January 1976

#74

The Current Status of Economic Integration in the European Community

by

Raymond Lubitz

The Current Status of Economic Integration in the European Community

Raymond Lubitz*

Introduction

The history of the European Community seems to be marked by alternations between periods of progress and cooperation and crisis and disarray. In 1974 the Community experienced one of its most pervasive crises as failures in several areas -- monetary union, energy policy, and political cooperation -- all seemed to converge. Recently, a good part of this gloom has been dispelled although, in terms of substantive achievements, not a great deal has been recently accomplished. However, with the U.K. renegotiations and referendum behind it, and a new sense of realism and pragmatism as to what can be reasonably accomplished, new initiatives may now be possible.

The one undoubted success of the European Community has been the creation of a customs union in industrial products. Among the original Six, internal free trade and the Common External Tariff were achieved in a series of tariff changes and were fully accomplished ahead of schedule in 1968. The failures of the EC have been in the coordination of national economic policies and in achieving progress towards economic and monetary union. The failure of monetary union has in turn created difficulties for the Common Agricultural Policy. In addition, the sense of disarray stalled policies that are essential

---

* The views expressed herein are solely those of the author and do not necessarily represent the views of the Federal Reserve System. I have benefitted from the comments of Donald Adams, George Henry, David Howard, Larry Promisel, Charles Siegman and John Wilson.

for creating a genuine economic union in Europe, for example industrial policy, which seeks as one of its ultimate goals large progressive European firms operating without regard to national boundaries.

In this note the focus is on the issue of economic and monetary union. The EC touches on many areas of economic life and is trying to evolve common policies in a variety of fields such as Social Policy, Industrial policy (which includes inter alia company law, taxation, workers participation, competition policy, industrial standards, government procurement) Education, etc. Most of these issues shall not be discussed. Rather, the theme is economic integration and includes monetary issues in a strict sense and those common policies -- in agriculture, the budget and the "regions" -- which are or soon will be in place and have a direct bearing on the success of economic integration. Some other topics which touch on the relationship of the EC and the rest of the world and some political considerations which have affected the progress of the EC will be also discussed.

Economic and Monetary Union (EMU)[1/]

Although I shall not present a detailed history of economic and monetary union, some background may be useful for understanding the present situation. After the completion of the transitional stage of the EC -- customs union and CAP -- a move began to try to establish monetary and economic union. The Council of Ministers agreed in February

1/ The literature on economic and monetary union is voluminous. A useful historical essay by A. Bloomfield appears in [7]. Corden's essay in [1] examines many of the analytical issues that are most relevant to this paper -- this essay appears in a different form in [7].

1971 to the creation of EMU in 3 stages with union to be completed in 1980. The long-run goal was a system of fixed exchange rates with no margin of fluctuation and no parity changes, a common central bank (along the lines of the Federal Reserve System), and a complete liberalization of capital movements. However, only the details of the first stage, which was to last from January 1971 to January 1974, were agreed upon. The members disagreed over the amount of supranationality they would grant collective EC decision-making bodies in a complete EMU. The French under de Gaulle were opposed to any significant lessening of national sovereignty.

The members did agree that they would try to narrow exchange-rate margins progressively and reduced them from the outset: from $\pm$.75 per cent of the dollar parity (i.e. $\pm$1.5 per cent between any 2 Community currencies) to $\pm$.60 per cent (i.e. $\pm$1.2 per cent between EC currencies). They also agreed to arrange medium-term credits (2-5 years) in addition to the short-term monetary support arrangement already put in operation in February 1970 by the Central Banks of the EC. Two other decisions of the Council at that time were: the Council of Finance Ministers would meet three times a year to establish guidelines for short-term economic policy for the EC member states, and the members would take steps to liberalize capital movements and create a European capital market.

Because of the monetary crises of 1971 the original narrow margin agreement was not implemented. The Smithsonian Agreement of December 1971 permitted currencies to move within margins of $\pm$2.25 per cent on either side of parities or central rates; this would have allowed any 2 EC currencies to move within ±4.5 per cent of parity or a maximum variation of 9 per cent. The members of the EC thought that such variation would place undue strain on the Community, particularly on the working of CAP, and would be inconsistent with the intention of aligning their economies. Therefore, the EC decided on narrower margins than permitted by Smithsonian, but wider than the earlier narrow margin agreement. In March 1972 they agreed to permit fluctuations of ±2.25 per cent between any two EC currencies and between any EC currency and the dollar. It should be noted that the agreement referred only to narrow margins and the members were still free in the first stage to alter their parities. The narrowing of margins went into effect in April 1972 and the snake -- as it is called -- was joined by the then prospective members -- the U.K., Ireland, Denmark and Norway (which in the end did not join the Community but has been associated since with the snake). However, the full snake had a short life: in June the sterling crisis prompted the United Kingdom and Ireland to leave and in February 1973 pressure on the lira caused Italy to depart. Thus there is only 2 months when all of the Nine were in the snake and about 10 months when the original Six were all a part of it.

The continuing international monetary turmoil in 1973 caused further changes in the snake. In March the EC abandoned the attempt to maintain parity against the dollar (the so-called tunnel within which the snake floated) and instead began a joint float. In January 1974 pressure on the franc caused the French to withdraw and left what was virtually a mark bloc -- Germany, the Netherlands, Belgium, Luxembourg and Denmark -- with Norway and Sweden as associates. In July 1975 the French rejoined the snake.

Thus, a "mini-snake" remains, but measured against the original intentions of the Community, EMU has not succeeded. Two major countries are outside the narrow margin agreement and it remains to be seen if the French will be more successful in remaining within the snake than previously. Moreover, one cannot fully appreciate the disarray of European economic union by focusing narrowly on the difficulties of the narrow margin agreement -- it is hardly surprising that a fixed-rate system would founder in the face of the international monetary disorder of the past few years. In fact, none of the elements of EMU have been implemented. Capital movements have not been liberalized since 1971 -- instead there was a proliferation of controls on the inflow and outflow of capital undertaken for national economic policy purposes. It is true that the Council of Finance Ministers meets regularly to discuss economic policy, but each member of the EC follows an independent monetary and fiscal policy.

It is interesting to consider why the EC has fallen so far short of its goals for EMU by 1980. It was realized in the EC that divergences in inflation rates and cyclical developments would occur between the economies of the EC, and that these divergences would prevent the immediate adoption of a completely-fixed-rate system. However, it was thought that, as the economies converged, the need for exchange-rate adjustment would be reduced. These considerations appear to have been the basis for the scheme the EC adopted: fixed-but-adjustable parities and the progressive narrowing of margins. However, in my view, the expectation of convergence implies that the degree of permitted parity change should be reduced, (as in a crawling peg), and it was misleading to focus on narrowing the margins. It seems to me to be inconsistent to choose a system that both permits discrete (and perhaps large) parity changes because the economies are still expected to develop divergently and at the same time to reduce the margin of fluctuation by a few percentage points becuase of growing convergence. I suspect that the EC opted for their scheme because, as we shall see below, wide exchange-rate fluctuations disrupt the CAP mechanism.

As we know, the balance of payments of the members of the EC developed in contrary directions as Germany's position strengthened and the external position of the U.K., Italy and France successively came under great pressure. Although parity changes were permitted, the U.K., Italy and France chose to float outside the snake while Germany (and the Netherlands) revalued. The countries that left the snake might have remained in, but only on conditions unacceptable to their partners -- very large devaluations or large amounts of credit on easy terms. (There was, of course, no resistance to the revaluations). Thus even fixed rates among EC countries (and not just narrow margins) were a casualty of the monetary turmoil of the last few years: the degree of divergence between the EC economies was too great.

Moreover, the supposition that the stresses of the fixed-rate system would force greater economic coordination was also incorrect -- the stresses led to a partial breakdown of the snake rather than greater coordination. The Europeans had made a false analogy between the progressive narrowing of margins and the staged linear tariff cuts in the movement towards a customs union. As the Marjolin Report published last year stresses[1/] "there was insufficient appreciation of the essential difference between a customs union, . . ., and an Economic and Monetary Union." When a tariff reduction is phased in, economic resources are given time to adjust; in most cases such adjustment would not imply actually moving already employed resources, but rather allocating the increment in an economy's resources in new directions or slowing down the growth of affected industries. But, in the case of narrow margins genuine policy coordination may be required, and one cannot graduate the degree of coordination with the narrowing of exchange margins. Furthermore, while parity changes are permitted in the snake, in practice devaluations have not occurred. The choice for currencies under substantial downward pressures appears to have been between remaining in the snake at the old parity or floating. In my view, the EC failed to recognize that the analogy to staged tariff cutting is not narrowing the margins of fluctuation, but reducing the amount of permitted parity change.

1/ See [3], p. 4.

There has recently been a rethinking of how EMU should be pursued. When the French returned to the snake certain changes in intervention procedures and credit facilities were adopted. But the basic framework is unchanged and parity changes will probably continue to be necessary unless economic policy is considerably more centrally directed. Thus it appears that the EC has agreed to a fixed-but-adjustable exchange rate system which may operate more smoothly than the snake has until now. Such a system might have some benefits, particularly for CAP. But the ultimate objective of the advocates of EMU -- that all economic participatts regard the EC as a economic whole in which economic decisions are neutral between currencies and countries -- can not be achieved in a fixed-but-adjustable system. It is hard to understand why the complex snake mechanism should be kept primarily for the smoother operation of CAP.

For the longer-run the Community has tacitly abandoned the goal of "EMU 1980" and is now trying to define more feasible objectives; it recognizes it will have to move more slowly and pragmatically than it originally wished.

Before concluding this section, we might mention some other aspects of the European unity issue. The first half of 1974 was a nadir of EC cooperation. In May Italy imposed an import deposit scheme which created trade barriers within the EC -- without prior consultation with the Community. The disarray was most dramatic in the early months of the oil crisis -- the Netherlands was deserted by its "partners" during the Arab oil embargo and later the French refused to join the International Energy Agency.

Since mid-1974 the Community has managed a few successes. Italy's import deposit scheme was brought under the EC's aegis and the Italians, under EC pressure, reduced the range of products it covered. In addition, the EC extended short-term credit to Italy and converted that credit to medium-term at the end of 1974. The EC also approved a plan for joint EC borrowing under which the Community would borrow oil money and lend to members who were in a serious balance-of-payments situation because of the oil crisis. The plan in effect provides EC guarantees for a member's borrowing. Other successes of the Community have been the Regional Development Fund, the successful outcome of the U.K. renegotiations and the signing of the Lomé Convention with 44 African, Caribbean, Pacific (ACP) countries. These successes, which will be discussed later, may have created the basis for a renewed drive towards European unity.

A particular aspect of European unity that is of great importance to the United States and the rest of the world is the extent to which the EC speaks with a single voice in international negotiations. In the field of trade negotiations, the Community does negotiate as a unit because it is in fact a single customs area with one set of tariff and other trade regulations vis-à-vis the rest of the world. In other areas, notably monetary and energy discussions, the problems are very delicate. The EC while not usually legally bound to act as a single negotiator has tried to evolve common positions in order to preserve its own internal unity. This gives any one member (and France has most often exercised this power) great international leverage far beyond its own international importance. In the case of the International Energy Agency the Eight joined without France. In the recent monetary discussions the EC was reluctant to break with the French even at times when it appeared that its positions were closer to the United States. Most recently, the United Kingdom argued (unsuccessfully) for independent representation at the Conference on International Economic Cooperation. The need, or desire, for joint positions in international negotiations have, probably, been a divisive factor within the EC.

The Common Agricultural Policy

The EC did not extend the industrial customs union to agricultural products because of the special nature of the farm problem, in particular the existence of national agricultural support programs. The Treaty of Rome calls for a "fair" standard of living for farmers. CAP is in effect the extension to the Community of national agricultural programs. It is based on the three principles of: common prices throughout the EC for given products, preference for EC farmers, and common financing. I will first describe the common pricing mechanism and than present an evaluation of CAP from the viewpoint of economic efficiency. The concluding section on CAP will describe the effects of exchange-rate changes on the system.

The basic principles of the price-support mechanism are straightforward although the details are complex and vary among products;

the following account is a simplification.[1/] At the start of the marketing year the EC Council sets a community-wide price for each commodity covered by CAP. If the market price falls to the intervention price, national intervention agencies will maintain the market price by purchasing and stockpiling the commodity. When the world price is below the internal price, imports are restricted by a variable levy which is calculated as the difference between the world price and the internal price. The variable levy is adjusted so that any fall in the world market price will lead to an offsetting increase in the levy. The EC price is set in terms of units of account (UA), and local currency prices are given by the exchange rates between national currencies and the unit of account.

CAP is financed through the European Agricultural Guidance and Guarantee Fund (FEOGA). The Guarantee Section of FEOGA pays for the costs of market intervention, stockpiling, export subsidies (the EC tries to reduce excess stockpiles through export subsidies) and some other activities; it accounts for the bulk of FEOGA's expenditures. The Guidance Section pays for assistance to improve the structure and productivity of agriculture. The 1975 budget appropriations (not actual expenditures) for the Guarantee Section was UA 4,240 million and for the Guidance Section UA 325 million.[2/]

1/ For a full description of the CAP pricing systems see Hudson [6].
2/ For purposes of budget transactions and monetary calculations (snake intervention and settlement, short- and medium-term credit), the unit of account is defined in terms of the gold content of the pre-Smithsonian dollar and is converted into national currencies at the central rates declared to the IMF. Because these rates get out of line with market rates, the EC has begun to shift towards a UA defined in terms of a basket of EC currencies. At present only some functions of the EC use the new UA -- the European Coal and Steel Community, the European Development Fund -- but the Community hopes to adopt the new method generally in the future. (In terms of central rates one UA equals $1.20635.)

FEOGA is now financed directly from the EC's budget. All revenues from customs duties and agricultural levies must be turned over to the EC and these revenues constitute a large share of the total budget receipts. Thus, heavy importers from outside the EC will tend to be substantial contributors to the budget. On the other hand, the EC members with the largest and relatively most efficient agricultural sectors will benefit the most -- from market intervention and export subsidies, the major expenditures of FEOGA. Before the enlargement of the EC, France was the largest net beneficiary of CAP while Germany was the major contributor. It had been expected that the United Kingdom -- because of its heavy dependence on imports and small agricultural sector -- would also have been a major net contributor. However, this does not seem to have been the case; because of the mechanics of CAP financing[1/] the burden has not until now been heavy. It is also interesting to note that the French recently have not been net beneficiaries because high world prices have reduced or eliminated export subsidies. However, in the long-run the French should be the major beneficiary of CAP and they have been its strongest proponents, arguing that it is a *quid pro quo* for the industrial customs union which they say benefits Germany the most.

1/ This is partially due to the subsidies on agricultural imports which, under the system of monetary compensatory amounts, are received by the U.K. Under this system, to be explained more fully below, countries (such as the U.K.), with currencies trading at exchange rates that are depreciated relative to the rates used by CAP, subsidize imports with funds received from the EC.

Evaluation of CAP

CAP has been the target of criticism -- from both inside and outside the EC -- from its inception. The United States has charged it with being protectionist and has tried to gain greater market access than the EC has been willing to concede. The EC has responded to U.S. criticism with the argument, inter alia, that American farm exports to the EC have continued to rise rapidly after the formation of CAP. This argument is unconvincing since the issue is how rapidly U.S. exports would have grown in the absence of CAP. Given the greater efficiency of U.S. agriculture compared to European, one would probably expect a growing market share for imports, but the degree of EC self-sufficiency has increased.1/

Within the EC criticism of CAP has been directed against the high prices, periodic accumulations of certain commodities (especially butter and beef), and the high costs of FEOGA. I shall deal with these interlocking issues by focusing on the problem of the price-support program and its relation to the EC goal of "fair" agricultural incomes.

The EC Commission has acknowledged in its various reports (the most recent is [2]) on the operation of CAP that market "disequilibrium" has sometimes occurred -- i.e., that support prices have

1/ Simple comparisons of self-sufficiency are difficult to make because of the variety of products and because of the accession of three new members, one of whom, the U.K. is a large food importer. But as the EC Commission has stated in various reports the degree of self-sufficiency for the original EC has gone up and "security of supply" is a proclaimed goal of CAP.

been set too high. But the Commission also contends that CAP benefits consumers because it keeps prices relatively stable. The Commission points out that in 1973-74 world prices for a range of commodities rose much more sharply than EC prices, and for some commodities surpassed EC prices (requiring a negative export subsidy -- i.e., an export tax to prevent supplies from leaving the EC.)

The Commission seems to be arguing one of two possible points neither of which seems to me to be valid. First, although for most of CAP's history world prices have been below EC prices, the gain from lower prices for 1973-74 for some commodities outweigh or at least offset the losses from the previous higher prices. This proposition is never demonstrated. And in the EC Commission's "Stocktaking" Report on CAP the Commission accepts the view that the long-run terms of trade for agriculture are declining and agricultural policy must offset this (See [2], p. 12) -- this almost surely means in practice that EC prices will be kept above the long-term world average. The Commission might alternatively mean that consumers prefer an average price that is higher but stable to a lower unstable price. Not only is this point far from obvious, but it is curious that the Commission does not apply this argument to farmers. Why shouldn't farmers accept a long-run stable lower price to an unstable higher one? One might argue that the long-run price should be set lower than the market price since farmers gain more from stability of farm prices (their entire income is involved) than consumers.

The Treaty of Rome's objective of a "fair" income for agriculture is so patently vague that the point need not be belabored. However, it is important to realize that whatever income per capita in agriculture is considered fair could be achieved in different ways and these should be distinguished. First, income per farmer will vary with the size of the agricultural population; a free market could produce fair incomes (in the sense that any income differential was offset -- in the view of farmers -- by the net joys of rural life) through a reduction in the number of farmers until supply and demand were equated at a price that generated that fair income. Second, a fair income (in the view of the EC) could be produced by freezing the size of the agricultural population if price supports are set high enough. The EC has rejected both of these procedures in a pure form but has followed some combination of them -- the farm population continues to decline while supports sustain prices above market levels. A third procedure is -- in EC jargon -- "socio-structural" reforms to improve farm productivity. This policy has been undertaken only in some slight degree. It shifts out the supply curve (via a lowering of cost curves) and allows a given number of farmers to achieve a desired income with lower price supports.

It appears to me that the Commission has not made a policy choice even conceptually among these alternatives. It is true that the Mansholt Plan in 1973 proposed <u>inter alia</u> reducing the farm population and raising the productivity of the remaining farms. The announced intention is to set prices such that "modernized" farms receive a fair income. However, the number of "modernized" farms and the degree of "modernization" (i.e., the farm's productivity) will depend on the amount of resources transferred to agriculture. Since the size of this transfer has not been determined then the position of the agricultural supply curve (even for "modernized" farms) is not determined, and the support price is not determined. We should also note that the Commission does not consider whether resources transferred to agriculture have a higher return in alternative uses.

I suspect that Commission policy will in the future be an uneasy mixture of the following: the continuation of the movement of the agricultural population off the land, a political constraint on how far, (or perhaps fast), the agricultural population will shrink, and an improvement of the productivity of the remaining farms so that EC prices are not too far out of line with world prices. If this prognosis is correct, CAP is likely to remain a difficult issue within the Community for a long time as wrangles will persist over prices, farmers will resist being "reallocated", and the net food importers in the Community will complain about the higher price of EC food.

Exchange-Rate Changes and CAP[1/]

Exchange-rate changes have continued to disrupt the operation of CAP, whether these changes have occurred as parity changes under a

1/ For a very useful discussion of the issues of this section, see Vittas [8].

fixed-rate system or under floating rates. Presently, CAP operates under a dual system -- six countries are in the "snake" and these currencies float against the other CAP currencies. It is instructive to examine how difficulties arise under both fixed and floating systems.

We can examine problems of parity changes under a fixed system in the context of the French and German exchange-rate changes of 1969. Neither the French devaluation nor the German revaluation of 1969 was allowed to affect internal agricultural price levels. The devaluation of the franc increased the number of francs per UA and, since farm prices are set in UA, should cause French farm prices to rise. Because the French authorities did not wish suddenly to raise the cost of food, the EC permitted France to maintain the old franc intervention price. Therefore, the mark equivalent of the franc intervention price was lower than the mark price at which the German agencies were intervening. This situation would encourage the arbitrage of agricultural products to German and flood the German intervention agencies. The French were therefore asked to impose an export tax, equivalent to the devaluation percentage, to prevent this arbitrage. They also were asked to impose an import subsidy in order to remove the artificial barrier created for German exports to France.

In order to prevent farm prices from falling and injuring German producers, the German revaluation was also not allowed to affect internal agricultural prices. For reasons analagous to the French case, the EC required the Germans to tax imports and subsidize exports. The effect of keeping the old franc/mark internal agricultural prices constant despite the exchange-rate changes means that no substitution between foreign and domestic sources of supply in agriculture will occur and the adjustment effects of the exchange rate changes on the trade balance are reduced. Moreover, since the franc/mark relative price for agricultural goods has not changed while the exchange rate has changed, the principle of common pricing has been violated.[1/]

Under a floating exchange-rate system intervention prices are set with respect to fixed parities with the UA; and the market exchange rates may diverge from the cross-rates implied by these parities. As in the previous discussion, the consequence will be undesired commodity arbitrage. Suppose, for example, the mark appreciates against the franc while the national intervention prices are fixed in local currencies given by the UA parity. French wheat would flood the German agencies because the DM intervention price converted at the appreciated market exchange rate for marks would yield more francs than the franc intervention price. The EC has established a system of monetary compensation amounts (MCA's) to eliminate this arbitrage incentive -- in the example, by

---

1/ Suppose that the EC fixed the price of a bushel of wheat at UA 100; also suppose that FF4 and DM2 equal UA 1 so that FF2 = DM 1. Now suppose that the franc is devalued by 10 per cent (i.e., FF4.4 = UA 1). The franc price of wheat would rise from FF400 to FF440 while the mark price remained at DM200. If the franc price is kept at FF400 the UA equivalent would be 91(400/4.4) and the mark equivalent 182. Since the German agencies are intervening at DM200 they would be inundated with French wheat. An export tax of FF40 will restore the price of French wheat to DM200. Similarly, a subsidy of FF40 on German imports will reduce the price of German wheat in France from FF440 (= DM200 x 4.4/2) to FF400. The principle of common pricing has been violated because French and German prices, valued at market exchange rates now diverge: i.e. FF400 at FF2.2 per DM equals DM 182 not DM 200.

taxing German imports and subsidizing exports. Common agricultural pricing is violated because internal prices are unaltered while exchange rates have changed.[1/] The rigidity of the franc/mark price for agricultural goods also hinders trade adjustment and places greater adjustment pressure on the rest of the balance of payments.

Under a floating exchange rate-monetary compensation regime the administrative burden is substantial (the compensations are computed weekly) and the complexity of the system confuses all but the *cognoscenti*. At the same time, even for the currencies in the "snake", the "green" rates (i.e. the rates used to convert agricultural prices set in UA into local currency rates) have not necessarily been equal to the central rates of the snake. Therefore, MCA's have been used generally in the CAP. In order to reduce the size and use of MCA's the EC has been revising the "green" exchange rates to bring them into line with market rates or central rates. Such green rate revisions, of course, alter domestic prices and Commission proposals have at times encountered opposition from members. However, the changes are not as large as those caused by more sizable discrete parity changes under the fixed rate regime; the opposition is also softened by embedding the green-rate revisions in the price increases at the start of the marketing year -- all countries' local currency prices will rise, but in the revaluing currencies by less than the UA price rise and in the devaluing by more.

1/ In terms of the example of the previous footnote, German wheat continues to cost DM200 and French FF400.

But the continuation of floating for some currencies puts CAP under strain and generates pressure for a return to the snake.

Other Aspects of Economic Integration - Budget Policy and Regional Policy

If the EC does eventually achieve a high degree of economic integration the range of common policies and coordinated policies will grow significantly. Currently CAP is the major common policy in the Community and in important fields such as energy and industrial policy little progress has been made. However, there are two other areas of emerging importance -- the budget and regional policy -- in which progress has been made and which deserve some notice.

A major element of supranationality in the EC is the "own resources" of the Community -- revenues that flow directly to the EC and that are not subject to the members' budgetary processes. The EC budget now finances all Community expenditures: CAP, the Regional Fund, Social Policy and Development Assistance. The 1976 planned budget is about UA 7.5 billion.

Presently, own resources come from customs duties (from the Common External Tariff) and agricultural levies (from the variable levy). These directly flow to the EC. In addition, the EC had intended to receive beginning January 1975 up to 1 percentage point of the Value Added Tax collected by the members. The VAT revenues are intended to cover any difference between total budgetary outlays and the revenues collected from the duties and levies. As a first step in switching to this system the members had to convert their existing indirect taxation systems to a Value Added Tax and this was accomplished by January 1973.

(The purpose of the switch was primarily to eliminate the economic distortions of the turnover tax systems many members previously used). But it is also necessary that the VAT revenues turned over to the EC bear a proportional relationship to the size of each economy (measured, say, by GNP), and therefore the transactions to which VAT applies must be similar across countries -- that is, in Community terminology the VAT base must be "harmonized." The members of the EC have not yet been able to agree fully on harmonization and therefore VAT has not become a part of the "own resources" system. Instead, the Community is continuing to apportion budget contributions, to supplement the receipts from levies and duties, on the basis of GNP shares.

The budget was one of the main issues in the U.K.'s renegotiations. The British argued that when the "own resources" system was fully operational their contribution would be greater than their relative GNP. The accompanying table, based on an EC Commission study, see [5], lends support to the British position. It shows relative shares of the Community budget calculated by three different methods. Column (3), a simulation of the 1974 budget under the definitive "own resources" system, indicates that the U.K. share would have been higher than its relative GNP given in column (4). These calculations cannot, of course, prove that future U.K. budget shares would also have been higher than relative GNP.

The other members of the EC agreed to a corrective mechanism if an "unacceptable situation" arose. The latter would be said to exist if three conditions held : (1) A member's per capita income is less than

Table

Relative Shares of Financing the EC Budget and of EC GDP - 1974 (per cent)

	(1)	(2)	(3)	(4)
Belgium[a]	7.2	7.6	5.6	4.7
Denmark	1.4	1.4	2.4	2.8
Germany	28.5	33.4	30.2	33.6
France	24.3	23.5	18.2	23.2
Ireland	0.4	0.3	0.6	0.6
Italy	18.2	14.8	13.2	13.2
Netherlands	9.0	10.0	7.8	6.0
United Kingdom	11.0	9.0	22.0	15.9
	100.0	100.0	100.0	100.0

a/ Including Luxembourg.

Columns (1) and (2) indicate actual 1974 contributions, column (1) calculated at budget rates of exchange (equal to central rates) and column (2) at market rates. Currencies, such as the DM, with central rates that are depreciated relative to market rates, will have a higher share under the second method of calculation. Column (3) presents an EC Commission calculation of what relative shares would have been in 1974 if the "own resources" system were fully operational -- that is, with the three new members paying their full share and VAT revenues going to the budget. It is calculated at market rates of exchange. Column (4) indicates the share of EC GDP calculated at market rates.

Source: European Community Information Service, Bankground Note, No. 1/1975.

85 per cent of the EC average, (2) its rate of growth of GNP is not more than 20 per cent higher than the EC average, and (3) its gross contribution to the budget exceeds by at least 10 per cent its share of GNP. The levels of reimbursement to the member will be determined by a specified formula.

Although the U.K.'s objections to the budget mechanism have been met, the budget is still very much an issue of controversy. The Germans, in particular, who pay the largest share of the budget (although as the table indicates, it is not out of line with its relative GDP) are complaining about the growth of EC expenditures. If the growth of the budget is limited, then it is likely that the EC will have difficulties in adopting new common policies which involve significant expenditures. This will, in turn, hinder the future course of economic integration.

Regional Policy might be viewed in two different ways. It can consist of aid to regions that either are "structurally" backward (e.g. the Italian Mezzogiorno) or regions that have experienced hardship due to a change in economic conditions such as a demand shift. Clearly, this distinction is not a rigid one -- some of the depressed regions of the United Kingdom which now seem structurally depressed were prosperous areas that suffered from economic changes. But, conceptually, Regional Policy as part of EMU would be a partial substitute for exchange-rate changes under a system of fixed rates -- that is, it would be a form of balance-of-payments adjustment and would fit under the second type of regional aid.1/ In fact, the Regional Policy

1/ See Corden [1] for a fuller explanation of this role of Regional Policy.

actually adopted by the EC seems at this point to address itself more to structurally backward or depressed regions rather than to balance-of-payments adjustment. Therefore, at present, EC members experiencing changes in their economic situations which produce balance-of-payments problems that cannot be eliminated by demand management policies would (because trade restrictions are -- in principle -- ruled out) have to change their exchange rates. Thus, in my view, the Regional Policy to be described below does not represent a significant step towards a full EMU.

At the Paris Summit in December 1974 the Community agreed on the creation of a Regional Development Fund and in March 1975 the EC Council of Finance Ministers gave its final approval. Members of the Community had quarreled for several years over the total size and the allocation of money in a Regional Fund. The United Kingdom had blocked all progress on other issues at the Copenhagen Summit in December 1973 because it could not get satisfaction on Regional Policy. The major split was between Germany which wanted a fund of UA600 million for three years and the U.K. and Italy which were asking for a UA3 billion fund. The EC compromised on a Regional Development Fund (RDF) of UA1.3 billion for 1975-77. The five largest recipients of funds are: Italy - 40 per cent, the U.K. - 28 per cent, France - 15 per cent, West Germany - 6.4 per cent, and Ireland - 6 per cent. The four other members will receive less than five per cent. The British pursued a hard line on the Regional Fund because they view it as an offset to the costs imposed by CAP and as an illustration to the British public of the tangible benefits that membership in the Community provides.

The RDF will operate by making grants to either private investment projects which are receiving national regional aid (up to 20 per cent of the total cost of the investment and not more than 50 per cent of the national aid), or to public infrastructure investment (up to 30 per cent of the cost). The Commission will choose the projects that will receive aid, giving priority to projects in the poorest regions and having the greatest impact on employment. Projects are expected to fit in with a country's overall program for the region and in addition the country is expected to have a national regional development program.

The Current Situation

As I indicated the Community has had some recent successes which might form the basis for a renewed drive for integration. The joint borrowing facility and the assistance to Italy have already been mentioned. The successful outcome of the U.K. renegotiations which had hampered the EC in much of its work over the past year may also contribute to a renewed drive towards integration. The budget corrective mechanism removes a potentially divisive issue in the future and the Regional Policy gives the U.K. an increased stake in the EC's future. The signing of the Lomé Convention with the 44 ACP (African, Caribbean, Pacific) countries is also an important accomplishment. The Convention (which is an extension of earlier Association agreements) grants trade preferences and development aid to the 44, and initiates an export-proceeds stabilization plan (STABEX) funded by the EC. The Lomé Convention, as well as other Association agreements and the Generalized

Preference Scheme (granting tariff preferences to all LDC's) indicates that the Community has not been inward-looking as early critics charged but has tried to respond to the needs of the underdeveloped countries.

However, as hopeful as these recent events are, I believe that European economic integration will proceed far more slowly than the EC had previously desired. This point is argued in the following section, in which I also try to draw some conclusions about the past developments in the EC.

Conclusions

The failure of the EC to achieve its stated goals of EMU by 1980 are due, in my view, to both the unreasonably optimistic goals th were set, as well as to specific circumstances. These latter causes include the international monetary turmoil that began in 1971 putting a fixed parity system under great stress, the energy crisis, and the temporary stalemate in the Community caused by the U.K. renegotiations and referendum. However, while these are important explanations for the lack of progress, they are not, I believe, fundamental.

Economic and monetary union was envisaged as involving genuinely fixed-exchange-rates (a single currency _de facto_ if not _de jure_), a complete freeing of capital movements, and a common central banking system. Such a scheme involves a loss of soveriegnty in the sense that there is collective decision-making in which individual members acquiesce in decisions that they perceive as contrary to their interests. But this degree of economic union exists only within nation-states where there is also political union and national economic units (particularly firms operating over a common political, economic and monetary entity). Decisions made by a common EC central bank, to take an obvious case, would affect fiscal policy, (e.g. the financing of budget deficits), and thereby political and economic realities (including, say, defense spending) which were not yet subject to common control. Unless the members of the EC were already committed to common policies in areas <u>outside</u> the specified fields of EMU, I do not see how they could agree to the partial loss of control in <u>non-EMU</u> areas that EMU involved.

Developments within the EC can also be related to the debate within the Community between the so-called monetarists and economists -- the former have argued that the stresses of EMU would lead to further economic changes and coordinated policy-making; the latter have held that EMU would not work unless national economies and policies were already more closely coordinated and integrated. Although I do not believe that this issue can be settled by economic theory, the EC experience seems to support the "economist" position -- the stresses placed on EMU did not lead to further integration.

There is little question that the EC will continue as a customs union with its present common policies (CAP, Regional) continuing to function -- although, of course, these policies will change over time. Its future evolution is more difficult to foresee. The recent talk within the EC is of a more pragmatic approach to economic unity. This would presumably mean agreement on common policies of limited scope. I am very skeptical whether much more than this will be achieved even in the long run unless there is also significant political unity. It is possible that an alternative scenario will develop -- a continuous increase in the number and extent of common policies and a growth in the size of the EC budget so that it comes to rival the national budgets; this would lead to a situation in which the powers of the EC in relation to the member states is much like that between the Federal governments and the state governments in the United States. I find this scenario of "federalism from below" implausible. The members would resist common policies that involved significant losses of sovereignty. Also, the existing political and administrative structure of the EC (Commission, Council of Ministers, Parliament) which must deal in terms of relationships among sovereign states[1] would be unable to legislate and administer the growing sum of policies and expenditures -- a fundamental political change would be required, i.e. the creation of a genuine European government, and this would be found unacceptable. Furthermore, the recent drive to limit the growth of the budget reduces the scope for future common policies.

1/ I do not believe that the direct election of the European Parliament which may begin in 1978 and replace the current system of delegations from the national parliaments significantly affects this point. The powers of the European Parliament remain very limited and the Council of Ministers is still the effective law-making body. Moreover, the fact that direct elections were agreed to with very little controversy over the substance (as opposed to the mechanics and timing) indicates that the members of the EC did not think that any issue of sovereignty was involved.

In my view, if a balance sheet were drawn up of the EC's successes and failures, the areas of greatest success are those in which no significant grant of sovereignty is involved -- in trade and in programs, such as Regional Policy and medium-term credits, that involve financial transfers. These successes differ more in degree than kind from other examples of international cooperation -- e.g. tariff cutting as in GATT, monetary support as in the IMF or through the G-10, and foreign aid. When transfers of control over monetary or fiscal policy are required, however, the EC has been less successful. The borderline case between these two areas is CAP in which substantial domestic interests are affected by decisions taken in Brussels. And CAP has been the most contentious issue within the EC, at times almost causing it to break up; moreover a major element of CAP -- common pricing -- is in disarray. In sum, the EC has succeeded most when its decisions resemble agreements between independent states and least when suprantionality is required.

References

1. W.M. Corden, Monetary Integration, Eassys in International Finance, No. 93, Princeton, April 1972.

2. European Communities, Commission, Stocktaking of the Common Agricultural Policy, Bulletin of the European Communities, Supplement 2/75.

3. __________, __________, Report of the Study Group "Economic and Monetary Union 1980", Brussels, March 1974.

4. __________, Monetary Committee, Compendium of Community Monetary Texts, Brussels, 1974.

5. European Community Information Service, Background Note, No. 1/1975, Washington, 1975.

6. John F. Hudson, The Common Agricultural Policy of the European Community, U.S. Department of Agriculture, Foreign Agricultural Service, November 1973.

7. Lawrence B. Krause and Walter S. Salant, eds., European Monetary Unification and its Meaning for the United States, Washington, 1973.

8. H. Vittas, "Effects of Changes in EEC Currency Exchange Rates on Prices, Production, and Tradeof Agricultural Commodities in the Community," International Monetary Fund Staff Papers, July 1972, 19, 447-467.