ASEAN and the EC

Institutions and Structural Change in the European Community

Ulrich Hiemenz
Rolf J. Langhammer

ISEAS ASEAN Economic Research Unit
INSTITUTE OF SOUTHEAST ASIAN STUDIES

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Ulrich Hiemenz
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Kiel Institute of World Economics

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Foreword

Structural change is the essence of economic growth both at the national and international level. Without structural change, stagnation will set in.

The production structure in a country at a given point of time is the result of interactions between a number of factors, ranging from the demographic pattern and skill composition of the economically active population, to the available financial resources, the technology and the institutional framework. In addition, the structure of manufacturing is obviously also influenced by the patterns of demand. Changes in these supply and demand factors will affect the production structure and thus lead to structural change.

The production structures of individual countries are increasingly linked and interdependent at the global level through international economic relations like trade in goods and services as well as movements of labour, capital, and other resources. Accordingly, changes in the production structure in one country will affect the structure of production in other countries and, hence, may have significant implications for the factors of production in these countries. Some factors of production may be adversely affected while others may benefit. Institutional changes may be required in order to adjust to the modified economic envircnment. Moreover, technological change may bring about yet unknown new developments in terms of products and production processes.

The present study is part of an international research project on "The Development of Manufacturing in ASEAN and the EC and the Potential for Further ASEAN-EC Co-operation". This project is one component of the long-term research programme on ASEAN-EC Economic Relations launched by the ASEAN Economic Research Unit, Institute of Southeast Asian Studies, Singapore, with the generous support of the Konrad Adenauer Foundation, Federal Republic of Germany.

The project on the development of manufacturing in ASEAN and the EC comprises studies on

- institutions and structural change;
- trends in the cost of labour and their effects on the production structure;
- trends in the cost of capital and their effects on the production

structure; and
trends in technological change and their effects on the production structure.

These trends and their impact on structural change are analysed in the context of both the economies of ASEAN and those of the EC. This international research effort will promote a better understanding of the nature and causes of structural change in each regional grouping as well as the mutual impact this change may have on both regions. We hope this study and others in the series will stimulate new ideas and reveal other areas for further ASEAN-EC co-operation.

Norbert Wagner
Institute of Southeast Asian Studies

Tan Loong-Hoe
Institute of Southeast Asian Studies

Narongchai Akrasanee
Thailand Development Research Institute

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I. Introduction

In any market economy a multitude of (partly interrelated) institutions intervene -- directly and indirectly -- into the functioning of markets in a myriad of different ways. In an economic integration scheme, such as the European Community (EC), the case becomes even more complex since the network of national institutions is intertwined with a network of supranational bilateral and multilateral institutions. To deal with all these institutions separately would be a futile exercise. This study rather provides an attempt to distinguish major actors, to determine the major thrust of their interventions, and to explain the driving forces behind institution building which have an impact on structures of production and resulting patterns of trade in the EC.

The Role of Institutions in a Market Economy

To set the stage for the subsequent empirical analysis, an analytical framework is required to identify different types of interventions and to understand the behaviour of institutions. Throughout this study, institutions are not understood as independent actors in the economic process -- comparable to producers or consumers -- but rather as the manifestation of a transitory compromise between widely varying groups of public and private interest group pressures. After some time of being in existence institutions may also develop certain self-interests and become interest groups themselves. With this approach the paper follows the main line of reasoning developed in the new political economy (see, e.g., Buchanan, Tollison, and Tullock, 1980).

There seems to be a broad consensus among all interested parties that institutions are required to set and enforce the rules of the game in a market economy. However, even if institutions are confined to establishing a legal framework for individual activities of market participants they are by no means neutral with respect to the outcome of the market process. Regulating competition in one way or another always benefits some market participants and discriminates against others. For this reason, institutional interventions into the functioning of markets are subject to interest group pressures (Stigler 1971) which intensify depending on actual or perceived effects of these interventions on group welfare.

Least controversial seems to be the need for an economic constitution. A number of generally public institutions are established to define and ensure the basic functioning of the economic system, to provide internal and external security for economic transactions as well as to create a favourable external environment for individual economic activities by implementing appropriate macro-economic fiscal and monetary policies. All these institutional activities have a fundamental impact on the well-being of the members of a society, but they are not considered in detail in this study since most of them do not intentionally benefit one sector over another.

Setting the rules of the game further implies establishing a framework for activities of sellers and buyers in individual markets. Supply and demand are subject to a host of technical standards, quality norms, safety and building codes, labour regulations, health requirements, etc., while access to markets is controlled by qualification requirements, regional and ecological considerations, anti-trust rules, business hour regulations, etc. There are a number of generally acknowledged reasons for constraining the activities of participants in individual markets such as health or safety considerations, but many of these indirect market interventions can only be derived from an individual rather than a collective welfare function. They often turn out to be means to reduce competition and to protect vested interests. Even health and safety requirements may serve the same purpose if they are excessive. Hence, it is not suprising that these rules of the game are subject to vigorous political debates and that there are changes of rules in response to changing constellations of pressure groups.

The relationship of interest group pressure and institutional intervention is most obvious in the case of direct interventions in the functioning of markets through:

- market participation such as government procurement,
- quantitative restrictions imposed on imports, exports, transfer of capital, or migration of labour, and
- measures directly affecting prices such as fixing of prices or price floors and ceilings, centralized wage determination as well as measures indirectly affecting domestic (specific taxes, subsidies) or border prices (tariffs).

All market-specific interventions have an immediate impact on the structure of production since they favour sellers over buyers, one sector over another, or the domestic economy over foreign supply and demand. The type and degree of interventions implemented in individual markets reflects the relative bargaining power of market actors and their capability to organize themselves in politically influential interest groups which in turn may become institutions themselves (e.g. trade unions). Since the capability to organize themselves is not equally distributed among market participants (Becker 1983) and since there may be collusion of interests in some markets but not in others, it is hardly surprising that degree and kind of institutional intervention varies widely among markets. Yet, there seem to be some common features for certain types of markets. In order to pinpoint such features of interest group pressures, the main actors and their interactions need to be elaborated a bit further.

The Major Actors

The network of institutions influencing market behaviour comprises not only different types of institutions with specific tasks but also essentially similar institutions at different levels of competence ranging from the local to the international sphere. In the EC this network is extremely complex. Public, parastatal, and private institutions operate at least at five different levels of competence: there are regional, national, multinational European, European Community, and international institutions. As a general rule, the influence of institutions follows a hierarchical order, i.e., laws and regulations agreed upon at a higher level of regional integration beat those at lower levels of integration. However, the dividing line between responsibilities at different levels is not always clear and, more importantly, responsibilities have been shifted up and also down in the hierarchy over time. Since institutions at different levels of competence pursue different interests, these shifts have had a significant influence on the nature and thrust of regulations implemented in different markets. Therefore, envisaging future shifts of responsibilities are an essential element in the analysis if future perspectives of institutional influences on the structure of production in the EC are to be evaluated.

Shifts of responsibilities from one level to the other do of course not happen exogenously but reflect changing political or other pressures and the emergence of new interest group constellations. An assessment of institutional influences and their shifts and changes over time as well as of the timespan needed for changes requires differentiation between different actors issuing different types of influence. At the surface, market interventions are implemented by public and private institutions assigned to do so by national or international law. In the public sphere, these are local and national governments, agencies or treaties encompassing some, but not all European countries such as, e.g., the European Space Association (ESA), the various European Community institutions, and international institutions and treaties such as GATT, MFA, COCOM, etc. Beyond the public sphere, an array of private institutions are assigned certain tasks by law. These concern the establishment and supervision of norms and standards, health care as well as, in some cases, price negotiations and introduction of supply or demand constraints. Examples for the latter are in particular wage determination and labour legislation which -- to a large part -- is left to business associations and trade unions in all EC countries.

Over and beyond their direct role in market intervention all mentioned institutions influence the institutional framework in various indirect, though crucial ways. Bureaucrats in public institutions develop self-interests which do not only have an impact on the behaviour of their respective institutions but may turn one public institution into a pressure group *vis-a-vis* another public institution (Chubb 1985). The competition for budget allocations is but one example for lobbying by public institutions which also takes place between different levels of competence within and among countries. The other category of lobbying activities concerns the influence of business associations, trade unions, and sometimes even consumers on decision-making of public institutions. Not surprisingly, pressure groups have organized themselves in accordance with the different levels of competence in public institutions, and the political power they can wield depends, among other things which will be discussed below, on whether they pursue common or conflicting interests with respect to public decision-making. And finally, there is the heterogeneous group of voters who nonetheless may be able to have considerable impact on the behaviour of politicians, and through them on economic policies. Their influence again hinges on the degree of common interest among groups of voters and between them and organized pressure groups.

Stylized Features of Institutional Influences on the Structure of Production

Despite these brief hints about the importance of special interest groups economic science still has a long way to go to fully comprehend the political economy of economic decision-making. Yet, following the early work of Downs (1957), Buchanan and Tullock (1962), and Olson (1965), some basic principles of the political economy and some empirically meaningful hypotheses have been developed which can be used as an analytical framework for the relevance of institutional factors in EC countries. The economic approach to the behaviour of institutions assumes that actual policy choices are determined by the efforts of individuals and groups to further their own interest in a political market. Politicians or political parties are understood as vote maximizers, bureaucrats seek to enlarge their realm of influence, and pressure groups behave as rent-seekers for their members. Competition among these interested parties determines the equilibrium structure of market interventions such as taxes, tariffs, subsidies and other political favours.

Politicians face elections in relatively short intervals of time and, therefore, tend to adopt populistic policy approaches to ensure re-election. Populistic pressures are strongest at the local level, but may transpire to the national government if common interests of large numbers of voters are concerned. Bureaucrats may support populistic policies advocated by politicians as long as these promise to promote their own importance measured in terms of budget allocations (Niskanen 1971). An additional problem arises, however, when national institutions are complemented by supranational institutions as is the case in the process of European economic integration. The question is which responsibilities national institutions are prepared to delegate to the supranational level. The answer is not clear-cut even if it is assumed that politicians behave as vote maximizers and bureaucrats seek to increase their budget.

Vaubel (1985) suggests that national politicians and bureaucrats view those policies as potentially dangerous to their image which benefit relatively small interest groups at the expense of the majority of voters, such as sector- specific tariffs or subsidies. Such policies are, therefore, likely to be shifted to the supranational level. This would give national institutions the excuse merely to execute measures agreed upon at a higher level which had to be accepted to further more general political goals such as European unification. Pelkmans (1983, 1986) presents a somewhat different viewpoint of the self-interest of politicians and bureaucrats. According to his analysis, sector-specific policies are an important means to redistribute income and hence, a major instrument to influence the electorate. National politicians will seek to keep this instrument under their control and rather shift general economic policies such as the liberalization of tariffs to supranational agencies (for a similar interpretation, see Frey 1984, p. 133). The reservation of national politicians against shifting responsibilities to supranational agencies may also be explained by the difficulty to control these agencies. Since the transfer of sovereignty represents a compromise between member governments, the performance of such supranational institutions can hardly be questioned by individual members later on. For this reason, international bureaucracy have a tendency to grow rapidly independent of the tasks they are assigned (Frey 1984, p. 151).

All explanations are plausible on theoretical grounds, and it is an empirical question as to which attitude of national politicians and bureaucrats actually prevails. The subsequent analysis of institutional influences in the EC is to provide some insights into the division of labour among institutions at different levels since the perspectives for future structural adjustment in the EC are heavily dependent on the actual behaviour of institutions.

The most important actors in the institutional arena are, however, organized pressure groups. These groups negotiate with governments and other institutions to obtain economic favours for their members, and they invest financial and other resources into lobbying activities. It has been shown that this investment is profitable as long as the returns in terms of subsidies or other preferences exceed the returns from productive investment (Buchanan, Tollison, Tullock 1980). The efficiency of each group in producing political pressure depends on a number of factors (Becker 1983). It is the greater the better the group can control free riders and the smaller the group of beneficiaries is relative to the number of taxpayers or consumers as, e.g., in the case of farmers. Large demands by pressure groups may, however, stir resistence of those who have to carry the burden in the form of higher prices or taxes. Shifts of demand and/or tax avoidance would, then, limit the political success of pressure groups.

The identification of institutions and special interest groups and the analysis of their interrelationship allows for stylized scenarios of different types of institutional intervention depending on the interest group constellation in the markets concerned. The empirical meaning of these scenarios for the member countries of the EC will be discussed in Chapter II.

The first scenario concerns declining industries and agriculture which are characterized by an accelerated depreciation of invested capital and a reduction of employment as a result of declining international competitiveness. In these markets, there is a collusion of interests among business/farmers' associations and trade unions which both stand to lose members in the process of shrinking output as well as voters in regions most affected by the loss of competitiveness. Their combined political pressure is likely to be successful in achieving support from national, EC or international institutions, but as Hillman (1982) and Cassing, Hillman (1986) suggest, political support may not be sufficient to entirely prevent industries from declining. The main reason for this limited success is essentially Becker's argument that the huge resources required to maintain previous output levels of ailing industries create incentives for those who have "to pay the bill" to issue countervailing pressure. Furthermore, all institutions are subject to budget constraints which cannot be overcome in the short run, and national institutions run the danger of retaliatory action by other national or supranational agencies. The empirical validity of these propositions will be scrutinized in Chapters III and V below.

The second scenario encompasses technology-intensive and service industries which -- in the context of the EC and other OECD countries -- are potential growth industries. Yet, firms in these industries are supported by subsidies and/or restrictive trade practices. Respective business associations and bureaucrats seem to share in the intention to maintain or even intensify this support. Contrary to the case of ailing industries, these groups do not have to envisage much opposition from other interest groups since sunrise industries are prosperous, create new jobs and burdens of protectionist measures remain largely invisible to consumers and taxpayers. However, self-interest may lead to controversies among bureaucrats at the national and the supranational level. The final outcome of such controversies can hardly be predicted purely on theoretical grounds. They may result in a simple shift of responsibility from one level to the other or they might induce a gradual process of deregulation. These issues are dealt with in Chapters IV and VI.

The final scenario presents the struggle between mainly private institutions (mostly at the national level), i.e. the case of labour markets. National business associations and trade unions bargain over wages and labour regulations which have an immediate impact on the international competitiveness of industries and, thereby, the structure of production. Despite their obviously controversial interests, both negotiating parties have some common ground, too. They are both concerned with the viability of the industries concerned, the preservation of industrial peace, and the overall employment situation. Analytical questions are

- whether and under what circumstances one group can prevail over the other and introduce an institutional bias into the process of wage determination, and
- whether the ongoing process of European integration towards a true Common Market will give supranational institutions rights to enforce Community rules over national rules.

Chapter VII attempts to provide an at least tentative answer to these questions. The lessons from past behaviour of institutions and the forces driving their activities are summarized in Chapter VIII in order to evaluate the hypothesis that a multitude of intervention levels in the EC has compounded the impact of institutions on the functioning of markets and added to distortions of the structure of production. This analysis also allows for an assessment of perspectives for institutional change in coming years. The future direction of institutional intervention in structural change and foreign trade will depend to a substantial degree on the level at which economic policies are going to be formulated and implemented, i.e. whether tendencies for supranational integration or for renationalization prevail. Both tendencies are present in the EC context. Finally, some major institutional barriers for the access of ASEAN countries to EC markets are identified, and some conclusions are drawn with respect to the impact of likely institutional changes on future ASEAN-EC economic relations (Chapter IX).

II. Structural Change in the European Community in the 1970s and 1980s from an Institutional Perspective

Driving Forces

In every economy, the structure of production is continuously changing in response to a multitude of demand and supply factors such as increasing per capita income, emergence of new domestic or foreign suppliers, new fashions, technological progress, shifts in the resource endowment, etc. The process of structural adjustment to changing internal and external parameters is geared by private and public policy decisions which influence prices and quantities in goods-, service- and factor markets. Policy decisions may either accelerate structural adjustment by lowering barriers to market access and allowing prices to reflect demand and supply changes, or delay adjustment by containing price fluctuations and regulating market entry and exit. The former decisions are forward-oriented and give incentives to resource flows from old to new industries, whereas the latter ones are defensive and protect employment and investment in declining industries. In reality, offensive and defensive adjustment policies are often implemented simultaneously in different sectors of the economy, and the overall economic performance then largely depends on which policy dominates.

The fact that there is no clear-cut adjustment policy in either direction can be attributed to the need of compromising with or balancing vested interests. In the EC, there are not only private and public vested interests to be taken into account, but various national interests as well. In addition, supranational pressure groups compete with national pressure groups for resources and competence.

The need to compromise between supranational and national interests has several causes. National decision-making e.g. in capital and labour market policies co-exist with an irreversible transfer of power and sovereignty to the Community level in other areas of decision-making such as in agricultural and trade policies. This distribution of power requires some degree of policy coordination between national and supranational institutions. But, even when European law is binding for national policies, a large number of safeguards and escape clauses exists which prevent national interests from being overridden. Should unanimous policy-making not be possible, policy competence may be allowed to slip back to the national level, thus creating different policy frameworks in the various member countries.

Alternatively, the European Court may have to decide ultimately when supranational institutions regard national policies as conflicting with the European treaties. Such conflicts can arise since European economic integration is in principle based on the harmonization of rules and regulations among member countries, but competition among regulatory systems of member countries is not permitted until harmonization is achieved. This means that goods and services can be sold and purchased in each member country only in accordance with the rules of that country (designated country principle).

The first step in evaluating this institutional framework is to assess which policies have on balance determined structural adjustment in the EC. This analysis is based on production and trade patterns that have emerged in the EC in the last fifteen years.

Sunset and Sunrise Industries

After a period of rapid growth in the 1950s and 1960s, industrial expansion slowed down considerably in all industrialized economies, but even more so in the EC. In 1972-82, average annual growth of domestic demand for industrial products in the EC[1] amounted to only 2.0 per cent in real terms compared to 2.3 per cent in the United States and 6.4 per cent in Japan (Buigues, Goybet 1985*a*, Table 3). The following three years until 1985 yielded but a modest recovery for EC industries (2.4 per cent in the 1982-85 average), compared to booming demand for industrial products in the United States (6.7 per cent) and Japan (6.5 per cent). These discrepancies between the three major industrial economies suggest that beyond business cycles and problems to adjust to the external shocks of the 1970s, EC industries faced additional difficulties.

An explanation is provided by the above cited study on the competitiveness of European industries undertaken under the auspices of the EC Commission. This study distinguishes between industries facing weak demand[2] (sunset industries), moderate demand, and high demand growth (sunrise industries), and shows for the EC, Japan and the United States that virtually the same industries fall into these categories in all three economies[3] (Table 1). The essential disadvantage of the European industry pattern *vis-a-vis* Japan and the United States concerns the relative importance of each of these categories. In 1982, sunrise industries represented only 23 per cent of total industrial value added (in real terms) in the EC compared to 28 per cent and 37 per cent in the United States and Japan, respectively (Table 2). Furthermore, growth of sunrise industries measured in percentage points of total value added was lower in the EC than in the United States and Japan, whereas the decline of sunset industries, albeit proceeding in all economies, was much less distinct in Europe than in Japan. Nonetheless, more jobs were lost in sunset industries of the EC than, for example, in respective U.S. industries, and these losses were not offset by additional employment created