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The European Internal Market Challenge and the Role of Microeconomic Analysis

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ABSTRACT. – This paper shows the role of the theories of imperfect competition and industrial organization for analyzing the channels through which the removal of the European Community's internal market barriers may result in economic gains, and for designing sensible accompanying policies. Some of the recent microeconomic research that provides a better framework for understanding the 1992 challenge than the one assumed in traditional trade theory are first presented. Then the main characteristics of corporate strategies in the internal European market are investigated. Finally two microeconomic policies intended to influence the allocative and the distributive effects of the integration process are discussed.

Le défi du marché intérieur européen et le rôle de l'analyse microéconomique

RÉSUMÉ. – Cet article montre le rôle des théories de la concurrence imparfaite et de l'économie industrielle, d'une part pour l'analyse des canaux à travers lesquels la suppression des barrières à l'intérieur de la Communauté européenne peut conduire à des gains économiques, d'autre part pour l'élaboration de politiques d'accompagnement adaptées. Sont successivement examinées les recherches microéconomiques récentes en commerce international, les caractéristiques des stratégies d'entreprise et les politiques en matière de concurrence et de redistribution.

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1 Introduction

The keystone of European economic integration is the common market, in which member states have combined to create a unified economic area. Since the Treaty of Rome establishing the European Economic Community (EEC) in 1957, the development of the internal market has undergone three phases. The first one was the elimination of customs duties and quantitative restrictions within the EEC. This phase was completed in July 1968 with the introduction of a common external tariff. During this period, and until 1972, the EEC witnessed a rapid expansion of intra-Community trade. The second phase, starting around 1973, saw the increasing recourse by member states to protectionist non-tariff barriers, due to rising structural problems and unemployment. As a result, there was a relative slowdown in intra-Community trade, as compared with trade of the Community with the rest of the world (JACQUEMIN and SAPIR [1988]). This situation prompted the Commission to prepare a White Paper listing the remaining barriers to intra-EEC trade and a detailed timetable for their removal. The passing of the Single European Act in December 1985, instoring "qualified majority voting" for the White Paper directives, has provided the institutional framework for completing the final phase in the creation of the internal market.

Establishing in the 1990s a single European Community home market of over 320 million people by removing the non-tariff barriers between its twelve national components is expected to lead to substantial gains in economic welfare. It will help bring down costs and prices. With some time-lag, the greater dynamism of the competitive process may also stimulate trade, promote entry, new investments, bring about restructuring and multinationalisation of firms, generate changes in location, and foster technological progress through an increased flow of innovative processes and products. It could also increase growth and employment and contribute to a better balance in the world economy. However non negligeable costs of adjustments will also be incurred.

To analyse the theoretical foundations, the empirical consequences and the economic policy implications of the "1992" initiatives, it is necessary to understand the reasons why a group of countries forms a preferential trading arrangement.

The analysis of the welfare effects of such preferential arrangements has for long occupied a central position in international trade theory. However, general results are hard to obtain given the second-best nature of these arrangements. Ever since Viner's contribution, two conflicting effects have been identified. On the one hand, the formation of a customs union is expected to expand trade among the partners as they remove trade barriers with each other (trade creation). On the other, it is expected to increase trade among the partners at the expense of third countries due to discriminatory treatment (trade diversion).

The traditional analysis assumes homogenous products, perfect competition and constant returns-to-scale. In recent years, however, contributors to the theory of preferential arrangements have recognized the need to incorporate product differentiation, imperfect competition and scale economies. Simultaneously, corresponding empirical testing and policy analyses have been developed, allowing a more realistic account of the present-day international issues.

The purpose of this paper is to show the growing role of the theories of imperfect competition and industrial organization for analyzing the channels through which the removal of the Community's internal market barriers may result in economic gains, and for designing sensible accompanying policies. In the second section of the paper I present some of the recent microeconomic research that provides a better framework for understanding the 1992 challenge than the one assumed in traditional trade theory. In the third section, I investigate the main characteristics of corporate strategies in the imperfectly competitive internal European market. In the final section, I briefly discuss two important microeconomic policies intended to influence the allocative and the distributive effects of the integration process, *i.e.* competition policy and redistributive policies.

2 Recent Microeconomic Research on the Internal Market

Even after the promised liberalisation in Europe, intra-EC trade will still be affected by extensive product differentiation, nonconvexities in production, incomplete information and various forms of collusive or non-collusive oligopolistic behaviour. The source of these imperfections lies in the exogenous characteristics of the demand and costs functions, as well as in the strategies adopted by private and public agents. In fact the major share of the potential gains from completing the internal market relies on the very existence of such features. Besides direct cost saving through lower real trade costs, three effects can be identified (JACQUEMIN [1982]): greater production efficiency achieved through the enlargement of the market, reduction in monopoly power in national markets leading to reallocation of resources from highly to less competitive industries and, generally, but not always, an enlargement of the range and diversity of available products and services.

An implication of this situation is that, in order to understand the mecanisms underlying European trade and identify the relevant issues for the EC common policies, it is necessary to overcome the limits of the traditional models relying on the Walrasian paradigm, and take into account the growing variety of economic analysis incorporating the new features of imperfect competition. In fact, the economics of integration has recognized

for a long time the importance of imperfect competition. VINER [1950] had mentioned scale economies as a possible, albeit minor, source of benefits from customs union. Similarly, several authors had underlined the importance of product differentiation for many internationally traded goods. For example, JOHNSON [1967] called for general equilibrium models incorporating monopolistic competition. Two types of works can be mentioned. The first one, following Max Corden, Richard Pomfret and others, are concerned with the introduction of the above features of imperfect competition into the traditional customs union theory. For example, CORDEN [1972] has offered the first convincing attempt to show that exploitation of scale economies can be an important motive for such union. In his survey, POMFRET [1986] analyses recent efforts to incorporate some missing pieces which would make the theoretical framework more satisfying. These include transport costs, tariffs outside the customs union and bargaining motives for preferential arrangements.

The second and rapidly growing type of research also views international markets as imperfectly competitive where economies of scale and product differentiation play crucial roles, but their focus is on the analysis of the conduct of trade and trade policy in the corresponding strategic environment where a relatively small number of economic agents make interdependent decisions. The works of Brander and Spencer, Krugman, Grossman, Helpman are well known. They have allowed the construction of formal models of imperfect competition that can be used for measuring the effects of suppressing trade barriers between member states. Two types of models can be distinguished: partial and general equilibrium models.

Until now, general equilibrium models of imperfect competition are very rare and few of them have been applied to the European Community. Two recent papers are, however, very relevant for evaluating the effects of completing the Common Market. GOTO [1988] develops a general equilibrium trade model under imperfect competition which incorporates labour market imperfection and variable elasticity of substitution. It shows that the opening up of trade brings about the following gains: greater consumer satisfaction due to an increase in the variety of goods; decrease in monopoly power; technical efficiency due to decrease in average costs; decrease in unemployment due to reduced imperfection in the labour market; and contribution to economic growth through the release of capital resources from the distorted sector. These gains, estimated for the US automobile trade, are fully in line with the conclusions derived in the European Commission's report on the benefits of a single market (EMERSON *et al.* [1988]). Similarly, HARRIS and KWAKWA [1988], have used a dynamic general equilibrium model for a small open economy to analyse the effects of the 1988 Canada-America Free Trade Agreements (CAFTA). This sequenced general equilibrium model incorporating imperfect competition, scale economies, entry and exit dynamics, and some labour rigidities, allows the authors to conclude that there are large gains in production coming from improvements in productivity achieved in the scale-economy-intensive industries through a process of rationalisation, and that the adjustment costs imposed on the Canadian economy in terms of job losses could be small.

Partial equilibrium models under imperfect competition have also been applied to international trade. Like in the above general equilibrium approach, these models cannot be used to test the theory but give it some realism by using observed data and parameters taken from econometric studies. Several of these models have been calibrated with European data and have been used for simulating the effects of various industrial and commercial policies on welfare. Two recent papers published in a special issue of the *European Economic Review* (d'Aspremont, Jacquemin and Jaskold-Gabszewicz Eds., [1988]) offer fruitful illustrations. Smith and Venables study the welfare effects of changes in the EC internal market, contrasting two scenarios: one in which there are small reductions in barriers to trade and the other where a fully integrated market is created. In the second case, substantial welfare gains are generated. Laussel, Montet and Pequin-Feissolle, following the same methodology as Smith and Venables, show that an increase in the present European tariff with respect to Japanese cars could be welfare-improving, but these gains would be low. When the policies are effective, the best one is a subsidy; quotas and voluntary export restraints are generally inefficient.

More applications of such models to the Common Market case could offer policy-makers useful and operational indicators.

3 Strategic Competition in the European Market

The concept of "strategy" is one which readily lends itself to many interpretations. In his remarkable work, T. Schelling [1960] defines a strategic move as "one that influences the other person's choice in a manner favourable to oneself by affecting the other person's expectations of how oneself will behave" (p. 160).

During the last few years, the workings of the European economies have been perceived as depending on such strategic relationships, the actors being firms which are endowed with varying powers and which position themselves, physically and psychologically, so as to influence the actions and responses of their current and potential competitors, and to anticipate the new conditions of the Common Market. The name of the game is to cooperate with one's competitors over common components yet maintain keen competition at the final product stage; to erect credible barriers against new players likely to enter the market; to merge in order to control products likely to act as substitutes for one's own activity or to speed up the learning process; to modify one's bargaining power vis-à-vis suppliers and purchasers or to increase the cost of inputs for rivals by means of long-term contracts or control of upstream operations; to influence the balance of forces by

making strategic moves and anticipating change (STIGLITZ and MATHEWSON [1986], JACQUEMIN [1987]).

Viewed from this angle, competition is not based on a series of simultaneous interactions between passive agents which view comparative advantages, the structures of markets and the behaviour of others as given. It is a sequential game in which the application of new forms of organization, the opening up of new markets and the introduction of new products and production methods continually undermine the possible equilibria and modify the rules of the game.

However, the strategic interplay between firms cannot be studied as a whole since it depends to a large extent on the structural characteristics of the sector in which the firms operate. In each of the broad types of structural environment, the completion of the internal market should have a different impact on the strategies to be implemented by firms. Three broad types of structural environment can be distinguished (BUIGUES and JACQUEMIN [1988]).

In a structural environment of the fragmented type, small firms predominate. Few firms thus hold a market share sufficient to enable them to exercise a powerful influence in the industry. The costs of market entry and exit are low, and economies of scale small. Product and customer differentiation is high and evolves over time, so that many small firms co-exist, with varying and unstable margins which often depend on the quality of their management. In these sectors, completion of the internal market should have a limited impact, except insofar as it might change the rules of competition and encourage a changeover to industrial-scale production of standardised goods. Non-tariff barriers play a marginal role compared with factors such as local or regional differences in consumer tastes (e. g. in breadmaking, wooden furniture, processing of leather or skins).

In structural environments of the specialised type, small firms exist in the market alongside large ones. Product differentiation is common, and is exploited. There are many niches for very specific products, but each niche market is generally limited by size of the domestic market. This partly explains the very large number of small firms in these sectors. Within each niche, however, the competitor with the largest market share is generally more profitable than the others. It should be stressed that emerging industries are often of the specialised type. They include a high proportion of new companies and small and medium-sized businesses (lasers, aquaculture, microcomputers, medical and surgical equipment, etc.). Several technologies co-exist, and there is no dominant standard. Technological development may, therefore, significantly alter the boundaries and nature of the activity. The fundamental choices for firms in these industries concern the breadth of their product range and the geographical area to be served. Completion of the internal Community market will have a considerable impact on specialised industries. A product/market niche will expand significantly with the size of the geographical area covered: hitherto, non-tariff barriers (standards, various type-approval procedures) have hampered intra-Community trade. The enlargement of the market that can be served without barriers is essential, since it will have a positive effect on

the dissemination and adoption of new technologies and new products. Pharmaceuticals, DP software and high-tech activities linked to public procurement (telecommunications) are the industries most affected.

In environments with volume as the principal feature, market share has a high value and the potential for differentiation is low. Here profitability is clearly linked to market share, and large firms predominate. This is the case, in particular, with office machinery, data processing machinery, telecommunications equipment and basic chemicals. These industries are those in which demand is currently expanding rapidly, and where the minimum level of R and D spending is high. These industries also depend to a great extent on public contracts.

Completion of the internal market then provides European firms with an opportunity to exercise fuller control over their basic market, *i.e.* the European market, with a leverage effect for moving on to the world market. In these industries, 1992 represents a challenge which has to be met. If European firms wish to compete effectively with their Japenese and American rivals, they must achieve the requisite size in relevant areas (components, production, R and D effort).

In this respect, the strategies employed in recent years by European firms in a more and more integrated common market point to new trends. They are trying to concentrate on the main product line and withdraw from other activities. This new type of specialisation is confirmed in the PIMS studies, which show that firms' profitability in their main activity is, in all cases, far greater than that in their diversifed activities. European firms are also seeking to extend their geographical market. They thus prefer to concentrate on their top-grade products or core activities, and increase their geographical diversification, as an alternative to product diversification in a limited geographical area.

In addition to internal restructuring and growth, mergers, takeovers and divestiture permit a rapid implementation of these strategies aimed at better exploitation of returns to scale, larger geographical markets, and greater international division of labour within the European market. These operations could one day create truly European companies which have no special links to a particular country and are thus able to escape from the "national champion" mentality.

Over the recent years, there has been in fact an increase in the number of Community and international mergers. Even though almost two-thirds of mergers and acquisitions of majority holdings are still inside the national borders of a Member State, at international level, merger transactions within the Community were on average about twice as numerous as international transactions involving non-Community countries. A look at the breakdown of acquisitions of majority holdings by size of firm (combined turnover of participants) show that this type of transaction continues to be dominated by large firms. About 50% of the operations involve companies which have a combined turnover of over a billion ecu.

Restructuring through mergers must not be confused with amalgamations based exclusively on financial or personal links and missing any genuine integration reflected in an overall strategy. Some mergers ultimately produce only combines with no internal coherence, represent a desperate attempt at survival on the part of ailing companies unable to make any new investment, or express a search for monopolizing the market. In this last case, a reinforced European competition policy can be expected.

Cooperation arrangements can also in certain circumstances facilitate the exploitation of the new opportunities afforded by an open internal market. They promote synergies, avoid costly duplication, internalize spillover effects, make it possible to disseminate technological information more widely, and reduce the time required to put a new product or process on the market; they also ensure that risks are more widely distributed among the partners. Recent theoretical studies have confirmed that cooperative behaviour can play, from a social welfare point of view, a positive role in industries characterized by R and D activities generating spillover effects (see KATZ [1986], D'ASPREMONT and JACQUEMIN [1988]). However, there are several obstacles to the conclusion of a cooperation agreement, and the failure rate is high. In addition to the difficulties of finding a partner able to make a balanced contribution, setting up a management structure to minimise the running costs of cooperation, and ensuring full and fair use of the proceeds, there is also a set of regulatory and political obstacles to cooperation in Europe. Differences in company law and tax systems, for instance, are often considerable. Moreover, specific national circumstances affect firms' attitudes towards transnational cooperation. They are inherent in the diversity of Member States' cultures, languages, business management traditions, administrative styles, labour relations and the nature of the relationship between public authorities and the private sector. In this respect, statistics and business surveys suggest that. agreements between Europeans are particularly difficult to forge and that non-Europeans partners are often preferred (URBAN and VENDEMINI [1986]). Reservations about cooperation are expressed, above, all, by strong national companies who do not wish to alter the terms of their competitive position (regarded as favourable) vis-à-vis their European rivals and who are more attracted by agreements with more distant American or Japanese partners. It is clearly for technological reasons that such ventures are being set up: R and D is the objective most often mentioned. It is in this area that national firms in the Community today prefer agreements with American or Japanese firms.

To conclude this section, the core concepts of competitive strategy that have been analyzed in recent works on industrial organization have a more or less direct counterpart in the observed behaviour of European business firms struggling for creating or sustaining their relative position in the new European environment. Here again interactions between the theory of industrial economics and the ways corporate strategies in the Common Market are effectively implemented could be fruitful.

4 Accompanying European Micro-economic Policies: Allocative and Distributive Aspects

The 1992 project can be seen as an adventure in deregulation: most of the 300 directives set out in the EC's 1985 White Paper on "Completing the Internal Market" are intended to create a common market in which goods, services, people and capital could move without barriers. However, a common market cannot be reduced to a free trade area: it is also characterised by policies, macro and micro, at the national and EC levels.

The role of common economic policies and coordination between EC member states economic policies has always been crucial given the existing high level of interdependance and the corresponding substantial amount of transnational externalities that can be internalized. It is well known that, while the European Community as a whole is only slightly more open than the US and Japan, the intensity of intra-EC trade is quite strong. And one must expect that completing the internal market will accentuate this situation. Furthermore, the challenge of 1992 is not just economic, it is also political and social. Accepting the corresponding social and political costs would require a greater solidarity among the member states.

I shall briefly focus on two types of European microeconomic policies. The first one concerns the allocation of resources, *i.e.* competition, and the second one the distributional effects, *i.e.* regional and social policies.

If the positive effects of completion of the internal market are to materialize, the *competitive process* must be maintained. That process enables firms to exploit new opportunities; productivity gains and cost reductions lead to lower prices, improved quality and a wider choice of products.

Yet it is by no means certain that, in this new context, economic agents will accept the operation of competition. As experience following the lowering of tariff barriers has shown, the Community authorities may well be confronted with more and more private and public strategies that seek to diminish or distort competition. There is a particular danger of:

(i) private or public concentration operations which are designed to create dominant positions and which may lead to such forms of abuse as the setting up of barriers to the entry of new firms, market sharing, discrimination and predatory pricing;

(ii) an intensification of direct and indirect government intervention to safeguard a policy of national champions or to prevent the opening up of certain national markets.

In all these cases, the Community authorities must ensure implementation of *credible rules* which are directly applicable to all, including third country companies. If the policy announcement lacks credibility, the expected

positive intertemporal effects will be substantially weakened. The competition rules of the Treaty of Rome are already applicable to both public and private restrictions of competition. At both levels, however, selective tightening of antitrust policy has to be expected, especially if we recall that traditional ranking of policies suggests that such a policy is more effective than most alternatives.

One central question is about mergers and takeovers. On the one hand the restructuring required for achievement of the internal market should lead in certain areas to beneficial concentrations. On the other hand, the expected restructuring could lead to a non-negligeable reduction in the number of competitors within the Common Market, especially given that the majority of these concentration operations are made by the largest corporations, and could create dominant positions.

Furthermore, as shown by several authors (see SHAKED and SUTTON, [1983]), some industries where product differentiation combines with economies of scale, yield higher returns than others. Countries have then an incentive to take unilateral measures to secure a larger share of these sectors. Through strategic policies they can be tempted to provide support to mergers and takeovers of their firms in order to ensure a strong position in those industries characterized by a "natural oligopoly" where, at the asymmetric equilibrium, few firms produce while the rest are losers.

As a partial answer, a regulation of European mergers is proposed by the Commission and could be adopted in a near future. This regulation would set-up EC controls over Community-wide, cross-border mergers and takeovers. There would be a mandatory prior notification of the planned mergers of this scale, but an "efficiency defense" would be allowed.

Although the probability of substantial allocative gains from increased integration is high, the *distribution* of these gains among sectors, regions and categories of workers is very uncertain. This is a broad subject and I shall focus on only one aspect.

It is well-known that the distributive effects of increased trade created by reduced barriers are less strong in case of intra-industry trade than with inter-industry trade.

Trade resulting from comparative advantage produces mutual gains in efficiency, but also creates problems of income distribution. On the other side, is trade motivated by unconventional factors: economies of scale, oligopolistic rivalry, informational asymmetries, and so on. This trade is similarly (usually) beneficial but involves less conflict of interest within countries. "The today's expansion of trade that will be generated by the further integration of the Community will probably involve an expansion of conventional comparative-advantage specialization. This represents a break with the past history of the EC, which was so successful in the 1960s, at least partly because of the predominance of "intra-industry" over "inter-industry trade (KRUGMAN [1989]).

With the entry of Portugal and Spain, intra-EC trade will involve partners with major differences in productivity, wages, and resources. For example, trade between Portugal and Belgium will surely be more conventional in its character than trade between Belgium and Germany; it will involve

specialization in labour-intensive, low-technology products by the one, and exports of higher-technology, capital- or skill-intensive products by the other.

"The point is that the trade expansion produced by EC further integration is simply not likely to be as painless as the trade expansion produced by the formation of the Community and earlier enlargement. There will certainly be income distribution problems created by the changes, and also quite possibly some real costs in terms of unemployment".

Such a situation requires a set of measures to cushion the negative redistributive effects which certain factors of production, activities and regions will experience.

On the one hand, the new member countries and the developing regions must be assured that they will have the means of overcoming their current structural handicaps of a lack (in some cases critical) of basic infrastructures (primarily of the technological kind) and of inadequate vocational training, in order to avoid the danger of "vicious circles" of growing divergence of regional fortunes. On the other hand, the completion of the internal market will help the declining regions by ensuring a freer circulation of information, technologies and services beyond national frontiers. Such a fluidity could thus facilitate the economic and socio-cultural reintegration of these regions into the overall Community framework. In any case, credible policies which minimize the adjustment costs and promote reintegration are vital if Community solidarity is to be safeguarded. Special attention has been paid in the *Single European Act* to the means of achieving this objective. It provides both for the *Structural Funds* to be reinforced and for national economic policies to be conducted in a way which serves the Community aim of strengthening economic and social cohesion. Since the so-called "Delors package" has been accepted, there has been a doubling of the total structural funds (agricultural, social, regional, development. Integrated Mediterranean programmes. . .). These funds, grants and loans combined with the loans from the European Investment Bank, could by 1992, reach about the scale of the present combined operations of the World Bank and the IMF. But the management of these financial flows is a real issue, if the intention is not simply a transfer of money but also allocative effects reinforcing the competitiveness of peripheral regions and industrial regions in decline.

5 Conclusion

The completion of the European Internal market by 1992 offers a remarkable "case study" for testing the new Industrial Organization models of trade with imperfect competition, for analyzing business strategies in a

rapidly changing structural environment and for elaborating critical evaluation of microeconomic policies.

But 1992 is more than a stimulating topic for research, more than a date in the calendar: it is the hope that completion of the internal market will lead to the regeneration of European industry and give a permanent boost to the prosperity, not only of the people of Europe but also of the rest of the world.

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