JEFFREY HARROP

# BUDGETARY POLICIES IN THE EUROPEAN UNION

## Introduction

The main focus in this paper is on the role of budgetary policies in the European Union to facilitate adjustment between member states. These are necessary since the EU is placing itself in a unified straitjacket – even trying to harmonise labour market conditions and creating monetary union. Without sufficient adjustment of wages, and ruling out exchange rate changes in a monetary union, then fiscal transfers offer the main way forward in creating a real and properly adjusted community. The terms EC and EU are used interchangeably, with the former referring more to the past and the EU currently. The paper discusses taxes initially because of their role in creating fair competition within the Market. It moves on from the central role of VAT to concentrate on the role of budgetary expenditure in creating a full Community; finally, it relates the accompanying role of budgetary policy to economic and monetary union. The paper is original in giving more emphasis to the role of budgetary policy, compared with the almost overwhelming preoccupation elsewhere in the general literature with the subject of monetary union.

## 1. Taxation in the single market

In relation to taxation, the EC has no proposals to harmonise direct taxes on labour income. These will remain under national sovereignty and the major instrument of national fiscal policy. The EC has also made only limited progress on company taxation; for example, removing double taxation on companies and also reducing the range of corporation taxes. These are needed to prevent capital movements and companies' product prices from being too distorted. The greatest impact of the EC has been on indirect taxation and is the major focus in this first section of the paper.

The EC has been concerned not just with free competition but with fair competition. This has necessitated the harmonisation of policies in many fields, including especially indirect taxation. Before the EC was formed countries had different systems of indirect taxation. It was argued that indirect taxes constituted a non-tariff barrier. Also, where countries used different sales taxes these distorted competition and adversely affected trade. Thus the Treaty of Rome (Article 99) specified in particular that indirect taxes should be harmonised and approximated. Progress has been greater on harmonisation of the indirect tax **structure** than of approximation of tax **rates** (Hitiris 1988, p. 106). Taxation is integral to national sovereignty, and issues such as "no taxation without representation". Taxation is still subject to the unanimity of the members of the EC.

## VAT

The 12 EC countries vary in their dependence on different types of taxes. For example, the UK traditionally used to rely more upon direct taxes because of the greater ease of collection (PAYE) than several continental countries which found direct taxes being avoided and evaded more easily than sales taxes. In fact, the UK decision to move to VAT in 1973 was "part and parcel" of EC membership. For example, the Richardson Committee in the early 1960s had concluded that the retention of purchase tax was preferable to VAT. However, one advantage by 1973 was the replacement of two taxes, Purchase Tax and the Selective Employment Tax, by one tax, Value Added Tax. The disadvantages, however, for the UK (as with the switchover in our system of agricultural support from the deficiency payments system) were less apparent than for many other EC countries. VAT is a regressive tax,whereas the Labour Government post-1974 preferred more progressive taxes. Fortunately for the Conservatives post-1979, raising VAT has fitted in better with their tax philosophy. This partly reflected the Meade Committee Report recommending the greater taxation of spending rather than earning (hence giving more choice over savings). We have seen VAT rise in the UK from 8% to 17.5% and direct taxation reduced to a top rate of 40%, a standard rate of 25% and a lower band of 20%. The supply-side incentive to work has been reinforced to substitute work for leisure to pay the higher prices created by VAT and the EC argicultural policy.

Other EC countries which were using sales taxes or retail value switched over to the French VAT system. It was argued that this reduced the distorting effect on production; that is, companies were increasing in size through vertical integration to reduce their tax burden. For example, assume three stages of production, no input, and sales value of £1,000 stage 1, £2,000 stage 2 and

£3,000 stage 3. With a 10% tax on total value, a tax payment of £600 would be paid, but would be reduced to only £300 in a vertically integrated enterprise. VAT by contrast is neutral in the production process, and £300 would be collected by a 10% VAT.

The EC has moved all Member States on using the system of VAT. But the share of Vat in total government receipts still varies widely. For example, indirect taxes were 11.3% of EC GDP in 1987. These varied from 9.6% in Italy and 10% in Spain to 17.6% in Denmark and 18.3% in Greece. The weight of both indirect and direct taxation is heaviest in Denmark. In other countries the higher level of indirect taxation tends to compensate for relatively low direct taxes on income and profits. For example, direct taxes as a percentage of GDP range from 6.4% in Greece and 6.9% in Portugal to 28.4% in Denmark.

The rates of VAT have varied quite widely, but the Single Market has led to the introduction from 1 January 1993 of a minimum rate of 15% VAT. Germany has moved up to this and France has moved down towards it. Also, those countries operating three different rates of VAT which included an increased rate on luxury goods – Belgium, Greece, Spain, Portugal, France and Italy – have agreed to conform to the Cockfield 2-band system. The lower rate is not to be below 5%, though zero rating may be retained for a transitional period. The UK, for example, has been exceptional in having zero rating for many necessities. Pressure is on the Chancellor of the Exchequer to continue re-aligning upwards on these.

The need to harmonise is reinforced by the Single Market measures to remove frontiers. In the past goods imported were taxed at their destination, but with progress towards a standard VAT rate, goods would flow freely from their origin. It has been agreed that the transitional movement towards this will enable a full origin system to operate from 1 January 1997. Furthermore, within this system, the tax revenue should still accrue to the Member State where the final consumption of the product occurs. Hence this requires a clearing system through which the Member States receive the taxes paid on the products consumed in their own territory.

## Excise Duties

These are important sources of government revenue since they are raised on products with a fairly inelastic demand. They constitute a significant proportion of the price of the three main product groups: oils, tobacco and alcoholic drinks. The greatest harmonisation has been on cigarettes, but for other products there has been wide variation on levels of excise duties. For example, excise duties on beer, wine and spirits have been high in Denmark, Ireland and the UK. Yet wine, for example, has had no excise duty levied on it in Spain, Portugal, Greece

and Italy. The Court of Justice has tackled Member States whose excises are seen to discriminate against imports. Also, the EC is seeking some convergence of excise duties, but has made less progress than with VAT. Although many minor excise duties have been abolished on products such as tea, coffee, salt, etc, there has been more resistance on grounds of national policies on health to greater harmonisation of the major excise duties.

As part of the Single Market measures from 1 January 1993 the EC adopted minimum excise duties. One example of this relates to mineral oils and these have been set (per 1000 litres) for leaded petrol at 337 ECU, unleaded petrol 287 ECU, road diesel oil, 245 ECU, heavy fuel oil 245 ECU and zero for heating gas oil. Furthermore, the aim of these excise duties is to move to target convergence over time. For excise duties, the EC has opted to retain the destination system. The main reason is that excise duty is levied at one stage only, generally when the product is released onto the market. The EC has proposed the integration of national duty-suspension arrangements and the adoption of a community system of warehouses. Goods can then move freely once taken from the warehouses.

To conclude, the Market has focused on harmonising and approximating taxes to deal with the most mobile elements, in particular relating to goods.

## 2. The role of the Budget in the European Community

Coverage of taxation leads us to examine a Community whose existence is manifested by its own Budget. Since 1970 the EC has been given its own resources including customs duties and agricultural levies. In addition, the EC receives a significant proportion of VAT receipts plus a GNP-based contribution. The latter covers the difference between EC spending and revenue raised from other sources. Both VAT and the GNP-based component may be considered really as national components. The composition of revenue sources in 1993 were customs duties 20%, agricultural and sugar levies 3.4%, VAT 54.5% and the GNP-based contribution 21.4% (plus miscellaneous 0.7%). The Budget constituted 1.20% of EC GNP in 1993 and the finacial perspective for 1997 is for a rise of the own resources ceiling to 1.27% of EC GNP.

The regressiveness of the revenue-side of the Budget which led to the acrimony over Britain's contribution bas been largely alleviated by giving back to the UK two-thirds of the difference between its VAT contribution and the EC's Budgetary expenditure in the UK. This has been reconfirmed since the Edinburgh Agreement in December 1992 where it was decided also to reduce the share of VAT in the Budget to 34.38% and raise the GNP share to 47.90% by the late 1990s. This will be achieved as the maximum rate on the harmonised VAT base is lowered in equal steps from 1.4% down to 1% by 1999.

In relation to assigning taxes to different levels of government, one finds that customs duties are nearly always the exclusive competence of the federal level, as in the EC. At the other end of the spectrum, wealth and property taxes tend to be applied exclusively at the lower state or provincial level (European Economy 1993, p. 184). Other taxes are split between the different levels. In relation to the European Community being assigned new taxes in the future, these could comprise a tax on Central Bank profits and a new environmental tax on pollution to curb the emission of carbon dioxide.

## National Budgetary Expenditure

Turning to **budgetary expenditure,** before examining that at the level of the EC it is necessary to provide some coverage of national budgets. This will show the role of **national budgets,** the extent to which such expenditure is to be constrained by EC policy, and finally, will provide a measure of comparison with the Community Budget itself.

There has been an inexorable growth of public expenditure in EC Member States to provide more public goods or social goods which have to be provided collectively, for example, law and order, defence, etc, and to stop "free riders". Although merit goods can be provided by the private sector, for example, in education and health, the issue is whether individuals are rational and income levels sufficiently high for consumers to chose more wisely themselves. However, politicians driven by short-term electoral pressures tended to reinforce increased governmental spending.

In addition, during the 1970s following the oil price shock in 1973, budget deficits increased to tackle rising unemployment. Macroeconomic stabilisation policy has been applied by governments to reduce deviations of actual output from full employment output. This has been done by influencing variables such as consumption and private investment by adjusting taxes and in particular by altering government spending. However, the effectiveness of stabilisation is limited by lags in obtaining and interpreting statistical data, lags before action is taken and lags before policy takes effect. Although the second oil price shock at the end of the 1970s created further macroeconomic problems, EC policy was better coordinated and less accommodating.

In conformity with the requirements of the Council's Convergence Decision (February 1974), the Commission has examined the economic situation of the Community and especially the budgetary policies of the Member States. During the 1980s the rate of growth of governmental expenditure slowed down, with some improvement in the budgetary situation. This has led to a growing consensus on basic budgetary principles. These are that there should be non-monetary financing of public deficits. The result would be that governments would have no automatic access to central bank financing. There would also be no compulsion on commercial banks to invest in government securities.

However, by December 1990 such monetary financing still occurred in Belgium, Greece, Spain, Italy, Ireland and Portugal. But such facilities were being curtailed in Belgium, Spain and Portugal (European Economy, December 1990, p. 173). It is no coincidence that excessive budgetary deficits have tended to exist in most of these countries.

EC Member States have come to recognise, somewhat belatedly, the need to constrain the growth of public expenditure since too much concern with equity through the redistribution of income conflicts at the margin with wealth creation; government spending may also tend to crowd out the private sector. Furthermore, increasing taxes and social security contributions add to wage pushfulness, reducing business profits and investment. It has been decided that excessive budgetary debts of any Member States will not be bailed out by the EC. The aim is to ensure that budgetary expenditure rises more slowly than the growth of GNP. Countries are being forced to take steps to tackle their budgetary debt by raising tax revenue and/or reducing budgetary expenditure. This is creating painful consequences since the main brunt is borne by public expenditure cutbacks, yet in many instances demographic factors such as an ageing population are dictating the need for higher expenditure on health care, etc. Hence there is growing recognition that some services may merit greater private provision. Perhaps the most favourable development will occur through the so-called "peace dividend" with the ending of the Cold War, even though there are signs of dangerous instability in Europe with the disintegration in Yugoslavia and the breakup of the USSR.

The main reason for pursuing greater prudence and budgetary discipline is to fulfill the new Maastricht budgetary limits. The main changes (compared with the 1974 Council decision) were that in embarking on stage 1 of EMU from 1 July 1990 there would be focus not only on convergence of economic policies but also of economic performance. Member States are engaged in co-ordination of policies in the framework of multilateral surveillance, with greater emphasis on ex-ante surveillance (Wildavsky and Zapico-Goni, eds., 1993). Countries have to sumbit their convergence programmes to the Ecofin Council.

During stage 2 of EMU there is to be further multi-lateral surveillance and Member States are obliged to avoid excessive budgetary deficits. To pass to stage 3 of EMU various criteria have to be met, including binding measures to avoid excessive budgetary deficits. The first condition to be met is that the ratio of planned or actual government deficit to GDP is not to exceed 3%, though the Commission may be tolerant provided the ratio has declined and is close to this, or alternatively if it is just over 3%, but this is exceptional and temporary. The second condition is that the ratio of government debt to GDP is not to exceed 60%, though again the Commission may be tolerant provided that the ratio is dropping sufficiently and approaching the 60% limit at a satisfactory pace (Wildavsky and Zapico-Goni, eds., p. 74). The Commission reports on the

budgetary situation, and after the Monetary Committee has given a view, if an excessive deficit is considered to exist, the Commission addresses an opinion to the Council.

In 1992 there were only four EC countries (Denmark, France, Ireland and Luxemborg) which had a budgetary deficit below 3%, though Germany and the Netherlands could be considered borderline cases. Also in 1992 only five Member States (Germany, Spain, France, Luxembourg and the UK) had a gross debt to GDP ratio less than 60%. The growing recession and high unemployment have worsened the budgetary situation and therefore on a strict interpretation only France and Luxembourg were achieving the two criteria. Therefore much hinges on economic recovery and the continued commitment of Member States to accepting a further tightening of their national budgetary situation. For example, the UK, despite its Medium-Term Financial Startegy committing it to balancing the budget over the medium term, has moved from a budgetary surplus to its current huge budgetary deficit. The latter necessitated in the last budget (with its combined tax and spending decisions) significant and unpopular tax increases. Whilst the Maastricht budgetary conditions do not impose automatic national expenditure cutbacks, with some leniency in times of slump, they do narrow even further the room for national manoeuvre. They represent a further move away from Keynesian contra-cyclical stabilisation policies. Nevertheless, in terms of budgetary policy most of this is still to be conducted nationally rather than at the level of the Community. I propose to move on now to consider the European Community Budget and the relative role of this in relation to the national budget.

## Community Budgetary Expenditure

The EC Budget has two distinctive features. The first of these is that it is very small, currently amounting to 1.2% of Community GDP, compared with an average of 48% of GDP for national spending by Member States. EC budgetary expenditure is similar to that of the UK education budget or German spending on the eastern Lander, or is less than 10% of what the US spends on defence. Furthermore, the assumption, as I will go on to show later, is that even with some further growth in the EC Budget it will continue to be small in relation to national bugetary expenditure. Although EC fiscal federalism is not a pre-condition for EMU since, for example, common currencies took place before this in both the USA and Canada, nevertheless an enhanced budget would greatly facilitate EMU (Eichengreen 1992, p. 152).

The second feature of the Community Budget is that it is an accounting budget and according to the Treaty, revenue has to balance expenditure. In contrast, national budgets have been functional ones based on automatic

stabilisers, and unbalanced. Following the legacy of the Keynesian revolution, usually there have been budgetary deficits as government expenditure exceeded the tax intake, increasing demand to reduce unemployment. In contrast, the EC Budget cannot run budgetary deficits in times of slump to stabilise the EC economy. Indeed, if it were to take on such a role there may well be conflict between countries, with some, such as Germany, traditionally being more concerned about inflation who perhaps would argue for a budgetary surplus to be achieved. The Community Budget does not play a stabilisation role and lacks flexibility as a result of its multiannual programming. If anything it could be said to be pro-cyclical since its spending ceiling is expressed as a percentage of Community GDP (European Economy 1993, p. 23). Clearly, some additional measure of Community stabilisation would be helpful (Italianer and Van Heukelen, 1993). The latter have proposed a reserve to operate outside the general Budget which would be transferred in the form of an outright grant to economies suffering an exogenous shock which raised their unemployment rate significantly above the EC average. It would probably account for about 0.22% of EC GDP.

However, one should remember that the EC does undertake loans, especially via the European Investment Bank; also, the New Community Instrument (Ortoli Facility) created in 1978 was concerned as an anticyclical weapon mainly to stimulate investment. Furthermore, the EC also offers conditional loans to Member States with balance of payments difficulties, though this will disappear in stage 3 of EMU in a currency union. In addition, the EIB has been given enhanced powers since the Einburgh European Summit in December 1992 to create the European Investment Fund, initially of ECU 2 billion to boost investment. This will be injected particularly into trans--European networks (TENs) and small- and medium-sized enterprises (SMEs), including loan guarantees and also through equity participation.

The degree to which the EC Budget can grow in the future depends upon a variety of circumstances and issues. These include the extent to which Member States are prepared to see some switch of spending upwards to the Community level. For example, unlike other federations which are responsible for defence, the EC, having rejected a European defence Community in 1954, has operated through NATO. If the United States reduces its defence commitment to western Europe, the EC seems likely to develop via the WEU and on the basis of Maastricht towards a common foreign policy and defence union. This would generate further economies of scale in the organisation, with common procurement policies providing an additional stimulus to high-tech EC industries.

The EC has been unusual in assigning most of its expenditure in a different direction from that of other federations in which defence and social welfare expenditure have been so extensive. In contrast, the EC budgetary expenditure has revolved so much (some would say too much) around agriculture. If the EC

is fully to reflect European citizenship then one could foresee some transfer of social expenditure towards it, perhaps taking over payment of a minimum EC-wide level of unemployment and social benefits.

In 1977 the MacDougall Report recommended that the EC Budget needed to increase to a minimum of 2 - 2.5% of GDP, and for successful monetary union the Budget needed to be raised to 5 - 7% of EC GDP. Whilst the Budget could evolve in this way under pressures for common defence and social responsibilities, there are also competing elements at work restricting the growth of a central EC Budget. These include concerns to decentralise and operate subsidiarity as enshrined in the Maastricht Treaty. There is also worry about greater waste and lack of democratic accountability in a centralised budget. Many Member States are also questioning the traditional role of the state in providing public goods and particularly merit goods. Privatisation is reining back the public sector and has spread from Britain to other Member States on the grounds of microeconomic efficiency, plus macroeconomic benefits in reducing government borrowing by selling off loss-making state activities and turning round their economic performance.

An influential report by an independent group of economists believes that a small budget of around 2% of Community GDP could be sufficient to sustain an effective EMU (European Economy 1993). An increase in the Budget to this level is likely to occur where there are common benefits to be reaped by an EC level of provision. For example, the EC role in R & D activities was 3.3.% of the Budget in 1993 and has potential to grow further. Similarly, the EC provides external assistance to the rest of the world (and this reached 4.6% of EC Budgetary expenditure in 1993). In addition, one also needs to add ECU 1.5 billion provided by the European Development Fund (which is kept outside the general Budget because of its financing). If the EC were given greater power in external relations, this would make aid programmes more rational, enabling countries to purchase from the cheapest EC supplier and making the value of the aid go further. EC aid in 1993 to LDCs was 0.48% of GDP compared with the UN norm of 0.7% of donors' GDP. National aid by the Member States is far in excess of that given by the EC, especially to LDCs, though the EC does handle about a third of the aid given to eastern Europe. Some would like to see an enhanced development effort by the EC for eastern Europe along the lines of the early post-war Marshall Aid Plan and on the same scale.

EC budgetary expenditure could also rise significantly with further EC enlargement. The inclusion of EFTA countries such as Norway, Sweden, Finland and Austria from 1 January 1995 will add significantly to EC revenue. Future enlargement to embrace eastern European countries will create major pressures on budgetary expenditure. For example, enlargement to include the Visegrad 4 plus the Balkan and Baltic Republics would require an additional 0.85% of EC GDP by 1999. If the former republics of the USSR were included it would rise by a further 1.3% of EC GDP – an amount similar to the existing Budget currently for the EC 12 (European Economy 1993, p. 114).

## Redistribution through the Budget

The main elements of redistribution have occured through spending on regional and social policies. However, the European Agricultural Guidance and Guarantee Fund (EAGGF) has tended to dominate budgetary expenditure. Since this has been concerned mainly with price guarantee rather than agricultural restructuring, it has meant larger producers have tended to benefit most. A more selective system of targeted direct income transfers would provide a more suitable approach to income redistribution. Since the effect of the Single Market is likely to exacerbate regional inequalities as competition leads to the closure of less efficient firms, the EC has recognised the need for regional expenditure to rise. Furthermore, EMU (discussed in the next section) prevents lower exchange rates making such firms competitive.

The unemployment rate in the EC is above that in the USA, Japan and the EFTA countries. Despite the creation of new jobs, with over 9 million created 1985-91, unemployment fell by only 3 million (Commission, European Social Policy 1993, p. 17). Many of the new workers who came into employment, such as married women, returned from households rather than unemployment registers. In depressed and more peripheral regions job opportunities were lower and regional unemployment consequently at a higher level.

The EC has concentrated its increased structural funding on five objectives. Objective 1 regions, whose GDP is less than 75% of the EC average, accounted for 63% of EC structural expenditure 1989-93, and this is set to rise to 68% of EC structural funding 1994-99. Objective 1 regions include the whole of Greece, Portugal, Ireland, southern Italy and most of Spain, plus several new areas, for example, the new Länder in eastern Germany and east Berlin (Commission, Community Structural Funds 1994-99, 1993, p. 12). The UK has three Objective 1 regions and these are Northern Ireland, Scottish Highlands and Islands, and Merseyside. The proposed EC expenditure over the six year period 1994-99 is 1160 million ECU in Northern Ireland, 816 million ECU in Merseyside and 311 million ECU in the Highlands and Islands. The dominant role is played by the ERDF, though the ESF is of growing significance and in Merseyside, for example, is intended to play a major role through education and training in rejuvenating the area. There is proposed a 51% increase in expenditure on structural funding by 1999 compared with 1993: this was agreed at Edinburgh in December 1992.

Other areas, especially the declining industrial areas of Britain, have benefited from Objective 2 status. Objective 3 is now redefined to include both the young and the old who are unemployed and all those groups socially excluded. Objective 4 is completely redefined to help those who are in employment but are threatened by industrial change. Objective 5 refers to agriculture.

The ESF has moved since 1958 from emphasising labour mobility in a high employment labour market to vocational training for the unemployed since the 1970s, particularly helping to tackle high youth unemployment. The ESF has also concentrated on those unemployed in depressed regions and in those sectors facing rapid decline, such as textiles. The creation of appropriate supply-side improvements and skills is helpful, particularly in Britain where skill levels have tended to be poor compared with our major competitors such as Germany. However, we object to other standardisation in labour market measures relating to social charges, worker participation and minimum wage legislation. These are seen as creating greater inflexibility in the labour market, adding to the difficulties in creating jobs.

The EC in its expenditure policies is of growing importance not so much in an absolute sense, but mainly in relation to particular areas of expenditure. For example, through its structural funds local beneficiaries have started to look more to Brussels than to national capitals. In other words, a local cadre exists, committed to an EC of the regions. For those fortunate enough to receive EC funds, they are making a significant impact. However, additionality is not easy to establish when the money is transferred to Member States, but they are expected to maintain their macroeconomic spending at least at its level in the previous programming period. The new Cohesion Fund accounting for 7% of total structural expenditure in 1993 is subject to macroeconomic conditions. Transfers cease if the Member State has an excessive budgetary deficit and has taken insufficient measures to eliminate it (European Economy 1993, p. 63).

Redistribution with the EC is of a different order from that within the nation state. In the latter, citizenship is conferred by certain common rights, including entitlement to welfare benefits. Income nationally is redistributed between people both from the side of ability to pay, with progressine tax ensuring the rich pay most, and from the side of benefits, with the poor getting most subsidies. Occasionally national policy may be criticised sometimes with high marginal tax rates for the relatively low paid and indiscriminate subsidies to all groups, not just the poor. Income redistribution within the EC has been much weaker and essentially between regions. Although there is considerable overlap between poor people and poor regions, one still has some poor people in rich regions subsidising some rich people in poor regions. Furthermore, EC citizenship is still insufficiently well developed to tolerate further income transfers. This has been apparent in German unification and applies even more at an EC level where income transfers are seen to be given to the poor who are unenterprising and workshy. Hence cohesion in the EC will continue to reflect the aim more of equality of opportunity with structural improvements to hard infrastructure such as transport, and soft infrastructure, such as human capital, to raise regional potential.

BIBLIOTEKA AE Poznań

## 3. Economic and monetary union

In the interests of conciseness, this section merely sketches in the background on EMU and more detail can be found elsewhere (Harrop, 2nd edition, 1992). Apart from touching on some of the key developments, most attention is given to the current Maastricht conditions for EMU.

The EMS was relatively successful in reducing exchange rate variability and there were fewer exchange rate re-alignments by the late 1980s. The UK finally decided that the time was ripe to join in 1990. This led to plans being drawn up for a complete EMU. Unfortunately no sooner was the new blueprint drawn up than a speculative crisis created currency turmoil in September 1992 and July 1993. There was political uncertainty related to ratifying the Maastricht Agreement. In addition, the resources needed for successful German re-unification drove up interest rates. Eventually the ERM collapsed in the cataclysm of widening bands to + or − 15%, apart from Germany and The Netherlands. The UK left the ERM acrimoniously blaming Germany.

Countries participating in EMU have to modify their national macro-economic preferences, reaching either some common preference, or following the preference of a dominant economy, such as Germany. The consequence for weaker economies in trying to attain a lower rate of inflation is a much higher level of unemployment. However, given the monetarist perspective that no long-run trade off between unemployment and inflation exists, then countries were prepared to converge towards the lower German inflation level. Unfortunately the short-term consequence of this has been heavy unemployment, necessitating even more transfers via the structural funds than when more exchange rate flexibility exists. Pressure to alleviate unemployment, especially via an expansionist fiscal policy, is placed on politicians who are reluctant to persevere with continued deflation when they see more readily effective measures being available in the short run.

### Maastricht

Essentially EMU in the past which promoted monetary union as a precondition for forcing economic union was "putting the cart before the horse". Only with economic convergence via economic union is a durable EMU feasible. This economic perspective is recognised mainly in the Maastricht Agreement. Stage 1 was launched under existing EC powers from July 1 1990, with action taken to improve economic and monetary co-ordination between Member States and to extend the work of the Committee of Central Bank Governors. Stages 2 and 3 necessitate changes in the Treaty since they involve setting up new institutions. These include in stage 2 from 1 January 1994 the establishment of a European Monetary Institute to strengthen co-operation between national central banks and co-ordinate monetary policies.

Four convergence criteria have been established and one of these – no excessive budgetary deficits – has already been referred to in part 2 of this paper. Failure of the Member State to co-ordinate economic policy and maintain budgetary discipline could trigger further action, such as the EIB reconsidering its lending policy to that country, a requirement to make an interest-free deposit with the Community, or imposition of fines. Not only are most countries failing on the budgetary criterion, but also some of the other criteria are in difficulty, in particular the collapse of the normal exchange rate bands of + or – 2.25%. The normal fluctuation margins of the ERM should have been respected for two years without severe tensions and without a devaluation on the Members State's own initiative. However, with the severe tensions since September 1992, are we to take the bands as + or – 2.5%, or + or – 15%? Also, is devaluation on one's own initiative to be excluded where realignments have been mutually agreed as they usually are in the system? The UK, Italy and Greece are not in the ERM. But France has succeeded in getting the franc back to narrow margins and also, as a result of the exchange rate re-alignments, the stage may be set for greater exchange rate durability in the immediate future. An additional convergence criterion is that long term interest rates are to be within 2% of the three lowest member states. Finally, inflation is not to be more than 1.5% more than that of the best three performing states. In 1992 these were Belgium, Denmark and France whose rates ranged from 2.1% to 2.8%, hence the reference value for inflation ranged from 3.6% to 4.3%. Five other member states satisfied this criterion, the exceptions being Greece, Portugal, Italy and Spain. At the end of 1993 eight out of 12 countries were meeting the interest rate and inflation criteria.

Stage 2 of EMU runs to 1 January 1997 if convergence criteria are met by a majority of member states (which means seven out of 12, or six if the UK does not take part in stage 3). If there is not a majority then the fallback date for EMU to begin irrevocably is 1 January 1999. We will then have in stage 3 a European Central Bank with a single monetary policy. All national bank Governors are part of the Central Bank, plus some independent members. The Bank's aim is to pursue price stability and is based in Frankfurt, giving some reward to Germany for giving up the D-mark for the ECU. As national central banks become more independent of government, only with reluctance will they surrender some of their new-found powers to the ECB. Furthermore, the UK and Denmark have an opt-out of stage 3 of the Masstricht Agreement. If the UK does not join stage 3 it retains all its powers for monetary and exchange rate policy and will not be subject to EC disciplines, apart from its commitment not to run excessive budgetary deficits. The likelihood is therefore that EMU will only go ahead with a smaller number of countries than the original 12 and perhaps with a delayed timetable.

## Conclusion

Member States are increasingly interdependent and therefore completely independent national macroeconomic policies are being surrendered within the EU. In fiscal policy this limits, for example, the Chancellor of the Exchequer's policies on indirect taxation. In budgetary expenditure we need and are likely to see some more spending switched towards the central EU level. The Community impact is significant, such as the growth in regional and social policy expenditure. However, EU budgetary expenditure is still likely to be too small and most expenditure will continue to be at national level. Nevertheless, it will be constrained by Maastricht conditions tending to reinforce a deflationary monetary stance.

Finally, EMU involves the surrender of the potent exchange rate instrument, monetary policy becoming more centralised in a new ECB and eventually a new single currency. The levers of national economic management are being weakend and will be shared increasingly with the EU. Given that Member States are still insufficiently integrated, for example, in terms of labour mobility in practice, there is need for greater EU budgetary redistribution than currently seems to exist.

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## SUMMARY

The paper focuses mainly on the development of budgetary policies in the European Union, whereas most writers have chosen to concentrate almost entirely on economic and monetary union per se. Both taxation and expenditure are covered, with the starting point being tax harmonization to create fair competition within the EU. Most progress has been made in harmonizing indirect taxation, particularly value added tax, with greater difficulties encountered in harmonizing excise duties.

In relation to budgetary expenditure, it is shown that the EU budget is still small compared with national budgets, and the latter are being affected by Maastricht budgetary criteria. This is likely to strangthen the deflationary policy stance. The EU budget is relatively under-developed in size, lacking a stabilization capacity since it has to balance. The Community Budget lacks the large defence and social security components of national budgets. Its redistributive capabilities need to be expanded and it is playing a growing role in regional redistribution through the structural funds. Although in reality the level of citizenship assumed in the Maastricht Treaty may not yet exist to underpin massive redistribution, this will be necessary in the future to promote the feeling of Comunity citizenship. The budget size is likely to grow through the pressures of enlargement and through policy deepening; for example, EMU will eventually preclude national exchange rate and interest rate policy rate changes, thus requiring complementary development of compensatory budgetary finance.