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6 Common Market

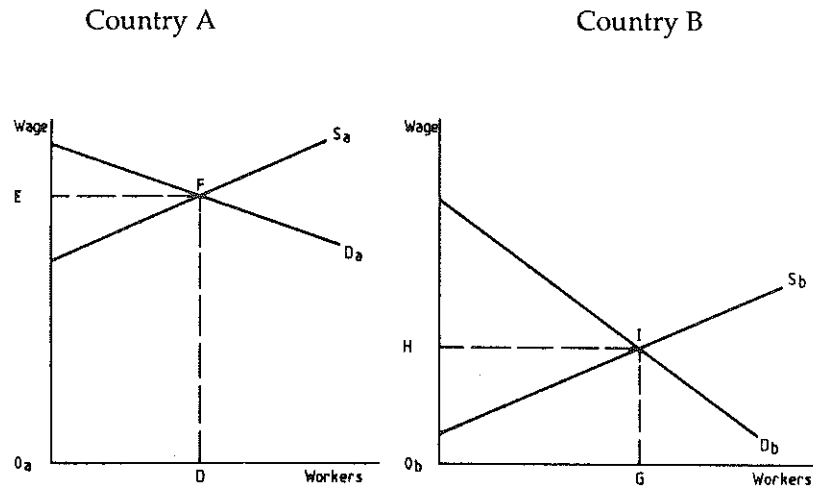
Introduction

In the previous chapter we discussed the integration of goods (commodity) markets. We assumed that production factors are completely mobile within a country, and completely immobile between countries. In Chapter 2 we gave a review of the types of barrier that exist on the international labour and capital markets. If an integration scheme removes the obstacles to free movement among partners not only for goods markets but also for factor markets, the stage of a Common Market (CM) is reached. In this chapter we will discuss the theoretical basis for this stage of integration. We will deal not only with the liberalisation of factor markets, but also with the interrelation of the goods and factor markets that is typical of the Common Market.

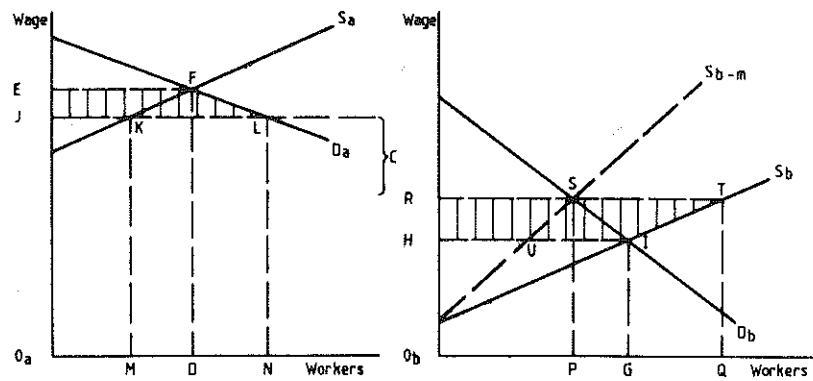
The reason to strive for a Common Market is the hope that the freedom of capital and labour to move from activities with a low marginal product to those with a higher one will lead to a more efficient allocation.¹ The next section will discuss to what extent the integration of factor markets helps to equalise factor returns and to create and distribute wealth.

Economic integration does not always proceed by the stages sketched in Chapter 2. In practice this means that trade impediments may persist where international capital and labour markets are already partly integrated. Goods markets and factor markets influence each other in many ways, and consequently the integration of one market affects that of others. How this mutual influencing operates, and how the removal of barriers to either goods or factor movements affects welfare, will be discussed next.

The abstract nature of neo-classical theory is not very well suited to grasping the reality of a world in which entrepreneurial skills and technological innovation vary among nations and the functioning of many markets is far from perfect. So our following step will be to present elements of a theory of international production likely to explain the intricacies of the Common Market better than the loose strands of thought so far developed on the integration of separate markets for goods and production factors.



(a) No factor-market integration



(b) Integration of factor markets, price convergence

Figure 6.1 Effects of movement of production factors

The chapter will be rounded off as usual with a brief summary and some conclusions.

Integration of factor markets; disregard of goods movements

Movement and movement cost; price convergence

The effects of the integration of factor markets can be illustrated by comparing situations with and without movement of factors (Lindert 1986). That is done in Figure 6.1. We have assumed that the world consists of two countries, A and B; the situation for A is depicted on the left-hand side, that for B on the right-hand side. The situation for the factor market is given by the upward sloping curves S_a and S_b , representing factor supply, and the downward sloping curves D_a and D_b , representing demand for either labour or capital. Together they determine the price of labour (wages) or capital (interest) and the number of workers (amount of capital) employed. We will now work out the effects of integration for the labour market; however, the same reasoning can be applied to capital markets.

- In the non-integrated situation, in which the labour markets of countries A and B are separate, that is, *without migration* (upper part of Figure 6.1), the supply and demand conditions in country A lead to high wages and those in country B to low wages. As was said in Chapter 2, two national labour markets with such different wage levels can be kept separate only by dint of control measures, for instance 'permits' or restricted access to professions.
- In the *integrated situation* (bottom part of Figure 6.1), such barriers are removed. Now workers of country B will move to country A where they earn a higher income. As movement entails costs, both in economic and psychological terms, this will not lead to the complete equalisation of wages. We assume these costs to be equal to C. The inflow of migrant labour into country A pushes the wages down, which leads to a lower domestic supply ($O_a M$) and a higher domestic demand ($O_a N$). The difference (MN) indicates the number of migrants from country B in country A. In country B the opposite occurs: the higher wages lead to less demand ($O_b P$) and increased supply ($O_b Q$); the difference PQ indicates the number of migrants from country B to country A. The number of out-migrants PQ is of course just equal to the demand for foreign labour created in country A (MN). The new curve of domestic supply of labour S_{b-m} pictures the consequences.

The *welfare effects* of the migration caused by the joining of markets are

There is an important point to be made here. The integration of the European market has led to a convergence of wages and prices across the different countries. This is a result of the free movement of factors of production. The book explains how this process works and why it is important for the European economy. It also discusses the effects of migration on the welfare of the different countries and the role of the government in this process.

also illustrated by Figure 6.1. They are fairly intricate and apply to both workers and employers in country A and country B.

Workers from country A lose area *JEKF* because their wages are forced down. (For that reason, many trade unions in developed countries are against immigration.) On the other hand, workers remaining in country B gain from out-migration; there is less competition for jobs, which raises the wage rate from O_bH to O_bR . The gain is the producer surplus above the new supply curve (*HRSU*). The migrants also gain: they earn a higher income in A than they would have in B. However, account should be taken of cost factor C. So, the gain is the area above the old supply curve S_b and below the new one S_{b-m} (*USTI*).

Table 6.1 Welfare effects of integrated production-factor markets

Category	Country	Gains	Losses
Workers	A	*	<i>JEFK</i>
Savers	B	<i>HRSU</i>	*
	B to A	<i>USTI</i>	*
Employers	A	<i>JEFL</i>	*
Investors	B	*	<i>HRSI</i>

*not applicable

Employers in country A gain considerably: the area *JEFK* is redistributed to them from workers, while the area *KFL* is a net gain. In country B, on the contrary, employers are losers: they have to pay higher wages and hence lose profits. Of their consumer surplus (employers are demanders of labour!) they have to hand over area *HRSU* to workers remaining in the country, and area *USI* to migrants.

Countries A and B are clearly in different positions. The receiving country A has a net gain (*KFL*). The sending country B on the contrary has a net loss *USI* (difference between employers' loss and migrant workers' gain). The migrants gain also: *USI* and *STI*. So, the net gain to the world is *KFL* and *STI*; the distribution of welfare among countries depends on the allocation over countries of the gains to migrants.

The reasoning followed here for the movement of labour can also be applied to the movement of capital. It suffices to put savers at the place of workers, investors at the place of employers and to use interest instead of wages etc. The interpretation of the cost difference *c* for capital movement may be in terms of extra cost of information that will

be incurred on investment abroad. The welfare effects of both labour and capital movements are reviewed in Table 6.1.

Movement of factors; full price equalisation

That the integration of factor markets will lead to better allocation of capital and labour can also be illustrated by a somewhat different neo-classical static two-country diagram (again, there is no influence of the rest of the world). In Figure 6.2, the curves of country B mirror those of country A, so that one picture describes the effects of integration on both countries (see Grubel, 1981). The effects of integration of markets for production factors (on the assumption that goods markets are not integrated) can now be illustrated by comparing the situation of Figure 6.2(a), in which there are barriers to movement, with that of Figure 6.2(b), in which these barriers have been removed.

We will first consider the situation of Fig. 6.2(a), in which the capital markets of countries A and B are completely separated; in other words, capital is fully immobile between nations.² The vertical axis gives the price of capital; with perfect competition on the national markets, this price is equal to the marginal product of capital. The horizontal axis gives the supply of capital (O_aO_b , indicating the total stock of capital at the disposal of the two countries), demand (not indicated in the figure) of capital being given. Country A has a relatively abundant supply, hence a low interest rate; in country B capital is scarcer and hence the interest rate higher. The differential is *ED*. The downward sloping curves for both country A and country B indicate that the marginal product of capital is lower as the capital stock is greater; with a given capital stock (*K*) in both countries (O_aC for A and O_bC for B) the price of capital *R* is given for either: R_a for A and R_b for B. We assume there is no unemployment. From this picture the distribution of income can be derived. Total output is *ADC* for country A and *BEC* for country B (the total production realised at all points on the horizontal axis). It consists of two components – capital income and labour income. Capital income (measured by the quantity of its input times the marginal product of capital at the point where the market is in equilibrium) corresponds to the rectangle O_aCDR_a in country A, and to the rectangle O_bCER_b in country B. The triangles ADR_a and BER_b represent labour income in countries A and B respectively.

What happens when the two countries integrate their national capital markets? Figure 6.2(b) illustrates the effects of the removal of obstacles. Owners of capital will now move their capital from the country where it earns a relatively low income (A) to that where interest is higher (B). On the assumption of equal risks and uncertainty for foreign and domestic assets and of no other costs being involved, this will lead to upward pressure on interests in A (smaller supply of capital) and

downward pressure in B (greater supply of capital). In the end it will bring about the full equalisation of return on capital in both countries at level R_{cm} (representing the marginal productivity of capital in the Common Market). The capital stock of A declines while that of B increases by the amount CG , equal to A's net foreign asset. So, country A will specialise in savings and country B in investment.

The same approach can be followed for *labour-market integration*. In Figure 6.2(a), R represents wages; they may differ in the two countries because of different endowments with qualified labour and barriers to migration between the two countries. If the latter are taken away, a number GC of workers will move from country A to country B, attracted by the higher wages there. The movement will equalise wages in the two countries.

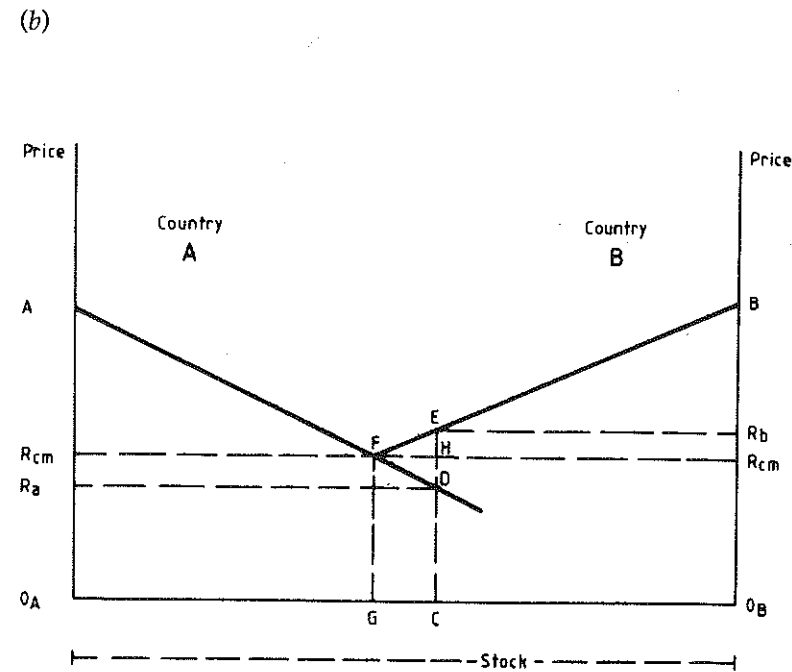
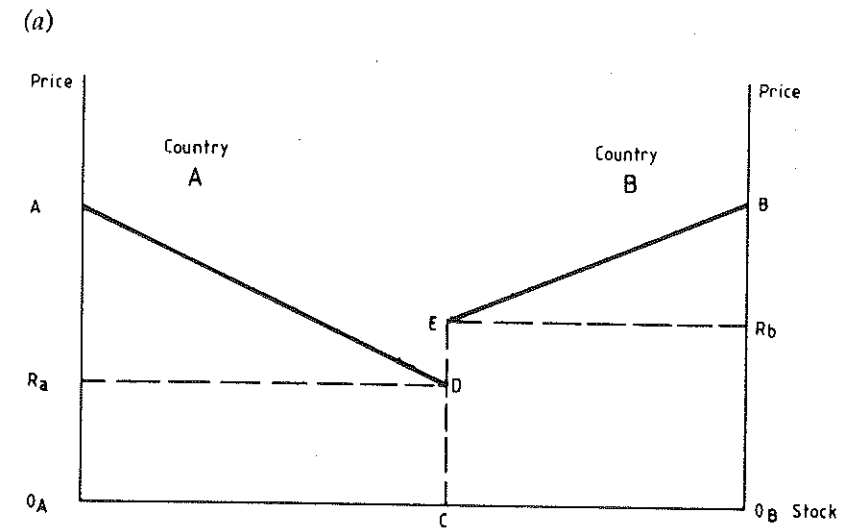
Even if there were no differences in factor prices between the two countries, the removal of controls is likely to favour a better allocation of resources. On capital markets, different liquidity preferences in the two countries will cause the importation of long-term capital and the exportation of short-term capital in A and the reverse in B. On labour markets, the different qualifications may lead to migration of certain categories of active persons from A to B while other professional categories may want to move from B to A.

Welfare effects

The integration of the two markets does not only lead to equal prices, but also has important welfare effects, which are different for different groups and hence lead to distributional disputes.

Total welfare will increase for both countries by the following process. The net domestic product of country A declines by $FDCG$; its net national product, composed of the domestic part $AOGF$ and the investment income earned abroad, $GCHF$, increases by FDH . The net domestic product of B increases by $EFGC$. As $CGHF$ must be paid to A, the net gain for B is the triangle EFH . The total net gain from the better allocation of capital through integration corresponds for both countries to the triangle EDF (FDH in A and EFH in B).

The *distribution of income between the main functional categories* (wage income versus capital income) changes when the factor markets are integrated. In country A the part of total income that accrues to labour is reduced in favour of the part that accrues to capital owners (by $R_a DFR_{cm}$), whereas in B the share of labour increases at the expense of owners of capital (by $FER_b R_{cm}$). This explains why trade unions tend to welcome incoming investment, but are opposed to domestic investment abroad even if it leads to a higher aggregate income. Of course that effect will come about only if markets function properly, that is if the wages are adjusted downward. If not, the result may be more



Figures 6.2(a) and 6.2(b). Integration of factor markets; price equalisation

unemployment leading to reduced production, which the growth of capital may fail to compensate in the short run.

Integration is bound to change *government revenue* springing from the taxation of international capital. If country B taxes foreign assets, a proportion of the area *FHCG* remains in B. If it exceeds the net gain of A (the triangle *FDH*), country A will suffer a net loss from opening up its capital market while country B had not done so completely.³

The welfare effects of *labour migration* are similar to those of capital movement. On the assumption that the migration is not permanent, the migrants will transfer a labour income *FHCG* to their home country, creating a net gain of *FDH* for country A and *FEH* for country B. Bear in mind, however, that the division of revenues resulting from labour movement may not run fully parallel to that of capital. Since labour will incur subsistence cost while staying abroad, the remittances will be less than *FHCG*, and may even become so small as to offset the gain *FHD* for country A, the emigration country.

Table 6.2 summarises the overall effects.

Table 6.2 Effects of the integration of production-factor markets (letters refer to Figure 6.2)

Indicator	Country			
	Segmented Markets		Common Markets	
	A	B	A	B
Stock (cap. lab.)	$O_a C$	$O_b C$	$O G$	$O_b G$
Price (int. wage)	R_a	R_b	R_a^{cm}	R_b^{cm}
Income (first factor)	$O_a CDR_a$	$O_b CER_b$	$O_a GFR_a^{cm}$	$O_b GFR_b^{cm}$
Income (second factor)	ADR_a	BER_b	AFR_a^{cm}	BFR_b^{cm}
Net domestic product	$ADCO_a$	$BECO_b$	$O_a GFA$	$O_b GFB$
Net national product	$ADCO_a$	$BECO_b$	$AFHC_a$	$BEFHCO_b$
Net gains	—	—	FDH	EFH

The removal of internal constraints and its effects on the balance of payments and welfare

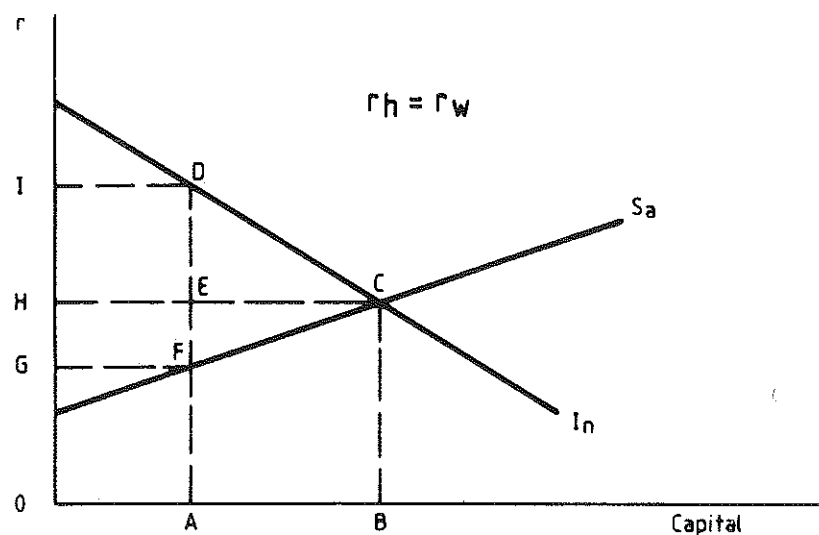
In the previous section we assumed full employment, on the national level, of the two production factors labour and capital. However, that assumption is unlikely to be fulfilled in reality. In small segmented markets specialised labour will be hard put to find sufficient demand

for its services, or the necessary capital with which to complement prevailing technological know-how. So in small segmented markets both the supply of and the demand for factors of production may be constrained, with negative effects on production and welfare. By taking away controls on the international movement of labour and capital, both supply and demand can assert themselves, and an efficient allocation of all specialised factors of production will come about.

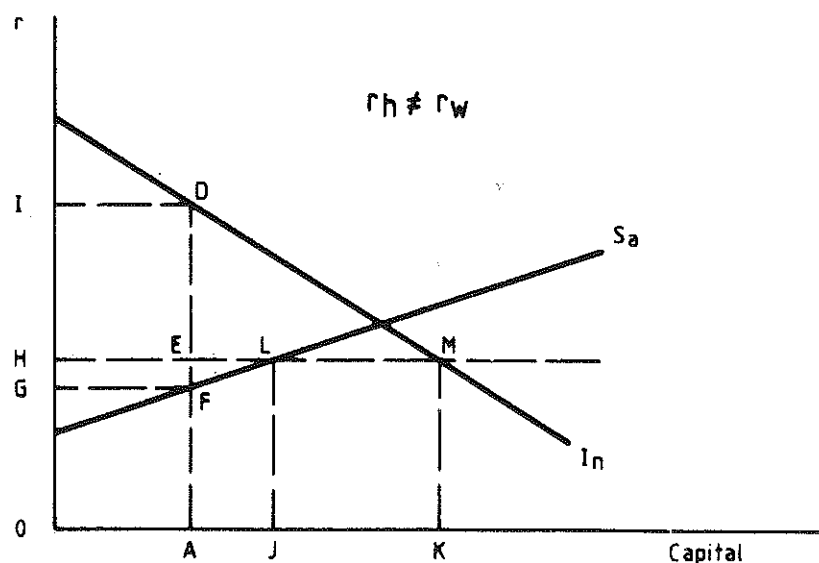
The 'trade' and welfare effects of removing the constraints on, for example, the capital market, are illustrated by Figure 6.3(a) which gives the supply and demand curves for capital. The supply of capital comes from savers, its demand from investors. Controls on capital imports and exports are making the capital market of country A inefficient. The financial products provided by the banking sector in A being inadequate, potential investors and savers refuse transactions, which implies that some capital remains idle – indicated in the figure by *AB* (given demand), investment and hence savings being limited to the amount *OA*. The price for the investor, or the borrowing rate, is *OI*, and the lending rate for savers is *OG*. The spread between the two, *GI* or *DF*, is the margin taken by banks for their intermediate role. This margin can be that high because banks are protected from foreign competition. This creates a 'monopoly' permitting banks to earn a monopoly rent of *GIDF* (quantity *OA* times the margin *GI*). Assume now that controls on international capital movements are abolished and thus all inefficiencies in the markets removed. Fear for new entrants from abroad taking away profitable markets will induce banks in the home country to propose new products, better adapted to the wishes of both savers and investors. This will bring additional supply and demand on the market. Let us assume provisionally that the resulting rate of interest (*OH*) is just equal to the interest rate abroad. Both savings and investment will now expand to *OB*. There is an important gain to society as a whole. First investors increase their 'consumer surplus' by the area *HIDC*. Next savers increase their 'producer rent' by the area *GHCF*. Of their monopoly rent *GIDF*, banks lose *HIDE* to investors and *GHEF* to savers. This leaves a net gain to society equal to the triangle *FDC*.

The effects of partial liberalisation are different. Under such conditions, the liberalisation of financial markets is unlikely just to balance out home supply and demand at the prevailing world-market price. Figure 6.3(b) represents the situation where the world interest rate *OH* is lower than the domestic-equilibrium rate without international exchange. Now, controls may affect only capital outflows leaving inflows free, or alternatively, affect only capital imports, leaving exports free. Let us analyse the effects of either case on the situation $R_w < R_a$.

In a situation of free outflow and controlled inflow, savers will take the opportunity of getting higher returns on the foreign market (*OH*) than on the domestic market (*OG*), and expand their supply to *OJ*.



(a) Price home market equals price 'world' market



(b) Price home market different from price 'world' market

Figure 6.3 Welfare effects of production factor market integration

Under the pressure, domestic banks will have to diminish their margins from $GI (= FD)$ to HI (or DE) to acquire the necessary capital (OA) for making the transaction with the domestic investors. The remaining supply AJ is invested abroad (either directly by savers or indirectly by banks). This will give rise to an inflow of interest payments equal to the area $AELJ$. The 'rent' of savers increases by the area $GHLF$, of which $GHEF$ is gained at the expense (transfer) of the banking sector's monopoly rent, and ELF is the net welfare gain to society.

In the situation of free inflows and controlled outflows, the same reasoning applies. In the closed domestic market, investment was constrained by savings to OA . In the new situation, foreigners will acquire equity (portfolio investment) or companies (direct investment) and get higher returns than on the world market. That inflow will take total investment up to OK instead of OA , the quantity AK being imported, which entails payment of interest on foreign debt corresponding to the area $AKME$. Investors find their 'surplus' increased by the area $HIDM$, of which $HIDE$ is at the expense of monopoly 'rents' of financial intermediaries (that is, a transfer), and the triangle DEM is the net welfare gain.

Evidently, in the situation where both inflows and outflows are liberalised the welfare effects of both can be combined. The net welfare gains (in case the equilibrium interest levels at home are higher than those in the rest of the world as depicted in Figure 6.3 (b)) amount to the area $FDML$.

In Chapter 5 we found that contrary to popular belief, welfare may improve if a good is produced less at home and imported more from abroad, provided that the resources set free are used to produce other goods for which the country has a comparative advantage, thus offsetting the negative balance-of-payment effect. Failing that, total growth will be constrained by the balance of payments. In much the same way we find that a liberalised capital market has positive effects on economic growth (welfare effects) despite an initial deterioration of the balance of payments (from the equilibrium of Figure 6.3(a) to the deficit of $LMKJ$ of Figure 6.3(b)). However, if the imported capital is used to create production units, the output of exportables may expand, compensating for the deficit in interest payments.

Other effects

In the foregoing we have shown some welfare effects of liberalising international capital and labour movements. There are other effects, which we will not discuss in detail but which nevertheless call for some attention.

For one thing, factor-market integration may ease the restructuring that will follow the liberalisation of trade in a CU. Indeed, new

There is an important point to be made here. The integration of the European market is not just a matter of removing trade barriers. It is also a matter of integrating the financial markets. This is particularly important in the context of the common market. The integration of the financial markets is essential for the proper functioning of the common market. It is also a matter of integrating the labour markets. This is particularly important in the context of the common market. The integration of the labour markets is essential for the proper functioning of the common market.