

Giersch, Herbert et al.

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Comments on "Economic policy for the European Community - the way forward". Selection of comments prepared for a Kiel Symposium on the report of the Group of Rome

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### Comments on

### "Economic Policy for the European Community – The Way Forward"

- **Europe's Role in the World Economy**

Herbert Giersch · Gottfried Haberler · Jan Tumlr  
Juergen B. Donges · Bela Balassa

- **Roads to Monetary Union**

Fritz Machlup · Johann Schöllhorn · Norbert Walter  
Pascal Salin · Roland Vaubel

- **Fiscal Harmonization**

Willi Albers · Fritz Neumark · Carl S. Shoup · Dieter Biehl

- **The Scope of a Common Regional Policy**

Dieter Biehl · Bela Balassa · Claus Noé · Sebastian Schnyder

- **New Approaches to Structural Policy?**

Agricultural Policy:

Adolf Weber · Tim Josling

Industrial Policy:

Gerhard Prosi · Gerhard Fels · Klaus Stegemann

AG 1871 75 Weltwirtschaft

Comments on  
"Economic Policy for the European Community -  
The Way Forward"

Selection of Comments Prepared for a Kiel Symposium  
on the Report of the Group of Rome\*

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Kiel

\*Economic Policy for the European Community - The Way Forward, by Sir Alec Cairncross, Herbert Giersch, Alexandre Lamfalussy, Giuseppe Petrilli, Pierre Uri, London, 1974, Macmillan. - German Edition: Wirtschaftspolitik für Europa - Wege nach vorn, München, 1974, R. Piper & Co. - Editions in French and Italian are forthcoming.

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## Address by Herbert Giersch to the Trade Policy Research Centre, London

Over the last two years or so, the Institut für Weltwirtschaft in Kiel has been sponsoring a study group on the economic future of the European Community (the Group of Rome). The Report of the Group, entitled Economic policy for the European Community - The Way Forward, is being published here tomorrow.

The members of the Group who prepared the Report were Sir Alec Cairncross, Master of St. Peter's College, Oxford; Dr. Alexandre Lamfalussy, Chief Executive of the Banque de Bruxelles; Professor Giuseppe Petrilli, President of the Istituto per la Ricostruzione Industriale, Italy; Professor Pierre Uri, Counsellor at the Institut Atlantique des Affaires Internationales, Paris, who, as most of you know, has played a prominent role in the formation and development of the Community; and myself.

My purpose this evening is to tell you something of the Report. It contains chapters on a great many different policy issues: monetary unification and fiscal integration, regional policy, agricultural policy, industrial and competition policy, social policy and external economic policy. Obviously, time does not permit an exhaustive presentation of the analyses, conclusions and recommendations on which we have agreed in all these fields of economic policy. I shall therefore concentrate on three areas which happen to be my personal pre-occupations: European monetary unification, European regional policy and European external economic policy.

**Monetary Unification.** - Let me start with an explanation of the conclusions we have reached on European monetary integration. There is no way of achieving monetary union on the cheap. What matters is making genuine progress towards it rather than simply insisting on the desirability of getting there. We recognize that in the long run monetary union, in some sense, is necessary in order to give permanence to European integration. Without monetary union there is a risk that convertibility may be restricted. Moreover, monetary union would bring conveniences in payments of all kinds. However, if monetary union were pushed through prematurely, and without complementary policies to reinforce it and complementary powers and common institutions to give effect to those policies, the result might well be needless unemployment and waste of resources.

The existence of separate national currencies ipso facto provides a powerful weapon in the form of depreciation for bringing a country's trade and payments back into balance when for any reason it runs into deficit; and when it is in chronic surplus, appreciation of the currency can be equally effective in restoring balance. But to abandon exchange-rate changes completely and finally without indicating how imbalances will be dealt with in future would be to run serious risks in relation both to economic stability and to that political will without which economic union will not hold.

Further, under a regime of fixed exchange rates and free trade, inflation in one country exerts an upward push on price levels in other parts of the European Community. To this extent the pressure on the inflating country to redress its external balance by deflation is reduced. This implies for the Community as a whole that some countries may end up with more inflation than they want and others with more unemployment than they are prepared to tolerate.

It would be part of the business of common management to assign responsibility for demand management to a Community-wide authority; and it would be one of the aims of this authority to establish a single monetary unit and pursue a single, harmonized monetary policy. In the

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**Remark:** This address was held on December 4th, 1974 on the occasion of the Report's publication in English. The speaker has made free use of the contents of the Report, and hence also the ideas of his co-authors.

light of these considerations, we have asked ourselves what is the optimal strategy for monetary unification in the European Community.

It is evident that the first, the apocalyptic solution, namely the immediate replacement of national currencies by a single European currency without any transitional phase is inconceivable in present circumstances and possibly too abrupt to ever be adopted.

A second approach - endorsed by the Werner Report - concentrates on exchange rates and envisages a gradual narrowing of margins for fluctuations in rates and of the scope for changes in parities. This process would lead ultimately to a locking of exchange rates and can be thought of as "exchange-rate unification." The first step in the process, which was supposed to be completed by the end of 1973, has not been reassuring. Ever since the Werner Report was prepared, rates of exchange have become progressively less stable. In our view, the strategy of approaching monetary union through a progressive narrowing of margins is misguided. It ignores the complex conditions that are necessary for the maintenance of monetary equilibrium between the member countries.

A third possibility would be to try to meet these conditions directly and aim at a progressive coordination of monetary policies throughout the European Community as a precondition for fixing exchange rates. The approach recognizes the danger that a premature fixing of exchange rates may serve only to bring about a suspension of convertibility and put an end to the free flow of goods and services as well as of capital and labour. If the common political will is strong enough against divergent national trends, coordination of monetary policy will lead eventually to constant rates of exchange; but if it is not, the outcome will be to forfeit convertibility.

These arrangements would be intended to lead in the course of time to a second stage, the creation of a central monetary authority which would take over responsibility for the framing of a unified monetary policy, not just for the coordination of the independently-conceived policies of the member countries. Once such an authority existed, and had been entrusted with this responsibility, the way would be clear for a locking of exchange rates and the introduction of a common currency.

We do not doubt the desirability of greater coordination of monetary policies. But to rely exclusively on this is to invite the objection that it was precisely because of disillusionment with efforts to secure coordinated monetary policies that this approach was abandoned in favour of exchange-rate unification. It was believed that the latter would impose a need for coordination that in the past had been evaded. The objection does therefore have substance. But if there were genuine difficulties in coordinating monetary policies it would seem better to face these difficulties than suppress them unexamined. But member countries remain sensitive to the risk that they may be tying their hands in the use of an important instrument of policy once they allow monetary policy to take shape elsewhere. If they have no assurance that the Community will devise adequate instruments of demand management, they will hesitate to submit to a central monetary authority or give up the freedom in monetary policy which they can enjoy so long as future rates of exchange are uncertain. We therefore suggest a more organic and less painful strategy for monetary unification, the establishment of a European Exchange Equalization Account and the creation of a European Parallel Currency.

If the European Community wishes to achieve a measure of exchange stability, it may be tempted to resort for this purpose to the use of controls over capital movements, particularly if the threat to stability comes from flows to or from third countries in North America or the Near East. However, experience does not encourage reliance on them as a method of checking capital flows and stabilizing exchange rates. The authorities may be misled into holding exchange rates too long; and the controls themselves, even when apparently effective, may simply divert capital movements into other channels where control is difficult or impossible. This would apply particularly to any efforts to make control directional and allow capital to move freely within the Community but not between the Community and third countries.

We therefore suggest that it would be much better to make use of a thoroughly adequate exchange-equalization account as a means of coping with capital flows than to seek to tighten controls. An exchange-equalization account would absorb foreign currencies when money flowed in and would sell foreign currencies when people sought to make withdrawals. The account would hold a portfolio of currencies, including the currencies of member countries. According to whether it was faced with an inflow or outflow, it would switch its portfolio so as to make available the currencies in demand at a fairly steady price, at the same time taking up into its portfolio the currencies on offer.

The purpose of such an account would be to steady exchange rates without fixing them or preventing adjustments called for by changes in competitiveness reflected in the current account. Insofar as capital movements took place within the Community, and were ostensibly reversible, no insuperable problems would arise. Insofar as they represented a movement of capital into the Community from outside, affecting member countries unequally, the proposed account would be a means of broadening the impact, just as would happen if the flow were subsequently outwards. But for this purpose it would have to be very much larger than anything hitherto created.

The management of the exchange-equalization account would be in the hands of the central monetary authority. If intervention were to be effective, however, the authority would have to enjoy considerable discretion, on the understanding that it would act in conformity with agreed rules and, too, that its operations would in due course be made public and submitted to scrutiny by outside experts, such as a committee of economic advisers associated with the European Parliament. We would hope that in the course of time, if the exchange-equalization account allowed reasonable latitude and was aimed specifically at the capital rather than the current account, governments might allow capital controls to wither.

The existence of enormous holdings of liquid assets in the hands of the oil exporters would greatly complicate the tasks of an exchange-equalization account. It would be highly desirable for the account, acting on behalf of all member countries, to come to some understanding with the oil countries both as to the way in which the deficits of individual countries should be financed and the form the resulting debt should take.

So far I have left open the question of settlement of accounts between the European Community's member countries. We suggest that they should settle in a unit created specially for that purpose. This unit might also serve as an international unit of account within the Community. There have been a number of proposals for the creation of such a unit as a complement to, rather than as a substitute for, existing European currencies. A new currency, the "europa," might be issued to circulate side by side with the currencies of member countries and gradually replace them as it came to be seen as a more convenient unit of account and store of value. To define the new currency in terms of a bundle of European currencies in some agreed ratio to one another seems to us to have many advantages. It would simultaneously provide an acceptable reserve asset for central banks and serve as an intervention currency with a value tied to that of the package of national currencies of which it was composed. It might also be agreed that there should in no circumstances be an appreciation of any national currency against the europa. The europa would then be at least as attractive an asset as the strongest national currency at any point in time. Or, to make the europa both an attractive store of value and an ideal unit of account, it could be given a purchasing-power guarantee, thus indexing the bundle of member currencies of which it consists. Such a unit would both minimize the exchange risk and eliminate the inflation risk. It would, in my view, represent an optimal way of linking European currency unification with the aim of European currency reform. This formulation implies nothing about the character of the issuing authority. It could take the form of an account, with no banking operations involved. Alternatively it could be a central monetary authority with power to issue additional units, to intervene in exchange markets, to extend credit to member countries, to hold balances for member govern-

ments in their individual or collective capacity and to exercise regulatory functions over the financial institutions operating on a Community-wide basis. Our own preference, however, is for the latter.

A composite currency, such as we suggest, could form the basis of international banking operations. This could occur in one of two ways. If europas were traded in commercial operations, as is implied in their suggested use as an intervention currency, they would have a function akin to that of the Euro-dollar and would provide both a credit instrument and a liquid asset for external as well as domestic operators. The europa would have to be convertible at sight into the component currencies since its use as an intervention currency in itself requires unlimited convertibility between the europa and national currencies.

The second way in which international banking operations might be encouraged would be through the use of the europa as a unit of account. In the capital markets of the European Community it would be possible to denominate loans, particularly those issued by public authorities, in terms of the europa along the lines of issues already made by European banking consortia. This would extend the European capital market insofar as it made for easier trading in the loan obligations across national frontiers. It would familiarize the financial community with a unit of account that promised greater stability than any single national currency and might displace these currencies from an increasing range of financial operations.

**Regional Policy.** - Let me now turn to the Community's task in regional policy. Overcoming regional imbalances is crucial in creating conditions in the European Community that are conducive to progress towards eventual monetary union. For in a monetary union there will be interregional adjustment problems to resolve. Much can be done before monetary union is reached to minimize those problems and thus smooth the process of economic integration.

An approximate measure of regional disparity is income per head. Income per head appears to fall steadily the further away a region is from the European Community's industrial centre in the lower Rhine valley. There is also evidence of a kind of curved development axis running down from a high point near the mouth of the Rhine in one direction to London and Coventry and in the other along the valley of the Rhine and over the Alps to Milan. The area lying along this axis covers about one-quarter of the surface area of the Community and contributes almost one-half to its total product.

The formation of the European Community might have been expected to intensify this concentration of industry and to widen the regional disparities within member countries by reinforcing the advantages of the regions closest to the centre. There is not much evidence that this has happened. Studies suggest that in the 1960s there was a narrowing of the spread in economic performances between regions in the Community.

Migration, which is at least as significant a feature of the regional problem as differences in income per head, has been on a vast scale. Migration of labour is a normal feature of rapid development and was on an even greater scale in the second half of the nineteenth century. But movements in the labour force pose acute social problems both in the areas losing and the areas gaining population. On both grounds it is highly desirable to keep the volume of migration within limits and this should be one of the principal purposes of regional policy.

Unemployment is a further reason for embarking on policies to improve regional balance. Even when differences in living standards are relatively small and the scale of migration is tolerable, employment opportunities vary from region to region, and this is reflected in unemployment figures. It has been shown that these differences increase in the 61 regions of the original member countries of the Community, the greater their distance from the Rhine-Ruhr area. Similarly in Britain, unemployment since World War II has been higher,



the greater the distance from Birmingham and London. The percentages in each region have maintained a fairly stable pattern throughout: unemployment in Scotland, for example, has remained about twice as high as unemployment in the rest of the United Kingdom with some oscillation around this ratio.

A successful regional policy would bring into play the underutilized potential of backward regions, enlarging employment and output in these regions without the risk of overheating. There are thus strong arguments, based on economic benefit to the country as a whole, in favour of measures aimed at narrowing regional differences in economic activity and achieving a better regional balance.

The present state of play within the European Community with respect to overcoming regional imbalances is disappointing. Ministers have been concentrating on the size of the common regional fund and the incidence of payments into and out of it, without much discussion of the principles put forward by the Commission for the shaping of regional policy. Some of them seem to wish to compound the errors of agricultural policy by compensating errors of regional policy provided the effect is to offset payments for one purpose by payments in the reverse direction for the other. But there is no obvious reason why countries that are net importers of food should coincide with those suffering most severely from regional problems; or, for that matter, why the "principle of juste retour" should govern the financial arrangements of the Community.

What the Community requires are acceptable guidelines for deciding which areas can hope to expand on the basis of aid and which should be given support only as a means of meeting the social cost of adjustment to a limited development ceiling. In the absence of these guidelines the Community's regional policy is in danger of becoming an exercise in chronic subsidization without bringing about much sustainable growth. There is also a danger that aid will be dispersed on small projects throughout the Community instead of being concentrated on particular areas that would repay assistance. In the process of deciding what projects to back, the European Community should start from national policy measures, without taking for granted that they were well-conceived, and see what elements in these measures merited support and what should be actively discouraged. The idea would be for governments to submit their regional policies for review at regular intervals, explaining the principles on which they were based, and indicating the elements in their plans to which they attached particular importance. Community aid might then be given either towards the implementation of national or provincial plans as a whole or towards the financing of specific projects drawn from them.

We think that, in spite of the deliberate discrimination between areas and the political opposition likely to result, a strategy of growth points should be intensively pursued by the Community. Some of the border areas of the European Community could be selected which now find themselves even more at the periphery because of European integration. There would be advantages also in inducing European research institutes or other research organizations to locate themselves in one of these regions.

The EC Commission's proposals for the use of regional aid recognize the key role of investment in infrastructure but they also rely heavily on the use of capital subsidies, which, as experience in Italy and Great Britain has shown, tend to attract capital-intensive industries without developing the more labour-intensive activities appropriate to the circumstances.

The proposal to raise contributions to the fund by taxing congested areas has been silently withdrawn because of opposition from countries like the Federal Republic of Germany that have most need to limit congestion.

The need for Community action arises in part because the formation of the Community, and the adoption of policies aimed at promoting economic integration, was bound to have unequal effects on different regions.

Regions cannot count on the kind of reciprocal advantage from free trade that national economies enjoy thanks to their ability to adjust, if necessary, the exchange rate of their currency.

A further reason applies to the less prosperous members of the European Community who lack the necessary resources to deal adequately with their regional problems. The backward regions in these countries are often strongholds of separatist movements; and it is in the common interest of the Community as a whole to discourage the forces of disintegration by offering additional help for the development of such regions. Furthermore, there is the problem that concentrations of electors in the industrial areas have been able to draw the special attention of governments to their problems, among them bottlenecks in transport and social infrastructure which make heavy demands on public investment. This, too, means that the larger industrial centres are being subsidized by the rest of the country. The less densely populated areas and medium-sized urban centres - unless they happen to include "marginal" constituencies - tend to be the losers in the contest for public funds and are thus deprived of the means to improve their own attractions as industrial locations.

The regional allocation of public funds promises to be efficient only if all regions can compete for the funds on an equal footing within the legislature. We accordingly propose, at Community level, the establishment of a separate house in the European Parliament to represent regional interests. Such a Chamber of Regions might be instituted on a basis similar to the Senate in the United States.

One of the main tasks at Community level is to ensure that regional policies are consistent with the objectives of free trade. Difficult as it may be to determine in practice, a distinction should be drawn between

- measures which discriminate in favour of specific economic activities in a backward region as compared with the rest of the Community and
- measures which are directed at raising competitiveness at large in a backward region and thus do not distort competition.

Only this latter type of measures is legitimate and necessary within the framework of a Community regional policy.

Similar arguments have to be born in mind in considering international economic policy and the European Community's place in an integrating world economy; for many instruments of regional policy fall within the definition of non-tariff distortions of international competition which have become a focal point of multilateral discussions on the further liberalization of international trade. Partially the more backward regions are often in direct competition with imports from outside the Community - sometimes from less developed countries. A liberal commercial policy, however much in the general interest, may then run counter to the immediate interests of the least prosperous regions, unless it is accompanied by appropriate adjustment assistance.

**External Economic Policy.** - As for the Community's external economic policy, we have expressed our disappointment about its half-hearted approach to the international liberalization of trade. The Community seems unaware of the profound influence which its behaviour, even if it just temporizes and does nothing, is bound to have on the world economic order.

Throughout the Report it is emphasized that the economic integration of the European Community should be pursued in harmony with the integration of the world economy as a whole. And by this we intend no lip service. Our proposals are concerned with how that objective might be put into effect. The interest of the European Community lies very much in the maintenance of a multilateral system of trade and payments that is open and non-discriminatory, one governed by explicit and internationally-agreed rules and principles. But

since the mid-1960s the international economic order has been subject to increasing strains and is now in need of repair and strengthening.

In order to avoid further internal disruption brought about by external "shocks" - inflation, monetary turmoil, commodity shortages, trade restrictions - the European Community should focus greater attention on the reform of the international system of trade and payments. Because of the differences between them, the countries of the Community are affected differently by global problems, which means that in the absence of Community initiatives their governments are bound to react in different ways.

In any case, the European Community could develop a distinct political identity, as between the United States and the Soviet Union, by advancing bold initiatives for the reconstruction of the international economic order. Waiting to react to initiatives from others only invites internal dissent; for the reactions of member countries are likely to differ and thus, even before discussions begin at Community level, individual governments are "digging themselves into positions." The reluctance of governments to work out external initiatives therefore impedes integration and makes the search for identity more difficult.

We have therefore urged the European Community to make itself the advocate of a progressive, linear and automatic elimination of practically all tariffs on manufactures, and to adopt an agricultural policy that is based on direct income support and international buffer stock agreements rather than on internal price support and variable levies on imports. All these measures would be of particular importance for the developing countries.

By improving its development assistance, the European Community could also assert itself in an important field of foreign policy. A common policy could make financial aid both more effective and less discriminatory. The distribution of aid should be determined less by historical and political ties than by economic criteria. One such criterion should focus on subsistence aid, particularly in food, aimed at keeping people alive. Further emphasis should be placed on improving the economic infrastructure of developing countries so that private direct investment can be attracted. Emphasis should be put on giving incentives for investments in labour-intensive lines of production so that unemployment can be reduced. Aid to agricultural extension, the provision of technical advice, can both provide more productive employment and prevent hunger.

The objective, in most general terms, should be to create an environment in which private capital can be found and employed for industrial production. This is the crucial problem for development assistance.

In order to encourage private capital flows and a net resource transfer to less developed countries, the latter should be permitted to have "undervalued" exchange rates in relation to the industrialized countries, including the European Community and the United States. An undervalued exchange rate represents a uniform tax on all imported goods and a uniform subsidy to all exports, thereby increasing demand for the production of less developed countries and attracting foreign investors to them. To the extent that imported capital goods become more expensive in local currency, exchange-rate undervaluation also weakens the tendency to adopt capital-intensive methods of production. Finally, the rise in foreign-exchange reserves which would be implied by undervaluation would represent a social saving, which later on could be used for investment, public or private, and a higher growth of the economy.

## I. Europe's Role in the World Economy

Chairman: Herbert Giersch

Gottfried Haberler

Let me start by saying that after the war Western Europe recovered very quickly. It regained its preeminence in the world economy and is now the largest trading unit in the world. I believe it is also the largest provider of development aid and the largest, or maybe the second largest, supplier of capital and know-how to less developed countries. Europe is also the largest importer of foreign labour. What I would like to do is to say a few words about certain interconnections between these developments. It is really nothing new I have to say; I'll more or less reiterate, perhaps elaborate a little bit, what Giersch has said on various occasions and certain things which are in the Report of the Group of Rome.

The main point is that the export of capital and the import of foreign labour are substitutes for each other. If the influx of foreign labour in Europe goes down, as it probably will and has already happened, for political and social reasons, wages go up, that means, that the competitive position of foreign countries increases and the competitive position in certain industries, let me say labour-intensive industries in Europe, decreases. This results in substitution of export of know-how for the influx of labour and later substitution of the import of foreign products, especially labour-intensive products for the importation of labour. European capital and know-how goes abroad and employs these workers in their native lands instead of in the congested areas in Europe. It seems to me that Giersch is very right when he said on several occasions that this would be a healthy development. If you look at the figures you can see that this process is already under way and one can only hope that it will continue. But will it be allowed to continue? And here the Group of Rome comes to certain policy implications of that development, but there may be many slips between the cup and the lip and certain policies may get into the way of this healthy development. For example, regional policies, industrial policies, monetary, or exchange-rate policies could get in the way. But I am not going to discuss the policy implications with respect to the three areas I have just mentioned because they will be discussed in the following sessions. But I would like to say a few words about the implication with respect to commercial policy.

Obviously if Europe, and the same holds of course for the United States and Japan, exports capital and know-how and then imports the products of the labour which is employed with the help of this capital and know-how, Europe, the United States and Japan have to accept the goods which those countries then export and that certainly will cause problems. And here commercial policy comes in. Certain labour groups will not like it. I don't know exactly what the situation is in Europe, but in the United States, the resistance of labour is very strong. The labour groups argue all the time against the "exportation of jobs" and they want to put restrictions not only on the import of the commodities but also on the export of capital. I have the impression that in Europe the situation is in that respect a little better than in the United States.

But now let me make a bold statement about the European Economic Community: I think the right policy would be to reduce the tariffs on industrial products, and let me be very bold and say eliminate them altogether. I have been emboldened to say that which usually does not go down very well except with a few economists, but in the Group of Rome Report, this position is taken and a little earlier, in the Report of the Groupe de Réflexion, Meade<sup>1</sup> took the same position. Meade recommends that the EEC should eliminate its tariffs on non-agricultural

<sup>1</sup> EC, Commission, Study Group on Economic and Monetary Union, European Economic Integration and Monetary Unification, Document II/520/I/73-E, Brussels, October 1973, Part II, pp. 155 sq.

products altogether, if need be, even unilaterally. Of course it would be much better to have a reciprocity arrangement with the other industrial countries, whereby the United States and Japan agree to reduce the tariffs in parallel fashion with the other industrial countries. I dare say it would do many less developed countries no harm, on the contrary it would do them a lot of good, if they too reduced their excessive protectionism. But Meade says, and I think he is quite right, the EEC should do it even unilaterally, if it cannot be done on the reciprocal basis. As I say, this is usually not easily accepted and I even know a few free trade economists who say that unilateral free trade is not advisable. Many people would go farther and would say it is absurd to preach unilateral free trade. But let us distinguish between political feasibility and economic rationality. Politically it may be awfully hard, I grant you that, and speaking of the United States I would say that there is not much chance that the United States ever would do such a thing. I hope that Europe is a little better educated in that respect. One can say there is no valid economic argument for protection which would exclude or make unadvisable unilateral free trade. The only argument I could think of is the terms-of-trade argument. Unilateral free trade may make the terms of trade worse. But then it would make allocation better and there are the reasons with which I started - that Europe would not import labour into a congested area but would rather employ it abroad and it would reduce monopolistic tendencies - all these advantages surely would greatly outweigh any possible deterioration in the terms of trade. I just wanted to put this problem before you and formulate it in a provocative way.

#### Jan Tumlr \*

I have been asked to place the problem of European unification policies into the context of the global economic system, a system that a European political initiative could do so much to strengthen, reform or perhaps to save. We are all sufficiently familiar now with the agenda of unsolved problems of international economic diplomacy. Instead of recapitulating these individual issues, I would like to offer some general observations on the nature of the system. These observations are necessarily more or less improvised but are an improvisation on several themes well stated and developed in the Report of the Group of Rome.

Let me begin, in good academic tradition, with a definition. The dictionary defines a "system" as "an aggregate of regularly interacting parts." The emphasis is on regularity; a system is a system only to the extent that it maintains regularity. Human and social systems are self-conscious, therefore also generate change, and therefore can only maintain themselves by combining the two - maintaining regularity while admitting change - in other words: by regulating change.

Both the policing of the rules and ensuring equity and justice in conflict resolution proceedings require some authority, very often an authority that can exert effective power. This issue of power is an important criterion distinguishing national from international systems. It is not an absolute criterion because in both systems the lower order units have surrendered some power to the central authority, but obviously the degree to which this has happened is vastly greater in the national than in international systems.

\* Remark: The author wished to emphasize that the views he presented here were his own and were not to be interpreted as reflecting the views of the GATT Secretariat of which he is a member.

This brings me to the international economic systems where the regular activity is exchange and where the system has to ensure, first, the regularity and second, the efficiency of exchange. And here I place a question - a problem - how do conflicts arise in this international system? I should make it clear that I am not talking about the very new conflicts arising with respect to common resources which have so far been free, such as air, oceans, rivers; nor of conflicts of the more or less distant future when even the right of a nation to economic growth may be questioned. I mean conflict between countries that subscribe to the traditional assumptions of the liberal economic doctrine as to the national sovereignty, the objectives of national economic life and the desirable form of international relations. The question is not as naive as it may sound. It is indeed something of a paradox to be talking about conflicts of national economic interest in the international system. The doctrine of comparative advantage is one of harmony. To the extent that nations want to increase their wealth and welfare, and presumably they still want to increase them, they can do it best through international division of labour. On the monetary side, it is presumably the dominant interest of every country that there be a smoothly functioning monetary system, and a system that would give one country or a group of countries a marked advantage over others obviously could function neither smoothly nor for long. So where is here a room for conflict of national economic interests?

The range of conflicts that we are able to observe seems to me to fall into two broad categories. The first is epitomized by the international conflict that exists about the textile industry and similar traditional labour-intensive industries, in the industrial countries. It is exhaustively discussed by the Group of Rome on pages 186-190. These industries are receiving increasing protection although they often cannot demonstrate an "injury" by any acceptable international criteria. When you think about it, this is not really a conflict of national interests. This is a situation in which state power is used to promote a sectional industrial interest which hardly ever coincides with the national interest and in most cases is not even compatible with it. When I mention this to commercial diplomats, I normally get a rather fatalistic response: "My dear man, but this is how the democratic process operates, can't you see?" No, I can't see it, and I still believe that it has less to do with the democratic process as such than it does with the financing of it. And I take some qualified optimism from seeing that at least in one democracy, in the wake of Watergate, something is being done about the financing of the democratic process. There are instances in this class of conflict in which no specific industrial or private interest need be involved. One of them is the conflict over the complex system of preferential trading arrangements, arrangements with different degrees of preference, constructed over the years by the European Community. Here, too, the Report of the Group of Rome makes it very clear (pp. 191 sq.) that it is impossible to discern a legitimate national or Community interest that would be served by these arrangements because less objectionable ways of helping the developing countries could be found which in most cases would also be more efficient ways of advancing their development. The reverse preferences may entail benefits to individual firms but the volume of trade transacted under them is hardly significant in relation to the overall level of economic activity in the community at large. Politically it is difficult to see how these arrangements create any benefit for Europe because each beneficiary country has reasons to suspect that it is being discriminated against relative to some other beneficiary country. So all of them are bitter. It is not easy to discover or to think of an interest that may be served by these arrangements and I am forced to the conclusion that in this kind of conflict we have to do with the interest of national or supranational bureaucracies who want to have something to administer. This I think will be a continuing problem for the future because bureaucracies everywhere are growing rapidly<sup>1</sup>.

<sup>1</sup> There are two causes for this rapid bureaucratic growth. One is that the functions that need central coordination are multiplying - whether inevitably or not is a question - and more people are needed to carry them out. The other cause is that the productivity of machines is growing very rapidly - they are replacing people and some jobs have to be found for those displaced from the productive process.

In the last analysis, this class comprises all the familiar, one is tempted to say mundane, conflicts of commercial policy, that is, those arising about restriction of imports, export subsidization, dumping, border tax adjustments, competitive devaluations and non-revaluations. One way of characterizing them is to call them neo-mercantilist conflicts. A much more important characteristic they have in common is that they are all potential joint-gain situations, in the sense that an economically rational resolution of such a conflict would actually increase national income on both sides. For this reason these conflicts are, in my view, ultimately not too serious. The potential joint gain constitutes an inducement to rationality. Often a conflict of this type, which appears irreconcilable at one level of national executive hierarchies, is easily disposed of when referred to a higher level.

The second broad class comprises conflicts that arise about prices at which one nation sells and another nation buys - the terms of trade. These conflicts thus involve a genuine and important national interest on both sides. They are, by definition, "zero-sum" conflicts: what one side loses the other gains. They are, therefore, much more difficult to resolve than the conflicts of the preceding class.

These conflicts are, also by definition, conflicts of monopoly or monopsony power. They cannot arise between or among national economies organized on the basis of competitive private enterprise.

Here I would go back to the definition of the international economic system and remind you that it is a system and can be a system only to the extent that it is based on competition. Frank H. Knight often deplored the word "competition"<sup>1</sup>. He considered it an unfortunate misnomer because it had the strong connotations of rivalry and fighting. In fact, competition is an impersonal order imposed on economic life. In a highly competitive system there cannot be any haggling since all prices are given. Power cannot be exerted since everyone has a choice among a number of equally good alternatives. It is precisely through this impersonality that competition minimizes conflict.

The international system that we know has been formulated for competition. In a world of centrally-planned economies all the basic concepts of, for example, commercial policy would not merely be inoperative but meaningless. What could be the meaning of such concepts as "most-favoured-nation treatment" or "tariff preference" in an economic system where all decisions would be made by a central authority?

The Report of the Group of Rome devotes fourteen pages (pp. 141-154) to the importance of strong and integral policy to protect and promote competition among buyers and sellers; and by the word "integral" I mean that these laws should be enforced on activities in the domestic market as well as on export activities of domestic firms. The Report distinguishes three distinct strands of development, all of them fairly recent, which have been converging and combining into a powerful threat to the competitive system. They are (1) the burgeoning of multinational enterprise, (2) the increasingly popular practice of protecting a domestic industry by forcing the exporting industry abroad to exercise "self-restraint," and thereby cartelizing it, and (3) the recent cartelization of the petroleum market, and the planned or attempted cartelization of a number of other important primary products. I do not intend to go beyond pointing out that all these phenomena are ultimately related. Their nexus lies in the domain of national competition laws and national policies for their enforcement. Only law can deal with them. And they have to be dealt with. What survival odds could you give to a world in which every price would be a test of power?

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<sup>1</sup> See, for example F. H. Knight, *On the History and Method of Economics*, Chicago, Ill., 1956, Chapter XI: "The Role of Principles in Economics and Politics", p. 258, where he calls the word "a linguistic accident calamitous for understanding."

## Juergen B. Donges

1. The European Economic Community is expected to intensify its economic relations with the countries of the Third World. According to the communiqué of the EEC Summit Conference held in October 1972 in Paris, "the Community must, without detracting from the advantages enjoyed by countries with which it has special relations, respond even more than in the past to the expectations of all developing countries." It is said that this will also persist in the enlarged Community. The Report of the Group of Rome places, implicitly and explicitly, much emphasis on this issue. It stresses the benefits, economic as well as political, which the Community could gain, should it move more vigorously towards removing the trade barriers which still exist and should it be strong enough to withstand joining the neo-mercantilistic sentiment - a sentiment which, alarmingly enough, seems to have gained ground since the energy crisis arose and happened to coincide with the newly emerging trauma in the affluent societies that scarcities of various kinds can exert substantial drags on their welfare.

2. At present, the developing countries are looking towards the seventh multilateral trade negotiations, the so-called Nixon Round, to which the industrial countries committed themselves in 1972 and which started at the end of 1973. The purpose of these negotiations is to further reduce tariff and non-tariff barriers to trade and, in addition, to provide greater trade benefits than hitherto for the developing countries. The fact that these countries have an interest in circumventing, as far as their trade with the EEC is concerned, the barriers of the Common External Tariff, the non-tariff trade restrictions and the wall imposed by the Common Agricultural Policy is so obvious, that it hardly requires extensive proof. For every developing country, including the southern European ones, the EEC is the most obvious single market. Taken together, the enlarged Community absorbs about 40 percent of total exports from less developed countries (LDCs). While the export performance of the developing countries will depend to a large extent on their own, supply-concerning efforts (particularly as far as manufactured products are concerned)<sup>1</sup>, the accessibility of industrialized-economy markets might continue to be of critical importance for the overall development prospects of the Third World (except, to be sure, for the major exporters of petroleum and some other minerals).

3. For the EEC there are both economic and political reasons why much attention should be paid to economic relations with the developing countries.

- Economically, the LDCs are important because they will provide a growing market for the member countries' exports of, particularly, capital- and skill-intensive manufactured products; they will become an increasingly significant source of EEC imports, not only of essential raw materials (as was suddenly shown during the recent oil crisis) but also of low-priced labour-intensive manufactured goods; and they will continue to be important recipients of EEC private investment.
- More politically, the importance of the LDCs is related to the fact that, as is now generally agreed, the old world economic system needs to be replaced by a new framework which reduces economic and political friction and tends to establish harmonious intercountry relations. As the United States is not going to supply the initiative to do this, it is not unreasonable to expect the EEC, the world's greatest trading power, to take the lead. Provided the Community has the political capacity to conceive and promote such a new international order - which is not at all sure at present - one cornerstone of the EEC's strategy has to be a close relationship of mutual support with the LDCs. Unless the EEC countries

<sup>1</sup> See, J.B. Donges, "Conditions for Successful Import Substitution and Export Diversification in LDCs: A Summary Appraisal", in: H. Giersch (Ed.), *The International Division of Labour, Problems and Perspectives*, International Symposium, 1974, pp. 346 sqq.



act in a way that reflects their willingness to provide adequate help for development, the developing countries will have little incentive to cooperate with the EEC in solving the global economic problem of shaping a new international order.

4. After the EEC member countries have declared their intention to be really serious about promoting development in the Third World via their trade policies, two fundamental questions have to be asked:

- To what extent is a straightforward and liberal trade policy which is concerned with all LDCs, on the one hand, in fact compatible with the commitment to individual developing countries inherited from the past, on the other?
- What are the implications for the EEC's trade policy if the "good intentions" are to become reality?

5. The first question has to be raised, because the Community faces a serious dilemma in consequence of the external policy pursued to date, which does not provide the same treatment for all developing countries. There are three major facets to this discrimination:

- One is that the Community feels itself specially committed, by historical links, to nineteen African countries which are associated by the Yaoundé Convention with the EEC. These countries (formerly Belgian, French and Italian colonies) are placed - together with the three East African countries associated by the Arusha Agreement - on the top of the hierarchy which characterizes the shape of the EEC's economic policy towards LDCs. Any trade provisions the Community may consider to help the non-associated developing countries inevitably reduce the advantage given to the associates.
- The second problem is that after the enlargement of the EEC, 22 British Commonwealth countries in Africa, the Caribbean and the Pacific are, according to the Treaty of Brussels, eligible for association along the lines of the Yaoundé Convention. As things stood for a long time, these "associables" did not seem to be willing to accept such an association agreement with the EEC. They wanted to strive, instead, for a special arrangement, which did not tie them economically and politically as strongly to the Community as the Yaoundé Convention does. Had they succeeded, the EEC would have reinforced - in Africa - the division of this continent originally imposed by France and Great Britain as colonial powers. This was to last until February 1975, when the enlarged EEC signed a trade-and-aid agreement (the Lomé Convention) with the 44 African, Caribbean, Pacific (ACP) countries.
- A third problem results from the fact that the EEC has, from the beginning, made efforts to settle its relationship with its direct and indirect neighbours around the Mediterranean. To date, the Community has concluded, bilaterally, preferential trade agreements with eleven Mediterranean countries - all of them mainly to fulfil political purposes and with differing rates of concessions - and it now seems to be in the process of thinking about the coordination of these separate agreements with a view to creating a Mediterranean free trade area, but without a clear idea of how to accomplish this.

6. The result of all this is that the Community is now involved in special, privileged trade relations with more than fifty developing countries. The implementation of the non-reciprocal Generalized System of Preferences (GSP) for manufactured exports from most LDCs in July 1971 may be regarded as a means of striking a balance between the EEC's bilaterally institutionalized commitments and its worldwide responsibility. However, apart from a number of well-known restrictive elements of the present GSP<sup>1</sup>, which allow only 22 percent

<sup>1</sup> See, for instance, R. N. Cooper, "The European Community's System of Generalized Tariff Preferences: A Critique", *Journal of Development Studies*, Vol. 8, London, 1972, pp. 379 sqq. - J. B. Donges, G. Fels, A. Neu u.a., *Protektion und Branchenstruktur*

of EEC dutiable imports (or 8 percent of total EEC imports) from the beneficiary countries to qualify for preferential treatment, the scheme still contains a general clause aimed at safeguarding the interests of the associated countries if their export possibilities to the Common Market are adversely affected by competition from third, general-preference-receiving developing economies.

7. To conclude this first question, five critical remarks, very briefly stated, are in order:

- First, it is very questionable, whether such a proliferation of special arrangements is still compatible with the most-favoured-nation rule of GATT, all the more because the Community has generally pressed these developing countries to grant reversed preferences for its own exports (the Lomé Convention now being the outstanding exception as it only provides the ACP countries tariff-free access to the Common Market for their major commodity exports). Such reverse preferences are hardly in tune with the needs of LDCs.
- Second, the kind of both preferential treatment and reciprocity agreed in any individual case casts doubts upon the compatibility of all these bilateral agreements with an efficient allocation of world resources. This view rests on the presumption that the infant industry argument will not hold on most of the trade generated within this bilateral institutional framework, particularly on exports from the EEC. In addition, historical evidence strongly suggests that bilateralism is clearly not conducive to a sustained rapid expansion of world trade.
- Third, this sort of policy is already, apart from the Common Agricultural Policy, the main source of American complaint against the EEC and might, therefore, in the Nixon Round contribute more to a mutually exasperating confrontation than to the desired transatlantic dialogue aimed at maintaining an open worldwide trading system for the benefit of all countries. Furthermore, the US Administration seems to be determined to refuse general tariff preferences, which, after all, are to be introduced by the new Trade Reform Act, to those developing countries which grant preferences to the Community.
- Fourth, even if the EEC has, contrary to what seems rational in economic terms, strong reasons of self-interest for pursuing a trade policy based on bilateral arrangements, one wonders whether it makes sense to shape that policy in a way which gives inferior treatment precisely to countries which might have the relatively greater economic and political potential, as is the case for some Asian and Latin American states (India, Indonesia, Argentina, Brazil, Mexico etc.).
- And fifth, the response of the Community to the "true" needs of LDCs might have been inadequate so far because the value for every country of a bilateral agreement is a decreasing function of the number of such arrangements in force.

All this means that if the EEC is going to do more than pay a great deal of lip service, it has to reorient the trade policies in a way which improves the competitive footing of developing countries in general rather than that of a particular country or group of countries.

8. This brings us to the second question I raised earlier. The reduction of discrimination against non-associable developing countries calls for substantial improvements of the GSP (provided that LDCs will continue to emphasize their interest in such trade preferences).

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der westdeutschen Wirtschaft, Kieler Studien, 123, Tübingen, 1973, pp. 86 sqq. - UNCTAD, Operation and Effects of Generalized Preferences granted by the European Economic Community, Document TD/B/C.5/3, Geneva, 1973. - H. R. Krämer, "Zwei Jahre Zollpräferenzen der Europäischen Gemeinschaften zugunsten von Entwicklungsländern", Die Weltwirtschaft, Tübingen, 1973, H. 1, pp. 196 sqq. - Similar restrictions can also be found in the GSP schemes implemented by other industrialized countries. For a comparison, see T. Murray, "Explanation of the Generalized System of Preferences", Asia Research Bulletin, Vol. 2, Singapore, 1973, pp. 1443 sqq.

Apart from the need to include agricultural products in this scheme (going beyond the recently decided tariff cuts by up to 40 percent), the agenda of immediate actions should contain: first, a further enlargement of the tariff-free quotas; second, a reduction of the limits imposed by the "ceiling" and "maximum amount" rules on the so-called sensitive products; third, a removal of the arbitrary and rigid allocation of the ceiling limitations applied to sensitive products among member countries; fourth, a liberalization of the rules of origin so that goods which have been manufactured in more than one developing country qualify for the preferential treatment; fifth, and most importantly, a dismantling of non-tariff barriers.

9. One may argue that any consideration about improvement of the Community's GSP is irrelevant, because the preferences will not prove very effective anyway. This scepticism, particularly widespread among policy-makers, is based on the observation that the existing level of tariffs is already very low in the EEC, while it is relatively high in most developing countries, thus reflecting the inefficiency, and hence lack of export competitiveness, of their industries. Many trade specialists are much more confident about the effect of well-designed preferences on export from developing countries, and so am I.

I can think of at least five reasons for sharing the optimistic view.

- The first one is that there is a tendency to use import quotas in order to restrict low duty market access.
- The second one is that the structure of the Common External Tariff shows an escalation of customs duties by stage of production.
- Third, more important than the nominal tariffs are therefore the effective tariffs which are significantly higher than the nominal rates and which prevent the developing countries from exploiting comparative advantage on the basis of their resources of relatively cheap labour. An actual computation of effective rates of post-Kennedy Round tariff protection in the Federal Republic of Germany, undertaken at the Institut für Weltwirtschaft, Kiel, provides some suggestive evidence<sup>1</sup>: among the labour-intensive industries, effective tariffs were found (in 1972) to be as high as 20.8 percent for textiles, 20.7 percent for clothing, 19.9 percent for paper manufactures and 11.1 percent for both glass products and leather manufactures - the industrial average being 10 percent. The highest effective tariffs are enjoyed by some of the genuinely raw material based industries, such as producers of pulp, paper and paperboard (29.6 percent), non-ferrous metal foundries (23 percent), and non-ferrous metal manufacturers (22 percent). As far as agricultural commodities and food manufactures are concerned, the system of variable import levies has the effect of soaking up any attempt of LDC suppliers to expand exports by selling at prices below the internal target price in the Common Market<sup>2</sup>. Therefore, it should be obvious that an improvement of the GSP, as suggested above, could make an important contribution to the export development of LDCs.
- Fourth, it may be true, that in many LDCs the supply response to such tariff incentives would be low, especially in the short run and particularly as far as manufactured products are concerned. The reason is that the typical pattern of industrialization in LDCs, import substitution, has made it difficult to develop, at the same time, competitive exports of manufactured products to a substantial extent. But there is an increasing number of LDCs which are aware of the need to give export industries the same chances to develop as import substituting activities. In this respect, the maintenance of the various restrictive elements of the Community's GSP would act as a serious hindrance to improving

<sup>1</sup> See Donges, Fels, Neu u.a., op. cit., p. 26.

<sup>2</sup> Some fresh estimates on the effective rates of protection for these commodities is provided by A. J. Yeats, *An Analysis of the Structure of Protection in Industrial Countries*, Geneva, December 1973, mimeo. - See also W. M. Corden, G. Fels (Eds.), *Adjustment and Assistance to Industry: Britain and Germany*, London, forthcoming.

export capabilities of LDCs; it would become a source of probably unjustified export pessimism, exports would be considered impossible, steps to undertake them would be regarded as useless, and therefore these countries would become less outward-looking than they otherwise would. Incidentally, should those people be right who think that LDCs are generally unable to compete effectively in the international market even with preferences, then one wonders why they offer such formidable opposition to an abolishment of existing tariffs.

- The fifth point is that straightforward preferences may encourage EEC producers who are suffering from high and rising labour costs, to transfer their production, or at least the relatively labour-intensive segments of it, to the developing countries, where comparatively cheap (and trainable) labour exists and where low capital costs per worker can be combined with a low capital-output ratio. *Prima facie* candidates are: textiles and clothing industries, footwear, printed matter, electrical appliances, standardized types of motors and engines, machine tools, agricultural machinery etc. The EEC producers must not fear that the EEC countries would impose restrictions once they export from the new location back to them; and they could even expect developing countries to be more sympathetic to private foreign capital and to loose exchange restrictions once the benefit from the GSP in the form of additional exports does accrue to these countries. A trading framework which induces such an international reallocation of production would certainly be in line with what one would expect on comparative advantage grounds, and it would definitely be superior to the given, paradoxical-looking system which hinders labour-intensive manufactured products from developing countries from entering the Common Market, while there is no impediment to free immigration of cheap labour (apart from some temporary restrictions in one or the other member state).

10. If one desires an improvement of the Community's GSP, the question arises to what extent one should share the widely held equity notion that the benefits of the scheme have to be fairly distributed across the array of the poor. The heterogeneity of developing countries' needs requires, so the argument goes, a scheme of preferences which, if effective, avoids a concentration of benefits among the ten or fifteen more advanced developing countries. Both the exclusion of some countries from the Community's GSP and the maximum amount limitation applying to EEC imports from any single beneficiary country are said to serve this purpose of equity<sup>1</sup>. However strong the ethical merit of this principle may be, it is arguable whether a policy of trade preferences is an economically adequate means to narrowing the gaps existing among the developing countries. I do not think it is. The reason is simply that to handle the problem of different trade needs, a complicated quota arrangement is required which allocates the preferential access both among the over a hundred LDCs and on a commodity-by-commodity basis. It is quite obvious that such an approach is bound to create political friction and to cause high economic cost. Making, however, the EEC scheme of preferences really "general," i. e. removing the non-trade barriers, widening product coverage and applying the preferences to all LDCs without discrimination, would mean that the GSP would respond better than now and, at the same time, in an economically efficient and politically not unacceptable way, to the potential of each developing country for generating particular types of export. The problem of development disparities among the LDCs ought to be dealt with by financial and technical assistance. These types of aid can be tailored much more easily, and more effectively, to the various needs of LDCs than trade arrangements.

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<sup>1</sup> For an alternative device involving tariff quotas in combination with ceilings for each preferred country and product, see R. Blackburn, A. Hone, "'Floor Value' Quotas within the EEC's Generalized System of Preferences: A Policy Proposal", *Journal of World Trade Law*, Vol. 8, London, 1974, pp. 447 sqq.

11. Having emphasized the importance of being receptive to LDC's trade requirements, the question inevitably arises of how to assess the chances of getting the necessary revisions done. This is obviously a matter of political will within the Community. In pure economic terms, it is easy to demonstrate that efforts to reduce, on the basis of non-discrimination, the restrictions on the entry of products from the developing countries will promote a better use of the Community's own resources, will increase competition, thus weakening existing monopolistic and oligopolistic positions, and will contribute to curbing inflation. All this might outweigh considerably the negative terms-of-trade effect which could arise from freeing - unilaterally - trade. Nevertheless, I expect that - under the given policy scenario - progress in this direction, if it takes place at all, would be very slow. Part of the explanation is political, part may also be fatigue with the development issue as such. Five points should be made in connection with this:

- At the Community level, one central problem is that the institutions lack autonomy from their own member states. Most trade matters have to be discussed at conferences within the Council of Ministers. This Council, however, has considerably restricted its own efficacy by accepting the French claim for making only unanimous decisions (although in trade matters the Treaty of Rome requires only a qualified majority). As every member country has its own priorities, the process of arriving at an agreed collective bargaining position is often so difficult that the position takes on an inflexibility which means that negotiations with developing countries (but not only with them) often become an intractable task.
- In the EEC member countries themselves, there is alarming evidence of the weakening of forces for further trade liberalization. The reasons are manifold, but certainly related to such issues as the troublesome coexistence of unemployment and inflation at rates that are no longer politically acceptable; to the broadened public awareness of the so-called quality of life; and to the pessimistic balance-of-payment forecasts as a result of the recent dramatic petroleum price increases.
- Probably even more serious is the adverse impact of the recent oil crisis on the readiness of most people in the EEC countries to commit themselves to international cooperation. Since the mid-1960s we have been able to observe an erosion of the priority given to development in the Third World as result of disappointment with the speed of progress made so far. Now many people of the EEC countries strongly feel that their standard of living is going to be depressed by these new events. As a consequence, one gets the impression that the dominant opinion on aid by trade and other support of development in LDCs is not just disillusioned; such support is not even being considered.
- The increasing preoccupation in the EEC with specific domestic issues may lend great support to the skilled protectionist lobbies operating in these countries. On the one hand, there are the farmers who will stress, more than in the past, the need to reach a high level of self-sufficiency in agricultural products in order to reduce dependence from foreign suppliers. They may succeed because the Common Agricultural Policy (CAP) already provides a means of encouraging output expansion in the member countries and reducing, thereby, the need for agricultural imports. In any case, it is very unlikely that a reform of the CAP will emerge as result of a desire to cope with the LDCs' trade needs. The reason is that the CAP represents a delicately balanced economic and political deal between the member countries. Any concession made to developing countries represents a loss to one or more member states and will therefore affect this balance in one way or another. If the CAP is changed someday, then it will be primarily as a result of the desire to meet more adequately the internal needs of the Community; whether or not the claims of developing countries will be more sympathetically considered when such changes are discussed, is a matter of pure conjecture at the moment.
- On the other hand, it has become even more difficult than in the past to make domestic industries, which have ceased to be internationally competitive (mainly labour-intensive

industries), prepared to redeploy their factors of production in enterprises of greater comparative advantage. Such a production adjustment is what the logic of the international division of labour would suggest. But any acceptance of this logic may be perceived, at least in psychological terms and even by those people who should know better, as a policy which is unfair, because it gives priority to the requirements of the LDCs at the expense of particular producers, lower-income workers and less developed regions at home - even if the great majority of the population, i. e. the consumers, benefit from freer trade, as do entrepreneurs and employees in the expanding and more export-oriented sectors of the economy<sup>1</sup>. The heart of the difficulty seems to be that structural changes caused by growing imports from LDCs can be expected to take the form of interindustry rather than intraindustry specialization (which characterizes trade among developed countries)<sup>2</sup>. It will take time for the progress in industrialization to help LDCs to diversify out of the simple labour-intensive goods and to include more and more skill- and capital-intensive products in their export assortment; only then will the LDCs' trade with EEC countries be more of an intraindustry type, thus making adjustment to a changing world production structure much easier than it appears today. Meanwhile, the slower the economic growth, the more difficult structural adjustment becomes, because resources from the contracting sectors cannot be absorbed as smoothly as would be desirable. It is theoretically easy to think of an adjustment assistance programme which compensates all those productive groups affected by increased competition from LDCs and which therefore could neutralize resistance against a liberal import policy, however dynamic or sluggish the domestic economic environment is. And safeguard mechanisms to cope with sudden surges in imports from LDCs which exceed the absorption capacity of industrial countries are likewise conceivable<sup>3</sup>. But politically it is, in a democratic society, often easier to follow a course which maintains, or even tightens up, trade restrictions to protect the domestic, structurally "sick," industries. The knowledge of economics among the general public is generally so limited that decision-makers can declare as "assistance" to trade-impacted industries what is in fact nothing other than perpetual subsidization of inefficient producers; and they can also trust that the costs of such a policy in terms of growing technical and economic inefficiencies in the domestic industry as a whole, of slower economic growth, of higher consumer expenses and of fewer well-paid jobs will be overlooked by most citizens.

12. This state of affairs clearly suggests two things. On the one hand it points to the kind of statesmanship which is now required in Europe if the EEC is to be receptive to the LDCs' trade initiatives and, at the same time, conscious of the well-being of its own citizens: governments which are truly motivated, active, open-minded and politically resourceful. On the other hand, it becomes obvious that consumers in the member countries have to be

<sup>1</sup> For a broad discussion of the various policy issues of the adjustment problem in the United States, the EEC and Japan, see H. Hughes (Ed.), *Prospects for Partnership - Industrialization and Trade Policies in the 1970s*, Baltimore, Md., London, 1973, pp. 149 sqq.

<sup>2</sup> Various empirical studies clearly demonstrate that the job displacement caused by an increase of low-priced manufactured imports from LDCs is well within the magnitude of adjustments which take place continuously in the industrial countries as result of both changes in demand structure and technical progress. For some recent analyses the reader is referred to G. Fels, E.-J. Horn, "Der Wandel der Industriestruktur im Zuge der weltwirtschaftlichen Integration der Entwicklungsländer", *Die Weltwirtschaft*, 1972, H. 1, pp. 123 sqq. - J. M. Finger, "The Generalized Scheme of Preferences - Impact on the Donor Countries", *Bulletin of Economic Research*, Vol. 25, The University of York, Heslington, 1973, pp. 43 sqq.

<sup>3</sup> See, for instance, J. Tumlin, "Emerging Protection against Sharp Increases in Imports", in: H. Corbet, R. Jackson (Eds.), *In Search of a New World Economic Order*, London, 1974, pp. 269 sqq.

mobilized in order to protect their own interests against the pressures of both the producers' lobby and the organized labour. Properly organized, the consumers could easily become a political force which, given their voting strength, is much more powerful than the lobbies representing the employers and workers affected by import creation. How this mobilization of consumers can be accomplished is, of course, the fundamental question; unfortunately I do not have a convincing answer to it.

13. There seems to be, at the moment, one major reason which justifies a slight modification of these somewhat agnostic-sounding conclusions. It is that in the context of the world economy, bargaining is an important issue. In the recent past the Organization of Petroleum Exporting Countries has dramatically shown that developing countries need not be totally powerless. It is, of course, likely that petroleum is unique among the essential raw materials imported by the EEC countries in the sense of being qualified as a commodity whose price can be boosted and held at a high level by an international cartel of fortunate countries. But although other developing countries supplying essential raw materials might not have the chance of creating an oligopoly position (all cartelization efforts of raw materials producing LDCs have failed so far, even in the case of bauxite, copper, tin and phosphate where LDCs dominate world exports), the EEC countries can no longer afford to protect, in any economic crisis, what they consider their vital interests irrespective of the real cost to the developing countries. Otherwise they will be heading for severe economic losses and serious political trouble. Thus producers in developing countries and consumers (as well as expanding industries) in the Community could form a sort of natural alliance striving for freer international trade. The countervailing power of the LDCs is, of course, the greater, the more they announce their interests in unison and the more they take this unity beyond the stage of general declaration into the level of imaginative and tenacious negotiations with the EEC. The active participation of developing countries in all aspects of the Nixon Round and the attempt of these countries to use in the Committee of Twenty of the IMF what influence they have might be an adequate means to persuade the industrialized countries to be aware of the LDCs' trade problems. The idea that the developing countries will be able to define a common interest is, I know, an optimistic hypothesis; but it is the highest hope I have at the moment.

## Bela Balassa

I will begin my comments with a reference to Haberler's statement, who, following in the footsteps of Meade, called for the unilateral elimination of tariffs on the part of the EEC. This is indeed something we often tell our students: if one neglects the terms-of-trade effects, it would be desirable for a country acting individually to eliminate its own tariffs. But if we place the problem in the context of world "political economy," where bargaining is an important issue, this view will need to be modified.

I am reminded here of the report of the Swedish Customs Tariff Commission prepared in the mid-fifties. The Commission used the concept of effective protection before Johnson and Corden and myself discovered, or re-discovered, it. The Commission further expressed the view that if it were not for using tariffs to bargain for tariff reductions elsewhere, it would be desirable for Sweden to eliminate all of its tariffs<sup>1</sup>. This line of argumentation applies

<sup>1</sup> Revision of the Swedish Customs Tariff, Stockholm, 1957.

even more to the Community, for the EEC can obtain concessions from the United States and from Japan if, rather than eliminating tariffs unilaterally, it enters into multilateral negotiations. As regards these negotiations, the Group of Rome (pp. 191 sqq.) engages in undue self-criticism in alleging that the Community is an obstacle to multilateral tariff reductions. While this might have been true ten years ago when the United States wanted to eliminate tariffs on a large number of commodities and the EEC demurred, it is no longer the case.

For one thing, with its successful economic integration, the European Economic Community has adopted a more favourable attitude towards trade liberalization. For another, things have changed for the worse in the United States, with labour moving from the free trade to the protectionist camp. In this connection, I may refer to a statement by Nat Goldfinger, the chief economist of the AFL-CIO<sup>1</sup>, who at a seminar on adjustment assistance in 1972, which I also attended, called for continuing protection on the grounds that American labour needs fifty years of adjustment assistance<sup>2</sup>.

Of course, there is the argument that the protectionist mood came to the fore during the period when the dollar was overvalued and, while the recent devaluations had not yet had their full impact on the US trade balance and thus on general attitudes towards trade liberalization, all this will change with an improvement in the US balance of payments. I hoped myself that this would happen, and at the seminar in 1972 I expressed the view that labour still lives in the period when the US dollar was overvalued. I am afraid, however, that I was too optimistic, and one would indeed be too optimistic to expect that a change in attitudes would take place in the near future. This is largely because of the power of special interests which play an important role in determining AFL-CIO attitudes as well as those of industry.

The role played by special interests can be exemplified by the case of the chemical industry, where, even though the majority of the producers would prefer free trade, the minority can impose its view. The American negotiators in the Kennedy Round worked out a deal that the Common Market would not grant substantial tariff reductions on chemicals, unless the United States eliminates the practice under which the American Selling Price serves as a basis of tariff setting on coal-tar based chemicals. While the US chemical industry as a whole would have benefited as a result, the American Selling Price system is still on the books because the majority bowed its head to a vociferous minority. Similarly, unions that are especially fearful of trade liberalization, in industries such as textiles, shoes, and clothing, have an important influence on the AFL-CIO.

There is an additional consideration which warrants greater optimism as regards attitudes towards tariff reductions in Europe than in the United States. Europe has a more homogeneous labour force and many of the temporary Gastarbeiter (guest workers) are in protected industries. Conversely, the US labour force is very heterogeneous, with education levels varying to a considerable extent and a relatively large proportion of the adult population being functionally illiterate; not only blacks but also poor whites in the south.

It is difficult to retrain these people and to move them into modern industries which require high skills because they do not have the educational level which the Danes, the Swedes, or the Germans possess. Furthermore, there is a regional problem. One should remember that the United States is a very large country, with a considerable dispersion of population, which makes adjustment to freer trade difficult.

These considerations should be taken into account in answering the question of whether it is realistic to assume that developed countries would negotiate the elimination of tariff barriers

<sup>1</sup> American Federation of Labor and Congress of Industrial Organizations

<sup>2</sup> The papers presented at the seminar, but not the discussion, were published in H. Hughes (Ed.), *Prospects for Partnership: Industrialization and Trade Policies in the 1970s*, A Seminar held at the International Bank for Reconstruction and Development, 5-6 October 1972, Baltimore, London, 1973.



at this juncture. I do not believe this to be the case. Even if the industrial countries were to sign an agreement to eventually eliminate tariffs, it would be without teeth; it would not be taken seriously.

In my view the best solution would be to adopt a stage-wise procedure. The Kennedy Round, which brought a very considerable reduction in tariffs, averaging something like 35 percent, should be followed by another round of negotiations with the objective of reducing tariffs by one-half according to a definite timetable. After this is completed, one could perhaps negotiate the elimination of tariffs on commodities subject to low duties and undertake another round of negotiations for reducing tariffs on all other commodities.

I propose this approach not only because protectionist sentiment is strong in the United States, but also because of the learning process involved. People have to learn that the effects of tariff reductions are not as adverse as generally assumed. This is because of the predominance of intraindustry specialization in trade among the industrial countries. It explains, as I have shown elsewhere<sup>1</sup>, that in the Common Market there was little unemployment or few bankruptcies following the elimination of tariffs on intraarea trade. The existence of a learning process thus speaks for a stage-wise procedure in trade liberalization. Such a procedure would also minimize the problem of adjustment in the United States I referred to above, and hence be more acceptable politically.

While the Group of Rome is very bold in regard to tariff reductions, in my view it does not go far enough in regard to non-tariff barriers. It makes the rather blunt statement that "the restrictions already in existence are unlikely to be liberalized through a process of multilateral bargaining" (p. 204). It suggests instead that one should start with policies designed to bring about adjustments in protected industries, which would be done nationally but supervised multilaterally.

We face again the chicken-and-egg question as to what comes first. Will the countries apply policies if there is no agreement among them to reduce non-tariff barriers? Will there be enough incentive for them to do so? And can one really expect that there be an effective multilateral supervision of such policies? I would rather opt for a solution under which one negotiates reductions in tariffs and in non-tariff barriers on a multilateral basis, as this would give a push to apply policies aimed at adjustments in protected industries.

Let me further add that if we go too fast in tariff reductions, the danger is that new non-tariff barriers would be introduced. This strengthens the case for combining negotiations on tariff and non-tariff barriers and applying a stage-wise procedure to both. In turn, the modalities of domestic adjustment to lower trade barriers could be left to the national, or in the case of the EEC the Community, authorities.

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<sup>1</sup> B. Balassa, "Tariff Reductions and Trade in Manufactures among the Industrial Countries", *The American Economic Review*, Vol. 56, Menasha, Wisc., 1966, pp. 466 sqq. - More recent results are reported in: *idem*, *European Economic Integration*, Amsterdam, forthcoming.

## II. Roads to Monetary Union

Chairman: Fritz Machlup

Johann Schöllhorn

0. May I first point out that I am not speaking as an official of the German Bundesbank: I am just going to present my personal opinion on the topics in question. As a general remark please let me say that I consider the Report of the Group of Rome to be a very fructifying and stimulating contribution to the problem of European integration. Above all, the Report represents a consistent view of the problems involved. This positive view does not, however, exclude some criticism of details, and also some scepticism as to the possibilities of realizing the various proposals.

1. I have been asked to make some short comments on Chapter 2, which is entitled "Monetary and Fiscal Integration." But I am tempted to make some introductory remarks on the present situation of the Community and the background of recent developments.

1.1 In the so-called Werner Commission we had to start from the fact that the solemn resolution of The Hague postulated the political intention of transferring responsibilities and powers from the national level to special Community institutions.

Monetary policy commitments, particularly with regard to the rates of exchange, were made dependent on at least parallel progress in the coordination of general economic policy, with emphasis on fiscal and incomes policy and also with regard to a minimum success in harmonizing the instruments of demand management. After all these day-and-night discussions, we were eventually convinced that all attempts to achieve an economic and monetary union must fail in the long run, unless the Community could be transformed into a political union.

All three vital preconditions of the scheme have not been brought about, nor was their realization tackled. In March 1971, the Council of Ministers was opposed to any kind of transfer of powers to EC institutions; in the coordination of economic policy they simply achieved the creation of a new committee; and the harmonization of instruments resulted in nothing more than a set of non-committal guidelines, leaving room for practically every separate national action. As to the political union, it was not even possible to come to an understanding about the organization of a political secretariat. It is said that this failure was due to the lack of agreement on the seat of such an institution.

1.2 It became quite obvious that there could be no progress towards an economic and monetary union unless the EC developed into a community of stability. In the former Community of the Six, there was a high degree of uniformity in the inflationary process. If anything at all could claim to be harmonized - at least between 1969 and 1972 - then it was inflation rates. But it was to be expected that, in the original EEC countries as well as in the enlarged Community, an increasing inflationary process would cause extremely different reactions in economic policies. This is due to different priorities in economic, social, and political aims. And this explains the present disintegrating process within the Community today. In my opinion, the oil crisis cannot be considered as one of the main causes of the present European dilemma. Undoubtedly it has more or less frustrated the efforts for stability recognizable in several countries and, in connection with the price boom for other raw materials, it is intensifying the impact on prices from abroad. Furthermore, the home made inflations and different inflation rates which appeared up to autumn 1973 endangered the existence of the Community in the long run. But the extremely high prices for crude oil also produced a certain advantage: they drastically revealed all the weak points of both European integration and Atlantic cooperation.

1.3 I should like to underline especially the statements in the Report (pp. 14 sq.) where it is pointed out that the disintegrating effect of inflation is the most important single obstacle to economic and monetary union.

The inflation did not only block the progress of integration; it has also endangered the further existence of the tariff union and the Common Agricultural Market. In spite of Giscard's and Schmidt's recent *pas de deux* in Paris I do not think that the problems are solved yet. In any case, successful control of inflation is the most important precondition for going back onto the path of economic and monetary union. By isolated action of single member countries this certainly cannot be achieved. The four elements mentioned on page 17 point to the necessary procedure. It is not sufficient to resort to general austerity. On the contrary, financial sources should be opened to enable countries with extraordinary structural and regional problems to restrict global demand without being forced to suffer from structural unemployment beyond a socially acceptable level.

I quite agree with the authors of the Report that unconditional financing of balance of payments deficits by means of credit is not advisable: the necessary adjustment process would only be delayed and global monetary inflation would be aggregated.

2. First of all, Europe has to achieve a reversal in the development of prices and bring about general confidence that inflation can be reduced gradually to a tolerable degree. Only in this way will it be possible to realize new progress in integration. I do not believe that we can simply restart with the stage plan of March 1971. The main concept of the Werner Report, which was the basis for this plan, should be revised in the light of the experience gained in the meantime. The four strategies offered in the Rome Report (immediate shift to a European currency, exchange-rate unification, coordination of monetary policies, means of settlement of account, pp. 35 sqq.) could be a great help for such a revision. In this way, it would be unnecessary to commission another committee à la Werner.

No doubt, the first of the four strategies is out of question.

2.1 I think we have to agree with the negative judgement on strategy number 2. But in this connection two facts should not be ignored. First: the experiment of narrowing the margins of exchange rates took place under extremely unfavourable conditions. This experiment had not yet started when the breakdown of the Bretton Woods System began, due to the suspension of the convertibility of the US dollar in August 1971. When, some time after the attempt to repair the Bretton Woods System by the Smithsonian agreement in April 1972, the narrowing of the margins and the corresponding system of interventions were established within the EC, the convulsions of the international monetary system became more violent and more frequent. There is no need to describe the development that followed.

Second: some representatives in the Werner Commission as well as many politicians and central bankers seemed to be convinced that a step-wise introduction of closer exchange-rate ties would produce pressure towards the coordination of monetary policies quasi-automatically. The scheme finally accepted requests an effective parallelism between narrowing the margins and progress in the coordination of monetary and fiscal policies as an unavoidable precondition. The fact that some member countries did not consider this obligation to be serious enough and none of them acted accordingly is another question. But this is not a reason to blame the original scheme.

In the meantime, practice has taught what arguments could not: premature fixing without monetary and economic harmonization is condemned to failure. A setback in the process of integration which will remain difficult to overcome for a long time is the high price for it; a price, in my opinion, too high for Europe.

2.2 Only the third strategy (p. 38) seems to be a conceivable method of reaching monetary union, that is, by the effective coordination of monetary policy in every respect. I agree with most of the excellent comments made on this subject and do not consider it necessary to mention all the points of agreement. I am also of the opinion that the establishment of an

exchange equalization account - as already exists as a nucleus in the European Fund for Monetary Cooperation - is the better solution for Europe as compared with the alternative of capital controls.

Of course, this conception meets with enormous difficulties, as already pointed out. And there is also no denying that there are substantial objections to this sort of solution. In the same way, it is undeniable that different countries have different priorities in their policy objectives. But a country which is insisting on a scale of national priorities and is not ready for the adoption of common aims must be content with a European tariff union.

2.3 As far as the parallel currency, the "europa," is concerned (pp. 46 sqq.), I do not think that it will become important as a strategy of its own. Whether it is a help for coordinating the economic policies remains an open question. In the realization of this project it is certain that not only technical problems will arise, which might be similar to those which appeared in connection with the attempt to make the Special Drawing Rights the principle reserve asset - problems which are still not solved completely today. It seems to me important enough to state that the national monetary authorities would, sooner or later, give up their sovereignty if the national currencies were displaced by a European Parallel Currency - as you can see, I am an orthodox of Gresham's Law. But I am afraid that politicians might find out the "ruse of the thought" very quickly. Perhaps the idea is not so bad and maybe you will convince me in the course of our discussion.

3. I only can underline the statement on the importance of fiscal integration. The dominating role of regulating the money supply as an instrument of demand management is recognized, but the second important pillar of integration policy is fiscal integration. It is absolutely correct that it is impossible to imagine an economic and monetary union without the power of the Community to tax and spend. The Werner Commission tried to make it clear that a future economic and monetary union would not be able to function without a minimum of taxes and expenditures of its own. Some had in mind the model of the Federal Republic of Germany as a pattern. Finally, however, we all agreed that the idea of a large common budget for the first two stages - sufficient for a successful common policy - would be too exacting a demand upon EC ministers of finance.

You see, we wanted to make it acceptable for the politicians at least on principle. Therefore, we discussed quite cautiously the necessity of an inter-Community financial settlement between member countries. Even this idea was shocking enough and consequently not accepted.

3.1 Nevertheless, the step-by-step creation of a rather comprehensive Community budget should not be abandoned. The common budget should be based on a concentration of existing funds and systematically supplemented by additional financial resources. In the long run, the harmonization of taxes which remain under the control of national authorities could be facilitated in such a manner. This way seems to me to be more promising than the attempt to harmonize as many national taxes as possible from the beginning.

3.2 All proposals for fiscal integration start from the assumption that not only has the sphere of competence of the European Parliament to be extended continuously, but also the actual character of this institution should be altered. We need a system of direct election to the European Parliament, which means that we need a "European Constitution" as a starting point.

4. In this way, I arrive at the necessity of political union. I do not think that significant and lasting improvements in the monetary and economic integration can finally be achieved without a step-by-step, simultaneous harmonization of foreign and defence policies, which would prepare the Community for political union. The recent experiences after the Yom Kippur War have demonstrated the substantial interdependence of economic, defence, and foreign affairs.

## Norbert Walter

1. The first road to European monetary union, the Werner Approach, has proved to be a blind alley. The way out, or the "way forward" as the Group of Rome call it in the sub-title of the Report, should not be a road to hell paved with good intentions, but a road with the highest possible probability of leading to monetary union. Political feasibility is not the best criterion to use in order to find solutions which are economically optimal and therefore durable; it only helps to avoid the proposal of so-called "non-starters" in the political debate. Improving old, misleading strategies only serves to delay the acceptance of the solution required. But, since it is so very difficult to admit that one has failed, in the political process new solutions are adopted only when the old strategies have already proved to be failures several times.
2. The philosophy of gradualism brought about the side-street of the Werner Approach, the European block floating. This lane is still used by a big, stable lorry, the D-mark, and various durable mini-cars, but the main traffic floats elsewhere, although not without traffic jams. Such oddly structured currency-traffic causes a lot of trouble. Therefore, three of the four big member countries of the EC have left the so-called "snake," and one de facto member, Austria, stepped out of line in widening the band and revaluing the Austrian schilling. The mini-snake seems to be the more alive, the less it sticks to its basic idea: fixed exchange rates. Thus one of the last hopes of utopian Europeans of arriving at monetary union by creating exchange market conditions as if monetary integration already existed increasingly disappears.
3. In a world of rather considerable exchange-rate changes, an aggravation of balance-of-payments problems by the oil price explosion, and a spreading of recessionary tendencies because of a stringent worldwide anti-inflationary policy, more Europeans feel need for a new start in European monetary unification. This is felt even more since the dollar reserves which accumulate with the Organization of Petroleum Exporting Countries (OPEC) are rather volatile; therefore, the international monetary system and especially export-minded, small and open economies seem to be endangered by sudden decisions of OPEC governments. This economic-political situation has proved to be a good precondition for a new effort to unify the currency area, Europe.
4. Most proposals for monetary integration in Europe are dominated by thinking of money as a product of the monopoly of the states. In nearly all cases it is not the market which determines what happens with European monetary integration, but the governments. The only solution which leads to monetary unification by governmental decisions is the surrender of national monetary sovereignty to a European central bank. But the precondition for this transfer of national power to a European body is, no doubt, political unification. There are hardly any signs of a political union being formed in Europe within the next few years. Nevertheless there is an indication of some demand for monetary integration.
5. To overcome this deadlock, the introduction of a European parallel currency has been proposed. This approach seems to have economic and political advantages, because it preserves crucial conditions for arriving at monetary integration: namely, that the process should be gradual and brought about by market forces released by doing away with the monopoly in money-creation of national central banks. These banks only have to accept the use of a European currency within their own currency area.
6. The European monetary integration issue has been given new impulses from two reports, the Report of the Groupe de Réflexion<sup>1</sup>, and the above-mentioned Report of the Group of Rome.

<sup>1</sup> EC, Commission, Study Group on Economic and Monetary Union, European Economic Integration and Monetary Unification, Document II/520/1/73-E, Brussels, October 1973 (referred to in this Section as Report of the Groupe de Réflexion).

The Report of the Groupe de Réflexion elaborates on the monetary issue: after discussing various exchange-rate systems, "a system of limited intra-Community flexibility combined with joint-floating erga extra is proposed" (Part I, p. 61). Since the Groupe de Réflexion has found that a common European currency would be beneficial, they discuss different solutions for a European parallel currency. The intended solution of the Groupe de Réflexion is a parallel currency which is constructed as a bag of currencies, but combined with a discretionary adaption to some purchasing power index. The Group of Rome Report is less precise on the monetary integration issue and rather vague on the parallel currency topic. There is only a very short hint of a bundle of European currencies-solution (p. 47) within the discussion on "Means of Settlement of Accounts." These discussions sum up the analysis of different strategies for monetary unification. While jumping into a common currency area and exchange-rate unification within Europe is looked upon as economically undesirable, coordination of monetary policy is judged to be politically impossible. Therefore, the Group of Rome proposes, after elaborating on the pros and cons of capital controls, the establishing of a potent exchange equalization account, thus forcing national authorities to behave in coordination.

7. The Reports of the Groupe de Réflexion and the Group of Rome both include proposals for some limitation of exchange-rate fluctuations. Intra-EC exchange-rate changes should be limited to cost and price discrepancies. Such a limiting device - managed by an exchange equalization fund or by national central banks - assumes that there is an omniscient being in the central banks or on the board of the exchange equalization fund. In any case only ex post corrections of the exchange rates due to cost and price divergencies would be tolerated by the authorities. Thus - as we know from experience - in most cases exchange rates would only then be allowed to change when the adjustment inflation is well under way in a country which had previously had a better price and cost performance, in other words, at too late a stage.

8. As both reports claim, it would of course be useful to have some instrument to avoid "temporary" and so-called "useless" capital movements and the exchange-rate fluctuations resulting from them. But it is not possible for anybody, except a know-all, to decide ex ante what is a temporary or a useless movement. Thus I would strongly advocate refraining from any intervention in the exchange market; I would condone intervention only when those who intervene assume all risks for their actions. This device is surely not the first best solution to the problem; but first best solutions are non-solutions as long as mankind remains imperfect. Or to say it in Friedman's words: "That [refraining from intervention] will sacrifice minor advantages from slightly smoothing exchange-rate movements most of the time; but it will gain the major advantage of avoiding occasional catastrophic mistakes"<sup>1</sup>.

9. Even if, as the Report of the Group of Rome states (p. 42), some capital movements seem to be counter-productive, the establishment of capital controls is not an integration force, but the opposite. Just as one should not forego freedom in a democracy just because it is misused in some cases, one should insist on freedom of capital movements. In any case only an omniscient being can decide whether market transactions are misguided. One wonders whether such transactions can be repeated very often without the sanction of heavy losses in due course. It seems, in fact, to be wise - at least it was wise in the past - to undertake those "counter-productive" capital transactions. But besides theoretical reasoning one should look at empirical findings and pay special attention to what previous defenders and "managers" of capital controls, namely central banks, have written about the effectiveness of capital

<sup>1</sup> M. Friedman, "Statement", in: How Well are Fluctuating Exchange Rates Working? Hearings before the Subcommittee on International Economics of the Joint Economic Committee, Congress of the United States, 93rd Congress, 1st Session, June 21, 1973, Washington, D. C., 1973, p. 119.

controls: "Experience has shown, however, that such measures are fairly ineffective against purely speculative money movements and that they are ultimately of secondary importance under a system of floating exchange rates"<sup>1</sup>.

10. Before discussing the plans for a European parallel currency, it is necessary to clarify the relative importance of monetary policy and fiscal policy for demand management purposes. Fiscal policy should be directed at structural and regional targets, because it clearly has comparative advantages in this field; monetary policy should be responsible for demand management purposes, with special emphasis on the price stability target.

In the Report of the Group of Rome the assignment solution seems to be somewhat confused: here, fiscal integration is called the "most promising" way of arriving at economic and monetary union (p. 49). To my mind, what is necessary for economic and monetary union, is a common monetary policy. The question of whether or not fiscal policy should be harmonized is not particularly relevant. Since, in the past, the harmonizing of monetary policy has not been very successful, it is necessary to arrive at this target step by step and without the discretionary decisions of politicians. A strategy which has these characteristics is the introduction of a parallel currency.

11. A parallel currency, which should lead to monetary union, must be preferred to national currencies. To prevent it from being hoarded, its price must be allowed to increase as its value increases. To alleviate the competition with the dollar it must be free of administrative regulations. It is rather difficult to analyze whether the proposals of either the Group of Rome or the Groupe de Réflexion meet these conditions; neither report includes precise proposals for a European parallel currency. Nevertheless some critical points should be mentioned:

- Both reports propose a bag of currencies-approach for the new European currency. The Groupe de Réflexion combines this approach with some commodity-price-index link. Thus two different rules are given for the management of one single currency. If, at the same time, it should be avoided that the new European currency displaces depreciating currencies too quickly (Groupe de Réflexion) one has to expect the new currency to be as stable or as unstable as the national currencies. Even if the common European currency is as stable as the strongest national currency (as presented by "way of illustration" (p. 47) in the Report of the Group of Rome) it is not shown why the new unit should be preferred by the public.
- In the proposal of the Groupe de Réflexion, the Council of Ministers should decide for each period what fraction of the commodity-price increase should be compensated by a revaluation of the common European currency. Such discretionary decision-making has failed in the past; therefore, academic advisers should avoid proposing those solutions.
- Another function of the new European currency should be to successfully compete with the Euro-dollar in European financial markets; but this target can hardly be achieved, if banks are to pay compulsory reserves against deposits in the new currency, while Euro-dollar deposits are free of minimum reserve requirements.

12. From this some essentials follow for the way forward via a European parallel currency:

- Firstly: In order to guarantee sufficient attractiveness to the common European currency it is necessary to have a value-maintenance provision, which is superior to those of national currencies. My proposal would be a purchasing power-stability of the European money.

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<sup>1</sup> Deutsche Bundesbank, Report of the Deutsche Bundesbank for the Year 1973, Frankfurt am Main, pp. 20 sq.

- Secondly: In order to guarantee that the common European currency's attractiveness especially as a store of value does not lead to its hoarding, fully flexible exchange rates, even within the EC, are required as long as national currencies exist.
- Thirdly: In order to guarantee that the new money can form the basis for a common European capital market, it is necessary to remove all capital controls, including all administrative measures of central banks, for example, minimum reserve requirements.

### Pascal Salin

There is general agreement about the final stage of monetary union. It will include:

- absolute fixity in exchange rates, if not a unique currency;
- unrestricted movement of goods, capital and factors of production;
- political unification ensuring sufficient coordination or centralization of economic policies to make fixity and transferability possible.

Disagreement arises as soon as roads to this final stage are considered. The problem is to define an optimal road and to determine which of the characteristics of the final stage have to be enforced at once. These choices imply making some guesses about the possible behaviour of governments and the public.

A first possible conflict of ideas is implied by the relation between European economic unification and political unification: is the latter necessary for the former - mainly monetary unification - or will economic unification necessarily lead to political unification?

As regards the narrower problem of monetary unification, one can ask whether the fixity of exchange rates could lead to a European currency or whether the reverse would be easier, i. e. the creation of a European currency would be an integrating factor, making fixity in exchange rates possible in the future.

The first approach is the "Werner Approach," the one chosen by the EEC. One does know that it has been a failure, as is sufficiently stressed by the impossibility of making the "snake" work. In the face of these difficulties, the second approach appeared more and more fruitful and it has been given a strong impulse from the Report of the Groupe de Réflexion. We shall first discuss the problem of adjustment in both approaches, then some technical problems concerning the new European currency, particularly problems related to its issuance.

I. Adjustment Policies. - 1. Criticism of the "Werner Approach." - The events of recent months have illustrated what seems obvious from a simple observation of the real behaviour of governments: the cooperation of authorities to enforce stability in exchange rates is not sufficiently accepted; when a conflict arises between what is deemed to be national interest and the interests of the EEC, national interests are given priority.

It is not relevant here to discuss the existence of the Phillips curves in Europe. The important point is the fact that different governments in Europe have different feelings about their existence, about their preferences and about the efficiency of different policies. It could also be added that different authorities are not equally efficient in monetary management and/or are under different social and political pressures. For instance, France is less aware



of the role of monetary policy to fight against inflation than some other countries. I personally believe that such differences are likely to last for decades in spite of any institutional arrangement and it may be sufficient to compare the Federal Republic of Germany and Italy in 1974 in order to be convinced.

2. Criticism of the Report of the Groupe de Réflexion. - For the reasons just given, I should be more extreme than the Group of Rome (pp. 35 sqq.) in the direction of flexibility. In fact, it is proposed in the Report of the Groupe de Réflexion (Part I, p. 25) that the range of permissible exchange-rate variations would not be higher than 2.25 percent within a calendar year. It seems much better to allow more frequent and larger changes or, even, complete flexibility in exchange rates. Some economists, including Robert Mundell, would argue that such changes in exchange rates are inefficient, because any depreciation or devaluation of a currency leads to further increases in prices, since consumers and wage-earners no longer suffer from "money illusion." In fact, it could be argued that:

- (1) for several European countries the ratio of external to internal transactions is low, so that the spreading of inflation due to devaluations is slow;
- (2) if inflation has already occurred, the country concerned must devalue or let its currency float downwards in order to avoid exchange controls.

3. The External Aspect of Adjustment Policies. - For a long time, the European countries have criticized the so-called "domination" of the dollar (and the United States), which took the form of the US balance-of-payments deficit, of the international transmission of inflation, etc. But it is important to recognize that the United States was unifying the world under the dollar standard and, by the way, unifying the European countries. The convergence of the evolutions of different European countries - especially as regards inflation - was convergence towards the American standard. The common float has rightly been perceived as a means to restore European independence, but, at the same time, Europe lacked a common standard, which does not mean a common unit of account or even a common currency, but mainly a common rate of inflation.

Intervention policy is the crucial problem at this point. Integration would be easier if one European currency was accepted as the intervention currency in Europe. However, this is politically not acceptable. The difficulties encountered in determining a "community rate of the dollar" when the European rates of exchange were stabilized in terms of dollars are only a consequence of this more general problem.

Thus, if one accepts the assumption that the determination of a "European identity" implies floating exchange rates vis-à-vis the dollar, a priori fixity in exchange rates between the EEC countries is impossible or at least more difficult than under a dollar standard. There is also the risk of countries entering into costly discussions to determine which country has to adjust, if they do not accept either a dominant currency or common targets, for instance for inflation. Another solution could be to create an "n + 1<sup>st</sup>" currency. Could the European Parallel Currency (EPC), advocated by the Report of the Groupe de Réflexion, be that currency?

II. The Working of the European Parallel Currency. - In order to help solve some of the problems which have just been recalled, the creation of a new European currency would have to avoid some of the "errors" made with Special Drawing Rights (SDRs), mainly:

- (1) SDRs are not held by the public, so they cannot be used for intervention; the dollar remains the intervention currency and countries desire SDRs to the extent that they are convertible into dollars, which are the ultimate liquid asset. Thus, one could say that SDRs are dollars created by the IMF. They are not an "n + 1<sup>st</sup>" currency at the world level.
- (2) The creation of SDRs takes place through an allocation process. Therefore, they do not necessarily meet the demand. It seems important that units of EPCs be created only or mainly when economic units want to hold them.

(3) As a consequence of these features, SDRs cannot play an important role in the adjustment process. This explains why some of the reformers of the international monetary system propose, for instance, that countries should be obliged to hold given ratios of SDRs to other reserves, which certainly cannot be an optimal system. Therefore, the EPC scheme must include provisions to induce countries to adjust in conformity with what is considered as an optimal process, while letting economic units hold any quantity of this currency they wish.

We shall discuss, hereafter, some problems of the EPC. We shall assume throughout that European national currencies are floating vis-à-vis the dollar and that there is a more or less limited flexibility of national currencies within the EEC (so that there is a need for intervention).

1. The Definition of the EPC. - I am somewhat dissatisfied with the proposed definition of the EPC as a "bag" of currencies. In fact, a standard of value is a standard of value and it has not to be defined and changed. Especially if European currencies were floating vis-à-vis the dollar, the EPC would have to play the role of a unit of account. The system would work perfectly well if the exchange rates of the European currencies were initially defined in terms of units of EPC (the D-mark is worth so many units, the French franc is worth so many units, etc.), according to initial cross-rates. Later, there would be devaluations and revaluations vis-à-vis the EPC, according to given rules.

2. The Problem of Value Maintenance. - A very large number of formulae<sup>1</sup> have been proposed in order to give the EPC a higher value maintenance than the European national currencies, so that economic agents would be induced to hold it. The definition of the EPC as a "bag" of currencies - eventually with a higher weight given to more stable currencies - is one possibility. However, if the EPC is considered as the unit of account and has no definition, it is also possible to give it a higher value maintenance than the other currencies or, at least, than the average. For instance, the European Central Bank issuing the EPC could give an interest rate on units held. Or, it could be decided that countries cannot revalue their currency vis-à-vis the EPC. Such a rule would imply that the most inflationary countries would be presumed to be responsible for any intra-European disequilibrium<sup>2</sup>.

It has been proposed<sup>3</sup> that the EPC be revalued vis-à-vis the national currencies by part of the rise in the Community cost-of-living index. Such a clause would give a maximum value maintenance to the EPC and it would not imply any problem if the debtor is a national authority (possibly through the European Central Bank); but it means that private debtors could hesitate in denominating their debt in terms of the EPC, except if the rate of interest is close to the real rate of interest and not to nominal interest rates in terms of national currencies.

3. The Problem of Adjustment. - One problem that any international monetary system has to solve is to determine which country is responsible for adjustment (which is not the same problem as determining which country, in fact, bears the burden of adjustment). Therefore, we would not agree with the following quotation from the Report of the Groupe de Réflexion (Part I, p. 25): "Changes [in exchange rates] would, as a rule, be shared by the deficit and the surplus countries. This would be in harmony with the emerging

<sup>1</sup> Cf. R. Vaubel, "Plans for a European Parallel Currency and SDR Reform: The Choice of Value-Maintenance Provisions and 'Gresham's Law'", *Weltwirtschaftliches Archiv* (Review of World Economics), Bd. 110, Tübingen, 1974, pp. 194 sqq.

<sup>2</sup> Such a rule would prevent a surplus country from revaluing in order to avoid undesired inflows of capital. However, rules can be designed so that surplus countries have not to intervene.

<sup>3</sup> Cf. Report of the Groupe de Réflexion and Vaubel, op. cit.

consensus in favour of more symmetry in the adjustment process for weak- and strong-currency countries. " In fact, such a rule (i) would not help in determining which country has to adjust; and (ii) must not be decided without reference to provisions on value maintenance, for the value of the EPC depends inter alia on devaluations and revaluations vis-à-vis itself. More generally, the possibility of devaluing and revaluing "at random" may contradict the definition of the EPC in terms of a bag of currencies.

In fact, the determination of the country (countries) which has to adjust is not solved by any of the proposals for the value maintenance of the EPC, except the one we made, i. e. the obligation not to revalue.

Value-maintenance proposals imply that the national central banks offer exchange guarantees to the European Central Bank issuing the EPC, so that the value of its assets in terms of EPC be maintained when a currency is devalued. Would such a guarantee be an inducement not to inflate too much or not to devalue? Depending on the case the process of adjustment varies.

If there is no floating against the outside world, but, also, a system of limited flexibility, it is better not to define the EPC as a bag of currencies but to define each European currency in terms of the EPC. Thus, each national bank would have to take care of the value of its currency vis-à-vis the EPC<sup>1</sup> and the EEC institutions would have to decide any common change in the EPC/\$ rate.

#### 4. The Creation of the EPC. - Three systems can be imagined:

(1) Allocation: units of the EPC are allocated to the national central banks by the European Central Bank according to given criteria. The system is similar to the SDR system, except that the EPC can be held by the public, which means that the national central banks can intervene in terms of EPCs. In the SDR system, allocation is a limitation of the right to exchange its own currency against foreign ones. In the EPC system, it could be decided that central banks can intervene in EPCs only and not in terms of other currencies (we do not consider here the need for intervention in the case where there is a limited flexibility with the outside world). Thus, if one country has no more EPCs it has to adjust (either deflate or devalue).

(2) Exchange of national currencies against the EPC: commercial banks would obtain the EPC from the European Central Bank either directly or through the national central banks, at a given fixed price. Thus, the elasticity of supply of EPCs is infinite and units of EPC are created whenever they are desired. Conversely, holders of units of EPC can freely exchange them against any national currency at the current exchange rate.

(3) Creation of the EPC by an open-market policy of the European Central Bank: in this case there would be a "traditional" system of fractional creation of money. The Board of the European Central Bank would be free to determine the conditions for the purchase of assets against units of EPC. The national central banks would intervene in terms of EPC.

In the last case, there would be a direct link between all the quantities of money in Europe, at least if the monetary policy of each country is aimed at maintaining fixity in exchange rates. The European Central Bank would determine the European rate of inflation, at least if the EPC has won a sufficiently wide area of circulation so that the units of EPC are a significant part of the national central banks' assets. However, the process of economic and political integration has not yet gone far enough for countries to accept the idea that a central authority decide which types of assets to buy and at which prices. This "traditional" system must therefore be conceived as the system of the future and the creation of the EPC will only leave the way open for such a system.

<sup>1</sup> This does not necessarily mean "intervention" in terms of EPC, as is discussed in Section 4.

The allocation system must be avoided, for it would not meet the main aim of the creation of the EPC, which is a gradual introduction of this new currency so that the desires of the demand could always be met. With a system of allocation, the supply could increase more rapidly than the demand, in which case the value of the EPC would decrease and there would be a risk of further inflation. If the supply increases less rapidly than the demand, the desired spreading of the new currency would not be optimally reached.

Thus, the only possible system, at least at the beginning, is a system where national currencies issued by the national monetary systems could be freely exchanged against units of EPC. Thus, the policies of all the European central banks would determine the quantity of money in Europe. The percentage of this quantity which would be held in the form of EPC would only be determined by the demand<sup>1</sup>. This market system is certainly better than the authoritative system of allocation.

However, in that case, there is a risk of one central bank issuing too much national currency and, therefore, obtaining a high part of the total seigniorage and exporting inflation to the other European countries. In fact, there is no real intervention of any national central bank on the exchange market: if, for instance, the demand for EPCs against one national currency is higher than the supply, the central bank issuing that currency does not have to deduct EPCs from its own stock, because it does not hold any. The excess demand is satisfied by the European Central Bank - possibly via the national central bank; the European Central Bank buys a national currency and sells units of EPC. An expansive monetary policy by a national central bank is not externally constrained. The creation of money is done by the national central banks, but the "intervention" is done by the European Central Bank. Some constraints have to be imposed on the national central banks, for instance:

- The European Central Bank could invest its holdings of national currencies at the corresponding national banks, possibly at increasing rates in order to restrain national central banks from creating too much money.
- The national central banks would have to give exchange guarantees to the European Central Bank so that it can maintain the value of the EPC according to what has been said before.
- Adjustment policies would have to be imposed on the national banks. However, it is difficult to imagine how the European Central Bank could enforce, for instance, more restrictive monetary policies. As regards changes in exchange rates, it has to be decided whether the European Central Bank could freely change its "intervention rate" or if a national central bank would be free to ask the European Central Bank to change its "intervention rate," or if a common decision would be necessary. Anyhow, this difficulty makes it clear that there is no simple way of coordinating national monetary policies to avoid international disequilibria<sup>2</sup>. The problem could be solved only with a system of open-market operations by the European Central Bank, which, precisely, assumes that countries have abandoned their monetary sovereignty. In that sense, it can be said that the "EPC approach" is not really superior to the "Werner Approach" as regards adjustment. The only improvement brought by the "EPC approach" is that there would be a progressive construction of a European monetary system, which could be easily transformed into a complete, unique European system when the coordination of monetary policies has improved sufficiently.

<sup>1</sup> However, shifts from one monetary system to the EPC system or the reverse could modify the "European" monetary multiplier.

<sup>2</sup> However, in the case where the European Central Bank would be entitled to change its intervention rate in terms of any European national currencies, each central bank would keep its own powers for monetary policy, but there would be a "common" decision as regards the consequences of the national policies.

- It could happen that the best limit to an excessively expansionary policy by one national central bank would be that the corresponding currency would be less and less desired so that the EPC would take the place of the national currency. The corresponding national central bank would thus be deprived of its possibility of having any monetary policy and of obtaining any seigniorage. The public would then obtain the EPC by exporting goods and assets.

## Roland Vaubel

The European Community faces a choice between three strategies for monetary unification:

- (1) the so-called "apocalyptic approach," i.e. the immediate and complete replacement of all national EC currencies by a Community currency;
- (2) the Wernerian coordination approach, concentrating political attention either on exchange-rate unification or on monetary-policy harmonization (from an economic point of view the one implies the other and vice versa); and
- (3) the parallel-currency approach, i.e. the creation of a Community currency which circulates side by side with the national EC currencies and may gradually out-compete them.

By what criteria can this choice be made?

**Gradualism and Automaticity.** - The optimum currency unification process is gradual and automatic.

The case for gradualism is both political and economic. From a political point of view, it is necessary to proceed gradually so that nationalist feelings are not provoked by sudden spectacular transfers of competences from national to Community institutions. From an economic point of view, gradualism has the advantage of facilitating adjustment to future developments: gradual changes can be anticipated more easily, misallocation due to disappointed expectations can thus be minimized. The political and the economic arguments for gradualism explain why the customs union of the European Community was not established at once, but why tariff reductions were spread over many years. In a similar way these arguments apply to the case of monetary unification; they imply that the "apocalyptic approach" (1) does not qualify for adoption: the immediate and complete replacement of all national EC currencies by a Community currency seems to be too abrupt a measure, too big a leap (forward), maybe, to ever be taken.

The case for automaticity also rests on both political and economic grounds. From a political point of view, a gradualist approach that is discretionary, i.e. the coordination of monetary and exchange-rate policy (2) based on an infinite series of painful compromises and concessions (all of which are reported in the press), maximizes political friction. The likely result: efforts for monetary unification are repeatedly suspended - recent European experience is a case in point - and the final stage is never reached. Or, under the most optimistic assumptions, the discretionary approach, faced with the notorious time constraint of political decision-makers, will produce a considerable and avoidable delay in the monetary unification

process<sup>1</sup>. The economic case for automaticity is the case for market choice: the users of money have to be free to choose the money that is most useful to them. Money is, of course, not a product like any other. It is not only a marketable good but also an instrument of economic policy. The market's choice of its money gives rise to externalities with regard to monetary and exchange-rate policy. By determining the size and location of currency domains the market determines the frontiers along which a differentiation of monetary policies and hence an exchange-rate policy is possible. If, however, the European Community is a desirable currency area (as is assumed in this statement), the market's choice in favour of a European parallel currency can only produce externalities that are positive.

Attractiveness through "Subsidization." - The parallel-currency approach (3) is the only strategy that can be made to conform both to the principle of gradualism and to the principle of automaticity. But the precondition for its success is that the European Parallel Currency (EPC) is more attractive for private economic agents than the national EC currencies (and, if possible, than the Euro-dollar). How can this condition be met?

A situation in which there is only one currency in the EC, it is true, would be preferred by private economic agents to a situation in which there are nine - they would save transaction costs. But this does not mean that they would prefer a new, tenth currency even if the latter were permitted to circulate side by side with the national EC currencies in all member countries. After all, the more currencies there are, the higher are transaction costs. It is therefore necessary to subsidize the EPC.

Such subsidization is justified on two grounds. The first is that currencies are subject to economies of scale which act as a barrier to entry for any newcomer. Just as production in locations which offer no linkages with complementary industries is often subsidized in the framework of regional policy so as to compensate for the lack of locational economies of scale, so the EPC ought to be subsidized to compensate for its lack of transaction economies of scale. The infant-currency problem is solved and the subsidy becomes redundant on this line of argument, when the EPC transaction domain has attained the size of the largest national EC currency domain(s).

A Purchasing-Power Guarantee. - The case for subsidizing the EPC is even stronger if a subsidy can be given that represents an exemption from an unjustified tax. Such a tax is the inflation tax which the issuer of money imposes on the users of an inflating currency. The issuer of money makes a (monopoly) profit in that he obtains an interest-free loan from the users of his money. If the money keeps its purchasing power, he earns seigniorage which is equal to the real rate of interest on perfectly liquid and riskless assets minus the costs of issuance, replacement and policing against forgery; if the money loses its value, he further imposes on the users of money an inflation tax which in the absence of money illusion, is equal to the difference between the nominal and the real rate of interest, i. e. the rate of inflation. To eliminate the inflation tax on the use of the EPC is to offer its holders a purchasing-power guarantee. Such a purchasing-power guarantee will make the EPC not only an attractive store of value, but also an ideal standard of value. This is because an EPC defined as an indexed (weighted) basket of member currencies<sup>2</sup> will represent a unit of account that eliminates the inflation risk and minimizes the exchange risk.

<sup>1</sup> Apart from those disadvantages which concern the process of monetary unification, there is, of course, the problem that the final state of the coordination process, the exchange-rate union, is abandoned much more easily than a currency union. Between currencies of independent and equal-sized nations such as the main EC member countries, exchange rates can never be assumed to be "irrevocably fixed."

<sup>2</sup> For the calculation of the indexed-basket type of EPC see H. Giersch, "Final Remarks", in: Report of the Groupe de Réflexion, Part II, p. 125.

An EPC of the currency-option type would be a less attractive store of value and an arbitrary standard of value, in particular if one of the smaller EC currencies proved to be the strongest. An EPC serving as a European pivot currency would be even less attractive as a store of value; it might facilitate coordination of national monetary and exchange-rate policies, but since coordination is neither - as I have tried to show - a promising road to monetary union nor a precondition for the parallel-currency approach, this is hardly an important advantage.

To propose an EPC of stable purchasing power is to invite the question of why it is the EPC's value and not (also) the national currencies' value that is to be stabilized, or rather why a problem which proves so difficult in the case of the national EC currencies should be so easy to solve in the case of the parallel currency. The answer is twofold. First of all, it makes a great difference from what position you start. It is much easier to prevent inflation than to get rid of it. This is because to reduce a given rate of inflation is to risk temporary unemployment because inflationary expectations are slow to adjust and hence real wages and the real rate of interest on fixed-interest liabilities rise above their full-employment equilibrium level. This is the reason why many times in history - also in German history - the creation of a new currency has been preferred to a stabilization of the old; this also is the reason why there is a case for linking European currency unification with European currency reform: instead of nine currency reforms there will be only one.

Secondly, it is much easier to regulate the purchasing power of a parallel currency than to regulate the purchasing power of a national currency. While the purchasing power of a national currency depends on how the public react to changes in its supply, and thus can never be kept perfectly stable, the purchasing power of a parallel currency can be stabilized with absolute precision if the European Bank regulates the EPC exchange rate vis-à-vis the (weighted) bundle of national EC currencies directly through currency interventions.

The Parallel-Currency Approach and "Monetary Sovereignty." - In fact, the European Bank should not issue EPC except by way of conversion against national EC currencies<sup>1</sup>. If the EPC were used to finance Community expenditure or if it were issued in the form of discount and other loans or through open market operations, it would add to the total nominal money supply from monetary authorities in the Community. To the extent that the issue of an EPC of stable purchasing power will raise the demand for real money balances such additions to the money supply can be absorbed without a simultaneous decrease in the demand for national currency. However, to the extent that EPC is demanded not in addition to given balances of national currency but as a substitute for them, the EPC cannot add to real money balances; thus, if it were not issued by way of conversion against national EC currencies, inflation would reduce the value of the increased nominal money balances until the original volume of real money balances were reattained. Since an EPC of constant purchasing power cannot be subject to inflation by definition, the adjustment would have to be brought about through inflation (and depreciation) of the national currencies - unless, of course, the national central banks supplied correspondingly less national currency than they would have done had no EPC been issued. Only by confining itself to the conversion issuing mechanism can the European Bank prevent the EPC from interfering with national monetary policies and thus minimize the loss of monetary sovereignty which the national central banks have to accept. Not before the EPC accounts for, say, more than half the EC money supply will the time have come to proceed to the final stage in which the European Bank becomes a central bank, i. e. conducts a monetary policy of its own and abandons its practice of guaranteeing the EPC's purchasing power through currency interventions.

<sup>1</sup> To keep the European Bank's balance sheet in balance the national central banks will be obliged to compensate the former for the losses in purchasing power to which its holdings of national EC currency will be subject. The national central banks would thus no longer exact inflation tax on that part of the supply of their national currency which the public has preferred to exchange for EPC.

Since the parallel-currency approach leads to currency unification, it requires for its success the political will for currency unification. It may seem unlikely that this will exist at present, and it may appear uncertain whether and when it will exist in future. What is certain, however, is that the parallel-currency approach is the strategy most likely to get started and the strategy most likely to lead to the final stage of currency unification, for it minimizes political obstacles and it maximizes economic advantages. The case for the parallel-currency approach is therefore not a case for making fools of European politicians, but the case for helping them.



### III. Fiscal Harmonization

Chairman: Willi Albers

Fritz Neumark

The term "fiscal harmonization" has a twofold meaning: in the sense of "harmonization of taxes," it aims if not at the abolition, at the diminution of fiscal obstacles to the economically useful exchange of labour, capital, and goods and services between the member countries of the EC; in a broader sense, it may be understood as the "harmonization of fiscal policy" which for its part makes use of tax measures as an important but not the only instrument to attain its various targets.

I. At the beginning of my comments, I would like to make a few remarks referring to certain possibilities and necessities of tax harmonization proper, likely to arise in the next future.

Looking back to the recommendations of the EEC Fiscal and Financial Committee Report published twelve years ago, one cannot deny that some important progress has been achieved. On the one hand, member states who then still levied cumulative gross turnover taxes have in the meantime substituted for this type of tax, which caused serious distortions of national and international competition, a net value-added tax. On the other hand, France and Italy have contributed to the harmonization of income taxation by replacing the romanic type of analytical or dualistic tax with the unitary or synthetic one, and the recent British tax reform measures have brought about a further advance towards the system which for a long time has prevailed in countries like the Netherlands, the Federal Republic of Germany, and Denmark. However, in spite of these achievements and the fact that today, income tax and net value-added tax, albeit in different proportions, are the two pillars of most European tax systems, there still is much work to be done. Quite rightly, the EC Commission in its proposals of June 1973, relating to net value-added tax points to the necessity of harmonizing the methods of the application of principles agreed upon by the member countries.

This, indeed, is quite generally one of the most important and crucial problems of further fiscal harmonization. It is all very well to say that by now, we have the same type of net value-added tax and - approximately - the same type of income taxation within the Common Market. But apart from rather large differences in the level of tax rates and the tax base, it is differences in the methods of assessment, the techniques of levying and control, the spirit of tax administrators as well as of tax payers etc. which determine the actual divergencies between the national tax systems. Some of these divergencies are compatible with a common European fiscal and economic order whereas others are not. For this reason, the very minimum necessary for a more than formal tax harmonization is the setting up of a supranational body of experts in tax administration regularly exchanging their views and national experiences.

A second point of general importance relates to the preparation of statistical and non-statistical fiscal data for all member countries: on the one hand, these data should be understandable not only to the handful of experts in Brussels but also to higher civil servants in the national ministries of finance; on the other hand, for the purposes of comparison, they should avoid any kind of misconception resulting from the effort to include in the same tax category national duties which are similar in some respects, but basically different. E. g., the essential differences between the West German "Gewerbsteuer" and the French "taxe sur les salaires" are concealed when both are classified as "indirect taxes." Further, the classification of certain "droits d'enregistrement" as taxes on capital is - to say the least - somewhat exaggerated. Provided I have not overlooked relevant official documents, it seems to me, then, that an ad hoc committee should be charged with a new approach to a thorough theoretical and empirical inquiry into the time-honoured problem of international tax comparisons.

My third comment refers to income taxation, but partly, it is of a more or less general importance. I think that now, since the basic problems of a harmonized net value-added tax have become notorious and since many of them are apparently soluble within a not too distant future, the main efforts of tax harmonization should be concentrated not - as has been the case during the last few years - on excise duties of relatively minor fiscal and economic relevance but on the individual and corporation income taxes. For in spite of the predilection which our French and Italian friends still harbour for so-called indirect taxes (including stamp duties), shared at least with respect to tea by the British and to salt and beer by the Germans, there is no doubt that a growing economy of the Western type will have to rely to an ever increasing degree on income taxation. As a matter of fact, in Western Europe (except for Italy), income and corporation taxes provide at present between 25 and more than 40 percent of tax revenue of all levels of government. But they do not only have great budgetary importance; they are also instruments of economic and social policies: to be more explicit, they can serve employment, stabilization, growth, and redistributive purposes. Even though a certain agreement among member states has been attained with respect to the individual income tax régime as such and an approach to uniformity of corporation tax systems seems to be under way, so far next to nothing has been achieved in a field which appears to be the most important one from the harmonization angle. What I have in view is less the global use of income tax for stabilization policy than the host of special provisions regarding exemptions, allowances, tax credits, special tax rates, etc., in short, what Stanley S. Surrey in his latest book on "Pathways to Tax Reform"<sup>1</sup> calls "Tax Expenditures." By that, he understands those exemptions, allowances etc. which are not inherent in an income tax system as such. Although some of those special provisions are found in all income tax laws (albeit with quantitative differences), many or even most of them are not. Quite apart from severe social injustice brought about by these deviations from the principles of generality and uniformity of taxation, they hamper free competition in two respects: on the one hand, at the national level, they give rise to a misallocation of resources; on the other hand, in international trade, they cause a distortion of market conditions which accentuate the consequences of national dirigism. At present, the exact "value" of all these tax provisions in terms of costs or net income is in many cases not known even to experts. But I believe that a rational tax harmonization policy requires an assessment of that "value." To the extent that maintenance of fiscal favours is thought indispensable, these favours should be granted in the form of explicit budgetary expenditures rather than of disguised subsidies. In fact, it may be assumed that normal expenditures fixed in monetary terms considered as maxima are much more carefully examined and evaluated by parliament than favours of a largely unknown magnitude granted through the tax system. In any event, a supranational agreement on all sorts of legal loopholes seems indicated. As already hinted at, such an agreement must by no means be restricted to income taxation, though for evident reasons, it is there that it would be of the largest importance for bringing about fiscal justice and fair competition in a common market.

In this context, attention has to be paid also to the extremely different national methods of household taxation. Even under the (unrealistic) assumption of equal tax rates, the coexistence of such disparate systems as the French "family quotient" on the one hand, the still widespread personal allowances (as e.g. applied in the United Kingdom) and the West German system with its mixture of unlimited splitting of incomes of spouses and tax credits for children on the other hand is a serious hindrance to an approximation of real tax burdens and at the same time a violation of the principle of tax transparency, so important for fiscal harmonization in a common market.

A fourth set of problems concerns the integration of the corporation tax with income tax. It is evident that the harmonization of the corporation tax is even more important for a smooth functioning of a common market than that of the individual income tax. Now theoretically,

<sup>1</sup> S. S. Surrey, *Tax Reform, The Concept of Tax Expenditures*, Cambridge, Mass., 1973.

the solution recommended by the Canadian Carter Report appears to be optimal. But a realistic observer cannot but doubt that in the foreseeable future, the enactment of those recommendations will be possible. That is why I believe that a second best solution should be considered. As such, the so-called imputation system seems in principle to be appropriate. However, the partial solution adopted e.g. in France, utilizing the so-called "avoir fiscal," is rather a hybrid measure. The new British system as introduced by the Finance Act, 1972, seems to me superior. To a large extent, it resembles that envisaged by the third tax reform bill of the Federal Republic of Germany.

I would like to add the following remark: harmonization in the field of individual and corporate income taxation is of such paramount importance for the reduction of purely tax-induced movements of labour and capital between the member countries that it should be furthered as soon and as much as possible. However, one should never forget that here as elsewhere, harmonization does not mean complete uniformity. Tax rates differences - if not too large - do not necessarily play a decisive rôle in this context, whereas large differentials of fiscal favours do. The examples of the United States and particularly Switzerland seem to show that even important differences in local and/or regional global tax burdens represent no serious obstacle to a common market. But on the one hand, although the postwar evolution in the United States indicates a rather strong trend towards a relative increase in non-federal income and corporation taxes, the revenue stemming from federal taxes of this kind still is about six times as large as that of corresponding duties levied by states and local communities. On the other hand, recent developments in Switzerland clearly demonstrate the desirability of a harmonization at least of the base and the rates structure of taxes on income and net worth; although so far, the attempts to attain this objective have failed, they will strengthen the more, the higher the absolute and relative burden of income taxation, and the same holds true for the EC.

There is further the much disputed question of current net wealth taxation. Ten years ago, the Fiscal and Financial Committee of the EEC Commission recommended - though with certain qualifications - the levy of such a tax in all member countries. Since that time, nothing has been achieved in this field, except that the new UK Government has announced that it will introduce a net wealth tax in the autumn 1974 budget. The Netherlands, the Federal Republic of Germany, and Luxemburg impose a wealth tax, while in France and Italy, that tax is considered too difficult to administer. In this context, I would like to mention the distinction recently made by Sandhurst<sup>1</sup> between a substitutive and an additional wealth tax. This distinction is particularly important for the present British tax system. By a substitutive wealth tax, Sandhurst means one substituting for the investment surcharge in income taxation and/or permitting a general decrease in income tax rates, whereas an additional wealth would not necessarily imply any modification of the income tax. I do think that, for several reasons, a harmonization of income as well as wealth taxes is desirable in principle but that a current wealth tax should form a complement to rather than a partial substitute for income taxation.

My last point refers to the problem of indexation of taxes. It is not altogether new, but parallel to the worldwide increase in inflation rates, it becomes more and more urgent. In several member countries of the EC, such as France and the Netherlands, there already exist legal provisions destined to mitigate the repercussions of a permanent and heavy inflationary process at least on some taxes. In others, e.g. the Federal Republic of Germany, one still clings to a monetary nominalism which each year or even each month becomes more unrealistic and unjust. This is especially true with respect to income taxation, and here again - at least in countries like France, the United Kingdom, and the Federal Republic of Germany - above all in regard to the taxation of wages and salaries. However, inflation makes itself felt also in the field of net wealth and inheritance taxation, the more so, the steeper the direct and/or indirect progressivity of these duties.

<sup>1</sup> C. T. Sandhurst, "Prospects for Wealth Taxes", *National Westminster Bank, Quarterly Review*, London, November 1973, pp. 27-40.

This practice is often defended by governments and even central banks on the argument that taxation of nominal profits and wages (and capital, for that matter) gives rise to additional revenue which for its part, could be used to combat inflation. Evidently, this argument holds true, if at all, only in case the additional tax yield is sterilized with the Central Bank; aside from that, one must emphasize the fact that the effects of inflation upon tax burdens bring about a hidden, or veiled, progressivity which adds to that originally envisaged by the legislator. Consequently, in many cases, the level of tax payments becomes unduly high and above all, because of the irregularity of empirical tax rate burdens, the personal distribution of disposable income changes in ways not exactly foreseeable and probably not intended.

All these distortions are objectionable not only on equity grounds because they violate the postulate of taxation according to individual ability-to-pay - in fact, they cause an undesired weakening of relative progressivity, and upon incomes just below and at the top rate, inflation does not have disturbing repercussions at all - but also because they impair fair trade among the member countries. This is particularly true if and when there are rather large differences in national inflation rates and if the methods - if any - used by the various countries to mitigate the inflationary effects on tax burdens differ from each other, as at present is the case. For this reason, it seems to me necessary not only that each member state for its own sake adopt a rational and just method of tax indexation but also that a supranational committee study thoroughly the theoretical and technical implications of different indexation methods and attempt to achieve the largest possible harmonization of these methods.

II. In the second part of my comments, I would like to say a very few words on possibilities and necessities with respect to the harmonization of fiscal policy.

First of all, let me stress my opinion that whereas a certain harmonization of important taxes is realizable before a unification of monetary systems and monetary policy, such a unification is probably a prerequisite to an efficient supranational fiscal policy. Disregarding in the following this aspect, it seems to me that any intra-Community fiscal policy is dependent on an agreement upon the definition and hierarchy of fundamental policy targets, such as high employment, monetary stability, economic growth, and redistribution of income and wealth. In order to be able to operate efficiently, such an agreement has to be flexible and to have regard for particular national needs and goals, but at the same time, to consider them in the spirit of the Community.

Such an agreement, then, cannot be permanently fixed in its details. But once a temporary accord has been reached, member countries must come to an understanding on the main instruments which may be effective in the efforts towards economic-monetary stability. I believe that for a long time to come, the Community budget will not be big enough to exercise by itself sufficient influence in this direction, so that fiscal policies - if any - of the member countries will continue to play the most important rôle.

Recently, an almost complete agreement seems to have been reached in that tax changes rather than variations in public expenditures should be used to maintain or restore monetary stability. But compared with such general accord, one observes essential differences of opinions as to which taxes should be managed counter-cyclically and within which legal framework adequate fiscal measures could, and should, be taken. In sharp contrast to ideas mainly to be found in countries heavily relying on indirect taxes and according to which the value-added tax (VAT) is the most efficient and manageable instrument of fiscal stabilization policy, I hold very strongly that a general consumption tax like the VAT should be used, if at all, as a fiscal stabilization instrument only to a modest extent. The main reason is that on the one hand, in the presently most important case of inflationary pressure, a rise in VAT rates will add, at least temporarily, to a further upsurge of prices and thus cause a strengthening of inflation-consciousness of the public. On the other hand, because of the imperfection of markets, a decrease in VAT rates during a recession will not lead to a correspondent lowering of prices.

Of course, whatever the tax be whose modifications are used as a weapon to combat disturbances of economic equilibrium, anticyclical tax variations serve their objective only if and when they are accompanied by complementary measures on the expenditure and/or credit side. From this aspect, then, there is no difference between VAT and income tax. However, I think that the latter is much more appropriate for stabilization purposes, particularly if its scope and yield are larger than those of the VAT.

Nevertheless, the stabilizing effectiveness of income and corporation tax variations depends on several factors whose consideration has been partly neglected in recent discussions. First of all, the variations have to be of such a magnitude that the psychological repercussions on tax payers are substantial. Secondly, though intended for short-run effects only, the relevant tax measures should be taken without provision of a legal time limit (this in contrast to variations of duties on durable or non-durable consumer goods). Thirdly, the rise or decrease in income and/or corporation taxes must in terms of revenue differentials be large relative to GNP. Fourthly, the variation of tax rates has to be accompanied by a corresponding enlargement or restriction of those special provisions concerning allowances, tax credits etc. which after consideration of the above-mentioned recommendations are still maintained. Fifthly, the time period between accrual of income and the actual date of payment of tax must be as short as possible. One may add that without granting the executive branch of government some kind of stand-by authorization to take within precise limits certain counter-cyclical tax measures, fiscal stabilization policy is doomed to fail because of too great time-lags. Admittedly, it will be extremely difficult to arrive in this way at a supranational harmonization of fiscal policy, because i. a. not only the structure and implementation of methods of taxation but also deeply rooted socio-political institutions and habits differ considerably from country to country. Nevertheless, without a certain intra-Community assimilation of these factors to each other, an effective harmonization of fiscal instruments and consequently, of fiscal policy appears unthinkable.

In passing, I would like to remark that harmonized fiscal policy must not be understood as including regional and/or sectoral policies. Important as these are for the development of the EC, I believe it preferable that measures aiming at a better intra-Community distribution of factors of production be comprised in a special category of public activities. Of course, within the framework of these activities, government will also make use of measures of taxation but will integrate them in a much wider arsenal of weapons - in correspondence with the basic concept of regional policy which is rather different from that of fiscal policy proper.

Of course, basically, fiscal policy can be most efficiently implemented by the central authority, i. e., in the case of the EC, by the Community as such. However, as convincingly demonstrated by the Group of Rome Report, the success of centralized fiscal policy largely depends upon the absolute and relative size of the Community's budget. In view of recent political developments, although not exclusively because of them, I share in this respect the doubts of the Werner Committee rather than the relative optimism of the Group of Rome Report. On the other hand, it seems to me that a certain harmonization of public expenditures is not altogether unrealizable, provided one does not cling to the modern idea recently advanced that industries and individuals living in different countries or regions should enjoy the same standards of public services. Instead, one could - and probably should - confine oneself to postulating similar standards, albeit with a proviso to guarantee an inter-Community minimum standard.

I feel also some hesitation in regard to the Giersch proposal to introduce a tax on increases in land values, which eventually, should be converted into a Community tax. Doubtless, such a levy would be highly desirable not only as an incentive to decentralization (in other words, as an instrument of regional policies), but also for reasons of fiscal justice and as a source of central revenue. But after having participated for more than a year in discussions of such a tax in the Council of Academic Advisers to the Federal Ministry of Finance, I no longer

believe that a solution that would be just, administratively applicable and at the same time produce a sizeable revenue can be found on the national plane, let alone on the supranational level.

My final remark concerns the old but recently revived discussion on "rules versus authority." Although theoretically, much is to be said for more or less automatic rules, I think it almost impossible to construct a system of indicators whose movements would oblige government and parliament to take the "right" fiscal measures at the "right" moments in the "right" dosages. This statement - which does not necessarily refer also to monetary policy - is already recognized to be true of measures on the national plane. In the framework of a supranational community, the search for any kind of workable automatic devices for common fiscal policy is only utopian. Instead, one should try to harmonize existing national instruments of a discretionary, though not altogether haphazard, fiscal policy. Even then, the decisive problem will prove to be not so much the availability of instruments as an agreement on the objectives, time, and degree of their use.

## Carl S. Shoup

I. Taxes to Be Used by the Community. - If the European Community's budget is to be expanded so that a major tax will be needed at the Community level, the question will arise, what type of tax should be chosen?

One proposal, made by Dosser<sup>1</sup>, is to transfer the corporation income tax from the national governments to the Community. This proposal has many attractions, including the elimination of arguments as to where within the Community a multinational corporation's profit arises. Business firms might also gain some assurance against frequent change in the structure of the corporation income tax and in its integration with the personal income tax (compare the experience of the British corporations over the past ten or fifteen years). Moreover, competition among Community countries for industry through tax incentive measures would be eliminated. Finally, revenue from the corporate income tax typically fluctuates widely with the business cycle, and such fluctuations can be coordinated with decisions regarding the size of the money stock, if there is true monetary unification.

There are, however, certain drawbacks. Community control of the corporate income tax would leave the national governments less free than they now are to differ in their methods of integrating the corporate tax with the personal income tax. They would presumably be restricted to a choice between the imputation method (credit or partial credit, to individual shareholders) and the so-called classical method (no allowance at all for the corporate tax). This objection may not be serious, especially since there seems to be a general trend toward the imputation method.

Another difficulty, possibly a minor one, is that the Community might appear as a formidable competitor with developing countries for capital generated within the Community, in view of what would now be Community-wide corporate tax incentives. On the other hand, if these incentives were reduced from their present average levels, as they might well be, the result would be beneficial for developing countries.

<sup>1</sup> D. Dosser, "Tax Harmonization in the European Community", Three Banks Review, No. 98, Manchester, June 1973, pp. 49 sqq.

It might take a great deal of persuasion to induce the Community national governments to give up their own particular sets of existing tax incentives. Would the United Kingdom, for example, be willing to relinquish the powerful incentive it now offers through 100 percent accelerated depreciation for machinery, equipment, and the like?

A much more important issue is whether such a transfer of the corporate tax to the Community would or would not be accompanied by increased taxation at the national level in order to make up for the revenue loss to national governments. This of course depends in part on whether the Community would finance, with the corporate tax, entirely new functions, especially redistributive functions.

Transfer of the corporate income tax to the Community level would involve a massive restructuring of that tax (for uniformity), not only with respect to tax incentives, as noted above, but also with respect to rules for valuing inventories, recognizing capital gains and losses, distinguishing between business expenses and personal expenses (for example, entertainment expenses) and other definitional problems. The transitional phase would be a difficult one technically. Even the drafting of the new Community-wide corporate tax law would probably take a year or two.

The Community would be committed to a tax that might be better eliminated at some later date, if satisfactory techniques could be found for taxing shareholders currently on their shares of annual profits, or for taxing capital gains, and allowing capital losses, as they accrue. There would remain, of course, the problem of how to treat profits accruing to shareholders residing outside the Community.

The treatment of foreign-source income (in this context, the treatment of income arising outside the Community) would be one of the more difficult technical and even political problems to settle under a Community-wide corporate tax. Some of the Community member countries exempt foreign-source income of domestic corporations; others tax such income but ordinarily only when it is repatriated. One proposal is to tax foreign-source income as it accrues, in place of waiting until it is repatriated. This would be strenuously opposed by developing countries, because it would make quite ineffectual the tax incentives they grant to attract capital, while at the same time, the Community would be offering Community-wide tax incentives to capital invested within the Community area.

The individual income tax is apparently not being considered as a candidate for Community use. Such a measure would, however, enhance the individual's awareness of the Community's functions and importance and might easily inspire more interest than resentment. National individual income taxes could exist along with a Community-wide individual income tax (compare, for example, the United States).

II. National Tax Systems under a Monetary Union. - What tax measures would the national governments take if they found they had to make up the revenue lost by relinquishing the corporate income tax?

If the replacement taxation at the Community level were to be additional points on the value-added tax (VAT), the net result would be that the Community's expenditures would be financed not truly by the corporate income tax, but by heavier taxation of consumers. Insofar as the Community's expenditures were designed to distribute income to poorer regions, there would exist the partial paradox of taxing the poor in rich areas to help the poor in poor areas.

If the Community is to utilize its own tax system as a partial regulator, along with monetary policy, the VAT may well prove better on this score than the corporate income tax. The usual assumption, however, seems to be that the Community will rely entirely, or at least largely, on monetary policy, leaving fiscal policy wholly or largely to the national governments.

Insofar as fiscal policy remains with the national governments, while monetary policy is determined at the Community level, the question arises, as to how any one member state can effectively move, through fiscal policy, in a direction opposite to that which the Community as a whole is following. Fiscal policy, after all, does not mean merely tax reduction or tax increase. It also includes the methods used to finance the deficit created by tax reduction or to sterilize the added revenue gained by an increase in taxes designed to check a boom. In the face of a hypothetical Community policy of monetary restraint, a tax-reducing national government would have to meet the resulting shortfall in revenue by borrowing already existing money, not newly created money. Someone else would thereupon be crowded out of the money market, with depressive effects, either in the country in question (undesired by that country) or elsewhere in the Community (a desired effect, presumably).

In any event, it is widely acknowledged that the increased openness of each of the national economies will make effective fiscal policy measures at the national level more difficult to achieve.

Stimulation of a depressed area within a member state by means of tax incentives, tax reduction, etc., offered by that state, might prove less ineffective under monetary union, than would a fiscal policy directed to that country's entire economy. Still, monetary union would almost surely hinder, not help, even in this case. There are, furthermore, certain technical problems that might be overlooked.

If the rate of the VAT is to be lowered in a particular region in order to stimulate economic activity there, the tax-from-tax method may have to be replaced by the simple subtraction method. It is well known that under the tax credit method a low rate at an early stage of production is completely negated by a higher rate at the final stage. Thus, even a VAT rate of zero for firms located in the depressed area would not enable them to sell intermediate products at any price lower than that they would have to charge under the standard VAT rate, if the final product is to be sold elsewhere.

This point brings up, in turn, the question of whether the tax credit method can be continued when the members of the Community move the VAT from its present destination basis to the origin basis. To be sure, this problem does not exist if all the countries' VAT rates are the same. If, however, the importing country levies its VAT at a higher rate than does the exporting country, the value-added in the exporting country becomes (under the tax-credit method) taxable at the high rate of the importing country, upon the first sale within the importing country. In effect, the destination basis still rules. Perhaps some clarification of this problem can be gained by studying the apparently successful technique employed by the West German Government when, in connection with one of its revaluations of the D-mark, it subtracted some points on its hitherto fully taxed imports without changing the rate applicable to domestic sales, yet, as I understand it, made that import tax reduction effective through to the consumer.



## Dieter Biehl

1. A general analysis of the European integration process since the early fifties seems to support the following two simplifying conclusions. First, despite the attempts to bring together as many European countries as possible, integration seems to have been successful in the past only for a small group of continental countries and only for specific partial unions as e. g. the European Coal and Steel Community and the European Economic Community. Second, these specific partial unions seem to have developed successfully mainly in a first phase characterized by some sort of "negative disintegration," i. e. the demolition of existing national protection.

An explanation compatible with both observations may be that European integration has been the more successful, the more it has been oriented towards the freeing of market forces from political constraints and the less national governments have been forced to surrender powerful national instruments for discretionary action to Community bodies not adequately controlled by a European parliament with sufficient competence. The failure of the Werner Plan strategy, for example, seems to be caused by the fact that this strategy intended to reduce national sovereignty in the important fields of exchange-rate policy and monetary policy too much and too fast. But to argue that it is only the exchange-rate union which failed and that to create a sort of budget union in assigning fiscal policy a central role in demand management and in advocating a large common budget will be more successful, may be equally misleading. The failure of the exchange-rate union has become apparent because the Werner Plan strategy started with a locking-of-parities approach. If the whole enterprise had been based instead (or at the same time) on a similar strong attempt to harmonize budgetary policy, I fear this budget union would have failed, too.

2. I do not think that this general evaluation of the relative chances of the budget union or fiscal policy approach is altered much if some of the more detailed arguments for what is called in the Group of Rome Report "another approach to economic and monetary union" (p. 49) are considered.

(1) It is postulated that the central role of fiscal policy in the management of modern economies and the need for coordinating and harmonizing national policies require a large central budget. But the transfer of taxation rights to the Community level to the extent that such a large budget can be financed will presumably conflict to the same degree with existing national conditions and priorities as did the Werner Plan strategy. If one agrees that this interference with national sovereignty has been one of the reasons why the Werner Plan strategy failed, there can be no great hope that the budget union approach will do better under the same circumstances.

Even if one puts aside the question of the "division of labour" and the coordination between monetary and fiscal policy for demand management purposes, it remains to be demonstrated that countries with large central budgets, especially non-federal countries, always have a better fiscal policy record than (federal) countries with smaller central budgets. In any case it cannot be expected that it will be sufficient to create a budget as large as possible in order to have a more efficient demand-management policy. The Report stresses that the simplistic view of the Werner Plan as far as fiscal policy is concerned, should be abandoned because the Werner Plan relied heavily e. g. on a crude concept like the size of the actual budget surplus or deficit as a measure for budgetary effects (p. 51). But, in order to be able to use fiscal policy more efficiently for demand management purposes, it is obviously necessary to dispose of improved measurement concepts for budgetary effects. Two such improved measurement concepts are already available, namely the "konjunkturneutraler Haushalt" (cyclical neutral budget) of the

German Sachverständigenrat<sup>1</sup>, and its extension, the "konjunkturgerechter Haushalt" (cyclical adequate budget)<sup>2</sup>. The results obtained especially with the cyclical adequate budget concept demonstrate that the consolidated budget e.g. in the Federal Republic of Germany has had in the past an expansionary trend and at the same time mostly procyclical effects. This creates some serious doubts as to the efficiency of a stop-and-go anti-cyclical fiscal policy.

(2) Although the authors of the Report feel that the Werner Committee's proposal placed too much emphasis on tax harmonization (p. 56), they use a similar kind of reasoning in order to justify a large common budget, namely that differences in the standard of public services are equivalent to distortions of competition (p. 52). If the existing nation-states would be judged on the basis of this criterion for a "truly" common market, hardly any of them could really be assigned this attribute because of the large differences existing between regions in one and the same country<sup>3</sup>. In addition, as the examples of many centralist, but also some federal, countries show, a large central budget is not necessarily guaranteeing smaller regional imbalances.

(3) In the Group of Rome Report (pp. 53 sq.) it is argued further that a large common budget is necessary to hold together the various regions of a single country and that even in federal countries the central budget tends to assume a growing proportion of total public expenditure. This statement contains what I should like to call a "centralist bias." The idea behind this proposition does not seem to be fully in line with historical evidence: richer countries on the one hand tend to have lower degrees of fiscal centralization<sup>4</sup>, which makes them, I think, better suited to allow for regionally differing preferences as to the optimal mix of private and public goods; on the other hand, there seems to be no clear statistical trend as to the relative importance of central budgets. It may be true that from a long-term historical point of view central budgets have grown in relative importance<sup>5</sup>. But if so, one of the main reasons for this seems to be that especially defence and war related expenditure increased their shares in central budgets. Statistical figures

<sup>1</sup> See, especially, Sachverständigenrat zur Begutachtung der gesamtwirtschaftlichen Entwicklung, Jahresgutachten 1970/71: Konjunktur im Umbruch - Risiken und Chancen, Stuttgart, Mainz, 1970, pp. 91 sqq.

<sup>2</sup> D. Biehl et al., "Measuring the Demand Effects of Fiscal Policy", in: H. Giersch (Ed.), Fiscal Policy and Demand Management, Tübingen, 1973, pp. 223 sqq.

<sup>3</sup> See e.g. the figures assembled in the Tables 29\* and 30\* for the six "old" EC Countries in D. Biehl, E. Hußmann, S. Schnyder, "Zur regionalen Einkommensverteilung in der Europäischen Wirtschaftsgemeinschaft", Die Weltwirtschaft, Tübingen, 1972, H. 1, pp. 63\* sqq. - In addition, it can be shown that regional differences in infrastructure equipment e.g. in Germany are relatively large and that they can explain a good part of per capita income disparities. (Cf., idem, "Bestimmungsgründe des regionalen Entwicklungspotentials - Infrastruktur, Wirtschaftsstruktur und Agglomeration", ibid., pp. 107 sqq.)

<sup>4</sup> Cf., W. E. Oates, Fiscal Federalism, New York, 1972, p. 208. This purely statistical relationship gives rise to the question of whether countries are richer because they have a lower degree of fiscal centralization or whether they are rich enough to support a less centralized political system.

<sup>5</sup> A whole theory, developed out of the so-called Wagner's law of expanding public activities, has been put forward by Peacock and Wiseman in order to illustrate this phenomenon. According to the "displacement hypothesis" of both authors, it is only in the context of wars and related serious social disturbances that the overall share of public expenditure in GNP is "displaced" to a higher level, which can then remain constant (or even go down) for a longer period. (Cf., A. T. Peacock, J. Wiseman, The Growth of Public Expenditures in the United Kingdom, Princeton, N.J., 1961.) This tendency should primarily be expected to be reflected in a growing share of the central budget.

to prove this are difficult to obtain. If one uses data provided by the International Bank for Reconstruction and Development, it can be shown that the share of central government in civilian expenditure at least between 1950 or 1955 and 1968 decreased, in some cases even considerably, for about 13 developed countries. As to the overall share of central budgets including defence, out of 31 countries for which comparable data exist, only 11 (mostly developing countries) show increasing shares, whereas 17 have marked decreasing shares<sup>1</sup>.

3. My next remark deals with the emphasis the Group of Rome Report still puts on the problem of harmonization of indirect taxes. It is explained that the general adoption of a value-added tax is not enough as long as exemptions and rate reductions for specific products and services vary from country to country; it is argued implicitly that only if the value-added tax becomes a "truly general tax," could border controls and compensatory tax measures be abolished (p. 55). This is the well known argument from the country of destination approach to the taxation of international trade. But this approach, first, overlooks a special feature of the type of value-added tax (VAT) already applied in most member countries and, second, is restricted in its validity because of the partial character of that approach.

The special feature of the VAT relevant here is the fact that this tax, due to its built-in deductibility of tax amounts paid on previous stages of turnover (the so-called catching-up effect), always secures that the tax charge at the consumer stage is equal to the tax rate applicable at that last stage. The "catching-up" effect of the VAT, therefore, equalizes different tax rates levied e. g. in the export and import countries to the effect that the consumer is charged the tax rate of the country of destination. Only if the relative tax rate differences exceed the relation between the consumer price and the import price will the catching-up effect be insufficient. But this presupposes relatively large tax rate differences. This means that VAT quasi-automatically realises a taxation as if the country of destination principle had been applied. It is also possible therefore to abolish the border adjustment measures at a stage where tax rate differences still exist.

The partial character of the country of destination approach lies in the fact that exempting exports and taxing imports restricts these border adjustment measures to internationally traded goods so that other non-goods transactions are not affected. The exchange-rate equivalent of these measures which is equal to the weighted average of these measures in relation to all international transactions, is, therefore, smaller than the specific effects of these measures on traded goods. This means that the implicit rate of exchange for goods is different from the rate of exchange for e. g. some forms of labour, capital, and income transfers.

A more detailed analysis shows that the possible number of distorted international transactions is higher for the country of destination approach than if the country of origin or what I called "the common market principle" is applied<sup>2</sup>.

4. If I criticize some arguments for a large community budget for being based on a "centralist preference," my own position may be characterized as federalistically biased. But I do not think this is a possible case for arbitrary value judgements, because the federalist approach to European integration is in my opinion for the foreseeable future the only politically feasible approach. Trying to realize too high a degree of centralization - and especially of governmental-bureaucratic centralization - may endanger even the indisputable advantages of the state of integration already reached.

There is no conflict between this federalist approach and the proposition to abandon the existing system of "funds" on the Community level and to integrate them into one single

<sup>1</sup> IBRD, World Tables, Washington, D. C., January 1971, Table 6. - See also, Oates, op. cit., p. 232.

<sup>2</sup> Cf., D. Biehl, *Ausfuhrland-Prinzip, Einfuhrland-Prinzip und Gemeinsamer-Markt-Prinzip, Ein Beitrag zur Theorie der Steuerharmonisierung*, Köln 1969, esp. Übersicht 12, pp. 352 sq.; Übersicht 14, pp. 382 sq.

European budget, as suggested by the Group of Rome Report (p. 53), subject to the control of a competent European Parliament. Although the funds system now in existence has really interesting similarities with the historical development of the central budget in a federal country like Germany during the nineteenth century, one could certainly claim that also in the budgetary field there has been some progress during the last hundred years and one should profit from such experience. But this proposition should be combined with the proposal to strengthen the European Parliament. Although government officials like to stress the well-known phrase that parliaments today are no longer the "brake," but the "motor" of public expenditure increase, they themselves cannot present a much better record as far as the evolution of the different Community funds is concerned, which is almost completely determined by government and administration decisions.

5. I do not think that these comments on the Group of Rome Report invalidate the central thesis of the chapter on fiscal and budgetary integration either, namely that it is the organic, political process, facilitated by appropriate decision making institutions, rather than any blueprints or prefabricated schemes which could make the Community ripe for political union proper (p. 58).

## IV. The Scope of a Common Regional Policy

Chairman: Dieter Biehl

Bela Balassa

In discussing regional policy, I will speak first about facts, then about policies, and finally about policy recommendations for the future. I would like to emphasize at the outset that I am in general agreement with the analysis and recommendations contained in the Report of the Group of Rome. Following time-honoured custom, however, I will concentrate on points of disagreement rather than agreement.

First of all, the facts. The Report states: "Studies suggest that in the 1960s there was a narrowing of the spread in economic performances between regions in the Community" (p. 66). In this connection, reference is made to a very interesting article by Biehl and others<sup>1</sup> in "Die Weltwirtschaft." But, if one looked at this article somewhat more closely, one might change the optimistic conclusion that regional disparities have narrowed and regional policy has worked in the EEC.

Considering income disparities among regions for the entire Community, it would indeed appear that the dispersion of per capita incomes has declined by nearly one-fourth. But if this result is separated into its two components - changes in the dispersion of incomes between countries and changes in the dispersion of regional incomes within each country - one finds that the entire decline has been due to the narrowing of differentials between countries. Now, one can hardly say that regional policy explains the decline in income differentials between countries. Rather, as intracountry regional income differences have failed to decline, one can conclude that regional policy has not been effective.

This conclusion may be objected to on the grounds that in Italy, the country with the largest interregional disparities, the dispersion measure does show a decline in income differences. However, the question remains: What is the appropriate criterion? Is it the dispersion of incomes or is one interested rather in what is happening to the poorest regions? If the latter criterion is adopted, the conclusion reached in my paper published in the "Weltwirtschaftliches Archiv"<sup>2</sup> applies, because the relative position of the south of Italy - the poorest region - has deteriorated compared to other regions. Thus, apparently, the decline in the dispersion of incomes is explained largely by the decrease in disparities between the high-income and the medium-income regions in Italy, while the south shows a slight loss compared to average incomes.

But why these results? Why was regional policy not more effective in the Common Market? There are several possible explanations. One is that the measures used have not been the appropriate ones. Among the member countries, France had used negative measures to discourage investments in Paris, consisting largely of physical controls, which did not seem to have worked very well. The expansion was moving towards the areas surrounding the capital, and in Paris itself we observe a locking-in of the industrial structure. New equipment was put into old buildings since it is new construction that was controlled. Further, special interests were created, for existing firms enjoy scarcity rents from the maintenance of the status quo. Finally, as the granting of building permits ensured large profits, incentives were created for bribery. The well-known construction scandals followed, involving people up to near ministerial level.

<sup>1</sup> D. Biehl, E. Hußmann, S. Schnyder, "Zur regionalen Einkommensverteilung in der Europäischen Wirtschaftsgemeinschaft", *Die Weltwirtschaft*, Tübingen, 1972, H. 1, pp. 64 sqq.

<sup>2</sup> B. Balassa, "Regional Policies and the Environment in the European Common Market", *Weltwirtschaftliches Archiv* (Review of World Economics), Bd. 109, Tübingen, 1973, pp. 402 sqq.

Secondly, the positive measures applied mostly subsidized capital investment. Now, economists have long been saying that subsidizing the use of capital will not appropriately serve the objective of increasing employment in a region, because it will lead to the establishment of capital-intensive industries and the use of capital-intensive methods. There is plenty of evidence in support of this proposition. Examples are the Bari area in Italy, Northeast Brazil, and the depressed areas in the United Kingdom.

Thirdly, regional policy became a means of competition among the countries of the Common Market as governments looked for measures they could employ in the place of tariffs that can no longer be used in intra-EEC trade. Thus, so-called regional measures were also used in the most developed central areas. And while two years ago an agreement was reached to put a 20 percent ceiling on regional aid to the central areas, expressed as a proportion of new investment, there is still no ceiling on regional aids outside central regions.

Furthermore, with the EEC countries being at different levels of economic development, national measures may increase inequalities. In Belgium, for example, regions are aided which have a higher income than regions such as Veneto or Umbria in Italy which do not receive assistance.

One may also recall that in Belgium a law was passed to provide regional assistance to 41 out of 43 regions. This gave expression to the policy of "even-handedness," designed to provide the same treatment to the Flemish and to the Walloon regions, irrespective of their income levels. The EEC Commission, after considerable difficulties, succeeded in negotiating the reduction of the number of regions receiving assistance from 43 to 28. Note further that regions are very narrowly defined in Belgium as compared to in France and Italy, thus creating additional disparities in the application of regional policies.

But what is to be done in the future? The Group of Rome Report correctly suggests (pp. 75 sqq.) the need for guidelines on the Community level. In fact, one can put part of the blame on the Community for the lack of coordination. This was noted in the Report (pp. 87 sq.) in regard to the operation of the various funds - regional, social and agricultural funds. Further, as noted in my paper (op. cit., pp. 406 sq.), there was little coordination among the various Directions Générales (D. G. s) responsible for regional policy measures in the EEC Commission, which differed in their views on the direction to take.

The D. G. for Economic and Financial Affairs, emphasized the need to set priorities for regional policy. In turn, the Regional Policy D. G. stressed the importance of the financial-institutional aspects. Finally, the Competition D. G., which had authority over various regional measures, was inclined to case-by-case decision-making.

Thus, it would indeed be desirable to have guidelines not only to coordinate national policies, but also to harmonize policies within the EEC Commission and to coordinate the Commission's actions in regional policy. In this connection, I would like to voice disagreement with the Group of Rome Report as regards the measures to be applied. The Report argues that "financial incentives operate slowly and relatively feebly" (p. 71) and expresses a preference for direct measures, with emphasis on investment projects. To quote the Report (p. 83): "A more immediate task is the mobilization of finance by way of loans or grants for projects in areas judged to be capable of more rapid development."

I have two comments in regard to this. Firstly, loans and grants to new investment may give inducements to the establishment of capital-intensive activities, an aspect I have criticized above. Secondly, there is a danger that the choice of projects might be to a considerable extent politically determined, because it is the result of bargaining among the countries concerned.

To avoid these adverse consequences, I would favour using an automatic mechanism. Such a possibility is referred to in the Report of the Group of Rome as well as in the Report of the Groupe de Réflexion, but it is not followed up. The Groupe de Réflexion (Part I, p. 48)

speaks about varying the value-added tax rate among regions but drops the matter immediately afterwards. There is a sentence also in the Report of the Group of Rome (p. 79) about using taxes and subsidies related to labour costs but without further discussion.

I submit that from the theoretical point of view the most appropriate measure would indeed be a tax on, or subsidy to, labour. If one assumes that capital is mobile - and capital is rather mobile within the Common Market - and that labour is the only immobile factor, a tax-subsidy scheme on labour is equivalent to a devaluation-cum-transfer. This is because the subsidy to labour not only reduces costs vis-à-vis the richer areas as would a devaluation, but also compensates for the terms-of-trade loss that would result from devaluation, for the cost of the subsidy is borne by the richer areas.

A tax-subsidy scheme on labour could be implemented by varying the social security tax among regions; the tax rate would be higher in the high-income, and lower in the low-income, regions. Thus, the scheme is "symmetrical" in encouraging activities in low-income, and discouraging them in congested high-income, regions. At the same time, the whole scheme can break even on the Community level if tax rates are appropriately set.

The proposed scheme could also alleviate regional imbalances that would result once monetary integration is accomplished. Thus, the usual objection about monetary integration, that it aggravates the problems of low-income regions because of their inability to devalue, would be obviated. And, while the Commission is opposed to the scheme on the grounds that it would provide a permanent subsidy to the poor regions, there is no reason to assume that the tax and subsidy rates would have to be set for ever; they could be changed just like exchange rates. At the same time, one could take care of problems of gray areas, which are in between depressed and congested areas, by appropriately setting tax/subsidy rates.

To conclude, I would favour the introduction of a tax-subsidy scheme on labour because of its automaticity and because it benefits employment rather than capital in the depressed regions. Nevertheless, the scheme could be complemented by other measures, such as investment in infrastructure and the development of growth poles. In regard to the latter, however, care would need to be exercised to avoid dispersing efforts, given the economies of scale involved.

## Claus Noé

I shall begin with a very simple question: who can tell with sufficient political authority a German worker in Hamburg that he and his colleagues must transfer a fortnight's earnings to Italy, in order to help raise the standard of living of their Italian fellow workers who may work as much as they do in Hamburg, but pay much less tax. Another question: who is competent enough in this country and in the European Community to tell other workers in Germany that they have to transfer a similar amount to Great Britain to pay premiums for structural immobility in the north of that country, knowing that wages in economically weaker regions of Germany are not subsidized. These questions may indicate the nature of the political question in the Federal Republic of Germany and in the European Community.

I should now like to consider the regional policy proposals of the EC Commission. As everybody knows, there has been a long debate in the Council of Ministers, and although some models have been elaborated, there is, economically speaking, still a lack of theoretic-

cal and practical knowledge in regional policy. National strategies differ considerably; their theory of regional policy is not very well-founded.

So what should or has to be the first step in this field? Years ago the Commission - von der Groeben was responsible at that time - made a pertinent proposal on regional policy - and even this was clear-cut compared with what we got from the same Commission six months ago. An attempt was then made along the guidelines of von der Groeben to quantify the problems in economic terms in order to tell people what the goals should be. The most recent proposal of the Commission includes the following two problems:

- As regional policy is important, we need money for it. As it is very important, we need much money for it. And the appropriate amount will be 500 million units of account in the first year, say 50 percent on top of that in the second and another 50 percent in the third.
- What do they want this money for, what are the goals, the targets, and what investments should be made? There is no clear answer to these questions. The major question in regional policy is what is going to happen in the regions concerned: everything can be regional policy, whether you are constructing a motorway in the south of Italy, a water supply system in Naples, or schools in Northern Ireland, etc.

Let me add some further questions:

- What should the measures be like, should we finance capital- or labour-intensive projects? Should we pay premiums just to make people stay where they are? Or should there be any closely defined strategy at all? Again, there is no clear answer to these questions.
- A possible solution might be the use of regional policy as an instrument to influence the national budgets, by providing some complementary finance from the Community budget. This idea has only been taken into account insofar as, where the Community pays, the respective member country has to pay, too. But if the Community is ready to pay a certain amount to a certain country for a certain project, there is nothing to ensure that the country itself uses this money for regional policy purposes only. Regional policy money from the Community may be used as substitute for the regional funds of a national budget. The effect would be: no increase in regional funds in member countries but monetary transfer and the same "old rotten strategies."
- Some time ago the Council of Ministers decided that Article 92 should be applicable so as to avoid major differences in strategies. The Commission did not follow up this suggestion.
- The proposal of the Commission does, however, contain development plans for the regions which are eligible for aid. These development plans are a precondition for the granting of aid, but not before 1976 and, moreover, almost nothing is said about the quality and content of these plans. So, if somebody presents a plan in 1976 for a certain region for which he has already received money, the Community fund is likely to pay again.
- In the end everybody - even including the Commission - can see that it would not have been reasonable to make the Council of Ministers take a decision on the fund and that it would have been rather more appropriate to inform it about the fact that its decision would mean the setting up of two committees of civil servants within the framework of the Commission to write down the regional policy strategies in Europe after all the political decisions have been taken.

So the only possible reaction for the West German Government to the regional policy proposals of the Commission was to say no for the time being.



I can only describe the Commission's proposal in German as the "Lust am Fonds." As has already been said, the Commission was mainly dealing with a regional fund, not regional policy - it was mainly a question of money. An attempt had been made to establish the transfer of budgetary funds within the Community and this was called "regional policy." So I would say it is not worth discussing this Commission paper any longer. What we need is a clear-cut regional strategy in the economic field - at least to be able to discuss targets and instruments and to be able to decide what is a necessity for European development and what is mere "Lust am Fonds."

### Sebastian Schnyder

1. Regional analysis normally begins with a description of drastic regional disparities. A measure often used is the difference in income per head. As can be shown as is cited in the Report of the Group of Rome, interregional differences are relatively large although they seemed to decrease for the six old member countries of the European Community in the sixties. Even if, as the Report states, "it is not possible to say how far this can be attributed to the success of regional policies," the authors seem to admit that regional policies have played some part because they argue that "the formation of the European Community might have been expected ... to widen the regional disparities" (p. 66). Contrary to this expectation, Italy shows a clear narrowing of income gaps and the other countries present practically no significant changes; however, at the start they had much smaller differences than Italy<sup>1</sup>.
2. The picture is not very different if one chooses unemployment as an indicator for regional disparities. Although international statistics in this field are not directly comparable it is - as mentioned in the Report (pp. 70 sqq.) - nevertheless evident that there exists a fairly stable pattern of registered unemployment differences between the EC regions, and that the rate of unemployment increases systematically, the greater the distance from the central regions<sup>2</sup>.
3. The registered unemployed are of course only a part of the unused potential labour force in the peripheral regions. Assuming the willingness to work is the same across regions and adjusting for age and sex structure of the population, the labour force participation rate of the central regions or the national average can be applied to population in the other regions. With these calculations a potential labour force can be derived<sup>3</sup>. The differences between

<sup>1</sup> See D. Biehl, E. Hußmann, S. Schnyder, "Zur regionalen Einkommensverteilung in der Europäischen Wirtschaftsgemeinschaft", Die Weltwirtschaft, Tübingen, 1972, H. 1, pp. 68 sqq. Interregional income distribution improved even if one applies a relatively extreme and unusual criterion according to which a positive evaluation is made dependent on the extent to which the lowest income region improved its position: whereas the average per head income in all Italian regions increased by 24 percent from 1960 to 1969, Basilicata and Calabria (the two poorest regions of the south) grew with 100 percent and 50 percent, respectively.

<sup>2</sup> See *ibid.*, pp. 73 sq.

<sup>3</sup> See D. Biehl, S. Schnyder, H. Vögele, Schätzung des Arbeitskräftepotentials für Schleswig-Holstein und die Bundesrepublik Deutschland, Kiel, 1971, mimeo.

this potential and the actual employment may be used as a more accurate measure of unemployment. It would certainly reveal rather drastic disparities between the EC regions.

4. If the still existing administrative and personal obstacles to international and interregional mobility of labour were to be reduced, the rate of out-migration from the periphery would most certainly increase and the problem of peripheral unemployment would be ameliorated. The question remains, as to whether this solution is a desirable one. The following points speak against this "solution."

First of all, movement of more and more people from the poorer regions of the EC to richer regions within one or two member countries could be politically intolerable from the central point of view as well as from the peripheral point of view.

On economic grounds further immigration to central European regions and consequently increasing concentration is undesirable because one can conceive that the central regions are reaching their regional limits to growth (diseconomies of scale and diseconomies of density), at least for further traditional industrial expansion. On the other hand, the peripheral regions most likely have a great unused potential of growth (economies of scale and economies of density).

The reasons for this unbalanced and furthermore undesirable growth pattern is the divergence between private and social costs: in the centre the social costs are generally greater than the private costs, in the periphery the reverse is true. To a larger extent the divergence between private and social costs results from the policy of central governments which favour the centres in terms of providing extensive infrastructure and distributing these costs over all regions, rich and poor. The centres, because of increasing population concentration, can always make a good case for more infrastructure investment, while periphery regions which are losing population find it difficult to make a claim for more overhead capital.

5. But how should undesirable concentration be dealt with? Peripheral regions unlike LDCs cannot adjust exchange rates to improve competitiveness in the hope of stimulating capital import and employment and reducing out-migration. In lieu of this alternative two strategies remain available:

- on the one hand one may attempt to adjust interregional real labour cost differences to interregional productivity differences,
- on the other hand one may attempt to bring productivity into line with real wages.

In the first case, trade unions should be persuaded to accept interregional real wage differences with productivity as a guideline, in the second, the government could bring real labour costs into line with productivity through a policy of wage subsidies. But we should recognize that labour productivity lags in the periphery not only because of the lack of private physical and human capital but also because of an inadequate economic and social overhead capital and because of too low a degree of agglomeration. As recent investigations for the German regional economies at the Institut für Weltwirtschaft have shown, there exists a significant positive relationship between indicators of social and economic overhead capital and agglomeration degree on the one hand and per capita income on the other<sup>1</sup>. This finding substantiates the recommendation of the Group of Rome Report to improve the infrastructural endowment of problem regions and to stimulate agglomeration in these areas.

6. Our investigations have also revealed that the depressed regions on the average enjoyed a per head income about 20 percent below the per head income of richer regions endowed with the same infrastructure and the same agglomeration degree. This relationship was found

<sup>1</sup> See D. Biehl, E. Hußmann, S. Schnyder, "Bestimmungsgründe des regionalen Entwicklungspotentials - Infrastruktur, Wirtschaftsstruktur und Agglomeration", Die Weltwirtschaft, 1974, H. 1, pp. 107 sqq.

to be true vis-à-vis a number of different types of infrastructure such as schools, roads, energy and so on.

The systematic average difference in per head income between regions with the same infrastructural and agglomeration endowment we call the regional factor. This regional factor may be interpreted as an indicator for the devaluation required, if the poorer regions had their own currency. Such regional factors could be calculated also on an EC-wide basis for all peripheral and for individual depressed areas. They would indicate the differences in competitiveness between the EC regions. Consequently they may be used as indicators of the assistance required in the poor regions and perhaps also as indicators of an upper limit of regional aid. Moreover the regional factors if calculated periodically could provide indicators of the success or failure of regional policy measures.

7. Concerning the management of regional policy there should be - in my opinion - a division of labour between the different government levels: namely between the Community and the nations on the one side and the provincial or regional on the other. The Community's and the nations' role should be limited to ensure that market incentives exist to facilitate international and interregional flow of goods and factors according to comparative advantages. This can be accomplished through a systematic tax-cum-subsidy system and/or through an improvement of the international and interregional infrastructure, for example through improvement of international and interregional communication and transport systems and energy networks. In this context the regions should be free to manage their own development policy and find themselves their - what may be called - appropriate professions.

8. Principles and concepts normally applied to explain the international trade could serve as a conceptual framework - *mutatis mutandis* - for regional development programs. Some regions will find their comparative advantage in natural resource based industries (for example tourism), others may specialize in mature standardized manufactured goods, while others may concentrate in new goods at the initial stage of the product cycle.

As a further point I would argue against designating as appropriate for development in the periphery only those so-called growth industries which are defined relative to performance in central regions. Indeed, declining industries in the centre may turn out to be growth industries in the periphery.

9. Furthermore I do not share the fear of wasteful competition between regions. On the contrary I believe that the positive effects of interregional development competition are greater than the waste of non-centralized regional planning. This point coincides with the ideal of a federation of European regions. A federation, as we know, can be expected to minimize the divergence of merit goods and individual preferences and therefore stem the tide of nationalistic chauvinism. The impetus toward separatism as mentioned in the Group of Rome Report I feel would be more effectively stemmed by increasing regional sovereignty rather than by just additional economic help from the Community as was suggested by the Report (p. 76).

10. To conclude let me cite an example of a successful regional policy based on a relatively high degree of sovereignty. The case in point is the Saarland which borders the French Lorraine. Saarland as one of the smallest German Länder together with the Lorraine make up an economic region. From the end of the sixties Saarland shows a fast improvement in employment and a drastic structural change while Lorraine remains based on the traditional mining and steel. The employment implications of the case I have cited are revealed by the fact that in 1967 the planning staff of the Prime Minister of Saarland projected for the seventies an annual commuter surplus of Saarland vis-à-vis Lorraine of 10,000 persons. However, as a result of regional development in Saarland in 1973 there were 20,000 persons commuting from France.

The reason behind the divergence in exploiting development potential could - at least in part - be accounted for by the differences in regional policy organization: namely Saarland's regional policy was flexible and largely determined within the region, while the policy in Lorraine was directed by Paris.

## V. New Approaches to Structural Policy ?

### a. Reforming the Common Agricultural Policy

Chairman: Adolf Weber

Tim Josling

I will divide my comment into three parts. I'll first discuss the place of agriculture in economic union, then make some comments on the Group of Rome Report and in the final part I will touch on some problems in the reform of the Common Agricultural Policy (CAP). In discussing any aspect of economic integration three types of questions tend to arise and the answers are not always consistent. In the context of the agricultural policy, the three types of questions are: How should agricultural policy develop in a politically integrated Europe? Secondly, how can agricultural policy itself assist in the process of economic integration? And third, what Community elements in an agricultural policy can assist national governments with their own economic problems and objectives?

The first approach seems premature, though intellectually interesting: the second seems dangerous in a period when the commitment to further integration as an aim in itself is not universally popular: the third approach is perhaps most convincing in the present political climate. To adopt a well-known phrase, we should ask not what we can do for European integration, but what European integration can do for us.

1. Agriculture in Integration. - Let me start with a few remarks on the place of agricultural policy in economic integration. Agricultural policy touches all the various facets of integration. First of all, it affects the balance of trading advantages that are implicit in a customs union of common market. These trade advantages are very important but are too often ignored in discussions of agricultural policy. There are two aspects to this. First of all, there are the familiar benefits of regional specialization and the division of labour, the "trade creating" effects of the customs union. But there is also a further aspect which has been discussed in the more recent economic literature on customs unions, which emphasizes the mercantilist rationale for preferential trade. The argument may be paraphrased thus: if a country has an export sector that is a candidate for support, a customs union may be a feasible way of granting that support; if that sector can get access to some other country's protected market then it gains from an improvement in the terms of trade and the home government does not have to pay its own export subsidies. This is in fact a major part of the rationale behind the development of the agricultural policy, the improvement in the terms of trade for exporting countries within the Community.

Secondly, agriculture has links with the whole complex of industrial, regional and social policies. In this connection a basic question is the way in which society organizes the economic system to distribute the gains from technical progress in a socially desirable manner, with the implication that this may not be consistent with the distribution of gains from technical progress that would exist in a free market. In other words, there could be an argument for intervention in the market in order to achieve a different distribution of the gains from technology. This is related to the question of the social development of the Community; the agricultural policy has strong links with the provision of social security payments, unemployment benefits, the desired population distribution and the preservation of the environment. Another aspect of the regional-industrial-agricultural balance, which arises as a result of the lack of real political union, is that policies such as the CAP often have to act as a balance mechanism for costs and returns through the common budget.

The agricultural policy also takes a part in economic management, and in particular the management of the price levels. A few years ago, one might have said that it also acted as

what one might call an internal monetary integrator, the idea that if the Community established common policies for agricultural products, this would inhibit changes in exchange rates, but that did not turn out to be the case in practice and therefore this particular aspect has lost its importance. Finally, the CAP is an important part of the common external commercial policy of the Community, and of its relationships with other countries. The necessity for the CAP to play all these various roles is enough to ensure that no simplistic policy changes are likely to be feasible, and that the process of reform is likely to be slow and complex. It also implies that all parts of Community institutions will need to work together on the solutions to the outstanding problems, and that decisions must be based on as wide a base of consultation and discussion as possible.

2. The Report of the Group of Rome. - The Group of Rome Report has three main references to agriculture. First, some general statements on the first three chapters, which mention the agricultural policy in the context of other types of European policies. I agree with most of the statements on agriculture in the first three chapters. Then there are some observations on the implications for external policy - in particular for the GATT negotiations in Chapter 7, and here again these are broadly in line with a liberal economist's approach to the place of agricultural policy in these negotiations. But the main comments on agriculture are in Chapter 4, on the form of the Common Agriculture Policy, and on this chapter I want to make a few critical comments, though broadly speaking I do not find myself in fundamental disagreement.

My first comment refers to the aspect mentioned above, the place of agriculture in economic integration. The Report does not give enough emphasis, to my mind, to the internal trade effects of the CAP. France, the Netherlands, Denmark and Ireland are all interested in export prices for their agricultural goods. This is one of the big problems facing those who favour the option of deficiency payments financed at the national level. Now, whatever one might think of such a policy in a purely national context, the main problem with it is that it does not give to agricultural exporters within the Community the assured markets for their agricultural goods at the prices that they wish to see. A major objection to the former British policy was that countries such as Denmark and Ireland had to give export subsidies to sell their products in the United Kingdom's protected market. These countries are unlikely to take very kindly to being excluded once again, and any assessment of future policy changes has to look at these trade effects on member exporter countries.

Secondly, I think the orthodox interpretation of the farm problem which they give in the Group of Rome Report is increasingly looking rather misleading. For instance, there is a great emphasis on low income elasticity for agricultural goods and low price elasticity and imperfections in the labour market. But the income elasticity is not very relevant in an open trading system. Wheat farmers in the Community are not dependent directly on how much yearly European consumption of wheat grows, they are dependent for their market on how competitive they are relative to suppliers in the rest of the world and to a lesser extent how the size of the world market is growing. Similarly, price elasticity in an open trading system as far as the producers are concerned is usually very high. Most of the studies on demand look at the price elasticity for a group of consumers but that is not the relevant consideration when one is considering the income possibilities of one group of producers in an open economy. Thirdly, the labour market in agriculture seems to be working rather well in the sense that large numbers of people do migrate, and that income differentials throughout most of the Community are more of a reflection of differences in educational standards than a result of a non-competing group in the labour market.

The third comment on the Group of Rome Report is that I think the authors have overplayed the collapse of the present agricultural system. One can put the matter rather more constructively: all countries have had to adapt their agricultural policies to a new set of political and economic conditions, and one might take the view that the change in the Community system to adapt to these new sets of conditions was remarkably rapid, given the cumbersome

nature of the Community decision-making system. The question now is to consolidate this adjustment so that the Community does not get back to the problems that were existing up to 1972.

Fourthly, the most serious economic cost of the Community agricultural policy up until now has, I believe, not been in terms of incorrect resource allocation per se, but has been mainly a result of the export subsidies. The implication of export subsidies is that domestic productivity gains are immediately transferred to foreign consumers. If the foreign consumers were in countries in Africa or Asia then one could perhaps justify this, but in fact it has not been the case that the transfers abroad have been related to any particular international income distribution objectives.

Fifthly, I think that the description of the agricultural policy system needs to be brought up to date. There is little mention of the export levies or of the other modifications to the systems to take into account the high prices. And, just as an aside, the export levy system affects the large farmers most, and so it is not always the case that the policy benefits this group of producers. If the policy acts to keep down prices, then the large farmers are hit proportionately worse than the small farmers.

Production changes - this is my sixth point - have taken place, contrary to the impression one gets from the Group of Rome Report. I would suggest that this is one reason farmers are not happy with the CAP. They themselves feel very strongly the pressure for production reallocation within the Community and this shows up in terms of the widespread dissatisfaction of farm groups.

3. Problems in Reform of the CAP. - The Report raises four questions which I think are crucial for present discussion of the reform of the CAP. Firstly, what should future policy look like? Secondly, what are the unavoidable transitional problems? Thirdly, how should it be administered? And fourthly, how should the costs be financed? I shall make some very very brief remarks on each of these four questions.

First of all, in terms of future policy, I think the basic idea in the Group of Rome Report is sound and its suggestions for future policy are desirable over a long period of time. Its basic idea is that the Community policy should aim to reflect to farmers the net value that the Community puts on their output, which may include the provision of environmental amenities or leisure activities as well as agricultural products. The market should in general be allowed to determine production levels and relative consumption prices, and there should be no attempt to plan output of various types of goods in contradiction to the way the market is operating unless it can be justified on the grounds that a special case of "market failure" exists. This does not involve a guarantee of price rises to keep up with domestic costs: but such costs will be covered if productivity in Europe keeps pace with that of overseas suppliers. Nor is it necessarily true that the prices should be the same in all parts of the Community. For instance, if the precept of paying "the net value the Community puts on the production" indicates that southern Italy should have higher prices for agricultural goods, perhaps because the social opportunity costs of labour are less in southern Italy, then that is what the Community should do.

The second aspect of the future market policy should be the use of both international trade and stocks to adjust production to market demand - in other words, to even out fluctuations within, say, a two or three year period. Stocks in commercial trade should take care of fluctuations within seasons but the Community might look more at the development of more comprehensive future markets within Europe in order to facilitate some of the problems between seasons. International trade itself is an efficient way of handling fluctuations in production of particular goods: that is one rationale for the existence of trade. A country rarely needs to hold stocks specifically to cover fluctuations in its own production. One may still need a public stock policy, but this should be geared to the interest of consumers as well as producers. In other words, rather than the present system of linking the intervention buying system to export

subsidies, the intervention system should be designed to even out flows of products onto the European market from year to year, acting as a sort of Community "deep-freeze."

In the interests of world market stability, it will be necessary to coordinate the management of such stocks internationally. Europe should react positively to the proposals which will be discussed in the next few months on the holding of stocks and of managing them in cooperation with other major trading countries.

The transition proposals in the Group of Rome Report are basically that compensation for the change towards a market oriented policy should be paid (a) in a way that is not linked to production, and (b) in a way that is limited over time. But my impression is that since price falls in nominal terms are no longer necessary, compensation is not anything like the same problem that it was two years ago. Secondly, the political balance has changed significantly in favour of consumers within the Community, and that as a result one would not now need the same degree of compensation which might once have been politically necessary. It may now be politically possible to limit the compensation to, say, the next generation of producers. But the main emphasis during the transition period should be on improving the expectations of producers in terms of what price they should get. If the government creates the right expectations, farm adjustment problems are much less than if the producers do not know what conditions they are adjusting towards.

There are no explicit proposals in the Group of Rome Report on the administration of the new policy. I just want to make the point that we should not confuse a centrally negotiated and administered policy which might be differentiated in terms of its impact on those parts of the Community, from a uniform policy which imposes the same conditions on all parts of the Community. One can still have a CAP with central administration and negotiation of a policy even though this policy be differentiated by regions and by countries. This, in fact, happens at the moment with the operation of monetary compensation amounts which are price levels differentiated by country or currency group but negotiated centrally and subject to the control of the Community organs.

The question of funding is always going to create problems. But one or two cautionary points should be made. It is dangerous to look at each item of the budget individually and to ask whether this is an equitable way of running a budgetary policy. One cannot examine each item of a fiscal system individually in terms of its income and distribution effects. And for the Community, international transfers include not just the budget but also the terms of trade transfers as well. If one looks solely at the budget, one is neglecting the very large terms of trade changes which go hand in hand with the budgetary items. Payments of levies may be necessary into the Community fund for various technical reasons, and the political problem is that they are very visible; you notice these and you do not notice the terms of trade effects. And the other point that I want to make on the funding is that if one does conceive of the Community agricultural policy as having a stabilizing function from year to year, in some years a country will benefit from the budget and in other years will have to contribute. It is misleading in this case to look at any particular year and calculate the benefits or costs associated with Community policy.



## b. Industrial Policy, Competition and Social Progress

Chairman: Gerhard Prosi

Gerhard Fels

1. I was asked to comment on industrial policy as discussed in the Report of the Group of Rome. In this Report a case is made for a common industrial policy. Referring to the Treaty of Rome, to the Colonna Memorandum, and to the Communiqué of the Paris Summit Conference in 1972, the authors emphasize four main reasons for such a policy:

- elimination of trade-distorting non-tariff interventions;
- adjustment assistance to declining industries;
- promotion of high technology; and
- creation of European companies.

With the possible exception of the last point these are important justifications of industrial policy in Western Europe. The authors approach the involved problems from a liberal point of view, stressing the necessity to implement new principles, but avoiding criticism of the policies already employed either by member governments or by the Community. I am in agreement with much of what has been said in the Report. I want, therefore, to concentrate my comments on a few points.

2. The first point which struck me is the authors' preference to upgrade the issue of industrial policy to a matter to be dealt with on the Community level. In other words, the question of how the division of labour between the various levels of political activity, or the distribution of authority - regional, national, and European - ought to be organized, remains undiscussed in this part of the Report. Admittedly, there are elements which could or should be managed by the Community, for instance, the formulation of general rules for non-survival industrial assistance, negotiations with non-member countries, or the promotion of big technology projects. For other problems of industrial policy the information and decision costs may be lower if they were handled on a national or even a regional level, especially since development levels within Europe differ, and comparative advantages also differ, which means that the patterns of adjustment to changing world market conditions cannot be uniform. In these cases, both adjustment assistance policy and the promotion of technologically leading industries require a more regionally or less centrally oriented concept.

3. The other points I want to raise refer to the ambiguity of industrial policy. Murphy's Law states, "if anything can go wrong, it will." Applied to economic policy this becomes: if anything can be used as a protective measure, it will. Actually, nearly all measures so far employed in developed countries under the label of industrial policy or adjustment assistance or technological promotion have been measures of survival rather than a means to restructuring. The reason for this is obvious: in six GATT rounds, trade discrimination against foreign competition was largely reduced, except for a hard core of protection in favour of labour-intensive and raw material-intensive industries. Not all industries which were exposed to freer trade were in a position to defend their original markets without governmental assistance. The governments intervened on behalf of the most endangered industries, mainly those which produce for primary needs or whose survival is closely associated with traditional ideas of an autonomous nation, for example, coal mining, oil production, the iron and steel and aircraft industries, shipbuilding, and computer manufacturing. Thus, industrial policy has to a large extent become a substitute for trade policy. The same holds partly true for adjustment assistance, as indicated in a recent UNCTAD report<sup>1</sup>.

<sup>1</sup> UNCTAD, Adjustment Assistance Measures, Report by the UNCTAD Secretariat, 3rd Session, Document TD/121/Supp. 1, Santiago, Chile, 1972.

4. The authors of the Rome Report are fully aware of the implicit dangers of industrial policy. They plead for trade liberalization, farsighted and outward-looking policies, and for a form of adjustment assistance aims to shift resources from declining industries. Apart from the formulation of principles, the Report does not investigate the question of how a shift from a survival policy towards an industrial policy which promotes adjustment can be brought about. There are a lot of economic, institutional and social aspects to be considered in this context. I can only mention a few of them. First of all, I think that policy-makers have to be provided with an idea of the future structures of the European economies. If one accepts the need for industrial policy at all, one can hardly deny the need for such a reference system. A more or less visionary view of the inevitable and the desirable structural changes would have fitted very well into a report of the type presented.

5. Most member countries of the Community have approached a state of economic development at which, according to well-known secular trends, not only the share in GDP and total employment of agriculture but also that of the manufacturing industry is tending to decline. But there are different opinions about the role of industry in future economic development. Britain, which has had a declining share of manufacturing since the late fifties is trying to raise her industrial productivity to continental standards. Italy is making substantial efforts to industrialize her south. France, whose industry, partly to the benefit of her agriculture, has performed less favourably than West Germany's industry in the course of European integration, seems to be pursuing an industry oriented growth strategy, imitating the West German model. In the Federal Republic of Germany, where currency undervaluation and other factors have generated an outstanding industry share, a feeling of "over-industrialization" has arisen. But there is strong resistance from labour unions and manufacturing organizations against losing industrial jobs. To sum up, a European competition in industrial growth is likely to occur - at the expense of the tertiary sectors, in which bottlenecks will arise, as well as at the expense of the developing countries which try to integrate into the international division of labour with manufactured goods. Again, a picture of the future is needed in order to prepare harmonization among national objectives on the one hand and between European and international objectives on the other.

6. An important field of policy actions for securing a non-protective industrial policy lies in the harmonization of trade policy and adjustment assistance policy. The hard core of protection which still works vis-à-vis the imports from developing countries reflects severe structural rigidities. To overcome these, a policy has to be launched which gives special incentives to motivate entrepreneurs and workers now producing highly protected commodities to move to other, highly competitive activities. On the other hand, direct assistance of trade-protected activities has to be excluded in order to avoid defensive investment.

7. The access to such restructuring assistance could be tied to a simple criterion. The tariff preferences scheme which the EEC introduced in favour of developing countries recognized a lot of commodities as "sensitive" and subjected them to a safeguard mechanism, the purpose of which is to limit tariff-free imports and to avoid so-called market disruptions. In addition, quantitative quotas are still employed for especially "sensitive" textile and clothing commodities. The catalogue of sensitive products can be interpreted as a kind of social consensus on domestic activities, the retention of which is inconsistent with the export interests of developing countries. This catalogue of products and production recognized as "sensitive" in terms of trade policy can serve as a tentative identification of domestic activities which are eligible for restructuring assistance.

8. A road to an outward-looking industrial policy also leads through the structure of incentives involved in all kinds of regional or sectoral promotion programmes. At present, the incentives commonly applied are based on the amount of funds invested. Hence, the factor of production primarily subsidized is capital, more precisely, physical capital. These incen-

tives are not conducive to an allocation of resources according to the relative scarcity of factors of production. A commonsense consideration, which oversimplifies of course, may illustrate this. Three main factors of production are taken into account: physical capital, low skilled or unskilled labour, and human capital which is a proxy for skilled labour and the capability to develop and apply new production and organization techniques. In developed countries, which have at their disposal a highly educated and well trained labour force and an efficient communication system, human capital seems to be relatively more abundant than low skilled or unskilled labour. "Relatively" means here that the scarcity relation is different in developing countries. There is plenty of unskilled and unemployed labour but a significant lack of workers and technicians who can operate and manage a modern production process - despite the fact that in some countries, people with a formal university degree are also unemployed. Physical capital has to be considered as the most mobile factor of production between developed and developing countries. Thus, what matters is to combine physical capital mainly with human capital in developed countries, and primarily with low skilled and unskilled labour in developing countries.

9. With this rough blueprint of a better international division of production in mind, the structure of incentives has to be revised. The developed countries in Western Europe require a mechanism which diverts capital into branches in which they can maintain comparative advantages. This mechanism has to work even before the pressure of increased import competition becomes severe. This could be achieved by domestic investment incentives in connection with regional or structural policies, which are based on the skill intensity of new projects or on the research and development investments associated with them. At least, the latter variable is as easily manageable as the sum of physical investment. In short, instead of hardware investment one has to encourage software investment. Complementary to this, however, policy changes in developing countries would also be desirable. For instance, incentives to direct investments which are related to the number of jobs created would generate more employment opportunities in these countries than the practice of incentives according to the amount of funds invested, presently employed in most developing countries. But independent of what developing countries will actually do, industrial policy contributes to a better international division of labour by revising the structure of incentives in the European countries.

## Klaus Stegemann

The Group of Rome, in the concluding paragraph of the foreword to its Report (pp. XV sq.), observes that in the past there has been

"a rather unnecessary desperation in a search for complete and irreversible forms of integration instead of seeking to work out what powers national governments would be bound to wish to retain and what the European Community as a whole would wish to keep under its own strict supervision or review. If we are right, the development of consistent policies will achieve more than ambitions for comprehensive integration in all areas of policy, which is more than even most established federations seek."

In accordance with this statement, the Report generally is very cautious as concerns the allocation of new responsibilities to the supra-national authorities in areas where the Treaty of Rome has not provided for a common policy. The Group warns emphatically that monetary and fiscal union should not be pushed through prematurely (p. 59) and it recommends that "the

prime responsibility for devising regional policies must rest with national governments" (p. 87). The drift of the Report is less clear when it comes to industrial policy (Chapter 5).

It is the purpose of this paper to clarify the concept of "industrial policy" in the context of international trade and to review the pros and cons of a common industrial policy for the European Community. The stress, it should be noted, is on common. Whether and why there should be an industrial policy at any level of government will not be investigated directly.

1. Aspects of Industrial Policy in an International Context. - The answer to the question as to whether the European Community needs a common industrial policy to a certain extent hinges on the definition of "industrial policy." The Group defines it as follows:

"An industrial policy should embrace a number of inter-related objectives relating to the sectoral allocation of resources, the structural organization of industries, the development of technological innovation and the maintenance of regional balance. Among its instruments are government loans and subsidies, public procurement policies, technical standards and specifications, concessionary charges for public services and preferential tax treatment" (p. 118).

In a footnote (p. 154) it is pointed out that, more broadly conceived, "rights of establishment, freedom of capital movements, and rules governing competition" frequently are also meant to be covered by the term<sup>1</sup>. Then, of course, one might add that traditional commercial policy, operating with tariffs, quotas, trade agreements, etc., to a very large extent also is "industrial policy" as regards the objectives stated in the Group's definition.

If one accepts a broad definition of "industrial policy" the term will almost inevitably encompass areas for which there already is a common policy or for which one is envisaged by the Treaty. Thus, to the extent that industrial policy is conceived to include tools of commercial policy, tools of agricultural policy, rules concerning international factor movement, regulation of the transport industry, and rules governing competition of private and public enterprises, it cannot be denied that the European Community, in accordance with the Treaty of Rome, has the mandate for a common industrial policy, and that the common policy in those areas is required to achieve the objectives of the Common Market<sup>2</sup>.

The Group, as quoted above, employs a narrower definition of industrial policy than discussed in the previous paragraph<sup>3</sup>. This definition has the great advantage that it focusses on the "new" tools of protectionism, nowadays summarily labelled as "non-tariff barriers to trade" or NTBs<sup>4</sup>. For the present purpose it seems useful to limit the discussion of industrial policy to financial government aid for manufacturing industries, be it in the form of grants, subsidized loans, preferential public procurement policies, or various kinds of tax incentives.

<sup>1</sup> This broader definition is implied in the statement of the 1972 Paris Summit of heads of governments on industrial policy. See EC, Commission, Sixth General Report, 1972, Brussels, Luxemburg, 1973, Section 5, p. 12

<sup>2</sup> In addition, of course, two sectoral treaties, the European Coal and Steel Community Treaty and the Euratom Treaty, provide for more extensive supra-national regulation of the coal, steel, and atomic energy industries.

<sup>3</sup> Occasionally, the Group appears to have had a broader definition in mind as it also employed the term "common industrial policy of the European Community" when considering policy areas not covered by its own definition. See, for example, p. 118.

<sup>4</sup> Industrial policy still cannot be thought to be a synonym for NTB protectionism since measures of industrial policy do not necessarily distort international trade (though neomercantilistic ideas frequently are a prime motivation for such policies). Furthermore, certain NTBs, such as quantitative restrictions, are usually counted as tools of commercial policy rather than industrial policy.

The Treaty of Rome, in principle, prohibits government assistance to industry that would distort trade in the Common Market (Article 92). It is an open secret, however, that practically all national governments are giving aid to industry to an extent that goes far beyond the exceptions of the ban on subsidies provided in the Treaty, and matters appear to be getting worse in spite of several declarations of good intentions<sup>1</sup>.

While the Group deplores this state of affairs it also recognizes the dilemma that advocates of undistorted international trade have to face when dealing with government aid to industry<sup>2</sup>. On the one hand, national aid programs may involve serious distortions of international trade, and there is a danger that they might spawn further protectionism because countries emulate each other's measures or resort to countervailing duties and similar forms of retaliation. On the other hand, economists by and large agree that subsidies do less harm than trade restrictions if one takes as given that governments desire to assist particular activities, groups, or regions. Furthermore, it has become a generally accepted idea that in certain circumstances the provision of temporary adjustment assistance may be a prerequisite for a reduction of import restrictions because the resistance of politically influential groups has to be bought off and/or because legislators would regard it as inequitable if overall gains from trade were achieved at the expense of serious injury to particular groups. In a similar vein, it might be argued that start-up aid for new industries can help to liberalize trade if start-up aid fulfils similar functions as adjustment aid or if it is conceived as "preventive" adjustment aid<sup>3</sup>.

In any event, it is only realistic to accept the conclusion that outright prohibition of all industrial aid cannot solve the problem because governments - for good or bad reasons - will insist on retaining or expanding their aid programs. A solution of the dilemma can only be found by placing constraints on industrial aid programs in order to curb the three principal dangers that may arise from the increasing reliance on such programs:

- (1) the danger of hardening that turns supposedly temporary adjustment or start-up assistance into more or less permanent support for non-competitive production;
- (2) the danger of emulation that defeats the development efforts of countries that have a natural comparative advantage for a certain industry and which might also lead to world-wide excess capacity (suboptimal size of plants) in certain sectors;
- (3) the danger of excessive retaliation, especially in the form of countervailing duties, that creates protectionist effects in excess of the compensative protection necessary to rectify export-promoting measures of other countries.

2. Pros and Cons of a Common Industrial Policy for the European Community. - In the context of the GATT or other international organizations that do not aspire after supra-national powers it is generally suggested that the necessary constraints on the use of industrial aids and countervailing measures should be arranged within the

<sup>1</sup> In accordance with Article 94, the EC Commission has made various attempts at drafting more specific guidelines and procedures to implement the rules of Articles 92 and 93. See for example: EC, Commission, Third Report on Competition Policy, Brussels, Luxembourg, 1974, Part 2, Sections 79 sqq.

<sup>2</sup> For a more detailed discussion of the dilemma, see K. Stegemann, Canadian Non-Tariff Barriers to Trade, Montreal, 1973, pp. 124 sqq. and the extensive literature quoted therein.

<sup>3</sup> "... the industrial countries must develop a mechanism which primarily directs physical capital to those industries in which the comparative advantages can be maintained. Such a mechanism should already be working before the pressure of import competition becomes serious." G. Fels, "The Export Needs of Developing Countries and the Adjustment Process in Industrial Countries", in: H. Giersch (Ed.), The International Division of Labour, Problems and Perspectives, International Symposium, Tübingen, 1974, p. 195. - See also UNCTAD, Adjustment Assistance Measures, Report by the UNCTAD Secretariat, Third Session, Document TD/121/Supp. 1, Santiago, Chile, 1972, Section 145, pp. 57 sqq.

framework of an international code of conduct. As mentioned above, the Report of the Group of Rome in part conveys the impression that the European Community should go further and should develop a common industrial policy rather than rely on a code of conduct for its member countries. The Group did not justify its preference for a common policy, although certain arguments for a common policy may be inferred from the Report and from the general discussion of European integration<sup>1</sup>.

(1) It might be said that the European Community needs a common industrial policy because it should be able to "speak with one voice" in international negotiations on the reduction of non-tariff barriers to trade. This argument is not convincing as it would be sufficient for the member countries to agree on a European code of conduct (or several such codes for various forms of subsidies) that could serve as a basis for the Community's negotiations with third countries. It may be necessary, though, to give the Community additional powers to enforce the agreed rules of conduct internally so that it can fulfil its external obligations. Vis-à-vis third countries, the Community could employ the available tools of the common commercial policy if retaliation against violation of the code should become necessary.

(2) It might be said that a common policy is needed for measures of adjustment assistance because considerations of equity and political expediency may demand that groups suffering through a reduction of the Community's external trade barriers should receive compensation at the expense of groups that gain from trade liberalization. As the distribution and competitiveness of industries varies considerably among member countries it cannot be expected that the positive and negative effects of a reduction of external trade barriers would generally be distributed equally on a national level. There may thus be an argument for a common fund for adjustment assistance on equity grounds. Indeed, the Community might be able to pursue a more progressive policy of trade liberalization if it could employ adjustment aid to reduce the resistance of groups that ought to give way to the forces of structural change<sup>2</sup>.

(3) On similar grounds, it can be argued that subsidies which are granted in order to assure a greater degree of safety of supplies should be governed by common rules and might have to be paid from common funds. Thus, to the extent that aid schemes for the production and stockpiling of energy, food, etc. are intended to provide insurance for all member countries the development of common aid schemes is mandatory. Without such schemes the Common Market could disintegrate rapidly during periods of supply crises.

(4) It might be said that a common policy is also needed for start-up aid in order to prevent competing national measures from creating overcapacity and a suboptimal size structure in the supported industries. While one cannot deny that economies to scale may

<sup>1</sup> One may take the position that, at the present time, a common industrial policy is a utopian idea as practically all member countries of the European Community are clearly unwilling to consent to any further centralization of policies at the expense of the national authorities. Even if such a position is warranted, it is interesting to examine for what reasons, if any, the quest of a common industrial policy should remain on the agenda for future discussion.

<sup>2</sup> As mentioned above, there always is the "danger of hardening," i. e. adjustment assistance may be abused to prolong unnecessarily the profitability of non-competitive production or to revitalize industries that in their present locations cannot be viable in the long run. An internationally agreed code of conduct is needed to reduce these dangers. As far as the present topic is concerned, it is hard to decide whether a common fund could be abused more or less easily than nationally administered measures of adjustment assistance. While political forces presumably would work toward a wide (and wasteful) dispersion of adjustment aid among industries and regions, the total funds allocated might be smaller in the case of a common scheme than in the case of competitive national measures. If adjustment aid were generally implemented on the Community level one could also hope to achieve a greater degree of transparency than is warranted under national schemes.

be very important for science-based and defence-related projects that are frequently subsidized by national governments, the experience with European aero-space and nuclear projects has shown that a common policy is no guarantee for an efficient policy (pp. 126 sqq.). It seems clear that several of the member countries are not yet ready to set aside national interests for the sake of an optimal allocation of efforts on a Community scale.

Furthermore, one should realize that rivalry among industrial policies of national governments can have stimulating effects on the effectiveness of policy makers and on competition among producers in the Common Market<sup>1</sup>. While a common industrial policy (under the influence of the Council of Ministers and of European lobbies) would be very careful not to hurt existing industries wherever they are located in the Community, national governments would be less concerned about creating competition for firms in other member countries. National governments might, for example, stimulate entry of producers from third countries that might be prevented under a restrictive common policy towards direct investment. Competing national policies are also less likely than a common policy to promote industrialization inside the Common Market predominantly at the expense of competing activities in third countries.

Of course, competing national schemes of start-up aid to industry will entail duplication of effort. But then, competition generally entails duplication of effort; it is a cost of the discovery of superior products and methods and also a motivation for firms to try harder in making the best use of available methods. Would it be consistent, on the one hand, to demand the prohibition of private mergers unless they can be shown to be in the public interest and, on the other hand, to suggest that the industrial policies of the member countries should be fully integrated? It seems to me that joint enterprises of national governments, such as the development of a European "airbus," should remain the exception. That means national efforts in high technology areas should only be pooled on a case-by-case basis and only if considerable economies to scale (a "natural" monopoly) can be convincingly demonstrated.

(5) It might be said that a common industrial policy is needed because, with competing national policies, a widespread use of countervailing measures would destroy the Common Market. The argument is not convincing, because a code of conduct could serve the purpose. The important consideration is that national governments should be able to anticipate correctly what measures of industrial aid will not be tolerated by trading partners, and any sanctions would have to be instituted in accordance with an agreed procedure and subject to well defined limitations.

(6) It might be said that a common industrial policy is needed as a step on the way toward a political union. The argument is not convincing since the Community does not appear to be ready for additional institutional integration. There is no sufficient consensus on what should be done, and national authorities are unwilling to surrender the power and funds required for a common policy. Other areas have shown that putting the institutional cart before the political horse does more harm than good in European integration.

(7) It might be said that a common industrial policy is needed as a mechanism of income transfers for the sake of equity and in order to counter separatist tendencies in the poorer member countries. While it is correct that measures of sectoral policy usually will have a redistributive impact among regions, the argument is as controversial as the equity

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<sup>1</sup> I made this point, in greater detail, almost ten years ago. See K. Stegemann, *Die Harmonisierung der nationalen Wirtschaftspolitiken und die Förderung des Wettbewerbs im Gemeinsamen Markt*, Dissertation, Universität Saarbrücken, 1965, publ. as *Wettbewerb und Harmonisierung im Gemeinsamen Markt*, Köln, 1966, especially Chapters 3, 4.

aspects of regional policy because the Community still lacks the spirit of solidarity that may make international redistribution acceptable in the context of a union of nation-states<sup>1</sup>.

(8) It might be said (as in the Group of Rome Report, p. 150) that a common industrial policy is needed in order to achieve a greater degree of "intellectual coherence" among various policy areas. There is no doubt that more should be done to prevent different branches of government (be it at a national or supra-national level) from working at cross purposes. However, it is not clear that a common policy with respect to industrial aid is required to achieve the coordination with other policy areas. After all, regional subsidies, taxes and public procurement would remain in the national domain. Besides, we do not know of any example that a "systems approach" to structural policy has been successfully implemented on a national scale, and there is little reason to believe that the European Community would be ready for such an ambitious venture. Merely setting up common funds could not do the trick. The common authorities would face greater difficulties of administration than national authorities, as there is no established communication network. "There is no international tradition of information feedback from the ruled to the rulers, and then back to the ruled"<sup>2</sup>.

3. *Conclusions.* - Of the eight arguments that potentially might be raised in support of a common industrial policy, few are fully convincing. There are two interrelated reasons that speak against a common policy and in favour of independent national or regional measures:

(1) A common policy would tend to protect existing enterprises, and would tend to preserve the status quo. Rivalry among governments could stimulate competition of private firms (and might promote more effective policies).

(2) A common industrial policy (or a common regional policy for that matter) would tend to develop Community industries at the expense of production in third countries. National or regional authorities would be less concerned that negative repercussions are restricted to third countries - as long as development is not taking place at the expense of activities within the same jurisdiction.

The measures of individual governments would have to be regulated by a code of good conduct. If the member countries of the European Community could be persuaded to apply the same constraints on industrial aid in their relationship with the outside world as they apply among themselves, common rules could act as a filter protecting third countries from injury. If subsidies of a member country do not cause serious injury to the exporting or import-competing industries of other member countries, third countries could be pretty safe that they would not be hurt either. Such "most-favoured-nation" behaviour might, however, depend on the willingness of third countries to abide by the same rules.

The enforcement of any code of conduct presents problems. Under the GATT system, retaliation with trade measures for all practical purposes is the only means of reminding recalcitrant partners of the rules of the game. In its dealings with third countries the Community may still have to resort to retaliation. Internally, however, every effort should be made to develop alternate procedures because the free movement of goods should remain an inviolable foundation of the Common Market. The Treaty of Rome is not very explicit as regards the enforcement of Articles 92 and 93, and the Commission is still struggling to implement guidelines for only the most conspicuous cases of government aid to industries such as ship-

<sup>1</sup> See the contribution by Noé on regional policy. Of course, other policy areas also have redistributive effects among countries. What aggravates the issue apparently is the transparency that comes along with the establishment of common funds fed from national tax coffers.

<sup>2</sup> K. W. Deutsch, *Nationalism and its Alternatives*, New York, 1969, p. 171.



building and textiles<sup>1</sup>. The Group of Rome recommends (p. 123) that codes of conduct should be "published and widely publicized" and that "the authorities should be required to consult a panel representing the public interest in the broadest sense" prior to granting a subsidy<sup>2</sup>. It might be possible for the member countries to agree on tougher measures such as financial penalties or a linking of the distribution of Community funds to the observance of a code of conduct in related areas of industrial policy.

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<sup>1</sup> See EC, Commission, Third Report on Competition Policy, op. cit., Sections 90 sqq.

<sup>2</sup> See also a similar proposal by R. E. Baldwin, Non-Tariff Distortions of International Trade, Washington, D. C., 1970, pp. 26 sqq., 127 sqq., 185 sq.

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