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Your reference

Our reference

Date *18* February 1991

Dear Mr Hill

EC AND DEVOLUTION

John Allen spoke to you recently concerning a research paper by Professor W Black on 'Developments in the EC: Implications for Northern Ireland'. I now enclose for your information a copy of the paper.

Yours sincerely

B GLENDINNING (MISS)

[RA]BGle-1701
CS/

EC BRANCH

31 JAN 1991

cf 659

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ESG(90)4

DEVELOPMENTS IN THE EUROPEAN COMMUNITY: IMPLICATIONS FOR NORTHERN IRELAND

- (1) The purpose of these notes is to provide a basis for discussion of the effects of current developments in the EC on Northern Ireland. The main focus is on the possible effects of the Single European Market (SEM) but some comments are also offered on the possible implications of economic and political union.
- (2) While the possibility that the SEM may have adverse effects on peripheral regions is widely recognised in the literature on the topic the Community view on the issue has been that the adverse effects can be offset by:
 - (a) increased economic growth; and
 - (b) a rigorous regional policy based on the enlarged Structural Funds (cf Padoa Schioppa, 1987; Cecchini, 1988).

As we approach 1992, however, concern has been growing in some peripheral regions that the adverse effects may be more severe than had been expected and that the Structural Funds may not be adequate to the task of preventing regional divergence in economic performance and living standards. The National Economic and Social Council (NESC) Report on Ireland in the European Community sets out a detailed exposition of this view for the Republic and provides a useful starting point for consideration of the possible effects of SEM on industry in NI.

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The NESC Report

(3) On the basis of a comprehensive analysis of the effects in each of the major sectors in the economy the Report concludes that, for the Republic, the pain generated by the SEM will outweigh the gain. The conclusion rests on a number of propositions:

- (a) The direct effects of SEM are likely to be positive because other Member States' barriers against Irish exports are more significant than Irish barriers against imports;
- (b) Indirect effects will be negative because Irish indigenous firms have limited ability to benefit from the two major dynamic effects that are expected to follow from the expanded market, economies of scale and enhanced innovation. In the long-term indirect effects are expected to be much more important than direct effects.
- (c) Proposition (b) is supported by the evidence that indigenous industry in the Republic has already suffered considerable erosion as a consequence of membership.
- (d) The SEM might generate an increase in inward investment but, even if it does, the long-term benefits of such investment are doubtful. (Foreign firms have short lives and there is little integration with the domestic economy).

The Implications for Industry in NI

- (4) How much of the NESC analysis for the Republic can we read across into NI?

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(a) Proposition (a) seems as likely to be true for NI as for the Republic.

(b) On proposition (b) there is a serious gap in our knowledge and it is important to get NIEC research in the area off the ground as soon as possible. Apart from the multinationals, however, it would not be unreasonable to start from the assumption that industry in NI will face similar problems to industry in the Republic in obtaining dynamic benefits.

(c) Surprisingly we do not have much detailed evidence on proposition (c) for Northern Ireland: we know very little about the impact that membership of the

Community has had on local industry. This is partly because it is exceedingly difficult to disentangle the effects of membership from the effects of other major events that have occurred since 1973 - oil crises, recession, the troubles etc. As part of the NIEC research it may be desirable to try to get some feel for the extent to which the decline of some of the more vulnerable sectors - textiles, clothing, footwear, furniture etc - has been the consequence of increased import penetration from other Member States, particularly in the GB market.

(d) Recent reports by both NIEC and NIERC have expressed concern about the performance of inward investment companies in NI since 1973. Our views on the issues are not as strongly developed as those expressed in the NESC Report but there are increasing reservations about the extent to which we can rely on inward investment to provide long-term increases in levels of employment.

(5) The NESC analysis does not put much weight on the "trickle down" effects emanating from faster growth in the Community

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as a whole as a consequence of SEM. In NI these effects are likely to have their main impact as a result of increased growth in GB. In the past manufacturing employment in NI has closely mirrored the performance of manufacturing industry in GB. If the SEM provides a stimulus to employment in the nation then we might expect some part of the increase to be reflected in the region. On the other hand we must expect the SEM and associated developments to have an effect on our competitiveness in some UK markets. The Channel Tunnel, for example, is likely to provide increased competition from the continent for NI producers selling in markets in the South-East. And there may be knock-on effects if producers in the South-East react to increased competition by trying to expand their markets in the rest of the UK.

- (6) We do not have enough information to enable us to reach any firm conclusions on the overall effects of SEM on industry in NI. Much of the debate on the issues has recognised that there will be opportunities for local industry and that there will be adverse consequences for weak players but there has been no comprehensive attempt to reach conclusions on the balance between the two tendencies. The NESC Report rings alarm bells by reaching a negative conclusion for the Republic. It seems probable that many of the problems identified in the Report are mirrored in NI. The crunch issue is whether the similarities are sufficiently close to warrant the presumption that for NI, as for the Republic, pain will outweigh gain.

Industrial Policy

- (7) What can be done to improve the prospects for industry in the SEM? Economic policy in NI has, for some time, attempted to address two objectives, strengthening the economy and supporting the economy. In fact, because much of the activity on the industrial development front has been

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focussed on the creation of employment the policy has been heavily biased towards support. Some, at least, of the interventions may have adverse effects on competitive strength. The new economic strategy which has been developed by DED is designed to correct that bias by concentrating on measures designed to increase productivity, improve product quality, reduce unit costs and improve industry's ability to meet competition at home and abroad. Concentrating on competitiveness is consistent with easing the pain from SEM particularly if it addresses the problems of improving managerial and marketing skills and sharpening the linkages between product design and R&D.

- (8) Some further targeting of the Industrial Development effort may be required to improve local industry's capacity to benefit from economies of scale. By comparison with other Member States firms in NI are generally small, and their ability to benefit from economies of scale is open to question. The ID institutions should address this issue. It is not clear whether policy should be positively geared towards restructuring to achieve larger units, or whether it should simply be "restructuring-friendly" in the sense that it would not seek to preserve weak firms if their disappearance would be likely to increase the scale of the survivors.

The Dimensions of 'Pain'

- (9) Starting from the presumptions that pain will exceed gain can we get any feel for how serious the outcome might be for industry and employment in NI during the course of the nineties? The general nature of the change that the SEM might bring about can be characterised as an increase in peripherality. The basis of the NESC analysis is that development will tend to be concentrated at central locations because the periphery is not equipped to take advantage of

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the increased trade opportunities that will arise. The relative economic advantage of regions changes only very slowly in the normal course of events. SEM can be regarded as a process that will open up new fault lines that could change the topology of economic space within the Community in a fundamental way. The effect might be to produce a shift in the development path of the NI economy away from what it would otherwise have been.

- (10) The NIERC forecasts for the economy provide an approximation to what might be expected in the absence of major competitive effects stemming from SEM. The methodology of the forecasts picks up the effects of accelerated Community growth on industry in GB and on the extent to which this might be reflected in NI but it proceeds on the broad assumption that the relative competitive strength of firms in the two areas does not suffer any dramatic change over the period under review. Even against this fairly optimistic background NIERC is predicting a loss of 4000 manufacturing jobs between 1990 and 1995.
- (11) Adverse competitive effects would add to this loss but it is not possible to provide any assessment of the number of jobs that might be at risk. Nor does the NESC Report offer any estimate of possible job losses in the Republic that might serve as a rough guide.
- (12) In very general terms, however, it seems unlikely that we will see much buoyancy in total employment during the course of the 'nineties. We are unlikely to see a repetition of the savage decline in manufacturing employment that occurred between 1973 and 1983. On the other hand we will not have a repetition of the expansion in public sector employment that offset the private sector decline. My own view is that, until we get a clearer picture of the competitive response of local industry to the SEM, we should work on the assumption

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that there will be a slow decline in total employment during the course of the decade.

Unemployment

- (13) At first sight it might appear that pessimism about the future course of employment implies pessimism about the future course of unemployment. To an increasing extent, however, it is being recognised that, while variations in employment may affect unemployment in the short-term, the main determinant of the level of unemployment in the long-term is the rate of migration. The rate of migration, in turn, is powerfully influenced by the level of unemployment in GB.
- (14) The impact of SEM on levels of unemployment in NI will operate through two main routes: first, through the effects on the level of unemployment in GB; second through the effects on the willingness of people to remain unemployed at home at any given level of unemployment in GB, ie through the effects on labour mobility.
- (15) Insofar as the SEM stimulates the Community growth rate it is likely, in the long-term, to have a favourable effect on unemployment rates in GB. The experience of the Republic of Ireland and France in the mid-eighties suggests, however, that there may be short-term problems arising out of membership of ERM as the UK finds it necessary to impose stricter monetary discipline in order to adjust to Community inflation rates.
- (16) A central aim of the SEM is to increase labour (and capital) mobility in the Community. Amongst the measures which will promote the movement of labour and those designed:
- (a) to give wider recognition to vocational and professional qualifications;

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(b) to remove barriers to movement between Member States;
and

(c) to develop a European approach to training and employment placing.

Welding NI more closely into the European labour market could be an important dimension of the Training and Employment Agency's activities during the nineties. If mobility can be increased in this way then long-term unemployment rates could be reduced even if the SEM has adverse effects on industry and employment.

Economic and Political Union

(17) In spite of proposed differences of opinion about the way in which the Community should develop in the future it now seems probable that there will be a movement towards fuller integration. Conferences on economic and monetary union (EMU) and subsequently on political union during the course of the next year could lead to greater Community involvement in the formulation and implementation of economic policy and to changes in the relationships between national and Community institutions. These changes may have implications for the conduct of economic and fiscal policy in Northern Ireland.

(18) Because there is great uncertainty about the course of future developments I propose to discuss the issues in terms of two extreme forms of economic and political union which might be characterised as 'soft' union and 'hard' union. 'Soft' union corresponds, in broad terms, to UK objectives in the current debate. 'Hard' union reflects the views of those who are seeking something akin to a United States of Europe; in particular it reflects the NESC view on the optimum objective for the Republic of Ireland.

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(19) 'Soft' economic union would be confined, almost exclusively, to monetary union. Although the UK may continue to argue about the way in which the objective should be pursued it now seems almost certain that there will be a Community Central Bank and some form of a single currency. In 'soft' union the role of the Central Bank would be confined to ensuring price stability. Although there might have to be some Community restraints on Member States' power to finance budget deficits by credit creation there would be no detailed Community control over either macro-economic policy or fiscal policy. 'Soft' political union could be confined to trade policy, where there is already concerted Community action, to defence and security policy, where there is a growing opinion that there ought to be Community action, and to areas such as international policy on the environment or on aid to the Third World.

(20) The main interest of 'soft' union for Northern Ireland lies in the fact that it would probably have fairly marginal implications for economic and fiscal policy in the region. If the Community Central Bank were to interpret its commitment to price stability rigorously and were to model its behaviour on the Deutsche Bundesbank then macro-economic conditions might be somewhat less favourable for regional development. In Northern Ireland we have generally achieved best results when the national economy was overheating. But the roles of the main institutions in regional policy would remain unchanged. The major part of regional support would continue to come from Westminster with resources from Brussels representing only a marginal supplement, and much of that presentational rather than real. Apart from the occasional political frictions which would continue to surface we could still take a relaxed view of additionality. The main publicised identity of interest between NI and the Republic would continue to be confined to cross-border projects with Structural Funds implications and to some

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details of agricultural policy. There would probably be pressures from poorer Member States for increased resources for the Structural Funds particularly if the SEM has markedly adverse effects on peripheral regions but it seems likely that Eastern Europe will be a major drain on Community resources for some time to come.

- (21) 'Hard' union could be a different kettle of fish. Full-blown monetary union would be accompanied by measures to harmonise macro-economic policy and fiscal policy. Political union would reflect a sharing of functions between Community and national governments that could give much greater power to Community institutions. The desire to harmonise taxes and significant elements of public expenditure would reflect two sets of forces that are already high on the policy agenda in Brussels. The first is the desire to complete the SEM by removing impediments to free competition such as differences in direct tax rates and differences in social security benefits. The second is the desire to promote social cohesion by transfers of resources to the poorer regions of the Community that would go far beyond anything envisaged in current Community Regional Policy. The characteristics of 'hard' union would be a substantial increase in the Community budget and in the scale of redistribution of resources between Member States. The attractions to the Republic of Ireland are obvious.

- (22) Living standards in Northern Ireland are currently maintained by a substantial re-distribution of income-generating resources within the United Kingdom. Movements towards 'hard' union would be likely to see Brussels substituted for Westminster as the centre of part of the redistributive process. The institutional implications of such changes are difficult to foresee.

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*This (including) : ed you with a letter for Mr Galloway to Mr Hill to cover
M. Allen a copy of Post Black's paper. We can discuss
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30 January 1991

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*Mr Allen
slightly more
rational than Allen White
but the same about*

Dear Derek,

EC AND DEVOLUTION - POSITION PAPER

1. I have now received ECD(I)'s comments on your draft position paper on the impact the UK's membership of the EC is likely to have on a devolved administration in Northern Ireland.
2. We urge that paragraph 1 a) and b) should be omitted. The assertion that the effects of ERM and SEA will be immense and adverse is sweeping and contentious. They and developments mentioned in 1 b) are, in any case, already in place. It is the method of governing Northern Ireland, not the activities of the EC, which would be changing.
3. In paragraph 1 c), where it says 'the UK Government is perceived as not having exploited this source of money sufficiently diligently', add after 'perceived' 'by some'. Some qualification is surely needed!
4. In paragraph 2 b), change 'the degree of derogation for EC policies' to 'the degree if any of derogation for EC policies'.
5. It is unclear what paragraphs 2 d) and e) mean and how they could become areas of conflict.
6. After the first sentence of paragraph 3, add 'The Germans and Spaniards in particular would contest any special arrangements, given their regional structures'.
7. At the start of paragraph 5 add 'In Brussels, UKRep would continue to act on behalf of NI interests (as well as those of the rest of the UK)'. After 'The Administration would undoubtedly wish to lobby directly in Brussels', add 'on some

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*This (including) : cd you draft a letter for Mr Galloway to Mr Hill to cover
M. P. Allen a copy of Prof Black's paper. We can discuss
it next week.*

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issues'. At the end of this sentence, after 'contrary to the national line', add a new sentence: 'UKRep would need to be involved in, or kept fully informed of, such activities'. At the very end of the paragraph, add 'ie avoid appearing as a political counterweight to UKRep, and concentrate on trade and investment promotion and informational activities'.

8. Paragraph 6 is not clear. It is not evident what is meant by SOSNI needing 'to be informed' on disputes between the devolved Administration and Whitehall Ministers on EC issues.

9. The logic of paragraph 9 is doubtful. The possibilities of sanctions against a devolved Administration are limited given that the Administration will not be self-financing; how can central Government pass on financial penalties to a devolved Administration it actually pays for?

10. Replace paragraph 11 with the following: 'Some in the IGC want agreement on 'subsidiarity' to include acknowledgment of the role of the regions. HMG on the other hand sees subsidiarity as describing the relationship between the Community and member states, not affecting relations between central governments and local/regional authorities. It is too soon to say whether the IGC debate, on outcome, might be exploited by those in NI seeking more direct Brussels - Belfast relations.'

11. At the end of paragraph 12 e), add 'and with appropriate arrangements on the mechanics'.

12. Paragraph 13 b) would not reflect the Treasury's thinking.

13. Much of the above echoes the points in Mr White's letter of 23 January, which we have just seen.

14. There is a final point, not related just to the paper. ECD(I) are very keen that the European Secretariat of the Cabinet Office (Lyn Parker for example) are quickly brought in to consideration of Northern Ireland devolution and the EC: should they not be consulted on this and future papers.

Yours sincerely, Edward Mason

Edward Mason
Republic of Ireland Department

cc Nigel Sheinwald, ECD(I)
Mr Pilling, NIO
Mr Thomas, NIO
Mr Dowdall, DFP
Mr Cooke, SIL, NIO
Mr A White, HMT

Constitutional Political Division
23 January 1991

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