differences have narrowed. The second – based on the so-called new economic geography – focuses on agglomeration forces that account for the way in which tighter economic integration can foster the clustering of economic activities within nations.

The chapter also presented the main outlines of the EU's regional policy. The goal of this policy is to help to disperse economic activity to less-favoured regions. Most of the money is spent on so-called convergence regions that typically have per-capita incomes that are less than 75 per cent of the EU average. The EU spends about a third of its budget on these policies.

### Self-assessment questions

1 Draw a diagram with the extensions to the agglomeration diagram suggested in Box 10.2.
2 Download the European Commission's proposal for reforming structural spending and compare it to the principles of the system in place up to the end of 2006.
3 The educational level in all EU nations is rising. How would this affect the spatial allocation of production in the Heckscher–Ohlin framework?

## Further reading: the aficionado's corner

For a more extensive discussion of the facts concerning changes in the location of economic activity in the EU, see:

**Brülhart, M. and R. Traeger** (2003) *An Account of Geographic Concentration Patterns in Europe*, Cahiers de Recherches Economiques du Département d'Econométrie et d'Economie Politique (DEEP), Université de Lausanne. Download from www.hec.unil.ch/deep/publications-english/e-cahiers.htm.

Each year, the Commission produces a report on 'cohesion' in the EU. This contains a large number of maps showing things such as unemployment, declining population, and share of the economy in agriculture, industry and services. It also presents a large number of indicators of social cohesion, such as youth unemployment and income distribution. See:

**European Commission** (2001) Second Report on Economic and Social Cohesion. http://ec.europa.eu/regional_policy/sources/docoffic/official/reports/contentpdf_en.htm.

For an advanced treatment of the new economic geography, see Part I of:

**Baldwin, R., R. Forslid, P. Martin, G. Ottaviano and F. Robert-Nicoud** (2003) *Economic Geography and Public Policy*, Princeton University Press, Princeton, NJ.

### *Useful websites*

The European Parliament's factsheets provide a wealth of information on EU regional policy. See: http://www.europarl.europa.eu/aboutparliament/en/displayFtu.html?ftuId=theme5.html.

The Commission department devoted to regional policy (DG Regio) has an extensive website that provides masses of data and several highly readable explanations of EU policy in the area. There is also a very handy facility to display regional data on maps. See http://ec.europa.eu/regional_policy/index_en.cfm.

### *References*

**Combes, P.-P. and H.G. Overman** (2004) 'The spatial distribution of economic activities in the European Union', in J.V. Henderson and J.-F. Thisse (eds) *Handbook of Regional and Urban Economics*, Volume 4: *Cities and Geography*, Elsevier, Oxford.

**Eurostat** (2013) *Eurostat Regional Yearbook, 2013*, Eurostat Luxembourg, http://epp.eurostat.ec.europa.eu/portal/page/portal/publications/regional_yearbook.

**Her Majesty's Government** (2014) 'Review of the balance of competences between the United Kingdom and the European Union: cohesion policy', gcn.civilservice.gov.uk/.

**Midelfart-Knarvik, K.-H., H.G. Overman, S.J. Redding and A.J. Venables** (2002) 'Delocation and European integration: is structural spending justified?',http://ec.europa.eu/economy_finance/publications/publication11136_en.pdf.

**Overman, H. and D. Puga** (2001) 'Regional unemployment clusters: nearness matters within and across Europe's national borders', *Economic Policy*, 17(34): 115–47.

**Redding, S.** (2010) *The Empirics of New Economic Geography*, *Journal of Regional Science*, 50(1): 297–311.

Chapter

*Keeping markets open to new entrants is a key factor for the promotion of innovation. When monopolies and tight oligopolies are allowed to occupy a market, they tend to resist change and often end up caring only about the preservation of their business models. Contestable markets, instead, allow new players to experiment, and new ideas to succeed. It is a major task of competition control to ensure that new generations of businesses are given a fair chance.*

**Joaquín Almunia, Vice President of the European Commission responsible for Competition Policy, 10 February 2012**

# EU competition and state aid policy

## Chapter Contents

## Introduction

Competition among firms is the heart and soul of the social market economy. It is what turns the profit motive into a socially beneficial urge. Competition, however, has and always has had a tendency to break down. In his 1776 masterpiece on market economics, *The Wealth of Nations*, Adam Smith wrote: 'People of the same trade seldom meet together, even for merriment and diversion, but the conversation ends in a conspiracy against the public, or in some contrivance to raise prices.' A strong competition policy encourages the process of rivalry among firms, which in turn boosts more choice for consumers, lower prices and higher quality. Competition also fosters an efficient allocation of resources and incentivizes innovation.

Deeper European economic integration – together with more general trends such as WTO trade liberalization and globalization – has put European manufacturing and service sector firms under a great deal of pressure. As discussed in Chapter 6, the long-run outcome of this heightened competitive pressure is typically a reshaped industry marked by fewer, bigger, more efficient firms engaged in more effective competition among themselves. However, in the short and medium run firms may be tempted to collude in order to avoid or postpone industrial restructuring, and Member State governments may be tempted to provide subsidies that delay the necessary but painful restructuring.

The founders of the European Union understood that pressures to collude and subsidize would arise in the course of economic integration. They also understood that anticipation of such unfair practices could reduce political support for economic integration in all nations; an 'I will not liberalize since the others are not playing fair' feeling could halt all deeper integration, especially in the sectors where it is most critical, i.e. those marked by important scale economies and imperfect competition.

To guard against these pressures, broad prohibitions were written into the Treaty of Rome on private and public policies that distort competition. Such strictures have been at the core of EU policy ever since. Of course, the Treaty of Rome has several provisions that have not been followed seriously, and the founders understood that this is frequently the fate of many provisions in many treaties. Yet, the Treaty writers felt that enforcing fair play in the internal market was so important that EU competition policy required special institutional arrangements – arrangements that would ensure that political expediency would not hinder the maintenance of a level playing field. Again, this practice continues even today.

To this end, the Treaty grants the European Commission the sole power (exclusive competence in EU jargon; see Chapter 2) to regulate the EU's competition policy. The Commission's decisions can be overturned by the EU Court but they are not subject to approval by the Council (i.e. what was called the Council of Ministers before the Lisbon Treaty) or the European Parliament. Of course, the Commission is not a 'Lone Ranger' in such matters. It continuously consults with Member States, especially via their respective competition authorities, but the Commission has the final word on whether mergers are allowed, whether particular business practices are allowed, and whether aid provided by Member States to firms is allowed. We can say that competition policy is one area where the Member States have truly transferred substantial sovereignty to a supranational level. The Lisbon Treaty confirmed the special position of competition policy and the control of state aid.

This chapter opens by providing an introduction to the economics of anti-competitive practices by private firms and subsidies by governments. It then proceeds to discuss the EU's actual policies.

## 11.1 The economics of anti-competitive behaviour and state aid

Before turning to how the European Commission regulates competition and state aid, it is important to understand the economics that lead private firms to engage in anti-competitive behaviour and what the effects of this are on the broader economy. This is the task we turn to first. Here, we study basic issues using the framework introduced in Chapter 6. The discussion here assumes readers have mastered the *BE–COMP* diagram, which is explained at length in Chapter 6.

### 11.1.1 Allowing collusion in the *BE–COMP* framework

As the EU's Single Market becomes less fragmented, firms experience greater competition, which forces them to restructure in a way that lowers their costs. Frequently, such adjustments involve waves of mergers and acquisitions. An alternative, however, is for the firms to collude in order to avoid or postpone



industrial restructuring. Or, to put it more directly, in many sectors firms face the choice between perishing or engaging in anti-competitive behaviour; some firms choose the latter. See Box 11.1 for some examples.

### Box 11.1 Examples of cartels

In July 2014, the German antitrust authority, BKA, fined 21 sausage producers over 300 million euros for fixing the prices of sausages. Thirty-three individuals were also penalized. The BKA determined that the collusion had occurred for a decade, with price-fixing deals struck on the telephone or in the Hotel Atlantic Kempinski – a five-star hotel in Hamburg. While exact prices were not agreed, the conspirators set price ranges. The cartel was uncovered with the help of an anonymous tip. Eleven of the companies involved admitted wrongdoing and cooperated with the authorities.

Other German food producers have also been caught colluding. In February 2014, BKA fined three German sugar producers 280 million euros for market manipulation and April saw 11 breweries fined 340 million euros for price fixing. The fined breweries accounted for half of German beer sales.

Interested readers can find details of the latest convictions on http://ec.europa.eu/competition/cartels/cases/cases.html.

#### *Theory*

While firms reacting to competitive pressure by price-fixing may be understandable, doing so is illegal under EU law and economically harmful for Europe as a whole. In a nutshell, allowing collusion among firms can result in too many, too small firms that must charge high prices to compensate for their lack of efficiency. The high prices result in lower demand and production. Thus protecting existing firms can end up reducing the overall level of industrial production.

One very clear real-world example was seen in telecoms services. Before liberalization, each European nation had its own monopoly provider; services were expensive since firms were small and as a result consumers did not spend much on telecoms. Since liberalization, competition has forced a massive industrial restructuring, a massive increase in the size of firms and a massive reduction in the price of services. The result has been a boom in the amount of telecoms services produced and consumed in Europe.

We illustrate this general point with an extended version of the *BE–COMP* framework from Chapter 6.

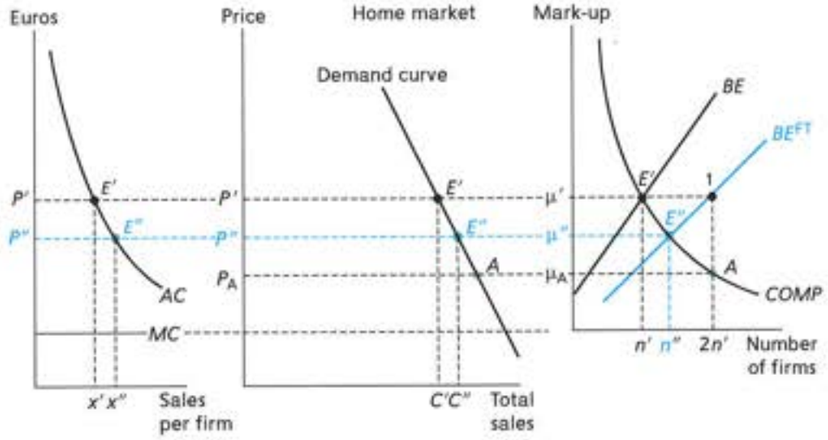
#### *The BE–COMP diagram*

Reviewing it briefly, the *BE–COMP* diagram, shown in Figure 11.1, has three panels:

1. The middle panel shows the demand curve facing the sector in a typical nation (the diagram assumes that there are two identical nations; the middle panel shows the demand curve for one of them – the Home market). This panel is used for keeping track of consumer surplus and the connection between price and industry-wide production (which must equal consumption). For example, in the closed-economy case, the long-run price is $P'$. This means that total consumption must equal $C'$. This in turn means that total production must be $C'$.
2. The left-hand panel shows the average and marginal cost curves for a typical firm (all firms are identical). The diagram assumes that firms enter or exit until all pure profit is eliminated, i.e. until price equals average cost. This panel is used to keep track of the typical firm's size, $x$, and its efficiency, as measured by its average cost (lower average cost means higher efficiency). The long-run equilibrium firm size is deduced from the long-run equilibrium price since we know that pure profits are zero in the long run, so the long-run price must equal the average cost of the typical firm. The average cost curve, $AC$, thus tells us how large the typical firm must be to have an average cost equal to the long-run equilibrium price. For example, if the long-run price is $P'$, the typical firm size must be $x'$ to ensure that price equals average cost.
3. The right-hand panel shows two equilibrium relationships between the mark-up and the number of firms. Recall that the mark-up is price minus marginal cost and that we denote it with the Greek letter $\mu$,

pronounced 'mu'. The number of firms is denoted $n$. The *COMP* curve shows the equilibrium combinations of $\mu$ and $n$ assuming normal competition; as expected, more firms corresponds to more competition and thus a lower mark-up. The *BE* (break-even) curve is upward sloping since, as the number of firms rises, the sales per firm fall and so firms would need a higher mark-up in order to cover their fixed costs.

**Figure 11.1** Analysis of economic integration without collusion or subsidies




The equilibrium in the three panels identifies the equilibrium number of firms, $n$, mark-up, $\mu$, price, $P$, firm size, $x$, and total output/consumption, $C$.

As in Chapter 6, we model European integration as a no-trade-to-free-trade liberalization between two identical nations. The equilibrium with no trade is marked by $E'$; the one with free trade between the two identical nations is marked $E''$. There are two immediate and very obvious effects from the no-trade-to-free-trade liberalization:

1. *Market size*: post-integration, each firm has access to a second market of the same size.
2. *Degree of competition*: post-integration, each firm faces twice the number of competitors.

The market-size effect shifts the *BE* curve to the right, specifically out to the point marked '1' (see Chapter 6 for a detailed explanation). The competition aspect is the simplest to illustrate in the diagram, Figure 11.1. Immediately upon opening the markets, i.e. before the industry has had time to adjust, the number of firms is $2n'$. Thus the typical firm will lower its mark-up in each market to point $A$ – assuming, of course, that firms do not collude (recall that the *COMP* curve shows the mark-up under normal competition).

The extra competition forces mark-ups down to point $A$, and this pushes prices down to $P_A$. At this combination of sales per firm and mark-up, all firms begin to lose money (i.e. $A$ is below the relevant break-even line, $BE^{FT}$). This 'profit pressure' forces industrial reorganization (mergers, acquisitions and bankruptcies) that gradually reduces the number of firms to the new long-run equilibrium number, $n''$. Note that after this long-run 'industry shake-out', firms are bigger and more efficient (the left-hand panel shows that $x$ has increased to $x''$ and average cost has decreased to $P''$); they are also facing more effective competition than before the liberalization (the right-hand panel shows that the price–cost margins drop to $\mu''$).

To summarize in words, deeper European integration boosts the degree of competition and this in turn requires the industry to consolidate so as to better exploit scale economies. Naturally, this consolidation involves the exit of some firms. The classic examples are telecoms, airlines, banking and autos, where market integration has resulted in a wave of mergers.



The key point as far as competition policy is concerned is that deeper European integration will generally be accompanied by a long-run reduction in the number of firms. This is important for two reasons:

- First, it means that Europe must be even more vigilant to ensure that the fewer bigger firms do not collude.
- Second, it means that firms may be tempted to engage in anti-competitive practices in order to avoid or delay the industrial restructuring.

We turn now to showing what anti-competitive practices look like in the *BE*–*COMP* diagram. Box 11.2 provides a real example of how four firms conspired to raise the price of beer in the Netherlands.

## Box 11.2 Collusion in the Dutch beer market

The Commission convicted four brewers of running a cartel in the Netherlands (the Heineken group, Grolsch, Bavaria and the InBev group). Beer is big business for the Dutch; yearly consumption is something like 80 litres per inhabitant! The four brewers involved sold a total of around 1 billion euros annually, and had a combined market share of over 90 per cent. The collusion was quite formally coordinated. According to the Commission's investigation, between 1996 and 1999 the four brewers held numerous unofficial meetings, during which they coordinated prices and price increases of beer. Such activity was successfully hidden from the authorities; however, when the Commission uncovered a cartel in the Belgian beer market one of the players in that case – InBev – provided evidence in order to reduce its fine. This is a tactic – the so-called leniency policy – that the Commission uses with great effect as it essentially faces the cartel members with a Prisoners' Dilemma. After the tip-off from InBev, the Commission raided (conducted a 'surprise inspection' of) brewers in France, Luxembourg, Italy and the Netherlands.

The raids involved collecting handwritten notes taken at unofficial meetings and proof of the dates and places when these meetings, called 'agenda meetings', 'Catherijne meetings' or 'sliding scale meetings', had taken place. The attendees at these meetings coordinated prices and price hikes at bars and stores. The Commission also found evidence that board members, managing directors and national sales managers actually participated in these meetings. Moreover, evidence was gathered that showed that the companies were well aware that what they were doing was illegal. Indeed, they employed cloak-and-dagger techniques to avoid detection (code names, abbreviations and holding meetings in various hotels and restaurants). One wonders whether they brought their own beer to avoid the high prices!

In the words of then-Competition Commissioner Neelie Kroes (the commissioner who oversaw an historic expansion in the effectiveness of the EU's competition policy in the 2000s): 'It is unacceptable that the major beer suppliers colluded to hike up prices and carve up the market between themselves.' The companies were fined a total of about 270 million euros. InBev escaped without a fine.

### *Perfect collusion*

The *COMP* curve in Figure 11.1 assumes that firms do not collude. Both before and after the integration, we assumed that firms engaged in 'normal' competition in the sense that each firm decided on how much to sell, taking as given other firms' sales. In other words, each firm decided its output without coordination among firms.

This assumption of 'normal' competition is quite reasonable for many industries, but it is not the most profitable behaviour for firms. If firms were allowed to collude, they could raise profits by reducing the amount they sell and raising prices. We consider some real-world examples in the policy section below (Section 11.2), but interested readers may wish to go to ec.europa.eu/comm/competition/cartels/cases/cases.cfm for details on the latest cases in which the European Commission has caught firms colluding.

There are many, many forms of collusion in the world. The first form we consider is the simplest to study. Instead of assuming no collusion on output, we consider the extreme opposite of perfect collusion on output.

If all firms could perfectly coordinate their sales, i.e. if they could act as if they were a single firm, they would limit total sales to the monopoly level. This would allow them to charge the monopoly price and to earn the greatest possible profit from the market. After all, the monopoly price–sales combination is – by definition – the combination that extracts the greatest profit from the market. In the diagram, this is shown by the mark-up, $\mu^m$, which corresponds to one firm ($n = 1$). The resulting price is the monopoly price, shown as $P^m$.

The hard part of collusion is finding a way to divide up the monopoly level of sales among the colluding firms. The problem is that, because the price is so much higher than marginal cost, each firm would like to sell a little more than its share. To keep things simple, we assume that the firms manage the collusion by allocating an equal share to all firms. This type of behaviour can be illustrated in the *BE–COMP* diagram with the 'perfect collusion' line shown in Figure 11.2. This line extends horizontally since it assumes that the mark-up always equals the monopoly mark-up, $\mu^m$, regardless of the number of firms.

**Figure 11.2** Perfect collusion


If all firms did charge the monopoly mark-up, then the maximum number of firms that could break even is shown by point '2'. This would involve new entry – an outcome that we rarely observed after liberalization. Another possibility is that all $2n''$ firms would stay in business, without any new firms entering; this is shown as point $A'$. Note that, at this point, all firms are making pure profits owing to the collusion (since $E^m$ is above the $AC$ curve in the left-hand panel and it is above the $BE^{FT}$ curve in the right-hand panel).

This collusion is good for firms' profits, but it is bad for society as a whole. Comparing the perfect collusion outcome to the long-run outcome without collusion (equilibrium, $E''$), we see that the price is higher, and consumption and production are lower. Moreover, since firms are smaller (since overall production is lower with collusion, the output of each firm must be smaller), average costs are higher, so the industry is less efficient.

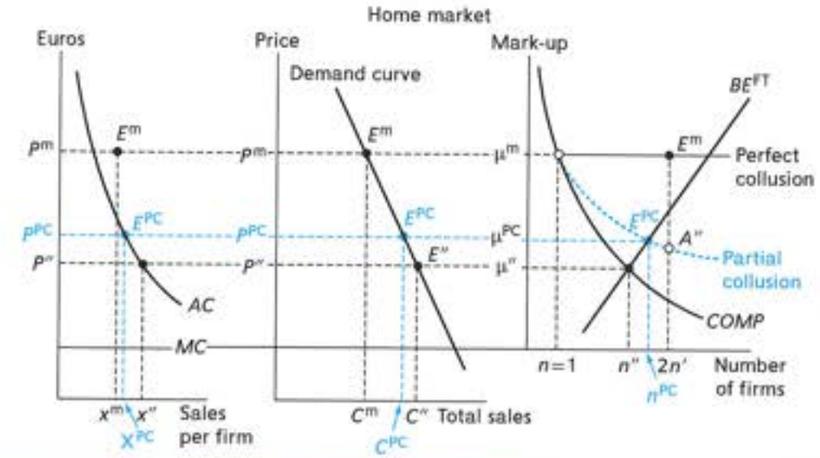
### *Partial collusion*

Perfect collusion is difficult to maintain since the gains from 'cheating' on other colluders are quite high. To reduce the incentive to cheat, the actual degree of collusion may be milder than perfect collusion. This sort of partial collusion restricts sales of all firms but not all the way back to the monopoly level, so the mark-up is lower than the monopoly mark-up but higher than the *COMP* mark-up. With the mark-up lower, it is easier to sustain the collusion since the benefits from cheating are not quite as large.



But how much lower would the mark-up be under partial collusion? As it turns out, an understanding of advanced economics is needed to formalize this notion of 'partial collusion', so we do not address it here explicitly (see Mas-Colell et al., 1995, for an advanced treatment). Fortunately, the basic idea can be easily depicted in Figure 11.3.

**Figure 11.3** Partial collusion and failed industrial restructuring




The curve labelled 'partial collusion' shows a level of collusion where the mark-up is somewhere between the monopoly mark-up and the no-collusion mark-up shown by the *COMP* curve. We do not specify exactly where it lies between the two as it does not change the qualitative analysis. All we need to assume is that the partial collusion curve lies between the *COMP* curve and the perfect collusion curve as shown in the diagram.

If the $2n'$ firms all engaged in this partial collusion, then the mark-up would be shown by point $A''$. This mark-up is higher than the long-run equilibrium mark-up without collusion ($\mu''$), so we see that this partial collusion offsets, to some extent, the increase in competition induced by integration. (Recall from Chapter 6 that the size of the mark-up is an indicator of the degree of competition.)

Note, however, that although this mark-up is higher than under normal competition, it is not high enough for all the firms to break even. We can see this from the fact that point $A''$ is below the break-even curve ($BE^{FT}$). What this means is that, even with partial collusion, some firms will exit the market. In the long run, the number of firms adjusts to restore zero pure profits, and this is where the partial competition curve and the break-even curve intersect, namely, at point $E^{PC}$.

Point $E^{PC}$ is the long-run equilibrium since with $n^{PC}$ firms the mark-up would be $m^{PC}$ and, with this mark-up, $n^{PC}$ firms would all break even. As before, we can read off all the important aspects from the diagram. The level of consumption in the Home market (which is half of total consumption since Foreign is assumed to be identical) is $C^{PC}$. Since supply equals demand in equilibrium, we know that $C^{PC}$ is also the total production in each nation. As usual, the equilibrium price also tells us the equilibrium efficiency, i.e. the typical firm's average cost. Using the average cost curve, we also know that the size of the typical firm is $x^{PC}$.

Now we study the economic implications of such collusion, comparing it to the long-run equilibrium with normal competition, i.e. equilibrium $E''$. To summarize the price and quantity changes, we note that, compared to the normal competition equilibrium, the partial collusion equilibrium involves firms that are smaller, less efficient and more numerous. The mark-up is higher along with the price, so consumption and total production are lower.

### *Long-run economic costs of collusion*

The first point is that collusion will not in the end raise firms' profits to above-normal levels. Even allowing for the way that partial collusion raises prices above $P'$, the initial number of firms after liberalization, namely, $2n'$, is too high for all of them to break even. Industrial consolidation proceeds as usual, but instead of the zero-profit level being reached when the number of firms has dropped to $n''$, the process halts at $n^{PC}$. As noted above, this is where pure profits – which started at zero in the pre-integration long-run equilibrium described in Figure 11.1 – are returned to zero. In other words, the higher prices do not result in higher long-run profits. They merely allow more small, inefficient firms to remain in the market. The welfare cost of the collusion is measured by the four-sided area marked by $P^{PC}$, $P''$, $E''$ and $B$. This is just the consumer surplus loss, but since there is no change in pure profits (it is zero in the long run with or without collusion), the change in consumer surplus is the full welfare effect.

To summarize, collusion prevents the full benefits of restructuring from occurring. By keeping too many firms in the market, anti-competitive behaviour thwarts part of the industry's adjustment that is the key to the gains from integration.

Having presented a general analysis that suggests why deeper European integration and competition problems tend to go hand in hand, we turn now to considering four types of anticompetitive practices in more detail. We start with cartels.

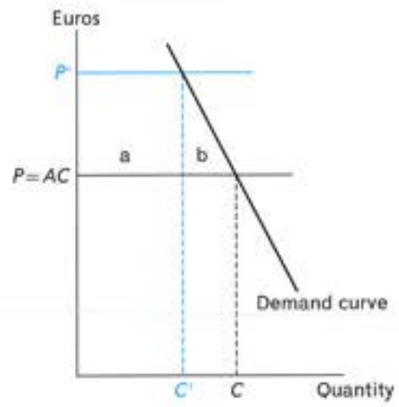
## 11.1.2 Anti-competitive behaviour

Firms like to make money. Competition hinders this, so some firms try to limit competition. One age-old way of doing this is to form a cartel with other firms in the industry. For example, one of the best-known cartels, the Organization of the Petroleum Exporting Countries (OPEC), has been controlling the international price of crude oil since the early 1970s.

### *Horizontal anti-competitive practices: cartels and exclusive territories*

The DRAM cartel is a European example (see Box 11.3). As Figure 11.4 shows, the economic effects of cartels are rather straightforward (see Chapter 4 if you need a refresher on this sort of economics). The diagram depicts the impact of the price-raising effects of a cartel.

**Figure 11.4** Economic analysis of cartels






### Box 11.3 The DRAM cartel

Memory chips are a key component in almost every bit of modern electronics – especially Dynamic Random Access Memory, or DRAM. They are used as the main memory for loading, displaying and manipulating applications and data and as such are critical to personal computers, servers and workstations.

The production of DRAMs is extremely capital intensive (the cost of plants runs into the billions), but the marginal cost of each chip is very low. This combination makes collusion especially tempting and the small number of producers globally makes it feasible.

In May 2010, the Commission decided that ten DRAM producers were running a cartel and fined them over 331 million euros. All the convicted companies but one are non-European (Infineon is German), but the case was based on their European sales. The convicted companies were Micron, Samsung, Hynix, Infineon, NEC, Hitachi, Mitsubishi, Toshiba, Elpida and Nanya, but Micron paid no fine as it testified against the others.

The companies ran the cartel between 1998 and 2002 via a network of contacts and the sharing of secret information bilaterally. Specifically, the companies had regular contact whereby they secretly exchanged information on pricing intentions and general pricing strategy. They also swapped commercially sensitive data to identify specific contract customers. In this way, they shared, verified and monitored prices charged to major electronics manufacturers. The companies used the secret information to set their own prices.

*Source:* This box is based on information from DG Competition's website at http://ec.europa.eu/competition/cartels/cases/cases.html

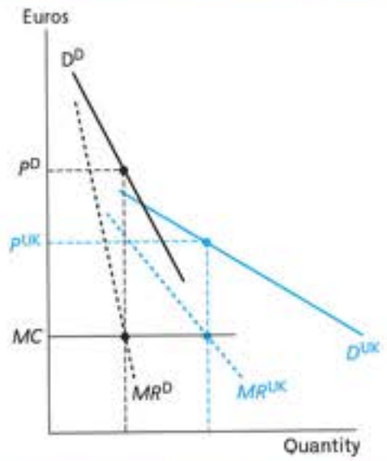
The diagram shows the situation for a particular market, say DRAM, where the price without the cartel would be $P$. This initial price is shown as being equal to average costs ($AC$), which indicates zero profits even before the cartel; the analysis follows through even if the initial price were above $AC$, but this way makes it easier to see the effects. When the cartel raises the price to $P'$ by reducing the volume of sales to $C'$, consumer surplus is reduced by area a + b. The cartel's profit rises by area b. This analysis illustrates the two main problems with cartels: the rip-off effect and the inefficiency effect.

First, the fact that they allow firms to profit at the expense of customers is considered by most people (and by EU law) to be unfair – a rip-off, to put it colloquially. Second, the gain to firms is less than the loss to consumers, so the cartel is inefficient from a purely technical point of view. Specifically, the net economic loss is area b. While few Europeans know or care about the efficiency loss, almost all would believe that the rip-off effect is something their governments should do something about.

Another rather common way of restricting competition is for firms to agree upon so-called exclusive territories. For example, one company would agree to sell only in its local market in exchange for a similar promise by its foreign competitors. One example of this can be found in the market for video games. Nintendo and seven of its official distributors in Europe teamed up in the 1990s to boost profits by dividing up Europe's markets and charging higher prices in those areas where consumers had a higher ability to pay. Under this practice, distributors had to prevent games being shipped from their territory to that of another EU market where prices were higher. Independent customers who allowed such sales among territories were punished by being given smaller shipments next time or cut off altogether. In this way, these companies managed to maintain big price differences for play consoles and games in various EU markets (e.g. Britons enjoyed prices that were 65 per cent cheaper than those faced by the Germans and Dutch). The European Commission fined Nintendo and the seven distributors 168 million euros.

Thinking more broadly, it is clear that such practices offset all the goals of European integration, which is exactly why the Treaty of Rome prohibited such behaviour. Figure 11.5 shows a situation whereby a firm would like to charge different prices in the German and UK markets.

**Figure 11.5** Economic analysis of exclusive territories




The diagram shows the two demand curves; the German demand curve $D^D$ is steeper than the British demand curve $D^{UK}$. The steepness of a demand curve reflects a 'willingness to pay' since it tells us how much consumption of Nintendo products would drop for a given price increase. The German curve is drawn as steeper to reflect the fact that Germans have fewer options when it comes to consumer electronics and games (owing to the smaller number of people who speak German versus English worldwide, and to widespread restrictions on retail outlets in Germany). In economics jargon, German demand is more inelastic, i.e. more unresponsive to price. In this situation, Nintendo would maximize profits by selling the quantities in Germany and Britain that correspond to the intersections of the marginal revenue curves ($MR^D$ and $MR^{UK}$) and marginal cost curves ($MC$); see Chapter 6 if this reasoning is unfamiliar. The quantities are not shown explicitly, but the resulting prices are marked as $P^D$ and $P^{UK}$.

In an integrated market, independent firms, often called 'traders', could arbitrage the price gap by buying Nintendo goods in the UK and shipping them to Germany. Such shipments – which are known as 'parallel trade' – would lower Nintendo's profits and that of its official distributors. To preserve their profits, Nintendo and its distributors attempted, illegally, to prevent such trade.

### *Bullies in the market: abuse of dominant position*

Business leaders and stock markets often evaluate a company's performance based on the growth of its market share, so many firms aim to conquer the market. Firms that are lucky or possess excellent products can succeed in establishing very strong positions in their markets. This is not a problem if the position reflects superior products and/or efficiency – Google's triumph in the market for search engines could be one example. However, once a firm has a dominant position, it may be tempted to use it to extract extra profits from its suppliers or customers, or it may attempt to arrange the market so as to shield itself from future competitors. According to EU law, such practices, known technically as 'abuse of dominant position', are illegal.

The classic example of this is Microsoft. Most computer users are happy that Microsoft has standardized the basics of personal computing around the world – especially those that move between nations or use more than one machine on a regular basis. In other words, computer operating systems are subject to network externalities. That is, computer operating system software becomes more valuable to each user as more people use it.



To understand how and why network externalities work, just think about why the English language has spread so widely and continues to do so; more and more people learn it since so many people speak it. Just as with English, industries characterized by network externalities tend to be marked by a dominant firm, or a handful of firms.

In the case of Microsoft, which has dominated the operating system software market for decades, the question is how it came to dominate applications with products such as Word and Excel. Although it has never been proven in court, many observers believe that the company used frequent updates of its operating system to induce users to drop competing applications (as recently as ten years ago, Microsoft had real competition from rival products such as WordPerfect and Lotus). The details of Windows updates are available to engineers updating Microsoft applications but not to those updating rival applications, so new versions of rival applications often had glitches caused by incompatibilities with the latest version of Windows. Even if a user preferred the other applications, incompatibilities with successive versions of DOS and Windows meant it was easier to switch to Microsoft's applications than it was to deal with the glitches. Moreover, when competing firms came up with innovative programs, Microsoft typically responded with similar programs and gave them away for free. Today, for example, Microsoft charges a high price for Word, where it no longer has any real competitors, but it charges a zero price on software where it has significant rivals, such as media readers and web browsers.

A similar set of issues arose with respect to Google's dominant position in search services. See Box 11.4 for details.

## Box 11.4 The Google case

In March 2013, Google was alerted by the Commission that it was under investigation for business practices that potentially violate EU antitrust rules prohibiting the abuse of a dominant position. These included: (1) displaying Google's own specialized web search services more prominently than those of competing companies; (2) using (without consent) other companies' original content; (3) obliging website publishers to obtain most of their online search advertisements from Google; and (4) restricting the transferability of online search advertising campaigns to rival search advertising platforms.

In February 2014, Google was made to change its practice in response to a Commission antitrust investigation. Specifically, Google guaranteed that the services of three rivals would be promoted along with its own specialized search services.

Commission Vice President in charge of competition policy, Joaquín Almunia, said:

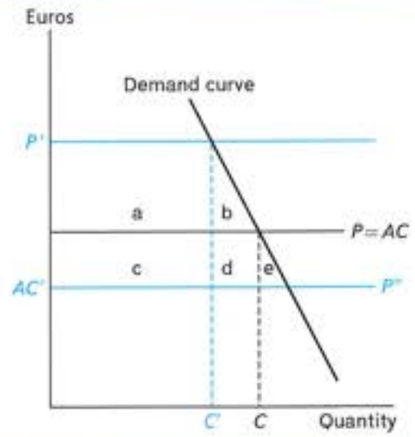
> *My mission is to protect competition to the benefit of consumers, not competitors. I believe that the new proposal obtained from Google after long and difficult talks can now address the Commission's concerns. Without preventing Google from improving its own services, it provides users with real choice between competing services presented in a comparable way; it is then up to them to choose the best alternative. This way, both Google and its rivals will be able and encouraged to innovate and improve their offerings. Turning this proposal into a legally binding obligation for Google would ensure that competitive conditions are both restored quickly and maintained over the next years.*

The investigation actually began in November 2010 following more than a dozen formal complaints about Google's business practices.

### 11.1.3 Merger control

In many European industries, the number of firms is falling as they merge or buy each other out. This sort of concentration of market power is a natural outcome of European integration, as Figure 11.1 showed, but it may also produce cartel-like conditions. The basic trade-off can be illustrated with the so-called Williamson diagram in Figure 11.6.

**Figure 11.6** Basic economics of mergers: market power vs. efficiency gains




Consider a merger that allows the merged firms to charge a higher price, but which also allows them to lower average cost by eliminating redundant capacities in marketing, accounting, sales representatives, etc. The price rise is shown in the diagram by the increase in price from $P$ to $P'$ (the diagram assumes that the market was in long-run equilibrium at $P = AC$ to start with). The efficiency gain is shown by the drop in average cost from $AC$ to $AC'$. The gain to the firm's profitability is strongly positive. Before, $P = AC$ meant there were no profits. After, profit is the area a + c. The merger is bad for consumers, since the price hike implies a loss of consumer surplus equal to the area a + b. The overall gain to society, taking profits and consumer surplus together, is the area c – b since area a is merely a transfer from consumers to firms.

There is a point here that is important for understanding the EU's new rules on mergers. Notice that if entry and exit in the industry are unrestricted, and the remaining firms do not collude, then the long-run outcome of this merger will be to drive the price down to the lower average costs, $P'' = AC'$. This is essentially what happens when the equilibrium shifts from $E'$ to $E''$ in Figure 11.1. In this case, the merger-with-efficiency gain is always positive and equal to area c + d + e since the consumer surplus gain from the lower long-run price, $P''$, is not offset by any loss of producer surplus; profits were zero to start with ($P' = AC'$) and to end with ($P'' = AC'$). Since entry and exit in most EU industries are fairly unrestricted, there is a presumption that mergers will generally be of the type that boosts efficiency and passes on this efficiency to consumers.

Note that our treatment of competition here is highly simplified. The impact of mergers on pricing and costs can be extremely complicated and highly dependent on the nature of the industry. Examples of such reasoning can be found in the Commission's analysis of actual merger cases on their website: http://ec.europa.eu/competition/mergers/cases/.

### 11.1.4 State aid

The Figure 11.1 logic linking integration and industrial restructuring presumes that profit-losing firms would eventually leave the industry – that they would be bought out by another firm, merged with other firms or, in rare cases, go bankrupt. All three of these exit strategies may involve important job losses in specific locations, or at the very least an important reorganization that may require workers to change jobs. Since job losses and relocations are painful, governments frequently seek to prevent them. For example, if the firm is government owned, trade unions may force the government to continue to shore up the money-losing enterprise. If it is privately owned, the government may provide subsidies through direct grants or through long-term loans that may not be repaid.



Here, we look at the long-run economics of such subsidies – called 'state aid' in EU jargon – under two distinct scenarios. The first is where all governments provide such support. The second is where only one does.

#### *EU-wide subsidies: thwarting the main source of gains*

Start by supposing that both governments provide subsidies that prevent restructuring. To be concrete, we make the additional, more specific assumption that governments make annual payments to all firms exactly equal to their losses. Under this policy, all $2n'$ firms in the Figure 11.1 analysis will stay in business, but, since firms are not making extraordinary profits, no new firms will enter. The economy, in short, remains at point $A$ owing to the anti-restructuring subsidies.

An insightful way to think about this subsidy policy is as a swap in who pays for the inefficiently small firms. Before integration, prices were high, so consumers paid for the inefficiency. After liberalization, competition drives down the price but this comes at the cost of extra pay-outs from the national treasuries, so now the taxpayers bear the burden of the industry's inefficiency. Moreover, since all the firms stay in business, integration is prevented from curing the main problem, i.e. the too-many-too-small firms problem. Firms continue to be inefficient since they continue to operate at too small a scale. As a consequence, the subsidies prevent the overall improvement in industry efficiency that was the source of most of the gains discussed in Chapter 6.

Do nations gain from this liberalize-and-subsidize scheme? As it turns out, both nations do gain overall, even counting the cost of the subsidies. We shall show this with a diagram, but before turning to the detailed reasoning, it is instructive to explain the deep reason for this result. Imperfect competition is inefficient since it leads prices to exceed marginal costs. Recalling from Chapter 4 that the consumer price is a measure of marginal utility, the fact that price exceeds marginal cost implies that the gain to consumers from an extra unit would exceed the resource cost of providing the unit. In short, society tends to gain from an expansion of output when price exceeds marginal cost. Because of this, policies that increase output tend to improve welfare. In the jargon of public economics, the subsidy is a 'second-best' policy since it reduces the negative effects of market-power distortion, even if it does not solve the root of the problem.

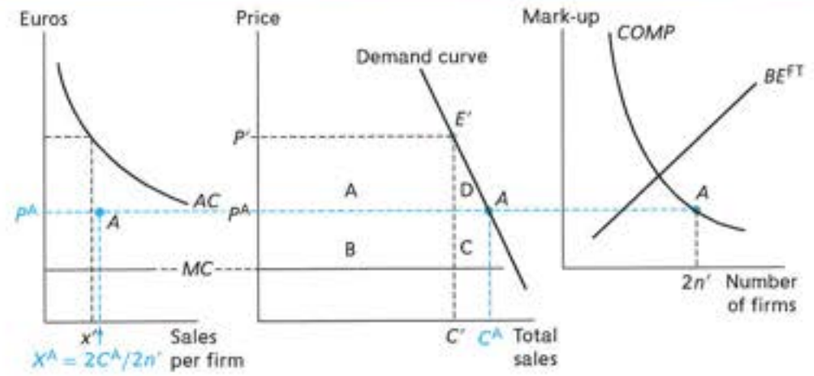
Note, however, that this reasoning is very partial. This sort of 'reactive' subsidy turns out to be a very bad idea in the long run. The subsidies are paid to prevent firms from adapting to changed circumstances. While the government may occasionally improve things by preventing change, a culture of reactive interventionism typically results in a stagnant economy. Staying competitive requires industries to change – to adapt to new technologies, to new competitors and to new opportunities. When firms get used to the idea that their governments will keep them in business no matter what, the incentive to innovate and adapt is greatly weakened. Firms with this sort of mindset will soon find themselves far behind the international competition.

#### *Welfare effects of the liberalize-and-subsidize policy*

To explain the welfare effects of the liberalize-and-subsidize policy, we refer to Figure 11.7. The policy we consider freezes the economy at point $A$ in the right-hand and middle panels (this point $A$ corresponds exactly to point $A$ in Figure 11.1). We know that the price falls from $p'$ to $p^A$ and consumption rises from $C'$ to $C^A$. Since the number of firms has not changed but total sales in each market (which must equal total consumption in each market) have increased, we know that the sales of each firm have increased somewhat, from $x'$ to $x^A$, as shown in the left-hand panel. At this point, firms are losing money, but the government offsets this with a subsidy.

How big will the subsidy be? The easiest way to make this comparison is to adopt a roundabout approach. First, consider the total size of operating profit that the whole Home industry needs to cover all fixed cost before the liberalization. The answer is already in the middle panel. Before the liberalization, the industry broke even by selling a total of $C'$ units at price $p'$. The operating profit on this was the area A + B in the middle panel of the diagram, i.e. the gap between price and marginal cost times the units sold. After the liberalization, the industry's operating profit is area B + C (the new price–cost gap, $p^A - MC$, times the new sales, $C^A$). The drop in operating profit is thus area C minus area A. The subsidy we are considering

**Figure 11.7** Welfare analysis of a liberalize-and-subsidize policy




would have to exactly offset the loss, so the subsidy would equal area A – C. With these facts established, we turn to the welfare calculation.

The consumer part of the welfare calculation is simple. Consumers see a lower price so consumer surplus rises by the area +A + D. To see the overall welfare effect, we subtract the subsidy, which equals A – C. The net welfare effect is A + D – (A – C), which equals D + C. We know this is right since this area is the gap between price and marginal cost summed over all the extra units consumed. Notice that this is the classic gain from partially redressing a market power distortion.

### *Only some subsidize: unfair competition*

The governments of EU Member States differ over how much they can or want to subsidize loss-making firms. Yet, when only some governments subsidize their firms, the outcome of the restructuring may be 'unfair' in the sense that it gets forced upon the firms in nations that do not subsidize, or stop subsidizing before the others. The real problem with this is that it may create the impression that European economic integration gives an unfair advantage to some nations' firms.

To examine this problem more closely while keeping the reasoning as tangible and simple as possible, we continue with the Figure 11.1 example of two nations engaged in an extreme no-trade-to-free-trade integration. The integration moves each identical economy from point $E'$ to point $A$. At $A$, all firms in both nations are losing money. Now suppose that restructuring takes, say, five years in the sense that, after that time, the number of firms has adjusted from $2n'$ to $n''$. In our simple example, there is no way of telling which of the surviving firms will be Home firms and which will be Foreign firms. Symmetry suggests that half the remaining firms would be Foreign, but nothing in the example ensures that this is the case. This is where subsidies can make a big difference.

To be concrete, suppose that prior to the liberalization there were 10 firms in Home and 10 in Foreign, and that after restructuring there will be 12 firms in total. Furthermore, suppose that Home provides a 5-year subsidy to all of its 10 firms, with the size of the subsidy being large enough to offset the liberalization-induced losses. The Foreign government, by contrast, is assumed to pursue a laissez-faire policy, i.e. it allows the market to decide which firms should survive – either because it believes in the market or because it cannot afford the subsidies. In this situation, it is clear that 8 of the 10 Foreign firms will go out of business, while all 10 Home firms will survive. At the end of the 5-year period, the Home government no longer needs to subsidize its firms since the exit of eight Foreign firms restores the industry to profitability.

From a purely economic perspective, the Foreign nation might have been the winner since having firms in our example brings nothing to national welfare (firms earn zero profit in the best of cases). The Home nation's subsidies were merely a waste of taxpayers' money. Two comments are relevant at this stage. First, this sort of conclusion shows that our simple example is actually too simplistic in many ways. For example, we did not consider the cost of workers having to switch jobs and possibly being unemployed for some time. Second, it shows that economics is only part of the picture.

### *The politics of state aid disciplines: I'll play only if the rules are fair*

From a political perspective, this sort of unfair competition would be intolerable. Indeed, if trade unions and business groups in Foreign anticipated that this would be the outcome, they might very well block the whole integration exercise. To avoid this sort of resistance to liberalization, the EU establishes very strict rules forbidding such unfair competition. In this sense, one of the most important effects of discipline on state aid is the fact that it allows governments to proceed with painful and politically difficult reforms.

## 11.2 EU competition policy

Having laid out the basic logic of collusion and subsidies, we turn now to considering actual EU policy that constrains such actions by private actors (anti-competitive practices) and governments (subsidies).

EU competition rules are laid out in the Treaty of the Functioning of the European Union and the implementing legislation. The main provisions discipline anti-competitive practices and abusive dominant positions in the market. The Treaty also sets rules on subsidies, or 'state aid' as the Commission calls it. Generally state aids are prohibited unless sanctioned by the Commission.

### 11.2.1 Institutions: the power of the European Commission

The founders of the EU were fully aware that integrating Europe's markets would result in restructuring and that this would produce incentives for private and public actors to resist consolidation. This is very clear, for example, in the 1956 Spaak Report, which was the economic blueprint for the Treaty of Rome (*Rapport des chefs de délégation aux ministres des affaires étrangères*, Bruxelles, 21 April 1956). Moreover, they feared that the perception that some nations might 'cheat' in an effort to shift the burden of consolidation onto others would, in itself, make deeper European integration politically impossible. To ensure that the prevailing attitude was 'I will reform since the rules are fair' instead of 'I cannot reform since other nations will cheat', the Treaty of Rome prohibited any action that prevents, restricts or distorts competition in the common market.

Importantly, the Treaty puts the supranational Commission in charge of enforcing these strictures. Just as European leaders decided to forgo their control over monetary policy (by making central banks independent) since they knew in advance that short-run politics would lead to bad long-run policy, the Treaty of Rome grants a great deal of power on competition policy directly to the European Commission. The idea was that the politicians in the Council of Ministers might not be able to resist the short-run pressure of special-interest groups opposed to the consolidation that is necessary to obtain the long-run gains from European economic integration. In fact, competition policy is probably the area in which the Commission has the greatest unilateral power.

The Commission has considerable powers to investigate suspected abuses of EU competition law, including the right to force companies to hand over documents. Most famously, the Commission has the right to make on-site inspections without prior warning, which the media often call 'dawn raids'. With a court order, the Commission can even inspect the homes of company personnel.

The Commission has the power to prohibit anti-competitive activities. It does this by issuing injunctions against firms. To back up these demands, the Commission has the right to impose fines on firms found guilty of anti-competitive conduct. The fines vary according to the severity of the anti-competitive practices, with

a maximum of 10 per cent of the offending firm's worldwide turnover. When it comes to subsidies, the Commission has the power to force firms to repay subsidies it deems to be illicit.

Unlike most other areas in which it acts, the Commission's decisions are not subject to approval by the Council of Ministers or the European Parliament. The only recourse is through the European Court. This is an area in which Member States truly did pool their sovereignty to ensure a better outcome for all.

### 11.2.2 EU law on anti-competitive behaviour

EU law on anti-competitive practices was first laid out in the Treaty of Rome and has not been changed substantially (apart from occasional renumbering of the articles, most recently in the Lisbon Treaty). Here, we review the main provisions, but it is important to note that we merely hint at actual policy. EU competition policy has been subject to many decisions of the European Court and one must master the details of these cases in order to fully understand which practices are prohibited and why. Moreover, the Commission publishes its own administrative guidelines so that firms can more easily determine whether a particular agreement they are contemplating will be permitted by the Commission.

Article 101 of the Treaty on the Functioning of the EU, TFEU (as the Treaty of Rome was re-labelled by the Lisbon Treaty) outright forbids practices that prevent, restrict or distort competition, unless the Commission grants an exemption. This article is clearly written and worth reading in its entirety (see Box 11.5).

#### Box 11.5 Article 101 (Article 81 pre-Lisbon; Article 85 in the original TEC)

1 The following shall be prohibited as incompatible with the common market: all agreements between undertakings, decisions by associations of undertakings and concerted practices which may affect trade between Member States and which have as their object or effect the prevention, restriction or distortion of competition within the common market, and in particular those which:

(a) directly or indirectly fix purchase or selling prices or any other trading conditions;

(b) limit or control production, markets, technical development, or investment;

(c) share markets or sources of supply;

(d) apply dissimilar conditions to equivalent transactions with other trading parties, thereby placing them at a competitive disadvantage;

(e) make the conclusion of contracts subject to acceptance by the other parties of supplementary obligations which, by their nature or according to commercial usage, have no connection with the subject of such contracts.

2 Any agreements or decisions prohibited pursuant to this Article shall be automatically void.

3 The provisions of paragraph 1 may, however, be declared inapplicable in the case of:

- any agreement or category of agreements between undertakings;
- any decision or category of decisions by associations of undertakings;
- any concerted practice or category of concerted practices, which contributes to improving the production or distribution of goods or to promoting technical or economic progress, while allowing consumers a fair share of the resulting benefit, and which does not:

(a) impose on the undertakings concerned restrictions which are not indispensable to the attainment of these objectives;

(b) afford such undertakings the possibility of eliminating competition in respect of a substantial part of the products in question.

Typically, the restrictions in Article 101 are classified as preventing horizontal or vertical anti-competitive agreements. Horizontal agreements are arrangements, like cartels and exclusive territories, upon competitors selling similar goods. Vertical agreements are arrangements between a firm and its suppliers or distributors (e.g. agreements by retailers to charge not less than a certain price, and tie-in arrangements whereby goods are only supplied if the vendor agrees to purchase other products).



The first part of Article 101 is so categorical that it rules out an enormous range of normal business practices, which can in fact be good for the European economy. The final part therefore allows the Commission to grant exemptions to agreements where the benefits outweigh the anti-competitive effects. The Commission does this for individual agreements notified to the Commission for exemption, but it also has established the policy of 'block exemptions' that grant permission to broad types of agreements. These exist for technology transfer and for R&D agreements. Political pressure has also forced the Commission to grant a block exemption to the anti-competitive practices in the distribution of motor vehicles.

The second major set of policies – restrictions on the abuse of a dominant position – are found in Article 102 of the TFEU (see Box 11.6). A dominant position usually depends upon a firm's market share. Abuse is a general term but it includes refusal to supply, unfair prices and conditions, predatory pricing, loyalty rebates, exclusive dealing requirements and abuse of intellectual property rights.

#### Box 11.6 Article 102 (formerly Article 82 pre-Lisbon; 86 in original TEC)

Any abuse by one or more undertakings of a dominant position within the common market or in a substantial part of it shall be prohibited as incompatible with the common market insofar as it may affect trade between Member States.

Such abuse may, in particular, consist in:

(a) directly or indirectly imposing unfair purchase or selling prices or other unfair trading conditions;

(b) limiting production, markets or technical development to the prejudice of consumers;

(c) applying dissimilar conditions to equivalent transactions with other trading parties, thereby placing them at a competitive disadvantage;

(d) making the conclusion of contracts subject to acceptance by the other parties of supplementary obligations which, by their nature or according to commercial usage, have no connection with the subject of such contracts.

### 11.2.3 Control of mergers

The Treaty of Rome did not address the control of mergers. The Commission, however, saw some control of mergers as essential to keeping competition vibrant. The issue was controversial among members. Some doubted that mergers needed controlling and others thought such control should be at the national, not EU, level. Some nations viewed merger policy as an important plank in their industrial policy and not a concern of the Commission provided that state aid and rules on 'abuse of dominant position' were respected. This reluctance shifted during the drive in the 1980s to complete the Single Market and 'European Union Merger Regulation' came into force in 1990 and has been amended occasionally since.

The Merger Regulation does not stand by itself but rather is one pillar in a merger control edifice that also includes guidelines on the assessment of horizontal mergers and on best practice in merger investigations, and reforms within the Commission. The Merger Regulation defines anti-competitive behaviour as: 'A concentration which would significantly impede effective competition, in the common market or in a substantial part of it, in particular by the creation or strengthening of a dominant position, shall be declared incompatible with the common market.' Under the rules, mergers that meet the relevant criteria do not have to be notified to the Commission since they are presumed to be compatible with competition. For details, see Commission (2010).

The current rules also give a prominent role to national competition authorities and courts under the so-called European Competition Network, which facilitates coordination among EU and national competition authorities and courts. Box 11.7 describes the decisions taken by the Commission on two particular mergers.

### Box 11.7 Two examples of merger decisions

The European pharmaceutical sector has experienced a wave of consolidation and, as part of this, two mega-mergers were brought to the attention of the European Commission, the Sanofi and Synthélabo link-up and the Pfizer and Pharmacia fusion. The Commission determined that both would lessen competition in certain market segments by limiting the choice of some drugs. The Commission, however, recognized the need for efficiency gains and believed that the mergers could be useful. The outcome was that the Commission allowed the mergers subject to conditions. The firms were required to transfer some of their products to their competitors so as to redress potential anti-competitive effects. For example, Sanofi/Synthélabo sold off certain antibiotics, hypnotics and sedatives.

Another case involved a mainly domestic merger between TotalFina and Elf Aquitaine, which were the main players in the French petroleum sector. The Commission determined that their merger would have allowed them to push up costs for independent petrol station operators (e.g. supermarkets) and the combined company would have operated around 60 per cent of the service stations on French motorways. The combined firms would also have been the leading supplier of liquid petroleum gas. The European Commission believed that this level of market power would be anti-competitive and agreed to the merger only on the condition that TotalFina/Elf sell off a large proportion of these operations to competitors. For example, it sold 70 motorway service stations in France to competitors.

## 11.2.4 EU policies on state aid

The EU's founders realized that the entire European project would be endangered if EU members felt that other members were taking unfair advantage of the economic integration. To prevent this, the 1957 Treaty of Rome bans state aid that provides firms with an unfair advantage and thus distorts competition. Importantly, the EU founders considered this prohibition to be so important that they actually empowered the supranational European Commission to be in charge of enforcing the prohibition. Indeed, the Commission has the power to force the repayment of illegal state aid, even though the Commission normally has no say over members' individual tax and spending policies.

The Treaty prohibits state aid that distorts competition in the EU, and it defines state aid in very broad terms. It can, for instance, take the form of grants, interest relief, tax relief, state guarantee or holding, or the provision by the state of goods and services on preferential terms. Some state aid, however, is allowed according to the Treaty since subsidies, when used correctly, are an essential instrument in the toolkit of good governance. The permitted exceptions include social policy aid, natural disaster aid and economic development aid to underdeveloped areas. More generally, state aid that is in the general interest of the EU is permitted. For example, the Commission has also adopted a number of bloc-exemption rules that explain which sorts of state aid are indisputable. These include aid to small and medium-sized enterprises, aid for training and aid for employment. More information can be found on the DG Competition website.

### Box 11.8 State aid and the global crisis

The global crisis that started in the USA in 2008 spread rapidly to Europe. EU policy makers responded by providing massive state aid to banks to prevent the financial shock from creating a second Great Depression. All these measures had to be approved by the Commission under its state aid policy. In the first 5 years of the crisis, the Commission authorized over 400 state-aid measures to the financial sector. Aid used for recapitalization and asset relief measures amounted to almost 600 billion euros or almost 5 per cent of EU GDP, and aid for guarantees and other forms of liquidity support was almost twice as large. As the crisis has calmed, much of the aid has been repaid.

The Commission duly adopted six 'Communications' providing guidance for Member States regarding what type of aid would be allowed and how it would be monitored. The goal was to allow Member States to underpin financial stability while minimizing distortions of competition between banks and across nations. Financial stability avoids major negative spillovers across EU banking systems and helps banks provide loans to the real economy.

When applying the rules to individual cases, the Commission looks beyond its usual industry-level criteria and takes account of the macroeconomic environment. Key points for the Commission are the long-term viability of the subsidized banks and whether the need for support arose from the crisis or bank-specific risk-taking. This is an ongoing challenge as large parts of the EU financial sector must be restructured.

*Source:* This box is based mainly on data from http://ec.europa.eu/competition/state_aid/scoreboard/financial_economic_crisis_aid_en.html

### *A contentious example: airlines in trouble*

The Commission is frequently in the headlines regarding its decisions on state aid since these often produce loud protests from firms and/or workers who benefitted from any state aid that the DG Competition judges to be illegal. An excellent example concerns the airline industry – an industry in which there are clearly too many firms in existence and the tendency to subsidize is strong. Many European airlines are the national 'flag carrier' and as such are often considered a symbol of national pride.

Consolidation of the European airline industry has been on the cards for years, but the problem was exacerbated by the terrorist attacks of 11 September 2001. The ensuing reduction in air travel caused great damage to airlines all around the world and led to calls for massive state aid. To prevent these subsidies from being used as an excuse to put off restructuring, the Commission restricted subsidies to cover only the 'exceptional losses' incurred when transatlantic routes were shut down immediately after 11 September. To date, the Commission has managed to resist the desire of several Member State governments to support their national airlines to the same extent that the US government has supported US airlines.

It is easy to see the logic of the Commission's stance. Low-cost airlines, such as Ryanair and easyJet, have done well without subsidies. Moreover, artificial support for inefficient national carriers hinders the expansion of low-cost airlines. As Bannerman (2002) puts it:

> *No-one will benefit from a return to spiralling subsidies, which damage the industry by encouraging inefficiency. Both consumers and taxpayers would suffer as a result. As for the national carriers, they would probably benefit from some market consolidation, creating fewer, leaner, pan-European airlines – although this process would need monitoring for its competitive effects on key routes. If the airline industry can use the crisis to create more efficient carriers, it will probably be the better for it. But this long-term view cuts little ice with workers who stand to lose their jobs, or with some politicians, for whom a flag carrier is a symbol of national pride. Unfortunately, the benefits of controlling state-aids occur mainly in lower fares and taxes, and are therefore widely diffused among the population. The costs, on the other hand, take the form of job losses, which hurt a small but vocal constituency.*

## 11.3 Summary

Three main points have been made in this chapter:

- One very obvious impact of European integration has been to face individual European firms with a bigger 'home' market. This produces a chain reaction that leads to fewer, bigger, more efficient firms that face more effective competition from each other. The attendant industrial restructuring

is frequently politically painful since it often results in layoffs and the closure of inefficient plants. Governments very often attempt to offset this political pain by providing 'state aid' to their national firms. Such state aid can be viewed as unfair and the perception of unfairness threatens to undermine EU members' interest in integration. To avoid these problems, the founders of the EU established rules that prohibited state aid that distorts competition. The Commission is charged with enforcing these rules.

- Private firms may also seek to avoid restructuring by engaging in anti-competitive practices and EU rules prohibit this. Moreover, as integration proceeds and the number of firms falls, the temptation for firms to collude may increase.
- To avoid this, the EU has strict rules on anti-competitive practices. It also screens mergers to ensure that they will enhance efficiency. Again, the Commission is charged with enforcing these rules.

## Self-assessment questions

1 Suppose that liberalization occurs as in Figure 11.1 and the result is a pro-competitive effect, but instead of merging or restructuring, all firms are bought by their national governments to allow the firms to continue operating. What will be the impact of this on prices and government revenues? Now that the governments are the owners, will they have an incentive to continue with liberalization? Can you imagine why this might favour firms located in nations with big, rich governments?

2 Look up a recent state aid case on the Commission's website (http://ec.europa.eu/competition/state_aid/register/) and explain the economic and legal reasoning behind the Commission's decision using the diagrams in this chapter.

3 Look up a recent antitrust case (Article 81) on the Commission's website (http://ec.europa.eu/competition/antitrust/cases/index.html) and explain the economic and legal reasoning behind the Commission's decision using the diagrams in this chapter.

4 Using a diagram similar to Figure 11.2, show what the welfare effects would be following a switch from normal competition to perfect collusion. Be sure to address the change in consumer surplus and pure profits.

## Further reading: the aficionado's corner

For a very accessible introduction to EU competition policy, see:
**Neven, D., P. Seabright and M. Nutall** (1996) *Fishing for Minnows*, CEPR, London.

Every interested reader should at least skim through the Commission audiovisual material on Competition Policy (http://ec.europa.eu/competition/consumers/index_en.html). It is well executed and highly accessible.

### *Useful website*

The DG Competition website has several highly accessible accounts of EU competition policy and information on recent cases; see http://ec.europa.eu/dgs/competition/index_en.htm.

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Chapter

# EU trade policy

## Chapter Contents

## Introduction

The European Union is the world's biggest trader. Counting EU exports both within the EU and to non-EU nations, the Union accounts for approximately a third of world trade – a great deal more than China, Japan and the USA combined. Its dominance of trade in services is even greater. Five of the EU27 members are individually in the top 10 trading nations in the world (Germany, Netherlands, France, Italy and Britain). The EU is also a leader in the world trade system, both as a key player in the World Trade Organization (WTO) and as a massive signer of bilateral trade agreements and extender of unilateral trade concessions to the world's poorest nations.

While the EU has been one of the staunchest supporters of the WTO's trade rules, many observers traditionally viewed EU trade policy – especially that on agricultural goods – as a major roadblock to greater liberalization worldwide. This situation is, however, changing. The EU's reform of its massive Common Agriculture Policy (CAP; see Chapter 9 for details) has greatly reduced the extent to which EU farm policy distorts world markets. For example, as this edition was going to press, the EU was committed to eliminating regular export subsidies for all farm goods by 2017.

This chapter covers EU trade policy by presenting the basic facts on EU trade, describing the EU's institutional arrangements as they concern trade policy, and finally summarizing the EU's policies towards its various trade partners. It is important to note that EU trade policy – like so much about the Union – is mind-numbingly complex. There is a whole army of specialists who do nothing but follow EU trade issues, and most of these have to specialize in one particular area in order to master all the detail. Plainly, then, this chapter cannot come even close to surveying all EU trade policy. Its goal is rather to present the broad outlines and key issues. Readers who are interested in greater detail on a particular trade partner, sector or policy should start with the European Commission's website: http://europa.eu.int/comm/trade/.

## 12.1 Pattern of trade and tariffs: facts

The EU trades mainly with Europe, as Figure 12.1 shows. The right bar shows the share of EU exports that goes to the EU's various partners. The figures include EU sales to non-EU nations as well as exports from one EU nation to another. This gives perspective on the relative importance of intra-EU trade and external trade. The main points are:

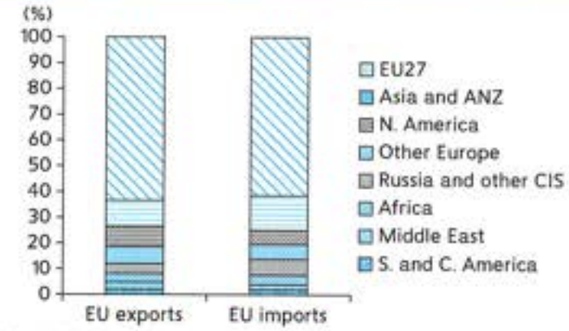
- Two-thirds of EU27 exports are to other EU27 nations. More than 90 per cent of such exports actually occur among the EU15, since the 10 new Member States are fairly small economically (see Chapter 2 for details).
- If we add in other European nations – EFTA (Switzerland, Norway, Iceland and Liechtenstein) and Turkey – the figure rises to three-quarters. In short, three out of four export euros earned by the EU27 are from sales within Europe, broadly defined.
- After Europe, Asia is the EU27's main trading partner, with North America in third place.
- Africa, Latin America and the Middle East are not very important as EU export destinations; their shares are each less than 4 per cent.

The pattern on the import side is very similar (left bar in Figure 12.1). The biggest difference lies with Asia since the EU imports more from Asia than it exports to it. The opposite is true of North America. The EU's trade with the rest of the world is approximately in balance.

It can be useful to take an even closer look by separating out individual nations, as in Table 12.1. Just 10 nations account for about two-thirds of EU27 *external* trade, but the list is slightly different on the import and export sides. The USA is the number one buyer of EU exports by a very large margin, and China is the biggest exporter to the EU. After China and the USA, the next most important market for EU exports is Switzerland, but the Swiss buy only 40 per cent as much as Americans (still, this is a big number given that there are 8 million Swiss and 300 million Americans). Russia, Turkey and Japan round out the top five partners – leaving aside imports from Norway (most oil and gas). This role of the so-called emerging economies in EU trade is quite clear from these numbers. Taking the BRICs (Brazil, Russia, India and China) together, they account for 18 per cent of imports and 27 per cent of exports.



**Figure 12.1** EU27 exports and imports by main partner, 2012




*Source:* WTO online trade statistics database

**Table 12.1** The EU's top 10 import and export partners, 2010 (€ billions)

| Partner | Exports | Share (%) | Partner | Imports | Share (%) |
|---|---|---|---|---|---|
| USA | 242 | 18 | China | 157 | 10 |
| China | 113 | 8 | USA | 105 | 7 |
| Switzerland | 105 | 8 | Russia | 72 | 5 |
| Russia | 87 | 6 | Switzerland | 68 | 5 |
| Turkey | 61 | 5 | Norway | 59 | 4 |
| Japan | 44 | 3 | Japan | 51 | 3 |
| Norway | 42 | 3 | Turkey | 26 | 2 |
| India | 35 | 3 | Korea | 26 | 2 |
| Brazil | 31 | 2 | India | 22 | 1 |
| Korea | 28 | 2 | Brazil | 19 | 1 |
| UAE | 28 | 2 | Libya | 16 | 1 |
| Hong Kong | 27 | 2 | Taiwan | 16 | 1 |

*Source:* http://epp.eurostat.ec.europa.eu/portal/page/portal/international_trade/introduction

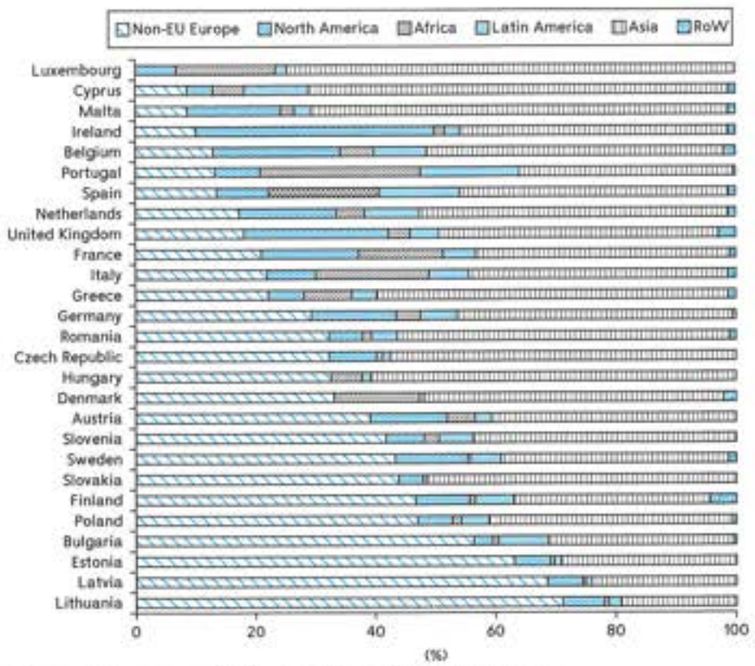
### 12.1.1 Differences among Member States

One of the things that makes EU trade policy a contentious issue is the fact that the various Member States have quite different trade patterns. Some members are landlocked and surrounded by other EU

members, while others are geographically and/or culturally close to Africa, North America or Latin America. It is not surprising, therefore, that the importance of various trade partners varies quite a lot across the EU27.

Figure 12.2 illustrates this divergence. The reliance of Member States on imports from the various regions is shown by the 100 per cent bars. The leftmost segment shows the share of imports from non-EU Europe. This ranges from about 5 per cent for Luxembourg to almost 80 per cent for Lithuania. Geography matters a great deal when it comes to trade partners, so it is not surprising that non-EU Europe countries – which include Ukraine and Russia – play a big role in the imports for the central European members such as Poland and the Baltic States. The importance of North America varies almost as much. North America's share in Irish external imports is about 40 per cent, while for the Baltic States it is 10 per cent or less.

**Figure 12.2** Main trade partners by Member State: imports




*Source:* http://epp.eurostat.ec.europa.eu/portal/page/portal/international_trade/introduction

The figure also shows some fairly natural linkages. The Iberians import a large share of their external trade from Latin America and Africa. Africa's share is also over 15 per cent for Italy and France. Asia's role is more constant, although it tends to be larger for members with easy access to the sea, such as Britain, Denmark and Poland.

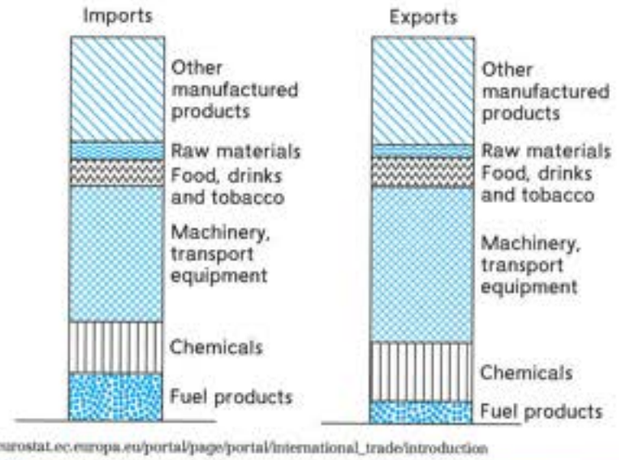


## 12.1.2 Composition of the EU's external trade

What sorts of goods does the EU27 export to and import from the rest of the world? As Figure 12.3 shows, the answer is 'mainly manufactured goods'. The main points from the diagram are:

- Manufactured goods account for almost 90 per cent of EU exports, with about half of all exports being machinery and transport equipment.
- On the import side, about two out of every three euros spent on imports go to buy manufactured goods.
- Being energy poor, the EU27 is a big importer of fuel; about one in every five euros spent on imports goes to pay for fuel.
- Other types of goods play a relatively minor part in the EU's trade.

**Figure 12.3** Composition of EU27 imports and exports, aggregate trade




*Source:* http://epp.eurostat.ec.europa.eu/portal/page/portal/international_trade/introduction

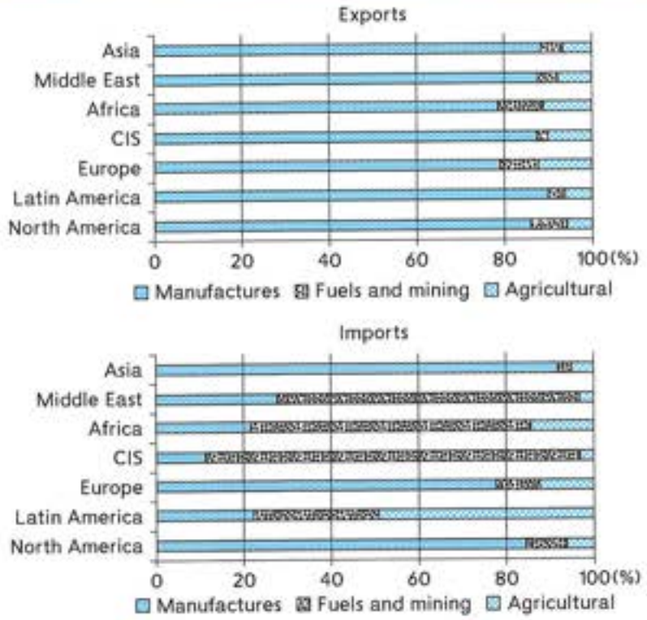
About 7 per cent of EU27 exports to the rest of the world consist of food (more precisely, food, drink and tobacco). The EU's imports of such goods account also for 7 per cent of all its imports. As the chapter on the CAP (Chapter 9) showed, Europe's trade in agricultural goods is massively distorted by subsidies to EU farmers, subsidies to EU exports and high barriers against imports. If the CAP were fully liberalized in the direction the Commission is pushing for (see Chapter 9 for details), all trade distortions would be removed and the EU would surely become a net importer of food.

### *What with whom?*

The situation illustrated in Figure 12.3 aggregates all the EU's trade with all partners. This is useful since it gives us an idea of just how dominant manufactured goods are when it comes to EU trade policy. It also provides an important perspective when we turn to EU trade policy, since EU import barriers for manufactured goods are very different from its import barriers on agricultural goods. Moreover, it illustrates quite clearly that agricultural goods play only a minor role in the EU's trade despite the dominance of agriculture in political conflicts both within the EU and with the rest of the world.

The aggregate trade pattern, however, hides a set of facts that are important to understanding the impact of the EU's external trade policy. Simply put, the commodity composition of the EU's *exports* is approximately the same for all of the EU's trade partners, but this is not true for its imports. Figure 12.4 shows the facts.

**Figure 12.4** Composition of EU27 imports and exports, by product and partner




*Source:* http://epp.eurostat.ec.europa.eu/portal/page/portal/international_trade/introduction

The diagram gathers EU trade partners into seven groups: Asia, the Middle East, Africa, Commonwealth of Independent States (CIS), Europe, Latin America and North America. The top panel shows the commodity composition of EU exports to these regions, while the bottom panel does the same for EU imports.

- Scanning across the top panel it is easy to see that bars are quite similar. That is, the shares of manufactures in EU exports to all regions are fairly similar, about 80 to 90 per cent.
- The bottom panel, however, shows that the EU's import composition varies a lot by partner. As might be expected, Europe tends to import a lot of primary goods – food and raw materials including fuel – from continents that are relatively abundant in natural resources – Africa, CIS, the Middle East and Latin America. With North America and Asia, the imports consist mostly of manufactures.
- Food is never a dominant import for any of the partners, but it amounts to almost half of the EU's imports from Latin America (and this figure can be much higher for particular nations, especially small, poor nations).

### 12.1.3 The EU's Common External Tariff (CET)

The EU has been an active participant in the 60-year-long sequence of global tariff-cutting talks known as GATT Rounds or, since 1995, WTO Rounds. As a result, the EU's tariffs are quite low for most goods that were bargained over in these Rounds. Since agricultural tariffs were not included in these Rounds until the end of the twentieth century, EU tariffs on such goods remain much higher.



As the EU defines individual tariff rates for about 10,000 products, we must generalize to get a handle on the numbers. The average CET rate is about 6 per cent, but this hides a wide variation. About a quarter of the rates on all products are set at zero (mostly industrial goods including electronics) and the average for industrial goods is about 4 per cent. The average on agricultural imports is four times this, namely, 16 per cent. The facts for various product categories are shown in Table 12.2.

**Table 12.2** EU's Common External Tariff (CET), 2010

| | Average (%) | Max (%) | Share of extra-EU imports duty free |
|---|---|---|---|
| Animal products | 23 | 162 | 10 |
| Dairy products | 49 | 163 | 0 |
| Fruit, vegetables, plants | 11 | 161 | 12 |
| Coffee, tea | 7 | 55 | 78 |
| Cereals and preparations | 18 | 111 | 2 |
| Oilseeds, fats and oils | 6 | 94 | 70 |
| Sugars and confectionery | 28 | 118 | 0 |
| Beverages and tobacco | 19 | 166 | 15 |
| Cotton | 0 | 0 | 100 |
| Other agricultural products | 5 | 117 | 68 |
| Fish and fish products | 12 | 26 | 5 |
| Minerals and metals | 2 | 12 | 56 |
| Petroleum | 3 | 5 | 84 |
| Chemicals | 5 | 13 | 43 |
| Wood, paper, etc. | 1 | 10 | 85 |
| Textiles | 7 | 12 | 2 |
| Clothing | 12 | 12 | 0 |
| Leather, footwear, etc. | 4 | 17 | 17 |
| Non-electrical machinery | 2 | 10 | 53 |
| Electrical machinery | 3 | 14 | 55 |
| Transport equipment | 4 | 22 | 17 |
| Other manufactures | 3 | 14 | 55 |

*Source:* WTO online database, 'World Tariff Profiles', www.wto.org

The table's three columns list the average tariff in the relevant product category, the maximum tariff in the category and the share of such imports that come in duty-free. The first column thus gives an idea of the overall protectionist tendency in the category. For example, the average tariff on animal products (meat, etc.) is 23 per cent, which is fairly high, but only half as high as the protection on dairy products (49 per cent).

The maximum tariff in both categories is astronomical – over 160 per cent, as the second column shows. The third column shows the share of the EU's external imports that come in duty-free because of reciprocal or unilateral preference agreements. For example, 10 per cent of EU imports of animal products come in at zero tariffs, but no dairy does. Below we discuss in more detail the various programmes that allow duty-free imports.

Now, looking down the rows we see that imports of primary goods are – with the exception of cotton – taxed at a much higher rate than manufactured goods. The maximum tariffs are also much lower. The share of imports that come in duty-free varies a lot by product. The maximum rates on some manufactured goods are still high, but the average rate on manufactures is always below 5 per cent, except for textiles and clothing where the averages are 7 and 12 per cent, respectively.

## 12.2 EU institutions for trade policy

Formation of a customs union – which means the elimination of tariffs on intra-EU trade and adoption of a common external tariff – was the EU's first big step towards economic integration. A customs union requires political coordination since trade policy towards third nations is an ever-evolving issue. To facilitate this coordination, the Treaty of Rome granted supranational powers to the EU's institutions as far as external trade policy is concerned – what is known in EU jargon as 'exclusive competence' (see Chapter 3 for details). This delegation of sovereignty has never changed and indeed over the decades the various Treaties have granted the EU more power in the area of trade. The 2009 Lisbon Treaty in particular greatly increased the extent to which EU members have delegated power on trade issues to the EU (see Box 12.1). This section reviews the institutions and practices governing this coordination.

### Box 12.1 Lisbon Treaty changes on trade in a nutshell

As far as trade policy goes, the Lisbon Treaty involves three big changes:

1 Big increase in European Parliament power on trade policy. Before Lisbon, the Parliament's power on EU trade policy was minor. Now its power is very nearly equal to that of the Council (i.e. the old Council of Ministers). Specifically:
   - All EU trade laws (e.g. imposition of anti-dumping tariffs, granting of trade preferences, etc.) must be adopted by the 'ordinary legislative procedure' (the old codecision procedure). Under this procedure, the Parliament and Council have equal power.
   - All trade agreements must now be approved by Parliament, but Parliament does not have the formal right to suggest amendments. However, as the discussion of the EU–Korea free trade agreement showed, Parliament can use its right of refusal to influence the content of agreements.
2 Increased powers for the EU as opposed to EU members.
   - Foreign direct investment (FDI) becomes clearly under EU authority, so only the EU can conclude international agreements and adopt laws on FDI.
   - The Lisbon Treaty clearly grants power to the EU on issues such as trade in services and commercial aspects of intellectual property, along with trade in cultural, audiovisual, educational and social and health services (in certain sensitive cases, like culture, the EU power is subject to specific voting rules that grant EU members the power of veto).
3 Qualified majority voting for most trade issues.

   Qualified majority voting (see Chapter 3 for details) is now the general rule in the Council for actions related to trade policy areas (including the new areas such as investment and services). However, members still retain a veto (i.e. unanimity is required in the Council) in certain cases; for example, when commitments in trade agreements might undermine the EU's cultural and linguistic diversity, or seriously disturb members' national organization of social, educational or health services. Unanimity is also required if the EU law or trade agreement covers issues that would be subject to unanimity for internal laws (e.g. tax harmonization).

Source: This box draws on European Commission (2011)



### 12.2.1 EU competences on trade

Trade policy is an EU 'exclusive competence' (see Chapter 3 for details). That is, the EU has the exclusive power to set trade policy with third nations – the so-called Common Commercial Policy. Individual Member States cannot legislate on trade matters or conclude international trade agreements. The logic of a customs union having one trade policy is extremely strong. After all, if each member did bilateral deals on its own, the single market might be undermined by third nations exploiting differences across EU members' external trade policies.

In the twentieth century, the EU's power on trade policy was basically limited to tariffs. This was not an important limitation; back then, tariffs were by far the most important aspect of trade policy. As EU tariffs came down during the course of multilateral trade negotiations, and the nature of international commerce grew more complex, the range of important trade barriers broadened.

As the logic of a unified external trade policy was as strong as ever, this trend created a need to expand the competence of the EU beyond tariffs. This was done in a series of small and practical steps in the Maastricht and Nice Treaties. It took a big step forward with the December 2009 Lisbon Treaty, which extended the Common Commercial Policy to explicitly include trade in services, foreign direct investment and some aspects of intellectual property rights (copyrights, patents, etc.).

#### *Protection and enforcement of intellectual property*

A key element in Europe's competitiveness lies in its intellectual property (the general name for things like patents, trademarks, designs, copyrights and geographical indications, like Parma ham or Champagne). To protect these, the EU and its members have signed many agreements establishing international disciplines that protect this intellectual property. These disciplines are meant to deter piracy, counterfeiting and the like.

A key role of EU trade policy is to see that such standards are respected by third countries. The Commission takes the lead here and pursues the objective in the WTO and bilaterally with third nations. Most recently, the EU participated actively in the negotiation of the Anti-Counterfeiting Trade Agreement (ACTA), which was signed in the autumn of 2011.

#### *Investment*

In many industries, investment has become an integral part of trade. For example, BMW and Airbus set up production facilities in China as part of their effort to sell goods to Chinese customers. Likewise, the internationalization of supply chains often involves EU companies investing in factories in third nations. Indeed, the EU is the largest generator of foreign direct investment (FDI) in the global economy (FDI is where a company from one nation directly controls an investment in another, say a factory, rather than merely owning some shares in the foreign company).

Such investment is facilitated by clear rules that establish legal rights for investors abroad and for foreign investors in the EU. Establishing, improving and enforcing such rules is the main thrust of EU investment policy. Here, the Commission works with the WTO and third nations in the context of bilateral trade agreements (e.g. the EU–Korea FTA that came into effect in 2011). Currently, the focus is on the negotiation of investment rules in the context of preferential trade agreements that the EU negotiates with third countries. The EU–Korea Free Trade Agreement is the most recent example of an agreement that reflects EU investment policy negotiations.

Prior to the Lisbon Treaty, investment was not part of the EU's responsibility, so Member States signed a large number of bilateral arrangements (called Bilateral Investment Treaties, BITs). It is not yet clear how the EU will deal with this tangle of agreements. For example, Turkey has a BIT with 11 separate EU

members. These will presumably be eventually merged into one, but such pre-existing BITs are likely to remain in force for some time.

### 12.2.2 Allocation of responsibilities

Trade policy in today's globalized world touches on a vast array of issues. Correspondingly, EU trade policy is extremely complex since it has to deal with issues ranging from quotas on men's underwear from China to internet banking to sugar imports. To keep EU policy coherent in the face of this complexity, the Treaties assign to the European Commission the task of negotiating trade matters with third nations on behalf of the Member States (Article 207 of the Treaty on the Functioning of the European Union). In practice, this means that the EU Trade Commissioner (currently Karl de Gucht) is responsible for conducting trade negotiations. These negotiations are conducted in accordance with specific mandates defined by the Council and the Parliament (called 'Directives for Negotiation'). The European Commission also takes the lead in trade policy in the sense that it has the right of initiative on, for example, trade agreements, and it is in charge of enforcement and surveillance of compliance with existing agreements and WTO rules.

The basic frameworks guiding the Commission are jointly decided by the European Parliament and the Council (i.e. what was called the Council of Ministers before the Lisbon Treaty). These decisions are taken on the basis of the 'ordinary legislative procedure' (see Chapter 2), which involves majority voting in the Council and the Parliament. The Council must adopt any agreements negotiated by the Commission after the Parliament has given its consent (i.e. the Parliament can say 'yes' or 'no' but cannot amend the agreements). For agreements that deal with areas under the exclusive competences of the EU, members' national parliaments no longer have to ratify the decision of the Council and Parliament.

The big change in the Lisbon Treaty on trade policy concerns the European Parliament. Specifically, it is now co-legislator with the Council on all basic EU trade legislation, such as anti-dumping tariffs and trade preferences for developing nations. Moreover, the Commission is required to inform the Parliament regularly about ongoing negotiations.

#### *Trade policy and foreign policy*

Trade policy has long been one of the EU's most effective foreign policy tools. After Lisbon, the lines between foreign policy and trade policy became even more blurred. The Lisbon Treaty institutes a hierarchy of principles that should be applied to trade policy (as well as other aspects of foreign policy). For example, Article 3 of the Treaty on European Union states:

> *In its relations with the wider world, the Union shall uphold and promote its values and interests and contribute to the protection of its citizens. It shall contribute to peace, security, the sustainable development of the Earth, solidarity and mutual respect among peoples, free and fair trade, eradication of poverty and the protection of human rights, in particular the rights of the child, as well as to the strict observance and development of international law, including respect for the principles of the United Nations Charters.*

It is not yet clear how much practical importance this will have, but it certainly means that the EU's general pro-business view of trade agreements will be tempered with more input from players – such as Members of the European Parliament – who are less concerned with exporting and more concerned with human rights, the environment and so on.

### 12.2.3 Anti-dumping and anti-subsidy measures

Under WTO rules, tariff liberalization is a one-way street. Once a nation has lowered a tariff in WTO talks (such talks are often called 'Rounds', e.g. the ongoing one is called the Doha Round), it is not allowed to put the tariff back up. This principle of 'binding' tariffs applies to the EU's external tariffs. The principle, however, is subject to some loopholes, the most important of which are anti-dumping and anti-subsidy tariffs.

Dumping is defined as the selling of exports below some normal price. According to WTO rules, a nation, or more broadly speaking, a customs area (i.e. the EU), can impose tariffs on imports if dumping 'causes or threatens material injury to an established industry'. The EU, together with the USA, is one of the world's leading users of such measures, especially in iron and steel, consumer electronics and chemicals.



The European Commission is in charge of investigating dumping complaints. If the Commission finds that: (1) dumping has occurred (this involves intricate and somewhat arbitrary calculations) and (2) material injury to EU producers has happened or might happen, it can impose a provisional duty (that lasts between 6 and 9 months). The Council of Ministers must confirm the Commission's decision before the tariffs become definitive (these stay in place for 5 years). Sometimes the Commission avoids imposing tariffs by negotiating 'price undertakings' with the exporting nation; these are promises by the exporters to charge a high price for their goods in exchange for suspension or termination of the Commission's anti-dumping investigation. In terms of EU welfare, price undertakings are worse than tariffs since the EU collects no tariff revenue. Nevertheless, price undertakings are often more expedient politically since they are a way of 'bribing' the exporting nation into not complaining too loudly about the EU's new protection. (See Chapter 4 for the economic analysis.)

Since dumping duties, like all tariffs, help producers but harm consumers and firms that buy the goods (see Chapter 4), the Commission often faces a tricky balancing act among Member States. Frequently, the EU producers are concentrated in one or a few Member States while there are consumers in every Member State. Typically, the former want the Commission to impose dumping duties while the latter oppose them. For this reason, the Commission implements anti-dumping measures only when it believes that they are in the broader interest of the EU. For historical and institutional reasons, the EU rarely imposes anti-subsidy duties, preferring to deal with such behaviour as 'below normal' pricing.

Many observers believe that both the EU and the USA employ a cynical manipulation of dumping rules – especially the calculation that determines whether imports have been dumped – in order to provide WTO-consistent protection for sectors whose producers are usually powerful politically. The iron and steel industry and the chemical industry are leading examples.

## 12.3 EU trade policy: broad goals and means

For most of its life, EU external trade policy meant negotiating:

- Reciprocal tariff cuts in FTAs with other Europeans (e.g. the EU–EFTA bilaterals for 1973).
- Reciprocal tariff cuts with non-European rich nations in the GATT/WTO (e.g. the 1967 Kennedy Round or 1994 Uruguay Round).
- Unilateral tariff preferences for developing nations.

This started to change as a result of a 2006 landmark communication from the Commission known as Global Europe. It set out a more global strategy for EU external trade policy as a complement to the renewed 'Lisbon Strategy'. (The Lisbon Strategy was a set of loosely-knit initiatives that EU members were supposed to undertake domestically to improve their growth prospects.) Specifically, Global Europe identified ASEAN, Korea, India and Mercosur as priority partners for new FTAs.

The logic behind these choices is still rock solid. Up until around the end of the twentieth century, about 60 per cent of world growth came from rich-nation markets – the USA, EU, Japan, Canada, etc. That share declined rapidly in the new century even before the global economic crisis. According to IMF forecasts, after recovery from the crisis, China and other developing nations will account for more than three-quarters of global growth.

There was also a shift away from 'shallow' FTAs, i.e. agreements that focused on many tariffs, towards deeper agreements that covered issues such as investment, public procurement, competition, IPR enforcement and regulatory convergence issues (i.e. what would be known as approximation of laws inside the EU). Such matters had to be dealt with in FTAs since the ongoing WTO Round – the Doha Round launched in 2001 – was based on an agenda that included few of these subjects.

#### *Europe 2020 and EU trade policy*

In March 2010, the European Commission launched a new ten-year strategy (similar to the Lisbon Strategy) aimed at promoting 'smart, sustainable, inclusive growth' (see http://ec.europa.eu/europe2020/index_en.htm for details). This, of course, included a trade and investment policy component laid out in a 2010 Commission communication titled 'Trade, Growth and World Affairs'. The communication notes that world trade has undergone profound changes, especially with respect to the internationalization of supply

chains. For example, two-thirds of EU imports involve intermediate inputs which boost the EU's productive capacity. Keeping ahead of the competition in manufacturing and export services requires EU firms to source parts and services from the most competitive locations.

Owing to these changes, the EU trade policy is to continue the tendency, started by Global Europe, of focusing on deeper integration; cutting tariffs is still important, but the big challenge is more complex. The goal is to tackle market access for services and investment by opening up public procurement, enforcing protection of IPR, removing restrictions on the supply of raw materials and energy, and overcoming regulatory barriers. Readers can follow a public debate on this new strategy on the policy portal www.voxeu.org (just click on the Debate tab and then on 'The Future of EU Trade Policy').

Given this renewed emphasis on 'beyond the borders' barriers to trade – and the continued inability of WTO members to conclude the Doha Round – the EU's emphasis shifts even more towards bilateral FTAs. The Doha Round remains the EU's top trade priority; however, getting more than 150 nations to agree on that complex deal is beyond the EU's power.

## 12.4 EU trade policy: existing arrangements

The EU's external trade policy is extremely complex. It has or is considering or is negotiating trade agreements with most nations in the world, as Figure 12.5 shows.

**Figure 12.5** Map of EU trade agreements, actual and potential, 2014






The key agreements underway when this edition went to press are the Trans-Atlantic Trade and Investment Partnership (TTIP), which was analysed in Chapter 5, the EU–Japan trade agreement and the EU's discussions with China on investment protection.

## 12.5 Summary

This chapter provided a broad introduction to the immensely complex topic of EU trade policy. It started by presenting facts on the EU's trade pattern. The main points were:

- The EU trades mainly with Europe, with itself in particular.
- The EU is primarily an exporter of manufactured goods.
- Most EU imports are manufactured goods, although imports of primary goods are important for Africa, the Middle East and Latin America.

The next topic was EU decision making on trade. In a nutshell, the European Commission is in charge of negotiating the EU's external trade policy, but its efforts are directed by mandates from the Council of Ministers and all deals are subject to Council approval. Before the Lisbon Treaty, the Parliament had a negligible role, but now it is a co-legislator with the Council on issues like anti-dumping duties, and it must give its consent on new trade agreements.

The last section in the chapter addressed the content of the EU's trade policy. The main points were:

- Trade arrangements in Europe can be characterized as hub-and-spoke bilateralism. The hub is formed by two concentric circles (the EU, which has the deepest level of integration, and EFTA, which participates in the Single Market apart from agriculture). These circles form a 'hub' around which a network of bilateral agreements is arranged with almost every nation in Europe (broadly defined) and the Mediterranean. These bilateral deals fall into three groups: the Euro–Med agreements, the Stabilisation and Association Agreements with Western Balkan nations, and the Partnership and Cooperation Agreements with former Soviet republics in the Commonwealth of Independent States.
- The EU has preferential trade agreements with its former colonies – the so-called ACP nations – that are currently asymmetric (the EU charges zero tariffs but the ACP nations do not), but they are aiming at establishing full-blown two-way FTAs in the coming years.
- The EU grants unilateral preferences of various types to almost all developing nations.

### Self-assessment questions

1. What is the role of the Member States and the Commission in relation to external trade policy? Be sure to distinguish between trade in goods and more 'modern' trade issues such as trade in services, trade in intellectual property rights and foreign direct investment.
2. What does the EU buy from and sell to the five continents: Europe, Africa, North America, South America and Asia?
3. What is the most protected good in the EU and which is the least protected good?
4. Why did the EU extend unilateral tariff preferences to former French and Belgian colonies, and why did it extend these to former British colonies in the mid-1970s?
5. Explain the term 'hub-and-spoke bilateralism' as applied to the EU's neighbours in Europe and around the Mediterranean.

## Further reading: the aficionado's corner

A very lengthy and complete treatment of the EU's trade policy can be downloaded from the WTO's website, www.wto.org (follow links to the Trade Policy Reviews, or use Google with the words EU, Trade Policy Review and WTO). This is an independent review of EU trade policy, which includes detailed presentation of its preferential, multilateral and sector policies. It also provides references to many academic studies on the impact of EU policies.

A very sceptical presentation of EU trade policy that includes explicit economic evaluation is:

**Messerlin, P.** (2001) *Measuring the Costs of Protection in Europe: European Commercial Policy in the 2000s*, Institute for International Economics, Washington, DC.

For general information on the WTO, see:

**Hoekman, B. and M. Kostecki** (2001) *The Political Economy of the World Trading System: The WTO and Beyond*, Oxford University Press, Oxford.

Also check out the **WTO**'s website, www.wto.org.

For more on the EU trade policy with poor nations, see:

**Hinkle, L. and M. Schiff** (2004) 'Economic Partnership Agreements between Sub-Saharan Africa and the EU: a development perspective', *World Economy*, 27(9): 1321–34.

**Panagariya, A.** (2002) 'EU preferential trade policies and developing countries', *World Economy*, 10(25): 1415–32.

For more on GSP in general, see:

**GAO** (1994) *Assessment of the Generalized System of Preferences Program*, US General Accounting Office, Washington, DC. Download from www.gao.gov.

### *Useful websites*

The best general site is the European Commission DG-Trade site, http://ec.europa.eu/trade/.

For information on preferential trade agreements worldwide, see www.bilaterals.org.

### *References*

**Baldwin, R.** (1994) *Towards an Integrated Europe*, CEPR, London.

**European Commission** (2011) 'What did the Lisbon Treaty change?' Factsheet, 14 June 2011, Brussels. Download from http://trade.ec.europa.eu/doclib/html/147977.htm.

**GAO** (1994) *Assessment of the Generalized System of Preferences Program*, US General Accounting Office, Washington, DC. Download from www.gao.gov.

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