appealed mainly to administrative considerations in devising its proposals on indirect taxation. In order to complete the internal market, physical, technical and fiscal barriers are to be removed. The most obvious example of physical barriers are customs posts at frontiers. However, the presence of physical barriers is inextricably bound up with the technical and fiscal divisions between member states. In Section 2 of this chapter dealing with administrative issues, these links will be discussed, together with the costs associated with existing formalities and controls.

This general background leads us to an important conclusion: tax approximation is a means to an end, not an objective in its own right. Indirect taxes are to be approximated to permit the removal of fiscal frontiers — the fundamentals of tax policy are not addressed.

Returning to the criterion of resource allocation, distortions in the location of production may arise from taxes on inputs to production which vary depending on the source of the inputs or the location of production. Taxes of this type include labour and payroll taxes and taxes on company assets and profitability. Differences in the rates of these taxes within the Community are more likely to affect the location of production than are differences in indirect taxes.

The Commission has previously attempted corporation tax harmonisation. Proposals were made in 1975 when the Commission submitted to the Council of Ministers a proposal for a directive on the harmonisation of systems of corporation taxation that aimed at tax neutrality. The proposals suggested a common imputation (tax credit) system, which would have partly relieved the double taxation of dividends and would also have involved some narrowing of differences both in the rates of tax on profits (the band suggested was 45-55 per cent) and in those of the tax credit. These proposals have not made any progress despite the fact that the harmonisation of Corporation Tax was implicitly required by Article 100 of the Treaty of Rome.

The Commission, in February 1989, published proposals for the harmonisation of taxation of savings. The proposals involve a minimum 15 per cent withholding tax applicable to interest income. The measures proposed are designed to ensure that tax flows are not motivated by tax considerations following the liberalisation of capital movements. They are considered more fully in Chapter 10.

Section 2 of this chapter deals with the administrative considerations underlying the Commission's proposals. Section 3 specifies the contents of the Commission's original tax approximation proposals. Section 4 examines the likely effects of the Commission's proposals from revenue, efficiency and equity perspectives. In Section 5, the Council's position is indicated.

It should be noted that the Chapter does not attempt to examine in detail all the ramifications of indirect tax approximation for individual businesses or sectors. The approach used is based on the unification of the internal market and on tax policy considerations.

2. ADMINISTRATIVE CONSIDERATIONS

(i) Costs of Customs Frontiers

Customs procedures, involving frontier stops at internal Community borders or inland, and related administrative costs borne inland by companies and the public authorities are maintained for the following reasons:

- (i) differences in VAT rates and excise duties, which are currently applied in accordance with the 'destination principle' and thus necessitate border tax adjustments in the member state of destination*;
- (ii) application of monetary compensatory amounts;
- (iii) veterinary and plant health checks, because of differences in national public health standards;
- (iv) checks to control road transport licences and the compliance of vehicles with national regulations;
- (v) formalities carried out for statistical purposes;
- (vi) the enforcement of certain bilateral trade quota regimes.

In the 'Cecchini Report', the direct costs associated with existing formalities and controls are identified under four main headings:**

- (i) Internal administrative costs of exporting and importing firms (e.g., staff, computing, overhead costs) and the corresponding costs to consumers of higher prices. These were estimated to amount to 7.5 billion ECU. Significant differences were found between countries and between firms. Costs were found to be lowest in the Benelux, due to the existence of simplified documentation procedures within these countries. The cost burden was found to be markedly higher for smaller firms, with the cost per consignment being 30 to 45 per cent higher for firms with fewer than 250 employees than for larger firms. The report thus notes that the deterrent effect of physical barriers and the associated compliance costs is of special concern to small and medium-sized enterprises.

*Interestingly, value added tax differences on their own also ranked fifth in terms of the seriousness of the different categories of barriers.

**An additional cost is that arising from organised fraud.

- (ii) External costs borne by exporting or importing firms through services directly associated with customs clearance (customs clearing agents, etc). These were estimated to amount to 1.6 billion ECU.
- (iii) Costs to exporting and importing firms through delays of road haulage transport imposed by customs procedures resulting in an increase in both inventory and transport costs. The costs were estimated at between 0.4 and 0.8 billion ECU.
- (iv) The costs to public authorities in terms of material and human resources in maintaining customs posts and associated administrative services. These costs were estimated at 0.5 to 1.0 billion ECU.

The total direct costs of customs formalities thus amount to 8.4 to 9.3 billion ECU. There are also, of course, indirect costs of customs procedures arising from the lesser pressure of competition on the domestic economy from foreign suppliers. Market fragmentation is due not only to customs barriers but also to other barriers and is dealt with elsewhere in this report.

Since the Commission's White Paper *Completing the Internal Market* (1985) proposes eliminating frontier controls and checks in their entirety, all of the procedures stated above will have to be either eliminated or reformed in ways that do not require border formalities. In this chapter, it is the changes required in item (i) (i.e., border tax adjustments) which primarily concern us.

(ii) Border Tax Adjustments: VAT

In order to ensure that VAT does not distort location decisions within the Community, it is operated according to the Destination Principle, i.e., the tax rates imposed are those of the country where the goods are *consumed* rather than of the country in which they are *produced*. At present, this adjustment is effected through a zero rating of exports. This means that no output VAT is charged on exports and VAT paid on inputs is refunded in full. Thus, exports leave the country VAT free, and VAT is charged by reference to the tax rates of the destination country. As a result of this arrangement, all revenues from VAT accrue to the country where the goods are consumed. The purpose of border controls under this arrangement is to provide documentary evidence that the goods have actually left the country.

As an alternative to this arrangement, the Commission proposes that once frontier controls are abolished, exports should bear the *exporting* state's VAT and that the appropriate tax adjustments would be made later by the revenue authorities of the *importing* country. Under this arrangement, however, not all revenue accruing to the importing country (i.e., the country in which the consumption takes place) will be received by the importing country. In effect, the importing firm, in submitting VAT returns, will credit against its VAT payment the VAT paid at previous stages. However, the VAT paid at previous stages will have been paid to the exchequer of the exporting country, i.e., the exporting

country will owe VAT to the importing country. In general terms, this system involves a substantial revenue redistribution between member states, since member states that were net importers or which had a lower than average rate of VAT would give credit for more input VAT than they would collect on exports.

The Commission proposes to deal with this problem by instituting a VAT Clearing House which would operate a system of compensating revenue flows. Effectively, this would involve ensuring that VAT collected in the exporting member states, and deducted by the final seller/importer from his VAT payment to the exchequer in the importing country, would be reimbursed to the latter. This system would involve less need to monitor exports than in a system where exports are zero-rated.*

The major question which now arises is whether such a system could operate without uniform VAT rates and structures across the individual member states? The Commission argues that the present widely divergent rates and coverage of VAT across member states would expose the system to the risk of heavy and systematic fraud and evasion. The Commission argues that this could occur through traders in high VAT member states obtaining supplies from low rate member states and omitting them from their records, leading to a loss of tax revenue and distortion of trade.

The Commission, in its original communication on tax approximation,** indicated that the Council of Ministers for Financial Affairs (ECOFIN) requested a high level group of fiscal experts, together with representatives of the Commission, to consider the fiscal proposals outlined in the White Paper and the possible alternatives to it. This high-level group reported to the ECOFIN Council in June 1986 that the proposal would achieve the removal of formalities and fiscal controls at borders in the case of intra-Community trade and that the alternatives they had considered would fail to result in the removal of fiscal frontiers and could not, therefore, be recommended.

However, a number of tax experts have argued that the operation of VAT does not require uniformity, and that tax adjustments to goods which cross intra-Community frontiers can be made from documentary evidence even when the frontier formalities have been abolished. See, for example, Simon (1981), Cnossen (1983) and Lee, Pearson and Smith (1988).

Thus far, we have only considered VAT from the perspective of commercial traffic. It is also necessary to consider cross-border shopping by individuals. If

*The Clearing House system has been criticised on effectiveness grounds. See Lee, Pearson and Smith (1988) for a discussion of what they label 'enforcement asymmetry'.

**COM (87) 320 Final

differences in VAT rates of the magnitude which currently exist were to remain, following the removal of frontier controls, then a significant amount of cross-border shopping by individuals, to take advantage of the lower rates of VAT in some member states, would be likely.

Those who argue (as above) that VAT systems with significantly different rates can operate without border controls acknowledge that personal importation would give rise to difficulties. They argue that the solution to this problem is a matter for individual Governments and that personal importation would act as a major restraint on differences in VAT rates between member states. Some role for the Community is acknowledged in setting rate minima to prevent competitive cutting of tax rates between states.

The limited role accorded the Community in setting tax rates is based on the premise that the consequences of differential tax rates are purely domestic and that national authorities face a choice between approximating rates or accepting the revenue losses associated with having higher rates than other member states.

In regard to these counter-arguments, it should be noted that different VAT rates on their own act as a barrier to trade, in addition to the fiscal frontiers to which they give rise. In fact, VAT differences ranked fifth in terms of the seriousness of the different categories of barriers.

(iii) Border Tax Adjustments: Excise Duties

Goods are exported from member states free of duty. As with VAT, it is necessary to ensure that goods which are designated for export actually do leave the exporting country. Imports into individual member states arrive duty free and are then liable to duty at the importing country's rate. This system relies on border checks to validate the actual exports of dutiable items. With the removal of frontiers, this check disappears. The system of administrative control which is adopted for excise duties has direct implications for the feasibility of allowing member states to retain some discretion over the levels of excise duty.

The Commission proposes a system of linked bonded warehouses whereby goods could go from their place of production or from a bonded warehouse in the exporting country and, with a minimum of control, cross the frontier to a bonded warehouse in the importing country. This system is one of close monitoring and supervision of the production and movement of dutiable goods. Excise duty would be charged when the goods were taken out of bond in the country of destination. However, if there were no restrictions on the *subsequent* movement of goods, i.e., if free movement of duty free goods was permitted, there would be incentives to route goods through bonded

warehouses in low rate countries and then ship them on for consumption in high rate countries. Consequently, the revenue yield in particular member states might cease to bear much relation to the level of sales of dutiable goods within that member state. This would also be accentuated where producers choose to centralise their operations and warehousing facilities (probably in low rate countries). In the Commission's view, the system of linked bonded warehouses which it proposes would, therefore, require either *frontier controls*, to prevent movement of 'duty paid' products, or alternatively a considerable measure of *approximation of rates* of excise duty.

On top of these difficulties with commercial traffic there is, of course, the issue of *personal importation*. Because it is easy to transport tobacco and alcohol, it is likely that levels of personal importation could be high, especially since (given the divergences in rates of duty) the gains to be made could be quite considerable. Without frontier controls and with the Commission's proposed system of linked bonded warehouses, the scope for evasion, distortion of trade and personal importation with different rates is likely to be significant.

An alternative method of control exists, however, based on physical marking of the goods on which duty has been paid, using tax stamps or banderoles. This distinctive physical marking could be used to limit the retail sale of duty-paid goods to a particular market. In the same way that a tax-stamp system within national markets provides a means of ensuring that only duty-paid goods are offered for retail sale, so it would also be possible for nationally differentiated tax stamps to prevent retail sale of goods in a particular market, when duty has been paid elsewhere. This would allow the removal of border controls, permit differential duty rates to exist across the Community and ensure that duty revenues accrue to the country of retail sale.

Countries of the Community use different methods of control. The physical marking system is an element of the control system for cigarette excises in the Benelux, Denmark and West Germany and in some member states it is used for other dutiable products. Its main advantage is that it does not require close production supervision and is, therefore, appropriate where there are many small-scale producers. The alternative system of bonded warehouses, used by Ireland and the UK, is based on close monitoring and supervision of the production and movement of dutiable goods. It has been argued that tax stamps will be necessary to ensure effective enforcement of duty payment on goods produced by many small-scale producers.

In the view of the Council, this alternative system of control based on physical markings could provide an appropriate control mechanism and would require far less disruption than the proposed system.* It would also avoid some of the

*There are some further technical tax administration issues, such as compression of the post-duty stages of the production chain. These issues, however, are solvable. See, for example, Smith (1988).

major obstacles to implementation of the existing proposals and would, therefore, be likely to hasten the removal of fiscal frontiers.

This solution still leaves one problem. Tax stamps cannot prevent cross-border shopping by individuals to take advantage of duty differentials. Where the differentials were high, such shopping could be substantial, particularly in the case of easily transported products such as alcohol and tobacco. The costs of cross-border shopping are three-fold:

- (i) revenue losses suffered by high tax member states;
- (ii) loss of business and consequent adjustment forced on retailers on the high-tax side of the border;
- (iii) resource costs of individual journeys across the border to make tax savings.

The Council is concerned at the possible magnitude of these costs for Ireland. Since the extent of cross-border shopping depends on the nature of the product and on geographical factors, an option would be for the UK and Ireland, which have broadly similar excise duty structures and rates, to bring their duties sufficiently close to minimise the degree of cross-border shopping.

In summary, there are two methods by which excise duty systems are controlled — a bonded warehouse system or a physical marking system. The bonded warehouse system chosen by the Commission would permit the removal of frontier controls but would require harmonisation of duty rates across the Community. The physical marking system would also permit the removal of frontier controls and would not require rate approximation for commercial purposes. However, a degree of approximation, especially within certain geographic zones would be required because of personal importation. The choice must be governed by other factors which we consider in the following sections.

3. THE COMMISSION'S ORIGINAL PROPOSALS

In the White Paper *Completing the Internal Market* (1985), the Commission outlined the broad parameters within which it viewed the evolution of indirect tax approximation. The Commission subsequently submitted to the Council detailed proposals on the rates and rate structure of indirect taxation.* Revised proposals were issued by the Commission in May 1989. This section examines the original proposals. The revised proposals are examined in a Postscript to the Chapter.

*Completion of the Internal Market: approximation of indirect tax rates and harmonisation of indirect tax structure. Global communication from the Commission, COM (87) 320 final.

(i) Indirect Tax Approximation: VAT

A number of VAT directives have been adopted by the Council since 1967 which attempt to harmonise the structure of VAT between the member states. Consequently, most member states exempt a similar range of goods and services, such as: postal services; medical care; education; social and cultural activities; non-commercial radio and TV broadcasting; insurance, banking and other financial transactions. While there is broad similarity in basic definitions and the list of allowable exemptions, the range of tax rates varies widely across member states. Table 12.1 provides a broad outline of the structure of the VAT system in the individual countries of the Community. It can be seen from the table that the *standard rates* currently applied range from 12 per cent in Spain and Luxembourg to 25 per cent in Ireland. Most member states apply more than one rate of VAT, with some countries having up to five rates. Denmark is the only state with a single rate.

Generally, countries with multiple VAT rates apply reduced rates to various necessities such as food, public transport, books, etc., with increased rates (i.e., those above the standard rate) being applied to various 'luxury' goods. Some countries, in addition to having reduced rates, levy zero rates (a form of exemption) on a variety of goods. Table 12.1 shows the scope of the zero rate in the countries in which it is used. It is notable that Ireland and the UK are the only two countries which zero rate a wide range of items.

Table 12.1
Value Added Tax Rates in EC member states

	Reduced rates	Standard rate	Increased rate	Scope of zero rate
Belgium	1 and 6	19	25 and 25+8	Newspapers
Denmark	—	22	—	Newspapers Large ship and aircraft
France	2.1 and 4 5.5 and 7	18.6	33½	—
Germany	7	14	—	—
Greece	6	18	36	—
Ireland	2.4 and 10	25	—	Wide range of items
Italy	2 and 9	18	38	Newspapers and some minor items
Luxembourg	3 and 6	12	—	—
Netherlands	6	20	—	—
Portugal	8	16	30	Basic foods, newspapers, medicines
Spain	6	12	33	—
United Kingdom	—	15	—	Wide range of items

Rates applicable as at 1.4.1987.

Source: Commission of the European Communities, COM(87)320 and Lee, Pearson and Smith (1988).

The major issues which arise with regard to VAT approximation are:

- number of rates;
- rate levels;
- coverage of the various rates, zero rates and exemptions.

Numbers of Rates

While believing that, in principle, a VAT system with only one rate is the simplest and most effective structure, the Commission argued that in terms of practicality and acceptability (primarily, the minimisation of disruptive consequences for all member states) a multi-rate system should be adopted. Given the present VAT structures in all the Community countries, the Commission argued that the choice lies between a *two rate* and a *three rate* system. On the grounds of simplicity and cost-effectiveness a *two-rate* system was favoured by the Commission. This system would be composed of a standard rate and a reduced rate. This would, essentially, involve the abolition of the 'increased' rates in those countries in which they currently exist.

Rate Levels

As indicated earlier, the current *standard rates* range from 12 per cent to 25 per cent. In the view of the Commission this range is too large to avoid significant trade and competitive effects. The need to establish a narrow range has, however, to be set against the objective of minimising the disruptive influence on individual member states' budgets. In order to meet these conflicting objectives the Commission put forward a permitted range of between 14 per cent and 20 per cent.

The *reduced rates* currently vary from 1 per cent to 10 per cent. However, the lowest rates apply to only a few products and those with significant coverage vary from 4 per cent to 10 per cent. The Commission acknowledge that many of the items which are likely to fall under the reduced rate are at present zero rated in some countries — primarily Ireland and the UK. The Commission has suggested a permitted range of between 4 per cent and 9 per cent — but with a recommendation that member states fix their rate in the lower half of the band.

Coverage/Zero Rating

The Commission proposed that the following basic goods should be taxed at the reduced rate — subject to the comments below regarding zero rating:

- foodstuffs (with the exception of alcoholic drinks);
- energy products for heating and lighting;
- supplies of water;
- pharmaceutical products;
- books, newspapers and periodicals;
- passenger transport.

In the rates and coverage which the Commission has proposed it has not included zero rates. It argues that basic necessities should be charged at the reduced rate, as is the practice in almost all the member states.

In outlining the rationale for not making any provision for zero rating the following arguments were put forward by the Commission:

- (i) zero rating of basic necessities is a less efficient way of achieving social policy objectives than measures more closely targetted towards those in need;
- (ii) zero rating, by giving a price advantage to the products of one member state, distorts competition within the Community;
- (iii) for any given yield of revenue, zero rating in one area must inevitably lead to a higher overall rate of tax elsewhere.

The Commission acknowledged that some member states may face difficulties and recognises that some may wish to be granted derogations to meet their particular difficulties.

(ii) Indirect Tax Approximation: Excise Duties

Tobacco Products

In Table 12.2 it is shown that the total tax per packet of cigarettes ranges from 0.12 ECU in Spain to 2.76 ECU in Denmark. The Commission's proposed rates have been calculated on the basis of the Community arithmetic average, which gives equal weight to the rates applied by each member state. The proposed duty contains a specific component of 0.39 ECU per packet of 20 cigarettes (Ireland's present specific duty is 1.0 ECU per packet) and an *ad valorem* component, inclusive of VAT, of between 52 and 54 per cent of the retail selling price.

Mineral Oils

The present situation in regard to mineral oils is shown in Table 12.3. The differentials across countries on duties on petrol are significant, ranging from 0.20 ECU per litre in Spain and Luxembourg to 0.53 ECU in Italy. The Commission proposed that petrol be taxed at the arithmetic average of the present rates, i.e., 0.34 ECU. The present Irish rate of 0.38 would, therefore, require little change under the Commission's proposal.

Table 12.3 also outlines the present excise duties on diesel oil. There is a clear hierarchy of countries in terms of duties: (i) low rate countries at 0.08-0.12 ECU per litre, with Spain having an exceptionally low rate; (ii) medium rate countries at 0.18-0.20 ECU per litre and (iii) high rate countries — Ireland and UK with rates of 0.29 and 0.26 ECU per litre respectively. The Commission proposal was for a weighted average of member states' present duty rates, giving a rate of 0.18 ECU per litre.

Table 12.2
Cigarette Taxation in EC member states

	Specific excise (ECU)	Ad valorem excise (incl. VAT) (%)	Ratio of specific to total tax (%)	Total tax per packet (ECU)	Retail price (ECU)	Proportion of tax in price in price %
Belgium	0.05	66	5	0.87	1.24	70
Denmark	1.52	39	55	2.76	3.16	87
France	0.03	71	5	0.51	0.68	75
Germany	0.52	44	40	1.29	1.77	73
Greece	0.01	58	5	0.26	0.43	61
Ireland	1.00	35	53	1.88	2.54	74
Italy	0.03	69	5	0.73	1.02	72
Luxembourg	0.03	64	5	0.65	0.97	67
Netherlands	0.24	54	25	0.97	1.36	72
Portugal	0.04	63	9	0.50	0.73	69
Spain	0.01	35	12	0.12	0.31	39
United Kingdom	0.96	34	55	1.76	2.35	75
EC Commission proposal	0.39					

52 - 54

Notes: Portugal and Spain apply more than one tax regime for cigarettes.

Calculations are based on the price of a packet of 20 cigarettes in the 'most popular price category' in each member state. The brand concerned, and its pre-tax price, differ considerably from country to country.

Source: EC Excise Duty Tables.

Table 12.3
Excise Duty on Motor Fuel in EC member states

	Duty per litre 4-star petrol (ECU)	Duty per litre of diesel oil (ECU)
Belgium	0.25	0.12
Denmark	0.46	0.19
France	0.39	0.19
Germany	0.24	0.20
Greece	0.42	0.12
Ireland	0.38	0.29
Italy	0.53	0.12
Luxembourg	0.20	0.10
Netherlands	0.29	0.08
Portugal	0.41	0.18
Spain	0.20	0.03
United Kingdom	0.31	0.26
EC Commission proposal	0.34	0.18

Notes: Figures are for leaded petrol.

Duty figures exclude VAT.

Source: EC Excise Duty Tables.

Alcohol

Table 12.4 shows the present structure of excise duties on spirits, wine and beer across the Community. Again, the countries divide up into three separate groups. In the case of *spirits*, Denmark, Ireland and the United Kingdom impose the heaviest excise duties; they are followed by an intermediate group of countries with duties generally under half those of the first group. The final group with very low rates are the southern European countries. The Commission's proposal was that spirits be taxed on pure alcohol content at the arithmetic mean of member states' existing duty rates. In the case of *wine*, the member states again divide up into three groups (two if we exclude those who impose no duties on wine). At the top of the list come Ireland, Denmark and the UK (with Ireland well above the other two) followed by an intermediate group of Belgium, Luxembourg and the Netherlands. The remaining countries apply zero duty. The Commission proposed an average of existing rates as can be seen from the table. With regard to duties on *beer*, the league table of rates is led by Denmark, Ireland and the United Kingdom, with Ireland virtually in a category of its own. An intermediate group, in terms of duty levels, is composed of Belgium, Greece, Italy and the Netherlands. The remaining countries apply quite low rates of duty. The Commission also proposed an average of existing rates of member states.

Table 12.4
Excise Duty on Alcoholic Drinks in EC member states

	Spirits per bottle ECU	Still wine per litre ECU	Beer per litre ECU
Belgium	3.76	0.33	0.13
Denmark	10.50	1.57	0.71
France	3.45	0.03	0.03
Germany	3.52	0	0.07
Greece	0.14	0	0.10
Ireland	8.17	2.79	1.13
Italy	0.69	0	0.17
Luxembourg	2.53	0.13	0.06
Netherlands	3.89	0.34	0.23
Portugal	0.74	0	0.09
Spain	0.93	0	0.03
United Kingdom	7.45	1.54	0.68
EC Commission proposal	3.81	0.17	0.17

Source: EC Excise Duty Tables.

Notes: Luxembourg only taxes imported still wines. Duty levels for spirits calculated for a 0.75 litre bottle of 40% spirits. Duty for wine is calculated for an alcohol content below 12%; duty on beer is for an original gravity of 1,050 (12.5 degrees Plato). All duty rates exclude VAT.

4. THE EFFECTS OF THE COMMISSION'S ORIGINAL PROPOSALS

Given the significant differences in indirect tax structures across the Community, the implications of approximation for individual member states would be very significant. As a result of the Commission's decision to specify the target rates as averages of existing rates, the consequences for those countries who are outliers in the present structure would be especially severe. The most immediate and obvious consequence of the approximation of indirect taxation lies in the revenue field.

Income distribution issues must also be addressed, particularly those arising from changes in the structure of VAT. In more general terms, the proposals must be assessed against efficiency, equity and administrative criteria.

(i) Revenue Effects

It will be recalled from the previous section that Ireland and Denmark, together with the UK had the highest excise rates in the Community. Denmark and Ireland raise a much larger proportion of their revenue through indirect taxes. Ireland raises 44 per cent of its revenues through indirect taxation with Denmark raising 35 per cent; these figures compare with approximately 25 per

cent in the case of other countries. Indirect tax receipts as a percentage of GDP show a similar pattern, with Ireland and Denmark each absorbing 17 per cent of GDP through indirect taxes (see Table 12.5). These countries would, therefore, face significant revenue shortfalls under the Commission's proposals.

We will now examine the implications for Ireland under each tax heading. Looking first at VAT, the following broad changes are proposed:

- (i) a reduction of the 25 per cent rate to somewhere in the range 14-20 per cent, i.e., the *standard rate*;
- (ii) the movement of items currently zero rated into the *reduced rate* range of 4-9 per cent or in some cases into the standard range;
- (iii) the movement of some items currently on the 10 per cent rate to the proposed *standard rate* (14-20 per cent). Some would move to the reduced rate;
- (iv) the imposition of either the standard or reduced rate on activities transitionally exempt from VAT.

Table 12.6 presents these changes in a succinct form. Table 12.7 shows the distribution of expenditure across the existing VAT rates and the distribution which would result from the harmonisation proposals. Of particular note from this table is the high proportion of expenditure subject to the zero rate. Under the harmonisation proposals, over two thirds of the VAT-able base would be subject to the standard VAT rate of between 14 per cent and 20 per cent.

The changes proposed would affect VAT receipts in different ways. For example, the reduction of the 25 per cent rate (which covers 44 per cent of expenditure) to the 14-20 per cent range would reduce revenue while the other changes itemised as (ii), (iii) and (iv) above would increase revenue. However,

Table 12.5
Indirect Taxes in the Public Finances of EC Member States (1984)

	Indirect Taxes as % of total tax receipts	of which:			Indirect taxes as % of GDP
		VAT	Excises	Other	
Belgium	23	15.5	4.7	2.8	11
Denmark	35	20.9	6.7	7.4	17
France	28	19.4	4.9	3.7	13
West Germany	26	16.6	6.8	2.6	10
Ireland	44	21.5	16.5	6.0	17
Italy	25	14.8	6.9	3.3	9
Netherlands	24	15.7	4.5	3.8	11
UK	29	14.5	11.2	3.3	11

Source: Lee, Pearson and Smith (1988).

Table 12.6
Irish VAT System: VAT Categories

Existing categories		Post-harmonisation ¹	
(1) Zero	Basic food, children's clothing and footwear, oral medicines, books, medical aids	<i>Low rate (4%-9%)</i>	Food (all) pharmaceuticals, energy products for heat and light, water supplies, publications, passenger transport
(2) 5%	Electricity		
(3) 10%	Building, personal services, tourist services, adult clothing and footwear, newspapers, non-road fuels	<i>Standard Rate (14%-20%)</i>	All other taxable goods and services at (1)-(5) opposite
(4) 25%	Confectionery, non-oral medicines, magazines, drinks, petrol, cars, electrical goods, household durables and other goods and services		
(5) Taxable activities transitionally exempt from VAT in Ireland	Telecommunications, undertakers, travel agents, vets, sports admissions, horses and greyhounds, water suppliers		

¹Mandatory exemptions unaffected by proposals: Health and education services, cultural activities, public broadcasting, banking and insurance.

Table 12.7
Percentage of Total VAT-able Base Under each Tax Rate (1987)

Existing Categories		Post Harmonisation	
Zero	24%		
10%	27%	4% — 9%	32%
25%	44%	14% — 20%	68%
Transitionally exempt	5%		

there are complicating factors which need to be considered. Once we have considered the possible effects on the excise side we will look at these factors.

It will be recalled from Table 12.2 that in respect of tobacco, the specific excise would fall from 1.0 ECU to 0.39 ECU under the Commission's proposals, with the *ad valorem* component rising from 35 per cent to 52-54 per cent.

In the case of alcoholic drinks, the following would be the duty changes:

	Current	Proposed
Spirits per bottle	8.17 ECU	3.81 ECU
Wine per litre	2.79 „	1.54 „
Beer per litre	1.13 „	0.17 „

In the case of excise duties on motor fuel, the following would be the duty changes:

	Current	Proposed
Per litre of petrol	0.38 ECU	0.34 ECU
Per litre of diesel oil	0.29 „	0.18 „

These changes in VAT and excise duty rates would set up a complex pattern of adjustment, the effects of which are difficult to predict. Estimates of revenue changes must take into account a number of factors. Since changes in the rates of tax will feed through into changes in the prices at which the various goods and services are sold, they will affect the amount which consumers choose to spend on the various goods and services. Government revenues are thus affected in two ways: a reduction in revenues from each unit sold, because of a reduction in tax rates, and an increase in revenues because of the increased sales. The net effects of these changes is an empirical question. It requires, first, an assessment of the extent to which tax changes are reflected in price changes; this is crucially dependent on the strength of competition in the relevant market. Secondly, it depends upon the responsiveness of demand to price changes (i.e., the price elasticity of demand).

An additional consideration relates to the overall macroeconomic effects. Given a significant revenue loss to the exchequer, a comprehensive assessment would require some assumptions regarding the reaction of taxpayers to the windfall and/or the efforts of Government to raise the revenue through other means. Finally, it would be necessary to take into account any changes which would occur in cross-border trade as a result of the price changes. These could be quite significant in Ireland's case.

An attempt to evaluate the public revenue effects of fiscal harmonisation has been undertaken for Ireland by Thom.* The value of his approach is that it includes a comprehensive assessment of potential revenue changes. The approach involves relating the consumption of each good or service to a set of consumer prices and real incomes. In this way, changes in the consumption of individual products can be related not only to their own price but also to the prices of substitute or complementary products.

*The Revenue Implications of Tax Harmonisation; Report prepared for the European League for Economic Co-operation.

The overall estimate which Thom arrives at is a revenue loss, based on 1985 tax rates and data, of £217m if a reduced rate of VAT of 9 per cent is applied, i.e., if Government decides to apply the reduced rates at the top of the range. If a 4 per cent reduced VAT rate is assumed the estimated revenue loss rises to approximately £350m.* Any results of this sort must be treated with great caution. Indeed, Thom does this in his paper when he argues that, given the magnitude of some of the price changes, a minor modification of the elasticities could result in significant changes to the revenue projections. Thom also acknowledges that the data relate to personal expenditure only and exclude revenue from business expenditures on items such as petrol.

There are a number of other points which need to be made when considering his revenue estimates. *First*, he assumes that rents will be chargeable to VAT after harmonisation, which is not so. *Secondly*, he assumes that the top rate of the Commission's standard VAT proposals is 19 per cent and thus builds into his conclusions a tax loss resulting from a fall of four percentage points (from 23 per cent to 19 per cent). The actual loss is a five point loss (from 25 per cent to 20 per cent). In total, there is an underestimate of the loss of approximately £100m. These estimates are crude since such changes would work all their way through the model. Adding this £100m to the figure of £217m given above, yields a revenue loss of £317m.

It has been estimated by the Department of Finance/Revenue Commissioners that the implementation of the Commission's proposals as they stand would result in an annual revenue loss of £350m, with an additional loss of £120m in year one arising from the abolition of VAT at the point of entry. It is understood that this official study had as its working assumptions that the proposed standard VAT rate would apply at 20 per cent and the proposed reduced rate of VAT would apply at 9 per cent. It was also assumed that all other changes as per the Commission's proposals would be implemented. The tax loss was calculated in terms of 1987 tax rates and structures.

The first step in the estimation process was to calculate the tax changes which would occur without any adjustment for changed consumption patterns. As shown in Table 12.8 below, a loss of £619m would be sustained on excises while a gain of £110m would accrue from VAT. Adjusting for consumption changes, the gain from VAT falls to £88m while the losses from excises fall to £570m. The net effect of the changes in VAT and excises is a revenue loss of £481m. However, this is not the end of the adjustment process — the relative price of overall consumption will have changed, thus setting up an adjustment between consumption and saving, again feeding into Government revenues. The precise figure to use in the exercise at this stage could be derived from a number of different approaches. The Department of Finance/Revenue Commissioners

*These figures are based on the results from Thom's unrestricted model.

Table 12.8
Estimates of Revenue Effects of Indirect Tax Approximation

	VAT (Gain +, loss -) £ million	Excise	Total
(i) Gain/loss before consumption effects	+109.9	-618.6	-508.7
(ii) Gain/loss after consumption effects	+88.0	-569.3	-481.3
(iii) Additional tax yield from additional spending power	N/A	N/A	+161.0
- Overall indirect tax loss ((ii) + (iii))	—	—	320.0

estimate that this further process will yield £161m, thus reducing the overall tax loss to £320m. This clawback is quite large in relation to the interim loss.

An overall warning must be inserted at this juncture and it is vital that it is understood.

Econometric models and the elasticity estimates which they contain are not developed to cope with huge structural changes or major variable shifts as the Department of Finance/Revenue Commissioners recognise. The resulting estimates must, therefore, be treated with extreme caution.

The above calculations assume that the revenue shortfall is made up by borrowing rather than by cuts in public expenditure or increases in taxation elsewhere. This assumption adds a further £30m to the revenue loss figure of £320m indicated above, to fund the additional borrowing required.

Neither has the exercise taken into account the effects of approximation on cross-border trade and its consequential revenue effects. The magnitude of this effect will be influenced by the present 48-hour rule in regard to traveller's allowances. In addition, there would be a once off net loss to the exchequer of £120m due to the abolition of VAT at the point of entry. This would be as a result of the proposal that sales and purchases across Community frontiers be treated in the same way as VAT within member states. Finally, there would be an exchequer cost arising from any compensation for adverse income distribution effects which may be considered desirable. This issue is taken up in a later sub-section.

(ii) Efficiency and Equity Dimensions

In this section, we assess the efficiency, equity and administrative aspects of the

proposals. To do this, we have to consider the rationale for the existing structure of the tax system, and then examine the proposals in the light of this rationale. In the levying of any tax, one of the primary considerations is efficiency. Efficiency in a narrow sense is taken to imply that the tax should not change the allocation of resources in the economy from that which would be optimal. Efficiency in the context of indirect taxation requires that such taxes should be set so as to minimise the distortion of consumer choice involved; in other words, the revenue should be derived without diverting tax-payers into less preferred patterns of consumption in their attempts to avoid tax.

Departures from a system of uniform commodity taxation are frequently engaged in for income distribution purposes. Advocates of non-uniform commodity taxes point to changes in the commodity composition of expenditure as income changes, and argue that indirect taxes can be used to influence distribution by imposing different tax rates on different commodities. For example, lower tax rates are suggested for those goods consumed disproportionately by lower income groups and *vice versa* for high income groups. However, this argument ignores the issues of the incidence of taxation and gives rise to disincentive effects by departing from uniformity.

While acknowledging the validity of the distributive objective in the above argument, the relevant question is whether there are alternative means of achieving the same distributional outcome without the undesirable consequences. In the Council's view, the answer is yes; adjustments to income tax and social welfare can achieve such results more sensitively and efficiently.

The administrative arguments against many different rates of indirect taxation are substantial. In order to exploit differences in demand elasticities and in the distributional characteristics of the goods, a detailed commodity classification would be required. These distinctions can frequently give rise to administrative nonsense. In general terms, therefore, there are few advantages and many disadvantages to be obtained by departures from a general principle of uniformity in commodity taxation.

This conclusion is supported by a number of related recent evaluations of indirect taxation. In order to evaluate the desirability of introducing the Value Added Tax to the United States, the Brookings Institute convened an international conference to examine the experience of six European countries with the value-added tax and to draw lessons from that experience for the United States. Consideration of the European experience yielded the view:

that the use of multiple rates and especially of exemptions, complicates administration and compliance and distorts consumption in ways that are unlikely to promote economic efficiency . . . these disadvantages outweighed any gains from reduced regressivity . . . distributional objectives should be

sought with other instruments, notably income taxes and direct transfers (Aaron, 1981, page 9).

The central lesson of the European experience is that multiple rates can be used to eliminate:

the regressivity of the value-added tax, but the penalties in administrative complexity, increased compliance costs and distortions in consumption decisions have been high and probably unjustified . . . it would be preferable to use other taxes and transfer payments to alleviate the undesirable distributional consequences generated by a value-added tax imposed at uniform rates (Aaron, 1981, page 16).

In a recent article on the problems and possibilities of extending the VAT base in the UK, the reason for the existing very limited base of VAT was queried. It was shown that the most important reason given for this limitation is an argument based on the distributional effects of the tax. It was also shown that: an extension of the VAT base, combined with substantial increases in income tax thresholds and in social security benefits would actually achieve these objectives more effectively. Such a package would, moreover, facilitate the administration of both income tax and VAT and reduce economic costs and distortions (Davis and Kay 1985, page 14).

Finally, the Commission on Taxation, in its report on Indirect Taxation stated: We conclude that the objective should be to levy a general value-added tax at a single rate. There are clear administrative advantages to be obtained from reducing the number of different rates of value-added tax and by having one rate applied to all goods and services. The proposed new structure would be simpler and more efficient. We believe that an active social policy of granting welfare benefits to people really in need of them would be more effective in achieving redistribution than the use of an indiscriminate instrument like zero-rating. The total system would, therefore, be more equitable (page 87).

While the argument above has led to a general conclusion that all commodities should be taxed in the same way, there are some arguments for special taxes or subsidies on particular commodities. These arguments revolve around the concept of "externalities". This arises when consumption of a product gives rise to costs that are not covered by the market price of a product. For example, typical arguments in favour of excise taxes on alcohol and tobacco are that they lead to increased health care costs which are not reflected in their price and are, therefore, not borne by consumers of these products. The Commission on Taxation, in its *Third Report*, identified costs associated with alcohol abuse, ranging from the loss in total production, absenteeism and death to the commitment of resources in the health care sector (page 112). Similar considerations arise for tobacco (page 126). In the case of excise taxes on transport,

through mineral oils, motor vehicles, etc., the rationale can also be on efficiency grounds; to offset costs imposed on the community by pollution, traffic congestion, etc.; or to act as a substitute for benefit or user charges such as covering the depreciation of roads.

While there are strong efficiency arguments for the imposition of excises on specific goods, in that they charge the consumer for the costs imposed on society by the consumption of the product, it is very difficult to quantify such net social costs. It is, therefore, equally difficult to ascertain the appropriate imposition on the product to correct for this failure. In addition, the reasons for such heavy excise impositions may have more to do with the fact that these forms of consumption are regarded by some as undesirable and that it is, therefore, more acceptable to raise revenue in this way. They are also very large revenue generators, because of their inelastic demand.* In addition, the revenue from excises is relatively easily collected.

In summary; (i) while different rates of VAT are frequently used to achieve distribution objectives, they entail an efficiency loss; (ii) adjustments to income tax and social welfare can achieve these distributional objectives more sensitively; (iii) there are strong efficiency arguments for the imposition of excise duties.

(iii) Income Distribution Effects

The arguments of principle regarding the redistributive role of VAT were considered in the previous section. It was concluded that modification of the VAT system is not a suitable mechanism for pursuing equity goals — for both efficiency and distributional reasons. This general argument about the redistributive effectiveness of VAT is supported by the NESCS recent research.

In its recent report, *Redistribution Through State Social Expenditure in the Republic of Ireland, 1973-1980*, the Council adopted a broad approach to redistribution and evaluated the relative effectiveness of cash benefits, direct taxes, indirect taxes and non-cash benefits as instruments of redistribution.** All of these instruments contribute to redistribution of resources between households, but cash benefits are considerably more efficient at redistribution than direct taxation, indirect taxation or non-cash benefits. (Details of this analysis are given in the Appendix.) Indirect taxes are, therefore, an inappropriate vehicle with which to pursue equity objectives in the overall system of taxation and public expenditure.

*The very fact of their inelastic demand is sometimes put forward as a justification for placing excise duties on these items on the grounds that the resulting changes in the pattern of consumption are less.

**NESCS, Report No. 85, *Redistribution Through State Social Expenditure in the Republic of Ireland 1973-1980*, Government Publications, Stationery Office, Dublin, 1988.

In the context of this analysis it is necessary, therefore, to examine the specific VAT harmonisation proposals, and the impact they may have on households' purchasing power, and to consider the policy implications which arise. The discussion of these issues is necessarily very tentative in view of the very limited data available.* However, it is possible to offer an analysis of the issues involved and to identify possible policy responses.

VAT and Redistribution

The redistribution issue arises from two related characteristics of the VAT system — the overall narrowness of the existing VAT base, and the proposed inclusion in the post-harmonisation regime of items which, at present, may be disproportionately consumed by low income households. An indication of the narrowness of the current VAT base can be gleaned from Table 12.9 which classifies the average expenditure of all households according to VAT categories. Almost a third of households' spending is zero rated; the largest single zero rating applies to food which comprises 27.7 per cent of all expenditure. Smaller proportions of expenditure are either mandatorily exempt (and, therefore, unaffected) or transitionally exempt (2.8 per cent). For any given level of revenue, therefore, a correspondingly higher VAT rate is required, given the extensive range of expenditure which is either exempt or zero rated.**

The item of particular interest is food — the largest item of expenditure in households, at 27.7 per cent. In Table 12.10, the percentage of expenditure spent on food is classified by income (gross weekly household) and, in the lower panel of the table, by type of household. The variation revealed in this table is not very great. Considering income first, the highest proportion is 39.5 per cent and the lowest 23.2 per cent; the expected positive relationship between income and food expenditure exists, but the slope of the relationship may not be very steep. The same pattern emerges across different types of households: some variation but not very great; there is some evidence that households with children allocate more expenditure to food, 30.5 per cent where there are 2 adults and 4 or more children.

Ideally, the analysis of food expenditure should be based on a detailed cross classification of income by type of household. Such details are not available, and a very composite classification system must be used, as in Table 12.11. These figures indicate that it may be the combination of income and type of household which is more closely correlated with expenditure patterns. The lowest allocation to food, 18.7 per cent, is among higher income, adult only

*We are drawing on the Household Budget Survey, the latest available edition of which contains data for 1980.

**The difference between 'exempt' and 'zero rated' should be noted. Exempt means that VAT is not charged to a good or service and tax on inputs is not recoverable. Zero rating means the application of a zero rate to a good or service which permits the recovery of tax imposed on inputs.

Table 12.9
Average Household Consumer Spending in 1980, Classified by VAT Status

VAT Current Rates	£ weekly	%	Post Harmonisation VAT Status	
<i>Zero</i>				
Food	35.33	27.7	Low VAT Rate (4% - 9%)	
Electricity	2.81	2.2		
Children's Clothing & Footwear	2.13	1.7		
Oral Medicines	0.75	0.6		
Books	0.48	0.4		
Medical Aids	0.22	0.2		
Sub Total (i)	41.72	32.8		
<i>10% VAT</i>				
Building			Standard VAT Rate (14% - 20%)	
Personal Services	1.77	1.4		
Tourist Services	0.46	0.4		
Adult Clothing & Footwear	9.21	7.2		
Newspapers	1.14	0.8		
Non-Road Fuels	5.03	3.9		
Car Servicing/Repairs	2.21	1.7		
Sub Total (ii)	19.82	15.4		
<i>25% VAT</i>				
Confectionery	1.55	1.2	Standard VAT Rate (14% - 20%)	
Magazines	0.27	0.2		
Petrol and Motor Oil	6.59	5.2		
Cars and Vehicles	6.62	5.2		
Electrical and Household Durable and Non-Durable Goods	9.46	7.4		
Miscellaneous, Records, Photos, Stationery, etc.	1.24	1.0		
Drinks/Tobacco	9.19	7.2		
Sub Total (iii)	34.92	27.4		
<i>Mandatory Exemptions</i>				
Health and Education Services	1.98	1.6		No Change
Banking/Insurance, etc.	4.81	3.8		
Licences, etc.	0.51	0.4		
Sub Total (iv)	7.30	5.8		
<i>Transitionally Exempt</i>				
Telecommunications	0.97	0.8	Standard VAT Rate (14% - 20%)	
Water Charges	0.05			
Travel	1.28	1.0		
Sports Admissions	0.31	0.2		
Betting	0.87	0.7		
Sub Total (v)	3.48	2.8		
<i>Balance of Expenditure</i>				
Expenditure Abroad	2.51	2.0		
Contributions to Clubs, Charities	2.98	2.3		
Other Expenditure	1.23	1.0		
Residual	13.54	10.6		
Total	127.51	100.0		

Source: Household Budget Survey, 1980, Volume 2.

Notes: Columns may not add exactly due to rounding errors. The 'residual' category includes expenditure which could not be re-classified from HBS classifications into VAT classifications.

Table 12.10
Percentage of Household Expenditure Spent on Food, Classified by Range of Gross Household Income and Type of Household

Income Range	Food Expenditure	Average Disposable Income	Average Household Size
	%	£	No.
Under £20	34.03	11.51	2.0
£20-£30	39.51	24.29	1.4
£30-£40	38.57	37.74	2.1
£40-£60	36.22	47.78	2.7
£60-£80	32.26	65.53	3.6
£80-£90	32.19	77.0	3.7
£90-£100	29.42	84.0	3.7
£100-£120	29.58	95.82	4.1
£120-£140	27.03	111.57	4.3
£140-£170	27.64	130.21	4.3
£170-£200	24.31	150.51	4.5
£200-£230	23.70	173.79	4.7
£230 and over	23.17	258.78	5.2
ALL	27.70	106.45	3.7
<i>Type of Household</i>			
1 adult	24.5	45.01	1.0
2 adults	27.0	82.38	2.0
2 adults, 2 children	23.0	102.71	3.0
2 adults, 3 children	27.2	114.76	5.0
2 adults, 4 or more children	30.5	112.47	6.7
3 adults	27.2	112.46	3.0
3 adults with children	29.9	120.92	5.5
4 adults	26.3	159.92	4.0
4 adults with children	30.9	137.79	6.4
Other households without children	27.0	215.58	5.6
Other households with children	30.5	176.11	7.3
ALL	27.7	106.45	3.7

Source: Household Budget Survey 1980, Central Statistics Office.

households; an impression of proportionately higher food expenditure among households with children emerges from the figures: Other households with children in the lowest income ranges spend over 38 per cent on food, and standard nuclear families about 35 per cent where they are in the lowest income category. Further support for this impression is contained in the Commission on Taxation's analysis of the patterns of expenditure. In this analysis, households were classified by expenditure, their expenditure was adjusted for household size and composition using equivalence scales and the households were then categorised into deciles of (adjusted) expenditure on zero-rated food items. These data, adjusted for family size and composition, show a clear relationship between total expenditure and the proportion allocated to food: those with low total expenditures spend a higher proportion on food.*

*Third Report of the Commission on Taxation, *op. cit.*, page 223 and Table 9.1.

Table 12.11
Per Cent of Expenditure Spent on Food by Household Type and Gross Household Income

	% of Expenditure spent on Food %	Disposal Income £ weekly	Average total persons No.
<i>One or Two Adults</i>			
Gross Household Income			
Under £60	37.9	32.47	1.431
£60 and under £100	25.3	69.48	1.615
£100 and under £150	22.6	99.33	1.683
£150 and over	18.7	168.08	1.837
<i>Two Adults with Children</i>			
Gross Household Income			
Under £60	34.5	38.63	4.610
£60 and under £100	31.3	74.71	4.579
£100 and under £150	27.3	104.54	4.610
£150 and over	22.2	180.90	4.647
<i>Other Households Without Children</i>			
Gross Household Income			
£60 and under £100	33.6	40.72	3.215
£100 and under £150	36.3	74.59	3.415
£150 and over	30.1	113.55	3.615
	24.0	211.69	4.272
<i>Other Households With Children</i>			
Gross Household Income			
Under £60	38.3	35.85	4.872
£60 and under £100	38.6	76.41	6.050
£100 and under £150	33.3	114.39	6.451
£150 and over	27.5	206.01	6.811

Source: Household Budget Survey 1980, volume 2.

Effects of Proposed VAT Changes on Households

Given the very limited data available it is not possible to offer accurate, representative estimates of the impact of the proposals on households. Illustrative assessments are offered here, not to suggest results, but to indicate the complexity of the issues involved and the scale of analysis required to examine the issues thoroughly.

An overall impression of the price impact can be tentatively outlined using the expenditure distribution in Table 12.9. Table 12.12 summarises the procedure and the results.

The average household, it is estimated, may have a price effect of around 4 per cent. This result is based on some simplifying assumptions. It is assumed that expenditure patterns are unchanged since 1980 (a period of relative price and income changes) and that VAT changes are fully reflected in retail prices. Further, it should be noted that no account is taken of the effects of changes

Table 12.12
Outline of Price Effects of VAT Proposals on "Average Household"

VAT category	% of expenditure	VAT change (assumed)	Price Impact	Weighted effect %
Zero rated	32.8%	Zero to 9%	+ 9%	+ 2.95
10%	15.4%	10% to 20%	+ 9.09%	+ 1.40
25%	27.4%	25% to 20%	- 4.0%	- 1.09
Transitionally exempt	2.9%	Zero to 20%	+ 20%	+ 0.58
Total effect				3.84

Note: The price change is weighted by the proportion spent on that category in 1980.

in excise duties. These assumptions may result in an overstatement of the price increases.

A second illustration for low income households is given below in Table 12.13. This table is derived from detailed HBS figures (not given) for expenditure patterns on the second lowest range of gross household income in 1980 (the data for the lowest range may be unreliable).

Table 12.13 — subject to the same qualifications and difficulties as apply to Table 12.12 — suggests an overall price impact of over 5 per cent. This higher effect derives largely from the greater proportionate expenditure of such households on zero rated items. In this table, the figure is 43.3 per cent, compared with 32.8 per cent for the "average household" in Table 12.13.

Finally, in relation to these estimates, their limitations should be borne in mind. In particular, if the spending patterns of households has shifted very significantly then the weights attributable to price changes for various categories of expenditure would be different to those applied in the tables, and the measured price changes would, accordingly, be different.

VAT Harmonisation: Compensatory Measures

The analysis above suggests that the tax harmonisation measures will result in a small decline in households' purchasing power. Lower income households are likely to have greater declines. A number of general options to address this issue are outlined below and their relative merits are examined.

Table 12.13
Outline of Price Effects of VAT Proposals on "Low Income" Households

VAT category	% of expenditure	VAT change (assumed)	Price Impact	Weighted effect %
Zero rated	43.3%	Zero to 9%	+ 9%	+ 3.9
10%	20.4%	10% to 20%	+ 9.1%	+ 1.9
25%	23.6%	25% to 20%	- 4.0%	- 0.9
Transitionally exempt	1.3%	Zero to 20%	+ 20%	+ 0.3
Total effect				5.2

(i) Retain zero ratings and exemptions: This option would be based on the argument that because of the differential impact on households of the zero-to-low rate proposal, food (or all currently zero-rated items), should remain zero rated, or should be levied at the lowest possible VAT Rate (4 per cent, for example). The general argument regarding the use of VAT, as against other mechanisms of redistribution, apply here. Exemptions/lower rates of VAT are not an efficient mechanism of redistribution in the context of the total tax and public expenditure system.

The point can be further developed if one variant of this option is considered — the continuation of zero rating on food. It is accepted that low income households spend higher fractions of their income on food, but excluding food from the VAT base also benefits higher income households. For example, in 1980, if households in the two *lowest* income ranges are considered, they comprise 10.8 per cent of all households, and account for only 4.8 per cent of all personal expenditure on food. In contrast, households in the two highest income brackets comprise 18.3 per cent of households and purchase 26.6 per cent of all food.* The benefits of zero rating, therefore, accrue to high as well as low income households.

(ii) Overall Increases in Social Welfare Payments: This option has the significant advantage of administrative convenience, but there are difficulties. First, this option is based on the premise that low incomes are social welfare incomes, and this identity may not, in fact, be true. There is significant variation in the payments: some recipients — especially among long term and pensioner recipients — have other incomes.** The point can be put another way: the ESRI research study on poverty used three relative poverty lines — 40 per cent, 50 per cent and 60 per cent of mean disposable income (per capita equivalent); some social welfare payments are above the highest line, and others are at a level below the 40 per cent line. The definition and measurement of poverty is, of course, a matter of some controversy, but whatever reasonable definition might be applied it would result in some social welfare recipients being above and some below the poverty line.

Secondly, analysis of expenditure patterns reveals a horizontal or household type dimension to the variation in spending patterns and needs. Therefore, a generalised approach which distributes compensation across all household types without any differentiation according to need, may be somewhat inequitable.

*In a similar analysis of expenditure patterns the Commission on Taxation pointed out that: . . . "expenditure on zero rated food items rises in absolute terms as total expenditure increases, so that the richest category of households spends almost twice as much on food as the poorest category, even though the poorest category spends a greater proportion of their total expenditure on food". (Third Report of the Commission on Taxation, page 223).

**See *Report of the Commission on Social Welfare*, 1986.

Thirdly, not all those on low incomes are in the social welfare net — some, in fact, are employees. The ESRI study revealed that if the highest relative poverty line is adopted (60 per cent of mean disposable income), 17.0 per cent of poor households are headed by employees in work.* (The corresponding figure for a 50 per cent poverty line is 13.2 per cent.) Some of those significantly affected by the VAT changes are, therefore, low paid employees — and they may, in fact, be in the income tax net (evidence on this is not yet available).

In the light of these comments, it is clear that a generalised small increase in social welfare may be an inappropriate response. It may be insufficiently focussed in relation to needs and resources and may also be unnecessarily costly.

(iii) A More Varied Approach: implicit in the critiques of the approach above is the argument that tax/benefit compensations be structured on the basis of dependency and planned to include low income households outside of the social welfare net, as well as inside it.

If the dependency/household point is considered first, then the channels of income support in respect of children should be noted. Three cash benefit channels currently exist — Family Income Supplement for low paid employees, Child Benefit for all families, and Child Dependent Additions for social welfare recipients. Each payment caters to a different population and to populations of very varying size. If Child Benefit were increased it would benefit *all* families (whether in work or not, whether dependent on social welfare or not, whether one or two parent families). This course is potentially expensive but one important development is the diminishing size of the child population: the costs of such a policy are declining as the child population falls. The child dependency ratio (0-14 years olds/15-64 years olds) is projected to decline from 0.481 in 1986 to 0.380 in 1996 and 0.344 in 2001.**

Family Income Supplement caters *only* to low paid employees with families — 5,532 families were beneficiaries at end 1987. If low paid employees are affected by the proposed VAT changes, the FIS scheme offers a potential route to those employees both with families and on low pay. There are two points to be recalled about FIS, however. First, because its remit is limited to low paid employees with families, it cannot be used as a general mechanism for dealing with all low income families and, secondly, the experience with FIS to date is that there is a low 'take up' of the scheme among the eligible population.***

*See T. Callan and B. Nolan, *Family Poverty in Ireland: A Survey Based Analysis*, in *Poverty and Family Income Policy*, C.M.R.S., Dublin, 1988.

**CSO, *Population and Labour Force Projects*, 1991-2011, CSO, 1989.

***John Blackwell, 'Family Income Support: Policy Options', in *Poverty and Family Income Policy*, CMRS, Dublin, 1988.

Child Dependent Additions are paid in respect of 470,000 children — 58 per cent are children of unemployed social welfare recipients. An argument in favour of directing resources here is that (on a per capita equivalent basis) unemployed people with families are at the lower end of the social welfare scale. One difficulty, however, is that CDAs could begin to incorporate disincentive effects if they are increased relative to the child supports received by those in work (this effect would arise in particular with large families).

In evaluating the relative merits of these cash payment mechanisms to families, consideration must be given to costs, labour market incentives and effectiveness in identifying relative needs. The Child Benefit route is potentially more expensive, but less so as time passes, and is also neutral as between employees/non-employees. Furthermore, internal restructuring could enhance its impact as an agent of life cycle redistribution (extra payments for older children, different treatment of family size, for example).

The other general question concerns low income households outside of the social welfare net. A clear implication of the ESRI's findings is that, depending precisely on definitions of poverty/low income, some of the poor are employed (or self employed). Modifications to the income tax system suggest themselves as mechanisms of 'compensation'. No specific suggestion in this area is made or implied here, but one general point should be noted. Careful consideration would need to be given to the *precise* income tax changes which would benefit the prospective 'losers': the relative merits of options such as changes in tax allowances, changes in tax rates, or alterations in tax bands would require quantification. More significant changes such as tax credits should also be assessed.

Policy Proposals

It is not possible at present to quantify precisely the impact on households of the proposed VAT changes. This is because the conversion of HBS data to VAT categories is crude and the HBS data only refer to 1980. We have, however, provided a framework for addressing the main issues. We have also outlined a variety of possible compensating responses. The thrust of the analysis is that a 'mechanical' approach to the issue is inappropriate; a more thorough identification of the low income 'losers', and a correspondingly more targeted and equitable set of measures is necessary. The main conclusion, therefore, is that detailed analysis of the incomes and expenditure patterns of households based on the 1987 data should be undertaken. At this stage, however, a number of general proposals can be made regarding compensatory measures.

First, modifications to social welfare payments should be directed relatively more towards beneficiaries with families of dependant children. This should entail relatively modest adjustments to payments on which non-family households rely, combined with more adequate adjustments in relation to payments which families receive.

Secondly, the choice of policy instrument in relation to families should be based on a number of criteria: cost and labour market incentives and flexibility of the instrument are key criteria. On balance, Child Benefit is the preferred option: it is neutral between those in work and out of work, it comprehends all families and it can be directed in a flexible manner towards children in large/small families, one/two parent families or children of different ages. Cost may act as a constraint, however.

Thirdly, for those in the labour market without child dependants, the income tax system can be efficiently used to offset losses of purchasing power, although no precise recommendation can be made here. In the Council's view, the indirect tax harmonisation proposals provide a further imperative for proceeding with the reform of *income* taxation. The *specific* modifications to income tax which are merited on tax harmonisation grounds (for those not benefitting from the measures indicated above) should benefit *low* income tax payers in particular. Changes in the exemption levels, or marginal reliefs, or reductions in the lowest rate of tax, for example, are more likely to meet this objective than generalised changes such as reductions in the standard rate of tax or increases in personal allowances.

(iv) Indirect Taxation and Competitiveness

The argument is sometimes put that differences in indirect taxes distort the pattern of competition between countries by giving an unfair cost advantage to producers located in low-tax countries. But in general, this is not an argument that can be applied to indirect taxes, either VAT or excise duties. As was discussed in Section 2 above, VAT is levied according to the Destination Principle, i.e., the rate of VAT which products bear is that prevailing in the country in which they are consumed rather than where they are produced. Exports from individual member states are, therefore, taxed on an equivalent basis to products produced in the export market. Irish exports of clothing to Germany, when sold in Germany, bear the same rate of VAT as German produced clothes sold on the German market.

The same arguments apply broadly to excise duties, which are levied at the rates of the country in which the goods are finally consumed. One exception to this general rule is that of duties on mineral oils, particularly diesel oil, which is an input into the production process in many businesses. It can, therefore, affect the competitiveness of production and thus alter production patterns across various countries. Another respect in which indirect taxes can affect the pattern of competition is in the tourism sector, where domestic consumption of goods and services by tourists forms part of the total tourism product. As countries compete in the international tourist market for tourist numbers, differential taxes between countries can affect the competitiveness of individual destinations. These factors must enter into our overall consideration of the approximation of indirect taxes.

There are some other possibilities also through which production can be distorted. For example, the balance between specific and *ad valorem* duties can favour the producers of one country over another. Also, the fact that countries can place heavier excises on products which are imported and lower rates on domestically produced goods can favour domestic producers. We do not consider these issues here.

5. THE COUNCIL'S POSITION

Since this chapter was completed, the Commission has issued a revised package of indirect tax proposals. The package contains specific changes to the original VAT proposals and an indication that revised proposals on excise duties will be issued. The Council's position on the revised VAT proposals is contained in a postscript to this chapter, against the background of the analysis contained in the chapter. Since the precise changes in the excise duties have not been indicated, the Council's position on the original proposals is presented in this Section.

Since the completion of the internal market has important implications for the *direct* taxation system in Ireland, the issues arising are considered and are evaluated in the context of the package of tax reforms previously devised by the Council. In addition, the overall public finance system in the Community, as it is at present, and as it would be after the completion of the internal market, is also evaluated on the criteria set by the principles of public finance.

The Council's position is outlined under three main headings:

- indirect tax harmonisation and integration;
- integration and direct tax reform;
- public finance in economic integration.

As indicated above, the Council's position on the revised VAT proposals is contained in the postscript.

(i) Indirect Tax Harmonisation and Integration

Integration and the Removal of Frontiers

The Council accepts the European Commission's argument that removal of physical frontiers is a necessary step in the process of economic integration. This is so, because frontiers constitute both a physical and a psychological obstacle to integration. The Council is, therefore, strongly of the opinion that removal of frontiers must be part of the completion of the internal market.

Removal of Frontiers and Indirect Tax Approximation

Value Added Tax

The Council agrees with the Commission that approximation of VAT rates is necessary for the removal of obstacles to trade in the Community. This requires

not only the removal of physical barriers but also of trade barriers arising from differences in VAT rates across member states. The original proposals put forward can also be justified on economic and social grounds. In particular:

- (i) the administrative arguments against many different rates of VAT are substantial;
- (ii) adjustments to income tax and social welfare can achieve similar distributional outcomes without the efficiency losses.

In these respects, the Commission's original harmonisation proposals and the considerations underpinning domestic tax reform are mutually supportive. The Council, in *Strategy for Development*, identified tax reform as the most powerful instrument available to Government to promote faster growth in output and employment. The Council also identified the narrowness of the tax base as the major source of many of the problems of the Irish tax system and recommended a widening of the base, not only of personal income tax but of capital taxation, corporate taxation and value added tax. The original VAT proposals would have involved a considerable widening of the VAT base.

In Section 4 (i), in which the revenue implications are addressed, it was pointed out that the total revenue consequences of the original VAT proposals, assuming that VAT rates would be at the top of both the lower rate and standard rate bands, would be a gain of approximately £90m. Even with a lower VAT rate of 4 per cent (rather than 9 per cent), VAT revenues would remain broadly unchanged from present levels.

If the Community's original VAT harmonisation proposals were to proceed they would affect the purchasing power of households, and in particular, low income households. In the Council's view, it would not be appropriate to simply apply a uniform increase to all social welfare payments in order to compensate those affected. This approach would be inappropriate as there is some variation in these payments; some social welfare recipients have an additional income and some low income households are not in the social welfare net.

Households with children would require greater compensation. This could be achieved most appropriately through an improvement in Child Benefit. Households without children can be classified approximately as those in the social welfare system and those with a direct income and, therefore, in the income tax system. The most appropriate response here would be an adjustment in the income tax system which specifically benefits those on *low* incomes, *not* an adjustment (such as an overall decline in tax rates or changes in tax allowances) which benefits the generality of income tax payers. Finally, for those without dependant children who receive social welfare, some adjustment to their allowances would be necessary. The Council believes that a very general approach to compensation — such as a uniform increase in all

social welfare payments — would not reach those households most affected. It is crucial that the specific categories of households affected in varying degrees are identified and that a careful mix of responses is applied.

The Council has not costed these compensatory measures. Again, the ultimate compensation necessary will depend upon the precise proposals which the Government may have to implement.

The Commission's revised VAT proposals and the Council's position thereon are contained in a Postscript to the chapter.

Excise Duties

As the Commission has said there are, indeed, arguments for approximation of excise duties. Certainly, harmonisation of these duties would be the simplest approach from an administrative point of view. However, the *large reductions* in Irish excise duties on alcohol and tobacco, which is what is proposed by the Commission, do not accord well with the principles used by the Council in devising a programme of tax reform for Ireland. In the case of alcohol and tobacco, there are sound economic as well as social arguments for the retention of high levels of duty in the Irish case. In addition, it is a generally accepted feature of fiscal harmonisation that countries should be permitted to retain differences in their fiscal systems that reflect important differences in social philosophy and public goals (Robson, 1987).

Furthermore, in the Council's view, retention of some differentials in excise duties may be consistent with the removal of frontiers. An alternative system of control, other than frontier checks, exists, which can provide an appropriate mechanism for controlling movement of alcohol and tobacco. This alternative system of control, based on physical markings, would provide an appropriate control mechanism and would require far less disruption than the proposed system.* It would also have the effect of avoiding some of the major economic, social and political obstacles to implementation of the existing proposals and would, therefore, be likely to hasten the removal of fiscal frontiers. The Council believes that serious consideration should be given to this alternative system.

This system could still give rise to some cross-border shopping for personal use. In order to minimise the costs attached to such cross-border shopping, approximation of duties between different geographic zones with common borders could be considered. The Republic and Northern Ireland is the most obvious example in this context.

Indirect Taxes and Competitiveness

In general, differences in indirect taxes do not distort the pattern of

*There are some further technical tax administration issues, such as compression of the post-duty stages of the production chain. These issues, however, are solvable. See, for example, Smith (1988).

competition between countries by giving an unfair cost advantage to producers located in low-tax countries. This is because indirect taxation is operated on the destination principle. There are two exceptions to this general rule:

- (i) duties on mineral oils, particularly diesel, which is an input into the production process in many businesses, can confer competitive advantages. It will be noted from Table 12.3 that Ireland is significantly above the European average in taxes on diesel oil;
- (ii) indirect taxes can also affect the pattern of competition in the tourism sector where domestic consumption of goods and services by tourists forms part of the total tourism product.

In other chapters of this report, we have documented the likely intensification of competition in general in the economy resulting from completion of the internal market and we referred specifically to the transport sector in Chapter 10. If Irish businesses are to compete effectively in this new environment, then taxes on inputs to the production process must be brought into line with the European average.

(ii) Integration and Direct Tax Reform

The Council agrees that the removal of barriers to the movement of persons is necessary to genuine economic integration. It, therefore, strongly supports the Commission's view that removal of these barriers must be an integral part of the completion of the internal market. The Council considers that the measures proposed in the internal market programme will significantly increase mobility of persons within the Community. In the Council's view this will greatly increase the existing pressure for approximation of income and some other *direct* taxes in the Community, if distortionary tax-induced migration of labour and capital are to be minimised.

The harmonisation of indirect taxes in the Community could also have major knock-on effects on the *direct* tax systems in member countries. The present proposals of the Commission, by determining the base for indirect taxes, effectively determine the level of indirect tax revenue in each member state. Continuation of budgetary balance in the context of significant changes in indirect tax revenue would require major changes in direct tax revenue.

As indicated above, aspects of the internal market programme — in particular, the measures to increase the mobility of persons — have profound implications for the direct tax systems of member countries. In the White Paper on *Completing the Internal Market*, the Commission considered it crucial that the obstacles which still exist within the Community to free movement of labour and professions be removed by 1992. Specific proposals for a system of mutual recognition of university degrees, apprenticeship courses and vocational training were put forward; some of these have already been adopted. The removal of such obstacles will take place against a background of significantly

different demographic profiles of European member states — the major European countries are now in a phase of significantly slowing population growth. This is likely to give rise to some tightening of labour markets, which, with mutual recognition of qualifications across the Community, is likely to set up pressures for migration flows.

This scenario will greatly increase the existing pressure for approximation of direct taxes on highly mobile factors of production such as labour.* In the Irish case, the increased pressure for approximation of direct taxes on labour amounts to pressure to reduce the high average and marginal rates of tax on earned income. The tax system at present bears most heavily on the most mobile segments of the labour force and also the most valuable in terms of human capital.

The Council, in *Strategy for Development*, argued that the narrowness of the existing tax base was the immediate cause of the most serious problems and costs which spring from the present taxation system and a major constraint to developing a system which would be more equitable and would provide greater incentives to enterprise and wealth creation.

In the personal tax system, the system of allowances and reliefs contributes to a narrowing of the tax base and the existence of high marginal tax rates. Those who are most mobile internationally are unlikely to be in a position to avail of the reliefs which are available — they are likely to be younger and single, without all of the expenditures on which tax relief is granted. Hence, they tend to suffer all the costs of high marginal tax rates but reap none of the benefits of the reliefs and allowances which are the counterparts of the high marginal rates.

There is another respect in which the Irish taxation system is anomalous in its treatment of mobile and immobile factors. The tax system is biased towards taxation of mobile factors while immobile factors are treated very favourably. This is particularly evident in the taxation of personal income *vis-a-vis* the taxation of property. This issue has been treated at length by the Council — in the context of local authority financing (NESC No. 80), in the context of the overall taxation system (NESC No. 83) and in the context of housing policy (NESC No. 87). The conclusions and recommendations from each of these perspectives pointed unequivocally in the direction of a property tax and a reduction in personal income tax. The measures currently being adopted to enhance the mobility of labour greatly increase the urgency of reforming the domestic tax system.

*The removal of exchange controls and the fact that capital is very mobile has already led to a proposed minimum withholding tax on savings across the Community.

(iii) Public Finance in Economic Integration

The Council supports the measures which are necessary for the achievement of genuine economic integration. Thus, it supports the approximation of value added taxes and looks favourably on the approximation of some direct taxes which will be necessary to avoid distortions of the internal market. But the Council has, independently of European integration, devised a programme of reform to bring the Irish tax system into line with the principles of good public finance. It has, therefore, felt it necessary to scrutinise moves towards Community tax harmonisation by reference to those principles. Individually, each of the moves towards harmonisation would, in the Irish case — accord well with good tax practice — with the exception of the large reduction in excise duties on alcohol and tobacco. The Council also felt it necessary to subject the overall system of public finance in the Community to the same scrutiny. However, the tax and expenditure system of the Community, either as it is at present or as it is likely to develop if the moves towards harmonisation are achieved, does not accord at all well with sound principles of public finance. Furthermore, until it does so, it is unlikely that substantial tax harmonisation will be acceptable to member states.

We will see, in Chapter 13, that the public finance system of the Community contradicts any rational principles of public finance. As a result, there are numerous economies of scale which are ignored and spillover effects which are generated. These result in substantial misallocation of resources and unintended and probably unequitable redistribution between persons, regions and member states.

The completion of the internal market, and the attendant pressure to harmonise taxes, brings this irrational system of public finance under scrutiny again. Indeed, tax harmonisation could force the distortions to such a level that unless the system was improved the Community would have to retreat from tax harmonisation and consequently from completion of the internal market.

Restraint on the indirect taxes which can be levied by a member state will restrain its freedom of action for policy purposes to direct taxation. Simultaneously, the increased mobility of labour will inhibit its freedom of action in relation to the rates of direct tax it can levy. Thus, since the public expenditure requirements of member states are not uniform, pressure towards uniformity of several major sources of tax revenue could force some member states into budgetary imbalance or into inappropriate cuts in public expenditure. For example, the pressure to equalise major revenue raising taxes — which the Council accepts as an unavoidable concomitant of integration — could frustrate the pursuit of adjustment or regional policy objectives.

The problematic aspect of current moves toward tax approximation can be understood by drawing on the concepts of *negative* and *positive* integration set

out in Chapter 13. The tax approximation proposals are essentially measures of negative integration — that is, measures designed to *remove* obstacles to the mobility of goods, capital and labour. Where the removal of national obstacles to mobility is either insufficient for the creation of genuine integration, or actually creates new problems or distortions which inhibit the achievement of Community objectives, then *negative* integration needs to be accompanied by measures of *positive* integration. It will be shown in Chapter 13 that *positive* integration consists of the establishment of policies, mechanisms and institutions at Community level which facilitate the achievement of Community objectives. Pressure for more uniformity of several major revenue sources in Community countries, in the context of non-uniformity of expenditure requirements, will both prevent the achievement of a genuine common market — by exacerbating the distortions created by spillover effects — and make even less likely the achievement of other Community objectives such as cohesion and convergence — by limiting the pursuit of structural and redistributive policies in poor member states. The obvious measure of *positive* integration needed to accompany moves towards a Community taxation system is the extension of the role of the Community budget. Such an extension would serve to move the overall system of public finance in the Community in the direction dictated by rational principles and thereby assist the achievement of a genuine common market and of other Community objectives.

Such an approach follows directly from the economics of integration. In his recent review of that subject Robson was emphatic that tax harmonisation is unlikely to be acceptable unless and until the fiscal role of the Community itself becomes much greater than it is today. As he points out, full harmonisation of VAT and corporation tax rates:

would almost certainly imply an EC budget that was: (1) substantially larger in relation to national budgets than is now the case; (2) perhaps endowed with the capacity of levying its own supplementary VAT; and (3) able to utilise its revenue in part for transfers among member states. These considerations underline, once again the close links between proposals for monetary integration, fiscal harmonisation and regional policy (page 135).

In view of all these considerations, the Council considers that moves towards tax harmonisation should be accompanied by an extension of the fiscal role of the Community. What the Council proposes is the development of a permanent system which facilitates integration, by balancing the moves towards a common tax system with moves towards a shared expenditure base. This would involve the Community developing a role in certain expenditure programmes — chosen by reference to the most rigorous principles of public finance — in which the Community is not currently involved.

The chapter was originally written against the background of the Commission's first set of proposals for tax approximation. The Commission's revised proposals, put forward in May, contain a number of very significant modifications to the original proposals. With regard to VAT, the proposal for a standard rate band of 14-20 per cent is replaced by a proposed minimum rate of 15 per cent. In addition, under certain conditions, it will be possible to maintain zero rates on a small number of products. The reduced rate would still be a band of 4 per cent to 9 per cent.

With regard to excise duties, the Commission acknowledges that more flexibility is necessary in order to take account of different levels of tax on products in different member states. The Commission also acknowledges that account must be taken of the priorities attaching to health (alcohol and tobacco), energy conservation and the environment (petroleum products). Thus, single taxes per product will be replaced by bands of taxes or by minimum tax rates. The specific proposals on excises are to be forwarded to the European Council before August.

The Commission has also revised its proposals on the VAT central clearing house mechanism. In addition, a transitional period up to the end of 1992 would encompass measures to simplify fiscal controls at frontiers for the benefit of business and a substantial enlargement of traveller's allowances.

In terms of the broad approaches towards tax approximation identified in the chapter, the Commission's revised proposals represent a distinct shift towards a 'market forces' approach, with the Commission confining itself to rate minima and taxation systems being subsequently forced into alignment by virtue of market forces. What market forces would be likely to become operative in the Irish case following the removal of fiscal borders? As indicated in the chapter, the greatest pressure would be likely to arise in the case of the common land frontier with the UK. Given that the UK does not have an 'increased' VAT rate and that its current standard rate is 15 per cent, (the minimum rate set by the Commission) then it is likely that the UK's standard rate will remain at this level. It is also likely that the UK would retain the zero rate on a number of items including food. Under a 'market forces' arrangement the Irish standard rate could not remain appreciably above 15 per cent and rates appreciably above zero on items zero rated in the UK would be unsustainable.

The main problems arising from this are of a revenue nature. It will be recalled from the chapter that the revenue consequences of the original Commission's proposals were derived on the basis of Ireland remaining at the top of the 14-19 per cent band and imposing a VAT rate of 9 per cent on items currently zero

rated. Maintenance of the zero rate and the reduction of the standard rate to 15 per cent would result in the overall package of VAT changes generating significant revenue losses. This is in contrast to the position under the Commission's original VAT proposals which, as calculated in the Chapter, would have been broadly neutral from a revenue point of view. The corollary of this revenue problem of course is that the compensation of those on low incomes, arising from the removal of zero rates, would not arise under the revised proposals.

In the chapter, the Council concluded that the Commission's original VAT harmonisation proposals and the considerations underpinning domestic tax reform were mutually supportive. Such is not the case with the revised set of proposals. In addition, the 'market forces' approach to VAT approximation would be likely to force Ireland into a significant loss of VAT revenue. The problems facing policy makers in regard to compensating for indirect tax revenue losses through direct taxation have been outlined in the chapter. This, again, highlights the need to proceed simultaneously with tax harmonisation and the extension of the fiscal role of the Community as recommended in the chapter. All the comments in Section 5 of the chapter, with the exception of those on VAT, are still valid in the light of the Commission's revised set of proposals. Despite the fact that the Commission's comments on excise duties are not very specific they appear more in line with what the Council has recommended in the chapter.

In this brief appendix a summary is given of the relevant material in the NESCS report, *Redistribution Through State Social Expenditure in the Republic of Ireland: 1973-1980*, on the role of indirect taxation in the redistribution of resources between households.

As Figure A.12(1) illustrates, redistribution is formulated as a process which brings households from the stage of *direct* incomes to that of *final* incomes. Direct incomes refer to earnings, income from self-employment and so on. These are supplemented by cash transfers such as social security payments, giving *gross* incomes. From these are subtracted direct taxes, leaving households with *disposable* incomes. However, when households incur expenditures they also incur *indirect* taxation such as VAT. In addition, they also benefit from State-provided services such as health, education and housing. When the impact of these indirect taxes and non-cash benefits is accounted for, a measure of *final* income is obtained.

In the study, the inequality in the distribution of income was measured at each stage. The contributions of cash transfers, direct taxes and non-cash benefits and indirect taxes to the reduction in inequality were then calculated. The study shows that the following have the most significant redistributive impact, in this order:

- cash transfers
- direct taxes
- indirect taxes and non-cash subsidies.

Table A 12.1 quantifies the relative redistributive effects of these mechanisms of redistribution. The calculations are based on the Musgrave Thin Index of the proportionate reduction in the Gini Co-efficient of Inequality. In 1980 a 17.6 per cent reduction in the co-efficient of inequality was effected by cash transfers; this compares with a figure of only 3.2 per cent for non-cash benefits and indirect taxes combined.

The empirical evidence shows, therefore, that although indirect taxes contribute to the overall process of redistribution they have only a very minor redistributive affect relative to the affect of cash transfers.

Figure A.12(1)
Stages in Income Redistribution

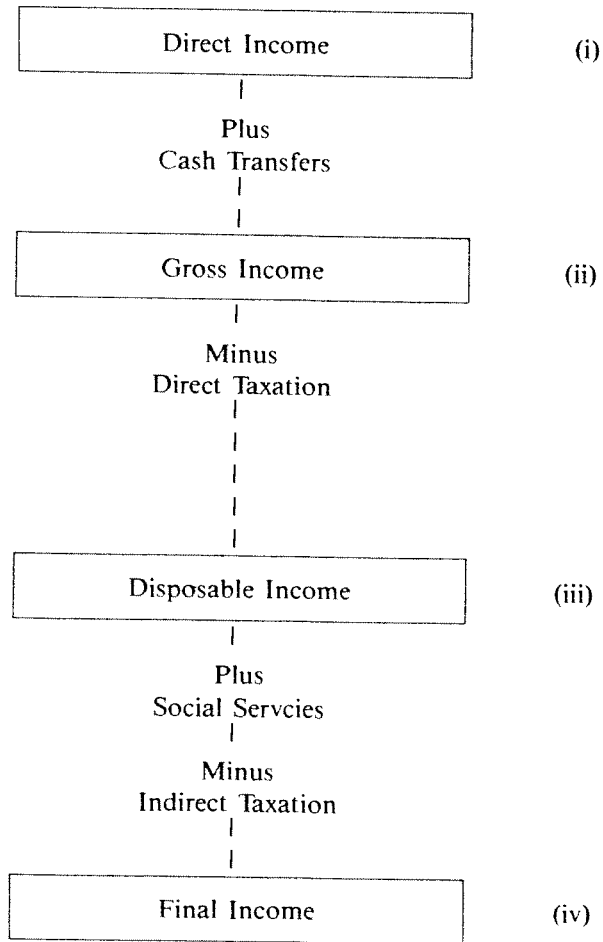


Table A 12.1
Proportionate Gains in Redistribution at Various Stages, 1973 and 1980

Stages of Redistribution	Redistributive Mechanism	Gain in equality %	
		1973	1980
Direct to Gross Income	Cash Transfers	15.0	17.6
Gross to Disposable Income	Direct Taxation	2.9	6.6
Disposable to Final Income	Indirect Taxes and non-cash subsidies	- 3.0	3.2

