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FOR ECONOMIC AND FINANCIAL AFFAIRS

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To: A. M. Costa

From: M. Emerson

Subject: Regional Implications of Economic and Monetary Integration.

I enclose two notes on this subject, as requested at a recent meeting with MM. Mingasson and Dixon.

The longer of the two is intended to serve potentially as an Annex to the Committee's report, and the shorter one to induce a discussion on the same issues at a forthcoming meeting.

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Regional implications of Economic and Monetary Integration

Some main issues for discussion

Four main issues are outlined in the Annex.

(i) Firstly is the issue of economic analysis whether the processes of market and monetary integration are inherently likely to be either progressive or regressive in their impact on regional disparities in the level of economic activity and incomes.

The economic literature points to the presence of several conflicting paradigms, which is why it seems not justified to make any simple predictions, such as that the geographic core will profit at the expense of the periphery, or that low-wage areas will profit at the expense of high-wage areas. It seems necessary to adopt a rather agnostic overall view, unless one is prepared to undertake an extensive and complex multi-factor analysis of the determinants of the evolution of individual regions. Actual trends of comparative regional developments in the industrialised countries would seem to confirm this call for caution.

Does the Committee share this view?

(ii) Second is the question of what level of regional convergence should be expected to accompany or even be a pre-condition to monetary union.

It is observed that disparities within the EC at present are considerable, but not incomparably greater than in some mature federations such as the United States, Canada or Switzerland. The political tolerance level for these disparities may be relatively high when language and cultural barriers result in a low propensity to migrate, as is the case in much, but not all (viz Ireland) of the Community.

Does the Committee share this view?

(iii) Third, regional policies have been evolving in the light of experience of the industrialised countries (in the Community and elsewhere), in the direction of a lesser emphasis on automatic, generalised and larger-scale transfers, and with more emphasis on incentives for decentralised local development efforts.

Such thinking is also reflected in the current reform of the EC's structural funds. However regional policy in the EC context is also addressed to specific problems such as cross-frontier infrastructure networks and easing the adjustment costs caused by EC policies such as 1992.

Does the Committee sympathise with these directions of policy development?

(iv) Fourth, there is the question what further needs would arise in the case of a European monetary union, notably as regards budgetary mechanisms having regionally redistributive effects.

The experience of all federal economic and monetary unions is that a diversity of budgetary mechanisms combine in assuring an important "shock-absorber" function as between regions and states with respect to the impact of cyclical and structural shocks.

However, the degree to which such shocks are absorbed, and the type of mechanisms used (budget equalisation transfers, specific-purpose grants, automatic regional effects of federal taxes and social security) is quite diverse. There is no apparent model on which all integration efforts seem destined to converge. It would thus seem plausible to suppose a substantial development of the budgetary function of the EC in the case of a monetary union, but the mechanisms would need to be chosen as a function of the specific needs of the Community at that time.

Does the Committee share this preliminary assessment?

ANNEX (   )

Regional Implications of Economic and Monetary Integration

Since monetary integration progressively eliminates the instrument of nominal exchange rate adjustment between the regions of the economy, this poses a number of issues concerning regional adjustment and convergence, notably:

- the question whether the processes of market and monetary integration are likely to be progressive or regressive in their impact on income distribution between regions;

- the degree of convergence of regional economic performance that may be judged normal or desirable in a double programme of market and monetary integration, or even as a pre-condition to embarking upon such a programme;

- the lessons of regional policy, as revealed in part by how the public authorities have in recent times being adapting their policy instruments or strategies,

- how the mature federal monetary unions have handled these issues and whether this is helpful in thinking about the future needs of a European monetary union.

The impact of integration on regional convergence. Economic analysis is currently more agnostic than has sometimes been argued about whether the process of economic integration should lead to regionally regressive or progressive outcomes. Both theoretical and empirical evidence contribute to this new view.

A traditional view, that predicts a regressive concentration of prosperity on rich regions at the geographic centre at the expense of a poorer periphery relies on two arguments: firstly, the locational disadvantage in terms of transport costs of the periphery, and, secondly, the cumulative advantages of economies of scale in large scale production (in the enterprise, and in the wider economic advantages of large urban agglomerations).

While these arguments have a certain weight, a more qualified view is obtained when a number of newer arguments are introduced. One relates to changes in technology and demand, which witness a faster growth of demand now in the industrialised countries for commodities that have a high value per unit of weight (electrics, electronics, office and data-processing products, chemical and pharmaceutical products, high quality foods and clothing), with low-growth seen in the case of many commodities that have low value per unit of weight (metal products, ores and metals, basic textiles, construction materials).(1) This means that transport costs are becoming, on average, less important in the location of industrial production.

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Developments in telecommunications and capital mobility also make it less evident where enterprises will choose to locate their different facilities. The factors just mentioned enhance the sensitivity of investment decisions to the relative levels of costs other than transport and the quality of the business environment in competing locations. In addition, EC initiatives in the 1992 programme and accompanying policies should have a beneficial impact on the transport and telecommunications facilities. All the main transport services will be rendered more competitive by the 1992 programme, which will further erode, without of course eliminating the locational disadvantages of the periphery.

Also relevant to the issue at hand, there has been a fundamental change of emphasis in the economic literature in the analysis of international trade and industrial organization.(2)

The new view gives less importance to the paradigm of comparative advantage as an explanation of trade. While for some sectors the distribution of comparative advantages remain relatively fixed (agriculture, tourism), for much of industry natural endowments are not so important. The alternative paradigm is that trade increasingly consists of a complex pattern of intra-industry specialisations between regions and countries of the industrialised world, especially in Western Europe. Competitive advantages are more to be attributed to deliberate strategies of the public authorities relating to market conditions and investments in human capital, R&D and economic infrastructure, and the reactions of mobile corporations to these strategies. The likelihood of systematic imbalances in the impact of market integration is reduced. So also the predictability of winners or losers is less.

This complex set of influences seems to be consistent with the uncertain pattern of regional economic trends in the industrialised economies. It may be observed, for example, that the United States economy has in recent years seen pronounced economic growth at its geographic edges rather than favouring any dominant centre. There have also been striking changes in the relative economic performance of certain regions: the emergence of much of the south from economic backwardness, and the recovery of New England. Extreme locational disadvantage in the Far East Asian economies has not prevented spectacular advances in their market shares in North America and Europe. Within Europe, much of the periphery has been growing faster in recent years than the geographic core of the EC.(During the present decade the UK, Spain, Portugal and Italy have grown on average 0.5 % per annum faster than the average of Germany, France and the Benelux). Within the larger EC countries the picture is also a complex one, but one in which one can recognise some of the arguments advanced above. Within Germany the traditional core regions (e.g. the Ruhr) have slipped behind, as also have other traditional regions such as Wallonia and north-eastern France, which are centrally placed in a Community perspective. Meanwhile new centres of growth have emerged, as in

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Bavaria and the Rhone valley where these trends are related to the technological shifts mentioned. Within Italy the problems of the Mezzogiorno have been gradually changing, with prosperity spreading down the Adriatic coast, and the deep problems of Calabria, Campania and Sicily manifestly influenced by non-economic factors. Within the United Kingdom, one has seen parts of Wales and Scotland, whose industrial structures had much in common with Wallonia and North-East France, make rather striking recoveries, in spite of their geographic peripherality.

Regional inequality in economic and monetary unions. A related question is to ask whether the experience of existing monetary unions points to certain minimum standards of regional convergence, which would be implicitly required for viability of the union. Put more strongly still, the question may be put whether there are pre-conditions of this kind to be met before unions should be formed.

Comparisons of regional product or income levels per capita call for care over the comparability of the unit sizes, since the smaller the units the larger tend to be the differences. In comparing the EC and the US, one may observe that the 12 Member States' GDP per capita ranges from 47 in Portugal to 129 in Luxembourg, whereas in the US, of 9 census regions the range of per capita incomes is from 77 in the South-East to 111 in the Far-West. If one looked for a closer comparison with the US census regions, thus merging small units into larger ones, one may note a range between 66 for the Iberian peninsula to 122 for North Eastern Europe (Germany and Denmark).(3)

At the level of small units, one observes a range of 66 for Mississippi to 131 for Alaska and Washington D.C., which compares with 45 for the poorest regions of Greece to 237 for Groningen, followed by 195 for Hamburg, 159 for the Ile de France and 155 for Greater London. Both top groups include regions which are conspicuous for their hydrocarbon production, which is a reminder of how these inter-regional comparisons may be of uncertain policy significance when small units are compared.

Other federations have considerable intra-regional differences. In Canada, Newfoundland at the bottom records GDP per capita of 60, compared to Alberta at 123. In Switzerland, Obwald at the bottom records a GDP per capita of 76 compared to Zug at 160. In the Federal Republic of Germany, the Saarland at the bottom records a GDP per capita of 91, compared to Hamburg at 165.

Among the unitary countries, France and the United Kingdom experience disparities which are of the same broad proportions as in Germany, whereas Italy experiences wider dispartities - comparable to those of Canada or Switzerland.

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Overall this data suggests that the regional disparities in the EC are somewhat greater than in the United States, but not incomparably so. Many economic and monetary unions observe considerable regional disparities. However, these simple statistical comparisons have to be qualified by a number of socio-political considerations, of which one of the most important is the propensity for people to migrate between regions and the political system's attitude to migration. Assuming a legal freedom to migrate between states, the important issues are whether the populations have a high propensity to migrate across political frontiers and whether such migration is considered, in terms of political values, politically, negatively or positively or neutrally. In the United States the propensity to migrate is high and its political acceptability is also relatively high. Across the language frontiers of the EC, the propensity to migrate is today rather low but, politically, mass migratory movements would also be viewed more critically.

A given degree of regional income disparity would call for a more prompt or powerful policy response where the propensity to migrate was high and its political acceptability was low. In practice, the US sees ~~a high case~~ a high propensity but also a high acceptability of migration: therefore there is a relatively relaxed view of inter-regional disparities. Within the EC, the political acceptability may be lower, but the propensity to migrate is also lower on the whole. It might be expected therefore that the EC could tolerate as great, if not somewhat wider regional disparities than the US. For these reasons the present level of disparities within the EC, while actually the target of policies to reduce them, need not be regarded as a road-block on the path to further integration: especially when it is observed that quite a few backward areas are now catching up or recovering.

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Ireland is today the only EC country experiencing a politically uncomfortable rate of emigration. The larger part of this goes to other English speaking countries (60% to the UK, 25% to North America). This may explain a high propensity to migrate in the Irish case, but of course does not ease the economic problem of loss of educational investment in human capital.

The case for Turkey, comparable in some ways to Mexico in relation to the United States, offers a further perspective on these issues. Turkey's income per capita is one-third lower than that of Portugal. Turkey's population shows a high propensity to migrate when the regulations of the countries of immigration permit it, no doubt influenced by the extremely low wage levels in Turkey and the almost non-existent social security provisions for much of the population. If the EC labour market were opened to Turkey, that country's potential emigration would appear to be very substantial. In this case it is realistic to discuss the issue of pre-conditions to joining a European economic and monetary union whereas among the present members of the EC this debate seems to be much less relevant.

Evolution of regional policies. To identify the essence of new trends in regional policy in the industrialised countries, it is useful to characterize three types of strategy. Practise does not correspond to any of these types in a pure way, but the evolution of their relative importance is significant. The three types are:

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(a) policies that are designed to compensate for institutional rigidities in factor prices or mobility. These are illustrated, on the side of labour, by the reduced social security taxes applied in the South of Italy since 1971 or the regional employment premium system of the United Kingdom of the nineteen-sixties (abolished in 19xx). On the side of capital, there is the widespread tendancy to differentiate investment grants regionally, although here also there is nowadays some tendency to apply such subsidies more selectively. These may be called "neo-classical" regional policies.

(b) policies that are designed to sustain income and demand in the regions that for structural or cyclical reasons may be economically weakened. The main mechanisms here are budget equalisation transfer systems, often found in federations, and the automatic inter-regional redistributive effect of central tax and Social ~~sound~~ security systems. The Reagan Administration in the United States, for example, reduced the importance of these mechanisms, abolishing the federal revenue-sharing system. These may be called "Keynesian" or "demand-side" regional policies.

(c) policies designed to improve the resource base of the region, not only through subsidised investments in physical infrastructure and human capital, but also through incentives to encourage local initiatives, even new institutions, to mobilise efforts for the regeneration of weakened regions or communities. The financial flows in these cases may be less than under the first two categories. Policies in several countries, in North America as well as Europe, and in the EC itself, have been heading more in this direction. These may be called "decentralised supply-side" regional policies.

There are some reasons why an attempt to move more in the direction of the first two types of policy would not seem advisable for the EC in its next phase of systemic development. Regional employment subsidies, on a macroeconomic scale, would risk an inappropriate signal to those responsible for labour competitiveness. With the reduction of exchange rate variability, it is important for the wage system to enhance its responsiveness to competitiveness considerations. To suggest that deficiencies in this respect would be compensated by subsidies would be dangerous. As regards the subsidisation of capital, the risks to be averted are also those of encouraging inefficient investment, and in particular a capital-intensive bias that may exacerbate employment problems. Experience in some European countries shows this to be not just a theoretical possibility.

As regards the Keynesian type of transfer policies, these are justified basically by either of two criteria, one political and the other economic, but neither of which are strongly represented in the EC at the present time. The political case is where a country chooses to write into its constitution, explicitly or implicitly, the objective of having nearly equal standards of public welfare and services in all regions, as seen in Germany or Australia for example. The economic case is where labour mobility is so fluid that moderate differences in public welfare service and tax systems may be

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sufficient to induce migration that has no other economic justification. (However, in the United States the fluidity of migration between jurisdictions is, to some degree, perceived as a control on the efficiency of local or state public administrations. This is an extreme extension of the paradigm of "competition between rules").

In much of the industrialised world there has developed a considerable scepticism over the effectiveness of the first two categories of centrally developed and financially rather massive systems of regional transfers. This is at least the case when the policy objective goes beyond purely distributional issues and is addressed to helping weak regions improve their relative economic performance. As a result there has been some shift in favour of policies that rely more on decentralised initiative and a more selective availability of central subsidies. In the United States some striking success stories have been seen in some states - such as Massachussets, Ohio, Michigan and Pennsylvania - which organised their own revitalisation programmes, and succeeded in achieving dramatic reductions in local unemployment levels. In general in the United States regional income disparities have reduced greatly over the last 50 years, with the South-East moving up from 53 to 86 in relation to the national average, the South-West moving up from 69 to 94 and the Plains from 76 to 96. Federal subsidies could hardly be regarded as the key to this convergence.

In Europe there have been only hesitant moves in the direction of more decentralised forms of regional policy, although political regionalisation has been important in some countries: Spain, Italy, to a lesser degree France, and more emphatically now in Belgium. The United Kingdom has seen considerable change in the organisation and powers of local government, and this has showed up in the emergence of regional development efforts with new organisational forms. An interesting example is seen in the Strathclyde area of Scotland, where there have been considerable achievements to the credit of the Scottish Development Agency and the Strathclyde Regional Council. These have been supported by the EC Structural Funds, including an Integrated Development Programme. The main points here have been a reduced emphasis on grants for large inward investment projects, with more emphasis on the encouragement of local entrepreneurship and labour training, environmental improvement of old urban areas and local institutional developments favouring policy innovation and local initiative. This has features in common with some of the US success stories.

Current reforms of the EC's structural funds push also in some of these directions. The new regulations entering into force in 1989, applicable until 1993 by which time the real level of annual expenditure will have been doubled to 14 billion ECU, call for the preparation of regional development plans, including a regional dimension even in the smaller Member States such as Ireland, Portugal and Greece. For these three countries, and to a lesser degree for Spain also, the funds will permit a qualitative improvement in economic infrastructure such as transport and telecommunications; also

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the expansion, in some cases establishment for the first time, of extensive manpower training schemes. Another point of emphasis in the reforms is to support the needs of industrial areas defined at the level of quite small regional units, hit by serious problems of restructuring. This should help overcome, inter alia, the adjustment problems posed by the 1992 programme.

The budgetary grants of the structural funds, combined with loans from the European Investment Bank, are due to rise, as a share of the beneficiaries GNP, to around 5% in the case of the three smaller countries, and 1 1/2% in the case of Spain. These amounts will represent substantial percentages of the total financing of these countries' economic infrastructure and manpower training programmes. In terms of the absorbtive capacity of the countries concerned, either managerial or from the standpoint of avoiding inflation bottlenecks in sectors such as construction, the funds are on a scale that already represents a considerable challenge for the beneficiaries. The Commission also has particular responsibilities for evaluating the experiences of this new phase of EC structural policy.

The case of economic and monetary union. As and when the system in the Community moves to a fully developed economic and monetary union one might expect the Community's budgetary mechanisms also to develop. The existing systems of the advanced federations have some common features, but it is not evident that between them they offer anything like an ineluctable model on to which all integration processes must converge.[4]

As regards the most explicit forms of inter-regional distribution, three federations (Australia, Canada and Germany) have budgetary equalisation mechanisms which raise the fiscal capacity of weak states to federally determined minimum standards. However two federations (United States and Switzerland) have done otherwise, relying more upon specific-purpose grant mechanisms for pursuing policy objectives such as health, education and investment in economic infrastructure. These programmes have a far weaker inter-regional redistributive power than the equalisation systems. The pattern here is more like a much extended version of the Community's structural funds and its instruments for pursuing technology policy objectives.

Of course the central responsibility for defense is a common feature of all the federations, together with its financing by federal taxation, usually including a heavy income tax component. This always results in a significant degree of automatic and implicit fiscal redistribution between rich and poor states.

Social security systems may also have an important role in automatic inter-regional distribution, and this is certainly the case in Germany. However social security in several cases has strongly decentralised features. Indeed in the United States social security regimes, especially for health care, probably differ more between the states than is the case between the Member States of the EC.

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A common feature, nonetheless, is that in all federations the different cocktails of federal budgetary mechanisms have powerful "shock-absorber" effects dampening the amplitude either of economic difficulties or surges in prosperity of individual states. This is both the product of, and source of the sense of national solidarity which all relevant economic and monetary unions share.(5)

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(1) For data see Table 1.1.3. of "The Economics of 1992", European Economy, No 35, March 1988.

(2) See Chapter 8 of "The Economics of 1992" for a fuller presentation of these arguments and further references.

(3) Detailed regional data is given in "Efficiency, Stability and Equity" (annexes D and E), report of a group of experts presided by T. Padoa-Schioppa, Oxford University Press, 1987.

(4) These mechanisms were documented in detail in "The Role of Public Finances in European Integration" (Vols. I and II), report of a group of experts presided by Sir. D. MacDougall, Commission of the EC, 1975.

(5) "Relevant" here is meant to exclude the frequently observed cases where very small units voluntarily enter into economic and monetary union with much larger neighbours, semetimes exploiting tax-haven advantages in preference to fiscal integration.