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Draft

Economic Policies in the European Union

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Introduction.

In December 2002, the possible number of members of the European Union increased from 15 to 25, one of the new members being Lithuania. Whether the 10 entrants will actually become members will, however, depend on the outcome of referendums, to take place in the new member countries. But the very fact that the number of members is going to increase substantially will, of course, affect the functioning of the European Union, for the newcomers as well as for the old members. On this background, it may be worth while to try to summarise some aspects of the development of the European Union, especially with respect to problems related to macro economic policies. In this field, the most important new aspect is the creation of a foreign exchange union. Since 1999/2001, the euro has been the common currency for 12 of the member countries.

The choice of subject also reflects the fact that, since 1991, I have had the privilege of visiting Lithuania almost every year together with my colleage, Jørgen Birk Mortensen. From 1992 onwards, we have participated in, and presented papers to, the yearly conferences in Kaunas, arranged by the Faculty of Economics and Management, Kaunas University of Technology. (In 1991, we participated in a seminar in Palanga with representatives from Lithuania, Latvia and Estonia as well as from Kaliningrad). The subject of most of my papers has been related to aspects of the European Union. On this background, it is appropriate for me to give some comments on the history and the future prospects for the new European Union.

It should be emphasised that the very fact that more than 20 European countries, which had extremely different political conditions 50 years ago, now are members of the same union, is an important accomplishment, not least from a political viewpoint and seen on the background of the history of the first half of the 20th century as well as the subsequent post war period. Of course, during this process many problems have not found satisfactory solutions. In the economic debate, problems related to a foreign exchange union have played an important role during the last 30 years; they will be dealt with in the last part of the present paper. In the first part, some comments will be made on other important problems, even if they are not basically economic, i.e. the political philosophy behind the Union, the number of member countries, now and in the future, the mobility of labour and the problems it may create, partly from a cultural viewpoint and partly from an economic.

Subsequently, before we embark upon the macro economic problems, the agricultural policy of the European Union deserves some comments.

Federation or Confederation?

The predecessor of the economic part of the Union, the treaty on European Economic Cooperation (EEC), was formed in 1957 with six members (France, Western Germany, Italy and the Benelux). In 1973, the EEC got three additional members (Britain, Ireland and Denmark), and during the 1980´ies the number of members increased to twelve (new members: Greece, Spain and Portugal). Finally, in 1995, Austria, Finland and Sweden became members, bringing the total to 15. In 1993, the Union got its present name.

During most of this period, there has been basic disagreement as to whether the cooperation should take the form of a federation (the United States of Europe) or a confederation (the Europe of Nations). A *confederation* implies that each member country only participates in the cooperation in areas where it shares the viewpoints of the other members. France - and de Gaulle in particular - always has had preferences for a basic confederation structure; France never has been happy to accept to be overruled by a majority of the other members. A confederation allows for a “Europe at different speeds”, where some members may extend the cooperation further than the rest. A right for each member to veto decisions is part of the pure confederation concept.

Obviously, with an increasing number of members, a pure confederation concept could easily lead to a complete lack of ability for the Union to make decisions, because one member might always veto any decision. If a group of members is allowed to proceed at a faster speed, they may, among themselves, intensify cooperation, but at the expense of the unity of the Union, seen as a whole. In addition, even in a confederation, the biggest (most influential) members may expect their vote to weigh more than those of the smaller member countries. In practice, most decisions will be taken by majority vote, the weight of each member country depending on its size etc.

In principle, a *federation* is simpler. The same legislation holds for all member countries, and decisions are taken at the central level, cf. eg. the United States. Hence a substantial part of sovereignty of each member country is handed over to the central authority. Perhaps some subject areas may be left with the individual member countries, cf. debates on the “principle of subsidiarity”, but such areas may be difficult to define and agree upon.

In practice, the legal framework behind the Union is a mixture of federal elements and elements of confederation. In most member countries, the population is reluctant to accept too many federal elements, while the top of the Union usually has federal preferences to a higher extent. In addition, disagreement has always existed with respect to the decision making bodies of the Union and the division of power between them. The Commission is not elected, but appointed, and is supposed not to represent national interests. The European Council (the Councils of Ministers) consist of Heads of States (cabinet members) and have the main political power. The Parliament is elected every five years (next time in 2004) by direct elections in all member countries, the number of members from each country depending on the size of the country.

Table 1. EU applicants: Population and per capita income, 2000.

Country	Population, million persons	GNP per capita, 1000 euro
Poland	38.7	4.4
Czech Republic	10.3	5.4
Hungary	10.0	5.0
Slovakia	5.4	3.9
Lithuania	3.7	3.3
Latvia	2.4	3.3
Slovenia	2.0	9.8
Estonia	1.4	3.8
Cyprus	0.8	14.2
Malta	0.4	9.9
Turkey	65.3	3.2
Rumania	22.4	1.8
Bulgaria	8.2	1.6
EU-15	377.0	22.6

With many new member countries, the decision process will easily become increasingly complex. Therefore, a Convention has been established with the purpose of designing a new constitution for the Union.The aim is to agree on a simple structure, but it is rather unlikely that such a result will be reached. Instead, the outcome will probably be similar to the present state of affairs or a complex constitution, reflecting many political compromises.

Member countries with many inhabitants will always have more weight in the decision making process than the small ones. Up to 1989, France, Western Germany, Britain and Italy all had roughly 60 million inhabitants each, but after the reunion the German population has increased to more than 80 million. After these four countries comes Spain with almost 40 million, a number similar to that of the biggest of the possible new member countries, i.e. Poland.

Additional members?

As appears from the foregoing, it will be a difficult task to create an efficient legal framework which will be acceptable for all the members, old and new, rich and poor. In this connection, the different income levels of the old members and the new ones should be stressed, the income level of the new members being much lower than that of the old member countries, cf. table 1. The figures in the second column on per capita income do, however, overestimate the difference in standards of living; the price level in low income countries is usually much lower than in the rich countries. Still, the difference is substantial and much bigger than the corresponding difference when Spain and Portugal, not to speak of Greece, became members of the EEC.

Experience shows that economic integration is easier to obtain when the income level of the participants is rather similar and - what may amount to the same - that urban industries in all the member countries play an important role. In rural areas, it is much more difficult to create conditions for increased efficiency and economic growth. This is part of the background for the problems with respect to the Common Agricultural Policy (the CAP), discussed below.

On this background, the difficult process of EU integration will be facilitated if a further increase of the number of member countries can be postponed, perhaps even avoided in a foreseeable future. Bulgaria and Rumania are already accepted as applicants, but their income level is at the very bottom of the European countries; in addition, the size of the Rumanian population is far from insignificant, more than 20 million inhabitants.

During the military and political unrest on the Balkan in the 1990´ies, the EU gave several promises with respect to closer ties to EU. Slovenia is one of the new EU countries, but how fast the other Balkan countries may get closer ties to the EU remains to be seen. An additional problem is here that a substantial part of the population is muslim.

This holds even more for Turkey. In addition, almost all of Turkey is situated outside Europe, and the size of the Turkish economy is not negligible; the Turkish population exceeds 60 million. The status of Turkey as a possible member is probably partly reflecting the high priority related to Turkey´s status as a Nato member. At least, the population has a cultural and religious background very different from that of the present EU countries. If Turkey became a full member, the EU would have Iran and Iraq as their neighbours with the Kurds inbetween.

In addition, the Turkish population has shown a substantial interest in emigrating to the European countries, but without much interest in becoming integrated in the countries where they have settled down. Hence the immigration problems of the EU countries to a large extent are caused by Turkish immigration.

Immigration and mobility of labour.

EU members have liberalized capital movements, and free capital movement for members of the euro area is an important part of the rules for the foreign exchange union, as is discussed further below. On the other hand, labour mobility inside the EU has turned out to be rather limited, not least for unskilled labour. The immigration problems which are facing many EU countries are due to immigration from the rest of the world: old colonies and not least from muslim countries.

Immigrants from other EU countries usually are rather easily integrated in the countries where they settle down, probably because their number is limited and their cultural and religious background is rather similar.

Immigration from less developed countries - often muslim - gives rise to more difficult problems, and even the order of magnitude of the yearly immigration is difficult to express in quantitative terms. Statistics from the United Nations use a definition of “Less developed countries” which is rather useful; the EU statistics do, however, include Turkey among the European countries.

Problems are even bigger with respect to comparable figures for the number of foreigners at a given point of time in various EU countries. How do we define a foreigner? If a person obtains citizenship in the country where he settles down, does his status change, independently of whether he actually has been integrated in his new country - and how do we establish criteria for, to which extent integration has taken place?

To analyse these problems will take us too far away. But it should be stressed that problems related to immigration from developing countries must be expected to be permanent. Here it should be recalled that the population in most EU countries is not able to reproduce itself. The reason for this is more advanced ways of avoiding pregnancy combined with increasing interest among women to take an active role on the labour market. With long run tendencies for the population in the rich (European) countries to decline and for the population in the poor, less developed, countries to increase, the immigration pressure must be expected to continue in the foreseeable future.

It is generally expected that the risk for the labour markets in the present EU countries to come under pressure as a consequence of the increase of the number of EU members from 15 to 25 will be rather limited. But other problems will gradually require attention, one being the structure of the social service systems in the various member countries. For instance, the Scandinavian welfare state is traditionally based on the idea that social benefits are obtained from government budgets and hence financed by the tax payers. With free mobility of persons, it may be tempting for citizens in EU countries to move to member countries with high rates for, e.g., old age pensions. On this background it must be expected that social security systems in the various EU countries will be adjusted so that payments to the individual citizen will depend on earlier insurance contributions or payments to social security funds as part of wages receipts.

The Common Agricultural Policy (CAP) of the EU.

The CAP has been an important - and controversial - part of EU policies ever since the start of the EU (the Six) in the late 1950´ies. Contrary to earlier schemes, the Common Market (the EEC) was to include agriculture; this was not the case for the European Free Trade Area (the Seven), established at the same time and including countries which had not become members of the EU, Britain and six others.

From the beginning, the basic EU idea was to stabilize prices obtained by EU farmers. Subsidies to farmers took the form of price support, EU producer prices exceeding world market prices. This implied incentives for agricultural output to increase, but this consequence was accepted since, around 1960, EU was a net importer of several agricultural products. However, this situation changed after a few years and ever since, the basic problem of the CAP has been that production exceeded consumption, the surplus production being exported, often at prices far below domestic prices (dumping?) or simply destroyed. Hence EU consumers have to pay higher food prices than consumers elsewhere, and farmers in the rest of the world, not least in developing countries, find it difficult to compete with cheap EU agricultural products, perhaps even imported as part of assistance to developing countries.

In addition, the CAP has been a very expensive scheme for the EU to carry through. A few decades ago agricultural subsidies corresponded to almost two thirds of total EU expenditures. This share has now been reduced to roughly one half, but this is still an impressive amount.

It will take us too far to embark upon a more detailed analysis of the CAP rules for individual products; they vary a great deal from product to product. Basically, consumers should be offered, and producers should receive, the same prices in all member countries, these prices exceeding world market prices. Obviously, changes of exchange rates vis-a-vis other member countries do create substantial difficulties for such a system to function, and these CAP problems were one of the strong reasons why the creation of a foreign exchange union got high priority.

Traditionally, French farmers have benefited from the CAP, while Western Germany has contributed to the scheme. Britain, being a net importer of agricultural products from its old empire, did not benefit from the CAP. This was one of the reasons for Margaret Thatcher´s critical attitude versus the EU.

The question may be raised why the CAP, giving rise to so many problems and having so large financial impilcations, has survived for almost half a century. One of the fundamental explanations is that the mobility of rural population is low, especially if they own their farms. Agriculture is a very capital intensive industry. Wage earners in agriculture may move to urban industries, but the owners themselves are rather immobile, and they find it difficult to adjust to urban activities. Hence structural changes mainly take place when they retire. If politicians want to speed up this process, they will usually be met by active lobbyism. This resistance is strengthened by the fact that farmers in rural areas often feel attached to their present way of life in surroundings where they and their predecessors have lived for generations.

Still, in the long run the CAP is bound to be changed. A policy based on incentives to increased production in economies with substantial surplus production does not make sense. When agricultural products can be purchased abroad to prices far below EU home market prices and the value added in part of agriculture, measured at world market prices, is insignificant, structural changes are urgently needed.

The basic principles behind the World Trade Organisation (WTO) indicate that export prices must equal domestic prices. Hence CAP will have to be scrapped. There will probably also be a long run tendency for agricultural prices in EU to decline. But completely to abolish subsidies to agriculture is not a realistic expectation. However, the WTO philosophy may point to a system, according to which subsidies should be given to low income farmers rather than to prices. Hence subsidies to agriculture should be considered part of social security and be financed by the individual member country (perhaps assisted by contributions from EU regional funds). Obviously, such a policy would not be welcomed by the new members, especially to the extent that each of them would have to finance the agricultural subsidies to their own farmers.

On this background, a change from price support to income subsidies is not likely to take place in the foreseeable future. Instead, present low agricultural prices in the new member countries will approach EU prices over a transition period; France and Germany have agreed on a ceiling for the total amount of agricultural subsidies. It was no accident that the final issue to be settled at the negotiations on extention of membership last December was Polish insistance on more favorable conditions for the new members with respect to agriculture. In Poland, the number of small scale farmers is high and efficiency in agriculture is low. And there was a symbolic aspect in the fact that it was Germany which gave the final concession.

The Economic and Monetary Union, EMU.

Lithuania being one of the new EU members, it is worth going into some detail on the status of the these countries with respect to foreign exchange cooperation. If a new member confirms its EU membership at the referendum, it will automatically also become a member of the Economic and Monetary Union (EMU), but only an "outer" member, ie. it will not join the euro foreign exchange union. Hence, it will get the same status as, eg., Sweden and Denmark.

But as a new member, it will have to introduce the euro when it fulfills the criteria for participation, the so-called *convergence criteria*, and it will have to adjust its economic policy in order to fulfill these criteria. It must, however, be expected that a substantial number of years is required for the new members of the EMU, before they are ready to join the euro. Institutions must be created or adjusted in order to be able to cope with the problems of a market economy, and a higher income level would also facilitate the process leading to entry into the euro union.

The convergence criteria have four main elements. The first is sound government finances, the second is price stability and the third requires that long term interest rates must be similar to those of the present members with low inflation rates.

Finally, the foreign exchange rates of the new member country must have shown stability vis-a-vis the euro over the two preceding years. Membership of the EMU for the new countries is planned to start in May 2004, hence they cannot become euro members before 2006.

The Foreign Exchange Union (Euroland).

The EU foreign exchange union became operational from 1999 onwards with the euro (EUR) as its unit of exchange. Today, it has 12 EU countries as members. Britain, Sweden and Denmark so far have remained outside; Sweden will hold a referendum on this issue in September 2003.

By definition, the members have to use the euro, hence they have no possibility of having their own foreign exchange policy; (this is a continuation of the fourth convergence criterion). If a member has inflation at a higher rate than the other members, it is bound to get into trouble.

Short term interest rates are determined centrally by the European Central Bank (ECB). When deciding on the short term interest rate, its main aim is to keep inflation below 2 per cent. (This is a continuation of the second and third convergence criteria). Only if this requirement is met, the ECB may pay attention to other factors, eg. unemployment, when it determines the common short term interest rate.
This arrangement, combined with free capital movements, implies that monetary policy is highly centralised; there is not much scope left for monetary policy by each individual member country. Such centralized decision making has never been accepted by member countries when it comes to fiscal policy. Here, each member country decides on its own budget. But this cannot be done without coordination of fiscal policies of all the member countries. Attempts to establish such a coordination, corresponding to a continuation of the first convergence criterion which required sound government finances, have given rise to

much disagreement, reflecting partly political considerations (budgets should be decided upon by parliaments in the individual member countries) and partly fundamental disagreement among economists on the importance of fiscal policy as compared with monetary.

Fiscal Policy in Euro Member Countries.

The immediate suggestion with respect to requirements for the fiscal policy of each individual member might be that total government budget should not be allowed to show a deficit, and the actual rules are not far from this idea: Budget deficits must not exceed three per cent of GNP, and government debt must not exceed 60 per cent of GNP.

A basic problem with such a simple rule is that surpluses or deficits on government accounts may reflect business conditions rather than being the result of changes of fiscal policy instruments. If the economy grows at full employment, the tax base will increase, and so will tax receipts. At the same time, government expenditures on social security, eg. unemployment benefits, will be low. Hence government finances will show a surplus. But to take advantage of the surplus and, eg., reduce taxes would lead to an increase of total demand, which at full employment may increase tendencies to inflation.

A similar way of reasoning can be applied when an economy goes into a recession. Tax receipts will decline, expenditures on social security will increase and government finances will deteriorate. To increase taxes in order to cover the deficit would, however, be a mistake; the consequence would be a further reduction of total demand and perhaps even bigger unemployment.

The conclusion of this way of reasoning might be that, when quantitative rules are established for good fiscal policy conduct, cyclical elements in the surplus/deficit on government accounts should be eliminated, eg. by calculating a “full employment” surplus or deficit. There is, however, no simple way of making such estimates.

Obviously, the bigger the government sector is, the more important is the way in which it is treated. The mechanisms, just described, may be considered “automatic stabilisers”, dampening booms as well as recessions. But in practice, fiscal policy has not always be assigned such a passive role. During recessions, there will be a temptation for the government to increase government expenditures (or reduce taxes) in order to increase total domestic demand. This may lead to a violation of the euro fiscal policy rules, but can perhaps be justified if the government accounts have shown surpluses in the preceding years, if the increased deficits are only temporary (but who can guarantee that?) and the economy shows no inflationary tendencies.

But perhaps the problems behind the deficit are structural, caused by, eg., insufficient rules of conduct in the labour market or other basic factors (eg. the German reunion, leaving the eastern part of the country in a very poor shape). Under such circumstances, structural problems require structural solutions - and not just an increase of government deficits in order to stimulate total demand.

Prior to the oil crises during the 1970´ies, the level of ambition in many countries on using fiscal policy for “fine tuning” of the economy at full employment was high. But the results did not live up to expectatios. Instead, tendencies emerged for the rate of inflation to increase.

Several explanations were given for this outcome. The timelag from the decision in Parliament on increased government expenditures and till they affect total demand is difficult to predict, especially for attempts to stimulate investment. In addition, a “crowding out” mechanism may be involved, increased government spending being neutralised by a reduction of private demand.

In my own view, the lack of success for economists to make reliable forecasts for the - national or international - economy is to a large extent due to the fact that, so far, no satisfactory way has been found to predict (changes of) expectations of the agents in the market with respect to the future behaviour of main economic macro variables: growth, inflation etc. Outbreak of wars etc. are, of course, far beyond the reach for economists to predict, but also forecasts of the length of future business cycles have not been very successful. The basis for our knowledge is limited to experience from the past, but expectations on the future are seldom rational.

Summarising these pieces of evidence, the role of fiscal policy as part of stabilization policies is regarded by many economists with a good deal of scepticism. It will, however, always be tempting for a government in a country with high unemployment to increase government expenditures, but this may lead to solutions with higher unemployment in the longer run, especially if inflation rates are accelerating. This is probably the background for the the strict rules on price stability to be observed by the ECB when it decides on the common short term interest rate.

A basic problem for the euro will probably always be that economic development in the individual member countries will differ. Hence some countries want the ECB monetary policy to be tightened, while others want it to be more expansionist. Also, inflation rates may differ, although there will be mechanisms, not least trade with other member countries, which may contribute to dampening this effect. If wages get out of control in certain member countries, the only remedy may, however, be increased unemployment.

An attempt of a few concluding remarks.

The main effect of membership for the new EU countries will probably be related to adjusting their institutions to a market economy and to the various EU schemes to support them, not least the revised CAP. But it would be of no advantage for most of them to join the Euroland in the foreseeable future. The main argument will probably be political: Closer ties to the West.

It is doubtful how much the present members will benefit from euro cooperation. It requires a substantial amount of political agreement between them, to be implemented in an institutional system which allows for efficient decision making. But so far, it has not been possible to find satisfactory rules for the conduct of fiscal policy, and existing rules are not respected by some euro countries. The deficits on government finances both in Germany and Portugal exceed three per cent of GNP. Maximum sanctions in this field are limited to fines.

On this background, the most likely development may be that euro members - not least the big ones - decide on their fiscal policies without taking into account the impacts on the whole euro area. This pessimistic conclusion is confirmed by the lack of cooperation between the big euro countries, which is being illustrated in the field of foreign policy. Most likely - and hopefully - the ECB will stick to its present strategy. The result may be one of differences between EU countries with respect to growth and employment, inflation etc. This, in turn, may reduce the credibility of the euro, inside and outside euro land.

If these pessimistic predictions turn out to be correct, the new member countries will enter a EU which cannot agree on very much and probably is on its way to a more extended period of stagnation, economically and politically.