

INTERNATIONAL ADJUSTMENTS THROUGH MICRO AND MACROECONOMIC COORDINATION: THE EXAMPLE OF EUROPEAN UNION

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Abstract: The process of 'globalisation' now a days leading to a greater interdependence among nations than ever before. And thus greater cross-border spillovers imply an increased need for international policy coordination. The internationalisation of assets and goods market together with the advances in transportation and information technologies, has guaranteed that what happens in one country, especially in a large country, will be felt by other countries. The upsurge in economic integration, in recent times, in the shape of free trade areas, customs union, common markets and various types of preferential association have clearly showed the widespread belief on the value of economic integration. Those interactions are chosen as a way of economic growth, export-led for example, even though they might have some conflicting features. The integration of not less than twelve currencies into a single one in Europe is one of the most amazing facts in the history of modern economics. This paper is primarily based on secondary sources. Extensive literature review has been conducted to frame the concept and issues. Despite the consensus on the benefits of micro and macroeconomic policy coordination, economic blocs still face many difficulties in doing it. Those difficulties arise from countries' varied and usually opposing views and principles about micro and macroeconomic policy. It is undoubtedly difficult to ensure the benefits for all the stakeholders while going for economic growth through opening the economy with all sides. The need for macroeconomic policy co-ordination is obviously a must in an integrated area to realize the full benefits of integration. It must be admitted however, that coordination is a difficult task for countries to do, considering their immense differences. With the increasing number of them forming regional arrangements, one cannot help asking of what path would this cooperation be heading towards-basically a question of success or failure.

Key Words: International adjustments; Policy coordination; Economic integration, Convergence; Competition

Introduction

The process of 'globalisation' is making nations more interdependent than ever before. Higher interdependence means greater externalities of domestic policies imposed on neighbouring nations. Greater cross-border spillovers imply an increased need for international policy coordination. It is well known that the sovereignty of nations implies that international agreements have to be 'self-enforcing', i.e., constructed such that each country finds it convenient to respect their requirements even in the absence of an international authority able to enforce them (Spagnolo, 1999). One of the important outcomes of globalisation is the increasing integration and interdependence among countries. The internationalisation of assets and goods market together with the advances in transportation and information technologies, has guaranteed that what happens in one country, especially in a large country, will be felt by other countries. This implies that policies of one country should have either positive or negative consequences on others.

In 1992 there were already 34 integrated areas and 29 new agreements notified to the World Trade Organization (WTO). This upsurge in economic integration was influenced either spontaneously by market forces or economic geography, in most cases formal structures are being created in the shape of free trade areas, customs union, common markets and various types of preferential association. All these clearly show the widespread belief on the value of economic integration (Cable and Henderson, 1994). Those interactions are chosen as a way of economic growth, export-led for example, even though they might have some conflicting features. We have already experienced a lot of successes in this regard and some very costly failures as well.

International policy coordination arises with the recognition of international economic interdependence. Coordinating policies is important for several reasons. Policy actions of individual countries could create negative spillover effects for other members. Coordination is the best possible way of internalising these externalities. Moreover, they are unavoidable and necessary since closely integrated countries share a common number of interrelated variables. Divergences among countries as to their desired level will surely create policy conflict. It is very interesting to see the way of managing conflicts among competitors, articulating instruments and putting consistency between short and long-term policies inside a federal country or inside an integrated area. It is undoubtedly difficult, however, to ensure the benefits for all the stakeholders while going for economic growth through opening the economy with all sides. Furthermore, the perceived benefits brought about by integration will be maximized when macro and microeconomic policies are harmonized. With increased interdependence, international policy coordination becomes more desirable and essential. International policy coordination thus refers to the modification of national economic policies in recognition of international interdependence.

Issues in International Policy Coordination

Despite the consensus on the benefits of macroeconomic policy coordination, economic blocs still face many difficulties in doing it. These difficulties arise from countries' varied and usually opposing views and principles about macroeconomic policy. Another difficulty in international policy coordination is the differences in political and institutional arrangements among member countries. Uncertainty on the "true" model of the world economy makes it difficult to be confident that coordinated policies would really be beneficial.

For macroeconomic policy coordination to work, a number of things must be considered. Coordination should be viewed as something that is done in order to achieve common goals. It should be emphasized however, that differences should remain at the country level so that complementarities remain and competitions are avoided. Another aspect that should be highlighted is the necessity for a reliable system of information and refinement of economic data among the members. This will facilitate a common evaluation of current national and global economic conditions as well as provide a common understanding of the priority of policies that must be coordinated. This will also ease multilateral surveillance and will smoothen monitoring of each member.

Objectives of the Study

There are a lot of issues regarding the interactions through trade between/among countries concerned. Among them, one is a convergence of economic performances between/among countries and regions with a differentiated level of economic development. The issues are more of development related rather than performance appraisal of those countries concerned. This paper is primarily based on secondary sources. Extensive literature review has been conducted to frame the concept and issues. Views of different expertise have been adopted and critically analysed to arrive at the possible conclusions. An extensive and clear example, i.e., EU, has been cited after the discussion of the related issues for the better understanding of the theories and concepts discussed in this paper.

Primary Objective: The primary objective of this paper is to examine the way micro & macroeconomic policies are coordinated for the purpose of meaningful economic integration. This paper is, in fact, designed to have an idea about the international policy coordination related to convergence, competition, regionalism and so forth. At this instance, European Union (EU) is used as an example, since EU is considered as the only region that is completely integrated regarding all the economic aspects.

Secondary Objectives: Following secondary objectives are aimed for the purpose of achieving primary objective:

To examine the way of managing conflicts among competitors, articulating instruments and putting consistency between short and long term policies inside a federal country or inside an integrated area.

To see how the international adjustment procedure, i.e., policy coordination is done regarding the economic policies when some different or unequal economies are converged.

Given that, it is very difficult to ensure the benefits for all the stakeholders while going for economic growth through opening the economy with all sides, should the attempts to integrate, as a result of exposure to global competition, be accompanied or confronted?

History of the European Union

In the years immediately after World War II, the Western European countries suffered a balance of payments disturbance in response to reconstruction efforts. To solve these problems, they initiated an elaborate network of tariff, quantitative controls and state trading. In the 1950s, Western Europe began to dismantle its trade barriers in response to successful tariff negotiations under the auspices of Generalized Agreement on Tariffs & Trade (GATT). Convertibility for most European currencies had been developed by 1958, and most quantitative restrictions on trade within Western Europe had been eliminated. It was based on this background of trade liberalization that the EU, then known as the European Community (EC), was created by the Treaty of Rome in 1957. The EU initially consisted of 6 nations: Belgium, France, Italy, Luxembourg, the Netherlands and West Germany. United Kingdom, Ireland and Denmark had joined the trade bloc by 1973. Greece became the tenth member in 1981 and the entry of Portugal and Spain in 1987 raised the membership to 12 nations. In 1995, Austria, Finland and Sweden were admitted into the EU. The primary objective of the EU has been to create an economic union in which trade and other transactions take place freely among member nations. From 1958 to 1968, liberalization of trade within the community was accompanied by a nearly fivefold increase in the value of industrial trade. By 1970, EU became a full-fledged customs union¹. In terms of static welfare benefits, one study concluded that the trade creation² was

¹A customs union is an agreement among two or more trading partners to remove all tariff and non-tariff barriers among themselves. In addition, however, each member nation imposes identical trade restrictions against non-participants.

pronounced mostly in machinery, transportation equipment, chemicals and fuels. Whereas, trade diversion³ was apparent in agricultural commodities and raw materials. In addition, it was widely presumed that the EU enjoyed dynamic benefits from integration. In 1985, the EU announced a detailed program for attaining the common-market stage of economic integration. Plans called for the elimination of remaining trade barriers by 1992. While the EU was pursuing the common market level of integration, its heads of state and government agreed to pursue much deeper levels of integration. At the Maastricht Summit of 1991, EU officials agreed to implement Economic and Monetary Union (EMU) in 1999. The EMU also resulted in the creation of a new European Central Bank (ECB) in 1999 to take control of monetary policy and exchange rate policy of the member countries. The ECB alone controls the supply of Euros (€) sets the short-term euro interest rates and maintains permanently fixed exchange rates for the member countries. To provide a basis for assessing the readiness of the countries to participate in EMU, the Maastricht Treaty established convergence criteria in the areas of inflation, public finance, interest rates and exchange rates. With the opening up of using a single currency, euro (€), throughout all the member countries on January 1 2002, the EU has been opened with all sides of the economies of those member countries (Carbaugh, 2000).

Conceptual Framework

What is the Optimal Size of National Governments: From a normative viewpoint, is there any optimal size of a country and if so, what are the economic considerations that determine the optimal size of a country, and what are the crucial economic functions of "national" governments? From a positive viewpoint, to what extent do economic forces drive the political restructuring that we observe, and where may these forces take us in the future? Gains from economic association through trade in goods and services and from free movement of factors of production are certainly crucial elements of this story. Demographic change, changes in the technology of communication and transportation, and the development of market institutions may alter the optimal or equilibrium boundaries of political units over time. Such change invariably raises questions about the organization of the public sector and the assignment of expenditures and revenues to different levels of government. The integration of labor and capital markets, for example, can be promoted by political union among governments or through policies such as deregulation of capital markets or relaxation of immigration controls. Such integration must certainly provide greater opportunities for the efficient deployment of factors of production over space and among industries, but, by affecting factor markets, it also affects the distribution of income. Conversely, the erection of barriers to factor movements through political separation may entail efficiency losses while facilitating government policy interventions. The patterns of gains and losses resulting from the reorganization of jurisdictional structures can thus be quite complex. This raises a series of questions that cuts across many areas of economics, including labor economics, finance, urban and regional economics, and international economics in addition to public economics and political economy (Baldwin et al, 1999).

Policy Coordination: International trade cooperation is crucial for the nations to seek benefits from opening up of the economy. Uncoordinated monetary and fiscal policies may lead to sub-optimal outcomes when international spillovers are substantial. Global environmental issues pose similar policy dilemmas. Many of these policy issues have, in their static structure, the features of an international prisoner's dilemma. Because countries face such policy dilemmas repeatedly in time, self-enforcing international agreements can be analysed as equilibria of infinitely repeated games (Cooper, 1994). The Maastricht Treaty, which is based on the Delors Report (1989), formulates the institutional framework in which a common monetary policy and national fiscal policies are to be conducted within European Monetary Union (EMU). Countries desiring to enter the EMU should meet certain convergence criteria involving public debt levels and fiscal deficits. After joining the union, member countries should subject their fiscal policies to surveillance by the European Commission. A number of academics have criticized the fiscal convergence criteria (see e.g., Buiters and Kletzer, 1990, and Bean, 1992). Others maintain that surveillance of national policies within the EMU is not necessary because financial markets will discipline national fiscal policies automatically. Moreover, the crowding-out effect of domestic public debt on private investment in other members of the union appears to be of only minor importance (see, e.g., Levine and Brociner, 1994).

At the context of the EU, the issue of policy coordination is often addressed in terms of institution, the question being whether decisions about a given policy instrument should be taken at a central level (the Union level) or be decentralized (at the national, regional or local level). Hence, everything else equal, the larger the cross-border externalities associated with decentralized policy actions, the stronger the case for

² Trade creation occurs when some domestic production of one customs union member is replaced by another member's lower cost imports and thus the welfare of member countries are increased since it leads to the production specialization through comparative advantage.

³ Trade diversion occurs when imports from a low cost supplier outside the union are replaced by purchases from a higher cost supplier outside the nation and thus reduce the welfare of the member nations of the union.

shifting decision-making powers to a higher level of government, possibly even to a supranational institution able to internalise all externalities and to deliver more efficient policies (Masson, 2000).

Competition Conditions: The most important elements of the economy that ensure the autonomies of local authorities are fiscal and social policies. These elements are not subject to market judgements and should explicitly be determined by economic authorities. Unbiased competition within an integrated area needs to have a harmonisation of those elements. This leads to the fact that those elements become a shared policy of national and regional authorities. Since, the fiscal and social clauses influence a major part of an economy, an efficient and effective coordination of those factors is required to continue with the benefits arising from being a member of an internationally integrated area. The constraint on national autonomies in an integrated area is straightforward, however. Since, fiscal and social charges on households have a crucial impact on the wage costs of the firms, harmonisation of those factors are very important for integration to be a successful one. If the social clause is put at the low rates that less advanced economies can afford, a wide margin of social competition will remain among the most advanced partners. If it is put substantially higher, it will be unbearable to the less advanced partners. Theoretically, it is possible to tackle it by currency devaluation. The issue of social threshold is thus a difficult one to decide among much unequal partners in an integrated area. Practically, in the case of EU, it means that new, less developed countries should not be admitted in the monetary union until they achieve a real, and not only nominal, convergence process.

EU is a case of mix of preferences towards progressive taxation and indirect taxation. Since all countries don't share the same preferences, the level of development is not the same as well. Putting the taxation in the system of direct and progressive is a natural phenomenon in richer countries. While on the other hand, it seems to be inevitable for the poorer or less advanced countries to put ahead the system of indirect taxation. As a result, a same system of taxation everywhere in an integrated area would deprive the government of the poorer partners of the means they need to meet their own competence. Sub-optimal supply of public goods in the lagging behind economies should be the inevitable result. Moreover, uncompetitive joint domestic markets with some more inconsistencies might also be present. It's important for an integrated area to be succeeded to meet these conflicting criteria of mutual competitiveness, fairness and national autonomies. Harmonising the firms' total burden, rather than only a part of them, is a possible solution in meeting all these conflicting requirements.

Competition policy is concerned with maintaining competition among firms in all the sections of the economy in an attempt to promote the efficient working of the market. The fundamental rationale for such policy is that the market does not, by itself, function perfectly or that there are certain necessary conditions for the proper functioning of markets, which the state can attempt to create. Mainstream economics has long emphasized the possible imperfections which may arise from monopoly power, public goods, externalities and so on and these may provide grounds for a degree of state intervention via public policy in order to attempt to alleviate such problems (Yound and Metcafe, 1994). Further, competition policy is often seen as being necessary or helpful in aiding the competitive process and in correcting any inadequacies or distortions existing in product market (or less often factor markets). But this view is based on a specific notion of the competitive process. Firms which possess a degree of market power that are able to influence the market price, are regarded as distorting the allocation of resources from the socially optimal position. The role of competition policy is therefore to correct these distortions and restore the market process to its correct path (Arte and Lee, 1994). An essential element in the concept of a common market is the unfettered mobility of goods, services and factors of production so as to ensure the greatest efficiency in resources allocation. Naturally, the first concern of the founders of EC was the free mobility of goods. It is apparent that competition policy at the European level has evolved considerably since 1958 and must continue to evolve as the EC grows in membership and the internal market develops. Central to this development will be its relationship with competition policies at national level within the EC and increasingly outside the EC as global competition plays an increasing role in EC thinking (Yound and Metcafe, 1994).

Micro and Macro Policy Coordination

Fiscal policy influences aggregate demand via both direct spending by the government and changes in private disposable income through the taxation and transfer payments system. In this way, fiscal policy affects demand and consequently price level. While demand, and thus inflation, pressures may originate from a range of different sources, the task of monetary policy is to respond so as to maintain an overall level of demand consistent with keeping inflation within the target range. For example, if the government increases its net spending, all other things being equal, monetary policy needs to be tighter for a time, so as to slow down the growth of private demand and "make room" for the additional government spending. As with monetary policy, the fiscal policy framework puts a great deal of emphasis on transparency. The emphasis on transparency in the framework is also thought to be likely to lead governments to give more weight to the longer-term consequences of their decisions for the fiscal position, increasing the likelihood

that fiscal policy settings will be more stable, sustainable, and predictable. Monetary policy influences aggregate demand via interest rates and the exchange rate, whereas fiscal policy influences aggregate demand via direct spending by the government and changes to disposable income via the taxation and benefit system. A concern is that there would be microeconomic costs if government spending and taxes were to be subject to frequent changes, as would be required if fiscal policy was to be given an active macro stabilisation role. Maintaining stable and predictable tax rates is thought to be helpful for generating growth in the private sector. Fiscal policy also tends to be less flexible than monetary policy. Constitutionally, all tax changes must be legislated by the Parliament, and all government expenditure must be appropriated by the Parliament. These processes take time, and the lag between policies being formulated and being passed through the legislative process means that there would be a risk of fiscal adjustments ending up being pro-cyclical rather than stabilising (New Zealand Treasury, 2000).

Monetary policy coordination started internationally during the post-war period through the Bretton Woods System adjustable exchange rate system. Though not so evident at that time, the system provided a strong mechanism for international coordination. Partly, this coordination resulted to lesser imbalances in economic performances, stable inflation rate, high and stable growth rates and timely correction of current account imbalances. The increasing interdependence among countries facilitates the need for policy coordination. Externalities coming from monetary policies would have bigger impact if countries were closely integrated. Integrated capital markets allow sustained fiscal deficit while keeping inflation under control through tighter monetary stance. The combination of lax fiscal policy and tight monetary policy raises world interest rate, which will eventually create negative spillovers on the supply performance of other countries. The conduct of monetary policy coordination (or of any policy coordination), can take different forms. One possible way is through the international meetings between officials or politicians of the different countries. This meeting may result into an informative exercise that will improve the understanding of development and economic trends of each country. Other coordination schemes may take the form of policy guidelines or formal written agreements (Debelle, 1993).

Fiscal Policy in European Union

Much has already been written about the possible evolution of fiscal policy in Europe in the light of the formation of a monetary union. The creation of the euro and the subsequent implementation of a common monetary policy by ECB have created a new immediacy for the issue. Any consideration of EU fiscal policies must acknowledge that the starting point is one in which European countries stand as having an extraordinarily high level of government services and taxation, relative to other industrial countries and even more so, relative to poor countries. The case for coordination of fiscal policies within the EU is based on two principal arguments. First, with greater integration among EU countries, tax competition may lead to reduction in tax rates, thus limiting the scope for financing otherwise desirable fiscal spending at the national level. Coordination of tax policies would be a possible response. The second argument for fiscal policy coordination lies with the externalities that cause uncoordinated policies to be sub-optimal. In general terms, this may occur if the benefits of public goods extend across national borders, if there are increasing returns to scale in the provisions of public goods, or if there are macroeconomic spillovers from fiscal policies. In fact, coordination of fiscal policies will be a major issue within the euro zone for the foreseeable future. In the absence of coordination, there will be pressures from tax competition to limit the level of services provided by the governments. Coordination can result from inter-governmental agreements to harmonise taxes and benefits, from a European wide fiscal policy, or from surveillance and peer pressure on fiscal policies. Stable systems that can dependably rule out the worst outcomes from uncoordinated policies are likely to involve the development of EU wide fiscal policies. However, agreement on what such a fiscal policy should involve seems distant at this point (Masson, 2000).

In contrast to monetary policy, fiscal policy remains largely a national responsibility within the EU. The analytical literature on European monetary unification has paid relatively little attention to the role of national fiscal policies and their interaction with the common monetary Policy (Levine and Pearlman, 1992 and Levine, 1993). In a closed economy setting with national monetary policy-making, the interaction between monetary and fiscal policy has been analysed by Alesina and Tabellini (1987), Debelle (1993) and Debelle and Fischer (1994). In investigating the macroeconomic implications of monetary unification, Beetsma and Bovenberg (1995) focussed on the links between fiscal and monetary policy in stabilizing and boosting employment. In the presence of endogenous fiscal policies, employment is stabilized not only through the traditional channel of inflation surprises but also through variations in seigniorage revenues and public spending. With national policy-making, they found that the optimally designed central bank may be less conservative than the society if real money holdings are large and supply shocks are important compared to the deterministic component of the government financing requirement (which is affected by spending targets, public debt service, lump-sum taxes, and non-tax distortions in output and labour markets).

In the absence of international transfers, monetary unification implies less effective stabilization of country-specific shocks. This raises the variability of not only output but also public spending as national fiscal policies bear more of the burden of stabilizing country-specific shocks. Unless national central banks attach a very low priority to price stability and thus focus too much on stabilization, less effective stabilization in a monetary union reduces overall welfare compared to national monetary policy-making. If monetary unification is accompanied by an optimally designed international transfer system, the implied insurance of country-specific shocks actually results in more effective rather than less effective stabilization, thereby reducing the variability of not only inflation but also output and spending. Accordingly, monetary unification raises welfare only if it is accompanied by a properly designed system of international transfers. In addition to political obstacles, another (and related) barrier to such a transfer system is that country-specific shocks may be difficult to observe. In particular, individual countries are likely to possess more information on these shocks than the supranational transfer agency. This may give rise to moral hazard.

Beetsma, et al., (2001) put forward a model regarding the desirability of fiscal policy coordination in EU when viewed from the perspective of macroeconomic stabilization. Firstly, they showed that fiscal coordination efforts not based on a strong pre-commitment capacity of the fiscal authorities are very likely to be counterproductive. If national governments enjoy such a pre-commitment capacity, then coordination is often desirable mainly because they can perfectly anticipate the adverse reaction of the ECB to their decisions and induce the latter to bear a greater share of the stabilization burden. Secondly, they showed that fiscal coordination is likely to be desirable when the European economy is hit by asymmetric disturbances. In that case, the area-wide policy stability objective is not jeopardized by the reactions of fiscal authorities and the optimal monetary policy is passive. Under coordination, fiscal authorities internalise the fact that their mutual actions partially offset each other and they economize on the use of their instruments. Both the likelihood of counterproductive coordination and its dependence on specific sets of circumstances seem to call for an ex-post type of coordination.

Tax Considerations in an Unionised Economy

The EU has imposed restrictions on the use of value added taxes (VAT) in the member states. In 1999, those rules were supplemented with a new directive that extended the range of services that could be subject to reduced tax rates. The motivation for this amendment was explicitly focused on employment objectives. Member states can apply the reduced rates as a three-year experiment, beginning on January 1, 2000. The services concerned must satisfy several requirements, including labour-intensive production and high price elasticity. The EU has recently proposed sectoral tax differentiation as a policy to fight unemployment. The member countries are allowed to reduce the VAT rates on goods and services that are particularly labour intensive and price elastic (Holmlund and Kolm, 2001).

Holmlund and Kolm (2001) explained a model that features monopolistic competition in the markets for goods and services and a labor market with union-firm bargaining over wages. Unemployment prevails in general equilibrium. The source of international policy spillovers is the endogenously determined terms of trade. Goods and services may be taxed at different VAT rates. To the extent that services are more labor intensive and more price elastic than goods, employment objectives may suggest lower VAT rates for services. The model concluded that a reduction in the tax rate on more price elastic goods in one country (home) most likely reduces unemployment in that country, but probably raises unemployment in the other country (foreign). The reason is that the policy induces a reallocation of workers in home towards the sector where unions and firms have less market power – the service sector – whereas the reallocation has the opposite direction in foreign. The reallocation of workers in foreign is driven by changes in the terms of trade: the decline in the supply of tradables produced at home causes a terms of trade improvement for home but a terms of trade deterioration for foreign. Increased employment in one country may thus come at the expense of reduced employment in other countries. However, a coordinated reduction in the tax rate on relatively price elastic goods will reduce unemployment in both countries, at least as long as the countries are symmetric (in which case there will be no effect on the terms of trade). This model has also explored the welfare implications of national and supranational tax policies. The results there are sensitive to the degree of product market integration, i.e., the magnitude of transport costs. If transport costs are negligible, they demonstrated analytically that each country, acting on its own, would set the tax rate on services too low relative to what a coordinated policy would imply. The reason is that each country attempts to use tax differentiation as a means to improve its terms of trade. This also implies that the employment objectives pursued under non-cooperative policies will be too ambitious relative to the cooperative welfare maximum. However, if transport costs are substantial, the aforementioned results may no longer hold.

Kanbur and Keen (1993) in their model consider a partial-equilibrium approach with two countries (home and foreign) and a single taxed good, the model takes into account the size of the country as well. The objective of each government is taken to be the maximization of its tax revenue. When border between two

countries is closed, the two governments can entirely ignore each other in setting their tax rates: there can be no tax-induced shopping. Each government will extract all the surplus of its own citizens by setting its tax at the levels of their reservation prices. If border is open, either each government adopt a non-cooperative behaviour by setting its own tax rates to maximize its tax revenue while taking as given the tax rate set by the other and bearing in mind the impact on cross-border shopping. The response of a country to the tax rate of its partner depends on its relative size. Many studies have shown that opening border to a small country reduces revenues in the larger country and bring benefit to the small country. The small country loses revenues from the ability to extract surplus from its own citizens but gains revenue from cross-shoppers if the differential in size is sufficiently great.

Employment Policy in European Union

Over the past 25 years, the employment policies in EU have by and large failed to address the unemployment problem in an adequate way. Policy makers differ on why this has been so. Some contends that the problem is due to policy ineffectiveness, viz., policy instruments have very little influence on unemployment. Others believe that unemployment policies are pointless, since they merely replace the unemployment problem by an inequality problem. And yet others believe that the underlying problem is one of policy inactivity. Orszag and Snower (1999) claimed that European unemployment policy have frequently been unsuccessful because governments have generally failed to exploit economic and political complementarities among policy measures. Economic complementarities exist when the effectiveness of one policy depends on the implementation of other policies, and political complementarities arise when the ability to gain political consent for one policy depends on the implementation of other policies. Orszag and Snower (1999) explained that the most basic complementarity (economic) between unemployment benefits reform and taxes reform arise because the firms' search for workers reinforces the workers' search for jobs, and vice versa. It is of no use to give the unemployed incentives to seek jobs, e.g., by reducing unemployment benefits, if firms lack the incentives to hire them, e.g., because wages after taxes are very high. Conversely it is of no use to give the firms incentive to create new jobs if the workers lack the incentives to seek them. The second complementarity between unemployment benefits reform and taxes reform arise because employees' effort reinforces employers' retention decisions, and vice versa. There is little point to give employees incentives to work hard, e.g., by reducing unemployment benefits, if firms have no intention of retaining them; and on the other hand, there is little point to give firms incentives to retain their employees if those employees lack the incentives to work. The best solution to put in is that of 'broad-base' reforms. The strategy involves abandoning the traditional approach to unemployment policy making, which involve determining the policy instruments on the basis of political criteria and then setting the magnitudes of these instruments in accordance with some specific economic goals. This dichotomy between political and economic decisions has inadvertently been supported through the mainstream economic methodology that takes the set of policy instruments as exogenously given and then optimises a policy objective function with respect to these instruments. Orszag and Snower (1999) suggested that unemployment policy decisions are not to be made in isolation from one another. They must be made together, and it is clear why the existence of economic and political complementarities calls for such an approach. Complementary policies call for a distinctive approach to policy making. When only a small number of unemployment policies are under consideration, it may be politically impossible to implement them, and even if they were implemented, their influence on unemployment would be small. It is only when a broad set of policies is all implemented in conjunction with one another that they become politically feasible and economically effective.

Social Policy in European Union

A social dimension has been present within EU since its foundation, broadly shaped by the process of economic integration, but continually evolving and always contested. One reason why the EU's social arrangements have remained unsettled is that the policy regimes of its member states continue to diverge. Although the very existence of EU imposes some degree of commonality, the possibility that initial divergences might eventually wither away has so far been blocked by fundamental disagreements, both about the proper scope and objectives of social policy and about the proper division of responsibility and power between the community and its member states. Because member states differ in demographic and social structure, they generate different demand for social expenditure. Because their economies are at different levels of development or display different standards of performance, they differ in their capacity to respond to those demands (Purdy and Devine, 1994).

Social policy has played a secondary role in the development of the EU, and social conditions do not directly affect the conditions necessary for monetary stability. Nevertheless, the deflationary policies which several EU governments adopted in an attempt to satisfy the convergence criteria undoubtedly contributed to high unemployment rates, high interest rates and low growth rates and thereby increasing the demand for social

expenditure at the same time as making it harder for governments to finance it. Since the resulting fiscal crisis was an element in the monetary and exchange rate crisis of 1992/93, there is a clear sense in which the inadequacy of EC social policy played an indirect role in derailing plans for monetary union. The legal basis of EU social policy is set out in the Treaty of Rome (1957), as modified by the Single European Act (SEA) (1987) and the Treaty on EU (TEU) (1993), the Maastricht Treaty. EU social policy was originally envisaged as a minor adjunct to economic integration, focused almost exclusively on the labor market with particular reference to labor mobility and the impact of internal free trade on working conditions, wages and social insurance. Policy makers assumed that aspirations for higher wages and social expenditures would met from the economies of scale and more rapid economic growth which they expected to result from market liberalisation (Purdy and Devine, 1994).

Integration of the European Union: Example of Convergence and Coordination

Member states of the EU are anxious to ensure their harmonious development by reducing the differences existing among the various regions and the backwardness of the less favored regions (Preamble to the Treaty of Rome, 1958). In order to promote its overall harmonious development, the Community shall develop and pursue its actions leading to the strengthening of its economic and social cohesion. In particular, the Community shall aim at reducing disparities among the various regions and the backwardness of the least favored regions, including rural areas (Article 130a, Single European Act 1986. Reaffirmed as Article 130a of the Treaty of Union 1992).

The above two ideas illustrate the strength of the EU's commitment to regional policy, the active coordination policy. The inspiration behind regional policies is of 'harmonious development' with the aim of 'reducing disparities among the levels of development of the various regions'. The justification is not meant to be solely political. It is also economic: the dis-equilibria indicate underutilization of human potential and an incapacity to take advantage of the economic opportunities that could be beneficial to the Union as a whole. Supporters of regional policy are skeptical of the ability of market forces to solve long-standing regional problems, as regional disparities are the inevitable outcome of the market system--something to be tolerated until market forces such as labor migration, capital investment and expanding trade combine to automatically revitalize low-wage depressed regions (Ali, 2001). EU improves the effectiveness of the regional policy effort by acting as a supra-national co-ordinating agency. Regional development initiatives within the member states are offered by an array of organizations, which include the member state governments, regional governments, local councils, non-elected development agencies and increasingly, private sector organizations and joint-venture schemes between private and governmental bodies. Valuable development opportunities (e.g. cross-border co-ordination transport links) may not be implemented as a result of co-ordination failures. Five main types of the meaning of the term of 'economic integration' are:

Preferential tariff areas: Member states set lower tariffs on imports from one another than they do on imports from non-member states.

Free trade areas: Free trade is established between member states but each state retains its own independent trade policies with non-member states.

Customs unions: These are free trade areas, which operate a common external policy for trade with non-member states.

Common markets: These are customs unions within which capital and labour move freely.

Economic and monetary unions: These are identical to common markets except that fiscal and monetary policy is dominated by a central authority rather than by the individual member states. Monetary unification with a common currency is the climax of a macroeconomic homogenisation.

The principal elements of the regional policy came into existence in 1975, with the establishment of European Regional Development Fund (ERDF). ERDF, European Social Fund (ESF) and the guidance section of European Agricultural Guidance and Guarantee Fund (EAGGF), form the Structural Funds. ESF is designed to finance training, retraining, migration, anti-discrimination and other labor market policies. EAGGF is used to encourage the restructuring of farming in EU and a diversification into non-farming activities such as tourism and manufacturing in rural areas. Since 1989, triggered by SEM process, the structural Funds expanded to include the fourth component--Financial Instrument for Fisheries Guidance (FIFG), which is designed to help fishing communities facing difficulties as a result of the operation of the Common Fisheries Policy (CFP).

The regional policy is implemented to deal with the problem regions according to a number of key principles: concentration of assistance, co-ordination, partnership, subsidiarity, programming and additionality. To join a stage-by-stage process towards monetary union, member states should meet a whole series of strict convergence criteria (e.g., inflation, public sector deficits and interest rates). Since EU was posing its own distinctive challenges for the disadvantaged regions, it doubles the financial resources

available to the Structural Funds in 1994-99 budget period. By 1999, the EU's regional policy had command 36% of the full EU budget.

EU identified four main types of problem region: Lagging Region ('Objective 1' regions), whose Gross Domestic Product (GDP) per capita falls below 75% of the EU average; Declining Industrial Areas ('Objective 2' regions); certain Rural Regions ('Objective 5b' regions); and sub-Arctic regions in Sweden and Finland ('Objective 6 regions'). Some of the problem region types are rural in nature while others are urban. Some regions are suffering from problems arising from their geographical isolation from the main EU markets, while others suffer from economic dislocation caused by the removal of internal frontiers (disrupting their traditional trade patterns), or because they lie along the external borders of EU.

EU implements the regional policies based on the very simple logic that transfers or infrastructure financing always favours the poor regions and that this in turn is bound to benefit the country or EU as a whole. The EU regional policies aim to ensure that the benefits of integration are more fairly spread. Taking Europe as a whole, a slow, long run process of convergence does indeed exist among regions, since the initially poor regions tend to grow faster than the rich regions. As Salai-I-Martin (1996) finds that over a long period of 1950-1990, the average growth rates of the regions are negatively correlated with initial income, though with little tendency to narrow again since 1985 (EC, 1996). The most interesting features of the more recent experience are the strong performance of Ireland, Spain and Portugal and this has created substantial progress in closing the gap with richer members of the EU. Whereas in the mid 1980s these countries' per capita incomes were 61%, 49% and 27%, respectively, of the income of the large EU countries; by the late 1990s the numbers had risen to 91%, 67% and 38% (Venables, 1999).

However, the economic integration for EU regional disparities processes at work is extremely complex and at times seems paradoxical. Empirical evidences show there is a distinct tendency for a well-established 'core-periphery' pattern to EU regional disparities-- the poorest regions to be located on the geographical periphery of EU and for the most prosperous regions to be centrally located. Some regional policies can have unfortunate consequences, including a reduction in the rate of growth (direct transfers) coupled with an increase in inequalities (infrastructure within a poor region) or reallocation of firms to the rich region (financing infrastructure between poor and rich region). It seems difficult to attain through these policies the objective of higher national growths (and therefore fast convergence towards the rest of Europe) and at the same time the objective of a decrease in regional inequalities. The Commission (EC, 1996) used macroeconomic input-output models and found that in the absence of the structural and cohesion funds, GDP growth in the four Cohesion group countries (Spain, Portugal, Ireland and Greece) would have been ½% lower than the actual outcome (Here, these numerical estimates focus on the positive short term Keynesian effect on local demand and not on the long-term supply effects). In the case of infrastructure that lowers the cost of transaction between regions (e.g., highways) the long-term location and supply effect is negative for the poor region and therefore exactly inverse to the short-term positive impact. An examination of the existing pattern of regional disparities in EU reveals an array of problems. No process of convergence exists within countries. In 1996, the most affluent ten regions in EU had GDP per capita values 3.1 times higher than the bottom ten. In 1997, the best ten regions had an average unemployment rate of just 3.6%, compared with an average rate of 28.1% in the ten worst performing regions--almost 8 times higher. In 1996, GDP per capita ranged from 193% of the EU average in Hamburg (Germany) to only 44% in Ipeiros (Greece). In 1997, unemployment rates ranged from a massive 32% in Andalusia (Spain) to 2.5% in Luxembourg (Armstrong and Taylor, 2000).

The neo-classical theory predicts that trade integration and liberalization of capital movements will accelerate convergence: because of decreasing returns, regions with low incomes and low availability of capital should, other thing being equal, have a high return on capital and this should therefore attract capital movements in an integrated area such as EU. Active policies to help the most disadvantaged regions cannot be justified fully in a neo-classical framework of perfect competition and without economies of scale, since within such a framework the process of integration should accelerate convergence among regions. Romer (1986) suggested that the lack of convergence was evidence and aggregate production was subject to increasing returns to scale. With emphasis on the importance of economies of scale, imperfect competition and phenomena of localized spillover, the new theories of endogenous growth do not predict convergence between rich and poor regions even when movements of goods and capital are free. Indeed, by abandoning the hypothesis of decreasing returns on capital, these models exclude the economic mechanism that generates the process of convergence. Thus, the neo-classical growth model holds at country level whereas the endogenous growth models hold for the regions within individual countries.

The new theories of endogenous growth offer explanations for self-sustaining phenomena of regional inequalities, with the positive effects of local spillover and economies of scale. It also implies that there are

positive effects from agglomeration and hence from regional inequalities (Fujita and Thisse, 1996; Jayet, Puig and Thisse, 1996). When economies of scale and localized spillover explain phenomena of increased regional inequalities, this necessarily implies that efficiency gains accrue from the existence of economic agglomeration. It is therefore illogical to claim that the diminution of regional inequalities, supposedly facilitated by regional policies, will generate efficiency gains in European level (Ali, 2001).

The 'core-periphery' nature of EU regional problems is the outcome of economic processes, which predate the existence of EU and others that have come into existence as a result of EU. The regional convergence process effects of Single Market, EU, and Enlargement have not yet been fully experienced, partly because the effects are extremely long term in nature. Existing regional disparities moreover continue to be affected by the creation of EU customs union in 1985, and by the successive widening of the customs union to include new member states in 1973 (Denmark, UK and Ireland), 1981 (Greece), 1986 (Spain and Portugal), 1991 (East Germany) and 1996 (Austria, Finland and Sweden). EU and Enlargement, with SEM eventually generate significant benefits, though the core of EU is more favored by them.

Each steps in the process of economic integration has its own very distinctive 'regional foot-print' and these processes operate only very slowly--it will take decades before their full effects are felt. Moreover, there are forces leading to divergence of regional disparities. Evidence to-date suggests that integration tends to favor the central core regions of EU. The divergence forces seem strong. The divergence forces may interact and reinforce one another in such a way that cumulative causation occurs. Some of the important factors related to these are:

Agglomeration economies: Better transport, financial and telecommunications facilities, large and well-qualified labors, information flows, proximity to the centers of political and administrative power.

Intra-industry trade and dominant market positions: There is evidence that intra-industry trade in similar products has shown the most rapid growth among the more prosperous core regions and member states of EU. Much trade in manufactured goods in EU is now dominated by large multinational enterprises that are already concentrated in the core regions of EU and they may exploit their ability to dominate markets in ways that are harmful for peripheral regions.

Lack of competitiveness in peripheral regions: The freer trading conditions of EU pose a severe threat to the backward economies of the peripheral regions in which the small firms suffer from serious difficulties in matching the competitiveness of firms in the more prosperous core regions, out of poor location, inadequate infrastructure facilities, low-skill labor forces, and local taxation and financial difficulties (Armstrong and Taylor, 2000).

Selective labor migration: The peripheral regions are also weakened, as integration proceeds, by the loss of migrants. The freeing of labor mobility stimulates migration from peripheral to core regions where migration is highly selective--the young, the skilled, and the economically active people are those who are migrating mostly.

Loss of macro-policy powers in peripheral member states: Peripheral member states face a future of very limited macro-policy powers. This is a particular problem with the EU. Weaker member states containing a high proportion of depressed peripheral regions had frequently resort to exchange rate devaluation and public spending to boost their lagging economies. Under EU, this is no longer possible. At least, 'the short term' effects of the loss of the power to use protective exchange rate devaluation could be serious. So too is the squeeze on public spending by member states as countries have struggled to meet the convergence criteria of the EU process (Armstrong and Taylor, 2000). Full monetary union in 2002 means the complete loss of powers to try to protect a weak local economy by way of currency devaluation. With interest rates tending to equalize across EU and with a single currency, the member states would have lost the power to use monetary policy to protect their local economies from competition from the other EU members.

Economies of scale: The concentration of production at larger plants can lead to greater efficiency gains. Firms seeking to exploit economies of scale are likely to be attracted to regions at the geographical core of EU where the input assembly costs are lower, and access to the whole EU market is much easier.

Conclusion

The need for macroeconomic policy coordination is obviously a must in an integrated area to realize the full benefits of integration. Increasing the capacity of poor regions to absorb technologies, reducing barriers to innovation or the costs of innovation makes it possible to achieve objectives of reducing regional inequalities, diminishing agglomeration and increasing the growth rate. Thus, the policies involved could be R&D subsidies, education infrastructure, lowering barriers to entry on goods markets, making capital markets more conducive to new start-ups. When infrastructure-improvement policy focuses on lowering the cost of conveying information rather than the cost of transporting goods, such a policy would have the objective of increasing the capacity of poor regions to absorb new technologies and to increase spatial diffusion of innovation. This could be done by financing infrastructure in telecom and in education. The

main equity consideration justifying the objective of regional policies to counter agglomeration is the existence of immobile economic agents who are penalized by the concentration of economic activities. From the regulatory point of view, housing and tax policies that facilitate their mobility should therefore be regarded wholly as regional policies. Policies that facilitate inter-sectoral mobility such as education and training should be reinforced (Martin, 1999). Another important factor to be considered is the issue of convergence, which leads us to the question of regional integration itself.

The integration of not less than twelve currencies into a single one in Europe is one of the most amazing facts in the history of modern economics. This step is a turning point for the globalisation of the world trade. The conduct of the monetary policy has already been handed over to a single supranational central bank. The stance of the fiscal policy can be expected to be pivotal for the functioning of EMU. The adoption of a common monetary policy in Europe has eliminated the possibility to use monetary policy for the stabilisation of country specific shocks. If monetary policies can no longer address country-specific shocks and factor market do not solve the problem either, then other solution need to be found. One possibility would be a further centralisation at the European level of the tax-transfer system that is now being operated mainly at the national level. Another possibility, as discussed by some authors, would be the adoption of a system of cross-border fiscal transfers to countries exceptionally hit by bad shocks. Fiscal policy seems to be the only instrument in the hand of national authorities and capable to stabilise local macroeconomic conditions. However, fiscal flexibility is hampered by large public debts and formal institutional constraints: the Maastricht rules and the Stability and Growth Pact (SGP), which forbid public debts exceeding 3% of GDP.

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