EUROPE 1992: ISSUES AND PROSPECTS

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Abstract

The process of economic integration in Western Europe is substantively under way; 1992 will herald a transformed competitive landscape in the region. This paper discusses some of the major changes in reducing technical, physical and fiscal barriers in the European Community, presents U.S. concerns regarding this process and suggests selective market opportunities and threats for companies.

Introduction

Just a short three years from now, many of the barriers inhibiting the movement of goods, people, and capital in an the twelve countries of the European Community[1] will have toppled. The vision of 1957 when the treaty of Rome marked the birth of the European Economic Community (EC) seems less blurred after years of being dormant. Competitive conditions, in a more integrated Europe, will change substantially with far reaching implications for U.S. business posing opportunities and risks.

This paper provides a brief background of the integrative movement in the European Community, the major changes through commission directives aimed at eliminating trade barriers, prime U.S. concerns about these developments and selected opportunities (and threats) for U.S. companies doing business in the changed environment. The paper does not attempt to include all ramifications of a United Europe - that would be encyclopedic - but does intend to be speculative (and perhaps judgmental) in suggesting possible implications of selected reforms. It is hoped that such an effort will help to generate additional ideas and debate on what Europe 1992 will mean for U.S. companies.

Background of Community Integration

The treaty of Rome in 1957 marked the birth of the European Economic Community and the call for a European Common Market. However, after the removal of tariff barriers in 1968 and limited success in forming a common commercial and agricultural policy, the move towards unification slowed considerably. Vested political and economic parochial interests prevented any substantial advances towards meaningful integration. In the seventies, European economies within the community faltered badly and declining economic fortunes prompted EC members to revive the integrative effort. From this emerged a heightened awareness that the community needed to be more cohesive so as to become more competitive, vis a' vis the Japanese, the newly industrializing countries, and the U.S. But it was not until 1985 that the EC's White Paper "Completing the Internal Market" provided a detailed blueprint on how the goals of the treaty of Rome could be accomplished (EC Commission, 1985; Cecchini, 1988). This was followed by a relatively more politically willing membership adopting the "Single European Act" in February 1986 and ratifying the same in July 1987. The Act called for "measures with the aim of progressively establishing the internal market over a period expiring on 31 December, 1992... an area without internal frontiers in which the free movement of goods, persons, services and capital is ensured..." (Harrison 1989).

This development was substantive in that adopting legislation was made easier through requiring a majority vote in the EC council rather than the previously necessary unanimity, providing the foundation for adopting the needed measures identified in the 1985 white paper. In the latter, the European Commission identified 300 directives -reduced to 279 since then - that were required to get rid of the physical, technical and fiscal barriers between member countries. Through specific directives (128 of which have been adopted as of September 1989) the community is following a systematic process of dismantling trade barriers.

Macro Benefits of Integration

The underlying basis for economic integration is the view that such unification can lead to many benefits for participant states. As tariff and non-tariff barriers decline, terms of trade for countries within the community can improve. With integration there can be multiple effects on the supply and demand side.

On the supply side, the combined larger market can generate opportunities to achieve economies of scale in production, marketing, research and development allowing companies within the area to be cost-competitive in internal and external markets. Increases in productivity could occur with higher rates of innovation spurring more efficient investments. Cost savings can also result directly because of elimination of border formalities, transportation rationalization and reduction in administrative costs. Demand side impacts include lower prices, greater consumer choice, and improved quality as a result of increased competition (Balassa 1961, Balassa 1988, Scitovsky 1988, Pelkmans 1987, Jacquemin 1988, Greenaway 1987). However, as "trade creation" occurs between member countries, there can be "trade diversion" to the extent that the integrated groups place barriers externally on goods coming in from the outside, increasing the costs of doing business for third country exporters (Seipp 1989). The benefits projected by the EC commission suggest gains in the medium term of between 200 to 300 billion dollars or between four to six and a half percent of gross domestic product (see table 1); 2 million additional jobs; and consumer prices that the EC's economic models estimate will be lower by about six percent after unification (Harrison 1988; Cecchini 1988).

Changes in Existing Barriers

Among the more notable changes that deserve special attention are the following:

[1] Belgium, Denmark, France, West Germany, Greece, Ireland, Italy, Luxembourg, The Netherlands, Portugal, Spain, and the United Kingdom.

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TABLE 1
MACRO BENEFITS OF THE 1992 PLAN:
EC COMMISSION PROJECTIONS

	Benefits (Billions of Dollars)	Percent of Gross Domestic Product
Gains from removal of barriers affecting trade	10-11	0.2-0.3
Gains from removal of barriers affecting overall production	71-89	2.0-2.4
Gains from removing barriers (subtotal)	81-100	2.2-2.7
Gains from exploiting economies of scale more fully	75	2.1
Gains from intensified competition reducing business ineffectiveness and monopoly profits	58	1.6
Gains from market integration (subtotal)	78-134	2.1-3.7
TOTAL GAINS		
- for 7 member states at 1985 prices	159-234	4.3-6.5
- for 12 member states at 1988 prices	213-313	4.3-6.5

Source: Harrison, Glennon J. The European Community's 1992 Plan: An Overview of the Proposed Single Market. Congressional Research Service, Washington D.C. September 21, 1988, p. 10.

Technical

Eliminating such barriers will be attained by harmonizing standards, testing and certification, packaging and labelling requirements. More importantly, rather than trying to achieve one standard, mutual recognition of standards will apply. Practically, this would mean that as long as a product meets the standards of one country, it would be freely admitted into other member countries. Similarly, regulations covering intellectual property such as trademarks, copyrights and patents will be harmonized. Also, major mergers, acquisitions and the like that could have community-wide implications would be considered centrally by the EC Commission for their potential impact.

Government procurement standards will have considerably fewer national restrictions on bids and would be more open to community-wide bidding, expanding opportunities for qualified EC firms in such sectors as telecommunications, water, transport and energy.

Physical Barriers

The EC hopes to eliminate non-tariff barriers that impede the flow of goods and services between member countries. Border formalities that are unduly burdensome will be eliminated. For example, ponderous documentation (70 pages at times) will be replaced by a single document which will include most of the consequential information needed for tax and statistics collection, licensing, plant and disease control, etc. Transportation firms will have free movement throughout the EC and quantitative restrictions such as national quotas applying to EC members would be effectively eliminated. Maintaining external quotas will be more difficult because of the ease with which goods brought in from the outside could move throughout the community. The commission is also attempting to eliminate the divided, separate and fragmented markets for services existing within the EC countries. In banking for example, a bank authorized to operate in one country will have the right to operate branches in other EC countries and transact business with depositors from them.

Fiscal Barriers

These are perhaps the most difficult to deal with and the most controversial. Differences in indirect taxes - value added (VAT) and excise rates - cannot be easily reconciled and harmonized because of their impact on national economies. For example, the French with high value added taxes will lose significant income. On the other hand, different VAT rates could mean retaining border customs control. At this time the EC is proposing a system with different ranges within which VAT taxes would be set. Similarly, there are tremendous differences in excise rates which would have to be lowered or increased substantially, depending upon the country and the product, to achieve uniformity. Also, differing direct tax rates such as corporate taxes can have a substantial impact on where a company chooses to locate. Similarly, differences in personal taxation rates could have an effect on migration patterns of people. Opposing national and community-wide pressures on taxation uniformity will make this a contentious issue. As trade barriers come tumbling down, the U.S. is naturally concerned about how U.S. business will be affected. The European Community is the largest trading partner of the U.S. Sales of U.S. firms in the EC - from European subsidiaries, joint ventures and exports were about 600 billion dollars, which is three times that in Canada and four times that in Japan (Verity 1988). Overall, the EC market represents a 4 trillion dollar market of 320 million people. There is much at stake.

The American reaction to EC integration has generally been favorable viewing it as an opportunity for enhanced trade and investment by the U.S. Nevertheless, there have been some concerns expressed and these are considered next.

U.S. Concerns

There are certain issues that are viewed as problematic as the process towards integration continues. These include:

Protectionism

The U.S. worries that as the EC develops its commercial and industrial policies on such matters as granting permission to merge, acquire, set up a plant, incentives for indigenous firms to increase their scale of operations, U.S. firms may not be afforded the same opportunities. Exporters also may face more restrictive barriers and some speak of the possibility of a "Fortress Europe" (Gallagher 1989; Riemer 1988; Montagnon 1988). The U.S. is impressing upon the community to not succumb to protectionist tendencies and honor their agreements such as those of the GATT.

Openness of Directives

Related to the above is the issue of "transparency" of directives. The U.S. expects that it would be able to provide its views on standards, certification and the like before they are adopted, particularly on those directives that adversely impact the U.S.

Reciprocity

The EC has stated that it intends to use "reciprocity" as a fundamental basis for trade and investment relationships. Firms from another country will be provided access to the integrated EC market if their markets are also accessible to EC firms. This could be a knotty issue, as the U.S. would like to interpret the reciprocity principle as "non-discriminatory" i.e. EC firms in the U.S. would be treated in the same way as U.S. firms and vice-versa.

The EC could easily use the reciprocity principle as a cover to promote any protectionist inclinations. The major sectors that would be affected under such circumstances would be those not covered by present GATT agreements, including the service industries.

Public Procurement

The EC has indicated that the bidding process would be opened up for any and all in the EC to participate. This is to be distinguished from the present discriminatory national procedures that are used. Here the major U.S. concern is whether the more competitive open process would be limited to companies headquartered in Europe. In addition, the reciprocity principle mentioned earlier could be applied unevenly to deny access to third country bidders. This is of obvious concern to the U.S. particularly since the EC will be opening up sectors to public bidding such as telecommunications, energy, water industries which were previously closed to other national companies.

Even as the EC provides assurances that protectionist and similar tendencies would be detrimental to their objectives of an improved trade and investment atmosphere, it is still unclear what the eventual shape and posture vis a' vis the U.S. will be, come 1992. It is within the context of such uncertainty that opportunities (and threats) need to be addressed by U.S. companies.

Selective Market Opportunities/Threats

The impact of EC directives will be broad and far reaching on many sectors and business dimensions. This paper, however, looks at selective market opportunities and threats by examining the following areas: 1) Product adaptations and strategies 2) Public contracts 3) Service industries and 4) Euro-business configurations.

Product Strategies

Product strategies in EC countries will be influenced by technical, health and safety standards. The emerging philosophy of EC members is to agree on basic minimum standards rather than deciding on how best to make a product. A corollary of this approach is to move away from trying to reach consensus on a detailed uniform EC wide standard to one that has some leeway. This implies that barring a few exceptions, product designs should aim at meeting minimum standards of acceptance within the EC countries, in place of one perfect ideal product configuration (Browning 1989).

Singular product designs may be best where differences between Euro-consumers in the generic need, applications, and use of the product are relatively minor. In all other cases, modular product designs with optional add-on features may be able to meet EC standards and still accommodate for differences in preferences among Euro-consumers. Product strategies will also be affected by the controversial stance of the community on product liability, where the burden of proof will shift from the consumer to the manufacturer. As a consequence, insurance claims may rise precipitously (Aldred 1988) and make manufacturers more conservative in introducing new products and more rigorous in product-market testing. On the other hand, new product introductions may simply increase because of increased competition and new entrants seeking advantage of a broadened internal market.

EC legislation may unevenly affect international firms. Some, in fact, would favor U.S. companies. For example, agreement reached on pollution control legislation is close to U.S. standards. To be put in effect for all cars by 1992 this may initially favor current U.S. manufacturers of pollution control equipment. Closer conformance to American standards may also make European automobile exports more appealing and cost competitive (Nelson 1989).

Public Contracts

A EC directive of significant importance deals with the area of public markets. Presently, foreign companies have a meager 3% of this market, the rest is awarded to local business. This may change as a result of measures recently approved to allow other than local companies to bid on many public projects, including those in the next year on contracts pertaining to the water, transportation and telecommunications industries (Nelson 1989). The long-range goals of the EC commission is to make 80% of public purchasing available to competition (Harrison 1988). With public contracts amounting to $400-600 billion dollars in value and 15% of European GDP (Gallagher 1989) an opening of this market may represent enormous opportunities for international and European companies. It is obvious that companies with a European connection will be the beneficiaries here, which for U.S. firms, would be their European subsidiaries and joint ventures.

Service Demands

Agreements on GATT may complicate and impede European unification. However, it is important to note that GATT deals with products not services. Thus, EC members would have considerably more flexibility in drawing common service standards that do not violate bilateral trade treaties with foreign countries. Being a net exporter of services, this may disadvantage U.S. companies unless they have a strong presence in Europe.

An approved measure with a pronounced impact on financial services will be in the removal of all controls on capital movements by July 1990 for eight of the most developed countries, to be followed later by Spain, Portugal, Greece, and Ireland (Nelson 1989). This will facilitate foreign direct investment, increase the availability of investment funds, and reduce the cost of credit, thereby expanding consumer demand. Credit options may therefore serve as a highly competitive and aggressive means of obtaining business.

Service industries would also be affected by standardization of rules. For example, internationally active banks must have capital equal to 8% of assets by 1992. With the same minimum capital ratios they would be able to operate under similar rules and requirements (Boreham 1988).

It is significant to note that the extension of benefits for foreign firms will be determined on a reciprocal basis. Thus, for example, a non-EC bank will be eligible for the same benefits as a EC bank only if the latter has the same benefits in the country of the former. Considering that the U.S. restricts interstate banking, this may grave implications for American banks. Also, since services are rendered locally, reciprocity would have lesser of an impact on exports than on the EC subsidiaries of foreign service firms (Gallagher 1989).

The deregulation effort in banking may produce overcapacity in the industry and depress profit margins. Japanese banks may be most adversely affected since they have been expanding operations in the EC while U.S. banks have been scaling back theirs. Yet, in the long run as the dust settles on competition, banks with a deeper commitment to Europe may be the ultimate winners. Overall, with greater flexibility to operate services in Europe, the costs of services such as after-sale service, R & D, and consulting will go down, while simultaneously increasing in demand.

Euro-Business Configurations

Efforts towards harmonization and standardization may enhance regional specialization among EC producers. Countries rooted in certain industries and possessing requisite strengths would benefit from this outcome. For instance, manufacturing of consumer durables would increase and become more centered in Germany and Italy and high-tech industries may proliferate in Germany, France and the Netherlands (Bates 1989). Regional specialization may thus force U.S. manufacturers in Europe to re-locate and make quality adjustments. A case in point would be the need to match the quality and high engineering designs of German appliances. Business and taxation structures of EC countries may also pose challenges for U.S. firms.

A potential development of significance is the concept of harmonizing value-added taxes (VAT). The EC is working towards a VAT policy that would levy taxes on not only domestic products and imports, as is the present case, but also tax exports. As a consequence, EC companies that have been exporters will gain revenues while those that have been importers will lose revenues. This will also affect U.S. joint ventures that import or export to other EC countries. VAT taxes are likely to be more standardized (suggested range 11% to 19%) and would reduce price differentials, further exacerbating price wars. It is also to be noted that the smaller European companies and family-owned businesses have traditionally resisted takeovers. U.S. firms may thus be forced to deal with relatively larger companies in their efforts to acquire increased influence and presence in Europe.

There is also a need to realize that the promise of market opportunities may not fully materialize if significant differences between Euro-customers are not reduced. Not only are there nine different languages in the EC but cultural differences including tradition, national tastes, nationalistic sentiments and age-old national rivalries prevail (Toman, 1989). Convergence in such values is not expected to occur quickly, if at all.

Conclusion

1992 as a date seems to have attached itself to everyone's view of Europe integrating, as if in one sudden moment in December of that year, the European Community will be a totally different place to do business in. That's simply not the case. It is much more appropriate to think of European integration as a process that is well on its way and will continue beyond 1992. While many restrictive technical, physical and fiscal barriers will be reduced, the process could be slowed in its tracks by incalculable events national, cultural and political differences and narrow parochial interests. Existing political differences will probably be aggravated as short-term results of integration will create unemployment and other dislocations in some sectors for each country. Whether the EC reacts to these transitional problems by becoming protectionist vis a' vis third countries such as the U.S., will also influence the pace of integration. The process of integration, however, will continue and U.S. companies need to be mindful of this as they prepare their European strategies.

Corporations need to consider whether adaptive business strategies that are more pan-European may be more effective. Here again, strategic alliances with European manufacturers including licensing, mergers and acquisitions should be given careful attention.

Additionally, the horizons of European integration will undoubtedly alter with the dramatic and rapid changes in the political and economic structuring of Eastern European nations such as East Germany, Poland, Hungary and Czechoslovakia. These countries present opportunities and challenges as potential markets and as possible manufacturing locales to serve a consolidated Europe and North America.

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