Introduction to the European Union

EUCONAS

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Seminar 10
Economics in the European Union
Part II

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Outline Part II

- **Analysis on unilateral discriminatory liberalization**
- Market size and scale effects
- Growth effects and factor market integration
- Economic integration, labor market and migration
- Location effects and economic geography
- Regional policy

Analysis on unilateral discriminatory liberalization

Preferential (i.e. discriminatory) liberalization

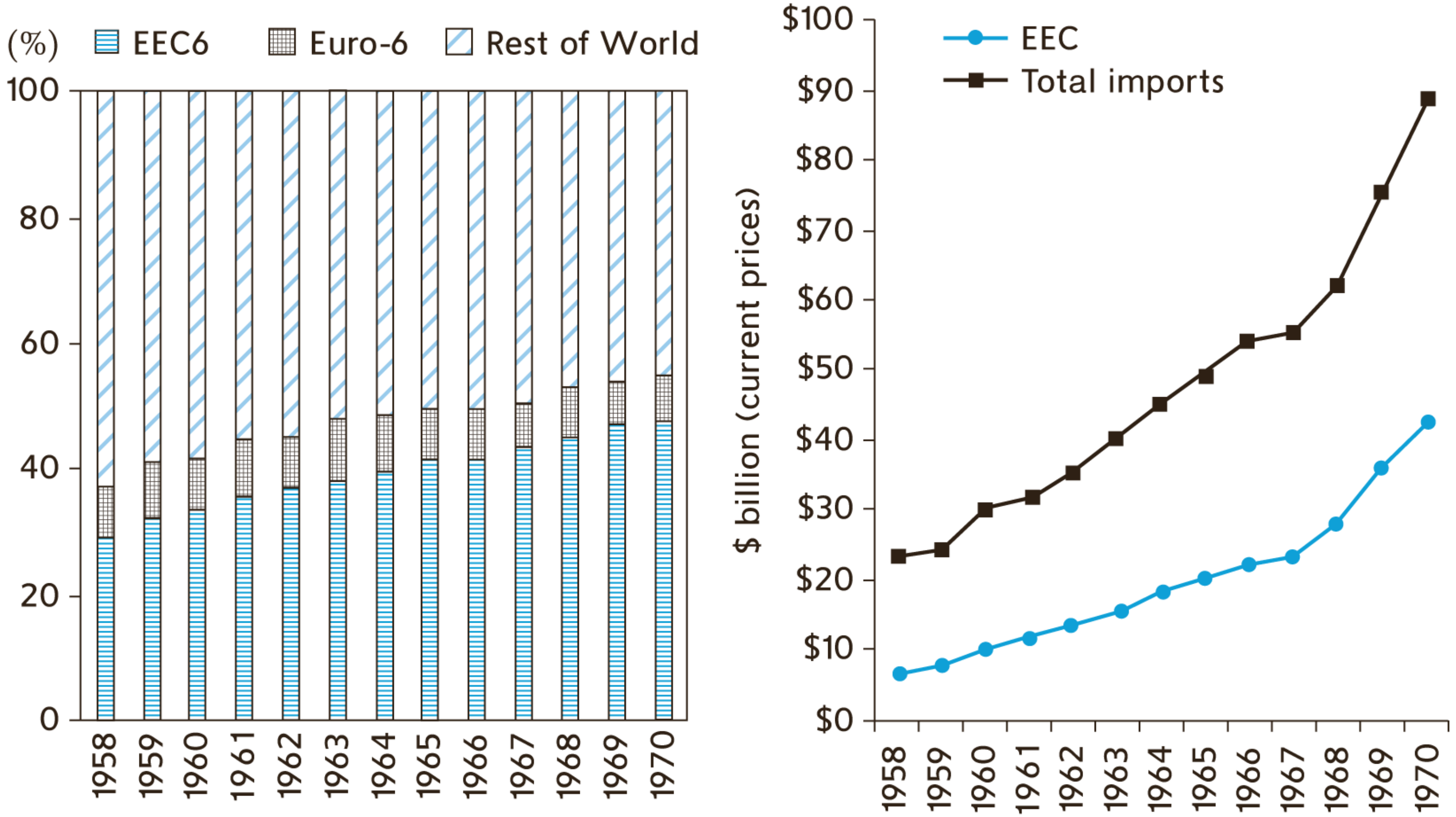
- Unilateral: A nation removes its tariffs on imports from only one of its trading partners.
- European economic integration almost always involves two-way integration (e.g. France and Germany lowered their tariffs against each other's exports at the same time during the 1960s).

There are only three elemental effects we really need to understand in relation to preferential liberalization.

Smith's certitude	**Haberler's spillover**	**Viner's ambiguity**
Adam Smith Foreign firsm gain (i.e. higher price and more exports) when tariffs against them are eliminated.	Gottfried Haberler Third nations (those excluded from the preference) must lose.	Jacob Viner Preferential liberalization might harm the preference-giving nation because discriminatory liberalization is both *liberalization* (which removes some price wedge and this tends to improve economic efficiency and home welfare and *discriminatory* (which introduces new price wedges and thus tends to harm efficiency and welfare).

The supply-switching effects of the formation of the EEC customs unions

Figure: Supply and formation of the Common Market, 1958–70



Note: The left-hand panel shows shares of the EEC6's imports from the three regions. The 'Euro-6' are the six countries that had joined the EU by the mid-1980s: the UK, Ireland, Denmark, Spain, Portugal and Greece.

Source: http://epp.eurostat.ec.europa.eu/portal/page/portal/international_trade/introduction © European Union, 1995–2014

This figure shows the trade volume effects that occurred when the EEC6 removed their internal tariffs between 1958 and 1968.

Left panel

EEC6 removed their internal tariffs between 1958 and 1968.

The EEC6 share exports to itself rose from 30 percent in 1958 to about 45 percent in 1968.

The main displacement came from all the rest of world, mainly imports from the United States.

Right panel

Imports from all sources were in fact growing rapidly.

If the custom union had not been formed, imports from non-EEC6 members would have risen even faster.

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Market size and scale effects

The countries of Europe are too small to give their people the prosperity that is now attainable and therefore necessary. They need wider markets.

Jean Monnet, 1943

By its size - the biggest in the world - the single market without frontiers is an invaluable asset to revitalize our businesses and make them more competitive. It is one of the main engines of the European Union.

Jacques Delors, July 1987

Logic and facts

- Europe's national markets are separated by a whole host of barriers.
  - Tariffs and quotas (Common Market, 1968)
  - Technical, physical, and fiscal barriers
- Restriction of intra-EU trade → EU firms can often be dominant in their home market while being marginal players in other EU markets. → Market fragmentation → Reduces competition, raises prices, and keeps to many firms in the market.
  - It results in an industrial structure marked by too many inefficient small firms that charge high prices to cover the cost of their inefficient.
  - Owing to the absence of competition, poor and/or low quality services and goods may also accompany the high prices (think of the European telephone service before liberalization).

Market size and scale effects

Logic and fact (cont.)

- Tearing down these intra-EU barriers defragments the markets and produces extra competition.
- The pro-competitive effect squeezes the least efficient firms, prompting an industrial restructuring whereby Europe's weaker firms merge or are bought out.

➢ **RESULTS: Fewer, bigger, more efficient firms facing more effective competition** from each other.

- Welfare effects:

Long-term gains	Medium-term adjustment costs
Δ consumer surplus • Price effect • Quantity effect	Industrial restructuring

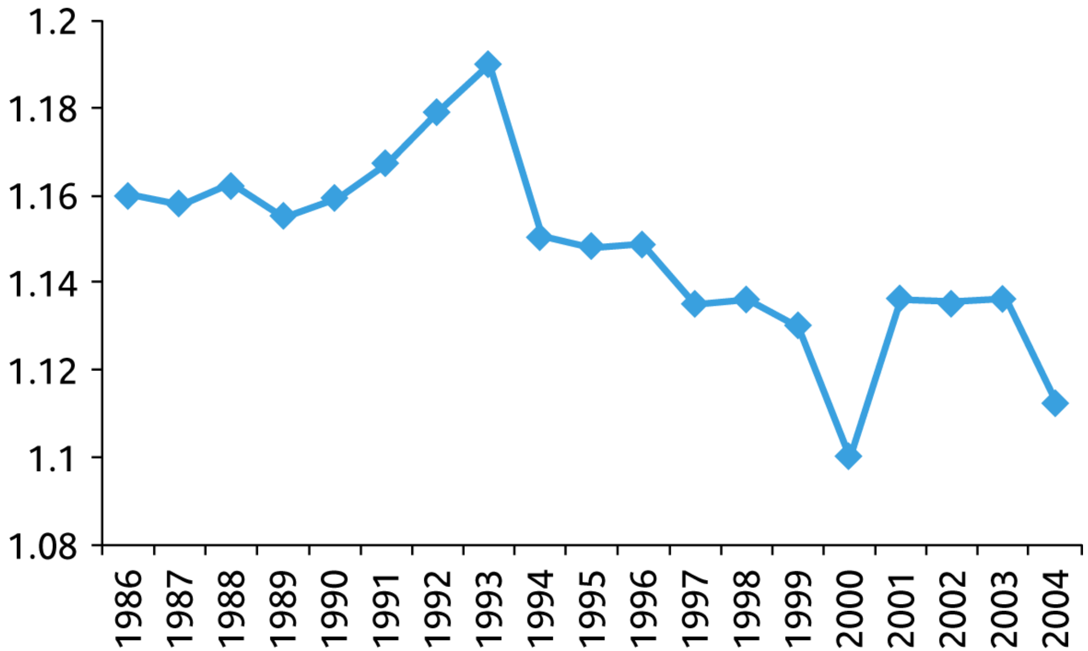
Two immediate questions:

1. As the number of firms falls, is there a tendency to collude in order to keep prices high?
2. Since the industrial restructuring can be politically painful, isn't there a danger that government will try to keep money-loosing firms in business via subsidies?

The answer to both question is "Yes"

➢ EU competition policy and state aid policy

Figure Price-cost margins for French industry, 1986–2004



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Growth effects and factor market integration

Logit of growth effects:

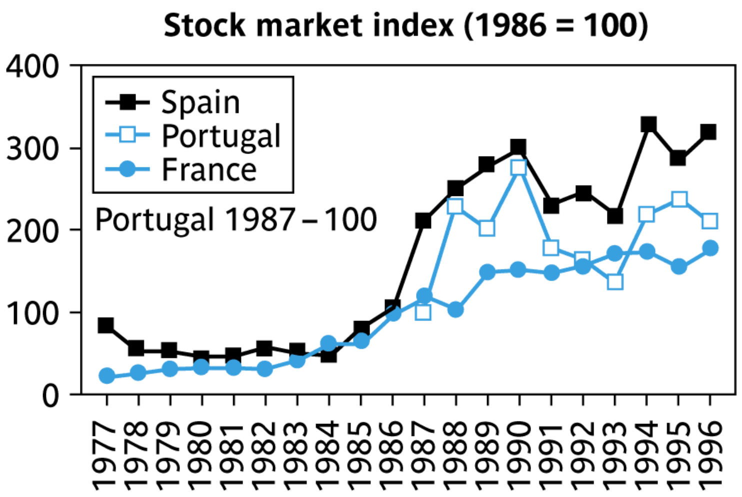
➢ Economic integration → Allocation effects → Better investment climate → More investment in machines, skills, and technology → Higher output per person → Higher welfare

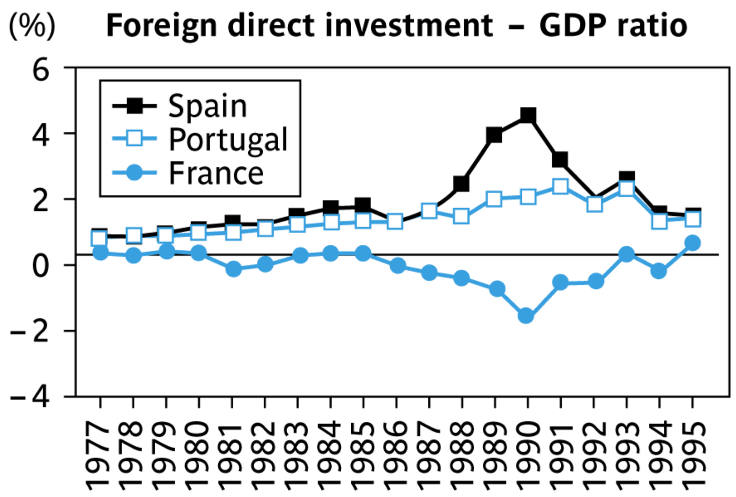
- Allocation effects: Efficiency in which economic resources are allocated across economic activities.
- Accumulation effects: Rate at which new factor of production (mainly capital) are accumulated.
  - Three categories of capital
    - Physical capital (machines)
    - Human capital (skills, training, experience)
    - Knowledge (technology)
  - Investment → Capital accumulation

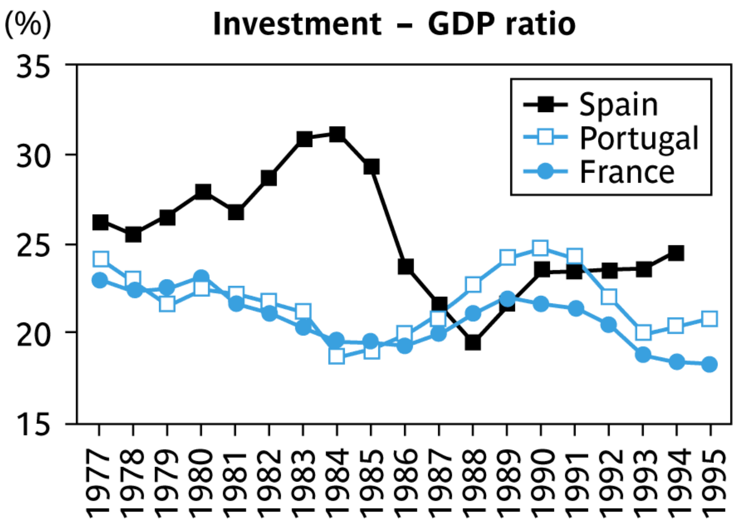
Medium-term growth effects	Medium-term growth effects
Physical capital Diminishing returns to scale. The rise in output per person eventually stops at a new, higher level. Empirical evidence.	Knowledge capital No diminishing returns to scale. Permanent change in the rate of accumulation, and thereby a permanent change in the rate of growth.

Growth effects and factor market integration

Medium-term growth effect: EU accessions (Spain and Portugal)







Control country: France
Variables:

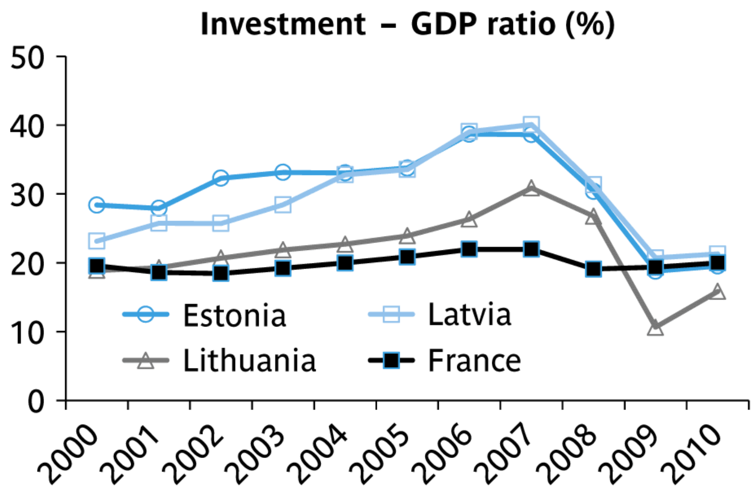
- Stock market index
- FDI/GDP
- I/GDP

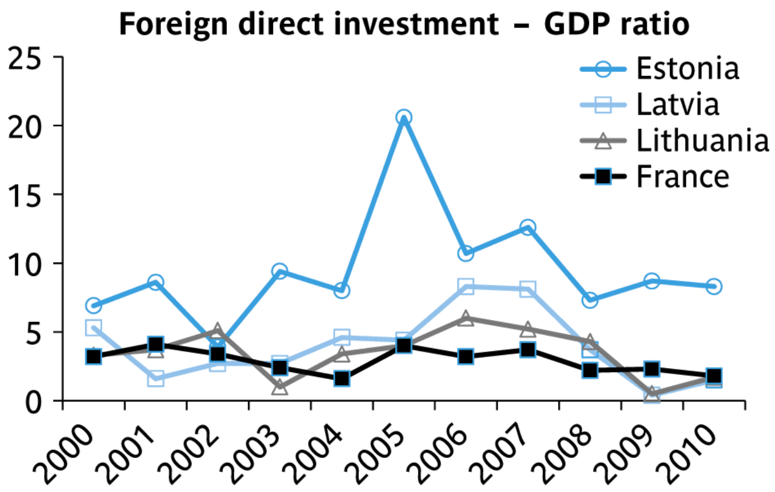
Growth in Portugal and Spain picked up rapidly and stayed high both during the negotiation and after the accession.

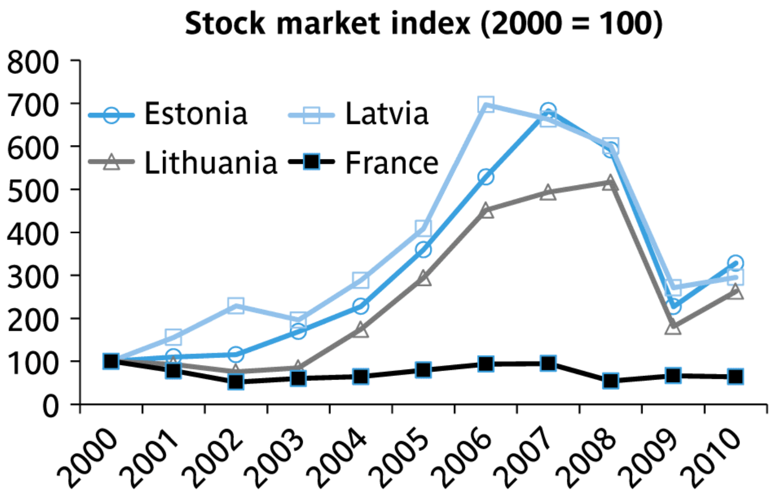
The pattern of Spain **investment rate** did not differ significantly from that of the control country until accession occurred.

Growth effects and factor market integration

Medium-term growth effect: EU accessions







Latvia, Lithuania, and Estonia were republic of the USSR until 1991. Upon independence they approached the EU to establish close ties. Transition from planned economy to market economy.

From 2000 we see the clear signs of investment-led growth.

FDI and Estonia

Estonia had shared lingual, historical, and geographical ties with Finland

Stock markets

As EU membership approached, investors bid up the price of Baltic companies (sign that EU accession was improving the investment climate.

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European labor market: a brief characterization

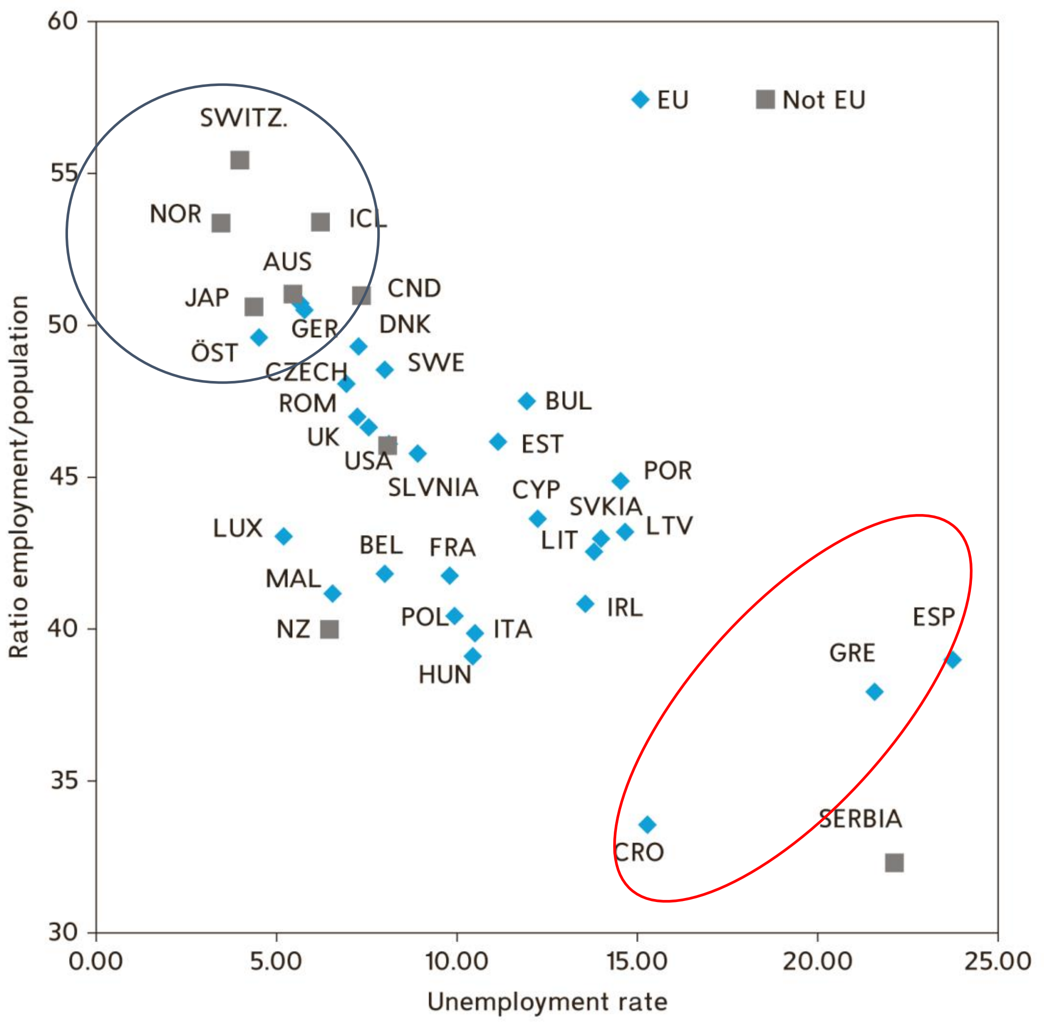
- Labor is a country's most precise input.
- For more people, a good job is an essential element of a good life.
- Unemployment is a critical political and economic issue.

- Each national labor market in Europe on its own.
  - Labor market policies remain at country level.
  - Each country has its own social customs (historical heritage).

- The European labor markets are among the more inflexible in the world.
  - Low geographical mobility.
  - High labor market rigidity.
- While, on average, European labor market underperform, the situation varies considerably from one country to another.

European labor market: a brief characterization

Figure 8.2 Employment-to-population ratios and unemployment rates in 2010–14: EU28 and comparable non-EU countries



Note: Averaged over the period 2010–14. The non-EU countries are Australia, Canada, Iceland, Japan, New Zealand, Norway, Serbia, Switzerland and the USA.

Source: AMECO, European Commission

- Variables:
  - ratio employment/population (y-axis)
  - unemployment rate (x-axis)

- Countries with the best-performing labor markets are closer to the top-left corner.
  - Non-EU countries: Switzerland, Norway, Iceland, Japan, Australia, Canada
  - EU countries: Germany, Denmark, Austria (ÖST)

- Countries with the worst-performing labor markets are in the bottom-right corner.
  - Non-EU countries: Serbia
  - EU-countries: Spain, Croatia, Greece

Labor market: the principles

- The labor market is a very special market, similar to none one.

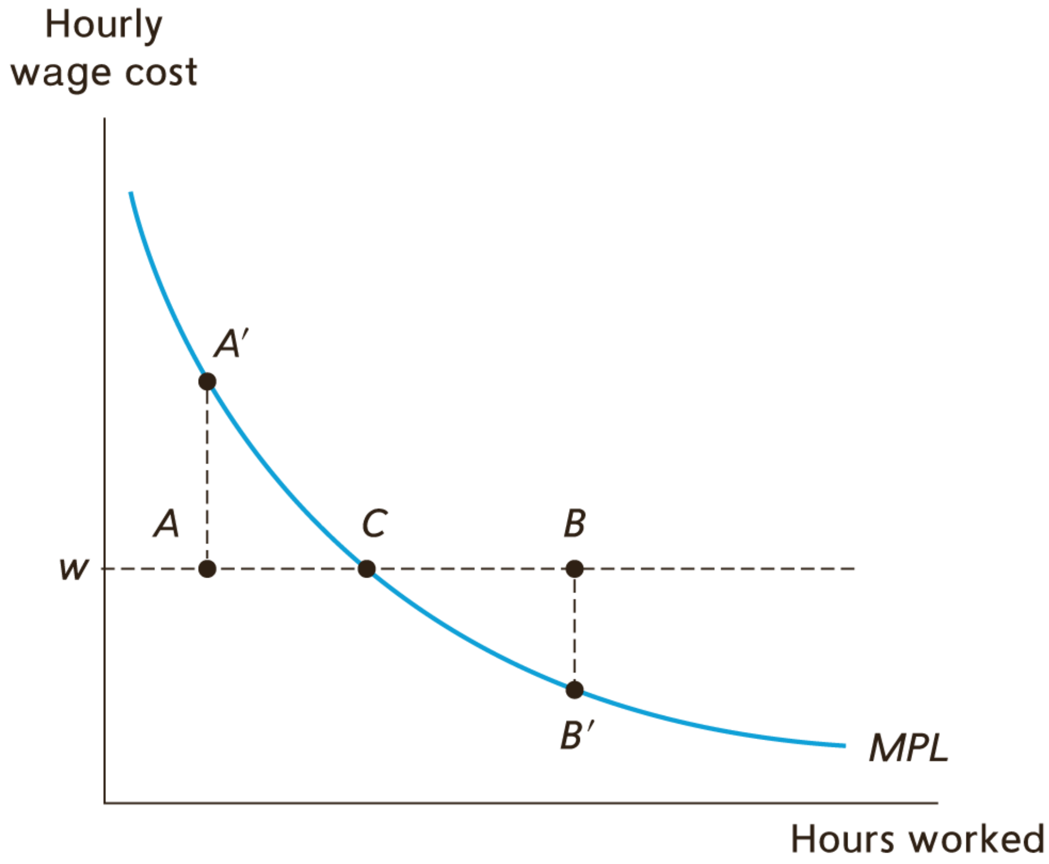
1. Salaries are not like the price of oil or corn, through bidding. They are collectively negotiated by representatives of employers and employees.

2. Negotiations take place at more or less regulated intervals and agreements hold for period that usually extend to one year or more. Thus labor markets react slowly to changing conditions.

3. Wage contracts are often regulated.
    - Worker condition: restrictions on hiring and firing, restriction on hour workers, etc.
    - Many countries have a minimum wage.

1. Unemployment benefits.
    - ➢ Discussion question: Do you think that the they disincentive the search of job?

Labor market: the principles

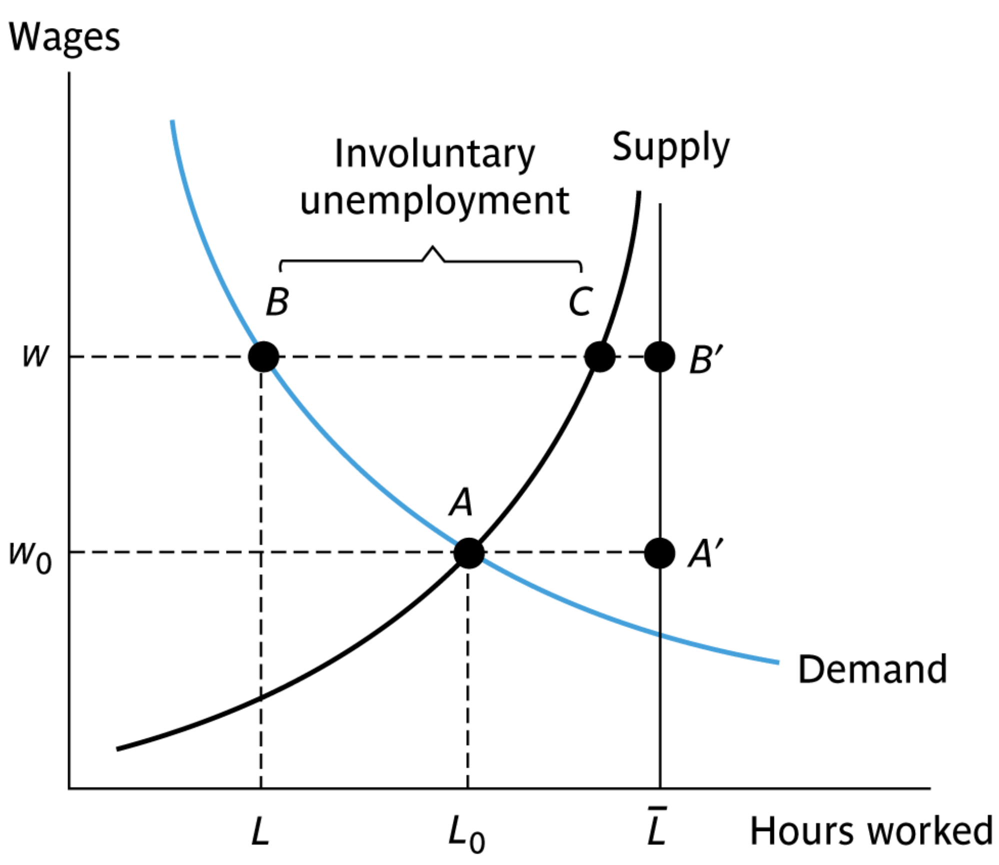


LABOR DEMAND

- Jobs exist because firms employ people.
- When deciding whether to hire or not an additional worker: To compare the cost and the benefit.
  - Cost: hourly wage costs (wage + contributions)
  - Benefit: Addition output that the worker will deliver: marginal productivity of labor (MPL)
    - Key feature: MPL declines as more hours are being performed. Why?
      - Equipment is fixed.
      - Workers are tired.
    - MPL is downward-sloping

➢ The MPL represents the firm’s demand for labor.

Labor market: the principles

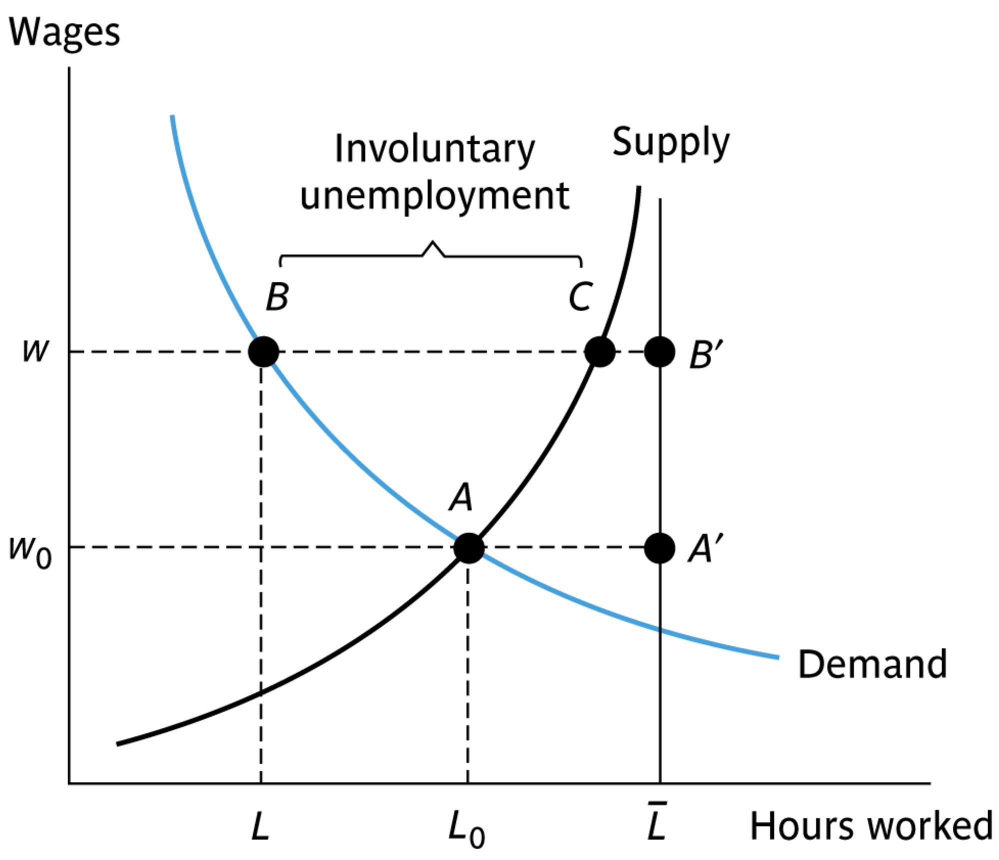


LABOR SUPPLY

- Labor is supplied by people.
- Work is tiring and less pleasure than leisure.
  - Remuneration (wage)
- Workers are heterogeneous, but we consider the "average worker".
- What has to happen to the wage to convince the "average workers" to work one more hour.
  - If the worker is unemployed…
  - If the worker already works…

➢ The supply of labor can be represented by an upward-sloping curve. The curve is steeper.

Labor market: the principles



EQUILIBRIUM

Point A

- Equilibrium with perfectly labor market (= full employment).

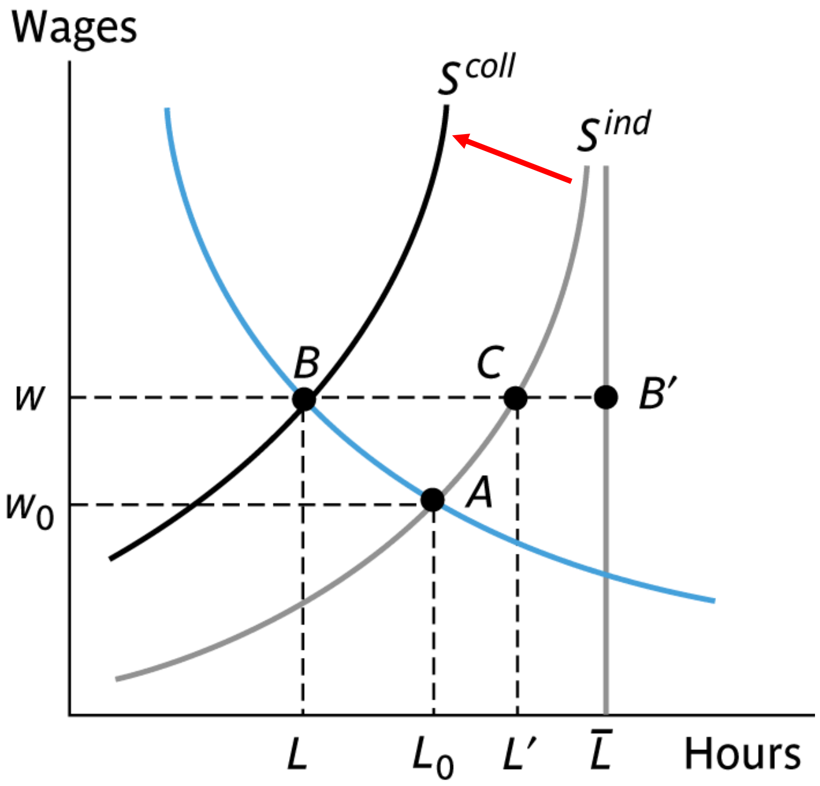
Point B

- Equilibrium with unemployment due to:
  - salaries are collectively negotiated;
  - agreements hold for long period; thus labor markets react slowly to changing conditions:
  - wage contracts are often regulated;
  - conditions for hiring and firing are also regulated;
  - unemployment benefits.

➢ Labor market rigidities lead to involuntary unemployment.

Labor market: the principles

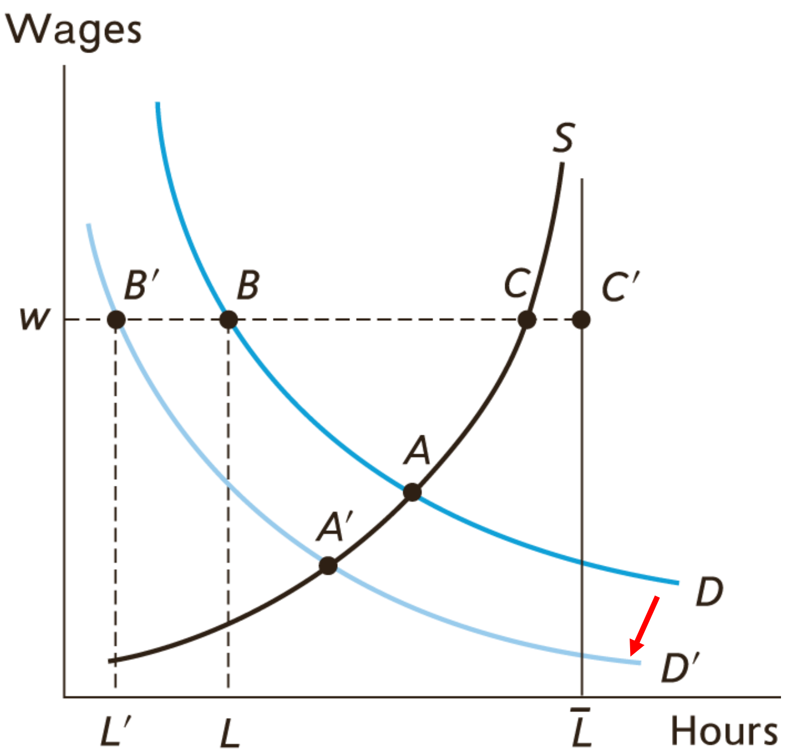
The economics of collective negotiation



Collective supply curve (S^{coll}) is above individual supply curve (S^{ind}) .

- **Pont A** → Absence of any rigidity.
- **Distance BC** → Involuntary unemployment.

The cyclical impact of wage rigidity



Imagine that the economy slows down. → Firms cannot sell all their products. → The demand of labor shifts down (**from D to D’**).

With wage rigidity at **w**, employment declines (**from L to L’**).

Labor market: the principles

Minimum wage

Economic impact	Social objective
• ↑ unemployment of the least skilled	• Protect the weakest • ↓ inequality

Eurostat (2017): National minimum wages in the EU

QUESTIONS

- Is the minimum wage compulsory in the EU countries?
- Map. Do you detect any pattern in the level of the minimum wage?
- Bar chart. What is the country with the highest minimum wage? What is the country with the lowest minimum wage?
- Disparities between countries are lower/higher when we take into account the PPS? Explain,
- Table: Minimum wages in the EU (in € per month). Comment the column "Change 2017/2008. What happen in Germany?

The Economist (2013): Why the minimum wage is immigration policy

QUESTIONS

- Why do people move to Britain?
- In which sort of jobs are working most of the immigrants that arrive "without plans"?
- Explain why reinforcing labor market laws has an effect on immigration?
- Is the objective of the United Kingdom to reduce immigration?

The effects of trade integration

- Single market: Free movement of goods services, labor, and capital.
- In order to compete in the goods and services markets, producer must flight on all fronts.
  - Production costs
    - Labor costs (high percentage)
    - Prices of the equipment
    - Price of the material
  - Quality
  - Technology

- Competition in the goods markets has deep implications for the labor markets.
- Countries indirectly compete in labor markets.

Social dumping

- Economic integration undermines valuable social protection.
- Workers of the EU-15 countries were convinced that competition from the new member states (EU-12) will force a reduction in the level of social protection.
  - Example: Limits on working hours, obligatory retirement benefits, maternity leave, sick leave, annual holiday, etc.
- Such fears lead to call for social harmonization.
- BUT since the 1950s social protection of workers rose throughout western Europe despite the deep integration between nations that initially had very different social protection level.

Migration

The European Union

Migration within the EU is, in principle, free.

- Treaty of Rome (1957): right to work
- Maastricht Treaty (1992): right to live
- Eastern enlargement (2004 and 2007): Some restrictions to limit migration from new to old members.
- Lisbon Treaty (2009): Policies that govern labor flow from non-member nations,
  - Visa and immigration policies for non-members.

"PM to review freedom of migrant movement" (by Helen Warrell and George Parker, Financial times, 7th October 2012)

- What is the motivation of David Cameron to review the freedom of EU migrants to live and work in the UK?

Schegen area

- No border checks
- Non-Schegen EU states: Bulgaria, Croatia, Cyprus, Ireland, Romania, and the United States.
- Schegen non-EU states: Iceland, Norway, Switzerland, and Liechtenstein.

➢ Video: "The Schegen area" (02:22)

Barriers to mobility

- Still there is low mobility within the EU:
  - Different social policies;
  - Differing pensions systems;
  - Unemployment benefits;
  - Regulated professions;
  - Language, housing, health system, etc.

➢ Video: "Which country will pay my old-age pension" (03:36)

Migration

The European Union

Economic and social effects

- Economic theory: Migration improves the overall efficiency of the EU economy.

- The movement of people have not only economic but also social effects.
- The fact that many young Europeans some time living, studying, or working in other EU nation has had a big impact on the way European view each other.
- In the following videos, people comment some advantages and disadvantages of being part of the EU.

➢ Video: “Europe on the move” (8:40)

➢ Video: “Erasmus” (01:44)

What do European think about migrants?

Eurobarometer 2015

Special Eurobarometer Survey (October 2017)

QUESTIONS

- Is immigration an important concern for people?
- Do EU citizens distinguish between non-EU migration and free movement of EU citizens? Why?
- Does EU citizens overestimated the number of immigrants residing in Europe and the proportion of illegal migrants? Why?
- According to European, what are the key factors that can support integration.

Migration

Broader interpretation: the notion of complementarity

- Economic notion of “complementarity” versus “substitutability”.
- Labor is heterogeneous.
- Capital could include “human capital” (highly educated workers).

- Consider the following example in he hotel service:
  - Inputs: food and bed lines
  - Unskilled workers; cleaners
  - Skilled workers: managers, marketing department
  - Capital: building, furniture
- In Norway unskilled labor is very costly, so hotels are very expensive.

- If Norway allows hotels to hire foreign workers at lower wages,
  - some factors would be hurt (Norwich unskilled workers)
  - but other factors would be helped (skilled workers and capital).
- Unskilled workers complement skilled workers and capital.
  - Demand for skilled workers and capital rises as the supply of unskilled workers increases and their price falls.

- Immigrants who have skills that are complement to the skill mix in the receiving nation are typically less likely to create losers in the receiving nation.

Migration

Broader interpretation: the notion of complementarity

	Overall EU employment	Immigrant workers from:		
		EU15	EU12	Outside EU
EDUCATION				
High	26	44	22	23
Medium	47	41	63	40
Low	27	15	15	36
OCCUPATION				
High-skilled white collar	40	55	16	20
Low-skilled white collar	26	24	28	25
Skilled manual	25	12	27	21
Elementary tasks	10	9	30	35

Education level and skills of immigrant workers in the EU-15 in 2005 (% of total)

- Immigrants from EU15 countries are generally better educated and occupy higher-skill jobs that the natives.
- Immigrants from outside the EU are complementarity in the opposite direction: they are often less educated and fill in elementary tasks/jobs.
- Immigrants from EU10 (countries that entered in the EU in 2004) are in-between as far as education is concerned and they tend to accept less-skilled jobs.

Migration
Economic effects

Economic effects of migration
- The article explains that the economic effects of migration vary widely.

QUESTION
- Distinguish these effects considering
    - Sending countries
    - Receiving countries
    - Long-term
    - Short term

"Immigration and economic prosperity" (Jaumotte, Koloskova and Saxena, VOX 2017)
- The article explores the long-term effects of migration on receiving advanced countries.

QUESTIONS
- Why do the attitudes to trade are different from the attitude to immigration?
- Comment the negative short-term effects of immigration on the host country? Do the empirical studies confirm these predictions?
- Explain the two channels through immigration can affect GDP per capital (long-term effect).
- Do only the high-skill immigrants raise productivity?
- Are the long-term effects unevenly distributed among the population?
- Comment: "the UN projects that without further migration, the working-age population would decline in most advanced economies over the next 15 years, due to population ageing."

    Population Pyramid

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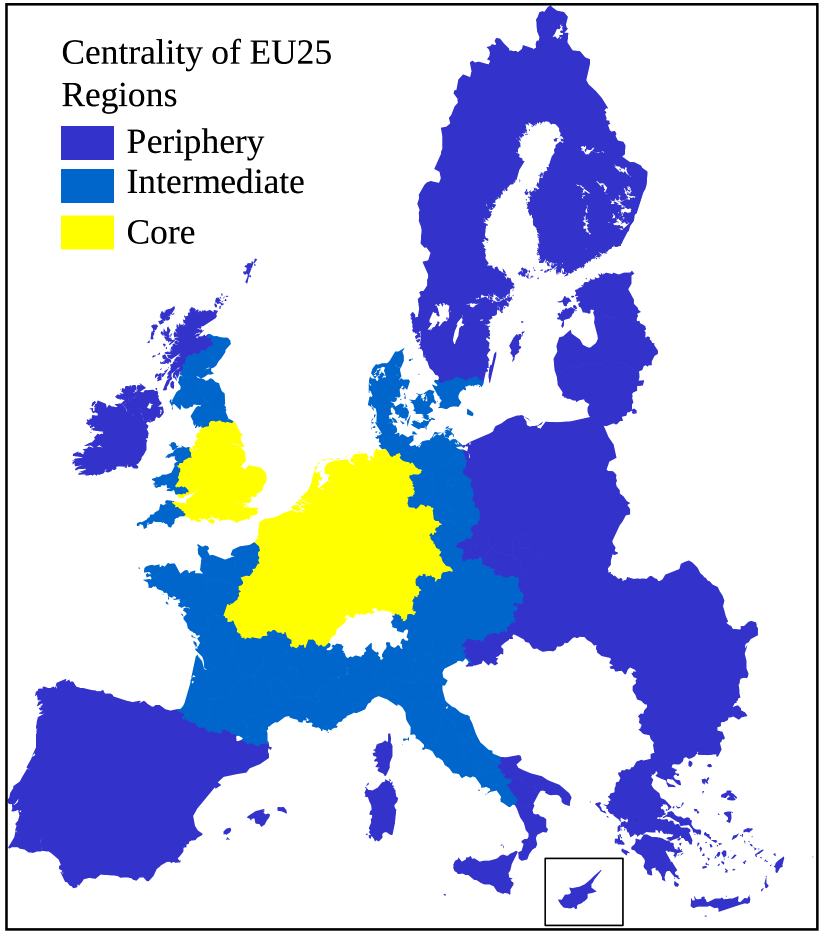
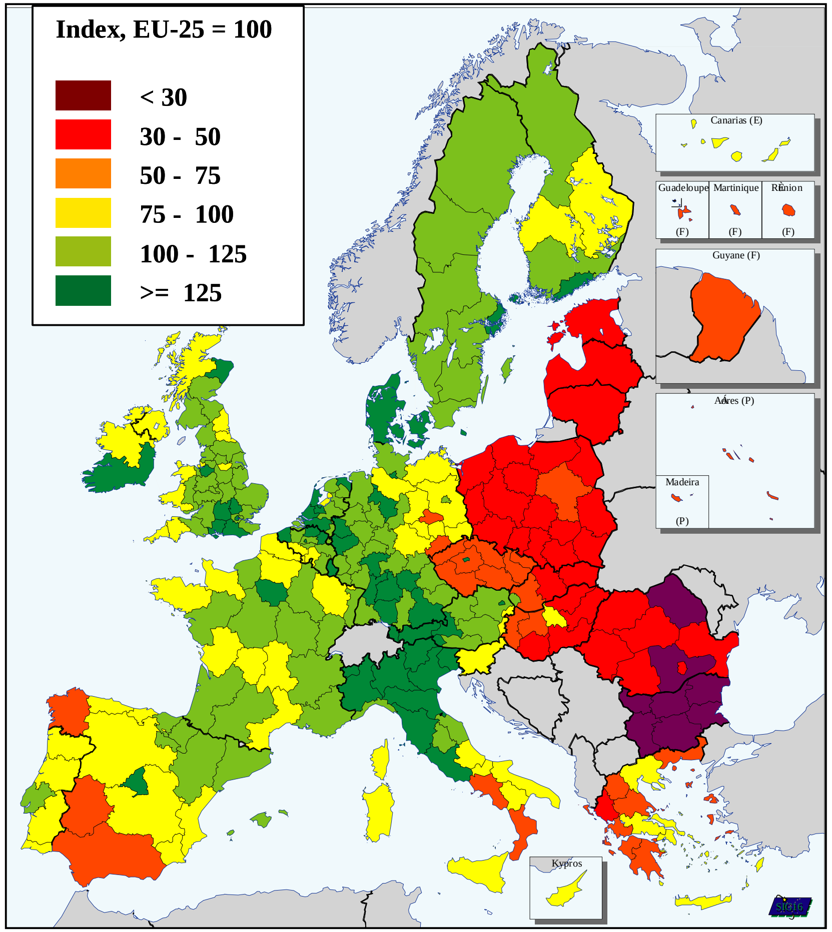
Europe’s economic geography: the facts

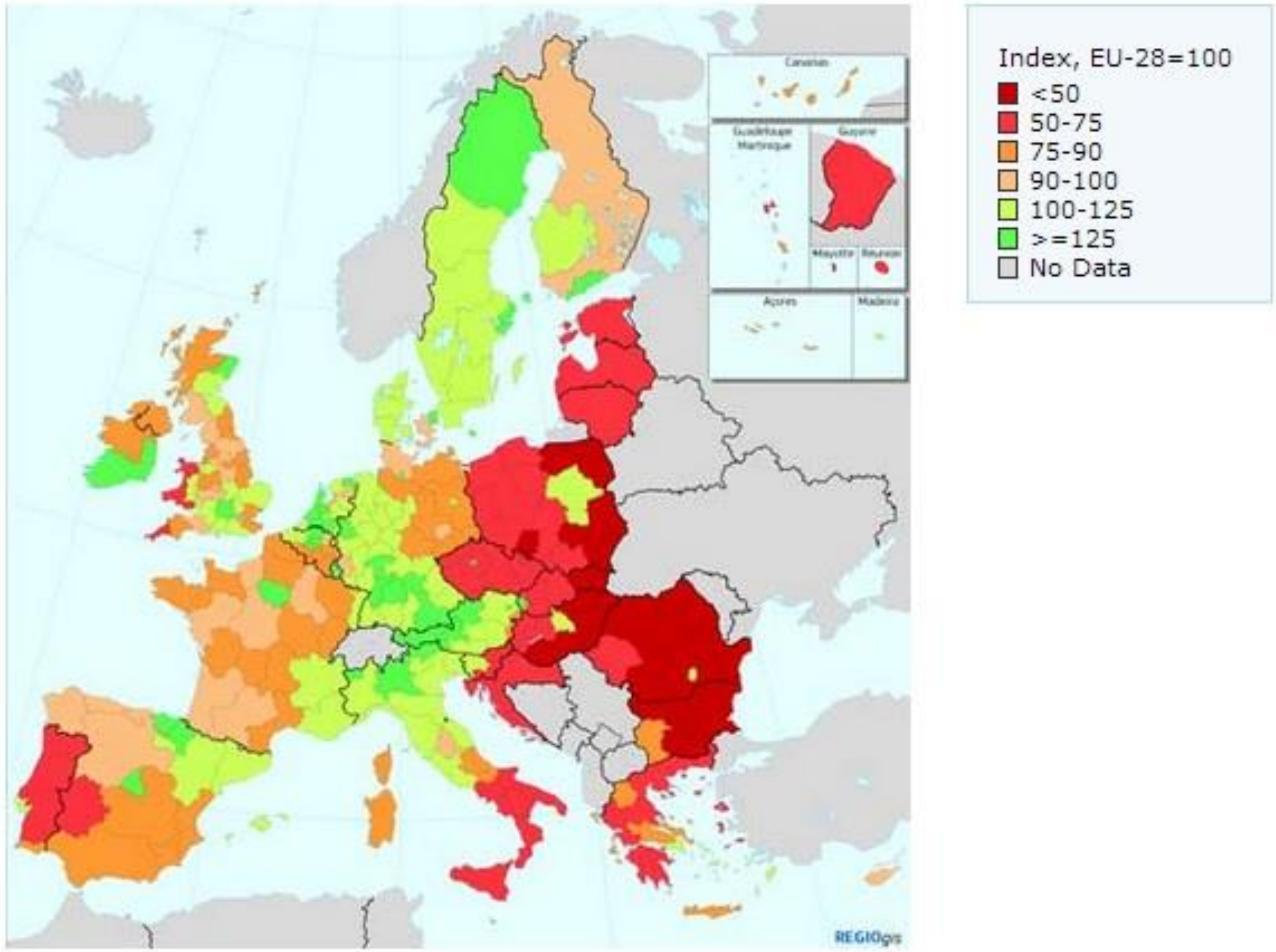




- Core and periphery structure.
- National border are not the best way to think about economic activity in Europe.
- Regions matter.

Europe's economic geography: the facts

Regional Disparities across EU28
GDP/head (PPS), 2010

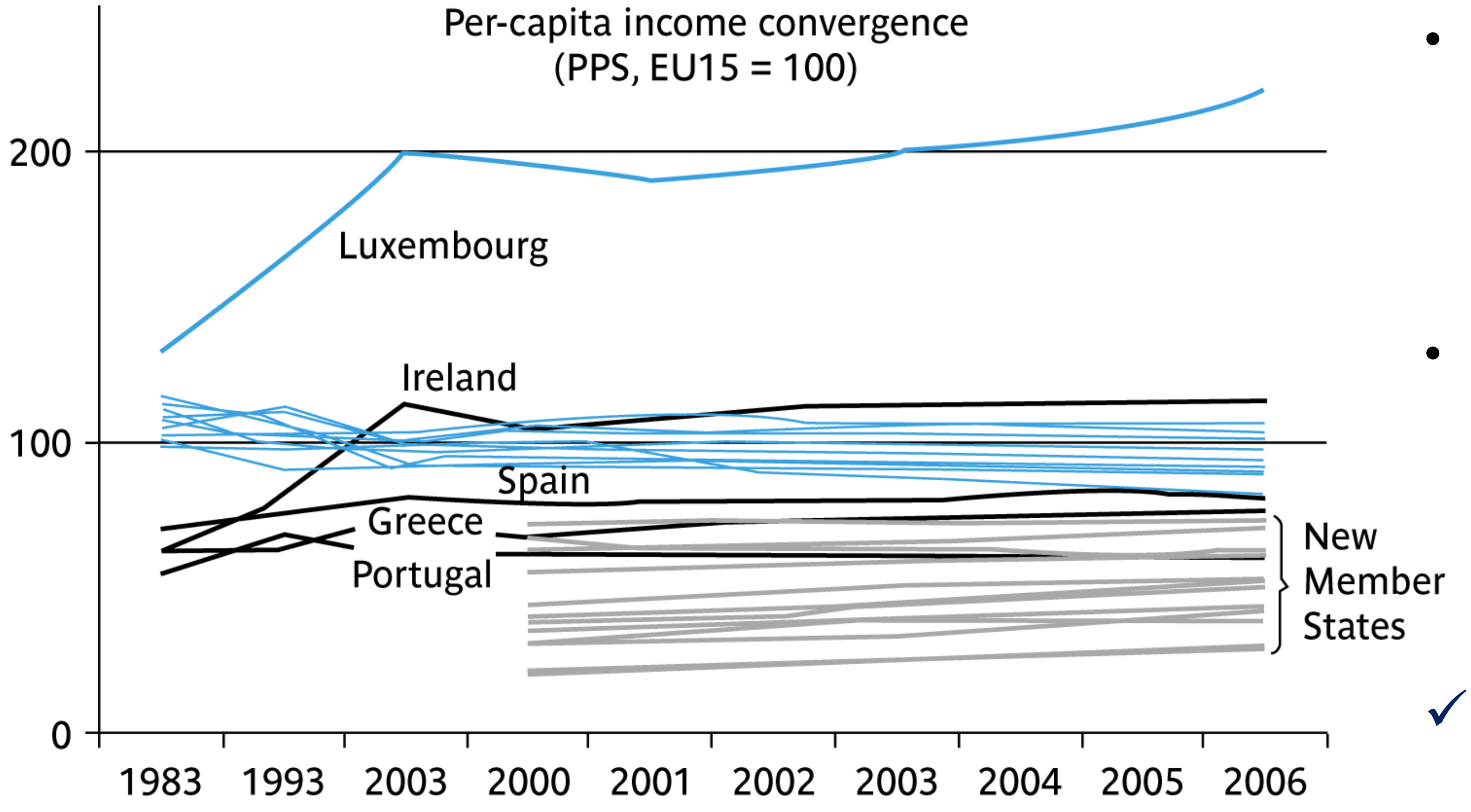


Source : Eurostat

- Most regions in the 12 new members have incomes that are below those of the EU nations.
- Apart from the wester-most and southern-most parts of the Continent, none of the EU15 regions have incomes below 75 percent of the EU27 average.
- High differences:
  - Poorest region: 28 percent EU average (Severozapaden, Romania)
  - Richest region: 343 percent higher that EU (Inner London, UK)
- Rich regions are clustered and form the "core" of the EU economy, as shown by regional GDP per capita (PPS) in 2010.

Europe's economic geography: the facts

Figure: Income convergence among old EU members, 1986–2006

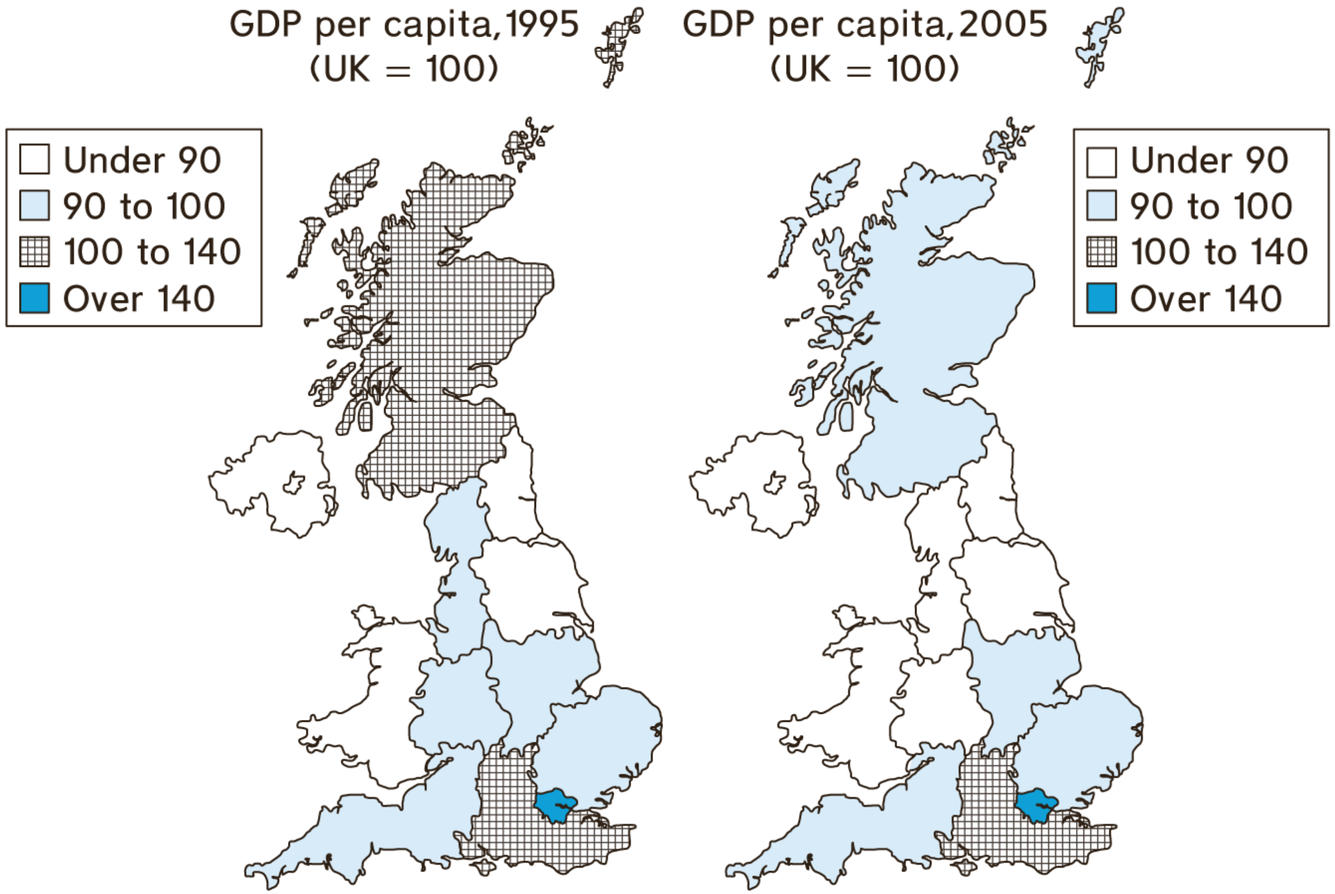


- While the dispersion of income levels across nations is still very high, the gaps among EU members have been steadily narrowing.
- EU15 members.

✓ Convergence among nations

Europe's economic geography: the facts

Figure: GDP per capita in British regions, 1985 versus 2005



Source: Authors' calculations based on Eurostat data

- However, income inequality within each EU nation has been rising.

✓ Divergence within nations

Theory

Two major approaches linking economic integration to change in the geographic location of economic activity.

1. Comparative advantage suggests nations specialize in sectors in which they have a comparative advantage.
2. New Economic Geography (NEG) suggests that integration tends to concentrate economic activity spatially.

•General idea:
- -Use comparative advantage approach to explain cross-nation facts.
- -Use NEG to explain within nation facts.

Theory

	Comparative Advantage Neoclassical trade models (Ricardo, H-O)	**New Economic Geography**
Key factors	Natural resources Factors of productions (K,L)	Agglomeration forces (+) - demand-linkages (market size) - cost-linkages (production costs) Dispersion forces (-)
Assumptions a) scale economies b) trade costs c) factors of production	 a) constant returns to scale (CRS) b) zero c) immobile	 a) increasing returns to scale (IRS) b) positive c) mobile across regions
Economic integration	More trade. Nations do what they do best and imports the rest.	Reduction in trade costs. Concentration of the economic activity spatially. Clusters - overall clustering - sectoral clustering

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Theory part I: Comparative advantage

Comparative advantage suggests that nations specialize in sectors in which they have a comparative advantage.

Example

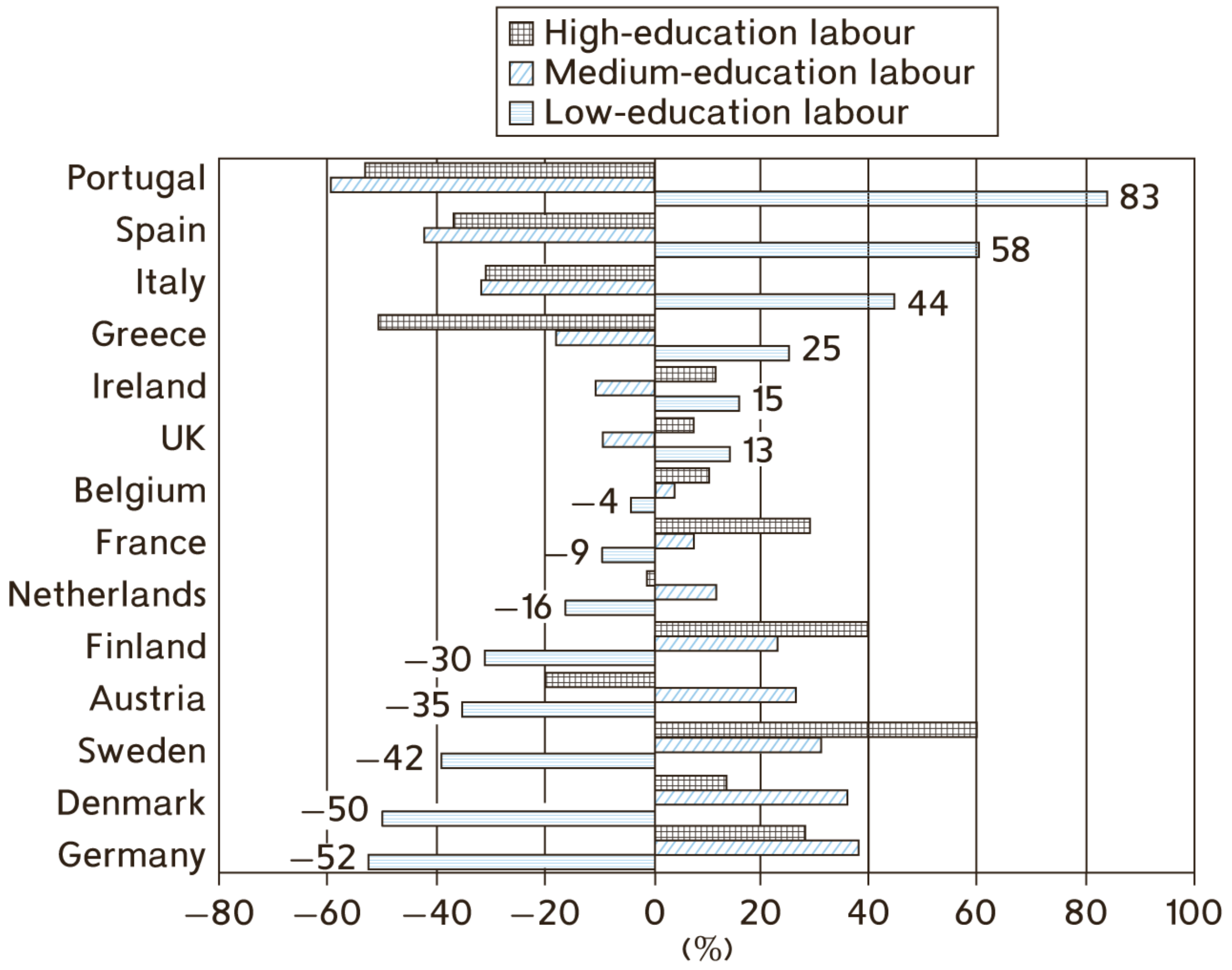
-Germany abundant in high skilled labor;

-Portugal abundant in low skilled labor;

-With trade: Germany specializes in pharmaceuticals and trades them for cloth from Portugal

-The industrial structures of both Portugal and Germany would become more specialized.

Figure: Relative labor endowment in Europe



Source: Data from Midelfart-Knarvik et al. (2002)

Theory part II: New Economic Geography (NEG)

New economic geography suggests that integration tends to concentrate economic activity spatially.

It is based on two pillars:

- **Dispersion forces** favor the geographic dispersion of economic activity (e.g., higher rent and land prices, high cost of non-traded services, competition with other firms);

- **Agglomeration forces** encourage spatial concentration:
  - demand linkages: big markets
  - cost linkages: availability of suppliers

Figure: Demand-linked circular causality

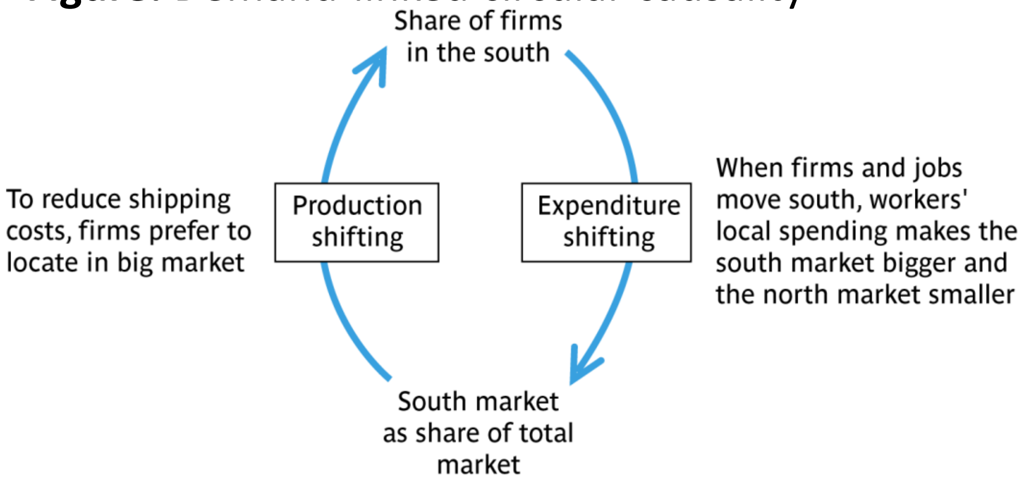
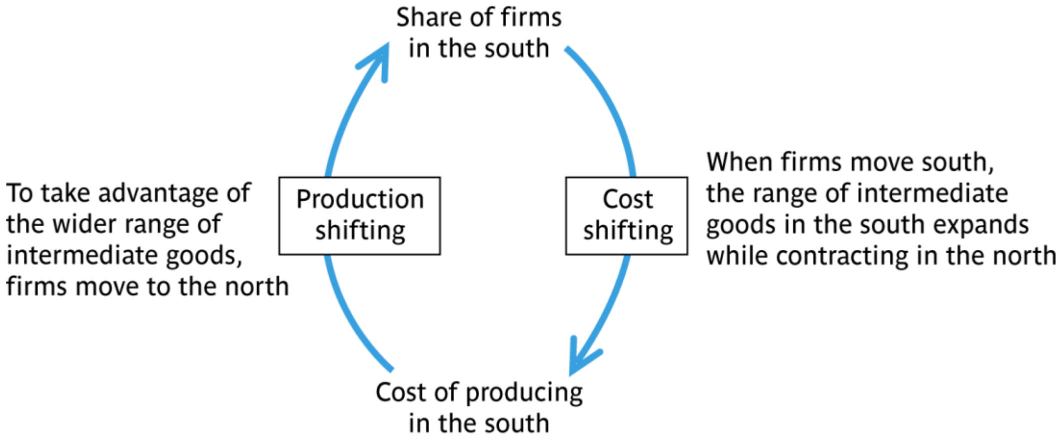


Figure: Cost-linked circular causality



Economic integration

- GDP pc tends to converge nation by nation. Within nations, however, the opposite has happened.

- The lack of factor mobility across nations means that agglomeration forces are not dominant at the national level.
  - Agglomeration forces operating at the sectoral level could result in nations specializing in particular industries.
  - But in the end each nation end up wit some industry.

- By contrast, the much greater mobility of factor <u>within</u> a country permits *backward* and *forward* linkages to operate.
  - As one region grows, it becomes attractive to firms for demand reasons and cost reasons, so more firms and more factors move to the region, thereby fueling further growth.

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Regional policy

- Regional policy = Policy taking into account in **eligibility criteria** a spatial dimension

  Examples: Subsidies in favor of plant locations in specific areas, infrastructure investments in geographically targeted areas,…

- Policies that do not directly target specific regions or firms/people located in specific regions, are not considered as regional policies but **might have spatially differentiated consequences**.

  Example: Unemployment subsidies might generate spatial redistribution if unemployment people are concentrated in specific regions.

➢ Video: "Cohesion Policy" (06:25)

- A concern for Euro's disadvantage regions has always been a headline goal of the EU.

- For the first three and a half decades of the EU's existence, however, the task if the helping less-favored regions was left firmly in the hands of national government.
  - Structural spending was only 2 percent of the budget in 1970, rising to only 11 percent by 1980.

- The situation changes in the 1980s (Greece, Spain, and Portugal).
- The structural spending doubles its share if the EU budget between 1986 and 1993.

EU Regional Policy
Purposes

- EU regional policy is an **investment policy**.
  - It supports job creation, competitiveness, economic growth, improved quality of life, and sustainable development.
  - These investments support the delivery of the **Europe 2020 strategy**.

- Regional policy is also the expression of the **EU's solidarity** with less developed countries and regions.
  - Regional policy aims to reduce the significant economic, social and territorial disparities that still exist between European regions.

- In order to specify the objectives an the eligibility rules **several pluri-annual programs** have been defined along time.
  - Since 2000, the cohesion policy framework is established for a period of 7 years.

- There are five main funds: (1) European Regional and Development Fund (ERDF), European Social Fund (ESF); (3) Cohesion Fund; (4) European Agricultural Fund for Rural Development; (5) European Maritime and Fisheries Fund.

EU Regional Policy

For the **period 2014-2020**, the EU will invest a total of € 351 billion in Europe's regions.

The funding helps, for example,

- to boost small and medium-sized businesses,
- to support research and innovation,
- to invest in a cleaner environment,
- to improve access to digital technology,
- to develop new products and production methods,
- to support energy efficiency and tackle climate change,
- to boost educations and skills,
- to improve transport links to remote regions.

Europe 2020 strategy

Europe 2020 is the EU's strategy **to promote smart, sustainable and inclusive growth**.

The EU has set ambitious objectives to be reached by 2020 in 5 main areas:

- **Employment** - 75 % of the population aged 20-64 should be employed.
- **Innovation** - 3% of the EU's GDP should be invested in Research & Development.
- **Climate change** - The "20/20/20" climate/energy targets should be met (including an increase to 30% of emissions reduction if the conditions are right).
- **Education** - The share of early school leavers should be under 10% and at least 40% of 30-34 years old should have completed a tertiary or equivalent education.
- **Poverty** - Reduction of poverty by aiming to lift at least 20 million people out of the risk of poverty or exclusion.

European Regional Development Funds (ERDF)

- When the first ‘poor’ member, Ireland, joined in 1973, a new the ERDF was set up to redistribute money to poorest regions.

- The ERDF aims **to strengthen economic and social cohesion** in the European Union by correcting imbalances between its regions. In short, the ERDF finances:
    - **direct aid to investments in companies** (in particular small and medium-size enterprises (SMEs) to create **sustainable jobs**
    - **infrastructures** linked notably to research and innovation, telecommunications, environment, energy and transport
    - **financial instruments** (capital risk funds, local development funds, etc.) to support regional and local development and to foster cooperation between towns and regions
    - **technical assistance** measures

European Social Funds (ESF)

- Objective: **to reduce differences in prosperity and living standards** across EU Member States and regions, and therefore promoting economic and social cohesion.

- The ESF sets out **to improve employment and job opportunities** in the European Union. It helps Member States make Europe's workforce and companies better equipped to face new, global challenges.

- The ESF supports actions in Member States in the following areas:
  - **adapting workers and enterprises**: lifelong learning schemes, designing and spreading innovative working organizations;
  - **access to employment for job seekers**, the unemployed, women and migrants;
  - **social integration** of disadvantaged people and combating discrimination in the job market;
  - strengthening **human capital** by reforming education systems and setting up a network of teaching establishments.

➢ Videos

Cohesion Funds

- The CF is aimed at Member States whose Gross National Income (GNI) per inhabitant is less than 90% of the Community average.

- It serves **to reduce their economic and social shortfall, as well as to stabilize their economy**.

- For the 2007-2013 period the Cohesion Fund concerns Bulgaria, Cyprus, the Czech Republic, Estonia, Greece, Hungary, Latvia, Lithuania, Malta, Poland, Portugal, Romania, Slovakia and Slovenia.
- Spain is eligible to a **phase-out** fund only as its GNI per inhabitant is less than the average of the EU-15.

EU Regional Policy - RegioStars

- The European Commission's **RegioStars** annual **awards** highlight the most innovative projects which have been supported by European Regional Policy.

- The objective is to identify **good practices** in regional development and to highlight original and **innovative projects** which could be attractive and inspiring to other regions.

➢ **Video: “RegioStars – The Awards for Regional Innovative Projects”**

Main references

- Baldwin, R and Wyplosz, Ch.: *The Economics of the European Integration*, McGraw Hill Education, 5th edition.