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A2 Economics

2005

European Economy in Focus

Geoff Riley (Eton College)

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1 BASIC INFORMATION ON THE EUROPEAN UNION

There is often a surprising degree of ignorance about which countries are inside the European Union and which are not! The table further below gives the current position as it stands in January 2005.

The European Union expanded to **twenty five nations** in May 2004 with the **accession of ten countries.** Two more are scheduled to join in 2007 (Bulgaria and Romania) and Croatia and Turkey both seek membership – they are known as candidate countries. Turkey is scheduled to start the process of negotiation to enter the EU in October 2005 but her final accession may be more than a decade away.

Member States of the EU		**EU Member State since :**	
AT	Austria		1995
BE	Belgium		1958
CY	Cyprus		2004
CZ	Czech Republic		2004
DK	Denmark		1973
EE	Estonia		2004
FI	Finland		1995
FR	France		1958
DE	Germany		1958
[East Germany is always included in **DE;** German re-unification occurred on 3.10.1990]			
EL	Greece		1981
HU	Hungary		2004
IE	Ireland		1973
IT	Italy		1958
LV	Latvia		2004
LT	Lithuania		2004
LU	Luxembourg		1958
MT	Malta		2004
PL	Poland		2004
PT	Portugal		1986
SK	Slovak Republic		2004
SI	Slovenia		2004
ES	Spain		1986
SE	Sweden		1995
NL	The Netherlands		1958
UK	United Kingdom		1973
Other European Economic Area (EEA) and in EFTA			
IS	Iceland	EEA : 1994	EFTA:1960
LI	Liechtenstein	EEA : 1994	EFTA:1991
NO	Norway	EEA : 1994	EFTA:1960
Other European Free Trade Association (EFTA)			
CH	Switzerland		EFTA:1960
European Union Candidate Countries			
BG	Bulgaria		
HR	Croatia		
RO	Romania		
TR	Turkey		

Norway and **Switzerland** are two rich, medium-sized countries that remain outside of the EU. Although Norway is a member of the **European Economic Area** which gives it access to the EU's single (internal) market and its four freedoms: free movement of goods, services, people and capital.

1.1 European Union in a Global Perspective

We first focus on data that outlines the place of the EU within the broader global economic system.

Data is for 2003		European Union	Euro Zone	United States	Japan
Population	million	457	309	291	128
GDP (PPP)	Euros trillion	10.1	7.3	9.9	3.2
GDP per capita (PPP)	Euros	22.1	23.5	34.1	25.1
Structure of industry					
Agriculture	% of total	2.1	2.3	0.8	1.3
Industry	% of total	26.8	26.9	19.7	29.1
Services	% of total	71.1	70.9	79.5	69.6

Source: European Central Bank Economic Review 2004

- **Population:** In 2003 the population of the EU was estimated to be 457 million. The accession of ten countries in May 2004 added around twenty per cent to the population of the EU. The EU is the world's largest international **single market**.
- **Value of National Output:** The EU and the United States are the world's two largest economies. In 2000, the EU accounted for 18% of global GDP compared to 23% from the United States. Adjusted for differences in relative price levels so that the data is expressed in purchasing power parity terms and expressing the figures in a common currency, the enlarged European Union is now slightly bigger than the USA with a combined national output of over 10 trillion Euros!
- **Living standards:** Average living standards in the USA remain higher than in the EU (34,100 Euros per head compared to 22,100 Euros for the EU in 2003). One of the main reasons for this is that **labour productivity** is higher in the United States. The entry of ten relatively poor countries into the EU in May 2004 has reduced the EU average per capita GDP although it is recognised that these countries have potential for faster growth and a process of convergence with their established EU neighbours and partners is likely to occur.
- **Structure of output:** Service industries dominate the economies of all Western European countries although the industrial / manufacturing sector of the EU contributes a higher share of GDP measured by value added that the industrial sector does in the USA.
- **The British economy** contributes around 17 per cent of total European Union output – it is Europe's second biggest economy. Britain has chosen to remain outside of the Single Currency (the Euro Zone) as has Denmark and Sweden.

1.2 European Union Budget

The activities of the EU are financed largely through its own resources. For example, income from agricultural taxes and customs duties together contribute 13% of total EU revenue. The main sources of revenue come from **VAT receipts** and **Gross National Income (GNI) based contributions** from individual member states.

In 2004, Germany, France, Italy and the UK were the largest contributors to the EU budget. Germany contributed 23% of the total, France 18% and the UK 12%. The UK is a **net contributor** to the EU (i.e. it

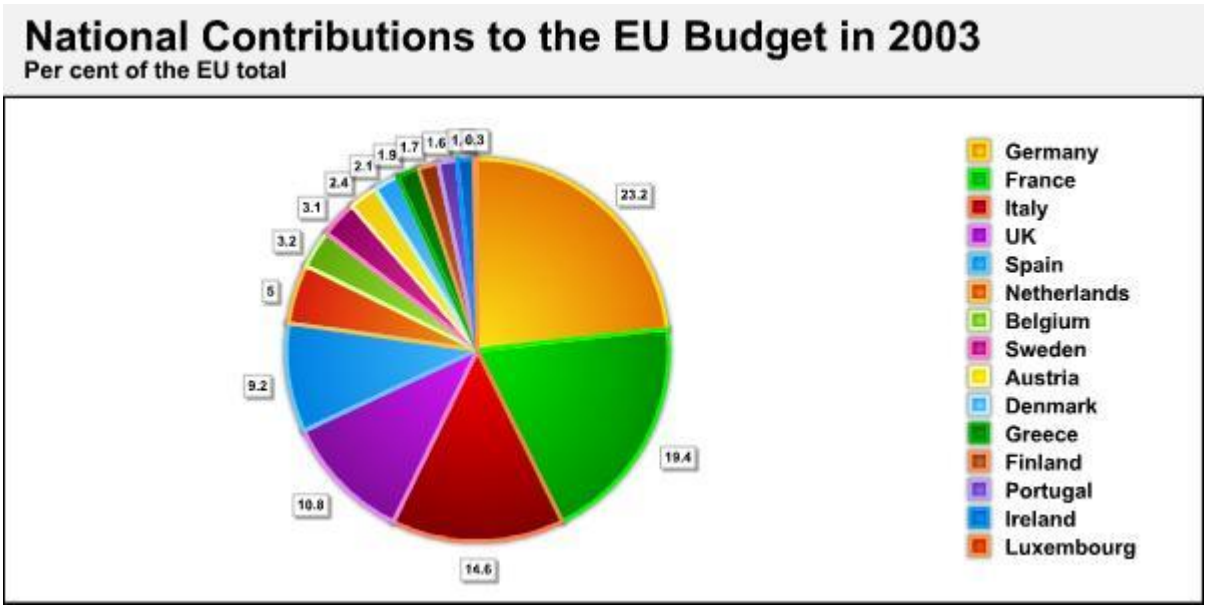
contributes more than it receives in allocated spending). In 2003 after deduction of the UK rebate, the UK contributed Euro 7.8 billion in 2003.

The 2005 budget for the newly enlarged EU totals Euro106.3 billion. This represents 1% of the EU Gross National Income and is an increase of 4.4% compared to the budget for 2004. 2005 will be the first year when the reform of the **Common Agricultural Policy** has an important financial impact on EU finances. The CAP budget will come to Euro 49.7 billion. Structural cohesion spending will be Euro 42.4 billion.

A summary of the proposed EU budget for 2005 is shown in the table below

Source: Eurostat	Total EU Spending Euros (million)	Spending as a percentage of the EU Budget Per cent
Agriculture & Rural Development	49,676	42.7%
Structural Operations	42,423	36.4%
Internal Policies	9,052	7.7%
External Action	5,219	4.4%
Administration	6,351	5.5%
Reserves	446	0.4%
Pre-excession strategy	2,081	1.8%
Compensation	1,305	1.1%
Total EU spending	116,554	100%

Spain is the largest recipient of EU expenditure. In 2003 it received 20.4% of EU allocated spending. Next come France (16.9%), Italy (13.5%), Germany (13.5%) and the UK with 7.8% of the total EU budget.



1.3 UK Trade with the European Union

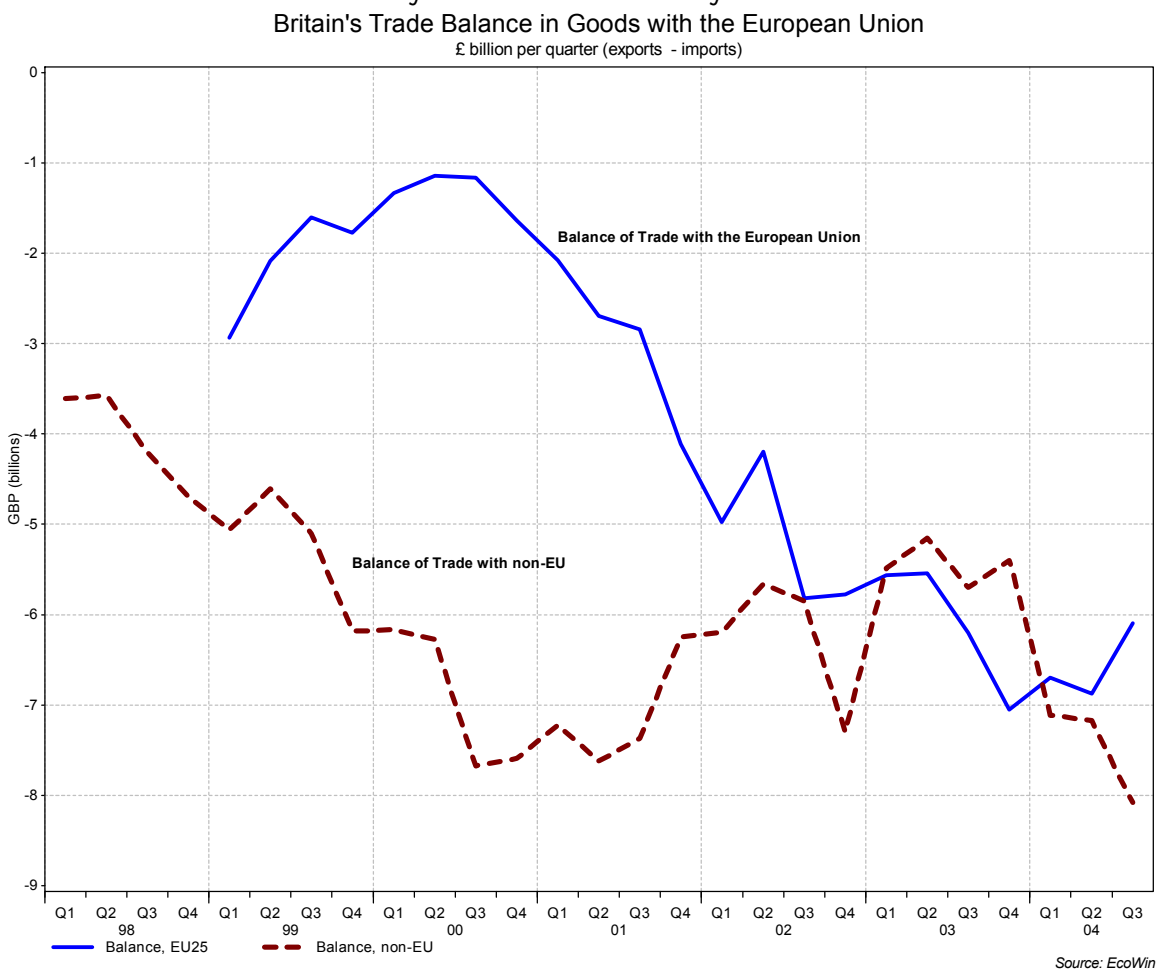
In this section we consider the current pattern and balance of trade in goods and services between the UK and the rest of the European Union.

Europe is far and away our **largest trading partner** and in this respect the health of the European economy is critical to our own economic prospects. Strong economic growth provides an opportunity for

the UK to increase her exports to other EU nations and provide an injection of **aggregate demand** into our own **circular flow** of income and spending.

The balance of trade with the EU

As the chart below makes clear the UK is running a sizeable **trade deficit** in goods with the EU and this trade deficit has widened considerably over the last four or five years.



2 ECONOMIC INTEGRATION, THE SINGLE MARKET

2.1 Introduction

The development of the EU is best described as a series of stages of **economic and political integration** between member nations. There are many different types of **integration** and these are summarised below.

Preferential trading area (PTA)
Free trade area (FTA)
Customs Union (CU)
Single Market - see later on in this chapter
Monetary Union - see the chapter on the Euro
Economic Union – complete economic integration

(i) Preferential Trading Area

A **preferential trading area** is the weakest form of integration between two or more countries. Nations enter into agreements with other countries to grant **preferential access** to certain products – for example a preferential trade agreement between the EU and the **ACP** (African, Caribbean and Pacific) which covers mainly agricultural products. Tariffs are lower but not zero under the terms of these agreements.

(ii) A Free Trade Area:

A **free trade area** occurs when countries simply agree to **remove import tariff and non-tariff barriers** between them to promote trade in goods and services. The **North American Free Trade Area** (NAFTA) is a good example of this as is the **European Free Trade Area** (EFTA). **ASEAN** (Association of South East Nations), the **Andean Pact,** and **Mercosur** are other examples.

(iii) A Customs Union

A **customs union** comprises two or more countries which agree to:

- **Abolish tariffs and quotas** between member nations to encourage **free movement** of goods and services. Goods and services that originate in the EU circulate between Member States **duty-free**. However these products might be subject to other charges such as VAT.
- Adopt a **common external tariff** (CET) on imports from non-members countries. Thus, in the case of the EU, the tariff imposed on, say, imports of South Korean digital cameras or motor-cycles from Japan will be the same in the UK as in any other EU country. The important point about a common external tariff is that it prevents individual countries imposing their own **unilateral tariffs** on different products that differ from other nations in the customs union.
- The EU is a member of the **World Trade Organisation** (www.wto.org) and, officially at least, subscribes to its free trade ethos. The EU certainly argues in principle for more free trade, but mainly in areas where free trade is to the advantage of the EU! For example, the EU is ready to use the WTO appeals mechanism in its frequent disputes with the USA (the recent battle over the introduction of US steel tariffs is a good example to quote)

A customs union shares the revenue from the CET in a pre-determined way – in this case the revenue goes into the main EU budget fund.

Examples of European Union Tariffs and other forms of Import Protection

Product	Average tariff for most favoured nation rate per cent	Maximum rate per cent	Non-Tariff barrier *see notes below per cent	Overall per cent
Cereals	14.0	15.2	5.0	19.0
Meat	11.2	12.1	64.8	76.0
Dairy products	9.7	10.3	100.3	110.0
Other agriculture	8.9	179.7	11.2	20.0
Food products	19.5	236.4	5.0	24.5
Tobacco	47.3	81.9		47.3
Clothing	11.6	13.0	19.0	30.6
Footwear	7.4	17.0		8.9

** Non-tariff barriers include quotas, technical standards, rules of origin, and anti-dumping measures*

Source: Messerlin

(iv) Single Market

A **single market** represents a **deeper form of integration** than a customs union. It involves the **free movement** of goods and services, capital and labour together with **economic policy harmonisation** for example in the areas of health and safety legislation, labour market regulations, environmental policy and competition policy.

Deeper **economic integration** requires some degree of **political integration**, which also requires **shared political and social aims and values** between nations. The current debate about the **new EU constitution** is a reflection of the divisions between politicians on the direction in which political institutions need to change to complement growing and more complex economic relationships.

2.2 Trade creation and trade diversion

The effects of the creation and development of a customs union can be analysed both in the short term and the long term. We make an important distinction between **trade creation** and **trade diversion** effects

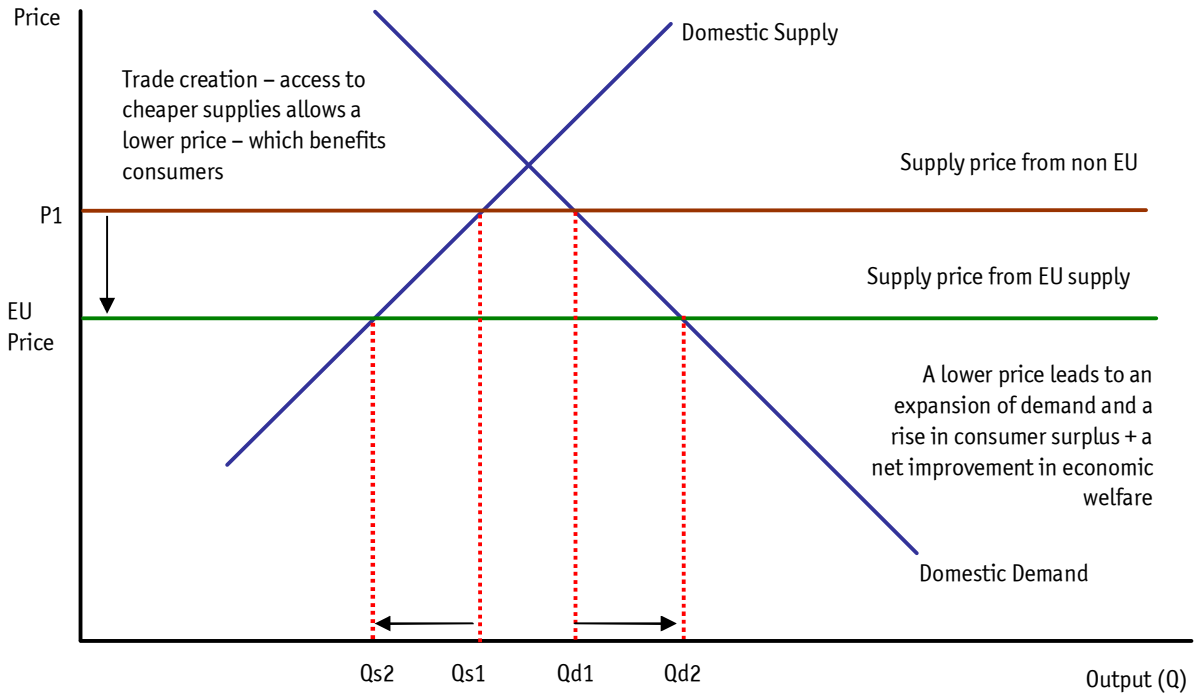
Trade Creation:

Trade creation involves a **shift** in consumer spending from a higher cost domestic source to a lower cost partner source within the EU, as a result of the abolition tariffs on intra-union trade.

So for example UK households may switch their spending on car or home insurance away from a higher-priced UK supplier towards a French or German insurance company operating in the UK market.

Similarly car manufacturers in The Czech Republic or Italy may be able to find and then benefit from a cheaper source of glass or rubber for tyres from other countries within the customs union than if they were reliant on their own domestic supply sources with trade restrictions in place.

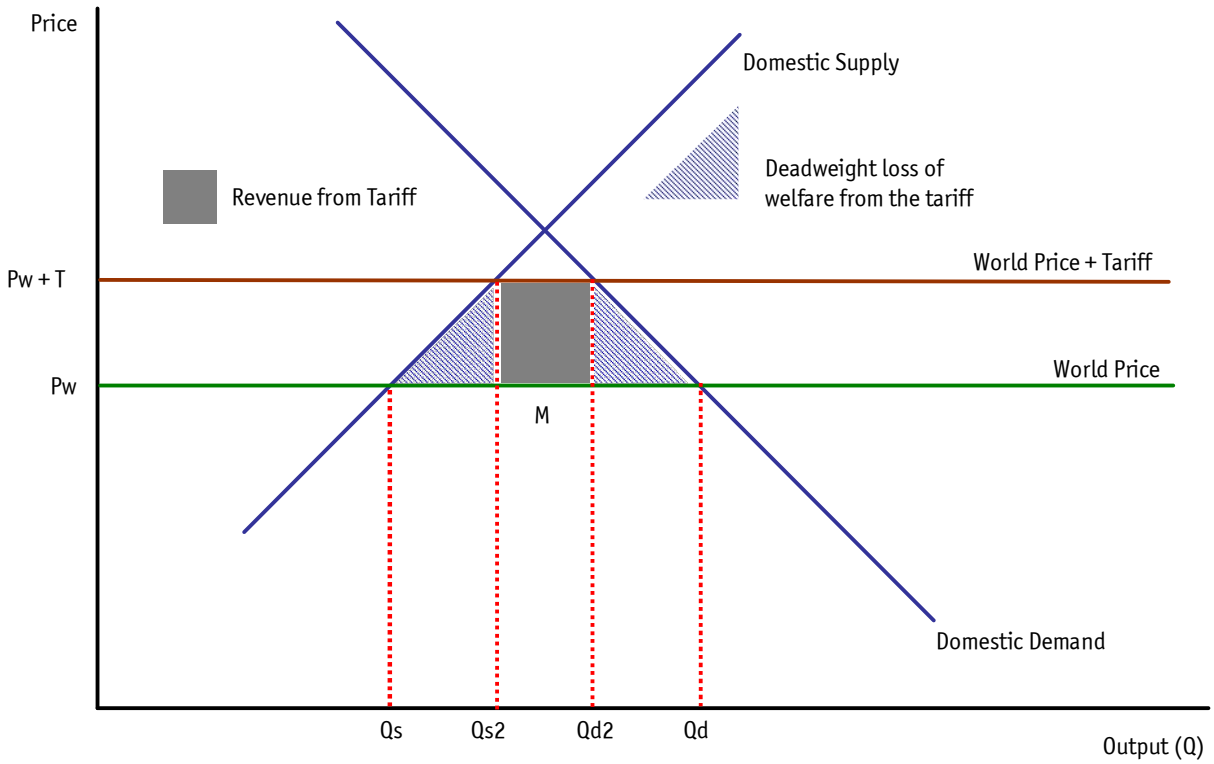
In principle, trade creation stimulates an increase in **intra-EU trade** within the customs union and ought to lead to an improvement in the efficient allocation of scarce resources and cause gains in consumer and producer welfare. Some of the welfare gains are illustrated in the diagram below.



Trade Diversion:

Trade diversion is best described as a shift in domestic consumer spending from a lower cost world source to a higher cost partner source (e.g. from another country within the EU) as a result of the elimination of tariffs on imports from the partner. The common external tariff on many goods and services coming into the EU makes imports more expensive. This can lead to higher costs for producers and higher prices for consumers if previously they had access to a lower cost / lower price supply from a non-EU country.

The diagram next illustrates the welfare consequences of a tariff on imports coming into the EU.



In general, **protectionism** in the forms of an import tariff results in a **deadweight loss of economic welfare**. Only short term protectionist measures, like those to protect infant industries, can be defended robustly in terms of efficiency. The **overall effect** of a customs union on the welfare of citizens depends on whether the customs union creates effects that are mainly trade creating or trade diverting.

James Wolfeson (Head of the World Bank) on the gains from trade and the costs of protectionism

"Expanding trade by collectively reducing barriers is the most powerful tool that countries, working together, can deploy to reduce poverty and raise living standards. A growing body of evidence shows that countries that are more open to trade grow faster over the long run than those that remain closed. And growth directly benefits the world's poor. A one percentage point increase in growth on average reduces poverty by more than 1.5 per cent each year.

Increased trade also benefits consumers and efficient producers, through lower prices and access to a wider variety of goods. This is because trade encourages greater specialisation - which dramatically lowers costs - and more intense competition, which is central to innovation. In sharp contrast, trade barriers can impose high costs on society - and particularly on those that can least afford them. For example, it has been estimated that barriers to imports in the 1990s saved 226 jobs in the US luggage industry, but at a cost to American consumers of nearly $1.3m per year for each job. And taxpayers in the European Union spend over $500m annually to subsidise the production of peas and beans."

Summary of different forms of economic integration

	No Internal Trade Barriers	Common External Tariff	Factor and Asset Mobility	Common Currency	Common Economic Policy
Free Trade Area	X				
Customs Union	X	X			
Single Market	X	X	X		
Monetary Union	X	X	X	X	
Economic Union	X	X	X	X	X

According to the Department of Trade and Industry, the European Single Market is the largest market in the world. It makes a significant contribution to our prosperity by stimulating intra-EU trade, reducing its costs and increasing productivity. The key aim of the Single Market – is to increase the **trend rate of EU economic growth** and also to **increase employment** and **improve average living standards**.

2.3 Four Freedoms in the Single Market

Over the last 50 years the EU has acted to break down barriers between the EU's national economies and to create a single market where goods, people, money and services can move freely. By creating a frontier-free single market and a single currency (the euro) the EU has given a significant boost to internal trade and employment. Trade with the rest of the world has also greatly increased and the EU is now a major world trading power.

Source: European Commission Annual Review 2004

The EU Single Market is based on the principle of **four economic freedoms**:

1. **Free Trade in Goods:** Companies can sell their products anywhere in the member states and consumers can buy where they want with no penalty
2. **Mobility of Labour:** Citizens of EU member states can live and work in any other country and their professional qualifications should be recognised. The aim is to improve the mobility of labour although in reality there are always barriers to the geographical mobility of workers
3. **Free Movement of Financial Capital:** Currencies and capital can flow freely between member states and EU citizens can use financial services in any member state. The mobility of financial capital has been enhanced by the removal of foreign exchange controls within the EU
4. **Free Trade in Services:** Professional services such as banking, insurance, architecture and advertising can be offered in any member state

Advantages from a Successful Single Market

What are the main benefits to flow from being part of a huge single market for goods and services? This brief extract from the annual review of the single market provides some useful clues.

A functioning single market – the textbook effects

In a fully functioning single market, prices should converge over time due to competitive pressures. Goods, services, workers and capital should circulate freely. And where once-protected utility industries are liberalised, prices should converge and hopefully even decrease over time due to the resulting increase in competition.

Source: EU Internal Market Scoreboard – latest edition published July 2004

Single National Market		Single European Market
Difficult – barriers	Access to national markets	Easy
Low	Price transparency	Higher
Low	Transparency of factor prices	Higher
Small	Market size	Large
Weak	Competition between suppliers	Stronger
Low	Tendency towards specialisation	High
Low	Effectiveness of research & innovation	High
Low	Economies of Scale	High

To draw an analogy from **game theory**, the EU Single Market programme seeks to be **a "positive sum game"** for all of the countries involved, because if a long-term expansion of trade and competition across European markets enhances productivity and reduces costs and prices, then there are **positive spill-over effects f**or both consumers and businesses. Lower prices for goods and services traded within the EU should boost consumers' real living standards and an increase in competitive pressure as many EU markets become more **contestable** ought to lead to a reduction in production "X-inefficiencies". And if higher competition reduces profit margins and **monopoly pricing power** and takes prices closer to the true factor cost of production, then there are **static gains in allocative efficiency** to be exploited.

The enormous size of the Single Market is also a catalyst for growth because those European businesses that are fully geared up to supplying across a range of different markets within countries inside the EU can exploit **economies of scale and scope** leading to improvements in **productive efficiency**. And there are welfare gains from a **freer movement of labour** – we shall return to this issue when we consider the costs and benefits arising from EU enlargement.

Although we tend to focus on the tangible benefits arising from deeper trade relationships in goods and services we should also remember that the Single Market has also stimulated the development of a **European capital market** which is important for companies wanting to raise extra **finance** to fund their capital investment and research programmes.

Evaluating the Impact of the Single Market

A number of studies have been published that seek to identify and quantify the effects of the Single Market. In general, they find that the macroeconomic effects of the single market on inflation and growth have been fairly small so far.

An expansion of Intra-EU trade

There is some evidence of an expansion in **intra EU trade**. For example, the share of total UK exports going to other countries within the EU has increased reflecting the **trade creating effects** of reductions in trade barriers and **increased factor and financial mobility**. We have also seen an expansion of **cross-border shopping** particularly where there are substantial **price differentials** between goods and services sold in the UK and similar goods available on mainland Europe.

In the European capital markets there have been plenty of **cross frontier (EU) mergers & takeovers** and a growing number of **joint ventures** and **technological alliances** between European companies, raising the prospect of gains in **dynamic efficiency** for EU consumers in the long run. Europe has also experienced a **rise in foreign direct investment** (FDI) both within its boundaries and from countries outside the EU. But whether this is the result of the single market itself - perhaps due to a desire by

non-EU multinationals to circumvent tariff barriers and other import controls, or rather the consequence of **globalisation** is hard to gauge and impossible to answer definitively.

Despite some limited evidence of a **fall in price-cost margins** in European manufacturing industries arising from increasing competition, there remain wide **price differentials** in many markets – including for example the prices of new cars. And, despite the requirement that government spending projects must be open to **competitive tender** from all countries within the EU, there are still many examples of **preferential government procurement policies** with national governments favouring domestic businesses when awarding contracts for large items of infrastructural spending or defence contracts.

A study by Pelkmans found that the single market had "changed the landscape of the EU economy almost beyond recognition" but it is difficult to establish the extent to which such changes have been the direct result of the single market programme or the inevitable consequence of deeper changes affecting Europe such as **rapid technological change** and **globalisation**. The telecommunications industry is a good example of this. The single market programme has opened up telecommunications to more intense **cross-border competition** as the power of state monopolies has been reduced. But the **emergence of new technology** such as fibre-optics and computerised telecoms exchanges must has done a huge amount to change the nature of the **barriers to entry** in the market and make these markets more **contestable**. Telecommunications is an industry whether further liberalisation is needed to create a genuinely competitive European telecommunications industry.

Has the single market made industries more competitive?

In some cases the answer is yes because **liberalisation** has taken away statutory monopoly powers in industries such as electricity and gas supply and air transport. But in industries where economies of scale are important and where there is a high **minimum efficient scale** relative to total market demand, we have seen a gradual process of consolidation and increasing concentration following mergers and acquisitions.

The extent of the economic efficiency gains arising from **trade creation** depends on the extent of differences in comparative advantage within the single market. The limited evidence available tends to suggest that the major nations in the single market have broadly similar factor endowments, unit labour costs and infrastructure, and so **comparative advantages** in many industries do not vary considerably throughout the EU. This has limited the benefits of trade creation within the EU.

However, the Single Market was enlarged in 2004 and the ten new nations including the Czech Republic, Poland and Hungary have different levels of development and unit labour costs from existing members. The potential efficiency gains from their inclusion in the single market will be significant as time goes by.

The main criticism of the Single Market has been that too little progress has been made in encouraging faster rates of growth of productivity and investment as a means of increasing the trend rates of economic growth. Indeed during 2004, there have been several reports critical of the deep lack of **competitiveness** within the EU particularly when one compares the EU with the United States and also with the emerging market economies such as **China, India and Brazil**.

Europe's poor competitiveness is attacked

Europe's attempt to overtake the US as the world's leading economy by 2010 has been laid bare in a critique by the European Commission. It cites Europe's **low capital investment**, **low productivity** and **high unemployment rates** as among the many reasons for its **poor competitiveness** and weak economic growth. The report warns that without substantial improvements "the EU cannot hope to catch up on the United States, as our per capita GDP is 72 per cent of our American partner's".

The report blames low overall European productivity on a lack of investment and poor use of information technology, and warns that China and India are becoming key competitors. Europe's low employment rate, especially among workers aged over 55, is described as "worrying indeed", while it is deemed unlikely that the EU will meet its employment rate target of 67 per cent by 2005 and 70 per cent by 2010. It cites failure to agree basic reforms, such as the introduction of a single community patent or the recognition of professional qualifications across the EU.

Adapted from newspaper reports, January 2004

2.4 Price Differentials within the Single Market

The long term aim of the Internal Market is to **reduce price differentials** for the same goods and services within the EU and for increased competition to drive down prices to boost consumer welfare. The reality is that the European consumer is being charged different prices in different national markets for what is essentially the same product – evidence here of widespread **price discrimination** taking place.

Price differences persist – the 2004 Single Market Scoreboard

A price survey carried out by the EU Internal Market Commission provides a mixed picture on the state of price convergence in the Internal Market, with the prices of some goods converging while the prices of others diverge. Prices for some well known brands (such as Coca Cola and Snickers) varied more in 2003 than in 2001, while prices of other well-known brands (such as Twix, Uncle Ben's rice and Gillette disposable razors) converged. No discernible pattern in price convergence of non-branded goods was detected over this period.

Source: European Commission, July 2004

Examples of price differences within the single market

Branded Products	Lowest price	Highest price
	Average EU price in the survey = 100	
Red Bull	Austria (79)	Finland (134)
Kellogg's cornflakes	UK (79)	France (144)
Barilla Dry Pasta	Italy (55)	Ireland (114)
Gillette Disposable Razors	Belgium (79)	Finland (131)
Pampers	UK (63)	Ireland (164)
Haagen Daaz	Italy (60)	Greece (117)

Highest and lowest supermarket prices (excluding VAT) of branded products across Europe for September 2002 – October 2003. Source: DG Internal Market, based on AC Nielsen.

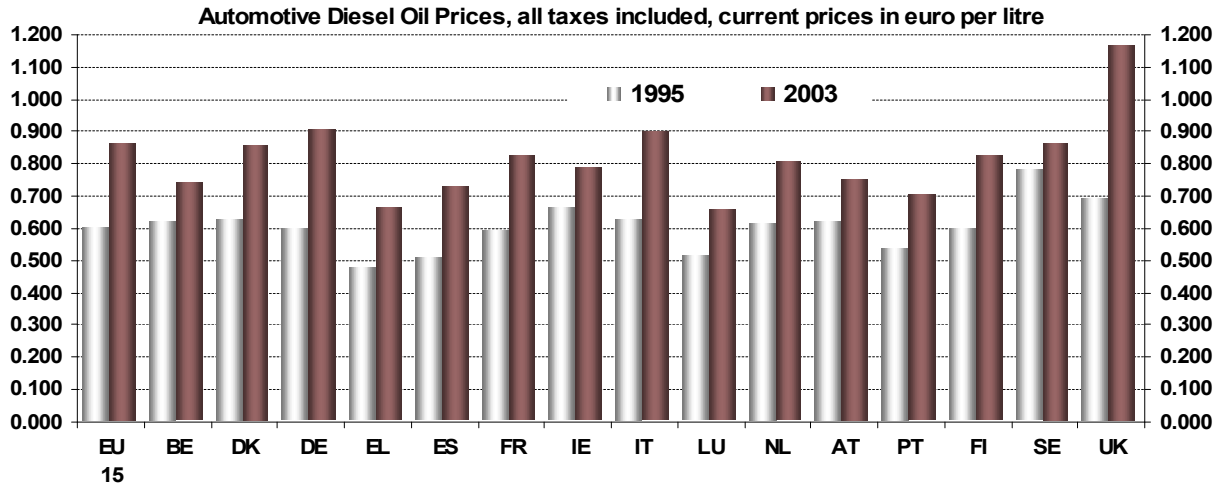
The data in the second table below is drawn from the most recent survey of price differences within the European Union – covering the 15 established members of the Single market. It suggests that the prices of non-branded goods can vary even more than those for branded goods

Non-Branded Products	Lowest price	Highest price
	Average EU price in the survey = 100	
Rice	Portugal (45)	Sweden (182)
Ground Coffee	Finland (71)	Ireland (298)
Ice Cream	Finland (40)	UK (214)
Hairspray	Sweden (47)	Ireland (142)
Sparkling mineral water	Italy (47)	Finland (148)
Tinned pineapple	Netherlands (53)	Finland (181)

Highest and lowest supermarket prices (excluding VAT) of non-branded products across Europe for September 2002 – October 2003. Source: DG Internal Market, based on AC Nielsen.

Why do differences in prices continue to persist? Economic theory has plenty to say about this – indeed price differentials in any market often have a number of causes:

- **Different pricing strategies of suppliers** - remember that not all firms are profit maximisers – many opt to pursue strategies such as revenue maximisation or protecting their market share
- **Differences in incomes and purchasing power of consumers** across regions and countries of the EU lead to variations in the level of effective demand. This affects what suppliers can charge
- **The effects if variations in indirect taxes on producers' costs and consumer prices** – although there is a minimum rate of VAT of five per cent, there remain big differences in excise duties and other indirect taxes which affect producers and which may be passed onto consumers – a good example is the huge level of excise duty on sales of petrol and diesel in the UK
- **The effects of fluctuations in exchange rates** – this is less of an issue now with the creation of the Euro but only twelve of the twenty-five members of the EU are inside the Euro Zone. A falling sterling-euro exchange rate for example would make the same products in the UK appear more expensive than in Germany or Italy when we express prices in a common currency
- **Differences in the costs of supply** - e.g. arising from variation in **labour costs**. A good example of this is the difference in wages between established EU countries and the accession nations.
- **Differences in the degree of competitive pressures amongst suppliers** – for example variations in the amount of monopoly power enjoyed by the largest food and non-food retailers in each European country



Car retailing – the 2004 reforms

New rules governing retail car distribution in the EU that eventually came into force in 2004 should gradually increase competitive pressure among car retailers and further integrate markets, once they come fully into effect. They should also simplify cross-border purchases of new and second-hand cars whether made directly by consumers, or through an intermediary who buys on their behalf. There is at the moment only limited evidence that the introduction of the Euro has helped to reduce car price differentials for European consumers by increasing the level of price transparency. Indeed the growing use of the internet to search for and then purchase cars from cheaper suppliers within the EU single market remains only a minor part of the car retail sector as a whole.

In other markets within the European economy there remain large variations in average prices. For example the prices of consumer goods vary by at least 15% around the mean, and in telecommunications, the variation in prices of calls remains clear. The UK price (shown in Euros) has barely changed since 1997 and there has been little progress in reducing the cost of local calls throughout Europe. In Britain this has led to increasing pressure on the regulatory agencies such as OFTEL (www.oftel.gov.uk) to impose tougher pricing regimes on British Telecom to reduce local call prices – they are amongst the highest in Europe and substantially above a similar call in the United States

More progress has been made in cutting the cost of international calls – but the explanation for this is rooted firmly in advancements in technology that has dramatically cut the marginal cost of making international calls. That said the emergence of increased competition among service providers in offering long-distance calls has contributed to falling prices.

The Single Market - Work in Progress

The single market is not yet complete and it is best described as a work in progress! The evidence is that the Europe Union remains essentially a series of **fragmented and segmented markets** with. One example of this is **postal services** where the EU Commission is pushing through a phased **liberalisation** of the market whilst at the same time trying to protect the uniform nature of postal services to households.

It is in the service sectors that most work needs to be done to fully implement the Single Market programme. The EU Commission has stated that '*the creation of the Internal Market for services is the most important mid and long term goal for reforms'*. The emphasis will be on establishing cross-border competition in distribution, transport, energy, business services and financial services.

2.5 Inward Investment into the Single Market

The creation of the Single Market has been a catalyst for a surge in **foreign direct investment** (FDI) within the EU economy. Three main motives for FDI can be identified:

Resource seeking – This is FDI which seeks specific resources which are unavailable in the home country, for example an overseas company investing in North Sea oil production

Efficiency seeking – This is FDI which aims to produce goods and services more efficiently (i.e. at lower average cost) than in the home country. This could include firms seeking to benefit from a more productive workforce, lower wages or from the **external economies of scale** available in a particular location or region.

Market seeking – This is FDI which seeks to gain access to **lucrative and fast-growing overseas markets**. For example a Chinese or Japanese car manufacturer investing in an EU country to gain access to the wider EU market.

Another way of classifying FDI is as either **vertical** or **horizontal**:

Vertical FDI is where a company **splits its production process** across a number of locations depending on where costs are lowest, for example locating the **labour-intensive** part of production in a low-wage country and the **research-intensive** part where there are high skill levels. Nokia produces mobile phone components and batteries in Hungary and assembles the completed phones in Germany and Finland, where it also has research and development facilities. This is also known as **out-sourcing**.

Horizontal FDI is where a company locates the same production process in a number of different locations, for example car manufacturers which invest in several European countries. For example, the US motor giant, General Motors has car plants in the UK, Germany and Spain, all producing Vauxhall and Opel brand cars.

Foreign investment into the UK

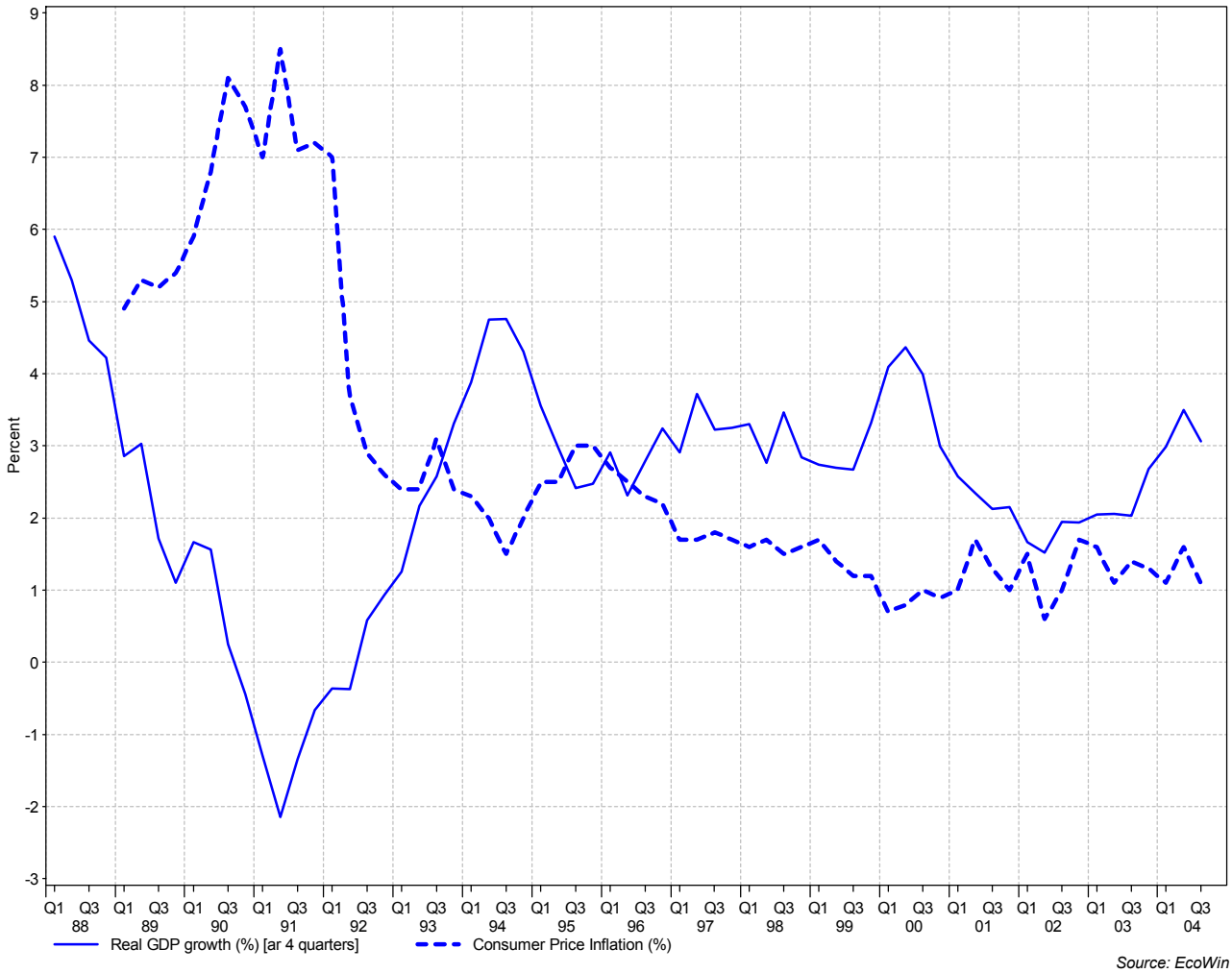
The UK has remained a favoured venue for FDI into the EU. Nearly 30% of the FDI projects into the EU during the period 2000-02 came into the UK. And the total stock of FDI in the UK is the highest among EU nations. A number of factors have contributed to the UK's status as a leading avenue for investment

- Over twelve years of **sustained growth** of the British economy since 1992

- A **cost effective labour supply** and attractiveness of the UK's flexible labour market. Reforms to the UK's employment laws have reduced the **exit costs** for multinational locating in the UK – for example such factors as lower redundancy payments and the ease of firing workers etc.
- An excellent **industrial relations record** over the last 20 years (this is without doubt a transformation from the adversarial industrial relations climate of the 1970s and early 1980s)
- **Relative macroeconomic stability** (e.g. a combination of low inflation, low interest rates and sustained growth of demand and output) – the British economy has outperformed the average for the Euro Zone countries since the single currency was launched in 1999.
- A **favourable corporate tax regime** + low personal taxes (by international standards) – many countries are now using corporate tax rates as a policy to attract inward investment from multinationals. The Republic of Ireland has been foremost in reducing corporate taxes as an incentive for new business location.
- Attractive **regional incentives packages** (including financial assistance for businesses locating in Enterprise Zones). It has been estimated that the UK government provided the equivalent of $30,000 - $50,000 per employee to attract businesses such as Samsung and Siemens respectively to the North East of England in the late 1990s
- An **efficient and deregulated telecommunications** system
- The **success of previous FDI projects** (i.e. positive feedback effects from other overseas firms)
- **Falling utility prices** (telecommunications, water, electricity etc)

Sustained growth and low inflation in the UK has encouraged foreign investment

UK Real GDP Growth and Consumer Price Inflation



Source: EcoWin

3 FISCAL HARMONIZATION

3.1 Introduction

The deepening of economic integration within Europe involves a process of **harmonisation of economic policies.** Nowhere is this more controversial than in the area of **fiscal policy** and whether member states are prepared to transfer some of their autonomy in fiscal matters (i.e. government spending, taxation and public sector borrowing) to the European Union.

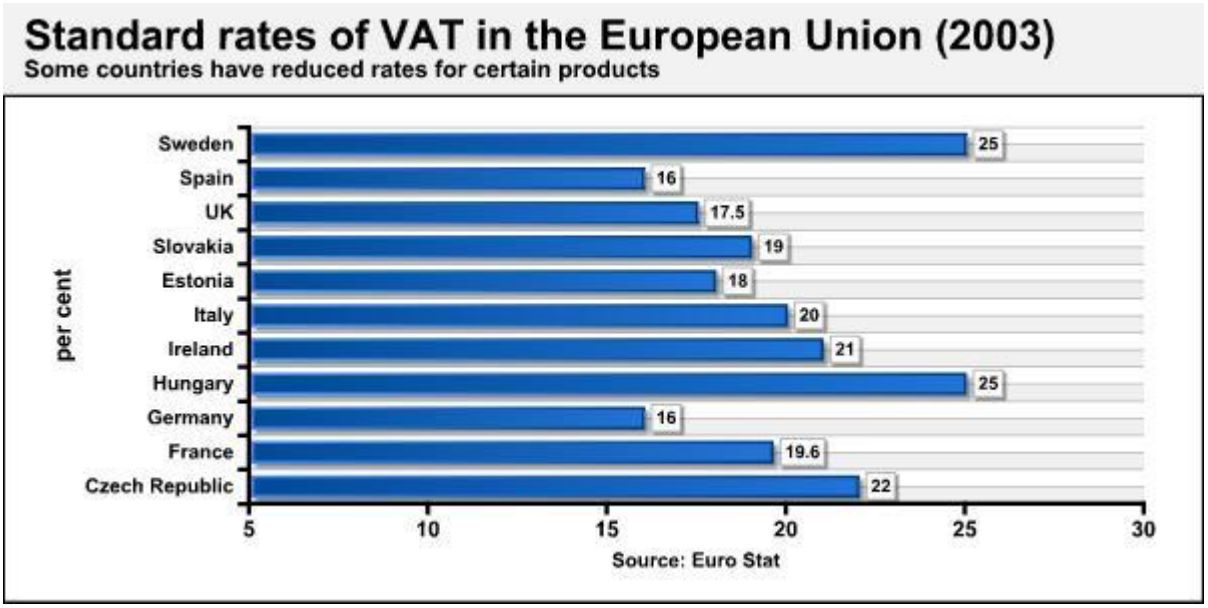
Fiscal harmonisation means **convergence in tax affairs.** A common currency would probably precede significant fiscal harmonisation. This would be a highly controversial step. If the price of fiscal harmonisation is a single currency, the current evidence from opinion polls is that many people in the UK would consider it too dear a price to pay. Harmonisation would include **direct** and **indirect taxes**

Direct taxes (including taxes on labour and capital) such as income tax, social security contributions, corporation tax, wealth taxes and the taxation of saving

Indirect taxes such as excise duties (e.g. on cigarettes, alcohol and fuel), value added tax and environmental taxes (i.e. energy taxes)

Current situation:

As it stands at the time of writing, national governments within the EU retain sole responsibility for direct taxes - the amounts they raise by taxing personal incomes and company profits. EU taxation policy focuses instead on the rates of indirect taxes like value-added tax and excise duties. For example there is a minimum excise duty rate for cigarettes and alcohol and also minimum duty rates for mineral fuels (e.g. duty on oil and petroleum products). Britain has the power of veto to block proposals to harmonise EU taxes.



There are already big differences in the **tax structures** of the main European Union countries The Nordic countries, Sweden, Denmark, and Finland, have relatively high shares of direct taxes as a % of their GDP (more than 40% compared to an EU-average of 35%) whereas Ireland, Portugal and Greece has relatively high shares of indirect taxes (more than 40% versus an EU-average of 34%). Countries have had the flexibility to decide on the pattern of indirect and direct taxes to suit their own preferences and interests.

3.2 Arguments for fiscal harmonisation

The main supporters of greater fiscal harmonisation are France and Germany. Indeed in a recent speech just prior to the enlargement of the EU to twenty-five countries on May 1st 2004, Chancellor Schroeder made clear his desire to achieve harmonisation of direct taxes and he criticised the practice of "fiscal dumping" by some of the new countries joining the EU.

"The future of our nation cannot be stuck in a merciless struggle over low wages and low taxes. We want fiscal competition, but we must avoid fiscal dumping - an EU tax corridor with a maximum high and low tax is needed to prevent "tax dumping" from harming countries like Germany"

A summary of the main arguments for tax harmonisation are provided below:

Improved economic efficiency: Harmonisation of government spending, tax allowances and other tax incentives may remove some of the barriers that can distort competition within the countries of the single market and provide a level-playing field for all member nations.

Labour mobility: Differences in income tax systems and the taxation of pensions can be a barrier to the geographical mobility of labour. Only 0.1% of people in the EU move to a different EU nation each year, a figure that is significantly below that of the United States.

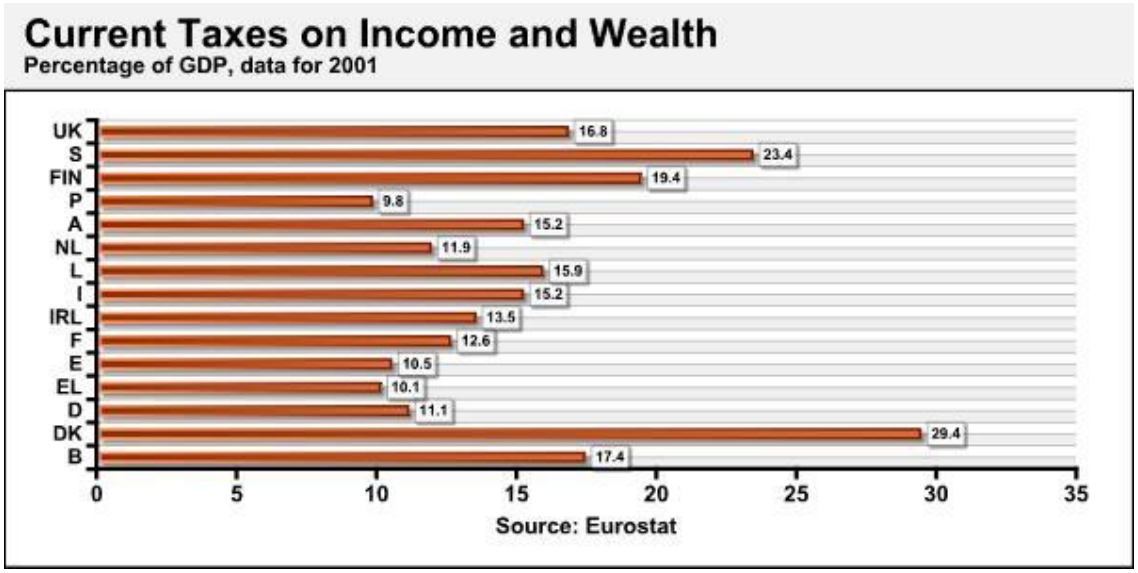
Distrust of countries that engage in tax competition: Different rates of corporation tax affect the relative attractiveness of an economy for inflows of foreign direct investment. Some EU governments are against the deliberate use of lower corporation tax as a strategy designed to promote investment. They argue that it amounts to "fiscal dumping"

Tax avoidance and evasion: Tax harmonisation might reduce the problem of tax avoidance and evasion. The wealthy are often able to avoid taxes by registering wealth in low tax areas, like Jersey. This benefits the low tax regimes but is a form of inefficiency as it lowers the progressiveness of the tax system of countries like the UK and reduces the finances available for public sector infrastructure projects and expenditure on public & merit goods.

Reducing the risk of "free-riders" viz environmental taxation: Negative externalities originating in one country can have significant impacts on neighbouring countries. For example, the burning of coal with sulphur in the UK has caused acid rain in Sweden. Tax harmonisation can be used to stop the free-riding problem of countries not considering the effect of their negative externalities over their borders. If countries have varying pollution tax regimes, many industries that are heavily dependent on fossil fuels may move to low pollution tax countries resulting in a negligible improvement in the quality of the environment.

Pollution and other negative externalities originating in one country can have a significant, and often larger, impact on neighbouring countries. For example, the burning of coal with sulphur in the UK has

caused significant acid rain in Sweden. Tax harmonisation can be used to stop the free-riding problem of countries not considering the effect of their negative externalities over international borders. If countries have varying pollution tax regimes, all industries that are heavily dependent on fossil fuels may move to low pollution tax countries resulting in a negligible improvement in the quality of the environment. However, countries in the EU could correct for externalities through international negotiation in treaties like the Kyoto protocol rather than through fiscal harmonisation.



3.3 Arguments against fiscal harmonisation

In April 2004, at an EU summit, Chancellor Gordon Brown was reported as stating that "tax harmonisation would be "unrealistic, unjustified and unacceptable". The position of the British government is firmly in the anti-harmonisation camp as is the Irish government. This is hardly surprising since a policy of low taxation is widely credited as being a contributory factor to the sensational growth and development of the Irish economy over the last fifteen years. The main arguments against fiscal harmonisation include the following:

Fiscal policy – "one size does not fit all": The twenty-five economies of Europe are structurally different, in terms of unit labour costs, size of labour supply, and access to raw materials and geographical location and advantage. Different fiscal policies are suited for each nation to help offset some of their natural economic and geographic disadvantages.

Different attitudes to progressive taxation and redistribution of income and wealth: Nations in the EU have different attitudes to what is an acceptable scale of income and wealth inequality and how **progressive** the tax system should be as a **tool of redistribution.** For example, Sweden's tax and welfare system is more progressive than the UK's. Attitudes to inequality are **normative** and the fact that the UK's and Sweden's tax systems have been decided democratically suggests that a different tax system shouldn't be imposed onto the economies of each country, as this would contradict the **expressed wills of the citizens** of those nations.

Fiscal policy and demand management: By entering the euro, member countries of the Euro Zone have handed over control over their own exchange rates and interest rates. Fiscal policy is the main macroeconomic policy tool left to stimulate aggregate demand and output if the economy suffers a slowdown or a recession. If the UK ever joins the Euro, the flexible use of fiscal policy will be important

as interest rates set by the ECB will be set for the whole EU region and won't be designed with the sole intention to reduce the output gap only in the UK.

Using fiscal policy to improve the supply side: Fiscal policy is an important tool for the government to improve the supply side of the economy. In the UK, Labour has used fiscal policy measures to take people out of the poverty and unemployment trap.

The economic development of the accession countries: Accession countries are supportive of lower corporation tax rates to stimulate capital investment. Their justification is that FDI will promote growth, rising real incomes and higher employment. In the long run, if this supports the process of **economic convergence** with fellow members of the EU, then accession countries will be making fewer claims on EU regional funds and agricultural support programmes. Their markets will also provide **export opportunities** for businesses in relatively richer EU nations.

Criticisms of the fiscal stability pact: The EU fiscal stability pact has been heavily criticised for forcing governments to reduce spending in a recession, as it is doing in Germany and failing to allow the automatic stabilisers to work through.

In short, critics of the idea of fiscal harmonisation argue that individual states of the EU should be free to choose the tax systems that they consider most appropriate to meet their particular economic and social needs. For example, some countries attach a greater degree of importance to using taxes to control externalities and correct for instances of market failure. They believe that more attention should be paid to implementing wider supply-side (structural) economic reforms within the EU to boost growth and employment rather than been forced into changing their tax systems. And under current arrangements, there is nothing to stop European countries **co-operating** with each other on tax rather than having to engage in full scale harmonisation – for example agreeing joint strategies for using taxes to help the environment.

The tax burden, the structure of taxes for selected EU countries

	Total tax burden		Indirect taxes		Direct taxes		Social security contributions		Top personal income tax rate, %	Effective top tax rate on corporate income, %
	as % of GDP		*as % of total tax burden*							
	1995	2002	1995	2002	1995	2002	1995	2002	2004	2004
Sweden	49.5	50.6	32.8	34.3	40.8	36.8	26.4	28.9	56	28
Denmark	49.3	48.9	34.8	36.1	62.1	60.5	3.1	3.4	48	30
Finland	46.0	45.9	31.0	30.6	38.2	42.9	30.8	26.5	53	29
France	44.0	44.2	36.8	35.2	20.6	27.6	42.6	37.2	50	35.4
Italy	41.2	41.7	30.9	35.9	37.4	34.5	31.6	29.5	45	37.3
EU25	**40.5**	**40.4**	**33.6**	**34.8**	**31.5**	**33.1**	**34.9**	**32.1**	**42**	**27.4**
Germany	40.8	40.2	30.1	30.5	27.5	27.1	42.4	42.3	45	38.3
Slovenia	41.3	39.8	39.5	41.9	17.5	20.2	43	37.9	50	25
Holland	40.6	39.5	29.3	33.5	31.2	31.3	39.5	35.2	52	34.5
Poland	34.3	39.1	37.5	40.4	33.2	18.7	29.4	40.9	40	19
Hungary	:	38.8	:	39.2	:	26.9	:	33.9	40	17.7
Portugal	33.6	36.3	43.5	42.1	26.6	26.9	29.9	30.9	40	27.5
Greece	32.6	36.2	44.1	40.5	23.8	26.9	32.1	32.5	40	35
Spain	33.4	36.2	32.6	33.6	31.3	31.3	36	35.2	45	35
UK	**35.4**	**35.8**	**39.9**	**38.9**	**42.6**	**44.2**	**17.5**	**16.9**	**40**	**30**
Czech Republic	39.9	35.4	34.7	31.3	25.1	26.2	40.2	42.4	32	28
Estonia	:	35.2	:	40.1	:	24.4	:	35.5	26	26
Slovakia	41.5	33.0	37.7	36.4	27.9	22.6	34.5	41.0	38	19
Lithuania	37.2	31.3	40.7	37.7	23.2	29.9	36.1	32.4	25	15
Latvia	28.6	28.8	43	43.5	30.7	26.2	26.4	30.2	33	15
Ireland	33.4	28.6	43.9	43.7	41.1	40.8	15	15.5	42	12.5

Tax dumping

The reduction in corporation tax rates in many of the eastern European accession countries threatens to lead to the **de-location** of industry and jobs from Western Europe to the east. Corporation tax levels in the east average 21.5% compared with an average of 31.4% in the old European Union of fifteen countries. Estonia for example has a zero percentage rate of company taxation for profits reinvested in the country.

To the French and the Germans this smacks of **tax dumping** whereas for many eastern European countries, it represents an attempt to **stimulate capital investment** and create new jobs in countries where unemployment soared from 1989 until the end of 2002.

There are signs that this strategy may already be paying off. The decision by Volkswagen and Siemens to relocate to Eastern Europe was a landmark event and Slovakia is well on the way to becoming the country with the world's highest car output per capita. Other countries have followed suit - for example Austria which lowered its corporation tax rate in January 2004 and Ireland where profits are taxed at 12.5 per cent.

3.4 Suggestions for further research on the single market and fiscal harmonisation

- A-Z of the Single Market (BBC) http://news.bbc.co.uk/1/hi/in_depth/europe/euro-glossary/1256396.stm
- DTI (Europe and World Trade) www.dti.gov.uk/ewt/emu.htm
- European Economic Area http://europa.eu.int/comm/external_relations/eea/index.htm
- European Integration (Guardian Special) www.guardian.co.uk/eu/0,7368,396838,00.html
- Internal Market Home Page http://europa.eu.int/comm/internal_market/en/
- Investment in the UK (UK facts) www.invest.uk.com/investing/key_facts.cfm
- Mandelson calls on the EU to reform http://news.bbc.co.uk/1/hi/business/3992391.stm
- NAFTA www.nafta-sec-alena.org/DefaultSite/home/index_e.aspx
- Polish cars are the cheapest in the EU (July 2004 report) http://news.bbc.co.uk/1/hi/business/3938029.stm
- Single Market for home loans is a possibility http://news.bbc.co.uk/1/hi/business/4094333.stm
- Ten years without frontiers http://europa.eu.int/comm/internal_market/10years/index_en.htm

4 EUROPEAN MONETARY UNION

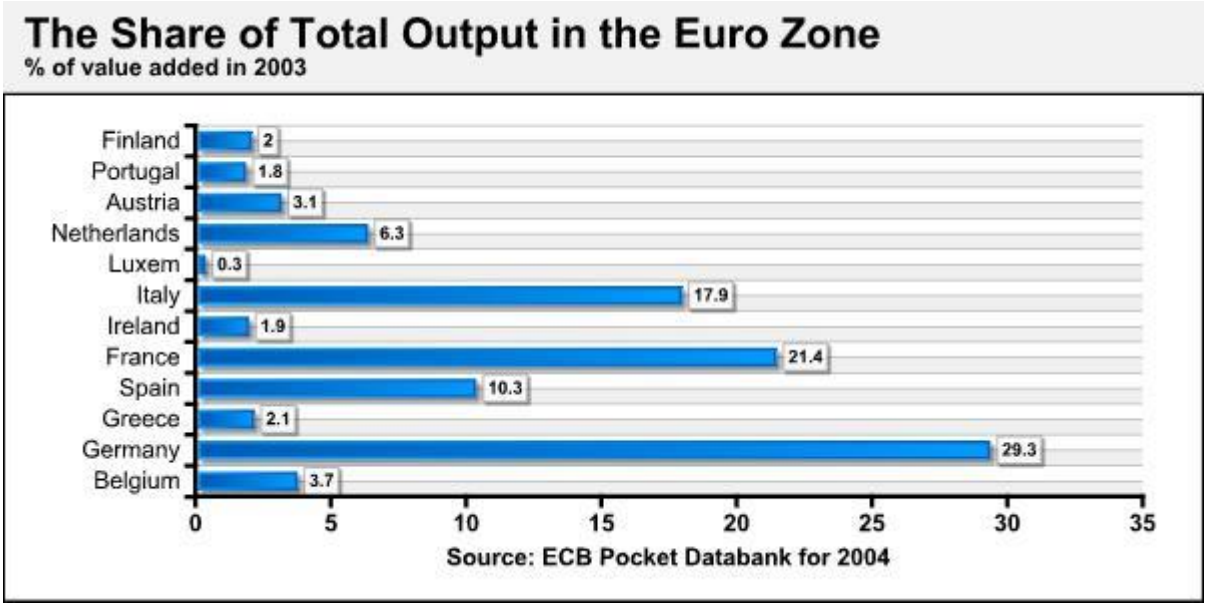
4.1 Introduction

The launch of the Euro as a new currency in **January 2002** marked a fundamental change in monetary arrangements for all members of the EU. No country is immune to some of the static and dynamic effects of the creation of a single currency covering twelve of the twenty-five member nations of the EU.

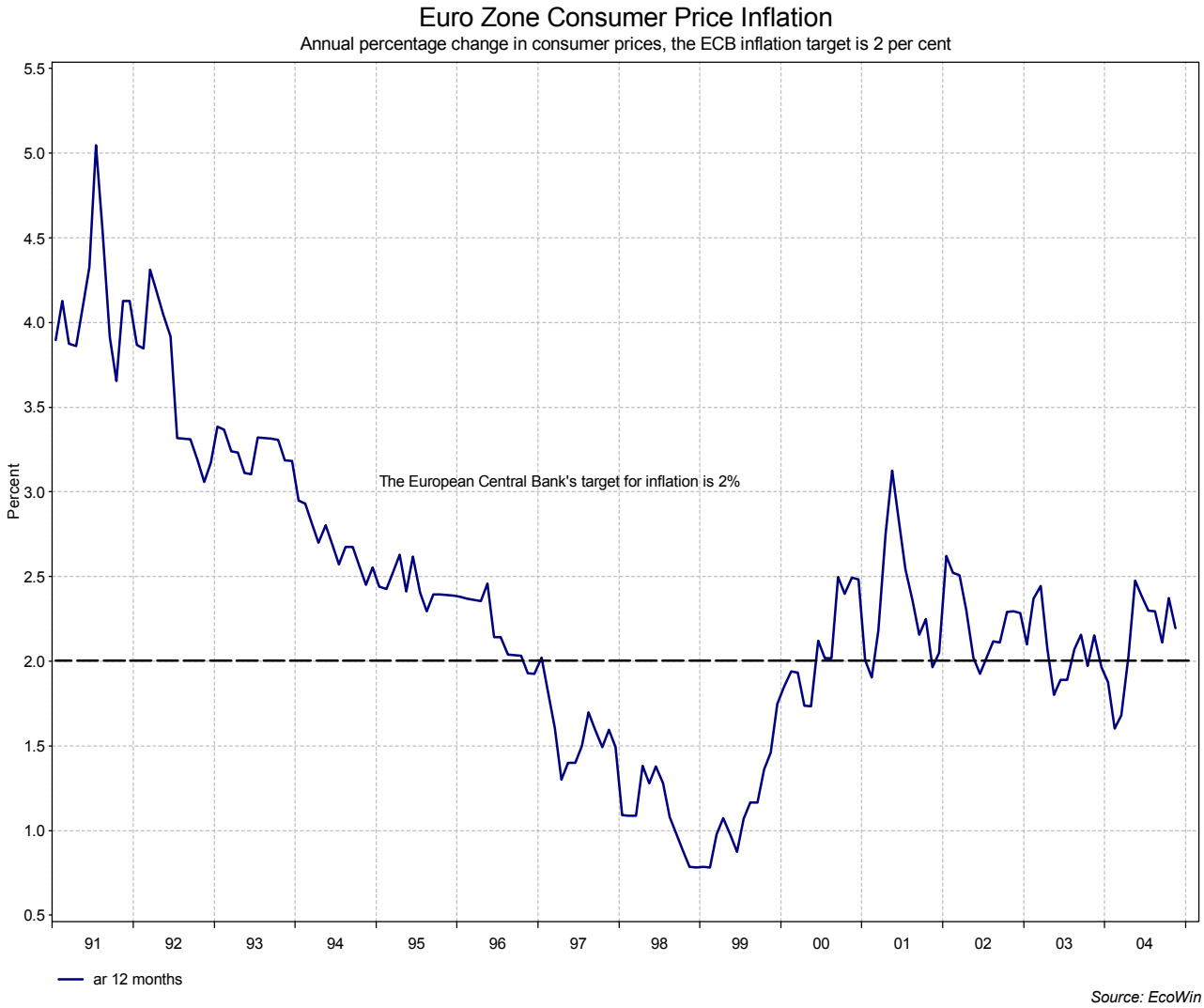
The British economy is currently outside of the Euro Zone and there is little or no prospect of her joining the single currency in the near term.

Landmarks on the Journey Towards Monetary Union	
1928	Europe returns to the Gold Standard
1944	Bretton Woods system of fixed exchange rates based on dollar-gold standard is created
1973	Breakdown of the fixed exchange rate system – move to floating exchange rates
1979	European Monetary System (EMS) is created – a forerunner to the single currency
1989	The Delors Report maps out a process to achieve Economic and Monetary Union (EMU)
1991	The Maastricht Treaty creates convergence process for countries wanting to join the Euro
1998	Eleven countries satisfy criteria for joining 1st wave of nations inside the Euro Zone
1999	Euro is launched and the European Central Bank sets official interest rates
2000	Greece becomes the 12th member of the Euro Zone
2002	Euro notes and coins come into common circulation on the 1st of January, 2002
2003	The Euro surges in value against the United States dollar, Sweden votes in a referendum not to join the single currency, the UK government publishes its assessment of the 5 economic tests deciding that the time is not right to join the Euro
2004	The Euro continues to appreciate against the dollar but the Euro Zone economy suffers from slow economic growth, weak investment and rising unemployment

4.2 Monetary Policy in the Euro Zone - The European Central Bank



The **European Central Bank** (ECB) is in charge of setting a **common interest rate** for the Euro Zone countries. Their main policy objective is to achieve **price stability** – defined as "a year-on-year increase in the Harmonised Index of Consumer Prices of below 2%".



Source: EcoWin

As we can see from the chart above, having started well below the 2% target mark, price inflation has remained a little above the target for most of the last five years although the deviation from the target is small. The data contained in this chart tends to hide quite marked variations in inflation rates among the member nations. Inflation in Ireland for example has been rising above four per cent whereas in Germany, the biggest risk has been deflation rather than a surge in price inflation in their economy.

Intermediate targets

The ECB targets the growth of the **broad money supply** as a guide to the future direction of interest rates. Broad money is basically determined by the growth of bank deposits – the majority of which are created through bank loans and over-drafts. The ECB does not have an exchange rate target, although it has intervened on a few occasions to influence the external value of the Euro. The main differences between the ECB and the Bank of England are summarised in the table below:

	European Central Bank	**Bank of England**
Location	Frankfurt	London
Goal	Price stability	Price stability
Chairman	Jean-Claude Trichet	Governor: Meryvn King
Inflation Target	Euro-Zone price inflation below 2% Inflation target is non-symmetrical	Consumer Price Inflation of 2% Permitted band of fluctuation = +/- 1%
Policy Tool	Euro Zone interest rate	Short term base interest rates
Voting	Votes split between countries who each have representation on the ECB Council	Nine member MPC - one vote each

One currency – one interest rate

The essence of a common currency is that it requires a **common interest rate**. But arguments continue to rage as to whether the twelve countries within the Euro Zone stand to benefit from a 'one-size fits all monetary policy'. Are they sufficiently similar (or convergent) in terms of economic performance for the benefits of Euro membership to outweigh the costs of having to accept a single rate of interest?

In this next section we rehearse some of the main arguments for and against British involvement in the Euro. It is worth reminding ourselves that the policy of the current Labour government is that it is in principle in favour of joining, but only if the economic conditions are right – based on their assessment of the so-called "5 Economic Tests".

4.3 Case for UK Membership of the Euro

"The main economic purpose of the single currency is to deepen integration among its members, by reducing the costs of cross-border commerce."

Adapted from the Economist, "Growing Apart", October 2004

The main justifications for the UK participating in the single currency are as follows:

- **A boost to trade, investment and productivity:** The Treasury's official assessment of its five economic tests published in June 2003 acknowledged that Euro membership for the UK could **enhance our productivity growth** by **increasing trade flows** between the UK and other EU nations; boost investment and stimulate competition in product markets. It could also help to promote **supply-side reforms** in the EU and encourage more specialization and further exploitation of the UK's comparative advantage in several sectors of the economy in the longer term. In their June 2003 assessment, the Government argued that **intra-euro area trade** has increased strongly in recent years as a result of EMU and that the UK could enjoy a significant boost to trade with the Euro Zone of up to 50 per cent over 30 years and that national income could rise over a 30-year period by between 5 and 9 per cent.
- **Increased price transparency:** Membership of the Euro should make it easier for consumers and businesses to **compare relative prices** from country to country. This will encourage an expansion in **cross-border trade** and increase competition. There are gains in consumer welfare if price transparency leads to improvements in **allocative efficiency**.
- **Business uncertainty and transactions costs:** Joining the Euro would reduce exchange rate uncertainty for British businesses and also lower transactions costs for companies and tourists. Nearly 60% of our trade in goods and services is conducted with other members of the European Union – a figure that is likely to grow further in future years

- **The Euro as a complement to the working of the Single Market:** The Euro is vital as a complement to the success of the Single European Market. This should lead to an increase in intra-European trade flows and higher **inward investment** within the EU region.
- **Britain's flexible labour market would enhance our performance within the Euro Zone:** Britain's flexible labour market would be highly effective inside a single currency area and would help to attract even more inward investment from outside the European Union.
- **Foreign investment flows and the development of UK multinational enterprises:** Britain has been a major recipient of foreign direct investment (FDI) in recent years. Some commentators believe this would be threatened if the UK remained outside the system in the long run. By removing a currency barrier to trade and potentially improving access to funding, membership of the Euro could also facilitate the development of UK-owned multinational enterprises.
- **Political and economic influence:** Britain stands to lose political and economic influence in shaping future economic integration if it remains outside the monetary system.

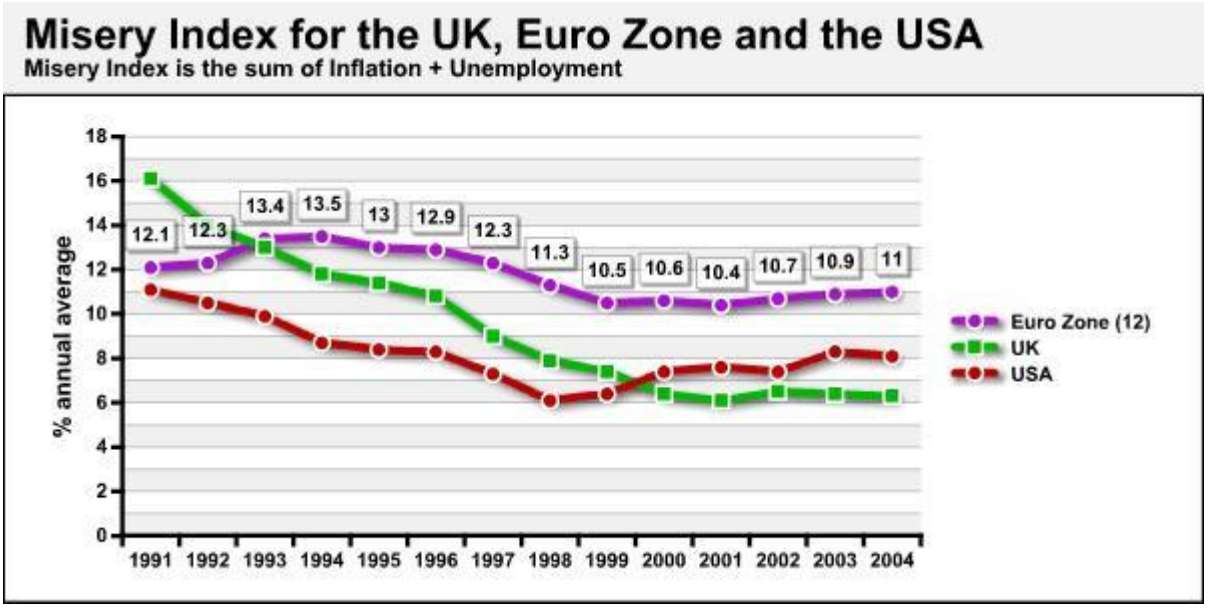
4.4 Case against UK Participation in the Euro

Critics of the Euro argue that it does not meet the requirements of an **optimal currency area** and that **structural economic differences** between member nations threaten to undermine the success of the project.

Other economists take a slightly different stance. They base their opposition to membership of the Euro on the belief that the UK can continue to enjoy a sustained period of macroeconomic prosperity outside the Euro Zone whilst still deriving some of the benefits from participation in the single European market. Here are some of the main arguments against joining and in continuing to stay out:

- **Past history and deflationary bias:** Currency unions have collapsed in the past and there can be guarantees that EMU will prove to be a success. It may indeed turn out to be a recipe for relative economic stagnation demonstrated from slower real GDP growth and higher unemployment if the ECB continues to pursue a deflationary monetary policy to keep inflation within the 2% limit. Many economists have been critical of the reluctance of the ECB to cut interest rates in a more aggressive manner during its first six years in operation. The ECB seems to have been trying to build up anti-inflation credibility – but this may have had the effect of depressing economic growth in the Euro Zone leaving it with a sizeable negative output gap.
- **The Euro is not an optimal currency area:** The Euro Zone does not meet the conditions required for an optimal currency area (OCA). For more on optimal currency areas – see below.
- **A lack of real economic convergence:** Member economies inside the Euro Zone have not converged fully in a structural sense. And, at some stage, there is a risk that excessively high interest rates will be set across the Euro Area because of an inflationary fear in one part of the zone that is totally unsuited to another area. This is the essence of the argument that in a currency union comprising many countries, it is virtually impossible for interest rates to be at a level than is optimum for any one country – i.e. there is no such thing as a **"one-size fits all" monetary policy**.
- **Loss of domestic monetary policy freedom:** Joining a single currency reduces Britain's monetary policy autonomy – or in other words the freedom for the UK to set her own interest rates based on her own internal macroeconomic objectives. Entry to the Euro Zone means a permanent transfer of domestic monetary sovereignty to the ECB and not one that can realistically be reversed.

- **Constraints of the fiscal stability pact:** Countries joining the Euro signed up initially to the fiscal stability pact which limited the scale of government borrowing to 3% of national income. Events have moved quickly during 2003-04 with several nations breaking the conditions of the pact and it has now effectively been abandoned. But remaining outside the Euro Zone gives the UK a degree of fiscal policy freedom not available to member states.
- **Monetary policy asymmetry between the UK and the Euro Zone:** There is evidence that the British economy is more sensitive to the effects of interest rate changes than other EU countries. In part this is because of the higher scale of owner-occupation in the housing market on variable-rate mortgages. Joining a currency union with little monetary flexibility requires the UK to have more flexibility in labour markets, product markets and in the housing market. Another factor behind the monetary policy asymmetry argument is that British companies tend to rely more heavily on debt finance to pay for their capital investment projects rather than the issuing of new equity (shares) through the financial markets. They are therefore more exposed to changes in short-term interest rates than businesses in other EU countries.
- **Joining the Euro – the adjustment costs:** The change over process to the introduction of the Euro will involve substantial **menu costs** for businesses and banks. These menu costs night bear heavily on small-medium sized enterprises.
- **Foreign investment issue:** Opponents of Euro membership argue that Britain can continue to attract capital inflows outside of the Euro Zone. Favourable supply-side factors in both product and labour markets make the UK attractive for foreign investment regardless of which currency is in circulation.
- **The performance of the Bank of England since 1997:** The Bank of England's success in keeping inflation within target and at the same time changing interest rates to keep the economy on track for sustained growth, may have undermined the case for UK entry into the Euro Zone for the UK. Would macroeconomic performance using the Euro be noticeably better?



The chart above provides an interesting illustration of the overall performance of individual countries. The **Misery Index** is calculated as the sum of the inflation rate and the unemployment rate.

What is striking is the divergence in the misery index between the UK and United States on the one hand and the Euro Zone on the other since the mid 1990s. In the UK and the USA there has been a sustained

fall in unemployment without any significant acceleration in inflation. The Euro Zone by contrast has been blighted by persistently high unemployment even though price inflation has remained subdued.

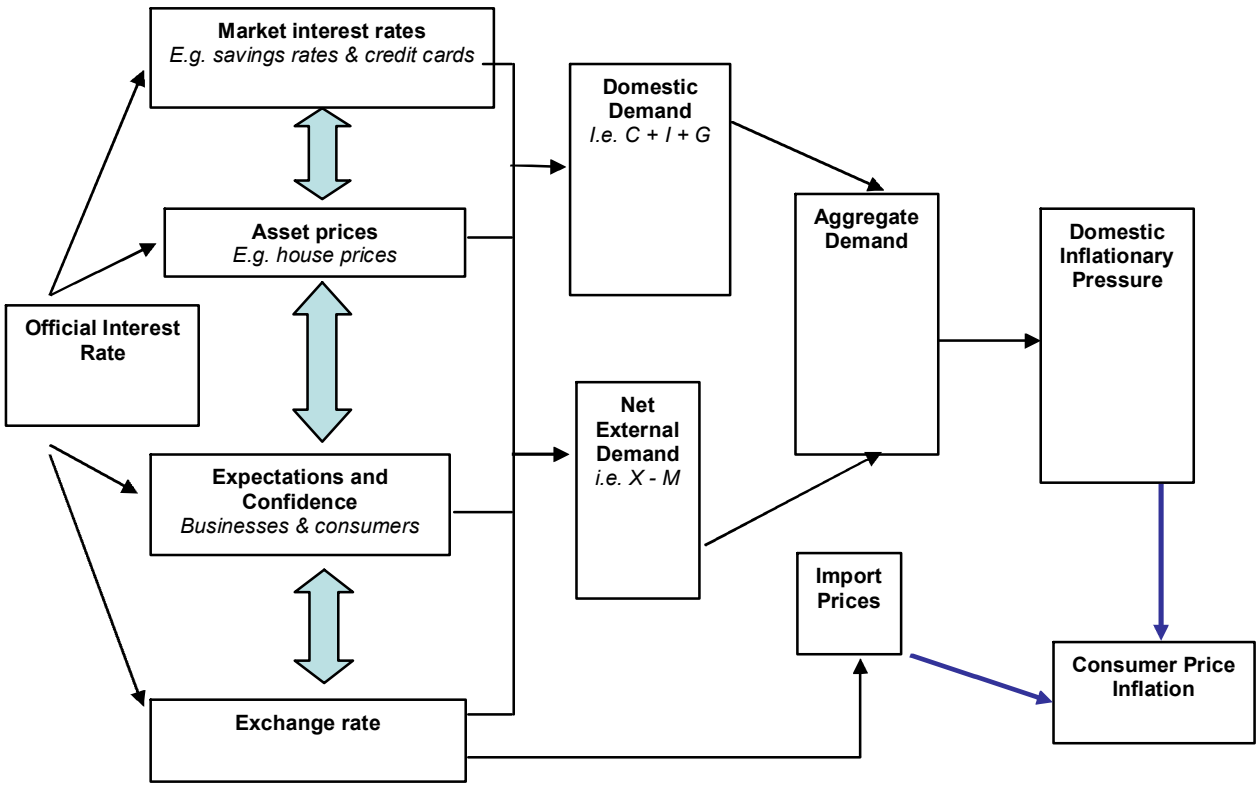
Optimal Currency Areas

The concept of an **optimal currency area** (OCA) is important to the debate about the Euro.

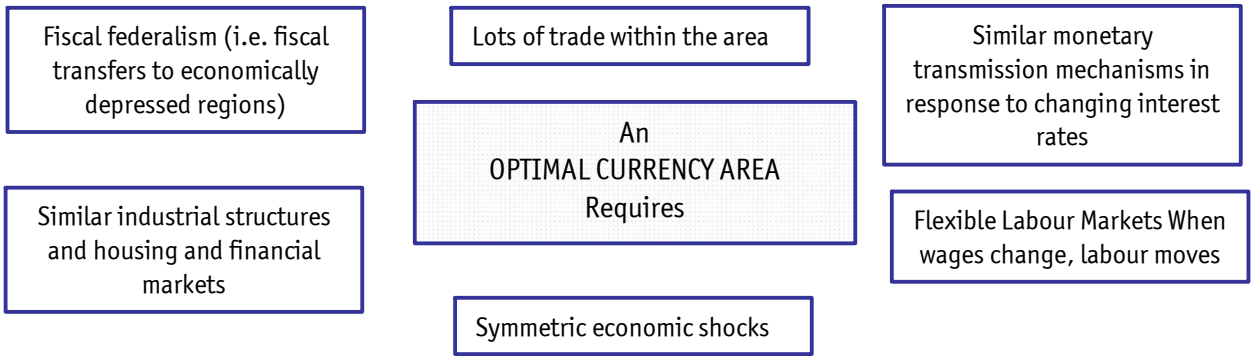
An OCA works best when the countries within it are already **highly integrated** with each other and where each has a sufficiently **flexible labour market** to cope with **external economic shocks**. The OCA is also likely to work well when the **monetary policy transmission mechanism** works in similar ways within each country – in other words, the effects of interest rate changes have a broadly similar impact on businesses and households, and the time lags involved in interest rate changes working their way through to affect output, employment and prices are pretty close to each other.

A reminder of the Bank of England's view of the **monetary transmission mechanism** is provided in the figure below.

Mapping out the Transmission Mechanism – the effects of changes in interest rates in the UK economy

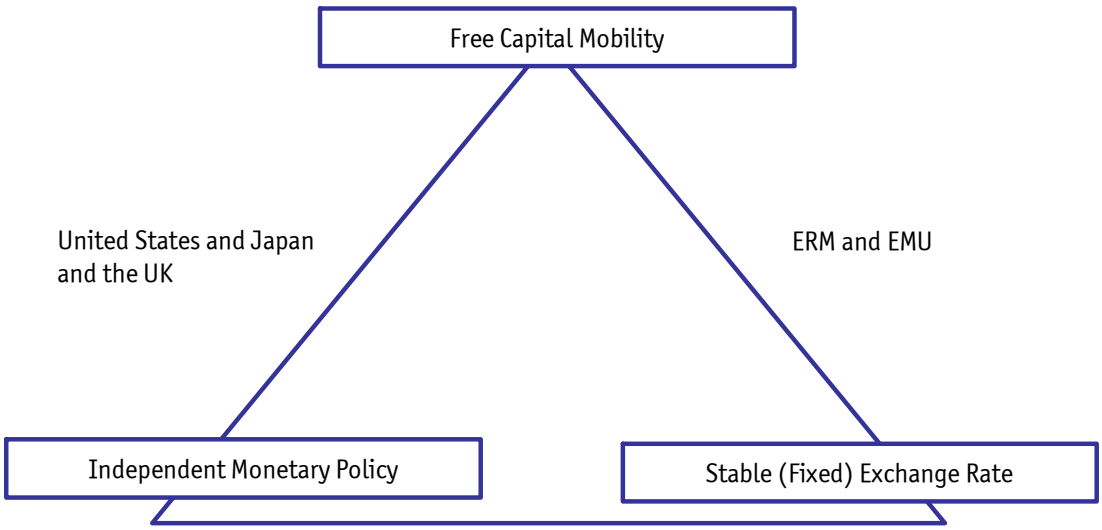


In most important respects, the Euro Zone is not an OCA – although a small group of countries within it are probably closely convergent in a structural sense. An OCA is better placed to succeed with a small cluster of countries rather than the coalition of twelve nations that count themselves as founder members of the single currency.



Another important issue for the UK is illustrated in the next figure.

The basic argument is this. A country might want all three of the features shown in the boxes below: Free capital mobility helps to attract inward investment and permits the free flow of investment capital overseas to take advantage of overseas investment opportunities. Secondly the freedom to pursue an independent domestic monetary policy (i.e. set your own interest rates to meet an inflation target or some other objective). Thirdly the benefits that might flow from having stable fixed exchange rate.



Only two of the three features can be chosen at any one time. If a country desires exchange rate stability and also capital mobility, it must use monetary policy to set interest rates to meet an exchange rate target. This was the case when the UK was a member of the **exchange rate mechanism** from October 1990 to September 1992. Interest rate policy was constrained by the need to keep sterling within the agreed bands of the ERM. Once the UK had left the ERM and moved to a **free-floating exchange rate**, this freed up domestic monetary policy. Interest rates could now be set to keep the growth of aggregate demand in line with aggregate supply so that the economy continued to grow but keeping inflation within target range.

At the moment the Government is keen to retain these two elements – a **floating currency** and an **independent monetary policy**. It believes that the Bank of England has done a good job in setting interest rates and the free flow of capital allows the balance of payments deficit on the current account to be financed whilst the sterling exchange rate is left to find its own level in the foreign exchange markets.

4.5 The 5 Economic Tests

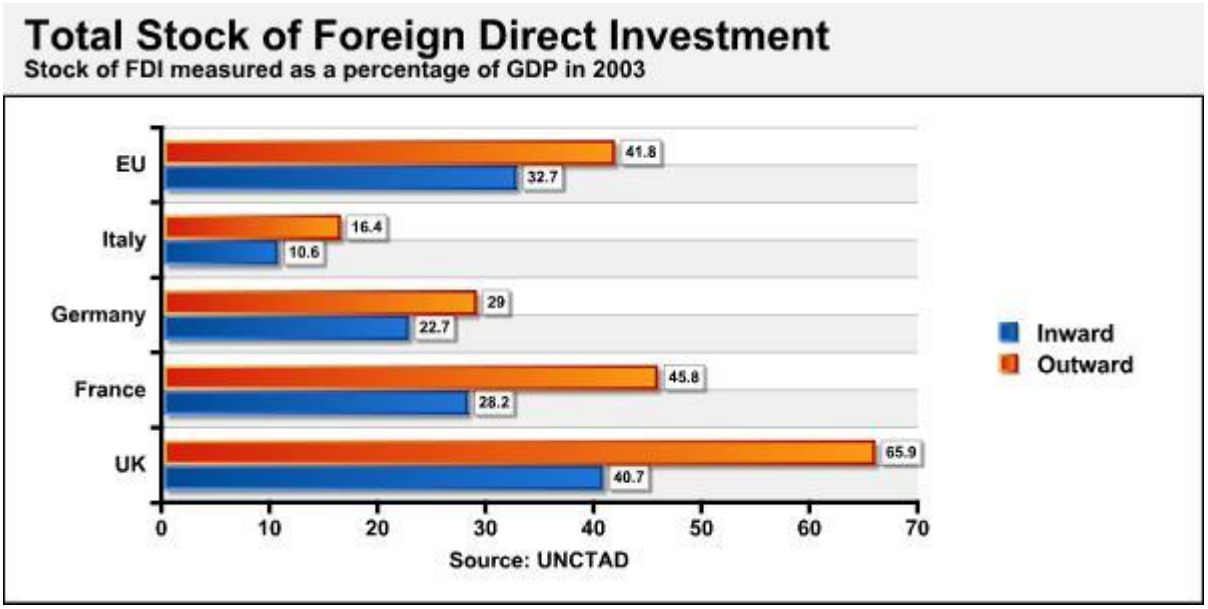
A long-term decision

The Government's decision on EMU membership reflects what it believes is best for the long-term economic interests of the British people and the performance of the UK economy.

Treasury Statement of Policy on the 5 Economic Tests, June 2003

Gordon Brown has outlined **five economic tests** to be met before he will recommend membership of the single currency.

1. **Economic Convergence:** This test revolves around the following question. Are UK and Euro Zone **business cycles** and **economic structures** compatible so that we and others could live comfortably with euro interest rates on a permanent basis?
2. **Economic Flexibility:** The second test considers whether there is sufficient **flexibility** in the system to cope with **external economic shocks**. Brown wants there to be more flexibility in the European labour market and increased competitive pressures in markets for goods and services. Some of this may happen naturally (driven for example by the impact of the Internet) but the European labour markets may require root and branch reforms. The British government is certainly pushing strongly for **wider economic reforms** in Europe before it will countenance membership of the single currency
3. **Investment:** This test focuses on whether membership of the single currency has a beneficial effect on capital investment across many sectors of the economy. Would joining EMU create better conditions for overseas firms making long-term decisions to invest in Britain?
4. **The Financial Services Industry:** The fourth test is not the most important one! It considers the likely impact of Euro participation on the health of the UK's financial services industry
5. **Employment:** Whether the Euro is good in the long term for raising employment and reducing unemployment – according to the Treasury, this test can be summed up as follows: 'Will joining EMU promote higher growth, stability and a lasting increase in jobs?'



4.6 Importance of Economic Convergence

The idea of **convergence** is perceived to be the single most important test against which the UK government is assessing the costs and benefits of UK participation in the Euro.

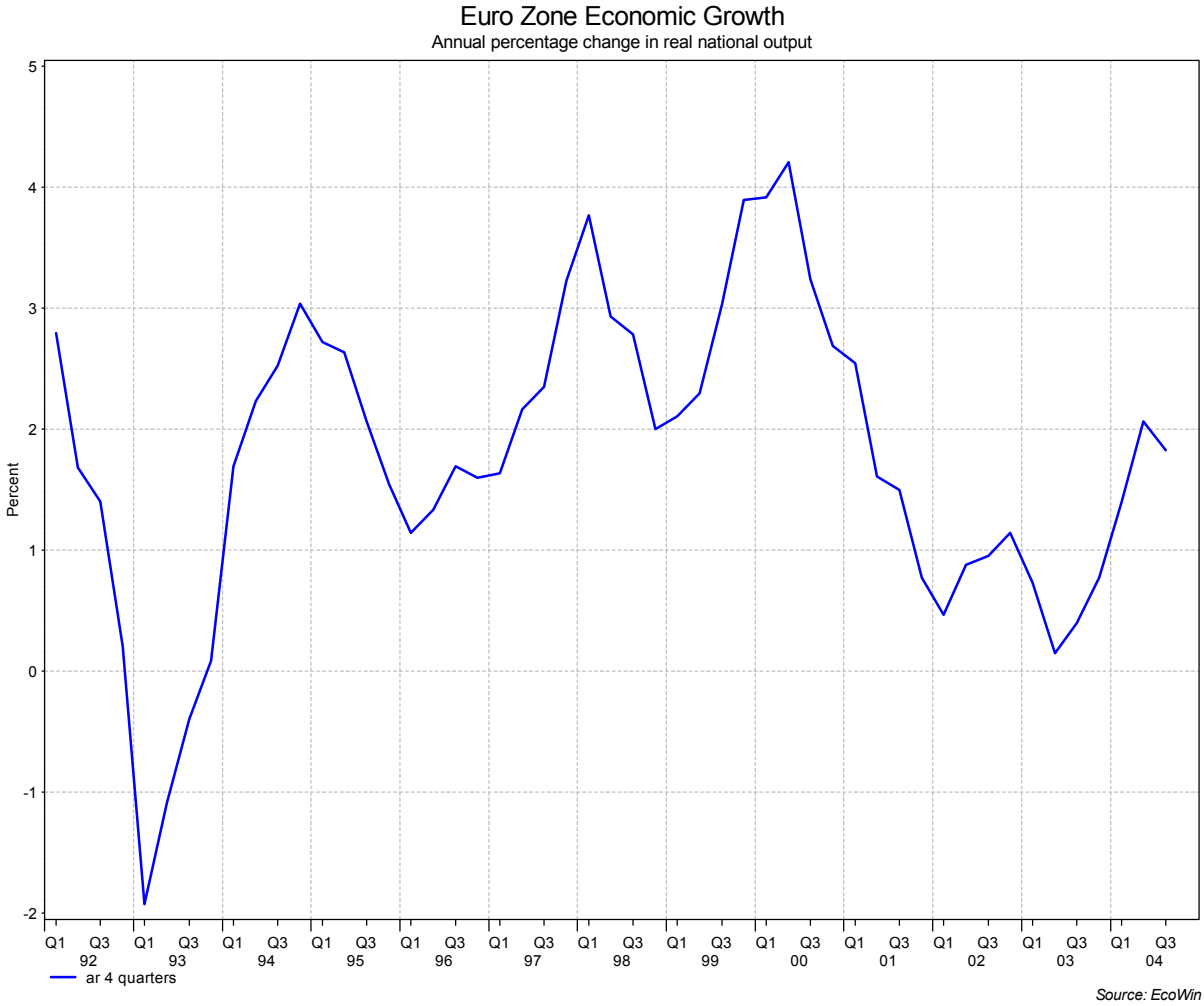
Three different types of convergence can be identified:

- **Cyclical convergence**: This considers the extent to which the **economic cycles** of the UK and the Euro Zone have aligned
- **Structural convergence:** Economic structures in the UK and the Euro Area are compared and the implications in terms of aggregate demand and aggregate supply-side economic shocks and their impact on prices, output and jobs are assessed
- **Endogenous convergence:** Endogenous convergence describes the convergence that may occur as a result of joining the Euro – for example the extent to which **wage bargaining in the labour market and price-setting in product markets** might be affected by being inside a single currency area, or changes in the balance between fixed and variable rate borrowing for households and businesses.

Cyclical Convergence

The main indicators of cyclical convergence are

- **National output:** The basic measure of convergence is the rate of real GDP growth
- **Short-term interest rates** - differences in short-term interest rates indicate disparities in either inflation targets or perceived inflationary pressures
- **Real interest rates** – this is the nominal rate of interest adjusted for inflation and it is important as a factor influencing investment decisions by businesses and savings decisions of households
- **The output gap** – this is the difference between actual and potential output. The output gap is used as an indicator of future inflationary pressure and is often at the forefront of decisions of central banks when setting interest rates to meet an inflation target
- **Labour market conditions** - labour market indicators would include the annual growth of wages and earnings, the rate of unemployment and surveys of skills shortages – reflecting the changing balance of labour demand and supply in an economy
- **Long-term interest rates and inflation expectations** – these indicate the success and credibility of monetary policy and macroeconomic policy more generally. The long term rate of interest on ten year Government bonds is widely perceived as the bond markets best forecast of inflation expectations for a country going forward
- **The exchange rate** - a further important indicator of the state of the economy because changes in the exchange rate can have a major effect on the pattern of demand and short term growth



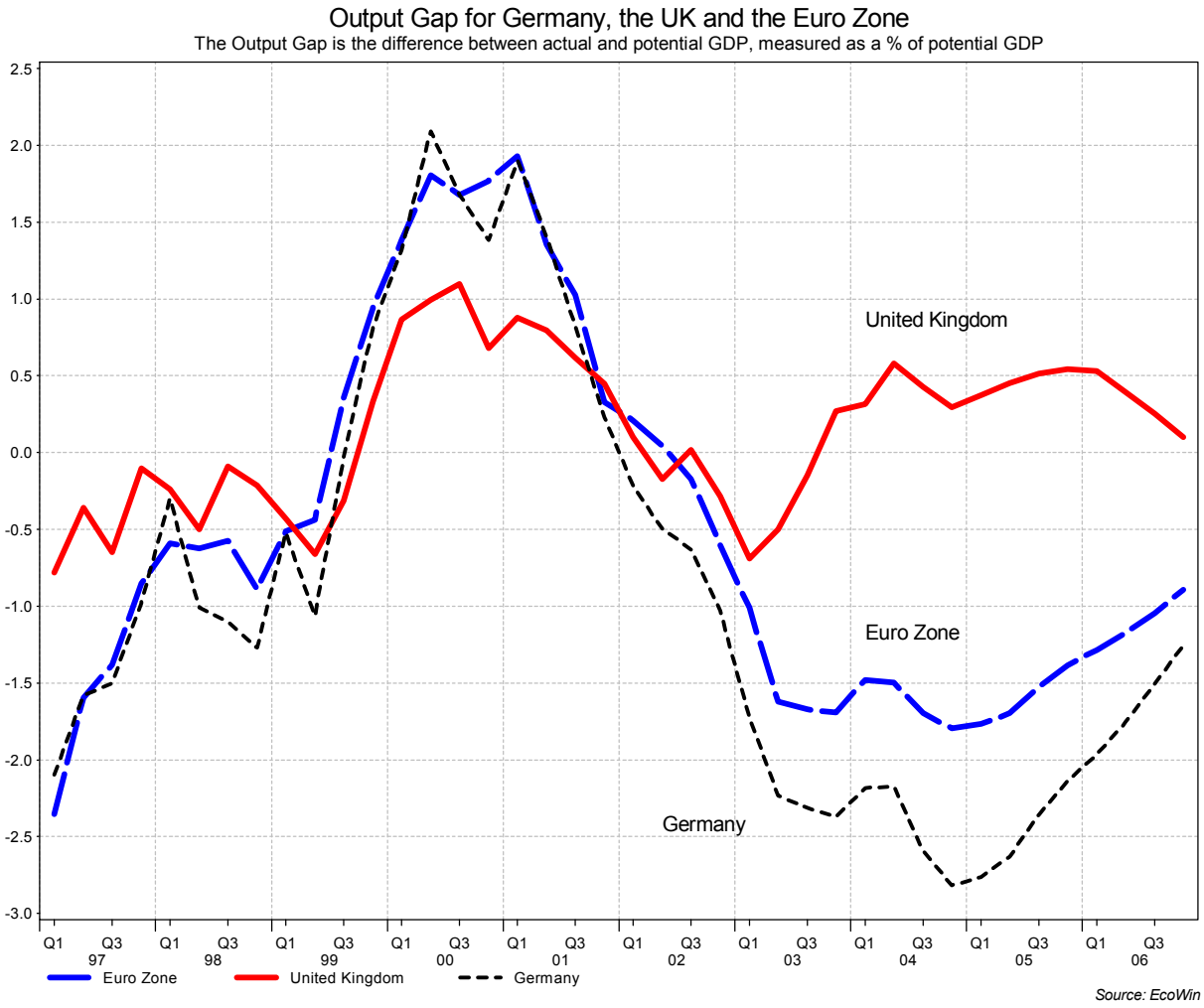
There is no guarantee that countries within the Euro Zone will see a convergence or synchronisation between their economic cycles. Indeed there is some evidence that economic cycles have diverged within the single currency area since the currency was fully launched at the end of 2001. For example the Spanish economy has grown by nearly 20 per cent since 1999 whereas Germany has grown by only 7 per cent. One of the reasons for this is changes in the **real exchange rate**. Although countries inside the Euro Zone share a common interest rate and have fixed nominal exchange rates between them, the real exchange rate can vary quite a lot. A country with low inflation for example will become more competitive over time and this should help to boost their export performance in trade in goods and services with other Euro Zone nations.

The divergence in cycles is not helped by having a common interest rate. In countries such as Spain and Ireland where growth and inflationary pressures have been strong, the need has been for higher interest rates to control the growth of demand. In Germany, on the brink of a deflationary recession and suffering from high rates of unemployment, the need has been for a more relaxed monetary policy (i.e. lower nominal and real interest rates).

A measure of convergence – the output gap

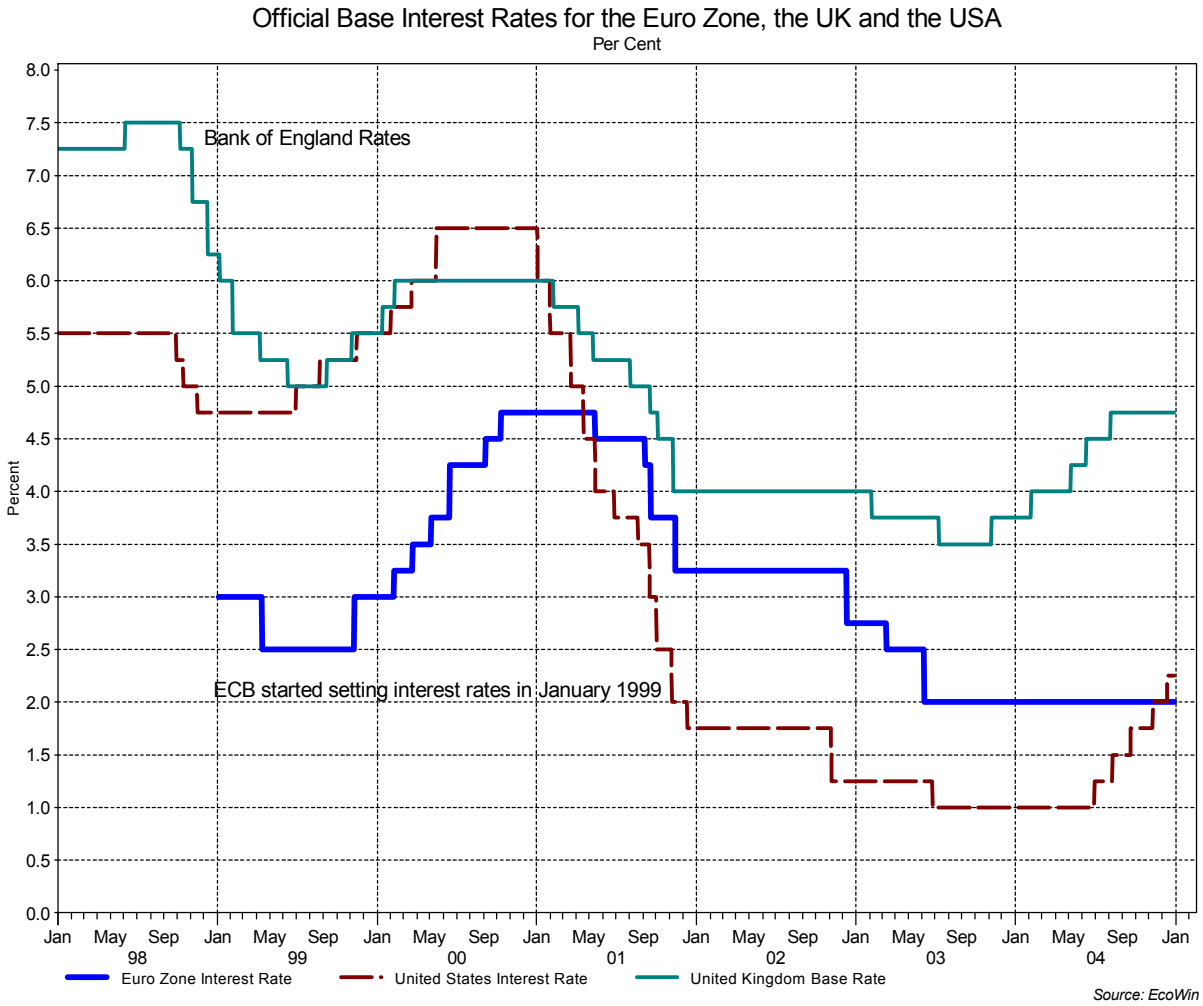
The chart above tracks the quarterly movements of the output gap. This is basically a measure of the amount of **spare capacity** available to an economy that wants to continue growing. When the output gap is negative then real national output is below its estimated trend level. When GDP lies above trend, there is a positive output gap and this is often taken as a sign that an economy has reached its output potential in the short run. There may be cost push and demand-pull inflationary pressures in the pipeline when a positive output gap emerges!

Although we cannot observe the output gap directly, (the data in the chart comes from estimates and forecasts published by the OECD), it is clear from the chart that there has been a divergence in the economic cycles of the UK and the Euro Zone since the second half of 2002. Whilst the UK economy has continued to grow close to its own trend rate, the slow growth in the Euro Zone (and Germany in particular) has left it with a sizeable negative output gap. One might think that this would be the cue for the European Central Bank to be cutting interest rates to give a boost to aggregate demand and output. But the ECB has been slow to change monetary policy because it fears a rise in inflation.



Recent Movements in Short Term Interest Rates

We now consider what has happened to interest rates within the Euro Zone in recent years. The reality is that relatively little has happened! Indeed the ECB has not changed official short term interest rates for the Euro Zone since the summer of 2003!



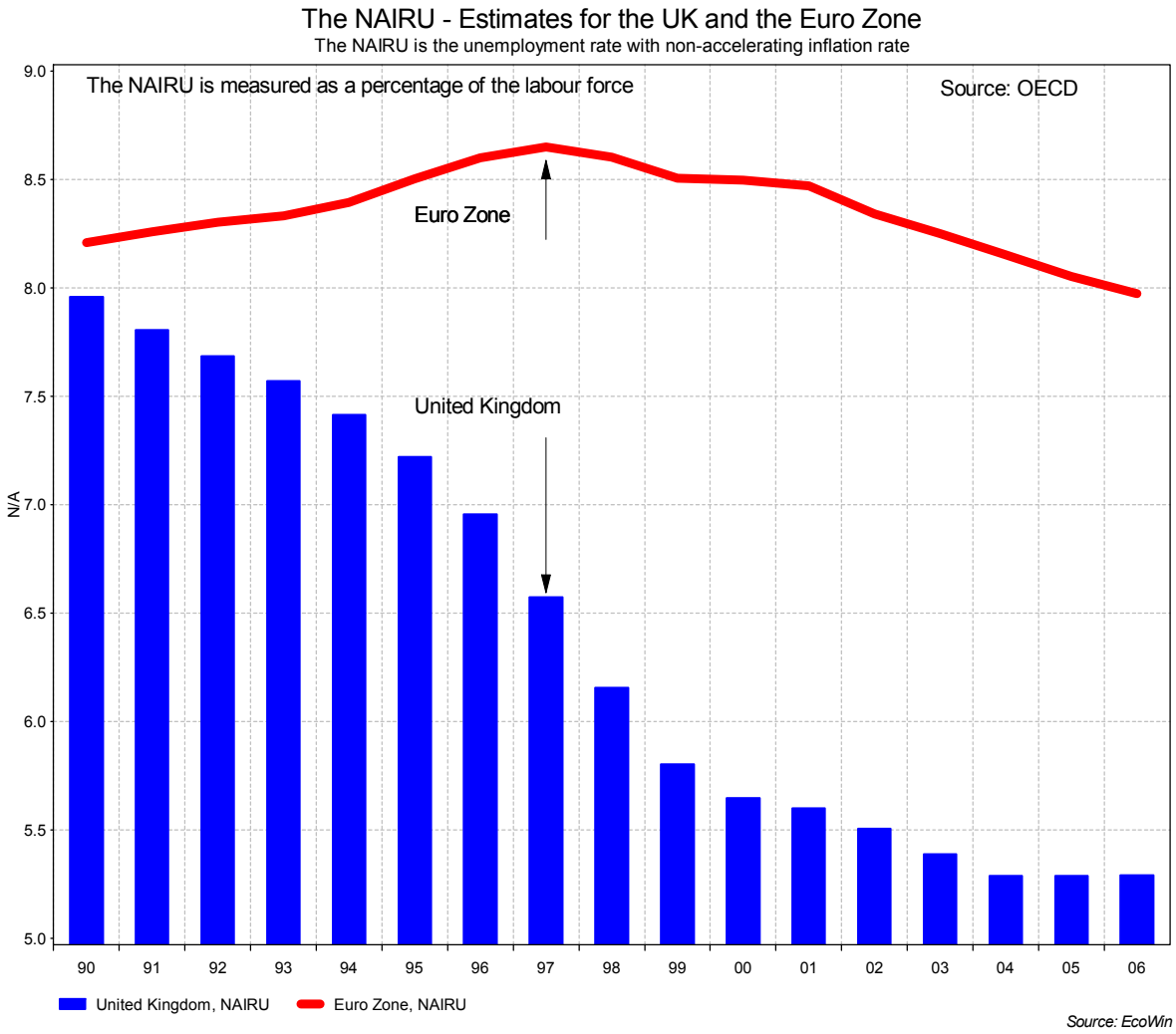
Once again the chart shows a divergence in the interest rates set by the ECB and those under the control of the Bank of England. In January 2005 the **interest rate differential** was 2.5%.

Structural Convergence

Structural convergence analyses whether the **supply-side structures** of the British economy might be different to countries within the Euro Area. And, if they are, the extent to which different structures could make the UK more vulnerable to **economic shocks** that do not affect the rest of the euro area (for example, volatility in house prices). There is also the risk that the UK could react differently to changes in circumstances that affect the whole of the monetary union (e.g. changes in Euro Zone interest rates).

The main structural features are:

- **The sector composition of national output** (e.g. the contribution to GDP in each country made by manufacturing, services, agriculture and the energy industries)
- **Patterns of trade** within and outside the Euro Area for each country
- **The structure of financial markets** including the structure of finance used in housing markets
- **Differences in estimated equilibrium rates of unemployment** – this affects the nature of the inflation – unemployment trade-off in each country and also impacts on how quickly an economy can grow without running into inflation problems. The evidence is that the Euro Zone has a poorer unemployment-inflation trade off indicated by differences in the estimated non-accelerating inflation rate of unemployment (NAIRU). This is shown in the next chart.



Differences in the rate of growth of factor productivity

Consider the structure of output between the UK, Germany and France, details of which appear in the next table: Germany has a relatively larger manufacturing base. Indeed its economic cycle is extremely closely tied to trends in the global demand for manufactured goods. In contrast the UK has moved more towards a post-industrial economy with nearly three-quarters of final output coming from the service sector.

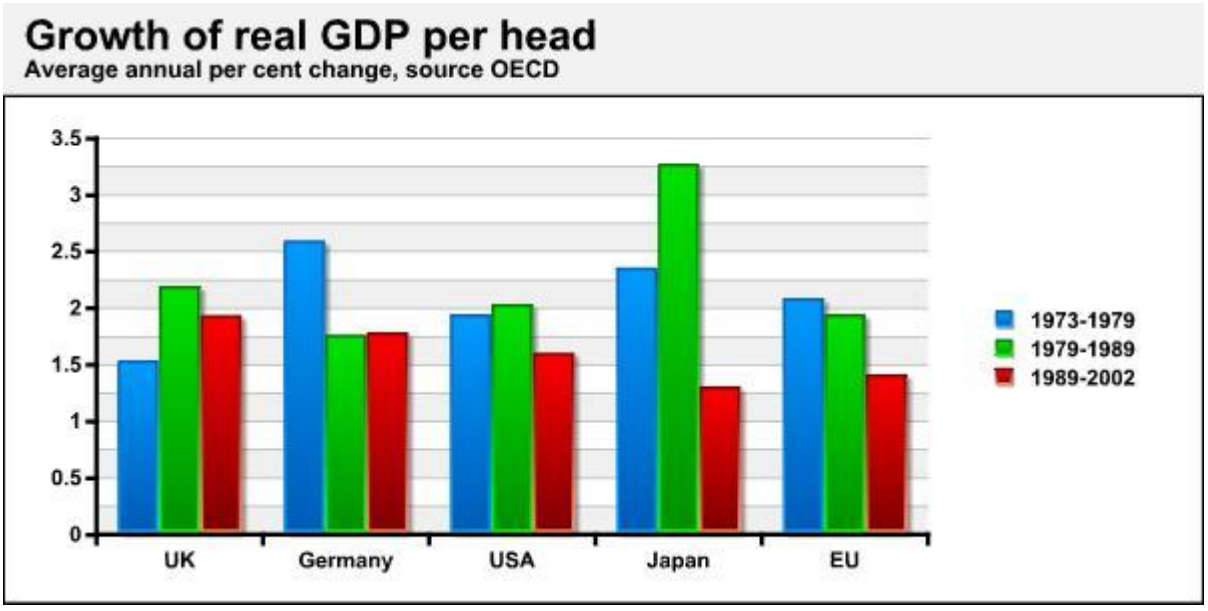
Comparing the structure of GDP by sector

Per cent of total output, data is for 2001	UK	Germany	France
Agriculture, hunting, forestry, fishing	0.9	1.1	2.8
Manufacturing, mining, utilities	19.9	24.2	20.1
Construction	5.5	4.4	4.7
Distribution, hotels, transport, communications	22.9	18.6	19.3
Finance, real estate, other business activities	27.9	30.1	30.1
Public admin, social security, education, health, defence	22.8	21.6	23.1
Services total	73.6	70.2	72.4

The Housing Market and UK Entry into the Euro Zone

To some economists, the housing market is a major barrier to the UK joining the single currency in the foreseeable future. Mortgage markets differ significantly across Europe with important implications for the sensitivity of household spending to interest rate changes. There are three main differences between the UK housing market and the system in place in many of our European neighbours:

- **Mortgage finance:** Home-buyers in the UK rely more heavily on **variable interest-rate loans** (mortgages) whereas in much of Western Europe, mortgages are taken out on **fixed rate loans**. In Germany, 80 per cent of mortgages are at long-term fixed rates of over five years, with all the rest shorter-term fixed rates.
- **Home-ownership:** Owner-occupation in the UK is not significantly above the European average. It is, though, much higher than in Germany and France, the two largest countries inside the Euro Zone and the countries that carries the highest weighting when making interest rate decisions.
- **Borrowing housing wealth:** In the UK, it is easier for home-owners to borrow some of the housing equity in their properties through mortgage equity withdrawal. This has been a key factor behind the strong growth of consumer spending in the UK over the last four or five years.



Differences in the Monetary Policy Transmission Mechanism

Taken together, the structural features discussed above will influence how monetary policy affects the real economy: the so-called **monetary policy transmission mechanism**. If a change in Euro Zone interest rates causes a different response in the UK compared to euro area countries, in terms of the speed of response or its overall effect on output and inflation, this might result in a **divergent cyclical path** or greater volatility of output and inflation in the UK. We have already referred to this as **monetary policy asymmetry** – and it is a hugely important aspect of the Euro debate.

The Sixth Test – Public Opinion!

The main constraint on the British entry decision is not technicality of convergence and finding the right entry level for the exchange rate against the Euro! The binding constraint for the Government is public opinion.

The process of changing hearts and minds on this issue will prove difficult - particularly if the economic performance of the UK continues to out-perform the average of other European countries, as has been the case in the second half of the 1990s and the early years of the new decade.

4.7 Suggestions for further research on European Monetary Union

- Business for Sterling www.bfors.com/
- Corsetti's European Homepage www.econ.yale.edu/~corsetti/euro/
- Euro Zone Economic Indicators http://europa.eu.int/comm/economy_finance/indicators/key_euro_area/keyeuroarea_en.htm
- European Central Bank (ECB) www.ecb.int/
- European Economy Charts (New York Fed Reserve) www.newyorkfed.org/research/global_economy/euroecon_charts.html
- Guardian special report on the Euro www.guardian.co.uk/euro/0,11306,606524,00.html
- History of the Euro (BBC news online) http://news.bbc.co.uk/hi/english/static/in_depth/business/2001/euro_cash/history/default.stm
- New EU members face tough Euro test http://news.bbc.co.uk/1/hi/business/3760916.stm
- The Euro – our currency http://europa.eu.int/euro/entry.html
- Treasury (UK Euro Policy) www.hm-treasury.gov.uk/documents/the_euro/euro_index_index.cfm

5 MACROECONOMIC DEVELOPMENTS WITHIN THE EURO ZONE

This chapter focuses on macroeconomic developments in the Euro Zone countries since 1999 – the year when the Euro became a reality and the currency began trading on the global foreign exchange markets.

5.1 Short Term Economic Growth

After strong growth in 1999 and the early months of 2000 the Euro Zone has experienced a period of slow growth of national output. Real GDP grew by only 0.9% in 2002 and just 0.5% in 2003. Despite a pick up in economic activity during 2004, output growth in recent years has been well below the estimated **trend rate of growth** for the EU. The result is that production in the Euro Zone is well below the estimated level of potential output i.e. a **negative output gap** which is leading to rising unemployment. The performance of the export sector matters hugely because exports account for twenty per cent of Euro Zone output.

Ireland tops the league table for average percentage growth rates during the last ten years. The table below covers the period 1995-2004 and shows that Ireland has grown at a rate four times faster than the Euro Zone average. It is worth noting that eight of the top ten countries in the European League Table are among the accession nations that joined the European Union in May 2004.

Real GDP Growth for European Union Countries

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	Average
Ireland	9.8	8.1	10.8	8.9	11.1	9.9	6.0	6.1	3.7	5.2	8.0
Estonia	4.5	4.5	10.5	5.2	-0.1	7.8	6.4	7.2	5.1	5.9	5.7
Latvia	-0.9	3.8	8.3	4.7	3.3	6.9	8.0	6.4	7.5	7.5	5.6
Lithuania	3.3	4.7	7.0	7.3	-1.7	3.9	6.4	6.8	9.7	7.1	5.5
Luxembourg	1.4	3.3	8.3	6.9	7.8	9.0	1.5	2.5	2.9	4.0	4.8
Slovakia	5.8	6.1	4.6	4.2	1.5	2.0	3.8	4.6	4.0	4.9	4.2
Cyprus	9.9	1.8	2.3	5.0	4.8	5.0	4.1	2.1	1.9	3.5	4.0
Poland	2.7	6.0	6.8	4.8	4.1	4.0	1.0	1.4	3.8	5.8	4.0
Slovenia	4.1	3.6	4.8	3.6	5.6	3.9	2.7	3.3	2.5	4.0	3.8
Hungary	1.5	1.3	4.6	4.9	4.2	5.2	3.8	3.5	3.0	3.9	3.6
Greece	2.1	2.4	3.6	3.4	3.4	4.5	4.3	3.6	4.5	3.8	3.6
Finland	3.4	3.9	6.3	5.0	3.4	5.1	1.1	2.3	2.0	3.0	3.6
Spain	2.8	2.4	4.0	4.3	4.2	4.4	2.8	2.2	2.5	2.6	3.2
UK	**2.9**	**2.8**	**3.3**	**3.1**	**2.9**	**3.9**	**2.3**	**1.8**	**2.2**	**3.3**	**2.9**
Sweden	4.1	1.3	2.4	3.6	4.6	4.3	1.0	2.0	1.5	3.7	2.8
Portugal	4.3	3.5	4.0	4.6	3.8	3.4	1.7	0.4	-1.2	1.3	2.6
Netherlands	3.0	3.0	3.8	4.3	4.0	3.5	1.4	0.6	-0.9	1.4	2.4
Belgium	2.4	1.2	3.5	2.0	3.2	3.9	0.7	0.9	1.3	2.5	2.2
Denmark	2.8	2.5	3.0	2.5	2.6	2.8	1.6	1.0	0.4	2.3	2.2
France	1.7	1.1	1.9	3.4	3.2	3.8	2.1	1.2	0.5	2.4	2.1
Cz. Republic		4.2	-0.7	-1.1	1.2	3.9	2.6	1.5	3.7	3.8	2.1
Austria	1.9	2.6	1.8	3.6	3.3	3.4	0.7	1.2	0.8	1.9	2.1
Euro Zone	**2.2**	**1.4**	**2.3**	**2.9**	**2.8**	**3.5**	**1.6**	**0.9**	**0.5**	**2.1**	**2.0**
Malta					4.1	6.4	-2.4	2.6	-0.3	1.0	1.9
Italy	2.9	1.1	2.0	1.8	1.7	3.0	1.8	0.4	0.3	1.3	1.6
Germany	1.7	0.8	1.4	2.0	2.0	2.9	0.8	0.1	-0.1	1.9	1.4

Source: Eurostat and OECD World Economic Outlook, December 2004.

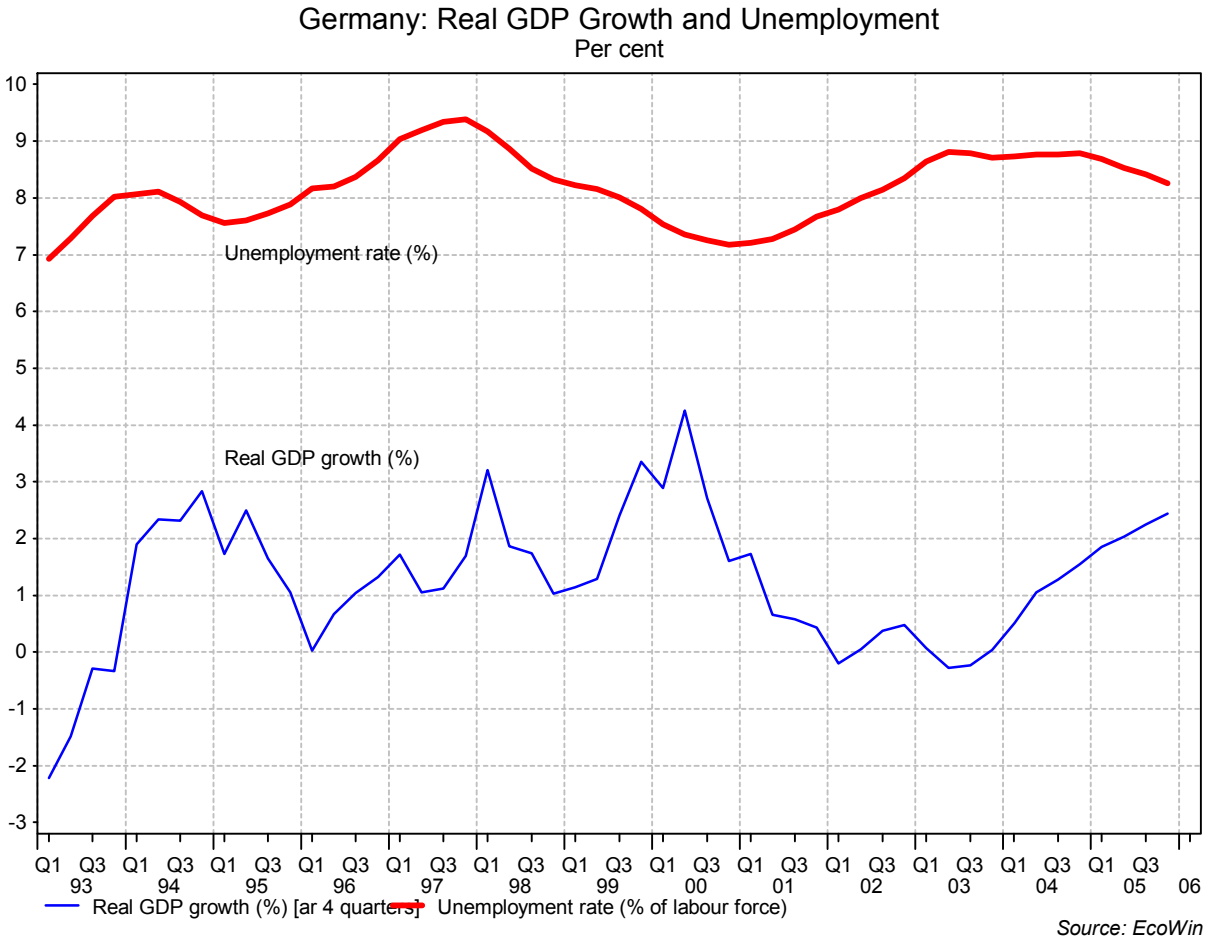
5.2 Macro performance of selected countries

Germany

		1999	2000	2001	2002	2003	2004
Real GDP	% change	1.9	3.1	1.0	0.1	-0.1	1.2
Consumption	% change	3.6	2.2	1.8	-0.7	0.0	-0.7
Gross Capital Investment	% change	3.8	3.4	-4.0	-6.3	-2.2	-2.0
Exports	% change	5.1	14.2	6.1	4.1	1.8	8.1
Imports	% change	8.1	11.1	1.4	-1.6	3.9	6.4
Unemployment	per cent	8.0	7.3	7.4	8.2	9.1	9.2
Government Borrowing	% of GDP	-1.5	1.3	-2.8	-3.7	-3.8	-3.9
Current Account of the BoP	% of GDP	-1.1	-1.4	0.1	2.1	2.3	3.3

Germany has endured several years of slow growth and its current problems have had a major impact on the overall pace of expansion within the single currency area. It is important to realise that Germany has been performing relatively poorly for some years now. Growth has been limited to an average of 1.4% since 1995, when other European countries experienced a mere 2.2%. There was a technical recession in 2003 and only a modest rebound in output in 2004.

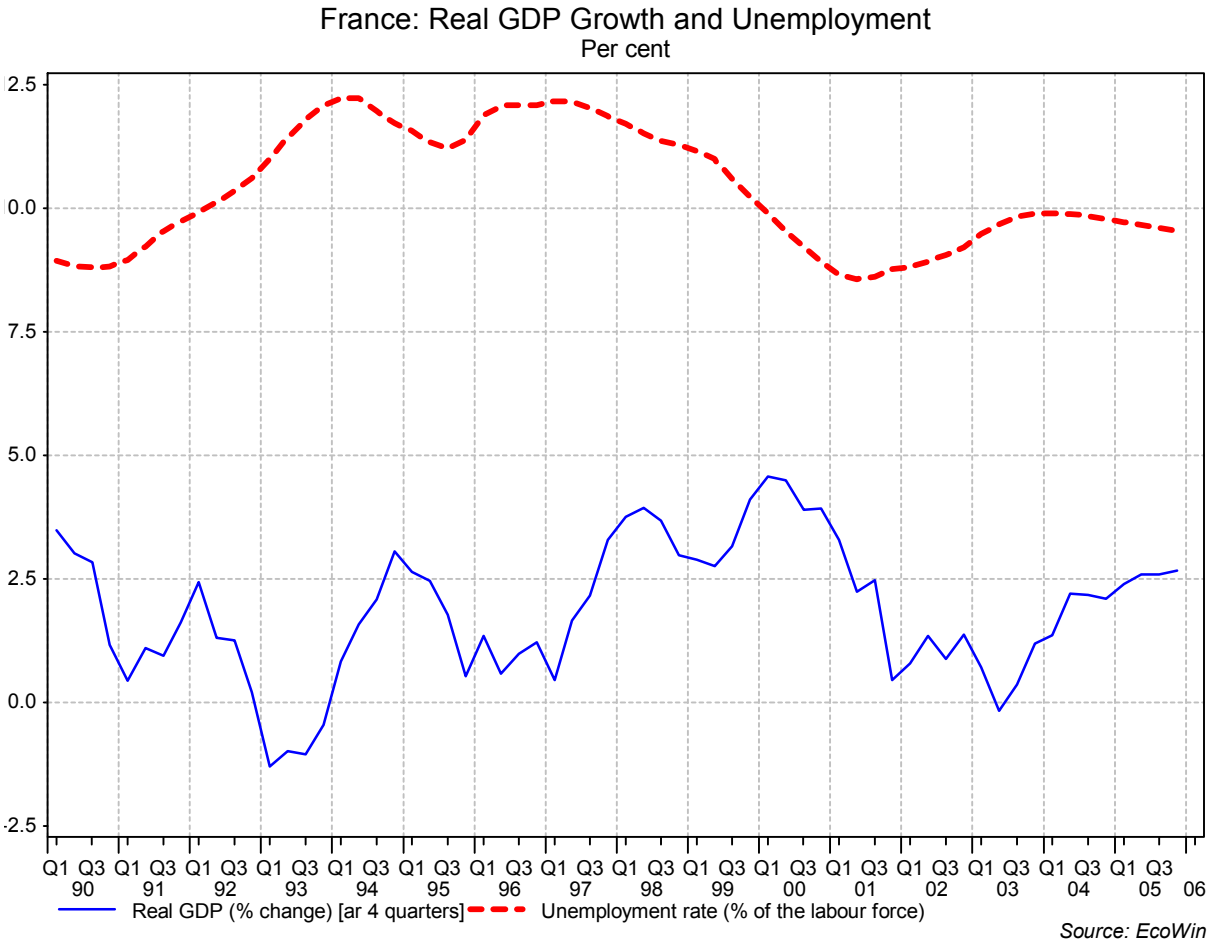
Of more concern is that growth in each of the last four years has been below the growth of potential GDP, leaving Germany with a huge amount of spare capacity. The end result of weak growth is a huge unemployment problem. The next chart maps out the path of real GDP growth and unemployment for Germany since 1993.



France

		1999	2000	2001	2002	2003	2004
Real GDP	% change	3.2	4.2	2.1	1.1	0.5	2.1
Household spending	% change	3.5	2.9	2.8	1.8	1.7	2.3
Gross capital investment	% change	8.3	8.4	2.1	-1.8	0.1	3.5
Exports	% change	4.2	13.4	1.9	1.7	-2.6	3.4
Imports	% change	6.1	15.2	1.6	3.3	0.3	7.7
Unemployment	per cent	10.7	9.4	8.7	9.0	9.7	9.8
Government borrowing	% of GDP	-1.8	-1.4	-1.5	-3.3	-4.1	-3.7
Current account of balance of payments	% of GDP	2.9	1.4	1.7	1.0	0.4	0.2

France is the second biggest economy in the Euro Zone and has managed real GDP growth of less than 2% in recent times. Together these two countries account for well over fifty per cent of aggregate output in the single currency region. Poor growth in France and Germany inevitably has a knock-on effect on trade and growth with their near neighbours (such as the Netherlands, Belgium and Austria).



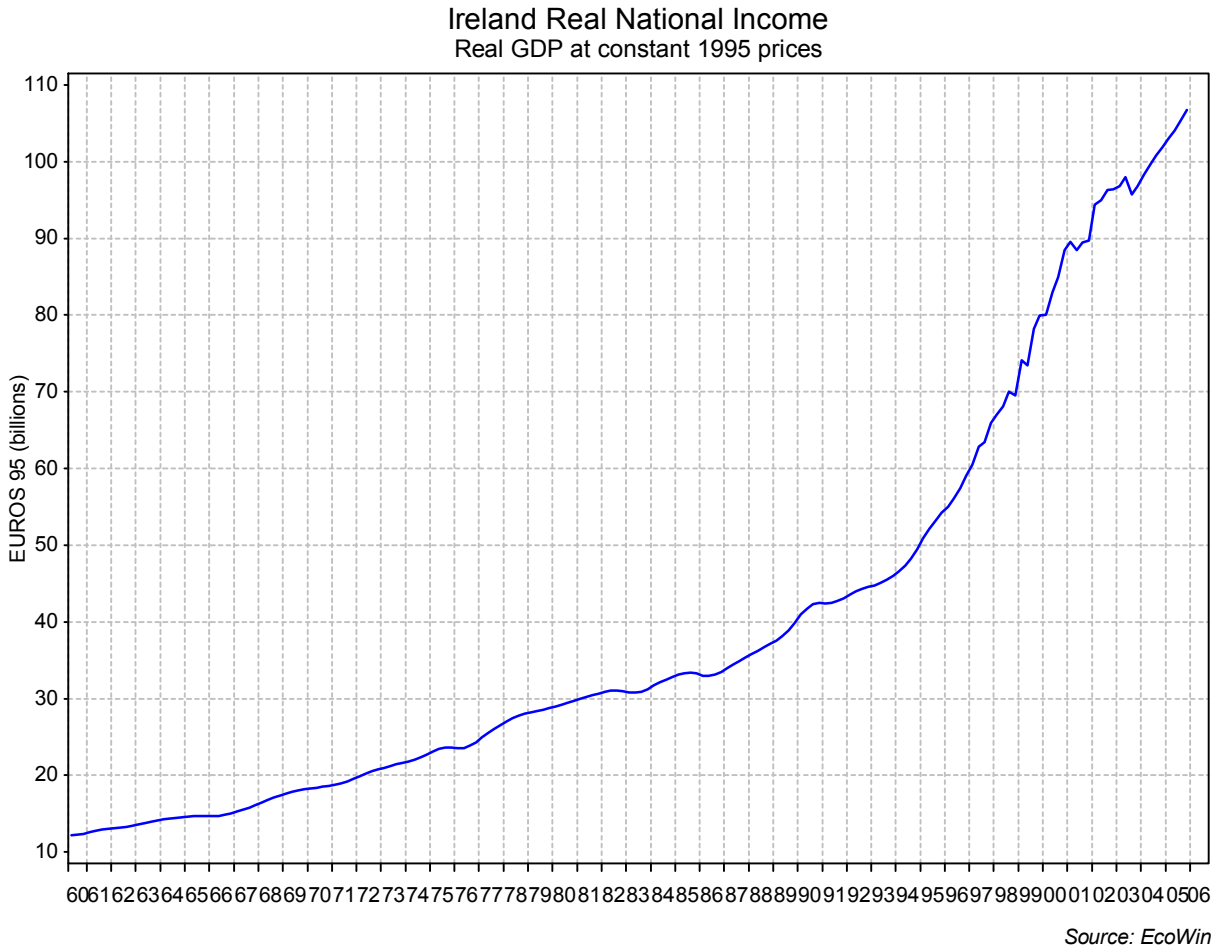
The best performing countries in recent years have been **Spain, Greece, Finland and Ireland** although in the case of the latter, the phenomenal growth and development achieved in the second half of the 1990s and in 2000-01 has slowed down appreciably. Nonetheless Ireland's sensational growth has lifted it up towards the top echelon of the EU league table for **per capita GDP** even though the Irish economy remains small within the context of the EZ as a whole contributing only just over 1% of total Euro Zone output.

Macroeconomic Performance of Ireland

% change per annum unless stated

	1999	2000	2001	2002	2003	2004
Real GDP	11.1	9.9	6.0	6.1	3.6	4.9
Household spending	9.6	8.5	5.2	2.6	2.6	2.7
Gross capital investment	15.5	7.1	-1.8	3.1	3.6	7.1
Exports	15.2	20.4	8.5	5.7	-0.9	6.6
Imports	12.1	21.3	6.7	3.4	-2.3	6.0
Unemployment (% of labour force)	5.6	4.3	3.9	4.4	4.6	4.4
Government borrowing (% of GDP)	2.5	4.4	1.0	-0.2	0.2	0.2
Current account of balance of payments (% of GDP)	0.3	-0.4	-0.7	-1.3	-1.4	-0.6
Short-term interest rate	3.0	4.4	4.3	3.3	2.3	2.1

2004 forecast is from the OECD www.oecd.org



Source: EcoWin

Why has the growth performance of the Euro Zone been so disappointing over recent years?

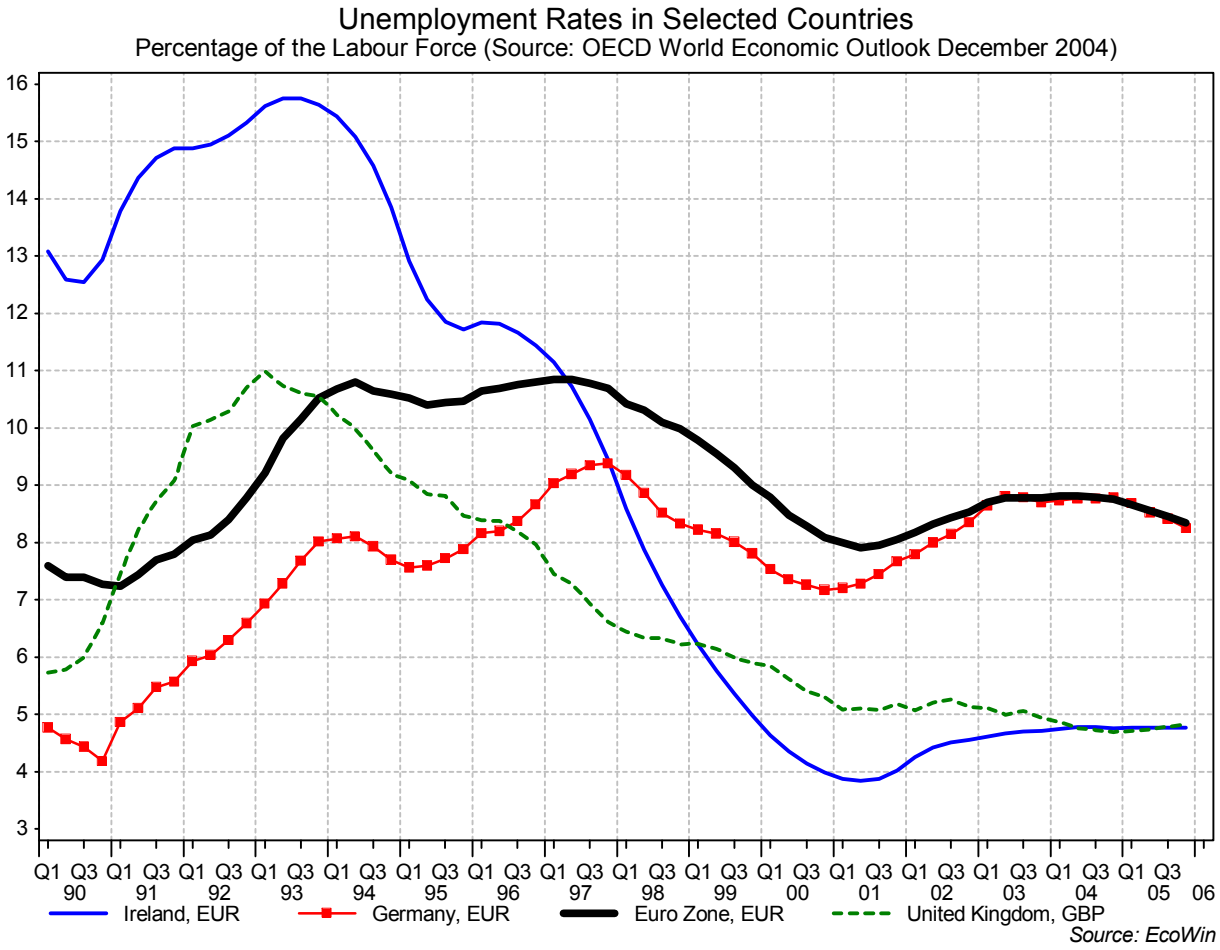
Some economists pin the blame on the **European Central Bank** (ECB) for keeping interest rates too high. Many analysts have been critical of the **fiscal stability and growth pact** which (until recently) has placed restrictions on how much governments of member nations in the Euro Zone can borrow and spend.

Other economists believe that the EU economy is still suffering from the **fall-out arising from German re-unification** more than a decade ago. The short term effect of re-unification was to unleash a

considerable consumer boom, higher inflation and higher interest rates. But in the years since, the German economy has grown at a rate of less than 1.5% pa with growth being held back by the need for huge subsidies to finance high unemployment in the eastern Lander of Germany.

In the long run, the main causes of economic growth are those that increase a country's productive potential. Therefore any analysis of slow growth in the Euro Zone must also focus on **microeconomic or supply-side causes** such as inflexible product and labour markets, weak capital investment and a poor employment-creation record.

5.3 Unemployment



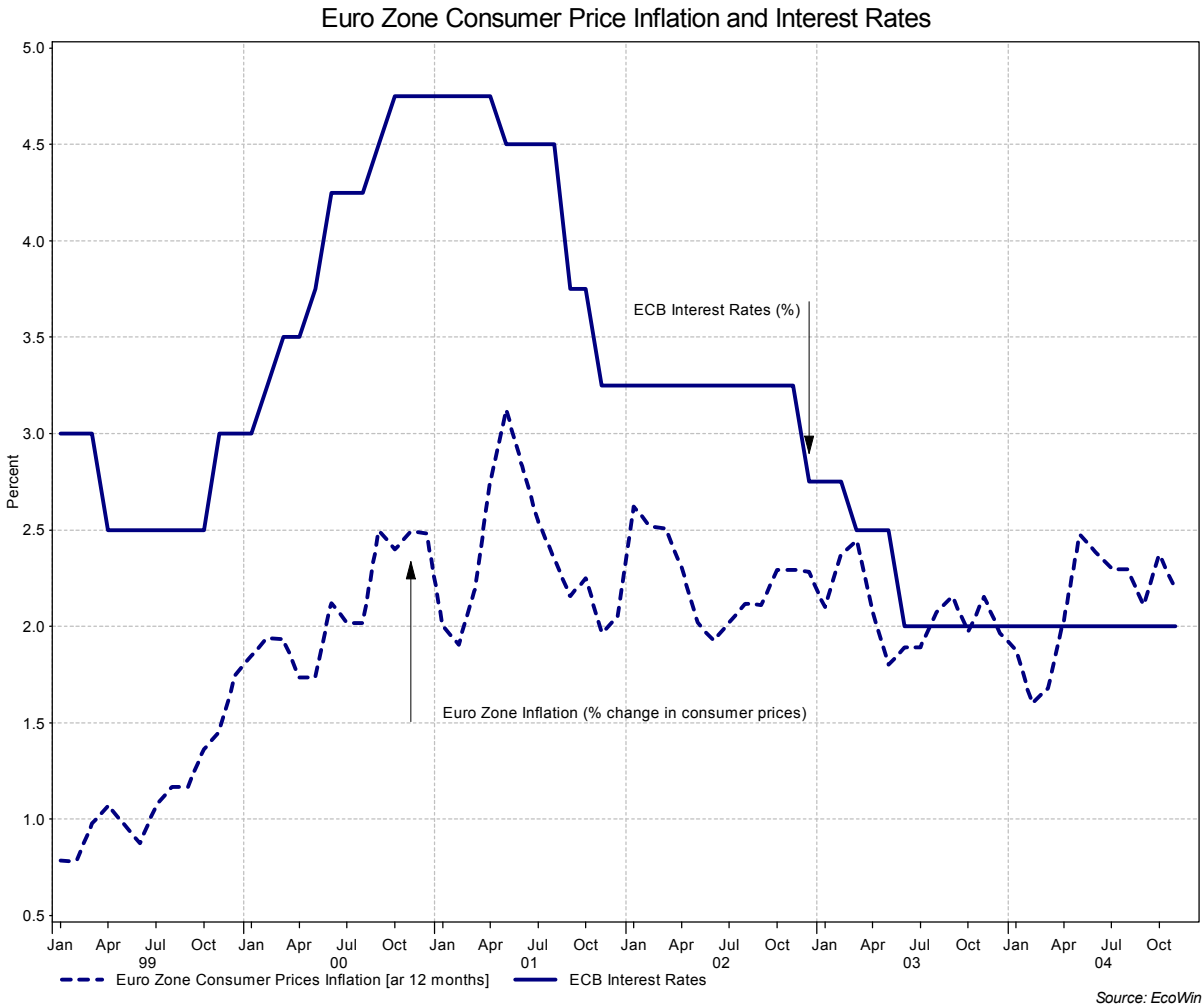
Euro Zone unemployment has been persistently above that of the UK and the United States for almost a decade. Partly this divergence in reflects differences in the timing of EZ and UK economic cycles. The last recession in the UK finished in 1992 whereas the EZ economy was still in recession in 1993-94.

However, most experts on the European labour market believe that a sizeable proportion of unemployment is **structural** rather than **cyclical**. This implies that although strong demand and output in Western Europe might provide a stimulus to employment, any success in reducing unemployment significantly over the long-term will require major **reforms to labour markets** to increase **incentives to work**; raise the **stock of human capital** and improve the employment-creation record of businesses within the European economy. Unemployment is covered in more detail in a separate section of this study companion.

5.4 Inflation and interest rates

The **European Central Bank** has responsibility for **setting interest rates** across the EZ to meet an inflation target of 2% or less using the **harmonized index of consumer prices**. Over the last three years, inflation has remained above the 2% target despite slow economic growth and the deflationary effects of a global downturn and increasing competition in international markets. This has limited the freedom of the European Central Bank to relax monetary policy by cutting interest rates in order to boost demand, output and employment. The ECB has been heavily criticized for responding too slowly to the weak growth and high unemployment within the EZ. But the **inflation target** has had a constraining effect on the amount of policy flexibility open to the ECB.

Within a single currency area, countries cannot rely on a **depreciation of the exchange rate** to restore some of the lost **price competitiveness** that results from having a high relative inflation rate. And interest rates are set by the ECB in order to meet an **inflation target** for the currency union as a whole and not for any single economy. This implies that countries with high inflation must seek to bring it down through the use of **fiscal policy** and improvements in the **supply-side performance** of their economies.



Source: EcoWin

Movements in interest rates for the EZ since the ECB took over the reins of implementing monetary policy in 1999 are shown in the chart above. The ECB tightened policy from late 1999 through to the end of 2000 because of fears that the combination of strong cyclical growth in the EZ and a depreciating currency would lead to demand pull and cost push inflationary pressure. Nominal interest rates peaked at 4.75% and remained at this level until mid 2001. Since then the ECB has been cutting rates – they fell to 3.75% in November 2001 – but at the same time it has come under increasingly fierce criticism for not

moving faster and further in reducing interest rates to stimulate the EZ economy. The last cut in rates came in the spring of 2003 when the ECB cut rates to 2% - they have remained at that level throughout the remainder of 2003 and the whole of 2004!

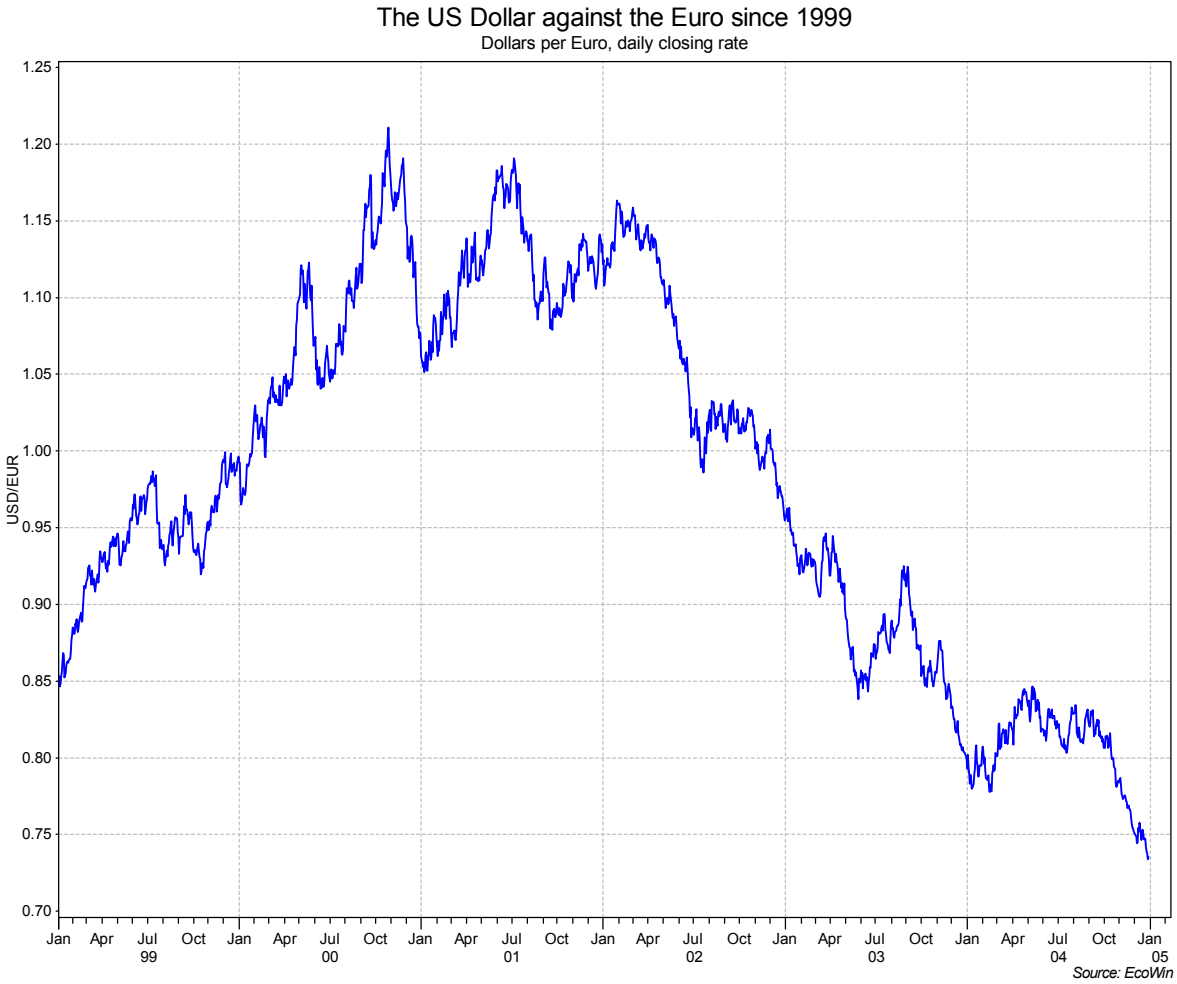
In the United States, the **Federal Reserve** under Alan Greenspan has been much more aggressive and pro-active in cutting short-term interest rates to prevent the US economy suffering a deeper than forecast recession, and in protecting business and consumer sentiment. UK interest rates have remained persistently above the Euro Zone level throughout the time under which the ECB has had jurisdiction over monetary policy.

The ECB fiddles whilst the Euro Zone falters?

Perhaps one reason for the policy inertia of the European Central Bank lies in its desire to achieve low-inflation credibility in the financial markets. Some critics of the ECB have argued that the ECB has tried too hard to emulate the low inflation record of the German Bundesbank in its early years of setting interest rates. In its defence, the ECB believes that EZ countries must themselves do more to **promote economic growth through supply-side policies** designed to increase competition, investment and productivity.

5.5 The Euro Exchange Rate

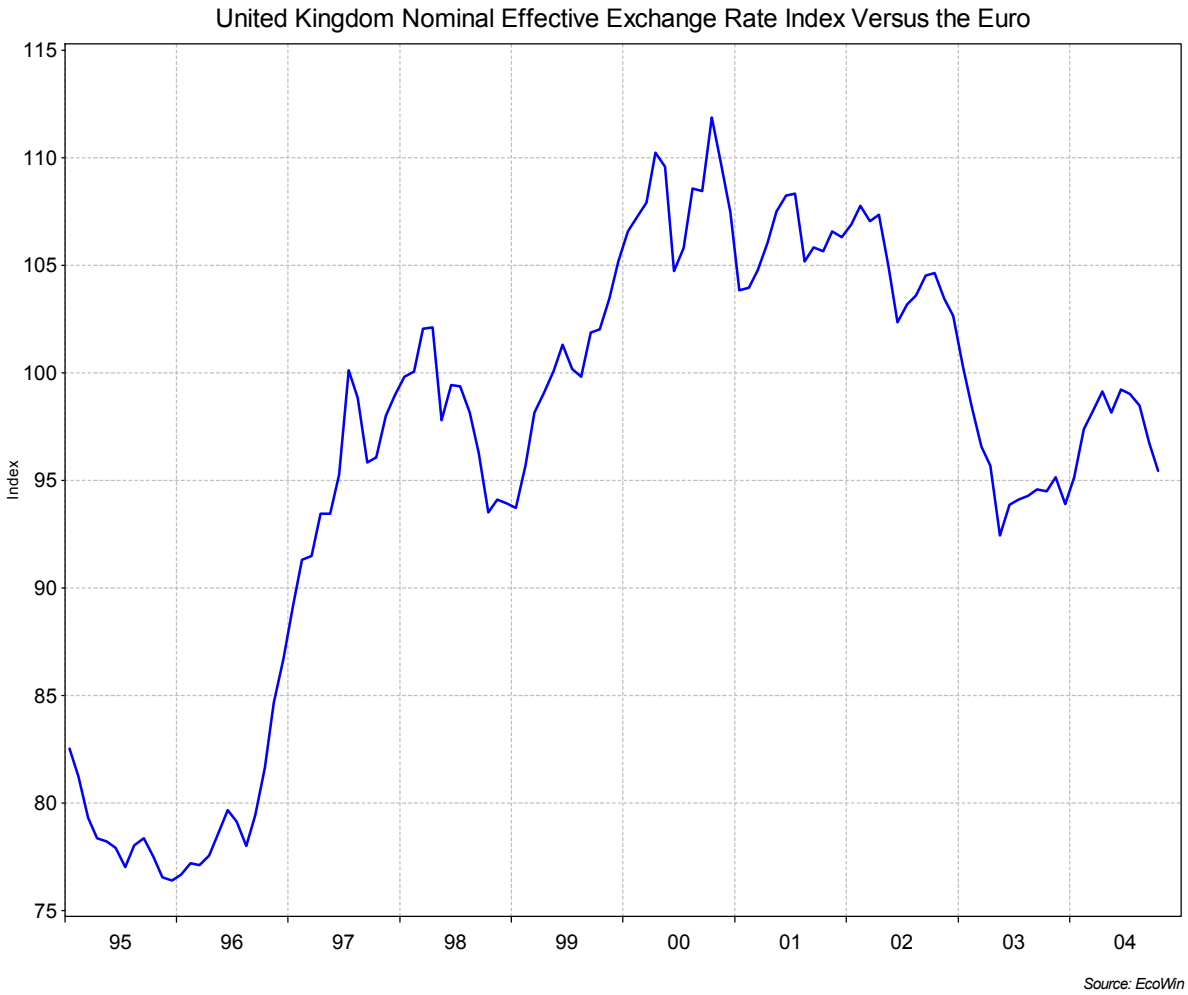
The Euro against the US Dollar ($)



The previous chart shows movements in the Euro exchange rate against the US dollar. The Euro is free to **float** against other currencies although occasionally the ECB has intervened in the foreign exchange markets to support the Euro. Two important phases can be identified. Between 1999 and 2001 the Euro was persistently weak against the dollar. The scale of the depreciation was very large. From January 1999 to November 2000, the Euro fell from $1.15 to $0.84, a depreciation of 27%. The Euro remained low in the foreign exchange markets through 2001 before it began a sustained appreciation against the dollar in the spring of 2002. The Euro broke back through parity with the dollar in the second half of 2002 and it has continued to appreciate against the US dollar ever since.

The Euro against Sterling (£)

The Euro fell sharply against sterling during 1999. At its launch, one euro was worth 70p but at its lowest point in October 2000, the euro had slipped to just 58p. Over the last three years the Euro has gradually gained ground against sterling and is now back to the level it was at the launch of the new currency.



The effects of an appreciation in the exchange rate

Changes in the exchange rate can have powerful effects on the macro-economy of countries affected by these fluctuations. Research by economists at the ECB has found that in the euro area, a 5% rise in the exchange rate is equivalent to a 1% increase in interest rates. The strength of this effect is partly because exports from the EZ to other regions and countries account for a bigger share of GDP than for example exports from the United States.

Thus a higher exchange rate, in the absence of offsetting interest rate reductions will lead to a slower growth of **aggregate demand** (through weaker consumption, capital investment and exports) and **higher unemployment**.

The appreciation in the euro has been caused mainly by the weakness of the dollar in the global currency markets. The USA has been running a huge trade deficit for several years and weaker growth in the States, lower relative interest rates and concerns about the size of the trade gap has precipitated an outflow of currency from the USA as foreign speculators seek a higher rate of return for their assets. In essence, dollar weakness has caused euro strength.

5.6 The Fiscal Stability and Growth Pact

The European **fiscal stability and growth pact** was created in 1996 in an attempt to make EU fiscal policy sustainable. It is part of the process of achieving **fiscal policy harmonisation**. The pact was intended to hold in check the government finances of many of the relatively smaller and poorer EZ

member states such as Ireland, Spain, Portugal and Greece, but the main problems have been with larger economies such as France, Italy and Germany where budget deficit problems have become acute.

The terms of the fiscal stability pact

- The pact imposed a 3 per cent ceiling on government budget deficits as a % of GDP
- Over the medium term, European Government had to seek **to balance their budgets**
- The EU Commission could impose cash fines (sanctions) if budget deficit limits were breached
- This more or less ruled out the use of fiscal policy to deliver a huge fiscal stimulus to an economy where output is well below potential and where unemployment is rising

There is a consensus among economists that it is sensible for governments to seek to stabilise their government debt/GDP ratios at reasonable levels because too high a level of debt and borrowing can lead to higher interest rates and an increase in the overall burden taxation – both of which could be damaging to investment, consumption and work incentives in individual countries. The aim of the pact was to discourage reckless government borrowing in a single country that may push up interest rates across the whole area. By the autumn of 2003 it became clear that the fiscal stability and growth pact was coming under enormous pressure – the reason was that several countries were breaching the terms of the pact and ignoring the threat of sanctions. Portugal was the first country to exceed the budget deficit limits of the pact in 2001 (having come perilously close in 2000) and Germany followed suit in 2001. France and Italy have also run budget deficits very close to the permitted levels and in 2002 the twelve nations of the Euro Zone as a whole were operating with fiscal deficits measured at 2.3% of GDP.

What has been happening to budget deficits in the European Union?

Budget balance as a % of GDP	2003	(-ve shows a budget deficit)	2003
Estonia	2.6	Netherlands	-3.0
Finland	2.3	Greece	-3.2
Denmark	1.5	United Kingdom	-3.2
Sweden	0.7	Slovakia	-3.6
Spain	0.3	Germany	-3.9
Belgium	0.2	France	-4.1
Ireland	0.2	Poland	-4.1
Austria	-1.1		
Lithuania	-1.7	Hungary	-5.9
Latvia	-1.8	Cyprus	-6.3
Slovenia	-1.8		
Italy	-2.4	Malta	-9.7
Euro-zone	**-2.7**	Czech Republic	-12.9
Portugal	-2.8		

Why have budget deficits increased within the EZ?

The main reason is the slowdown in economic growth that has led to a slower growth of tax revenues (from direct and indirect taxes) and led to increasing pressure on state welfare benefits. Persistently high unemployment (much of it long-term and structural) has added to government spending and reduced the level of tax receipts. Consumer spending and company profits have also been weak in many EZ countries. This has caused a downturn in tax revenues from indirect taxes and corporation taxation.

The budget deficit inevitably worsens when economies experience downturns – and in this sense much of the fiscal deficit problems facing EZ countries are **cyclical** rather than **structural**. However there are some longer-term factors putting pressure on government finances. A large percentage of unemployment in the EU is thought to be structural. Secondly many European countries are facing up to the long-term impact of an **ageing population** that threatens to increase future government liabilities in supporting state pensions.

Criticisms of the European Fiscal Stability Pact

The stability pact came under criticism from several quarters. Romano Prodi, the president of the European Commission, once famously termed the pact "stupid"!

1. **Fixed rules creates a fiscal straight-jacket:** The main criticism of the fiscal stability pact was that it provided a straight-jacket for countries that wanted the freedom to run an expansionary fiscal policy at times of prolonged economic weakness – e.g. rising unemployment, low business and consumer confidence and a negative output gap. Gordon Brown has argued on a number of occasions that the stability pact rules are "too rigid" and must be applied with more flexibility if they are to be effective
2. **No adjustment for the impact of the business cycle:** The ceiling did not make any adjustment for the effect on borrowing of fluctuations in the economic cycle. A fiscal rule expressed over the cycle would mean that a government still has room to allow the automatic stabilisers to operate - such as increased government spending on unemployment benefits – in order to dampen fluctuations in real GDP and unemployment resulting for example from external economic shocks
3. **Structural reforms cost money:** Another criticism is that some countries are running larger than permitted fiscal deficits because their governments are committed to supply-side reforms, improvements in national infrastructure – all of which costs money in the short term but which should bring long term economic benefits for the whole of the European Union
4. **Debt to GDP ratios may be more important:** The pact did not take into account for each nation, the ratio of public debt to GDP. Expressing fiscal rules in this way might have provided a country like Germany, whose public (government) debt is 60% of GDP, compared with over 100% in Italy, more room to support its economy by boosting government spending (e.g. higher state investment in public services)

What next?

It is highly unlikely that the euro-zone countries will dissolve the Stability Pact partly for political reasons and also for more pragmatic economic reasons. Euro countries with a more expansive fiscal policy (i.e. a higher budget deficit) would eventually have to pay higher interest on their government bonds. As this would be the situation that is in fact currently faced by the large economies of Germany and France, interest rates would be pushed upwards throughout the euro-zone – and this would damage further prospects for economic growth.

Britain is in favour of reforming the stability and growth pact before any further progress is made in terms of our potential entry into the single currency

5.7 Overview of the macroeconomic performance of the Euro Zone and the UK from 1999-2004

Macroeconomic Performance of the Euro Zone

% change per annum unless stated

	1999	2000	2001	2002	2003	2004
Real GDP	2.8	3.7	1.7	0.9	0.6	1.8
Household spending	3.5	2.9	1.9	0.8	1.1	1.2
Gross capital investment	6.0	5.4	0.0	-2.3	-0.4	1.9
Exports	5.0	12.4	3.5	1.7	0.1	5.9
Imports	7.4	11.3	1.8	0.6	1.9	5.9
Unemployment (% of labour force)	9.4	8.4	8.0	8.4	8.8	8.8
Government borrowing (% of GDP)	-1.3	0.1	-1.7	-2.4	-2.8	-2.9
Current account of balance of payments (% of GDP)	0.4	-0.5	0.1	0.7	0.4	0.7
Short-term interest rate	3.0	4.4	4.3	3.3	2.3	2.1

2004 forecast is from the OECD www.oecd.org

Growth has remained under two per cent for the last four years with household (consumer) spending remaining very weak and gross capital investment following suit. On average, government borrowing is very close to 3 per cent of Euro Zone national income and unemployment remains stuck at very high levels.

Macroeconomic Performance of the United Kingdom

% change per annum unless stated

	1999	2000	2001	2002	2003	2004
Real GDP	2.9	3.9	2.3	1.8	2.2	3.2
Household spending	4.4	4.6	2.9	3.3	2.3	3.0
Gross capital investment	1.6	3.6	2.6	2.7	2.2	6.5
Exports	4.3	9.4	2.9	0.1	0.1	2.6
Imports	7.9	9.1	4.9	4.1	1.3	4.7
Unemployment (% of labour force)	6.0	5.5	5.1	5.2	5.0	4.7
Government borrowing (% of GDP)	1.0	3.8	0.7	-1.7	-3.5	-3.2
Current account of balance of payments (% of GDP)	-2.7	-2.5	-2.3	-1.7	-1.9	-2.2
Short-term interest rate	5.4	6.1	5.0	4.0	3.7	4.6

2004 forecast is from the OECD www.oecd.org

In contrast, the British economy has enjoyed faster growth boosted by strong consumer demand and a stronger capital investment performance, although the UK is running a sizeable trade and current account deficit. Government borrowing is high, reflecting large increases in real government spending over the last few years and a slowdown in tax revenues. This is likely to be a constraint for the UK government in the next phase of our economic cycle.

5.8 Suggestions for further research on macroeconomic developments in the Euro Zone

- BBC (European news) http://news.bbc.co.uk/1/hi/world/europe/default.stm
- European Central Bank (ECB) www.ecb.int/
- Financial Times www.ft.com see also http://news.ft.com/world/europe for European news and http://news.ft.com/world/uk for UK economics and business news

- Guardian Special Report on the Euro www.guardian.co.uk/euro/0,11306,606524,00.html
- Independent http://news.independent.co.uk/business/ see also http://news.independent.co.uk/europe/
- UK Treasury www.hm-treasury.gov.uk/Economic_Data_and_Tools/data_index.cfm

6 LIVING STANDARDS AND POVERTY IN THE EUROPEAN UNION

This chapter considers evidence on **relative living standards** and **poverty** within the EU. It also focuses on the **regional policies** of the European Union.

6.1 Defining and Measuring the Standard of Living

The standard of living (SoL) is best defined as a measure of the **material welfare** of the inhabitants of a country or a region.

The base line measure of the standard of living is **per capita real national income**. Other things being equal, a **sustained increase in real GDP** increases living standards providing that national output rises faster than the total population. The faster the rate of growth, the less time it takes for living standards to reach a target level. For example during the years 1996-2000, the annual growth of real GDP per capita in the EU was 2.36%. On this basis it would take 30 years for living standards to be doubled. Over the same period, real per capita incomes in the United States increased by 2.57% per year – on the basis of this slightly faster growth, living standards would double every 27 years.

Real income per capita on its own is both an **inaccurate** and **insufficient** indicator of true living standards both within and between countries. National income figures need adjusting for:

- **Population size** to calculate income per capita
- **Inflation data** to calculate real income per capita
- **Exchange rate data** to convert local currencies into a common currency i.e. Euros
- An adjustment to reflect differences in the **average cost of living** between different countries (to provide information according to a **purchasing power standard** PPS)

Even then per capita real PPS measures of living standards ignores important issues such as the **size of the informal economy**, the **length of working week**, environmental indicators including the extent and cost of **externalities**, the issue of the sustainability of living standards and also income & regional inequality factors. Other factors would include evidence on other **quality of life indicators** such as **educational and health provision**; the quality of public services and transportation and factors such as the levels of disposable income (e.g. we might want to take into account differences in the burden of direct and indirect taxes between different countries):

Per Capita Incomes in the European Union
Index of GDP per capita, PPP adjusted, EU(25) average = 100

	1995	2000	2001	2002	2003	2004
Luxembourg	179	219	213	213	215	217
Ireland	99	126	129	134	133	132
Denmark	125	127	126	122	123	123
Austria	129	128	124	123	122	121
United Kingdom	**110**	**114**	**115**	**118**	**119**	**120**
Netherlands	120	122	124	122	121	119
Belgium	120	117	117	117	118	117
Sweden	118	120	117	115	115	115
Finland	106	114	114	113	113	113
France	115	114	115	113	111	111
Germany	119	112	110	109	108	108
Italy	115	111	110	109	107	105
EU (25 countries)	**100**	**100**	**100**	**100**	**100**	**100**
Spain	88	92	92	95	98	97
Greece	72	73	74	78	81	82
Cyprus	85	86	89	83	81	80
Slovenia	68	73	75	75	77	78
Malta		79	75	74	75	73
Portugal	73	77	77	77	74	73
Czech Republic	70	65	66	68	69	71
Hungary	50	54	57	59	61	62
Slovakia	45	48	49	51	52	53
Estonia	34	42	43	46	49	51
Lithuania	34	39	41	42	46	49
Poland	41	46	46	46	46	47
Latvia	30	36	37	39	41	44
Romania		*25*	*27*	*29*	*30*	*32*
Bulgaria	*31*	*27*	*29*	*29*	*30*	*32*
Turkey	*30*	*30*	*26*	*27*	*28*	*29*

The table above compares GDP per capita for each EU country over the period 1995-2004 with the data adjusted for differences in living costs to allow a purchasing power standard (PPS) estimate. The data is expressed in index number format with average GDP per capita for the EU given a base value of 100. The UK has a GDP per capita just over 20% higher than the EU25 average.

Ireland has made huge strides in improving her relative standard of living. In the late 1980s and early 1990s Ireland's GDP per capita was well below the existing EU average but extremely rapid economic growth allowed the Irish economy to firstly catch up and then surge past the EU15 average in 1997 and this progress has been maintained. The accession of ten relatively poor countries has seen its living standards rise to over a third higher than the EU25 average. In contrast, Germany's relatively slow economic growth has seen erosion in her relative advantage in living standards – from a level 20% above the EU average in 1995 to a level only 8% above the average in 2004.

Problems of interpretation when assessing living standards

There are numerous issues relating to how national income data can be interpreted as an indicator of the standard of living of citizens of the EU. Some of these are discussed below

Regional variations in income and spending -National GDP data can hide **regional variations** in output, employment and income per head of population. Within each region of Britain for example there are areas of relative prosperity contrasting with unemployment black-spots and deep-rooted social and economic deprivation. The same is true for every country within the EU with the exception of Luxembourg which obviously does not have a regional problem! These regional disparities highlight the need for an **active European regional policy** as a means of promoting economic development, raising living standards and reducing relative poverty for economically deprived areas within the EU.

Inequalities of income and wealth -GDP figures can obscure **inequalities in the distribution of income and wealth**. Wages and earnings may be unequally distributed among the population and rising national prosperity can co-exist with **rising relative poverty.** It is interesting to note that, although average household incomes are much lower, income inequality in the ten accession countries is, on the whole, less of a problem than for many fully developed Western European market economies. Will accession into the Single Market serve to widen inequalities within accession countries even if it also helps to promote higher average standards of living?

Economic growth and externalities - Economic growth and its impact on our environment is a huge and growing issue and one that environmental policy at EU level is seeking to address. Rising national output is often accompanied by an increase in air and noise pollution and other externalities that have a negative effect on economic and social welfare. Faster growth may cause long term damage to our eco-systems, threatening the long-term **sustainability** of the economy. EU environmental policy seeks to achieve lasting improvements in environmental conditions – this is covered in a separate chapter of this Study Companion.

Leisure and working hours - A higher national output might have been achieved at the expense of leisure time if workers are working longer hours. Several reports for example have highlighted the fact that British workers have the longest working week in Europe, with full-time workers putting in an average of 44 hours - three and a half hours longer than the EU average. This has an inevitable impact on the quality of family life. The EU **Working Hours Directive** seeks to address the issue of lengthy working hours across the EU.

The balance between consumption and investment - If an economy devotes too many resources to satisfying the short run needs & wants of consumers, there may be insufficient resources for investment needed for long-term economic development.

Changes in Life Expectancy - Professor Nick Crafts from the London School of Economics has argued recently that improvements in average life expectancy have had a huge impact on people's living standards. Reductions in infant mortality have been followed by prevention or cure of diseases that might have led to the premature death of even the richest of our ancestors at any time. Safer workplaces have enabled far more people to enjoy many years after retirement, lengthening even the average life expectancy of those who have reached middle age by more than a decade.

The Development of New Products - One of the problems in comparing and contrasting living standards and the quality of life across different generations is that new goods and services become available because of the dynamics of market competition, investment, invention and innovation that simply would

not have been available to the richest person on earth less than fifty years ago. About half of what we spend our money on now was not invented in 1870 examples include air travel, cars, computers, antibiotics, hip replacements, insulin and other life enhancing and life saving drugs.

6.2 Living Standards: The Purchasing Power Parity Adjustment

Data on relative standards of living is normally adjusted to reflect estimates of **purchasing power parity** to take account of differences in the cost of living – so that the purchasing power of each unit of currency has (approximately) the same purchasing power. One Euro of income in each country may not have the same real purchasing power because of differences in the average cost of living. Typically for example, Scandinavian countries in the EU have significantly higher consumer prices whereas Mediterranean countries have relative price levels less than four fifths of the EU average. The new accession countries have general price levels well below that of established EU countries.

But we must also be aware that any PPP adjustment made when making cross-country comparisons of living standards has limitations. For example, at any given time, the exchange rate for a country is unlikely to be at true purchasing power parity levels perhaps because currency speculation in the global currency markets or other economic and political factors may have driven the exchange rate above or below its estimated PPP level. The PPP calculation/estimation is also constrained by the fact that

- **Not all output produced within the EU single market is traded internationally** – some goods and services are produced only for domestic consumption and do not find their way onto European and other international markets
- Price differences between goods and services in different EU countries may reflect **product differentiation** – i.e. where the supplier has changed the specification / design of a product to meet different consumer requirement in different countries and this is reflected in the final price.
- **Differences in degree of competition and monopoly power** in local and national markets can also affect relative price levels within the EU
- **Local indirect taxes and tariffs cause differences in the cost of living** – petrol prices in Northern Ireland are significantly above those in the Irish Republic because of differences in excise duties between the UK and the Republic. Progress towards fiscal harmonisation in the future might well bring about a greater degree of convergence in price levels

Data on relative price levels for a selection of EU countries is provided in the table below. The EU (25) average is given an index value of 100. Britain's relative prices are a little above the EU average and, as we might expect, the relative prices of consumer goods and services in the new EU members are significantly lower than the average for the time being. Life is pretty cheap in Slovakia!

Relative price levels for selected EU countries	1995	2000	2003
Denmark	139.4	127.9	139.3
Ireland	98.9	111.6	127.0
Finland	135.0	123.0	125.9
Sweden	125.4	126.8	124.3
Germany	119.6	105.6	108.9
France	118.6	107.0	108.2
United Kingdom	88.9	117.3	103.2
Italy	86.0	94.0	102.2
EU (25 countries) average	**100.0**	**100.0**	**100.0**
Spain	87.8	85.0	85.6
Greece	83.4	84.0	84.3
Hungary	44.0	48.4	58.0
Czech Republic	41.2	47.3	55.2
Latvia	38.3	57.6	55.1
Lithuania	30.8	51.7	54.4
Poland	46.5	56.3	53.3
Slovakia	39.8	44.2	49.8
Source: Eurostat			

If the index of the comparative price levels shown for a country is higher/ lower than 100, the country concerned is relatively expensive/cheap as compared with the EU average.

6.3 Relative Poverty in the European Union

How great is the extent of **relative poverty** within the EU? The **official EU poverty line** is an income threshold used to define the risk of poverty. This has been fixed at **60% of the national median disposable income per equivalent adult**. It therefore varies from one country to another. Based on this measure, 15% of EU inhabitants in 1999 (around 56 million people) were at risk of poverty, i.e. living in households with a disposable income below the poverty threshold. This share was lowest in Sweden (9%), and Denmark, Germany, Netherlands and Finland (all 11%), and highest in Greece and Portugal (both 21%). One of the reasons why relative poverty is lower in Sweden and Finland is that their **social benefits (or welfare) system** provides a significant increase in disposable incomes of low-income households.

The UK has a higher percentage of people defined as "at risk of poverty" than the EU average (the figure was 19% in 1999). The scale of inequality of original income is shown by the evidence that 30% of inhabitants are defined as poor before the effect of **social transfers** is calculated (the second highest figure in the EU, with only Ireland coming in higher than this). Another feature of concern is that the UK has the second highest percentage of people living in **jobless households** – defined as a household where no adult is in any form of paid employment and is therefore almost inevitably dependent on various forms of state welfare assistance.

7 EUROPEAN REGIONAL POLICY

7.1 Introduction

Supporting the Regions

Regional policy is not just about the poorest areas. To improve the UK's long-run growth and prosperity, it is essential that every nation and region of the UK performs to its full economic potential. That is why a modern regional policy must focus on improving the economic performance of every nation and region, by tackling the diverse market and social failures that are hindering their performance, and promoting opportunities for all.

(UK Regional Policy White Paper, March 2003)

The European Union remains one of the most prosperous economic areas in the world but the disparities between its Member States are striking, even more so if we look at the EU's various regions Europe's regional policy permits the transfer of over 35% of the Union's budget, which comes mainly from the richest Member States, to the least favoured regions

The Core and Periphery

Until recently, an EU core and periphery was clearly visible

The core: Austria, Belgium, Denmark, Finland, France, Germany, Luxembourg, the Netherlands, Sweden, the UK, and Northern Italy

The periphery: Greece, Ireland, Portugal, Spain, and Southern Italy

This picture has changed and continues to evolve not least with the expansion of the EU to twenty-five nations. However there remain **strong regional contrasts** in virtually every EU country: Consider the regional imbalances in several of the leading European countries:

- **Portugal** (Lisbon and the North vs. the South and Centre)
- **France** (Paris vs. the rest)
- **Spain** (Northeast and Madrid vs. South and West)
- **UK** (South East and London vs. the North)
- **Germany** (South vs. North)
- **Sweden** (South vs. North)
- **Belgium** (North vs. South)

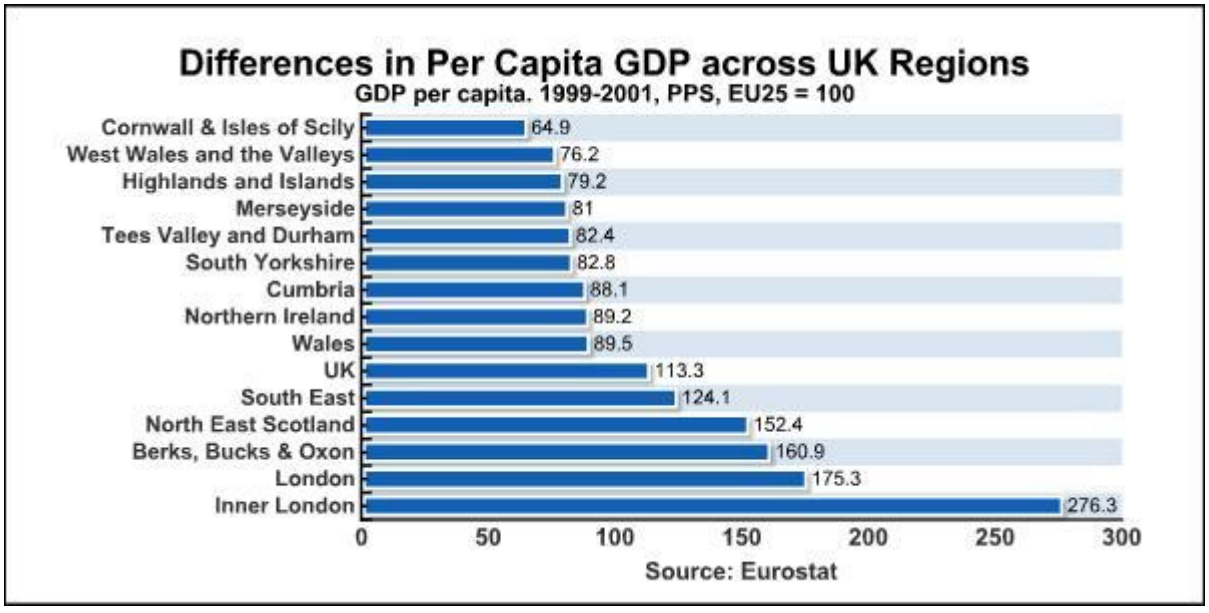
Measuring the Regional Divide

There are numerous measures of the regional economic and social divide

- Real gross domestic product per capita
- Real household income and spending
- Unemployment - including the problems of long term unemployment; youth unemployment
- Quality of life indicators (including life expectancy and the quality of public utilities and services such as education, transport and health services)
- Structural economic indicators (e.g. productivity; trade performance; indicators of overall competitiveness including rates of business investment and creation of new small businesses)
- Differences in the quality of infrastructure (I.e. transportation and communication networks)

The Regional Divide in the UK

	Unemployment Rate (%) In 2002	Long term unemployment Per cent of unemployed in 2002
UK	*5.1*	*21.9*
North East	6.8	26.9
North West	5.3	26.6
Yorks & Humber	5.2	21.5
East Midlands	4.5	23.0
West Midlands	5.6	20.7
East	3.7	18.2
London	6.7	23.6
South East	3.7	14.8
South West	3.7	14.1
Wales	5.6	20.1
Scotland	6.5	23.5
Northern Ireland	5.8	37.3



The European Regional Divide

In 2001, GDP per capita, expressed in terms of purchasing power standards, in the EU's 213 regions from the EU15 countries ranged from 53% of the EU15 average in Dytiki Ellada in Greece, to 263% of the average in the Inner London region of the UK. 10% of the regions were above 125% of the EU15 average, and about one fifth were below 75% of this average. GDP per capita in the 41 regions of the 10 Acceding Countries varied between 29% of the EU15 average in the Lubelskie region of Poland and 135% in the Praha region of the Czech Republic.

Source: Eurostat

The regional divide in the established 15 countries of the EU is shown in the table below

	The ten most prosperous regions			The ten poorest regions	
1	Inner London (UK)	263	1	Dytiki Ellada (EL)	53
2	Bruxelles-Capitale (BE)	217	2	Anatoliki Makedonia, Thraki (EL)	53
3	Luxembourg	194	3	Extremadura (ES)	53
4	Hamburg (DE)	171	4	Ipeiros (EL)	54
5	Île de France (FR)	165	5	Açores (PT)	56
6	Wien (AT)	152	6	Norte (PT)	57
7	Berkshire, Bucks & Oxfordshire (UK)	149	7	Centro (PT)	58
8	Oberbayern (DE)	148	8	Cornwall & Isles of Scilly (UK)	60
9	Stockholm (SE)	145	9	Ionia Nisia (EL)	60
10	Provincia Autonoma Bolzano (IT)	143	10	Dessau (DE)	60

And the scale of income disparities across the regions of the ten new members of the EU is demonstrated in the second table below

	Accession Countries The ten most prosperous regions			Accession Countries The ten poorest regions	
1	Praha (CZ)	135	1	Lubelskie (PL)	29
2	Bratislavský (SK)	102	2	Podkarpackie (PL)	29
3	Közép-Magyarország (HU)	81	3	Warminsko-Mazurskie (PL)	30
4	Cyprus	78	4	Podlaskie (PL)	31
5	Malta	69	5	Swietokrzyskie (PL)	31
6	Slovenia	68	6	Opolskie (PL)	33
7	Mazowieckie (PL)	64	7	Latvia	33
8	Jihozápad (CZ)	55	8	Eszag-Magyarorszag (HU)	34
9	Nyugat-Dunántúl (HU)	54	9	Vychodne Slovensko (SK)	34
10	Jihovýchod (CZ)	53	10	Eszag-Alföld (HU)	34

A broad classification of types of problem regions

Although every region within the EU is different, one might make the following classification:

(a) Under-developed rural areas

- These are often located in mountainous areas and islands and suffering from low labour productivity and persistently low incomes
- Low occupational and geographical mobility of labour
- High rates of social exclusion
- High youth and female unemployment / and low participation ratios in the labour market

(b) Regions suffering from the long-term structural decline of existing basic industries

- For example regions that have experienced the long run decline of textiles, steel, fishing, coal and shipbuilding employment
- Often industries with a high geographical concentration in a particular region – where demand, output and incomes may have become too dependent on a few main sources of jobs and investment
- Much of the unemployment is long term and structural which is difficult and costly to reduce

(c) Regions that are basically over-developed and too congested as a result of fast economic growth

E.g. in Paris, London and SE England - this can lead to demand-pull and cost-push inflationary pressures (which then affect less prosperous regions) shortages of factor inputs; house price inflation and the negative externalities associated with increased congestion and pollution

7.2 Instruments of regional policy

EU regional policy is based around an **"integrated EU regional policy"** delivered through the EU budget and based on regional activities of the 'structural funds':

- The **European Regional Development Fund** (ERDF)
- The **European Social Fund** (ESF)
- Regional aspects of the operation of the **Common Agricultural Policy** (CAP)
- Role played by the **European Investment Bank** (EIB)

The main instruments of regional policy assistance can be summarised as follows:

- **Direct financial assistance for new and existing industry** (i.e. government grants, special depreciation, loans for new capital projects)
- **Public sector expenditure on regional infrastructure** (i.e. new roads, bridge, rail links, ports and housing projects) - the accumulation of social capital
- **Subsidies to reduce production costs** (e.g. labour subsidies, tax allowances)
- **Negative inducements** for example planning controls that limits new construction projects in areas of heavy economic activity

The aims of EU Regional Policy

The principal objective of EU regional policy is to create the conditions throughout the Union for **balanced and sustainable economic growth**. These are objectives of both economic and social **cohesion** and improved **competitiveness**.

The main economic justifications for an activist EU regional policy are on grounds of

- **Equity and Fairness** – treating each region on the basis of a fair assessment of their economic and social needs
- **Economic Efficiency** – a more balanced regional economy in Europe should actually help to promote improvements in employment opportunities, rising incomes, greater trade within and between regions and a faster rate of economic growth in the long run

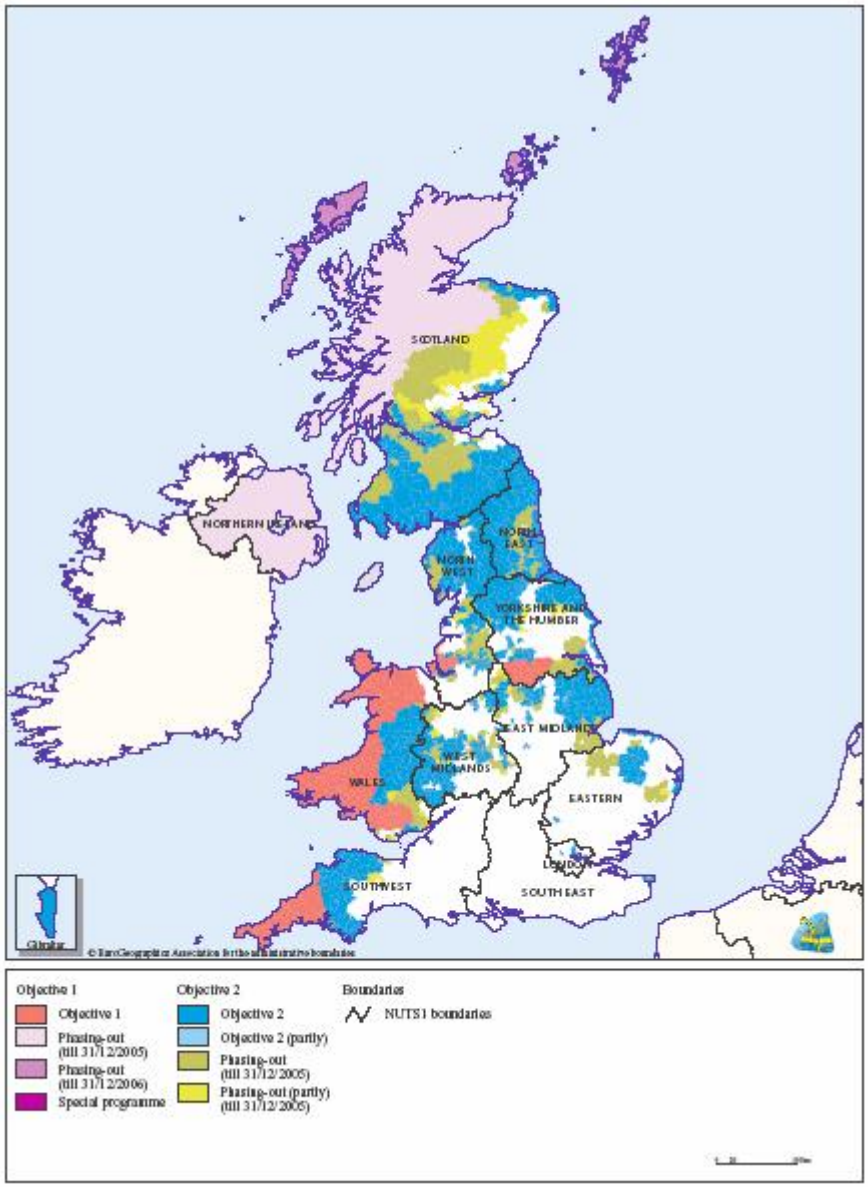
- **Minimising wastage of labour resources:** Reducing the deadweight loss of resources that comes from high and persistent unemployment
- **Imbalanced growth:** Avoiding the bottlenecks that often arise from fast growth in some regions
- **The environmental perspective:** Balanced growth between the regions is likely to be more sustainable in the long run in terms of its impact on the environment
- **Population movement:** Effective regional policies help to moderate the pressures for labour migration / population movement that can come when there are stark variations in living standards and employment opportunities across regions and countries within the single market

The Allocation of the EU Budget

Regional policy **transfers** funds to the less prosperous regions within the EU between the years 2000-2006 will account for one third of the Community budget, or €213 billion. €195 billion will be spent by the four **Structural Funds** (the **European Regional Development Fund**, the **European Social Fund**, the **Financial Instrument for Fisheries Guidance** and the European Agricultural Guidance and Guarantee Fund); €18 billion will be spent by the Cohesion Fund

EU Regional Policy should not be seen in isolation with other components of European economic integration. EU competition policy, and in particular the removal of barriers to trade, the cornerstone of the single European Market is also designed to be a regional development tool, to be used to encourage long-term economic convergence. The operation and reform of the Common Agricultural Policy can also be seen as having a regional impact on incomes, output and employment.

The EU Regional Funding Map for the UK



Article 158 of the amended Treaty establishing the European Community reads:

"The Community shall aim at reducing disparities between the levels of development of the various regions and the backwardness of the least favoured regions or islands, including rural areas"

7.3 Has EU Regional Policy Worked?

Recent research suggests that regional policy has helped to erode some of the wide EU regional disparities - but such are the structural differences in economic performance between the regions that they have not fundamentally changed the regional picture viz living standards

Although substantial progress has been made in basic infrastructure, other structural economic imbalances still remain: research and technological development, access to skills and the information society, opportunities for education and on-going training and the quality of the environment.

Many economists question the effectiveness of regional policies in making a serious contribution to reducing regional economic disparities – and argue that each individual country should have the right to set their own regional and fiscal policies in order to promote regional development (e.g. the Irish growth miracle of the 1990s largely built on lower corporation taxes – although undoubtedly helped by regional funds from the EU that improved its economic infrastructure).

How might the effectiveness of regional policy be assessed? For example - new firms created, new jobs created, levels of graduate retention, cluster development, technology take-up, new social capital, improvement of health and well-being etc)

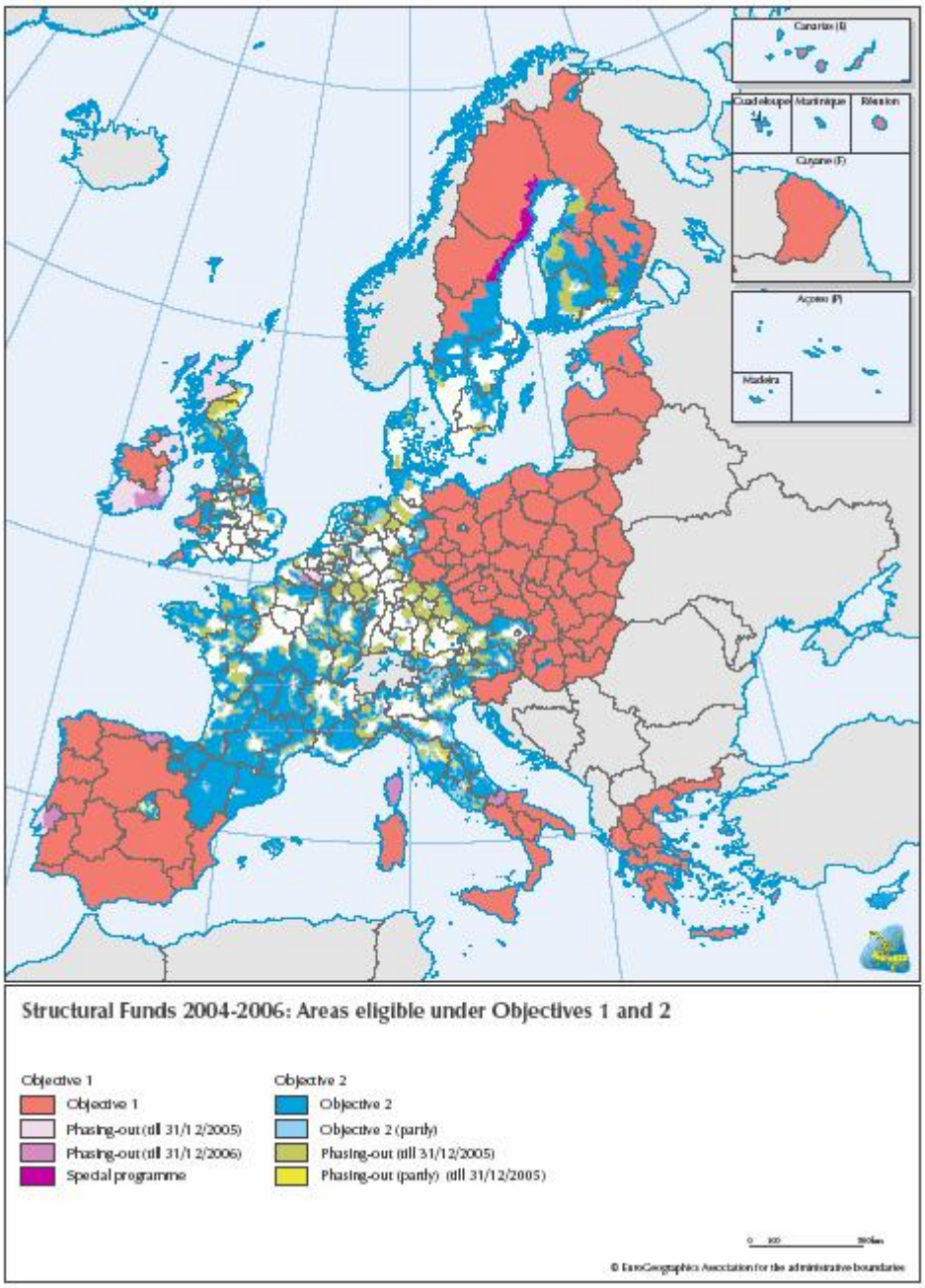
- Differences in fiscal policy can be an important instrument for attracting inflows of foreign direct investment which can boost both the demand and supply side of the economy
- Some EU regions lack the structural competitiveness to grow at the same rates as more prosperous regions both within the single market and also in the global economy
- Globalisation affects localities in very different ways, and some regions are still suffering from the decline of their dominant industries of the past

7.4 Enlargement and Regional Policy

Enlargement will have a big impact on EU regional policies and will ultimately lead to a net redistribution of EU financial support (e.g. structural funds together with remaining agricultural subsidies) towards the relatively poorer countries. This will have an impact on the regions currently benefiting as net recipients from Structural Funds mainly located in Spain, Portugal and Greece.

The medium-term economic and social consequences of these countries joining the EU and integrating into the single market may serve to deepen existing levels of regional inequalities within accession countries and thereby increase the challenges raised by the objective of economic, social and territorial cohesion of an enlarged EU. Are existing members of the EU prepared to increase regional funding to ease the structural transition of the accession countries? Will the partnership and cohesion model developed over the last twenty five years come under too much pressure?

Regional funding map for Europe post EU enlargement



The Structural Funds finance programmes in four main areas

- Developing infrastructure, such as transport and energy. The hi-speed EU train network is having an important regional effect
- Extending telecommunications services
- Helping firms training workers – as a means of reducing structural unemployment and increasing the occupational mobility of labour
- Disseminate the tools and know-how of the information society

The EU Cohesion Fund provides direct finance for specific projects relating to environmental and transport infrastructure in Spain, Greece, Ireland and Portugal, as these are still deemed to be inadequate

7.5 EU Regional Policy and the UK

Objective 1 and Objective 2 Funding

Regions in the UK with a GDP per capita of less than 75% of the Community average are eligible for Objective 1 funding. The UK's allocation from the Structural Funds over the period 2000-06 is in excess of £10 billion. Objective 1 areas (having less than 75 per cent of the EU's average GDP) in England are: Merseyside, South Yorkshire, Cornwall and the Isles of Scilly.

Objective 2 (the economic and social conversion of areas facing structural difficulties) covers nearly 14 million people in the UK.

Objective 3 is designed to develop labour markets and human resources. It will also help workers adapt to new working conditions. The Objective is aimed at the long-term unemployed and those facing particular obstacles to entering the labour market because of their disability, racial origin or sex

Britain is a **net contributor** to EU Regional Funds although several regions are in receipt of Objective 1, 2 and 3 funds - The UK's allocation from the Structural Funds for 2000 - 2006 is over £10 billion.

Britain's poorest regions say that they will suffer job losses and economic stagnation because of a huge switch of development funding to the poorer Eastern European countries that will join the European Union in May 2004. The regions are set to lose about £3 billion in EU funding used to help businesses and to improve infrastructure. Because the new member states have much lower incomes than existing members, some of the regions will no longer officially be considered poor.

7.6 Importance of the regional Issue

The regional divide within the European Union is not an isolated topic! It is important to recognise the important inter-relationships between EU regional development and many other significant European wide issues and policies. Some of these are summarised below:

Fiscal harmonization – this links in with the flexibility of individual countries within the EU to use their own fiscal policies to promote regional development and growth (e.g. Ireland's reduction in corporation tax as a means of attracting an increase in inward investment and the decision by many of the new EU countries to do exactly the same)

CAP – Might reform of the CAP increase the regional divide within the EU (e.g. the effects on Europe's poorest farmers and those countries with heavy agricultural bias)?

The EU in the global economy – what are the key factors that make a region competitive both within the European Union but also in the wider global economy? What might be the impact of globalisation on different regions?

Unemployment problem – what are the reasons for wide variations in regional unemployment across regions of the EU and which policies are likely to be most effective in increasing employment potential within the EU and all of its regions?

7.7 Suggestions for further research on living standards and regional policy issues

- DTI (Regional Policy) www.dti.gov.uk/regions/index.htm
- European Commission (Regional Policy) http://europa.eu.int/comm/regional_policy/index_en.htm
- European Regional Development Fund (ERDF) http://europa.eu.int/publications/en/e02a.htm
- European Structural Funds www.dti.gov.uk/europe/structural.html
- Regional Policy success stories http://europa.eu.int/comm/regional_policy/ns_en.htm

8 ENLARGEMENT OF THE EU

The market reforms in Central and Eastern Europe have been a huge success. I would bet that in another 10 years' time, living standards in Prague will be indistinguishable from those in other European capitals

Hamish McRae, the Independent October 2003

This case study considers some of the many economic and social implications of **enlargement** within the European Union (EU). The EU has enlarged several times since the "Common Market" was originally set up with just six member states in 1957. Thus far there have been four main waves of enlargement:

- 1973 (UK, Ireland and Denmark)
- 1981 (Greece)
- 1986 (Portugal and Spain)
- 1995 (Austria, Finland and Sweden)

The most recent enlargement brings the EU to a membership of 25 through the **accession** of ten countries. This enlargement process represents a **widening of the EU** at the same time as existing countries are considering a further **deepening of economic and social integration**.

8.1 The Accession Countries

2003	Population (million)	GDP €bn	GDP per capita EU-15 = 100	Unemployment %	GDP PPP €bn	GDP per capita € at PPP
France	61.5	1549.0	104.1	9.4	1555	25295
Germany	82.5	2129.0	99.0	9.3	1985	24054
UK	59.4	1589.0	108.9	5.0	1572	26466
EU-15	**382.5**	**9295.0**	**100.0**	**8.0**	9295	**24303**
Cyprus	0.7	11.3	77.5	4.4	14	18825
Czech Rep.	10.2	80.1	63.8	7.8	158	15503
Estonia	1.4	7.4	41.2	10.0	14	10007
Hungary	10.1	71.6	55.1	5.8	135	13382
Latvia	2.3	8.9	37.1	10.5	21	9019
Lithuania	3.5	15.8	42.7	12.7	36	10373
Malta	0.4	4.1	64.2	8.2	6	15603
Poland	38.2	185.2	42.7	19.8	396	10376
Slovakia	5.4	28.9	48.3	17.1	63	11742
Slovenia	2.0	24.3	71.3	6.5	35	17335
AC-10 av	**74.2**	**437.6**	**48.7**	**14.3**	878	**11838**
EU-25	**456.6**	**9732.6**	**91.7**	**9.0**	10173	**22278**

Turkey

Turkey wants desperately to join the EU, but there is no agreed date for this. The official excuse is Turkey's poor human rights record (especially with regard to it Kurdish minority). Apart from the Mediterranean coastal areas, most of Turkey is poor and backward. Its high population means enormous economic costs to acceptance into the EU. But the real reason is that Turkey is Islamic, and its rural interior is quite conservatively Islamic so there may be enormous scope for culture clashes. In December 2004 it was agreed that negotiations on Turkey's accession to the EU could begin in October 2005.

Other non-EU countries

- Bulgaria and Rumania are scheduled to join the European Union in 2007
- Russia is far too large for the EU to absorb, and at present shows no wish to join
- Switzerland, Iceland and Norway are the only Western European countries not in the EU

8.2 Economic Structure of Accession Countries

The relative success or failure of enlargement will do much to determine the speed and extent of any future widening of membership of the EU. How do the accession countries joining in May 2004 shape up ahead of joining the Single Market? In this section of the case study we consider a range of macroeconomic indicators

- **Income per capita:** Average GDP per head of the ten accession countries in the year 2003 was only 49% of the EU average although it should be pointed out that there has been progress in closing this gap over recent years. Many transition economies experienced a deep and prolonged recession in the early 1990s but have grown more quickly since then. Of the ten accession countries, Cyprus and Slovenia are closest to the EU average in terms of a purchasing power parity adjusted income per capita.

- **Structure of output:** Comparing the accession countries with existing EU members, we find that a higher percentage of their national output comes from primary and basic secondary sectors and relatively less from high-technology manufacturing and high-knowledge services. This is likely to change as these countries undergo further development, but in the short term, it means that their **comparative advantage** may, in general, lie in areas of manufacturing such as household goods, motor car manufacturing and electronics. This is a generalization – but essentially the accession countries in the main are stronger in manufacturing than they are in service sectors.

- **Stronger trend growth?** Professor Nicholas Crafts of the LSE estimates that accession countries have a higher **potential growth rate** mainly because of higher rates of **capital accumulation**. The potential for faster productivity growth will also boost long run potential output (LRAS) in the years ahead. The growth performance of Central and Eastern European countries since they resumed growth after the initial setback that followed the fall of the Berlin Wall has been impressive. The trend rate of growth for the ten new countries may be as much as two percentage points higher than that for the established EU countries.

- **Export-led growth and economic integration with the existing members of the EU:** The leading central European countries (notably the Czech Republic, Hungary and Poland) have increased exports to western European countries at impressive rates in the last few years. Many are already highly integrated into the EU economy as they enter into the single market.

Transition economies

Eight of the ten new EU countries were **socialist economies** operating under a **centrally-planned system** until at least 1989. In the intervening sixteen years most have made huge strides in transforming their economies into ones based on **western free-market norms.** This process has involved **privatisation of state assets**, **liberalisation of markets** and the development of fully fledged **financial markets** e.g. money markets and capital markets to boost savings and finance investment.

Hungary is thought to be the closest to an advanced western-style market based economy followed by the Czech Republic, Estonia, Poland, Latvia, Lithuania, Slovakia and Slovenia. But there is still much to be done – not least in developing proper systems of corporate governance and in reducing fraud. There are still many political and social tensions resulting from this transition process.

Openness to trade and investment

The accession countries have become increasingly open to international trade and investment. The average ratios of trade (imports plus exports) to gross domestic product of the accession countries is already above 50 per cent, up from 35 per cent in 1995, compared with 65 per cent for existing members of the EU. This can be expected to increase still further as these countries settle into the EU Single Market.

Trade Integration between the new member nations and the European Union

	Trade with EU25 as % of total trade, in 2002	Extra-EU25 trade, in 2002 (bn euro)		
		Exports	Imports	Balance
Slovakia	80	1.8	4.8	-3.0
Czech Republic	78	6.2	11.9	-5.7
Latvia	77	0.5	1.0	-0.4
Estonia	74	0.7	1.6	-0.9
Poland	74	8.6	17.9	-9.4
Hungary	72	6.6	14.5	-7.9
Slovenia	72	3.6	2.7	0.8
Lithuania	62	1.7	3.5	-1.8
Malta	59	1.1	0.9	0.2
Cyprus	57	0.2	1.7	-1.5
USA	21	714	1 236	-522

Western Europe as an export market

By 2002, the share of EU markets in the exports of the accession countries was 63 per cent. This is much the same proportion as existing EU members. The key point here is that for most of the accession countries, the adjustment to Western Europe becoming their major export market has already occurred. We will see further **trade creation** in the years ahead. As the Economist noted in a special article on EU enlargement in April 2004, "for the latest entrants, formal membership of the EU is just the icing on a cake they have been eating for some time."

Foreign investment flows

Between 1989-2003, cumulative inflows of **foreign direct investment** (FDI) into the accession countries of central and eastern Europe were £66 billion with the largest quantities going to Poland, the Czech Republic and Hungary. In 2003, inflows were 8.3 per cent of Estonia's GDP and the inflow into the Czech Republic was 11.9 per cent of GDP!

These inflows were made in anticipation of EU accession – so although opportunities for foreign investment remain, much of the flow of new foreign capital into these countries may already have occurred for example investment into the newly privatised industries.

Unemployment and Employment in Accession Countries

	Unemployment rate				Share of employment		
	%				2002 %		
	2000	2001	2002	2003	Agriculture	Industry	Services
CZ	8.7	8.0	7.3	7.8	4.8	39.7	55.5
ES	11.3	10.6	11.4	11.3	5.9	29.4	64.6
CY	5.2	4.4	3.3	4.1	9.5	22.3	68.2
LV	13.7	12.9	12.1	10.5	15.1	24.4	60.5
LT	16.4	16.4	13.7	12.4	17.6	27.5	54.9
HU	6.3	5.6	5.8	5.9	6.2	34.1	59.7
MT	7.0	6.7	6.9	7.6	1.9	26.1	72.0
PL	16.4	18.5	19.9	19.6	19.3	28.6	52.0
SI	6.6	5.8	6.3	6.7	11.2	37.5	51.3
SK	18.7	19.4	18.7	17.6	5.0	34.5	60.5
UK	*5.4*	*5.0*	*5.1*	*5.0*	*0.9*	*19.0*	*80.0*
EU25	*8.7*	*8.5*	*8.9*	*9.1*	*5.4*	*26.0*	*68.7*

Unemployment is a major concern for accession countries but four countries already have unemployment below the existing EU average. **Youth** and **female unemployment** are two key structural problems – the employment rate for both groups is well below the EU level (and even the EU rate is poor compared to the United States). Progress has been made in reducing unemployment within the new member nations, but in Poland unemployment remains close to 20% of the labour force and in the Slovak Republic it is also high and forecast to remain above 15% over the next few years.

One underlying weakness is that the **employment rate** among people of working age is significantly below that of the existing EU nations. The hope is that **growth** and the effects of increased **foreign direct investment** will be a source of new jobs for accession economies. But further **labour market reforms** will be necessary not least an improvement in **incentives** within national labour markets and increased **provision of adequate education and training** to boost the **human capital** of each country's respective workforce.

8.3 Joining the European Union – Requirements for Entry

The new EU nations have spent many hundreds of millions of Euros to meet the extensive criteria laid down by the **Copenhagen Summit** of 1993 which outlined detailed entry requirements: These are summarised below:

- **The stability of political institutions** guaranteeing democracy, the rule of law, human rights and respect for and protection of minorities

- **A functioning market economy, which can deal with the market forces of the EU** – this requires countries to introduce widespread micro-economic reforms to their economies to extend the scope of the market in allocating resources.

- **The adoption and implementation by each member of the "acquis communautaire"** – this is the body of existing and new EU law – including labour market laws and regulations concerned with the operation of the Single Market including competition policy and social regulations

8.4 Advantages of Enlargement for Accession Countries

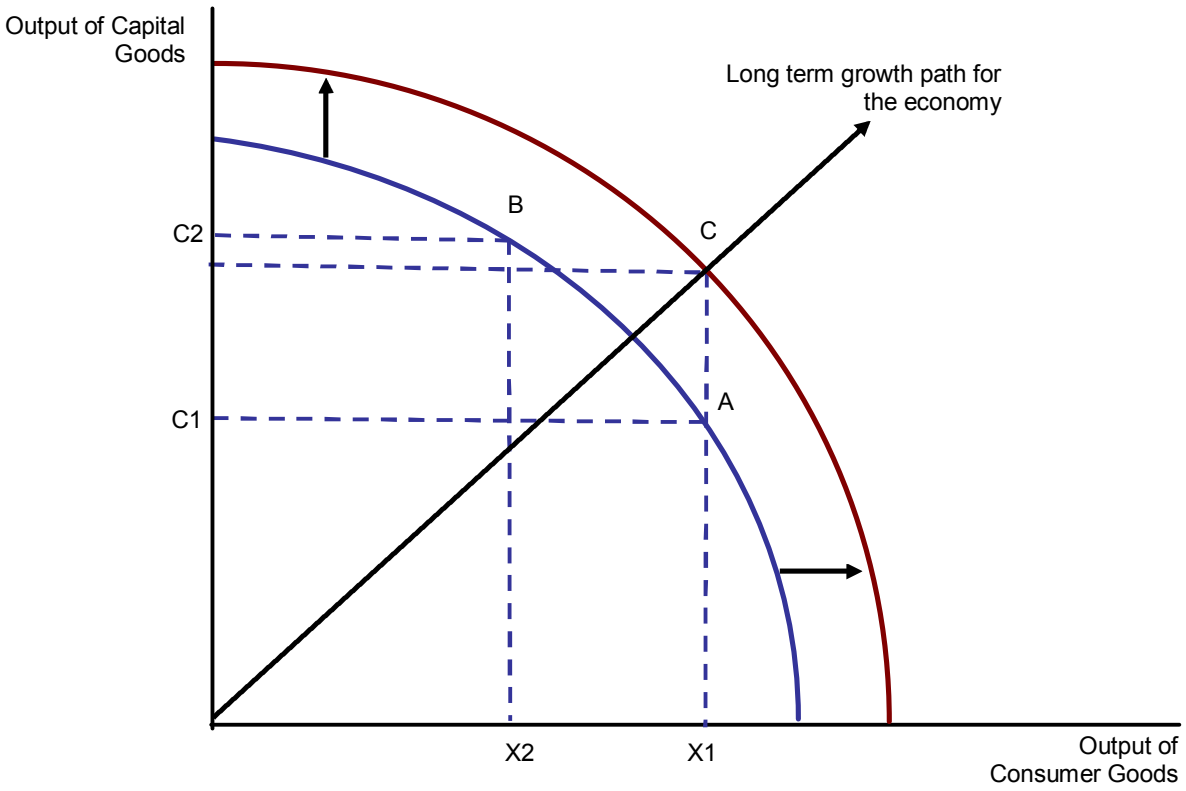
Many of the **static and dynamic effects** of **increased trade and competition** between the 25 nations have already occurred. To put things into perspective, the ten accession countries will add directly only 6% to total EU GDP – the equivalent to adding to the EU a country of the size of the Netherlands!

That said, the new EU members hope that joining the EU club will bring significant economic and social benefits in the medium and longer-term.

Membership of the Single Market – enhancing trade and growth potential

Membership of the EU allows these countries to develop and exploit their **comparative advantage** in industries where they have a cost and non-price advantage and increase exports to "richer EU nations" and thereby promote **growth** and **development**. The experience of the EU's southern enlargement in the 1980s when Spain, Greece and Portugal all joined the EU suggests that **income convergence** is likely, albeit far from guaranteed. Much depends on the ability of the accession countries to make maximum use of EU funds and to maintain exchange rate competitiveness and relatively sound government finances. According to the EU Commission dealing with enlargement issues, the four central European countries (namely the Czech Republic, Hungary, Poland and Slovakia) are expected to experience an average real GDP growth rate of over 4.0% per year from 2004–2010. The **Baltic trio** of Estonia, Latvia and Lithuania have achieved healthy growth rates of 5%-7% for the past two years and they hope that accession to the European Union will provide a further boost to their economic growth over the next few years.

Rising Investment in Enlargement Countries will help to stimulate economic growth



Free movement of capital – opportunities from foreign direct investment (FDI)

Foreign investment will be encouraged by

1. **Low unit labour costs** (labour productivity is almost a third lower on average, but wage costs currently are one fifth of EU levels) – this will encourage out-sourcing. There is a large pool of reasonably well-educated, low-cost labour and previous foreign investment successes may well prompt new flows of investment
2. **Low land prices**
3. **Lower corporation taxes** - In the Czech Republic the main business tax rate has been cut by 7 percent to 24 percent. Like Poland before, Slovakia this year introduced a uniform tax rate of 19 percent for individuals and businesses. In Latvia, the poorest accession country, several special economic zones have been established in which corporations enjoy tax exemptions of over 80 percent. Estonia has completely exempted business profits from taxes. This "tax competition" has caused a stir in some existing EU countries.
4. **Access to relatively fast growing markets** in the accession countries and beyond - many consumer markets are under-developed (for example in services such as banking & pensions)
5. **Infrastructure projects -** a desire by overseas multinational businesses to participate in large-scale infrastructural projects – partly funded by the EU included hi-speed rail links and environmental projects
6. **Growth potential for services -** the opportunity to establish business service industries in these fast-growing economies - about 15 multinationals, including IBM, Fiat and KPMG, the accountants, have already established business service centres in Poland for example

The investment boom in Eastern Europe

Multinationals are stepping up their investment in Eastern Europe as low wage costs and cheap land prices cause a boom in manufacturing production. Although the UK has retained its position as the leading venue for inward investment, there has been a surge in capital investment flowing into Central and Eastern Europe where ten countries joined the European Union in May 2004. Hungary attracted eight-four new projects in the first six months of 2004 and this took it ahead of Germany.

The FDI map of Europe appears to be altering very quickly. Wage costs in the accession countries are rising, but they remain very low relative to wage costs in established EU countries. And the prospect for fast real GDP growth and expanding consumer demand in these countries provides a demand-side reason behind strong inward investment. Hyundai, the South Korean carmaker has decided to build a new car plant in northern Slovakia, the £600 million project is scheduled to open in December 2006 and will employ nearly 3,000 Slovaks, producing 200,000 cars a year and creating significant regional multiplier effects.

Adapted from newspaper report, October 2004

	Hourly wage costs	Labour productivity
	€, 2000	000s €, 2002
EU-15	**22.21**	**57.9**
Cyprus	10.74	na
Czech Rep.	3.90	16.9
Estonia	3.03	12.0
Hungary	3.83	17.0
Latvia	2.42	12.0
Lithuania	2.71	10.7
Malta	na	na
Poland	4.48	16.9
Slovakia	3.06	13.3
Slovenia	8.98	25.4
EU-25	**19.09**	**51.9**

Technology transfers and increased investment in **training and skills** arising from an increase in FDI will have a positive effect on the **productive capacity** (LRAS) of the new EU countries. Western European investment will probably provide a boost to labour and capital **productivity** and thereby improve unit labour costs and competitiveness in the European and global markets

Competitive pressures of being within the Single Market

Increasing competition should act as a boost to productivity within the accession countries. Underperforming businesses not meeting consumer needs and wants will lose market share. The possible gains in **productive** efficiency might be complemented by gains in **dynamic efficiency** for example arising from a higher rate of innovation.

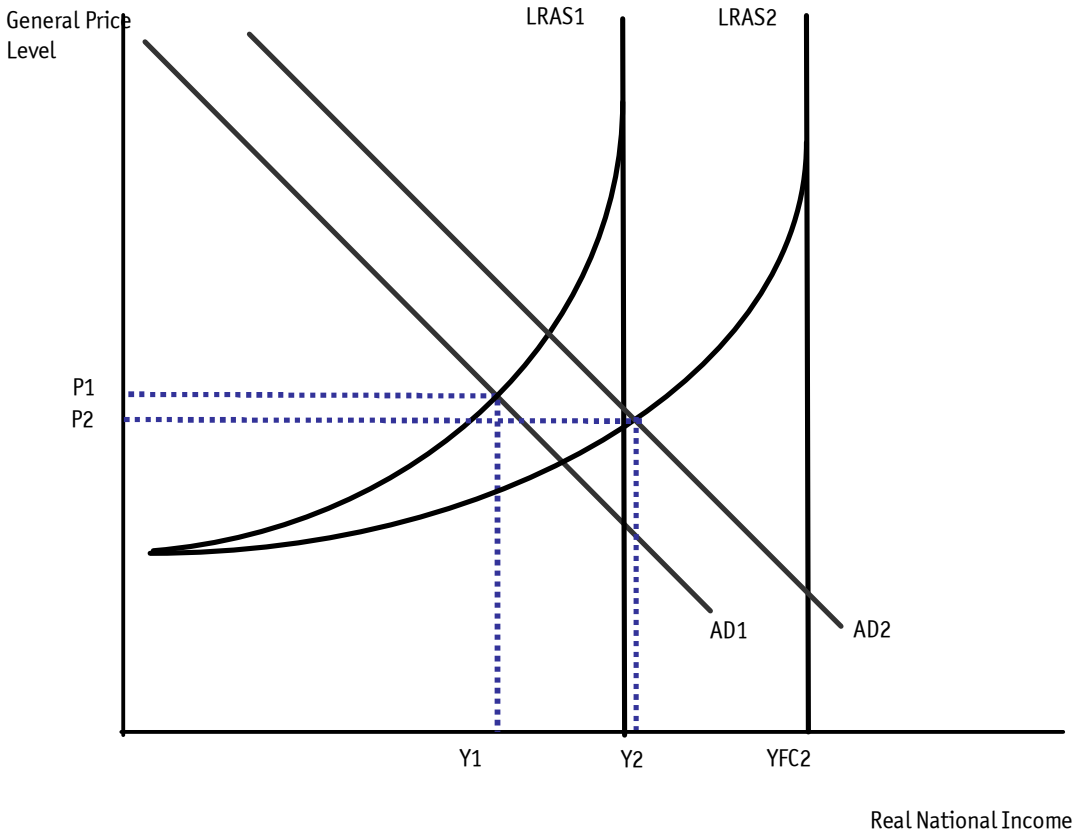
EU funding to promote growth and development

Transitional financial support has been agreed between existing and new EU members – but the final support total is below what the accession countries initially wanted. Between the years 2003-2006, the EU is allocating €40bn (£26.8bn) for the ten new members. New members will also have to make contributions to the EU's budget, which will reduce net receipts to €10bn a year, or 0.1 per cent of the aggregate GDP of the EU. Transition funding also applies to the Common Agricultural Policy (CAP) – it will not be until 2013 that eastern European farmers are entitled to the same farm support levels as those of the west.

Although the financial support is constrained, it doesn't fundamentally alter the rationale for these countries coming into the single market. As a recent article in the Financial Times made clear: "The chief determinant of success (inside the EU) is not money, but how well a country exploits the wider advantages of membership" The Economist also has a similar perspective on the importance of EU funding. "The EU's "cohesion" funds are not terribly effective. Liberal

handouts of aid are at best a poor substitute for liberal movements of goods, capital and labour."

If membership of the European Union leads to an expansion in aggregate demand (from increased exports to existing EU countries and the demand stimulus from inward investment) together with a rise in potential GDP from higher productivity, increased investment and an expansion in the labour supply, then the result should be sustained **long-term growth** for many of the accession countries. This might be illustrated using a standard AD-AS framework shown in the figure below



Potential macroeconomic advantages

The new member nations hope that joining the EU will help to bring **macroeconomic stability**, for example a reduction in consumer price inflation; lower short-term and long-term interest rates and enhanced stability in the foreign exchange markets. Short-term interest rates in accession countries have fallen in recent years but for the most part they remain well above the average interest rate for EU-15 economies.

The main aims of joining the European Union for the accession countries can be summarised as follows:

- An increase in the scale and extent of **economic integration** with Western Europe
- The aim of providing a catalyst to long-term growth and higher employment
- **Raise relative living standards closer to the EU average**. There is support for this view from the experience of previous waves of enlargement. Portugal raised its average living standards from 55% of the EU average to 75% within 15 years of entering the customs union. Spain increased her GDP per capita from 75% of the EU average to 85% and Ireland was the top performer of all. When Ireland joined the EU at the same time as the UK (in 1973) it had a per capita income of just 70% of the European average. Ireland is now one of the richest nations within the EU

8.5 Disadvantages and Costs for Accession Countries

Although most accession countries regard joining the European Union as a "**positive sum game",** there are risks and costs. Further structural reforms of product and labour markets and financial institutions may be needed for accession to be judged a success

Fiscal Costs of Transition

Extra government spending has been required to improve **national infrastructure** and meet the requirements of EU entry. This has placed great pressure on government finances with most countries already running sizeable budget deficits. This may cause problems of **accumulating national debt** and **higher interest payments in the future** which will put increasing pressure on government spending in other critical areas – notably education, welfare and health spending.

The case of the Hungarian economy is particularly important. Her budget deficit soared to over 9.3% of GDP in 2002 and this has cast serious doubts about the macroeconomic stability of the Hungarian economy in the near term. A budget deficit of this size inevitably puts pressure on long term interest rates (the government needs to find investors prepared to buy the debt) and it also has potentially inflationary consequences if aggregate demand is stoked up too high and a lack of overseas investment causes a fall in the value of their exchange rate.

Vulnerability of Accession Countries to EU competition

One of the interesting questions as ten new countries join the EU is whether the major domestic industries of the new members will be able to maintain their competitiveness and market share against larger-scale Western European businesses? New entrants can expect an **increase in cross-border trade** and there will be pressure for further pan-European mergers and acquisitions in many industrial and service sector industries. This process is already well established.

Domestic industries in many of the CEECs are still being weaned off government (state) subsidies and there are risks of higher **structural unemployment** if industries cannot compete within the single market. This will threaten economic and social cohesion in these countries where unemployment is often already very high.

8.6 Advantages of Enlargement for the EU

We now consider some of the implications of enlargement for the existing members of the EU including the UK. The British government is strongly in favour of enlargement – it regards the process of offering important demand and supply-side opportunities for Britain, but this will require UK businesses to tap into the opportunities that arise from an increase the size of the **single market**

Export Potential

There are classic **trade creation effects** from **increasing the size of a customs union**. Britain for example should now be able to source some of her imports more cheaply from the ten accession countries leading to an improvement in her **terms of trade.** The efficiency of the economy should increase as resources are diverted to areas of the UK's **comparative advantage**. Collectively in 2003, the ten accession countries accounted for less than 2% of UK exports. Economists at Oxford Economic Forecasting (www.oef.co.uk) have estimated that it will take a doubling of exports to the ten accession countries to raise UK national output by just 0.5%.

Accession countries are small – but they have grown more quickly than EU-15 in recent years and they have **faster growth potential.** Typically they have tended to achieve an annual rate of growth of real GDP about 2% higher than the EU (15) average. The long run economic potential of the accession counties is much greater than their current size! Trade and investment linkages with the EU are likely to become even deeper. **Inter-industry trade** was initially prevalent, but in recent years most of the growth has come from **intra-industry trade**, reflecting growing **vertical integration** within industries.

Exploitation of economies of scale from supplying to a larger market

As the size of the European market increases and accession countries become richer, businesses should be better placed to reap gains in productive efficiency arising from **increasing returns to scale.** However this should be put into context – most Western European businesses will gain more in terms of increased efficiency from expanding the scale of their export operations to fast-growth emerging Asian economies, such as China and India in the next ten years.

Foreign Investment and Incomes and Profits

FDI from the EU-15 into accession countries will provide a net flow of **interest profits and dividends** thereby boosting a country's **GNP** and supporting the current account of the balance of payments. FDI flows are likely to *supplement* rather than reduce domestic capital spending and FDI will help to speed up the economic transformation of accession countries.

British companies likely to benefit in particular from the enlargement of the EU include businesses in the following sectors:

- Infrastructure - steel, construction, equipment, building materials
- Telecommunications networks
- Roads, sewage, rail
- Banking and financial markets - lending, fund management (e.g. pensions)

A more diverse European labour market

There will be opportunities for British and other EU-15 businesses to import **lower-cost skilled labour** in areas where there are **persistent labour shortages**. The **migration of labour** from accession countries may help to offset in part some of the longer-term effects of ageing populations and the slow growth of the population of working age. Enlargement will also open up increased opportunities for EU people to travel, live and work in Central, Eastern and Southern Europe – something that is likely to be attractive for younger workers in particular.

Higher EU economic growth:

Independent research suggests that accession of the 7 largest Central European candidates could increase UK GDP by £1.75 billion pa although the scale of the likely growth effects is difficult to estimate accurately and all forecasts should be treated with an appropriate degree of caution. Enlargement is also likely to increase the pressure towards economic and labour market reform in the EU, ultimately fostering a more dynamic economic environment and leading to higher levels of productivity

A cleaner environment:

Accession countries have spent huge sums improving air and water quality to meet more stringent EU standards – so reductions in cross-border pollution will have positive externalities for all EU countries.

8.7 Disadvantages of Enlargement for the EU

There are three significant potential costs of enlargement:

- The costs for government finances
- The potential costs of labour market disruption and
- The costs of wage competition

In many ways the costs of enlargement are driven by **political** rather than **economic factors** – i.e. how they depend in part on how generous the existing members of the EU are prepared to be to new members. Several "controls" have been put in place during final negotiations on accession – most of them relating to the scale of regional aid, arrangements for CAP funding and the limitations on the free movement of labour within the EU.

Budgetary Costs for the EU

The accession process will increase the budgetary contributions of existing members although several steps have been taken to limit the fiscal costs to EU-15 countries. These include:

Farm subsidies for new member-states will be gradually phased in over a period of nine years and will amount to only 25 percent of the amount received by western European farmers under the Common Agricultural Policy. Poland, where 20% of the workforce is employed in agriculture, has negotiated the right to supplement them with EU "structural" funds. The full CAP subsidies received in existing member states will not be paid to the new members until 2013, to avoid crashing the EU budget and causing havoc with Eastern Europe's agricultural pricing system.

Limits to Structural Funds: Accession countries will receive 25bn euros in structural aid over the first three years

Net Contributions: The EU will ensure that accession countries do not pay more into the EU budget than they get back between 2004 and 2006

Longer-term need for higher regional subsidies:

The EU is widening to twenty-five nations and the result is that the EU is becoming **a club of mainly small countries** with the prospect of a widening **wealth-gap** between rich and poor regions. The poorest regions can therefore claim the highest regional and social cohesion funds. Accession countries will tend to dominate regional funds and this implies less for relatively poorer areas within the EU-15 such as Spain, Greece and Portugal. The total EU regional funding budget will have to increase in the long-run to meet the growing economic and social requirements if relative poverty and inequality within the EU worsen. This will put huge pressure on other parts of the EU budget given that member nations will be reluctant to increase appreciably their contributions to EU finances.

Labour Market Issues

There are fears of **higher structural unemployment among accession countries** that might lead to large immigration of labour into higher-income countries as well as increasing political and social tensions. Unemployment in accession countries is already well above the EU average – much of it is long-term in nature. Although enlargement is designed to promote growth and employment, there is no guarantee that unemployment will fall following integration with the EU. And, persistently high unemployment creates large economic and social costs and will put accession countries under increasing fiscal pressure given their already fragile government finances.

8.8 Enlargement and the Labour Migration Issue

"The coming hordes"

On one side stand economists armed with formulae and tables of data, arguing that migration from the poor countries of central Europe to the rich countries of Western Europe will be modest and manageable after ten new members join the European Union in May. On the other stand Euro sceptics, trade unions and some governments, worried that enlargement will bring a rush of migrants chasing jobs and social-security benefits. Almost drowned out are voices from the poor countries themselves, demanding the rights and freedoms of EU membership, but fearing a drain of skilled workers.

Adapted from the Economist, January 2004

The effect of enlargement on the movement of workers within the EU is a controversial political issue. There are concerns that it may prompt a large inflow of people into the UK seeking to exploit the welfare system. But in February 2004 the UK government moved to limit this risk – in particular it has introduced controls on the minimum length of time that new workers must be in paid jobs before they become eligible for state welfare benefits.

Free movement of labour will be restricted during a seven-year transition period to limit the size of potential migration flows. Once the restrictions are lifted, inflows of workers from central Europe are unlikely to exceed 0.4% per annum of the EU-15 labour force, due in part to a forecast decline in the per capita income gap between existing and new EU member states. Immigration flows are likely to be more meaningful in Germany's case, due to geographic proximity to the AC-10. Austria and Germany are allowed a **"safeguard clause"** to restrict cross-border supply of services in industries such as construction and industrial cleaning. In general, the balance of studies on enlargement and labour migration is that the overall effects will be small and certainly below what some of the right-wing British newspapers are predicting.

A modest net inflow of workers into the British economy should help to alleviate labour shortages in certain industries including agriculture, construction and the public services. However the total macroeconomic effect of inward migration is minor. It would take an increase in migration of around 75,000 people per year into the UK for our economic growth rate to rise by 0.1% per year!

The effects of labour migration on the labour markets and competitiveness of the richer countries inside the European Union may depend on where the main source of competitive advantage lies, according to research from Marques and Metcalf in a paper delivered to the Royal Economics Society. They argue that industries that source their competitive advantage from building a large, skilled workforce will gain from an influx of younger, well-educated workers. These industries usually grow more quickly than the economy as a whole and depend on a continuing expansion of the labour force to sustain this growth. Hi-tech industries such as high-knowledge manufacturing, transportation and financial services may well gain from an increase supply of skilled workers from Eastern Europe. If growth is sustained, workers

will benefit from higher real wages. In contrast industries that continue to rely on low-educated labour-intensive workers will tend to lose out because production will gravitate to those countries where unit labour costs are much lower. Examples of include textiles, leather, and clothing and leisure sectors.

Some economists believe that enlargement will help to control migration because full access to the EU single market will provide new employment opportunities that will keep central European workers employed in their own countries. Many Western European manufacturers and service businesses see accession countries as profitable locations for investment because of their lower unit labour costs, offering them a means of retaining global competitiveness against the challenges of globalisation and intense cost and price competition from the Far East. In this sense, economic integration within an expanded EU-25 promises to be an effective anti-immigration strategy.

Most of the static and dynamic effects of deeper integration within a single market come from the free flow of trade in goods and services and financial capital rather than the extra mobility of labour. Trade and migration are substitutes – capital investment spending will tend to flow to those regions and countries where unit labour costs are lowest. We should also remember that there are also **natural barriers** to the geographical mobility of labour which suggest that the flow of economic migrants will probably be smaller than forecast. These include the costs of moving, differences in national housing markets, cultural differences, the ties of social and family relationships and linguistic barriers. The main long-term issue is unlikely to be migration *within the EU* (25) but rather the pull of a more prosperous European Union to people living *outside* its current boundaries. Looking back to previous enlargements of the EU, there was no significant increase in immigration to UK from EU following 1986 enlargement (and migration outflows from Spain to EU fell from over 200,000 in 1970 to about 10,000 at beginning of 1990s). Studies of migration patterns within Europe suggests that long-term migration could be 3% of new countries population or 0.6% of the existing EU population

Barriers to mobility in Europe

Scare stories that millions of East Europeans would head westwards in search of comfort and prosperity are wide off the mark. Wages are lower in the East, but so are prices and rents, with the result that most East Europeans enjoy a reasonably good standard of living. Surveys show that only very few (perhaps 1% of the population in the new Member States) may be willing to leave their homes, families and friends to look for new jobs in the West. High unemployment and slow growth in the EU, as well as cultural and linguistic barriers are also putting off potential migrants.

Source: Centre for European Reform, June 2004

8.9 Enlargement and Tax Competition between Nations

The enlargement of the EU is leading to increased tax competition between member nations competing for inflows of overseas direct investment. Company taxes in the European Union are falling because of competition from low-tax countries in central and Eastern Europe that join the EU on May 1. Corporate taxation in the 10 accession countries is generally lower than among existing members. Estonia, the most extreme, has a zero rate for some corporate profits. Such competitive considerations have obliged

Austria, among the most exposed of the EU's existing members because of its proximity to the low-tax accession states, to slash corporate taxation. Rates will be cut to 25 per cent from 34 per cent next year. Among Austria's neighbours, Slovakia has introduced a 19 per cent flat rate tax; Slovenia levies 20 per cent; while Hungary is due to cut rates from 18 per cent to 16 per cent. The average rate for corporation tax in the 10 accession countries is 21 per cent.

The possibility of tax cuts to maintain competitiveness is viewed with serious concern in some bigger EU countries. Germany and France are among those most fearing a downward race, not least because of the fragile state of their government finances - both countries are already running sizeable budget deficits that have exceeded the deficit allowed under the European Union Fiscal Stability Pact. Both are keen to harmonize EU business taxes to eliminate what they regard as "unfair" competition. The increased mobility of companies globally has led to a general decline in nominal business tax rates in the EU in recent years. Britain was seen as a pioneer of corporate tax cuts in the 1980s, cutting rates from 52 per cent to 35 per cent, but it is now easily surpassed by Ireland, with a 12.5 per cent rate. The European Commission, which polices the EU single market, says it is in favour of tax competition, but it clamps down on "beggar my neighbour" tax incentives to attract inward investment that are not available to domestic companies.

Corporate tax burden			
Estonia	0.0%	Luxembourg	30.0%
Ireland	12.5%	Denmark	30.0%
Lithuania	15.0%	Czech Rep.	31.0%
Cyprus	15.0%	Portugal	33.0%
Latvia	19.0%	Austria	34.0%
Slovakia	19.0%	Belgium	34.0%
Poland	19.0%	Italy	34.0%
Hungary	20.0%	Netherlands	34.5%
Slovenia	25.0%	Spain	35.0%
Sweden	28.0%	Greece	35.0%
Finland	29.0%	France	35.4%
UK	30.0%	Germany	38.7%

8.10 Enlargement and the Single Currency

Are the enlargement countries joining the Euro?

The answer is no – although a commitment to enter the single currency at some point in the future is part of the accession process. Some countries such as Estonia - could join the single currency almost immediately if they were permitted to do so. But the reality is that the vats majority of the accession countries do not yet have the macroeconomic stability / economic convergence that is required as part of the entry process into the Euro. In particular most of the countries are running sizeable government fiscal deficits and long-term interest rates are well above Euro Zone levels.

In principle the majority of enlargement countries do want to join the Euro – particularly if it helps to provide lower inflation and (in the medium term) lower interest rates. For the moment they will operate outside, choosing their own exchange rate regime (fixed, floating etc).

The countries joining the EU in 2004 have chosen a variety of **exchange rate regimes** with respect to their fellow EU-15 members. In Cyprus for example, the currency is pegged to the Euro in a **semi-fixed exchange rate system** with a wide band of agreed fluctuation of +/- 15%. A similar regime is used by the Hungarian government and central bank. The Czech Republic is operating with a **managed floating** exchange rate – essentially the currency is allowed to find its own level in the foreign exchange markets, but the Czech central bank occasionally intervenes in the market through interest rate changes and official intervention (the buying and selling of domestic and foreign currencies) to influence it's value. In Slovakia, the currency is in a managed floating system but with the euro as the main reference currency. In contrast, the Polish government has opted for a fully floating exchange rate.

8.11 Comparative Advantage and Trade Deficits

The success of enlargement of the EU depends greatly on whether EU integration encourages and stimulates accession countries to exploit their comparative advantages with existing EU countries and in trade with non-EU economies. It is impossible to say how this will turn out – to a large degree the trade data in goods and services over the coming years will allow analysts to pinpoint revealed comparative advantage in different sectors.

Patterns of Trade for the New Member Nations
The three main export products by value, 2002

EU15	*Motor cars*	*7%*	*Medicines*	*4%*	*Telecoms equipment*	*3%*
Czech Republic	Motor cars	8%	Motor vehicle parts	7%	Computers	5%
Estonia	Telecoms equipment	15%	Furniture	7%	Wood, simply worked	6%
Cyprus	Medicines	17%	Fruit and nuts	7%	Vegetables	6%
Latvia	Wood, simply worked	17%	Wood in the rough	5%	Iron and steel bars	5%
Lithuania	Refined petroleum oils	16%	Ships	7%	Motor cars	6%
Hungary	Telecoms equipment	11%	Engines	9%	Computers	5%
Malta	Electronic components	49%	Men's clothes	7%	Aircraft	5%
Poland	Furniture	7%	Ships	6%	Engines	4%
Slovenia	Motor cars	8%	Furniture	7%	Household electrical	6%
Slovakia	Motor cars	15%	Refined petroleum oils	5%	Rolled iron & steel	5%
US	*Electronic components*	*7%*	*Aircraft*	*6%*	*Motor vehicle parts*	*4%*

One important aspect of comparative advantage is the difference in **labour costs** between countries. These can be offset by differences in factor productivity and fluctuations in the exchange rate. In

contrast to most of the existing EU nations, accession countries have much lower labour costs and, these labour cost advantages should be an attraction to Western European businesses looking to relocate their manufacturing plants in Eastern Europe to compete on cost with producers from the Far East.

The ability to build state of the art manufacturing plants in new EU countries and transfer their technology and management practices should help to offset partially any **productivity gap**. Many of the accession countries have a good track record in education attainments – another source of potential comparative advantage. Although we can expect rapid growth in relatively labour-intensive low-value added production in many accession nations, in the long run, many of these countries will be looking to invest in human capital and technologically advanced fixed capital to exploit the growth opportunities of fast growth in higher value-added manufacturing products and high-knowledge service industries.

According to new research from the World Economic Forum, some of the accession countries are already ahead of some existing EU members in terms of international competitiveness. Estonia is ranked first among accession countries. Among Estonia's specific strengths are the quality of its business enterprise environment and the level of sophistication of information society elements present in its economy, both areas in which it scores above the EU average. Estonia has one of the most highly developed ICT sectors in the EU. Slovenia is ranked second among accession countries with relative strengths in the dimensions of network industries and sustainable development.

Trade deficits

Accession countries are currently running a large trade deficit with the existing EU countries and this raises questions about the sustainability of large trade deficits over the medium term. Partly these trade deficits are the result of strong economic growth in the last five years including large-scale imports of capital goods and technology from Western European countries. Lower interest rates and rising levels of household spending have also contributed to a widening trade gap suggesting that accession countries have a high income elasticity of demand for European Union products. Recent appreciation in the exchange rates of individual countries against the Euro has been another factor switching demand away from domestic producers towards imported output.

In the short to medium term, large trade deficits are sustainable provided that they can be financed by capital inflows. In the long run however, accession countries will need to build and then sustain comparative advantages in growth sectors to avoid political and economic pressures. Data from Eurostat finds that from 1996 to 2000, net FDI flows into accession countries financed a minimum of 54% of the deficit arising from trade in the goods and services account.

Gains for the UK

UK exporters should benefit from more rapid growth in the accession economies. And while there is concern about potential job losses as more production is 'offshored' to central Europe, consumers should benefit from cheaper imported goods, and the efficiency of the economy should increase as resources are diverted to areas of the UK's comparative advantage. The UK should also benefit from an increase in immigration of people of working age from the accession countries, which will help to alleviate the increasing labour shortages in much of the economy

Trevor Williams, Lloyds-TSB Chief Economist, May 2004

A summary of the arguments

Opportunities for UK	Risks for the UK	Advantages for Accession Countries	Risks / problems for the Accession Countries
Trade opportunities in emerging consumer markets and in business services	Labour-intensive low cost producers many threaten some parts of UK manufacturing	Political stability, security and an economic framework for future growth	High levels of government borrowing (fiscal deficits)
Foreign investment opportunities and chance to outsource manufacturing	Some UK regions may lose eligibility for securing EU regional funding (Objective 1)	Limited EU accession funding – mainly through the CAP and regional funds	Threats to domestic industries from foreign investment – can smaller scale producers compete?
Attract inflows of younger, well educated and dynamic workers – e.g. to relieve shortages of key public sector workers	Social pressures created by labour migration – increased pressure on education, housing and health services etc	Access to overseas capital – promoting employment and higher living standards	Costs of meeting the requirements of the single market (e.g. health and safety legislation and environmental regulations)
Increased competitive pressure on the UK to raise productivity in faces of new competition	Our net contribution to the EU budget may have to rise in the medium term	Access to the single market - opportunity to exploit comparative advantage	Social unrest – already apparent e.g. in Poland, expectations may be unfulfilled – puts pressure on governments
Opportunities for UK farmers – e.g. in exporting high-added premium products	Tax competition from accession countries may reduce the scale of foreign investment coming into the UK	Eventual membership of the single currency brings opportunities for macro-stability	Unemployment may rise in the short term – still many economic reforms to be carried out

8.12 Focus on Selected Accession Countries

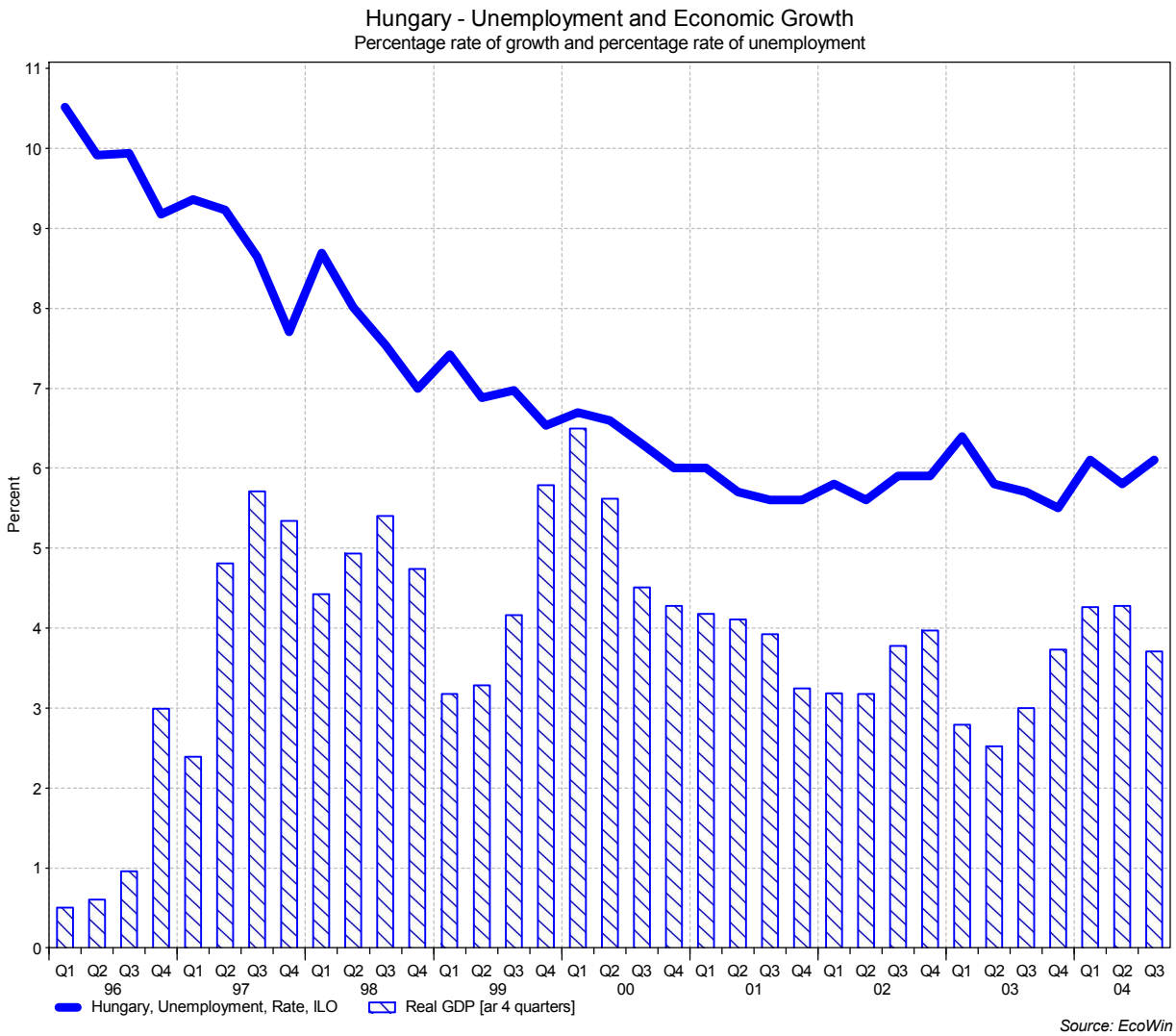
Hungary

Macroeconomic Performance of Hungary

% change per annum unless stated

	1999	2000	2001	2002	2003	2004
Real GDP	4.2	5.2	3.8	3.5	2.9	3.9
Household spending	5.4	3.8	5.7	10.2	7.6	3.5
Gross capital investment	5.9	6.7	5.0	8.0	3.0	9.0
Exports	13.1	21.8	7.8	3.7	7.2	14.7
Imports	12.3	21.1	5.1	6.2	10.3	14.7
Unemployment (% of labour force)	7.1	6.5	5.8	5.9	5.9	5.9
Government borrowing (% of GDP)	-5.6	-3.0	-4.7	-9.3	-6.2	-5.4
Current account of balance of payments (% of GDP)	-7.8	-8.7	-6.3	-7.1	-8.9	-9.1
Short-term interest rate	14.7	11.0	10.8	8.9	8.2	11.5

2004 forecast is from the OECD www.oecd.org



Main Economic Strengths

- Hungary has one of the highest standards of living of former Communist countries: Life expectancy: 71 years and Population below national poverty line: 8.6%
- Ranked 39th in the World Economic Forum International Competitiveness Index in 2004
- Hungary is already highly integrated into the EU: 38% of exports to Germany, 5% to Netherlands, 6% to Italy, 10% to Austria. Exports of goods and services as a % of GDP have risen from 31.1% in 1990 to 64.5% in 2002. 75% of her exports go to the European Union. The Hungarian currency is strong against the Euro – perhaps too strong since it has limited export volume growth
- The country is open to foreign investment in part because of a favourable tax regime – indeed Hungary has received one third of the FDI into CEECs between the years 1989-2002
- Inflation has fallen from 14.2% in 1998 to just 5.2% in 2002. Unemployment is also falling (now about half of the average during the 1990s)
- Relatively small agricultural sector (less than 6% of labour force) and a high level of industrial production – Hungary posses many state of the art production plants (particularly in car manufacturing – partly the result of high levels of foreign direct investment)- 85% of Hungarian exports are manufactured goods
- High potential growth rate. Oxford Economic Forecasting estimate that 'potential output' can rise by 4.5% pa over the next 10 years, with actual GDP growth averaging just under 5% driven by high levels of capital investment contributing to a sharp rise in the country's capital stock

Main Economic Weaknesses

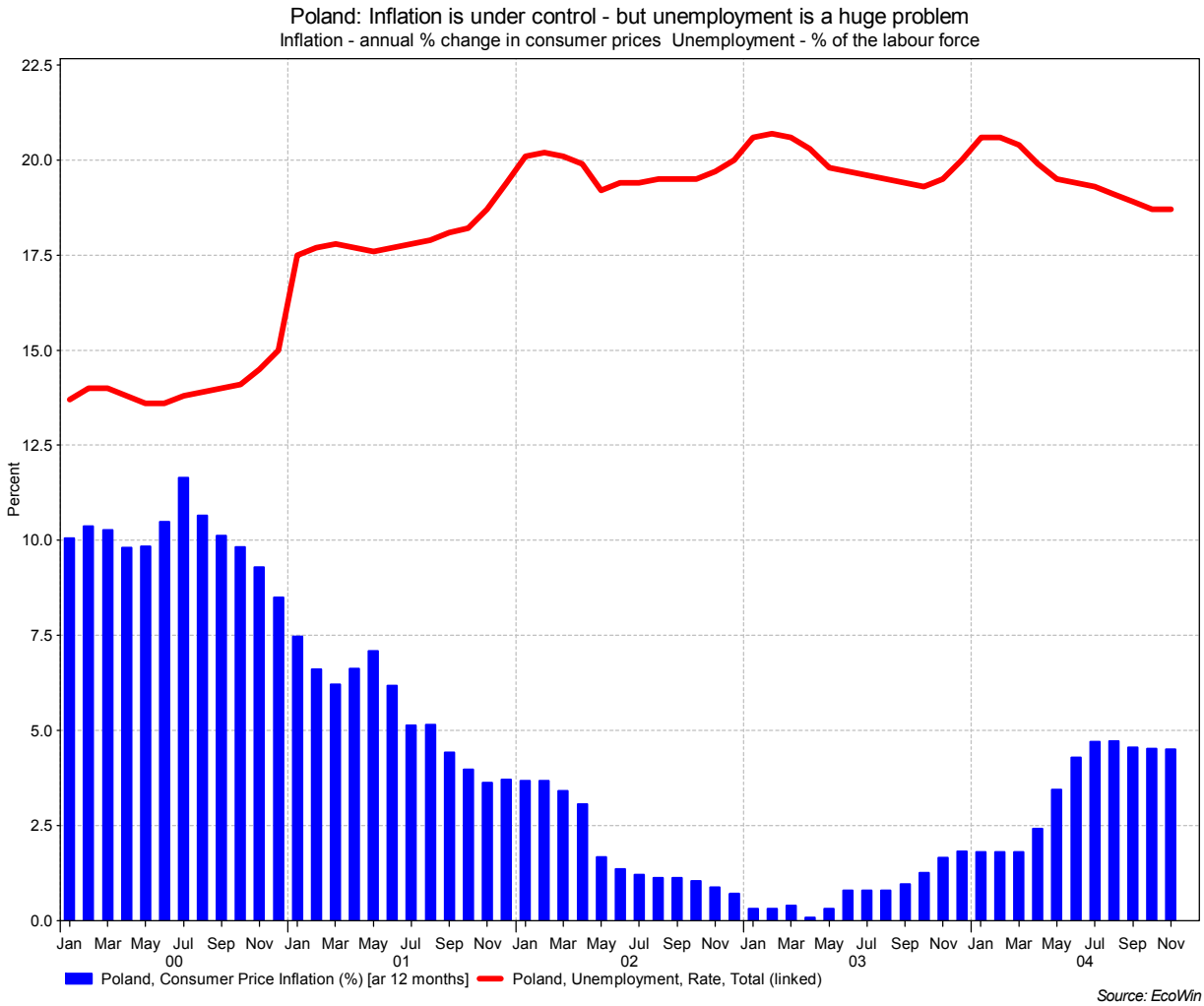
- West-east split (economic development has tended to by-pass eastern rural areas)
- Sharp rise in the budget deficit (it has grown from 3.0% of GDP in 2000 to 9.2% of GDP in 2002)
- Health care spending is only one third of the OECD average
- A falling share of foreign direct investment as a share of GDP over the last three years

Poland

Poland is the largest of the 10 countries that joined the European Union in 2004 (it has a population of 38.2 million). It is perhaps the dominant market place among the new EU member states. Certainly from a geo-political viewpoint it is strategically important. It is ranked 59th in the world on GNP per capita and 38th in the world on the Human Development Index:

Macroeconomic Performance of Poland	*% change per annum unless stated*					
	1999	2000	2001	2002	2003	2004
Real GDP	4.1	4.0	1.0	1.4	3.8	5.4
Household spending	5.2	2.8	2.0	3.4	3.1	4.0
Gross capital investment	6.8	2.7	-8.8	-5.8	-0.9	3.9
Exports	-2.6	23.2	3.1	4.8	14.7	13.4
Imports	1.0	15.6	-5.3	2.6	9.3	10.4
Unemployment (% of labour force)	13.9	16.1	18.2	19.9	19.6	19.1
Government borrowing (% of GDP)	-3.2	-2.4	-3.8	-4.9	-3.8	-5.4
Current account of balance of payments (% of GDP)	-7.6	-6.0	-2.9	-2.6	-2.0	-1.5
Short-term interest rate	14.7	18.9	15.7	8.8	5.7	6.4

2004 forecast is from the OECD www.oecd.org



Main Economic Strengths

- Successful privatisation of many former state run industries has smoothed some of the transition to a market-based economy
- High rates of foreign investment – Poland is a highly open economy – strong investment should give Poland the capacity to grow at a trend rate of close to 4% over the next ten years – this will improve average living standards

- Poland is ranked 60th in the 2004 International Competitiveness Index
- The currency (zloty) is now fully convertible and floats freely in international markets
- Education spending is high (7.5% of GDP); Life expectancy = 73 years
- Integrated into EU economy (70% of exports go to the EU) although only 30% of GDP is exported – benefits from proximity to the markets of wealthier Western European countries
- Poland is now running a trade surplus with Germany for the first time and thousands of workers in former East Germany are now migrating from Germany to Poland in search of work
- Polish economy has successfully brought inflation down (contrast its much better inflation performance in the 1980s and 1990s with the most recent data)
- Growth is pretty strong with a 6 per cent rise in real GDP forecast for 2004 – the export sector is a major contributor to short term economic growth
- Recipient of EU structural aid – amounting to Euro 13 billion between 2004-06 and an estimated Euro 50 billion between 2007-13 – this will boost investment in national infrastructure with consequences for potential real GDP growth

Main Economic Weaknesses

- Despite the recent fall in unemployment there remains a high level of structural unemployment and poverty (18% of population live below the poverty line). Long term unemployment in 2002 was estimated to be 10.9% of the labour force and official unemployment remains high – close to 19% of the labour force
- The agricultural sector suffers from lack of capital investment – there is a high concentration of very small farms with large scale under-employment that are uneconomic
- There remains widespread rural poverty – with an ongoing dispute with the EU over its claims to CAP subsidies when Poland joins the EU
- Serious pollution problems remain partly because the Polish coal industry supplies 70% of electricity generation – major spending required to clean up and meet EU environmental standards
- Poland has a high fiscal (budget) deficit and current account deficit and short-term interest rates are high in a bid to control demand-pull inflationary pressures

Leading foreign investors in Poland

All countries	From the UK
France Telecom	Tesco
Vivendi	Pilkington
Citibank	GlaxoSmithKline
AIB	BP and Shell
Unicredito	HSBC
Fiat	Cadbury
Gazprom	Unilever

The Czech Republic

Macroeconomic Performance of the Czech Republic *% change per annum unless stated*	1999	2000	2001	2002	2003	2004
Real GDP	1.2	3.9	2.6	1.5	3.1	3.9
Household spending	2.1	2.9	2.6	2.8	4.9	3.5
Gross capital investment	-3.5	4.9	5.4	3.4	7.4	9.5
Exports	5.7	16.8	11.8	2.7	6.2	16.7
Imports	5.0	16.2	12.9	4.9	7.8	17.3
Unemployment (% of labour force)	8.8	8.9	8.2	7.3	7.8	8.4
Government borrowing (% of GDP)	-3.6	-3.7	-5.9	-6.8	-12.6	-4.3
Current account of balance of payments (% of GDP)	-2.5	-4.9	-5.4	-5.6	-6.2	-6.5
Short-term interest rate	6.9	5.4	5.2	3.5	2.3	2.4

2004 forecast is from the OECD www.oecd.org

Main Economic Strengths

- The Czech Republic is perceived to be among the best prepared of the EU new members
- The country has a small population but significant progress made in integrating with the EU and in raising living standards in recent years - GDP per capita was measured at US$ 10,160 (2004, at market exchange rates) and GDP per head in 2004 is estimated to be 71% of the EU average.
- High rates of foreign direct investment – FDI in 2002 was 8 billion Euros, the highest among CEECs – and a high level of gross fixed capital formation as a share of GDP (26.6% in 2002). Foreign-owned companies represent half of industrial output and over seventy per cent of exports.
- Czech potential output GDP growth is estimated at 3.5% over the next decade
- Ranked 40th in the International Competitiveness Index for 2004
- The Czech Republic is already highly integrated with the EU. 68% of exports in 2002 went to EU-15 countries. 35% of exports go to Germany and only 4.5% to the UK. 60% of their imports come from the EU-15. Exports of goods and services account for 65% of national income
- Their Banking system is fully privatised and the Czech Republic benefits from a high quality education system
- Czech government has recently announced a cut in the main rate of corporation tax - it is exploiting its comparative advantage in automotive and electronics industries

Main Economic Weaknesses

- Their welfare system is perceived as being too expensive – high non-wage employment costs may eventually lead to a decline in foreign investment inflows
- The Czech Republic is running a sizeable fiscal deficit and also a widening trade deficit – in part due to very strong consumer demand. This might put downward pressure on the currency unless the fiscal and trade deficits are addressed
- Unemployment remains high at nearly ten per cent of the labour force

8.13 Suggestions for Further Research on EU Enlargement

- Candidate Countries http://europa.eu.int/comm/enlargement/candidate.htm
- Country Briefings (Economist) www.economist.com/research/articlesBySubject/countries.cfm
- DTI Web Site (Enlargement issues) http://www.dti.gov.uk/ewt/enlargement.htm
- Enlargement – In Depth Report (BBC) http://news.bbc.co.uk/1/hi/in_depth/europe/2003/inside_europe/default.stm
- Enlargement (audio visual library) http://europa.eu.int/comm/mediatheque/photo/enlarg_en.html
- Enlargement (CER) www.cer.org.uk/enlargement/index.html
- Enlargement countries photo gallery http://europa.eu.int/comm/enlargement/picture_candidate.htm
- Enlargement Special (The Guardian) www.guardian.co.uk/eu/enlargement2004/0,14516,1204600,00.html
- EU and labour migration (BBC news) http://news.bbc.co.uk/1/hi/uk_politics/3499035.stm
- EU Enlargement (EU Commission) http://europa.eu.int/pol/enlarg/index_en.htm
- EU Integration (The Guardian) www.guardian.co.uk/eu/0,7368,396838,00.html
- EU workers register in the UK (Dec 2004) http://news.bbc.co.uk/1/hi/uk/3998725.stm
- EU-West Poverty Gap (BBC) http://news.bbc.co.uk/1/hi/world/europe/1901293.stm
- Guide to the EU's new members (June 2004) http://news.bbc.co.uk/1/shared/spl/hi/europe/04/enlarging_europe/html/introduction.stm
- Migrant World (BBC) http://news.bbc.co.uk/1/hi/talking_point/special/migration/default.stm
- Turkey's bid to join the EU (December 2004) http://news.bbc.co.uk/1/hi/world/europe/4085283.stm

9 UNEMPLOYMENT IN THE EUROPEAN UNION

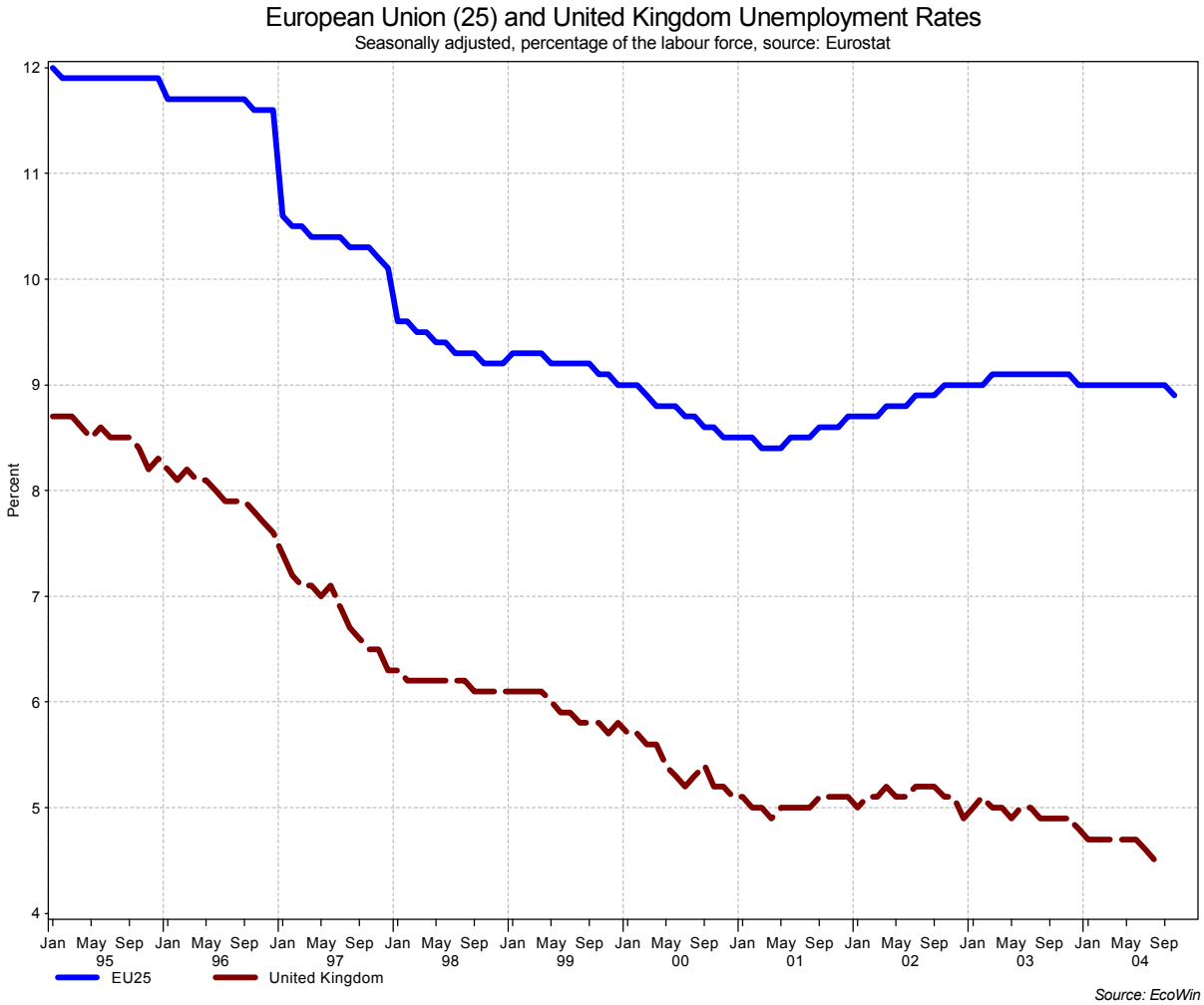
9.1 Introduction

Mass unemployment

In October 2004 it is estimated that 12.7 million men and women were unemployed in the Euro Zone and 19.1 million in the twenty-five member nations of the EU. Measured as a percentage of the labour force, this means that unemployment in the Euro Zone was 8.9% - the same rate as for the EU25.

Unemployment is one of the most important challenges for policy-makers in Europe over the next decade. The question is – how should they respond to the challenge? Should there be a co-ordinated strategy across Europe to reduce unemployment and create plenty of new job opportunities? Or should the problem be left to the micro and macroeconomic policy decisions of individual governments?

There is little doubt that high unemployment threatens the **economic and social cohesion** of the EU. Indeed all EU countries now have targets for **raising total employment** and the **participation ratio** in the European labour market, but the most significant problems appear to be **structural** in nature and may take many years to resolve. Europe's labour market shows many signs of **market failure** and this threatens **living standards** for millions of people. At the 2000 **EU Summit at Lisbon** in Portugal, the EU agreed to take concerted action to reduce unemployment. However progress has been limited.



The chart above shows the unemployment rate in the Euro Zone over the last ten years compared to the jobless rate in the UK. The data is expressed as a percentage of the civilian labour force using a standardised measure of unemployment. After a welcome fall during the late 1990s, unemployment in the EU has rising again during the first four years of the new decade. The average rate has been above 8% of the labour force in every year since 1990.

Some economists have questioned whether there is in fact an EU unemployment problem at all. Unemployment is high in the four largest economies of Continental Western Europe, namely France, Germany, Italy and Spain. If we exclude these four countries, the problem seems less acute. The countries with the highest unemployment are dominated by nations that joined the EU in 2004.

As the table below indicates, Poland and Slovakia had the highest unemployment rates in 2004 and in eight countries the jobless rate in 2004 was over 10 per cent of the labour force. In contrast, unemployment in Hungary, Slovenia, Malta and the Czech Republic last year was below that of Europe's largest economy Germany.

Unemployment within Europe

	1998	1999	2000	2001	2002	2003	2004	Average
				Percentage of the civilian labour force				
Luxembourg	2.7	2.4	2.3	2.1	2.8	3.7	4.2	2.9
Netherlands	3.8	3.2	2.9	2.5	2.7	3.8	4.6	3.4
Austria	4.5	3.9	3.7	3.6	4.2	4.3	4.5	4.1
Denmark	4.9	4.8	4.4	4.3	4.6	5.6	5.4	4.9
Ireland	7.5	5.6	4.3	3.9	4.3	4.6	4.5	5.0
Portugal	5.1	4.5	4.1	4.0	5.0	6.3	6.6	5.1
UK	**6.2**	**5.9**	**5.4**	**5.0**	**5.1**	**4.9**	**4.7**	**5.3**
Sweden	8.2	6.7	5.6	4.9	4.9	5.6	6.3	6.0
Hungary	8.4	6.9	6.3	5.6	5.6	5.8	5.8	6.3
Slovenia	7.4	7.2	6.6	5.8	6.1	6.5	6.0	6.5
Belgium	9.3	8.6	6.9	6.7	7.3	8.0	7.7	7.8
Czech Republic	6.3	8.6	8.6	8.0	7.3	7.8	8.4	7.9
Germany	9.1	8.4	7.8	7.8	8.7	9.6	9.8	8.7
Euro-zone	**10.2**	**9.3**	**8.4**	**8.0**	**8.4**	**8.9**	**8.9**	**8.9**
EU (25)	**9.4**	**9.2**	**8.7**	**8.5**	**8.8**	**9.1**	**9.0**	**9.0**
France	11.1	10.5	9.1	8.4	8.9	9.4	9.6	9.6
Finland	11.4	10.2	9.8	9.1	9.1	9.0	8.9	9.6
Italy	11.7	11.3	10.4	9.4	9.0	8.6		10.1
Estonia	9.2	11.3	12.5	11.8	9.5	10.2	9.4	10.6
Greece	10.9	11.8	11.0	10.4	10.0	9.3		10.6
Spain	15.2	12.8	11.3	10.6	11.3	11.3	10.9	11.9
Latvia	14.3	14.0	13.7	12.9	12.6	10.4	9.8	12.5
Lithuania	13.2	13.7	16.4	16.4	13.5	12.7	11.0	13.8
Poland	10.2	13.4	16.4	18.5	19.8	19.2	18.9	16.6
Slovakia	No data	16.7	18.7	19.4	18.7	17.5	18.2	18.2

Source: OECD World Economic Outlook, December 2004 and International Labour Office

Long Term Unemployment

The **economic and social costs of unemployment** are greater when the causes are structural rather than cyclical or frictional, and when the time during which people stay unemployed is long. The EU has a high incidence of **long-term unemployment** and evidence for this is shown in the table below. The data shows the percentage of the civilian labour force who have been out of paid work for twelve months or more.

Long Term Unemployment in Europe

	2000	2003		2000	2003
	% of labour force			% of labour force	
Netherlands	0.8	1.0	Belgium	3.7	3.7
Sweden	1.4	1.0	Czech Republic	4.2	3.8
Denmark	1.0	1.1	**Euro-zone**	**4.0**	**3.9**
Cyprus	1.3	1.1	Spain	4.7	3.9
United Kingdom	**1.5**	**1.1**	**EU (25 countries)**	**4.0**	**4.0**
Austria	1.0	1.2	Latvia	7.9	4.3
Ireland	1.6	1.5	Estonia	5.7	4.6
Portugal	1.7	2.2	Germany	3.9	4.7
Finland	2.8	2.3	Italy	6.4	4.9
Hungary	3.0	2.4	Greece	6.0	5.1
Slovenia	4.1	3.4	Lithuania	7.6	6.1
France	3.6	3.5	Poland	7.6	10.7
			Slovakia	10.1	11.1

Source: International Labour Office Employment Research and Eurostat

- Long term unemployment tends to be concentrated on a relatively small number of workers and can be a cause of **income inequality** arising from a lack of paid work opportunities
- The long term unemployed tend to become **detached from the labour market** (they are often called "outsiders") and therefore they exert little influence in moderating pay settlements and wage inflation. This means that they can add to the **natural rate of unemployment**
- The longer people are out of work, the less attractive they become to **potential employers** even when there are plenty of job opportunities available in the economy

9.2 Economic and Social Costs of Unemployment

To many economists, high unemployment is a sign of **the** failure of the labour market to generate sufficient new jobs for people entering the labour market and also a failure to match people to those jobs. In labour markets where there are deep-rooted structural problems then employment opportunities are not as high as they could be. Unemployment has many economic and social costs.

Economic costs of unemployment

- **Lost output:** Unemployment is a **waste of scarce resources** leading to a **loss of potential output** and a loss of allocative efficiency. This is illustrated in the European Union by the fact

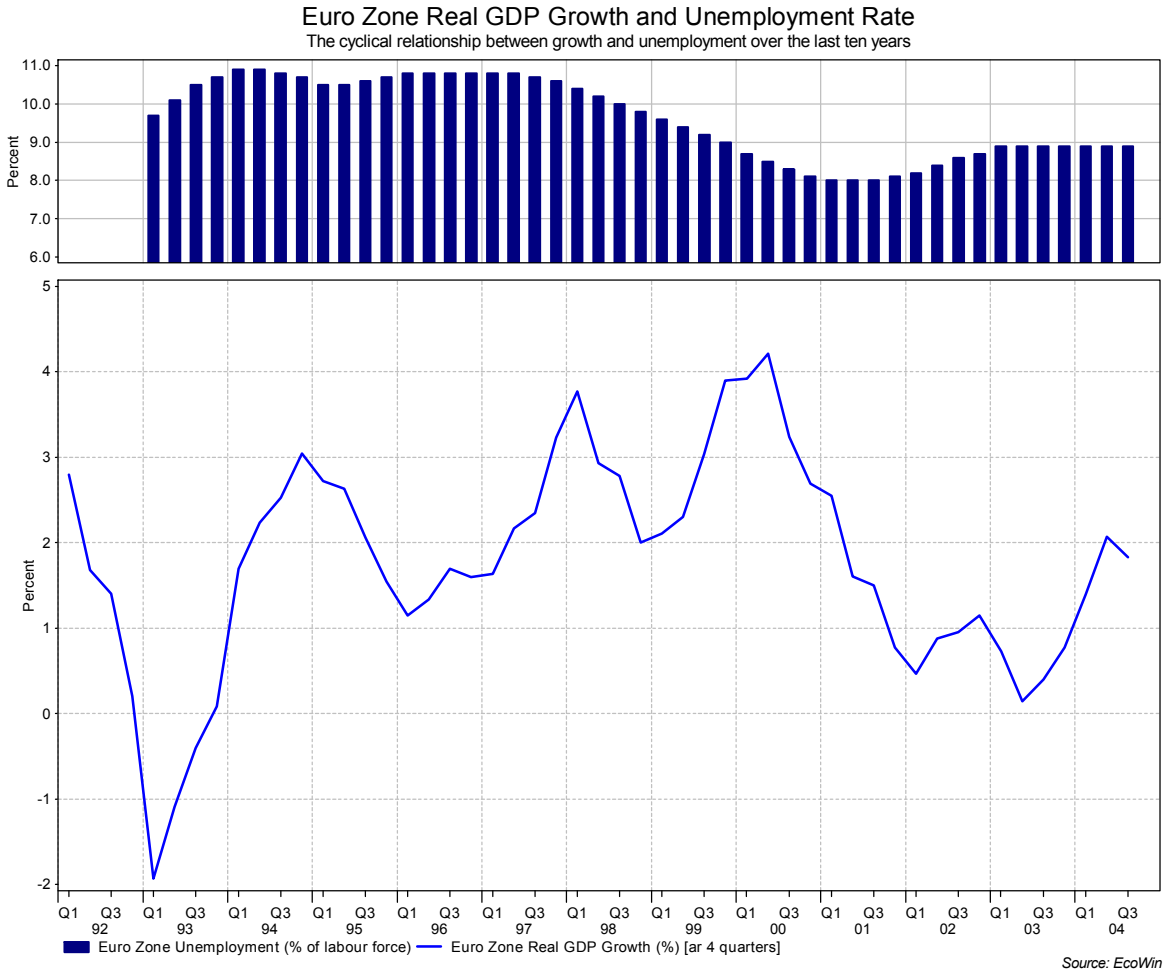
that in recent years the EU economy has been operating with a level of national output well beyond the estimated level of potential GDP – leading to a negative output gap.

- **A deadweight loss of resources used in training:** High unemployment wastes scarce resources invested in training and educating workers. The longer each person's period of time out of work, the greater the loss of skill and motivation
- **A reduction in growth potential:** If a country is running a persistently high jobless rate, it risks damaging long run growth. Growth of potential output comes from an expansion of the capital stock (investment tends to be weaker when unemployment is high); an expansion of the labour supply (structural long term unemployment is often associated with an increase in economic inactivity) and thirdly higher productivity.
- **The fiscal policy effects:** High unemployment affects **government finances** with higher spending on unemployment benefits and other welfare payments plus falling revenues from income tax, national insurance and VAT. It is clear that the **budget deficit problems** in much of the Euro Zone are linked to the unemployment problem.

Rising unemployment is linked to **social deprivation** leading to **external costs.** There is some relationship with crime, and social dislocation (for example increased divorce rates, worsening health and lower life expectancy). Areas and regions of high unemployment see falling real incomes and a worsening in **inequalities of income and wealth**.

9.3 Explanations for high unemployment

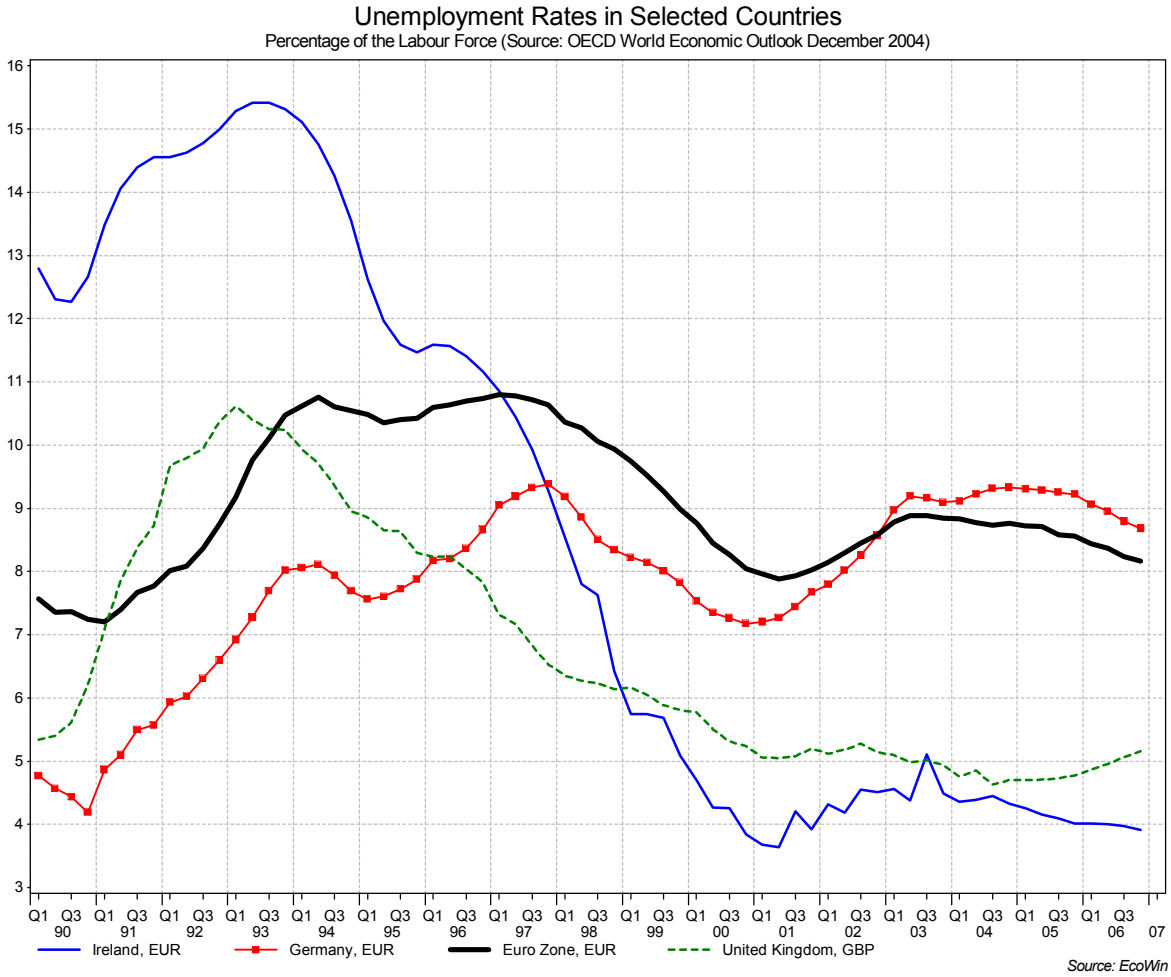
The high rates of unemployment must in the long run be the result of a mix of demand and supply-side explanations. Understanding these causes is important when we come to recommending strategies for government intervention that bid to raise employment potential.



There are as many explanations for unemployment as there are alternative schools of thought. A contrast can be drawn between those **schools** that emphasize the **efficiency of market forces** and those that focus on the failure and inefficiencies of market forces and the **need for government intervention** at micro and macro level. The former tends to favour a non-interventionist (`laissez-faire') approach to policy including `small government', deregulation of product and labour markets and the encouragement of private ownership (shares, housing etc). The latter tends to favour an interventionist approach including **demand management** using fiscal and monetary policy and wider government regulation of markets.

Neo-classical economists have faith in the ability of all markets (including the labour market) to work optimally providing that the right **incentives** are in place and that the **price mechanism** is allowed free rein in determining the allocation of resources. They would argue for the liberalization of EU labour markets as an essential part of any strategy to reduce unemployment.

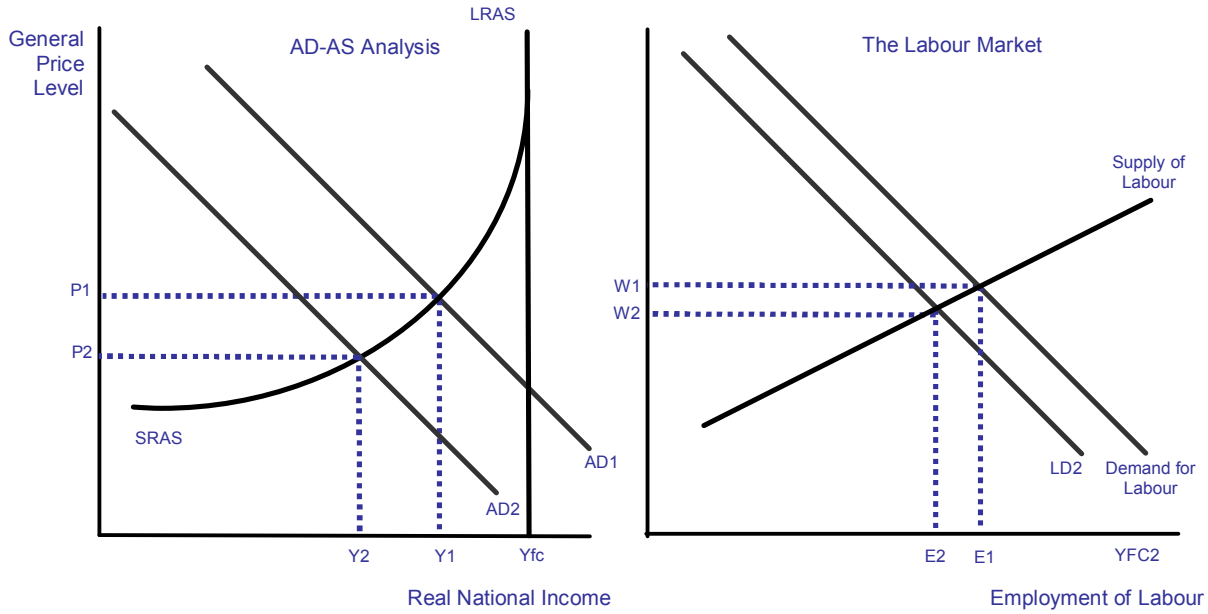
Keynesian economists stress the importance of AD in maintaining high levels of employment. The price mechanism does not automatically ensure a macroeconomic equilibrium at full employment and demand management policies and a strong regional policy is often required to counter the effects of the business cycle and boost investment and employment potential.



Demand Side Explanations for High Unemployment

To what extent is weak aggregate demand a factor behind high European unemployment? Economic growth in the Euro Zone has been disappointing over the last few years and this has had a negative impact on employment. Germany in particular has suffered a major slowdown teetering on the edge of a full blown recession, with its industrial sector experiencing a slump in output and jobs. The weakness of output, investment and jobs has adversely affected business and consumer confidence in the Euro Zone. From this standpoint, there is scope for macroeconomic policy in the Euro Zone to become more expansionary, for example through cuts in short term interest rates by the European Central Bank (ECB) or a range of reflationary fiscal policy measures. As often happens though, the policy options are limited by other circumstances.

A fall in aggregate demand causes a reduction in the demand for labour



Supply-side explanations unemployment

To what extent is the **supply-side of the labour market** responsible for high unemployment in many European countries? Should they move towards the **flexible labour market system** associated primarily with the United States and latterly the UK and a handful of other Western European states?

Neo-classical economists believe that imperfections in the labour market can lead to a higher equilibrium (or natural) rate of unemployment. Some of these labour market rigidities are summarised below

(1) The impact of trade unions – In most countries in the OECD, the majority of workers have their wages set by **collective bargaining** between employers and trade unions at the plant, firm, industry or aggregate level. The bargaining power of trade unions can lead to inflexible real wages and the maintenance of restrictive practices which can lead to lower levels of employment

Supporters of labour market reforms believe that a **reduction in trade union power** can help to reduce the risk of real wage unemployment. However this remains a controversial area of economic thought and policy-making. Trade unions can through partnership with employers, contribute to higher productivity and improved competitiveness which in the long run can do much to protect and boost employment. Other factors, such as the tax rates applied to the employment of extra workers, are probably more important in determining employment levels. For example, France has one of the lowest trade union density rates in Europe, but also one of the highest rates of unemployment.

(2) Higher non-wage employment costs for example associated with high employer contributions to social security systems and the costs of meeting employment laws

(3) Employment laws that make it harder and more expensive to hire and fire labour – a barrier to employment creation and to **inward investment** from multinationals into the EU. And, protectionist employment laws may act as a disincentive for businesses to take on new workers

in an upturn and therefore slow-down the rate at which the unemployed are reintegrated into the labour market

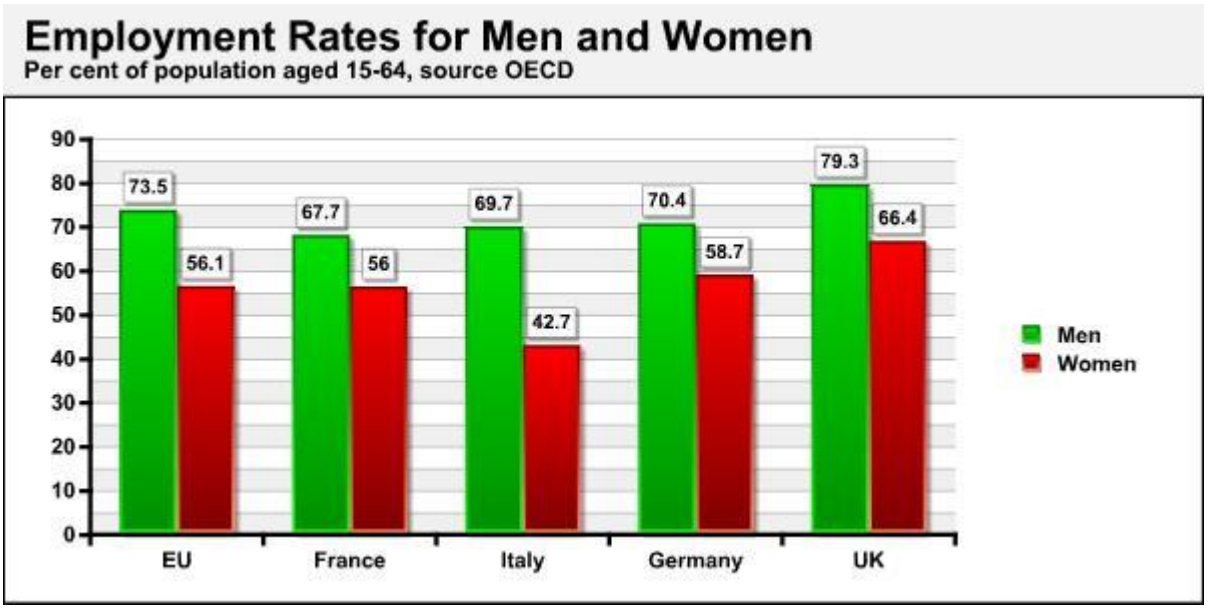
(4) Relatively generous unemployment benefits which might increase frictional unemployment by reducing the incentives to look for and accept paid work. High unemployment may be sustained by the disincentives created by the **unemployment and poverty traps** and supply-side economists argue that reforms of tax and welfare systems are required to **improve incentives** for different groups of workers.

(5) Rising levels of structural unemployment - caused by the occupational immobility of labour. Evidence from the OECD suggests that there is a major problem within the Euro Zone. In both the UK and the USA progress has been made in reducing the rate of structural unemployment. For example the estimated rate (which according to the OECD corresponds to the **NAIRU**) for the UK has fallen from over 8% at the start of the 1990s to just over 5% now. In contrast, the estimated level of **structural unemployment** for the Euro Zone remains high.

9.4 Reforming Europe's Labour Markets

The 2000 Lisbon Summit identified structural weaknesses in the EU Labour Market:

- An insufficient number of jobs being created in the service sector (ranging from tourism to highly skilled knowledge industries)
- A high rate of long-term structural unemployment
- The lack of women participating in the labour market – the employment rate for women in the EU in 2003 was only 56% of women aged between 15-64 compared to 73.5% for men
- Demographic developments – i.e. the ageing of the population
- The NAIRU for most EU countries is higher than the USA – implying a poorer inflation-unemployment trade-off which limits the extent to which reflationary macroeconomic policies can be effective in reducing the scale of unemployment



Is Labour Market Flexibility the Key?

A flexible labour market has several defining characteristics

Flexible employment patterns – both in terms of the **flexibility of hours** that workers are expected to offer and also the **flexibility of skills** within the workplace

Ease and cost of hiring and firing workers – employment laws can be changed to make it less costly to hire and fire workers - this reduces the expense to the employer of making modifications to the size of their labour force. Output and employment can more easily be matched during the economic cycle

Switch to shorter-term employment contracts – in many industries, workers are offered jobs on six months, sometimes on month-to-month contracts

Greater flexibility in pay arrangements. This can be seen in the expansion of **performance related pay** and the **decentralization of pay awards** so that wages and earnings can reflect differences in the demand for and supply of labour in different industries and regions

Location flexibility – many businesses now expect their workers to be able to move within and across different regions as part of their career development – this can be helped by relocation grants

The EU has set ambitious targets for raising employment in a bid to reduce unemployment. At the heart of this objective is a desire and economic need to increase **participation ratios** in the EU labour market which vary greatly across the EU.

Which strategies and reforms are likely to be most effective in achieving this? Supply-side policies on their own are unlikely to create sufficient new jobs to permanently reduce European unemployment. There has to be **sufficient aggregate demand** for European produced goods and services for fresh jobs to be sustained. In this sense, macroeconomic policies (e.g. relating to the operation of Euro Zone monetary and fiscal policy) must work in co-ordination with microeconomic reforms of product and labour markets.

Keynesian economists would argue that the root cause of high unemployment is the result of aggregate demand being held down artificially below full-employment national income leading to a rising level of cyclical unemployment.

The key to raising employment in the long term is for the EU to achieve a faster rate of **trend economic growth. Labour productivity** needs to be improved and higher levels of **capital investment** are required to boost the productive capacity of the EU economy.

The **enlargement of the EU** provides both opportunities and risks for the existing fifteen member nations of the EU. The opportunities centre on the potential for exporting goods and services to fast-growing countries with a population in excess of one million people.

There are also huge opportunities for profitable direct investment into these countries. The risks are that output and jobs will head east because **unit labour costs** are much lower in accession countries.

Competitiveness is the key to creating new jobs

In a global economy, maintaining **competitiveness** in domestic and international markets is the key to sustaining a high level of output and investment across Europe. In the long run the ability of an enlarged EU to maintaining sufficiently robust growth will be vital to expanding employment.

- **Encouraging competition in European product markets** – designed to raise capital investment, reduce prices and boost consumer demand and exploit to the full the benefits of the single market
- **Policies to encourage entrepreneurship** and the development of small-medium sized enterprises, a major source of potential employment growth
- **Maintaining macroeconomic stability** – low and stable inflation is a condition for lower long term interest rates and higher rates of capital investment
- **Changes to Macroeconomic Policy Targets in the EU -** some economists argue that the operation of monetary policy within the Euro Zone is biased towards deflation and that the European Central Bank should operate with a more generous inflation target that would allow it to run lower interest rates – thereby boosting aggregate demand. The current inflation target is 0-2%.

Microeconomic Reforms to Europe's Labour Markets

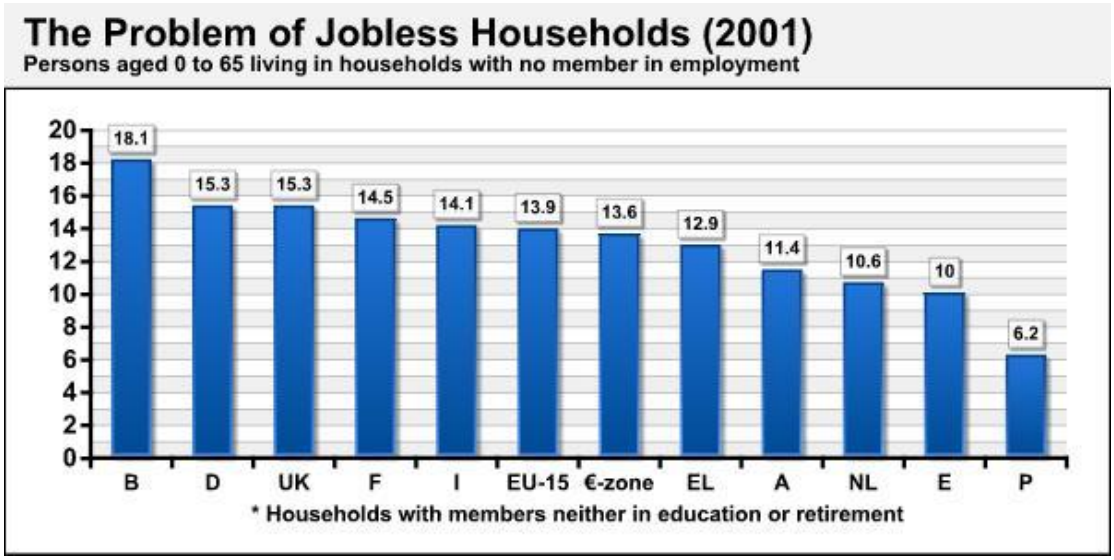
Microeconomic reform of the labour market is often associated with the term **deregulation** – but this does not have to be the case. Indeed within the EU there is widespread support for greater regulation in some areas – for example the boom in people working for agencies whose employment protection is extremely weak. Measures are also being developed for bringing into the formal economy the millions of people who currently earn their income in the informal (or shadow) economy.

The risk with wholesale labour market deregulation is that it will serve to widen **inequalities** in the European economy, by pushing more people into badly-paid and precarious jobs in the informal sector, where there is a near total lack of employment or social security (welfare) protection.

It is highly unlikely that the European economy will switch to the deregulated, flexible labour market that has emerged in the United States. But some labour market reforms can provide support to the aim of increasing total employment and reducing economic inactivity. Around 77 million working-age adults are estimated to be inactive in the EU; almost a third of the working-age population. Even excluding the 15-19 year old age group, many of whom are in education or training, this still leaves 53 million. Measure to increase **employability** might include the following:

- **Reducing direct tax rates for low-wage households** in a bid to increase incentives to look for and then accept work
- **Reforms to welfare (state benefit) systems** so as to make work pay and encourage active job search – perhaps by introducing tighter conditions for claiming benefits; reducing the duration over which benefits can be claimed; or expanding the availability of in-work benefits & tax credits

- **High levels of investment in education and training** designed to raise the stock of **human capital** and reduce occupational immobility – the European economy suffers from a **training deficit** which adversely affects productivity and competitiveness in the long run.
- **Labour market policies aimed to raising employment among certain high-risk groups** - such as younger workers, single-parent households and females. This may require fiscal incentives such as employment subsidies for the long-term unemployed
- **Encouraging further decentralization of wage bargaining** within the European economy so that wages are determined with more account taken of local economic conditions affecting the demand for and supply of labour.



The onus is on individual countries to introduce the labour market reforms they fell are appropriate to their own specific problems and priorities. In the UK, the emphasis in recent years has been on raising employment among the long-term unemployed and in improving work incentives for low-wage households through the expansion of schemes such as the Working Families Tax Credit and the introduction of the National Minimum Wage. The effectiveness and financial cost of such policies is often questioned. For the UK, the labour market reforms of the last fifteen years have yet to be fully tested by the effects of a full-blown recession.

9.5 Suggestions for Further Research on Unemployment in Europe

- A Picture of European Unemployment: Success and Failure Stephen Nickell (Bank of England) www.bankofengland.co.uk – look under speeches by MPC members
- EU calls for faster economic reform (BBC) http://news.bbc.co.uk/1/hi/business/2658849.stm
- EU Commission (Employment and Social Affairs) www.europa.eu.int/comm/employment_social/index_en.htm
- European Economic Integration (Guardian Report) http://www.guardian.co.uk/eu/0,7368,396838,00.html
- Explaining European Unemployment, Oliver Blanchard http://econ-www.mit.edu/faculty/download_pdf.php?id=932
- Germany's army of unemployed grows (BBC) http://news.bbc.co.uk/1/hi/business/3977993.stm
- International Labour Office www.ilo.org

10 THE COMMON AGRICULTURAL POLICY

This chapter considers the Common Agricultural Policy. It focuses on the welfare effects of European farm support under CAP and the thorny and long-running saga of CAP reform. Among the questions we will consider are the following:

- Are the original aims of the CAP still relevant to the needs of consumers and farmers?
- What are the economic and social costs arising from the CAP?
- Is there a case for abandoning price support and exposing European farming to free market forces?
- Is there a case for government intervention to encourage farming as a public good on grounds of protecting our commonly owned environmental resources?

Farm Support around the World

The agricultural sector in many developed countries continues to be characterised by high levels of support and protection. Support to agricultural producers accounted for 32% of total farm receipts. But this is still too large a share that it continues to distort production and impedes the trade of agricultural commodities on the world market. Agricultural policies continue to impose unnecessary costs on domestic consumers and taxpayers, penalise competitive suppliers, including those in developing countries and put a strain on the environment

Source: OECD Survey of Agricultural Policies, 2004 www.oecd.org

The tortuous path towards reforming the CAP

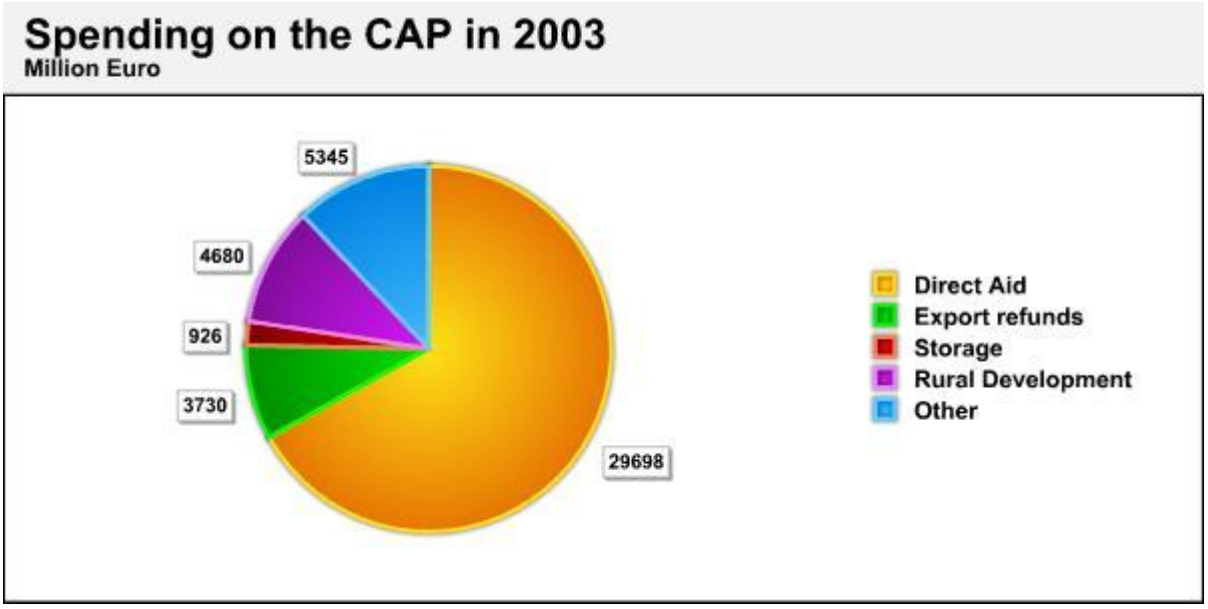
The **CAP** has shaped the landscape and development of European agriculture for over forty years. But the process of reform has been complex, slow and protracted.

It is important to realise that CAP has wide-ranging and far-reaching effects on many **different sectors** of both the UK and European and international economy. And, decisions on the future of CAP will impact on many millions of individual consumers and households across the twenty-five member nations of the EU and millions more consumers in agricultural industries that trade with EU countries. The CAP also affects industries that supply and support farmers, food manufacturers and the environment, as well as farmers and exporters of food in other countries trading with the EU. This demonstrates the important **inter-relationships** between domestic sectors and the global implications of policy changes on farm support to the European Union.

10.1 Background to the CAP

The CAP was introduced in 1962. At its inception the CAP aimed to provide across Europe a **fair standard of living for farmers** and **reasonably priced food for all.** But many people now question whether the original aims are relevant to the future of European farming.

Original Aims of the CAP	Evaluative Comment
Improving production yields to guarantee farm supplies	The CAP is no longer needed to achieve this aim. Freely competitive agricultural markets and technological innovation in agriculture guarantee increased farm production and higher yields. In a market-based system free of widespread government intervention, farmers would have to produce efficiently to remain profitable in the long run
Ensuring a fair standard of living for EU farmers	There are major doubts as to the **equity** of the CAP in delivering this objective. There is a wide division between large-scale and smaller-scale farmers within the EU and the accession of ten new countries as part of the enlargement process has exposed the extent to which farm support affects farmers of different size
To stabilise agricultural markets	This objective has been largely achieved at great economic and environmental cost – and there is a limit to which government intervention can and should seek market stability in terms of prices and incomes
Ensuring availability of farm supplies	Climactic variations in farm output are now reduced by developments in **agricultural technology** and **biotechnology**. And, the globalisation of markets makes fears of food shortages less of an issue. Geo-political factors are not particularly relevant any more to the question of maintaining adequate food supplies within the European Union
Ensuring food supplies are available to consumers at reasonable prices	The CAP system has increased European food prices not reduced them leading to a loss in welfare for consumers. Many economists believe that competitive market disciplines are the best route to achieve lower prices in the long run



Agriculture in the UK and Europe

- In the EU the agricultural sector as a whole contributed about 1.8 per cent of GDP in 2001. In the UK the figure is low, below 1 per cent, although the total **agro-industrial complex** has a bigger share in national income. Including agricultural merchants and distribution, wholesalers, food and drink manufacturers, retailers and caterers, the contribution is around 9 per cent or £55 billion to UK GDP.
- Agriculture also accounts for a small and declining proportion of EU employment. 4.3% of the employed labour force in the EU was employed in the agricultural sector in 2001. In the UK this figure was just 1.4%.
- The EU is a key producer of food in the world market. In 2002, exports of food from the European Union totaled $233 billion (40% of world exports of agricultural products) and it also represents the largest single import market in the world. In 2002 the EU imported over $253 billion worth of agricultural products.

10.2 The Economics of Farm Support

The CAP is **not a single comprehensive or uniform policy**, but is best described as a collection of separate regimes or packages of policy instruments applied to different commodities and sectors. For example, EU wheat production is currently relatively unsupported by market intervention and EU wheat prices are little different from world prices, whereas some other grains, oilseeds, protein crops and beef have all remained more heavily supported by these mechanisms. Traditionally in Western-European countries, **price support** and **intervention schemes** have been at the heart of government policies protecting domestic farming industries.

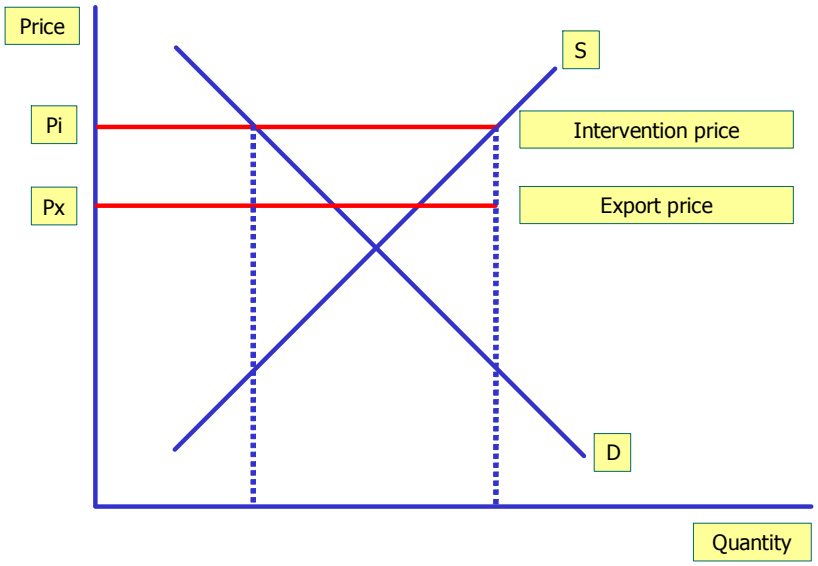
Market price support policies include

- Import duties and levies
- Export subsidies
- Price and buying guarantees
- Production quotas

The CAP has provided financial support to farmers through several important channels

- Guaranteed minimum prices (with surpluses bought up and put into intervention storage)
- Export subsidies (to encourage farm surpluses to be exported outside the EU rather than stored)
- A common external tariff on food imports from non-EU countries
- Set-aside payments – i.e. payments for leaving a percentage of arable land fallow
- Subsidies for switching to organic farming

Guaranteed Minimum Prices and Export Refunds



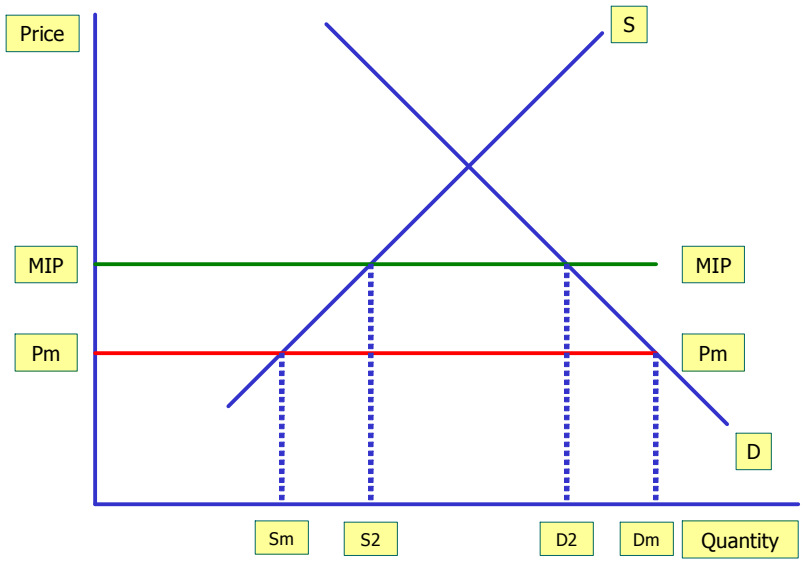
The effect of a **guaranteed minimum price** in a market is shown in the diagram above. The intervention price is normally set above normal world price levels. It encourages an expansion of supply but a contraction of demand. Under "old-style" CAP intervention purchases, the excess supply was bought up and put into storage.

Reforms to the CAP have gradually reduced the scale of intervention purchases but the **cost of storage** is still a major issue as is the system of **export refunds** of EU farm output to a third (non-EU) country.

Export refunds

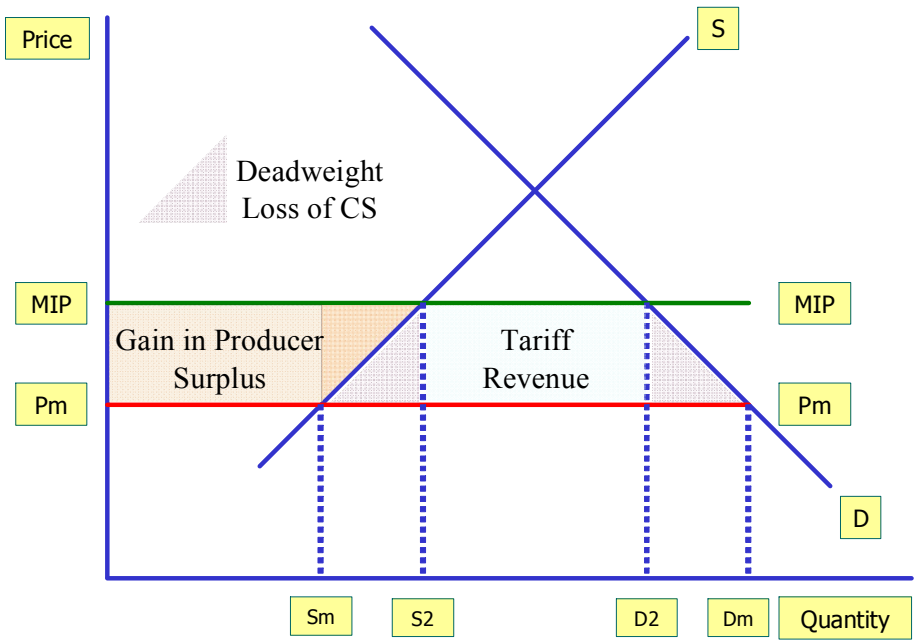
Export refunds are paid to an exporter of goods from the EU to Third Countries in order to compensate for the difference between Community and World prices. The CAP system keeps food prices higher than they would otherwise be, but the EU also funds producers to offload their surplus production onto world markets by providing a **compensatory payment** (the refund) to adjust EU prices back down to prevailing world levels. This strategy is highly controversial in terms of the effect it has on developing countries because at times of falling world food prices, generous export subsidies can take European export prices well below the production costs of farmers in developing nations.

Import Tariffs – Minimum Import Prices



The effects of an import tariff are shown in the diagram above. The EU sets **Minimum Import Prices** achieved through a variable import levy on foods coming into the EU. The tariff leads to an expansion of EU farm output from Sm to S2 but higher prices cause a contraction of demand (Dm to D2). Therefore the volume of imports into the EU declines. If world food prices fell, the EU variable import levy would increase to maintain the minimum import price – insulating the EU from falls in real price levels around the world

Tariffs inevitably have **welfare consequences**. The standard analysis of a tariff on consumer and producer welfare is shown in the diagram below. To the extent that the tariff raises prices above the prevailing world level, consumer welfare is reduced – shown by the **deadweight loss of consumer surplus** indicated by the shaded areas. Tariffs provide protection for EU farmers and thereby boost output and protect farm employment and incomes – but there are other means of support for farmers other than using tariffs.



10.3 Main Failures of the CAP

Is the CAP a cause of **government failure**? The UK government has been at the forefront of demands to produce a lasting and viable settlement for the EU farming industry.

UK Government Policy on the CAP

The current CAP is not delivering what farmers, the rural economy or the environment need. It is an expensive policy and is insufficient to meet the challenges posed by the World Trade Organization (WTO) and enlargement of the EU. Reform is also vital to improve the position of developing countries, who find it harder to access our markets when the EU subsidises its own production. The UK Government's goal is to reduce the overall burden of the CAP, delivering better value for money to taxpayers and consumers; encouraging animal welfare; reducing damage to the environment; giving a better deal for farmers and making world trade fairer.

Source: Adapted from the DEFRA web site www.defra.gov.uk

Normally, a failure of the free market is justification for **intervention** designed to correct for market failure and achieve an improvement in economic and social welfare. Likewise, a government may choose to intervene to achieve a more equitable distribution of income and wealth. But intervention can have the effect of **deepening existing market failures** and worsening the original perceived misallocation of resources – leading to **government failure**.

There are several ways in which the CAP can be said to have led to government failure

- **The pursuit of self-interest** in protecting the farming industry has over-ridden economic concerns, in part because of political influence that the farming lobby in Western European countries can bring to bear. Some national Governments have been "captured" by the farming industry in blocking or diluting the proposed reforms to the CAP.
- **A failure of governments to appreciate the longer term economic and environmental consequences of farm support policies** – including the effects of dependency on farm subsidies and the high costs arising from structural surpluses and waste in many agricultural markets.

What are the main arguments against the current system of farm support within the EU?

(1) Production inefficiency and surplus: CAP intervention prices have encouraged excess production and permitted production inefficiencies and dependency on farm subsidies - all of which leads to a misallocation of scarce resources

(2) Loss of allocative efficiency: The CAP is seen by much of the public as failing to deliver what society wants and needs from agriculture in terms of food safety, animal health and the rural environment. Until recently the CAP has been neither consistent with policies on sustainable development, nor with demands for high quality, local and regional foods

(3) Fiscal costs: The budgetary cost of EU farm support policies has been huge and involves a large opportunity cost – that money might have been directed to more beneficial uses

(4) Fraud: The cost of maintaining the CAP is magnified by what some regard as endemic fraud within the system and rising costs of administration and compliance

(5) **Damage to consumer welfare:** Farm support imposes higher food prices for EU consumers – the cost tends hits low income families most because they spend a higher proportion of their income on food implying a regressive effect on the distribution of income. Consumers pay twice – firstly because of import tariffs and secondly through higher taxes to finance the CAP support system

(6) **Environmental concerns:** The CAP has encouraged intensive farming which is prompting concern about the environmental impact of CAP. One recent study of olive growers showed they used more than 400 times the recommended level of pesticides

(7) **Global market distortions:** The CAP distorts domestic, European and international markets threatening the development potential of many lower-income countries. This is a cause of tension between the EU and the rest of the world in global trade negotiations.

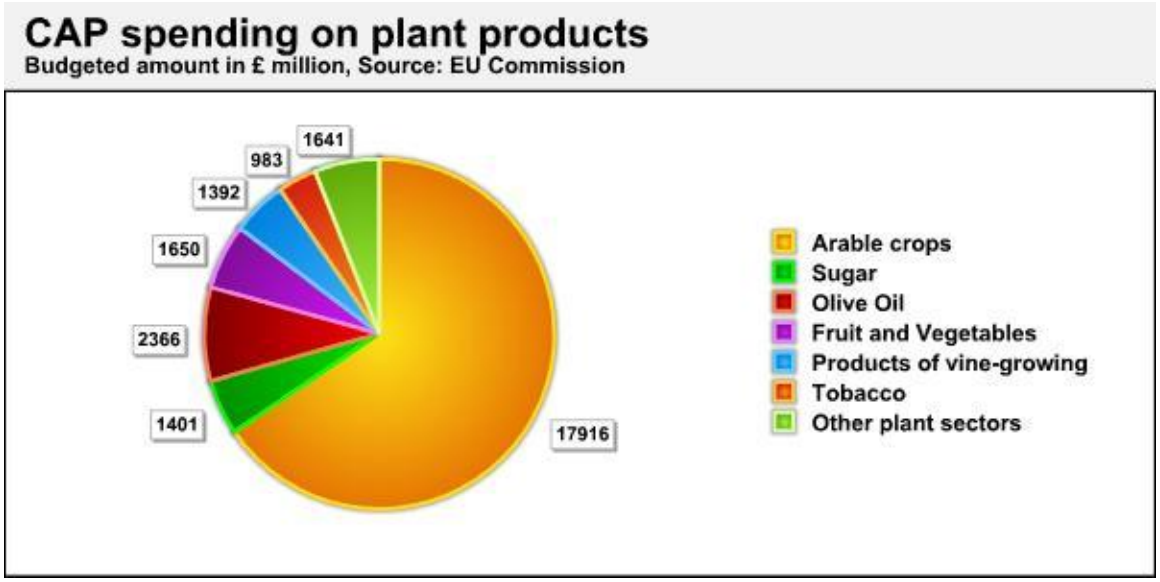
Agricultural Support Fails to Target Farmers Most in Need, Says OECD Study (Jan 2003)

A large proportion of government support to agriculture does not go to the farmers who need it most. The OECD study shows that because most support is **production-based**, the bulk of it goes to the larger, often the richer, farms who are able to exploit **economies of scale**.

At a cost to consumers and taxpayers of more than $300 billion a year, agricultural support in OECD countries is inefficient. There is no evidence that the majority of programmes are efficient at protecting the environment, strengthening the viability of rural areas or contributing to food security. In most cases it is more efficient to pay directly for a public service such as maintaining an agreeable countryside, and to charge those whose activities pollute the environment. Payments for a public service would contribute to raising farmers' incomes.

(Source: www.oecd.org)

Government failure is often the result of the **law of unintended consequences** so that the effects of a particular form of intervention are far removed from their original aims and objectives.



Equity Considerations: "Winners and Losers" under CAP

The CAP raises fundamental issues of **efficiency** and **equity** arising from different forms of intervention in markets for specific agricultural products

The distributional effects of the CAP are complex and often difficult to measure

Transfer of welfare from consumers to producers: There is a transfer of welfare away from consumers towards the EU farming sector because consumers must pay **higher retail prices** and they also have a restricted access to cheaper imports from overseas. The consumer cost of the CAP can be estimated by considering the difference between UK prices and world prices on agricultural food products purchased by consumers. In the UK, the Consumers' Association has estimated that the cost of the Common Agricultural Policy alone (including subsidies as well as import tariffs) costs each family in the UK around £16 per week in tax and higher food prices. It is estimated that in 2002 EU taxpayers paid €42 billion and consumers €52 billion through higher prices, a combined total of €94 billion, under the CAP.

Transfer of welfare from one country to another: CAP payments are not allocated in an equitable way across each member nation of the EU. Some countries receive a larger share of expenditure under the CAP budget than they contribute to the EU budget as a whole. Countries with a large share of output of more heavily subsidised commodities emerge as winners, including France and Denmark. Because many 'southern' commodities, such as fruit and vegetables are relatively lightly subsidised, there is generally held to be a 'northern' bias in the CAP. Nonetheless, certain southern products including olive oil, tobacco, rice and cotton receive a high level of support per unit of output benefiting countries such as Spain and Portugal

Distribution of gains between large and small scale farmers within the EU - The distribution of direct support under the CAP is skewed heavily in favour of larger farmers because it has been based to a large degree on the **scale of production** – either farms' present capacity or output (in land area or livestock numbers) or their output in the relatively recent past. Thus the more is produced, the more aid is received.

The Environmental Costs of the CAP

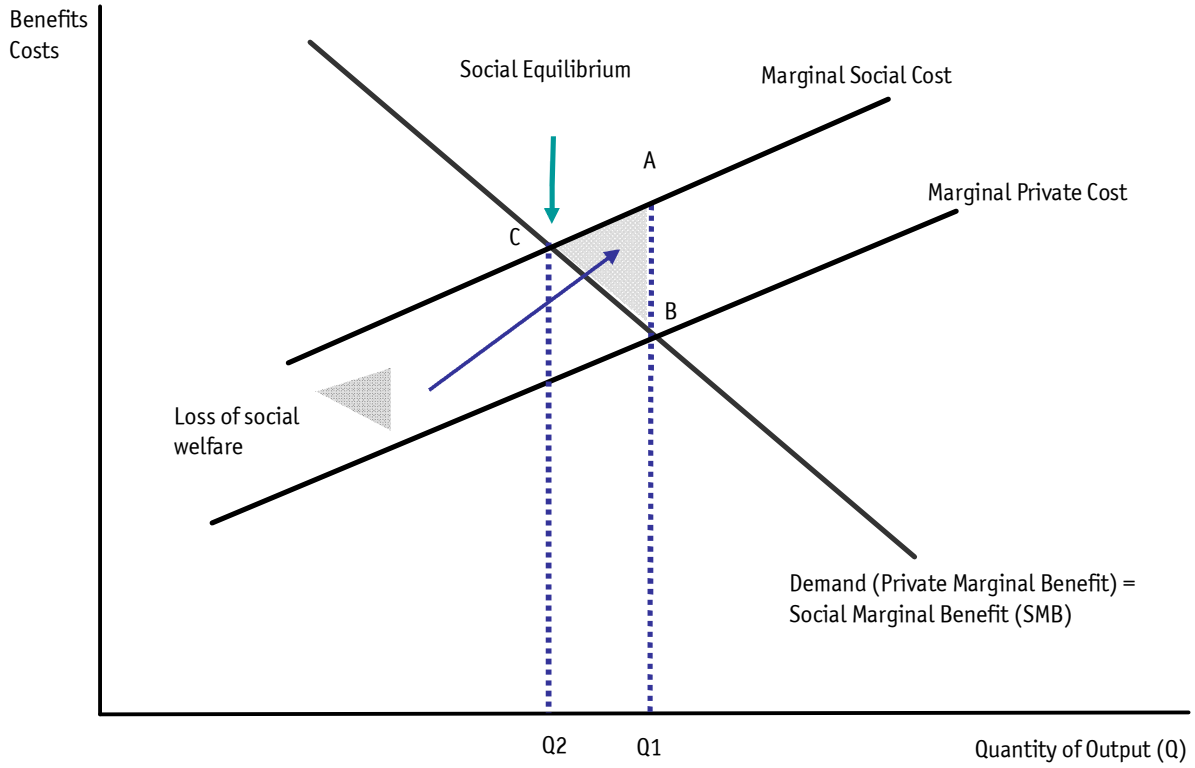
What of the **external costs** of farm support? Many environmentalists argue that in promoting quantity, not quality, the CAP has encouraged farmers to ignore many of the **environmental impacts** of their farming methods. **Intensive farming** has destroyed much of the countryside, turning once traditional landscapes into stretches of tightly packed rows. The disincentive to follow normal crop rotation strategies ruins the soil and in markets where price supports still exist, there remains a direct link between production and profit. Naturally, they then make maximizing production their first priority.

On the surface, this is a fairly damming indictment of the social costs of the CAP. But research by economists at DEFRA finds that CAP has had both positive and negative effects on the environment. Although **measuring the effects of these are difficult**, estimates of the economic value of these impacts in the UK range from £1 billion to £1.5 billion for negative impacts; and just under £1 billion per year for positive impacts.

Agricultural economist Jules Pretty from the University of Essex has argued that the external costs of farming are far greater than official estimates suggest. He estimates that the **social cost of farming** in Britain is more than £2.3 billion each year (equivalent to over £200 per hectare). This bill, which includes the cost of cleaning up pollution, repairing habitats and coping with sickness caused by farming, almost equals the industry's income.

Externalities and Market Failure in Farming

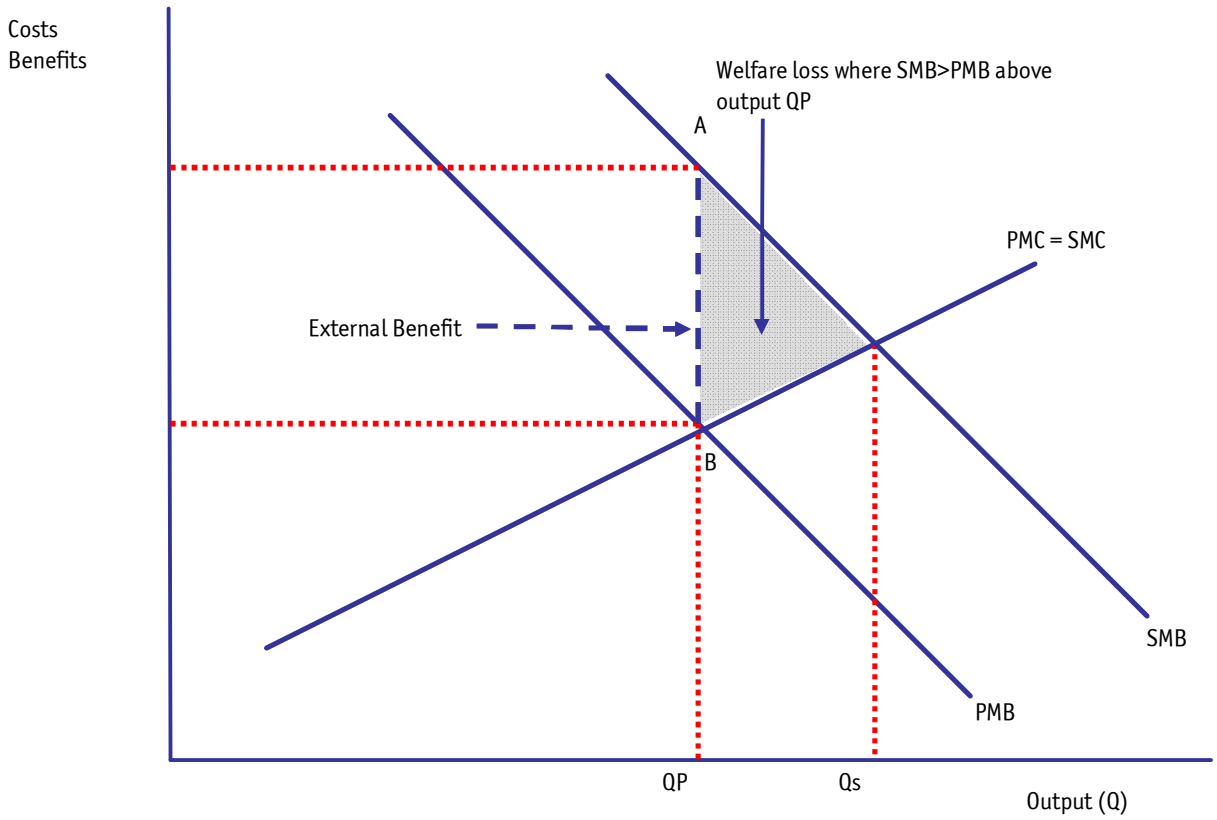
An **externality** occurs when an activity generates unintended effects on 3rd parties on others for which no payment or compensation is made. Externalities arise because of the **absence of private property rights** – if they existed, some form of compensation would occur. In the absence of a corrective policy, the level of an activity that gives rise to external costs (which affect people outside of the market) will be too high leading to **market failure**. So if the production of food generates external costs (negative externalities) then the free market is **under-pricing** and **over-consuming products** leading to a loss of economic and social welfare. The effect of externalities arising from production is shown in the diagram below. The shaded area represents the deadweight loss of economic welfare arising from the over-production of products that generate external costs



Environmental husbandry – a public good with positive externalities

On the other hand, it is often claimed that management and protection of the environment by farmers and maintenance of rural traditions, culture and communities brings about **positive external benefits** not only for people directly involved in farming but for millions of people who spend time in rural areas. If there are **positive externalities** from these environmental activities, there is a risk that they would be under-valued and under-provided by the free market, because they are not included in retail farm prices.

Is there now a case for government intervention to support **rural environmental management** – regarding protection of rural heritage and natural habitat as a **quasi public good** that ought to be financed directly in the form of **income payments**? The next diagram illustrates an activity that creates **positive externalities** such that the **social benefit** exceeds **private benefit**. Measuring and valuing the scale of these external benefits is difficult.



10.4 CAP and Developing Countries

The CAP has always been a contentious issue with Europe's international trade partners. Consider the arguments put forward in this extract from a recent CAFOD report.

Distorting the Market and Development Potential

The CAP isn't working for consumers, for EU farmers, for the environment, and certainly not for farmers in developing countries: they are hit by a double whammy - cheap food dumped in their home markets by the EU's massively subsidised farmers and exporters and unfair competition in their export markets, most of all in Europe. Farmers and farm workers represent only one per cent of the working population in the UK, the lowest in the EU. Greece, with 20 per cent, has the highest proportion of the working population in agriculture; then comes Spain with 10 per cent. All other countries are in single figures. For some African countries this proportion can be as high as 80 per cent. Farm subsidies to this minority group are stifling the development prospects of the poor majority all over the developing world

According to Oxfam, three quarters of the world's 1.2 billion extremely poor people live and work in rural areas: agriculture is crucial to their survival and the global fight against poverty. Nearly 3 billion people - half the world - live on less than $2 a day. Oxfam argues that CAP damages producers in developing countries in two main ways. First, it undermines producers in developing countries by **dumping subsidised goods** on their local markets. An Oxfam study published in 2002 found that the EU's wheat export prices are 34 per cent below typical costs of production.

Secondly CAP reduces the potential for developing countries to **exploit their natural comparative advantage** in food production by exporting farm produce to richer European and other international markets. This has important implications for the scale of rural poverty in developing countries.

Milking the CAP – Oxfam Report (2003)

How Europe's dairy regime is devastating livelihoods in the developing world

European citizens are supporting the dairy industry to the tune of €16 billion a year. EU surpluses of milk and milk products are dumped on world markets using costly export subsidies, which destroy people's livelihoods in some of the world's poorest countries. Dairy processing and trading companies are the direct beneficiaries of these subsidies. Meanwhile, many small-scale European dairy farmers are struggling to make ends meet. Oxfam is calling for an immediate end to EU dairy export dumping and for agricultural support to target small-scale farmers.

Source: www.oxfam.org.uk

However many developing countries do have **preferential trade agreements** with the EU which offers them the prospect of a guaranteed market opportunity at prices closer to EU levels.

Farm Reforms – Lessons from New Zealand

New Zealand is one of a handful of countries which have embarked on free trade for agriculture and some say it should be used as a model for changes in Europe. When price supports were suddenly and unexpectedly abolished in the 1980s, New Zealand farmers went through a period of painful structural adjustment and many of them had to abandon their businesses.

Prior to the end of farm subsidies, over 40% of the average New Zealand sheep and beef farmer's gross income came from subsidies. By 1985 this financial support had virtually come to an end. Real output in the New Zealand farm industry has expanded by 40% over the last fifteen years and the sector now contributes nearly 17% of GDP (compared to 14% in 1986-87). Annual productivity growth since 1986 has averaged 6.0%, a contrast to productivity growth languishing close to 1% in the period before the subsidy bonfire. Real farm incomes have not yet recovered to their pre-subsidy levels and there has been a reduction in total sheep stock numbers (although cattle numbers have expanded by 35%). But a growing share of farm income comes from rural tourism and payments for management of the rural environment.

Transition in the New Zealand Farming Industry after the Removal of Subsidies:

- Loss of financial subsidy on farm profits worsened by sharp appreciation in the New Zealand dollar which damaged the competitiveness of the farm sector and hit exports
- Falling incomes and rising farm debts led to some forced sales of farms which then depressed land prices – but forced land sales were not as high as forecast – and lower land prices encouraged younger farmers to enter farming
- Farmers helped by fall in prices of farm inputs (including labour and components) because these suppliers knew that farmers' purchasing power had declined
- The New Zealand welfare system provided support for low-income farmers and one off "exit grants" to those who wanted to leave their farms
- By 2001, only 1% of the value of New Zealand farm output was attributable directly to government financial support – the lowest of any country inside the European Union where the OECD average is closer to 30%.

The success of the New Zealand farming industry in adjusting to a world without government financial support is valuable evidence in support of the arguments for reforming the CAP. No reform process is without risks and costs. Reform is likely to be more effective when

- Farmers are able to diversify into new markets (such as rural tourism and light industry)
- There is sufficient geographical and occupational mobility of labour within the farming industry (e.g. for those who decide to leave their farms and move elsewhere)
- The welfare system is prepared to cover the cost of transitional fiscal transfers to the farming sector to alleviate the risk of rural poverty arising from unemployment

10.5 Reforming the CAP – the Long March

There have been three major attempts to reform the workings of the CAP over the last ten-twelve years.

The MacSharry Reforms

The main aim of MacSharry was to break the link between support given to farmers and output produced. There were cuts in farm support prices, lower milk quotas and a reduction in intervention purchases of beef. MacSharry also introduced the principle of direct income payments rather than guaranteed prices and brought in a system of obligatory set aside payments. There were also moves towards encouraging less intensive farming techniques, forestation subsidies to encourage the planting of more trees and financial support to encourage the early retirement of farmers. MacSharry was an important phase in CAP reform affecting in the main production of cereals. It began the process of fundamentally questioning the efficiency and equity of CAP support for EU farmers.

The Agenda 2000 Reforms

Agenda 2000 represented further progress along the long road to reforming the CAP. It included further cuts in intervention prices for cereals and beef and an extension of the milk quota regime. The Agenda 2000 reforms emphasised the desire to move away from direct payments for production towards direct subsidies for farming and stronger environmental targets for direct income payments

The Fischer Reform Proposals

The key elements of the Fischler Review announced in January 2003 were as follows:

- A single farm payment independent from production (this is a principle known as “decoupling”)
- Income payments would be conditional on EU farmers meeting agreed standards of environmental care, food safety and animal welfare (these are known as cross compliance payments)
- A reduction in payments to bigger farms (known as “modulation” and “digression”) from 2007 to help transfer funds to EU rural development programmes (e.g. specific grants for marketing and processing local foods)
- Incentives to help farmers improve the quality of agricultural products

-

Fischler – the Principles of Radical CAP Reform

"Farmers will no longer be forced to produce at a loss in order to receive support. They will have the opportunity to maximise their income on the market. Studies show that farm incomes would improve with the reforms. Society is ready to support farming provided farmers give people what they want – safe food, animal welfare and a healthy environment. The new single farm payment will not distort international trade and hence not harm developing countries."

(Herr Franz Fischler, Former EU Farm Commissioner)

De-coupling

One of the most important aspects of the 2003-04 farm reforms is the concept of **de-coupling**. There are strong arguments for breaking the link between production and farm support payments. It should help to reduce farm surpluses and the costs of administering the system will fall. It also gives farmers an incentive to **optimise** rather than **maximise** their production. In other words, it is designed to change the pattern of production as farmers alter their production to areas where free-market demand and prices are highest rather than where government financial support is greatest.

The concept of decoupling

"The link between the subsidy paid to farmers, and the level of production has been broken"

Decoupling cuts the links between EU farm subsidy and the volume of production. It is designed to allow farmers to move away from unprofitable production and respond faster to market changes. Under decoupling, A Single Income Payment will replace the current direct payments schemes for arable crops, beef and sheep. Milk is to be phased in from 2004. An EU farmer who receives a Single Income Payment can use his land for any agricultural activity except for permanent crops.

Under the terms of the Single Income Payments, farming land must be kept in good agricultural order and farmers must also meet cross-compliance requirements: including those relating to public, animal and plant health, the environment, animal welfare and occupational safety. The Single Payment will be reduced if these requirements are not met

England will decouple fully in 2005, which is the earliest opportunity to do so, and will move towards a flat rate single farm payment to farmers.

Source: Presentations from the National Farmers Union www.nfu.org.uk

The June 2003 CAP reform agreement

In June 2003, Europe's farm ministers finally agreed one of the most radical and far-reaching reforms in the CAP's long history although the proposals did not go far enough for the CAP's harshest critics.

10.6 Costs and Benefits of CAP Reform

Evaluating the likely effects of reform of the CAP is a difficult process. We can take into account how reform has affected farming industries in other countries but the effects of reform will vary from nation to nation within the EU and there are likely to be significant regional implications for individual countries

Some of the main issues to consider are as follows:

- Will reductions in direct payments for production stimulate increases in farm productivity arising from **a switch to larger-scale production**? Trends in the Danish pig industry which is a sector free of farm support are illustrative of what might happen. In 1991 only 9.5% of pigs were reared from suppliers with pig herds of 5,000 or more. By 2001 that percentage had grown to 34.1%.

- Will reforms to the CAP stimulate improvements in the **dynamic efficiency** of the European farming industry? Supporters of reform believe that cutting dependency on financial support will encourage farmers to **diversify the use of their land** including breaking into rural tourism and focusing resources on supplying niche products to local markets / farmers' markets. Farmers will need to diversify into markets where there is sufficient "valued added" to generate enough income to remain profitable.

- Will there be sufficient **geographical and occupational mobility** in the farming industry to offset the problems that structural change will cause? The main risk is a sharp rise in **structural unemployment** in farming regions and the associated problems of **rural poverty** arising from **occupational immobility of** labour. That said, the British farming industry has suffered greatly in recent years even without fundamental reforms to the CAP!

- Will there be **forced sales of land** leading to a collapse in farm land prices?

- How **will smaller farms survive**? Should governments target assistance on poorer farmers?

- **Will food prices fall for consumers**? Textbook analysis would suggest that dismantling import tariffs for food coming into the UK and reducing farm support prices should lead to an increase in non-EU food supplies into the EU, and increased competitive pressures should in the medium term cause higher productivity and lower food prices in real terms. However the extent to which lower costs passes through the **supply chain** to lower prices for consumers at retail level is dependent on several factors. Will food processors and food manufacturers (who should benefit from lower input costs) pass these savings onto final consumers? What of the monopsony power of supermarkets? The degree of competition at retail level is also a key factor

- **There will be losers and gainers** throughout the EU – a shift from market support to direct income payments alters the distribution of gains and losses under CAP depending on the relative shares of each country's consumption of CAP products and its share of EU budget financing

10.7 EU Enlargement and CAP reform

The **enlargement of the EU** has accelerated demand for an overhaul of the CAP system. 10 new member states from Eastern Europe - most with large, poor agricultural sectors would normally qualify for

billions of euros in subsidies under an unreformed CAP. After enlargement, a further 4 million farmers have been added to the EU's existing farming population of 7 million.

The agricultural sectors of the ten accession countries contribute over 3% of their total GDP – nearly double the relative contribution of agriculture in existing EU member countries. And whereas agriculture accounts for less than 4% of total employment in the original fifteen member nations of the EU, that figure rises to 13% for the ten accession nations. These countries have a greater dependency on farming as a source of income and jobs. Many of the farms in accession countries are much smaller and poorer than their Western European counterparts – a major problem given the bias within the CAP to offer disproportionately more financial support to larger more efficient farms. Poland has the largest agricultural sector of the ten new countries joining the EU.

10.8 Winners and Losers from CAP Reform

Main Winners	Main Losers
Consumers – via **lower food prices** – especially important for consumers in countries where food is a high % of total spending (Greece 23%, Portugal 21%) and **improved food safety** in the long run	**Uncompetitive farmers** currently kept viable by farm subsidies – the future of small and family farms is a major issue in France, southern Europe and many of the ten accession countries
Taxpayers – from the reduced fiscal burden of farm support – especially important to countries such as Germany and the UK (both of whom are net contributors to the CAP)	**Farmers least able to diversify** and therefore less able to qualify for rural development funding
Food manufacturers and food retailers – they should enjoy higher profit margins	**Landowners** – fundamental farm reforms may lead to a sharp fall in value of their assets (deflation in land prices may expose their debts)
Developing countries – freer access to EU markets. The World Bank has estimated that a 50% cut in the subsidies and tariffs protecting developed countries' farmers would boost developing countries' economies by $150 billion (£90 billion)	
Larger-scale commercial farmers with modern capital inputs, able to exploit economies of scale and already competitive in international food markets	

10.9 Suggestions for further research on the CAP

- Controversies over farm funding (BBC) http://news.bbc.co.uk/1/hi/world/3937387.stm
- DEFRA – UK Policy on CAP reform - www.defra.gov.uk/farm/capreform/
- EU Commissioner for Agriculture http://europa.eu.int/comm/agriculture/index_en.htm
- Europe's Farm Reform Plans June 2003 http://news.bbc.co.uk/1/hi/business/3021728.stm see also http://news.bbc.co.uk/1/hi/business/3022312.stm and also http://www.guardian.co.uk/editor/story/0,12900,986833,00.html
- Friends of the Earth www.foe.org.uk/campaigns/real_food/resource/farmers.html
- Kick All Agricultural Subsidies http://kickaas.typepad.com/kickaas/

- National Farmers Union www.nfu.org.uk
- New Zealand Farming "Life after Subsidies" http://www.fedfarm.org.nz/
- Rich countries should scrap agricultural subsidies (William Keegan, Guardian July 2003) http://www.guardian.co.uk/economicdispatch/story/0,12498,995364,00.html
- Rural Development in the EU http://europa.eu.int/comm/agriculture/rur/index_en.htm
- Rural Development in UK Farming www.defra.gov.uk/erdp/default.htm
- Sustain (Alliance for better Food and Farming) www.sustainweb.org/agtrad_index.asp
- The Return of the Countryside http://news.bbc.co.uk/1/hi/sci/tech/3556658.stm
- UK farmers must embrace the new to survive (BBC) http://news.bbc.co.uk/1/hi/sci/tech/4060259.stm
- World Trade Organization (WTO) www.wto.org/english/tratop_e/agric_e/agric_e.htm

11 EUROPEAN FISHERIES POLICY

We now consider the crisis within the European fishing industry. The EU fishing sector is facing up to huge problems, in particular the long term sustainability of fish stocks and the threats to the livelihoods of thousands of people employed directly and indirectly in the fishing and fish processing industries.

Basic background on the European fishing industry

According to Eurostat, the EU is the world's largest market for processed fish products and farmed fish such as salmon, trout and shellfish. In the late 1990s the whole sector – from fishing to marketing – was worth over S20 billion, or 0.28 per cent of EU GDP. At least 12,000 people work as fishermen in the UK while a further 14,000 onshore jobs are dependent on catches of UK stocks. Some 260,000 people work as fishermen across the EU.

11.1 Resource depletion - the long term decline in European fish stocks

The major challenge facing the Common Fisheries Policy (CFP) of the EU is to strike a **sustainable balance** between the available marine resources and their commercial exploitation. Fish stocks are falling and permanent, irreversible resource depletion may have already occurred for many types of fish because of over-exploitation and the **government failure** associated with the Common Fisheries Policy of the EU.

Over-fishing has lead to **smaller stocks**, **smaller landings** and **smaller incomes** for producers but **higher prices** for consumers. Recent surveys in the North-East Atlantic show that over 40 of the 60 main commercial fish stocks are "outside safe biological limits". Over-fishing is a cause of **market failure** arising from a **failure to enforce agreed fishing quotas** and the **absence of enforceable property rights** for what is perceived to be common ownership of a natural and renewable resource. Resource depletion like this is sometimes referred to as an example of the **"tragedy of the commons"**

The "Tragedy of the Commons"

A resource such as the ocean is common to many, but an individual **"free rider"** can benefit from plundering that commons or dumping waste into it, knowing that the **external costs** of his actions will be distributed among many neighbours. In the case of shared fishing grounds, the absence of individual ownership drives each fishing business to snatch as many fish as they can—ultimately to the detriment of all. The collapse in fish stocks off Newfoundland in Canada in the late 1980s is a warning of what can happen when over-fishing leads to a permanent, almost irreversible decline in an industry. Canadian stocks are showing little sign of recovery despite a near total cessation of fishing since 1992. Europe must now face up to the same problems.

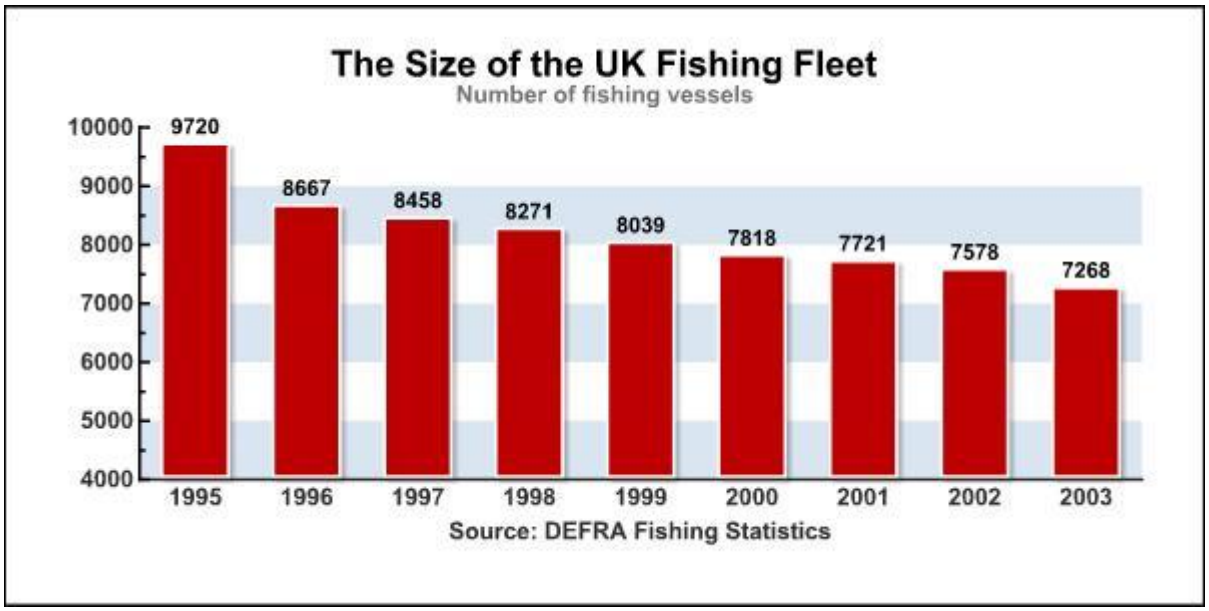
A report published in December 2004 by the Royal Commission on Environmental Pollution shows that modern industrial fishing practices in Europe are destroying the seabed. The dearth of fish in the North Sea means that many trawlers are dragging their nets along the beds in an effort to find fish, thereby causing irreversible damage. The report warned that Britain and neighbouring countries could soon end up surrounded by a lifeless sea.

Adapted from the Royal Commission Report, December 2004

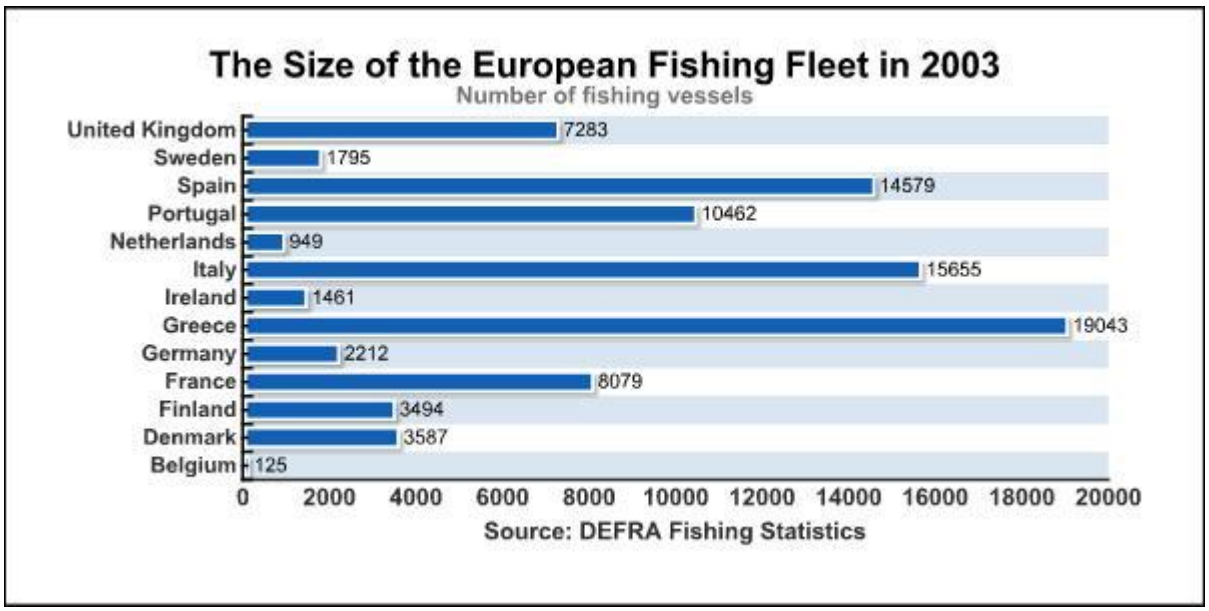
Excess capacity in the EU fishing industry

The second challenge facing the EU fishing industry is one of **excess capacity.** The capacity of the European fishing fleet is too large and the fisheries sector must be restructured if that balance is to be attained. A contraction in the size of the European fishing fleet has already begun. In 2002 there were 91,000 fishing vessels in EU member states. This was an 11% reduction on the 102,000 vessels operating in 1997. The largest falls in the size of the fishing fleet over the last five years have occurred in Sweden (down 20%), Spain (down 17%) and the UK which has experienced a 13% contraction in vessels.

Background Data on the EU Fishing Industry



The EU fishing sector contributes on its own less than 1% of EU GDP. But the industry is more significant as a source of employment in areas where there are often few alternatives – so the regional dimension to this issue is of increased significance. For example, in some sub-regions of Scotland, the Atlantic coast of Spain and the east coast of Italy, nearly a quarter of the population is employed in the fishing industry. Some 260 000 fishermen are directly employed in catching fish in the EU. Their activities generate more jobs in **complementary industries** such as fish processing, packing, transportation and marketing on the production side and in shipyards, fishing gear manufacturing, and maintenance on the servicing side. A decline in **employment**, **profits** and **real incomes** in EU and UK fishing will have important **multiplier** and **accelerator** effects in related industries.



The UK Fishing Industry

As the following table shows, the volume of output in UK fishing in 2002 was 25% below the 1995 level and this recession has been a major factor behind a collapse in employment. The UK is now a major **net importer** of fish with UK exports having fallen in recent years (affected by a reduction in fish quotas) and imports of fish from outside the EU having grown strongly to meet an expansion in consumer demand.

The decline of the UK fishing industry	1991	1995	2000	2002
GDP for Fishing volume index (1995=100)	104.6	100.0	82.0	75.2
Fleet size at end of year (no. of vessels)	10,862	9,174	7,242	7,033
Employment (no. of fishermen)	No data	19,921	14,894	12,746
Total landings by UK vessels quantity (000 tonnes)	787.2	911.8	748.1	685.5
Value of output £ million	496.0	590.1	550.3	545.6

The Challenge of Globalisation for the EU fishing industry

Increased competition due to the **globalisation** of the market in fish products represents another major long term challenge. The ability of EU fishing suppliers to compete in international markets depends on the capacity and productivity of the industry to adjust in order to respond to the constraints imposed both by the scarcity of resources and by the changing nature of international market demand. Financial support has been available from the EU to assist the fishing sector during its unavoidable restructuring process. This support conforms to the objectives of its economic and social cohesion policy of encouraging economic development in less-well-off EU regions.

11.2 The Common Fisheries Policy (CFP)

The cornerstone of the CFP is the conservation and management of Europe's fish stocks. The EU aims to prevent over-fishing by regulating the activity of European fishermen and the amount of fish that each fleet is allowed to catch.

The CFP sets **maximum quantities of fish** that can safely be caught every year – the CFP has been criticised for **poor monitoring and enforcement** (an example of government failure)

These maximum quantities, called **total allowable catches** are divided among Member States. Each country's share is called a **national quota** – there is always political pressure for countries to seek an increase in their own allowable catch. EU funding is available for modernisation of the fishing fleets as well as for getting rid of excess fishing capacity

Government subsidies to the EU fishing industry may themselves in the past have contributed to over-fishing and the threat of extinction for commercially caught fish. There is also increasing concern about the **environmental aspect of intensive fishing** in EU waters. Though the EU's fisheries policy is meant to promote sustainable fishing and reduce the size of the EU fleet, many of its programmes actually do the reverse. So while the EU has spent hundreds of millions of euros to take some boats off the seas, it has spent even more on aid to renovate others and keep them afloat and at work.

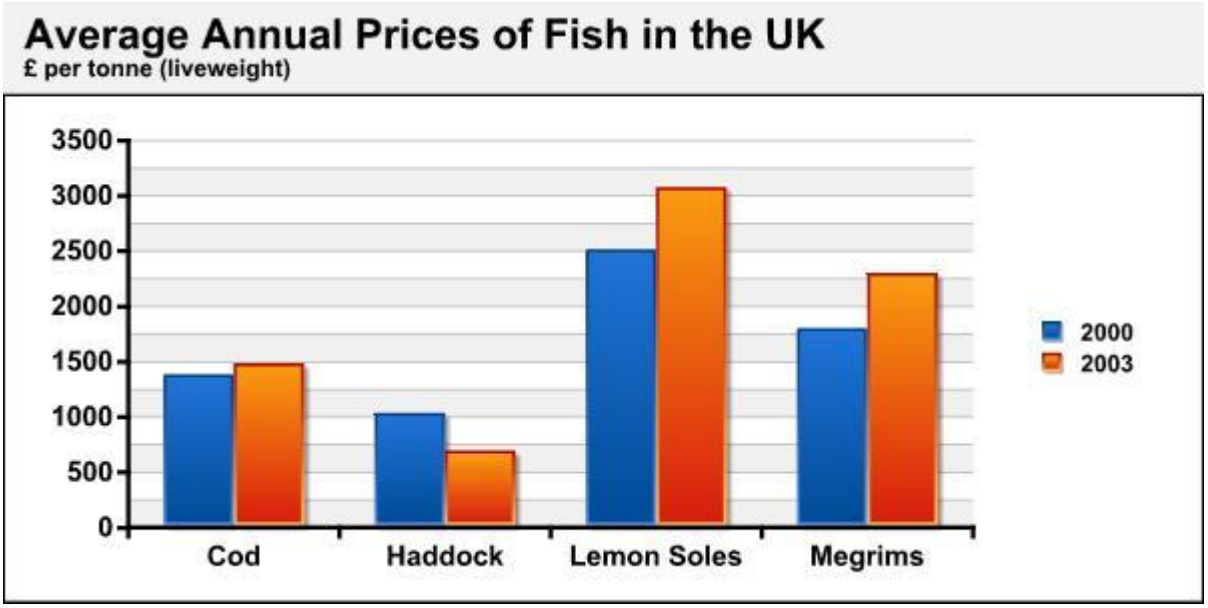
Entrenched **political interests** in countries like Spain, France, Portugal and Greece are likely to frustrate a thorough-going reform of the EU's fisheries policy. Though the EU commission may urge EU countries to heed scientific advice, experience suggests that all fisheries policy inevitably gets enmeshed in political haggling—and ends in fish-catch quotas that go well beyond what the scientists deem prudent. Meanwhile, the EU will continue to export its problems by sending its fleets ever farther away – an inefficient use of factor resources and a factor driving fish prices even higher for consumers.

11.3 EU Fisheries Reform Deals

European Union ministers reached a deal in 2002 on saving depleted fish stocks by agreeing new fishing quotas. The agreement envisages drastic cuts in the number of cod caught and only 15 days of fishing in a month, which includes travelling to fishing grounds. Beyond this reform, marine economists believe that there are other practical steps that member states can take to reduce over-capacity, including:

- Ending financial subsidies for building new trawlers, and an increase in transitional payments for fishing crew members to leave the industry move into alternative employment
- Limiting the number of days the remaining vessels spend at sea – GPS satellite monitoring should make this feasible particularly if the fines for non-compliance are heavy and enforced
- Putting fish spawning grounds completely out of bounds to allow the fish to reproduce
- Enforcing regulation that requires fishing vessels to use nets with larger mesh sizes or special panels to let juvenile / smaller fish escape
- The EU might also establish 'no-take marine reserves' or National Parks of the Sea

The success or failure of the reforms to the EU fisheries policy will be a true test of the ability of European governments to work together to solve what is a potentially irreversible decline in fish stocks. Of course, the structural problems facing deep-sea fishing businesses open up an opportunity for other businesses in related markets.



The long term problems facing the ocean-based fishing industry creates an opportunity for the rapidly expanding **fish farming sector.** The global demand for fish is forecast to rise by more than 20% over the next decade. Global fish consumption doubled from 44 million tons in 1973 to 90 million tons in 1997, largely due to rising demand from developing countries. But with wild fish production stagnating, growth in overall fish production now comes almost entirely from the **aquaculture industry.** Worldwide, fish farms now take over thirty per cent of total global market share and this is expected to rise substantially in the future as large-scale fish farming expands still further.

11.4 Web Links for Further Research on the Fisheries Issue

- Prince Charles warning on vanishing fish http://news.bbc.co.uk/1/hi/sci/tech/3530111.stm
- EU Business (Guide to Fisheries Policy) http://www.eubusiness.com/guides/fisheries
- EU Common Fisheries Policy http://europa.eu.int/comm/fisheries/doc_et_publ/cfp_en.htm
- EU Fisheries Director-General http://europa.eu.int/comm/fisheries/policy_en.htm
- EU Fisheries policy – an outrage (BBC news report) http://news.bbc.co.uk/1/hi/sci/tech/3162434.stm
- EU set to close fishing grounds (BBC) http://news.bbc.co.uk/1/hi/sci/tech/4078481.stm
- Europe's Fishing Crisis (Guardian) www.guardian.co.uk/fish/story/0,7369,1110622,00.html see also http://news.bbc.co.uk/1/hi/programmes/crossing_continents/3850885.stm
- European Commission (Fisheries Policy) http://europa.eu.int/pol/fish/index_en.htm
- European Environment Agency http://themes.eea.eu.int/Sectors_and_activities/fishery
- Global Fishing Crisis (Guardian special) www.guardian.co.uk/fish/0,7368,349369,00.html
- Interactive guide to the fish stocks crisis www.guardian.co.uk/flash/0,5860,835358,00.html

- International Council for the Exploration of the Sea http://www.ices.dk/
- Picture of North Sea Fish decline http://news.bbc.co.uk/1/hi/sci/tech/3694390.stm
- UK Department for the Environment http://www.defra.gov.uk/fish/fishindx.htm
- WWF "Stop over-fishing campaign" www.panda.org/about_wwf/what_we_do/marine/what_we_do/policy_events/index.cfm
- EU agree fish quotas for 2005 (December 2004) http://news.bbc.co.uk/1/hi/world/europe/4116887.stm
- UK rejects EU plan for North Sea fishing (Dec 2004) http://news.bbc.co.uk/1/hi/sci/tech/4102635.stm

12 EUROPEAN ENVIRONMENT POLICY

Environmental problems and strategies to correct for many of the market failures that result from environmental damage have become hugely important for the EU. An avalanche of regulations and directives is now directed towards improving the environment. Whether or not these regulations prove to be effective in meeting their objectives is open to question. As with all types of regulation and other forms of 'command and control' intervention, there is always the possibility of government failure that can serve only to deepen some of the existing market failures.

Attention is also turning to using **environmental taxation** to achieve environmental goals and there is also a growing interest in **emissions trading** at a European level.

12.1 Concerns over environmental damage

According to the EU Environment Commission, damage to the environment has been growing steadily worse in recent decades. The volume of **municipal and industrial waste** is growing in excess of ten per cent each year and CO2 emissions from homes continues to rise although progress has been made in curbing **greenhouse emissions** from the energy generation, industrial and household sectors. Transport though remains a major cause of CO2 emissions not least from the inexorable rise in demand for and use of motor vehicles.

CO2 Emissions from Energy in Europe

(EU-25, Million tonnes CO2)

	Total	Power & Heat Generation	Industry	Transport	*of which: Road*	Households	Services & other
1990	3 775	1 487	723	793	*675*	500	273
1995	3 655	1 417	640	857	*726*	486	255
2000	3 692	1 426	598	971	*811*	464	233
2002	3 750	1 472	593	986	*835*	454	246

Source: EU Energy Statistics, 2004

Many urban areas across Europe now suffer from increasing **congestion, noise and air pollution** that inevitably damages the quality of life for millions of people. An EU Commission report on the environment for 2003 finds that there are strong links between environmental problems and poor health with at least 60,000 deaths per year in large European cities caused by long-term exposure to air pollution and asthma affecting one child in seven. At the same time there is a deepening awareness of the dangers of **permanent resource depletion** resulting from growth and consumption of goods and services. We have seen this issue highlighted in our discussion of the fisheries crisis.

A particular issue is the threat of **climate change** – a special problem for Eastern and Southern Europe given the forecast rise in average temperatures. Many parts of Europe may experience higher and more intense rainfall which brings a greater risk of the kind of floods that damaged Europe in 2001 and 2002.

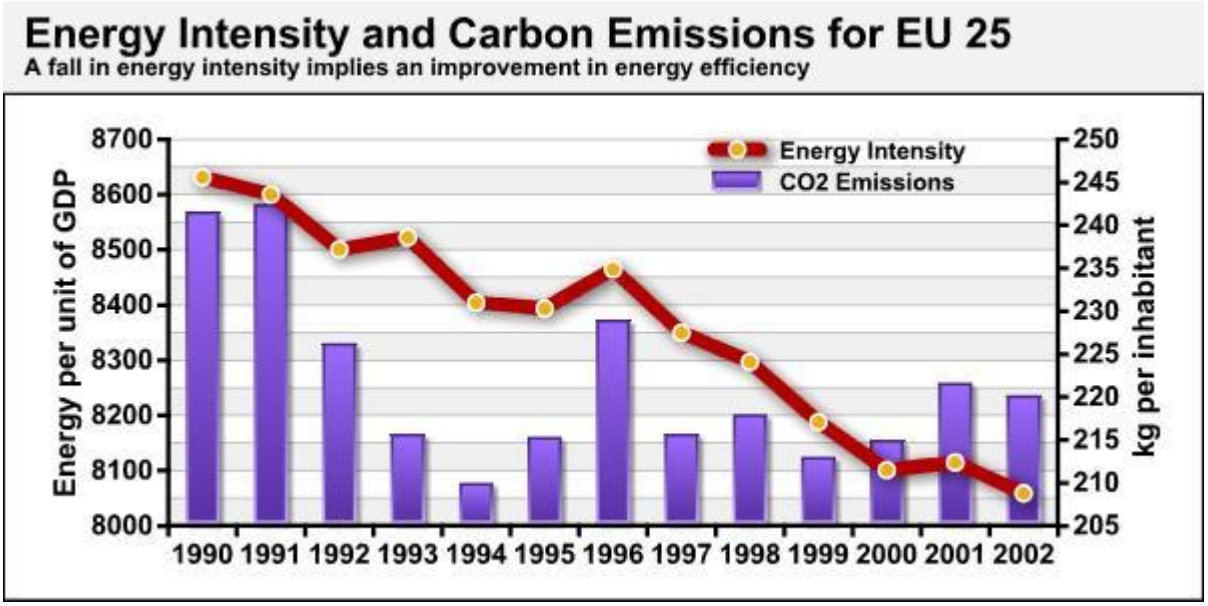
12.2 Europe's commitments to the Kyoto protocol

The EU ratified the **Kyoto protocol** on 31st May 2002. According to the protocol of the **United Nations Framework Convention on Climate Change**, countries should reduce their emission of greenhouse gases to 5% below the 1990 level by 2008-2012. The **EU** and its Member States have committed themselves to an 8% reduction. In the **EU** in 2000 the reduction stood at 3%, while over the same period greenhouse gas emissions increased in the **USA** (+11%) and **Japan** (+10%).

The desire to achieve sustainable development

Sustainable development is the buzz-word within the EU environment commission. The Treaty of Amsterdam in 1997 enshrined the principle of **sustainable development** as one of the EU's main aims and individual governments are now being encouraged to take **voluntary action** (e.g. through fiscal policy and other instruments) to impact on all of the many causes of pollution – be they from manufacturing industry, construction, business services, households, transport, energy, tourism or agriculture.

12.3 Main principles and instruments of EU environmental policy

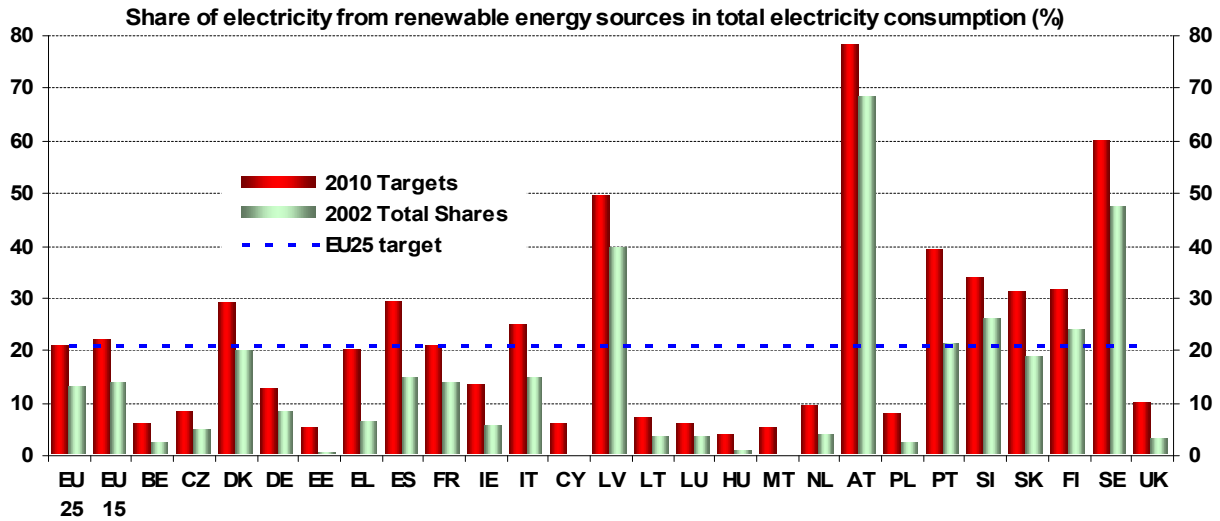


Environmental policy at EU level is becoming incredibly complex but the basic principles of policy are by now fairly well established:

- **Making the polluter pay:** That the generators of negative externalities should pay for some or all of the external costs they create (i.e. that environmental taxation has a role to play)
- **Promote renewable energy:** That financial support is needed to promote the development of renewable energy sources. Only 4% of European energy consumption in 2002 came from renewable sources. By 2010 the EU has a target of reaching 25% of electricity coming from renewable supplies.
- **Market incentives have a role to play:** That the expansion of flexible "market-based" instruments of pollution control has a role to play in meeting environmental objectives including the targets for reducing climate change. The EU is committed to the development

of **market pollution permit schemes** (also known as **emissions trading**) as an alternative to a regime based heavily on regulation and taxation/subsidy instruments

- **The precautionary principle should apply:** That greater emphasis should be given to sustainable development based around the precautionary principle – i.e. the principle that action should be taken to prevent harm to the environment *before full evidence is available*. One of the high-profile issues relating to this is the debate over genetically-modified foods
- **Fiscal harmonisation to achieve environmental goals:** That some harmonisation of environmental policies is needed to have a systemic effect throughout Europe on the environment – but that individual countries can continue to develop their own strategies within the context of broader European aims



12.4 Environmental taxation

Many countries are now using direct and indirect taxation to meet various environmental objectives. On the whole, most European countries have relatively high levels of environmental taxation at least compared to the USA. Over the last ten years, several member states including Denmark, Germany, Italy, the Netherlands, Sweden and the UK have introduced **"green tax reforms",** and Portugal and Finland plan to introduce similar measures in the near future.

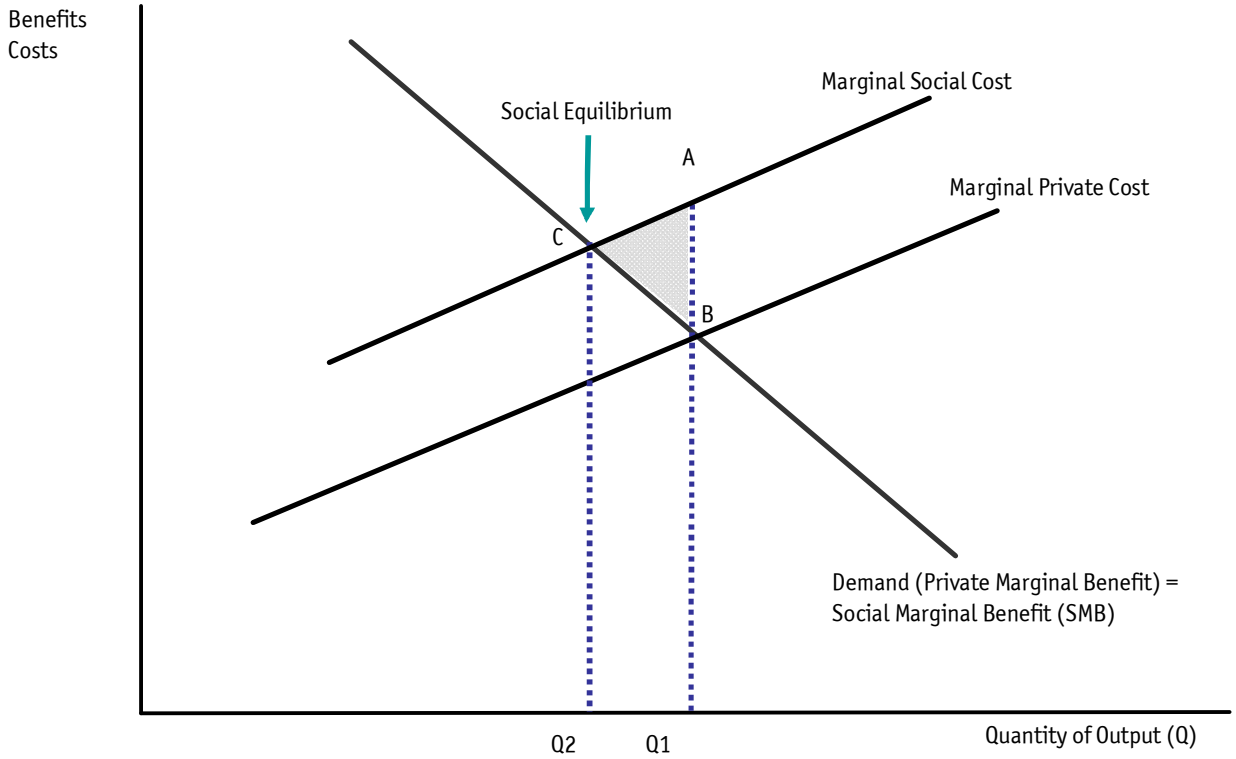
In 2001 revenues from environmental taxes in EU amounted to €238 billion or 6.5 per cent of total revenues from taxes and social contributions.

- Germany has introduced a **waste water tax**
- The UK has introduced a landfill tax, a climate change levy, a congestion charge and an aggregates tax (among others)
- The Danish government has introduced a **pesticides tax**
- The Irish government introduced a **plastic bag tax** in 2002

The Danish pesticides tax launched in December 1999 is part of a plan to more than triple the amount of organic farmland and to curtail the use of pesticides by households. In Ireland, the 2002 plastic bag tax was seen by many to have been an effective method of environmental taxation.

12.5 "Polluter pays principle"

Green taxation is often justified on the grounds of the **"polluter-pays-principle"** – in other words that the consumer or business responsible for creating the **external costs** associated with **pollution** and **environmental degradation** should have these external costs "internalised" through the form of taxation. An increase in the private marginal cost of consuming or producing should then reduce output and bring an accompanying decline in total pollution.



Of course any intervention in the form of environmental taxes must be proportionate and well-targeted, and needs to take into account factors such as the distributional effects and any impact on the global competitiveness of EU businesses. The broad trend is that "green taxation" has become more popular but has also been accompanied by other tax changes so that the impact of the taxation is neutral viz the costs of employing labour. For example, the introduction of the carbon tax by the UK government was tied in with a reduction in national insurance contributions for businesses meeting strict pollution reduction targets so that the impact on employment was minimised.

Many economists argue that the widespread adoption of pollution taxes can create further problems which lead to **government failure** and little sustainable improvement in environmental conditions. Environmental taxation might be critically evaluated using some of the following criteria:

Efficient policies: i.e. does a particular policy result in a better use of scarce resources among competing ends? E.g. does it improve allocative, productive and/or static efficiency and therefore lead to an improvement in economic welfare? For example, would the introduction of a new EU tax on aircraft fuel be an efficient way of reducing the external costs linked to the rapid growth of aviation transport?

Effectiveness: i.e. which environmental policy is most likely to meet a specific objective? For example, which policies are likely to be most effective in reducing road congestion across the EU? Many governments are now actively looking at road pricing as a means of tackling the growing problem of congestion. Which EU policies are likely to reduce carbon emissions at the lowest feasible cost?

Equitable policies: i.e. is a policy fair or does one group in society gain more than another? Consider for example some of the equity issues involved in the government imposing higher taxes on household waste collection, cigarettes, domestic fuel or introducing a new tax on aviation fuel.

Sustainable policies: i.e. does a policy reduce the ability of future generations to engage in economic activity and share the benefits of a rising standard of living?

12.6 Difficulties with Environmental Taxation

The main problems with using environmental taxation are as follows:

Assigning the right level of taxation: There are problems in setting taxes so that private marginal cost will equate with the social marginal cost. No government cannot accurately value the private benefits and cost of firms let alone put a monetary value on externalities such as the cost to natural habitat, the long-term effects of resource depletion and the value of human life.

Imperfect information: Without accurate information setting the tax at the correct level is virtually impossible. In reality, therefore, all that governments and regulatory agencies can hope to achieve is a movement towards the optimum level of output.

Consumer welfare effects: (linked to the important issue of equity): Taxes reduce output and raise prices, and this might have an adverse effect on consumer welfare. Producers may be able to pass on the tax to the consumers if the demand for the good is inelastic and, as result, the tax may only have a marginal effect in reducing demand and final output.

Distribution effects: Taxes on some de-merit goods may have a regressive effect on lower-income consumers and leader to greater inequality in the distribution of income. Having said this, it should be possible for authorities to develop "smart taxes" where account is taken of the economic impact of pollution taxes on vulnerable households such as low low-income consumers.

Employment and investment consequences: If pollution taxes are raised in one EU country, producers may shift production to countries with lower taxes. This will not reduce EU pollution, and may create problems such as structural unemployment and a loss of international competitiveness. Similarly, higher taxation might lead to a decline in profits and a fall in the volume of investment projects that in the long term might have beneficial spill-over effects in reducing the energy intensity of an industry or might lead to innovation which enhance the environment.

12.7 Pollution Regulation – European Directives

An alternative to intervening in the market mechanism is to use **regulatory command policies** to reduce pollution and achieve stated environmental standards. The EU has certainly not been lacking in using this approach over many years, to the extent that the annual costs of monitoring, compliance and enforcement run in hundreds of millions of euros. There are literally thousands of EU **regulations and directives** that have an explicit environmental focus, they include:

- **Landfill Directive –** the main aim of this directive is to reduce waste and encourage recylcing because of the pollution risks to water and soil that comes from heavy reliance on landfill sites. From July 2004, the EU has banned the joint disposal of hazradous and non-hazardous waste. Critics of this directive argue that it will increase the costs of transporting waste and lead to

increased fly-tipping. The UK has responded to the landfill directive by increasing the Landfill Tax by £3 a year aiming for a final tax of £35 per tonne.

- **End-of-Life Vehicles Directive** – this directive introduces strict recycling targets for cars which currently create nearly 9 million tonnes of waste per year in the European Union. Car manufacturers are now legally required to pay take-back and recovery costs for all vehicles sold after July 2002.
- **Harmonisation of product standards** including minimum energy efficiency standards and the energy labelling of domestic appliances
- **Stricter environmental and food safety legislation** applying directly to the agricultural and food processing industries. The recent reforms to the Common Agricultural Policy are designed to link annual farm income payments to farmers meeting environmental standards and the partial de-coupling of direct payments to farm payments should also, in the medium term, help to control the environmental damage caused by large scale intensive farming methods
- Tighter regulatory control of the external costs associated with the **EU fishing industry**
- EU wide regulations on **water quality and safety** and the environmental standards of inland waterways and beaches
- Regulation and legislation covering the use of **toxic substances in industry** and the **disposal of synthetic chemicals**
- New regulations on **technical standards required by all incineration plants** in the EU
- Regulations on **hunting and forestry management**

12.8 Pollution Emissions Trading

A **pollution emission trading scheme** which starts in January 2005 marks an important development in EU environmental policy. The EU scheme is the first multi-national emissions trading scheme in the world although the UK has developed its own trading scheme in advance of the introduction of the European system. About 1,000 UK firms will be participants in the new European emissions trading scheme.

A **marketable permit** gives a business the right to emit a given quantity of waste or pollution into the environment. Ideally, the number of permits that are issued corresponds with the total level of pollution that is admissible at the estimated social optimum level of output. Once this has been determined, the permits are issued by an **auction process** and firms that pollute the environment can begin to bid, buy and sell them amongst themselves. While the total level of pollution is not affected by these transactions, the total cost of pollution control to society is reduced. All firms are given an incentive to develop and install pollution control equipment.

Permits give firms an **economic incentive** to control pollution emissions for less than it would cost to buy permits, and there is widespread evidence that the costs of monitoring pollution reduction and administration of the permits system is smaller than when an industry is subject to direct environmental regulation. Consequently the use of marketable permits allows the cost of pollution control to be minimised. Another advantage is that the revenue from a traded pollution permits scheme can be re-cycled into other schemes for environmental improvement.

The basic idea behind traded pollution permits is through the incentive to cut pollution directly to the producers themselves by creating **a market in "property rights"** where one did not exist previously. Companies can then make their own decisions about the costs and benefits to them of particular routes/

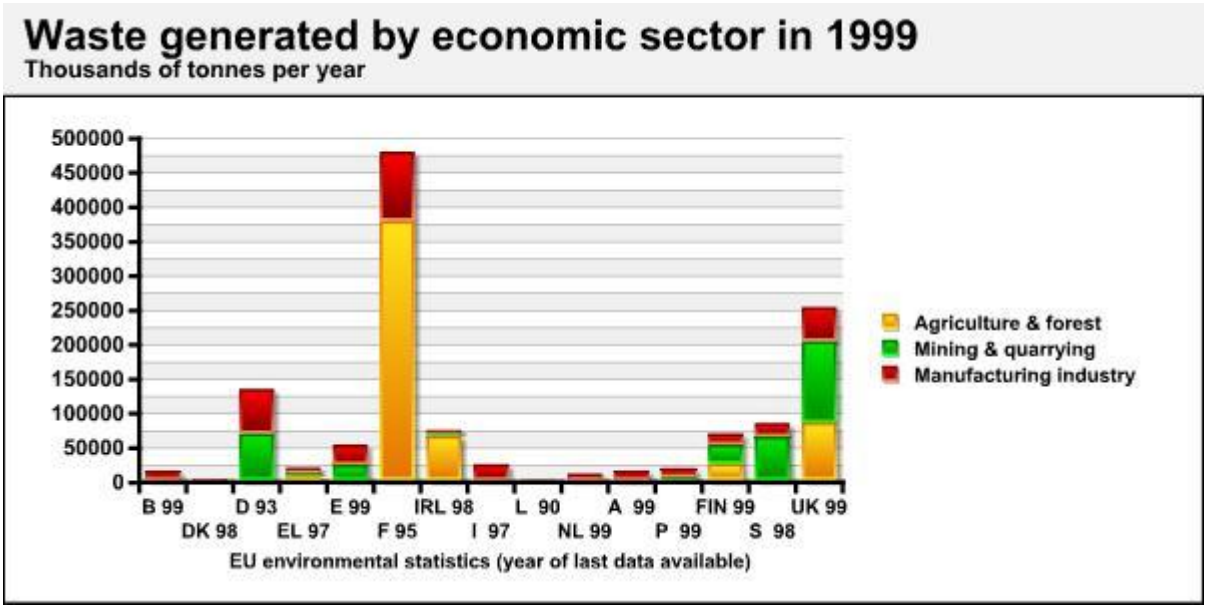
pathways to emission reductions. In other words, market forces are brought to bear on the issue of pollution and potential market failure. Across the whole pollution trading scheme, those companies with lowest cost emission reduction opportunities (i.e. those who can achieve cuts in pollution most efficiently) will tend to sell allowances to those with higher cost options thus reducing the overall cost of delivering the environmental benefits.

The EU trading scheme

The EU Emissions Trading Scheme is a **"cap and trade allowance"** scheme. A three year mandatory "warm-up" phase lasts from 2005 to 2007 followed by a five year mandatory Kyoto phase from 2008 – 2012. The scheme initially covers five main industrial sectors and concerns only carbon dioxide emissions in the first instance although the scheme may be expanded to cover other pollutants in the years to come.
Member nations of the EU may auction for pollution emissions permits of up to 5% reduction in emissions for 2005-2007 and up to 10% for 2008 – 2012. Each country then draws up an allocation plan for these permits – in most cases EU national governments will allocate emissions permits using an auction system. It will be up to companies monitor and report pollution emissions following a common set of EU guidelines and these will be subject to independent verification. For every tonne of carbon dioxide that is not covered by an allowance, a company will have to pay a penalty of 40 euro in 2005–2007 and 100 euro thereafter.

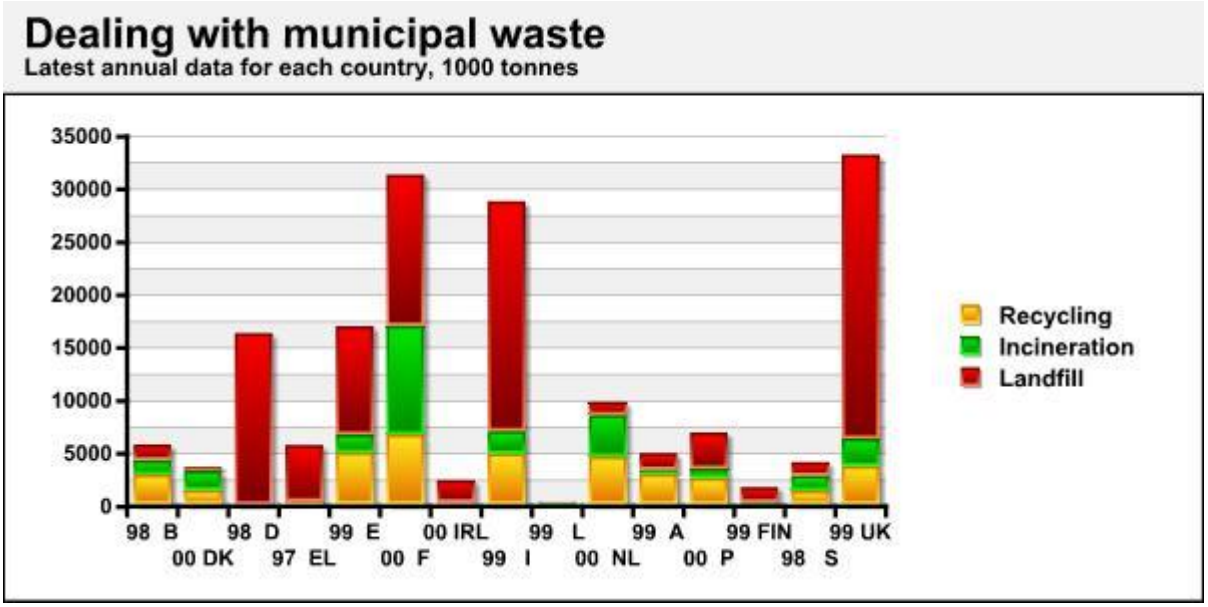
12.9 Policies towards Waste Management

Waste is an enormous problem for the European Union and there are real fears that if the EU achieves the Lisbon Strategy target of economic growth of 3% per annum over the next decade, the environmental consequences of a huge increase in household and industrial waste will be enormous. The Chart below provides a summary of the waste created by selected industrial sectors in 1999.



A huge amount of municipal waste comes from households and businesses. In many European countries, **landfill** remains the dominant method of disposing of this waste (consider the chart below which shows how each country deals with its waste). Landfill is often the cheapest option but one which has important environmental costs. The UK has so far failed to meet the targets set for shifting the balance of waste management away from landfill and incineration towards re-use and recycling. Often the basic

economics of recycling make it a fairly expensive and uneconomic form of waste disposal even though the social benefits are fairly well understood.



EU policies towards waste have concentrated on

- Reducing the growth of household and industrial waste at source by improving product design
- Introducing measures and incentives designed to re-cycle and re-use waste
- Reduce pollution created by incineration

Attacking the problem of waste requires strategies designed to affect both producers and consumers. The main focus of EU policy in recent years has been to **target producers**, be they supermarkets and their packaging of food, or manufacturers of consumer durable goods and the regulations for collecting and disposing of products when they come to the end of their normal working life. Good examples of EU regulation are the ELV and WEEE Directives.

The **ELV Directive** ("End of Life Vehicles") applies to passenger and light vehicles and the **WEEE Directive** ("Waste Electrical and Electronic Equipment") covers a range of electrical equipment such as household appliances, IT equipment (computers, printers, scanners etc) and lighting tools. The directives set down minimum requirements for producers as to the amount of waste from these industries that goes to landfill and sets targets for recovery, re-use and recycling of waste. Importantly they also place the financial responsibility for disposing of waste products on producers rather than taxpayers. It should be remembered that these directives on their own can lead to **unintended side effects.**

European Fridge Mountains

A good example of this came with changes in EU rules on waste disposal that led to the build up of a "fridge mountain" in the UK. The EU rules said that old fridges must be either burned at high temperature or recycled using specialist equipment which captures chlorine gases (CFCs), present in the

cabinets and doors of fridges, produced before 1996. In order to stop the harmful ozone-eating gases escaping the atmosphere, old fridges could no longer be exported or sent to landfill. But no specialist recycling equipment was available in the UK in January 2002 when the EU directive came into force. Incineration facilities were available at only two sites capable of disposing of a total of 8,000 fridges per week and retailers that used to take back old fridges from consumers when delivering new ones, stopped this practice, because it was not possible to sell them on for export, reconditioning or scrap. 75% of unused fridges in the UK had previously been exported for reuse in Africa. The end result was huge "fridge mountains" building up at sites all over the country and an estimate that the mountain had cost the UK government almost £40 million to deal with.

12.10 Farming and the Environment

Pollution from agriculture remains one of the major threats to the European environment with over 11% of total greenhouse gas emissions coming from the farming sector. It also has serious public health and economic consequences, in terms of microbial and toxic risks to drinking and bathing waters and the siltation of reservoirs and surface drainage networks.

A range of polluting substances from agricultural industries is of concern to the EU environment commission. For example, the contamination of fresh waters by pesticides, from overspray, spray-drift and run-off, is a major ecological threat. And, according to recent estimates of the external costs arising from farming in the UK alone, significant external costs arise from contamination of drinking water with pesticides, damage to wildlife, habitats, hedgerows and dry stone walls, from emissions of gases, from soil erosion, from food poisoning, and from bovine spongiform encephalopathy (BSE).

The types of externalities encountered in the EU agricultural sector have several important features:

- They often occur with a time lag (consider the growing awareness of the long-term damage of use of pesticides and the impact of environmental damage on food quality and human health)
- They often damage groups whose interests are not represented (e.g. consumers, animal welfare)
- The identity of the producer of the externality is not always known (partly because of the absence of legally enforceable property rights)
- They result in sub-optimal economic and policy solutions (i.e. market failure) – leading to a loss of economic and social welfare

Farm policy and the environment

The principal problem giving rise to market failure and subsequent government failure is that European farm policies and food prices have not until now reflected the social and environmental costs of resource use. The external costs of modern farming, such as soil erosion, health damage or polluted eco-systems are not incorporated into individual decision-making by farmers. Farmers are assumed normally only to consider the private costs and private benefits of decisions over output levels. In this way resource-degrading farmers bear neither the costs of damage to the environment or economy, nor those incurred in controlling the polluting or damaging activity.

The latest CAP reforms mark an attempt to improve this situation. Single income payments to farmers are conditional on them meeting strict environmental standards.

12.11 Web Links for Further Research on European Environmental Issues and Policy

- Battle to scale fridge mountains http://news.bbc.co.uk/1/hi/england/manchester/4037821.stm
- DEFRA (Waste and Recycling) http://www.defra.gov.uk/environment/waste/index.htm
- Emissions Trading Information for the UK http://www.emissions-trading.info/
- European Environment Agency http://www.eea.eu.int/
- Friends of the Earth (Europe) http://www.foeeurope.org/
- Green Party http://www.greenparty.org.uk/
- Guardian special report on waste and pollution www.guardian.co.uk/waste/0,12188,747275,00.html
- Ireland's plastic bag environmental levy www.mindfully.org/Plastic/Laws/Plastic-Bag-Levy-Ireland4mar02.htm
- Ireland's smoking ban www.oasis.gov.ie/employment/health_and_safety_in_employment/ban_on_smoking_in_the_workplace_in_ireland.html
- Planet under Pressure (BBC) http://news.bbc.co.uk/1/hi/in_depth/sci_tech/2004/planet/default.stm
- Royal Commission on Environmental Pollution http://www.rcep.org.uk/
- United Nations Environment Programme http://www.unep.org/

13 EUROPEAN TRANSPORT POLICY

13.1 Introduction

Basic transport statistics for the EU in 2003

The transport services sector employs about 7.5 million persons in the EU-25. 61% of them work in land transport (road, rail, inland waterways), 2% in sea transport, 5% in air transport and around one third (32%) in supporting and auxiliary transport activities (such as cargo handling, storage and warehousing, travel and transport agencies, tour operators).

Private households in the EU-25 spent € 745 billion or roughly 14% of their total consumption on transport in 2003. About one sixth of this sum (€ 124 billion) was spent for purchased passenger transport services, the rest (€ 621 billion) for private transport (mainly cars).

In 2001 the EU produced a White Paper entitled "European Transport Policy for 2010" in which a series of objectives for the European transport system for the next decade were outlined.

The main aim of the transport strategy is to deliver "an efficient and integrated transport system that offers a high level of quality and safety for Europe's citizens". It is designed to be consistent with the objective of promoting s**ustainable development** and tie in with EU **environmental policy** and **regional / social cohesion objectives**. On the environmental issue the strategy proposes policies that "break (decouple) the link between constant transport growth and economic growth" in order to reduce the pressure on the environment and prevent increasing levels of traffic congestion

The key objectives of EU transport policy can be summarised as follows:

Improving road safety – in 2002, 49719 persons were killed on the road in the EU-25

Preventing transport congestion – through shifting the balance between different modes of transport and promoting an integrated solution to Europe's transport needs

Take into account the environmental effects of different modes of transport – including measures designed to combat transport externalities and encourage the use of the least polluting modes of transport (essentially a shift away from car use)

Move towards some harmonisation of taxation of fuel for professional road transport as part of developing a level-playing field for the road transport industry throughout the Single Market

Investment in major infrastructural work - including the building of trans-European networks covering both rail (the trans-European high-speed passenger rail network) and air. Investment in **infrastructure** is now a hugely important component of EU transport policy. It is seen as essential in maintaining the competitiveness of EU businesses in global markets and in contributing to economic development and regional cohesion between member nations and regions

13.2 Economic Importance of Transport

Modern economies simply cannot function without an adequate transport system and an efficient transport network is essential to the domestic and international competitiveness of a modern economy.

According to the most recent European Union Transport White Paper, every day within the EU-15, transport systems

Carry 150 million people to work and home again
Enable over 100 million business trips to be made
Enable over 90 million people to go shopping
Carry 50 million tonnes of freight
Handle over 15 million postal items
Transport affects every area of economic life and influences the quality of life, work and leisure of millions of people each day. Efficient transport systems help to overcome the effects of distance and:

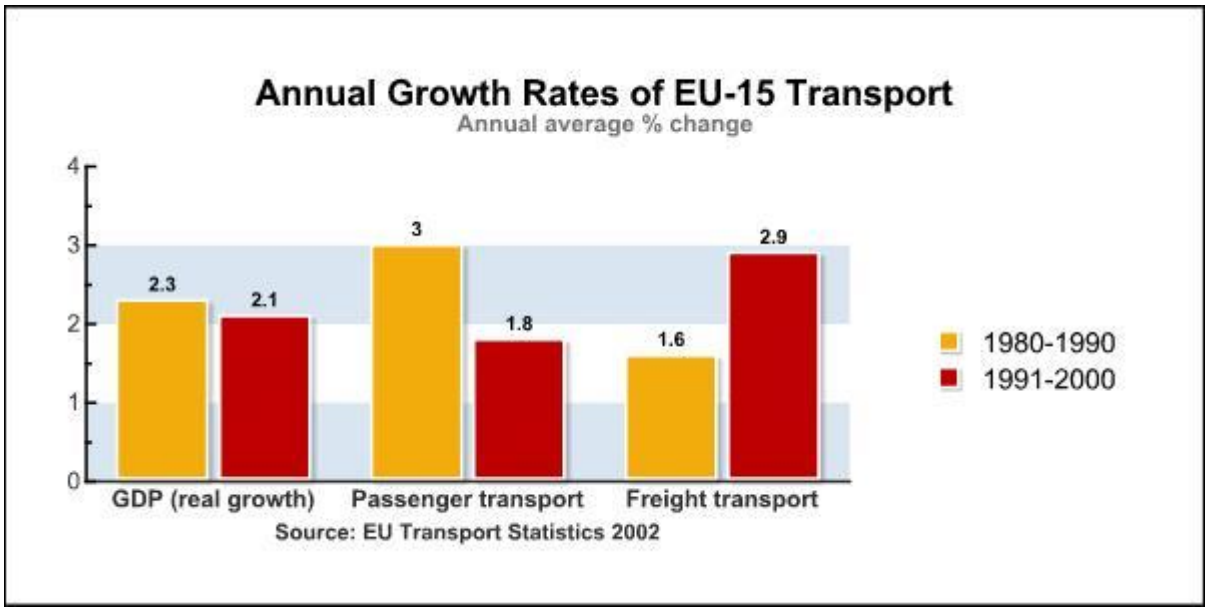
- Increase the size of the market by enabling domestic goods to be sold globally
- Help to create mass markets that mean extensive use of **specialisation** is viable and encourages large scale production with associated **economies of scale** reducing unit costs and prices
- Enhance opportunities for **international trade** and the benefits or economic integration - hence transport policy is crucial to the future success of the Single Market within Europe
- Enables **Just in Time (JIT) production techniques** where components are delivered when needed reducing a firm's stock levels hence unit costs. JIT delivery substantially reduces working capital tied up in stocks.
- Improves the **geographical mobility of labour**: workers can live many miles from work and commute
- Improves the **competitiveness** of businesses in domestic and international markets - efficient transport systems minimize travel times and so lower domestic unit costs

13.3 Main Characteristics of Transport

- The demand for transport is **derived** from the demand for what traveling makes possible e.g. commuting and carrying freight.
- Transport is a **service** consumed immediately and cannot be stored - each journey is unique in terms of time and space consumed
- Transport is usually an **intermediate output** i.e. a stage in the process of creating products
- Transport has a **distance and a time dimension**. All trips are made over a particular distance, between start and end destinations, and for a given duration of time
- Transport generates **externalities** potentially causing market failure because the market price of different transport services does not always reflect the full **social cost** to society. E.g. airlines generate significant **external costs** such as noise, pollution and congestion. Hence there are important links between EU transport policy and environmental policy objectives.

13.4 Growth of Demand for Transport in Europe

The growth of the EU economy has stimulated an increase in demand for all forms of transport and this is putting increasing pressure on existing transport networks. The annual percentage growth of passenger transport dipped below 2% during the 1990s (partly due to a slower rate of growth of real GDP) but the growth in freight transport rose quite sharply over the same period.



Nearly 60% of intra-EU trade is carried by **road** whereas 40% of extra-EU trade (i.e. trade with non-EU countries) is carried by sea and over a quarter of extra-EU trade is currently carried by air. The rail network is a fairly insignificant in terms of transporting traded goods within and outside the EU. Indeed between 1970 and 1998 the share of the European goods market transported by rail fell from 21% to 8.4% whereas it remains close to 40% in the United States. Passenger traffic carried by rail continues to grow – despite the closure of hundreds of km of railway lines each year – and the EU is hoping that huge spending on a trans-national European high speed rail network stretching from Western Europe into many of the accession countries will further expand the potential for long-distance travel within Europe and provide a close and attractive substitute to short-haul air travel.

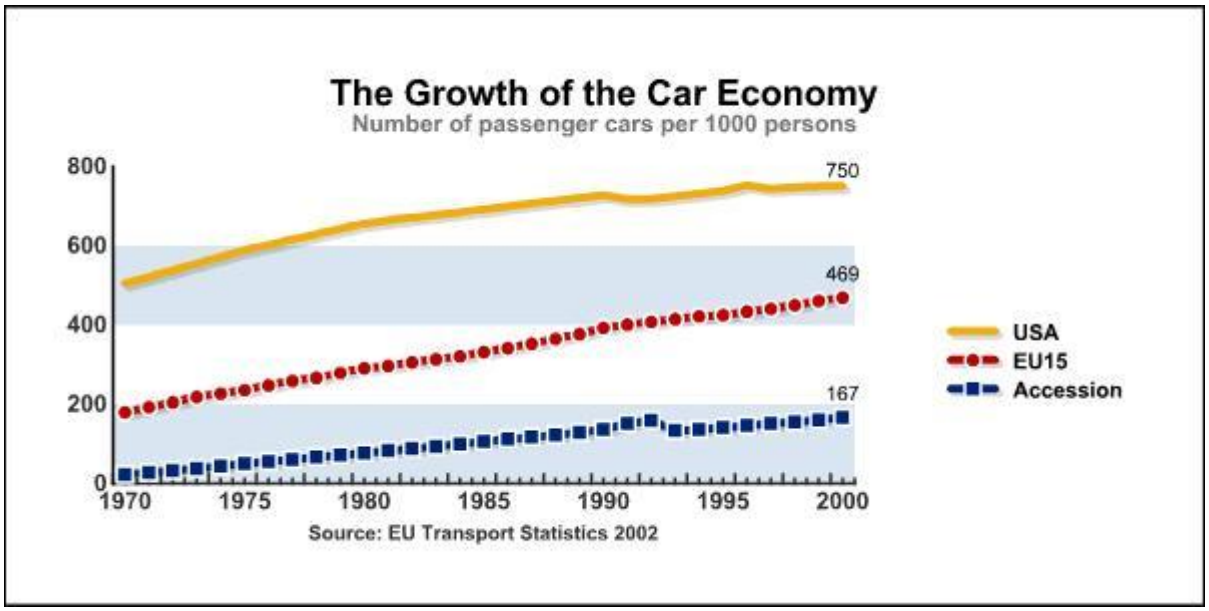
Europe's Transport Infrastructure

		EU-25	USA	Japan	China	Russia
Road network	1000 km	4 800	7 173	1 172	1 700	585
Motorway network	1000 km	55.6	90.0	6.9	20.0	No data
Railway network	1000 km	199.7	315.3	23.7	70.1	86.1
Electrified rail lines	1000 km	100.2	No data	16.5	18.7	40.3

The Modal Split of Transport Modes

Europe is without doubt a car-driven economy! The percentage share of car transport in total inland passenger transport varies from country to country. It is highest in the UK (88% of passenger kilometres in 2000 were achieved by car) and lowest in Austria (76.5%) but the dominance of the car in individual's transport decisions is pretty clear as the next chart demonstrates.

European transport policy aims to achieve a long term switch in transport modes away from the heavy reliance on cars towards alternative forms of mass transport (including bus, rail and tram).



Number of passenger cars per 1000 inhabitants

	1970	1980	1990	1995	2002
UK	214	277	360	375	447
EU25				392	459
EU15	184	293	394	427	491

Source: EU Transport Statistics, 2004

Passenger Transport by Mode in 1999 – an international comparison
Billion passenger kilometres

	EU 15	USA	Japan	China	Russia
Passenger car	3788	6245	644.9	na	na
Bus / coach	406	258	88.7	615	200.4
Railway	295	22	385	413	141
Tram + metro	51	24	30.5	5	72.8
Waterborne	24.4	1	4.48	12	0.84
Air (domestic / intra-EU)	260	796	79.348	86	53.4

13.5 European Aviation Industry

Of all transport modes, air transport has shown the largest increase in passenger volumes over the last 20 years. Expressed in passenger/kilometres, air traffic has increased by an average of 7% per year since 1980. The traffic handled by the airports of the member states of the EU has shown a five-fold increase since 1970. Every day, more than 25,000 aircraft fly the skies above Europe. And, the proportion of passenger transport accounted for by air travel is forecast to double from 4% in 1990 to 8% in 2010.

Congested skies and external costs

Congestion, resulting in **environmental nuisance** and a higher risk of accidents, is getting worse across Europe day by day, and penalises both users and the economy. If nothing is done, aviation industry observers estimate that the **cost of congestion** will, on its own, account for 1% of the EU's gross domestic product in 2010 while, paradoxically, the outermost regions in the EU (mainly located in the accession countries) remain poorly connected to the central EU markets. Delays in the aviation network throughout Europe are estimated to raise total fuel consumption by 6%. Indeed, congested skies limit the potential for economic development and trade for the whole EU economy.

The Expansion of EU aviation

The single market at work

Air transport liberalisation has meant that any airline can operate on any route in the EU. This meant an increase in the number of carriers from 119 in 1992 to a peak of 140 in 2000. The number of routes linking Single Market countries has risen by 46% since 1992 boosting choice to passengers. Fares at the lower end of the market fell by 41% between 1992 and 2000.

Source: adapted from a DTI report on trade and investment, 2004

The EU airline sector has historically been dominated by national **"flag carriers"** who together account for over 70% of civilian passenger traffic. These airlines emerged along national boundaries after World War II and historically were important **state-owned** or **state-sponsored** instruments of economic development. Examples include British Airways, Lufthansa and Air France. The dominance of the flag carriers is currently being eroded as the European airline market is being changed by market forces. A rising share of the market is now migrating to the most efficient and largest **low-cost airlines** in the sector.

Market structure is changing all the time – a process that is accelerating because of

- **Aggressive ticket pricing strategies** including widespread use of yield management (i.e. price discrimination) with the aid of Internet sales
- A fast growth of **route expansion** – particularly from the low-cost airlines – as they seek to exploit network economies of scale
- **A process or mergers and takeovers** within the industry leading to **market consolidation**

Market size and structure

Over 400m passengers use Western European airspace each year. The European airline market was partially **deregulated** in 1987 and was completed only in 1997. The market faces competition from many state-run railway networks. However the high level of population density within the EU (six times larger than the USA) will continue to fuel the growth of short-haul point-to-point routes within Europe providing major opportunities for low-cost airlines.

Flying with a low cost airline is increasingly affordable for most Europeans. **Average air fares** in the low-cost airlines sector now account for just 3% of the average monthly EU industrial wage. In Britain for example, over half the population flew at least once during 2002 – this would have been unheard of less than a decade ago.

There are 280 airports in Europe of which over 100 now has a low-cost service. The major hub airports (listed in the table below) are dominated by a small number of large scale flag carriers

Europe's Leading Airports

			Total movements of aircraft (take-off and landing) per year, thousands	
			1998	2003
1.	Paris Ch. de Gaulle	*FR*	430	515
2.	London Heathrow	*UK*	452	464
3.	Frankfurt Rhein/Main	*DE*	416	459
4.	Amsterdam Schiphol	*NL*	393	408
5.	Madrid Barajas	*ES*	269	384
6.	Munich	*DE*	279	336
7.	Rome Fiumicino	*IT*	258	301
8.	Barcelona	*ES*	218	282
9.	Zurich	*CH*	306	269
10.	Copenhagen Karstrup	*DK*	281	259
11.	Bruxelles	*BE*	300	252
12.	London Gatwick	*UK*	251	243
13.	Stockholm Arlanda	*SE*	268	231
14.	Milan Malpensa	*IT*	77	217
15.	Vienna Schwechat	*AT*	189	217
16.	Manchester	*UK*	180	207
17.	Paris Orly	*FR*	246	207
18.	London Stansted	*UK*	127	186

Source: EU Transport Statistics, 2004

In 1998 the Flag-Carriers took 75% of all passenger traffic with charter airlines taking a further 23% and the low-cost segment accounting for just 2%. By 2001 the low-cost airlines took an estimated 7% of all traffic with the Charter (21%) and Flag Carriers (72%) losing market share. This occurred however against a backdrop of an overall growth market. Passenger numbers jumped 19% from 1998-2001 fuelling demand in all markets.

Opportunities for aviation from EU Enlargement

Over the medium term a new market beckons in the ten countries that joined the EU in 2004. There is a strong relationship between rising **real incomes** and demand for air travel. Providing the new EU member nations enjoy economic growth and development once inside the Single Market, there is every chance for existing airlines to exploit market opportunities. Existing services to these countries are limited but the ten new members of the EU become part of the EU **Open-Sky Treaty** allowing **point-to-point service** between any EU nations. The high level of price-sensitivity (price elasticity of demand) for routes to and within accession countries is naturally suited to low cost airlines.

Consolidation of the Low Cost Airline Sector

History suggests that the low cost airline sector will experience market consolidation and increased market concentration over the coming years. Because of the network **economies of scale** available to large scale low cost airlines and other factors (including aggressive defences of existing profitable routes) the low-cost airline segment in the European market may eventually be dominated by just two carriers – EasyJet and Ryan Air. Numerous start-ups will come and go.

Scale matters in the aviation industry. EU Airlines and their customers are failing to benefit from the full potential of the EU Single Market. On a global level, many European players are of a **sub-optimal size**, compared to their major international rivals. Some traditional Flag Carriers are facing serious financial difficulties and need airline partners or new investment to improve their long term commercial viability. The consolidation process is well underway with the acquisition of **Go** by **EasyJet** and the takeover of **Buzz** by **RyanAir**.

Europe's biggest airlines in 2003	*Country*	Employees	Aircraft Fleet	Turnover (million euros)
1. Air France	*FR*	71 525	247	12 337.0
2. British Airways	*UK*	47 702	300	10 954.9
3. Lufthansa	*DE*	39 068	332	9 070.0
4. KLM	*NL*	37 487	126	5 877.0
5. SAS	*DK/SE*	22 945	174	5 476.5
6. Iberia	*ES*	26 314	140	4 619.3
7. Alitalia	*I*	22 200	195	4 385.0
8. Swiss Int. Air Lines	*CH*	8 838	85	2 659.2
9. Austrian Airlines	*AT*	7 137	91	2 242.7
10. Virgin Atlantic	*UK*	6 912	28	1 843.2
11. Finnair	*FI*	6 920	58	1 557.6
12. RyanAir	*IE*	2 288	74	1 556.6
13. Turkish Airlines	*TR*	10 239	65	1 533.6
14. EasyJet	*Uk*	3 453	73	1 350.3
15. TAP	*PT*	8 360	38	1 144.0
16. British Midland	*UK*	4 548	43	1 118.7
17. Air Berlin	*DE*	1 800	43	*898.0*
18. Aer Lingus	*IE*	4 476	30	888.3

Over the last decade, European aviation has moved from a **highly regulated market**, based on **bilateral agreements** between countries and a **duopoly** and therefore having little or no competition, to a **competitive single market**. In this new situation the discretionary powers of the national authorities have been curbed and airlines have enjoyed greater **freedom to set fares**, **open new routes** and determine what **capacities to offer**, according to economic and financial considerations.

At the present time any airline holding a valid Air Operators Certificate in the EU cannot be prevented from operating on any route within the European Union, including flights wholly within another country. This is one of the **"freedoms of the air",** in fact the 7th freedom - the right of an airline to pick up passengers in one country and to fly them to another country without stopping in the airline's home country. Such granting of 7th freedom rights to EU airlines is wholly consistent with EU policy on the free movement of citizens and goods around the Union.

Despite the liberalisation of air transport in the EU, the airlines can only operate from their national base and do not have the same merger possibilities as other industries within the single market. Transatlantic routes are divided up between more than 20 airlines on the European side as opposed to six US companies, which might soon be reduced to four or five as a result of the ongoing mergers in the United States. The European airlines are limited to a single market for their intercontinental services and often to a **single hub**. A French company, for example, can offer flights from Berlin to Malaga, but not a service from Berlin to New York. Their competitors, notably the US airlines, have several hubs from which they can propose intercontinental services not only to their final destination in the Community but also to other destinations on the basis of inter-airline alliances. 85% to 90% of passengers now travel at reduced fares within the European Union. The EU Commission has, however, noted that the **"fully**

flexible" fares, which are not subject to any kind of restriction as regards changing the reservation, the length of stay at the destination, etc. are still excessively high

Aviation and the Environment

"Short-haul passenger flights, such as UK domestic and European journeys, make a disproportionately large contribution to the global environmental impacts of air transport and these impacts are very much larger than those from rail transport over the same point-to-point journey."

(Royal Commission on Environmental Pollution 2002)

The air transport industry is growing at rates above the average growth of the economy of the European Union. Growth in demand for aviation averaged 5% per year for the period 1980–95 and this growth rate is expected to continue until at least 2015.

It is a high priority for the EU to reconcile pressing **environmental needs** with the development of an industry which is of importance for the competitiveness of the economy and for job creation. Inescapably, the **environmental impacts of air transport have also increased**. Globally, air transport contributes to the greenhouse effect and at a regional level aviation contributes to emissions of air pollutants. At local level, in the immediate vicinity of airports, concerns focus on the potential health and environmental effects of noise and air pollution from emissions such as oxides of nitrogen, volatile organic compounds and particulates. Expanding airports also add to road traffic congestion.

Greenhouse gases from British airlines cost the country £1.4bn in 2000, which is estimated to rise to £4.8bn by 2030. UK civil passenger aviation produced 30 million tonnes, or 5 per cent, of Britain's carbon dioxide in the year 2000. By 2020 this will have gone up to 55 million tonnes, or between 10 and 12 per cent. The UK White Paper on the future of air transport published in December 2003 made clear reference to the need to balance the economic and social costs and benefits of aviation when deciding on the future expansion of the UK airport network and capacity. European airlines currently enjoy substantial tax exemptions, particularly from all taxes on kerosene. This exemption for kerosene applies to international and intra-EU flights alike. This tax exemption for fuel provides no incentive for airlines to use the most efficient aircraft and to contribute to reducing CO2 emissions (of which air transport accounts for 13%). It also creates situations where the competition between air transport and other modes is unfair.

The Royal Commission argued against an EU-wide aviation tax to control externalities.

"Instead of a fuel tax, a better way of addressing the market distortion would be a Europe-wide emissions charge, which airports would be required to levy on all aircraft, passenger or freight, taking-off from or landing at European airports. The charge would be differentiated between aircraft types and loads and the distance travelled over Europe, or over the ocean to the point mid-way to the nearest country in the direction of the flight, to reflect their estimated emissions."

Adapted from the Royal Commission Report, November 2002

13.6 Suggestions for further research on European Transport Policy

- British Air Transport Association http://www.bata.uk.com/contact.htm
- Commission for Integrated Transport http://www.cfit.gov.uk/
- Department for Transport http://www.dft.gov.uk/
- Environmental effects of air transport http://www.rcep.org.uk/aviation.html

- EU Commission (Transport) http://europa.eu.int/pol/trans/index_en.htm
- EU Director-General for Energy and Transport http://europa.eu.int/comm/dgs/energy_transport/index_en.html
- EU Rail (Trans European Networks) http://europa.eu.int/comm/ten/index_en.html
- EU White Paper on Transport Policy http://europa.eu.int/comm/energy_transport/en/lb_en.html
- European Best Practice in delivering Integrated Transport http://www.cfit.gov.uk/research/ebp/key/index.htm
- Green Party http://www.greenparty.org.uk/
- International Air Transport Association http://www.iata.org/index.htm
- Transport in Britain (Guardian Special Report) www.guardian.co.uk/transport/0,2759,180795,00.html
- White Paper on the future of air transport http://www.dft.gov.uk/aviation/whitepaper/

14 EUROPEAN UNION COMPETITION POLICY

14.1 Introduction

Competition is a mechanism of disciplined pluralism, which rewards success and penalises failure. The purpose of competition policy is to protect that mechanism.

(Adapted from an article by John Kay, Financial Times, November 2002)

This case study focuses on **competition within product markets** and the ways in which European Competition Policy seeks to monitor market structures and the behaviour and performance of businesses within the Single Market

"Ronald Coase said he had gotten tired of anti-trust because when the prices went up the judges said it was monopoly, when the prices went down they said it was predatory pricing, and when they stayed the same they said it was tacit collusion."

William Landes, "The Fire of Truth: A Remembrance of Law and Econ at Chicago", JLE (1981)

European **economic integration** seeks to **remove the barriers** which restrict the free movement of goods, services and the factors of production between national economies. EU competition policy applies only to inter-country trade, targeting the behaviour of firms that could frustrate the process of EU integration through trade in goods and services

Competition policy in the EU is governed by the principle of **subsidiarity**. Each member state has its own competition legislation relating to the exercise of restrictive practices and the abuse of a dominant position within their own countries. So for example in Britain, we often focus on the work undertaken by the **Office of Fair Trading** (www.oft.gov.uk) and the **Competition Commission** (www.competition.gov.uk) in implementing the 2001 UK Competition Act.

Main Aims of European Union Competition Policy

In a free market, business is a competitive game. Sometimes, companies may be tempted to avoid competing with each other and try to set their own rules for the game. At times, a major player in the game may try to squeeze its competitors out of the market. The European Commission acts as the referee to ensure that all companies play by the same rules.

The aim of EU competition policy is to increase economic well-being by **promoting competition** and creating a **single market** which transcends national boundaries.

There are some industries in the EU in which a fully-fledged single pan-European market does not yet exist. In these markets the degree of actual and potential competition is limited. Such markets include energy supply, car retailing, and telecommunications & postal services industries. There is still much to be done to make these markets more fully contestable but the Competition Authorities have a key role to play in establishing the conditions under which new competitive pressures emerge.

The Importance of Competition to the Consumer

According to a statement on the EU Competition Commission web site –

"Competition in the market-place is a simple and efficient means of guaranteeing consumers products and services of excellent quality at competitive prices. Suppliers (producers and traders) offer goods or services on the market to meet their customers' demands. Customers seek the best deal available in terms of quality and price for the products they require. The best deal for customers emerges as a result of a contest between suppliers."

"Competition also puts pressure on firms to innovate and to reorganise their business activities in order to continuously improve their cost structure and reap productivity gains. Over time, competition leads to the introduction of improved products and processes, weeding out inefficient firms and reallocating productive resources from retreating or failing firms to new entrants or more efficient competitors."

Competition policy aims to ensure wider consumer choice, technological innovation and effective price competition, thus contributing to both consumer welfare and to the competitiveness of European industry. This is achieved by ensuring that companies compete rather than collude, that dominant companies do not abuse their market power and that efficiencies are passed on to final consumers.

The Main Components of EU Competition Policy

There are **four pillars** of EU competition policy

Antitrust & cartels: The primary target of the European antitrust rules is to make certain that companies compete rather than collude. This involves the elimination of agreements which restrict competition (e.g. price-fixing agreements, or cartels, between competitors) and of abuses by firms who hold a dominant position in a market.

Market Liberalisation: Liberalisation involves introducing fresh competition in previously monopolistic sectors e.g. energy supply, telecommunications and postal services together with the new block exemption arrangements for car retailers inside the single market

State aid control: We are focusing here on the control of state aid measures by Member State governments to ensure that such measures do not **distort competition** in the Single Market (e.g. the prohibition of a state grant designed to keep a loss-making firm in business even though it has no prospect of recovery). Examples to focus on here might be state aid for steel producers, the coal industry, transport service providers, farming and aviation.

Merger control: This involves the investigation of mergers and take-overs between firms (e.g. a merger between two large groups which would result in their dominating the market).

14.2 Anti-Trust Policy - Abuses of a Dominant Market Position

A firm holds a **dominant position** if its economic power enables it to operate within the market *without taking account* of the reaction of its competitors or of intermediate or final consumers. In appraising a firm's economic power in the marketplace, the EU Commission considers its **market share** and other factors such as whether there are **credible competitors**, whether the firm has ownership and control of its own **distribution network** and whether it has **favourable access to raw materials**.

Holding a dominant position is not wrong in itself if it is the result of the firm's own effectiveness. But if the firm exploits this power to stifle competition, this is deemed to be an **anti-competitive practice**

which constitutes abuse. It is therefore the abuse of the dominant position which is prohibited by **Article 82 of the EC Treaty**.

Investigating Microsoft

A good recent example of this was the investigation by the EU Commission into the alleged abuse of market power by Microsoft. Microsoft was accused by the Commission of continuing to abuse its monopoly in the software market. In his interim report published in November 2003, Mario Monti, Europe's said that Microsoft was continuing to exploit the dominance of its Windows operating system illegally to muscle out rivals. The Commission gathered evidence from more than 150 companies in the high-tech industry over the course of its four-year investigation. It said: "In light of this evidence, the Commission's preliminary conclusion was that Microsoft's abuses are still ongoing." The investigators alleged that Microsoft **bundled** Media Player with Windows, unfairly damaging rival programs such as Real Networks' RealPlayer and Apple Computer's QuickTime.

In the market for servers, which are used by big business to operate large computer networks, the regulators allege that Microsoft has designed Windows to work better with its own software than that of rivals, hurting competitors who use Linux or other versions of the UNIX operating system. Among the remedies outlined by the Commission was forcing Microsoft to "lift the lid" on how Windows communicates with other Microsoft software in the server market, "so that rival vendors of low-end servers are able to compete on a level playing-field". The Commission also proposed to force Microsoft either to split Media Player from Windows or to bundle rival audiovisual software in with its operating system, giving customers the choice of which one to use from the moment they switch on their computers. In December 2004, Microsoft lost their appeal against the rulings of the EU Competition Commission and a Euro 497 million fine.

14.3 Anti-Competitive Practices:

Anti-competitive practices are best defined as business strategies designed deliberately to **limit the degree of competition** inside a market. Such actions can be taken by one firm in isolation or a number of firms engaged in **explicit or implicit collusion**.

Where firms are found to be colluding it would generally (not exclusively) not seen to be in the public interest) and the competition authorities would be propelled to intervene on the grounds of **market failure** and a loss of **economic efficiency** and **economic welfare**.

The EU Competition Commission has been **pro-active** in investigating allegations of cartel behaviour among businesses within the single market. Since 1998 there have been numerous investigations in industries such as chemicals, banks, pharmaceuticals, airlines, beer, and paper, plasterboard, food preservatives and computer games! We can expect more examples to crop up in the media on a regular basis!

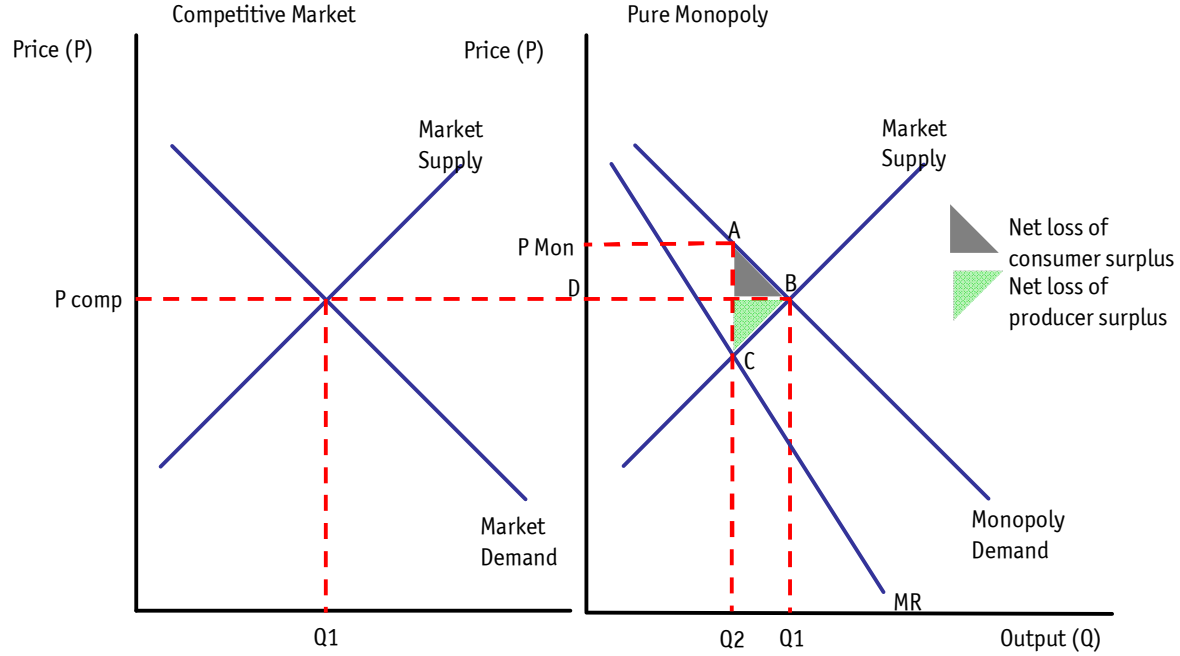
Competitive processes inevitably involve **intense rivalries** between firms in which they attempt to injure one another. When one firm cuts the price of its product, it does so in the knowledge that, **ceteris paribus**, it will take market share from a competitor as consumers switch to the relatively cheaper product. The introduction of new products to a market has the same purpose.

The plain observation that one firm's conduct has a detrimental effect on another is not enough to demonstrate and prove any form of anti competitive behaviour. It is normally the sign of the normal working out of competition pressures in a freely functioning market. Thus it is not easy to identify and separate anti -competitive practice from pro competitive behaviour! Sufficient evidence is needed of

clear cartelised behaviour among participating businesses in a market and this can often take many months, indeed years to gather before a formal investigation is possible and successful.

Arguments in favour of more competition

The standard pure monopoly versus perfect competition diagram can be used to show that, given 'similar cost conditions, prices will be lower and output higher in a competitive market than a monopoly. There is also likely to be greater choice. This leads to an increase in consumer surplus and as such, a move away from producer sovereignty towards consumer sovereignty.



Abnormal (supernormal) profit will be gradually removed as suppliers compete with each other, effectively **transferring income** from shareholders to households. A more efficient allocation of resources results with competition since monopoly involves a firm setting price well above marginal cost at the profit maximising output whereas under competition, profit margins are reduced and prices paid by consumers are closer to the factor cost of production

Examples of anti-competitive practices

Anti-competitive practices can take a number of forms, many of which are subtle (they are obviously trying not to catch the attention of the competition authorities!). Examples can include:

(1) Predatory pricing financed through **cross-subsidization** (not all price discrimination is anti competitive though – much of it is simply a genuine attempt to remain competitive in a market)
Firms who have market power in more than one market may **set prices below cost** in one period in order to drive out rivals and restrict market entry. Having done so, it once again raises price – this is what is commonly known as predatory pricing and it is illegal.

(2) **Vertical restraint** in the market:

Several forms of vertical restraint can exist in a market-place:

(i) Exclusive dealing: This occurs when a retailer undertakes to sell only one manufacturer's product and not the output of a rival firm. These may be supported with long-term contracts that bind a retailer to a supplier and can only be terminated by the retailer at great cost. Distribution agreements may seek to prevent instances of **parallel trade** between EU countries (e.g. from lower-priced to higher priced countries) – this lay at the heart of the decision by the EU to fine Nintendo in October 2002 (see later)

(ii) Territorial exclusivity: This exists when a particular retailer is given the **sole rights** to sell the products of a manufacturer in a specified area.

(iii) Quantity discounts: Where retailers receive progressively larger price discounts the more of a given manufacturer's product they sell - this gives them an incentive to push one manufacturer's products at the expense of another's in order to widen their own profit margins

(iv) A refusal to supply: Where a retailer is forced to stock the complete range of a manufacturer's products or else he receives none at all, or where supply may be delayed to the disadvantage of a retailer (for example the distribution of stocks of new products that must be sold on the day of release for the retailer to make much impact)

(3) Creation of artificial barriers to entry: Through advertising and marketing and brand proliferation

(4) Collusive practices: These might include agreements on market sharing, price fixing and agreements on the types of goods to be produced.

Practices are not prohibited if the respective agreements "contribute to improving the production or distribution of goods or to promoting technical progress in a market. Examples include:

- Development of industry standards /technical standards of production and safety
- Research joint-ventures and know-how agreements which seek to promote innovative behaviour

Case Studies: Fines Imposed by the EU Competition Commission

2001 - Deutsche Post

On 20 March 2001, the Commission issued its first Article 82 decision in the postal sector, finding that Deutsche Post AG (DPAG) had abused its dominant position in the market for business parcel services by engaging in **predatory pricing**. DPAG was fined 24 million Euros. The EU antitrust watchdog found Deutsche Post had offered large mail-order firms bigger discounts if they agreed to send all their parcels through them. United Parcel Service (UPS) complained to the Commission in 1994 that Deutsche Post was involved in predatory pricing by using profits from its monopoly of delivery of letters to subsidise its business parcel services (this is known as **cross-subsidization**). After talks with the Commission, Deutsche Post agreed to split off the parcel unit and establish it as a stand-alone business that would compete like UPS or any other firm.

2001 - Michelin

On 20 June 2001, the Commission fined French tyre maker Michelin 19.76 million Euros for abusing its dominant position in the French market for retread and replacement tyres for heavy vehicles. The Commission's investigation established that, between 1990 and 1998, Michelin operated a complex

system of **rebates, bonuses and commercial agreements**, which had the effect of **tying dealers** to Michelin as their main supplier, and thus of artificially barring Michelin's competitors from the market.

2001 – The European Vitamin Cartel

In November 2001, the **European Competition Commission** fined eight companies a total of €855 million for participating in eight secret market-sharing and **price-fixing cartels** affecting vitamin products. The companies are thought to have cost shoppers millions of pounds, by carving up the market and **rigging prices for vitamins** included in everything from cereals, biscuits and drinks to animal feed, pharmaceuticals and cosmetics. Because Hoffman-La Roche was an instigator and participated in all the cartels it was given the highest cumulative fine of €462 million. According to the Commission, the prime mover and main beneficiary of the vitamin cartels was Hoffmann-La Roche, the largest vitamin producer in the world, with some 50% of the overall market. The cartel arrangements covered its full range of vitamin products.

2002 - Nintendo

In October 2002, Nintendo, the Japanese video games manufacturer, was found guilty of ripping off its customers in continental Europe for most of the 1990s and fined £94m by the European Commission. Edinburgh-based John Menzies, the sole UK distributor of Nintendo products, was also punished for its role in the scam.

2003 - The Plasterboard Cartel

In 2003, the European Commission has fined French building materials giant Lafarge and three other companies 478m euros for fixing the price of plasterboard, a common building material. Lafarge was fined 249.6m euros, while Britain's BPB was fined 138.6m euros, Germany's Knauf 85.8m euros and Belgium's Gyproc 4.32m euros. The fine, the second largest ever handed out by the Commission, was because the cartel controlled 80% of the European market, worth 1.2bn euros in 1998 when it ceased operating. The Commission said the plasterboard cartel began in London in 1992 when BPB and Knauf agreed to stop competing in the German, French, British and Benelux markets. Lafarge joined later in 1992 and Gyproc in 1996 and the cartel operated until 1998.

2003 - The Food Preservative Cartel

In October 2003 the EU Competition Commission fined European and Japanese companies a total of 138 million euros for operating a price-fixing cartel in sorbates, one of the most widely used food preservatives in Europe. The companies involved had met twice a year to discuss setting prices for each country and allocating quotas of output for each other. The EU Commission decided that the cartel ran between December 1978 and October 1996.

2003 - The Organic Peroxides Cartel

In December 2003 the EU Competition Commission fined five European companies nearly 70 million Euros for fixing the prices of key industrial chemicals. The EU regulators concluded the companies colluded over sales of organic peroxides, which are used to make plastics and polystyrene for products like containers and packaging. The European Commission said the producers operated a cartel between 1971 and the end of 1999.

2003 - The EU Commission and the Sky Soccer Television Deal

The EU Commission intervened in the autumn of 2003 to investigate the successful bids made by Sky to win a three year deal for live-right packages with the English Premier League. The Commission was concerned that the bidding process for the television rights was not sufficiently competitive and might have broken the Treaty of Rome concerning the abuse of a dominant position. The UK Consumers' Association supported the intervention of the EU Competition Authorities. In a research paper they concluded that the Sky / Premier League deal was "anti-fan"; that no one broadcaster should have exclusive rights to all games and that individual clubs should be allowed to sell games not included in pre-set packages.

In an attempt to promote greater competition in the market for television rights, the EU Commission had insisted that the television rights be sold off in a number of packages. Although the BBC won the bidding to screen recorded highlights, Sky won all of the main live-rights packages. They also hold internet rights and are able to screen "near live" games. In December 2003 it was announced that English premiership matches will be shown to television viewers for free during the 2004-05 season after a compromise deal agreed between BSkyB, the Premier League and the European Commission. Under the provisional agreement, up to eight matches a season will be shown by terrestrial broadcasters.

2004 – The Animal Feeds Cartel

In September 2004, the European Union fined three big chemical companies 66.4 million Euro for fixing prices on animal-feed vitamins. German firm BASF AG was ordered to pay the largest fine of euro35 million, while Dutch company Akzo Nobel NV was fined euro21 million and Belgium's UCB SA was fined euro10.4 million. The three companies were found guilty of secretly colluding between 1992 and 1998 to set prices and share markets for additive choline chloride. Choline chloride, also known as vitamin B4, is used mainly as a feed additive for poultry and pigs, to increase growth, reduce mortality and improve meat quality.

14.4 Market Liberalization

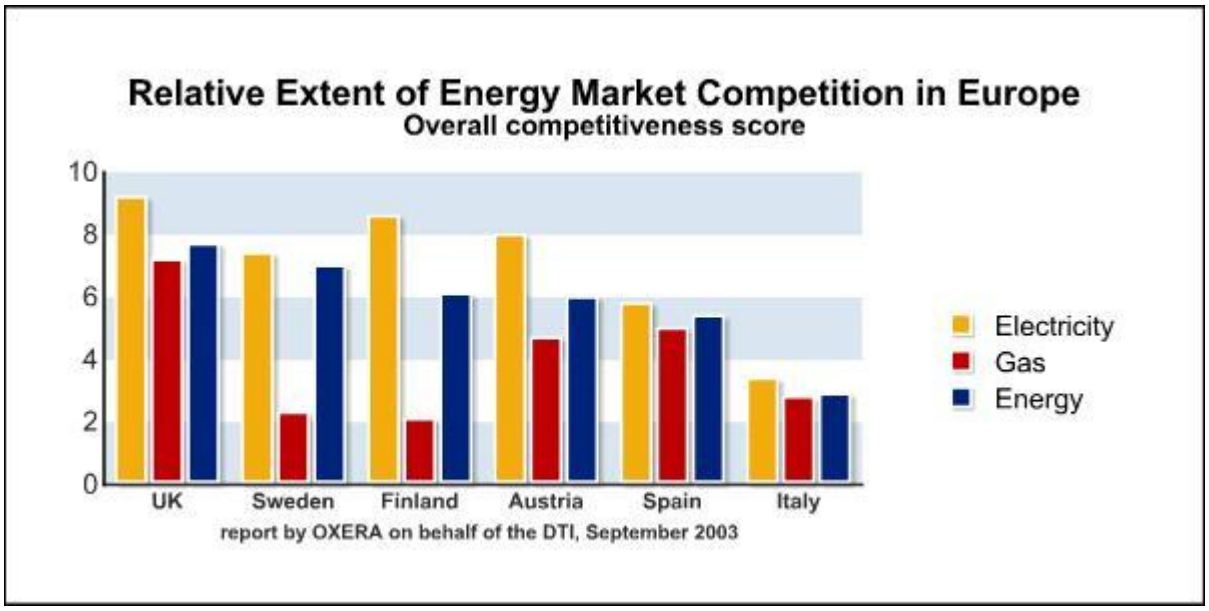
The main principle of EU Competition Policy is that consumer welfare is best served by introducing competition in markets where monopoly power exists.

Frequently, these monopolies have been in **network industries** for example transport, energy and telecommunications. In these sectors, a distinction must be made between the **infrastructure** and the **services provided directly to consumers** over this infrastructure. While it is often difficult to establish a second, competing infrastructure, for reasons linked to investment costs and economic efficiency (i.e. the natural monopoly arguments linked to economies of scale and a high minimum efficient scale) it is possible and desirable to **create competitive conditions** in respect of the services provided.

Separating infrastructure from services

The Commission has developed the concept of **separating infrastructure from commercial activities.** The infrastructure is thus merely the vehicle of competition. While the right to exclusive ownership may persist as regards the infrastructure (the telephone or electricity network for example or the supply of gas and electricity to the individual household and business), monopolists must grant **access** to companies wishing to compete with them as regards the services offered on their networks (telephone communications or electricity supply). This is the general principle on which the Community liberalisation directives are based.

The EU Commission can initiate the opening-up of markets. It may itself adopt a European liberalisation directive which must be enforced by the Member States. The Commission checks that these objectives are actually achieved.



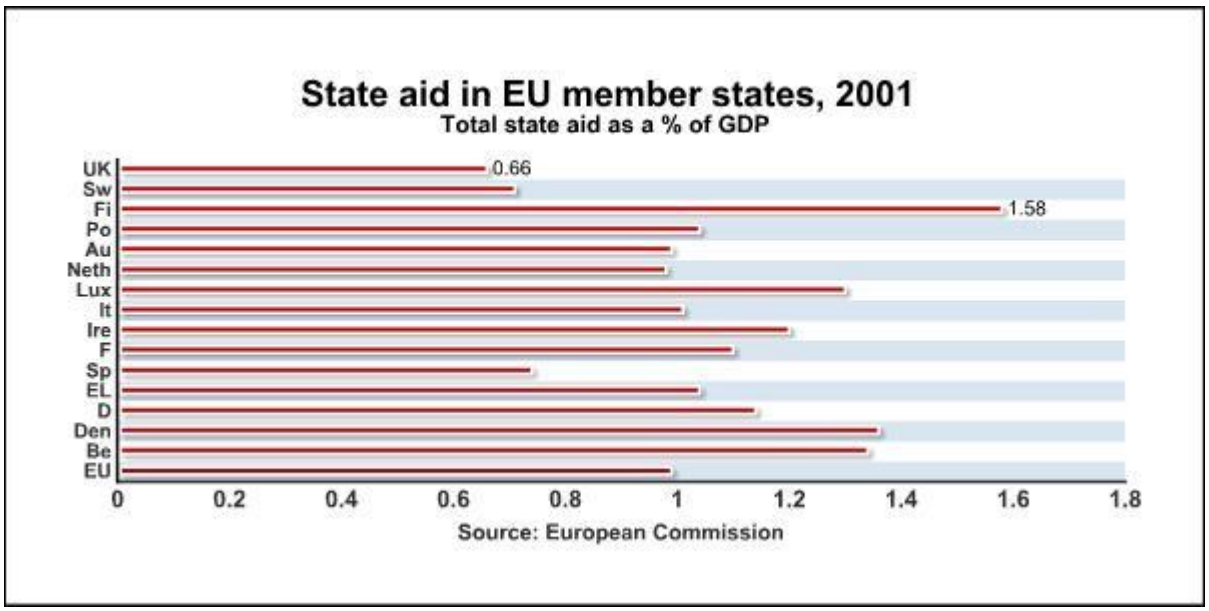
Progress has been made in liberalising many markets as part of the Single Market programme. But the extent to which truly competitive pressures exist in any given industry continues to vary across countries. The chart above provides some evidence drawn from evidence presented to the UK Department of Trade and Industry. In three key utility industries, the overall scale of competitiveness for consumers does vary a great deal with the UK coming out well in a comparison with most European Union countries.

14.5 State Aid in Markets

The argument for monitoring state (public sector) aid given to private and state businesses by member Government is that by giving certain firms or products favoured treatment to the detriment of other firms or products, state aid **disrupts normal competitive forces**. According to the EU Competition Commission, neither the beneficiaries of state aid nor their competitors prosper in the long term. Often, all government subsidies achieve is to delay inevitable restructuring operations without helping the recipient actually to return to cost and non-price competitiveness. Unsubsidised firms who must compete with those receiving public support may ultimately run into difficulties, causing loss of competitiveness and endangering the jobs of their employees. Ultimately, then, the entire single market will suffer from state aid, and the general competitiveness of the European economy is imperilled.

State aid that **distorts competition** in the Single Market is prohibited by the EC Treaty. Under the current European state aid rules, **a company can be rescued once**. However, any restructuring aid offered by a national government must be approved as being part of a feasible and coherent plan to restore the firm's long-term viability.

The EU Competition Commission considers not just the transparent forms of state aid such as government loans and grants but also assistance in the form of tax breaks and loan guarantees. However government aid designed to boost research and development, regional economic development and the promotion of small businesses is normally permitted.



Data released by the European Commission has found that in 2001 the UK spent less of its national wealth on public (state) aid to industry than any other European Union country. Britain devoted just 0.66% of gross domestic product (GDP) to state assistance to business and to the transport, agriculture and fisheries sectors. This compared with an EU average of 0.99%. Finland headed the European rankings for state aid in large part because of the scale of financial assistance that it gives to its farming industry. The majority of UK state aid has gone in financial subsidies to the transport sector, in particular the railway industry, although the coal industry has also managed to extract additional funding over the last few years.

The total amount of state aid provided within the European Union has declined from £70 billion in 1997 to £60 billion in 2001 in line with the objectives of EU competition policy. The aim is to redirect funds away from subsidising loss-making businesses towards schemes designed to improve the environment, encourage small and medium sized businesses, research and development and entrepreneurship. This is designed to complement the economic growth and employment objectives agreed at the 2000 Lisbon Summit (covered in a separate case study on European unemployment and labour market reforms).

State aid - the RyanAir Issue

The issue involving Ryan Air is an important one that touches on the role that state aid can play in distorting the allocation of resources in a market. During 2003, a coalition of European airlines urged the European Commission to take action against the leading Irish budget carrier RyanAir in a dispute over state-aid payments from airports.

The Association of European Airlines (AEA), a Brussels-based lobbying group which represents 31 major carriers, called on the European Commission to take a hard line against "state aid", in a thinly veiled reference to the RyanAir case. Some of RyanAir's rivals complained that the payments to the Irish carrier, when made by public sector bodies, amount to state aid that distorts competition. RyanAir has four aircraft based in Charleroi, south of Brussels, serving around 2 million passengers per year. In September 2003, RyanAir decided to suspend services from Strasbourg after a French court decided that its deal with the local airport amounted to illegal state aid. The initial complaint came from the French "flag-carrier" Air France.

RyanAir has transformed the European airline sector by offering flights from smaller provincial airports and a no-frills service to passengers. Much of RyanAir's business model is based on negotiating payments from under-used airports and regional public bodies in recognition of the economic boost the airline generates to their areas

State aid and bond ratings

In another example of EU Commission intervention on the issue of state aid, in December 2003 the Commission announced that Electricite de France, the French state-owned power group, must repay the French government about E1 billion (dollars 1.2 billion) and phase out government guarantees. Mario Monti, competition commissioner, argued that the French state-owned power group was unique among European companies in enjoying a "triple A credit rating" in the European bond market as a direct result of government guarantees, which gives it an unfair advantage in raising capital.

14.6 European Merger Policy

Mergers may allow the newly created business to exercise market power or more generally harm competition. However, mergers may also make companies more efficient, strengthen their competitiveness and result in cost-savings that are passed on to consumers.

Source: EU Competition Commission Briefing – October 2004

As the chief enforcer of EU competition policy, the European Commission can make or break the word's biggest companies. The **control of mergers and acquisitions** is one of the pillars of European Union competition policy. Corporate restructuring is a fact of life. There is a natural tendency for markets to consolidate over take through a process of horizontal and vertical integration.

The main issue is whether a proposed merger or takeover is thought to lead to a **substantial lessening of competitive pressures in the market** and risks leading to a level of **market concentration** when **collusive behaviour** might become a reality.

When companies combine via a merger, an acquisition or the creation of a joint venture, this generally has a positive impact on markets: firms usually become more efficient, competition intensifies and the final consumer will benefit from higher-quality goods at fairer prices.
However, mergers which create or strengthen a dominant market position can, after investigation, be prohibited in order to prevent ensuing abuses. **Acquiring a dominant position by buying out competitors is in contravention of EU competition law.**

Companies are usually able to address the competition problems, normally by offering to **divest** (sell or offload) part of their businesses.

Evaluating the factors behind approving or rejecting a merger within the EU

Consider a situation where the EU Competition Commission is asked to investigate the grounds for approving or blocking a merger between two European businesses
Examples to think about might include

- Two low cost airlines seeking a merger
- A takeover of one large pharmaceutical manufacturer with another
- The merger between two European holiday companies

The main economic grounds for approving a merger:

Often a merger is allowed to progress without any intervention by the competition authorities when the economic benefits of allowing the integration to take place are significantly greater than the potential costs. Here are some of the main justifications for approving a merger between two businesses:

(1) Efficiency arguments

Static efficiency: Mergers may result in the exploitation of further internal economies of scale and therefore improved productive efficiency (cost savings)

Dynamic efficiency: Increased profits can be used for R&D into new products and new production processes (innovation) creating long term dynamic efficiency; provides funds for capital investment

(2) The role of the capital markets: The capital markets will sort out mergers which eventually fail to deliver the promised benefits. If unsuccessful mergers occur, corporate raiders are always ready to kick out the unsuccessful management who are not making enough profit for shareholders). The survival of the fittest ensures efficiency by keeping management on their toes (thereby reducing X-inefficiencies). It is argued that this is a more effective mechanism than government intervention which will only make matters worse because of the potential for government failure.

(3) Market contestability arguments: There has been a huge growth of interest in the concept of contestable markets and this tends to complement the free market approach to mergers. By concentrating on removing entry barriers to a marker, monopolies and mergers can only remain dominant by producing good products efficiently

(4) The capital investment argument: Lower costs and a bigger combined business may prompt higher levels of capital investment which is good news for the productive capacity of the EU economy

(5) The globalisation argument – mergers and takeovers can reinforce and improve the competitive position of EU companies relative to non EU companies – this is increasingly important in industries that are becoming truly globalised and where increasing returns to scale / falling LRAC is an important ingredient of competitive advantage

(6) Mergers and takeovers as a means of enhancing economic integration within the EU: Mergers and takeovers are an inevitable consequence of the creation of a single market – perhaps the EU competition authorities should take a benign view of mergers if they have at their core, the aim of creating businesses large enough to provide goods and services to a community of over 370 million people (soon to be close to 500 million with EU enlargement)

Economic arguments for not approving a merger:

Under what circumstances might the EU Competition Authorities block a merger/takeover or insist on some form of redress before permitting it to proceed?

(1) **Monopoly power**: Mergers and takeovers create monopolies and market dominance; consumers are exploited and resources misallocated if there are significant entry barriers inhibiting competition leading to market failure and a deadweight loss of economic welfare. In practice, there are always barriers to market contestability especially in industries where set up (fixed / overhead) costs and sunk costs are high. Sunk costs are those that cannot be recovered if and when a business decides to leave a market.

(2) Mixed evidence on benefits of mergers: The evidence is mixed as to whether mergers improve companies' performance, either in terms of profitability, or cost savings – indeed many of the claims for increased efficiency and economies of scale made prior to a merger or a takeover prove to be exaggerated with the benefit of hindsight.

(3) Imperfections in the capital markets: The market for corporate control does not work optimally. Unsuccessful managements in poorly performing businesses may remain in place for a long time. Shares are mainly held by financial institutions but whilst they are the owners, they do not run the companies on a day to day basis. This means there is a divorce of ownership and control with managers pursuing their own interests (salary and welfare) rather than maximising profits for the shareholders.

(4) Employment effects – mergers and takeovers nearly always lead to rationalisation as part of a process of cost cutting but this may be at the expense of jobs (possibility of structural unemployment) and fewer outlets / choice for consumers (an issue of equity)

The record on merger investigations in the EU

The vast majority of cases referred to the EU competition authorities are cleared. Since 1990 the commission has vetted more than **2,300 deals**, blocking only **18 mergers**!

In July 2001 the European Commission has blocked the $45bn deal between US firms General Electric (GE) and Honeywell. Although US competition authorities had given their approval to the deal, the

commission was worried that the integration of Honeywell's avionics and GE's strength in jet engines could lead to dominance of the market.

The EU also blocked a proposed merger between Air Tours and First Choice Travel in 1999 on the grounds that "the proposed operation would create a dominant position in the market for short-haul foreign package holidays in the United Kingdom, as a result of which competition would be significantly impeded in the common market"

Sony and Bertelsmann merger given the go-ahead by EU Competition Commission
The planned merger between music giants Sony and Bertelsmann (BMG) has been given the green light by the European Union competition authorities. The integration of these two businesses will leave four dominant firms in the industry with about 80% of the world music market.

The EU competition commission was moved to investigate the merger because of initial concerns that the deal could lead to higher CD prices and a reduction in consumer choice. The EU must investigate any merger or takeover where there is a significant risk of a "substantial lessening of competition". Japanese Sony and German Bertelsmann are the second and fifth biggest record companies worldwide. The merger will create the world's second largest record label, behind Universal Music. The merged company, to be called Sony BMG, is to be based in New York.

The Japanese and German parent groups argued that their businesses need to join forces to tackle the crisis in the global music industry faced with both pirate CDs and an explosion of illegal music downloading. The deal between Sony and Bertelsmann will leave 80% of the market in the hands of four groups: Sony-BMG, Vivendi Universal, EMI and Warner Music.

Most mergers and takeovers take place in technologically dynamic industries – this has important implications for competition policy. Will a merger act to enhance or slow down the pace of innovation and levels of investment. Each investigation has to be considered on a case by case basis. The EU is making modifications to merger rules to make them more flexible and transparent ahead of the entry into the EU in May 2004 of ten new Member States. All current EU competition rules will apply in those countries from this date.

Adapted from news reports July 2004

14.7 Suggestions for further research on European Competition Policy

- Anti-trust policy http://europa.eu.int/comm/competition/citizen/citizen_antitrust_en.html
- Competition Commission (UK) http://www.competition-commission.org.uk/
- DTI (UK) Consumer and Competition Policy http://www.dti.gov.uk/ccp/
- EU busts plasterboard cartel (2002): http://news.bbc.co.uk/1/hi/business/2519913.stm
- EU Competition News (Legal Today) http://www.legalday.co.uk/current/eumerger.htm
- EU Competition Policy and the Consumer (briefing document) http://europa.eu.int/comm/competition/publications/#consumer
- EU fines food preservative cartel (2003): http://news.bbc.co.uk/1/hi/business/3155384.stm

- European Union Competition Commission
  http://europa.eu.int/comm/competition/index_en.html
- Liberalisation policy
  http://europa.eu.int/comm/competition/citizen/citizen_liberalisation_en.html
- Merger policy http://europa.eu.int/comm/competition/citizen/citizen_mergers_en.html
- Microsoft hit by record EU fine (2004) http://news.bbc.co.uk/1/hi/business/3563697.stm see also Microsoft loses appeal against the EU Competition Commission
  http://news.bbc.co.uk/1/hi/business/3561291.stm
- Office of Fair Trading (UK) www.oft.gov.uk
- State aid policy http://europa.eu.int/comm/competition/citizen/citizen_stateaid_en.html
- Vitamin cartel fined for price fixing (2001)
  http://www.guardian.co.uk/medicalscience/story/0,1129,603206,00.html

15 MEDIUM TERM ECONOMIC CHALLENGES FACING THE EUROPEAN UNION

No country, region or group of nations is immune to challenges and threats to their economic health. The European Union has achieved a remarkable degree of economic integration over the last thirty years but the future cohesion and success of the Union is under pressure from a variety of internal and external sources. We touch upon some of these briefly now although many of them are covered in separate chapters in this study guide. The key issue is whether the EU will be able to agree and implement economic reforms together or whether individual countries will prefer to go their own way in shaping economic policies to suit their own national interests.

Some of the major challenges facing the European Union economy are as follows:

1. **Enlargement:** Successfully incorporating the ten new members into the Single Market and create the conditions in which these countries can achieve sustained economic growth and development
2. **Economic Growth:** Raising the trend rate of economic growth as a means of lifting living standards and promoting increased employment opportunities throughout the EU. Europe needs to get more people of working age into employment. In 2004, over 93 million working-age adults were estimated to be economically inactive across the enlarged European Union together with over 18 million registered unemployed
3. **Productivity:** Increasing productivity throughout the EU. Only a handful of European countries currently have a level of productivity above that of the United States. Partly as a consequence of this, EU GDP per capita, a broad measure of living standards, is currently around 70 per cent of that in the USA
4. **Unemployment:** Europe does have an unemployment problem. Much of the unemployment is long-term in nature. And it contributes to worsening government finances which then act as a constraint on the provision of welfare services including education and health. Europe's employment creation record is poor. Between 1992 and 2002, the EU achieved average annual employment growth of just 0.6 per cent – under half the average annual US employment growth rate of 1.4 per cent.
5. **Challenges of globalisation:** Meeting the competitive challenges from emerging market economies including in particular the rapid growth and development of countries in South East Asia and the Indian sub continent. Fundamental to this will be encouraging entrepreneurship and innovation for example through raising the share of European Union GDP that is allocated to private sector research and development. Asia is set to be the driving force behind the world economy over the next ten years
6. **Inequality:** Reducing some of the deep-rooted geographical inequalities in income and wealth within the European Union so that social cohesion is better protected
7. **Population change:** Addressing the issues posed by Europe's ageing population which will reduce the number of people of working age who are available to support people beyond working age - according to the latest United Nations population projections, the average demographic old-age dependency ratio in the EU is set to rise from 24 per cent in 2000, to 36 per cent by 2025 and 50 per cent by 2050.
8. **Farm reforms:** Implementing far reaching reforms to the Common Agricultural Policy and try to achieve improved trade opportunities for less developed countries
9. **The single currency:** Although the single currency came into being relatively smoothly, there are few signs so far that it has done much to boost the overall macroeconomic performance of the Euro Zone. Indeed economic differences between member nations may be becoming wider rather than narrow

16 REVISION ADVICE

This section contains advice for A2 exams on the Economics of the European Union

The Nature of a Synoptic Paper

Exams on economic aspects of the European Union are all **synoptic** in nature

- Synoptic means **affording a general view of a whole**. QCA offer the following characteristics of synoptic assessment in Economics. It:
  - Test candidates' understanding of the **connections** between different elements of the subject
  - Requires candidates to draw out some of the **connections** between economic theory and the real world
  - Tests whether a student understands the **inter-relatedness** of many economic issues problems and institutions
  - Tests whether a student can **apply economic concepts, theories and techniques** in analysing economic issues and problems and in evaluating arguments and evidence.

This means a synoptic answer at A2 will be both **evaluative** and **integrated**. The highest marks are reserved for candidates who can demonstrate their knowledge and understanding of economics and bring to their answer the **toolkit of concepts, ideas and relationships**. To achieve a very high mark on the module there must be a sufficiently **deep level of analysis and evaluation**.

Synoptic knowledge of the following topics is common to all A2 economics modules:

- Competitive and contestable markets and how they work
- Different market structures including monopolistic and oligopolistic markets
- Economic efficiency within different market structures
- Market failure and the potential for government failure arising from government intervention in the economy
- The role of government intervention in markets and the different instruments of policy that can be applied to a particular problem or issue
- Macroeconomic performance of the economy and a comparison of the performance of different countries
- Processes (relationships) and policies in macroeconomics including the effects of changes in government policy
- International trade and protection and the economic causes and consequences of globalisation

Each of these aspects can be applied directly to the European Union.

16.1 The Economist's Toolkit

One method of classifying essential concepts in the toolkit is by the area of the syllabus

Market Systems	Market failure	Macroeconomics	International Trade
Economic problem	Efficiency –allocative & productive	Circular flow of income & the multiplier effect	Balance of payments
Opportunity cost	Market failure	Economic & development indicators	Gains from trade and exchange between nations
Production possibility frontier	Externalities	Real & nominal GDP & GNP	Comparative advantage
Specialisation & exchange	Equity	Measuring the standard of living	Exchange rates
Supply & demand	Public, merit & demerit goods	Macroeconomic policy objectives and possible conflicts / trade-offs between policy objectives	Purchasing power parity
Price controls and other forms of government intervention	Missing markets	Economic growth & business cycles	Globalisation
Elasticity of demand and supply	Factor immobility	Production & Productivity	Import controls
Consumer & producer surplus	Human capital	Employment & unemployment	**Techniques**
Product & factor markets	Distribution of income	Costs & prices i.e. inflation	Short v long run effects
Costs, revenues & profit types	Cost Benefit Analysis	Aggregate supply & demand	Static & dynamic effects
Economies of scale	Government intervention techniques	Transmissions mechanisms of monetary and fiscal policy	The importance of the "margin" in the decisions of consumers and businesses
Competitive markets & market dominance	Government failure	Fiscal. Monetary, exchange rate and supply side policies	Costs and benefits (including private and social costs and benefits)
Barriers to entry		Automatic stabilisers	Stock & flow values
Contestable markets			

The AQA Exam on the Economics of the European Union

In the AQA Unit 4 exam for the A2 exam, you will be asked to assume the **role of an economist preparing a report** or a **briefing** on a specific topic and asked to **inform** and then **make recommendations.** You will be asked to **justify your recommendations using evaluation and analysis.**

Report format – which style is best?

The mark scheme does not allocate marks explicitly for writing in report format – but you should resist the temptation to write an answer in purely normal essay style. The "report format" encourages you to organise your ideas and select those that you consider most important. The best approach is probably to strike a balance between writing in a structured report format (i.e. with use of sub-headings and bullet-points) and an extended essay format. The most important aim is to find a style that allows you to express your ideas and let an argument evolve. Too much reliance on bullet points will stunt your style and this will show through in most of the assessment criteria!

The assessment criteria for the exam

The AQA Unit 4 paper is marked out of **84** and carries 20% of the marks for the overall A2 exam grade.

Marks are awarded on the basis of your performance in four assessment criteria:

- Knowledge and Understanding (10 marks)
- Application (20 marks)
- Analysis (20 marks)
- Evaluation (30 marks)
- Quality of written communication (4 marks)

Strategies for scoring high marks on the European paper

To maximise your marks on this paper try to remember the following points

Build your knowledge by wider reading: You are not expected to be a complete expert on the European Union – but strong candidates will always demonstrate a sound and broadly-based knowledge and understanding of the core European economics topics. Wider reading and background research on many of the core topics on the syllabus will improve your scores.

Read through the paper carefully: Spend the first **ten minutes** reading carefully through the material presented to you in the exam paper and remember to highlight as many of the key points as you can. The first ten minutes are crucial to **sorting out the nature of the report** and some of the key arguments you might want to explain and develop. Make use of a highlighter pen and write down some key points around the stimulus material whilst starting to think about your basic analysis

Time management is critical! Make sure that you allocate your time carefully so that you **address of all of the tasks set** out in the paragraph entitled the **'requirements of the report'**

It is a very good idea to use the bullet points in the 'requirements of the report' as guidance to the **section headings of the report** when you are writing your answer

The AQA paper allows **100 minutes** – make sure that you leave yourself at least **20-25 minutes** towards the end to make your recommendations and then justify them

Use relevant economic concepts: Include in your answer as many relevant concepts as possible. These concepts might be microeconomic or macroeconomic ideas – providing they are relevant, they allow you to use concepts and theories to explain the background behind a particular issue. You are expected to bring to your answer the economic theories that you were taught at AS and A2!

Clear definitions and explanations: Define your terms precisely – this shows to the examiner that you have a sound understanding. Aim for clear and concise explanations

Don't copy out too much of the stimulus material: Avoid excessive copying of points already covered in the stimulus material provided – always try to bring in your own knowledge and understanding – using evidence to support your arguments. However – remember to make constant reference to the Extracts.

Make use of the data! There is usually plenty of scope for **re-interpreting the data** and presenting it as evidence to support your recommendations

Diagrams are helpful: Theoretical diagrams can be a very effective way of developing your arguments – particularly if you are asked to consider the theoretical effects of a question (for example the welfare

effects of the CAP, the potential gains from trade of new countries joining the EU or the microeconomics of pollution and market failure). This will increase your score on analysis and application.

Legibility and clarity: Your answer should be neatly organised and all diagrams should be fully labelled and explained. Presentation does matter.

IMPORTANT!

The highest marks are reserved for students who make critical use of the data:

Try to make effective use of the data provided and be ready to **critically evaluate the evidence provided**. As the published mark schemes stand at the moment, unless you attempt to criticise the data, you cannot score more than 18 out of 30 for evaluation!

To reach the highest marks for evaluation you must attempt to **challenge the data in some way**. Here are some pointers to sharpen up your evaluative skills in this type of paper:

- **How up to date is the information provided?** Often the data will be one or two years out of date from the time that you sit the paper
- **Has the information changed since the report was published?** Are you aware of what has happened in the intervening period? This might usefully fit into your final conclusions and recommendations
- **Is use made of economic forecasts?** Be aware that with any economic forecast there is always a margin for error! Small percentage errors can cause huge changes in **macroeconomic aggregates** such as the level of government borrowing or measured national income, because we are dealing with huge measures in hundreds of billions of Euros or pounds!
- **Can you extrapolate "going forward" from the end of the data series?** Will a trend continue? Or are there grounds for thinking that the data you have cannot be considered significant because the **time series is simply too short** to draw a meaningful trend
- **From what sources has the data and commentary come from?** Might the information be **biased**? Does it come from official sources or from individual organisations (such as a pressure group) all of whom might have a particular **vested interest** when pursuing their own agenda?
- **To what extent is the data insufficient to come to a clear view?**
    - Which indicators have been included in the material and which have been left out?
    - What extra information would be helpful to you before making your recommendations?
- **Throw some doubt on the way that the data is presented** for example the use of fore-shortened graph axes or two or more charts have cover a different time dimension
- **Contradictory evidence:** Do some of the data and other evidence provided in the case study **contradict** other data in the exam paper?

Make specific references to extracts in your text through the use of references e.g. "as extract A shows", "chart B provides useful evidence on" "figure 1 supports the argument that" and so on – don't ignore the information / data that you have been presented with!

Respond to the data in charts and tables (remember to bring your calculator!) – But use the data rather than simply copy out vast chunks. You might reproduce the data in some format (e.g. by creating a chart or by summarising some relevant data in a small table)

Justify your recommendations!: Be sure to leave enough time not just to make your final recommendations within the report – but also to **justify them** – this is where many of the marks for critical evaluation will come, although evaluation should be included throughout your report if possible

Think on your feet: You simply must work with the information and evidence that you are presented with. Preparation for this paper is well worth it, but on the day itself, you must rise to the challenge of writing a report as a young economist, bringing to your analysis and discussion your broad understanding of the subject and using the tools of the trade – the concepts and arguments that can be **applied** to any question – even if it not immediately familiar to you!

There is no optimum size of answer – if you are writing focused and relevant economics that tries to do exactly what the questions are asking of you, and if you make good use of the data and select the appropriate economic ideas to analyse an issue, then you will always be rewarded by the examiner. On the contrary, reams of irrelevant material score very few marks because they do not meet the assessment criteria of the exam

Topics that have appeared on the AQA Unit 4 Paper

June 2004 Paper

The paper covered aspects of European unemployment and the economic policies likely to be most effective in raising employment levels within the European Union

Feedback from the examiners:

- The best answers entered into the spirit of the case study scenario. They used the information in the Case Study to the full, and combined this with **pre-existing knowledge** of economic facts, principles, and theories. They also used the **language of economics** effectively.
- Facts, figures and comments from the extracts should be quoted throughout the candidate's response and not just as an "add-on" at the end
- The better candidates analysed and evaluated throughout the paper

January 2004 Paper

The paper covered the economics of agriculture and the arguments for and against reforming the Common Agricultural Policy.

Feedback from the examiners:

- Candidates found the topic of Common Agricultural Policy (CAP) accessible and were able to write at considerable length about it.
- Many candidates were aware of the looming EU enlargement and linked this to the topic in a relevant way
- Most students drew a diagram to show the intervention price above the equilibrium price but only better candidates used this to explain how a surplus then developed. Some candidates questioned the morality of a policy which harmed the farmers in the less developed countries

- The better candidates analysed and evaluated throughout the paper and were distinguished through their appreciation of issues such as the unpredictability of agricultural incomes. Another sign of evaluation was an understanding that the CAP disadvantaged the consumer who was faced by higher than necessary prices for food purchases as well as costs to be paid through taxes. An international perspective and consideration of the relationship between Less Developed Countries and the European market was also displayed in many answers.
- Many candidates considered the validity of the data in terms of dates.
- In the best scripts candidates questioned whether there was sufficient information on prices to draw valid conclusions

June 2003 Paper

The paper covered the regional problem in the EU context; measuring the regional divide in the EU and an evaluation of the effectiveness of regional policy in reducing unemployment and raising growth. Discussion of the arguments for and against a substantial rise in EU regional funding (bringing in issues to do with government intervention, enlargement and the allocation of funds within the EU budget)

Feedback from the examiners:

- Weaker candidates simply copied out the data rather than making an appropriate selection from the information and link it directly to the tasks required within the report.
- Better candidates injected something new into the discussion (i.e. brought their wider awareness into the answer but kept it relevant to the issue of the regional dimension)
- The best answers made strong links to economic principles and used wider knowledge to interpret the data
- Good answers adapt their pre-learnt material to the task in hand and avoid the temptation to write an answer to the topic that they expected to appear on the paper
- High level answers address all of the tasks set out in the 'requirements of the report'

January 2003 Paper

The paper covered the EU Single Market and Trade Blocs together with a consideration of the arguments for and against the UK leaving the EU and joining NAFTA – partly from the perspective of a US manufacturing company based in the UK with plants in Western Europe

Feedback from the examiners:

- Stronger answers selected relevant economic principles and applied them to the data. Weaker answers went off on long and irrelevant tangents concerning perfect competition
- Only the best answers examined the data critically

June 2002 Paper

Issues relating to possible UK membership of the single European currency and the importance of convergence as one of the tests behind any decision to join the euro

Feedback from the examiners:

- This question on the Euro was welcomed by many students, but too many relied on pre-rehearsed answers. Only the best answers *adapted their pre-learnt material* and sought to apply it and adapt it to the particular questions on the paper
- Application skills are often successfully demonstrated through the use of theoretical diagrams

January 2002 Paper

The widening of European integration and the potential costs and benefits of EU enlargement both for accession countries and also existing EU members including the UK