The CEPR, International Trade, and the Single Market in Europe

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Preliminary and Incomplete

Comments Welcome

A Categorical Imperative

In the first two chapters of *The Wealth of Nations*, Adam Smith showed the importance of the specialization of labor. The next chapter is entitled "That the Division of Labour is Limited by the Extent of the Market" and economists have been free traders ever since. After all, what better way to enlarge the market and thereby enhance specialization than to remove artificial impediments to the flow of goods and services? There is literally no other policy issue on which economists have so much consensus as the desirability of free trade, as a recent *Economic Policy* paper shows.[1] As one well-known CEPR researcher, Paul Krugman, has put it 'If there were an Economist's Creed, it would surely contain the affirmations "I understand the Principle of Comparative Advantage" and "I advocate Free Trade."'[2] So almost all mainstream economists – read "those most likely to be in the CEPR" – probably approached the issue with a strong prejudice in favor of the single market in Europe, at least for goods and services (capital liberalization being another beast altogether).

1992 and all that

Before the Single European Act (hereafter "SEA") of 1986, there were certainly plenty of "artificial" barriers to trade (meaning policy-induced barriers, as opposed to "natural" technological such as distance) inside the so-called common market. Indeed, the lack of actual free trade inside the EEC was one of the key motivations behind the SEA. The stagnant pace of European integration –

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[1] For *CEPR 20th Anniversary Conference*, Nov 21-22 2013, London.

memorably referred to as “Eurosclerosis” – was perceived to result in high unemployment and slow growth in Europe, especially slow productivity growth. The SEA eliminated border stops within Europe by 1992, ended discrimination in government procurement and public works, required mutual recognition of product standards, tax harmonization, encouraged labour and capital mobility, and much, much more. The regulatory reform and enhanced competition – not to mention the “four freedoms” (of the movement of goods, services, labour and capital) – made the SEA much more than liberalization of trade in goods and services. One might have imagined great zeal for the “1992” reforms creating the single market, at least among economists.

Not exactly. Few economists would have considered the existing European barriers to be very costly or important. Indeed, one of the first CEPR Discussion Papers was entitled “Patterns of World Trade in Manufactures: Does Trade Policy Matter?” (Winters, 1987).[3] After all, even before the SEA came into effect in 1992, the EEC already consisted of a dozen relatively affluent and open economies in a customs union with a common external tariff widely known as the common market. How costly could the remaining artificial barriers be within Europe?

More generally, any initial enthusiasm for the single market and scorn for the “virtues” of protectionism would have been, for almost all economists, based more on theory and anecdotes than on solid empirical analysis. Harberger (1959, p. 135) estimated the welfare costs of a 50% tariff to be no more than 2.5% of GDP; ever since economists have been skeptical about finding quantitatively significant costs of trade distortions. The one thing we all learn about Harberger triangles is that they are usually small. That feeling would have been strengthened by the Cecchini Report, which estimated that the SEA would raise output by a small amount, between 4.5% and 6.5% of GDP.[4] It was also consistent with early work by researchers such as Smith and Venables (1988), who estimated that even with pro-competitive effects, welfare would only rise by 2.3% of base consumption as a result of an integrated single European market.[5] So the superficial early impression in the profession was that 1992 might be a good thing, but it would likely be a small good thing. Still, more analysis was clearly necessary.

The SEA *Ex Ante*

Enter the CEPR, self-described as “a network of over 100 Research Fellows, based primarily in European universities.”[6] CEPR’s work on the SEA consisted primarily of two tracks, both conducted in parallel and intended to provide *ex ante* analysis of the SEA’s impact. The first track involved successive issues of *Economic Policy*, in October 1989 and April 1990; both were devoted to 1992. The second was a research programme conducted by the CEPR 'The Impact of "1992" for International Trade'. As part of the latter, Alan Winters and Tony Venables organized (with a pair of Italian organizations) a conference 'The Impact of "1992" on European Trade and Industry' in Urbino in March, 1990; the resulting conference volume is Winters and Venables (1991). A second volume, Winters (1992), contains the proceedings of a conference 'Trade Flows and Trade Policy After "1992" ', which was held in Paris in January, 1992.[7] Between the four volumes, there are over a thousand published pages, with work by over sixty economists. There was also lots of other activity, e.g., Sarris (1990), Viñals (1990), Persson and Tabellini (1991). No one can doubt the level of CEPR's commitment to providing timely policy-relevant research on the implications of the European single market.[8]

How does this research look in hindsight? Pretty good. In probably the best-known and most provocative contribution, Baldwin (1989) focused on growth effects of 1992 and suggested, with all appropriate caveats, that the SEA might add between 0.2 and 0.9 percentage points to the long-term European growth rate.[9] Most of the papers were less ambitious, and more traditional. This being mainly a topic of international trade, the focus was usually either on the direct effect of the SEA on goods markets, or its general equilibrium effects on factor markets; there was also a substantial interest in the external economic effects of the SEA.[10] The individual papers deal with a variety of topics including: airline deregulation, capital income taxation, textiles, the physical location of financial activity, spillover effects on EFTA, the appropriate level of regulation, pharmaceuticals, footwear, … even high Spanish unemployment. One is struck by the range of topics considered by both conference and *Economic Policy* volumes, and their conservative nature.[11]

The issues considered by CEPR researchers when considering the SEA a generation ago seem close to what they would probably work on now in a comparable exercise. For instance, there was much concern expressed by CEPR researchers about wasteful trade diversion resulting from the SEA. Most of the quantification indicated that diversion would be small, for at least two reasons. First, pre-SEA barriers were already low. More importantly, as Walters (1992, p5) wrote "… the reduction of waiting times at internal borders will add little to the existing trade diversion induced by the Common Agricultural Policy", a sentiment with which most CEPR researchers would still agree. Perhaps more importantly, CEPR scholars also showed great enthusiasm in the early 1990s for increasing external competition from entities beyond the (then) dozen members of the EC. Much of this has in fact come about as the EC has expanded from twelve members into the 28-strong EU (including former EFTA members) and the establishment of the EEA. Indeed, CEPR's early focus on the transformation of Eastern Europe and the extension of single market has, in my opinion, played an important role in spurring policy-makers to continue looking East. Enlargement hasn't done all the heavy lifting though; some of the external competition has come about through the completion of the Uruguay round, and multilateral trade liberalization remains a policy issue on which the overwhelming majority of CEPR scholars agree.

With the exception of Baldwin's paper – itself, skeptically received at the time – the estimates are modest. For instance, Victor Norman estimated (p 449) that as a result of 1992, "the typical EFTA gain could easily amount to some 2-4% of initial consumer expenditure." Indeed, CEPR economists seemed cautious almost to the point of opacity. The introduction to the second volume edited by Winters (1992, p 26) ends with a section titled "Some Policy Conclusions" which begins

> " The CEPR study of '1992', the main results of which appear here and in Winters and Venables (1991), has generated a number of important policy conclusions. The prime one is, perhaps, that '1992' is likely to be economically beneficial within Europe – especially if, as seems likely, it is extended to EFTA countries – and not of great significance – either positive or negative elsewhere."

It seems fair to say that CEPR researchers (and lesser beings) were skeptical about any claim that the SEA would have any very dramatic effect; economists anticipated only a small positive boost to European welfare stemming from the 1992 program. Which leads to the question of how it actually worked out.

How did it Work Out?

Part of the motivation for the SEA was persistently high European unemployment and poor productivity growth; this was perceived at the time to be due in part to excessive regulation and fragmented input and output markets – Eurosclerosis.[12] By uniting the disparate European economies, the idea was that the SEA would improve the standard of living and lower unemployment. How did things actually work out? The quick answer has got to be "not so great."

A superficial look at unemployment rates certainly provides one with the motivation for the SEA-change. The top-left graph of Figure 1 is a simple time-series plot of European unemployment; the relentless increase through the mid-1980s is highly visible. Unfortunately, the steady state level of

European unemployment has remained essentially constant since both the SEA-passage in 1986 and its implementation in 1992. Analogous plots for the three other G-7 members are also presented in Figure 1; as with the European graph, 1992 does not seem to be anything special. There are the usual cyclical fluctuations, and steady state movements of the unemployment rate down for Canada and up for Japan. But any large effect on European unemployment is too subtle to be seen. The same is true of any growth effects; annual growth in real GDP per capita is analogously plotted in Figure 2. Even abstracting from cyclic fluctuations, there is little sign of any resurgence in European income growth.

Even if European unemployment and growth do not seem to have been dramatically affected by 1992, what effects did the SEA-change actually have on European *trade*? Figure 3 displays analogous plots of trade (measured relative to GDP); the first impression looks great. After a big increase in European openness, trade did indeed stagnate (relative to output) from about 1980 on. But shortly after 1992, trade started to rise consistently, almost doubling over the twenty years that followed. A rising tide on a successful SEA?[13] Unfortunately, not; the other G-7 members have also experienced big increases in openness during the same period. Since the major industrial countries share common trends in both technology and policy (e.g., the Uruguay round), it seems inappropriate to attribute all the increase in European openness to the SEA.

So the SEA doesn't seem to have had any dramatic effect on European unemployment, growth, or openness. This would have been no surprise to CEPR economists … and it would also have been little surprise to most European citizens. Eurobarometer gauges public opinion on a large number of relevant issues, including the single market. Some of their data is provided in Figures 4-7.[14] The data in Figure 4 indicate that a plurality of European citizens thought that the single market would be a good thing, though a third were neutral and a tenth thought it would be bad. This ambivalence is reflected in Figure 5, which shows that a majority of participants were hopeful about the effects of the SEA, but most of those held their view weakly. Most importantly though, Figure 7 shows that neither the passage nor the implementation of the SEA had any visible effect on the perceived benefits associated with being part of the European Community. The European public certainly doesn't think much of the internal market; only a quarter think that the internal market is related to trade within the EU, and more than third can't link it to anything at all.[15]

This analysis can be (justifiably) criticized on the grounds of its superficiality; a few plots do not a rigorous argument make. However, more careful *ex post* econometric analyses agree that the effects of the single market have been positive but small. For instance, a recent report by the British government and CEPR argues that "Between 1992 and 2006, the Single Market is estimated to have raised EU GDP by 2.2% (or €518 per person) and created 2.75 million additional jobs across Europe."[16] Alternatively, Eichengreen and Boltho (2008) estimate the total effect of *all* economic integration in Europe – including early programs such as the payments union, the coal and steel community, the community, the EMS and the Euro, above and beyond the SEA – are about 5% of income. These estimates are right in the ball park of the *ex ante* estimates provided by CEPR researchers.

A Curious Transformation

To recap: CEPR researchers were initially cautious in their claims regarding the aggregate size of the benefits from the SEA. This skeptical attitude towards exaggerated claims of the benefits from the Single Market turned out to be justified. So far, so good. But there's an ironic twist to the tale: somehow the Single Market has become an extraordinarily popular institution among economists, arguably the single most popular European economic institution. Huh?

First some evidence concerning the near-sacred status of the single market. This is not hard to find. Consider two quotations from the relevant and influential *Monitoring European Integration* series. In *MEI* 12, Berglöf et. al. (2003, p xv and 11) claim as motivation for their new European political economy (emphasis added):

> "Europe's fundamental problem is that economic integration has preceded the construction of the relevant political institutions. The economic house, *a remarkable achievement*, has shaky political foundations … Free and undistorted trade between EU member states is one of the overriding principles on which the EU is built."

In *MEI* 6, Dewatripoint et. al., (1995, pp. 1011) argue in favor of a new structure for the EU which would include, besides optional "open partnerships" for enhanced integration:

> "A *common base,* in which all members of the Union must participate, that encompasses a well-defined set of shared competences deemed essential to preserve the gains from free trade and mobility in a European Union open to new member … a natural starting point for the common base is the Single Market. The common base would then incorporate those elements of European integration necessary to preserve the four freedoms, namely a prohibition on barriers within the Union to mobility of goods, services, people, and capital. In addition, the common base would include transfer programmes to make the Single Market politically viable. So far these have been the CAP and the Structural Funds. But the opportunity to make the transfer programmes more efficient should be exploited now, given the challenge that enlargement represents for the CAP and the Structural Funds."

Admiration for the single market is not restricted to CEPR economists; it is wholly mainstream. Consider some quotations from the middle of the road *Economist*:

> "Europe's liberal project—to dismantle barriers to the free movement of people, goods, services and capital—needs work, as the shabby tale of Opel shows. *But it is a great project* that has so far survived the economic crisis" http://www.economist.com/node/14699583 (emphasis added)

> "*Enforcing the single market is perhaps the most important, and most visible, thing that the [European] union does*. The competition and single-market commissioners have the power to tell national governments that they may not subsidise or manage companies. They can break up monopolies, intervene to lower prices and, to judge from the squealing in capitals, manage to annoy more national politicians than any of their colleagues" http://www.economist.com/node/8134936/print?story_id=8134936 (emphasis added)

> "Economic integration has been at the heart of the European project from the outset. The single market dates to the 1986 Single European Act, comprising nearly 300 measures that were to be completed by the end of 1992, from the abolition of physical customs checks to the mutual recognition of standards. It gives the EU heft in international trade, and attracts investors seeking access to 500m consumers ... The single market is the one thing that David Cameron, the British prime minister, says he likes about the EU." http://www.economist.com/news/europe/21564851-euro-was-meant-underpin-single-market-it-may-end-up-undermining-it/print

And it goes almost without saying that Eurocrats love the single market:

> "The Internal Market is a cornerstone of the European Union. First introduced in 1993, its purpose was to break down barriers between individual Member States and, in doing so, to create "four freedoms" across the EU: the free movement of people; the free movement of capital; the free movement of goods; and the freedom to provide services. Through these freedoms, the EU has been able to further integration, to deliver economies of scale, and to improve the opportunities available to European citizens."[17]

The natural question is: why the enthusiasm for the Single Market, especially given its relatively small benefits? At least three answers come to mind.

1. Perhaps economists are really just free traders at heart. The costs from protectionism are low, since Harberger triangles have always been considered to be small. But trade policy is different from most issues of economic policy, since almost all economists are notoriously skeptical of alternatives to free trade. Economists tend to see trade policy as being mildly costly in welfare, ineffective compared with alternative targeted policies, largely redistributive, and likely to incur foreign retaliation. The desire to reduce trade barriers is natural to economists, almost innate.

2. Perhaps we as economists believe that there are other benefits to the single market (such as keeping and extending the European peace), but feel more secure having something economic to point to.
3. A small benefit is still a benefit, especially when the benefits from protectionism usually flow as transfers to rent-seekers.

Looking Forward

If one were to probe now, I feel sure that there is widespread agreement that the single market is not only a good thing, but one that could be made better still by removing barriers that still remain.[18] The exchange of services across national borders remains the most important issue for the internal market, as the EC itself admits.[19] Considerable work is going in the CEPR network concerning the liberalization of service markets, especially in online and financial markets; I expect it to continue.

More generally in the area of international trade policy, the CEPR is an important player in at least two respects. First, and most importantly it encourages in the *production* of basic research. However, the CEPR has always played, and continues to play a significant role in the *dissemination* of rigorous but policy-relevant research. Many of us remember the tedium of producing 3-page non-technical summaries for each of our CEPR discussion papers. The pain was sufficiently felt by CEPR researchers that the non-technical summaries were eventually dropped. Still, these summaries made a useful contribution in making CEPR research accessible, and are missed. Happily VOX has now filled the void left by their absence, at least to some extent. Also, the innovative use of the internet has extended well beyond the CEPR and VOX websites in the area of international trade policy, since Global Trade Alert has played a notable and commendable role in naming and shaming modern protectionism since its inception in the wake of the global financial crisis; this initiative, backed strongly by CEPR has been a tremendous force for good in the world.[20]

A few final thoughts. The CEPR is not an institution that is widely known by the populace.[21] That is probably as it should be; the business of the CEPR is to push the thought frontiers inside the profession and the decision-makers who make policy; basic rather than applied research. In fact, CEPR often doesn't try to influence the debate directly at all. The comparative advantage of the CEPR is in being a behind-the-scene idea leader, helping economists produce and disseminate research. Nowhere has that been truer than on the issue of the internal market in Europe. It's hard to excite the public with a policy that might deliver a long-run increase in welfare of 2.5% of output. But defending and extending the single market is still the right thing to do.

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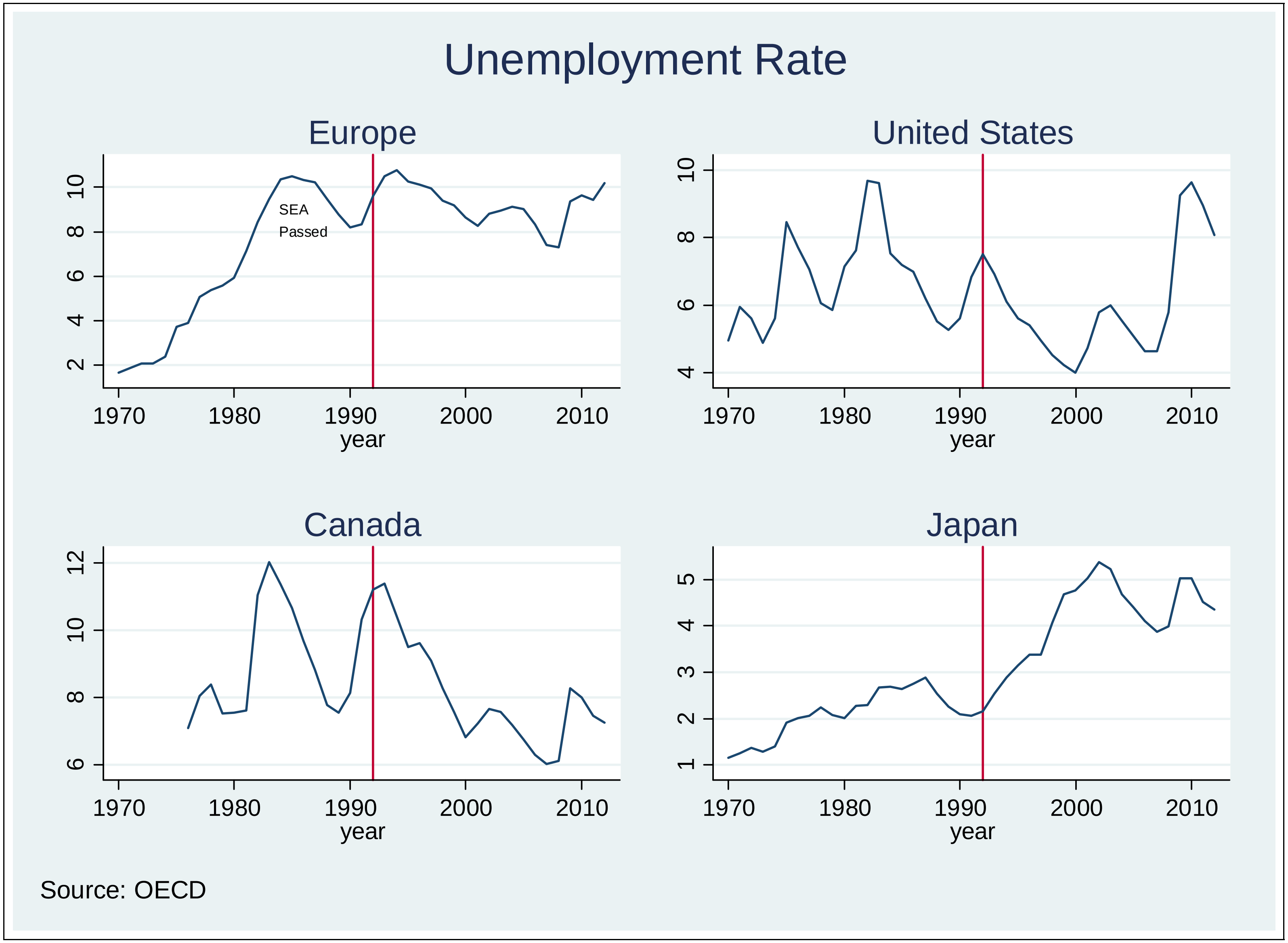
Unemployment Rate
Europe
SEA
Passed
2
4
6
8
10
1970
1980
1990
2000
2010
year
United States
4
6
8
10
1970
1980
1990
2000
2010
year
Canada
6
8
10
12
1970
1980
1990
2000
2010
year
Japan
1
2
3
4
5
1970
1980
1990
2000
2010
year
Source: OECD

Figure 1

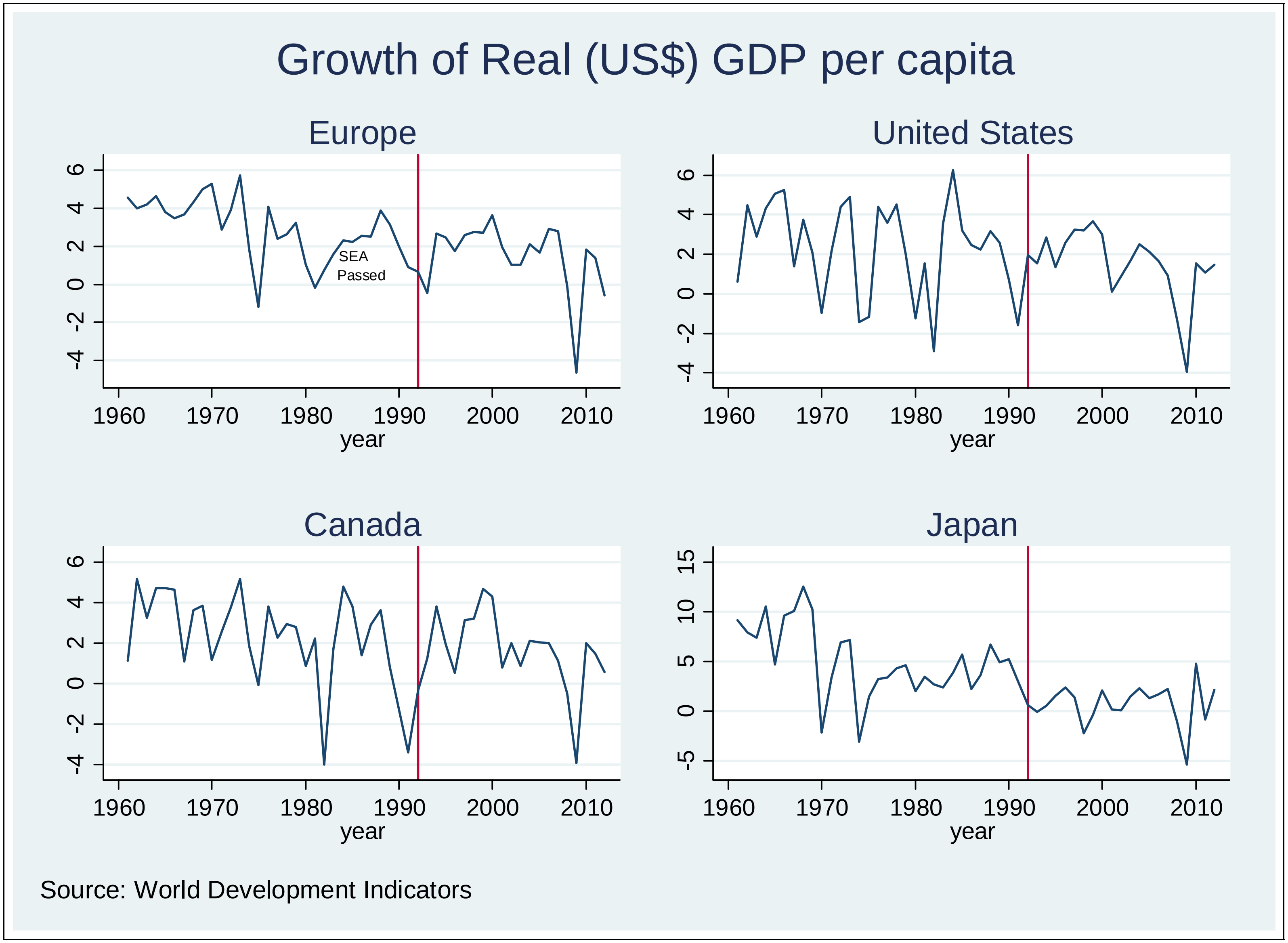
Growth of Real (US$) GDP per capita
Europe
SEA
Passed
United States
Canada
Japan
year
1960
1970
1980
1990
2000
2010
Source: World Development Indicators

Figure 2

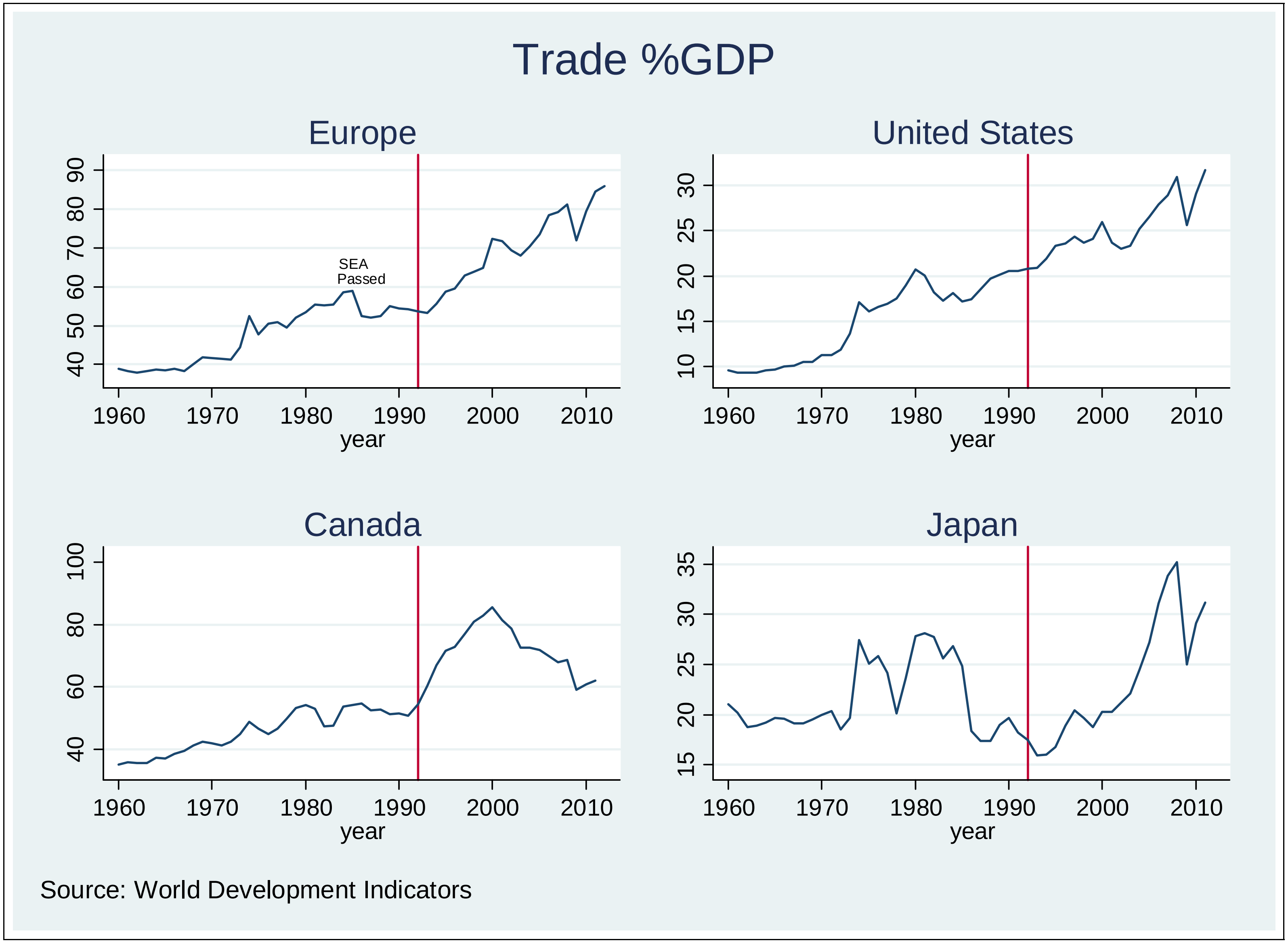
Trade %GDP
Europe
SEA
Passed
40
50
60
70
80
90
1960
1970
1980
1990
2000
2010
year
United States
10
15
20
25
30
1960
1970
1980
1990
2000
2010
year
Canada
40
60
80
100
1960
1970
1980
1990
2000
2010
year
Japan
15
20
25
30
35
1960
1970
1980
1990
2000
2010
year
Source: World Development Indicators

Figure 3

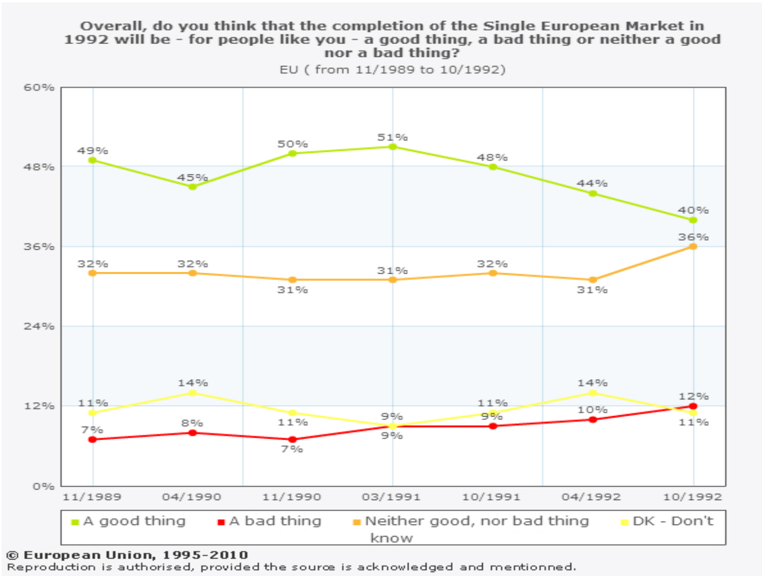

Figure 4

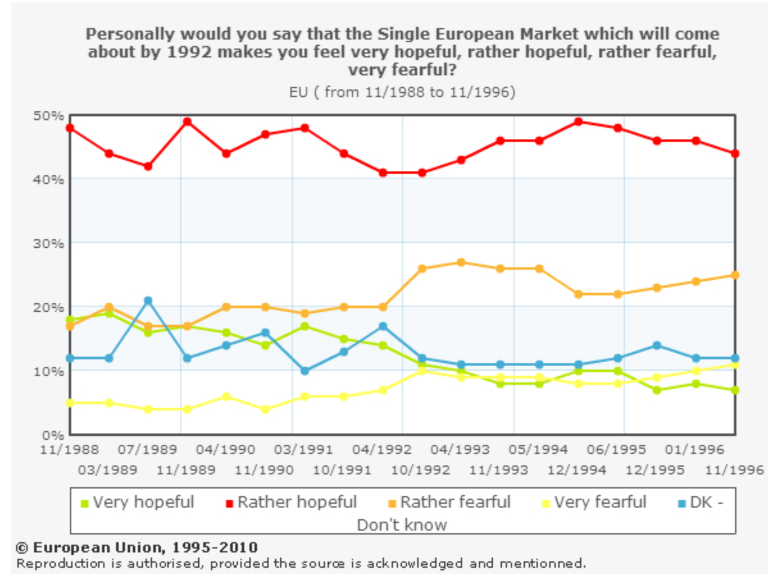

Figure 5

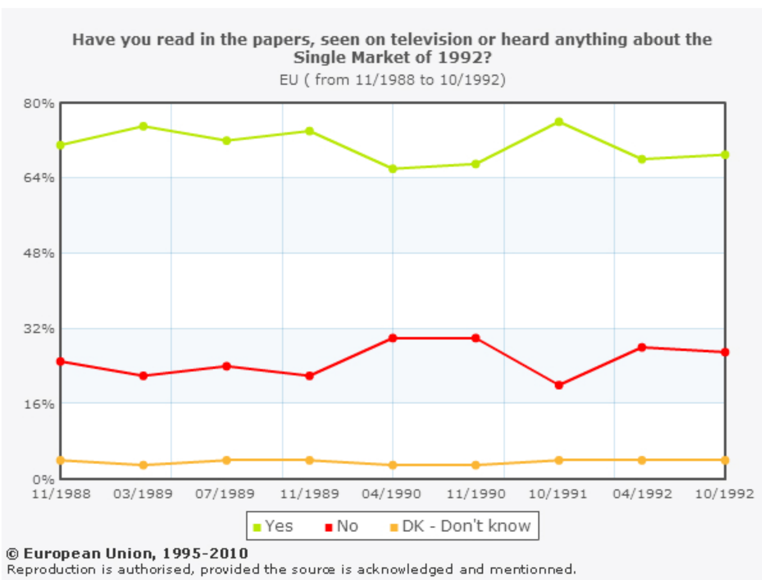

Figure 6

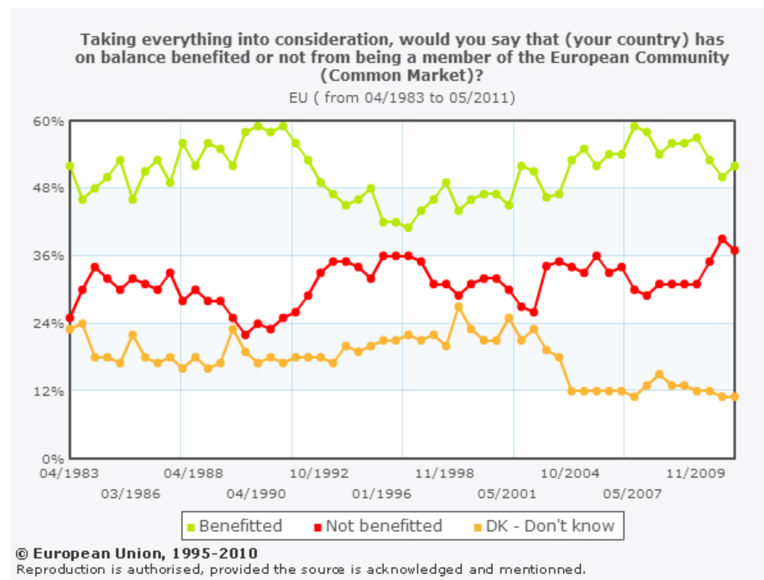

Figure 7

Endnotes

[1] http://www.cepr.org/content/discussion-papers?dpno=8937.asp

[2] http://www.aeaweb.org/articles.php?doi=10.1257/jep.1.2.131

[3] Like most papers which pose a question in the title, the answer is a resounding “no.”

[4] http://eescopinions.eesc.europa.eu/EESCopinionDocument.aspx?identifier=ces\sous-comite\sc035%20pour%20une%20analyse%20actualisee%20du%20cout%20de%20la%20non-europe\ces1374-2012_00_00_tra_ac.doc&language=EN and http://ec.europa.eu/economy_finance/publications/publication7412_en.pdf

[5] Smith and Venables in 1988 were affiliated with Sussex and Southampton respectively; by 1991 they were both affiliated with Southampton and CEPR.

[6] Now a network of over 800.

[7] Since we’re in London in November, I’ll simply note the CEPR’s continuing predilection for holding conferences in nice places at the wrong time of the year.

[8] CEPR Discussion Papers are ranked (by h-index) as the second most important working paper series in Economics;[8] the most cited CEPR Discussion Paper seems to be #363 “Integration and the Competitiveness of Peripheral Industry” by Krugman and Venables, with 536 Google Scholar citations.

[9] There is no reason at all for this sentence to be viewed as payback for “Trade Effects of the Euro” http://e-jei.org/upload/126T187Q985L4612.pdf .

[10] Sapir (1989) was an early contribution to the latter.

[11] By way of contrast with some other writers in *Economic Policy*, not that any names come to mind.

[12] Eichengreen (1992).

[13] Sorry.

[14] More details available at http://ec.europa.eu/public_opinion/cf/index.cfm?lang=en

[15] http://ec.europa.eu/public_opinion/archives/ebs/ebs_363_en.pdf

[16] HM Government (2012): “The European Union Single Market – what has been achieved in twenty years?” in Centre for Economic Policy Research (Ed.) (2012): Twenty Years On: The UK and the Future of the Single Market, p. 9. See also Allen et al (1998) for more on the competitive effects of the SEA. An interesting argument of relevance is presented by Head and Mayer (2000) who believe that there were indeed many European non-tariff barriers at the time of the SEA, but that the measures enacted in the SEA were essentially unrelated to the barriers of relevance.

[17] http://ec.europa.eu/public_opinion/archives/ebs/ebs_363_en.pdf

[18] See, e.g., http://www.voxeu.org/article/services-market-integration

[19] See, e.g., the introduction to “Internal Market: Awareness, Perceptions and Impacts” http://ec.europa.eu/public_opinion/archives/ebs/ebs_363_en.pdf. This is a widely held belief. For instance, “In the European Union this includes the completion of the much-heralded single market in services. In manufacturing, says another new paper, by Rachel Griffith, Rupert Harrison and Helen Simpson, of London's Institute for Fiscal Studies (CEPR Discussion Paper No. 5849), the single market has increased competition, innovation and productivity as a consequence. Thanks to IT, America's banks and retailers have taken fuller advantage of huge continental markets for mortgages and groceries. Europe's would surely do the same.” http://www.economist.com/node/8000860

[20] Those of us with 14-year old sons only wish that Global Trade Alert had picked initials not shared by the most popular video game of all time.

[21] For instance, "CEPR" receives only 41 hits at ft.com; http://search.ft.com/search?queryText=CEPR