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The Impact of the EC's Internal Market on Nonmember Countries:  
The Case of EFTA

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Abstract

This paper presents an overview of the impact of the EC's Internal Market on the EFTA countries. It starts by examining the history of EC-EFTA relations; the institutional and legal changes that closer cooperation may require; and the general implications of the Internal Market Program for EFTA countries. This is followed by an exploration of specific issues relating to the goods trade, transport services, labor mobility, financial services and capital flows. Subsequent chapters focus on the potential impact of the EC's proposed monetary unification on EFTA countries and the implications of the EC's efforts in the area of tax harmonization.

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### Summary

The member states of the European Community (EC) and the European Free Trade Association (EFTA) are one another's most important trading partners. Nevertheless, the EC is a far more important trading partner for the EFTA countries than the EFTA countries are for the EC.

A major step in EC-EFTA relations came in 1984, when Ministers of the EC and EFTA issued the so-called Luxembourg Declaration, which envisaged intensified and expanded cooperation between the two organizations and the creation of a dynamic European Economic Space (EES).

In 1985, the EC Commission issued a White Paper, Completing the Internal Market, and the Single European Act was adopted in 1986. The White Paper laid out legislative plans and a timetable for the Internal Market Program, including the free movement of goods, services, persons, and capital--the four freedoms--within the EC. The Single European Act made the Internal Market Program possible by modifying the EC's rules in a number of areas.

A 1989 speech by Jacques Delors, President of the EC Commission, inviting EFTA to form a more structured relationship with the EC, intensified efforts to clarify EC-EFTA relations. In the same year, EFTA agreed to talks on this issue, and working groups began to investigate the institutional and legal changes prerequisite to a more structured relationship. Formal negotiations on forming the EES started in June 1990.

This paper surveys the likely impact of the the EC's Internal Market on the EFTA countries. It examines the origins of the EC and EFTA and the history of their relationship; the institutional and legal changes that may be needed for greater joint cooperation; and the implications of the Internal Market for trade, production, and resource allocation in the EFTA countries. It then explores issues relating to trade in goods, transport services, labor mobility, financial services, and capital flows. Finally, it examines the potential impact of the EC's plans for monetary unification on EFTA countries and the implications of the EC's efforts regarding tax harmonization.

## I. Introduction

### 1. Overview

The member states of the European Community (EC) 1/ and the European Free Trade Association (EFTA) have a special relationship, based on geographic proximity, a shared history, a common set of fundamental values and, as some see it, a shared destiny. 2/ 3/ They are also one another's most important trading partners. The EC countries account for over half of the EFTA countries' exports and more than 60 percent of their imports (Chart 1). Indeed, the EFTA countries trade as extensively with the EC countries as the EC countries trade among themselves. On the other hand, the EFTA countries by themselves do not constitute a cohesive area. Intra-EFTA trade is--with the exceptions of trade between Switzerland and Austria, and between Finland, Norway and Sweden--insignificant relative to the trade of individual EFTA countries with the EC.

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

Although the EC and EFTA have had close relations, the two organizations have taken on very different forms. The EC sought from the beginning to move towards a broad-based economic, social and political union, which has given increased authority and power to its central governing bodies. The EFTA, on the other hand, has remained loosely knit, because of its members' desire to preserve national sovereignty.

EC-EFTA relations have evolved rapidly in recent years. A major step came in 1984, when ministers of the EC and EFTA agreed that renewed efforts were needed to deal with the changing global economy. The so-called Luxembourg Declaration envisaged intensified and expanded

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1/ Technically, it is the European Communities, but the terms are used interchangeably.

2/ The EC member states include Belgium, Denmark, France, Greece, Germany, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Spain and the U.K., while the EFTA is made up of Austria, Finland, Iceland, Norway, Sweden and Switzerland. The U.K. and Portugal were EFTA members, but they left EFTA and joined the EC in 1973 and 1986, respectively.

3/ The preambles to many statements on relations between the two organizations, including joint declarations, emphasize this commonality, e.g. "EFTA Summit..." (1989) and European Community (1989).

cooperation between the two organizations, including the creation of a dynamic European Economic Space (EES)--which at the time was left undefined.

Attitudes toward integration in Western Europe began to evolve rapidly after the White Paper, Completing the Internal Market, was issued by the EC Commission in 1985 and the Single European Act was adopted in 1986. 1/ The White Paper laid out full legislative plans and a timetable for the Internal Market Program, which was to clear the way for the free circulation of goods, services, persons and capital--the four freedoms--within the EC. The Single European Act made the Internal Market Program possible by modifying the EC's rules in a number of areas, including the replacement of unanimity rules by qualified majority requirements for voting in a number of pivotal areas. 2/

While EFTA members do not appear worried that the Internal Market Program will cause the EC to become more protectionistic, they have become increasingly concerned about their competitive position vis-à-vis the EC as the Program has advanced and gained momentum. 3/ 4/ Efforts to clarify EC-EFTA relations intensified in 1989. Much of the impetus came from a speech by Jacques Delors, President of the EC Commission, to the European Parliament in January 1989, in which he invited EFTA to form a more structured relationship with the EC, the Delors Initiative. During 1989, not only did EFTA agree to such talks, but working groups were formed to study cooperation in a number of areas, including the institutional and legal changes needed to allow the development of a more structured relationship--this was to be called the Oslo-Brussels process. In December 1989, ministers of the EC and EFTA met and agreed to hold negotiations of forming this more structured relationship; concrete negotiations began in June 1990.

## 2. Outline of the study

This paper provides an overview of the likely impact of the creation of the EC's Internal Market on the members of EFTA. The focus is on the four freedoms and the institutional and legal changes that may be required to allow increased economic cooperation between the EC and

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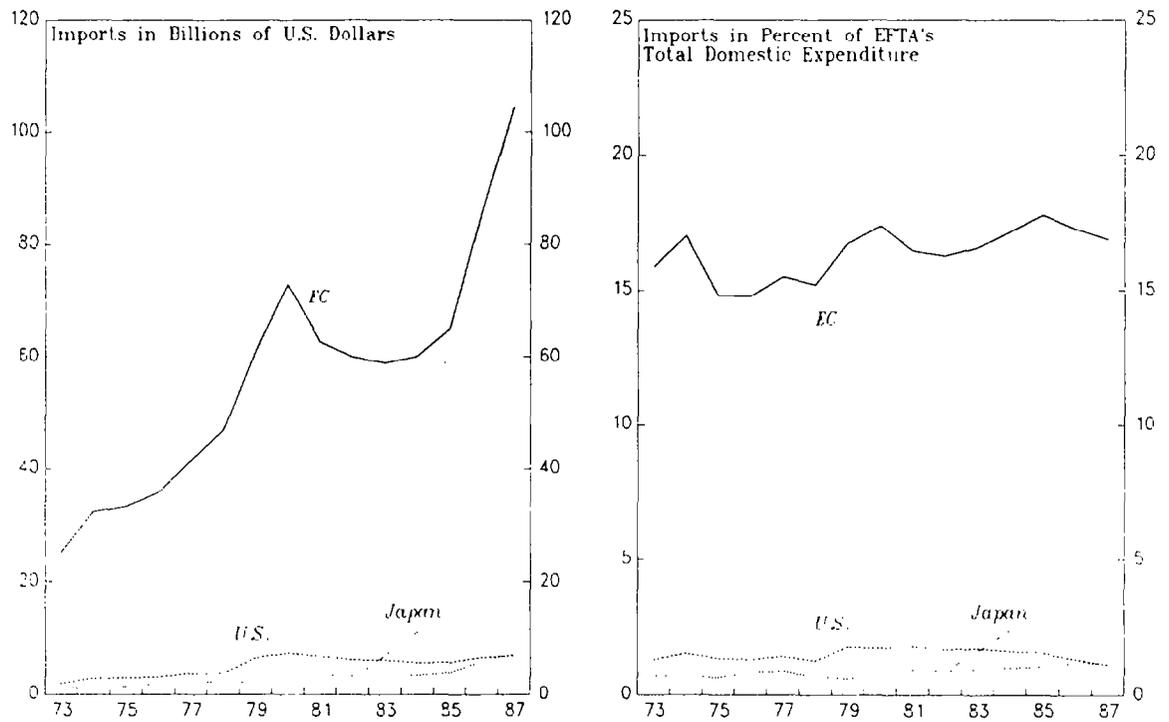
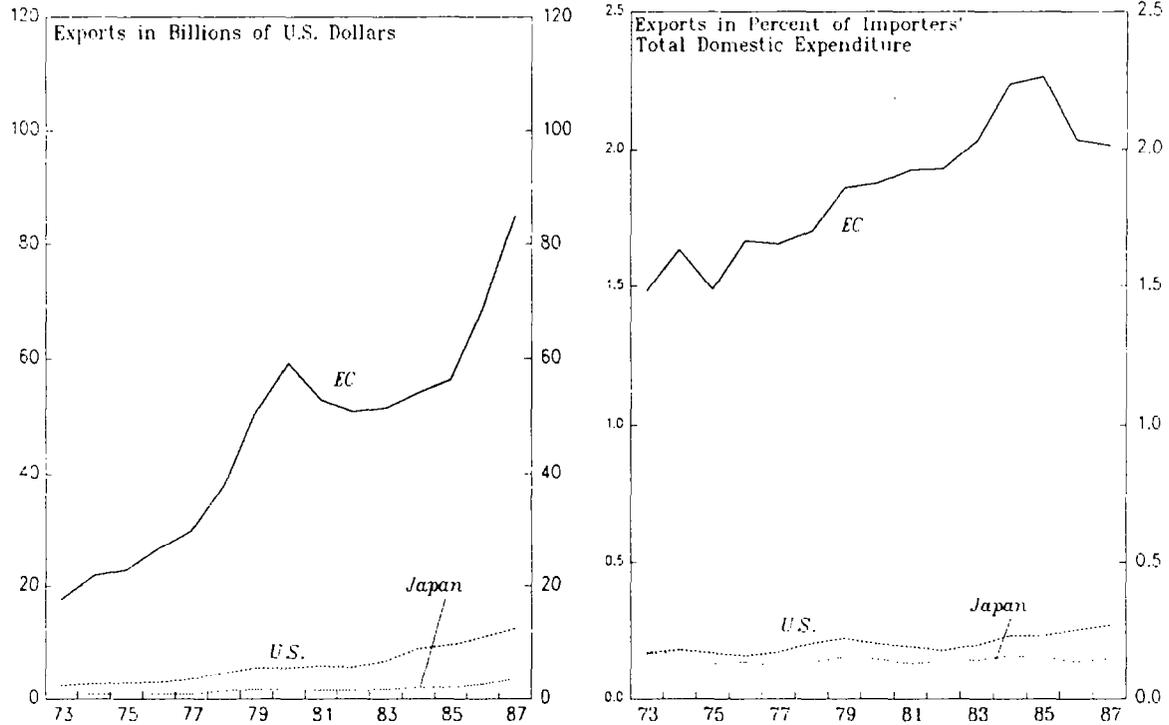
1/ EC Commission (1985) and (1986a).

2/ For details on the definition of a qualified majority, see Article 148 of the EEC Treaty.

3/ By end-1988, the halfway point to the start of the Internal Market, the EC Commission had submitted to its Council of Ministers over half of the 279 legislative proposals envisaged in the White Paper, and the Council had adopted 45 percent of the proposals. "Europe without Frontiers...", (1989), p. 3. By end-1989, the Commission had submitted virtually all of its proposals and the Council had adopted almost two thirds of them. Delors (1990), p. 27.

4/ Concerns about the Internal Market seem to be the primary reasons for Austria formally applying for membership in the Community in 1989.

CHART 1  
EFTA  
TRADE WITH SELECTED PARTNERS

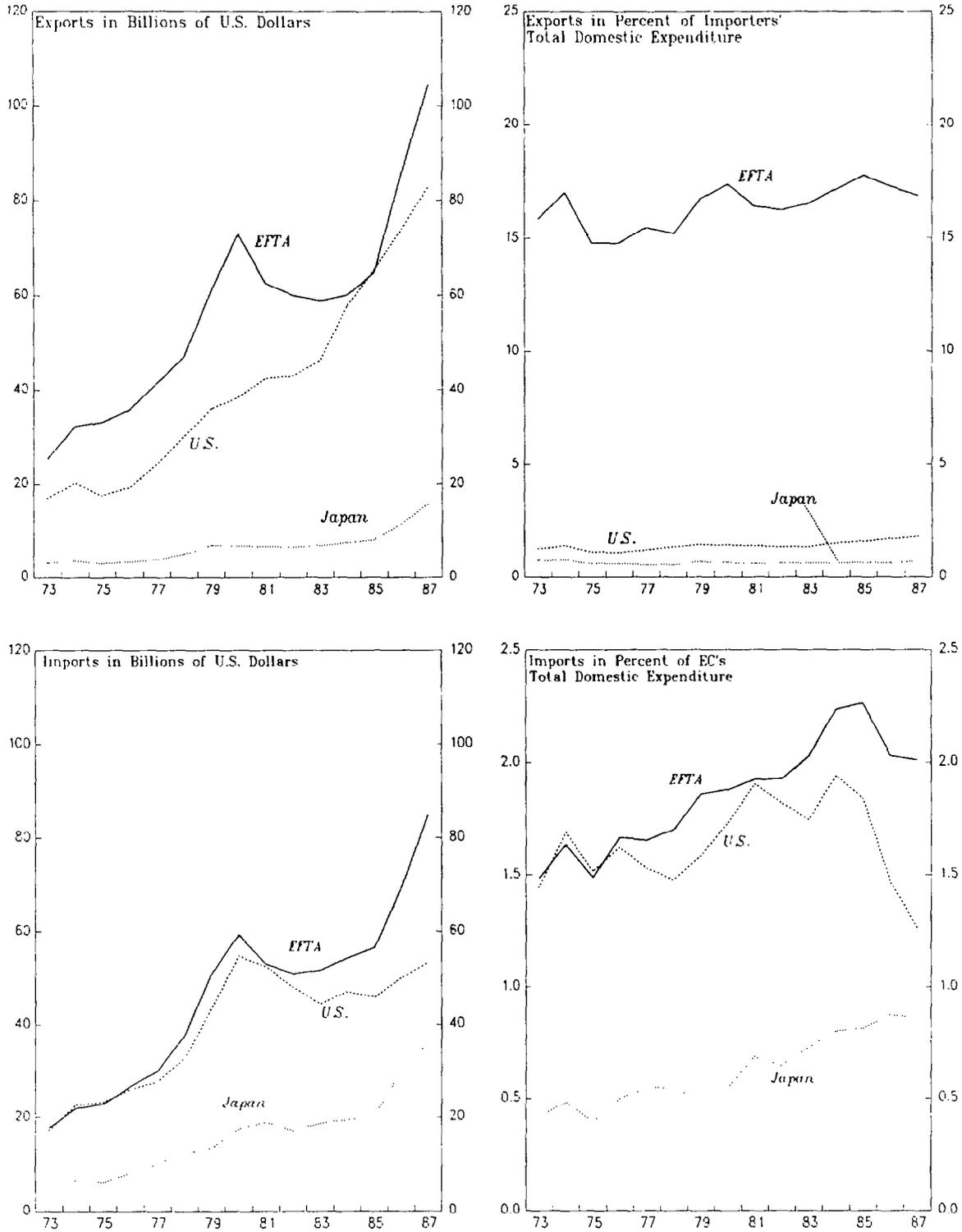


Sources: IMF, IFS, and DOT; and staff calculations.



EC

TRADE WITH SELECTED PARTNERS



Sources: IMF, IFS and DOT; and staff calculations.



EFTA. However, although not formally part of the negotiations, certain tax issues are also raised. The body of the paper is in ten parts and a glossary is included as an appendix. The first part--Chapter II--provides background, discussing the origins of the EC and EFTA and the history of their relationship. Its main focus is on events since the Luxembourg Declaration, especially since the Delors Initiative. However, the discussion in the text only goes through the end of 1989; more recent developments are largely covered in footnotes.

Chapter III discusses institutional and legal issues which may be needed to allow greater EC-EFTA cooperation. This section focuses on the institutional changes that may be needed for the creation of the EES; the need for greater mutual recognition in civil law; and issues relating to corporate law and industrial and intellectual property rights.

Chapter IV examines the implications of the Internal Market for trade, production and resource allocation in the EFTA countries. It begins by examining the structure of EFTA's foreign trade. Next, the effects of economic integration are examined. This is followed by a discussion of the benefits and the costs of closely cooperating with the Internal Market, possibly through the EES. Numerical estimates of the impact are avoided because of uncertainties regarding the form the Internal Market will take and because the specification of the underlying model makes empirical estimates indicative at best.

Chapter V examines issues related to trade in goods. The focus is on industrial goods, but fish and fisheries-related issues are also covered. Agricultural trade is not discussed because the EC and EFTA have agreed that talks will not cover EFTA's participation in the EC's Common Agricultural Policy. <sup>1/</sup> The main issues covered are border controls, technical regulations, public procurement policies, rules of origin and state aid.

Chapter VI covers transport services including road haulage, marine transport and air transport. Road transport of passengers, rail transport and inland waterways are omitted both because the EC has made little progress in its internal discussions on these areas and because they are relatively less important for the EFTA countries.

Chapter VII examines issues relating to labor mobility.

Chapter VIII examines trade in financial services, primarily banking and insurance, and movements of capital.

Chapter IX goes a step beyond the Internal Market Program and examines the potential impact of the EC's plans for monetary unification

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<sup>1/</sup> However, the highly protective agricultural policies of several EFTA members could become an issue in the future.

on the EFTA countries. Special attention is given to the possible participation of EFTA members in the European Monetary System (EMS), since free trade in financial services may result in an increasing need for greater monetary and economic cooperation.

Chapter X examines the implications of the EC's efforts regarding tax harmonization in the areas of indirect taxes and capital taxation.

The Chapter XI provides a summary and conclusions.

## II. Background

### 1. The origins of the EC and EFTA

The issue of economic and political integration has been on the Western European agenda since the end of World War II. 1/ The first step towards the formation of the European Communities (EC) was taken in 1951, when Belgium, France, Germany, Italy, Luxembourg and the Netherlands formed the European Coal and Steel Community (ECSC) with a supranational administrative body, the High Authority. 2/ In 1955, after the failure of plans to form a European Defense Community and a European Political Union, the same six countries agreed in principle to form a common market, which envisaged the free movement of goods, services, labor and capital--the four freedoms. The founding document of the European Economic Community (EEC)--the EEC Treaty signed in March 1957--embodied a vision for broad-based economic integration going well beyond simple cooperation on trade issues.

Talks on a larger Western European free trade zone--instigated by the U.K.--failed in 1958, partly because of British insistence on preferential treatment of its Commonwealth partners and partly because the EC Commission in Brussels, as well as several EEC member countries, feared an undermining of the EC consolidation process. In reaction, Austria, Denmark, Norway, Portugal, Sweden, Switzerland and the U.K. formed the European Free Trade Association (EFTA) in January 1960; Finland joined in 1961 3/ and Iceland in 1970. 4/

### 2. The Free Trade Agreements of 1972/73

The EC was more cohesive from the outset than EFTA. 5/ The EFTA countries tried to bridge the opening gap between the two blocs. As early as 1961, the EFTA countries applied bilaterally to the EC, either

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1/ In 1946, Winston Churchill suggested this to promote recovery and stability in war-torn Europe. See Siegler (1961), p. 4.

2/ The European Communities of today comprise the European Coal and Steel Community (ECSC), the European Economic Community (EEC) and the European Atomic Energy Community (EURATOM), which all use the EC Commission as their secretariat.

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

4/ European Documents (1986) and du Bois (1987), pp. 18-26.

5/ Bilateral trade flows hint that political rather than economic considerations governed many countries' decisions on which organization to join. Wijkman (1988), p. 4, presents data on trade flows between EFTA and EC countries which show that Germany was a major market for all EFTA countries, while some EFTA countries, e.g., Sweden and Switzerland, were more important for Germany than some of its fellow EC members. Trade between the Nordic and Alpine members of EFTA was minimal.

for association or membership. However, the political climate in Western Europe and setbacks in the EC's internal integration delayed new accessions to the EC in the 1970s. Negotiations between four countries--Denmark, Ireland, Norway and the U.K.--and the EC began in June 1970 and resulted in Danish, British and Irish membership in 1973. Denmark and the U.K. left EFTA concurrently. Norway chose not to join after a national referendum on membership turned it down.

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

To help solve problems caused by differing trade policies regarding third countries, a system of rules of origin was developed. The initial bilateral provisions of the FTAs treated the EC as one country and did not allow for cumulation of processing by EFTA members.

The Free Trade Agreements of 1972/73 helped to integrate the Western European market for industrial goods. For the EFTA countries, the FTAs still provide the legal framework for more than half of their foreign trade. 1/

### 3. The Luxembourg Declaration and its Initial Follow Up

In April 1984, ministers from all 18 members of the EC and EFTA agreed on a second generation of EC-EFTA initiatives in the so-called Luxembourg Declaration. Faced with a changing global economy, Western European countries saw a need for increased cooperation, including the creation of a "dynamic European Economic Space (EES)," a concept which, however, was not given a precise definition. 2/ The accord focused on three questions. 3/ First, it supported continued efforts to combat protectionism and encourage free trade in Western Europe. Second, it stressed continued pragmatic and flexible cooperation beyond the framework of the FTAs, including such areas as joint research and development projects. Third, it encouraged increased consultations and exchanges of information to help find equitable solutions between trading partners and foster an open and multilateral trading system.

In September 1984, the High Level Contact Group, representing the member countries of EFTA and the EC Commission, began holding semi-

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1/ See EFTA (1987a), p. 95.

2/ Lichtenstein is also envisaged as being a participant in the EES.

3/ See EFTA (1987a), pp. 106-111; for text, see pp. 159-161.

annual meetings to monitor progress towards implementing the Luxembourg Declaration. At its first meeting, it agreed that major areas of focus should be on EC-EFTA cooperation in eliminating technical barriers to trade, particularly in the areas of technical regulations and in simplifying rules of origin and border formalities.

In May 1985, the EC Commission reconfirmed its commitment to the Declaration and set four criteria for further cooperation. 1/ First, the EC's independent powers of decision must not be affected. Second, eliminating technical barriers to trade and simplifying administrative formalities at EC-EFTA frontiers should be pursued in parallel to the progressive integration of the EC's internal market. Third, no field should be excluded a priori; and, fourth--to discourage a pick and choose policy--the EES can only be achieved if the costs and benefits are shared fairly, requiring real reciprocity between the partners.

#### 4. The White Paper and the Single European Act

A turning point came when the EC Commission issued the White Paper, Completing the Internal Market in 1985. 2/ The White Paper was a comprehensive document which laid out a step by step plan to create an integrated, coherent economic framework for all of the EC by January 1, 1993. The plan contained some 300 legislative proposals--later cut to 279--designed to eliminate all man-made physical, technical and fiscal barriers which could hinder the free functioning of a single market in the EC. The program was also seen as requiring a harmonization of laws needed for the functioning of a common market. The White Paper also set a timetable, calling for some actions to be taken as early as 1985. However, in 1987, the Commission moved up the timetable for drafting proposals, with the goal of drafting all proposals by the end of 1988 to allow four years for their adoption and implementation.

The Internal Market Program required certain amendments to the EEC Treaty. These were set out in the Single European Act, which was signed by the 12 EC governments in 1986, with effect from July 1987. 3/ The most important change was that it replaced the requirement that decisions be taken unanimously with one allowing decisions to be taken with a qualified majority in all areas regarding the Internal Market with the exception of fiscal provisions, provisions relating to the free movement of persons and the rights and interests of employed persons. It also enhanced the role of the European Parliament in the decision-making process and made foreign policy cooperation a formal part of the

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1/ The conditions are summarized in EC Commission (1986b), p. 1.  
2/ EC Commission (1985).  
3/ EC Commission (1986c).

EC's activities. The Act was seen as important because it provided the political impetus and the legal framework needed to achieve a truly unified market by 1992. 1/

5. EFTA's response to the White Paper

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

Although progress was made, the EFTA countries were divided in their negotiation strategy with the EC. While aware of the potential gains from negotiating as a bloc, they were not formally committed to this path. Individual members sought bilateral talks in areas they saw as either especially important to them or as likely to yield concessions from the EC, e.g., Iceland sought bilateral talks on fishing rights and trade in fish, Switzerland on financial services, labor mobility and road transport. This led to a situation where the individual EFTA members also avoided negotiations in areas where they might suffer a net loss or where concessions might need to be granted, giving rise to the criticism that EFTA members wanted to "pick out the raisins."

6. Recent developments

Cooperative efforts between the EC and EFTA accelerated following a speech to the European Parliament by EC Commission President Delors on January 17, 1989. In the speech, he said that progress in the pragmatic, step by step cooperative process that had started with the Luxembourg Declaration was becoming increasingly difficult. He saw two options for future relations. Either the present pattern of bilateral relations could continue, with the aim of creating a free trade area encompassing the Community and EFTA, or the two blocs could strive for "... a new, more structured partnership with common decision-making and

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1/ European Documents (1988), p. 23.

administrative institutions to make our activities more effective and to highlight the political dimension of our cooperation in the economic, social, financial and cultural spheres." 1/

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

*EC-EFTA cooperation was the main topic of the meeting of EFTA heads of state in March 1989. At the meeting, they reaffirmed their commitment to the EES and voiced support for the Delors Initiative. 2/ They proposed a two track approach to future talks, with the follow-up to the Luxembourg Declaration focusing on specific topics and this new approach examining forms of cooperation to achieve a more structured relationship. This statement was also important because it showed that EFTA could agree on a political platform going beyond the lowest common denominator and that the ambition of the EFTA governments was greater than was earlier believed. 3/ 4/ Soon after, at an EC-EFTA ministerial meeting in Brussels, further support was given to this new cooperative process--called the Oslo-Brussels process--when most EC ministers also confirmed their support of the Delors Initiative.*

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

The High Level Steering Group met in October 1989 to discuss the findings of the working groups and to decide whether to propose formal negotiations on intensified cooperation. While details were not disclosed, the meeting was a success. However, the EC restated its unwillingness to allow changes that would interfere with its autonomous

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1/ Delors (1989), p. 17-18.

2/ For text, see "EFTA Summit...", (1989), pp. 4-7.

3/ "Editorial--Two Tracks...", (1989), pp. 1-3.

4/ Prior to the issuance of this statement, it may be argued that the common bonds in EFTA were that its members were not EC members and that they had similar FTAs. However, this statement appeared to show that the group was now united with a common purpose.

decision-making process. EFTA members, while expressing a wish to participate in the four freedoms, also wanted to remain independent from the EC and to retain autonomy in their relations with third countries. They also did not wish to participate in the Common Agricultural Policy (CAP) and did not favor the removal of borders between the blocs, as was envisaged within the EC.

At their meeting in December, the EC and EFTA ministers decided to start negotiations on expanded cooperation in the first half of 1990, with the aim of concluding them as rapidly as possible. In their statement, they noted a convergence of views on determining the scope and content of a renewed framework for EC-EFTA relations. 1/ Three objectives were cited:

--to achieve free movement of goods, services, capital and persons on the basis of the relevant *acquis communautaire*, [--the EC's achievements to date--] to be identified jointly; exceptions, justified by considerations of fundamental interests, as well as transitional arrangements, could be matters of negotiation; equal conditions of competition should be ensured;

--to strengthen and to broaden cooperation in the context of the Community's actions in other areas, such as research and development, the environment, education, working conditions and social welfare, consumer protection, programs for small and medium-sized enterprises and tourism;

--to reduce economic and social disparities between their regions. While ensuring the decision-making autonomy of the two blocs, it was agreed that efforts would be made to facilitate a consensus on decisions relating to the EES. It was also agreed that steps be taken to permit "appropriate formulae to ensure the direct effect of common legislation, surveillance of its implementation as well as judicial monitoring". 2/ The ministers envisaged the full implementation of the four freedoms, with only limited scope for exemptions, and a broadening of EC-EFTA relations, possibly including significant legal and institutional actions that could require changes in the relationship between the two blocs and in the structure of EFTA. 3/

While some EFTA members voiced a preference for a rapid conclusion of the discussions--ideally by end-1990--EC representatives noted that

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1/ "EC and EFTA...", (1989).

2/ Ibid.

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

the discussions only needed to be concluded by end-1992. 1/ Under the circumstances, the latter date would seem more likely, since EC-EFTA agreements cannot be concluded in many important areas before the EC formulates its own position.

Formal negotiations began in June 1990. At this stage, there appear to be three major problem areas. The first, and most difficult, involves the extent to which EFTA will be allowed to participate in the decision-making process for laws and regulations governing the EES. The second is the degree to which EFTA must strengthen its institutional structures as part of the EES. The third problem area is the extent to which EFTA countries will be granted exemptions--permanent or temporary--from implementing EC laws in the areas covered by the EES agreement.

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

### III. Institutional and Legal Issues

#### 1. Introduction

This chapter examines a number of institutional and legal issues that may arise as a result of efforts towards intensified EC-EFTA cooperation. 1/ The first section examines the need for increased mutual recognition in civil law, particularly with regard to commercial judgments, and the institutional changes that may be required as part of the creation of the EES. The second section covers corporate law and the third discusses industrial and intellectual property.

#### 2. Mutual recognition under civil law and institutional issues

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

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

Allowing judicial monitoring and enforcement of joint agreements, as well as creating common decision making institutions, would require changes in both the EFTA and in EC-EFTA relations. Some of these changes could prove difficult to implement. At present, EFTA has no supranational power over its own members. Decisions are by consensus and EFTA has only limited facilities for monitoring its membership and no coercive powers. Institutions with these powers may be needed if cooperation both within EFTA and between the EC and EFTA is to be enhanced. In fact, the EC is insisting that the creation of such

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1/ For a very good overview of the legal and institutional issue raised by the EES, from the EFTA's perspective, see Norberg (1990).

institutions is a precondition for the successful conclusion of the EES negotiations. However, EFTA members will probably seek to minimize the powers of any such institutions to preserve the greatest possible degree of national sovereignty.

Perhaps the most difficult issue in the EES negotiations involves EFTA participation in the legislative process on issues relating to the EES. The EC has stated that it will not compromise its control over its legislative process, 1/ although it will allow the EFTA countries to express their views on legislative issues. EFTA members, on the other hand, are apparently insisting on a "genuine" joint decision-making mechanism on issues relating to the EES. It is possible that the EFTA countries may accept a junior status, if they are allowed to present proposals and they are given assurances that attempts will be made to reach a consensus on decisions affecting EFTA before the EC votes on the issue. However, in general, it appears the laws of the EES will be based on EC legislation, with the EFTA countries incorporating this legislation into their own laws as necessary. Exceptions would require special negotiations outside of areas not covered by EES cooperation. The number and type of exceptions, as well as the issue of whether the exceptions will be made on a temporary or permanent basis, may also provide the basis for additional difficult negotiations. 2/

The EC may also not wish to give up full control over judicial oversight and enforcement of judgments. On the other hand, the EFTA countries may be unwilling to give the EC full power over inter-bloc disputes. They may insist that such disputes be settled before a new judicial institution, which would presumably be an expanded version of the EC's Court of Justice. 3/ However, a compromise seems possible, if, as noted, such a court bases its decisions on the EC's legislation, rulings and principles of law.

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

2/ At this stage, the EC Commission has stated that EFTA is requesting too many exceptions, while the EFTA has emphasized the brevity of the list. Factions within the EC, including the Foreign Affairs Committee of the EC Parliament have argued that no exceptions should be granted, even on a temporary basis.

3/ Some prescreening system would also be needed to avoid the awkward situation where the broader court could be asked to overrule a decision by the EC's Court of Justice.

These areas are being examined as part of the Oslo-Brussels process. However, the findings have not been published. If key decision are to be made jointly, it would appear that some form of joint Council of Ministers would be helpful to advance those decisions. However, it is not likely that this group would be given any direct power over the EC's legislative process.

### 3. Corporate law

The EC's laws on company establishment and merger policy are of vital interest to EFTA members. However, while talks within the EC have centered on details of trans-Community corporations and limits on intra-Community mergers, EFTA members are more concerned about being "able to conduct mergers, acquire subsidiaries and establish business throughout the European Economic Space on an equal footing with companies in the EC countries." 1/ While EC members states must allow citizens and firms of other member states the same rights and privileges to engage in business activities as their own citizens, rules differ regarding third countries. The majority permit companies of third countries to establish economic enterprises and acquire domestic firms in most sectors. However, France, Greece, Ireland, Portugal and Spain, require official approval. Thus, a key issue is whether the EC will apply unified rules to all third countries and, if so, whether this will be based on reciprocity.

The outcome for third countries is not yet clear. While a number of directives have been passed, many important issues are outstanding. The focus will probably not shift to third countries until most internal issues have been settled. Few predict a protectionist outcome; however, there have been calls for fair or similar treatment as the price for non-discrimination. A major agreement on merger policy in December 1989, 2/ did not have a reciprocity clause, but it did permit the Commission to negotiate with third countries that discriminate against EC firms in takeovers or mergers. In March 1989, an EC-EFTA expert meeting was held to discuss EC directives that had been passed. The EFTA representatives examined how the directives differed from the EFTA countries' company law and a meeting was planned to define the areas where further cooperation was needed. Further discussions were presumably held by joint working groups under the Oslo-Brussels process, although their findings remain confidential.

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1/ Council of State Concerning Finland's ... (1989), p. 38.

2/ The regulation, which was approved after sixteen years of negotiations, with limited exceptions, gave the Commission the sole power to block or permit mergers involving companies with combined turnover of over ECU 5.0 billion of which ECU 250 million of each company was within the EC; smaller mergers remained under the jurisdiction of national authorities. The regulation is to take effect in the fall of 1990; however, certain revisions suggested by the European Parliament will need to be considered.

One potential problem area is regulations governing foreign ownership of domestic firms. In the EC, these rules are currently set by the individual member states and are subject to much variation. However, the EC plans to harmonize this legislation. This could put several EFTA members in a difficult situation. At present, all EFTA members, except Austria, limit foreign ownership of private, non-financial joint stock companies to keep strategic industries--or all industries--under domestic control. The Nordic members of EFTA have laws limiting both foreign ownership of domestic firms and the creation of joint stock companies by foreign firms, with special permission required for exemptions. Swiss firms, while not subject to legal limits, have a gentlemen's agreement on the the sale of registered stock in domestic firms to foreigners, and until late-1988, none was sold. 1/

Some EFTA members believe that the price for equal treatment within the EC will be reciprocity, including liberalizing and harmonizing rules on foreign investment. 2/ This may be why some EFTA members have eased their rules on foreign ownership. In 1987, Finland raised its limit on foreign ownership of domestic corporations from 20 percent to 40 percent, while in 1989, Norway raised its limit from 20 percent to 33 1/3 percent. Sweden is preparing similar legislation. The Finnish Parliament has set up a committee to study the further liberalization of foreign ownership rules. However, new legislation is not likely to be enacted before 1992.

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

Proposals regarding European Companies were put forward in July 1989. They are EC-chartered, limited liability, joint stock companies, headquartered in a member state, with capital exceeding ECU 100,000. While not receiving preferential treatment under national law, they are to be free from many of the constraints of functioning within twelve

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

2/ E.g., Council of State Concerning Finland's ... (1989), p. 38.

distinct national legal systems by dint of their EC charter. Rules governing foreign participation are to be developed. However, should the EES discussions be successful enough to include competition policy, it is likely that this legislation, as well as the EEIG, will also cover EFTA members.

4. Industrial and intellectual property rights

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

Some progress also seems to be taking place in trademark legislation. After over ten years of talks, the first directive was passed by the Council in December 1988. Its aim was to harmonize the essential points of the trademark laws of the member states. In April 1989, EFTA and EC experts met on this topic. Apparently, the talks focused on modifying the multilateral Madrid Agreement on trademarks, <sup>1/</sup> so the Nordic countries would be willing to sign and on making the EC directive compatible with the revised agreement.

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

The EC is deadlocked on patent legislation. A Community Patent Convention (CPC) was agreed on in 1975 and ratified by seven member states. However, implementation required unanimity and several members were slow to agree; Denmark and Ireland were constitutionally barred from signing. In December 1989, nine members agreed to a revised CPC, while a tenth gave conditional approval and Denmark and Ireland could

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<sup>1/</sup> Twenty-eight countries, including most EC countries and Austria and Switzerland, have signed the Madrid Agreement.

still not sign. 1/ The CPC may be revised to allow only signatories to use the patent. Four EFTA members have ratified the 1977 European Patent Convention, which is similar to EC legislation. Norway signed the agreement but did not ratify it, while Finland, the only EFTA member not to sign, has harmonized its legislation with the convention. EC-EFTA talks probably must await a unified EC position.

Should the Oslo-Brussels process prove successful, talks in all of these areas could come under the process. Otherwise, they will probably be handled on a case by case basis, generally involving either bilateral or inter-bloc talks. However, in some cases, e.g., the Nordic group in copyright legislation, subgroups of EFTA members could become involved.

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1/ Passage might be academic, since the costs of registering patents under this convention are expected to be high, perhaps prohibitively high.

#### IV. Effects of Integration

##### 1. Introduction

The EC Internal Market Program has potential effects on the allocation of resources not only within the EC but also in countries with close ties to the Community like the EFTA countries. Increased integration in the EC is widely expected to stimulate the EC economies and to contribute to a better utilization of their resources. For the EFTA countries, there are in principle two issues involved: whether participation in the EC integration process--assuming that the EC would agree to this--would yield substantive economic gains; and whether the decision not to join would entail substantive losses.

This chapter examines the likely effects of the Internal Market on trade and resource allocation within both the EC and EFTA. The implications for the EFTA countries will depend on both the form of the Internal Market and the future relations between the EC and EFTA countries. Although many institutional arrangements may be possible, it is convenient for analytical purposes to concentrate on two highly stylized cases: a non-integration case where the EFTA countries do not integrate further with the EC; and an integration case where they fully participate in the economic dimension of the EC integration process. <sup>1/</sup> Arrangements in between, which seem more likely than either extreme, may be viewed as a combination of these two cases.

##### 2. The structure of EFTA foreign trade

The EC has long been the EFTA countries' most important trading partner (Table 1). This is particularly the case for Austria and Switzerland which traditionally have been more closely linked to the EC core than the Nordic EFTA countries. Among the Nordic countries, the sharpest increase in trade with the EC in recent years has been registered in Finland although in comparison with the other EFTA countries, Finland still has relatively little trade with the EC, a reflection of traditionally extensive commercial relations with the U.S.S.R. and Sweden. Norway is the only country in which trade with the

EC generally has been decreasing in recent years. However, in relative terms, it still exports more to the EC than any other EFTA country. In both Iceland and Sweden--the smallest and largest exporter among the EFTA countries--the Community has gained a larger share of both exports and imports.

The trade of the EFTA countries is heavily concentrated in manufactures, which account for over four fifths of total EFTA exports (Table 2). Reflecting the dominant role of industrial products, EFTA

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<sup>1/</sup> This does of course not necessarily imply that the EFTA countries must become full Community members.

Table 1. EFTA: Trade With Selected Partners 1983-87

(In percent)

	Exports	Imports
Austria	100.0	100.0
EC	58.9	65.1
Of which:		
France	4.1	3.9
Germany	32.2	42.5
Italy	9.5	9.0
EFTA	11.0	7.6
Of which: Switzerland	7.2	4.7
Other	30.1	27.3
Of which:		
United States	3.9	3.4
USSR and other nonmember countries	7.0	6.1
Finland	100.0	100.0
EC	39.0	40.2
Of which:		
France	4.4	15.6
Germany	9.9	3.7
United Kingdom	11.0	7.0
EFTA	20.6	18.0
Of which: Sweden	13.7	12.4
Other	40.4	41.8
Of which:		
United States	5.8	5.2
USSR and other nonmember countries	21.1	20.4
Iceland	100.0	100.0
EC	51.4	51.7
Of which:		
Germany	9.6	14.0
United Kingdom	17.4	8.5
EFTA	8.9	20.1
Other	39.7	28.2
Of which: United States	23.7	7.1
Norway	100.0	100.0
EC	67.9	48.8
Of which:		
Denmark	4.1	7.0
Germany	17.1	15.6
United Kingdom	32.0	9.6
EFTA	13.4	25.2
Of which: Sweden	9.9	18.2
Other	18.7	26.0
Sweden	100.0	100.0
EC	50.0	56.0
Of which:		
Denmark	8.0	7.0
Germany	11.6	19.3
United Kingdom	10.3	11.9
EFTA	18.0	16.3
Of which:		
Finland	6.0	6.6
Norway	10.5	6.4
Other	32.0	27.7
Of which: United States	10.9	7.9
Switzerland	100.0	100.0
EC	54.0	70.8
Of which:		
France	8.1	11.2
Germany	20.5	31.6
Italy	7.7	10.0
EFTA	7.5	6.7
Of which: Austria	3.9	3.7
Other	38.5	22.5
Of which: United States	7.9	6.4

Source: IMF, Direction of Trade Statistics.

Table 2. EFTA: Merchandise Exports by Commodities <sup>1/</sup>

(In percent)

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

Source: OECD, Foreign Trade by Commodities.

<sup>1/</sup> According to SITC Rev. 2. Product classification as follows: food and beverages: 0-1; fish: 03; raw materials: 2+4; wood: 24; paper pulp: 25; fuels: 3; crude oil: 33; natural gas: 34; manufactures: 5-9; paper products: 64; and non-ferrous metals: 67.

trade is of the intra-industry rather than the inter-industry type. There are, however, important differences within the group of EFTA countries. Iceland and Norway are highly dependent on primary products. While the bulk of Iceland's exports consist of fish products, Norway is a major exporter of crude oil and natural gas. Although these are the most obvious cases of inter-industry specialization, there are other examples as well. Much because of the availability of low-cost hydro-electric power, a significant part of Norway's non-oil exports consists of energy-intensive products such as aluminum. Similarly, reflecting an abundance of raw materials, Finland and Sweden are large exporters of forestry products, which account for a considerable portion of exports particularly in Finland. However, with the exceptions of Iceland and Norway, the EFTA countries are essentially exporters of differentiated industrial products and in that respect very similar to the most advanced EC countries.

### 3. The nature of remaining barriers in Western Europe

There is general agreement that European markets remain highly fragmented despite the fact that trade in manufactures within the EC and EFTA is free from all tariffs and quantitative restrictions. The existence of large price differences for most commodities between national markets provides clear evidence supporting this view (Table 3). <sup>1/</sup> Judging from these price differences, in general, the original six EC countries appear to constitute the most integrated area in Western Europe. The degree of price dispersion is higher when Denmark, Ireland and the U.K. are included. As perhaps can be expected, the area which includes all the current EC members and the EFTA countries appears to have achieved a much lower degree of integration than the six original EC members. The Nordic EFTA members stand out as the high-cost countries of Europe (Table 4). Of course, this may to some extent reflect factors such as higher real per capita incomes, higher indirect taxes, higher transport costs and perhaps to some extent currency valuation. However, smaller home markets, implying both less competition and scale disadvantages, may also be important.

Although tariffs and quantitative restrictions on trade within Western Europe have largely been abolished other obstacles remain. These can be divided roughly into two different groups. The first group includes various administrative procedures such as border controls. These give rise to trade costs in much the same way as transportation does. Unlike tariffs and quotas, which either generate government revenues or rents to private companies, border controls impose net resource costs both on governments and companies. The second group includes government practices such as public procurement rules,

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<sup>1/</sup> For more details on price differences in the EC and EFTA, see the EC Commission (1988) and Wieser (1989).

Table 3. Price Dispersion in EFTA and EC in 1985

(Standard deviations from EC average)

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

Source: Wieser (1989).

1/ All current EC members plus Austria, Finland, Norway, and Sweden.  
Data for Iceland and Switzerland not available.

Table 4. Price Levels in EFTA in 1985

(EC=100)

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

Source: Wieser (1989).

technical standards and regulations, barriers to entry and public monopolies. These act as import quotas in the sense that they tend to generate rents both to foreign and domestic firms. 1/

Common for all these obstacles is that while they do not generate any government revenues or perhaps are not as direct as quotas, they may still be as harmful as conventional barriers. First, they entail trade costs and are therefore generally trade-decreasing. Second, by restraining foreign competition and preventing arbitrage between different national markets, they encourage market segmentation and effectively serve to create local markets. While barriers resulting from government regulations may be the most obvious reasons why European markets remain less than fully integrated, other factors may also contribute. The most important are private anti-competitive strategies aiming at exploiting market power and differences in buyer preferences among different markets. Whether or not the Internal Market Program will eliminate these more subtle obstacles is unclear.

#### 4. Some theoretical considerations

The EC is seeking to remove all artificial barriers that inhibit trade within the Community. To better understand the likely effects of the Internal Market, it is useful to start with a brief review of the determinants of the pattern of international trade. Economic theory identifies three principles why trade in general may be beneficial: it allows countries to specialize according to comparative advantage; it results in a better utilization of scale economies; and it serves to increase competition.

According to the theory of comparative advantage, gains from trade arise because countries differ in some respect. The most common explanation is that countries differ in factor endowments as in the so called factor proportions model. 2/ However, the fact that the Western European countries are at similar levels of economic development and that trade costs are already quite low suggests that the theory of comparative advantage can explain only the relatively small fraction of total trade among these countries which comprises products based on natural resources. 3/

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1/ Baldwin (1988) has suggested that restrictions on labor mobility may have similar effects.

2/ Another but less likely possibility is that countries have access to different technologies. For a survey of tests of different trade models, see Deardorff (1984). The factor proportions model is described in Helpman (1984).

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

Greater integration in Western Europe may yield important gains from a further specialization based on comparative advantage. Are there any costs involved? As far as trade arrangements are concerned, the EC is at present essentially a customs union. This means that internal tariffs and quotas within the Community have been eliminated while each country has to conform to a common external trade policy. When union members reduce barriers among themselves and coordinate their external trade barriers, there are two conflicting effects: the first tends to increase welfare of the participating countries while the second tends to decrease it. 1/

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

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

The recognition that most trade among industrial countries is in similar but differentiated products has in recent years resulted in alternative theories which explain trade mainly in terms of scale economies and imperfect competition. 2/ With differentiated goods subject to increasing returns to scale and with consumer preferences for diversity, gains from trade arise which have nothing to do with comparative advantage. The basic proposition is that if each country concentrates its resources on a limited range of goods, it can produce them on a larger and more efficient scale while the variety available for domestic use is increased through imports.

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

2/ For an introduction to international trade under imperfect competition and increasing returns to scale, see Helpman and Krugman (1985).

The traditional analysis of trade liberalization is based on a framework similar to the neoclassical growth model in which the equilibrium growth rate is determined by the growth of labor supply and technical progress. The latter is usually assumed to be invariant to policy changes. In conventional models, because of the assumption of constant returns to scale, trade liberalization has no permanent effects on growth. If barriers to trade are lowered, output will grow faster for some time, it will eventually return to its steady state growth path. This result does not necessarily hold in models with increasing returns to scale. 1/ In such models, trade policy may permanently affect the rate of growth of output through its effects on investment. 2/ It is thus important to distinguish between the static and the dynamic effects of trade liberalization.

With increasing returns to scale, markets will be imperfectly competitive. 3/ An often made assumption is that of monopolistic competition, implying that there are many firms producing differentiated products of the same variety. However, despite their monopoly power, firms will earn only normal rates of return. Although the model of monopolistic competition is attractive in its simplicity and has provided some valuable insights, most markets are probably oligopolistic in that firms take each others actions into account and consistently extract monopoly rents. In this case, the possibility of international trade may induce a more competitive behavior and make oligopolistic pricing strategies less likely. 4/

In conventional models based on perfect competition, measures that distort free trade generally tend to be welfare-decreasing. This is, however, not necessarily the case once oligopolistic behavior is

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

2/ Baldwin (1989) argues that the single market may significantly raise the equilibrium growth rate in the EC.

3/ This requires of course that there are scale advantages at the firm level.

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

present. Recent theoretical studies have shown how discriminatory actions by governments, so called strategic trade policy, could actually be beneficial by helping firms to exploit market imperfections. 1/ It remains to be seen how important the arguments of strategic trade policy really are. Nevertheless, the Internal Market Program has some elements reminiscent of strategic trade policy. It appears that one of the most important motives behind the new initiatives has been to improve the ability of EC firms to compete with firms in other countries notably in Japan and the United States.

The existence of scale economies and imperfectly competitive industries provides strong arguments for seeking greater integration. It should be recognized, however, that while the creation of the Internal Market in general can be expected to be beneficial, a formal analysis is complicated by second-best problems. In a typical imperfectly competitive industry, the elimination of internal barriers is likely to stimulate firms both to decrease prices and to increase production. This tends to be welfare-increasing. From a general equilibrium perspective, however, the net effect on welfare may be smaller. For example, if factor prices are distorted, an expansion in one particular industry may adversely affect the allocation of resources elsewhere in the economy. 2/

The expectation that the Internal Market will lead to improvements in economic conditions within the EC is based on all three principles why trade in general is beneficial. There will be some further specialization based on comparative advantage; there will be some increase in the scale of production in certain industries; and there will be some increase in the degree of competition. However, although comparative advantage is important, most of the potential gains will probably derive from a better use of scale economies and increased competition in the larger united market. 3/ The costs in terms of trade diversion are likely to be relatively low. Profit-shifting through

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1/ This point was first raised in Brander and Spencer (1983). For a survey of the literature on strategic trade policy, see Helpman and Krugman (1989). The classical example is that of Airbus and Boeing. See Dixit and Kyle (1985).

2/ Different criteria for gains to arise from integration are presented in Helpman and Krugman (1985).

3/ Since there is little scope for a further expansion of trade based on comparative advantage, most of the gains from reducing trade costs simply come from the cost saving itself, at least in isolation from secondary effects on the degree of competition and scale of production. This is illustrated in several model simulations. See Venables and Smith (1988) who studied the effects of a reduction in trade costs and an elimination of market segmentation within the framework of a partial equilibrium model in ten EC industries. A similar exercise for Norway and Sweden is presented in Norman (1989) who also analyzed the effects of these two experiments in a general equilibrium context.

strategic effects is a possibility that may add further benefits as the market position of EC firms may strengthen relative to their competitors.

There seems to be little doubt that the Internal Market Program, if successfully implemented, is likely to bring substantial gains to the Community. However, to accurately calculate the magnitude of these gains is difficult if not impossible. 1/ There are several reasons, theoretical as well as empirical, behind this pessimism. In principle, the effects of the Internal Market could be simulated with the help of a general equilibrium model. 2/ The basic problem with this approach is as follows. There is no general theory of imperfect competition. The modelbuilder is forced to make a series of arbitrary choices among a number of more or less equally plausible assumptions concerning in particular the interaction of firms in oligopolistic markets. 3/ Unfortunately these assumptions typically turn out to be crucial for the results. In addition, as soon as imperfect competition is present, second-best effects make any comparisons of alternative non-optimal situations difficult.

There are also empirical problems. The observed price differences among Western European markets may not only reflect barriers imposed by governments but also an important element of price discrimination. It is not clear to what extent the observed price differences are the result of obstacles that the Internal Market Program is supposed to remove. As a consequence, it is very difficult to predict to what extent prices will converge. Although a number of plausible arguments can be put forward why firms will be less able to discriminate between different national markets--in particular that it will be easier to engage in cross border arbitrage--it is unlikely that the Internal Market Program will bring all such practices to an end. This is crucial since most of the gains from the Internal Market Program are expected to come from an elimination of market segmentation rather from a reduction in trade costs. 4/ Also, to take advantage of scale

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

2/ Computable general equilibrium models have become a standard tool in the analysis of trade policies. See for example Andersson (1989) who studied the recent U.S.-Canada free trade agreement.

3/ See Flam's comments on Norman (1989).

4/ See for example Venables and Smith (1988) and Norman (1989).

economies, the number of domestic competitors in each country must decrease. This can only be compensated for by an increase in competition at the European level. There is of course a risk that the current stream of mergers and acquisitions in Europe may prevent such an increase from materializing.

5. Benefits and costs for the EFTA countries

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

Since this strategy would amount to nothing less than the formation of a customs union, it would not be without costs. The creation of an internal market encompassing both the EC and EFTA would require a complete coordination of trade policies. As trade between EFTA and EC would be liberalized while barriers to trade with the rest of the world would remain, trade diversion effects could arise, which would tend to decrease welfare in the EFTA countries. How important these effects are depends to a great extent on the future course of the EC's trade policy which may be hard to predict. With some notable exceptions, tariffs do not seem to differ substantially between the EC and EFTA countries. 1/ However, quantitative restrictions may be a more serious issue. 2/ In any case, the fact that the EC may be more restrictive with respect to third countries or is prepared to be more restrictive in the future suggests that the problem of trade diversion cannot be completely dismissed. 3/

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

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1/ For more information on average tariff levels in the EC and EFTA see Herin (1986).

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

3/ For a more detailed discussion of external barriers in EFTA and EC, see Pintado et al. (1988).

demand for domestic goods in domestic markets actually would need to decrease. On balance, however, it can be expected that the expansion would take place mainly in export markets.

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

While the effects on the EFTA countries are qualitatively the same as those on the EC, there are reasons to believe that the EFTA countries may have more to gain from participating in the Internal Market than the EC on average. The EFTA countries have considerably smaller home markets than the majority of countries in the EC. This generally implies a more severe trade-off between scale advantages and competition. 1/

If the EFTA countries would fail to integrate further with the EC, they would not be able to reap the gains accruing to EC members. Are there any additional costs? A reasonable answer appears to be that there are some economic losses involved although it is difficult to say how large these are. To see how the EFTA countries will be affected, consider first the present situation. As far as manufactures are concerned, the EC and EFTA constitute a free trade area. No tariffs or quantitative restrictions restrict the free flow of these goods within Western Europe. The remaining barriers to trade affect the EC and EFTA countries more or less equally.

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

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1/ This point is illustrated in model simulations by Norman (1989).

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

The adverse effects stemming from the reduction in demand for EFTA products are likely to be reinforced by a less efficient use of scale economies. In a typical industry operating under increasing returns to scale and imperfect competition, the more competitive environment in the EC would force EFTA firms to make both price and quantity adjustments. Exactly how EFTA firms would react depends, among other things, on their competitive position on foreign and domestic markets and the relative importance of these markets. 1/ EFTA firms probably have a stronger position on their domestic markets than on foreign markets. They may therefore partly resist to lower their prices on domestic markets or in any case lower their prices less than their EC competitors. 2/ Nevertheless, in contrast to the integration case, prices and volumes of EFTA firms are both likely to decrease as barriers within the EC are being eliminated. As in the integration case, the fall in prices on EFTA and EC products will increase welfare of consumers while decreasing of producers. However, on balance, the negative effects are likely to dominate.

Reflecting the adverse shift in demand for EFTA products, the EFTA countries' trade balance is likely to deteriorate. With less demand for EFTA products, firms would cut back production, resulting in a fall in the demand for labor and a rise in unemployment. The only way production and employment would be unaffected is through a decrease in production costs. This can only be achieved through an offset in labor

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1/ Assuming that firms are unable to discriminate between different markets the same price will be charged in each market. This price will then be a weighted average of the hypothetical prices which would prevail in each market if price-discrimination was possible.

2/ If firms would be able to discriminate between different markets, it is possible that prices in the EFTA countries would rise while prices in the EC would decline. Since the completion of the internal market may result in a decrease in the production of EFTA firms, average costs could rise, forcing these firms to increase their prices in EFTA markets. This may also allow EC firms to charge higher prices in EFTA markets than in the EC. The implications of different assumptions about segmentation for the effects of trade policy are discussed in Markusen and Venables (1988).

costs. In order to maintain employment, wages in the EFTA countries would need to decline relative to wages in the EC. With such a decline, EFTA employment and production would again rise, thereby restoring demand for EFTA products through a decline in EFTA relative prices. While general equilibrium considerations may complicate the picture, the conclusion of this discussion is as follows. With unchanged relative wages, the deterioration in the EFTA countries' relative position will show up in higher unemployment and a deterioration in competitiveness. On the other hand, if relative wages are allowed to decline, EFTA terms of trade will fall further. Both possibilities imply a reduction in EFTA purchasing power.

A failure to integrate further with the EC may also have important consequences for firms' locational decisions. In order to avoid the deterioration in external competitiveness which is likely to take place in the non-integration case, EFTA firms may be tempted to move some of their production facilities into the Community. There are several reasons why this possibility may be attractive. First, with increasing returns to scale and transport costs, it makes sense to concentrate production facilities as close as possible to the most important market. <sup>1/</sup> This trade-off is particularly stringent in the case of the EFTA countries which all have small domestic markets. Second, establishment in the EC may help EFTA firms to compete for public procurement under the same conditions as EC firms and also avoid restrictions related to rules of origin restrictions and technical standards. Third, the Internal Market may give rise to external effects which make establishment there more profitable. All three factors suggest that EFTA terms of trade would decline and that relative wages would have to compensate for the shortfall. Most disadvantages obviously disappear if the EFTA countries would become fully integrated with the Community. However, a complete integration is likely to reduce the costs of establishment in the EC. If the external effects from the concentration of economic activities in the EC are sufficiently strong, establishment in the EC is likely to become more attractive even with full integration.

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<sup>1/</sup> This point is illustrated in Krugman (1988).

## V. Trade in Goods

### 1. Introduction

Most of the trade in goods between the EC and EFTA is in industrial products, which account for over 90 percent of EFTA exports, and fish products, which while accounting for only a small percentage of EFTA exports, are the main export for one EFTA member, Iceland. Since EFTA does not wish to participate in the CAP, the impact of the Internal Market on inter-bloc trade in agricultural products is likely to be small.

The main issues in the future goods trade between the EC and EFTA will depend on their trading relationship. This could take on a range of forms varying from the status quo to a common market including all eighteen countries. While the latter may have important benefits, the requirement of a common trade policy towards third countries would pose major difficulties for several EFTA members. Therefore, this chapter will not cover issues associated with the creation of a common market.

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

### 2. Border controls and other physical barriers

Border controls inhibit the free movement of individuals and form a costly impediment to the free flow of goods and services. <sup>1/</sup> These controls are motivated by a number of factors including commercial, fiscal, economic, health, statistical and security considerations. While both the EC and EFTA have eliminated customs duties and quantitative restrictions on their internal trade, border checks remain to assure compliance with national rules on indirect taxation and to enforce quota agreements with third countries. They also protect against terrorism, drugs, the entry of unwanted goods and individuals and the enforcement of Community policies in areas such as agriculture, trade and for various safety and health checks.

Border controls are costly to both firms and governments. The direct costs are mainly administrative. For importers and exporters, it involves the costs of staff, computing and processing for the extra

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<sup>1/</sup> For details, see White Paper, para. 24-56.

paper work needed for foreign trade. Governments must bear the costs of handling this paper work and manning the internal borders. Additional costs also arise from shipping delays at border checks. 1/

The White Paper envisaged the elimination of all internal frontier controls within the EC, requiring that policies restricting the flow of goods, services and individuals between member states be relaxed and eventually abandoned. In addition, policies regarding the EC's external borders needed to be unified so that any individual or commodity entering one member state from outside the EC would be free to enter any other member state. This required harmonization of national regulations for the entry and exit of goods and individuals as well as confidence that these regulations would be effectively enforced. 2/

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

Differing trade policies towards third parties are likely to force the retention of some form of border controls between the two blocs. Therefore, the competitive position of EFTA firms within the EC will partly depend on the administrative costs of these controls and the time

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

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

involved in crossing protected borders. 1/ Much progress has been made in cutting the administrative costs of border crossings. In January 1988, the Single Administrative Document (SAD) agreement came into force, greatly simplifying the administrative procedures associated with the goods trade between the EC and EFTA. 2/ In the agreement, the EC and EFTA agreed to replace all customs documents used in EC-EFTA trade with the single document used in intra-EC trade. It was also planned that the EC and EFTA countries would fully computerize their customs data and customs procedures by 1992, helping to minimize the relative cost disadvantage of EFTA exporters to the EC, while placing EC firms on an equal footing with EFTA firms trading in EFTA.

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

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

### 3. Technical standards and regulations 3/

A producer wishing to sell a good within the EC or EFTA may be subject to a different set of rules governing the product in each of the eighteen countries. These rules fall into four categories: technical standards, which are formally voluntary but may have quasi-legal status by government decision or commercial reality; regulations, which are legal requirements set by the EC governments; testing procedures; and

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

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

3/ For details on the making of technical regulations and standards in the main European standardization organizations, see Nicolas (1988).

certification that the product conforms to the regulations or standards. 1/ In the EC and EFTA, standards, testing, and certification procedures are normally set by private groups which may be national or multinational. The two main multinational groups, CEN and Cenelec, include all members of the EC and EFTA. 2/ Interviews with EC firms showed that these rules were seen as the single most important barrier to the Internal Market. 3/ However, ending these differences will be difficult and complex because of sheer volume. It was once estimated that there were 100,000 different technical regulations and standards within the EC alone. 4/

Divergent regulations and standards may distort firms' behavior in several ways. 5/ By raising the costs of doing business in a broader market, firms may only seek to fill the niche created by their national regulations, instead of competing on a broader basis. Problems from divergent regulations and standards are especially severe for certain investment goods--such as transport equipment, precision and office equipment--pharmaceuticals, food and tobacco. Domestic orientation not only reduces trade, the resulting market fragmentation may also hinder R&D efforts, especially in areas with major scale economies. Additional costs may include duplication of R&D and higher inventory and distribution costs. Public expenditures may also rise as a result of duplication of testing and certification of products, while consumers must bear the direct costs passed on by producers and government and the indirect costs of reduced competition and less rationalization of production and marketing.

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1/ Calingaert (1988), pp. 25-26.

2/ CEN and Cenelec are French acronyms for Committee for European Standardization and Committee for European Electrotechnical Standardization, respectively. A third body, the European Telecommunications Standards Institute (ETSI) sets standards in the area of telecommunications.

3/ Cecchini (1988), p. 28.

4/ This figure is used in EC Commission (1988b), p. 43.

5/ These arguments are presented in Cecchini (1988), p. 24 and EC Commission (1988b), pp. 51-53.

The cost of technical barriers is believed to be high. However, they are difficult to quantify because they tend to be industry specific and are often intertwined with other barriers, including content requirements and restrictive government procurement practices. 1/

The White Paper proposed to reduce and eventually eliminate divergent regulations and standards using a three part strategy of selective harmonization, mutual information and mutual recognition. 2/ Selective harmonization requires legislation on the essential characteristics of the product--the European, or EC standard. However, the passage of binding legislation is difficult, requiring Council unanimity. 3/ Thus, it will only be required when national regulations differ in essential characteristics in terms of health, safety or consumer or environmental protection. 4/ In these cases, the EC standard will normally only cover the essential requirements necessary to allow the product to circulate freely within the EC. When no major disparity exists, mandated groups, mainly CEN/Cenelec, will be charged with setting the EC standard. Once the standard is set, these groups will also set the final specifications which would conform to the standard. EFTA members are in a special position in this regard, since they not only participate in setting EC standards, they are also generally subject to the standards once they are passed. 5/

To ease replacement of national standards by EC standards, the Commission is working to strengthen the standard setting bodies. However, while industry bodies will be charged with setting the EC standards, the Commission has insisted that the interests of all sectors affected by the standards, including both sides of industry, commerce

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1/ The Cecchini Report estimated the costs of the EC's internal barriers for seven industries, accounting for 43 percent of EC industrial output. The estimated savings from the removal of barriers from technical regulations, import restrictions and restrictive government procurement policies was equivalent to about 0.3 percent of EC GDP. Half were in telecommunications equipment as a result of ending of restrictive government procurement practices. Cecchini (1988), pp. 25-27 and 50-68.

2/ White Paper, para. 61-79.

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

4/ This is based on Article 36 of the EEC Treaty.

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

and consumers are taken into account. The Commission may also withdraw a mandate from any body that is not effectively and fairly fulfilling its task. The EFTA has worked closely with the EC in both helping to set the EC standards and in setting the work priorities.

Much progress has also been made in the area of mutual recognition of technical regulations and standards within the EC. In the Cassis de Dijon decision, the European Court of Justice held that products lawfully produced and marketed in one member state must, in principle, be admitted into every other member state. Mutual recognition is to be accepted when harmonization is not essential or it has not yet been introduced. Barriers are to be permitted "only when they are necessary to satisfy mandatory requirements, serve a purpose in the general interest and are essential for the purpose to be attained." 1/

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

Efforts have started to use mutual recognition to avoid duplication of testing and certification procedures. However, countries have more faith in their own certifying systems than in foreign ones. To overcome this bias, the EC Commission and most EFTA members favor centering efforts in CEN/Cenelec. 2/ A major step was taken in June 1988 when EFTA and EC members signed a framework on the mutual recognition of test results and certification. While presupposing common guidelines for testing procedures, it was seen as a necessary first step towards EC-EFTA negotiations on framework and sectoral agreements. 3/

Fears have been voiced that EC standards may be drafted to discriminate against nonmembers. However, EFTA members discount this. Unifying regulations for twelve EC countries--eighteen including EFTA--is sufficiently complex to discourage such efforts. Discrimination would also be against the interests of distributors and consumers in the EC and contrary to the Commission's mandate. In addition, gains from discriminatory standards would be short-lived, since outsiders would modify production methods to meet the standard.

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1/ EC Commission (1989b), pp. 39-40.

2/ EC Commission (1989b), p. 8.

3/ "Joint Conclusions" (1988).

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

While eliminating technical barriers to trade will involve a major effort for the EC and EFTA alike, EFTA is well positioned to move in step with the EC. The outlook is good for several reasons. First, as members of CEN/Cenelec, EFTA members already participate in the decision making process in these organizations. Second, most EFTA countries already use EC standards whenever possible. In cases where there is no standard, the only requirement for sale in the EC is that the good meets the standards of some member state; although in cases it does not meet the standards in the country in which it is sold, it must be shipped through a member state where it does meet the standards. <sup>1/</sup> Third, increased EC-EFTA cooperation is likely to result in an agreement to eliminate technical barriers between the two blocs, which will probably follow the lines of the measures being taken in the EC.

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

#### 4. Procurement policy

Public sector purchases of goods and services by all levels of government and public enterprises accounted for roughly 15 percent of Community GDP in 1986. <sup>2/</sup> While much of this involved purchases that were non-competitive, non-tradable or in quantities too small to be covered by the EC's rules on contractual procedures, contractual purchases by the public sector--public procurement--were equivalent to

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<sup>1/</sup> Presumably, EFTA states will be required to give reciprocal rights to EC member states and probably the other members of EFTA.

<sup>2/</sup> For a summary of the costs of restrictive procurement policies, see Cecchini (1988), p. 16-23 or EC Commission (1988b), pp. 54-59. This discussion is largely based on these two reports.

7-10 percent of Community GDP. Public sector purchases by EFTA countries are estimated to have been on the order of 10 percent of GDP, implying public procurement in the range of 4.5-6.5 percent of GDP. 1/

Public procurement has remained largely closed, despite legislation which was to open up public works contracts in excess of ECU 1 million (1971) and public supply contracts of over ECU 200,000 (1977). 2/ In 1986, about 20 percent of the tenders covered by the directives were published, while 2 percent went to bidders from other member states. This was mainly caused by two factors. First, energy, transport, telecommunications and water supply were exempt from the rules. Second, EC legislation has been bypassed and ignored, showing "that the Community legislator has proved no match for national and local purchasing bureaucracies." 3/

The costs of nationalistic procurement policies are high. 4/ The savings may be divided into three categories: the static trade effect of buying from the cheapest EC supplier; the competitive effect of opening closed sectors; and, the restructuring effect of forcing small firms in protected sectors to grow to take better advantage of scale economies. The savings would be even greater if procurement was fully open to non-EC bidders. In addition, the savings to private buyers from less restrictive trade practices and the dynamic effects of greater competition, innovation, investment and growth may also be large.

The White Paper laid out a three part strategy for opening public procurement. 5/ First, legislative loopholes would be closed and efforts made to increase the transparency of public tenders to encourage greater participation by other member states. Second, losing bidders would be given improved legal redress and the Commission would be given greater powers to police and enforce compliance. Third, procurement rules would be extended to energy, transport, telecommunications and water supply and later to the services sector.

Efforts to implement these plans have started, but progress has been slow. A program of action was set by the Commission in mid-1986. In 1988, three directives were tabled before the Council of Ministers: one opening the energy, telecommunications and water supply sectors to international tender; and two others designed to ensure compliance with

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1/ Pintado et al. (1988), p. 27.

2/ The possibility of opening public procurement is receiving much attention in association with the Uruguay Round of the GATT.

3/ Cecchini (1988), p. 18,

4/ Atkins (1988) studied Belgium, France, Germany, Italy and the U.K., using some 40 product categories and 1984 data. The estimates, extrapolated to the EC-12, showed a potential saving of about 3/4 of 1 percent of EC GDP, about one fifth from defense. About half the savings were in telecommunications, power turbines and data processing.

5/ White Paper, para. 81-87.

existing public procurement directives. In April 1989, a revised report on opening protected sectors was presented to the European Parliament for supply contracts over ECU 750,000 and works contracts over ECU 5 million. 1/ In February 1990, after some delays, the directive was passed. 2/ One change--which was the cause for the delays--was a "Buy European" clause which gave bidders from member states a 3 percent margin of preference versus bidders from outside the EC, unless the outside bids contained at least 50 percent "European content." The ministers also stated that the content requirement would be waived if a worldwide agreement to drop such requirements could be made under the GATT. Discussions on public procurement of services is next on the agenda.

The Luxembourg Declaration listed public procurement as a primary area where EC-EFTA cooperation was desirable, but no proposals were made. Negotiations began in 1986. Efforts have focused on gradually opening up public works contracts at all levels of government. EFTA ministers have also agreed to provide copies of tender requests in accordance with the GATT agreement for publication in the EC's official paper and inclusions in data banks regarding public procurement. 3/ Plans have also been discussed to revise EFTA rules on surveillance and enforcement. 4/ These rules, which must be enacted at the national level, are equivalent to those in the EC.

While the level of concern about opening public procurement varies among EFTA members, 5/ progress may be made in this area. As noted, agreement at the EC-EFTA meeting in December 1989 was based on the principle of free movement of goods and services and that, with limited exceptions, EFTA members would follow actions taken by the EC. This implies that joint agreements may eventually have to be reached on opening procurement policies on equal terms to bidders throughout the two blocs. However, while the accord grants EFTA members greater input in the EC's own discussions on this topic, joint progress is likely to be slow until the EC has finished its own work in this area.

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1/ Committee on Economic and Monetary Affairs ... (1989).

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

3/ Council of State Concerning Finland's ... (1989), p. 34.

4/ EFTA (1989), pp. 2-3.

5/ For example, Finland, which sees its policies as open--and where procurement was one third as large in terms of GDP as in the EC--argues that competition should be as free as possible; Council of State Concerning Finland's ... (1989), p. 34. A Swedish bill on the Internal Market did not list procurement as a major policy goal--procurement in Sweden nears the EC average GDP terms; Swedish Ministry of Foreign Affairs, (1987), p. 24.

5. Rules of origin and anti-dumping

The EC has two sets of origin rules. 1/ Preferential rules are used to determine if a product originates in a particular country and is eligible for preference under special agreements, including FTAs and the Generalized System of Preferences. These normally require that the product undergo sufficient processing to change the product's tariff heading. Other tests may also be used, such as the form of processing or the percentage of value added. Non-preferential rules relate to commercial policy measures and rules, including anti-dumping measures. They are based on the "last substantial operation" rule, 2/ which may be based on either a technical test on change in product properties, an assessment of the importance of the last operation in the totality of the manufacturing process or a value added criterion.

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

Under EC procedures, the definition of dumping is based on the price in the exporter's home market. However, if this is not considered representative of costs, prices in third countries may also be used. 3/ If dumping is detected, GATT provisions permit the imposition of a countervailing duty if injury is found and the dumping may be attributed to state subsidies. The dumping is not applied to intra-Community trade, since the maintenance of price differentials is, in principle, not possible within a free market.

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

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

3/ The EC's anti-dumping rules are summarized in Kelly (1988), pp. 95-96.

EFTA members have sought to be exempted from the EC's anti-dumping regulations, arguing that anti-dumping rules discriminate against EFTA-based firms since large price differentials exist within the EC 1/ There are also fears that, after the start of the Internal Market, price cuts will be necessary to maintain market share within the EC, making EFTA-based firms vulnerable to anti-dumping actions. The Commission has stated that the EC would be prepared to drop anti-dumping rules with regard to EFTA, if they were replaced by uniform competition rules. However, EFTA is still trying to form a common position on this issue. The negotiations following up the Oslo-Brussels process could lay the groundwork for progress in this area.

#### 6. State aid

The White Paper states that a strong competition policy requires that "discipline on state aid be rigorously enforced." 2/ EFTA members stress the need for this discipline to the EC and report lapses they detect. 3/ These protests are usually based on the FTAs, which state that "any public aid which distorts or threatens to distort competition by favoring certain undertakings or the production of certain goods" 4/ is incompatible with the functioning of the FTAs. While these disputes may be brought before the GATT, EFTA and EC members generally seek to avoid settling their differences in this way.

Talks on state aid have started. The first goal is to develop a system for reporting all state aid in the EC and EFTA countries and a consultation procedure for problem cases. 5/ Preliminary proposals in both areas were advanced in November 1988 and are under study. One problem is that EFTA countries do not have a monitoring and enforcement mechanism with the same legal status as the EC's. Work has also been started within EFTA to strengthen their internal procedures; progress is thought to be a precondition for successful inter-bloc discussions. It is hoped that an enforcement mechanism may be developed as part of the institutional changes associated with the Oslo-Brussels process.

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1/ Council of State Concerning Finland's ... (1989), p. 31-32.

2/ White Paper, para. 158.

3/ Council of State Concerning Finland's ... (1989), p. 32.

4/ EFTA (1987a), p. 100. It is based on Article 23. The EFTA Convention has a similar prohibition for trade between its members.

5/ Council of State Concerning Finland's ... (1989), p. 32-33.

7. Fisheries and trade in fish

Within EFTA, only Iceland sees discussions regarding fisheries and trade in fish as a major concern. 1/ In Iceland, fisheries and fish processing account for one sixth of GDP and about three fourths of merchandise exports, half of which go to the EC. While the the other FTAs did not cover fish, Iceland was given favorable terms on its sales of fish and fish products to the EC, with about 50 percent of its fish exports enjoying special preferences. 2/ 3/

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

In 1988, five percent of the EC's imports of unprocessed fish came from Iceland. While Iceland's fish exports to the EC have gradually risen, EC policy on processed fish has caused problems for Iceland, particularly for its trade in salted fish. The principal customers for salted fish are Spain, Portugal, Italy and Greece. When the FTAs were signed, Greece, Portugal and Spain were not members of the EC. Their accession to the EC has made their imports of salted fish subject to the same restrictions under the CFP as the other imports of EC member states. As a result, the share of Icelandic fisheries exports enjoying preferential treatment in the Community fell by about 15 percent. 4/

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

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1/ Norway and Sweden both share their fishing rights with the EC in exchange for preferential treatment for their fish exports.

2/ Although the Free Trade Agreements were reached in 1972, the dismantling of EC duties on certain fish products came into force only in 1976, when the so-called "cod war" was settled.

3/ See Gislason (1987).

4/ See Olafsson (1989), p. 10.

In its negotiations with Iceland, the EC Commission insisted on access to Icelandic fishing grounds as the price for freer access to the EC. 1/ Because of its heavy dependence on fisheries and the fact that Iceland's fishing zones are already fully utilized, such an agreement is not seen as a feasible option for Iceland. There is also a political consensus in Iceland in support of this position.

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

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1/ See Gibbs et al. (1989).

## VI. Transport Services

### 1. Introduction

Liberalization of the EC's transport sector is important not only because of its size, but because extensive restrictions in the sector are thought to have had a negative impact on trade and industry. The White Paper laid out conditions for establishing a free internal market in road transport of goods, road transport of passengers, international inland waterway transport of goods, sea transport and air transport. 1/ This chapter focuses on three areas, road transport of goods, sea transport and air transport, since the other areas were seen as being of less importance for the EFTA countries (Table 5).

### 2. Road transport of goods

The White Paper's plans were more ambitious in the area of road transport of goods than in other transport areas, since over 80 percent of intra-Community goods trade is by road. 2/ The main goals were abolishing internal border checks, phasing out quotas on inter-country hauling and allowing nonresident carriers to provide road transport services between other member states (cabotage). Technical standards, vehicle taxation and working conditions were also to be harmonized.

At present, rules and restrictions governing trucking operations, safety standards, market entry and price regulations all differ between countries. The methods of taxing trucking operations and the level of taxation also vary, causing large differences in a firm's cost structure depending on where it is incorporated and where it operates. 3/ In addition, rules governing nonresident carriers are set by bilateral negotiations with over half of cross border trips rationed by bilateral permits. 4/

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1/ White Paper, para. 108-112.

2/ Pelkmans and Winters (1988), p. 51.

3/ Within the EC, some countries, e.g., the U.K. and Germany, rely on direct taxes on trucking operations, while others, e.g. France and Italy, make little use of these taxes. In 1986, the annual tax for large truck varied from ECU 345 in Italy to ECU 4870 in the U.K.. In addition, countries with high direct taxes make little use of road tolls, while countries with low direct taxes use them heavily. Fuel taxes also vary sharply. EC Commission (1986b), Tables 2, 4 and 13.

4/ "Europe's Internal Market" (1988), p. 36.

Table 5. EFTA: Mode of Transportation of Foreign Trade

(In percent; in 1985)

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

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

Liberalization efforts began slowly, as member states with more heavily taxed and regulated trucking sectors sought to protect the competitiveness of their firms, while maintaining adequate safety standards in the face of deregulation. The first major pact was made in June 1988, when it was agreed that the number of EC licenses for inter-country transport would be raised by 40 percent immediately and by another 40 percent in 1989. <sup>1/</sup> It was also agreed that by 1993, all remaining restrictions would be scrapped; an EC-wide truck drivers' license would be introduced to give haulers freedom to trade if they meet a set of professional standards; and member states would harmonize their rules on road taxes and drivers' working conditions.

Opening borders and liberalizing the trucking industry should reduce transport costs. Border delays cause international shipments to take as much as 50 percent longer than comparable domestic shipments, <sup>2/</sup> while the permit system forces trucks to return empty on many international hauls. <sup>3/</sup> These factors, along with rationalizing the structure of the sector could result in marked reductions in intra-Community transport costs. <sup>4/</sup>

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

Liberalization may still have an impact on firms hauling goods between the EC and EFTA. The demand for their services will vary with the level of trade and with inter-bloc road transport policies. The existing bilateral pacts will be scrapped by 1993, since they

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<sup>1/</sup> In December 1989, a further quota increase of 40 percent was tentatively agreed for 1990-92; however, the measure has not yet been allowed to take effect.

<sup>2/</sup> Border delays are also estimated to cost about ECU 0.4-0.8 billion annually, Cecchini (1988), p. 12.

<sup>3/</sup> Empty return hauls are estimated to cost another ECU 1.2 billion annually. EC Commission (1988b), p. 97.

<sup>4/</sup> A 5 percent saving was estimated in EC Commission (1988b), p. 95, and "Europe's Internal..." (1988), p. 36, while some estimates are as high as 20 percent; however, these were made by representatives of other transport sectors.

discriminate against third party EC members and new agreements will be needed by that time in order not to risk interruptions in inter-bloc transport. However, the outlook for EFTA firms is not clear. 1/

Within EFTA, there appears to be a desire to reach an agreement on road transport with the EC. EFTA's Transport Committee has a goal of "Non-discriminatory access to the market for carriage of goods by road between the Community and the EFTA countries, meaning in practice an extension of the common road haulage market to the EFTA countries...to achieve a common West-European transport market." 2/ This would require at least partial harmonization of rules on road transport, taxation of commercial vehicles and market access. EFTA members are expected to mirror EC regulations in all areas, except, perhaps, regarding vehicle weight (see below). While a joint EC-EFTA agreement is favored--perhaps as part of the EES negotiations--divergent interests and bargaining power could result in bilateral solutions.

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

### 3. Sea transport

EC policy on maritime transport is evolving. While the White Paper envisaged a phasing out of restrictions between member states and the creation of conditions under which these services could be freely provided, there was no EC-wide legislation in this area. In 1986, four regulations were passed. The first sought to counter discrimination by third countries against EC-owned vessels. The second condoned the principle of cabotage for EC-owned vessels. The third made certain maritime activities subject to monopoly regulations and the fourth set procedures to combat dumping in international shipping. The first regulation was to enter into force in 1993, while the others took effect

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1/ It has been estimated that EC demand for non-EC transport services would fall by about 7 3/4 percent, if trade barriers are only removed within the EC. EC Commission (1988b), p. 182.

2/ EFTA (1988), p. 16-18.

in July 1987. These were seen as first steps towards a comprehensive shipping policy, with issues such as the decline of the EC's shipping fleet left for future discussions. Plans to harmonize national maritime policies regarding crew regulations, taxation and technical standards were also envisaged.

The regulations were generally well received within EFTA. 1/ The main concern was that cabotage was only favored for EC-owned ships. The EFTA committee on transport issues proposed that the rules be broadened to include EFTA members. 2/ However, some EFTA members thought problems could be avoided by using EC-based subsidiaries.

While no new regulations have been enacted by the EC since 1986-- and progress on cabotage has been minimal--a proposal for an European Ship Register was advanced in May 1989. Under the plan, EC-based shipowners could register their ships under the EC flag (Euros). Euros would be subject to high technical and safety standards and all officers and at least part of the crew would need to be EC nationals. In exchange, only Euros would be granted cabotage within the EC. Minimum safety and labor standards were also proposed for non-EC ships using EC ports, although this is unlikely to affect ships flying EFTA flags.

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

#### 4. Air transport

Until recently, every state in the EC had full sovereignty over its air space. In addition, perhaps because most airlines were largely or wholly state owned, air transport was exempted from the competitive statutes of the EEC Treaty. A report put out by the EC Commission stated, the system of air services in Europe had become mainly one of licensed duopolies, with "some 200 separate bilateral agreements between 22 countries...in which designated carriers provide services whose cost, capacity and conditions are directly or indirectly regulated. Rights by a Community carrier to offer services between two other Member states, so-called fifth freedom rights, are effectively prohibited...In 1987 only 5 % of European routes had multiple designation, i.e. more than one

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1/ Council of State Concerning Finland's ... (1989), p. 52.

2/ EFTA (1988), pp. 29-30.

airline per State per route. In a number of cases the revenues on city pair routes are pooled and split 50:50 between both carriers. Price competition is limited." 1/

The cost of these arrangements appears high. During 1978-82, the average cost of international air services in Europe was 60 percent higher than similar services in North America, while the cost of air shipment per ton/kilometer was 50 percent higher. 2/ In addition, the variable costs of flying routes of similar lengths were 20 percent higher in Europe than in North America, while ticket costs were on average 35-40 percent higher. 3/

Liberalization has moved slowly. The first proposals were made in 1974, but none were enacted until 1983, when a measure easing inter-regional air service was passed. The White Paper discussed liberalizing the sector in general terms, so the Commission was freed to set its own strategy. By 1987, it aimed to allow greater freedom to provide air services between member states, by changing the system of setting and approving tariffs and limiting governments' rights to restrict capacity and market access. No mention was made of policies towards third parties. By 1992, the Commission hoped to increase competition within the EC by ending block exemptions from competition rules for the intra-EC operations of airlines owned by nationals of EC member states and by allowing these airlines full fifth freedom rights within the EC. It was hoped these efforts would not be undercut by increased concentration in the sector. However, mergers, joint ventures and cooperation agreements are all up sharply. 4/

In December 1987, an agreement was made limiting the freedom of authorities at one end of a route to reject lower fare proposals by carriers at the other end and setting conditions for offering discount fares. It also set a three-year timetable for expanding the minimum range for capacity sharing from a 50:50 to a 40:60 range; allowed more airlines to compete on crowded routes and regional hubs; and gave certain fifth freedom rights to carriers within the EC. While route

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1/ EC Commission (1988b), p. 97.

2/ EC Commission (1988b), p. 97, cites Pryke (1986).

3/ "Europe's air cartel," (1989), pp. 19-23.

4/ For example, British Airways took over British Caledonian and Air France has plans to take over UTA, while many airlines have bought or exchanged stock. It is feared that increased concentration in the sector may act to undercut the potential competitive gains from the EC's open skies policy. The EC Commission is concerned about these developments. In February 1990, the Commission sent a statement of objections to Air France regarding its planned takeover of UTA; this was the first step in raising formal antitrust objections to the takeover.

sharing and fares have fallen on the busiest routes, the benefits of this agreement are seen as limited, with no major impact on non-EC carriers. 1/

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

A major accord was reached in December 1989, when the EC transport ministers approved in principle guidelines for three reforms. First, all capacity and revenue sharing arrangements between governments should end by January 1993. Second, governments should lose the right to unilaterally reject non-predatory changes in air fares by January 1993. Third, governments should end discrimination against smaller, domestic airlines by July 1992. In June 1990, the EC transport measures formally approved the timetable. However, it is not yet decided how these rules will be applied to carriers from third countries flying to Western Europe.

Liberalizing intra-EC air services may have an impact on airlines owned by EFTA nationals and governments, particularly SAS which is owned by interests in Denmark, Norway and Sweden. 2/ The EFTA committee on transport issues argued that air transport rules were best suited to a region covering all of Western Europe, with EFTA members included in the EC's air transport regime. The key issue for the committee was whether mirroring or comparable legislation should be adopted by the individual members or by EFTA as a bloc. 3/ However, so far, talks have only been on a bilateral basis. Negotiations have started with Norway and Sweden and EC-EFTA talks may begin in 1990. 4/ The outcome is not clear. While accords with Norway and Sweden seem likely, a multilateral accord is possible if the EES talks are successful.

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

2/ SAS is treated as an EC carrier because of Danish participation in the company.

3/ EFTA, (1988), p. 40.

4/ The joint talks may allow Norway and Sweden to be treated separately from the other four EFTA members.

## VII. Labor Mobility

The free movement of labor is one of the four freedoms, which the EC views as essential preconditions for the success of the Internal Market Program. For this, citizens of the member states must be free to engage in their professions throughout the EC without being subject to any restrictions which could serve to discourage such movements. As in the case of trade in goods, free labor mobility requires the elimination of both border controls and technical barriers, with technical barriers posing the greatest problem. Within the EC, the primary technical barriers relate to differences in national rules on professional and vocational qualifications.

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

Restricting labor mobility in the EC implies a sub-optimal factor allocation, leading to efficiency losses and lower overall welfare. 1/ On the national level, these effects have long been recognized and labor mobility within countries is usually encouraged. However, at the Community level, protecting insiders' positions vis-à-vis outsiders-- particularly if domestic unemployment is high--and pride in national traditions and institutions may still lead to segmented labor markets. The importance of cultural and linguistic differences should also not be underestimated.

Labor mobility is driven by similar factors as the goods trade. 2/ Labor migration from one country to another, one-way migration, corresponds to inter-industry trade in goods. When labor moves from a low-wage country to a high-wage country, world income rises because labor is allocated more efficiently. On the other hand, two-way migration, which corresponds to intra-industry trade, can take place for a number of reasons, with the two most important being mismatches in the supply and demand for specific skills in particular labor markets and movements within multi-national firms. This too may have a beneficial effect on labor allocation.

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1/ See Pintado et al. (1988), p. 51.

2/ See Krugman (1987), p. 129.

One-way migration has been the main form of labor movement within the EC. In the 1960s and early 1970s, unskilled workers moved from the south of Europe to the strong labor markets in the north. This was motivated by the possibility of better jobs and higher wages in the north. However, wage disparities have continued. A recent study showed that industrial labor costs in Europe range from 25 percent of the EC average in Portugal to 30-40 percent above the average in some of the urbanized regions of the north, mainly Germany and the Netherlands. 1/ However, a rise in unemployment in the north, has caused a fall in one-way migration despite continued wage differentials. 2/ 3/

The EFTA countries, for their part, generally require foreigners to obtain a work permit before allowing them to work in their domestic market. However, since 1954, all Nordic citizens have the right to work in another Nordic country without a work permit; although movement is not yet allowed in certain professions, e.g., the legal and medical professions. Nordic citizens also enjoy the same social security and social rights as the host country's own citizens. 4/

EC-EFTA cooperation is still at an early stage regarding labor mobility. Some progress has been made, e.g., the mutual recognition of higher education diplomas and participation in European Community Action for the Mobility of University Students (ERASMUS). However, there also seems to be a growing awareness within EFTA that efforts must be intensified if they hope to fully benefit from the creation of the EES.

In October 1989, the EC-EFTA High Level Steering Group stated that the free movement of persons would be an important supplement to the three other freedoms. Employees, self-employed and their families should be allowed to move freely within the EES on the basis of mutual recognition, nondiscrimination and reciprocity. However, recognizing the special situation in some of the EFTA countries, EFTA emphasized

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1/ See Begg (1989), p. 92. Large disparities have also been observed within countries.

2/ Helm and Smith (1989), p. 15, argue that this also reflects the power of trade unions in the northern EC countries.

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

4/ See Pintado et al. (1988), p. 52.

that special agreements were required for negotiations in this area. 1/ On the other hand, it would appear that a major accord in this area would not be reached outside of the EES negotiations.

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

While concerns remain about a large one-way migration 2/ from EC countries with high unemployment rates, it appears that the EFTA countries attach greater importance to the potential gains from two-way migration. It is also believed that, with rapid technological change, growth may be hampered by bottlenecks in specific skills and that barriers to labor mobility may slow technological development. Free labor mobility within the EES would also tend to reduce labor market pressures in countries with low unemployment and help contain wage drift.

Switzerland apparently still has reservations about allowing free labor mobility within the EES, although it did not raise objections to recommendations of EFTA's Consultative Committee. 3/ Switzerland is already a substantial net importer of labor 4/ and the size of the foreign work force is a sensitive political issue. On the one hand, it is feared that the free flow of labor within the EES could cause the foreign work force to triple after 1992. 5/ On the other hand, the authorities are aware that inhibiting labor mobility could cause difficulties in hiring much needed skilled labor from EC countries. 6/ Thus, the decision whether Switzerland will go along with the EFTA decision to endorse free flow of labor across frontiers, will be a tricky one.

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1/ See "Schlussfolgerungen der EG-EFTA-Steuergruppe" (1989).

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

3/ See "Officials Agree on Framework ..." (1989).

4/ In 1987, one fourth of all workers were foreign, with three fourths coming from EC countries, See Conseil di Suisse (1988).

5/ See "Officials Agree on Framework ..." (1989).

6/ See Hanser et al. (1988), p. 71.

## VIII. Financial Services and Capital Movements

### 1. Introduction

This chapter deals with the creation of a European financial area. 1/ The Community's efforts in this field can be divided in two different but interrelated parts: the removal of all barriers that inhibit cross-border trade in financial services and establishment of EC firms in other markets within the EC; and the removal of all exchange and capital restrictions in the Community. Formal discussions between the EC and EFTA are being carried out in the working group on services and capital movements which was created as part of the Oslo-Brussels process. The prospects for closer cooperation are generally good. However, certain policies, mainly related to the access of EC firms to EFTA markets, may still pose problems for some EFTA countries.

### 2. Implications of financial integration

The liberalization of trade in financial services and capital movements is a key component of the Internal Market Program for several reasons. 2/ First, the financial sector accounts for a substantial share of output and employment in the Community. Second, trade in financial services is still subject to considerable protection, particularly in the retail sector. Third, financial services are used as inputs in other economic activities, implying important spillover effects throughout the economy. The gains from a unified financial market should be substantial. 3/ However, these gains may not accrue equally to all member states. They may be particularly large in the southern member states which are relatively less integrated with world capital markets.

The economic effects of liberalizing trade in financial services are similar to those of liberalizing trade in other products. 4/ First, liberalization may help to achieve a more efficient resource allocation within the financial services sector. Since trade in financial services is essentially of the intra-industry type, the main benefits should come

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1/ The EC Commission's original proposals are in its 1985 White Paper. In the course of implementing the Internal Market Program, certain proposals have been withdrawn and others have been added. For a recent overview of the legislation covering financial services and capital movements, see the European Communities (1989).

2/ The economic implications of the liberalization of the financial services sector are analyzed in the EC Commission (1988b).

3/ The EC Commission (1988b) has estimated that the creation of a common market in financial services may raise GDP in the Community by 1.5 percent as compared to a cumulative gain of 4.5 percent for the Internal Market Program as a whole.

4/ See Chapter IV for a more detailed discussion of the economic effects of integration.

from a better utilization of scale economies and increased competition. Second, liberalization may also help to improve resource allocation across different sectors of the economy. Although the economic effects are similar to those in other sectors, since the provision of financial services usually requires a physical presence, there is likely to be more cross-border establishment than in non-service industries.

The current variation in retail prices for financial services in Western Europe provides significant incentives for further cross-border expansion. 1/ In the retail sector, strong local networks in many countries suggest that the expansion will take place through mergers and acquisitions rather than through new establishments. Indeed, this process is already underway. The wholesale sector has long been more exposed to foreign competition and is less limited by the need for a physical presence. Cross-border trade may therefore play a more prominent role in the wholesale sector than in the retail sector.

The benefits of liberalizing capital movements are somewhat different in nature than those of liberalizing trade. 2/ Free capital movements allow for an efficient allocation of saving and investment. In this respect, one-way capital movements are similar to inter-industry trade, that is trade driven by comparative advantage. However, even without net resource transfers, there can be important benefits. Two-way capital flows, often short-term, give rise to gains for much the same reasons as intra-industry trade. With free access to foreign financial markets, investors are able to diversify their portfolios and achieve a more efficient asset composition. Free capital movements will also help to increase competition in financial markets.

While free capital movements in general can be expected to be beneficial, this may not always be the case. If other distortions are present, liberalizing capital movements may actually lower welfare. The most obvious example of distortions that may have this effect is the existence of different tax systems. Although free capital movements may equalize the real after tax rates of return in different countries, real rates of return before taxes may still differ, implying an inefficient allocation of capital. However, it is generally better to remove the original distortions than to introduce additional distortions. In a way, the Internal Market Program turns the second-best argument around in that the removal of regulations and restrictions in the financial

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1/ Data on price differences for financial services within the EC are presented in the EC Commission (1988b).

2/ See Krugman (1987) for a discussion of the benefits of eliminating capital controls.

sector may make the underlying distortions more transparent. 1/ Particularly, in the area of taxation, there may be pressures for a harmonization of the tax treatment of capital income. 2/

The effects on the EFTA countries depend on several factors. 3/ A complete integration--implying both the harmonization of rules and regulations and the elimination of all remaining capital controls--would enable the EFTA countries to fully share in the gains from financial integration in Western Europe. 4/ EFTA customers would benefit both from lower prices and access to other European markets. EFTA financial institutions would gain improved access to foreign markets but they would also face more competition in their domestic markets. The effects of allowing more foreign competition may be different for different EFTA countries. Switzerland appears to have the strongest and most developed financial sector among the EFTA countries. Financial institutions in Norway, and in particular in Iceland, may face difficult challenges. Financial institutions in the EFTA countries are already preparing for the more competitive environment in the 1990s. In the Nordic countries, several banks and insurance companies have either merged or formed strategic alliances in order to build a stronger market position.

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

### 3. Banking

The EC's approach to liberalizing trade in financial services is based on three fundamental principles: home country control, mutual recognition and harmonization of essential laws and practices. 5/ The first principle stipulates that supervision of a financial institution, including all of its branches, should be handled by the authorities in its home country which implies that authorities in host countries must

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1/ For a further elaboration of this argument, see Basevi (1988).

2/ See Bovenberg and Tanzi (1990).

3/ The effects on the EFTA countries are discussed in more detail in EFTA (1989).

4/ Estimates by Pintado et al. (1988) based on the same assumptions as those employed by the EC Commission (1988b) suggest that the EFTA countries actually would have more to gain than the EC.

5/ This goes back to the Cassis de Dijon judgment by the EC's Court of Justice in 1979. See Chapter II.

accept the judgments of the authorities in the home country. 1/ The second principle requires each member state to recognize the supervisory bodies of other Community members. If a financial institution is authorized by one member's authorities, it should also be allowed to operate in the other member states. The third principle calls on the EC Commission to establish certain minimum standards for prudential supervision of financial institutions which all member states have to comply with. Since business is likely to flow to the least regulated areas, the EC hopes to stimulate regulatory convergence through competition between the regulatory frameworks of different member states. Community-wide minimum standards provide a floor to this process.

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

The single banking license is based on a universal banking model. It therefore allows banks to operate in a broad range of activities including leasing, portfolio management and securities trading. Once a bank has been authorized by its home country authorities to undertake a certain activity, it is free to undertake that activity throughout the Community regardless of whether or not banks in other countries are authorized to do so. To safeguard the interests of depositors and investors--as well as the stability of the financial system--each member state has to comply with certain basic standards with respect to capital requirements, the range of permissible non-banking activities and supervisory control of its main shareholders.

The Second Banking Directive is complemented by a number of directives on the harmonization of prudential standards and banking supervision. Common standards for the own funds of credit institutions were established with the adoption of a directive in April 1989. A solvency ratio directive adopted in December 1989 requires banks and credit institutions to limit their lending and financial exposure to a fixed multiple of their capital. These two directives create the harmonized prudential requirements necessary for implementing the single banking license. Both closely follow the recommendations on capital standards by the Committee on Banking Regulation and Supervisory Practices of the Bank for International Settlements (better known as the

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1/ However, supervision of a subsidiary is the responsibility of the authorities in the country in which it is chartered.

Cooke Committee or the Basle Committee). 1/ A number of other directives and recommendations deal with similar prudential issues and issues related to accounting standards. 2/

According to the Second Banking Directive, subsidiaries of foreign banks will generally be able to operate under the same conditions as EC banks. They may engage in all activities authorized in the EC country where they were first established and where they are supervised. While existing EC-based subsidiaries will be covered by a grandfather clause, newly established subsidiaries will be subject to a reciprocity requirement. 3/ Banks from non-EC countries may establish subsidiaries in any EC country if their home countries treat EC banks similar to domestic banks. Branches of banks which are not headquartered in the EC may not have the right to provide services across the EC. The rules for the establishment of branches have not been set on an EC-wide basis and are likely to remain under the discretion of each member state.

The original draft of the Second Banking Directive called for reciprocity based on equivalent treatment. This would have implied that non-EC countries were required to grant EC banks the same treatment as that granted by the EC. Since Europe has a universal banking tradition, while the U.S. and Japan still impose a legal dividing line between banking and securities operations, this approach met with substantial criticism both within and outside the Community. The directive was subsequently modified and the EC has therefore indicated that it will apply the principle of national treatment. This implies that foreign banks will have access to the EC on the condition that their home countries do not discriminate between EC banks and domestic banks. However, the Commission will continue to use equivalent access as a bargaining tool. If the Commission finds that a non-EC country is not granting EC banks treatment comparable to that granted by the EC to

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1/ Committee on Banking Regulation and Supervisory Practices, "International Convergence of Capital Measurement and Capital Standards", July 1988. Among the signatories were Belgium, Canada, France, the Federal Republic of Germany, Italy, Japan, Luxembourg, the Netherlands, Sweden, Switzerland, the U.K. and the U.S..

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

3/ Different reciprocity concepts and their implications for third countries are discussed at length by Key (1989).

non-EC banks, the Commission can initiate negotiations. <sup>1/</sup> Licenses can be denied in cases where non-EC countries do not grant national treatment to EC banks. Subsidiaries of non-EC banks established in the Community prior to the the implementation of the directive are subject to grandfathering provisions and will be treated as Community banks.

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

In Austria, while foreign banks may establish subsidiaries and acquire shares in Austrian banks, they are not allowed to establish branches. The Nordic countries all have restrictions on foreign ownership and establishment. However, all countries have recently taken important steps to liberalize these restrictions. Although the existing legislation in Finland limits foreign ownership to 20 percent of Finnish banks, upon special permission, foreigners can acquire up to 100 percent. Finland is considering to allow foreign banks to establish Finnish branches which at present is not allowed. In Iceland, while foreign participation in non-bank financial institutions is already allowed, banks are only allowed to have representative offices. However, Iceland recently declared its interest to open its banking industry to limited foreign competition and new legislation has been prepared to allow foreign ownership of up to 25 percent of shares in Icelandic banks. Norwegian banking legislation generally limits foreign ownership in Norwegian institutions to 15 percent. Upon special permission, this limit can be raised to 25 percent. The Government has proposed to raise the foreign ownership limit to 33 percent. With effect from July 1, 1990, Sweden has announced a lifting of the ban on foreign ownership of Swedish banks, securities firms and consumer-oriented finance companies. Foreign banks will also be able to establish branches. At present, they can only set up subsidiaries. All

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<sup>1/</sup> It is still unclear if the EC in fact could insist on equivalent treatment given legal commitments by several member states. The OECD code on capital movements generally prohibits discriminatory measures between OECD countries. The only exceptions relate to countries forming a customs or monetary union or to countries which have made an explicit reservation for reciprocity. However, some EC countries have not lodged such a reservation.

countries are considering further liberalization measures. The EC's reactions on these moves have been positive. Provided that certain key provisions would be adopted, the EC Commission has indicated that it would be willing to include EFTA in the single market for banking services. 1/

#### 4. Insurance

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

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

In contrast to the Second Banking Directive, the Second Non-Life Insurance Directive deals only with cross-border provision of services and do not provide for Community-wide branching of insurance companies under home country control. Therefore, the EC is considering a framework directive for non-life insurance that will introduce a single license and home country control for all insurance risks. 2/ This

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1/ Speech by EC Financial Services Commissioner Leon Brittan in Copenhagen on August 31, 1989. See "Financial Services..." (1989).

2/ Speech by EC Financial Services Commissioner Leon Brittan in Cologne on June 7, 1990. See "Insurance ..." (1990). A similar directive is to be proposed on life insurance policies.

directive will also deal with technical reserves, the choice and content of laws applicable to insurance contracts and administrative procedures regulating the activities of insurance companies outside their home state.

The EC took a further step towards a unified market in life insurance policies with the adoption of the Second Life Insurance Directive in December 1989. This directive essentially frees Community citizens to take out life insurance policies in any member state. However, it distinguishes between the case when an individual wishes to take out a policy in a country other than his or her resident country-- in which case he or she would have to accept the degree of protection in the country of the insurer--and the case where an insurance company wishes to conclude an agreement outside its resident country--in which case the insurance company would have to accept the provisions of the country in which the risk is located. This is an exception to the principle of home country control. Further harmonization efforts may therefore be needed for a common market for life insurance policies to be achieved.

The EC's policy with respect to insurance companies from nonmember countries is similar to that in the area of banking. Subsidiaries of EFTA insurance companies operating in the EC will be subject to the same treatment as EC companies. Once a subsidiary is established in any member state, it is free to compete with EC companies on an equal footing. However, the Second Life-Insurance Directive includes a reciprocity clause which follows the wording in the Second Banking Directive. Moreover, the 1973 First Non-Life Insurance Directive and the 1979 First Life Insurance Directive both seem to imply that subsidiaries of non-EC companies would be subjected to certain provisions requiring them to deposit assets in relation to their commitments in each member state. Most member states have also made reservations in the OECD code on capital movements which would allow them to apply reciprocity requirements on non-EC countries. Finally, as in banking, the freedom of non-EC insurers to provide services does not apply to branches or operations of companies whose headquarters are situated outside the Community.

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

All the EFTA countries regard it as important that their insurance companies have good opportunities to operate abroad. The talks between the EC and EFTA have so far been of a rather general nature. In the Nordic countries, the insurance industry has been highly regulated with prohibitive restrictions on foreign establishment and ownership. In line with the general trend of financial deregulation in other countries, efforts to liberalize the insurance sector are now being considered. EC reciprocity requirements are likely to demand that the EFTA countries remove all existing restrictions on foreign establishment.

#### 5. Investment services

The White Paper envisaged the creation of a unified European securities market system which would link the existing stock exchanges in the Community. A number of directives have been proposed or enacted aiming at breaking down barriers between national markets. A major step was taken by the Council of Ministers in November 1985 with the adoption of a directive establishing the free marketing of units issued by investment funds. 1/ It was the first directive which established the freedom to market a financial product throughout the Community on the basis of the principles of mutual recognition, home country control and harmonization of essential standards. Several directives have focused mainly on the harmonization of listing and information requirements. 2/ In the area of mergers and acquisitions, the Commission has issued a 1987 proposal for a directive on insider dealing and a 1988 proposal for a directive on public takeover bids.

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

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

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

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

#### 6. Capital movements

Without free movements of capital, a complete integration of financial markets is impossible. The EC has made rapid progress in this area. In June 1988, the Council of Ministers adopted a directive which called for a complete removal of all remaining capital controls in most EC countries by July 1, 1990 which has now become effective. Several countries implemented the directive well in advance of the actual deadline. While France and Italy abolished remaining restrictions in January and May respectively, Belgium and Luxembourg abolished their two-tier exchange market in March. However, Ireland and Spain have been authorized to maintain certain restrictions until end-1992 and Greece and Portugal through end-1995. The directive contains safeguard clauses that allow member states to reintroduce restrictions on short-term capital movements in the event of disturbances to monetary and exchange rate policies. Such restrictions must be authorized by the EC Commission and may be maintained for a period not exceeding six months.

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

The EFTA countries have gone through a similar liberalization process. Switzerland was the first EFTA country to free capital movements followed by Austria. However, until very recently, all the Nordic countries maintained tight capital and exchange controls. Sweden removed all remaining restrictions in July 1989. Norway removed most of the existing restrictions on the corporate and institutional sectors in December 1989. Effective July 1, 1990, Norway abolished nearly all remaining restrictions including those affecting individuals. Finland has taken many steps to liberalize capital movements in recent years. While a number of restrictions still remain, the Finnish Government has indicated that it wants to proceed with this process, albeit in a gradual fashion. Iceland still retains a rather comprehensive system of restrictions. However, the Icelandic Government intends to introduce extensive liberalization measures to be implemented by 1993.

Free capital movements raises a number of fiscal issues with respect to the scope for tax harmonization and how such a harmonization should be brought about. 1/ The EC Commission has so far considered three options: increased cooperation and exchange of information among national tax authorities; stepped-up reporting requirements; and a minimum withholding tax imposed on dividends and interest income imposed at source on all EC residents. Initially, the Commission opted for the third approach as it proposed a minimum withholding tax of 15 percent on interest income in February 1989. After much opposition from some member countries, the Commission shifted the emphasis in the direction of enhancing the exchange of information to assist member governments in enforcing taxation of their respective residents. It is unclear at this stage what will be the final solution. Taxation is outside the scope of the Oslo-Brussels process. However, as in the EC, the EFTA countries will have to reconsider their tax systems in the process of liberalizing capital movements. 2/

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1/ Bovenberg and Tanzi (1990) provide a detailed discussion of these issues.

2/ Finland, Norway and Sweden are all in the process of carrying out major tax reforms. Reform efforts in all three countries have been guided by the need to conform with international trends. However, it is premature to predict to what extent further adjustments will be needed. For details on EC-EFTA issues in taxation, see Chapter X.

## IX. European Monetary Unification and the EFTA Countries

### 1. Introduction

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

### 2. The evolution of monetary integration in the EC

The EEC Treaty did not include precisely defined commitments regarding monetary and exchange rate policies. Monetary unification was not a stated objective, although the Treaty did cover most of the factors necessary for monetary integration. <sup>1/</sup> However, when the fixed exchange rate system came under pressure in the late 1960s, the Heads of State and Government of the EC decided to seek to create an EMU in Europe. The Werner Plan, which was presented in 1971 and envisaged fixed exchange rates, free movement of capital and coordinated monetary policies supervised by a common monetary institution, also favored harmonized economic policies, especially in the fiscal field. However, events in the world economy prevented its implementation.

In April 1972, after the suspension of the U.S. dollar convertibility and the Smithsonian agreement of December 1971, <sup>2/</sup> the EC member states concluded a common margin agreement in Basle with the aim of narrowing the margins between their currencies. Under this agreement, the EC central banks set up an arrangement known as the "snake in the tunnel," because the allowed margin in the arrangement was only half the 4.5 percent allowed under the Smithsonian agreement. In May 1972, the Norwegian krone became associated with the snake. In March 1973, pressure from speculative capital flows forced the participants to jointly float vis-à-vis the dollar, causing the tunnel around the snake to disappear. Norway and Sweden both participated in this new arrangement. However, conditions in the snake remained unstable, causing several currencies--including the British and Irish

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<sup>1/</sup> See Emerson (1979), p. 23.

<sup>2/</sup> The Smithsonian agreement re-established fixed exchange rates, with margin of <sup>±</sup> 2.25 percent, instead of <sup>±</sup> 1 percent under the Bretton Woods agreement.

pound, the Italian lira, and the French franc--to leave the snake. 1/ Although limited progress was made toward monetary integration during this period, the snake arrangement served as a useful framework of cooperation for the remaining countries and became the predecessor of the EMS.

In December 1978, a resurgence of interest in monetary cooperation led to the adoption of the resolution of the European Council which formed the basis of the EMS. In the hope of creating a zone of monetary stability in Europe, the EMS was based on three cornerstones: the Exchange Rate Mechanism (ERM); the European Currency Unit (ECU); and several credit facilities. 2/ The EMS, which became operational in March 1979, has shown much flexibility, as well as the ability to gradually evolve over time. 3/ The success of the EMS in fostering monetary convergence to secure increasingly stable exchange rates within the ERM, 4/ has created favorable conditions for, as well as a renewed interest in, further European economic and monetary integration. 5/

As the initial goals of the EMS have progressively been achieved and the start up of the Internal Market approaches--with full capital liberalization occurring even earlier--it has been widely felt that the demands on the EMS may eventually exceed the system's capabilities. 6/ At the Hanover summit in June 1988, the European Council appointed a committee chaired by Jacques Delors, President of the EC Commission, to propose steps leading to monetary unification within the EC. The Delors

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1/ Sweden and Norway left the snake in August 1977 and December 1978, respectively, after monetary policy in the other participating countries was regarded as too restrictive and incompatible with the overriding domestic objective of high employment. See Gylfason (1989), p. 5.

2/ For details, see Ungerer (1979).

3/ See Ungerer et al. (1983), (1986) and Ungerer (1990).

4/ When the EMS became operational in 1979, the then nine EC members all joined the EMS with all but the U.K. participating in the ERM. Greece, Portugal and Spain joined the EMS after acceding in to the EC. Greece and Portugal have stayed out of the ERM, while Spain became a participant in June 1989.

5/ For discussions of the achievements of the EMS, see Giavazzi et al. (1988), Gros and Thygesen (1988) and DeCecco and Giovannini (1989).

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

Committee presented its report in April 1989. 1/ The report proposed a three stage process to achieve a monetary union based on total and irreversible convertibility of currencies, completely free capital movements, fully integrated financial markets and irrevocably fixed exchange rates.

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

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

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

At its Madrid meeting in June 1989 the European Council endorsed the Delors Report. Restating that the EMU would be indispensable for the completion of the Internal Market, it was decided that the first stage of the realization would begin on July 1, 1990.

### 3. Exchange rate arrangements in the EFTA countries

In contrast to the EC, where national monetary and exchange rate policies aim at convergence, exchange rate policies in the EFTA countries differ markedly, especially between the Alpine and the Nordic member countries. Austria has pegged the external value of the schilling to the deutsche mark, requiring the authorities to use

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1/ See Committee for the Study of Economic and Monetary Union (1989).

monetary policy exclusively to maintain exchange rate stability. 1/ Switzerland has adopted similar monetary targets as in Germany, leading to a de facto harmonization of monetary policies. 2/ It has not set a formal exchange rate target, but since monetary policies of the Deutsche Bundesbank and the Swiss National Bank have been guided by similar targets, the deutsche mark/Swiss franc exchange rate has remained remarkably stable. 3/

In contrast to the Alpine EFTA countries, all Nordic EFTA countries have pegged their exchange rates against baskets of currencies in which the ERM currencies have a substantial weight (Table 6). 4/ Margins have been set within which the exchange values of the currencies are allowed to move. Currencies included in the baskets generally reflect the relative importance of trade with other countries. Except for Norway, which has adopted a multilateral weighting scheme, 5/ the baskets are mainly based on bilateral trade weights. However, in the case of Sweden, the U.S. dollar has been given double weight, since a substantial share of Swedish exports is denominated in dollars. The dollar has also a disproportionately high weight in the Icelandic currency basket, reflecting the importance of the dollar for capital account transactions. The currency weights in the baskets are periodically reviewed.

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1/ Until 1978 Austria's exchange rate policy was based on a currency basket, with the deutsche mark being of dominant importance. Before the schilling was more or less completely tied to the deutsche mark in 1981, the exchange rate was determined primarily by the deutsche mark. Austria's strategy of pegging the schilling is often described as a "hard currency policy." For details see, for example, Genberg (1986), p. 18, and Haltunnen (1984), p. 1.

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

3/ Although the external value of the Swiss franc is, in principle, endogenous, the Swiss National Bank occasionally modifies its policy of base money control by using the Swiss franc/deutsche mark exchange rate as a secondary intermediate target for monetary policy.

4/ For details see Gylfason (1989) and IMF (1989).

5/ The weights were based on the IMF competitiveness weights which take into account not only bilateral trade relations but also competitiveness in third markets. See Brekk (1987), p. 16.

Table 6. Currency Basket Arrangements in the Nordic EFTA Countries 1/

	Finnish markka	Icelandic króna	Norwegian krone	Swedish krona
Composition of the basket <u>2/</u>				
Austrian schilling	1.6	0.4	1.5	1.3
Finnish markka	--	2.1	3.0	6.7
Norwegian krone	3.8	5.2	--	8.7
Swedish krona	19.1	5.3	15.0	--
Swiss franc	2.4	2.3	1.2	2.1
Total weight of EFTA currencies	26.9	15.3	20.7	18.8
Belgian franc	3.1	1.7	2.4	3.7
Danish krona	4.4	7.0	6.8	7.6
Deutsche mark	19.1	13.4	17.7	16.4
Netherlands guilder	4.8	4.7	4.6	4.6
French franc	6.5	4.7	9.2	5.2
Italian lira	5.0	3.2	3.3	3.8
Spanish peseta	1.9	2.2	--	1.5
Total weight of ERM currencies	44.8	36.9	44.0	42.8
Canadian dollar	--	0.4	3.6	1.2
Japanese yen	6.3	7.9	6.0	3.6
Portuguese escudo	--	4.5	--	--
Pound sterling	13.6	15.2	14.7	11.1
U.S. dollar	8.4	20.0	11.0	22.5
Organized foreign exchange market	Yes	No	Yes	Yes
Weighting scheme <u>3/</u>	Bila- teral <u>4/</u>	Bila- teral <u>5/</u>	Multi- lateral <u>6/</u>	Bila- teral <u>7/</u>
Margins	±3.0	±2.25	±2.25	±1.5
Adjustment frequency	quarterly	annually	unspecified <u>8/</u>	annually

Sources: Information provided by the national authorities.

1/ As of January 31, 1990.

2/ Weights in percent of total.

3/ In percent of the basket index.

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

5/ the trade index contains 15 currencies of those countries which are the most important ones for Iceland's foreign trade.

6/ The weights are, in principle, based on Norway's exports of processed goods to each of the countries whose currencies are included, also taking into account competitive relations with third countries.

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

8/ The weights are considered at certain time intervals, and can also be considered in connection with changes in IMF's competitiveness weights (MERM). The current index has not been changed since August 1982.

4. EFTA's interest in monetary consultations with the EC

The EFTA countries, while willing to participate in financial integration in Western Europe, (see Chapter VIII), recognize the implications of free trade in financial services, particularly as they relate to monetary independence, currency substitution, fiscal policy and the ability to deal with country-specific shocks. 1/ There is growing concern whether the EFTA countries--with the EC as their largest trading partner--can achieve full integration in financial services without participating in the EC's economic and monetary cooperation. 2/ For example, the report of the EFTA's Economic and Social Subcommittee on the Creation of a European Financial Area stated:

Having in mind the interdependence of the EFTA and the EC countries and the goal of the European Economic Space, the avoidance of divergent exchange rate developments between the countries is an important task . . . Instabilities . . . will undermine the creation of a European Financial Area. 3/

Reflecting these concerns, the EFTA heads of state in March 1989, voiced an interest in intensified consultations with the EC in the areas of economic and monetary policies. 4/ However, they did not say whether the talks should be on an informal basis or within the framework of the EMS. This aim, which was stated even before the Delors Report, has been interpreted as being "not far from what is foreseen as part of the first step of the EMU." 5/ Some have argued that--considering the challenges arising from financial integration--there is no alternative for the EFTA

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1/ For a discussion of the effects of financial integration, see Folkerts-Landau and Mathieson (1989), pp. 7-11.

2/ See Wolfbrandt (1989), p. 22.

3/ See Consultative Committee (1989), p. 20.

4/ See paragraph 12 of the Oslo Declaration, "Declaration of the Heads of State" (1989).

5/ Kleppe (1989), p. 8.

countries but to join the EMS, since only through formal economic and monetary cooperation with the EC can the EFTA countries hope to defend their interests within the European Economic Space (EES). 1/

Mr. Duisenberg, the head of the Dutch central bank, has also argued that having the EFTA countries join the EMS might be in the interest of both the EFTA countries themselves and the present EMS members: 2/

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

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

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

2/ See Duisenberg (1988), pp. 40 and 42. See also Matthes (1988), who argued in the same direction from the view of the EC.

5. The concept of the optimum currency area

There is considerable debate as to what constitutes an optimum currency area. 1/ The literature goes back to a classic article by Mundell (1961). In his analysis, he argued that an optimum currency area must have a high degree of mobility of factors of production requiring a large measure of openness for both labor and capital. McKinnon (1963) also viewed openness as an essential feature of a currency area. However, he focused on goods and services, arguing that openness should be measured by the size of the tradeables sector. Kenen (1969) argued that the degree of diversity of the product mix in an economy was another important factor in determining a currency area. Finally, shifting the emphasis from the goods to the capital markets, it has been argued, for example by Ingram (1969), that an optimum currency area must have a high degree of financial integration. Capital mobility alone, as suggested by Mundell, would not be a sufficient condition.

All these approaches seek to establish objective criteria for the formation of a currency area. 2/ The extent of factor mobility, product diversification and financial integration, as well as the share of tradeables in production, are all seen as indicators for determining if a country's economic policy interests would be furthered by joining a given a currency area. Based on these criteria, the EES--with the EFTA countries fully participating in all four freedoms--may indeed form an optimum currency area. 3/ As observed earlier in this paper, the formation of the EES, in combination with the Internal Market Program, would imply free movements of capital and labor between the EC and EFTA. With the removal of capital controls and the deregulation of cross-border restrictions on the provision of financial services, financial markets would become integrated. Moreover, all EFTA countries are very open economies and most have a relatively high degree of product diversification.

In addition to the approaches which emphasize objective criteria, there is another literature which focuses on "subjective" criteria. 4/ This approach can be broadly divided into two categories, one focusing on commonality of aims and one focusing on similarity of policy attitudes. The former includes, for example, Haberler (1970) and Fleming (1971), who stressed the importance of broadly equivalent rates of inflation, and de Grauwe (1975), who emphasized the need for similar

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1/ This brief overview largely follows Guitián (1988), pp. 4-5. See also Ishiyama (1975).

2/ See Guitián (1988), p. 4.

3/ Although the position of Iceland would appear somewhat tenuous.

4/ See Guitián (1988), p. 4.

inflation-output or inflation-employment tradeoffs. The latter category includes, for instance, Tower and Willett (1970), who argue that a high degree of policy integration is needed for an optimum currency area. 1/

The "subjective" approaches are not very different from a third approach which focuses on the costs and benefits of participating in a currency area. 2/ Although the cost-benefit approach takes a different perspective, there are obvious similarities with the "subjective" approaches. In principle, it can be assumed that if differences between national economic policy objectives and attitudes exist, the costs of joining an existing currency area will depend on the degree of necessary policy adjustments. The more economic priorities are in line with those in the area, the less the need for adjustments and hence the lower the costs of joining (and vice versa).

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

The following section will focus on the "subjective" approaches, comparing exchange rate behavior, monetary growth, and inflation in the EFTA countries with the EMS. Next, the costs and benefits of joining the EC's exchange rate arrangements will be discussed.

#### 6. Exchange rate behavior, monetary growth and inflation

A closer examination of the EFTA countries' exchange rate and monetary policies yield the following observations. First, the short-term exchange rate variability of the currencies of the Alpine states against ERM currencies is remarkably low. 3/ In fact, the variability of the Austrian schilling is lower than for the currencies in the ERM. While relatively limited exchange rate movements vis-à-vis the ECU can be observed for the Finnish markka, the Norwegian krone and the Swedish krona, over the medium and long run, the movement of the

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1/ Of course, there is a close relationship between common aims and the degree of policy integration.

2/ See Guitián (1988), p. 5.

3/ Guitián (1988), p. 20. The same study also examined the short-term variability of the Norwegian krone and the Swedish krona.

frequently devalued Icelandic króna differed markedly from all ERM currencies (Charts 3 and 4). The Alpine EFTA states' currencies, on the other hand, have maintained their values vis-à-vis the ECU at least as well as most of the de jure ERM participants. Over time, both currencies have followed the appreciation of the deutsche mark and the Dutch guilder against the ECU. 1/

The differing exchange rate developments in the EFTA countries may to a large extent be explained by differing monetary growth rates. For example, monetary growth rates in the Alpine members of EFTA seem to have followed developments in the EMS relatively closely (Table 7). A tendency toward lower monetary growth rates is also observed in Sweden, while monetary growth in Finland and Norway has remained faster than in the EMS. However, the faster monetary growth may be partly explained by the financial reform which took place in these countries during the mid-1980s. On the other hand, monetary growth in Iceland greatly exceeded monetary growth in the EMS.

Since a currency area with (quasi) fixed exchange rates requires converging inflation rates at least in the medium run, it is useful to consider to what extent price developments in the EFTA countries have deviated from those in the EMS (Table 8). Inflation in the EMS also seems to have converged to a lower level. 2/ Again, relatively low inflation rates can also be observed for Austria and Switzerland, whereas in the Nordic countries inflation rates have remained higher.

These findings imply that at present, the "subjective" approaches, would not support the view that the EMS is an optimum currency area for the Nordic EFTA countries, 3/ whereas Austria and Switzerland behaved as if they already belonged to the EMS. This suggests that if EFTA were to join the EMS, major policy adjustments could probably only be avoided in the two Alpine countries. In the Nordic countries, however, joining would require--to different degrees--changes in their economic

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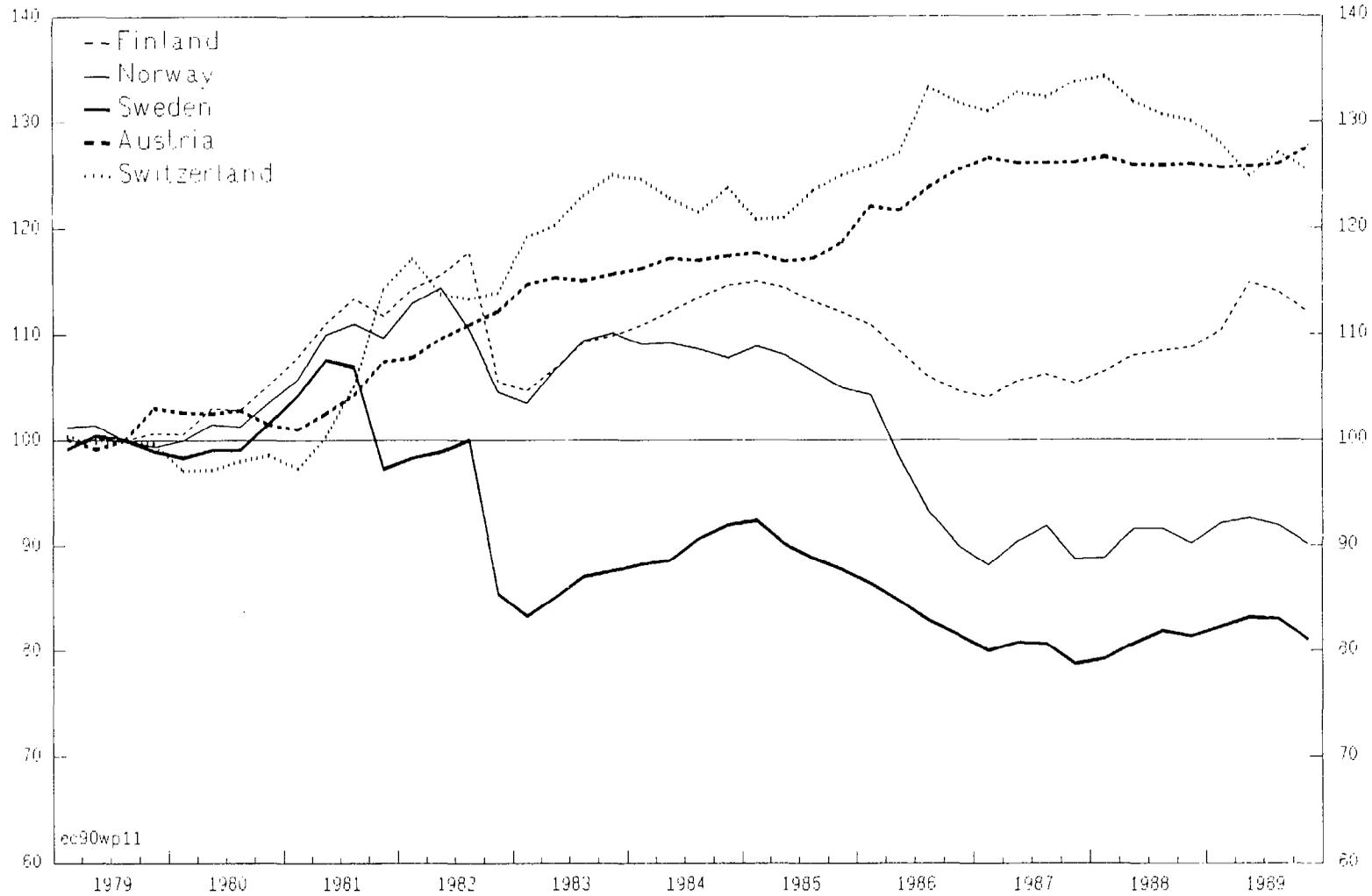
1/ According to Russo and Tullio (1988), the EFTA countries behaved as if they belonged to the EMS at least since 1983. However, the study did not include Finland or Iceland. Their findings would probably not apply in the case of Iceland.

2/ This did not necessarily occur because of the EMS. However, most empirical studies (an exception is, for example, Collins (1988)) concluded that the EMS have provided a framework in which anti-inflationary policies could be pursued more effectively by providing a binding constraint to high-inflation countries. See Russo and Tullio (1988).

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

CHART 3

MOVEMENT OF EFTA CURRENCY EXCHANGE RATES AGAINST THE ECU  
(Monthly averages, Quarter 3 1979 = 100)



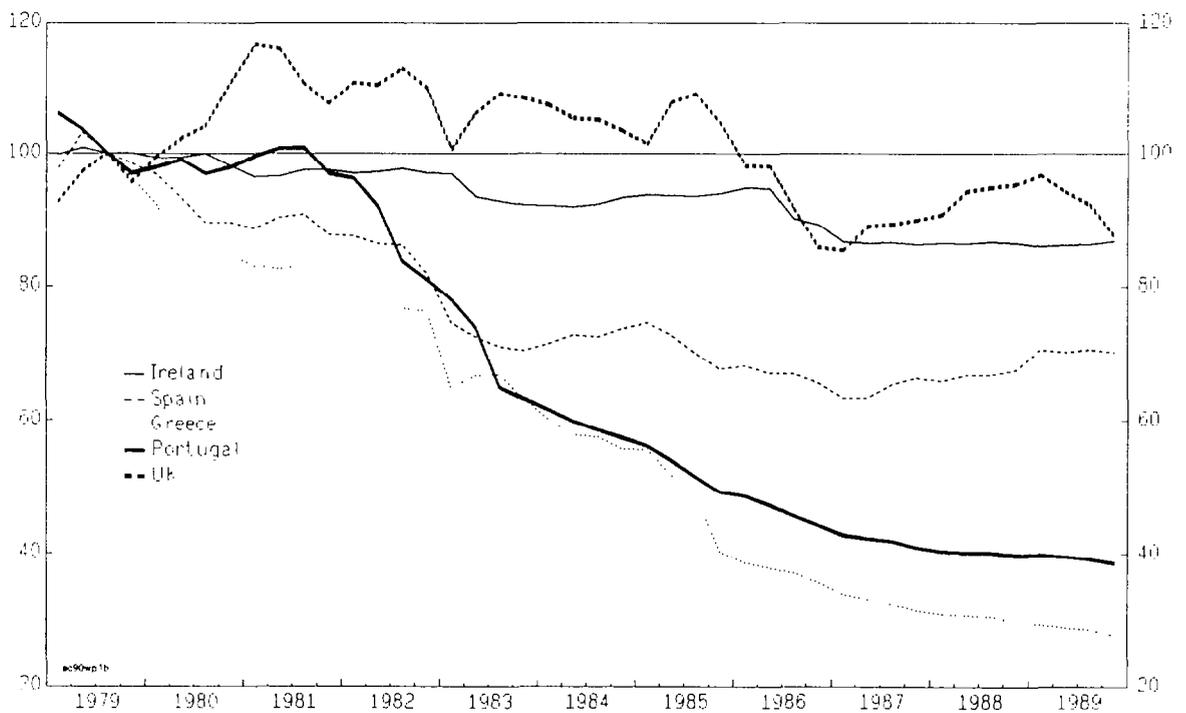
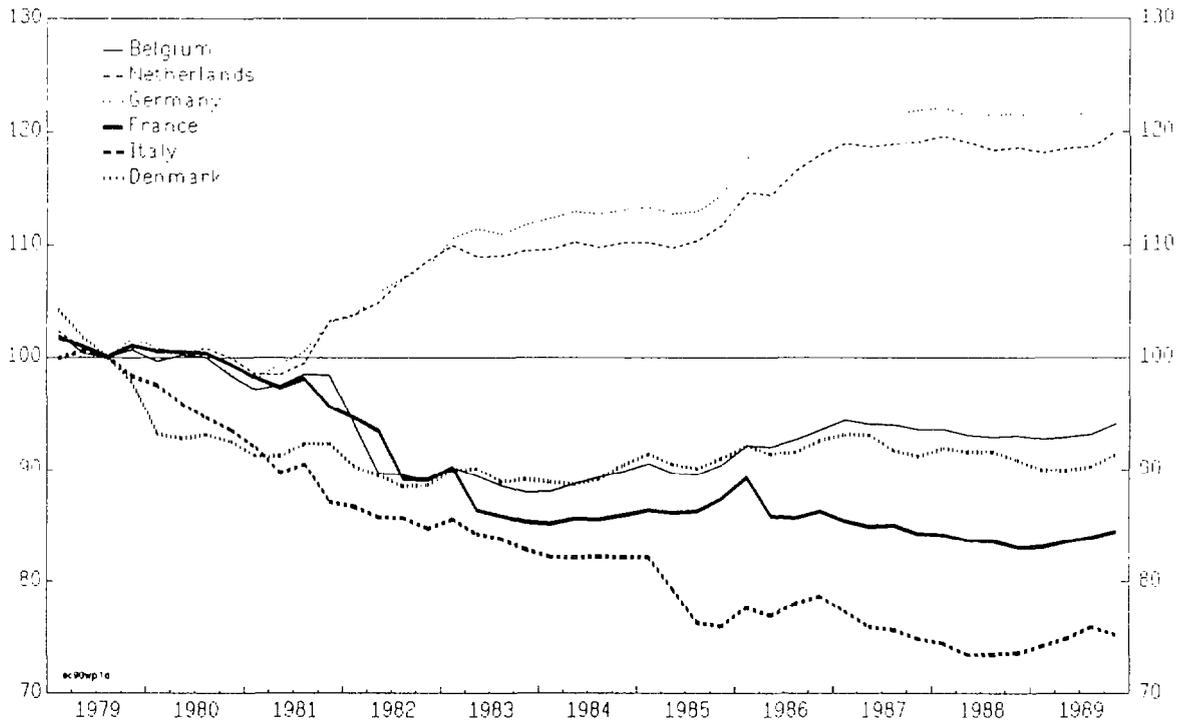
Source: IMF, International Financial Statistics.



CHART 4

MOVEMENT OF EMS CURRENCY EXCHANGE RATES AGAINST THE ECU

(Monthly averages, Quarter 3 1979 = 100)



Source: IMF, International Financial Statistics.



Table 7: Monetary Growth in the ERM  
and in the EFTA Countries <sup>1/</sup>

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

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

<sup>1/</sup> Monetary growth (changes over preceding year) refers to broad money.

<sup>2/</sup> In percent.

<sup>3/</sup> In percentage points.

Table 8. Inflation in the ERM and the EFTA Countries 1/

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

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

1/ Changes in consumer prices (over preceding year).

2/ In percent.

IM9-Table8

3/ In percentage points.

policies. From the view of the cost-benefit approach to optimum currency areas, does an accession of the EFTA countries to the EMS seem desirable?

7. The costs and benefits of joining the EMS

With perfect capital mobility--which is an implication of financial integration--and fixed exchange rates, monetary policy autonomy is lost. The central bank controls neither the domestic interest rate nor the money stock. The only effect of an open-market operation is a change in the composition of its balance sheet. A purchase of bonds leads to a loss in reserves as rapidly as the central bank buys bonds. This is one of the main conclusions of the Mundell-Fleming model 1/ which originated in the early 1960s and has been extended during the ensuing quarter century. 2/

The experience with the EMS--where capital mobility has been less than perfect and exchange rates not completely fixed--has shown that such a system severely limits autonomy in policy formulation. 3/ Under present arrangements, monetary coordination involves using the Deutsche Bundesbank's policy as a reference for the conduct of monetary policies in the other ERM member countries. However, with full financial integration and irrevocably fixed exchange rates as envisaged in the Delors Report, any remaining independence would be lost, requiring complete monetary coordination among the EMS members. 4/

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1/ See Mundell (1968) and Fleming (1962).

2/ See Frenkel and Razin (1987), Genberg (1989) and Kenen (1985).

3/ For an overview see, for example, Guitián (1988).

4/ As argued, for example, by Giavazzi and Giovannini (1988) the present form of coordination--where monetary policy is set by Germany and the other countries have the option of going along with German monetary targets or realigning--is inconsistent with fully integrated financial markets. Pointing at the Italian experience, where there was a major speculative attack when administrative controls on export credits were removed in May 1987, the authors emphasized the need for the setting of monetary targets by a supranational institution. Otherwise, speculative attacks could cause realignments which may be regarded as inconsistent with economic fundamentals.

The EFTA countries which, with the exception of Switzerland, pursue exchange rate targets, are aware of the constraints which fixed exchange rates impose on economic policy making. 1/ Joining the EMS would not imply a change from a flexible exchange rate regime to a fixed rate regime, but one from a fixed but adjustable exchange rate regime to another. 2/ The important difference would be that under present arrangements discretionary exchange rate changes are the Government's decision, while in the EMS agreement must be reached with other participants. With exchange rate realignments in the EMS depending on a joint decision of all participants, the authorities are forced to follow the monetary policy stance in the other member countries which, in effect, has been dominated by the anti-inflationary policy of the Bundesbank. This additional constraint on policy autonomy becomes more severe, the more monetary policy and inflation rates at present deviate from those in the EMS.

The further loss in monetary autonomy would constrain the authorities' ability to reduce the cyclical or "demand deficient" component of unemployment with an expansionary monetary policy. As a result, the reliance placed on structural and fiscal policies would increase. 3/ However, a reduction in monetary autonomy may also reduce the extent to which fiscal deficits can be financed by seigniorage from money creation (Table 9). Part of this loss would come from a reduction in monetary expansion to a rate compatible with lower inflation rates. 4/ In addition, financial integration would bring pressure for the harmonization of reserve requirements for commercial banks. Those countries with relatively high reserve requirement ratios face, ceteris

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1/ Capital controls in the EFTA countries have almost completely been removed and the remaining controls do not appear very effective. Akerholm and Tarkka (1987) argued that the Nordic EFTA countries could not conduct an independent monetary policy even when all controls were in effect. For empirical evidence, see Viren (1989).

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

3/ See Folkerts-Landau and Mathieson (1989). In addition, financial integration may make it easier for European residents to switch among monetary assets denominated in different currencies so that the demand for key monetary aggregates may become less stable than in the past, which might complicate monetary control.

4/ This has been observed for ERM countries in the 1980s. See Dornbusch (1988).

Table 9: Seignorage in the EFTA Countries 1/

1980-1987

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	In Percent of GDP	In Percent of Total Government Revenues
Austria	0.4	1.2
Finland	0.8	2.9
Iceland <u>2/</u>	2.0	6.3
Norway	0.4	0.9
Sweden	0.4	0.9
Switzerland	0.4	4.2

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

1/ Seignorage is measured as the December to December change in reserve money.

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

paribus, the largest prospective loss of seigniorage. 1/ Although the effects on financing fiscal deficits may be relatively small, it may still increase the burden on stabilization policies.

A loss of monetary autonomy can be seen as a disadvantage for economic policy making. However, by joining a fixed exchange rate system under German leadership, more inflation-prone countries can gain credibility in the disinflation process, provided realignments are not frequent and entail political as well as economic costs. 2/ This gain in credibility arises from the fact that maintaining fixed exchange rates requires the authorities to keep their policies in line with the policy stance in the EMS. In this case, participation in the ERM has a disciplinary effect and thus allows a country to more easily "buy" the anti-inflationary reputation of the Deutsche Bundesbank. 3/

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

However, competitiveness will be reduced if discipline is less than perfect--and differences between the anti-inflationary policy stance in Germany and in the country concerned remain--and needed realignments are

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

2/ See, for example, Giavazzi and Giovannini (1989). However, as Lane and Rojas-Suarez (1989) have shown, the gain in credibility depends also on the degree of capital mobility and the margin within which the exchange rate is allowed to fluctuate.

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

postponed. 1/ To determine the net impact of ERM participation, the credibility gains have to be weighed against the output loss caused by the real appreciation of the exchange rate. 2/ While this is a difficult task--requiring intertemporal judgment--it cannot, a priori, be excluded that ERM participation may reduce welfare. 3/

It should also be remembered that the present currency basket arrangements in the Nordic EFTA countries are designed to provide the maximum average stability in the effective exchange rate. This implies that adverse effects of global exchange rate fluctuations on competitiveness are minimized, which would no longer be the case if they joined the ERM. However, the basket arrangements do not appear to be so different from the ERM that this effect would be of dominant importance. Moreover, an even stronger similarity would exist, if the Pound Sterling participated in the ERM as envisaged in the Delors Report. 4/ In this case, the weights of the EC currencies would probably be raised, thus diminishing the existing differences between their currency baskets and the ERM arrangements.

It has also been argued that financial integration--especially the removal of all existing capital controls--may increase the risk of large and destabilizing capital movements. However, joining the ERM would have the advantage of giving access to unlimited very short-term support when the currency is under pressure. 5/

#### 8. The views of the individual EFTA countries

The picture in the preceding discussion does not give a clear cut answer whether participation in the ERM would yield benefits which would unambiguously exceed the costs of such a step. Such a judgment would depend on the economic preferences in the country concerned, as well as their weighting of the potential costs and benefits. While EFTA recognizes the need for closer economic and monetary cooperation with the EC, the standpoints of the individual member states are very heterogeneous as to whether this requires a formal accession to the EMS.

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

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

3/ Melitz (1988) argued that this may have been the case for France.

4/ Until recently, the Norwegian authorities, maintained that EMS membership would hinge on that of the U.K.. See Skånland (1988), p. 46.

5/ See Kleppe (1989), p. 8.

Until now, only Austria has initiated concrete steps toward an association with the EMS according to Article 5.2 of the EMS agreement. 1/ Having applied for EC membership in 1989, the Austrian authorities recognize that an accession to the EC would also imply the participation in the EC's formal monetary arrangements. However, even before the Austrian National Bank was authorized to enter into detailed exploratory talks on Austria's association with the EMS, several preliminary steps had already been taken in this direction. At Austria's request, the Austrian National Bank was granted the status of "other holders of ECUs" in July 1989. The Bank has also been a participant in the daily concertations of EC central banks, while the ECU has been quoted on the Vienna Foreign Currency Exchange since 1986.

The Swiss National Bank was the first central bank outside the EC to be granted the status of "other holders of ECUs" by the European Monetary Cooperation Fund. However, Switzerland does not plan to join the EMS. There are two main reasons. First, Mr. Lusser, President of the Swiss National Bank, has said that the additional discipline provided by fixed exchange rates was not seen as necessary to achieve price stability and that EMS membership would hardly improve Switzerland's situation. 2/ Second, it has been argued that the EMS is not an optimal currency area for Switzerland. 3/ Such an optimal currency area would exist if labor and capital were mobile. However, unlike Austria, Switzerland has objected to the removal of labor mobility restrictions vis-à-vis EC members.

Among the Nordic countries, so far only Norway has indicated that it may seek to join the EMS. 4/ A report published in 1989 by a government committee on monetary policy suggested that EMS membership would be advantageous mainly for two reasons. 5/ First, the ERM would provide Norway with better protection against speculation than the current basket arrangement, by giving access to unlimited short-term support when the krone came under pressure. Although the krone has been quite stable since it was last devalued in 1986, each year it has been subject to isolated speculative movements against the currency. Thus, the gains from access to the very short-term financing facility may outweigh the losses--in terms of exchange rate stability--from abandoning the present basket arrangement. Second, it has been argued that EMS membership would add credibility to Norway's stabilization policies. Although participation in the EMS would also result in a loss

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1/ See "Dr. Klauhs Presents an Austrian View ..." (1989).

2/ See "Dr. Lusser warns against exaggerated expectations . . ." (1988) and "Schweizerische Notenbank: Absage an Beitritt zum EWS" (1988).

3/ See "Das EWS als währungspolitische Alternative" 1988).

4/ See "Norwegians May Seek EMS Entry" (1989); and "EC Outsiders Pursue Connection with EMS" (1990).

5/ See Norges Offentlige Utredninger (1989).

of monetary autonomy, the overall benefits would still be positive. 1/ Therefore, it would be conceivable that Norway might seek accession to the EMS, even if its fellow EFTA members decide not to.

Finland, Iceland, and Sweden do not have plans for joining the EMS or for closer links with the EC's exchange arrangements. Although the authorities in these countries are aware that closer financial integration in Western Europe reduces the degree of policy autonomy 2/--irrespective of whether they join the EMS--it appears that they are not yet willing to surrender the exchange rate instrument and to subordinate monetary policy to exchange rate stability. 3/ However, if a number of other EFTA countries were to join or become associated with the EMS, closer ties might become more attractive, at least for Finland and Sweden. 4/ In this respect, action on the part of Norway toward joining the EMS might lead to a change in their position. However, as far as Iceland is concerned, which is subject to frequent supply shocks due to its heavy reliance on fisheries, participation in the EMS appears to be difficult at this point of time. Given the fact that Iceland's overriding economic policy goal has been the maintenance of full employment, the costs of subordinating monetary policy to exchange rate stability would probably by far exceed the benefits of joining the EMS.

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1/ The Norwegian authorities recognize that the resulting loss in monetary autonomy may be particularly important for their country, which, as a major oil exporter, is subject to shocks that may be seen as country-specific relative to its trading partners. In fact, this has been one of the major reasons why the United Kingdom has refused to join the ERM. See Ungerer et al. (1986), p. 4.

2/ See Svensson (1989) and Viren (1989).

3/ See Moe (1990).

4/ See Kotilainen and Peura (1989).

## X. Tax Harmonization

### 1. Introduction

With free mobility of commodities and factor inputs being implemented, the EC Commission has stressed the need for tax harmonization. The Commission has given top priority to harmonizing indirect taxes, since, at present, the administration of these taxes is crucially dependent on the existence of border controls, which are to be removed with the start up of the Internal Market. As no removal of border controls between the EC and the EFTA is currently envisaged, the implication for the EFTA of indirect tax harmonization in the EC is limited. Moreover, the EC countries have tended to postpone decisions relating to tax harmonization. While an alignment of taxes may still come about spontaneously through competitive pressure, this would be a slower process than a centrally administered one.

Harmonization of indirect taxes is discussed in Section 1 and issues relating to capital income taxes in Section 2. Harmonization of corporate and capital income taxes is potentially an urgent problem because these taxes fall on a highly mobile base. In contrast, the Commission has no plans for a general harmonization of taxes on labor income, reflecting the fact that the psychological and cultural barriers to international mobility of labor are still high.

### 2. Harmonization of indirect taxes

At present the EC countries (as well as the EFTA countries) maintain widely different VAT rates (see Table 10) without this having adverse effects on any country's competitiveness or providing incentives for shifting production from high-tax to low-tax countries. <sup>1/</sup> The reason is that the VAT systems are operated according to the "destination principle" under which goods are taxed in the country of final consumption. Thus, a product carries the domestic tax rate whether it is produced domestically or imported, while exported products leave the country free of any VAT. In order to ensure that the domestic VAT is charged on imported products and that goods for which zero-rating is claimed are in fact being exported, countries rely on tax adjustments at the border. Border controls are also used to monitor cross-border trade, so that consumers making direct purchases abroad are made subject to the domestic VAT on purchases in excess of the personal exemption. Thus, the frontier formalities permit a member country to set its own tax rates without imposing adverse externalities on other countries.

If the VAT system is to remain neutral after border controls are eliminated, an administrative substitute for the fiscal checks at the frontier has to be devised. In addition, member states with higher rates of indirect taxation may have to reduce their tax rates in order

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<sup>1/</sup> Switzerland has a turnover tax instead of a VAT.

Table 10. EC and EFTA: VAT Rates 1/

(In percent)

Country	Lower Rate	Standard Rate	Higher Rate
I. EC			
Belgium	1-6	19	25-33
Denmark	--	22	--
France	5.5	18.6	25
Germany	7	14	--
Greece	3-6	16	36
Ireland	2-10	25	--
Italy	4-9	19	38
Luxembourg	3-6	12	--
Netherlands	6	18.5	--
Portugal	8	17	30
Spain	6	12	33
U.K.	--	15	--
II. EFTA			
Austria	10	20	32
Finland	--	19.5	--
Iceland <u>2/</u>	14	24.5	--
Norway	--	20	--
Sweden	--	23.46 <u>3/</u>	--
Switzerland <u>4/</u>	--	16	--

Sources: "Rates of VAT in the EC on January 1, 1989," European Report, December 14, 1989, p.II, 4; "Value Added Taxation in Europe," Guides to European Taxation, Vol. IV; and data provided by country authorities.

1/ January 1, 1989, unless specified otherwise.

2/ January 1, 1990.

3/ Reduced rates are applied for construction and certain other services. A temporary increase to 25 percent entered into effect on July 1, 1990; it will expire on December 31, 1991.

4/ No VAT. Turnover tax levied at 6.2 percent on consumers and 9.3 percent retailers. Imports are taxed at 9.6 percent unless imported by registered enterprise.

to avoid a diversion of retail business (and tax revenue) to lower-tax member states. For the former purpose, the Commission has proposed that the system of zero-rating of exports from one member country to another be ended, i.e., transactions between countries would be treated in the same way as those within countries. Thus, exports would carry the exporting country's VAT, which would be reimbursed as input VAT to the importer. Such a change would have implications for the international distribution of tax revenue. <sup>1/</sup> Accordingly, a clearing system would be set up to redistribute VAT revenues, so that they continue to accrue to the country where the products are consumed. In relation to nonmember countries, the EC would continue to operate a traditional system based on fiscal documentation at the border. Thus, the administrative aspects of the proposed VAT reform would have no consequences for the EFTA as long as border controls are maintained between the two blocks.

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

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

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

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<sup>1/</sup> Under this proposal, exporting countries with relatively high rates of VAT would gain, as would countries with export surpluses.

Along with its proposals for alignment of VAT systems, the Commission has also made suggestions for the harmonization of excise taxes. In this area, the tax systems of the EC countries are even more divergent than in the case of the VAT, with important differences existing for example in the treatment of manufactured tobaccos, alcoholic beverages, and mineral oils.

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

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

While Switzerland's dependence on its turnover tax is comparatively modest, most EFTA countries rely heavily on revenue from the VAT (Table 11). A removal of border controls between the EFTA and the EC and a concomitant harmonization of VAT rates would thus lead to sizable losses of revenue for the EFTA countries. The latter may therefore opt

Table 11. EC and EFTA: Revenues from VAT and Excise Taxes

(In percent)

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

Sources: IMF, International Financial Statistics, March 1990; and IMF, Government Finance Statistics Yearbook, 1989.

to follow Denmark's approach to harmonization, which is to give priority to the lowering of rates on goods that are important in cross-border trade.

### 3. Harmonization of capital income taxation

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

At present, there are large differences among EC member countries in the taxation of capital income. The calls for harmonization have been prompted by the fact that with full capital mobility in prospect, these differences are creating considerable scope for tax arbitrage and tax evasion. Moreover, when capital is free to move to countries with a favorable tax regime or where it can escape taxation altogether, it is apparent that the capital will not necessarily be used to finance the most efficient investments.

The Commission has made a number of proposals in the area of corporate income taxation, with the first dating back to 1969. They address such issues as the harmonization of company tax systems, the elimination of double taxation of foreign source company income, the crediting of shareholders for the tax on company profits, etc. Thus, the main features of a directive proposed in 1975 included: a single statutory rate of corporate income tax set in an interval between 45 percent and 55 percent; a common imputation system for distributed dividends with a single rate of tax credit to shareholders; a common approach to the taxation of dividends crossing borders, etc. The proposal was never adopted. At present, the Commission is addressing the concerns expressed by the European Parliament over the lack of uniformity in the computation of the company tax base.

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

It appears that progress toward concerted harmonization of capital income taxes in the EC will be slow. This may not give great comfort to the EFTA countries, however. First, with increasing capital mobility, the EFTA countries may be just as exposed as the EC countries to the risks of tax arbitrage, tax evasion, distorted investment incentives, etc., that the present EC system poses. Second, concerted action may be replaced by harmonization through uncontrolled competitive pressure. The proliferation of tax reforms in both the EC and the EFTA in recent years may be an indication that this process is already underway. One problem with such a process is that the competition may in the long run drive tax rates down to sub-optimal levels or create tax systems that are less efficient than if they had been the result of a coordinated effort. In any event, the hardships are likely to be particularly great for high-tax countries (like Norway and Sweden) where substitute revenue sources may be difficult to find.

## XI. Summary and Conclusions

The EFTA countries and the EC have long had a close relationship, based on such factors as geographic proximity, a shared history and common fundamental values. The EC is by far the most important trading partner of the EFTA countries and the EFTA countries as a group are the largest outside trading partner of the EC. However, because of the difference in size, the EC is a far more important trading partner for the EFTA countries than the EFTA countries are for the EC.

The two organizations have taken on very different forms. While the EC is moving towards an economic, political and social union, increasingly subordinating national interest and power to its central governing body, cooperation in EFTA has not been allowed to interfere with national sovereignty. The two groups have cooperated on a range of topics, including a series of Free Trade Agreements (FTAs).

EC-EFTA relations have evolved rapidly in recent years. A major step was taken in 1984, when the EC and EFTA jointly issued the Luxembourg Declaration aimed at creating a dynamic European Economic Space (EES) and signalling the political will to extend cooperation beyond the FTAs. However, relations developed a new sense of urgency--particularly on the EFTA's side--after the EC Commission's White Paper, Completing the Internal Market, was issued in 1985 and the Single European Act was adopted in 1986. As the Internal Market Program gained momentum, the EFTA countries became increasingly concerned about the risks associated with being left out.

In January 1989, efforts to improve cooperation received a new push from a speech by Jacques Delors, President of the EC Commission, inviting EFTA to form a more structured relationship with the EC. The heads of state of the EFTA countries responded in March 1989 with the so-called Oslo Declaration, in which they stated their willingness to explore the "ways and means to achieve a more structured partnership..." This put the EES negotiations on a two track process. The legal and institutional changes that greater cooperation may require were to be covered under the so-called Oslo-Brussels process, 1/ while issues related to laying the basis for the free movement of goods, services, capital and labor--the four freedoms--within Western Europe, continued to be worked out in the follow-up to the Luxembourg Declaration. Since the start of the Oslo-Brussels process, a major change has taken place in EFTA's relationship with the EC. Instead of speaking as six different countries, as EFTA members have usually done in the past, EFTA has sought to present a united front. In December 1989, ministers from EC and EFTA countries agreed to start formal negotiations on forming this more structured relationship, which

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1/ While all EFTA members are cooperating in the Oslo-Brussels process, Austria also applied for EC membership in 1989.

began in June 1990. While the EES appears to be gaining momentum, the possibility of little or no change in EC-EFTA relations cannot be excluded.

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

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

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

Changes would also appear desirable in the areas of industrial and intellectual property rights, notably counterfeiting, trademarks, copyrights and patents. While progress has been made both within the EC and in joint talks on counterfeiting and trademark legislation, the EC is moving slowly in copyright legislation and it is deadlocked on patents. Progress is not likely until the EC settles its own

differences in these areas. Joint progress will probably be made on either an inter-bloc basis, probably under the Oslo-Brussels process, or through bilateral talks. However, in some cases, such as the Nordic group on copyright legislation, subgroups of EFTA could get involved.

While most trade within and between the EC and EFTA is free from conventional barriers, Western European markets remain fragmented. Although tariffs and quantitative restrictions on trade in the region have largely been abolished, other obstacles remain. Some are imposed by governments like border controls, technical standards and public procurement rules. However, private anti-competitive strategies aimed at exploiting market power may also be important. Whether or not the Internal Market Program will eliminate all these more subtle obstacles is not clear.

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

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

If the EFTA countries fully participate in the EC's integration process, they will also share in the gains from the Internal Market Program. While the effects are similar to those on EC countries, the smaller home markets of EFTA countries may actually give rise to greater potential gains than in some EC countries. However, the EFTA countries may also have to bear some costs, if they are required to coordinate their external trade policies with that of the EC.

A decision not to integrate further with the EC is likely to result in some losses for the EFTA countries both compared to the present situation and compared to full integration with the EC. These losses would arise because EFTA firms would become less competitive vis-a-vis their EC counterparts. As trade barriers are eliminated within the EC, there will be a tendency for demand to shift from EFTA products to EC products, which will depress production in EFTA. To avoid a deterioration in competitiveness, EFTA firms may be tempted to shift

production to the EC. In order to maintain employment within EFTA, the deterioration in the EFTA terms of trade would need to be offset through a reduction in relative labor costs.

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

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

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

Much progress has been made regarding rules of origin, but difficulties remain. For some time, the key problem for the EFTA countries was that their FTAs with the EC were bilateral and that there were no cumulation rules for inputs from other EFTA members. These rules were broadened in January 1989. However, concerns remain about the EC's anti-dumping laws. There is some fear that preserving market shares in the EC after the start up of the Internal Market may require price cutting, which could be treated as dumping. The EC has said it will not exempt EFTA members from these rules unless they agree with the

EC on a uniform set of competition rules. Previously, such an accord did not seem likely, but a solution may be found as part of the talks relating to the EES.

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

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

Most talks on transport issues are still at an early stage. While the EFTA committee on transport and the EC have started discussions, the outlook is not likely to become clear until the EC forms its own position several areas. The outcome is likely to take one of two paths, either an accord will be made on an inter-bloc basis, possibly as part of the EES, or between the individual EFTA countries and the EC on a case by case basis.

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

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

The outlook for a liberalization of the movement of people within Western Europe is not yet clear. The EC views labor mobility as

essential for the efficiency of the Internal Market. The EFTA countries have agreed in principle with this objective for the EES and some progress has been made in reducing technical barriers to mobility in Western Europe. While there are concerns about labor mobility in several EFTA countries, only Switzerland has publicly raised official objections. However, it seems unlikely that political support can be raised within the EFTA countries for such an accord unless it is part of a wider agreement on the EES. Even in this case, Switzerland may seek a partial exemption and some EFTA countries may retain the right to introduce restrictions under certain circumstances. However, as noted, the EC has been taking a firm line on such exceptions.

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

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

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

However, increasing financial integration in Europe intensifies the need for policy cooperation with the EMS, either on a formal or informal basis.

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

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

APPENDIX

GLOSSARY OF TERMS 1/

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

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

CAP: The EC's Common Agricultural Policy.

Cassis de Dijon ruling: A 1978 decision by the European Court of Justice which established the rule that products made and marketed according to the legal requirements of one member state must be allowed to circulate freely throughout the rest of the Community.

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

CFP: See Common Fisheries Policy.

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

Committee of Central Bank Governors: Committee composed of central bank governors which takes certain decisions regarding the operations of the EMS, and involved in preparation of all decisions and resolutions of the Council of Ministers on monetary policy.

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

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1/ The primary sources used in this section are Folkerts-Landau and Mathieson (1989), pp. 21-22 and Noel (1988).

Community: See European Communities.

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

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

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

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

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

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

EEC: European Economic Community.

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

EEIG: See European Economic Interest Grouping.

EES: European Economic Space

EFTA: European Free Trade Association.

EMCF: European Monetary Cooperation Fund.

EMS: See European Monetary System.

EC credit facilities: See medium-term financial support facility, short-term monetary support facility and very short-term financing facility (the latter limited to participants in the ERM.)

EMU: See Economic and Monetary Union.

EOTC: See European Organization for Testing and Certification.

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

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

ERM: See exchange rate mechanism.

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

European Commission: See Commission of the European Communities.

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

European Communities: Consists of the European Coal and Steel Community (ECSC), established by the Treaty of Paris (1951), the EEC, and the European Atomic Energy Community (EURATOM), established by the Treaties of Rome (1957). The institutional structure of the EC (organized along the lines of a national administration) consists of the EC Commission, the Council of Ministers, the European Parliament, and the European Court of Justice. Its member states include Belgium, Denmark, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Spain and the United Kingdom.

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

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

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

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

European Economic Interest Grouping (EEIG) A trans-EC partnership created in 1989 to expedite joint ventures between EC firms. Its legal form may vary, there are no capital requirements and partner's liability is unlimited. It may not employ over 500 persons and must have participants from more than one member state, although a subsidiary of a multinational firm may count towards this requirement. All profits must be transferred to its owners. Once registered in a member state, it may operate throughout the EC without further registration requirements.

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

European (or EC) Standard: Product standards legislatively set by the European Council. It is hoped that these will only be used when EC member states' national regulations differ in essential characteristics in terms of health, safety or consumer or environmental protection. The European Standard will normally only cover the essential requirements to allow the product to circulate freely within the EC.

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

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

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

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

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

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

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

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

FTA: See Free Trade Agreements.

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

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

Home country control: Principle calling for supervision and enforcement of legislation by the authorities in the country in which a company is incorporated rather than in the countries in which it operates. For example, a British bank operating in Italy is under the control of British rather than Italian authorities. Home country control, mutual recognition and essential harmonization are the three basic principles that underlie much of the EC's integration efforts in areas spanning from technical standards to financial services.

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

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

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

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

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

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

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

Reciprocity requirement: Calling for nonmember countries to apply a non-discriminatory treatment of EC companies in exchange for access to EC markets. What this means in practice depends on if the requirement calls for equivalent or national treatment.

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

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

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

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

Snake: See European Common Margins Arrangement.

Treaty of Rome: See EEC Treaty.

Very short-term financing facility (VSTF): A very short-term credit facility that central banks participating in the ERM may grant to each other through the EMCF to permit interventions in Community currencies. Such operations are denominated in ECUs, and the debtor and creditor interest rates are equal to the rates applicable to net users and holders of ECU assets. The duration of such financing is 45 days and can be extended by three months.

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

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