COMMISSION OF THE EUROPEAN COMMUNITIES
Directorate-General for Economic and Financial Affairs

REPORT OF THE STUDY GROUP

"Problems of Inflation"

This report has been prepared by a group of independent experts set up by the Commission. The opinions expressed in this report remain the sole responsibility of the group and not that of the Commission and its services.

BRUSSELS, 3 MARCH 1976

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FOREWORD

At the end of 1974, the Commission of the European Communities instructed this Group to draw up a report on the problems of inflation. The Group which had the following composition proceeded with its work throughout 1975.

List of the Members of the Group

Chairman

R. Maldague	- Head of the National Plan, Brussels

Members

F. Archibugi	- Professor at the Università di Calabria, Cosenza
J. Delors	- Associate Professor at the Université de Paris-Dauphine, and Director of the Work and Society Research Institute, Paris
D. Dolman	- Member of the Dutch Parliament, The Hague
S. Holland	- Lecturer in Economics, The University of Sussex, Brighton
H. Markmann	- Director of the Economic and Social Research Institute of the DGB, Düsseldorf

Secretariat

G. Speranza	- Commission, Directorate-General for Economic and Financial Affairs
E. Sambach	- Commission, Directorate-General for Economic and Financial Affairs

In July 1975 it forwarded an interim report to the Commission. In its Final Report it has endeavoured to take account of the comments and suggestions provoked by the interim report.

It goes without saying that the members of the Group have expressed themselves with complete independence and that they alone are commited by their opinions.

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INTRODUCTION

1. Inflation has become a deeply-rooted problem which is undermining our democratic Western societies.

It distorts the assessment of economic performance and frustrates rational calculation in both the public and private sectors. In particular it alters the terms of lending, the criteria for choosing investments, and the level of investment itself. The increasingly frequent and sudden "stop-go" policies which inflation triggers off result in a less rational distribution of the factors of production, a waste of resources, a reduction in growth and higher unemployment.

Inflation reinforces inequalities of income and wealth, in as much as the income of some social groups is not adjusted as effectively as that of others.

Relations between social groups deteriorate, attitudes harden and become more extreme, leading to unrest and even in some countries to a concealed state of crisis, which jeopardizes social peace and democracy.

The Group is deeply concerned by this slow but steady deterioration in our social systems. Therefore, without under-estimating more conventional explanations and remedies, it has sought to go further and break new ground with a structural analysis of inflation.

2. However dramatic it has recently been, inflation is neither an accidental nor a short-lived phenomenon. Well before the seventies, it had gone far beyond tolerable levels, had increased even during the recession (1967-68) and continued in all the Community countries, with considerable differences between countries.

Price deflator for private consumption
in the Community of Nine

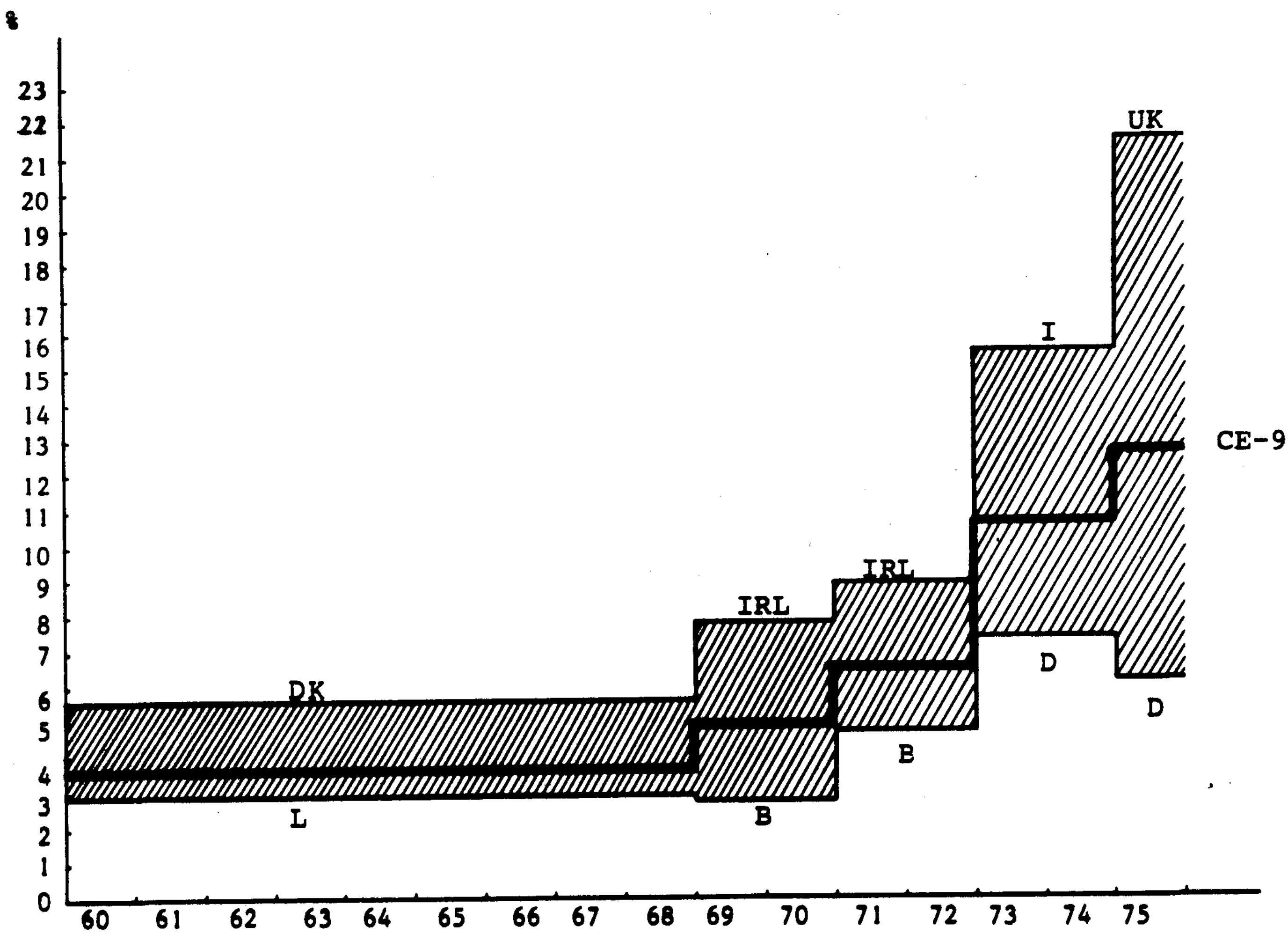
Period	D	F	I	NL	B	L	EEC-6	UK	IRL	UK	EEC-9
1960-68	3.1	3.8	4.0	3.9	3.2	2.9	3.5	3.6	4.0	5.6	3.6
1968-70	3.5	6.1	4.9	5.4	2.7	3.4	4.4	5.8	7.8	5.1	4.8
1970-72	6.2	5.7	6.1	8.3	4.7	4.9	6.1	7.6	8.9	5.8	6.4
1972-74	7.3	10.3	15.5	9.4	9.6	7.8	10.0	11.8	14.5	12.2	10.6
1975	6.1	11.8	17.0	10.8	12.4	10.5	10.4	21.5	20.9	9.5	12.5

Source: 1960-72 figures: calculated on the basis of the SOEC national accounts, 1960-74

1972-75 figures: calculated on the basis of information from Commission departments

Price deflator for private consumption

Annual average growth for the Nine and for the countries with the highest and lowest rates of inflation



3. The increase in the pace of inflation is due to a combination of extremely diverse causes. The most generally quoted are:

- a particularly sharp economic upturn in all industrialized countries from 1969, combined with increased "synchronization" of cyclical trends in the EEC countries;
- disorder and incoherence in the international monetary system;
- the explosion in raw material and fuel prices, due partly to overheating and ancillary factors (such as the scarcity of certain agricultural products and the sharp rise in the price of oil);
- an excessive increase of direct and indirect earnings;
- manifest errors in economic policy.

However, these are only partial explanations. Indeed, several factors which fed inflation for some time during recent years have disappeared or at least lost much of their importance: the US balance of payments deficit, the rise in agricultural prices and prices of raw materials, and so on. Yet inflation has continued at high levels.

Moreover, although rates of inflation vary sharply within the Europe of Nine, few countries seem able, in present conditions and in the medium term, to bring the rate down to under 5 to 7% a year.

4. In effect it is clear that the accidental or cyclical factors which accelerated the inflationary trend occurred against a background of structural and ongoing inflation. This background is rooted in profound economic, social and political changes which have occurred in the last twenty years.

These problems were at the centre of the interim report; they are also the subject of this report, which is supported by personal contributions from the experts and statistical annexes.

All in all, inflation is inseparable from:

- new economic structures, in particular the emergence of a powerful "meso-economic" sector[1], and new inflexibility in the price mechanism;
- a social impetus which, while representing positive and undeniable gains, also has involved some inflationary consumption, has failed to meet key qualitative needs, and has entailed major structural changes in the use of national production and incomes, without full admission of the consequences of such changes;
- social strains and social tension, new tendencies towards "corporatism" and a growing weakness of political and social decision-making.

4.1 Many industrial or service sectors are dominated by a few meso-economic firms. No doubt over the last twenty years some prices have fallen in relative terms and even in absolute terms in these sectors, in particular for current household goods and certain durable goods. But they have still fallen less than might have been expected from the technical progress and economies of scale achieved by these firms. In particular, during the current recession, it is striking that while there have been considerable price reductions for some raw materials and intermediate goods, many industrial prices nonetheless have continued to rise. This inflexibility in bringing prices down is due to several factors. First, these meso-economic firms are able to set their prices at a relatively high level, in relation to the costs and prices of smaller marginal firms (a price-umbrella effect). They can also "transfer" profits from one country to another through control of their subsidiaries' pricing (transfer pricing). Secondly, competition between them is often expressed by artificially differentiated and over-sophisticated products leading to increases in price, or restraining the lowering of prices made feasible by technical progress.

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[1] The term "meso-economic" refers to the increase and growth of monopolistic, multinational companies <u>between</u> the macro- and micro-economic levels. They have a significant macro-economic impact in a manner totally different from that of small-scale national firms in the micro-economic competitive model.

Labour markets also exhibit a certain inflexibility which is the normal result of reforms that no one would think of reversing. But this inflexibility makes it all the more necessary to redefine labour and employment policies so that they are compatible with the new facts of this market.

In addition, the concentration of funds, the changing role of the banks and different patterns of saving have considerably altered the structures of the capital markets by reducing flexibility and mobility in the allocation of financial resources.

The State, which, to varying degrees according to industry and country, is an important producer and customer, has so far made little use of its power to offset the inflexibility of the system. In some cases, the protection or subsidies given to certain industries, social groups and regions has increased their inflationary effect. The same has been true for too lax an administration of national budgets and the public sector.

4.2 Profound social changes are taking place in all our countries.

Peoples' demands are increasingly concerned with the quality of life and working conditions. In general, these aspirations are poorly perceived and poorly satisfied both by the public authorities and by trades unions and employers. Dissatisfied with the quality of life, people seek compensation in increases of direct and indirect wages which, while failing to solve the problems involved, increase inflationary consumption. These tendencies are reinforced by a mode of consumption which encourages a large measure of frivolous, ostentatious or non-essential goods and services. In short, our society wants to consume too much too quickly.

The changes which have been initiated by the public authorities to meet new needs or to reduce inequalities of opportunity and income, even though largely inadequate, also have had certain inflationary effects, because they were not preceded by a conscious and consistent policy choice between the aims of society and the means of attaining them.

4.3 Social and political consensus is increasingly difficult to achieve. Indeed, despite the social progress made in the last thirty years, considerable inequalities of income and wealth persist; these are increasingly felt and aggravate social tension.

The growing tendency towards corporatism has increased the degree of competition between different social groups. In this situation there has been a regrettable degree of public indecision, with a tendency to react passively to pressure from particular interests, thereby reducing the possibility of resolving basic conflict.

Political decision-making, made increasingly necessary by these trends, has never been so lacking in force. Consequently it is inflation which blindly adapts claims to real possibilities.

5. <u>These structural factors broadly explain the differences between countries' rates of inflation</u>. Inflation is lowest in countries where economic and social structures are to some extent adaptable, and where collective procedures and better structural conditions make possible a relatively judicious use of traditional policies. In countries where these conditions do not obtain and where in practice the socio-political system is called into question by the political and social struggle, inflation is higher.

6. The traditional policies of restricting demand are unsuitable for fighting the structural causes of inflation: such policies must be increasingly brutal to achieve any significant effect. The current recession is overwhelming proof of this. The lasting effect of these demand deflationary policies also is open to question. Certain countries have no doubt been able to reduce inflation in the short term, but at a very heavy economic and social cost, particularly in terms of unemployment and a stagnating standard of living. And no sooner does recovery begin than there are fears of a fresh spurt to inflation, starting from an inflation "base" of about 9% in the Community.

There are two main ways in which inflation could be mastered:

- either by accepting recession and depression resulting from over-reliance on traditional instruments of economic policy; i.e. "stop-go" measures, posing a threat of permanent underemployment to the future of our societies;
- or by undertaking a programme of more fundamental reforms and measures designed to achieve a more balanced economic, social and political structure, which means first shaping and then progressively establishing a new model for development.

7. The Study Group, while fully aware of the difficulty of the undertaking, has opted for this second approach, because it is convinced that the structural causes of inflation are increasingly important and largely explain the disarray of our economies and hence of our societies. But its choice of the second approach is also justified by the fact that the structural causes of inflation are either misunderstood or disregarded.

However, in implementing the recommendations made in the present report, two major dangers must be avoided. Under no circumstances can a structural approach to the problem of inflation be a means of escaping from the present, or a pretext for not strengthening by all possible means the effectiveness of short-term policies. Even if the structural sources of inflation are tackled, the short-term problems of demand management, of regulating monetary policy, public finance policy, etc. are still there and must be solved, especially in the period of transition towards a new model of development.

Moreover, a policy which really tackles the structural causes of inflation can only be gradual. Indeed, it would be futile to shut our eyes to the complex transitional problems inherent in the move to a less inflationary model for development, or to underestimate the weight of the opposition or the inertia resisting this change.

But, for their effects to be lasting, "reflationary" policies must be based from now on a new approach to growth, new consumption and production patterns and new dimensions to social policy, on the main lines described below.

8. The final report of the Group does not pretend to be exhaustive. It confines itself to making specific recommendations in the areas considered most important in terms of the perspectives for a structural approach to inflation.

First it endeavours to establish the general framework surrounding these recommendations, i.e., the aims of the proposed model for development,

This is the subject of Chapter I.

Chapters II, III and IV examine the principal problems raised by the new pattern of our development:

- labour and employment policies;
- less inflationary consumption;
- new guidelines for and management of public finance.

Just as it would be futile to ignore the strength of the psychological and sociological constraints on these fundamental changes, it would also be dangerous to underestimate the obstacles due to the way in which the economy is organized: the strength of meso-economic firms, their great decision-making power and influence, the very logic of their development. Chapter V is therefore mainly devoted to the problems of organizing competition and containing meso-economic firms.

Preparing the way for a future growth pattern that is more consistent and less anarchic, more balanced and less inflationary, and organizing new consumption, production and investment patterns, obviously presupposes a strategy for change.

Hence, the prime importance of planning procedures which are both more rigorous and more selective, based on a new approach to economic accounting. This is the subject of Chapter VI.

9. Key measures proposed in these chapters should be undertaken at Community level reinforcing essential action at the level of individual Member States with sufficient weight to guarantee success.

Bearing in mind the appreciable differences in the economic, social and political structures of the Member States, the recommendations made must not be applied uniformly to all Member States.

CHAPTER I - A NEW MODEL FOR DEVELOPMENT

10. The model for development on which our European economies have been based in the post-war period and which has for a long time ensured growth and full employment is now leading to growing contradictions, not least of which is the simultaneous problem of high inflation and high unemployment.

This situation had developed gradually before its aggravation by the dramatic events which have occurred since 1970 at international level, particularly in the monetary and energy areas.

11. In the face of this situation it gradually became apparent that a new model for development must be conceived and introduced, with the following objectives:

- restoring and maintaining full employment;
- helping to establish a better social balance by improved organization of everyday life and life at work (regional policy, housing and the environment, labour policy, etc...);
- protecting the environment and combating pollution;
- reducing the inequalities by a wider distribution of collective services (education, cultural activities, leisure..) and making such services genuinely available to the whole population;
- by systematically reviewing unfair situations in connection with taxation and equivalent charges, etc...;
- developing participation and democratic practices in social and political organizations and at the place of work.

12. It is not for this report, which is devoted to inflation, to give details of the content of these broad objectives and the methods of attaining them.

But it must be strongly emphasized that although it is only possible to attain these objectives in the context of better balanced and less inflationary growth, this new model, if it is well managed, should in its turn make it possible to combat inflation effectively, since its objective is to achieve growth which is less anarchical, less wasteful of natural resources, to re-establish valid norms for social interaction and to reduce social tension by giving greater attention to the qualitative factors on which welfare increasingly depends.

For this to become a fact, it is, however, important

- to perceive and measure peoples' aspirations and needs more effectively;
- to see to it that people and social groups adopt a new approach to accounting and social analysis which will really make them take account of the qualitative satisfaction they should derive from the new type of development.

On these two points, we refer to the specific proposals contained in pages 37 and 38 of the Study Group's Interim Report.

However, we would stress the need to replace the concept of "personal income" which until now has dominated wage claims and industrial bargaining, with that of "social income". Social income covers:

- traditional private consumption and saving;
- goods and services supplied to households at reduced prices or free of charge (e.g., drugs, low-cost housing, etc.);
- the use of public infrastructure created by or with the participation of the public authorities (e.g., hospitals, schools, roads and communications systems, etc.);
- satisfaction derived from social organization and in particular the organization of the work process (e.g., leisure activities, sharing in decision-making).

13. Nevertheless the major problems raised by the new criteria for development should be seriously confronted. These problems will be dealt with in later chapters. But three objections immediately spring to mind:

- will it not be more difficult to attain the objective of full employment, which remains the fundamental priority of all our societies, bearing in mind the new type of development and the increased risks for employment stemming from the faster structural adjustment of directly productive sectors, and the new dimensions to the international division of labour ?

- how can consumption be restrained so as to free resources for other private and public expenditure (especially investment expenditure), to produce the exports required to offset the recent rise in the cost of some imports, and to provide aid to developing countries?
- how can any room be found for the increased public expenditure essential for the new pattern of development, when recent years have already seen the rapid expansion of expenditure and of taxation and equivalent charges?

13.1 In the context of this new model of development, which has just been broadly outlined, new jobs will of course be created, even though the rate of expansion is lower than that recorded in the past. New patterns of production will gradually be introduced, probably with a slower growth in certain industrial and tertiary jobs, and even though we must beware of any systematic and Malthusian vision. Although the growth in jobs may slow down in certain areas affected by both the transition to a new model of development and the constraints of the new international division of labour, this will be at least partially offset by the sharp increase in maintenance and service activities.

But the range of possible action is not restricted to the permanent restructuring of activities for producing goods and services. It extends to a redistribution of work, to new arbitration procedures between management and labour and lastly to the creation of jobs without high cost investment. However, the means to these new ends must be carefully defined if we are to avoid increasing the risks of disequilibrium and inflation.

13.2 The new distribution of a more restrained consumption must derive from profound changes in its structure. These are changes which will entail far greater individual satisfaction in so far as they are correctly perceived.

These structural changes will be examined later in detail. Fundamentally they amount to:

- changing the existing mechanisms by which the structure of private consumption tends to adjust to high consumption groups (advertising, social status, etc.);
- reducing the effect of superfluous 'imitation' consumption by a fairer distribution of income;
- reducing the consumption of useless, over-sophisticated goods, with a very short technical and commercial life;
- eliminating the general inadequacy of certain services, particulary social and cultural services.

13.3 In the area of public expenditure, research should be devoted, by way of priority, to the more rational management of public services and to greater selectivity in social transfer payments, to avoid having to resort to inflation to finance public expenditure.

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The mere statement of these three problems indicates that although the new kind of development proposed can eliminate some of the most deep-rooted and pernicious causes of inflation, it is in no way the sole remedy. In no way does it relieve us from making the effort essential for combating the excesses of economic power, establishing better social consensus and restoring the ability of political authorities to make effective decisions.

CHAPTER II - A COMBINED LABOUR AND EMPLOYMENT POLICY

14. There are two major features in the labour and employment situation of our countries:

First, forecasts show that underemployment is a very serious danger in the medium term in all the Community countries. This is partly structural underemployment which may well persist even in the event of an upswing in production. In other words, if the mode of development is not profoundly altered, expansion will be neither continuous enough nor strong enough to create a sufficient number of jobs.

Secondly, working people are showing a general discontent which is reflected in an increased disinclination to work, at least in certain jobs, greater absenteeism, high staff turnover, halted production and in many cases, increased disputes. Wage increases alone will be less and less able to cope with such problems. Confronted with this increasing rigidity, employers have tended to create a peripheral labour market (immigrants, temporary workers, etc.) - both less demanding for them and less protected socially. This results in a new form of wage inequality in relation to the right to work. An active employment policy must fight against such phenomena.

15. This trend is basically inflationary because of the social tension it causes, the increases in direct or indirect costs which it generates, the inequalities it maintains, etc.

In order to combat this trend, <u>a combined labour and employment policy must be put into effect</u>; <u>the policy must be centred on two main principles</u>:

- <u>creating new conditions for full employment</u>, which remains the prime objective of our societies, and combating structural unemployment, which remains a social and economic curse, whatever the short-term palliative of unemployment benefits;

- <u>making work into a means of fulfilment for the greatest number of people</u>: failing this they will continue to seek empty compensation in a sophisticated and inflationary way of life, or continue increasingly to refuse work in those forms in which it is offered.

A. LABOUR POLICY

16. A labour policy must be comprehensive and must operate on several fronts:

- improvement of hygiene and safety conditions;
- introduction of greater flexibility in arranging working time per day, per year, per lifetime, etc., so that each worker may have the opportunity for a genuine choice, and himself decide between the merits of work, leisure or training;
- elimination, as far as possible, of shift work and monotonous work in workshops and offices through enrichment and broadening of jobs, independent teams, the right to change occupations several times in a lifetime, greater opportunities for promotion at work;
- improving the standing of manual work;
- reviewing the income pyramid in order to increase pay for work which is unskilled but essential for society; and conversely, reviewing the level of certain incomes based on social status and tradition rather than on services actually rendered;
- establishment of industrial democracy by improving relationships between workers and management, and opportunities for workers to express their interests at work; as well as more direct responsibility for production units, and employee representation in the management of undertakings, on those lines relevant to each country and to its own socio-political view.

17. To support this policy, a <u>minimum percentage of official aid to investment should be compulsorily devoted to improving working conditions</u>.

Since this improvement will not always be reflected immediately in productivity gains, a country's firms may well be reluctant to embark on it if the other member countries do not do the same. It would therefore be essential for the Community to take an initiative in this area.

B. A NEW MODE OF DEVELOPMENT AND FULL EMPLOYMENT

18. The new mode of development, which has been broadly outlined in Chapter I, will create new jobs, even if the rate of expansion is lower than that recorded in the past. Even though the growth in jobs may slow down in certain areas affected by both transition to the new model of development and the constraints of the new international division of labour, this will be at least partially offset by the sharp increase in maintenance and service activities, as well as the development of 'services in kind' to satisfy social needs and improve social relations.

But it will not be sufficient to plan and to organize the restructuring of activities for producing goods and services. Achievement of full employment over the next few years must depend on:

- redistribution of labour;
- the direct creation of jobs in areas where prior large investment is not required;
- a more active employment policy.

19. As far as redistribution of labour is concerned, it seems that a policy boldly aimed at reducing working hours promises more for the achievement of full employment than one of lowering the retirement age. Furthermore, this reduction should be both planned and negotiated between employers and unions at the most relevant level: the industry itself. This would prevent the formation of bottlenecks due to the shortage of skilled workers which in turn entails excessive increases in labour costs.

20. We should contemplate, in line with the new aims of growth, the direct creation of jobs in areas which do not require prior large investment.

The growing needs of society must be satisfied, in the areas of education, culture, the organization of social activities, specific aid to all those who experience difficulties in living in a society dominated by large-scale organizations and bureaucracy (people living alone, the handicapped). Also a more favourable environment must be created, entailing capital expenditure (improvement of accommodation, town planning). The main difficulty lies in the need to increase public expenditure for these purposes, when resistance to increased taxation and social security charges is already emerging (see Chapter III).

21. It will still be necessary to review active employment policy, the effectiveness of which has been called into question in recent years because of the increased inflexibility on the labour market. By way of priority this review should cover the following points:

- The public employment agencies should improve the effectiveness of their activities for the benefit of sections of the population which experience the greatest difficulties in entering or remaining on the labour market (young people, women, older workers, foreign workers). They might succeed in adjusting labour supply more closely to demand if they were wholly responsible for temporary work and also had the means to influence demand from firms and public departments (content of work, location of activities, conversion operations, jobs reserved for those most in need);

- Bearing in mind the changes which must take place in employment structures, it is vital to restore a more genuinely voluntary job change and mobility and by providing material assistance, promotion opportunities and improved work content. But at the same time it is just as important to make greater efforts - they have been inadequate until now - to bring jobs to the workers, since their attachment to their region or the community among which they live is a factor which should be taken into consideration in the context of a development which places more emphasis on qualitative factors. Moreover we know how much inflation is sustained by regional imbalances, because of the relative over-employment and the under-employment of overhead capital and production capacities;

- The links between training and employment should be reconsidered, taking into account the need to relate training to actual jobs. Education policy can help the attainment of labour policy objectives, by improving basic training, by giving young people the taste and the opportunities for training and improving their skills, by broadening the contribution of further education. Conversely, labour policy can help training policy, by permitting sandwich course experiments and by facilitating the transition from school to working life thus making it possible to combat inequality of opportunity and lack of adaptation in professional training.

CHAPTER III: A NEW WAY OF LIFE - LESS INFLATIONARY CONSUMPTION

22. The gradual introduction of a new model for development implies in particular a change in the type of consumption, reflected in a change in peoples' attitudes, in their way of perceiving and taking account of society and in the definition and weight given to society's values.

However, we must not ignore that this poses formidable problems: How can we give proper attention to qualitative aspirations such as the increase and free use of leisure time, changes in the way of life and work, etc., and at the same time curb the consumption of goods and services which are of questionable usefulness and with a purely meretricious novelty value? For if we do not do this, the combination of traditional and new types of consumption will be directly inflationary.

In order to direct the consumption model towards a less wasteful (and consequently less inflationary) economy, which is less geared to meretricious or useless innovations, four major steps must be taken:

- broadening the range of needs to be satisfied;
- reducing inequalities;
- more information and better protection for consumers;
- combating waste.

A. Broadening the range of needs to be satisfied

23. This step is essential because it should make it possible to take account of all aspects of the quality of life and thus restrain purely quantitative claims:

- increase the size and effectiveness of community services (particularly for families, the elderly and those living alone);
- improve living conditions and the environment for both town and country;
- review location criteria in order to combat "gigantisme", congestion and other social costs;
- increase the possibility of access to education and cultural activities.

B. Reducing inequalities

24. Vigorous action to reduce inequality is an important weapon in the fight against inflation. A highly compartmentalized hierarchy of income and wealth exploited by aggressive advertising encourages the tendency towards a highly sophisticated, ostentatious, wasteful and hence very inflationary way of life. This tendency in turn highlights inequalities and aggravates social tensions.

Moreover, a reduction in inequalities is probably a precondition for getting people to accept a less inflationary model of development geared more to the quality of life given the problems of adjustment this would involve.

Consequently it is recommended that:

(a) Hierarchial differences between all disposable incomes and wealth should be reduced by action on prices and incomes, worker shareholding and participation in the capital of enterprise, taxation and more selective social transfer payments. Measures of this kind would help to channel the pattern of consumption away from sophisticated goods to which it is at present drawn by the habits and lifestyle of those in the highest income bracket. This would entail a greater degree of transparency of incomes and wealth, particularly from the point of view of taxation;

(b) Collective property and services should be made accessible to everyone by a policy aimed at improving the siting of public facilities and providing better information and training for those concerned.

C. More information and better protection for consumers

25. The measures described below are aimed at making markets more transparent and in particular at helping consumers to see through "new" products which are not genuinely new, artificial differentiation of markets and products, unjustified price rises, the practice of concealing reductions in quality by changing the presentation of products, deceptive marketing and advertising etc.

25.1 All the Member States should implement as soon as possible the Council Resolution of 14 April 1975 on a preliminary programme of the European Economic Community for a consumer protection and information policy[1], which contains recommendations on:

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[1] Official Journal of the European Communities, Volume 18, No C 92, 25 April 1975.

(a) health protection and safety;
(b) protection of economic interests;
(c) advice, help and redress;
(d) consumer information and education;
(e) consultation and representation.

25.2 In particular, the public authorities should implement a policy aimed at defending and illustrating the new model of consumption by providing information and publicity laying stress on qualitative requirements and putting people on their guard against artificial and wasteful "innovations".

25.3 In the field of advertising and marketing:

(a) The first essential is a clearer overall statistical picture of the phenomenon by sector and type of firm. The questionnaires sent to firms to determine production statistics should therefore also include a separate section devoted to spending on advertising;

(b) Measures on advertising would be more effective if they were part of a minimum common programme at Community level. It is therefore essential that the consumer's right to information, defined in the European Charter, be organized as soon as possible at Community level (see above);

(c) For products which are in some way harmful a series of measures should be adopted, ranging from a complete ban on all advertising in some cases, to obligation to obtain prior authorization for advertising, compulsory indication of the possibly harmful effect of the product, limiting advertising to simply giving direct information on the product, discriminatory measures in the field of advertising and credit;

(d) For other products the following steps should be taken:
   (i) the advertising industry should be encouraged to exercise self-discipline, and, if necessary, the public authorities could fix minimum rules to be incorporated in the industry's code of practice;
   (ii) excesses should be monitored and held in check by the following methods:

- more preventive action by the public authorities, intervention by price surveillance and/or monitoring bodies;
- reversal of the burden of proof of abuse of competition on the lines of the procedure introduced in France;
- publishing corrective and comparative advertising;
- promoting action by consumer groups;

(iii) in certain cases the amount of spending on advertising which may be deducted from taxable profits could be limited.

25.4 Other measures also could make a useful contribution, such as:

(a) establishing the fundamental right of consumers to buy goods where they want by determined action to prevent agreements between firms to divide up sales territory;

(b) re-examining or even limiting some sales methods (mail order, tie-in sales etc.) and certain forms and methods of providing credit (customer cards, credit cards, etc.);

(c) public authorities should publish details of potential price cuts made possible, for example, by fluctuation in the price of raw materials or exchange rates;

(d) firms which receive government contracts should be forced to respect strict price discipline;

(e) courses on pricing and advertising could be introduced in primary and secondary schools.

D. **Combating waste**

26. This is particularly necessary to prevent an inflationary imbalance between the supply of and demand for comparatively rare goods (particularly sources of energy, raw materials, etc). It would involve changing relative prices and raising some prices (costs of recycling, costs of after-sales services, etc.).

The following steps, in particular, should be taken:

(a) promoting the manufacture of more durable goods (increasing the period of guarantee, rules on after-sales services, maintenance and repair activities);

(b) giving priority to public as opposed to private individual transport in urban areas and inter-urban travel;

(c) encouraging the recycling of materials by adopting an appropriate product policy, organizing waste recovery networks and providing information and publicity;

(d) incorporating energy saving measures in a coordinated policy for transport, the environment, telecommunications, etc.

CHAPTER IV - NEW GUIDELINES FOR AND MANAGEMENT OF PUBLIC FINANCE

27. The introduction of a less inflationary development model based more on qualitative factors and yet able to provide more jobs will entail more public expenditure to improve the framework of life in the community as a whole and combat the various forms of inequality.

During the period 1960-75 there was a very sharp upward trend in expenditure particularly on social transfer payments and public consumption. This increase undoubtedly helped to stimulate excessive demand especially during the 1969-73 boom.

Despite progressive scales of income tax and the sharp rise in public expenditure on welfare benefits, financed by an appropriate increase in social security contributions, public finance policy has not gone very far on the way towards redistribution of income or change in the social structure. Indeed in certain cases it has even gone against the trend.

Attempts to put the "brakes" on public expenditure, have been mainly concentrated on public investment, thus hampering the development of those collective goods and services needed to forestall or remedy the deficiencies of the past twenty years' development (congestion, noise, injustices etc.).

Resistance to taxation, which grows stronger as the burden of taxation increases, has led on the one hand to a widening gap between expenditure and revenue (which certainly has an inflationary effect) and on the other hand to an increase in social security contributions, which has undoubtedly weakened the impact of social security as an instrument for redistributing incomes and wealth, and increased cost inflation.

28. The problem is therefore how to make provision for the new expenditure required for the proposed new type of development without:

(a) increasing taxes and parafiscal duties at an even faster rate than in recent years thus giving a boost to tax push inflation and bringing the proposed development model into disrepute;

(b) allowing the gap between spending and revenue to increase still further and thus finance new expenditure by inflation;

(c) allocating certain collective functions to the private sector at the risk of intensifying the inequalities that one wishes to remove;

(d) blindly putting the brakes on any increase in expenditure, a measure which past experience has shown would mainly affect public investment and the new expenditure required to change the pattern of development.

Public expenditure must be made more selective and more effective if this dilemma is to be avoided.

29. Whereas budget policy in recent years has increasingly borne the brunt of demand management policies, what in fact should be done is to link an increasing proportion of the budget very closely to a medium- and long-term Plan.

Expenditure which is vital to the gradual introduction of the new development model (in particular the public investment and operating expenditure involved) will thus be an essential feature of a planning process as described in more detail below (Chapter VI).

30. A thorough review should be made of the effectiveness of the transfer policies conducted by the public authorities over the last fifteen years.

(a) The rules on tax exemption should be reviewed and this form of indirect subsidy gradually replaced by more transparent direct subsidies;

(b) There should be greater selectivity in social transfers, involving combined action on the formation of direct income and wealth, the role of taxation, contributions and transfer payments;

(c) Health services and benefits should be rationalized by giving priority to preventive measures and health education;

(d) Subsidies to firms should be used more effectively to bring about a genuine reduction in regional and sectoral disparities.

31. The public authorities should also, without neglecting their priority duties but with the twofold aim of democratization and efficiency, entrust ad hoc groups of citizens with the implementation, under contract, of certain activities of public interest, such as tourism, the arts, consumer information and protection, etc. They could also delegate certain tasks to private firms, which would receive a subsidy or concession and undertake in return to respect a number of criteria laid down or approved by the public authorities.

In addition, they could transfer certain tasks to publicly owned companies which can manage their affairs with greater flexibility.

32. Generally speaking, there must be <u>greater coordination of the measures taken by the various public or semi-public authorities</u> to reduce costs and increase the effectiveness of the expenditure (e.g. coordinated action on public transport, housing, town planning; welfare benefits, health protection, environmental protection etc.); plus Planning Agreements between the State and the decentralized authorities.

CHAPTER V - ORGANIZATION OF COMPETITION AND CONTAINMENT OF MESO-ECONOMIC FIRMS

33. All modern economies now represent key new rigidities:

(a) only part of the benefits of productivity increases achieved by firms in the meso-economic sector are passed on to consumers;

(b) there is a tendency towards uniform wage and salary levels in all industries irrespective of productivity differentials;

(c) there is inflexibility in the distributive trade which often cancels out price reductions achieved at the industrial level;

(d) some industries are artificially protected by the public authorities who pursue an autarchic policy in other industries (data processing, aircraft industry etc.).

Rigidity in all these forms is a direct source of inflation. These were analysed in the group's Interim Report (see pages 7-10).

34. The rise of meso-economic power is of particular importance, for a small number of meso-economic firms are playing an ever-increasing role in most industries and countries of the Community. In the United Kingdom for example, less than 1% of the firms account for 50% of the country's output and direct exports. Similar trends are visible in France, Germany and Italy.

Unlike micro-economic firms, those in the meso-economic sector wield considerable influence over the macro-economic variables such as production, prices and foreign trade.

The rise of "meso-economic power" has undoubtedly brought with it a number of benefits such as large increases in productivity, thanks to technological progress and the advantages of scale. But this development has also profoundly changed the conditions of competition and price formation.

34.1 Large firms frequently set their prices in relation to the costs and prices of small and medium-sized firms thus providing a kind of price umbrella for these smaller marginal firms, which can thus remain in business, and giving the large firms super-normal profits.

In practice, prices are often determined by the most efficient producer, as in the classical theoretical model, but on the basis of the costs of the least efficient firms, which the meso-economic firms, and in many cases the public authorities, want to keep in business for various reasons.

This policy is far from being the only explanation for inflation but in practice means that prices rarely fall, at least not in normal economic conditions. In other words the major improvements in productivity which the meso-economic sector can achieve by economies of scale and technical progress are not passed on in full to consumers.

34.2 Sometimes large firms keep prices steady or even reduce them. But they now can do so to facilitate mergers or prevent other firms gaining a foothold on the market. In such cases prices are no longer a valid sign of competition since the price ceilings or price cuts represent elimination of competitors or prevent them gaining access to markets.

35. These developments have been intensified by changes in the structure of international trade, an increasing proportion of which is accounted for by exchanges between the subsidiaries of multinational companies. This encourages transfer pricing between subsidiaries in different countries not only with the aim of transferring profits from countries with higher levels of taxation for those where taxes are lower or to tax havens but also to make it to under-state profits and thereby easier to obtain aid State. The most common technique is that of artificially raising the price of imports from foreign subsidiaries thus adversely affecting both the trade balance and domestic price levels of the country concerned.

36. Action on controlling the inflationary effect of rigidity in the public or private meso-economic sector should be threefold:

(a) more control over the activities of meso-economic firms and their more effective containment as part of an increased planning effort;

(b) promoting the creation and survival of viable small and medium-sized firms;

(c) closer monitoring of price structures and price changes.

As a general rule, the elimination of such artificial advantages is a key factor in the efficient organization of competition and reduction of inflationary tensions.

A. Containment of meso-economic firms

37. In this vital field, realistic efforts must be made to:

(a) improve information;

(b) increase the supervision of mergers;

(c) conclude planning agreements between government, management and trade unions.

It is abundantly clear that, given the size of the firms involved, key action in this area can be undertaken at the Community level, reinforcing national policies.

Improving information

38. In order to improve information on the activities of meso-economic firms both at national and Community level, it will first be necessary to collect and organize existing information from different sources on such subjects as employment turnover, prices, wages and salaries, social security contributions, profits, taxes, subsidies, and investments etc. For the purposes of easier comparison and use of these various statistics it will be necessary:

(a) to end statistical and tax secrecy for the firms concerned so that more information can be obtained, particularly regarding turnover, prices, cost levels and structures;

(b) to use a common coding and identification system for the same meso-economic firm in the various sources of information.

39. Folowing existing practice in similar cases, the firms concerned should be obliged, as in certain Member States (Belgium and Italy) to make available certain information, for example when notifying investment plans to the responsible authorities (see below).

Greater supervision of mergers

40. The improvement of information discussed above should provide the basis for a greater degree of supervision. Meso-economic firms should be made responsible for the onus of proof that their pricing activities are in fact competitive.

In addition, supervision of mergers must be intensified to include an obligation on large firms to obtain prior authorization for any merger.

Planning agreements

41. The governments, meso-economic firms and trade unions should negotiate and conclude at national level and, in the case of multinationals (whatever their size), at Community level, planning agreements covering:

(a) norms and guidelines for those variables directly linked with inflation (prices, wages and profits);

(b) modernization and reorganization measures, for example in the field of employment and investment (including regional location);

(c) direct or indirect public aids and assistance to firms and the firm's obligations to the State.

42. Such agreements, which already exist in several Member States, if in an as yet insufficient form, and have been proposed by the United Kingdom, would be a practical instrument for changing production and pricing structures within the planning framework described in Chapter VI.

As such agreements would often entail public expenditure, their implementation would have to be monitored by parliaments.

The public authorities should oblige all meso-economic firms to give advance information on their corporate plans with a view to such Planning Agreements.

The Community's responsibilities

43. The abovementioned activities are just as important at European as at national level in cases where the following factors are involved:

(a) objectives or guidelines laid down at Community level;

(b) aid granted at Community level;

(c) mergers involving firms in two or more Member States;

(d) information which can only be obtained or compared at European level.

Institutional arrangements and procedures should therefore be adapted and developed with this in mind. For example, a Committee of representatives of employers' organizations and trade unions should be set up to advise the Commission's Directorate-General for Competition on restrictive practices and further ways of containing multinational firms more effectively.

In other words, it is a matter of bridging the gaps in the means of intervention of individual member states and opening the possibility of intervention at the relevant Community level.

B. Promotion of viable small and medium-sized firms

44. It is in the interests of economic and social balance and dynamism as well as of competition that there should be a sizable number of small and medium-sized firms. However, it is becoming increasingly difficult to set up viable firms of this type, let alone keep them in business. We have already seen that keeping marginal firms in business artificially, a policy pursued simultaneously but for different reasons by meso-economic firms and the public authorities, is a definite cause of inflation.

45. The viability of small and medium-sized firms must be improved by:

(a) developing and coordinating vocational training, re-training, and technical assistance;

(b) improving the financial machinery to allow small and medium-sized firms easier access to risk capital and credit without curtailing their independence vis-à-vis large firms;

(c) favouring the creation and establishment of new enterprises capable of innovating and responding to the needs of society.

(d) ensuring that all small and medium-sized firms have access to technological developments through joint research centres and, in the same field, reviewing the rules on the period of validity of patents and licences;

(e) making it compulsory for public purchasing to be subcontracted through to the level of small and medium-sized firms.

C. Price Supervision and Scrutiny

Action in this field would also be more effective if carried out simultaneously at national and Community level.

National level

46. The group does not intend proposing the systematic surveillance of all prices. Instead, the prices of meso-economic firms, and those firms occupying a dominant position on a specific market should be monitored. This applies particularly to firms working on public contracts or those receiving some form of State subsidy.

47. Prices policy should also be strengthened by:

(a) requiring manufacturers (and importers) to give prior notification of increases in the prices of certain key products (prices with a high inflationary potential);

(b) obliging exclusive distributors to make available their price lists and other conditions of sale for inclusion in a public register. Participation in an unauthorized restrictive price agreement should also be classified and penalized as an offence.

Community level

48. It is often not within the power of a single Member State to ensure effective surveillance of the price policy of meso-economic firms.

The information needed to coordinate surveillance of the prices practised by these firms should therefore be collected at Community level with a view to detecting and combating the following practices:

(a) compensatory dumping within a meso-economic firm, i.e. fixing different levels of prices or profit margins

- for a number of products in the same country
- for the same product in various countries
- for a number of products in various countries;

(b) transfer pricing by meso-economic firms.

A Prices Commission should be set up at Community level bringing together representatives of the Commission, business, trade union organizations and consumer groups.

49. To make the cost levels and structures, prices and profit margins of meso-economic firms comparable, an accounting plan for firms will have to be worked out at Community level. This could be made compulsory for meso-economic firms and a simplified version could be introduced for other firms. This plan should set down minimum guidelines for the presentation of firms' accounts and the rules for entering transactions and stocks in the accounts (evaluation, definition of periods, etc.) and for the calculation of significant ratios (profitability, etc.).

50. For the purpose of monitoring transfer pricing export and import transactions between national subsidiaries of multinational firms should be presented in separate disaggregated form in international trade statistics.

D. Elimination of artificial advantages

51. It is essential to eliminate as far as possible any artificial advantages which may distort competition:

(a) subject to Planning Agreements the heads of public firms and corporations should be given greater responsibility to enable them to charge realistic prices. This may entail a reduction in public subsidies to these public firms or corporations by:

(i) wider application of the principle of global self-financing of costs, including depreciation on plant and machinery and servicing debts;

(ii) limiting subsidies to public firms to those costs resulting from public decisions (e.g., for social or cost-benefit reasons);

(iii) abandoning the practice of setting off losses and surpluses between various public firms or corporations (for example,at local level losses on public transport would not be covered by surpluses from gas, water or electricity boards);

(b) all abusive restrictions on access to the market should be prohibited and the following specific measures taken:

(i) a review of all restrictions on access to a profession imposed by the profession itself or subject to quotas;

(ii) a time limit on exclusive contracts and concessions, particularly those of large firms;

(c) removal of obstacles to the introduction of new production and distribution processes and new products;

(d) removal of obstacles to the re-exporting or re-importing of goods;

(e) public or "authorized" rules on the fees charged by certain professions, should be regularly adjusted, notably those for professions which thereby maintain a monopolistic position (lawyers, architects, doctors, according to country concerned).

CHAPTER VI - A NEW FRAMEWORK FOR PLANNING AND NEGOTIATION

52. Clearly all the changes proposed in the preceding chapters will not come about spontaneously.

Hence the vital importance of planning, not merely as a forecasting instrument for analysing future possibilities and risks, but as an effective instrument for guiding the economy in new directions granted the highly varied choice of possible means of action. These planning means range from incentives to direct intervention, establishing a new model of competition where this can bring about the best distribution of resources and resorting to direct intervention and public action where competition is lacking or counterproductive.

53. If it is to be effective planning must fulfil certain fundamental conditions.

Planning must be an instrument which is:

- rigourously coherent and strict in its priorities;
- democratic;
- adjustable from year to year.

But it also must be made more rigorous by the use of an integrated data processing system using detailed socio-economic accounts.

Planning prepared on the basis of alternative courses of action and strategies culminating in a table of precise objectives must be the main instrument in the dialogue between public authorities and the two sides of industry.

It should include other activities aimed particularly at:

(a) linking part of the budget more closely to the Plan;

(b) carrying out the structural adjustments required both by the new conditions of the international economic order and the introduction of the new development model;

(c) ensuring effective surveillance and monitoring of meso-economic firms;

(d) improve the effectiveness of the Common Agricultural Policy - without disregard for its total cost, by a better combination of price support and direct production support to individual farmers;

(e) rationalizing the overall framework of public expenditure and receipts.

A. An integrated data-processing system based on enlarged economic accounts

54. An effective system of planning and negotiation presupposes the enlargement of the scope of traditional economic accounts as a step towards integrated socio-economic accounts covering:

54.1 Adjustment of the aggregates in the present national accounts from the point of view of welfare to take account of factors:

- which are not covered by the concepts used at present (welfare, leisure time, real wealth and financial wealth, social costs, etc.)[1]
- which are swallowed up in larger aggregates (for example distribution of income by categories, economic branches, socio-professional groups; regional breakdown of wealth, production and its use).

54.2 A breakdown of national product by function (education, health, social security, research, public policy, housing, recreation, etc.) coupled with:

- the economic categories of the national accounts,
- the economic branches in the input-output tables,
- the regions of the country;

54.3 A regular supply of information on market structures and economic power, indicating in particular the importance in each sector of meso-economic firms. It would thus be possible in future to obtain information covering a large part of the market from only a few firms. This information should cover:

[1] Such a range of social indicators could complement the economic indicators of traditional accounting. They should thus improve the content of political debate on the terms of reference for the new modes of development.

(a) the degree of concentration in the various sectors,

(b) separate indication in foreign trade statistics of imports and exports by meso-economic firms, notably those which have subsidiaries within and beyond the boundaries of the Community.

Moreover, as well as giving prior notification of price changes and investment plans (see above) firms should be obliged to provide statistics on such matters as individual costs and prices. Analysis of the various sectors could then highlight the various phenomena mentioned in the previous chapter: price umbrella effects, no-entry barriers and elimination pricing, transfer pricing;

54.4 Presentation of socio-economic accounts expressed in current prices and constant prices. This would give a coherent system of indices of real prices and - for non-market transactions - shadow prices, which would make it possible to analyse the trend of relative prices.

55. The improved socio-economic accounts should be stored in a data bank to which all public authorities and social groups would have direct access.

The Community should have studies carried out immediately into the feasibility of this system and the organization of the Community "network". It is already clear before such a system was introduced that the principle of statistical secrecy would have to be reviewed and a major reorganisation of data collection and statistical departments undertaken.

B. Democratic negotiation on precise and coherent objectives

56. The integrated data-processing system is an essential prerequisite for more effective and constructive social negotiation.

It must serve in each country as a basis for a socio-economic model on which alternative courses of action and strategies set out in reference tables, showing the weighting given to particular specific objectives and the means needed to implement them, can be worked out with the help of the various social groups.

Preparation and discussion of alternative tables would culminate in a target table containing:

(a) overall guidelines and norms concerning:

(i) allocation of the national product by economic sector and function, plus the regional distribution of the means of production;
(ii) public expenditure and income;
(iii) the structure of economic finance, notably investment;
(iv) money and credit;
(v) personal incomes (earned and unearned) and social incomes;
(vi) the qualitative benefits from development, in terms of the new social indicators;

(b) a consistancy check on the indispensable relationships, starting with the problem of matching real supply and nominal demand.

The timescale of Planning

57. If it is to cover the various types of objectives and actions adequately planning must be three-dimensional:

(a) a long-term plan (15-20 years): essentially the strategy for changing the mode of development. Objectives which can be attained only after a fairly long period should be fixed: the structure of national consumption, wealth and the labour market, the education system, regional planning, etc. Long-term plans should be divided into five-year periods laying down medium-term policy objectives.

(b) a medium-term plan (5 years): particular emphasis on priority investment programmes, disaggregated annually with intermediate objectives;

It is in this framework that:

(i) the links between national budgets (annual sections of the plans) and the medium-term plans themselves should be strengthened;
(ii) above all, the link between the State budget (including social security) and the plan should be reinforced.

(c) Short-term forecasts and policy.

Principles of and procedures for negotiation

58. Although technically equipped to make a coherent choice between the objectives of society and the means of attaining them and thus strike a lasting blow against inflation, the main protagonists on the economic and social scene must respect a number of essential principles:

(a) enlarging the scope of and participation in the negotiations, particularly on the basis of the new system of accounts proposed above;

(b) concentrating the process of cooperation in a central body which would bring together the representatives of central and regional government authorities, employers and trade unions;

(c) restoring the primacy of the political debate thus giving Parliament back its decisive powers of intervention in the negotiation process;

(d) helping the two sides of industry to make major choices. In this context the planning bodies could make better use of their preparatory role which should provide them with the essential minimum of independence.

59. The procedure for preparing and discussing the plan, based on these principles, could operate as follows:

(a) analysis of requirements at the level of regions, sectors and firms.

On the basis of this information:

- preparation and discussion of various possible policies and strategies in the framework of the central body mentioned above;
- subsequently a final decision by Parliament on the policy and strategy adopted;

(b) allocation at local level (region, sector, firm) of the overall package, at least for certain strategic variables.

60. Within this process the decision on the final use of resources must be made by political authorities. Once the plan has been decided on:

(a) the central government must work out medium-term Planning Agreements with the regional authorities or local government, and meso-economic firms;

(b) the two sides of industry operating within the framework of free bargaining must reach agreement at branch or firm level within the overall guidelines or norms fixed in the plan.

C. Selective planning

61. Coherent and democratic planning based on an exhaustive analysis of requirements must define the priorities adopted more clearly than in the past.

In the present circumstances, the emphasis must be on:

(a) planning increased production of collective property without endangering still further the balance of public finance and restimulating inflation;

(b) organizing the redeployment of investment production.

62. The national plans must contain an obligatory section covering priority public expenditure for the planned development strategy (see public finance). This obligatory section would take the following form:

(a) an overall ceiling and individual ceilings would be fixed for the major categories;

(b) a few major programmes would be defined within each of these ceilings (covering both operating expenditure and capital expenditure) accounting for a modest proportion of the ceilings. Implementation of these programmes would be backed up by the techniques for rationalizing budgetary decisions already successfully used in various countries;

(c) the necessary cyclical flexibility for implementing the annual budget would therefore be maintained within the ceilings fixed.

Redeployment of investment and production

63. The redeployment policy must be planned both at Community and national level:

(a) at Community level the procedure for the notification of investment must be introduced in those sectors where the risks of excess investment (and therefore increased inflation) are particularly great.

(b) at national level the incentives given by public authorities and public contracts must be concentrated on firms which agree to be contractually bound to the planned redeployment organized by the public authorities. The instruments for such a policy already exist in several countries (planning agreements, contrats de programme, contrats de progrès, contratti di programmazione) (see point 41).

To have a reasonable chance of success, this policy must be negotiated with the real negotiating partners at company level and with the workers' organizations (see above).

The new planning must focus at the same time on both economic objectives and the new social ends, notably on promotion of means for adaptation and conversion of activities, the new employment criteria, new training for workers etc.

In this way the foundations will be laid for a healthier economy based on: realistic planning for necessary change through the negotiation of the state with both the main professional groups and the trade unions.