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The Rome Treaty at 50

MORE HONOURED IN THE BREACH THAN IN THE OBSERVANCE?

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On March 25, 2007, the Rome Treaty turns 50. This is the anniversary of a remarkable period of economic integration and cooperation in the history of Europe. The original six founding countries have been joined by an ever-growing community of countries. This geographical extension has also been accompanied by a significant deepening of European cooperation. Several new policy areas have been integrated in the European policy context and are now subjected to EU policy coordination.

Pillared on the experience from competitive economic nationalism in the interwar period, and the ensuing world war, the economic integration manifested by the Rome Treaty has been a successful story of peace and economic prosperity. Welfare in Western Europe since 1957 has increased radically. Today the founding six countries are on average almost 200 percent richer (adjusted for purchasing power parity) than they were when the treaty was signed. The interconnectedness of European countries – facilitated by flows of goods, services, capital, and people across borders – is stronger than ever. The EU enlargement to former communist countries in East and Central Europe serves not only as a great political symbol of the peaceful resolution of the Cold War world. It shows the attractiveness of the basic

SUMMARY

In March, 2007, the Treaty of Rome celebrates its 50th anniversary. The chief lesson from this remarkable period of European cooperation is the contribution to growth and prosperity from economic integration. The common commercial policy that emerged from this treaty has had a significant impact on European economic development.

Equally important, regional liberalisation in Europe spurred multilateral trade liberalisation under the auspices of the GATT and the WTO. The Kennedy Round of trade liberalisation in the 1960s, facilitating considerable tariff reductions, was partly a response to European liberalisation. Similarly, the Uruguay Round of trade negotiations in 1986-1994 gained impetus form the Single Market programme.

But regional liberalisation of trade in Europe has only been partial and confined to trade in goods. The service sector represents 75 percent of European production but only 20 percent of intra-European trade. European trade in services still suffers from considerable regulations. The agricultural sector is far less important for European wealth than services, but intra-European trade is severely distorted by the Common Agricultural Policy.

To honour the theme of economic integration manifested in the Treaty of Rome, Europe must put the programme of trade liberalisation back on track. The liberalisation of trade in goods 50 years ago pushed global liberalisation. Considerable reduction of barriers to trade in services and agriculture is now necessary for Europe to not become an obstacle to international trade liberalisation.

theme in the Rome Treaty. It demonstrates the benefits of a policy model pillared on closer economic integration and market economy exchange. This is a key lesson of the past fifty years.

But Europe's economic integration and development in the last fifty years is not only a tale of closer European cooperation. Equally important to the European project of integration, and to the quest for prosperity, is the ensuing post-war development of a global division of labour and a rapidly expanding world economy. European integration would not have been an attractive model had it not been accompanied by global integration. Fundamentally as well as institutionally, the Rome Treaty principles of dismantled barriers to exchange are part of this larger development. They are a function of the increasing internationalization of the economy, but they also provided incentives and momentum to globalisation.

This Policy Brief assesses the role of the Rome Treaty principles of closer economic integration in a wider context of globalisation and the world economy. It analyzes the fate of these principles in Europe, and how the global trend towards closer integration has interlinked with intra-European development. Taking stock of economic integration in a broad political-economy fashion, this Policy Brief assesses the extent to which the Rome Treaty themes of economic integration have been put into practice.

A FRESH START: EUROPE REINVENTS ITSELF

The Treaty of Rome is a comprehensive document that covers many fields of policy and areas of cooperation. More than anything, it is a manifest for closer economic integration between the countries of Europe. The backdrop to the treaty was one of war and competitive economic nationalism. In 1957 the European Economic Community (EEC) was in a way a direct response to the catastrophes of World War II. The interwar period had witnessed a collapse of the pre-1914 order of globalisation and the recourse to protectionism and to beggar-thy-neighbour policies.

But the EEC was not the first step towards a supranational European authority. The foundation of the European Coal and Steel Community (ECSC) in 1952 marks the first milestone in the history of post-war European integration. Economic issues soon became the chief area of cooperation as they where much less subject to national resistance than other political areas. Supranational cooperation in political affairs carried much more sensitivities, and efforts in that direction were soon lying idle when not supported by the perennial gale of economic integration.

Therefore, economic cooperation in order to "promote economic and social progress" has been the main feature in the matching of different national opinions and conflicting interests in many fields. Political integration has followed on the heels of economic integration.

This choice of a distinctly economy-focused agenda was correct. The Rome Treaty was of course much more than economics. It provided an institutional setting of the European Commission and the European Court of Justice. But the focus on economic integration also offered an entrance to other and more contentious areas of cooperation. The early crisis of the integration process, the failure of the European Defence Community (EDC) in 1954, contributed to the designing of the EEC by engineering a response that, in concentrating on economic integration, successfully circumvented the tension between sovereignty and supranational cooperation.

TRADE EFFECTS OF EUROPEAN INTEGRATION

A direct consequence of the Treaty of Rome was the incremental reforms of the external trade policy of the member states and of the intra-European tariff cuts. These two tenets formed the basis of a common commercial policy – a Customs Union. The external tariff rates decreased from about 15 percent in the late 1950s to about 6,6 percent after the completion of the Kennedy round of trade liberalizations in the late 1960s. By 1968 all internal tariffs had been eliminated and the final phases of external trade policy had been implemented.

Table 1 exhibits key phases in the early stages of the Customs Union. There was an evident difference between the tariff rates of the founding members. Soon after the Second World War Germany had embarked on a comprehensive economic reform programme that involved a liberal trade policy. Italy and France, on the other hand, followed regimes based on extensive protection. The Dillon Round of liberalization in the early 1960s coincided with the programme to form a common external tariff for the EEC. This programme was done in several stages and rested on a simple formula of averaging the tariffs applied when the Treaty of Rome was signed. With the Dillon Round effects, the common average tariff rate for the

	AVERAGE TARIFF RATES 1958	AVERAGE TARIFF RATES DILLON ROUND	EXTERNAL TARIFF IN 1968	EXTERNAL TARIFF AFTER THE KENNEDY ROUND
GERMANY	6.4	5.8	10.4	6.6
FRANCE	17.0	15.3	10.4	6.6
ITALY	18.7	16.8	10.4	6.6
BENELUX	9.7	8.7	10.4	6.6
UK	16.5	14.9	14.9	9.2
DENMARK	5.6	5.2	5.2	3.2
AUSTRIA	14.9	11.4	11.4	8.2
SWEDEN	6.5	6.3	6.3	4.2
NORWAY	10.3	10.3	10.3	6.4

Table 1: Average tariff rates in selected European countries (percent)
The introduction of a common tariff rate in Europe coincided with two GATT Rounds – the Dillon Round and the Kennedy Round. The design of the common external tariff in Europe took account of the reductions negotiated in these two rounds. The implementation of the common external tariff was achieved in 1968. The increase in the German and the Benelux tariff rates between the end of the Dillon Round and the implementation of the CET (the second and third column respectively) was hence not a consequence of the Dillon Round.

Source: Resnick & Truman (1975)

original six countries was 10.4 percent when this programme had been implemented. In the late 1960s, a new round of trade liberalization under the auspices of the GATT started. This round had a considerably higher ambition than the Dillon Round, and when the Kennedy Round agreement had been implemented in the early 1970s, the common average tariff in the EU was 6.6 percent. In other words, 15 years after the Rome Treaty the average applied tariffs in Europe had been more than halfed.

It is quite clear that countries such as France and Italy would not have reduced their external trade barriers to the extent that they actually did without the pressure from Germany. It is also clear that one of the most immediate effects of the elimination of internal tariffs in the EEC was a considerable change in intra-European trade. The share of intra-EC trade increased after the introduction of the common commercial policy, from less than 40 percent in 1958 to almost 50 percent in the mid-1960s and rose steadily until the early 1970s (see Figure 1).

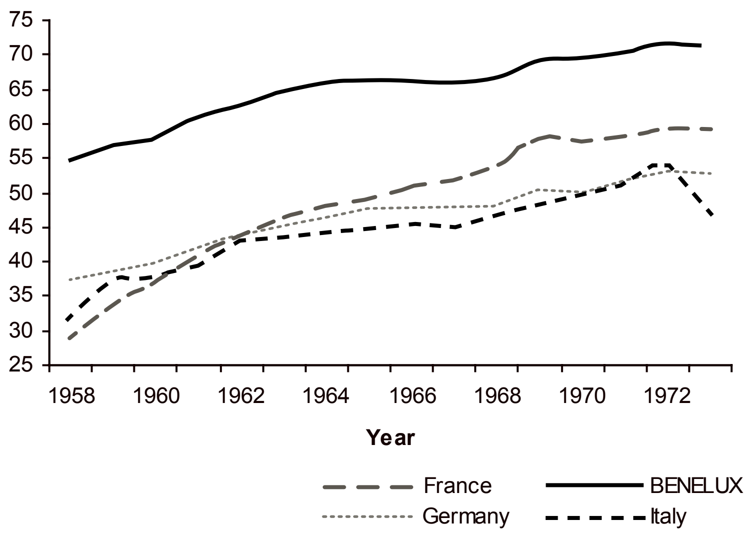

Figure 1: Intra-EC trade 1958-1973 (percent of total trade)
Source: Own estimates on the basis of data provided by Eurostat

Another significant result of the trade liberalization amongst the six member states was the increase in intra-industry trade. Trade liberalization resulted in a higher degree of product differentiation and intra-industrial specialization rather than in a large shift in

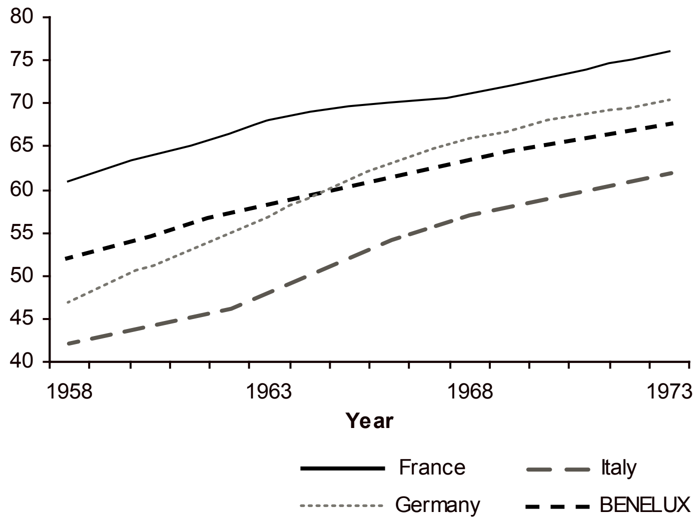

Figure 2: Share of intra-industry trade (1958-1973)
Source: Own calculations on the basis of data provided by Eurostat and Balassa (1975)

the resource allocation between sectors and countries (see Figure 2). The adjustment costs of these liberalizations were therefore modest[1] and prevented an uprising of fierce resistance by labour unions and interest groups against liberalization. The low adjustment cost of the establishment of the EC depended on the relatively large economic homogeneity of the member states and their similar levels of economic development.[2]

The substantial impact of the early stages of European integration on trade flows has been shown in several studies.[3] The rise in intra-EC trade replaced trade with non-EC members to some extent. Furthermore, the German case shows that trade diversion did play a significant role in the post-Rome years: from 1960 to 1972 (the year of the free trade agreement between EC and EFTA) Germany's trade with EFTA dropped from more than 70 per cent of its trade to little more than 30 per cent. By 1989 it had risen again to 60 per cent.[4] The vast majority of empirical studies analyzing the trade creation and trade diversion effects of the EC (and the EFTA), show a profound and significant trade creation effect and a rather negligible trade diversion effect on manufactured goods of the EC in its early stages.[5] *Mutatis mutandis*, the net effect of European integration on trade flows and volumes has been distinctively positive.

Moreover, European integration and the common commercial policy gave an impetus to other kinds of liberalization of trade – to multilateral liberalization as well as regional liberalization. This is not necessarily the case with trade liberalization outside the context of multilateral institutions. The idea of competitive liberalization – that one bilateral or regional effort to liberalize trade on a preferential basis will spur other efforts of the same kind – has repeatedly been challenged by trade agreements that are weak and partial and contain no substantial element of market openings. But the common commercial policy became a major promoter of other kinds of trade liberalization.

The establishment of the European Free Trade Area (EFTA) in the early 1960s can be interpreted as a reaction by other European countries to the Customs Union of the EC. In a way, the EFTA was a direct side effect of the Treaty of Rome. The existence of two more or less competing trading blocks in Europe fostered further international trade liberalization, although that was not always without problems for multilateral trade negotiations.

More important, European integration and internal trade liberalization gave an impetus to multilateral liberalization. Concerted reductions of trade barriers within the GATT/WTO framework would have progressed without the European efforts to liberalize regionally, but probably to a lesser extent. The Kennedy Round in the late 1960s, which agreed on an ambitious reduction of tariffs, gained a lot of impetus from the common commercial policy. To avoid competitive disadvantages in Europe, the United States insisted on substantial cuts in the overall Most Favoured Nation (MFN) tariffs. The same dynamics have been in operation at later stages as well, in particular in the late 1980s and the early 1990s when the European Single Market and the North American Free Trade Area were negotiated and agreed.

This is important. Without the multilateral reduction of tariffs, the trade diversion effect of the common commercial policy would have been far greater. Its effect on global welfare would have been significantly lower. Freer intra-EC trade complemented rather than substituted freer trade with the rest of the world. Accordingly, many countries have gained from the income effects associated with European integration, via the increased demand for their export commodities.[6]

Figure 3 shows the tariff reductions within the GATT/WTO, and the EC/EU. As can be seen, there have been almost parallel liberalization efforts, though the EC/EU having substantial lower average tariff rates than the rest of the world. The tremendous increase in merchandise trade during the last 50 years underpins the overall positive effect of international integration

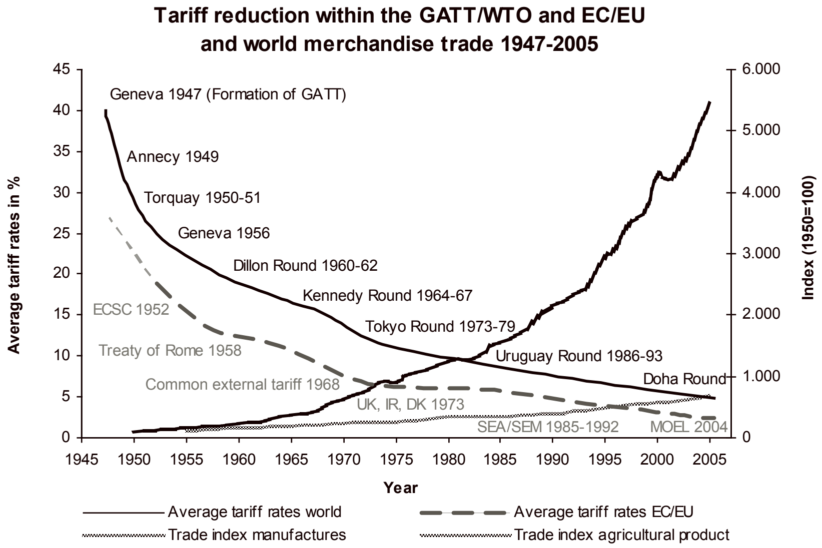

Figure 3: Tariff reduction, European integration, and trade (simple average tariff rates)
Sources: WTO; IDB; World Bank; IMF Global Monitoring Tariff; Senti, R. (2000)

EUROPEAN INTEGRATION AND ITS CONTRIBUTION TO ECONOMIC GROWTH

Economic integration is a central part of the quest for prosperity. Is it possible, then, to demonstrate a significant effect on economic growth and welfare from the Treaty of Rome and the common commercial policy?

It is not a trivial task to separate the effects of these institutions and subsequent integrative initiatives on trade and growth from other effects emerging from the general post-war recovery, other institutional reforms, the effect of monetary cooperation, and multilateral liberalization of trade. The high growth rates in the six member states in the late 1950s and in the 1960s seem to support the presence of a positive static effect of the Rome Treaty. In the six member states, GDP increased by more than 20 percent between 1957 and 1961, by far surpassing the growth rates in other industrialized countries such as the US or the UK. But it is not as simple as that; the growth disparities between Western European economies and other industrialized countries already occurred in the early 1950s. Therefore, the strong economic growth in the six countries finally joining the common market was, to some extent, due to a catching-up and a recovery process after World War II. This recovery received significant support from transfers from the United States.

But a recovery process implies falling growth at a later point in the recovery cycle. That happened to European countries. Several empirical studies suggest that the introduction of the common commercial policy delayed the deceleration of economic growth rates.[7] One leading economist at that time estimated that the formation of the EC added a one percent increase in GDP due to increased savings and investments in the early 1960s.[8] According to another estimate the Gross Domestic Product of the EC in 1972 was 2.2 percent higher on the average and in 1981 even 5.9 percent higher than it would have been without integration.[9] More recent studies using improved econometric methods confirm the positive growth effect of the early stages of European integration.[10]

The considerable economic effects in the early stages of European integration were not only due to specialization and trade. They were also a result of increased Foreign Direct Investment (FDI), especially by the US. Members of the European Community accounted for just about 5 percent of US direct investment abroad in 1950, but attracted much more FDI in the years after the Treaty of Rome. By the mid-1960s their share of US direct investment abroad had doubled. The increase of US direct investment was substantially higher in the EC countries than in the EFTA and other European countries (see Table 2).

	1950		1957		1964	
	$US MILLION	SHARE (%)	$US MILLION	SHARE (%)	$US MILLION	SHARE (%)
EC	637	5.4	1,680	6.6	5,398	12.2
EFTA	986	8.4	2,245	8.8	6,045	13.6
OTHER EUROPE	110	0.9	226	0.9	624	1.4

Table 2: US direct investments abroad
Source: Yannopoulos (1990)

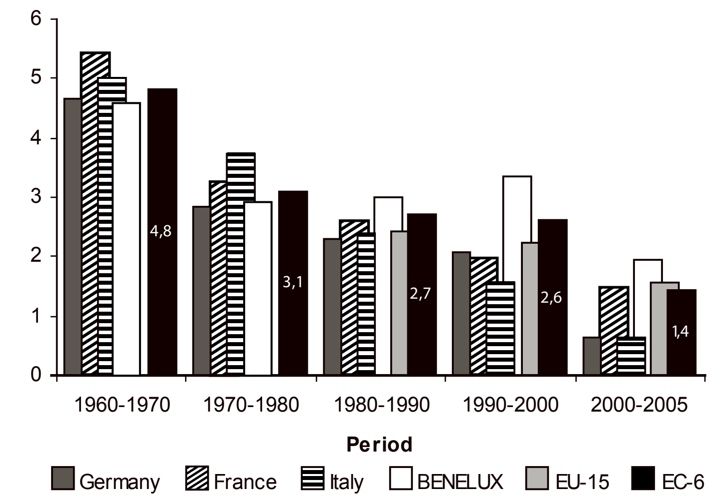

Figure 4: Annual average growth rates in European countries (percent)
Sources: OECD; Eurostat

More important than the static effects of integration are the dynamic effects. Dynamic growth effects of economic integration are supposed to manifest themselves in enhanced competition between producers leading to an increase in efficiency, the exploitation of economies of scale, the creation and diffusion of knowledge and technology, and the attraction of additional investments, both from inside and outside the integration area. These dynamic effects lead to higher permanent growth that might accelerate over time.

Can such a growth bonus be observed in Europe? The empirical evidence of the dynamic growth effects of European integration is somewhat mixed. While some studies suggest that the EC membership had no significant effect in per capita income growth, or found a significant, but only temporary, effect of European integration on growth in the common market's countries,[11] others demonstrated a significant dynamic and permanent growth effect of European integration.[12] The mixed and uncertain results might be due to the fact that it is even more difficult to separate integration-induced effects from other factors in a dynamic context.

Figure 4, showing falling growth rates in Europe since 1960, seems to challenge the hypothesis of a strong dynamic growth effect of European integration. Compared to other parts of the developed world, Europe did not perform well. Since the mid-1970s economic growth in the EC/EU has substantially lagged behind the growth rates in other (newly) industrialized countries.

But these purely descriptive statistics do not contradict the hypothesis of positive dynamic effects of economic integration. Many studies about the expected and experienced growth effects of European integration point to the crucial role of competition and the openness of the economy to account for the success of the integration process. Competition effects were most dramatic in those member states that had been pretty sheltered economies before the Treaty of Rome. In France, for instance, the import exposure more than doubled, from less than 8 percent to 16 percent, within 10 years after the Treaty of Rome.[13] This increased competition put pressure on former monopolies and lead to enhanced efficiency rates in the member countries.

Further integrative efforts, especially the Single Market Programme, have enhanced intra-EC competition and efficiency, lowered consumer prices, and significantly contributed to economic growth. The Ceccini Report, using an ex-ante microeconomic approach, estimated the potential welfare gains of the Single Market programme to be in the range of 2.5 to 6.5 percent of the community's output[14] Another central study estimated an even more permanent positive contribution of the Single Market to GDP growth in European countries of about 0.25 to 0.9 percentage points per year.[15] Without intra-EC liberalizing efforts the member states would undoubtedly have been worse off in terms of economic growth and welfare. Later studies have generally confirmed the presence of positive dynamic effects, in particular after the Single Market reforms.[16]

HONOURED IN THE BREACH

The principles and articles of the Treaty of Rome comprise trade in goods. This is not surprising. The treaty mirrored the structure of the economy at the time with its heavy concentration of trade in goods. Trade in services was in several ways an irrelevant issue. Nor is it surprising that the common commercial policy has had static as well as dynamic effects on growth in Europe; this follows the basic knowledge of economics and age-old wisdom concerning the gains from an exchange-based economy.

What is surprising, however, is that fifty years after the treaty was sealed and stamped, its basic theme of economic integration and open borders in Europe still essentially confines itself to trade in goods. The treaty should be celebrated as a success; its signatories should be praised for their efforts. But consecutive generations of European political leaders should be criticized for foot-dragging and inability to apply the basic theme of the Rome Treaty to a new generation of trade reforms. The backdrop to the treaty is clearly the economic and non-economic benefits of reduced barriers to trade. The preamble of the treaty mentions the elimination of barriers that divide Europe and hinder economic and social progress. But this theme, this principal context of the treaty, is, to use a Shakespearean phrase, more honoured in the breach than in the observance.

Agriculture still lies largely outside the boundaries of the Common Market. Agriculture is subject to the Customs Union and its system of common external tariffs, but agricultural produce is hardly produced or traded without serious internal distortions. This field of policy, still consuming almost 50 percent of the EU budget, has not only affected the welfare of European consumers, but also been detrimental to the integration of developing countries into the world markets.

This last point is important. The legitimacy of the common commercial policy partly hinged upon its benign effect on multilateral liberalization; it spurred new initiatives of trade reforms that opened up Europe to world trade. A preferential system in Europe did not become an excuse to build a Fortress Europe. But in these fifty years the multilateral trade policy agenda has advanced. Liberalizing trade in goods is no longer its chief task, for the simple reason that not much remains to be liberalized. A considerably more challenging task today is liberalizing trade in agriculture. But the Common Agricultural Policy (CAP) has clearly been detrimental to multilateral efforts to liberalize trade. Representing only a tiny part of Europe's economy, agriculture and its protectionist context is an important reason to why it has been difficult to progress the Doha Round of trade liberalization. With tariff protection up to 427 percent, several European farmers (and large companies in Europe's food industry) stand to loose considerably from liberalizing trade.

This setting of European agricultural policy can be traced back to the very beginning of the integration process. Title II (Art 38-47) of the treaty, solely addressing agriculture, is a unique part of the treaty in terms of regulatory scope and impact. It not only extended the common market to agriculture and agricultural trade, but also introduced a distorting system of minimum prices, substitution, quotas and other restrictions. The treaty emphasized the non-discriminating nature these restrictions should embody, but only with respect to intra-European production and trade. The distorting consequences of the Common Agricultural Policy, established in 1962, have increased over time and jumped to a higher level with almost every successive enlargement of the community.

Trade in services is also anathema to the theme of the Rome Treaty. The service sector is the most important sector in European economies today (more than 75 percent of the total value added is accounted for by service production; the service sector employs more than 150 million employees), but represents just about 20 percent of intra-EC trade. There are some non-regulatory circumstances that partly explain this imbalance; all services are not internationally tradable. But the chief reason for the low share of services trade in the total trade is regulatory barriers to trade in services: government monopolies (e g in postal services and energy utilities), restrictions to offer services abroad, quantitative and/or territorial restrictions, price and wage regulations, et cetera.

Liberalization of the services sector could have tremendous welfare and employment effects by enhancing competition and reducing unjustifiable rents. The effort by the European Commission failed to push through a Service Directive, pillared on the fundamental freedoms of the Treaty of Rome, and the diluted version that was recently agreed upon will not contribute substantially to increased trade in services. It does not follow the theme of economic integration in the Treaty of Rome.

The policy implications should be evident. To honour the spirit of the Treaty of Rome the European programme for trade liberalisation must get back on track. The common commercial policy was instrumental to European growth and pros-perity in the post-war period. It gave impetus to regional liberalisation in other parts of the world and to multilateral reduction of barriers to trade.

Regional liberalisation in Europe can have a similar effect today if European leaders target reforms of distortions in agricultural trade and advance the idea of a Single Market for services. This is required if Europe should take up a real leader-ship role for reducing barriers on the global scene.

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NOTES

1. Sapir (1992).
2. For the theoretical background see Krugman (1980)
3. See for example Aitken (1973) and Jaquemin & Sapir (1988).
4. Giersch, Paqué & Schmieding (1992)
5. See Balassa (1967), Truman (1972), Verdoorn & Schwartz (1972), and Aitken (1973)
6. Sapir (1992)
7. Balassa (1963).
8. Balassa (1975)
9. Marques Mendes (1986)
10. See for example Henrekson, Torstensson & Torstensson (1997) and Badinger (2005).
11. See for example Badinger (2005) and De Melo, Panagariya & Rodrik (1993).
12. See for example Henrekson, Torstensson & Torstensson (1997) and Crespo Cuaresma, Dimitz.& Ritzberger-Grünwald (2002).
13. Adams (1989).
14. See Emerson (1988) and Cecchini, Catinat, & Jacquemin (1990).
15. Baldwin (1989).
16. Contrary to the ex-ante studies that have predicted a short-term loss of jobs, the European Commission estimated a sharp increase of employment due to the Single Market programme in the late 1980s.

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