The Mythology of EU-wide Transfers

A critique of David McKay and other "fiscal federalists"

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Publication date:
2000

Document Version
Early version, also known as pre-print

Link to publication from Aalborg University

Citation for published version (APA):
Zank, W. (2000). *The Mythology of EU-wide Transfers: A critique of David McKay and other "fiscal federalists"*. European Research Unit, Aalborg University.

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The Mythology of EU-wide Transfers –
A Critique of David McKay and other 'Fiscal Federalists'

Wolfgang Zank

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European Studies is published by the European Research Unit in collaboration with the Department of Development and Planning and the Department of Languages and Intercultural Studies at Aalborg University, Denmark.

Requests and orders for issues can be made to the following address:

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ISSN 0906-0308

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The Mythology of EU-wide Transfers – A Critique of David McKay and other 'Fiscal Federalists'[1]

1. The EMU - a "high-pressure cooker without safety valve"?

Many authors have claimed that the Economic and Monetary Union (EMU) must be complemented with a system of financial transfers across the national borders. Otherwise it will not be sustainable. This way of reasoning can be found in many places in the academic world, and in many variations. A journalistic short-hand recently entered the Danish Press: Within a few years the Danes could expect an EU tax, on top of the existing tax burden, corresponding to 20 per cent of GDP.[2]

As far as I know, David McKay has presented the most elaborate version of this reasoning so far. In his view, the European Union became a proper federation with the Maastricht Treaty, and he then explores the question under which condition this federation could be sustainable. On the basis of much empirical evidence and sophisticated reasoning he concludes: "Ultimately, it will be the willingness of some states and regions to subsidize others and/or the extent to which mass publics will tolerate centrally induced welfare state retrenchments that will determine whether the union stands or falls".[3]

Professor Sverker Gustavsson, of Stockholm, presented an even more dramatic version of this line of thought. To him, without a system of fiscal transfers among the

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[1] This paper was presented to the annual conference of the DSE (*Dansk Selskab for europaforsking* - Danish Society for European Research), 21st September 2000, in Copenhagen. I have to thank numerous colleagues, in particular Henrik Plaschke, for careful criticism.

[2] Berlingske Tidende, 13th July 2000, p. 7.

[3] David McKay, *Federalism and European Union. A Political Economy Perspective*, Oxford University Press, 1999, p. 173.

EU member states, the EMU is a "high-pressure cooker without safety valve". Among four possible scenarios of the future development he discusses one, according to which democracy gets replaced by authoritarian regimes; democracy crumbles under the impact of the harsh conditions, imposed by the Stability and Growth Pact (SGP).[4]

If this is the case, the matter is serious: None of the leading politicians seem to have been aware that they endangered democracy by signing the Maastricht Treaty and the SPG. And it is striking too: A key role during the preparations and negotiations for EMU was played by central bank presidents, central bank experts, and officials from the finance and economic ministries; i.e. highly-skilled people with daily contact to the real world problems of monetary and economic policy, and with privileged access to new data. In contrast to many of their academic colleagues, none of them seem to have seen the necessity of transfers. Not even by now, in 2000, do top politicians seem to be aware of the high pressure to increase transfers. In May 2000 the German foreign minister Joschka Fischer outlined an ambitious vision of future federal structures in Europe. But the question of transfers he did not address at all. Nor did Jacques Chirac, when presenting a similar vision to the *Bundestag* six weeks later.[5] And even more strange: At a time when numerous academics emphasize the necessity to increase transfers, the EU financial planning shows *declining* transfers. In 2000, the Structural and Cohesion Funds assign 32,045 million Euro (1999-prices), in 2006 only 29,170 million.[6] Is the European Union on a *Titanic* course?

The aim of this paper is to make the reader relax. There is no danger of explosions, democracy is not at peril. For the foreseeable future, there will be comparatively few transfers across the borders of the member states, and this will not threaten the cohesion of the Union. Contrary to the above-mentioned positions, the low level of

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[4] Sverker Gustavsson, 'Hvad gør en monetær union, uden en parallel skatteunion, politisk holdbar?', Rådet for Europæisk Politik, *Danmark og ØMU'en, Bd.1, Politiske aspekter*, Aarhus, 2000, p. 60-93. "Højtrykskoger uden sikkerhedsventil", p. 75; scenario "autoritarisme", p. 81f.
[5] See the text of the speeches, e.g. *Frankfurter Allgemeine Zeitung*, 15th May 2000, p. 15, and 28th June 2000, p. 10f.
[6]Europa-Kommissionen, *Europas Agenda 2000. På vej mod et større og stærkere EU*, Bruxelles, 2000, p. 17.

transfers is even a necessary condition for the progress of European integration. But I have also to disappoint those federalists, who might think that the battle is already won. EMU will not automatically push the union to much more federalism. Those who want federalism have to work for it. If there will be substantial progress on the way to federalism (and presumably there will be), it will be due to completely different problems and mechanism.

I certainly do not exclude any increase in the size of the EU budget. It is, for instance, likely that the development of the Common Foreign and Security Policy will lead to a kind of European Defence Fund, out of which a common command structure, military infrastructure, air and naval bases, and the like will be financed. Also a kind of European FBI is conceivable, or a common police force to guard the borders, a kind of *Bundesgrenzschutz*. This way, some tasks will be transferred to the European level. The nations have to pay for it, but they also can reduce their own spending accordingly. So, the overall tax burden will not increase. And this kind of enlarging the EU budget has nothing to do with EMU, and it will hardly enlarge the transfers across borders.

This does not imply that EMU will not create spill-over effects. Monetary experts or statisticians have to co-operate intensively, banking supervision needs a lot of common regulation, and already by now, countries with budget deficits are under a kind of moral pressure from the fiscally more virtuous ones. A better co-ordination of fiscal policy is likely (though it will not come automatically), and so is a better co-ordination on the field of monetary diplomacy. EMU will presumably also have a very considerable *cultural* impact. Money is a strong symbol of mutual dependence, of co-operation, of power, and it assists in structuring space and time. Not the least because of its symbolic impact, EMU has released so many high-energy emotions. When the Euro enters the private life of the European citizens, it will presumably shift mental borders and increase the feeling of European identity. EMU's likely spill-over effects will make a transition to more federalism more easy. But they do not build up a *pressure* for more federalism. It is not advisable to leave EMU as it is. But if the politicians wanted to do so, they could do so.

Part of the confusion stems from the fact that many scholars see the EU as a federation. But the EU should be studied as a construction *sui generis*. Analogies to the US and other federations can be misleading.

2. Why transfers are necessary – allegedly

Those who regard transfers among the EU member states as necessary for the survival of the union, have forwarded various lines of argumentation. One set of arguments is based on economic models of optimum currency areas.[7] The argument runs, in short, as follows: A country is likely to be exposed to an "asymmetric" economic shock, which hits this country, but not the neighbouring one. Or at least, it hits one country harder than the neighbouring one. Such a shock could hit the supply side, e.g. an oil-price increase. On the demand side, a country might experience a sudden fall in export earnings, due to e.g. changing consumer preferences, and the like. Theoretically, such a shock could be absorbed in many ways: The country could resort to deficit spending, trying to stimulate its economy by a high level of public spending. Or it could devaluate its currency, thereby strengthen its competitiveness on the export markets. Competitiveness could also be strengthened by wage reductions. Or the unemployed people might move to other regions where there are better employment possibilities. But in a monetary union, a devaluation is excluded; and in the European countries, wages are rather inflexible, so wage reductions will hardly work. Further more, mobility across borders is low. And to make everything even worse: EMU countries are not allowed to run high fiscal deficits, so Keynesian demand stimulation is excluded. Conclusion: The shock will produce long-lasting misery and unemployment, which in turn creates massive political tensions.

In the United States such a disaster cannot occur, because of the transfers. If one state is hit by a shock (e.g. Texas by falling oil-prices), money will automatically flow from Washington to Texas in the form of unemployment subsidies. At the same time, Texas will pay less taxes to Washington, and this results in a considerable net flow in Texas' favour. So, if the EU wants to avoid disaster, it has to establish a similar fiscal

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[7] See, e.g. McKay, p. 142-146.

and transfer system. In federations, this comprises roughly 20 per cent of the GDP. So, we can expect a centralised EU fiscal system of about the same magnitude.

A similar argumentation addresses the uneven effects of monetary policy: If the European Central Bank (ECB) rises interest rates, the various regions of the EU are affected quite differently. A rent rise might be perfectly justified for the Euro zone as a whole, but it could produce strongly negative effects in e.g. Portugal or Ireland. If we want to avoid massive political tensions, with the risk of the monetary union breaking apart, the negatively-hit countries must receive compensating transfers.

A group of Euro-sceptic German economists drew attention to the social consequences of monetary integration in general: "With a common currency, the weaker members of the European Union will be exposed to greater competitive pressures, suffering growing levels of unemployment as a result of their lower productivity and competitiveness. Substantial transfer payments in the interest of financial equalization will therefore be necessary."[8] In this line of thought, economic integration, also in the absence of asymmetric shocks, produces social polarisation, which in turn makes transfers necessary, if we want to avoid unsustainable political tensions. Many political scientists seem to adhere to this kind of reasoning

The high disparity of income levels in Europe is also at the centre of a more culturally-based argumentation: The common currency makes the income disparities more visible. High income disparities are, however, not compatible with a European identity. If the EU wants to keep its cultural, and thus also political cohesion intact, it must practice solidarity with its poorer members.

This is an impressive row of arguments, drawn from a wide range of intellectual activity. But none of these arguments survives closer scrutiny.

3. On asymmetric shocks, and shocking misunderstandings.

The argument of asymmetric shocks, and the calamities produced by the impossibility of devaluation, is plausible at first glance. But it is hard to fill it with empirical substance. How could an external shock look like, which hits e.g. Denmark,

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[8] As quoted in McKay, p. 149.

but not the others? It is not enough to find a shock scenario. The shock must be of a kind to produce a motive for devaluation. Of course, Danish bacon exports to the UK might collapse after the detection of a Mad Pig Virus, or the windmill industry might suffer a decline because Indian producers might learn to fabricate mills better and cheaper. But no Danish government would ever contemplate to devaluate the crown in such a case. A devaluation makes imported commodities more expensive, it is therefore the equivalent to an income reduction for the rest of the population - by far the majority in these cases. Furthermore, a devaluation would - overnight - destroy investors confidence in the stability of the crown. Denmark would have to face massive interest rises which would strangle huge parts of her economy.

During the last two decades, all EU member states have worked hard to stabilise their currencies. After much sweat and tears they harvested the rewards in the form of low inflation and low long-term interests. And it is the long-term interests which are most important to growth and employment. No European government, regardless of its ideological stance, will put these achievements at risk, in order to please one branch (which, because of the adverse interest rate effects, in fact will not be pleased).

Of course, one country might experience, not a particular shock, but a general recession, a downward phase of the business cycle. Under the conditions of closer economic integration within the EMU it is not very likely that the cycles will be very asynchronic. It can, however, not be excluded. Previously some countries devaluated their currency in such a situation. But also in this case, under the conditions of free capital movements, the country in question would be punished immediately by high long-term interest rates. So, EMU or not, no EU country would use this instrument.

In the case of an economic downturn, the EMU member countries can instead use fiscal policy, i.e. practice a Keynesian policy of deficit spending, in order to prop up demand. It is a misunderstanding that the Stability and Growth Pact impedes this. Only deficits larger than three percent of GDP are forbidden. In the case of severe recessions, even this restriction falls.

The fiscal position of the EU member states has improved dramatically during the last years. Denmark, Finland, Ireland, Luxembourg, and Sweden register budget surpluses by now, and no country is at the bad side of minus two per cent. And all prognoses are good. Presumably already in 2002 no country will be placed worse than minus one per cent.[9] That means that already by then practically all member countries are safe. The OECD has calculated that a budget deficit of between 1 and 1.5 per cent gives a probability of 90 per cent that the budget deficit will keep clear of the 3 per cent threshold, in case of a recession. This implies, of course, a remaining 10 per cent risk to hit the threshold.[10] If a government deems this risk as being to high, or if it in general finds it is too risky to build its policy on calculations of this kind, it might emulate the Nordic countries and produce budget surpluses.

Against the option of deficit financing in order to stimulate demand, David McKay argues: "... this option is limited in the longer term as capital markets downgrade the state's credit rating."[11] Of course this option is limited. Does he imagine an economy experiencing a down turn, but going on for a long period producing the same old things as before, although demand is lacking, and at the same time keeping the earnings all the time at the same high level as before? And would such a behaviour qualify this country to transfers from other countries? Fortunately, periods with falling GDP are rather short and seldom. Between 1983 and 1999, most EU countries experienced a declining GDP only in one single year, 1993. Worst hit were Finland and Sweden, with a prolonged recession between 1991-1993, when both countries ran high fiscal deficits. Within a few years both transformed deficits into surplus, and by now they receive top ratings on the capital markets.

In numerous articles and books the provisions of the Stability and Growth Pact have been presented as inhuman, asocial, as an attack on the welfare state, and the like. To McKay the convergence criteria "looked like almost unattainable."[12] And in Sverker Gustavsson's eyes, the Stability and Growth Pact, if respected, implies a

[9] Giancarlo Corsetti and Paolo Pesenti, 'Stability, Asymmetry, and Discontinuity: The Launch of the European Monetary Union', *Brookings Papers on Economic Activity*, 2: 1999, p. 295-372, esp. p. 354.
[10] Rådet for Europæisk Politik, Danmark og ØMU'en, Bind 2, Økonomiske aspekter, Aarhus, 2000, p. 61.
[11] McKay, p. 147.
[12] McKay, p. vii.

reduction in unemployment subsidies and reduction of welfare benefits.[13] This perspective is erroneous.

Firstly, to improve a countries budget position does usually not require *cuts* in the level of public sector spending. After the recession in 1993, the countries of the Euro area experienced substantial growth every year, usually well above 2 per cent. The projections for 2000 and 2001 predict 3.5 and 3.3 per cent respectively.[14] In a growing economy, improving the budget balance means keeping the further *increase* of public sector spending *temporarily* a bit underneath the GDP growth rate. This fact seems to have been overlooked by many, so a simple model calculation might help. We assume a generous welfare state which spends half the GDP. The receipts, however, cover only 46 per cent, which implies a budget deficit of 4 per cent. This is forbidden, according to the convergence criteria, and the SPG. We let the GDP grow by a modest 2 per cent a year. Then, restricting the *rise* in public spending to one per cent a year, will bring the deficit well below the threshold within 3 years:

Table 1: Improving the budget position by raising expenditure.

Year	1	2	3	4
GDP	100.0	102.0	104.0	106.1
Public spending	50.0	50.5	51.0	51.5
Public receipts (46 per cent of GDP)	46.0	46.9	47.8	48.8
Budget deficit	4.0	3.6	3.2	2.7
Deficit in percent of GDP	4.0	3.5	3.1	2.5

[13] Gustavsson, op. cit., p. 70.
[14] OECD, *Economic Outlook*, no. 67, Paris, June 2000, p. 245.

So, after three years of *rising* public expenditure, by one per cent a year, we are well below the threshold. A fourth year brings the deficit down to 2.0 per cent. It was exactly this mechanism which provided for the general improving of the budget balance in the EU member states. Restricting the growth of public spending often means *temporarily* cutting expenses in *some* sectors, in order to channel more money into high-priority areas. Temporary cuts in some sectors provoke, of course, resistance, and the media focuses upon them. So, they are usually difficult political issues. But unattainable? Destruction of the welfare state? Social burdens which threaten democracy?

At the Intergovernmental Conference which led to the Maastricht Treaty, the Spanish, Portuguese, Greek and Irish delegations forwarded the idea of a Convergence Fund, to assist financially weaker countries (i.e. themselves) in meeting the convergence criteria. The proposal met the strong opposition of the German, British, French, and Luxembourg ministers. They feared that such a fund could dilute the criteria and weaken domestic efforts to meet them. At Maastricht, this question was solved as "essentially a symbolic side-payment for the Spanish, Portuguese, Greeks and Irish".[15] Only as a minor ("symbolic") issue, mainly for the time of the *transition* to EMU, did the question of transfers enter the field of practical politics.

The table above depicted a model of an ordinary case. An unusual case was Sweden. An extraordinarily severe recession with falling GDP figures for three years in a row created a public deficit corresponding to 12 (!) per cent of GDP in 1993. But also the recovery was extraordinary. The toughest years of the budget recovery are assembled in the following table:

[15] Kenneth Dyson and Kevin Featherstone, *The Road to Maastricht. Negotiating Economic and Monetary Union,* Oxford, 1999, p. 430 and 765.

Table 2: Budget consolidation in Sweden, 1993-1996, Skr. million, current prices:

	1993	1994	1995	1996
General government, current revenue	849 736	887 179	950 182	1 040 729
Current expenditure	985 485	1 023 272	1 058 659	1 069 886
Net lending	-177 492	-158 148	-128 669	- 36 483
Per cent of GDP	-12.3	-10.3	-7.8	-2.2
Per cent, Maastricht definition			-7.0	-3.6

Source: OECD Economic Surveys, *Sweden*, 1997-98, Paris, 1998, p. 173.

This was the toughest consolidation policy in Europe. The Social Democratic government, back in power in 1994, was clever enough to commit the necessary cruelties at the beginning of its term. If the figures above were adjusted for inflation (3.7 per cent in 1995), real public expenditure was actually falling from 1995 to 1996, and 1994-1995 meant a freeze in real terms. This could only be achieved by substantial cuts in many sectors in those years. But just in time, i.e. when the elections in 1999 approached, the government could be generous again. And currently, public expenditure if rising rapidly, and *surplus* is nevertheless above three per cent: The table above shows not the destruction of a welfare state, but its saving.

Conversely, what are the effects, from a social point of view, if a government does *not* bring a deficit down, but leaves it at, say 4 per cent GDP? That means, public debt increases every year. Not only in absolute figures, but also in relation to GDP. This implies that interest payments occupy an ever growing share of the budget. Welfare state functions must be restricted, first in relative terms, then in absolute terms, to make room for interest payments. Most European states made exactly this experience. In e.g. Denmark in 1986, government interest payments covered 16 per cent of the budget; in 1998, the figure was still at 9 per cent. If Denmark had not piled up a high burden in the 1970s and 1980s, she could double up the expenses for her public health service, right out of hand.[16]

The gigantic interest payments have implied a massive redistribution of income from wage earners to the owners of capital assets. Every state with barely a minimum of democratic functions intact, must stop this monstrousness sooner or later, whether they signed the SPG or not. Most European states embarked on this course already in the 1980s. Also the US have register budget surpluses the last years.

It was not the main aim of the SPG to promote social justice. But as a side effect, by speeding up the process of budget consolidation, it did exactly this.

To sum up, the provisions of the SPG and the loss of the possibility to devaluate, do not build up any pressure to establish a transfer system at the EU level. The nations can cope with recessions by using the budget as stabiliser. And to depict the SPG as an asocial monster attacking the welfare states and, by implication, qualifying a high-deficit policy as social: That is almost Orwell language.

4. Compensation for a lower interest burden?

Neither Maastricht nor the SPG contain any provision as to the size or construction of the welfare state. They just have to be financed properly, i.e. not by excessive deficits, a claim which all members now fulfil. In this context, no future burdens of any kind are to be expected from "Brussels". The matter is, however, different as to the decisions of the ECB. It is indeed conceivable that e.g. a decision to rise interest rates can produce negative effects in some regions or countries. McKay must have had this case in mind, when he wrote: "Representatives from aggrieved countries (or regions of countries) will demand changes in EU policy including possibly assistance to help

[16] Wolfgang Zank, 'ØMU'en – et værn imod omvedte Robin Hood'er', Rådet for Europæisk Politik, *Danmark og Ømu'en, Bd. 1, Politiske aspekter*, Aarhus, 2000, p. 252-270, esp. p. 264.

economies adjust. If conceded, these measures will have to be financed by an enhanced EU tax base ...".[17]

Populist claims can, of course, not be excluded. But it can be excluded that they will be conceded. Firstly, the situation where European monetary decisions produce negative effects for member countries, is by no means new. In the 1980s and 1990s, it was the *Bundesbank* to make monetary decision for Europe. Particularly in 1993, the German rent hikes – appropriate for the German situation – had devastating effects on Germany's neighbours. The dominance of the *Bundesbank* was one key motive for the creation of the EMU. Now, monetary decisions are taken on the basis of European considerations, all member states having a say. Compared with the situation before, this is an important improvement for all countries, except Germany. Given the point that transfers in practice mainly mean transfers from Germany to other countries: Shall Germany now pay because she gave up the *Bundesbank*?

The transition to EMU has meant a dramatic improvement of the monetary conditions for most countries, in particular the Mediterranean ones. The nominal long-term interest rates in e.g. Spain fell between 1989 and 1999 from 13.8 to 4.7 per cent. If we deduct inflation and calculate real interest rates, they fell from 6.7 to 1.6 per cent![18] This is, of course, to great extent a result of the Spanish policy. But the elimination of any exchange rate risk for investors is a central factor too.

For the period from 1994 onwards, the OECD figures allow for an overview about the development in Italy, Ireland, Portugal and Spain (comparable figures for Greece are not available):

[17] McKay, p. 157.
[18] OECD, op. cit, p. 279 and 258.

Table 3: Nominal and real long-term interests four Mediterranean countries and Ireland:

	1994	1999
Nominal long-term interests, Italy	10.5	4.7
Ireland	8.0	4.8
Portugal	10.4	4.8
Spain	10.0	4,7
Real long-term interest rates, Italy	7.0	3.2
Ireland	6.3	0.8
Portugal	4.1	2.2
Spain	6.0	1.6

Source: OECD, *Economic Outlook*, no. 67, Paris, June 2000, p. 279. Real interest rate: Nominal interest rate minus GDP deflator (ibid., p. 258).

As we can see, all countries experienced an enormous relaxation of their monetary conditions, not the least due to the transition to EMU. Against this background, possible adverse effects of rises in the short-term interests administered by the ECB, are almost trivial.

The concept of compensation claims against ECB decision rests on a misconception of the process of European integration. Every important integration step has entailed a broad package of decisions and effects. Each member state could accept such as package, if the perceived *sum total* of the effects for it was positive. German governments actively worked for EMU, because as a whole, they perceived it as being in Germany's interest. The loss of monetary autonomy, not just a *petitesse*, was regarded as acceptable against this background.

The Mediterranean governments worked hard for EMU membership. For some time, Italian politicians were seriously worried about the possibility that their country might not be accepted. All leading Mediterranean politicians did not have the slightest doubt that EMU membership was in their interest, politically and particularly economically. Given the vast positive impact of the whole package, there is no basis for compensation claims against single ECB decisions. No leading politician will ever forward such a claim.

5. The Spectre of Social Polarisation

The idea that closer economic integration produces greater social polarisation, which in turn makes transfers necessary to maintain the cohesion of the EU, seems to have considerable appeal to many political scientists. But also as to this point, we may relax.

The question whether closer economic integration produces polarisation, or on the contrary, is beneficial for all partners, has been the subject of debate for many decades. Several eminent economists have pointed at the danger that the fall of economic barriers might make the rich ones richer and the poor ones poorer. Probably best known in this context is Gunnar Myrdal's *Economic Theory and Underdeveloped Regions*, written in 1957. Myrdal worked with a concept of "circular and cumulative causations"; those can work in a beneficial way, but they can also push a region successively downwards. According to him, Southern Italy experienced this after the abolition of the tariff walls between North and South after unification in 1861.[19] Other authors emphasised the existence of "increasing returns to scale" (higher returns for investments in locations where already much capital has been invested), or special effects of geography which place lesser developed regions at a disadvantage. However, the majority of the economists, since the days of Adam Smith (1776) and David Ricardo (1817), have been insisting that closer economic integration, as a rule, is beneficial for both sides involved. Both sides gain because of the existing of absolute and comparative advantages, and the bigger market allows for further specialisation. Instead of polarisation we will witness gradual convergence on ever higher levels. The last many decades, this reasoning has been the intellectual underpinning for the

[19] Gunnar Myrdal, Ökonomische Theorie und unterentwickelte Regionen, Frankfurt/M. 1974, p. 39.

advocates of free trade, liberalisation of capital movements, and the like. It is therefore somewhat ironic that the above quoted eurosceptic German economists, many of them neo-liberals of high profile, predicted a growing social polarisation as a consequence of EMU. Thereby they implicitly delivered intellectual ammunition to those who forward protectionist and interventionist claims.

Currently, the vast majority of the economists seems to adhere to the position that negative cumulative effects or "increasing returns" cannot be excluded, but that they are unlikely in most cases. This is in particular valid for higher developed countries. We keep the particular problems of African or some East European countries outside our discussion and concentrate on Western Europe. We compare the Mediterranean EU members and Ireland with Switzerland. The indicator is GDP per capita, adjusted for Purchase Power Parities, from 1970 to 1997.

Table 4: Mediterranean countries and Ireland, GDP per capita, purchase power parities, relative to Switzerland (=100), 1970, 1987, 1991, and 1997:

	1970	1987	1991	1997
Greece	28.3	40.2	36.1	53.7
Ireland	40.2	47.6	53.3	79.7
Italy	58.6	77.4	77.9	82.1
Portugal	30.0	39.7	42.6	59.0
Spain	44.1	54.8	59.0	61.7

Source: Calculated after the figures in OECD, National Accounts, as quoted in Statens offentliga utredninger 1993:16, *Nya villkor för ekonomi och politik*, Stockholm, 1993, p. 13; OECD Economic Surveys, *Sweden*, 1988/89, Basic statistics international comparisons; Economic Surveys, *Spain*, January 2000, Basic statistics, international comparison.

The picture is one of clear convergence, all five countries are *much* closer to the Swiss level in 1997 than in 1970. In fact, apart from Greece between 1987 and 1991, the table shows progress in convergence in any period. In our context, the convergence in the 1970s and 1980s is particular interesting because in those years the EU Structural Funds were non-existing, or of a trifling magnitude. So they cannot have brought the convergence about. Furthermore, the figures for the time after 1997, including the projections for 2000 and 2001, show growth rates considerably above EU average for those countries. So, convergence goes on. Only Italy experiences currently growth rates which are positive, but below average.[20]

We also find convergence, albeit not so unambiguously, if we move from the international comparison to the disparities between the regions in one country. Among others, Robert J. Barro and Xavier Sala-i-Martin, in a very detailed study, analysed the economic disparities of the regions of seven European countries between 1950 and 1985 relative to their national means, and between the US states from 1880 and 1988.[21] Barro and Sala-i-Martin found a remarkable similarity of slow, but steady convergence: The poorer regions grew faster than the richer ones, disparities became reduced. This is not valid for every year (e.g. the disparities between the British regions grew in the second half of 1970s), and a few regions actually fell back relatively to the national mean (the Auvergne, for instance). It is therefor possible to subdivide the period thereby modifying the picture; e.g. the 1980s saw only little convergence, partly even growing disparities, and this gives some room for debate. But for the period as a whole (1950-1990), convergence is the clearly dominating picture.[22] Contrary to widely held beliefs, that was also the case for the Italian South: In 1950, the GDP per capita in the four most prosperous regions of the North was 70 per cent above the national mean, in the seven regions of the South it was 32 below. In 1985 the

[20] OECD, op. cit., p. 245.
[21] Robert J. Barro and Xavier Sala-i-Martin, 'Convergence across States and Regions', *Brookings Papers on Economic Activity*, 1/1991, p. 107-182.
[22] See also their recent publication, with additional material (e.g. Japanese prefectures, etc.): Robert Barro and Xavier Sala-i-Martin, *Economic Growth*, MIT press, Cambridge/Mass. and London, 1999. p. 401.

figures were down to plus 38 in the North and minus 25 in the South.[23] As to the US, they also calculated the importance of the transfers for the progress of convergence. Between 1880 and 1950, a period of considerable convergence, they were completely negligible. In the following decades they were of very limited importance.[24]

In the progress of European integration, not one country or region has become poorer. There are a *few* cases of *relative* decline in relation to the national average. But the general picture is growth above national average for the poorer regions, and the national averages themselves have been clearly converging. Here we have another explanation why most politicians in the Mediterranean countries have been strongly pro-Europe and pro-EMU.

To sum this point up: The dynamics of regional development do not support the idea that transfers will be necessary in order to avoid a growing polarisation.

6. Inequality and transfers.

Sometimes the mere *existence* of economic disparities is forwarded as an argument for the necessity of transfers. The European Union has to organise practical solidarity with its poorer regions, otherwise, again, the stability of the Union is at jeopardy.

But we can, again just dryly state that the assignments to the Cohesion and Structural Funds are decreasing, at least until 2006. No top politician seems to see any necessity to enlarge them. Certainly, it would be *nice* if the richer countries sent more money to the poorer regions. But obviously, they are not so nice.

Also the position that inequality makes transfers *necessary*, rests on a misunderstanding of the process of European Integration. Integration has been possible so far on the basis that all partners involved could see that a new step towards integration brought net advantages to everyone. Substantial transfers, just because some are poorer than others, will not entail advantages for all the parties involved. The better-off countries would loose. So, they will not agree.

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[23] Barro and Sala-i-Martin , 1991, p. 150.
[24] Ibid., p. 122.

At present, as McKay documents very thoroughly,[25] every survey shows that most citizens of the EU member states regard themselves primarily as members of a national community. Europe comes second. This means that substantial transfers to other member states in the name of solidarity, would provoke populist revolts, whose militants would claim that the poor in the own country should have priority over people in other countries. As the Italian experience (*Lega Nord*) shows, transfers to other regions can even create populist revolts inside a nation state. Mentalities being as they are by now, and properly being so in the foreseeable future, substantial transfers at the EU level would create many *Leghe Nord.*

And how could poorer countries legitimate claims for more transfers? No member country was forced to join the EU or the EMU. All did so voluntarily. And in particular the countries of the EU periphery – with very good reasons (see above) worked hard to become EMU members. Countries such as Germany and Holland were reluctant to accept Italy and other Mediterranean countries as EMU members. In the end, they were so moved by their pleadings that they gave in. And now they should pay? Here perhaps an analogy from private life is appropriate: When you are accepted as a member of a club, it is not cricket to demand money from the others.

How is the often-heard argument to be understood that there will be "tensions" inside the EMU, unless there are substantial transfers? Will e.g. Greece threaten to leave EMU? Greece would hit herself severely, but hardly the others. Of course, Greece (or other countries) could threaten to veto further integration in the fields where unanimity is still required. But how effective will it be, to use a veto in order to blackmail the others? Blackmailers effectively isolate themselves, while the others will go on. We can safely suppose that top politicians are clever enough to anticipate the immediate consequences of attempted black-mail. So, there will be no tensions.

7. Concluding remarks.

The transition to the EMU was an important step in the process of European Integration. Before EMU, the EU member countries experienced divergent inflation

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[25] McKay, p. 162-172.

rates, divergent and rather high interest rates, and consequently exchange rate volatility; the dominance of the *Bundesbank* created distortions for many countries, severe political tensions were the result. In 2000, inflation rates and long-term interests are low everywhere, the exchange rate volatility among the member states is eliminated, and so are the political tensions which were caused by the *Bundesbank* dominance. So, contrary to McKay's, let alone Gustavsson's position, EMU did not create tensions, it removed them. The EMU will produce spill-over effects, political and cultural ones. But they alone will not push the EU on the way to federalism. The architects of EMU constructed in a way that it could be a Stand-Alone-Project. And certainly did EMU not create a need for substantial transfers.

The history of the US is a fascinating subject. But it should not lead us to think in crude analogies. The factors which produced fiscal centralisation there, might be absent in Europe. The EU is best studied as a construction *sui generis*. And if we want to get an idea, in which direction the development might go, we can start with actual factual developments.

The EU is currently filling the project of a Common Foreign and Defence Policy with substance. The apparent risks of a potentially unstable political environment in e.g. Southeaster Europe, were a major factor to bring this development about. But it has nothing to do with EMU.

Another major problem is the Eastern Enlargement. Also the Eastern Enlargement has nothing to do with EMU. The prospect of enlargement was a catalyst for renewed efforts to reform the EU's institutional set-up. An important part of the on-going negotiations is exactly the necessity to *reduce* the automatic transfers, mainly those via the Common Agricultural Policy. If there is one certain method to block the enlargement, it is presumably the construction of new automatic transfer mechanisms. Then the resistance in many member countries against enlargement will considerably stiffen. As was high-lighted by EU commissioner Günther Verheugen's proposal to organise a German referendum on the question of Eastern enlargement, large sections of the population in Germany (and in other countries) are not convinced that the enlargement is in their interest. The main problem is presumably the (probably erroneous) idea that the result would be a mass immigration into the wealthier EU countries. Against this background, what would be the popular reaction if the EU top politicians installed new automatic transfer mechanism, not only to the Mediterranean countries, but also to Eastern Europe?

So, it is not the absence, but the creation of transfers which would create tensions, burden the cohesion of the Union considerably, and block the enlargement.

But, again, we can relax: New automatic transfers are not on the agenda.

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