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REGIONAL TRADE LIBERALISATION SCHEMES: THE EXPERIENCE OF THE EC

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Section A
Introduction

Although the analogy must be treated with caution, the experience of the Western European states in forging economic and political links between themselves and with developing countries provides some lessons for the architects of a Western Hemisphere Free Trade Agreement (WHFTA). This paper describes two sets of lessons that may have relevance for the selection and design of the instruments of a WHFTA. They centre on the extent to which the reduction of barriers to trade is sufficient to foster commerce between countries at very different levels of economic development, and whether more positive measures involving the transfer of resources from the centre to the periphery are needed either to reinforce integration or, at least, to maintain political support for the process.

In identifying these lessons the paper draws upon the experience of the twelve Western European states in moving towards a Common Market, and their joint endeavours as an Economic Community in establishing regional trading zones with developing countries in the South. Any analogy must be drawn with care because the economic divergence between the rich and poor candidates for a WHFTA is considerably wider than that between the richest and poorest states within Europe, and because the formative period of the EC's relations, internal and external, occurred in a very different politico-economic climate than obtains in the Americas in the early 1990s.

Nonetheless, the European experience of regional integration has achieved such prominence that it would be foolish for those entering the uncharted waters of full western hemispheric integration not to pay it due heed. Despite the uncertainties created in the wake of the Danish rejection of the Maastricht Treaty and the problems of the Exchange Rate Mechanism (ERM), the progress made by Western Europe towards, first, economic and, then, political integration has been impressive. The achievement appears particularly marked when the state of play in 1992 is compared with the situation less than ten years previously, in the mid-1980s. The bold initiative of the original six members of the EEC in 1957 to set in train a process that would create a Common Market had run into the sand by the mid-1980s. Progress towards the removal of barriers to trade between member states had become bogged down and policy makers were forced increasingly to address non-tariff barriers to trade such as differing technical standards, government procurement rules, and member state national quotas. The most important Community-level policy instrument, the Common Agricultural Policy (CAP) had become deeply contentious and, partly as a result, the Community's highest decision making councils were turned over to unseemly bickering about the distribution between members of relatively small sums of money. The 'Europe show' was put back on the road with the adoption of the Single European Act and 1992 as the target date for completing a barrier-free Single European Market. States outside the EC queued up to join and tentative steps towards political and monetary integration were taken in parallel with the large strides towards a complete customs union. It is unlikely that all trade barriers will be removed by 31 December 1992, and the future of political and monetary integration is in some doubt. Nonetheless, the achievements of Western Europe in these areas are so great relative to the recent experience of other parts of the world that they are a natural focus of interest for those wishing to promote integration elsewhere.

The last five years of European integration pose many interesting questions for third parties. Does integration in trade necessarily require closer co-operation in monetary and political affairs? How important is it for there to be an independent initiating authority (like the EC Commission) and an independent arbitration system that can impose penalties on the powerful and weak member states alike (such as is found in the European Court of Justice)? Given the short period of time that has elapsed and the current uncertainty, such questions are inevitably speculative and are not the focus of this paper. Rather, the question posed of the European integration experience concerns the role of fiscal transfers between rich and poor states/communities as a political or economic requirement for effective regional liberalisation. It is the first thirty years of the EC's history, rather than the last five years, that is the main focus for attention. From its outset, there have been clear distributional elements to the EC. The CAP, for example, was regarded clearly by France, at least, as a necessary 'compensation' for opening its manufactures market to Germany. And, whilst its distributional effects have been ambiguous, to say the least, the CAP has had very differential effects in the various parts of the Community. At the same time, there have been specific provisions for intra-state and intra-regional transfers both of a commercial kind (through the

European Investment Bank) and in terms of public expenditure (through the Social and Regional Funds). The relevance of these instruments for the architects of a WHFTA is examined in Section B of this paper.

The EC's external economic relations with developing countries are of interest to a WHFTA for two reasons. First, the complex web of regional trade preferences woven by the EC provides the most extensive evidence available on the utility of selective liberalisation in promoting trade between rich and poor countries. The ultimate goal in the western hemisphere is, as the WHFTA title indicates, a free trade area, but this is to be approached through progressive rounds of liberalisation. Do regional trade preferences work? Will selective preferences between North and South America foster either closer commercial integration or the economic development of the poorer countries? The answers to be drawn from the experience of the EC's thirty-year history of such preferences is far from clear. How far is any failure of the EC experience due to the restrictions placed on the trade preferences (that full liberalisation might be expected to overcome) and how far is it inherent in a geographically restricted scheme?

The second point of interest for a WHFTA is that the EC's existing policies create divisions and conflicts of interest within the Americas; are these policies likely to change and thus make the task of regional co-operation more easy? At present, the western hemisphere is split into no fewer than six different groups in terms of its access to the EC market. The clear conflict of interest between the Caribbean and Latin America over the EC import regime for bananas is only the most dramatic example of the conflicts that this creates. But, there is strong evidence that the EC's existing policies are withering and that the barriers to collaboration among the western hemisphere states may start to decline.

Because the two lessons of EC experience covered by this paper - domestic integration and links with developing countries - are substantially different they are treated in separate sections, each with its own author. Section A (the introduction) and Section C (the lessons of EC-South trade preferences) have been written by Christopher Stevens. Section B (the role of fiscal transfers in European integration) has been written by Stephany Griffith-Jones with Nicholas Georgiadis.

Ancillary policies to support rapid European integration; lessons for the WHFTA

A. The Rationale for Ancillary Policies in the EC

The general principle, behind increasingly important supportive and ancillary policies in the EEC (such as the creation of the European Investment Bank) is that the removal of barriers in order to free trade needs to be accompanied by the integration of policies for purposes beyond trade liberalisation. The removal of trade barriers is called "negative integration" and the making of common policies beyond trade liberalisation, both for the purpose of enabling the market to function effectively and also to promote other broader policy objectives in the union, is called "positive integration".[1] This principle, and the EEC experience detailed below, offers important lessons for a WHFTA, which we will extract below.

The above discussed principle, and the resulting policy actions in the EEC, are based on fairly broadly recognised conclusions of economic theory which show that trade integration has two types of effects:

i) Via mechanisms such as economies of scale, integration of economies leads to more rapid growth overall, including that of relatively more backward regions. Furthermore, poorer countries and regions would tend to benefit as factors of production (including both labour and capital) would tend to move from high cost regions to low cost regions, until cost differences are reduced, contributing to an increase in the amount of capital in the low cost regions and to an increase in the level of wages. This would lead to relatively higher growth of the more backward regions.

ii) There are, however, a number of factors which are likely to contribute to relatively less rapid growth (or even decline) of relatively poorer areas. For example, capital may flow from poorer to richer areas, due to factors such as greater availability of economic infrastructure, access to specialised services, proximity to large markets, greater relative development of capital markets, greater institutional and administrative capability of a region. Furthermore, inter-regional mobility of labour, which is in any case far from perfect (it is partly restricted by feelings of preference to remain in areas to which people have cultural or linguistic attachments), tends also to be highly selective, drawing particularly on the most dynamic groups, that is those in particular age groups (e.g. between 20 and 35 years, with their children) and in the more skilled groups. As a result, the poorer regions of out-migration lose the more talented and vigorous sections of their labour force, as well as the more entrepreneurial ones. Also, widening of markets (due to trade liberalisation) will often give competitive advantages to the industries in the more advanced regions, which often work with increasing returns, and firms in the poorer regions may have difficulties. An historical example of this negative trend (often quoted in the European context) is the economic domination of Northern Italy over Southern Italy after the unification of the country.[2]

Furthermore, the movement of labour and capital in response to market enlargement will be determined by private rather than social cost; where the two differ significantly, misallocation of resources may result. In the context of location of industry and population, such differences are seen to be likely. Thus, factor movement into an already densely populated area is likely to impose serious external diseconomies of congestion on enterprises and people already in the area; such costs will not enter into the calculations of the decision-maker concerned, nor will the welfare costs associated to possible deterioration of the natural environment (e.g. pollution). On the other hand, an opposing problem may be posed for the region "exporting" labour and capital, where the usage of services can fall below the point at which their provision is viable. Public transport or medical facilities are good examples.

Therefore, in <u>economic</u> terms, there was a strong case for regional policies in the EEC based on the perception that: i) factors such as the immobility of some resources and external economies and diseconomies are sufficiently large and long-term to justify policy actions to partially counteract their effects, and ii) that the costs of dealing with these factors by regional development policy in the poorer areas was clearly less than the costs of eliminating them (for example by increasing mobility or removing external effects such as congestion or pollution) through action in the winning areas.

However, the justification for ancillary policies in the EEC (and for regional policies in particular) was never purely based on economic analysis or factors. It was strengthened further by social and political factors, which often played a very important role. Social arguments (e.g. the need to avoid high levels of unemployment in some regions) were reportedly[3] the main reason for the initiation of regional policies in

Europe in the late 1950s and early 1960s. Political factors, related both to the perceived need to reduce inequalities for moral and human reasons and even more to the need to keep losers in the trade integration process enthusiastic about the long-term benefits of trade integration (and therefore either neutral or supportive of the process) played a major role in influencing the EEC to take policy action (for example through regional policies) which complemented progress on trade liberalisation. The social and political significance of ancillary policies in the EEC integration process could be particularly relevant in the different stages of a WHFTA.

We have stressed till here policy actions necessary to reduce potential growing inequalities between regions and countries, as a result of trade liberalisation. Another important area of action in the context of the European Community was policy actions to inter-connect national networks within the EEC, for example of infrastructure, telecommunications, etc. These measures, also crucial for facilitating the operation of an increasingly integrated market, were to an important extent funded by public resources, with the European Investment Bank playing a very crucial role in this process. These complementary measures continue to play an important role in European integration at present (see, for example, the emphasis on trans-European networks placed in the Maastricht Treaty). It is interesting, however, that the role of the private sector - both in financing and operating such networks - is expected to increase, with a possibly growing indirect role (e.g. via guarantees) to be played by the Community public sector, via the European Commission and the European Investment Bank (see below). However, still a fairly large role in trans-European network investment is being played by public investment, via the European Investment Bank and via the Structural Funds.

Again relevant lessons can be drawn for a WHFTA on the need for supportive measures to trade liberalization via major investments in trans-border interconnection of infrastructure.

B. The Evolution of Ancillary Economic Policy at the Community Level

In analysing and describing the European Community's ancillary economic policies, we will describe both relevant budgetary policies (with specific reference to regional funds) and the crucial role played by the European Investment Bank (EIB).

With respect to the EIB, we will stress its important role in supporting European integration, for several reasons. First, because as we will describe below, the EIB played a very crucial supportive role from the start, as it was created together with the EEC. The EIB remains today the premier long-term credit bank in Europe, with its focus continuing to be on infrastructural and other fixed capital formation in the Community. Surprisingly, the important role which the EIB plays is relatively little known, especially outside Europe. Second, given that the Western Hemisphere already has a dynamic, large and experienced development bank in the Inter-American Development Bank (IADB), the EIB experience becomes particularly relevant in suggesting further actions which could be taken by the IADB in the context of increased hemispheric integration.

With respect to ancillary policies, we will describe the evolution and examine the effectiveness of the main instruments for the implementation of these policies. This will be done in two steps; first we shall present a historical account of how the various instruments have developed, focusing in particular on the social and political conditions that made these instruments necessary. Second, we will review the redistributive impact of the EC ancillary policies and of the operations of the EIB on the poorer countries and the laggard regions of the Community.

Three main phases can be distinguished in the development of ancillary policies since the establishment of the EEC. The first phase, which lasted until 1973, was characterized by the formation of regional economic policy, and the sincere efforts to reduce disparities among the laggard regions of Southern Italy (Mezzogiorno) and the more developed regions of the Community. The second phase was marked by the creation of new instruments, the strengthening of the regional policy dimension of other policies already available, and a steady increase in the money spent. The third phase is connected with the reform of the so-called Structural Funds in 1988. It constitutes a turning point in the search for greater effectiveness of common instruments, coupled with a substantial further increase in EC expenditure with a regional basis.

1. The First Phase

(A) The Treaty of Rome

It is important to note that the first phase of the development of regional policy in the EC coincided with the "golden age" of the Western European economies, characterized by rapid economic growth, low unemployment rates and relative monetary stability. As the size of the cake grew bigger, European integration was perceived as a positive-sum game in which there were gains to be made by all the countries involved.

The original six members of the EC constituted a relatively homogeneous economic group, with the exception of the South of Italy; a problem which was, in fact, recognized in the protocol for the Mezzogiorno, attached to the Treaty of Rome.[4] Article 2 of the Treaty referred to the objective of

> "...establishing a Common Market and progressively approximating the economic policies of Member States, to promote throughout the Community a harmonious development of economic activities, a continuous and balanced expansion..."

In the preamble of the Treaty the contracting partners went even further by calling for a reduction in "the differences existing between the various regions and the backwardness of the less favoured regions".

The fundamental objectives of the Treaty implied a regional policy at the Community level as the realisation of the objectives of Article 2 was unimaginable without such a policy.

The Treaty of Rome also clearly reflected the perception that common policies could be an instrument of regional policy at the Community level. As a result, a number of Articles referring to agricultural, social, transport and aid policy implied regional preoccupations.[5] (For a summary of the most important of those policies in the Treaty of Rome see Appendix I).

The Creation of the EIB

There were several provisions in the Treaty for the creation of instruments which could contribute towards this "harmonious development" and the reduction of regional disparities. The European Investment Bank (EIB), the most powerful instrument in the Treaty, was established in order "to contribute to the balanced and smooth development of the Common Market in the interest of the Community".[6] The EIB was intended as a source of relatively cheap interest loans and guarantees which would facilitate the financing of:

> "(a) projects for developing less developed regions; (b) projects for modernising or converting undertakings or for developing fresh activities called for by the progressive establishment of the common market; (c) projects of common interest to several member states, which are of such size or nature that they cannot be entirely financed by the various means available in the individual member states".[7]

The EIB was therefore created especially as <u>a Bank to support the European integration process</u>. Its three objectives, outlined in the paragraph above, reflected three major concerns, expressed during the process of negotiation of the Treaty of Rome. The first was to help reduce the gulf between relatively prosperous and relatively poorer regions. It was also based on the fear that, if not compensated for, European integration could increase such imbalances. In the negotiations of the Treaty of Rome, the Italian government pressed very strongly for the creation of the EIB, with this purpose; according to some sources, it even put the creation of the EIB and its concentration on lending to Southern Italy as a pre-condition for Italy to join the EEC. The second major concern was to help "senile industries", and/or areas where such industries were dominant, which could not, on their own, face competition, but required support for modernisation, conversion or development of new activities. The third concern was for the need to finance investment which helped integrate the European economies, and which related to several member states or to the Community as a whole. This refers in particular to the area of cross-frontier communications (and especially transport). This concern was related to the fact that much of existing infrastructure at the time was geared to meeting domestic needs; the creation of the EEC lead to a new dimension and new cross-border needs. It is noteworthy that these three aspects (possibly in somewhat different proportions) could also be central as supportive measures to a WHFTA.

As regards the first aspect, regional development, the European Investment Bank remained till 1975 (when the European Regional Development Fund was created) the sole important Community source of funds for general financing of regional development prospects. A very large proportion of EIB lending, estimated at 75 per cent in the 1958-78 period,[8] was channelled to investment in disadvantaged areas. The redistributive impact of EIB lendimg in the Community is discussed below in Section C.

The EIB was set up as a separate legal entity from the EC Commission although it was part of the Community, and was committed to pursuing EC objectives in the public interest. This legal distinction implied that the Bank had to raise most of its own funds, on the markets. The idea therefore was to create an autonomous project-financing body capable of financing the bulk of its loans out of the proceeds of borrowing. However, the capital of the EIB was totally provided by the EEC member governments.

The creation of the ESF

Provisions for the free movement of labour also had an indirect regional dimension in the sense that labour mobility would help to deal with the problem of high unemployment in a less developed region such as Mezzogiorno. In this direction, the European Social Fund (ESF) was established under the Treaty of Rome to render "the employment of workers easier and of increasing their geographical and occupational mobililty within the Community".[9] When this Social Fund was reformed in 1971 it included a more precise commitment to give differential assistance to regions with employment problems. The Fund was devided in two sections, one section operating in response to changes in the Community employment situation, and the other being used to help eliminate long-term structural unemployment and underemployment, particularly in underdeveloped regions and regions affected by the decline of industry. Depending on the employment situation, the Fund acted either to remedy, in certain specific fields, an employment situation adversely affected by Community policies and measures, or because common measures were regarded as necessary for certain categories of persons, such as the long-term unemployed. Following a second review of the Fund in 1977, provision was made for aid to be concentrated more in regions and countries with the worst employment problems and the fewest economic resources. The redistributive impact of ESF financing is discussed later in Section C.

The creation of the EAGGF

The setting up of the European Agricultural Guidance and Guarantee Fund (EAGGF) in 1962 to finance the Common Agricultural Policy (CAP), was also expected to contribute towards the reduction of disparities, since farm incomes were generally much below the EC-6 average, while economic backwardness was often identified with a heavy regional concentration on agriculture.[10] Among the objectives of the CAP as laid down in Article 39 of the Rome Treaty was "the concern of raising the productivity of agriculture by technical progress and rationalisation in order to increase per capita income...". The EAGGF consists of two sections: (i) the Guarantee Section, which deals with the expenditure required for the operation of the markets and guarantees the "intervention price" or "support price system" of the CAP; (ii) the Guidance Section which dates from 1964 and deals mainly with the socio-structural measures in the agricultural sector.

The Guarantee Section developed very quickly and eventually came to account for almost 75 per cent of the Community budget in the early 1970s. Recently steps have been taken to reduce its size with the introduction of a more cautious price policy, and greater emphasis on structural improvements.

The Guidance Section represents the structural part of the CAP and follows its general objectives (as laid down in the Treaty of Rome, Article 39). Its activities are divided into direct and indirect measures. In the case of direct measures, aid is granted for private or public investment projects; in the case of indirect measures the Fund reimburses member states for expenditure incurred for certain structural improvements.

(B) Regional Policy at the EC level is Formulated

EC regional policy was shaped in the 1960s and the beginning of the 1970s. Three factors were instrumental in the formation of such a policy; first, the fact that the Community became increasingly aware of regional disparities; secondly, the national governments developed their own regional policies and the necessity of co-ordination of those policies became apparent; finally, the elaboration of certain common policies was not possible without more EC impact on the regional level.

The realisation of regional disparities in the Community was emphasised in a number of conferences, documents and decisions the most important of which are noted below:[11]

As early as in 1964, the Council decided to integrate regional policy in medium term economic policy.[12] In 1968 a Directorate General for regional policy was created (DG XVI). In mid 1968, Jean Rey, President of the Commission proclaimed in a speech to the European Parliament: "Regional policy in the Community should be as the heart in the human body...and should aim to reanimate human life in the regions which have been denied it".[13] Shortly afterwards, in 1969, a Council Regulation recognised that "...the introduction of the customs union...required growing Community responsibility for regional development."[14]

By the late 1960s national aid systems had been extended for two reasons. First, with the elimination of tariffs and export subsidies, member countries' governments had increasingly applied measures of regional assistance. Second, with the extension of aid, these measures had become instruments of competition among national firms and means of attracting foreign investment. It soon became obvious that co-ordination of national regional policies was necessary to prevent an "overbidding" between regions, which would normally be at the expense of the poorer ones. Several attempts were made in this direction but it was only in 1971 that a real step forward towards the adoption of policy measures in that direction was made.[15] This event led to the resolution of the Council of 22 March 1971 which expressed a political engagement to start with a regional policy. The Conference of the Heads of State or government, held in Paris (October 1972) established the Community Regional Policy as an "essential factor in the strengthening of the Community".

At the same time it was becoming increasingly evident that there exists a close relationship between other common policies and regional development. The best example is the Common Agricultural Policy, the unintended impact of which on Community disparities will be discussed more extensively in Section C. However, it is interesting to note that as early as 1971, the Council resolution concerning the CAP argued that "rapid progress must be achieved with other Community policies, especially as regards regional and social policy".

2. The Second Phase

As pointed out above, interest in regional policy grew dramatically in the EEC in the early and mid-1970s. This seemed was a result of three factors. First, by the end of the 1960s, the foundations of European integration had been laid. Continued progress was likely to be politically more difficult, as the first bursts of enthusiasm were weakening, if the interests of the hardest hit regions within the member countries were not clearly protected.[16] An interesting lesson here for the WHFTA from the EEC experiences is that timing is very important for overcoming opposition to ancillary policies, from the richer member countries, who would finance such policies.

Second, the 1960s had clearly been a decade of very rapid growth within Europe, which had implied that the poorer regions had experienced increases in both their absolute levels of output, employment and income. The early 1970s saw a sharp deterioration in the economic performance of all European countries, due to external factors such as the sharp rise in the international price of oil, as well as to internal factors. In such harsher economic circumstances, regional policy becomes both more necessary and more difficult. It became more necessary because both intra- and inter-country disparities, in terms of income, were still large in the early and mid-1970s. By 1977, this led the European Commission to conclude that the strengthening of EC regional policy was "not only desirable; it is now one of the conditions of continuing European economic integration". Regional policy became more difficult, as the measures followed were more difficult to have effects in the context of overall stagnation or slow growth in the poorer areas and as its funding by richer members was made more problematic by the same poor economic trends. The third reason for the development of regional thinking and policy in the early 1970s was due to the political necessities of the prospective accession of three new members, and especially Britain.

The accession of the three new members brought countries with serious regional problems inside the EC. The problems of Ireland might have been met partly with the allocation of CAP resources, but disadvantaged British regions (with "senile" industries) suffered on the whole from industrial rather than agricultural decline. The British position was further complicated in that it seemed certain that Britain would emerge as a net contributor to the Community budget. This budgetary pressure was reinforced by the turning of public opinion in Britain against the EC. The British government tried to find areas of potential Community expenditure from which Britain would benefit, and the creation of the European Regional Development Fund (ERDF) soon became the spearhead of this effort.[17]

The creation of the ERDF

The decision to set up a Regional Development Fund (RDF) before the end of 1973 had been reached earlier at the Paris Summit of 1972. The Commission allocated the regional portfolio to George Thomson, who produced his first "Report on the Regional Problems of the Enlarged Community", a vigorous proponent of the Fund. However, by the end of 1974 substantial differences of opinion persisted among the Nine over both the main principles and the proposals. The more demanding countries were Britain, Ireland, and Italy.

The greatest reservations came from Germany, the chief paymaster. The political change in the United Kingdom in 1974 led to further delay as the new Labour government promised to renegotiate the terms of British accession to the EEC. In the months that followed it looked as if there was little hope of making progress on the ERDF front until the British problem had been resolved. However, Thomson and his staff in the Commission persisted in their efforts to prevent the ERDF slipping into oblivion, with the continuing support of the Irish and Italian governments. By the end of 1974 extreme tactics were used, when reportedly the Irish and the Italians threatened to sabotage the summit to be held in Paris in December 1974, unless the other governments would give an immediate commitment to set up the ERDF.

It is interesting to see how political pressures from the interested countries played, in the context of the EEC a crucial role in establishing this key regional fund; it would seem likely that similar political pressures would need to be exerted for similar actions in the context of a WHFTA.

The heads of government agreed to create the ERDF as from 1 January 1975, with 1.3 billion units of account over three years to be distributed among the member states in quotas.

Funds available through the ERDF grew steadily as a share of the EC budget, increasing from 2.3 per cent of total EC budget expenditure in 1975 to 12.3 per cent of the total in 1992. The increase was particularly marked from 1984 as the share of total expenditure grew from 4.7 per cent in thet year to 12.3 per cent in 1992 (for percentages and levels of ERDF expenditure see Table 1 below). Disbursements were in the form of matching grants for the financing of investment projects, with almost exclusive emphasis on infrastructural investment. There was also a clear redistributive bias in favour of poorer countries with more severe regional problems and an increasing concentration of resources on the least developed regions. The redistributive effect of the ERDF is discussed in detail in Section C. By the end of the 1980s, the ERDF had become the main instrument of Community regional policy.[18]

Table 1

Budgetary Expenditure of the EC; Selected Funds (1971-1992)
(Mio UA until 1977, Mio ECU 1978 onwards and as % of Total Expenditure)

Year	EAGGF	ERDF	ESF	OTHER	TOTAL	EAGGF %	ERDF %	ESF %	OTHER %
1971	1883.6	-	56.5	622.7	2562.8	73.5	-	2.2	24.3
1972	2477.6	-	97.5	755.8	3330.9	74.4	-	2.9	22.7
1973	3768.8	-	269.2	899.9	4937.9	76.3	-	5.5	18.2
1974	3651.3	-	292.1	1343.8	5287.2	69.1	-	5.5	25.4
1975	4586.6	150.0	360.2	1315.2	6412.0	71.5	2.3	5.6	20.5
1976	6033.3	300.0	176.7	1856.6	8366.6	72.1	3.6	2.1	22.2
1977	6463.5	372.5	325.2	1881.4	9042.6	71.5	4.1	3.6	20.8
1978	9602.2	254.9	284.8	2759.9	12901.8	74.4	2.0	2.2	21.4
1979	10735.3	671.5	595.7	3253.9	15256.4	70.4	4.4	3.9	21.3
1980	11596.1	751.8	502.0	3891.8	16741.7	69.3	4.5	3.0	23.2
1981	11446.0	2264.0	547.0	5208.0	19465.0	58.8	11.6	2.8	26.8
1982	12792.0	2766.0	910.0	5952.0	22420.0	57.1	12.3	4.1	26.5
1983	16331.3	2265.5	801.0	6419.7	25817.5	63.3	8.8	3.1	24.9
1984	18985.8	1283.3	1116.4	5844.8	27230.3	69.7	4.7	4.1	21.5
1985	20546.4	1624.3	1413.0	5790.3	29374.0	69.9	5.5	4.8	19.7
1986	23067.7	2373.0	2533.0	8175.2	36148.9	63.8	6.6	7.0	22.6
1987	23939.4	2562.3	2542.2	7662.5	36706.4	65.2	7.0	6.9	20.9
1988	27531.9	3092.8	2298.8	11100.8	44024.3	62.5	7.0	5.2	25.2
1989	25868.8	3920.0	2676.1	15135.9	47600.8	54.3	8.2	5.6	31.8
1990	29525.5	5007.5	3677.4	10325.9	48536.3	60.8	10.3	7.6	21.3
1991	35458.0	6309.0	4069.0	13546.0	59382.0	59.7	10.6	6.9	22.8
1992	36008.0	7702.8	4872.2	13824.3	62407.3	57.7	12.3	7.8	22.2

Source: Court of Auditors Annual Reports. EEC data elaborated by authors.

3. The Third Phase

The ground was gradually prepared for a major qualitative change in the use of policy instruments coupled with a major shift in the scale of EC intervention. The decision to establish the internal market and the third enlargement of the EC which had brought a further substantial widening of regional disparities, provided the catalysts.[19]

Through its earlier efforts, the Community had created various mechanisms for providing regional assistance which were increasingly seen by some users as excessively complex. This eventually led to the reform of the Structural Funds in 1988. The improvements in Community regional policy since the mid-1980s and especially since 1989 have included: a) the replacement of detailed and complex criteria by a simple and objective "problem index" (relating to the proportion of a region's per capita GDP in comparison with the EC average, and the (inverse) proportion between the region's unemployment and the EC average), for a region to qualify for support; b) more emphasis is placed on multi-annual development programmes generating permanent employment and less on one-off projects; c) improved procedures for follow-up of implementation and evaluation of regional policy actions.

The legal foundations had been laid earlier with the Single European Act (SEA). The latter introduced Title V to the Treaty of Rome under the heading "economic and social cohesion". This was a formal recognition of the greater political importance of the redistributive function, while also constituting an integral part of the overall package deal behind the SEA and the relaunching of European Integration. The new Articles 130a to 130e linked the objective of "harmonious development" and the reduction of regional disparities, with specific EC instruments, namely the ERDF, the ESF, the EAGGF-Guidance section (all three referred to now as Structural Funds), and the EIB. The ERDF was entrusted with the principal task of redressing intra-EC regional imbalances. The new articles called for the effective co-ordination and rationalization of the activities of Structural Funds. This signaled the beginning of a new era in EC regional policy.

The reform of the Structural Funds was accompanied with a decision for the doubling, in real terms, of the resources of the three funds between 1987 and 1993. This means that expenditure through the Structural Funds is expected to reach 25 per cent of overall EC budget expenditure by 1993 (14.1 billion ECUs in 1988 prices), as compared with 17 per cent in 1987. The doubling of the resources of the Structural Funds, undoubtedly the most important decision ever taken by the Community in terms of internal redistribution, was part of a package of measures, including the reform of the CAP and the EC budget. The so-called Delors package was presented as a necessary precondition for the successful implementation of the Internal Market programme. Interestingly enough, the link established between the internal market and the doubling of resources through the Structural Funds was an implicit recognition of the danger that the weaker regions of the Community could end up as net losers from further market integration, and that their commitment to such integration could be weakened.

The doubling of resources was accompanied by an effort to improve the effectiveness of EC action through the adoption of clearer objectives, improved co-ordination of different financial instruments, and a close monitoring of jointly financed programmes. Five priority objectives were assigned to the Funds, and the EIB was also expected to contribute to these objectives which related to:

Objective 1: The less developed regions

Promoting the development and adjustment of the regions whose development is lagging behind (i.e. where per capita GDP is less than, or close to, 75% of the Community average). The list of objective 1 regions is to be revised every five years. The main instruments to be used are: ERDF (80% of its resources), ESF, EAGGF, Guidance Section and EIB.

Objective 2: Areas of industrial decline

Converting the regions seriously affected by industrial decline. The criteria used to define these regions are: average unemployment rate above the Community average, industrial employment rate above the Community average, decline in industrial employment. The list is to be revised every three years and the main instruments to be used are: ERDF, ESF, EIB and ECSC.[20]

Objective 3: The long-term unemployed

Combating long-term unemployment (above the age of 25, unemployed for more than 12 months). Instruments to be used: ESF, EIB and ECSC.

Objective 4: Employment of young people

Facilitating the occupational integration of young people (job-seekers below the age of 25). The instruments are the same as in objective 3.

Objective 5a: Adjustment of agricultural structures

Adapting production, processing and marketing structures in agriculture and forestry. Instrument to be used: EAGGF, Guidance Section only.

Objective 5b: Development of rural areas

Criteria for definition of such areas: agricultural employment accounting for a high proportion of total employment; low level of agricultural income; low level of socio-economic development in terms of per capita GDP. Instruments to be used: EAGGF, Guidance Section, ERDF, ESF, EIB.

In addition to the emphasis on co-ordination at the EC level, there is another important feature of the reform. This is the submission of regional development programmes of three- to five-year duration. These programmes have provided the basis for the adoption of Community Support Frameworks which set the main guidelines for expenditure through the Structural Funds in each region. The switch from the financing of individual projects, which had been the main characteristic of EC action in the past, to medium-term programmes and operational grants has now been generalized.

Expectations from the restructuring of the Structural Funds (SFs) are very high. A combination of macro-economic models has been used by the Directorate General XXII (responsible for the co-ordination of the SFs) in order to estimate the impact of the Community interventions on Objective 1 (less developed) regions. Table 2 summarises the findings which point to a significant impact of the Funds on these regions. Indeed, according to DGXXII's estimates (see Table 2), the impact of the disbursement of the enlarged Structural Funds will imply an additional annual GDP growth of 0.7 per cent, 0.5 per cent and 0.5 per cent in Portugal, Ireland and Greece during the 1989-1993 period. In the case of Greece, this would imply an increase of almost a third in its estimated annual GDP growth rate, without Structural Funds for that period! For Objective 1 regions in Italy and Spain, the estimated increase in annual GDP growth due to the impact of the Structural Funds, though somewhat smaller than for Portugal, Ireland and Greece, is still meaningful at 0.3 per cent of GDP.

Table 2

Structural Funds and GDP Growth 1989-1993
(Objective 1 Regions)

	Annual GDP Growth including SFs	Annual GDP Growth without SFs	Increase in GDP growth due to SFs
Portugal	4.1	3.4	0.7
Ireland	4.0	3.5	0.5
Spain (obj1)	3.5	3.2	0.3
Italy (obj1)	2.6	2.3	0.3
Greece	1.6	1.1	0.5

Source: DGXXII, Evaluation de l' impact potentiel des Fonds Structureles sur les regions objectif 1 a travers l' utilisation de modeles macroeconomiques, Brussels, 31.03.92, mimeo.

C. Evaluation of the Regional Policy of the EC

There are two ways to conduct an evaluation of the effectiveness of the regional policy of the EC. One is to look at each financial instrument separately and discuss the redistributional impact of its operations. The other is to select a variable (i.e. real GDP growth per capita) and measure the performance of the member countries on a time series basis. The latter exercise can be conducted not just at the national level, but also at the regional which provides more detailed information.

1. Evaluation of Financial Instruments

In this section we will bring together our analysis of the Community's different instruments, to attempt to provide a general overview of their operation and scale.

The EIB, an evaluation; old trends and new tendencies

Since its creation and until 1990, the EIB has remained the largest long-term lending institution within the Community. EIB lending has been particularly valuable due to its concentration on relatively poorer contries. During this period the EIB has lent 96,346.4 million ECUs for industrial and agricultural projects, energy and infrastructure development of the EC Member States (See Table 3 for a breakdown of EIB financing by sector).

Table 3

EIB: Lending by Sector
(in billions of ECUs)

		1987	1988	1989	1990
1.	Regional	3.8	4.9	7.0	7.4
2.	Transport & Telecom	0.7	1.7	2.7	3.1
3.	Environment, etc.	1.3	1.2	1.7	2.2
4.	SMEs	1.4	1.6	2.0	2.0
5.	Competitiveness	0.8	0.8	1.0	1.8
6.	Energy	2.0	1.8	1.7	1.5

1. Regional development
2. Transport and telecommunications infrastructure
3. Protection of the environment, improvement of the quality of life and urban development
4. Ventures promoted by small and medium-sized enterprises
5. International competitiveness of industry and its integration on a Community basis
6. Energy

Source: EIB Annual Reports and EIB Information No.67

In many aspects, the EIB has continued to play the role it was allocated in the Treaty of Rome. For example, the EIB continues to lend for the six objectives established in the Treaty. As can be seen in Table 3, the EIB, in 1990, lent 7.4 billion ecu for regional development, 3.1 billion ecu for transport and telecommunications infrastructure, 2.2 billion ecu for protection of the environment, 2.0 billion ecu for SMEs, 1.8 billion ecu for international competitiveness of industry and 1.5 billion ecu for energy. (The total of sums listed above is higher that the 12.6 billion ecu of total lending in 1990 by the EIB, because some lending is categorised under more than one heading).

The scale of European Investment Bank lending has continued to grow, with its current level being similar to that of the World Bank. The context for, and the role of, the EIB, have changed fairly significantly since it was established.[21] In 1958, European national capital markets were much less developed and international capital flows were far smaller in order of magnitude than they are at present. Therefore, the market imperfections which led to the creation of the EIB have been reduced over time. However, important market imperfections do remain at a Community level. One study[22] revealed that the reported cost ratio for banking services within different Community countries was as high a five-to-one for some products. This is an important factor explaining the concentrated geographical pattern of EIB lending. It lends where the local banking system is a high costs one. This is an important public service and may be one of the most effective ways in which the Bank contributes to EEC cohesion. It not only lowers the cost of funds to borrowers, but the competition it provides stimulates the domestic banking system to respond with improved efficiency.

There is also the function of financing large scale, trans-European projects, where even the relatively more efficient financial markets of the 1990s may hesitate to provide sufficient finance, and for a sufficiently long period, for projects which have a high priority from a Community perspective (playing an important role in helping develop the internal market in the context of the 1992 effort). The role of the EIB in helping finance the Channel Tunnel is a clear illustration of the EIB's important public policy role in this area.

It is interesting that - in its attempt to support investment in trans-European networks of transport, telecommunications and energy infrastructure - the EIB and the European Commission are looking at innovative ways of financing, which would give an increased role to private financing, and where the participation of the EIB and the Community could be mainly indirect, via the provision of guarantees.

For this purpose, at the suggestion of the EIB and the European Commission, the EC governments have in December 1992 (at the Edinburgh Summit) approved the establishment of a large Community loan guarantee facility, which would help encourage <u>private</u> lending/investing in very major trans-European infrastructure, mainly with connections to other countries such as those in Central and Eastern Europe. A particularly important reason for the establishment of such a guarantee relates to the very long maturities in which many such investments become profitable, maturities which are often far longer than those for which the private capital or other markets wish to lend for or insure against.[23] This is also especially important for the relatively poorer Community countries, whose somewhat higher perceived political risk, as well as their relatively under-developed capital markets imply that bank lending is available for <u>far shorter periods</u>, (e.g. 6-8 years' maturities) than in the relatively richer Community countries, with more developed capital markets. This guarantee mechanism is also seen as particularly valuable to tackle the specific interface risks (due to differences between countries, e.g. in legal, regulatory, tax systems) related to the cross-frontier or transnational nature of TEN projects.

Finally, it is noteworthy that at a Community level, a guarantee facility is seen as a way to support European budgetary convergence - by reducing budget deficits of some countries, especially the relatively poorer one - as indirect public interventions (via guarantees) would, by encouraging private finance, help reduce direct public intervention, via direct government funding.

Thus, in the 1990s, the EIB together with the European Commission is looking for new and innovative ways to catalyse private flows both for enabling more rapid and efficient trade integration and for supporting lending to the relatively poorer countries in the Community, with relatively less developed financial and capital markets. They are beginning to do so in a context of increased use of the private financial and capital markets, which have developed very substantially in Europe since the EIB and the Community was created.

Another important feature of EIB lending is the bias favouring the poorest regions of the Community, which was consistent throughout the years. Table 4 shows for 1989 the importance of EIB financing in relation to the GDP of the poorest countries of the EC. In 1989, EIB loans reached 1.8 of the GDP of Portugal, 1.6 of the GDP of Ireland and 0.6 of the GDP of Greece.

Table 4

Importance of Redistribution Instruments to Greece, Ireland and Portugal (1989)

Percent of GDP

	ERDF	Three Structural Funds	EIB
Greece	1.3	2.3	0.6
Ireland	1.0	2.2	1.6
Portugal	1.4	2.7	1.8

Sources: Court of Auditors Annual Reports and EIB Annual Report 1990

Almost 60 per cent of the whole EIB lending in the first fifteen years of its operation went to Italy, practically all of which went to the poorer areas in Southern Italy (Source: EIB 1958-78, 20 Years) . This is natural as it was with the Mezzogiorno in mind that the EIB had been originally set up.

Table 5

EIB Financing 1958-77
[million ECUs and thousands (population)]

	1 Amount (mln u.a.)	2 % of Total	3 Years of Membership	1/3 Total / Years	4 Population*	1/4 Total / Population	5 1/3 :4 (x100)**
Belgium	112.0	1.5	20	5.6	9822	0.01	0.06
Denmark	85.9	1.2	5	17.2	5088	0.02	0.34
Germany	793.5	10.7	20	39.7	61400	0.01	0.06
France	1449.3	19.6	20	72.5	53145	0.03	0.14
Ireland	243.8	3.3	5	48.8	3272	0.07	1.49
Italy	3039.3	41.0	20	152.0	55930	0.05	0.27
Luxembourg	9.0	0.1	20	0.5	361	0.02	0.12
Netherlands	105.2	1.4	20	5.3	13856	0.01	0.04
United Kingdom	1458.3	19.7	5	291.7	56190	0.03	0.52
Total EC-9	7406.8	100.0			259064		

* Population for 1990
**EIB financing deflated by time of membership and population. (The indicator is multiplied by 100).

Source: EIB Annual Reports.

Figure 1

Weighted EIB Financing (1958-1977)
[Total/ Membership Yrs and Population]

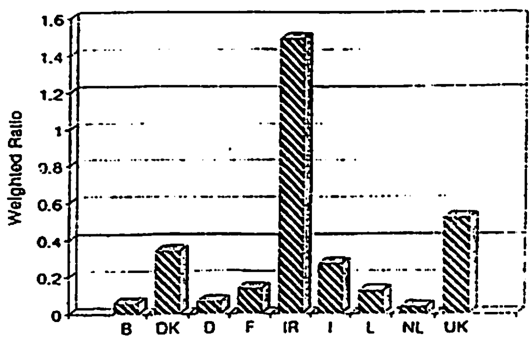


Table 5 which breaks down EIB funds by country from 1958-1977 shows that Italy was still the major recipient of EIB loans but Ireland and the U.K. absorbed substantial amounts over the first three years of their accession. Column 5 of Table 6 and Figure 1 deflates EIB weighted lending by number of membership years and population of borrowing country (authors' calculations) to account for different length of EC membership and different size of population. Column 5 of Table 6 and Figure 1 shows that in per capita terms Ireland is by far the main beneficiary of EIB loans over the time period examined. The next beneficiary (though far behind Ireland) is the United Kingdom.

Table 6

EIB Financing Provided from 1986 - 1990
[million ECUs (column 1), thousands (column 3)]

	1	2	3	1/3
Member Countries	1986-1990	% of Total	Population	Total / Population
Belgium	392.3	0.8	9948	0.04
Denmark	2178.0	4.3	5148	0.42
Germany	3041.3	6.0	62857	0.05
Greece	1052.0	2.1	10046	0.10
Spain	5597.1	11.0	38957	0.14
France	6063.9	11.9	56420	0.11
Ireland	1000.0	2.0	3527	0.28
Italy	17086.7	33.5	57637	0.30
Luxembourg	31.6	0.1	377	0.08
Netherlands	941.6	1.8	14951	0.06
Portugal	2690.9	5.3	9808	0.27
United Kingdom	7179.7	14.1	57341	0.13
Other	3714.0	7.3		
Total	50969.1	100.0	327072	0.16

Source: EIB Annual Report, 1990.

Table 6 shows the breakdown of EIB finances provided to EC-12 in the more recent 1986-1990 period. In these most recent years, Italy is still the main beneficiary in terms of shares of total allocations. However, Column 4, which shows the per capita allocation of EIB, reveals that all the member countries of the "periphery" (especially Italy, Ireland and Portugal) borrow substantially from the Bank. Denmark also scores very high in terms of per capita absortion of EIB funds in the latter period.

Table 7 and Figure 2 summarize the redistribution impact of the EIB over the whole period of 1959 to 1990. The total allocations of EIB lending deflated by years of membership and population show a very strong bias in favour of the poorer EC countries. Indeed, amongst the countries obtaining highest loans from the EIB during that period (per capita and per year of membership) are Ireland, Portugal, Greece and Spain. These are the poorest countries in the Community.

Table 7

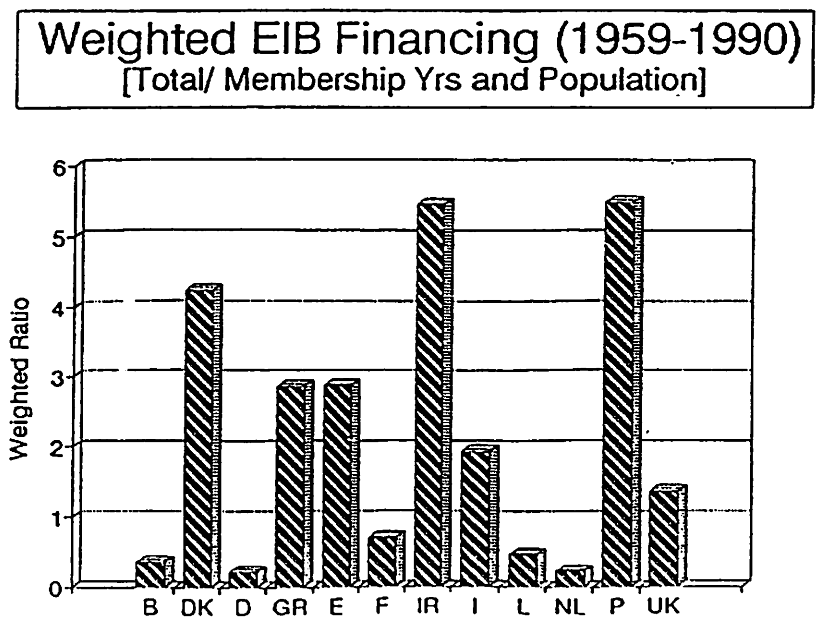
EIB Financing Provided from 1959 - 1990
[million ECUs and thousands (population)]

Member Countries	1 1959-1990	2 % of Total	3 Years of Membership	1/3 Total / Years	4 Population*	1/4 Total / Population	5 1/3 :4 (x100)**
Belgium	1131.4	1.2	32	35.4	9948	0.11	0.4
Denmark	3916.9	4.1	18	217.6	5148	0.76	4.2
Germany	4341.0	4.5	32	135.7	62857	0.07	0.2
Greece	2872.3	3.0	10	287.2	10046	0.29	2.9
Spain	5597.1	5.8	5	1119.4	38957	0.14	2.9
France	12432.2	12.9	32	388.5	56420	0.22	0.7
Ireland	3461.1	3.6	18	192.3	3527	0.98	5.5
Italy	35588.2	36.9	32	1112.1	57637	0.62	1.9
Luxembourg	57.0	0.1	32	1.8	377	0.15	0.5
Netherlands	1115.9	1.2	32	34.9	14951	0.07	0.2
Portugal	2690.9	2.8	5	538.2	9808	0.27	5.5
United Kingdom	14080.6	14.6	18	782.3	57341	0.25	1.4
Other	9061.8	9.4					
Total	96346.4	100.0			327072	0.29	

* Population for 1990
**EIB financing deflated by time of membership and population. (The indicator is multiplied by 100).

Source: EIB Annual Report, 1990.

Figure 2



Thus, the Bank has played a very crucial role in backing European trade integration, as a support to regional policies (mainly in more backward regions, such as in Southern Italy and also in declining regions, such as parts of the North of England). The EIB has also played an equally crucial role in facilitating the building of major intra-European infrastructure, important for facilitating trade integration.

The ESF

Strictly speaking, the European Social Fund in its original form did not represent an instrument of regional policy. Its objective was social (unemployment) and not a regional one. But as long as the regional problem was one of unemployment (the original idea), the social objective of the Fund would contribute at the same time to a solution of the regional problem.

The appropriations of the Fund increased very rapidly. The aid granted approved went up from 269 million u.a. in 1973 to 575 million u.a. in 1979, 1,413 million ECUs in 1985 and 3,671 million ECUs in 1990. (See Table 1 above). The interventions of the ESF were increasingly concentrated in the less developed regions of the Community. This was probably a result of the 1977 reform which ruled that at least 50 per cent of the overall aid granted had to be channelled into the less developed regions, defined as those regions eligible for ERDF support. In fact, this was a confirmation of the status quo as in 1976 and 1977 more than 70 per cent of the ESF appropriations went to less developed regions. In 1981, this share increased to 87 per cent and 90 per cent in 1982.

The 1983 reform went even further in the direction of concentrating on the poorest regions. Of the annual operations, 44.5 per cent should be made available for operations complying with the guidelines for the management of the Fund and aimed at promoting employment in Greece, Ireland, the Mezzogiorno, Portugal, Spain, Northern Ireland and the French overseas departments. The remaining appropriations were to be directed into operations to expand employment in areas of high and long-term unemployment and/or industrial and sectoral re-structuring. Due to the concentration of its aid in the less developed regions, the Fund became a valuable complement to the ERDF and a very useful instrument of regional policy.

Table 8 calculates the redistribution impact of the ESF for three different periods; 1978-80 (for EC-9), 1981-85 (for EC-10) and 1986-89 (for EC-12). The share of the richer countries of the Community are very low throughout the period examined. Column 15 deflates total ESF per capita financing for every country, taking into account the differences in membership periods of member states. Ireland is the main beneficiary followed by Portugal, Greece and Spain (see Figure 3). Therefore, it is clearly the poorer countries that are benefitting. as intended.

Table 8

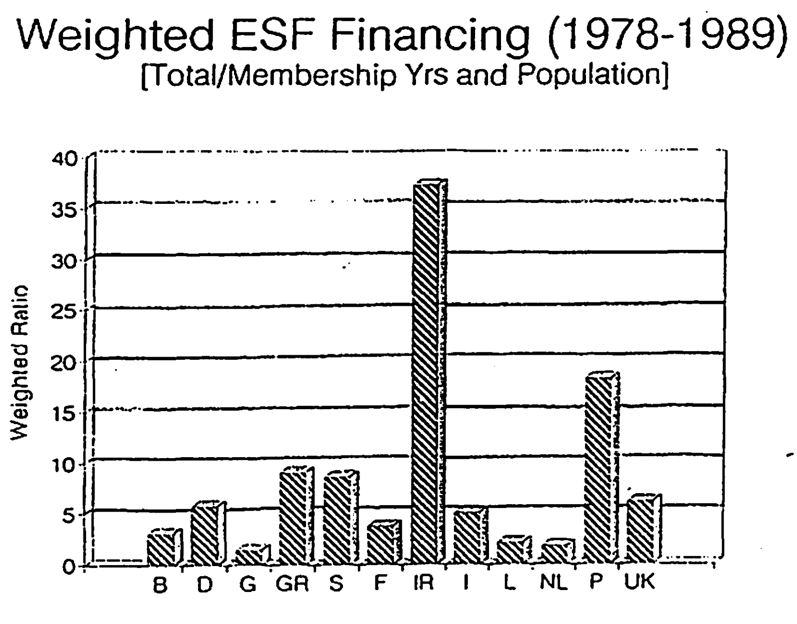
Redistributive impact of ESF (million EUA and ECU) - 1978-89

	1 Population (1990)	ESF for EC-12 (1978-1989) 11 Total	12 Percent	13:(11/1)*1000 Weighted	14 Years of Membership	15:(13/14)
Belgium	9948	380.3	2.2	38.2	12	3.2
Denmark	5148	361.7	2.1	70.3	12	5.9
Germany	62857	1176.9	6.8	18.7	12	1.6
Greece	10046	825.1	4.8	82.1	9	9.1
Spain	38959	1363.3	7.9	35.0	4	8.7
France	3527	2592.4	15.1	45.9	12	3.5
Ireland	3527	1574.4	9.2	446.4	12	37.2
Italy	57637	3583.2	20.8	62.2	12	5.2
Luxembourg	377	9.8	0.1	26.0	12	2.2
Netherlands	14951	332.7	1.9	27.3	12	1.9
Portugal	9808	717.8	4.2	73.2	4	18.3
UK	57394	4271.0	24.8	74.4	12	6.2
EC-12	327072	17188.6	100.0	52.6		

Note: The weighted ESF financing is calculated by dividing the total amount for each period over the population multiplied by 100.

Source: Court of Auditors Annual Report, authors' own calculations

Figure 3



The EAGGF

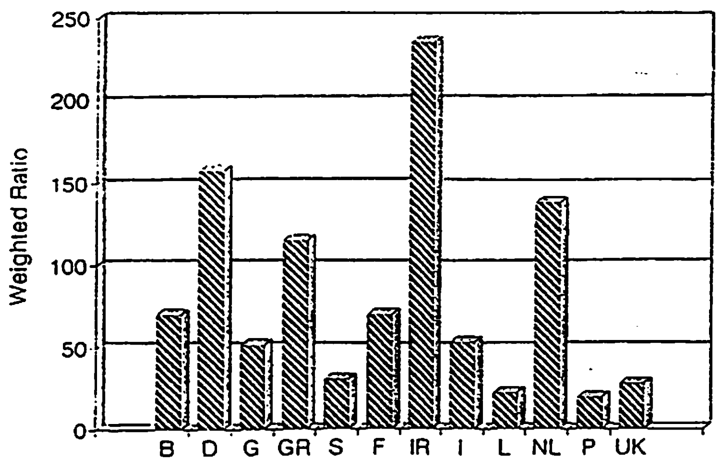
The link between the EAGGF and the regional policy of the EC is indirect. The agricultural regions of the EC are frequently the poorer areas but since the Community support mechanisms of the Common Agricultural Policy are essentially linked to the volume of production, it is a logical result that CAP price policy leads to more support for those who produce more. In the beginning of the 1980s it was clearly demonstrated that the regions of the North and to a lesser extent the Centre, were better supported than the peripheral regions of the South. This pointed to the necessity of co-ordination of the EAGGF with other regional policy instruments. This basic approach guided the Commission in its preparation of the integrated Mediterranean programmes in 1985. The reform of the Structural Funds in 1988 is another step towards the increase of the regional impact of the EAGGF.

Figure 4 shows the redistribution impact of the EAGGF for the 1979-89 period. The lack of any substantial redistribution effect from the Agricultural Funds in favour of the poorer areas of the Conmmunity is obvious. Figure 4 deflates total EAGGF per capita financing for every country, taking into account the differences in membership periods of member states. The shares of EAGGF allocation for Denmark and Netherlands are fairly high, although poor countries like Ireland and to a lesser extent Greece also benefited quite substantially. Indeed, Ireland is the country that benefited the most. On the other hand, some poor countries like Portugal and Spain are allocated the lowest shares (with the exception of Luxembourg) in per capita terms. Although it can be argued that EAGGF funds support the poorer areas of the rich countries in which they are allocated, still the net redistributive effect of the Fund is very unclear.

The Fund has been the most important instrument of the EC budgetary expenditure. It accounted for 73.5 per cent of total expenditure in 1971, 69.9 per cent in 1985, and dropped to 57.7 per cent in 1990. (See Table 1). The declining trend of the share of the EAGGF in the Budget of the Community is indicative of the intentions of the EC to boost the respective share of the ESF and the ERDF in order to strengthen its regional redistribution policies further. (See again Table 1, please.)

Figure 4

Weighted EAGGF Financing (1978-1989)
[Total/Membership Yrs and Population]



The ERDF

The importance of the ERDF in certain regions of the Community was substantial. In 1989 while the Fund's commitment total appropriations represented 8.2 per cent of the Community budget, equivalent to only 0.08 per cent of the EC GDP, in Greece, Ireland and Portugal it accounted for 1.3, 1.0, and 1.4 of GDP respectively (see Table 9). It was over 6 per cent of those countries' total investment. These shares are going up significantly till 1993 (see again Table 9).

Table 9

Commitments of the ERDF and the three Structural Funds as a percentage of investment and GDP in Objective 1 regions, 1989 and 1993.

Objective 1 regions	ERDF expenditure as a percentage of				Three Structural Funds as a percentage of GDP	
	Investment (GFCF)		GDP			
	1989	1993	1989	1993	1989	1993
Greece	6.8	7.8	1.3	1.7	2.3	2.9
Ireland	5.8	6.3	1.0	1.3	2.2	2.7
Portugal	4.9	6.0	1.4	2.1	2.7	3.7
Parts of Spain	2.5	3.0	0.6	0.8	1.1	1.2
France	3.1	10.0	0.7	2.2	3.3	4.6
Italy	2.1	2.8	0.5	0.6	0.7	0.9
United Kingdom	2.6	2.1	0.6	0.4	1.1	0.9
Total	3.1	4.1	0.7	0.9	1.2	1.6
EC-12	0.5	0.6	0.1	0.1	0.2	0.3

Source: Estimates by DGXVI.

From 1975 to 1988 Italy was allocated 32.4 per cent of the total ERDF financing commitments (almost all of it for the Mezzogiorno), the United Kingdom 20.9 per cent (to assist declining industrial areas), France 11.5 per cent (mainly for its overseas departments) and Greece 10 per cent.

Table 10 shows the clear redistributive effect of the ERDF. By dividing ERDF financing by the years of membership and population, we observe that the major beneficiaries are Portugal, Greece, and Ireland (see column 4, Table 10 and Figure 5).

As we have already discussed earlier, the 1988 reform of the Structural Funds implies among other factors an important enlargement of their commitments by 1993 to levels approximating 2 per cent of the GDP of Greece, Portugal and Ireland and 6-8 per cent of their total investment. Therefore, we can conclude that ERDF transfers are now playing a sizeable role in promoting investment in poorer regions.

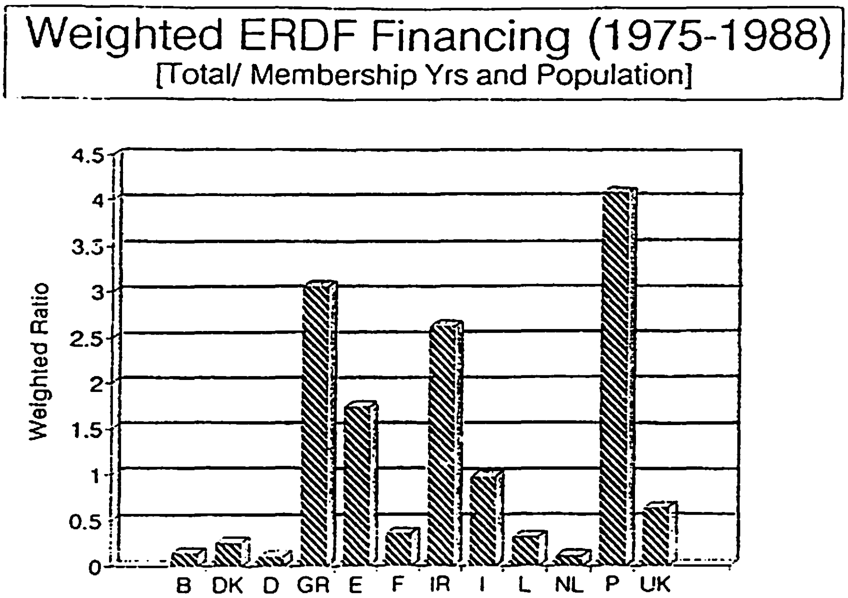
Table 10
ERDF Financing Commitments from 1975-1988
[million u.a. (1975-78), million ECUs (1978-88) and thousands (population)]

Member Countries	1 1975-1988	2 Years of Membership	3 Population*	4 1/3:4 (x100)**
Belgium	203.7	14	9879	0.1
Denmark	182.7	14	5130	0.3
Germany	927.6	14	61449	0.1
Greece	2447.8	8	10005	3.1
Spain	2034.4	3	38809	1.7
France	2814.1	14	55884	0.4
Ireland	1301.9	14	3538	2.6
Italy	7912.0	14	57441	1.0
Luxembourg	16.6	14	373	0.3
Netherlands	247.7	14	14760	0.1
Portugal	1199.8	3	9777	4.1
United Kingdom	5103.3	14	57065	0.6
Total	24391.6		324110	

* Population for 1988
** ERDF financing deflated by time of membership and population. (The indicator is multiplied by 100)

Source: Commission of the EC, Eurostat 1990

Figure 5



Summary of Findings

Summing up this brief evaluation of the performance of the major policy instruments of the EC, the following can be observed: (a) There is an increasing redistributional impact from the operations of the EIB, ESF and ERDF, towards poorer countries. This is true both absolutely (allocations as a per cent of total finances) and relatively (deflating the allocations accordingly to allow for distortions due to differences in periods of membership, and to calculate the per capita effect of the Funds); (b) There is clearly no significant redistributive effect in the operations of the EAGGF, (and some of it seems regressive) however its share in the total EC budget is decreasing; (c) The shares of EIB, ESF, and ERDF in total EC expenditures have been continuously increasing in the last decade and will be doing so even more dramatically in the years to come. The trend in the net effect of the EC budget <u>increasingly favours redistribution</u>. Furthermore, by 1993, the three Structural Funds are expected to disburse almost 3 per cent of Greece and Ireland's GDP and almost 4 per cent of that of Portugal.

Thus, looking to the future, if an important part of these resources are used for funding additional investment, in raising labour force qualifications, infrastructures and the real capital stock of firms, substantial and lasting effects are expected on the supply in these economies, which should lead to higher levels of output, incomes and employment. Furthermore, given their large size, the transfer of resources via the Structural Funds will alleviate possible balance of payments constraints and allow a direct increase of available goods via imports. Due to the positive impact on both the domestic and external financing of investment in the relatively poorer countries, fairly large direct and indirect dynamic effects are expected to take place in the poorer countries and regions of the Community. Table 2 above shows most recent Community estimates on the projected impact of Structural Fund disbursements on growth of poorer countries and poorer regions; as discussed above, the projections indicate that at least 0.5 per cent annual additional growth of GDP in Ireland, Greece and Portugal is projected to result from the effects of Structural Fund disbursements. EIB lending also provides additional resources, at cheaper costs and/or to areas and sectors where otherwise lending might not be available.

2. Performance of Member Countries

ITALY

The existence of considerable disparities at the national level in the 1960s between Italy and the rest of the EC-6 is well recognised. The GDP per capita of Italy was in 1960 only 75.2 per cent of the average GDP of EC-6 and 60 per cent of the average GDP of Germany and France.[24] (See Table 11).

In 1970 the figures had increased dramatically to 87.1 and 67.9 respectively. The decade of the seventies was not as good for Italy as the 1960s in terms of convergence with the performance of the North of the EC. Nevertheless, the average GDP per capita for the 1970s was at 78.4 per cent of the EC, still a significant increase in comparison with the figures of 1960. Convergence with the EC average advanced spectacularly in the second half of the 1980s, and in 1989 Italy exceeded the EC average for the first time. In 1992 Italy's GDP per capita was expected to surpass that of the EC by 4.2 per cent.

IRELAND

When Ireland joined the EC in 1973, its GDP per capita was at 53.6 per cent of the average of EC-9 and 41.3 of the average of Germany and France. By 1980 the figures were 57.4 and 44.3 respectively. This positive trend continued for Ireland throughout the 1980s and in 1990 the Irish GDP per head was at 65.3 of that of the EC (see Table 11).

Table 11
European Community, GDP per capita 1961-1990
(Indexed: EC-12=100)

	B	DK	D	GR	S	F	IR	I	L	NL	P	UK	EC-12	EC-6	EC-9
1960	115.4	123.2	128.8	39.8	36.3	126.9	59.1	75.2	158.0	97.0	28.0	131.1	100.0	101.0	102.1
1961	112.4	124.5	127.7	40.9	37.7	125.8	58.7	76.3	143.6	96.4	27.7	126.4	100.0	99.0	100.4
1962	110.7	128.6	127.3	39.9	40.0	127.5	58.5	78.7	138.2	95.2	27.3	121.7	100.0	98.4	99.9
1963	109.0	125.5	123.8	41.0	43.2	129.8	57.6	82.6	134.5	94.2	27.1	118.2	100.0	97.9	98.7
1964	110.5	129.7	123.3	41.9	44.1	130.1	59.4	81.5	138.9	99.7	26.6	116.8	100.0	99.7	100.4
1965	110.8	134.1	123.0	44.0	47.1	128.6	58.5	80.7	133.8	102.0	27.6	116.0	100.0	99.6	100.7
1966	110.4	136.7	121.1	45.4	50.3	128.9	57.4	81.3	130.3	102.0	28.3	114.8	100.0	99.2	100.5
1967	111.8	139.8	116.6	46.1	52.1	131.0	58.2	84.6	124.3	105.6	30.1	112.1	100.0	99.2	100.6
1968	114.1	138.8	120.3	47.9	48.6	135.1	54.8	87.7	129.8	110.9	32.0	101.5	100.0	101.9	100.7
1969	114.4	142.3	123.6	49.4	49.7	132.7	57.3	87.1	135.6	112.9	32.2	98.8	100.0	103.9	102.4
1970	115.0	140.1	133.3	49.5	49.1	123.4	57.4	87.1	142.7	112.2	32.2	97.0	100.0	106.6	103.8
1961-70	111.9	134.0	124.0	44.6	46.2	129.3	57.8	82.8	135.2	103.1	29.1	112.3	100.0	100.5	100.8
1971	114.1	138.2	136.4	48.3	49.1	121.3	58.9	84.7	130.7	114.8	32.6	97.5	100.0	105.0	102.7
1972	118.1	141.9	136.8	46.3	51.8	123.7	60.4	82.2	135.2	117.8	33.5	93.8	100.0	107.0	104.2
1973	119.9	147.6	144.0	47.4	54.2	126.3	55.8	78.5	145.9	121.7	35.5	83.6	100.0	110.7	105.7
1974	126.6	147.5	143.6	49.1	59.9	120.9	52.3	79.8	158.6	128.5	36.9	81.4	100.0	116.2	108.7
1975	127.2	150.0	136.2	46.5	60.3	131.0	53.3	77.2	132.6	128.4	34.1	83.9	100.0	110.3	105.5
1976	133.1	160.1	141.5	48.2	59.7	131.5	50.7	73.8	140.1	135.3	33.9	78.3	100.0	113.9	108.1
1977	136.6	157.8	145.0	48.5	58.4	126.7	52.5	75.0	136.7	139.5	31.3	78.1	100.0	115.2	108.5
1978	135.2	154.9	146.2	46.9	56.6	126.9	54.7	74.5	137.9	137.9	27.6	80.4	100.0	114.7	108.7
1979	127.3	148.4	142.6	46.5	61.5	125.3	55.4	76.3	132.2	129.2	25.5	85.9	100.0	111.5	106.5
1980	121.7	131.4	134.2	42.3	58.3	125.2	57.4	81.5	126.7	121.6	27.4	96.9	100.0	107.3	103.3
1971-80	126.0	147.8	140.7	47.0	57.0	125.9	55.1	78.4	137.7	127.5	31.8	86.0	100.0	111.2	106.2
1981	113.3	129.5	128.0	44.1	57.1	124.6	61.5	83.8	121.0	115.0	30.2	105.3	100.0	103.0	101.6
1982	104.5	131.6	129.0	47.6	57.4	122.5	65.9	86.0	115.0	116.6	29.9	104.2	100.0	101.4	101.1
1983	102.2	136.8	133.3	44.4	51.3	120.0	65.5	91.7	116.7	116.0	27.4	101.8	100.0	101.9	101.7
1984	101.8	139.7	132.0	44.8	53.9	118.9	65.9	95.1	119.9	113.2	26.2	100.1	100.0	102.7	102.4
1985	102.8	144.1	129.4	42.6	54.6	120.4	67.1	94.4	119.7	110.4	27.0	102.3	100.0	101.9	102.8
1986	104.7	148.9	134.9	36.5	55.3	122.2	65.6	97.4	125.7	111.2	28.1	91.2	100.0	104.9	103.9
1987	106.1	149.7	136.9	34.5	56.7	119.3	63.1	98.7	124.9	108.6	28.2	90.5	100.0	105.3	103.9
1988	103.4	144.1	132.4	35.8	60.1	115.7	62.6	98.0	122.3	104.3	28.9	98.8	100.0	103.4	102.9
1989	103.2	138.7	128.6	36.2	65.5	114.4	65.7	100.9	124.9	101.0	31.0	98.1	100.0	104.0	102.8
1990	104.9	137.9	129.2	35.3	68.4	113.9	65.3	102.1	124.5	100.9	33.1	94.0	100.0	105.0	103.0
1981-90	104.7	140.1	131.4	40.2	58.0	119.2	65.7	94.8	121.5	109.7	29.0	98.6	100.0	103.3	102.6
1991	103.5	133.5	129.5	35.8	70.8	110.5	63.2	103.3	125.1	99.9	37.0	94.1	100.0	105.4	102.5
1992	103.4	132.1	129.2	35.8	72.2	109.0	62.6	104.2	126.2	97.4	39.9	94.1	100.0	105.4	102.4

Source: European Economy, Annual Economic Report, No 50, Dec. 1991.

GREECE

Greece is the exception to the rule of convergence of incomes in the EC. When she joined the Community her GDP per capita was 44.1 of the average EC. In the second half of the eighties the performance of the Greek economy deteriorated and her GDP indicators started diverging from the EC average. In 1990 Greece's per capita GDP was at only 35.3 per cent of the average EC performance (see Table 11).

The relatively poor performance of Greece has been studied extensively and has been attributed to several endogenous factors (eg macroeconomic mismanagement and excessive government spending), and exogenous (eg EC commercial policies).[25] In the context of this discussion, however, it is important to stress the fact that Greece failed to absorb a significant amount of regional aid available.

SPAIN and PORTUGAL

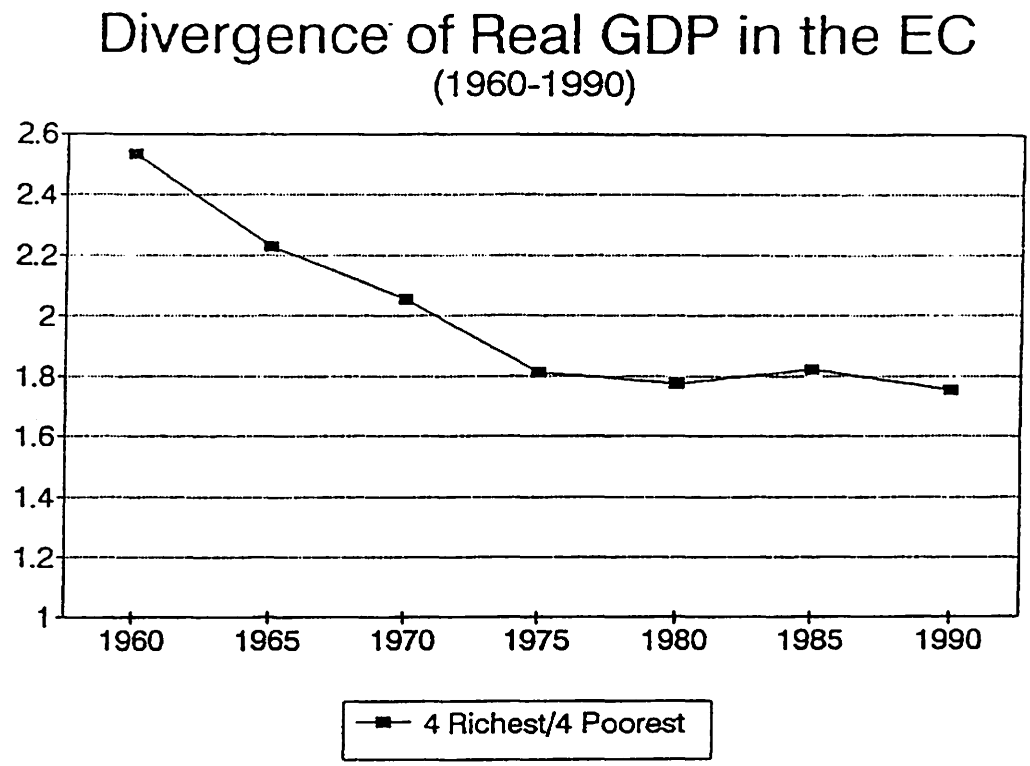
Spain's GDP per capita had the most dramatic improvement in the six years of EC membership. It started at 55.3 per cent of the EC average and it is estimated to reach 72.2 per cent in 1992. The performance of Portugal is also admirable; in 1986 when it joined the EC its GDP per capita was at 28.1 per cent of EC average. In 1990 it had risen to 33.1 and is expected to reach 39.9 per cent in 1992 (see Table 11).

Summary of Findings

With the exception of Greece, there has been a substantial convergence of national incomes in the Community. The most significant period of convergence started in the 1960s and ended in the mid 1970s, at the time of economic recession. During the first half of the 1980s disparities in incomes per head remained at around the same level and in the second half of the 1980s, a trend towards further convergence started against a background of more vigorous economic growth in the EC, and enhanced redistribution mechanisms within the EEC.

These trends can also be observed in the comparison of real GDP over the years 1960-1990. The ratio between the 4 richest and the 4 poorest countries of the EC declined substantially until 1975. In the first half of the 1980s a slight regressive phase is observed which, however did not continue in the second part of the decade, when divergence again decreased (these trends are shown in Figure 6).

Figure 6



(*) This indicator reflects the ratio of Real GDP of the 4 richest to the 4 poorest countries.
Source: Own calculations based on Eurostat data.

It cannot, of course, be mechanically argued that regional policies are the only (or even the main) cause of growing convergence within Europe. Indeed overall growth seems an important element in explaining convergence. However, the existence and scale of regional policies in the EEC is clearly also an important factor for explaining growing convergence in that region, as the evidence presented above shows.

3. Performance of the Regions

At the level of regions (at NUTS level 2) the trend in disparities in income per head was similar to the trend observed at the level of Member States.[26] This was supported by Molle (1990)[27] whose findings are summarised in Table 12.

Table 12

Indices* of regional disparities of wealth in the EC 1950-1987

	1950	1960	1970	1977	1987
#1 disparity among regions	0.1241	0.1020	0.0775	0.0983	0.0689
#2 disparity among countries	0.0948	0.0808	0.0610	0.0821	0.0519
#3 2:1 in %	76	79	79	84	75

* Theil indices of Gross Regional Product per capita
Source: Molle (1990)

Of course the disparities between the poorest and the richest regions of the Community are much larger than the national ones. In 1970 the regional GDP per capita of Calabria was 36 per cent of the EC average while that of Hamburg was 177 percent of the EC average (a ratio of 1/4.9).[28] In 1988 the ratio decreased to 1/3.1 as the GDP per capita of the regions converged.

A very recent detailed study (Leonardi 1991)[29] was conducted on a time-series basis, covering two decades (1970 to 1990), using two dependent variables for the measurement of cohesion among the regions of the Community: (i) GDP per capita and (ii) Purchasing Power Standards (PPS). The first variable is an indicator of the level of productivity while the second, of the level of well-being.

The results of the study of the dependent variables were then compared with one independent variable, the level of EC expenditure on regional policies, to measure whether the scale of EC contributions is correlated with changes in economic growth and social well-being.

The findings of the study are summarised as follows:

(a) There has been a significant reduction of the cohesion gap between the core and the peripheral regions in the EC. Comparing the level of economic cohesion between the five most and the five least developed regions between 1970 and 1989, the gap in 1970 was 3.5/1 and in 1989 it had declined to 2.5/1 (Variable 1: GDP per capita). For variable 2 (PPS) the results were 3.0/1 and 2.1/1 respectively.

(b) The gaps decreased more significantly during the first decade (1970-1981). The regions of the three peripheral member states after the enlargements (1981 and 1986) have varied performance: Spanish regions show tendency towards convergence; half of the Portuguese regions show tendencies towards convergence while the other half towards divergence; Greek regions demonstrate a consistent tendency towards divergence.

(c) The level of correlation between regional policy expenditure and the performance of the variables is somewhat low until the beginning of the 1980s but <u>increases significantly as the expenditures and the institutional - administrative capabilities of the structural funds increase</u>. However, it should be stressed that in a counterfactual situation where regional policy would not exist, divergence among the rich and the poor regions would have most probably increased, due to the reasons discussed above (see pp. 4 and 5).

Summary of Findings

It can be concluded from available EC studies that disparities of income levels between countries and between regions have decreased since the EEC was created, and as new members have joined. This was particularly true in the early "golden years", when growth in all the EEC was very rapid and also more recently, since the late eighties, when regional policy instruments have seen their size increase and their targeting sharpened. Therefore, ancillary financial mechanisms have played a fairly important, and increasing, role in reducing income and other disparities within Europe. It should however be stressed that other factors such as rapid growth (in some periods) and economies of scale in the context of trade integration have also played an important role. Besides the economic impact, there has been an equally important political impact, in that poorer regions/countries and/or those which fear possible negative effects of increased trade integration have been reassured of the positive long-term effects of such integration, and have therefore remained supportive or even enthusiastic about the process. It is also worth stressing that the political needs and demands for regional policy measures in the EEC have changed through time, with a tendency to increase. This would seem to offer lessons for the WHFTA (see below).

D. Lessons from European ancillary and financial policies for the WHFTA

A variety of interesting lessons can be extracted from the EEC experience, for the WHFTA, particularly because the EEC has overall been so successful in a number of aspects. Naturally, lessons have to be carefully drawn, as there are obviously many and important differences between a future WHFTA and the EEC experience.

A first lesson which becomes clear from the EEC experience is that, besides so-called negative integration (trade integration via reduction of trade barriers), it is necessary to have positive integration measures, to support the development of poorer or declining regions, a) to compensate and above all help provide alternative sources of income to any potential "losers" of the process and b) to provide supporting elements for an integrated market, such as trans-border connections of infrastructure, in the broadest sense.

In the case of the EEC, new institutions had to be created for these purposes, such as the EIB, the ESF and the ERDF. In some ways, the Western Hemisphere integration would have an easier task, as some of the appropriate institutions already exist.

In the context of financial measures to support the trade integration process, the existence of a large regional development, the Inter-American Development Bank (as well as its well-established reputation and its long experience in lending to Latin America and the Caribbean, its long expertise in project lending, as well as more recently in sectoral lending) is a valuable asset.

There would therefore seem to be a strong case (drawing on the EEC experience and on the IADB's strengths) to significantly expand the scale of operations of the IADB, and to gear an important part of these increased operations to the new needs related to trade integration in the context of WHFTA as WHFTA progresses. In this context, drawing again on the EEC experience, it would seem logical that such enlargement of IADB resources and roles, would be taken in parallel (or even slightly before) steps taken towards trade integration in the WHFTA.

A complement to this option would be to create special institution/s tailored to support progress in the WHFTA. In this context, Fishlow's

(1992, op. cit.) proposal of a North American Development Bank and Adjustment Fund (NADBAF) in the context of NAFTA is very interesting. Such a new institution would not just fund projects in the relatively poorer countries (in this case Mexico), but also in relatively richer countries (in this case US and Canada), for facilitating re-allocation of resources (for example by financing re-training of workers), in response to increased Mexican competition. Clear parallels emerge with the functions performed by the European Structural Funds and by the EIB in Europe, to provide funding for countries like Britain, some of whose industries are declining and have difficulties facing increased competition. Another function, which would primarily benefit Mexico, would help meet the need for integrated border development (including infrastructure), fund projects for environmental improvements and support expansion of social infrastructure aimed at improving trade performance. This part of the finance could either be provided by the special Fund or jointly with the IADB, or disbursed via the IADB, given its expertise in these areas. Indeed, the IADB already has extensive expertise in evaluating, funding and monitoring infrastructure projects, as well as having a valuable past experience and increased emphasis at present and in future on lending for the social sectors. Thus, an expanded role for the IADB in the context of supporting ancillary measure for the WHFTA would flow very smoothly from the IADB's past experience and future plans. Emphasis on increased lending for investment in sectors such as education, health, and technological innovation, that the IADB is planning would clearly be particularly valuable in a contest of improving LAC countries' international competitiveness in the context of a WHFTA, thus helping reduce negative effects on them from such trade integration, as well as enhancing positive effects of such integration.

Again, parallels from Europe show that the EIB and the Structural Funds are increasingly collaborating in pursuing Community objectives, and that such collaboration is very fruitful.[30]

When and if NAFTA is broadened to other countries, the NADBAF could be expanded, as could its collaboration with the IADB.

A second lesson from the European experience for the WHFTA is that different needs of positive integration arise as trade integration progresses; such needs tend to increase as does political support for them, as both benefits and costs of integration become evident.

It seems important in the case of the WHFTA for clear ideas on positive integration measures to be developed early with a fairly detailed blueprint/s throughout; political realities and the nature of the bargaining process will determine when the institution's creation is actually approved and/or their funding is approved. There may therefore be a case, in the initial stages of a WHFTA, for the relatively poorer countries to focus on bargaining for the recognition of the principles of the need for ancillary redistributive policies, and for relatively limited specific measures to be adopted. As the WHFTA both deepens and widens, the case for enlarging such policies can be better made.

The LAC countries should also evaluate sympathetically any ancillary measures that the U.S. or Canada propose (e.g. in the field of environment protection), attempting either to transform them as far as possible into instruments that will help their own development and/or bargain acceptance of such ancillary measures conditional to the U.S. and Canada accepting ancillary measures of the kind that will favour the LAC countries.

As regards recognizing the principle of the need for ancillary redistributive policies, it would be valuable to include in the Treaty that will establish a WHFTA (and indeed previous stages like NAFTA), a clause similar to Article 2 of the Treaty of Rome, referring to the objective of promoting harmonious and balanced development among member states. Furthermore, provision should be made for the creation of specific instruments to carry out redistribution policies.

Economic and ideological realities will influence not just the scale and timing of approval of redistributive measures/institutions, but also their features. An interesting issue in the context of the WHFTA is the extent to which private flows can directly or indirectly be channelled/encouraged to achieve some of the ancillary purposes described above. However, where private lenders/investors are unable or unwilling to become involved (due for example to low private profitability, very long maturities, the need to attract investment in very poor areas, with little infrastructure, etc.), public funding (or public guarantees) may become acceptable as necessary to all parties involved. The recent establishment by the EEC and the EIB of a public guarantee facility to encourage private long-term lending in infrastructure seems to offer relevant lessons of innovative mechanisms for the WHFTA, especially in the context of increasing international private flows to the LAC region.

A third lesson from European integration is that a very strong impulse for the creation and improvement of financial instruments came from the Commission itself, and the other Community institutions, bodies which to some extent (and with some natural limitations) represented the <u>European interests of trade and other integration</u>.

There would therefore seem to be a need in the context of WHFTA to create similar institution/s to promote and support the WHFTA <u>interests of trade integration</u>. Existing institutions such as the IADB, ECLAC, OAS clearly have an important role to play (especially as their role expands to meet this new challenge), but it may be necessary also to create new institutions for this purpose. Clearly further thinking and study is required in this important institutional task.

Though very fruitful lessons can be extracted for the WHFTA from the EC experience, it should be stressed that the WHFTA naturally would have very different structural characteristics to those of the EC when it was created. Thus, income differentials between countries would be far larger in the WHFTA, as would be the relative size of the poor economies. This both increases the need for, but may also limit the extent to which it is politically feasible, to make major public transfers of official resources from rich to poor countries.

Further, there are at present very large private flows from the rich countries in a future WHFTA to the poorer ones. If these flows are sustained, to some extent and in some countries (the more successful and less poor) those private flows may - albeit with some limitations - perform the function which official flows performed in the early stages of the EC; nevertheless, for the relatively poorest countries in a WHFTA, the need for public transfers would clearly remain. For the relatively less poor countries in the WHFTA, institutions like the IDB could play a central role in helping to catalyse such private flows (as well as possibly regulate them, so they become more sustainable).

Another feature of the WHFTA is that free movement of labour has not been mentioned in the discussions. If, as seems very probable, free movement of labour does not become an objective of a future WHFTA, there is a particularly strong case for ancillary redistributive measures that will: a) compensate the poorer countries for not allowing free movement of labour and b) providing incentives - via measures that encourage creation of productive employment in the poorer countries - to discourage migration both legal and illegal. This gives a particularly strong case for ancillary redistributive measures. This is a case which the poorer countries in the WHFTA would need to make forcefully and to which the rich countries would seem likely to be sympathetic.

Finally it should be stressed that it is difficult in this paper to define suggestions for the precise scope of ancillary policies for a WHFTA, as the nature of the WHFTA is as yet not clearly defined. However, what is clear is that whatever the nature of the free trade area that emerges in the Western Hemisphere, there is a need for explicit provision for ancillary policies to be included. The EC experience can, in this context, be used in a successful precedent; it offers valuable suggestions both on the nature and the institutional structure of the model of redistribution that WHFTA could usefully apply.

1 The terms "negative" and "positive" integration were originally coined by Jan Tinbergen (1965) International Economic Integration (12th ed.). Amsterdam. Elsevier. For another good, early discussion, see J. Pinder "Positive Integration and Negative Integration: Some Problems of Economic Union in the EEC", The World Today, January 1968.

2 See, N. Vanhove and L. Klaasen (1987) Regional Policy: A European Approach. Gower. London. 2nd ed.

3 See, again, N. Vanhove and L. Klaasen, op. cit.

4 See Treaty of Rome - Protocols and Conventions.

5 For a detailed account of the explicit and implicit references in the Treaty of Rome to regional problems see Vanhove and Klaassen (1987).

6 Treaty of Rome, Article 130.

7 Treaty of Rome, Article 130.

8 Based on estimates in EIB Report on the EIB's activities in its first twenty years, 1958-1978. Luxembourg. 1980.

9 Treaty of Rome, Article 123.

10 The rationale behind this argument is the following: Because income elasticity is much higher for industrial than for agricultural products, the demand for workers in industry also tends to increase faster than in agriculture. In combination with the relative immobility of labour, these differences in demand cause substantial and permanent differences in regional income.

11 For a full account see Vanhove and Klaassen (1987).

12 The first medium term programme (1966-70), approved by the Council, contained one chapter dealing with regional policy.

13 European Parliament 15.5.1968.

14 CEE, Doc. Com. (69) 950, Brussels, 15.10.1969.

15 For an account of the legal arrangements of the regulations of 20 October concerning the coordination of aids grants in the framework of regional policy in the central regions of the EEC see Vanhove and Klaassen (1987). The recommendation was twofold: first that regional aids should be transparent and measurable; second, that there should be a distinction between the "central" and the "peripheral" regions, with restrictions on the level of state aid in the central areas.

16 See, E.T. Nevin "Regional policy" in El-Agraa, A. (ed.) The Economics of the European Community. 1990. Phillip Allan, London.

17 For a full account of the negotiations see Ross B. Talbot, (1977), "The European Community's Regional Fund: A Study in Politics and Redistribution", Progress Planning, No 8., Pt 3.

18 For a detailed analysis of its operation and its evolution, see Vanhove and Klaasen, op. cit. For recent and future developments, see, for example, CEC Directorate General for Regional Policy The Regions in the 1990s, Brussels, 1991.

19 It was estimated that the accession of Spain and Portugal had led to a doubling of the population of the least-favoured regions (those with a per capita GDP of less than 50% of the Community average). See Guide to the Reform of the Community's Structural Funds, EC 1989.

20 The European Coal and Steel Community (ECSC) was established by the Treaty of Paris in1951. It contributes to the attainment of economic and social cohesion in the Community by granting loans; (a) either to coal and steel industries to facilitate their modernization, or (b) to investors who, by creating new and economically sound activities, are capable of reabsorbing redundant ECSC workers. The ECSC has not been discussed in detail as an instrument of regional policy because of its minor significance; its operational budget in 1990 was only 488 million ECUs (less than 10% of ERDF).

[21] For an interesting analysis, see P. Honohan Community Lending and the Community Support Frameworks. Report prepared for the EC (DG XXII). June 1991, mimeo.

[22] EC "The Economics of 1992" European Economy. Vol.35, 1988.

[23] For a background study for this, see S. Griffith-Jones Loan guarantee facilities: the issues and possible lessons for a European facility. Report prepared for the European Commission, DG XXII. June 1992, mimeo.

[24] In this analysis disparities are measured in Gross Domestic Product per head, which indicates the income generated in Member States by the resident producer units.

[25] For a study of the trade diversion effects induced by the accession of Greece to the EC see Plummer (1991).

[26] Analysis of socio-economic problems at the regional level requires a definition of "region" which helps to capture as clearly as possible the issues under examination at Community level. The Nomenclature of statistical territorial units ("NUTS") provides a uniform frame of reference for regional statistics. It distinguishes between three levels of regional disaggregation: (a) NUTS I: 64 regions in the EC; (b) NUTS II: 167 basic administrative regions; (c) NUTS III: 824 subdivisions of level II regions.

[27] Molle W.T.M. (1990), "Will the Completion of the Internal Market Lead to Regional Divergence?", in Siebert, H. (ed.), 1990, The Completion of the Internal Market, Symposium 1989, Institut fur Weltwirtschaft and der Universitat Kiel, Tubingen: Mohr.

[28] For the calculation of these figures adjustments have been made for purchasing power differentials between countries. (See Seers and Vaitsos 1980).

[29] Leonardi, R. (1991), "The State of Social and Economic Cohesion in the Community Prior to the Creation of the Single Market: The View from the Bottom Up", EC Commission, DG XXII, Brussels.

[30] See above.

Section C

Lessons from the EC's Regional Trade Preferences

The Foundations of EC-South Relations

For a variety of reasons the EC has developed what is probably the most complex set of regional trade liberalisation systems currently in existence. Has it worked? Has selective regional liberalisation fostered trade in a way that has promoted sustainable economic development among the partners? Can free trade be approached by progressive approximation? Do restricted trade preferences tend to lead on to more substantial liberalisation or to become fixed and unchanging? Are they a 'thin end of the wedge' that, by overcoming protectionist pressures, opens the way to more generalised liberalisation, or do the regional participants themselves become a lobby against broader liberalisation? The answers to these questions are of clear importance to the architects of a WHFTA.

The ostensible objective of the EC's systems has been to foster the growth of exports by its developing country (LDC) partners. Widespread doubts have been expressed on their effectiveness in achieving this goal. These doubts, while well-founded in some respects, have been overstated. There now exists over thirty years' experience to be analysed to illustrate how, and under what conditions, partial liberalisation involving a group of rich and poor countries can promote trade.

Some explanation of the instruments used to effect the partial liberalisation is a necessary background to the analysis of this experience. A characteristic of the European Community (as opposed to the member states) is that it does not possess the full array of attributes of a nation state. It cannot conduct a normal foreign or defence policy; even its responsibilities on debt are limited. Among this limited range of instruments there are three principal foundations for Community-level policies affecting the Third World. They are the Common Commercial Policy (CCP), the Common Agricultural Policy (CAP), and the partially common aid policy. The first two of these form the basis of the preferential trade systems.

Trade policy

The existence of the common external tariff (CET) means that the foundations of Europe's foreign trade regime are established at Community level. The member states adopt a common position at meetings of the GATT and UNCTAD and have negotiated at EC level a host of bilateral and multilateral trade agreements with the Third World states.

The CET's purity is reduced in practice as member states adopt to a greater or lesser extent national policies that influence trade flows. Most important are the growing number of non-tariff barriers (NTBs) to imports. Whereas the EC institutions have an unambiguous responsibility for setting tariff policy, their position on NTBs has been less secure (although this will change as part of the Single European Market). Individual member states have negotiated bilaterally numerous 'voluntary export restraints' (VERs) with developing countries. In addition, there are many national quotas within 'Community NTBs', which restrict the volume of imports that have access to the national markets of particular member states.

The precise number of effective national NTBs is unknown: some are secret, some are not enforced, and some are made on an industry-industry basis and fall outside government scrutiny. But an indication of their extent may be gauged by analysing member states' recourse to Article 115 of the Treaty of Rome. This article, which permits a member to restrict imports from its neighbours of goods originating outside the Community, is a legal linchpin of the national NTB system. Clearly, the Spanish NTB on Brazilian sewing machines would be unsustainable if exporters could evade the restrictions by routing goods indirectly via Germany. During 1988 and the first seven months of 1989, there were sixteen cases of LDC exports being excluded from an EC national market through the use of Article 115, and a similar number of cases in which there was surveillance of imports [Davenport and Page, 1991:43]. The import exclusions were imposed in the French, Italian and Spanish markets; the LDCs affected were Brazil, China, Hong Kong, Singapore and Taiwan; and the products involved were footwear, umbrellas, toys, car radios, televisions, silk, handtools, sewing machines, slide fasteners, videos, imitation jewellery and cars.

The Common Agricultural Policy (CAP)

The CAP is particularly important because of the dominance of agriculture in many developing countries. The transformation of the EC from a major importer of agricultural products to a net exporter of an increasing number of commodities has had profound and complex effects on the Third World. It is the negative effects that receive most attention, and on balance these are quantitatively the most important. But this should not obscure the fact that, as with most complex policies, the CAP's overall adverse impact is the net result of a host of particular effects which are both positive and negative.

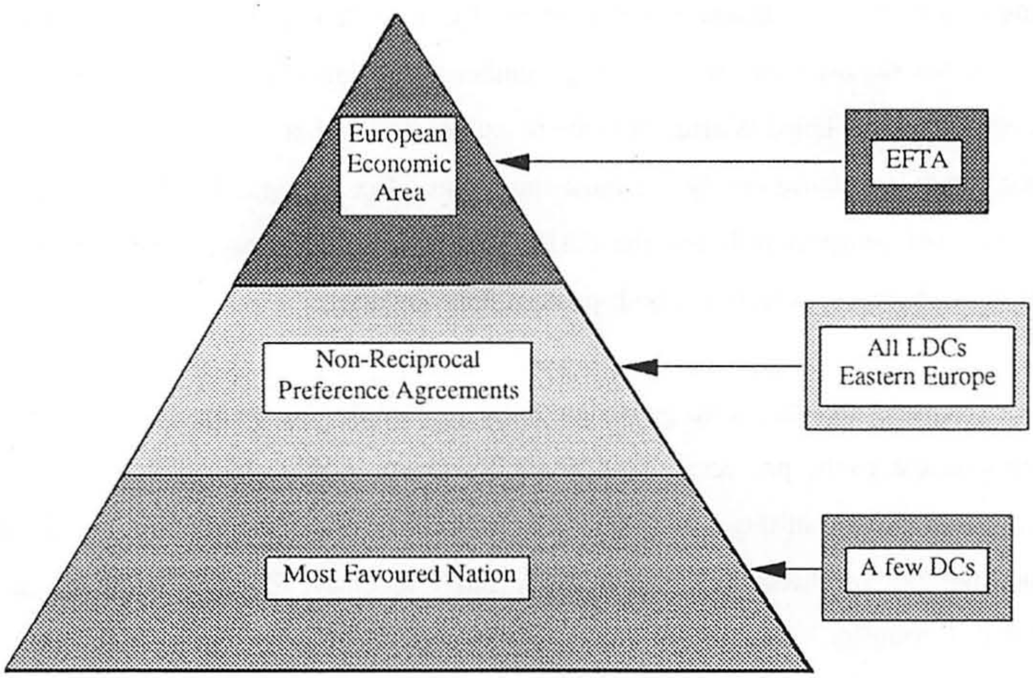
On the positive side are the static gains that some preference-receiving LDCs have gained from limited access to the protected, high prices European agricultural market. These gains are concentrated on some of the signatories of the Lomé Conventions, including the Caribbean states, the non-EC Mediterranean states and, most recently, Poland, Hungary and the Czech/Slovak Republics. Other LDCs have also benefited when the price distortions of the CAP have created a demand for commodities which would not otherwise exist, as is the case of European demand for Brazilian animal feed.

The 'Pyramid of Privilege'

On the basis of these two trade policy instruments plus aid the Commission has fashioned a complex set of agreements through which it has conducted a quasi foreign policy with the rest of the world. The bulk of the EC's trade is now conducted on 'better-than-MFN' terms (Figure 1). These 'preferences' are not restricted to developing countries; the most extensive are with EFTA and are now being deepened in the EEA.

The EC's bilateral and multilateral agreements have been described as a 'pyramid of privilege' by virtue of the fact that those at the top provide more favourable treatment than those at the base. The countries at the top have preferences not only over some developed countries but also over other LDC members of the pyramid. It is therefore a shifting pyramid, since improvements in the terms for states lower down the hierarchy can cut the

Figure 1
The EC trade hierarchy

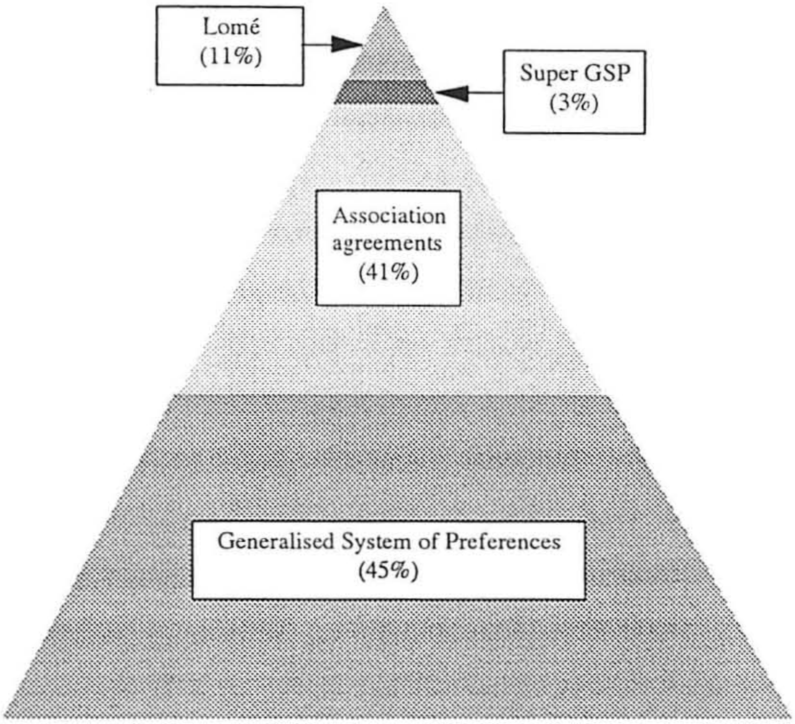


value of concessions made to those higher up (e.g. the EC's new association agreements with Eastern Europe could downgrade the preferences of some western hemisphere states).

The non-reciprocal agreements in the middle band of Figure 1 themselves form a pyramid (Figure 2). These preference agreements can be grouped into four broad categories. The height of each band in the figure is scaled according to the share of the countries represented in each category in EC imports from all of the states covered by the 'pyramid'.

- At the apex of the pyramid sits the Lomé Convention. Under it the sixty-nine African, Caribbean and Pacific (ACP) states - now including Haiti and the Dominican Republic - benefit from the most liberal set of non-reciprocal trade preferences that the EC has offered to any group of states. They also receive more EC-level aid than do other LDCs both in absolute and in *per capita* terms. The practical effects of these liberal trade preferences have been limited, however, by the fact that many of them apply to products that the ACP have a very limited capacity to produce.

Figure 2
The 'pyramid of LDC privilege'



- The Super GSP is available to countries on the UN list of least developed states and, on a temporary basis, to some states in Latin America. The EC granted to four of the Andean Pact states - Bolivia, Colombia, Ecuador and Peru - Super GSP treatment for a range of industrial and agricultural products for four years from the end of 1990. And, from 1992, it has granted similar temporary treatment to Central America, but for agricultural products only. Both sets of agreements expire at the end of 1994; it is as yet unclear whether they will be extended. Where preferences are granted under the Super GSP they are of similar depth to those under Lomé, but the product coverage is less broad.

- In the middle of the pyramid are the Mediterranean states, which are accorded trade preferences that are nominally less favourable than those of the ACP but, in practice, may be the most valuable. The main limitations on these agreements (all of which are bilateral and differ from each other in their details) is that they limit diversification into 'sensitive' products whilst allowing the states to continue with traditional exports, albeit often with quotas.

- The broad base of the pyramid includes all the remaining LDCs (ASEAN, the rest of Latin America outside the Super GSP countries, South Asia, etc.). Despite a number of impressive-sounding 'framework agreements', these countries trade only on terms of the Generalised System of Preferences (GSP) - the lowest common denominator of the EC's trade preferences - and tend to receive less Community aid *per caput.*

At present the western hemisphere is split into six groups in terms of its access to the EC market.

- Most favoured are the 'traditional' Lomé signatories in the Caribbean area.

- Next come the Dominican Republic and Haiti which, although signatories of Lomé IV, do not receive all of the trade preferences available to the first group.

- Third are the quartet of Bolivia, Colombia, Ecuador and Peru, which are accorded Super GSP concessions on many of their exports.

- Fourth are the states of Central America that receive the Super GSP for agricultural goods.

- Fifth are the remaining states of Latin America that obtain only the standard GSP.

- And, finally, there are the USA and Canada, which trade with the EC on MFN terms.

Have Trade Preferences Worked?

One striking feature of this pattern created by formal relationships is that it is the inverse of the pattern created by trade performance over the past two to three decades. At both Community and member state level, sub-Saharan Africa and the Caribbean have been given pride of place in formal policy, while East and South-East Asia have been relatively neglected in Community-level policy and not unambiguously favoured by member states. Yet during the period from 1975 to 1990 the ACP's share of EC imports from LDCs fell by one-quarter. Indeed, the ACP share of EC imports from outside the Community fell from 10% in 1960 to 4% by 1990. The East Asian NICs' share of extra-EC imports, by contrast, rose from 1% in 1970 to 5% by 1990.

So sharp has been the contrast between the ACP's position as most preferred and yet least successful trading partners with the EC that commentators have begun to question the efficacy of the EC's extensive preference system and, moreover, to assert that since the ACP have gained little from preferences their potential losses from liberalisation will be correspondingly modest [see, for example, Brown, 1988; Davenport, 1988].

The apparent lesson for a WHFTA is clear - if thirty years of trade preferences under Lomé and its predecessors have been ineffective, what chance is there that western hemispheric liberalisation will foster trade growth? The Lomé Conventions represent probably the most extensive experiment in this area. If they have failed, other schemes, like the WHFTA, need to learn from the shortcomings. Similarly, to the extent that they have succeeded there will be lessons to be learned by the architects of a WHFTA.

However, it is too easy to write off the Lomé trade preferences as valueless (and, by implication, to cast doubt on a WHFTA); much more cautious conclusions are required. The ACP's poor overall performance reflects the very heavy concentration of their exports on traditional, unprocessed primary commodities. This has had two consequences:

- First, the Lomé Convention, despite its liberal potential, has in practice provided the ACP with either zero or very limited preference over their major competitors for the greater part (by value) of their exports because MFN tariffs on these products are low. In 1987, five commodities accounted for 63% of the total value of ACP exports to the EC. They were crude petroleum, coffee, cocoa, copper and rough wood; the EC's MFN tariff rates were 0%, 5%, 3%, 0% and 0% respectively. Moreover, there are no major non-tariff restrictions on imports into the EC of most traditional ACP exports.

- Second, ACP exports have been more heavily concentrated than are those of other LDCs on commodities for which EC demand is growing slowly, so that the relative decline in market share is not unexpected.

The implication is that without the Convention the ACP trade performance might have been even worse. As explained below, there have been some positive trade effects of Lomé for the ACP. It is important to examine this evidence for lessons on the utility of regional trade liberalisation.

The extent of preferences

The suggestion above is that the commodity composition of ACP exports rather than limitations on trade preferences has been the main reason for their poor impact. Nevertheless, there are restrictions on all preference agreements. Despite the apparent liberality of the EC's preferential trade arrangements, it is by no means clear that LDCs are always the beneficiaries of positive discrimination by the EC. A critical part of the negotiations for a WHFTA will be to ensure that promises are translated into practical reality.

Limitations

In respect to tariffs, for example, the actual rates applying to LDC exports may be higher than apply to DC exports. LDCs appear to face lower tariff barriers in the EC market than do DCs only if the analysis is limited to formal tariff rates. In 1983, for example, the average MFN rate applied to total EC imports from DCs was 7.2%; this was much higher than the average GSP rate applied to imports from LDCs. But the average tariff rate *actually imposed* by the EC was lower on imports from DCs than from LDCs (at 4.7% as against 5.3%) [Sampson, 1989]. There were two reasons for this. First the DCs benefit from a number of trade EC preferences and so do not usually trade on MFN terms. Second, LDC exports to the EC tend to include a higher proportion of 'sensitive' goods than do DC exports.

In the case of NTBs, too, the commodity basket of exports may result in discrimination against LDCs. In 1983, for example, 25% of the EC's imports from LDCs faced NTBs, compared with only 19% of its imports from DCs. The impact of NTBs can be especially severe on some of the poorest LDCs: EC imports from India, for example, face significantly more border NTBs than do imports from the NICs! [Sapir and Stevens, 1987:Table 1].

There is also evidence that imperfections in the EC's most preferential accord, the Lomé Conventions, are a constraint on utilisation; the nature of this constraint is of importance for the negotiators of a WHFTA. The rules of origin have been a clear impediment, and the quotas that apply to many of the CAP concessions may become a binding constraint in the future. Partly because of such residual protectionism, EC imports of manufactures from the ACP have risen much more slowly than have those of the USA (which provides preferences to many of the ACP states although not to the group as such). Although the EC remains the ACP's principal trade partner it is fast losing this position. ACP exports of clothing to the USA, for example, now exceed sales to the EC. And the ACP export some manufactured goods, such as electrical machinery, to the USA which do not figure in their trade with Europe.

The growth in exports to the USA can be explained partly in terms of buoyant American demand, but there is also an element of EC protectionism in the story. Jamaican exports of clothing, for example, increased by an annual average 81% (in US dollar value terms) between 1983 and 1988. But almost all of this increase was accounted for by exports to the USA, with nascent exports to the EC emerging only at the end of the period. The dominance of the USA reflects in part the fact that it is very close geographically to Jamaica and has been able to absorb almost all the goods that have been supplied. However, US trade preferences are superior to those of the EC in a number of respects.

Exporting to the EC has faced one major 'demand-side' obstacle: the rules of origin. Their impact on clothing exports has been particularly noticeable. The requirement in the rules of origin that woven clothing be produced either from yarn or from cloth imported from the EC has effectively prevented the development of woven clothing exports to Europe. Jamaica has one textile mill, but it does not produce a quality of cloth suitable for export clothing. Because of Jamaica's distance from Europe and, no doubt, the dominance of US and Far Eastern companies, the import of cloth from the EC is considered financially unviable [JAMPRO, 1989]. Clothing exports are not the only ones to be inhibited by the rules of origin. Two biscuit manufacturers have attempted to export to the EC under the Lomé

Convention. Neither has succeeded in obtaining duty-free access because of rules designed to protect European agriculture.

The EC rules of origin are more stringent than those applied by either the United States or Canada. The USA's TSUSA 807 rules encourage 'outward processing', whereby garments cut in America are assembled in the Caribbean for re-import. Under the standard 807 rules the garments may be cut from Asian material, a practice that is prohibited by the EC's Lomé rules of origin. Because of the rules of origin, exports to the Community are concentrated in knitted goods, notably sweaters and T-shirts. Exports to the USA, by contrast, are much more broadly based. Canada has a similar interest to that of the Community in fostering its cereal exports, but nonetheless it gives preferential treatment to Jamaican biscuits made from US wheat.

Provisions exist under the Lomé Convention for 'derogations' (i.e. temporary exemptions) from the rules of origin. But the derogation procedure was widely criticised during the 1980s because the EC has tended to interpret the rules narrowly and their administration has been slow and costly. Under Lomé IV the derogation procedures have been improved, in terms both of their administration and of the criteria for approval. It remains to be seen whether this will result in a faster growth of non-traditional ACP exports.

Useful preferences

Despite the limitations on 'preferences' some LDCs do have significant advantages on some products. It is possible to identify the salient characteristics of 'useful preferences'. In the case of the ACP, for example, there are some preferences on goods that are also produced within the EC and that benefit from substantial protection, most notably products those that fall within the CAP, plus clothing and textiles that are controlled by the Multifibre Arrangement (MFA).

These are particularly valuable for three reasons. First, they may facilitate export diversification. Second, LDC exporters, like DC producers, are protected against competitive imports from other third party suppliers. And, not least, export earnings are increased by the artificially high prices in the DC market brought about by the restriction of supply. For these reasons these are the type of goods for which preferences should be sought by the LDC members of a WHFTA.

In the case of CAP products the ACP benefit from a number of openings to the European market, although these are usually restricted by quotas, calendars (that limit preferential access to certain periods of the year) or both. In the case of clothing the ACP are not subject to the MFA, though there have been a number of instances of VER and anti-dumping actions. Preferences on NTBs tend to be more useful than those on tariffs alone.

The range of CAP products on which the ACP benefit include sugar, rice, beef and horticultural products, plus bananas. The Mediterranean states and some other LDCs (including some in Latin America) benefit also from horticulture preferences. Although the mechanisms employed vary between these products, the fundamental nature of the benefit is the same in each. Because the CAP restricts supply onto the EC market, prices prevailing in Europe are artificially high. The beneficiaries of trade preferences gain at least part of this economic rent for at least part of their exports. The reason for the 'at least part' caveat is that in some cases the EC treasury obtains part of the economic rent through the application of import tariffs, and because access to the EC market is normally limited to a fixed quota which may be less than total exports. If a country is able to sell only a part of its total exports to the EC the effects of high European prices may have to be offset against lower returns in other markets. This would happen, for example, if the CAP resulted in world market prices being lower than they otherwise would be. Hence, the critical factors in determining whether, in the short term, the export revenue of LDC preference holders is higher or lower as a result of the CAP are: the proportion of exports that gain access to the EC market, the level of economic rent received by the exporter, and the price-depressing effects of the CAP in other markets.

Several of these preferences are of particular importance to some western hemisphere states. They include sugar, rice and bananas.

□ *Sugar*

The EC-ACP Sugar Protocol is attached to the Lomé Conventions although it is not part of them; it is of considerable importance to seven Caribbean/Central American states. The principal reason for this distinction is that it is of 'unlimited duration', and therefore not subject to periodic renegotiation.

The Protocol provides Barbados, Belize, Guyana, Jamaica, St Kitts, Suriname and Trinidad plus nine other ACP states with a global quota of 1.3 million tonnes of sugar (white sugar equivalent) for which the EC guarantees to pay similar prices to those offered to European sugar beet producers. These prices are normally well above world levels. The Protocol, which represents a major breach in the CAP system of protection, was negotiated as part of Britain's accession to the Community. The imports are consumed almost exclusively in the UK market.

The share of sugar exports covered by the Protocol varies between the ACP beneficiaries. But in all, with the possible exception of Zimbabwe, the financial gain of high prices on the EC quota has almost certainly exceeded the financial loss due to the CAP-induced depression of world market prices.

□ *Rice*

Most rice imports face a levy equal to the Community threshold price less certain fixed deductions. But, for the ACP, 50% of the levy is replaced by an equivalent tax in the exporting state. The principal beneficiary has been Suriname. The preference is volume-constrained. Under Lomés I and II, the EC was entitled to suspend the preference if total imports from the ACP exceeded the average of the previous three years plus 5%. From Lomé III this threshold was replaced by a fixed quota that was significantly in excess of actual flows during Lomé II. For long-grained husked rice it has been set at 122,000 tonnes annually, compared with average annual imports 1982-86 of 95,673 tonnes. However, ACP exports increased rapidly during Lomé III, so that the quota became a binding constraint. In Lomé IV the quota has been increased to 125,000 tonnes of husked rice equivalent, plus 20,000 tonnes of broken rice.

□ *Bananas*

About half of the Community's consumption of bananas is supplied by the ACP states and by the Community itself (the French overseas départements of Guadeloupe and Martinique, as well as Crete and the Canary Islands), while the other half consists of 'dollar' bananas, mostly from Central and South America. Until the creation of the Single European Market the former half entered the Community under special arrangements designed to preserve traditional markets. Thus, France provided a guaranteed market for bananas from its overseas départements and from Cameroon and Côte d'Ivoire. Italy and Britain provided similar guarantees for Somalia and for the English-speaking Caribbean and Suriname respectively. The arrangements for continuing these traditional arrangements in the Single European Market have created serious controversy within the western hemisphere. Central and Latin American suppliers claim that the new EC regime discriminates against their exports.

The impact of preferences

What evidence is there on the impact of preferences? Clearly they have not prevented the ACP as a group being marginalised in the EC market. But some ACP states have begun to diversify into non-traditional products which benefit from substantial trade preferences. Early evidence on the Super GSP regime for the Andean Pact countries also suggests that there has been a diversification of exports to the EC, notably into sensitive agricultural and manufactured goods. How far can the growth of non-traditional exports be attributed to preferences? This question is of vital importance to other attempts to foster trade through regional liberalisation.

The most substantial evidence comes from studies which have been carried out in a select group of ACP states, the results of which are reported in three *ODI Working Papers*: on Jamaica, Kenya and Ethiopia, on Zimbabwe and on Mauritius [Stevens, 1990; Riddell, 1990; McQueen, 1990]. Between them, these five states illustrate the differing importance of the various Lomé trade preferences in relation both to each other and to those offered by the ACP's other trading partners. They show also the interaction of demand-side constraints (such as the rules of origin) and those on the supply-side (notably unsupportive government policies) and the scope for aid to ease the bottlenecks that limit further diversification.

In none of the cases do the non-traditional exports 'solve' the problem of stagnant demand for traditional exports. The new markets into which they have diversified are highly competitive; diversification is a continuing exercise, not a once-for-all shift. But they confirm the findings of the statistical analysis, that the ACP are not somehow incapable of diversification. Furthermore, they provide some evidence that the Lomé preferences have made a contribution.

It has not been possible to draw an unambiguous causal link between the Lomé Convention and the development of non-traditional exports. A host of factors is at work to explain both the success in exporting *these* new products and the failure to export *others* for which Lomé preferences are also substantial. Government policy in the exporting state is clearly a critical factor. In the cases of both Jamaica and Kenya, for example, the move into non-traditional exports has been very recent, partly because of the unsupportive nature of government policies in the earlier period. Nonetheless, there is some degree of circumstantial evidence to suggest that a link exists.

Lessons for a WHFTA

The EC-South relationship provides guidance for the architects of a WHFTA in three areas: it illustrates the extent to which regional liberalisation can be beneficial to participants and, importantly, some of the factors that should be present in an agreement to foster such benefits; and it provides a guide to some of the changes in the external situation of potential members that may influence their attitude towards hemispheric liberalisation.

Despite the apparent failure of EC-ACP trade to prosper even with apparently substantial trade preferences, the Lomé Convention experience does not show regional trade preferences to be ineffective. What this experience, and that of the Mediterranean agreements, does show is that the considerations applying to the design of a regional trade preference scheme are somewhat different from those relevant to generalised liberalisation. In a limited membership scheme, the principal benefit of liberalisation occurs when the economic rent arising from protection in one market is partially distributed to exporters in other participating states. The total world gains are likely to be less than those arising from generalised liberalisation but those for specific participating groups or states may be greater or smaller depending on the circumstances of each case. Hence, while partial liberalisation may be sub-optimal it *may* be politically more easy to negotiate because the identifiable gains for participants are clearer.

The crucial determinants of potential gain are: whether there exists in some or all participating markets substantial protection on products that other participants can export competitively; and whether the protecting states are willing to make substantial reductions in this protection within the regional agreement. To the extent that the Lomé and Mediterranean agreements have resulted in commodity diversification by the developing country members it has been predominantly into products which are heavily protected in the EC but for which regional preferences exist, i.e. CAP products and clothing. The slow take-up of such preferences by the ACP reflected a lack of competitive exports, but as these have begun to emerge in some states so diversification has occurred. The principal constraints on further diversification have been supply capacity and, on the EC side, impediments such as the rules of origin that reduce the effective level of preference below the nominal level.

These factors will also affect the political ease of negotiation. If the baseline protection in potential members is low, or if there is little prospect of competitive intra-regional trade in protected products, the negotiation of liberalisation will tend not to face serious political problems, but the trade gains will be correspondingly limited. If protectionism is high and competitive exports substantial, the potential gains from regional liberalisation may be great but there will be strong vested interests to be overcome during the negotiations.

This is one set of lessons that may be derived from studying EC-South relations; another is that the future may bring some moderation of those divisions within the western hemisphere that are reinforced by the EC's differential preferences. Some of the Lomé preferences result in a clear diversion of trade from some states in the region to others. This is most clear in the case of bananas and also rum, with Caribbean supplies being favoured at the expense of those from Central America. It would also be true of other soft fruit and horticulture if the Caribbean were able to supply these on a substantial scale. Such direct trade diversion almost certainly does not apply to sugar; if the ACP Sugar Protocol were to disappear the result would not be an increase in Latin American exports to Europe but a decline in EC imports. There may be, however, some indirect diversion: to the extent that the Sugar Protocol maintains in existence high cost production capacity in the Caribbean which could not survive at world prices, it increases global supply and, hence, lowers the price of Latin American exports to non-preferential markets.

This trade diversion has contributed to conflicts of interest between the Caribbean and Latin America. The argument of this paper is that the Caribbean's existing preferences in the EC market are likely to atrophy. This would tend both to reduce such conflicts of interest and to increase the need of the Caribbean to find new markets to offset the declining value of the old.

The third set of lessons concerns the relationship between selective and generalised liberalisation. The experience with EC policy shows clearly that selective preferences need not be a barrier to more generalised liberalisation. The very complexity of the 'pyramid of privilege' is a testament to this since it arises in part from considerable *ad hoc* tinkering that has extended new preferences to new countries (thus diluting pre-existing regimes) as a perceived need has arisen. The 'preferred' states do have a vested interest in opposing generalised liberalisation. The ACP, for example, have lobbied against liberalisation on tropical products in the GATT Round. But their pressure has rarely had any significant effect.

Section D
Conclusion

Both of the two main sections of the Report carry their own, specific conclusions on the lessons to be drawn for a WHFTA from, on the one hand, the experience of closer integration between the twelve members of the EC and, on the other hand, the impact of selective liberalisation between rich and poor countries. In addition to these specific conclusions there are some general points to be made that derive their force from the fact that they are supported by evidence from both sections. They centre on the importance of positive as well as negative measures to promote integration and, related to this, the political and economic dimensions of regionalism.

There is a division among supporters of integration, between those that regard it primarily as an exercise in which barriers to the flow of goods, services, labour and capital are removed, and those that see the need for a more positive promotion of such flows. In other words, will the market bring economies closer together if freed from the shackles of policy, or may it lead to such imbalances that the reimposition of barriers becomes inevitable?

The experience of one set of countries in a particular period of history cannot be taken as an unambiguous guide for other states at another time. Nonetheless, such experiences should not be overlooked. Although there is no precise guidebook on 'how to create a regional integration scheme', this does not mean that proponents of one or other viewpoint should not be required to justify their views against the experience of history.

While the lesson to be drawn from the EC experience on the role of positive versus negative integration strategies may be ambiguous, the nature of the European experience is not. The EC was created through a certain amount of 'barrier removal', but also a significant degree of 'positive assistance'. The regional fund, the social fund and, above all, the Common Agricultural Policy, were deemed necessary to 'compensate' some members for 'concessions' to others. A similar lesson is to be found from trade preferences with poor countries. The experience of the ACP demonstrates that the simple removal of barriers is by no means a sufficient condition for the growth of trade. The much better performance of the Mediterranean states, which have wider-ranging links with the EC, suggests that a mixture of barrier removal and positive support has been more effective.

This leads to the second conclusion to be drawn from the European experience. This is that integration, whilst it is concerned with economies, is very largely a political exercise. One may discuss whether or not the regional and social funds have actually fostered economic integration, but this is not perhaps the most relevant question. The key question is: would barriers have been removed, and stayed down, if there had been no political 'sweeteners' to puncture opposition? Economic integration in Europe was not achieved without substantial - and often prolonged - political bargaining. Whilst the mechanisms used to facilitate this process may well not be directly exportable to the western hemisphere, the need for the bargaining appears to be clear.

Regardless of what economists say, in the political arena there will always be seen to be winners and losers in an integration scheme. And these are not unified camps: each party has its own set of interests. Hence, the Mediterranean states and the ACP have mutual interests in relation to states within the EC, but are also competitors with each other for what they may perceive to be better treatment by the Community. Similarly, the creation of NAFTA cannot avoid creating tension in other parts of the western hemisphere, regardless of whether the fears expressed by states outside the scheme are justifiable in economic terms.

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