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E R R A T A

Insert P. 11 after Par. 4.

As far as Greece is concerned, the Association agreement, which came into effect on the 1 November 1972, was in practice a kind of "mini-Rome Treaty". By the 1 November 1974, Greece had zero duties on 3/4 of imports from the EEC and had adopted the Common External Tariff. For sensitive goods, zero tariffs should be in force by 1984. The Preference agreement with Spain, which came into effect on the 1 October 1970, had a similar effect. By the 1 January 1977, Spain had reduced its tariffs by 60%, plus a further 25% for a number of specified products. Portugal is also reducing her tariffs. The reductions are to take place in three stages beginning in 1977, 1980 and 1985 respectively.

1. While there is widespread agreement on the political need for a positive response to the request for full membership of the EEC formulated by three Southern European countries (namely Greece, Spain and Portugal), opinions are widely divergent as to the timing and details of the next enlargement.

What is at stake is the future of the EEC itself. There exist schools of opinion, particularly in the Federal Republic of Germany, which fear that enlargement would lead to a scaling down of Europe's ambitions. Faced with the impossible task of pulling together countries that are too far apart, the Community would fall back on the defence of the "aquis communautaire", thereby implicitly giving up the goal of political union, and becoming a mere customs union. Other opinions have it that, in the last analysis, enlargement would not make such a great deal of difference to the present situation; in this view, the three candidate countries are more competitive than is normally believed. In any event, the market will take care of structural differences (e.g. through continuous adjustment in exchange rates). It is implied that no "deepening" of the Community is necessary or indeed desirable even if there is no enlargement.

Finally, there are some politicians who seem to think that enlargement will worsen a number of pre-existing problems (Mediterranean agriculture, regional imbalances), forcing the Community to give great attention to these and thus speed up their solution. On economic grounds, this rather Machiavellian approach may appear scarcely credible. Nonetheless, it is a view which is quite widespread even if concealed behind the idea of "a shift in the Community's centre of gravity to the South", increasing the influence of present Mediterranean members.

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This paper does not purport to give a final answer to the questions posed in this debate, but tries to shed some light on some aspects of the problem that we believe to be crucial. As it turns out, there is a lot of confusion in the way these arguments are generally approached; methodological and definitional aspects are of the foremost importance, and will be dealt with in detail.

2. If the Community we wish to develop is to effectively advance towards political union, it is clear that the mechanism of economic integration must work towards reducing differences between member countries.

Such a statement, evident as it may appear, hides in fact a great number of different points of view.

Some scholars maintain that the statement itself is invalid. It is not difficult to show that in all past experience of political unification, differences have in fact grown, at least for a period of time (which on occasions has run into decades). At the same time, it should be remembered that most, if not all, past experiences of political unification have been far from peaceful: it is to be expected that no sovreign state will willingly accept a deal that involves a deterioration in its relative position.

It is, however, important to admit that there exist circumstances when this could very well happen. In the case of the Southern European countries, it is difficult to estimate the value attached to the political advantages of entering the Community. It is not inconceivable that the first and foremost objective of these countries is to consolidate their present institutional equilibrium. From this point of view, EEC membership might be worth much more than one percentage point in annual GDP growth, and the difference between salaries in Hamburg and Tarrugana might be totally irrelevant.

True, this particular "objective function" could not last forever, and eventually the problem of regional differences would have to be tackled. But "eventually" might mean after quite a few years, and in the meantime political unification might progress substantially - as a result, perhaps, of direct elections of the European Parliament.

One is in any case obliged to ask what alternatives these countries have to entering the Community. It might well turn out that the EEC still offers the best deal available, even if "differences" are not be reduced.

In short, we must remember that these countries are in a weak bargaining position. This will become much stronger the day their representatives are allowed into the Community's institutions. The solution of a rapid "institutional"enlargement and a delayed "economic" enlargement would, in other words, involve a shift in the relative bargaining powers of the parties to the negotiations, unless, that is, the timing for "economic" enlargement is so determined as to avoid the Community having to face structural differences for a considerable time - e.g. a decade.

This appears to be the strategy followed by Herr Helmut Schmidt: in ten years the Community will have time to "deepen" and progress towards political union. The Community that would have to face the economic problems of enlargement would not be the same Community that we know today.

We may thus discuss the consequences of enlargement on structural differences, come to the conclusion that the latter will not be reduced by "market forces", ask ourselves: "how should common structural policies be changed?" and still come to the conclusion that they should not be changed at all, because "deepening" (direct elections, monetary union......) is the priority, and the enlargement agreement must be designed in such a way as to allow postponement of a modification in structural policies.

3. In what follows, we assume that, contrary to our hypothesis in the preceding section, the reduction in structural differences is, in practice, politically essential.

The second open question is: "how should these differences be measured?" What we have in mind, of course, is not merely a statistical problem, but one of substance.

In political terms (i.e. to guarantee consensus) one would assume that the relevant variable is real income. In general, people in one country (or region, city, neighbourhood, family) do not like to see that their neighbours become steadily richer than they are. Nonetheless, if one is to conclude that inter-country income differences must thus necessarily be eliminated, the argument must be stated much more fully. The problem is a difficult one: to give one example, are we going to consider different income distributions?

Let me stress that this is far more than a mere academic point. Redistribution of income in the applicant countries may be much more important in determining political consensus than fast relative growth in average incomes. At the same time, it would, no doubt, be possible for the applicant countries to reach a faster growth in GDP than the present member countries have if they were ready to adopt an incomes policy that would further concentrate the distribution of income.

Given that income raises so many problems and that it is seen as a function of the "degree of development", itself considered as a function of the share of industry on GDP, structural differences tend to be measured in terms of industrial development.

It is very easy to challenge this approach. Although it may be taken for granted that industry generates higher income than agriculture, the same is not true for services. It should also be pointed out that not all industrial sectors are equivalent. Would it be justified to argue that structural differences will only be dealt with when all countries have reached a closer level of industrial development, and similar industrial sector? Quite a few studies on the Mezzogiorno argue exactly in this way: industry exists, they say, but it is the wrong kind of industry. The Thompson Report on EEC regional policy suffers from the same defect: the proportion of the work force employed in agriculture is considered an indicator of backwardness, as is the proportion employed in declining industries.

Is this the right approach? Can we take it for granted that industry will be as "strong" in the coming years as it has been up to now (where "strength" is a function of changes in the terms of trade for industrial products)? Should not integration involve a division of labour, a greater degree of specialization than in the past? Why should we rule out a specialization in the services sector. Why should we consider tourism an "inferior" sector relative to industries that need cheap labour to be competitive (or an environment no authority is keen to protect)?

Again, let me stress that this is not an academic point. Industrialization is not the same thing as income growth: in the European context, there are important instances in which it becomes necessary to choose between the two. Consider just one simple example: a relative devaluation reduces the real income of the citizens of the country involved (because their terms of trade deteriorate); at the same time, however, it helps its industrial sector. Sure enough, one could devalue the peseta to such an extent that Spanish industry would become very competitive, investment from abroad would increase dramatically, and all differences in industrial development would be wiped out in a few years. Is this what we want?

If not, if the goal is reduction in real income differences, then is not the return to fixed and stable exchange rates a most important goal? If we measure structural differences in terms of real income, we might come to the conclusion that monetary unification is the best structural policy of all.

4. Nevertheless, it is a fact that "public opinion" and most political leaders still equate industry with economic respectability. Let us then accept the measurement of structural differences in terms of the share of GDP generated by industry, and ask ourselves what will be the impact of accession to the EEC on the industrial sector in the candidate countries.

How shall we approach this question? We know that there is a body of literature on customs unions, and this has been used in the past, for instance in connection with the first enlargement. Results, however, have been poor.

This comes as no surprise. The theory is based on assumptions that are far removed from reality. The industrial sector in Europe cannot be described as being perfectly competitive: there are strong barriers to entry in every important sector. Even if tariffs were completely abolished, we would still have non-tariff barriers to trade, and past and present history proves that these are substantial. For most manufactured goods, elasticities both of supply and demand seem to be generally low.

The traditional analysis is based on comparative statics. Even if we accept the assumptions on which it is based, all it can tell us is that eventually and "coeteris paribus" some kind of transformation will take place. How long a period will be necessary, we do not know. The longer the time needed to go from one state of equilibrium to the other, the less the political relevance of the argument. What is more, the longer this period lasts, the less acceptable is the "coeteris paribus" assumption.

In the past "environmental conditions" (the "coetera") have changed very fast, but the direction of change was such that structural transformations were made easier. Rapid EEC growth resulted in a significant redistribution of industrial activity by differential rates of growth of each sector in the various countries. In the few instances in which an absolute reduction in the size of one sector in one country was necessary, this was made much easier by the fact that other sectors were expanding rapidly. The traditional analysis thus seemed to be useful. "Environmental conditions" were changing but this change favoured the outcome predicted by the theory. Today, this is no longer the case: before we can discuss possible developments in the industrial sector in the candidate countries following accession in the EEC, we should state our assumptions with regard to these key environmental variables.

5. The first question that we need to answer concerns the period of time we should consider. If we choose a remote horizon, the probability that structural transformations will take place increases considerably. At the same time, however, our ability to make significant assumptions relative to the environmental variables is drastically reduced; if we opt for a relatively close horizon, we may be more confident in formulating hypotheses on the environment, little room is left, however, for structural transformations.

Let us assume for a moment that enlargement negotiations be concluded by the end of 1978, and that the agreement involves the immediate abolition of all tariffs between candidate countries and present members. Needless to say, this is an unrealistic assumption. Still, investment decisions would only be affected in 1979 at the earliest, and the effects on the distribution of productive capacity would not be felt in a significant way before 1983, i.e. five years from today. A ten year horizon is thus the minimun we may opt for if we want to avoid the obvious and stupid conclusion that nothing will change at all because time is too short.

If we make a more realistic assumption relative to the timing of negotiations and tariff elimination, we would conclude that even 1988 is not a distant enough horizon. The German position is that the agreement should involve a ten year "moratorium", in which only small changes would be made. This would mean that the candidate countries would not become full members before 1989. The effects would then be felt only in the 1990's. True, business may discount future developments once a precise timetable has been agreed upon. Nonetheless, it is difficult to tell how one could predict business reations in this respect.

On the other hand, no reasonable assumption can be made on environmental conditions in such a distant future. Even a 1988 horizon makes a great deal of pure subjective speculation unavoidable.

6. The first environmental variable that we need to project is the state of economic growth in the EEC. My opinion is that it is impossible to take average GDP growth rates for past years and assume that this will continue in the coming decade. We know that European countries will not be able to equal the average rates of growth that they experienced before 1973. Hopefully, they will be able to do somewhat better than they have done since then.

The truth, however, is that we can only give very limited indications here. In practice, we have no convincing interpretation for the 1973-1976 recession. Some observers think that this recession was just another business cycle, and it will be followed by a new period of good growth and low inflation, although, for some mysterious reason, not as good growth and low inflation as in the past. Others believe that something fundamental has changed in the functioning of the Western economic system. But what has changed? Opinions differ widely.

The price of oil, of course, is a key element. Most forecasts agree that a new shortage of oil will develop by the early 1980's. These assume rates of growth of around 4 or 4.5 percent in real terms. If they are correct, we would have to conclude that such rates of growth are not sustainable beyond 1985: a shortage of oil would develop leading to a further sharp increase in oil prices, and thus to a new period of stagnation.

Alternatively, we may assume that rates of growth in the EEC range from 3 to 3.5 percent. In this case, there will be no shortage of oil before 1985. The overall outlook would not, however, be a bright one.

As 2 percent is generally considered the rate of growth generated by "autonomous" productivity increases, a 3 percent GDP rate of growth implies:

a) persistently high or increasing unemployment (depending on the shape of the age distribution of population); and
b) that investment to create additional productive capacity is going to be very limited.

If the present very high rates of unemployment are to continue well into the 1980's, it is difficult to accept that European countries will allow their national industry to loose significant ground to foreign competition. After accession, the candidate countries could not exploit the competitive advantages that they might have, for present members would react by introducing non-tariff barriers or by applying safeguard clauses. Redistribution of industrial production would thus be limited to additions to productive capacity; existing capacity will not be touched.

Additions to productive capacity will, however, necessarily be small. A slow rate of growth thus implies that candidate countries will be allowed to exploit their advantages only to a very limited extent.

At the same time, if capacity utilization remains low (which does not need to happen, in the long run, if industry continues to reduce investment at the same rate as at present), European industry will make every effort to increase sales in the candidate countries during the phase of tariff reduction.

7. The second most important environmental variable to be considered is the exchange rate. In Table I we show the changes in the exchange rate between the DM and the currencies of the candidate countries in recent years. These have been very large indeed.

The monetarist's dream tells us that changes in freely fluctuating exchange rates will reflect differentials in rates of inflation: overall their influence would be neutral. Most unfortunately, empirical data do not support this conclusion. This is no surprise, because ours is not a perfectly competitive world, and the rates are not freely fluctuating - and for very good reasons.

Changes in exchange rates make a difference. What is more, there is no way in which we can possibly predict the direction and the intensity of change to 1988.

8. This is even more disturbing when we consider that tariff barriers between candidate countries and the EEC have already been substantially reduced.

This does not necessarily mean that further tariff abatement will have no effect whatever. Its effects will, however, be minor if compared with a one percent change in the rate of growth of GDP in the EEC, or continuing divergences in exchange rates. One might very well try to estimate the effect of complete tariff elimination "coeteris paribus". This, however, is to concentrate attention on one relatively minor aspect of the overall enlargement problem, while neglecting those variables which, in practice, will in fact determine the shape of things to come.

9. We are thus obliged to conclude that it is extremely difficult to discuss the effects of a second enlargement on European structural policies, for the simple reason that enlargement in itself is relatively unimportant in the determination of structural distances.

What is possible is to discuss the possible shape of structural policies for an enlarged Community, without considering the effects of enlargement itself. After all, even if the total abolition of tariffs has no effect at all, an enlarged Community would still have to suffer from deep structural differences. It makes sense to ask how these might be reduced.

This implies accepting that enlargement would in itself make no impact on structural distances and/or policies. The discussion would then shift from "the impact of enlargement on common structural policies" to "structural policies for an enlarged Community". In this second case, we do not need to discuss the effects of tariff abolition, nor do we need to predict environmental variables, or to determine a time horizon; all we need is a description of existing structural differences, and the proposition of some mechanism capable of reducing these. This appears to me a much more sensible approach.

The only difficulty is that for the moment the Community has no real structural policy at all - i.e. no policy designed to automatically offset and reduce structural differences. The closest proxy to a structural policy is the present regional policy; nonetheless

a) the Community has no regional policy of its own - it only gives some backing to some actions taken in the context of national regional policies;

b) the money is divided according to a fixed key.

Therefore, if we accept the present design of regional policy, the only point open for discussion is: what should be the distributive key for an enlarged Community? I suspect that the answer to such a question has very little to do with economics, otherwise, we could discuss alternative regional policy schemes, or other forms of structural policy. This would open a Pandora's Box limited only by our possible lack of imagination. I am not interested in pursuing this possibility.

10. The objective limits to relevant research ought to be recognised. In the case of enlargement, industry is not just an obvious parallel to agriculture. In the case of agriculture, we have a fully fledged common policy - the CAP - and conditions of production and trade can be discussed more easily because the number of products is more limited and one may assume that conditions of perfect competition prevail. A parallel discussion for industry is inconceivable.

Research relative to the industrial sector in the candidate countries should be less speculative and more descriptive, fact-finding. To study individual sectors in order to find out what is the existing industrial structure in these countries is useful. The temptation to speculate on possible consequences of enlargement should be resisted.

Anyone who seeks to conceive a new structural policy for an enlarged Community will find this background material useful. I think, however, that we can rule out the possibility that a single paper might seriously start from an analysis of existing conditions, discuss future developments, and derive from it a logically necessary structural policy.

11. Among various fact-finding pieces of research one may think of, I still think it would be useful to enquire on prospects

for foreign investment in Spain.

I am in no position to show that this is a particularly interesting or relevant topic. It might be of crucial importance if we came to the conclusion that there is going to be a wave of investment in Spain. If on the other hand, we find out that multinational corporations really do not care too much about Spain, then the whole exercise would turn out to be less than exciting.

My a priori hypothesis is that multinational corporations will show less interest in Spain today than they did in the past. Consider the following:

a) the abolition of tariffs on trade with the EEC reduces the attractiveness of Spain;
b) industrial relations will be less amenable than in the past;
c) the political climate is more uncertain;
d) Spain has an abundant supply of labour, but this is not a very interesting aspect in a time when unemployment is at record level everywhere in Europe;
e) reduced income growth will reduce investment in Europe generally; investment abroad will be affected.

I can hardly think of any reason why enlargement should encourage direct investment; or, indeed, why the outlook for direct investment should be bright, independently of enlargement.

Conducting interviews with managers of multinational corporations in Spain might nevertheless be interesting to reach an in-depth understanding of their point of view about the current conditions of the Spanish economy and its prospects for integration with Europe.

But we should be aware that we will not be able to derive

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any useful hints for a definition or re-definition of EEC structural policies.

12. From the considerations above more substantive conclusions may be drawn.

The process of European integration needs a new start and a fresh impetus. This has been true for quite a few years now: the prospect of a new enlargement makes it even more true.

A new impetus might come in three respects:

a) direct elections to the European Parliament;
b) the enlargement of the EEC budget and the creation of some disguised automatic method to compensate disequilibria in the balance of payments of each member country, along the lines drawn in the McDougall report;
c) monetary unification, in the form suggested by Roy Jenkins' recent speech in Florence.

The development of new or existing structural policies will be used as a political justification to cover the transfers under b), that is to have the taxpayer in one country pay for public expenditure in another country. If transfers are politically unacceptable and the Community sticks to the principle of "juste retour", then we will never have effective common structural policies. If transfer is politically acceptable, then progress is possible.

How much progress is made depends on the size of the acceptable transfer. The McDougall report states that the allocation to the Community budget of 5% of GDP would be sufficient to make monetary unification viable among the Nine. It would also allow a faster rate of growth overall and more stability in exchange rates: two extremely positive developments in view of a reduction of structural imbalances.

The exact channels through which income would be redistributed among members are not very important: what is important is that the distribution be "virtuous", that is those countries which have lower per capita real income get more money. If this goal is reached through a common policy that is not related to structural differences, individual governments will equally be in a position to spend more money on structural policies. After all, there is no a priori reason why structural policies should be enacted at the Community level.

Thus the impact of enlargement will be felt at this level: to reach the same goals for a Community of Twelve, we would be obliged to allocate a larger share of GDP to the Community budget. This might turn out to be politically unfeasible.

13. What matters in political terms is not the shape of whatever structural policy is finally decided, but its cost in terms of Community budget. Even if we were in a position to go through the whole logical process - from analysis of existing structural differences to formulation of the optimum structural policy- the political relevance of this effort would be attached to only one small figure: the final cost.

The experience of all countries that have structurally different regions proves that structural policies are very costly and their benefits are very slow to appear.

The reality of the EEC is that readiness to accept policies that would involve substantial inter-country transfers has been small indeed. The goal of a Community budget of 5% of Community GDP, that the McDougall report deems necessary to progress towards mone-

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tary union, seems impossible to reach. And that is a minimum requirement for a Community of Nine.

This allows for a wide range of conclusions:

a) if one thinks that the Community will not make much progress anyway, then a second enlargement will have no negative consequences on European integration;

b) if, to the other extreme, one foresees a complete change in the European climate, and an increase of the Community budget to levels above 5%, then a second enlargement would make a difference, but would not necessarily frustrate progress in European integration;

c) if, finally, one thins or hopes that substantial but limited progress is possible, then enlargement is a danger, because the increase in Community budget that is politically feasible might be enought to pay for deepening in a Community of Nine, but insufficient for a Community of Twelve.

14. These different evaluations of the future of the Community are what is reflected in the differences we mentioned at the beginning. The position of the Federal Republic is linked to their willingness to progress in European integration; at the same time, since they would pay most of the bill, they are concerned that if there is a second enlargement the cost of Community deepening would become excessive.

The weaker members of the Community should share this concern: they should be aware that a second enlargement means that there would be less money left for them. The whole idea of "shifting the centre of gravity" makes sense only if one believes that nothing much will change in the Community. Substantial deepening is ruled out anyway, and in this case, the advantages of a different distribution

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rating power in the institutions might be superior to the disadvantages of a larger company.

Finally, those who think that both enlargement and deepening are possible, and I rate myself in this category, do so not because of excessive flirtation with Utopia; but because they trust in the fact that, once it is agreed that enlargement is a political necessity as well as progress in economic and political union, some way to pay for it will be found, even if no-one is today in a position to determine the cost.

T A B L E I

VARIATIONS IN THE DRACHMA, PESETA AND SCUDO EXCHANGE RATES WITH RESPECT TO THE DEUTSCHMARK

1 DEUTSCHMARK =

	1970	1971	1972	1973	1974	1975	1976	1977
Drachma	8.22	9.18	9.37	10.99	12.45	13.60	15.67	16.00
Peseta	19.08	20.16	19.82	21.03	23.29	22.79	28.71	36.40
Scudo	7.88	8.43	8.43	9.56	10.21	10.48	13.35	16.05

DEVALUATION INDICES WITH RESPECT TO THE DEUTSCHMARK

1974 = 100

Drachma	151.5	135.6	132.9	113.3	100	91.5	79.4	77.8
Peseta	122.1	115.5	117.5	110.7	100	102.2	80.6	64.0
Scudo	129.6	121.1	121.1	106.8	100	97.4	76.5	63.6

Calculated from:

International Financial Statistics,
October 1977

Pub.: IMF