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MERCOSUR REPORT SERIES C.3

Report

Prepared under UNDP-financed TSS-1 facility

V.93-89902

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FOREWORD

UNIDO's current work on MERCOSUR, under UNDP-financed TSS-1 facility, is focused on three main areas within a medium-term outlook:

A. A review of the situation of specific industrial subsectors in order to identify the implications of the MERCOSUR schedule for industrial restructuring.

B. An assessment of the past record and prospects of inter-industry MERCOSUR trade as a possible engine for trade creation and efficiency gains.

C. An evaluation of the experience of the EC from a MERCOSUR perspective in three specific areas:

   (i) Manpower policies, with emphasis on vocational training;
   (ii) Investment incentive regimes;
   (iii) Competition policies.

UNIDO has already published a first background paper entitled **Trade Integration and Industrial Restructuring: The case of MERCOSUR** (PPD. 225 (SPEC.), 28 January 1993). UNIDO's MERCOSUR project includes seven additional reports, as follows

A.1. Medium-term Scenarios for Industrial Restructuring: The Pulp & Paper Subsector

A.2. Escenarios de Mediano Plazo para la Reestructuración Industrial: El Subsector Cuero y Calzado

B. Comercio Intraindustrial e Integración Regional entre los Países de MERCOSUR

C.1. Training Policies in the EC Countries

C.2. Investment Incentives, Subsidies and Related Regulations in the EC Countries

C.3. Competition Policy in the EC

D. UNIDO's MERCOSUR Project: Overview Report

The analysis contained therein spans a broad geographical and subsectoral coverage and is by no means exhaustive. Every attempt has been made to maintain neutrality of approach from a MERCOSUR point of view. However, conclusions have necessarily been drawn, which should not be seen as definitive, but rather as a contribution to the analysis of an ongoing process.

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EXECUTIVE SUMMARY

A major trend in world trade in recent years is the formation of regional'free-trade zones. The US, Canada and Mexico signed a North American Free Trade Agreement (NAFTA), the newly industrialized countries of South East Asia have also taken steps in this direction, and in 1991 Argentina, Brazil, Paraguay and Uruguay signed the MERCOSUR treaty aimed at creating a common market between these countries by 1995.

In the light of this emerging trend, it is important to try to analyze the implications of a free-trade agreement, both to the countries participating in the agreement and to countries outside it. It is also important to learn as much as possible from the experience of other free-trade regions in order to identify the factors that contribute to success and to try to apply them, whenever possible, to new treaties such as MERCOSUR. In this respect, it is useful to try to learn from the experience of the European Community (EC), which is the longest standing free-trade area, although the removal of some trade barriers has only occurred recently and there are still measures to be implemented before a completely free trade zone can be achieved among the member states of the Community.

The goals underlining the formation of the EC encompass unification on both economic and political levels, with the roots of these goals going back to the two World Wars. The ultimate aim of the union's founders was to form an economic and political interdependence that would elevate the economic well-being of the people living in the unified Community, as well as to prevent the occurrence of another war.

It is important to distinguish between the political goal of interdependence and the economic goal of increasing the economic well-being of the member countries. We will concentrate our attention on the latter goal, although it should be stressed that it is difficult at times to distinguish between the two, since some of the economically significant EC decisions were also taken for political reasons. This report focuses on the competition policy of the EC and its development. It examines the changes in EC competition policy during the thirty-six years since the initiation of the EC, its effectiveness, its interaction with other Community policies, and areas of friction within the Community and with the Community's major trading partners in regard to the implementation, or lack of implementation, of competition policy. This last point is of particular importance because of the interest in new approaches to industrial policy, both within Europe and elsewhere, and to changes in foreign trade flows because of regional trade agreements.

The report concludes by drawing several inferences from the EC experience with competition policy that are relevant to other trade integration regions such as MERCOSUR.

I. MAIN DIMENSIONS OF THE EC COMPETITION POLICY

European competition policy was first outlined for the steel and coal industries with the formation of the Economic Community for Steel and Coal (ECSC) in the 1951 Treaty of Paris. Article 3 of the Treaty of Paris outlined the duties of the Community institutions to ensure the proper supply, production and trade in steel and coal within the Community. Article 4 listed practices that were incompatible with the new market and Article 5 stated the obligation of the Community to "ensure the establishment, maintenance and observance of normal competitive conditions".[1] It was thus stated, from the inception of the union, that free competition was an important factor for economic success. Therefore, a basic function of the community institutions was to identify and eliminate anti-competitive behavior.

A common competition policy was included in the Treaty of Paris because of the belief that the European steel and coal markets lacked sufficient rivalry. Also, the Community looked to the United States as a model of a successful economy, based on the ideal of free competition and tough anti-trust legislation, and set out to emulate this success.

Six years later, the Treaty of Rome of 1957 laid the foundations of a competition policy for all economic sectors of the Community. Article 85 provided the EC anti-trust law and Article 86 provided the EC law against monopoly. The Treaty of Rome also laid the foundations for a common market for goods, labor and capital among the original member states and later for the 12 EC member countries. However, it took a long time for a common market to materialize. Although many steps were taken over the years to develop the Common Market, the big push came only with the Single European Act (SEA), signed in 1985. The SEA represented a turning point in the willingness of the member states to surrender a significant part of their economic independence in order to achieve a common internal market. Economic independence was further reduced in the Maastricht Treaty in order to establish greater economic and social cohesion, a Community industrial policy, and a research and technological development policy.

The growing willingness towards closer economic and social cohesion was due to several factors. First, the economic recessions of the 1970s and the early 1980s reinforced the belief that Europe needed a unified economy in order to sustain a leading international economic role. Second, changes in national economic policies and attitudes allowed the member states to more readily phase out some of the policy instruments which they had used in the past to protect their industries from foreign competition. Third, the improved economic conditions in the EC after 1982 reduced resistance to conceding powers to the Commission. The GDP and export share of the EC rose considerably after the early 1980s, a process which was complemented by a major restructuring of European industry. GDP, at constant market prices, increased from 0.2% in 1981 to 4.4% in 1988. The rise was due, in large part, to the recovery from the recession of the early 1980s and also to the catching-up process of new member countries. The trend was towards upwards economic convergence, though not all countries benefitted to the same extent and a few economies actually fell farther behind. However, it is probable that the improved economic climate in the EC facilitated increased cooperation.

The economic and political changes in Europe over the 36-year history of the Community are reflected in the implementation and development of EC competition policy.

The early history of the EC was characterized by a lack of awareness of competition policy and of the functional tools to implement it. Only after the implementation of Regulation 17 in 1962, which introduced the practical aspects of law enforcement such as group exemptions in regard to certain rules, did the implementation of competition policy begin in earnest. The Directorate General responsible for enforcing competition policy, DG

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[1] Goyder D.G., 1988, p. 17.

IV, began to bring cases before the European Court of Justice. Although the European Court of Justice is independent of the Commission, its legal judgements often supported the Commission's view on competition policy. As a result, the Court decisions gave a deeper and more concrete meaning to the competition rules and extended the Commission's power to act against any breach of competition law (for example, by introducing the requirement that a firm which has received illegal state aid must return it to the government). This allowed the Commission to enforce competition policy at a time when there was little cooperation on the part of the member states. This was of the utmost importance, because for many years the Council and the Commission were unable to legislate new competition laws because the necessary cooperation of the member states was not forthcoming. Not enough cooperation greatly hindered the development and implementation of competition policy. An example of this is the length of time required for the members states to accept new proposals by the Commission, such as the merger control clause, which was introduced by the Commission in 1972 but only ratified in 1989.

II. THE EFFECT OF THE EC'S INDUSTRIAL AND COMPETITION POLICY ON THE EC'S PAST AND PROSPECTIVE COMPETITIVE PERFORMANCE

It is difficult to assess the effectiveness of the EC's competition policy, mainly because this would require an evaluation of the nature and progress of the court rulings of the European Court of Justice and the achievements of DG IV. Changes over time to reflect conditions in the European market and changes in economic thought pose an additional difficulty. For example, the original Articles of the 1957 Treaty of Rome did not address the control of horizontal mergers because, at the time, concentration was regarded favorably as a prerequisite for European international competitiveness[2]. Control was mainly directed at vertical mergers, which were believed to constitute the biggest hindrance to competition.[3] The lack of concern about horizontal mergers contributed significantly to the surge in concentration during the 1960s, though the increase in concentration was mainly between firms from different EC countries and, contrary to the Community's intentions, included foreign firms. Concentration did not, hence, increase the international competitiveness of European firms; it might have even deterred the European economy from moving more quickly towards a freer market.

Nevertheless, there are two reasons why the competition policy of the EC was successful. First, a greater exposure to competition evolved in most sectors of the European market, including the coal and steel industries. Second, European business became more familiar with EC competition law so that greater adherence to it resulted. The latter has been largely favored by the persistent support by the European Court of Justice to competition policy .

Despite the general success of EC competition policy, there are still many problems to be solved. One area is public procurement, where recent surveys show marked biases towards local contractors. Another problem is state aid to industry. This is still very high and

[2] The ECSC Treaty only addressed mergers in the steel and coal sectors.

[3] In the 1950s and 1960s, agreements between firms to control distribution and prices were common. They were often achieved through vertical mergers.

often takes subtle forms that are difficult to detect or counteract.

To summarize, EC competition policy has been within its own terms "successful", given the framework provided to DG IV and the Commission and the legislative powers accorded to the European Court of Justice. However, effectiveness in the implementation of competition policy has been deterred by a lack of political cooperation on the part of the member states, particularly in the area of legislation.

III. THE INTERACTION OF COMPETITION POLICY WITH OTHER EC POLICIES

The reach and relative weight of competition policy instruments in the EC have been relatively constant since the Treaty of Rome, although they have been extended over the years, particularly during the 1980s, to accommodate the changing goals of the EC. The most recent changes were made to accommodate the new industrial and technclogy policies that were introduced in the 1980s to facilitate cooperation between firms and to support technology transfer and the economies of scale and scope needed for investment in new technologies. The goal of these new policies is to restructure European industry by reducing the fraction of industrial output due to traditional industries and by increasing the fraction due to high technology and growth industries.

The interaction between competition policy and the new industrial, technology, and foreign trade policies of the EC probably constitutes the most important issue facing competition policy. Several competition policies have been altered to help meet the new policy goals. The most important impacts on competition policy came from strategic industrial support schemes and foreign trade policies.

The new industrial policy aimed at strengthening key sectors, such as Information Technology, use "strategic" support schemes that, at face value, would appear to interfere with the free market. The aim in the long run is improving the competitiveness of European industry. Competition policies that were altered to allow for strategic support include anti-trust laws, which now permit cooperative R&D ventures. Exemptions were also extended to agreements for the protection of industrial property rights, to rights relating to production and industrial application processes, and to the application of prototypes. In addition, the anti-monopoly laws and the application and approval process for exemptions were simplified in order to minimize the red tape faced by firms.

One worry with the new industrial policies, from a pure competition policy perspective, is that the new European industrial policy might substitute for protective policies at the national level. The prospect of industrial policy increasing concentration and possibly cartelisation in certain sectors by supporting European champions could from this perspective be much greater at the Community level than at the national level, so that market distortions may cause greater damage to consumers than the old national protection policies.

European competition policy also interacts with industrial policy in the area of foreign trade. Regional free-trade agreements require progress towards a common foreign trade policy. This again can alter international trade flows and consequently the position of international trading partners towards the trade union. It is bound to increase both the sensitivity towards issues liable to affect foreign trade and the probability that disagreements be solved through political channels.

EC foreign trade policy has affected several aspects of trade. The prospect of more external trade barriers between the EC and the rest of the world is believed to have played a significant role in the increase in Foreign Direct Investment (FDI) in the EC. Japanese automotive firms, for instance, established a large number of assembly plants during the 1980s in the UK and in Spain. Strategic industrial policies can also affect international trade relations, as shown by the US complaint against Airbus subsidies. If competition rules were more generally applied including extra-EC trade, the chances of friction between trading blocs may diminish.

From this perspective, the growing number of regional trading blocs will demand closer scrutiny of regional industrial policies to ensure that they do not interfere with the overall goal of free competition on a global scale. This problem has not escaped the attention of the European Commission. In principle, EC policy aims at opening the internal European market to both intra-European and extra-European competition. This is most clearly stated in the 1990 Bangemann Report of the Commission of the European Communities on European Industrial Policy for the 1990s:

'Respecting competition on international markets will become much more important. Globalization of markets and the ever greater dimension of major groups requires that mechanisms be created that can avoid the creation at an international level of monopolistic or oligopolistic situations which would be unacceptable at national or regional level.'

How far such open market policy will be actually enforced remains to be seen. Rules of origin, designed to prevent foreign investment in "screwdriver" assembly plants, and voluntary export restraints (VER) to limit imports are forms of protection susceptible to political pressure from industry. Import quotas on Japanese cars, for example, are only due to be completely abolished by 1999, but there is now already considerable concern that pressure from the European car industry may further delay that deadline. The EC currently has rules of origin for 14 products and it still uses many VER agreements to protect the EC market. One example is the agreement with the Japanese government to limit Japanese car exports to the EC to one million cars in 1994. There is also the temptation to use these regulations, for example, to support a strategic targeting of high-technology industries. It is hard to envisage how legislation which affects trade will develop because these rules still provide a substantial protection measure for domestic EC industry against foreign competition, whilst rules of origin are to some extent a defining characteristic of a regional trade zone. Yet, protective measures also epitomize the image of a Fortress Europe and increase trade frictions between the EC, Japan and the US

IV. MAIN AREAS OF CONVERGENCE AND FRICTION WITHIN THE EC AND BETWEEN THE EC AND ITS MAIN TRADING PARTNERS, WITH RESPECT TO THE EC'S COMPETITION POLICY

The basic competition rules established by the Treaty of Rome have generally been followed: cases of unlawful agreements and abuse of a dominant position are brought before the European Court of Justice. Community law has succeeded in determining the competition rules in cases of disagreement between the national courts and the European Court. Friction within the Community in regard to competition law is revealed by the inability to reach consensus and delays in legislation. An example is the history of the Colonna Report of 1970. This report outlined a proposal for a common industrial and competition policy for the

EC, but these plans only materialized in the 1980s because of the inability to reach a political consensus on the concessions to be made by each member state. Also, conflicts in legislation lead, sometimes, to substantial revisions and a softening of Community regulatory framework law, such as in the case of the merger control law.

Historically, firms from Europe's main trading partners have reacted to European unification by trying to accommodate to conditions in the European market; i.e., by establishing subsidiaries within the Community. These subsidiaries were set up partly because of the intrinsic belief that the economic union would make the Community less open to foreign trade and partly because of the intrinsic economic attractiveness and opportunities offered by the European market, an opportunity which foreign firms were quick to realize. It is therefore not surprising that the two major influxes of investment into Europe corresponded, first, to the initial formation and, later, to the forging of the Community after the SEA. This not only because of the need to ensure market access in a unified Europe, but also because of the improved economic environment which paralleled these two stages in the development of the EC.

Barriers to EC firms trying to establish a foothold in a new EC market were almost as great as those experienced by extra-EC firms. National aid, procurement, R&D support and favorable tax schemes are some examples. Foreign firms, already well acquainted with large, homogeneous markets and strict anti-trust policies at home have been often in a better position to exploit the emerging single market. Furthermore, these firms were not pampered by policies to support national champions, as some of the national EC firms were (some of which aimed at becoming European champions). The result was a surge of foreign investment, mostly by American firms, which had already begun in the late 1950s but intensified during the 1960s.

In the 1980s, a second surge in foreign investment occurred, including both American and Japanese firms. Subsidiaries were often established in countries or regions with small domestic markets such as Belgium, the Netherlands or Scotland. These regions were open to foreign investment and their good infrastructures and close access to larger markets made them competitive production locations.

Today, questions about the impact on trading partners often concern the interaction between competition policy and macroeconomic, industrial and technology policies. The current US complaint regarding assistance to Airbus exemplifies this problem. While the US claims that Airbus has an unfair advantage over US industry because of state assistance, Europe points towards the importance of previous military government support in helping Boeing develop some of its presently most profitable wide-bodied aircrafts, and to the opening up of such "monopolistic" market thanks to the entrance of Airbus[4].

Shifts in industrial and competition policy affect the foreign trade scenario in several ways. First, as the Airbus example shows, industrial and technology policies may be used to shield a particular industry from foreign competition; they can, however, also be used to develop a potentially competitive industry in the long term . Second, there is the question of

[4] Airbus is not an EC project and its main funding is not from EC institutions. However, most of the countries participating in it are EC countries.

the treatment of foreign subsidiaries, some of which are long-established in the EC, sometimes through take-overs of old European firms. The right of these firms to participate in cooperative R&D programmes is an issue under debate: their inclusion might undermine much of the "raison d'être" for such policies/programmes, whereas their exclusion might not only be difficult to achieve, but also unfair from a competitive point of view.

V. INFERENCES FROM THE EC EXPERIENCE ON THE ROLE OF COMPETITION POLICY IN A FREE-TRADE ZONE

The three main lessons in regard to competition policy that can be drawn from the EC experience relevant to other free-trade zones can be summarized as follows:

1. A free trade agreement, in order to have its full economic effect, should be complemented by a common competition policy. The GATT rounds towards freer trade need to be complemented by a set of global competition rules. Otherwise, the benefits of free trade might well accrue to the large global firms rather than to the consumers. The need for economic integration to be accompanied by a competition policy has far reaching implications because the harmonization of existing competition policies at a national level demands a high level of economic and political cooperation.

2. Greater cooperation on competition policy requires a political commitment based on trust, since it depends upon relinquishing control on domestic policy tools and the shift of decision making in these matters from the national to the economic community level.

3. Once begun, the economic integration process may be delayed, but hardly reversed because it is a holistic process that affects all major economic activities. From this perspective, integration is very much a cumulative, path dependent process.

KEY EVENTS IN EC COMPETITION POLICY

1951, Apr.	Signature of the Treaty of Paris, establishing the European Coal and Steel Community.
1957, Mar.	Signature of the Treaty of Rome establishing European Economic Community. First Council Regulation 17 implementing Articles 85 and 86 of the Treaty of Rome comes into forces. First Regulation to give the Commission powers and procedures in competition matters; 1962, Mar.
1962, Jan.	First decision by DG IV prohibiting agreement under Article 85: the 'Convention Faience'.
1964, May	The first Commission decision on vertical agreements: the Grundig-Consten case, in which the Commission decided that a distribution agreement between Grundig and Consten was void because it prevented parallel imports into France, of Grundig products, other than by Consten, thus constituting a prohibited agreement.
1965, Mar.	First Council Regulation, 19, authorizing the granting of group exemptions by the Commission, for exclusive distribution, exclusive purchasing and industrial property rights licenses.
1966, July	The first European Court decision on vertical agreements: the Grundig-Consten case, in which the Court upheld the Commission's decision that a distribution agreement between Grundig and Consten was void, because it was capable of endangering the freedom of trade between member states in a direction which could harm the attainment of the object of a single integrated market.
1969, July	First fines imposed by the Commission for the violation of Article 85: the Quinine Cartel case.
1971, June	First Commission decision on Article 86, in which the Commission decided that some rules of the overruling German Performing Rights Society discriminated against nationals of other member states.
1973, Jan.	The first European Court decision prohibiting a merger on the ground of Article 86: the Continental Can case, in which the Court ruled that any undertaking, including mergers, which establishes a dominant position or strengthens it, to the extent that it might endanger free competition in the relevant market, is void.
1985, Jan	Passing of Commission Regulation 2349/84 granting group exemption for patent licenses.
1985 Mar.	Passing of Commission Regulation 417/85 granting group exemptions for specialization and Regulation 418/85 granting group exemption for R&D projects.
1986, Feb.	Signature of the Single European Act.
1986, Oct.	Commission's communication on industrial policy.
1989	Delor's Report which emphasizes cohesion as a key objective.
1990, Nov.	Bangemann Report.
1993, Aug.	In a contradictory move, the working of the ERM is suspended (exchange rates are allowed to float within a 30 % band instead of a 5.5 % band) and Britain ratifies the Maastricht Treaty, leaving Germany as the only EC country yet to do it.

1. Main Trends in the Structure and International Competitiveness of the EC Manufacturing Industry since the early 1980s[5]

1.1. Structural change in the industrial sector

Since the early 1980s, industry in the EC and in most other industrial countries has undergone several structural changes. The relative share of high-technology manufacturing subsectors in total output increased at the expense of traditional manufacturing subsectors based on low-technology. Extensive restructuring and productivity growth occurred in all major industrial activities. Productivity increases resulted from capital deepening, technological change, and investment policies that were implemented in response to the economic crisis of the early 1980s. At the same time, the rise in unemployment and internal competition pressures reduced the growth rate of real wages. As a result, real labor costs in the EC economy fell by 7% between 1980 and 1989.[6] These two factors combined - productivity increases and real wage decreases - substantially reduced unit production costs.

The rise in the share of high-technology products in total output is closely associated to the diffusion of information technology (IT) across industry within the EC. The diffusion of IT also contributed substantially to the relative increase in the share of the service sector in the national product of the EC countries, amounting to a major structural change in these economies.

The cause of the decline in the low-technology sector in total output is mainly due to the declining share of the metal and petroleum refining subsectors. Industrial restructuring and technological change are at the root of such a decline via capacity reductions, improved production methods, and lowered production costs along with a relative fall in the demand for metals and petroleum products caused by reduced materials and energy needs in other industrial subsectors undergoing technological change. These factors combined led to a substantial reduction in production volumes[7].

The structural changes which occurred in the EC industrial sector contributed to the acceleration in GDP growth in the latter half of the 1980s. Average GDP growth per year was 2.3% between 1980 and 1990, with an average rate of 3.14% for the years 1986-90.[8] The faster growth rates were also aided by other factors, including an increase in EC exports to the US due to the appreciation of the US dollar in the early 1980s, the general increase in investment (including foreign direct investment) in preparation for the single market; and the unification of Germany.

Faster growth rates were also aided by the compatibilization of macroeconomic

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[5] Unless otherwise stated, all data is taken from the Commission Statistical Supplement for 1992, the European Economy Report for 1991-92 and the January, 1993 Supplement to the Report.

[6] Ibid., p. 228.

[7] OECD, 1992, p. 8.

[8] Somers F., 1991, p. 222.

policies among the member states in preparation of economic unification. In the 1980s, some member states, most notably France, Ireland and Holland, started to cut their budget deficits and lowered inflation in accordance with future European Monetary System (EMS) requirements. Except for Greece, the poorer member states have, since the late 1980s, reduced their income gap with the Community average, which also contributed to an improved economic performance of the EC as a whole.

Despite structural change towards a higher share of high-technology subsectors in total output, the growth rate has remained considerably slower in the EC than in some of its main trading partners: Japan, the US and the EFTA-countries. Furthermore, the EC's share of the world market in subsectors where demand is strong, such as computers, electrical and electronic goods and chemical products, remains smaller than that of the US, despite its larger market, and is similar to that of Japan. In contrast, the EC still maintains a larger share than Japan and the US in industries with a moderate to weak growth in demand, such as food products, textiles and metal products (see Table 1). In spite of the significantly higher growth of high-technology subsectors compared with other subsectors, the former's export performance has been worsening.

The slower rate of structural change in Europe compared to the US and Japan can be explained by several macroeconomic and microeconomic factors. Although total investment intensity per employee is higher in Europe than in the US and Japan, the investment ratio is rising at a slower rate. This could explain the faster growth in labor productivity in the US and Japan, compared to the EC. Also, R&D levels in the EC are relatively low and have stabilized at the 1978 ratio. In computers, the US leads in R&D intensity and Japan has overtaken the EC.

The weakness of European industry in the high technology sectors is of particular concern, since these sectors are expected to be the main contributor to the growth of national output in the industrialized countries in the future[9]. In response to this situation, the EC has placed a high priority on increasing the competitiveness of the European high-technology sectors and has allocated considerable resources since the mid-1980s towards meeting this goal.

1.2. The international trade performance of the EC

A glance at the aggregate trade figures for the EC shows a healthy increase in exports. Since the early 1980s, the total trade of the EC has gone up significantly, both in real and relative terms, though the share of GDP due to exports (9.1%) is still smaller in the EC than in the US and Japan (9.9% and 13.9% respectively). Exports as a percentage of the GDP of EC countries have grown by a total of 11% between the years 1980-90, though the

[9] As Table 1 shows, the substantial rise in production volumes of the high-technology subsectors relative to other subsectors: the former are becoming the major propellers of growth and their GDP ratio is steadily increasing.

main jump occurred between 1980-81, when export share rose 5%.[10]

Table 1 Changes in Output, Employment and Export Volumes for Major Low, Mid and High Technology Sectors of the EC, 1980-1990[11]

	change in output	change in employment	change in net exports
iron & steel	+17%	-37%	-43%
food, drink & tobacco	+74%	-11%	+455%
textiles,leather & footwear	+12%	-6%	-1800%
shipbuilding	-19%	-44%	-13%[12]
chemicals	+92%[13]	-11%	+40%
transport equipment	+118	-20%	-5%
mechanical engineering	+93%	-13%	+50%
electrical engineering	+110%	-99%	-230%
electronic engineering	+119%	_	-563%
telecommunications	+82%	-33%	-29%[14]
computers & office equipment	+268%	+23%	-502%
consumer electronics	+55%	-20%	-252%

The contribution of Portugal, Ireland, Spain, Italy and Germany to EC exports has increased, while that of Greece, Belgium/Luxembourg, the Netherlands and the UK has decreased. The shares of Denmark and France have remained unchanged. Thus, on the whole, the contribution of the EC member states to total EC trade shows signs of convergence.

The main factor contributing to the rise in EC exports is the increase in intra-Community trade, which has been growing at 5.1% per year. Intra-EC trade now makes up

[10] Somers F., 1991, p. 268, Table D-22.

[11] Taken from the CEC Statistical Supplement, 1992.

[12] % of world production.

[13] from 1981-1990.

[14] from 1980-1987.

a significant part of the total trade in most EC countries. In the smaller EC countries, Belgium/Luxembourg, the Netherlands, Ireland and Portugal, intra-EC trade now accounts for over 70% of their total exports of manufactured goods. In France and Spain intra-EC trade makes up 63% and 66%, respectively, of their exports of manufactured goods. (The percentage is lower for the UK, Denmark and Germany: around 53%.)

In contrast, since the early 1980s the growth of exports from the EC to the rest of the world has been relatively modest, i.e., an average of 0.7% per annum between 1982 and 1990. This modest performance is reflected in the EC's market share of world exports, which has been declining until very recently.[15] In fact, in many subsectors, the good export performance of EC countries has often been limited to the region. EC exporters appear to have found it more difficult to expand into other markets. The worst situation is in the high-technology sector, where intra-EC exports grew 7.5% in the years 1982-1990, whereas extra-EC did so by a mere 2%. Conversely, since 1982, the volume of imports have been steadily increasing. Over 1986-90 imports of manufactured products from the rest of the world have grown more rapidly than intra-EC imports (9.4% compared with 7.1%). The sharpest rise in imports from non-EC countries took place in high-technology products, where Community imports from the rest of the world increased by 7.7% per annum over 1982-90. Within the EC, only Germany and Ireland have a positive trade balance in IT. The surplus in Germany is decreasing and the positive trade balance in Ireland appears particularly due to assembly plants owned by foreign subsidiaries of Japanese and US firms.[16]

An examination of internal and external EC trade flows raises questions about the effect of a free-trade zone on imports and exports. The increase in internal trade within a trade zone such as the EC is an expected result of increased economic cohesiveness and cooperation, a major goal in the formation of a regional trade zone, and of higher industrial specialization, which is another positive outcome of a regional trade agreement. On the other hand, the increase in internal trade could come at the expense of external trade if favorable conditions within the trading prevail that shield firms from external competitive threats. In addition, policies to protect industry within the trading zone, such as rules of origin or import restraints, may lead to trade diversion, a fall in international trade, and an unwelcome reduction in the competitiveness of firms within the trade zone, compared to those in other locations.

Trade statistics provide some idea on whether or not European industry is losing competitiveness. EC's declining share of total world trade is at least partly explained by the rise of several developing countries and their growing contribution to world economic output and trade. The identification of problem areas for European competitiveness requires searching for economically significant sectors with marked external trade deficits.

The external trade deficit of the EC in industrial products suggests that intra-Community trade may have grown at the expense of extra-Community trade. Today,

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[15] In the years 1980-1988 EC's share in world export, as a percentage of total OECD exports, declined 3.6%, from 26.7% to 23.1%.

[16] Grupp and Soete, 1992, pp. 24-35.

manufactured products account for more than two-thirds of the total merchandise imports. Imports of machinery and equipment and other sophisticated manufacturing products have increased faster than the rest. Yet, such imports are not being matched by equivalent exports.[17] Instead, exports to non-EC countries are shifting towards lower technology and value-added products.

The increasing import dependency in the fast-growing, high technology subsectors is causing serious concern in the EC. Such imports from non-EC countries account for more than one-third of total Community imports of manufactured goods. This suggests that EC manufacturers may be losing ground to extra-EC producers. Subsectors where extra-EC imports have grown particularly fast are computers, electrical machinery and plastics. The EC's trade deficit in electronics has doubled over 1986-1990 to 31 billion ECU.[18] With the exception of professional and scientific equipment, the data for the 1980s indicate that high-technology products manufactured by non-EC firms are continuing to enjoy a relative competitive advantage with respect to products manufactured by EC firms.

Europe's high technology industry could be going through a crisis akin to that which hit mature industries in the 1970s and 1980s. Increasing R&D costs coupled with tough competition, could make it difficult for European firms to regain market shares. The EC now has only one-tenth of the world market for semi-conductors. In response, measures have been taken to support high technology activities by favoring gains in innovative ability and productivity.

Trade diversion may also have contributed to the recent decline in the competitiveness of the European IT industry. The decline seems to have taken place alongside the more recent phases of economic integration following the enlargement of the EC to twelve members states. There is some evidence to suggest that European IT firms have focused on the enlarged EC market at the expense of non-EC markets.[19]

2. Main Dimensions of EC Competition Policy

2.1. The development of the EC competition law

EC competition policy began with the Treaty of Paris which formed the ECSC. Articles 3, 4, and 5 of the Treaty laid the basic competition rules. Articles 65, 66 and 67 provided the legislation for their enforcement. These basic rules were used to build the EC general rules of Competition in the Treaty of Rome.

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[17] This can be seen in **Table 1**: although production growth in the mid and high-technology subsectors has been high, export volumes have decreased, even in sectors where the EC still has a notable comparative advantage, such as chemicals and telecommunications.

[18] CCE, SEC(91) 565, p. 34.

[19] See Grupp H. and Soete L., 1992, pp. 35-45.

The competition policy of the Treaty of Rome was designed to facilitate the main economic objectives of the Community: i.e., assuring Community consumers that a larger free and competitive market for the free movement of products, services, labor and capital would help maximizing their economic and social welfare. The removal of barriers to competition was intended to promote a more efficient use of resources and thus benefit both competitive firms and consumers. The objective of free movement within the Community was to be achieved by harmonizing the competition rules among the EC member states in order to form a single market.

The EC competition policy developed over the years through the acceptance of the decisions and proposals of the Commission and through rulings of the European Court which widened the scope of Community legislation and restricted national legislation.

The basic competition rules of the Treaty of Rome did not give the Community authorities complete responsibility for the enforcement of competition policy. Articles 87-89 of the Treaty of Rome, which deal with the implementation of the competition laws, stated that the implementation of rules relating to competition required the cooperation of the member states. The Commission was not able to deal, on its own, with the complete range of practices and agreements that fell under its jurisdiction. Consequently, the Directorate General responsible for competition (DG IV) had, from the start, no choice but relying on the national courts to complement its work. Although this worked satisfactory, there were major differences in the interpretation of competition rules between the European court on the one hand, and by the national courts, on the other. For example, the European Court judged cartels on the basis of the obstacles they created for free trade within the Community, whereas national courts based their decisions primarily on the basis of the behavior of the firm within the particular member state concerned. However, because infringement of competition law, such as prohibited agreements[20] and abuses of a dominant position[21], tended to take place for a long time within single member states, the rulings of the different courts were often compatible.

During the early years of operation of the Treaty, few cases came before the European Court. This was because it took time for the Commission to organize the Directorate responsible for applying the competition rules, i.e., DG IV, and also because the technical details of the laws were not established in the Treaty of Rome.[22] Articles 85 and 86 were sufficient for the articulation of a coherent competition policy, but the procedural

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[20] Any agreement between firms that is defined by Article 85 of the Treaty of Rome to pose a threat to free competition in the market for a certain product.

[21] Any way in which a firm, which has a strong enough position in a product market to enable it to restrict free competition in that market, uses this power to this end (by strong position, the meaning is usually that a firm produced a high share of total market output for a certain product).

[22] This report discusses the Commission's view on competition policy as a whole. However, it should be noted that significant conflicts have occurred within the Directorate Generals of the Commission competition policy. These conflicts are not discussed here.

details and group exemptions were provided in 1962 in Regulation 17. DG IV is based on this regulation.

The lack of specific technical regulations allowed broad interpretations of the basic competition rules, which allegedly helped the Commission and the European Court extend the scope of the competition rules beyond the specified intentions of the Treaty of Rome.

The European Court, which dealt with cases of infringement of the EC competition laws, is independent in its decisions from the Commission. Nevertheless, its judgements have historically supported the position of the Commission and DG IV. The Court has emphasized the importance of Articles 85 and 86 and interpreted their meaning in a broad sense which gave the Commission greater power of action. The Court also treated the creation of a single market as a priority, rather than focusing on issues of efficiency or consumer protection. The Commission in turn capitalized on the Court's decisions and usually broadened the meaning of the Articles on competition.

Aside from ruling in competition infringement cases brought to it by the Commission, the European Court also has the power to cancel or reduce penalties imposed by DG IV and to annul the Commission's decision.

DG IV has, from the beginning of its operation, suffered from many weaknesses, not least of which a lack of resources to deal with breaches of competition rules. For this and other reasons the Commission sometimes adopted a relaxed attitude towards infringements which were not deemed to pose a significant threat to competition. For example, during the 1960s and 1970s the Commission rarely opposed state aid to industry. This situation only changed in the early 1980s in response to the mounting pressure on the part of member states to control state assistance in other parts of the Community.

As the EC competition policy developed over the years, with DG IV bringing infringement cases to court, new situations arose which were not addressed by the initial competition policy framework. For example, the original version of the Treaty of Rome did not address mergers. This turned out to be perhaps the greatest flaw in EC competition policy. Only mergers in the coal and steel sectors were covered, under Article 66 of the Treaty of Paris.

Up to 1989, the only rule relating to the control of mergers in other sectors rested on the decision of the 1973 Continental Can case. The omission of legislation to control mergers in the original framework led to the attempt to achieve some control under Articles 85 and 86. Article 86 was seen as most amenable to an interpretation allowing merger control. Thus it was used in the Continental Can case, which was the first merger case to come before the European Court. The fact that it was the only case of merger control under Article 86 shows the weakness of the Commission's position as a result of the lack of suitable legislation.

The decision of the European Court in respect to Continental Can established that only a merger with a firm holding a dominant position can be controlled through Article 85. Thus, the Commission was powerless to stop a merger unless abuse of a dominant position could be proved, even if the outcome of the merger was ultimately a dominant position. Thus in the 1970s and 1980s the Commission was generally unable to engage in merger control, and the European Court was unable to supply the legislative power to do so[23].

Only in December 1989, with the adoption of the new Merger Regulation, was the Commission given explicit jurisdiction for merger control. Council regulation 4064/89 applies to industrial concentration which has an effect at the Community level, and includes mergers, joint ventures and takeovers. In addition, a specific list of controls afforded to the Commission came into effect a few months earlier, in september 1989, in order to simplify the application and decision process for the approval of mergers and agreements between firms. These measure distinguish between mergers that require and do not require the Commission's approval and eliminates the need for approval from both national and EC authorities. The laws also allow the Commission to veto deals involving firms with a combined turnover of over a specified limit. The new controls were already extensively used by the Commission to block mergers.

The new measures came into effect during a new wave of mergers and acquisitions within the EC. The number of mergers or acquisitions between Europe's leading 1000 companies leaped from 227 in 1987 to 492 in 1989. This process is mainly due to preparations for unification, although it is worth noting that most of the mergers were still national in scope.[24]

Another weakness in the original outline of the competition policy concerned the rules for state aid. The Commission had no authority to issue regulations or directives in this area and was at a loss when the economic crisis of the 1970s greatly increased state aid schemes for the industrial sector. Certain industries, such as textile, shipbuilding, steel and coal receive large amounts of state aid and this was only partly remedied during the 1980s with the establishment of deadlines for the discontinuation of national aid earmarked to major industries.

2.2. The Competition Rules

The Treaty of Rome contains the basic competition rules (Articles 85-94) which deal with three forms of infringement of competition: agreements among enterprises, abuse of a dominant position (Articles 85-91) and state aid (Articles 92-94). These articles have been extended, by subsequent legislation and by rulings of the European Court of Justice, to include public procurement rules and laws against state monopoly.

The Community's competition law has precedence over national law in the case of conflict, but it does not automatically replace national law. The Commission must consult the member states concerned when it finds a discrepancy between national and Community law, or if national legislation hinders competition. If an agreement is not reached, the Council issues the necessary directives and takes whatever measures are provided in the treaty to deal with distortions to competition (Article 101 of the Treaty of Rome).

[23] See Downes T. and Ellison G., 1991, p. 7.

[24] The Economist, June 6, 1991.

Competition policy is restricted to inter-member state trade relations. For example, Article 85 on restrictive practices refers to "practices which are likely to affect trade between member states". Therefore, actions which only have domestic effects, or an effect outside of the EC, are excluded. On the other hand, actions originating outside of the EC but affecting any member state are included. Thus, a non EC company participating in the EC market directly, or through a subsidiary, is liable to EC law in regard to its subsidiary.[25] In addition, the company's position outside the EC is taken into account, for example, in establishing a dominant position status (Commercial Solvents case, 1974).[26]

2.2.1. The EC anti-trust law

Article 85 deals with prohibited agreements between two or more companies. These are agreements liable to affect trade between member states and which have as their objective, or effect, the prevention, restriction or distortion of competition within the Common Market. Prohibited agreements include market sharing (an agreement to divide the market for a certain product on a geographical or other basis), price fixing (an agreement to sell a certain product at the same price), exclusive purchase (an agreement that a firm will purchase a product only from another firm), and selective distribution agreements (an agreement that a distributer will only distribute the product of a specific company, to the exclusion of other companies).

The Commission can stop agreements between firms or between firms and governments only if they have a restrictive effect on trade between member states. It cannot act on restrictions to domestic trade.

Conditions for exemptions from the anti-trust rules initially included agreements which were thought to contribute to improving the production or distribution of goods or to promoting technical or economic progress. They also included agreements that allowed consumers a fair share of the resulting benefits. The exemptions were later extended to agreements for the protection of industrial property rights between only two parties. Finally the Council extended the exemption to the application of standards and to R&D undertaken before industrial application in order to encourage cooperative R&D.

In its first stage, the most widespread use of Article 85 was in regards to vertical price-fixing. The Commission paid more attention in the early days of the EC to the dangers of vertical integration than to any other form of restrictive agreement. This was reflected in Regulation 17, where group exemptions applied to vertical rather than to horizontal agreements. After 1966, the Commission's preoccupation with vertical relationships focused

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[25] This was established through court rulings, originating with the Dyestuffs case in 1972, where the European Court ruled that ICI was liable for the practices of its subsidiary in Belgium, even though the subsidiary was legally independent and the parent company was neither present nor trading with the Community. The Court decision was based on the fact that ICI was present within the Community through the corporate control it was entitled to exercise over its subsidiary. See Goyder (1988, p.388).

[26] Goyder (1988, p. 388).

on exclusive distribution arrangements. Articles 85 and 86 were also used to control the surge in foreign investment in the EC during the 1960s by foreign multinationals and foreign subsidiaries within the EC.

The preoccupation with vertical relations resulted in less attention being paid during the 1960s to horizontal agreements, and in particular to cartels within national markets. Only in the late 1960s were major cases, such as the Dyestuffs and the Sugar cartel, dealt with by the European Court. The result of the early focus on vertical agreements is that it is more difficult for horizontal agreements to benefit from the group exemptions, particularly joint ventures relating to R&D. Article 85 is still mainly used to prevent price fixing.

2.2.2. The EC law against the abuse of a dominant position

Article 86 of the Treaty of Rome outlaws any abuse, by one or more firms, of their dominant position within the Common Market, in so far as they affect trade between member states. A dominant position is defines as a share of the market large enough to influence the price or quantity of supply in order to reap monopoly profits at the expense of the consumer.[27]

Unlike in the US, market dominance by itself is not regarded by the EC as wrong. Only the abuse of a dominant market position is deemed illegal, for example price discrimination, unfair purchase or selling prices; restriction of production, outlets or technological development; or irrelevant conditions for outlets or dealers.

Article 86 has been extended through Court rulings to encompass more than the sheer size of the firm. For example, when a firm has "the power to behave to an appreciable extent independently of its competitors, customer and alternatively of its consumers", it is considered to have a dominant position (United Brands case, 1978)[28]. Article 86 has also been used to prohibit mergers where the merger strengthened pre-existing dominance in a particular market.

As stated before, Article 86 has been used by the Commission to try and block mergers, as the initial competition law did not address this form of hinderance to competition. In the 1973 Continental Can case[29], the Court of Justice established that Article 86 applies to mergers that constitute an abuse of a dominant market position. However, the Court ruling only gave the Commission the power to control mergers and acquisitions if they involved firms in dominant positions.

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[27] The EC legislation in regard to abuse of a dominant position is extensive. Accordingly, the definition of a dominant position is rather complicated. For example, a 30% share of the market is considered dominant if the next largest firm has only a 5% share. In the definition of a dominant position a distinction is drawn between increasing, steady or decreasing market shares.

[28] See Goyder (1988, p. 303).

[29] See Goyder (1988, pp. 321-325).

Today, the area of a dominant position touches on the question of private ownership of what used to be government enterprises. Until the 1980s there was a lack of concern over the complete absence of a market for public utilities. In the 1980s, several member states moved towards deregulation and the withdrawal of exclusive rights for the use of resources and for the production and distribution of certain products. Part of this movement was influenced by the breaking-up of what appeared to be natural monopolies. An example of this is the telecommunications sector, where technological advances allowed services to be provided by more than one supplier.

The Open Network Provision Framework Directive in telecommunications and several subsequent Directives regulate the access of private firms to the networks of telecommunications administrations, which are still, in part, national monopolies. It is likely that certain parts of these services will always constitute a natural monopoly, so the question remains as to whether or not the holders will abuse their dominant position. This question is obviously more important for privatized natural monopolies. In the energy sector, the problem is more complicated, due both to the technological characteristics of gas and electricity networks and to the greater sensitivity of this sector to security of supply.

In both telecommunications and energy access to networks, a key issue, may have natural monopoly characteristics. The extent to which firms are allowed to compete in value-added services is closely regulated and the natural monopoly section of the network closely supervised against abuse.

2.2.3. The EC state aid laws

National aid is controlled under Articles 92 and 93 of the Treaty of Rome. Government aid includes both direct subsidies and indirect subsidies, such as tax rebates and export premiums. As a rule, all government aid to business is banned under Article 92 because it poses unfair competition to firms from other member-states by lowering the consumer price of locally made products.

State aid is perhaps the least efficiently implemented competition law of the EC. The Community laws tend to be more lenient towards subsidies than towards unfair trading practices simply because it is much harder to control a government than a single firm. In principle, the state should inform the Commission and obtain the Commission's consent before granting any assistance other than that specifically authorized by the Council. In practice, the Commission is usually informed after the implementation of subsidies by a firm or a member state hurt by another member state's subsidy policy.

State aid is also difficult to control because it can be subtle and indirect. An example of this is the Daimler Benz case, in which the company received large subsidies from the German government under the terms of a 1989 agreement to cover the company's claimed exchange rate losses on Airbus work. The U.S has taken the case to GATT, arguing that the subsidies are equivalent to $2.5 million per aircraft.

Public enterprises pose a special problem. Under Community law they are supposed to be treated as private enterprises, but this principle is not well enforced.

Perhaps the most difficult problem in applying rules for state aid is to distinguish between direct aid and the competitive advantages which arise indirectly through national economic, fiscal, and social policy. Indirect state aid can be regulated under Articles 101 and 102 of the EEC Treaty, though it requires either the agreement of the member states concerned or the adoption of Council Directives.

Article 92 contains rules of exemption where state aid is permitted. These include regional aid for poor regions and support for fundamental R&D not directed towards commercial objectives. For basic research, aid up to 50% of cost is normally allowed and aid for applied research is limited to 25% of the cost. Government aid to projects in areas of importance to the Community, such as environmental protection, industrial restructuring, employment and training schemes, are allowed under certain conditions.

The amount of industrial subsidy differs within the Community, with subsidies highest in Greece, Spain, France and Portugal. With the exception of France and Belgium, a strong negative correlation exists between the level of economic development in a country and state aid to industry. This suggests that state aid could be replaced by EC regional policies designed to improve economic conditions in less-favored regions.

The Commission began scrutinizing state aid more carefully during the 1980s because of the negative role played by state aid in the economic crisis of the 1970s and early 1980s. State aid played an important part in maintaining overcapacity and slowing productivity increases in several industrial sectors during these crises. Limits on state aid to industry are part of the drive towards the completion of the single internal market and European monetary union. The importance of convergence to the adoption of a European Monetary Unit adds urgency to the control of state aid, as they are an additional burden in countries with annual deficits and cumulative public debts above the Community average. In 1990, the Commission moved to end government investment aid programmes, such as the assistance of 6 billion Ffr by the French government to Bull and Thompson Groups (which are state owned), Belgian assistance of 35 billion Bfr to Sabena, and Italian aid of 287 billion lire to the trucking industry.

The Commission's 1990 White Paper on industrial policy noted the need for strict controls on state aid to counter the danger that state aid will be used to avoid the economic effects of dismantling trade barriers. Furthermore, it noted that state aid can hinder the achievement of the Community objective of improving the living standards and competitiveness of the less-developed regions, since the larger and more efficient member states will be able to afford higher subsidies than the less-developed member states in the periphery. To counteract this, the Commission suggested progressive reductions in aid levels in the central and more prosperous regions of the EC. The EC also tried to address the problem of state aid through the structural funds, which were created in part to provide an adequate substitute for national assistance (see MERCOSUR Report Series C.2, Investment Incentives, Subsidies and Related Regulations in the European Community).

The Commission's rising determination in the 1980s to eradicate, or at least substantially reduce, national state aid was supported by European Court rulings. In the 1980 Philip Morris case, the Court ruled that the company was not entitled to state aid, which Dutch law provided to any company conducting an investment project above a certain threshold, because the firm was not in a sector facing difficulties, nor located in a region with economic problems.[30] In the 1984 Intermills case, the Court ruled that state aid which was given illegally had to be repaid.[31]

State aid still acts as a barrier to a free market. The first Commission survey on state aid, completed in 1989, shows that between 1981 and 1986 the average level of state aid in the Community was 3% of GDP[32] and the average ratio of industrial aid to industrial GDP in the EC averaged 7.5%[33]. The second survey, made for the period 1986-88, shows that 2.2% of the GDP of the EC and 4.5% of total government expenditure was still spent on government aid.[34] State aid to industry exceeds state revenues from corporate taxation to the manufacturing sector.

The Commission's findings also show that state aid is very concentrated. Nearly 60% goes to transport, 16% to the coal industry (these subsidies were to end by January 1st, 1993), and 13% to agriculture and fisheries (also due to change in light of the recent GATT agreements). The remaining 14% goes mainly to manufacturing, although conventional recipients of state aid, such as steel and coal, now receive a mere 4% because of the EC rules in effect since 1992.

There is progress towards the goal of reducing state aid to industry. In 1973 the Court of Justice stated that the Commission has the right to order a member state to recover illegal aid from the recipient firm. Since 1985 the Commission has systematically ordered member states to recover illegal state aid from recipient firms and this considerably strengthened discipline. A good example of this is the 1989 case of French government aid to Renault, where the motor company was ordered to repay state funds and the Commission persisted in its demands even in the face of the French government's lack of cooperation.

2.2.4. Public procurement law

The EC public procurement laws are aimed at establishing the right of firms to tender for public contracts throughout the Community.

The Commission has been seeking to make public procurement procedures more transparent and available to firms throughout the Community by issuing directives which impose mandatory specifications to the publishing of public contracts. Two Directives were issued in 1976, covering public works and supply contracts. Both contain detailed rules

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[30] See Goyder (1988, p. 378).

[31] See Goyder (1988, p. 382).

[32] Welford and Prescott (1992, p. 81).

[33] The ratio is 4% when steel and shipbuilding are excluded. See Ludlow (1991, p. 69).

[34] Commission of the European Communities Directorate General for Economic and financial affairs, Report. no. 48, Sept. 1991.

regarding advertising, technical specifications, tendering procedures and the criteria for awarding contracts. The Commission estimates that only about 25% of public contracts are advertised in accordance with the directives.[35] To amend this, the Commission accepted additional directives to establish greater transparency for public supply contracts. These directives outline common conditions for wider publication, participation, and awarding of public supply contracts above a certain size.

In the light of the 1988 GATT Government Procurement Agreement, the Commission extended the coverage of the public procurement law (1987, Article 233). New directives widened the definition of contracts that were covered and extended the scope of Community public purchasing to the purchasing of supplies and works in five key sectors: energy, transport, water, construction and telecommunications. The 1990 Directive also contains a clause which allows governments to ignore bids from outside of the EC if they are no more than 3% cheaper than the best EC tender.

Purchases by national and local authorities are still affected by specifications which tend to strongly favor domestic suppliers. The Commission has tried to fight this trend, for example through the European Investment Bank, but its success has been limited in the absence of a procedural evaluation for tenders.

Public procurement is also among the least followed EC competition rule. In 1986, average procurement contracts in EC countries were worth between 7% and 10% of Community GDP. However, only 5% of contracts are awarded to companies from other EC countries and many are awarded without competitive bids.[36] All contracts above a certain value should be widely advertised, listed in the EC procurement booklet, and a reasonable period given for application. The contract should then be awarded to the lowest reliable bidder regardless of nationality. In practice, only major national contracts are published in the EC booklet. Most contractors are chosen according to traditional methods of reputation and location. This is especially true of regional government contracts.

One reason for this problem is that governments are not yet convinced that the public sector will benefit as much as the private sector from the single market. Public sector industries are therefore frequently protected, particularly because they constitute a major employer in many EC countries.

There are a number of reasons why governments tend to award procurement contracts to local firms. Geographical proximity is important because many government contracts entail prolonged service and maintenance. There are also language and cultural barriers. Yet biases in the awarding of contracts exist also for political reasons. A government will prefer to give the contract and supply the resulting work to its own constituency. Even at the national government level, over 90% of contracts are with national firms.

Another reason that makes unbiased national biddings hard to obtain is that strict

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[35] Ibid, p. 97.

[36] Welford R. and Prescott K., 1992, p. 92.

enforcement could, at times, undermine the objectives of the social and regional policy of the Common Market. If biddings were absolutely unbiased, this could lead to advantages for large engineering firms at the center of the Community over smaller firms at the periphery. It could also deepen the technological divergence that already exists between technologically strong and weak member states by blocking a major source of stimulus to local industrial firms.

Although biases in public procurement are still a problem, there is progress. An example is the 1989 Bouygues case concerning the Danish government's specification that local materials and labor were to be used for a local construction project. The European Court ruled in favor of the French construction company which filed a complaint against the Danish government.

2.3. The Effectiveness of EC Competition Policy

An assessment of the effectiveness of the basic competition rules outlined in the Treaty of Rome requires an examination of 1) the development of Commission legislation and rulings, 2) their implementation in court decisions, and 3) changes occurred in the EC market which could be attributed to EC competition policy.

1. The development of Commission legislation shows that it has, within its powers, been effective in adapting competition rules to changes in the EC market.

The effectiveness of the Commission in implementing competition policy is due primarily to the substantial powers granted to it by the Treaty of Rome. The competition rules outlined in this Treaty were general and did not cover the actual process of implementation. The drawing of the technical details of implementation was left to the Commission and its acting body on competition policy, DG IV, and to the jurisdiction of the European Court of Justice. This gave the Commission a wide scope of action in implementing and interpreting the competition policy, even during the 1960s and 1970s when the Council remained largely inactive as a result of political deadlock between the member states.

What the Commission has been unable to achieve is to introduce new competition laws without the ratification of the Council. Because of this, some proposals were greatly delayed and extensively altered in order to let consensus. The Commission tried to circumvent this problem by relying on the existing framework and trying to apply it to new areas through new interpretations and Court rulings. But its success, as the merger control example shows, was limited. A similar problem also existed with state aid, which the Commission was unable to sufficiently curb when it surged during the 1970s.

It is apparent, therefore, that the competition policy of the EC leaves something to be desired in terms of its independence from political factors and from other Community policies.

The limited independence of the Commission is also expressed in the limited funding of DG IV. A review of the achievements of the Commission and DG IV suggests that they tend to be most remarkable in the absence of severe budget constraints. For example, the greatest progress in enforcing the competition rules took place in respect to vertical integration, to which most of the resources were allocated. Horizontal agreements provide the opposite example. The Commission did not have the resources to deal with the large number of cases and complex situations. The amount of labor involved with cases such as the Dyestuffs and Sugar Cartel made DG IV hesitant to pursue such cases in the absence of clear proof.

There is still much to be done in the competition policy field, especially in the development of guidelines and group exemptions. Part of the problem is that the variety of agreements and ventures make it difficult to define group exemptions.

2. Competition policy has been one of the first areas of legal and judicial activity in the EC. By the early 1970s a substantial body of case law and subordinate legislation had accumulated, in addition to the original provisions of the Treaty of Rome.

The success of the Community competition policy can be largely attributed to rulings by the European Court of Justice, which have often upheld the viewpoints of the Commission.

In the first two decades of the EC, when the Commission viewed vertical integration as constituting the greatest breach of Article 85, the European Court rulings were in line with this view. When the focus turned to mergers and state aid in the 1980s, the Court decisions again reflected this. As it turned out, the cooperation between the European Court and the Commission was a fruitful one and pushed competition policy forward. But the vital need of the Commission for the backing of the European Court shows the limited power of the Commission to deal with new areas of competition policy that were not covered by the original competition rules.

The inability of the Commission to pass new competition laws without the ratification of the Council still constitutes a problem area, especially given the questions raised by the interaction between competition and industrial and science and technology policies. Conflicts between industrial policy and competition policy are therefore likely to occur.

3. Three major changes within the Community market can be attributed to EC competition policy.

First, the level of competition within the EC has risen significantly since 1957. Industry has gone through a significant decrease in concentration and the market in most sectors has become more easily accessible. This is most notable in mature sectors such as steel, coal and textiles.

The change in the level of competition within the EC market also owes to the cooperation of most member states in passing and implementing national competition rules. This cooperation was conceived by the common Community framework set up in 1957 and constantly pushed by the Commission, highlighting how important a common competition policy is to a regional trade agreement, not just as a regulatory instrument, but also for providing a framework and guidance for national competition law.

The second change due to the success of EC competition policy is the awareness and familiarity of European business with EC law. Today, firms are much more likely to consider EC law before they take action than they were thirty years ago. This is chiefly due to the rulings of the European Court and the heavy penalties imposed by it in recent years for breaches of Community competition law.

The third change attributable to EC competition policy consists of adaptations in the national competition rules of the member states. When the Treaty of Rome was signed in 1957, only Germany had a comprehensive competition policy. Soon afterwards many member states moved to legislate competition law. These laws have been made stricter over the years. Today all member states of the Community, except for Italy, have national competition laws and in many states these laws are more rigorous than the Community law. The development of national competition rules was the result of the increasing awareness and attention paid to competition issues within the EC framework.

2.4. Interactions between EC Competition Policy and other Policies

2.4.1. Industrial Policy

The first industrial policy framework

EC industrial policy was not framed initially as a common Community policy. Instead, it was a rather casual collection of policy instruments, each one aimed at achieving a different objective. It originated with the establishment of the ECSC as a method to restructure the steel and coal industries. These industries were considered of vital importance because of their high relative weight in industrial output and employment and their significance in case of war. Industrial policy was later extended and combined with regional policy to assist industries undergoing restructuring processes. Thus, the ECSC dealt with efforts to restructure the coal and steel industry with the objective of reducing excess capacity and increasing efficiency and productivity. Under the guidance of this objective, the ECSC passed legislation which allowed state aid to the coal and steel industries only if it was directed towards the implementation of a restructuring programme. The Community also contributed directly to restructuring programmes, redeployment, and the financing of early retirement schemes.

The ECSC's legislative power allowed it to act in times of crisis to relieve the situation of the steel and coal industry. In addition to the declaration of a 'manifest crisis' in 1982, the ECSC also ruled that no national subsidies were to be given to the steel industry after 1985. All investment programmes in steel had to be approved by the Commission and no one was accepted without a respective restructuring plan (normally to reduce capacity). Under the Merger Treaty of 1967, the European Commission kept executive authority to control production and prices of steel and the Community kept the power to declare the industry in manifest crisis under Articles 58 and 61 of the Treaty of Paris.

One of the greatest achievements of the ECSC was the prevention of mutual dumping between the major steel producing countries during the early 1980s. This might have been extremely damaging to the industry. The ECSC also had a decisive role in the reduction in capacity, rationalization and improved efficiency in these industries during the 1980s (mainly through quota and price restrictions). However, both industries, especially steel, are still in bad need of restructuring, particularly in Spain.

The ECSC combined EC competition and industrial policy. In regard to mature industries, the problem lays mostly in national aid programmes. However, some industrial policy measures taken by the EC provided the basis for potential conflicts with competition policy.

Most of the EC support for mature industrial sectors, such as textiles and leather, consisted of soft financing of R&D programmes or of aid through the European Regional Development Fund (ERDF) to regions dependent on the textile industry. Ex post, some of this assistance to mature sectors may be considered to have delayed rather than speeded up the process of adjustment and capacity reduction. But they were also addressed to social purposes.

Another form of assistance at the EC level consists of voluntary export restraints (VERs). During the 1970s, VER were commonly used to protect local textile industries through the Multi-Fibre Arrangements. Again, these trade measures might well have delayed adjustment. They helped at the same time in the gradual deconcentration and productivity growth of the textile sector, which was mostly achieved in the second half of the 1980s.

A more important deterrent to competition due to the EC's early industrial policy framework was the policy towards concentration.

In the 1960s, under the influence of American industrial organization ideas, the EC sought to exploit the link between size and competitiveness. This goal was also pursued at the national level, for example, the French, British, Italian and many other national governments introduced policies to increase the level of concentration in various sectors such as textiles, motor cars, etc.[37]

This strategy of reaping economies of scale while reducing intra-Community barriers made the EC tolerant of the potential negative consequences of a concentrated market structure, including things such as cartel agreements. Policy makers expected that the gains from concentration were likely to exceed the costs: scale economies were widely believed to bring about substantial efficiency gains while it was assumed that the cost of concentration would ultimately be very low. In addition, it was believed that the forthcoming integration of the European market would allow firms to realize economies of scale without achieving a level of concentration that would alter market structure and behaviour unfavorably.

The only one of these arguments that still applies today is that the enlarged EC market would allow larger firms without changes in market structure. However, policies to support large national firms did not necessarily increase international competitiveness. Large 'national

[37] The economies of scale paradigm was proposed by France, which was the first member state to put forward steps to encourage concentration through cross-border mergers, tax schemes and coordinated legislation of business law in the EC and at a national level.

comfort of national subsidization, preference in government procurement, etc., made large firms often averse to establishing cross-border ties and did little to increase their ability to compete in open markets.[38]

It was precisely in those sectors shielded from external pressure that economic adjustment had been slow, the level of competitiveness low, and contribution to growth and employment limited. This can be seen, for example, in the French and Italian car industry. Even though the EC has been removing national quotas from non-EC suppliers, VER still remain in this sector as well as in the electronics, footwear and textile industries.

Throughout the 1960s and 1970s EC legislation encouraged trans-border mergers, but the policies of member states often encouraged national firms to remain national. This, with three results:

First, contrary to the US, the early concentration process in the 1960s meant a transformation of the European corporate economy towards horizontal mergers, i.e. among firms competing in the same industry.

Second, the mergers were either on the national level, or involved non-EC firms, mostly from the US. Trans-national concentration within the Community was not as significant as expected.

Third, mostly American firms took advantage of the favorable climate towards concentration by establishing trans-national networks in Europe. These firms already had experience in operating in a large and varied market, did not have the national benefits of the local European firms, and were used to much stricter laws against concentration. Thus, during the sixties, major American firms such as GM and IBM established a strong presence in the European market.

A number of empirical studies suggest that the welfare costs of increased concentration in the 60s and 70s were much higher than originally believed. A comparison of the international competitiveness of the UK, Germany and the US found that "productivity differences are explained much less by differences in the size of establishments than by differences in labor relations, training and the availability of skilled workers."[39] The industrial policy of the 60s and 70s towards concentration may consequently have been wrongly focused.

The Commission's lack of judicial power prevented it from stopping the concentration process in the EC when its negative effects became apparent. This was only remedied when

[38] Pelkmans, in Ludlow (1991).

[39] For a wider discussion of early EC policy and its effect on industry, see Gersoki and Jacquemin (1989, pp. 198-334).

the member states finally reached consensus on the new regulations in 1989[40].

The new industrial policy framework

Despite the importance of the ECSC and its political relevance at the time of its inception, it became clear during the 1980's that it was an utterly insufficient industrial policy tool. It only addressed two industrial sectors whose relative weight in industrial output decreased significantly over the years. There were also other problems: the ECSC ex-post method of industrial assistance was inefficient, support for economies of scale increasingly failed to produce the expected benefits, European industry was unable to deal effectively with the economic shocks of the 1970s and early 1980s; and the innovative capability and competitiveness of the high-technology sectors was rapidly deteriorating.

Today, the intensified unification process following the SEA suggests that a common industrial policy became a prerequisite to the completion of a single market and to raising the international competitiveness of the Community. There was indeed the need to integrate the ECSC, the cooperative R&D programmes and the regional programmes into a common framework.

The EC developed the concept of an industrial policy, contained in the Commission's communication of October 30th 1986 to the Council and European Parliament, on the basis of the broad idea that help was needed so that European industry could regain the global competitiveness that it appeared to be losing. The framework for a new industrial policy was published by the Commission in November 1990 and later came to be known as the Bangemann Report.

The Bangemann Report defined the objectives of a new industrial policy as long-term growth, a stable macroeconomic environment, and a free and competitive market. The following policies were proposed to meet these goals: the establishment of common standards and regulations, the opening of public procurement, the abolition of national quotas, a common legal framework for companies, the creation of trans-European networks, programmes to assist the formation and competitiveness of SMEs, policies to promote international investment, and policies to strengthen competition, both in the internal market and in global trade.

The Bangemann Report regards free competition and an open market as the foundation for the new industrial policy. Competition policy has, according to the report, a key role in the development of the European common market and also applies to foreign trade. For example, the EC should not only reduce trade restraints such as VER, but also barriers in foreign countries, such as FDI limits in Japan.

However, it is hard to see how the EC could manage to abolish all trade barriers

[40] It is also possible that other new drawbacks in the competition policy framework will be found in the future which the Commission will not be able to effectively remedy without the cooperation of the Council. This suggests a need for improved decision-making processes to allow more rapid changes to ineffective or inefficient competition law.

against non-EC firms. Political pressures from major industrial sectors, such as the motor and textile industries, pose major obstacles. Also, the opening up of some foreign markets to European investment will not be easy.

Even though the new EC policy is to open up the EC market to competition, the EC still uses subsidies and other support policies to high-tech subsectors considered of strategic importance. The two approaches are prone to collide over foreign trade issues.

Although the need for increased competition was recognized by the EC, the advantages of concentration are still not clear. The new industrial and technology policy is likely to encourage concentration of the kind that does not necessarily promote competitiveness, such as horizontal mergers, but anti-competitive behavior. A complaint has already been filed in the joint R&D programmes launched by the Community for allegedly enabling unlawful agreements between major European firms. These programmes were initiated by the EC, together with the leading European IT firms, and began in the mid-1980s. They appear to have successfully strengthened transnational ties between firms within the Community, but their beneficial effects on the international competitiveness of Europe's high-tech industry is still a debatable issue. [41].

EC competition policy and industrial and technology policy are liable to contradict each other, as they did during the 1960s, when the industrial policy of supporting greater concentration through mergers lead to dominant positions and their abuse. Similarly today, the industrial policy of supporting cooperative R&D and transnational business cooperation may lead to the same result as an unforeseen and undesired side effect. Cooperative R&D programmes might be used by European companies to strengthen their dominant market position[42], rather than their technological capacities and competitiveness.

Although there are still major problems in implementing a common industrial policy, an argument put forward in its favor is that the economic integration of the member states will render their national industrial policies ineffective and cumbersome, since a policy exercised over a much larger market is likely to be more influential than national policies.[43]. The removal of trade barriers such as public procurement and state aid also means the removal of major national instruments of industrial policy.[44]

Competition policy can also conflict with polices to protect local industry, such as rules of origin, anti-dumping regulations and VER.

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[41] See Mytelka (1992).

[42] Attention should be called, however, to the fact that the resources allocated by the EC for cooperative R&D programmes is only a small fraction of the total R&D expenditures of EC firms.

[43] For a wider discussion of the arguments for a common industrial policy, see Nicolaides (1993).

[44] Ibid, p. 12.

Rules of origin are a characteristic feature of a free-trading zone. Yet, the key question is how extensively should they be used and to what end.

In 1968, the EC define origin as the place where the good underwent its last major transformation. However, this specification became open to different interpretations and more precise rulings were established in the 1980s. These have now become the common EC rules of origin, as distinct from those of individual member states. For example, the Community rules require 35%-45% added value in the EC for radio and TVs and 60% for cars made in EFTA countries. Electronic chips are considered to be made in the EC if the etching onto the silicon was done in one of the member states. The community also has a common 14.9% tariff on chips imports.

One noticeable effect of the rules of origin has been to increase foreign investment in the EC. This has benefitted the European economy through increased employment, supply and users linkages of various sorts and technology transfers. Yet, less noticeably they have often also led to substantial overcapacity in those sectors.

The establishment of direct manufacturing plants operations in the Community has often given foreign firms a competitive foothold. At the same time, regulations on FDI have served as an industrial policy tool for several member states and EC regions.

VER have been used by the EC in order to control the level of non-EC imports that compete with EC production, especially from newly industrialized countries. Since they are bilateral and impose limits on exports rather than on imports, they are often argued not to come under GATT rules, making them a presumably more attractive means of protection.

There are a range of quotas on Japanese car imports into EC countries (the recent agreement limits Japanese car exports into the EC to one million cars in 1994). The Commission has proposed the gradual lifting of the quotas by 1999.

The problem with such VER, as with all non-tariff barriers, is their limited effectiveness as a means to promote positive industrial adjustment. Given the wide difference between the restrictions imposed by individual EC member states on countries outside the EC, efforts at standardising the level of European quotas is likely to provoke a great deal of resistance and hence not to be very effective.

The US experience shows that VER and local content regulations have a relatively limited effect. They have served to increase Japanese investment and production in the US and contributed to raise the prices of Japanese imported cars. VERs hardly address such fundamental problems as productivity differentials.

Anti-dumping actions are often used as a threat to obtain VER. However, they provoke retaliation. There are signs that the use of anti-dumping laws is spreading to newly-industrialized countries which could threaten EC future exports.

EC's old industrial policy framework was often at odds with the efficient implementation of competition policy. The new industrial policy framework poses additional problems. The main risks appear to be linked to the increased use and importance of tools, such as rules of origin and VER, which are aimed at limiting foreign trade. Tools such as support for cooperative R&D schemes may obstruct free competition and alter the market structure within the Community in the future, but this seems unlikely for the time being because of the relatively small level of resources allocated to these programmes.

2.4.2. Science and technology policy

In the 1980s the EC member states realized that their technological infrastructure was inferior to that of Japan and the US and that their trade balance in high tech products with these countries was worsening. In addition, it became apparent that the support of R&D in some subsectors would pose a burden on single member states and thus should not take place without cooperation within an EC framework. It was thought that cooperation between the leading EC information technology firms would create the strength needed to compete with US and Japanese firms.

The S&T policy of the EC is part of the new industrial policy framework and takes the form of direct support to R&D projects, cooperative or otherwise. Its goal is to increase the competitiveness of EC industry, especially the high-technology subsector, encourage trans-border alliances and networks, and improve the industrial infrastructure. This is achieved through the initiation and support of cooperative research programmes and through the setting up of organizations and committees that provide an infrastructure for new leading technologies and innovative technological performance.

The EC also facilitates structural change and technological progress through policies aimed at making the economic climate favorable to innovation. This includes legislation to protect intellectual property rights, company laws to enable inter-country mergers and cooperation, a Community patent system (which introduced changes to the system of mutual recognition), unified technical standards and safety regulations, and through facilitating the exchange of information.

The adoption of the Single European Act in 1987 provided a new and explicit basis for R&D policy that built upon the positive response to the ESPRIT programme, begun in 1983. The first general Framework Program for Community R&D ran during 1984-87 and set a common strategy in the field of research and technology. The programme encompassed eight areas of action: health, information technology (ESPRIT and RACE), modernization of industry (BRITE), biotechnology (BAP), energy (JET and NET), development aid, exploitation of marine resources, and improvement of European scientific and technological cooperation.

In order to facilitate cooperative R&D, Article 85 of the Treaty of Rome has been extended to allow agreements between firms for pre-competitive joint R&D. In 1984 the Commission adopted a 'block exemption' regulation for R&D agreements between firms which allowed for the agreement to take place without prior notification to the Commission. The exemption also allowed for the joint commercial exploitation of the results of the research, a considerable change from the earlier guideline of Article 85.

A second Framework Program was adopted to run between 1987-91. Its scope was expanded to include additional fields of research. The third Framework Program was adopted in 1990 for the years 1990-1994 and a fourth Framework Program is currently under development.

It is still hard to assess whether these programmes have increased the competitiveness of the EC high technology sectors. Criticisms of the programmes include: they spread resources too thinly by financing too many projects, there is insufficient coordination between the various programmes, the time schedule is too long; and, they provide support in areas where there is no comparative advantage for Europe, such as in computer hardware and semi-conductors, instead of in software and systems integration. In response to these criticisms, the third Framework Program has targeted research projects more directly and laid more emphasis on the commercial phase. This might mean that the innovation programmes could evolve into a direct industrial policy for high technology sectors.

Nevertheless, it is claimed that these programmes have successfully raised the level of trans-European R&D cooperation between firms. Yet the eventual benefits in terms of increased competitiveness are still debatable. Two questions are pertinent here, i.e. to what extent have these initiatives led to further cartelization of the European IT industry at the expense of the European consumer? and, to what extent have the benefits of these R&D programmes been captured largely by foreign firms, either directly or indirectly, through strategic alliances?[45]

It has been noted that cooperative projects should be subject to two limits in order to prevent unfavorable changes in market structure and bureaucratization.[46] First, they must be limited in time. Once the aims of the project have been reached (such as developing trans-European information networks and cooperation between firms in R&D), the project should be terminated. On the whole, direct cooperation between firms should be as limited as possible. More stress should be put on building up networks via neutral bodies such as technological institutes. Second, the projects must be limited in scope. They should only consist of a small fraction of total firm R&D. Major innovative efforts should be channeled through in-house R&D.

2.4.3. Regional policy

EC regional policy was originally set up to assist regions which were overly dependent on a declining industrial sector. Regional policy can therefore be deemed as a component of EC industrial policy.

For historical reasons, traditional industries were often situated in geographical proximity to each other. This is especially true for the steel and coal industries due to their heavy dependence on natural resources. This has led to over-dependence of several regions within the Community on such industries.

Since the mid-1970s regional policy of the EC began to play a more important role

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[45] For further discussion see Soete, 1992.

[46] Freeman and Soete, 1991, p. 22.

as means to improve economic cohesion within the Community. The discussion in the 1970s on speeding up the process of economic integration, together with the first enlargement of the Community, highlighted the subject of convergence. In 1975 the European'Regional Development Fund was created and the European Social Fund was reformed and extended. Also the Guidance section of the European Agricultural Guidance and Guarantee Fund was established in the 1970s.

The increased attention to regional issues was due to factors other than the addition of new countries with lower GDP per capita and the increasing need for economic convergence. For example, the shift in competition and industrial policy at the EC level meant that the EC also had to provide regional assistance - previously given by national governments. The resources allocated to the structural funds have increased substantially, doubling between 1987 and 1993. They now account for 25% of the EC budget in 1993.

The importance of regional issues is also shown by the inclusion of cohesion as an EC objective in Article 130a, adopted by the Commission in 1988. Cohesion was also a prominent factor towards the end of the 1980s in the steps taken to move towards completing the EMU. The official objective stated in the Delors Report of 1989, is: ".... regional policies should not be to subsidize incomes and simply offset inequalities in standards of living, but to help to equalize production conditions through investment programmes in areas such as physical infrastructure, communications, education and transportation."

The role played by FDI in the national regional policies of EC member states matters in this context. Foreign investment has become an important part of the regional policy of some EC member states because it transfers resources and know-how and catalyzes the reorganization of local production through increased backward and forward linkages. Since their entrance into the EC, the Iberian countries have experienced a surge of FDI which contributed to increase their GDP growth rates in the late 1980s. FDI was found to be highest in financial services, scale intensive, and technologically-advanced industries[47].

Member states have been split in their opinion about how FDI should be treated. According to the Bangemann Report, the EC position is currently favorable to FDI as a tool for advancing local industry. It is therefore likely that the Community will continue using instruments, such as rules of origin, aimed among other things to encourage foreign investment into the Community.

2.4.4. Foreign trade policy

EC competition policy has traditionally been applied to foreign firms and to the activities of EC firms in foreign markets. Articles 85 and 86 do not permit any anti-competitive actions to be taken against a foreign firm without proof. Before an action, such as anti-dumping duties, can be pursued, it must be proven that a material injury has been caused to firms within the EC.

Both the Commission and European Court decisions, such as the decision on the 1976

[47] See Pelkmans, in Ludlow (1991, p. 83).

Sugar Cartel[48], prohibit agreements to control export prices. The rationale behind this stance is not necessarily to support fair trade with non-EC countries, but to prevent agreements related to export markets from inevitably spilling over into the EC.

Traditionally, the member states have encouraged export cartels on grounds that they would spread the high risks imposed by export activities, pool knowledge and skills, and allow SME to export. Export cartels have also been used as a means to negotiate VER to protect local industry. The Commission has tried to restrain this practice by issuing Directives warning that voluntary export agreements among private firms would breach Articles 85 and 86. However, the Commission has been aware of the political implications of this issue and has therefore tended to be rather lenient towards VER. Consequently, the effect of the competition rules on international trade does not seem to be as clear cut as originally expected.

The push for the completion of the single market was partly motivated by its predicted favorable impact on international competitiveness. However, international competitiveness cannot be achieved without exposing local industry to foreign competition. Accordingly, trade policy and competition policy need to complement each other.

It has been advised that EC trade policy be continually subjected to two tests: first, how it affects the nature and extent of competition in the single market; and second, how important is international competition for EC competitiveness in each relevant sector. The Community should subject its anti-dumping policy and VER policy to these tests as well.[49]

Industrial, competition and trade policies meet when national or EC industrial and foreign trade policies undermine free competition on a global level. Foreign trade barriers such as VER are a known problem, but several EC industrial policies have attracted increasing opposition from EC trading partners. EC-sponsored and subsidized programmes are under renewed atack from the US

In the light of these trade problems, competition policy has an important role not only in regard to intra-EC trade but also in regard to foreign trade. There are major distortions to international trade posed by differences in public funding and industrial policy which have not been sufficiently addressed. For example, the EC-sponsored cooperative R&D programmes have, to a large extent, excluded foreign owned firms, some of which are long established in the Community. These exclusions tend to increase differential of access to technology and investment.

The above raises the subject of international competition and fair trade rules. A

[48] See Goyder (1988, p. 394).

[49] Jacques Pelkmans states that a liberal trade policy is the most effective form of competition policy. To back his statement, Pelkmans quotes an empirical study made by Jacquemin and Sapir which concludes that, on average, imports from non-EC countries have a greater competitive impact than intra-Community imports. See Pelkmans, in Ludlow (1991).

regional trade agreement with a protective foreign trade policy runs the risk of retaliation by other regions and countries by means of complementary subsidization, tariff or non-tariff barriers, or, in the extreme case, overt trade war.[50]

It has been stated that the greatest danger facing EC's external dimension is that external competitive pressures on EC industry and services might be curtailed.[51] It is in sectors where national protection has remained substantial that adjustments have been slow and the contribution to European growth has been negative (the car industry, for example). Although the EC has removed many quotas for the import of industrial goods, VER still apply to textiles, cars, consumer electronics and footwear.

The existing merger control legislation in the EC does not suffice. The greatest drawback of this regulation is the criterion for merger size. In many cases a firm operates in a number of product markets through several mergers and agreements. Thus, although each agreement does not exceed the EC size threshold, a firm may significantly increase its power in one product market through multiple agreements.

3. Main Areas of Convergence and Friction within the EC and with its Main Partners in Regard to Competition Policy and its Interaction with other EC Policies

3.1. The Effect of the EC Competition Policy on the EC's Major Trading Partners

The formation of the Single European Market affects world trade relations. The potential of European firms to increase their competitiveness through economies of scale due to the enlarged market are likely to intensify international competition. The main concern of the EC's trading partners is that the EC will turn into a Fortress Europe, a fear partially endorsed by laws on foreign competition. These include the recent reassessment of anti-dumping rules, the rules of origin formulated for 14 products, and the importance being attached to reciprocity regarding FDI and tariff barriers.

Historically, Japanese and American firms have responded to the surges in the unification process by matching surges of inward investment in the Community. Both Japanese and American firms have substantially increased their direct investment manufacturing presence in Europe in the 1980s. These firms will probably be among the first to benefit from the EC single market as they have a headstart in establishing cross-border activities. The US has invested in the EC more than Japan, both in absolute and relative terms, and it has invested in sectors which are expected to have high growth rates, such as pharmaceuticals.

The recognition of the role that FDI can play in regional policy is possibly one of the

[50] For a wider discussion of the trade risks of strategic industrial policies, see in Soete, in Stanford (1992).

[51] Pelkmans, in Ludlow (1991, p. 52).

reasons why the Commission is taking a more lenient view towards Japanese firms who want to invest in the EC, compared to foreign firms who just wish to export to the EC. Yet this policy may backfire, given the importance of supply links in Japanese manufacturing. Japanese firms complain that the EC does not have the infrastructure and input supply that they require. As a result, Japanese-owned firms in the EC tend to rely on Japanese suppliers, rather than stimulate the development of local supplier networks.

It is not clear yet how unification will affect the trade links with the US and Japan. The 1987 free trade agreement between Canada and the US was instigated by Canada because of fears of increasing US trade protectionism, but was later interpreted, in part, as a counter movement to a Fortress Europe. This interpretation has intensified since the agreement to extend the Canada - US free trade agreement to Mexico within NAFTA. The fear is that world trade will be increasingly limited to trade blocks, whereas external trade will be highly politicized and made up of reciprocal agreements.

3.2. Frictions within the EC

The main friction within the EC over competition policy concerns the disagreement over the role that protection should play in EC's external trade. The UK leads the call for reduced protectionism, whereas France and Italy favor some protective measures. This friction will not be easily solved, particularly because Japanese FDI constitutes a major part of the UK's national regional policy. The governments of France and Italy, on the other hand, are under intense political pressure from their respective industries to grant protection against foreign competition.

Friction also results from economic differences among the member states. They differ markedly in per-capita income, employment rates, labour productivity, market share, and the size of deficit. Labour productivity in the UK machine-tool subsector is lower than Germany's. Homogenizing the wage level between the two countries would make British industry uncompetitive.

These differences in economic conditions between the member states have a bearing upon their respective positions on a common industrial and competition policy.

Major disputes are still pending on the role of national governments in industrial policy and on the nitty-gritty of the policy itself. The industrial policy approach of the EC countries can be broken down into two major forms. One is the decentralized approach, which consists of maintaining an infrastructure for SME, whilst providing indirect aid to industry through tax incentives, anti-trust laws and a highly advanced capital market, such as in Germany. The other is the centralized approach, which entails direct assistance to key sectors and a strong national presence in industry, such as in France.

National centralist and interventionist policies are increasingly viewed as obstacles to further EC integration. During 1981-2 France's industrial policy was criticized in the EC because of its protectionist and discriminatory effects. These measures were designed to favor the machine-tools, textiles, furniture, leather goods and toys and games subsectors because of their importance in employment and in the balance of trade. The machine-tool subsector in France, as well as in other EC countries, has fallen behind international best practice and needs to strengthen product development - particularly in the area of NCMTs. Another source of tension in the Community is support by some member states for the development of sectors which are depressed in the Community as a whole, such as the steel industry in Spain. Incentive schemes at the national level are viewed as essentially discriminatory.

In some cases, national governments are reluctant to give up national champions, often because of the political pressure exerted on them by the respective industries. An example is the car industry in France and Italy. These two countries still have substantial import quotas on cars and it is unlikely that the abolition of quotas in 1999 will pass without resistance. The subject of industrial protectionism has also been a major source of disagreement between the member states because, despite the convergence in policy during the 1980s, it still differs markedly across countries.

Another problem is an apparent mismatch between EC's long-term policies and the development of the weaker Community economies such as Greece. Greece pledge to fully link its industrial policy with EC rules means a weakening of policies at the national level. Greece is denied important aid to its industry, such as infant industry protection. In addition, the main burden of regional development and small firm enhancement, which are of prime importance in Greece, fall on Greek authorities.[52] To make things worse, there is also concern that the opening up of the EC to free capital movements will attract investment away from peripheral and weak economies, such as Greece, while the aid schemes of the EC to regional areas and problem industries will not compensate for this.

4. Inferences from the Experience of the EC on the Role of Competition Policy in Trade Agreements

4.1. The Effect of Free Trade Agreements on the Role of National Governments

One obvious outcome of a regional trade zone is the change in the role of national governments. The formation of an economic union imposes restraints on the discretion of policy-makers at the regional/national level by moving policy decision-making to the supra-national level.[53] The goal of a true single market with free movement of capital, labor, services and goods requires the synchronization of all economic policies that affect the market. This is shown by the new EC joint policy, which encompasses industrial, environment, research and technological development, social, monetary, fiscal and competition policy. In addition, it brings cooperation in foreign policy into the picture and provides it with more effective support than before. Furthermore, the powers of the European Council have been increased. The Council can now make decisions with a qualified majority vote on issues concerning the internal market. Moreover, the agreement for the creation of the Economic Monetary Union in three stages, with the first two stages already enacted, increases the probability that the monetary union will be achieved provided that the current

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[52] Wilkinson, in Jacquemin (1984, p. 57).

[53] Pelkmans, in Ludlow (1991, p. 85).

monetary disturbances are overcome.

The 1980s have been characterized by the disengagement of major European governments from active interventionist industrial policies. "Whether it is telecommunications, electronics or biotechnology, the state is no longer seen as the prime mover, but rather as the regulator and facilitator, helping to create the right environment".[54] France and the UK, especially, have seen a change in policy over the last 20 years from nationally-based systems of direct protection towards more complex positions which include some of the older policies, but where the locus of activity shifts towards the Community. The new approach lies not in direct intervention, but in equipping industry with the capabilities that it needs. The governments' change of attitude and the prospect of unification are intimately linked with each other: the change is coming to Europe at a time when the member states are more ready for it than ever before.

As the Commission increasingly determines how and to what end the member states spend their tax-payers money, EC countries' actions are increasingly falling under the scrutiny of the European Commission. This puts pressure on governments to foster deregulation and privatization programmes and to promote the role of the private-sector within the economy. Because the completion of the EMU requires economic convergence, the requirement for countries joining the Community are strict: manageable deficits, low inflation rates, low interest rates and a small range of currency rates fluctuation. The current disarray in this last respect raises serious questions as to the magnitude of the setback currently facing the cause of the European Union.

The move towards unification, according to the SEA guidelines, could vitally change the role of the national governments. The main change would be a reduction in the number of independent economic instruments which national governments may use. Once the main macroeconomic tools are transferred to the hands of the Community (interest and public borrowing rates, tax laws, the monetary system, regional policy, social policy, environment policy etc.), national industrial policies will be restricted to micro-economic policy.

There are three major reasons why, as a result, competition policy acquires greater importance within the framework of a free trade zone.

First, as the tools left in the hands of the national governments may be expected to become fewer and weaker, national governments may resort to indirect tools, such as public purchasing and government sector demand management, in order to influence the market. This is an added reason why a strong competition policy framework becomes important at the regional level.

Second, the shift in the locus of policy decision making towards the supra national level makes each policy decision more sensitive, since its consequences affect more people. Each mistake is magnified and imposes more severe penalties.

Third, once policy decision making is transferred to the supra-national level, questions

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[54] Sharp and Holmes (1989, p. 219).

relating to foreign trade also become more sensitive, both for the trading zone and for its major partners. The trend towards the formation of regional trading zones is bound to affect the flow of world trade from multi-country trade towards trade between the trading blocs. This change in the structure of world trade flows can be expected to increase the likelyhood of disagreements over trade issues, as well as to heighten their political importance. The ensuing risks are numerous. This is why it is important to keep a strong system of competition rules within the framework of regional trade. It is better to encourage fair trade by means of a transparent set of competition rules than through political bargaining.

4.2. The Prerequisites for a Successful Trade Agreement

A basic prerequisite for the formation of a trade area is **a minimal threshold level of macroeconomic stability and a trend towards convergence.** This is needed both, to ensure a stable climate for trade and for industrial development and to reduce the need of national governments to resort to non-tariff restraints to trade. Stable exchange rates are one of the key variables for a regional free trade zone. Macroeconomic stability is also needed in order to develop capital markets and encourage long-term investment. The aim of a trade agreement is to enhance the growth potential of the economies by means of efficiency gains. This is why the factors affecting growth and industrial restructuring cannot be separated from the trade agenda.

A common competition policy is also of importance to trade agreements for a number of reasons.

First, there is an inherent danger that market control at the national level becomes market control at the regional level. This is particularly so when the trade agreement takes place between countries prone to support national champions.

Second, as world trade moves from multi-national trade into trade between trading blocs, problems of unfair trade practices will tend to be solved on the political level. One way to avoid this is to apply strong competition rules to foreign trade.

A competition policy within a trade zone should be articulated with regional industrial policy in order to prevent these policy tools from inhibiting competition within the trading zone and with foreign countries.

The causal connection between the widening of the market and the reduction of market failures is key in this context. The enlargement of the market can facilitate the growth of industry and specialization. But it could also damage previously shielded industries which could find that they are unable to compete in a common trade area. This is why competition policy is so essential in order to prevent excessive concentration and/or market power, which might be encouraged by the opening-up of national markets.

Finally, free trade agreement requires **a high degree of political commitment** on the part of national governments to give up control on a number of national policy tools and surrender a growing share of their economic autonomy. The EC experience shows that harmonization of competition and industrial restructuring policies require an awareness of the benefits of such convergence, a process which has taken a long time to materialize and came only after the painful experience of several recessions.

As a result, the importance of complementary measures to trade, such as investment related issues, local content requirements, export regulations, technology transfer and standard regulations is enhanced. These need to be harmonized. Since investment is such an important issue in developing countries, and particularly foreign investment. A common policy in the foreign investment field and regarding procedures to handle and solve disputes is necessary in order to prevent distortions and cumulative disagreements which might eventually lead to frustrate integration efforts.

To conclude, three main lessons from the EC experience can be highlighted. First, in order to be effective, a free trade agreement must be complemented by the eradication of reciprocal non-tariff barriers. This, in turn, means that cooperation in industrial, regional and competition policies is needed in order to ensure the harmonization of market conditions in the free trade area.

Second, such a kind of economic cooperation entails considerable loss of macroeconomic decision-making freedom by the member states. This demands a high level of political cooperation.

Third, economic unification within the EC in areas such as competition and industrial policy has taken a long time to mature, and is yet far from complete. Part of the delay can be blamed on the cultural differences between the member states and the inherent rivalry still present within the Community.

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