EMBARGO: 3.3.1978, 6.00 p.m.

Speech by Christopher S. Tugendhat, Member of the Commission of the European Communities, at a seminar organised by the University of Stirling on Friday, 3 March 1978 in Glasgow

"ECONOMIC AND MONETARY UNION AND THE COMMUNITY BUDGET

"Why is the Commission advocating Economic and Monetary Union for the European Community when it must be clear that the idea is simply not on at the moment? Don't you as a practical politician think it is absurd?" That in essence is the question I have been asked many times since Roy Jenkins, after consulting the rest of us, committed the Commission to this proposition last autumn.

It is based on the assumption that the Commission should be only concerned with proposals that have a chance of acceptance by the Member States - if not at the next Council Meeting then within the reasonably near future. On that basis, of course, our ideas have no chance of success.

But the Commission has another task as well. It should draw attention to problems, suggest solutions and point the way forward. In doing so it should concern itself both with the construction of Europe and with issues that are or will be of direct concern to ordinary people. As an independent political institution it should campaign for its ideas and try to create a climate of opinion in which what is impossible now, can become practical and eventually be carried into effect.

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We are now campaigning for EMU both because it is central to our long term aim of developing the Community and because we believe it will provide a framework within which Europe's central political-economic problems of high unemployment, low investment and inadequate growth can be tackled. It will not of itself solve those problems. But it will remove a number of obstacles to overcoming them which now exist.

There is certainly an urgent need for new ideas. It is now five years since the oil crisis signalled the end of the high and more or less continuous economic growth which characterised the nineteen fifties and sixties. Since 1973 the Member States of the Community have tried a variety of different policies to restore prosperity, but their economic performance is still inadequate to fulfil the expectations or even the needs of their electorates.

How long can we go on like this? Few see any prospect of an upturn of economic activity in the immediate future. Yet it is estimated that between now and 1985 nine million more young people will join the Community work force, than old people will leave it. Moreover, the difficulties this will create will be greatly exacerbated by the mounting pressure which many vital sectors of European Industry, including steel, textiles and shipbuilding, will continue to experience from low cost competitors in the rest of the world.

If economic reality continues to fall far short of people's expectations, increasing strain will be placed on the fabric of political life in all Member States. Amid mounting disillusionment the proponents of extremist ideologies will find golden opportunities. The Commission has a duty to point out how in its view a further development of the Community could provide an opportunity to escape from the impasse.

At present policy makers in both the weak and strong countries find their freedom of action desparately circumscribed. Normally when faced with low growth, spare capacity and high unemployment a government would reflate. But in present conditions of extreme exchange rate instability a country with a vulnerable currency cannot do so to the extent necessary before its exchange rate goes through the floor, and its inflation rate through the ceiling.

A country with a low inflation rate and a healthy balance of payments is in this respect not much better off. The strong economies of Europe, unlike the U.S., depend very much on exports, and in Germany, our strongest economy, they account for about 24% of GNP, and about 40% of them go to other Community countries. Consequently foreign orders must play a critical role in any recovery. A purely domestic reflation is likely to have only a limited effect on employment, and Germany's future prospects must therefore depend in a large part upon the action taken by her partners.

With a single European currency, the exchange rate constraints at present experienced by most of the other Member States would be much reduced which will make it easier to pursue growth directed policies. In some Community countries there are, of course, other formidable barriers impeding sustained growth, including structural defects in their economies and the antiquated attitudes of many trade unionists and managers. But a monetary union would provide a more stable and satisfactory framework in which to get to grips with problems of this kind.

EMU will have other advantages as well.

Among the many factors restricting new investment in the Community is fear of exchange risks. In the last five years - not long in terms of the time it takes to transform a board decision into a multi-million pound plant working at full capacity - the relationship between some European currencies has altered by as much as 122 per cent. In such circumstances the risks inherent in any large scale investment are enormously increased. With a single currency those risks would be removed, and in my view this would create a much more favourable climate for trade and investment.

One of the reasons for the change in currency values has, of course, been differential inflation rates. A single European currency would not mean the end of inflationary pressures. But for those countries with the worst records it would provide the dramatic break with the past that has helped to overcome deeply rooted inflation psycholigies in national contexts. It would also provide the opportunity to establish a monetary authority with more discretion to control monetary aggregates in future than those totally under the thumb of a single government.

The European currency could in addition provide the alternative to the dollar as an international reserve that the world so badly needs. At present even a country as powerful as Germany finds its exchange rate, and so the competitiveness of its industry, vulnerable to movements in the dollar arising from US Government decisions often taken largely on the basis of domestic considerations.

If we had a European currency the ability of the Member States together to control these questions would be greater than is often the case now when they supposedly have the independent power to do so.. A reserve currency backed by a weak economy causes great problems as Britain well knows. But as the US has shown such a currency backed by a strong economy provides the holder with greater freedom of manoeuvre in deciding on its economic strategy.

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Clearly the bigger the Community becomes the more difficult EMU will be to attain. But by the same token the greater the need for it will be. The coordination of economic policy and the creation of a single currency which it will provide should be the foundations on which the next stage of the Community's development will be based. As the diversity of the membership increases the more important it becomes for the foundations to be firm and durable.

The Means of Attaining EMU

My concern today, however, is not primarily with the reasons for EMU, but rather with the means by which it can be attained. And since my personal responsibility as a European Commissioner is for the European Budget, I want to concentrate in particular upon the nature and the cost of the powerful fiscal mechanisms financed through that budget which the Commission believes must necessarily accompany the successful introduction of a common Community currency.

The Reasons for Redistribution

The purpose of the new financial instruments which would have to accompany monetary union would be to secure a more equal distribution of resources between the Member States. This would be necessary because, although monetary union would certainly bring enormous economic gains to the Community as a whole, it is unlikely that - without deliberate intervention - these gains would be spread evenly. On the contrary, in the absence of adequate safeguards, the changed pattern of production and employment likely to characterise a Community with a single currency is one in which weaker regions or nations could easily suffer heavily

Obviously no Member State of the Community is likely to assent to monetary union - which will entail the loss of its separate ability to control both exchange rates and also monetary and to some extent fiscal policy - if for it the economic consequences are likely to be adverse.

Nor indeed would it be in the best interests of the stronger Member States to press for a union of a kind which would impoverish their weaker partners. For the stronger member states can only hope to maintain their prosperity if the rest of the Community is able to provide them with a stable and buoyant market for their exports. Moreover, the unchecked and intensive economic development of some parts of the Community at the expense of the others would inevitably - especially in a Community enlarged to include Greece, Spain and Portugal - lead to very considerable migration, entailing not only the further decline of poor areas, but also unacceptable congestion in rich ones.

How Much Redistribution?

But, granted that monetary union must, for political and economic reasons be accompanied by a geographical redistribution of resources, just how great should that redistribution be?

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The obvious point of departure for any attempt to answer this question is an investigation of existing monetary unions. And the Macdougall Committee - a group of independent experts set up by the Commission-has in fact recently made a detailed study of geographical redistribution in 5 federations - West Germany, the United States, Canada, Australia and Switzerland - and three unitary states - Italy, France and the United Kingdom.

The Macdougall Committee's research has revealed that in these eight countries public expenditure and taxation reduce regional inequality very considerably indeed. The average extent of equalisation by these means of differences in average per capita incomes between the richest and poorest regions was found to be about 40 per cent - France and Australia being above this figure, and the United States and Germany below.

Another of the Committee's findings was that as well as redistributing income regionally on a continuing basis, public finance in existing economic unions also plays a major role in protecting weaker regions from the full impact of short term and cyclical economic fluctuations. For example, the Committee reckoned, on the basis of English and Italian data, that one half to two thirds of a short term loss of primary income in a region due to fall in its external sales may be automatically offset through lower payments of tax and insurance contributions to the centre, and through higher receipts of unemployment and other benefits.

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But would the differences in living standards between the stronger and poorer Member States of the Community have to be reduced by the same percentage as public finance reduces the differences between rich and poor regions within the nation states which the MacDougall Committee studied?

The answer to this question may well be no. It is true that the present inequality in average per capita incomes between the richer and poorer Member States of the Community - an inequality which has been scarcely affected by the very small Community Budget - is at least as great as the regional income differences within the eight countries investigated would be were it not for the fact that public expenditure and taxation substantially reduce them. But it does not necessarily follow from this that to sustain a monetary union the Community needs to achieve the same degree of equalisation as those countries. One reason for this is that although, as I have pointed out, the absence of substantial redistributive mechanisms would, in the event of a monetary union, stimulate considerable intra-Community migration, the barriers of language and separate national culture would almost certainly ensure that this migration was on a smaller scale than could be anticipated within most other integrated industrial economies, if redistributive policies were not pursued.

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Another reason why less redistribution may be necessary is that even when the Community becomes a monetary union it will undoubtedly remain in many respects a much looser political entity than the nation states which comprise it. In these circumstances, the inhabitants of the weaker Member States are unlikely to expect the same degree of economic equality in relation to the inhabitants of the stronger members, as those living in the poorer regions of a particular country usually demand in relation to those living in the same country's richer areas.

But there can be no certainty, about just how much difference these factors would make and the MacDougall Committee therefore decided that it would be safest to proceed on the working hypothesis that the amount of equalisation required to support a single Community currency would in fact be the same as that achieved in existing monetary unions. This seems to me sensible. In matters of this kind it is much better to err in the direction of pessimism than to be open to the charge of being over-sanguine.

The cost of equalisation

Yet on the face of it such a hypothesis may appear to raise formidable difficulties, for the national public finance systems which achieve the substantial regional equalisation found in existing unions are unquestionably very costly ; on average, expenditure by the federal governments of unitary states which the MacDougall Committee studied is about 30 per cent of gross national product.

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At present the Community Budget is only 0.7 per cent of the Community's gross domestic product. If, in order to attain the same degree of equalisation as in existing unions, this figure had to be raised to about 30 per cent of Community GDP, there would frankly be little point in discussing the matter further. The political obstacles would certainly be deemed too great.

Happily, however, there are good grounds for believing that a measure of equalisation similar in scale to that found in existing monetary unions can in fact be achieved by means of proportionately very much lower sums of public money than those unions choose to spend.

The Different Methods of Redistribution

The reasons for thinking that this is so stem from a study of the ways in which geographical redistribution is in fact achieved.

Investigation reveals that existing monetary unions use a wide variety of redistributive instruments; that the mix of instruments differs from union to union; and that the various instruments and the various possible combinations of instruments vary enormously in terms of the amount of regional equalisation which they secure per unit of expenditure.

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In this context, there is a very important distinction between unitary and federal states. In unitary states a great deal of the total redistribution between regions arises from expenditures on public goods and services which provide roughly equal per capita benefits, (these being redistributive in terms of their effect on regional income differentials) ; and also from the social security system which tends to provide most support to poor regions with high ratios of children, women not seeking work and retired people - a process observed most clearly in France and Italy, where male workers migrate from poor areas in very large numbers. A significant but smaller degree of inter-regional redistribution in unitary states is due to a regionally progressive tax system.

In federal states, in contrast, while some redistribution is achieved through expenditure on goods and services providing equal per capita benefits, a high proportion of total redistribution is also achieved through the use of intergovernmental grants. These grants are by far the most efficient instruments of redistribution found in existing monetary unions, reducing inter-regional differences dramatically for relatively very small sums of expenditure.

In the federal states which the MacDougall Committee studied, intergovernmental grants achieve an average reduction of about 19 per cent in average regional income differentials for average expenditure of only 3.7 per cent of GDP. This is possible mainly because the net regional transfers which these grants achieve are to a much lesser extent than in the unitary countries, the result of differences between large gross payments in opposing directions i.e. in and out of the central budget. In a unitary state most of the tax paid in a region passes outside its frontiers to the centre. Central government, therefore, can only secure a net transfer to that region's advantage if it pays back to it an even larger sum than the considerable revenue which it has extracted. The component states of a federation, on the other hand, pay a much smaller proportion of their total tax burden into the federal budget, and the outflow of resources in taxation which the federal government has to offset before its spending in a poor state has a net equalising effect is therefore correspondingly lower.

The Different Kinds of Grants

Grants used for redistribution can be divided into two main categories. First there are general purpose grants. In Canada and Australia, for example, there are major general purpose grant systems designed to raise the fiscal capacity of poorer states up to a politically determined standard - to 100 per cent of the national average in Canada, and to the standard of the two dominant and wealthiest states in Australia. These grants are intended to enable state levels of government to provide adequate standards of public services without forcing poorer states to impose significantly higher tax burdens, and without depriving state governments of the freedom to manage these services according to their own preferences.

The second kind of grant is the "specific purpose grant" which is used for the pursuit of a particular objective. The most important form of these is the matching grant whereby the federal government provides a given percentage of the total of a specific public expenditure programme which the state government wishes to pursue. In some matching grant systems the percentage provided by the federal government is the same whichever states are the recipients, but in others - and this obviously ensures greater geographical redistribution - the percentage provided by the federal authorities varies according to individual states fiscal capacity, providing for example, 80 per cent of the total for the poorest states, and only 20 per cent for the richest. For the most part, these grants are given in one of five areas of policy : health, welfare, transport and regional development.

Of the two main kinds of grant, general purpose grants are, in redistributive terms, by far the most cost effective. For an average expenditure of 2.5 per cent of GDP on specific purpose grants, the federal governments studied secure a 6 per cent compression of differences in income per capita between states. For an average expenditure of 1.2 per cent of GDP on general purpose grants the same federations secure a reduction in income differentials of 13 per cent. The highest federal expenditure on general purpose grants is in Australia, at 3.4 per cent of GDP. The results are spectacular : differences in average incomes between Australian states are in consequence reduced by about a quarter.

The Scope at Community Level for Using the Most Efficient Methods of Redistribution

The discovery of the effectiveness of federal grants suggests the way in which a considerable amount of redistribution within the Community can be secured. Admittedly, to establish which are the most efficient methods of redistribution is not necessarily to have the opportunity to use them. If many of the spending programmes of unitary and federal states, for example their social security policies, have only a relatively small geographic redistributive effect per unit of expenditure that does not reflect inefficiency or incompetence - but rather the fact that redistribution is not, in these instances, the only nor even the primary objective. A modern nation state whether unitary or federal has numerous and extensive responsibilities.

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In a world of finite resources it often has to pursue policies which simultaneously fulfil a number of purposes - including geographical equalisation adequately, but do not always achieve every individual objective as satisfactorily or completely as could be managed if it alone was the end in view.

Similarly, the Community has objectives other than redistribution. Therefore it would be wrong to suggest that it is in a position to concentrate the resources likely to be at its disposal purely and simply on the most efficient transfer policies. But at the same time, the Community's present and likely future responsibilities are more limited than those of the Member States. And in consequence of this the Community is in a position to give efficient methods of redistribution a very high priority.

The Community's Responsibilities

As the Budget Commissioner, I have frequently stated the broad criteria which I and my colleagues believe should determine the policy objectives pursued at Community level. We strongly believe that the Community should only be responsible for carrying out those necessary tasks which it can discharge better or more cheaply than other levels of government. We also believe that in current economic circumstances the Community should as far as possible not pursue policies which entail an increase in total public expenditure at all levels of the Community: this means to a large extent concentrating upon transferring existing activities from national to Community level, rather than upon initiating new ones.

The MacDougall Committee has described a hypothetical future Community Budget in line with these criteria. They divide spending programmes at all levels of government into three headings "Social Welfare Services", "Economic Services", and "General Public Services". Under "Social and Welfare Services", they envisage very little community development. Responsibility for health, education, social security and welfare would essentially remain at national level. Community expenditure in this area would in the main be devoted to a general purpose equalisation mechanism making transfers to the weakest member states to enable them to top up their own budget efforts. There would also be specific expenditure in the context of European redevelopment programmes.

As regards "Economic Services", the Community would be extensively involved in structural and sectoral actions covering agriculture, public infrastructure, industrial, regional and labour market policies, but would aim for the most part at selective intervention to a great extent through specific purpose of grants (with variable matching ratios) designed to complement member states' actions and to assist the weakest member states in particular.

Especial emphasis would be put on improving productivity in the weakest states. This is an essential feature of any proposal for monetary union for there is an obvious danger that once the Community has a single currency, wage-earners in the poorer Member States will demand wage levels equal to those of their counterparts in the richer ones with - in the absence of improvement in productivity - severely inflationary effects.

As regards "General Public Service" the Community's share of expenditure on public administration and law and order would remain very small. But the Community would, however, account for all foreign aid expenditure and a sizeable part of research expenditure.

The MacDougall Committee estimates that in order to discharge all these tasks the Community would require a budget of the order of 5-7 per cent of the Community's GDP. This sum is much smaller than the top tier of spending in the federations which the Community studied (between 20-25 per cent of GDP). Nonetheless the Committee feels that if the transfers and equalisation mechanisms for "social welfare services" and "economic services" were technically designed to be as redistributive as possible, then this expenditure (which could be financed by a revenue system based on VAT but made regionally progressive by virtue of national contributions being adjusted in accordance with a personal income tax capacity key) could attain the degree of redistribution achieved in fully integrated economies elsewhere.

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This is a conclusion of great significance. Obviously the MacDougall report is not a source of infallible truth. Its conclusions and the methods by which it arrives at them must be, and are being, rigorously studied and appraised.

Startling though it may seem, it may even be the case that MacDougall overestimates the cost of monetary union. For throughout the report there is a tendency to assume that a significant degree of redistribution in the Community can only be achieved by action on either the receipts or expenditure side of the budget. Yet this is far from being the case. For example, effective regulations concerning the location of new investment can achieve a re-allocation of resources towards deprived regions without entailing any extra expenditure whatever. Moreover, this is a form of redistribution to which each Member State is already well accustomed within its own boundaries and which already plays some - rather uncoordinated - role in international investment planning. The possibility of this type and of other non budgetary methods of redistribution is one which I believe should be examined very closely indeed.

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In addition to redistribution,the achievement of monetary union will of course require action on other fronts. It will, for example, be necessary to remove existing obstacles to the creation of a single capital market in the Community, and progress will have to be made towards greater harmonization of taxation. But problems of this kind are not insurmountable. And it is my conviction that once it is widely understood that the budgetary cost of introducing a single currency is - in relation to the potential economic gains - strikingly modest, the political determination on the part of the Member States necessary to deal with reamining difficulties will become swiftly and irreversible manifest.