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The Building of the New Europe: National Diversity versus Continental Uniformity

BY

J.E. MEADE

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BIOGRAPHICAL NOTE

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FOREWORD

The David Hume Institute was very glad to welcome Professor Meade to its list of authors with the publication of his Hume Paper *Agathotopia: The Economics of Partnership* published in 1989 for the Institute by Aberdeen University Press. In that much-acclaimed work, he set out his ideas on the study of industrial organisations which would best accord with a harmony of interests between workers and capitalists.

Although well known for his explorations in reconciling capitalism and socialism, he is professionally even better known for a long list of treatises and articles on international trade theory and policy. Indeed, it was this aspect of his work that won him the Nobel Prize in Economics in 1977. The Institute has now been twice blessed, for Professor Meade has paid it the compliment of asking it to publish his views on how to reconcile the preservation of a large measure of freedom within individual countries within the European Community with economic co-operation of a far-reaching character between them. In an important sense, this paper is a sequel to his earlier Hume paper for it deals, inter alia, with the question as to whether the kind of economic experiment outlined in *Agathotopia* could be conducted by individual countries within the European Community itself.

Although the Institute has to offer the usual disclaimer that it has no collective view, its supporters and readers of this Paper will immediately recognize its importance as a contribution to the present debate on the future of Europe.

Gordon Hughes

Executive Director

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I. INTRODUCTION

This paper is concerned solely with certain internal economic aspects of the relations between the member countries which may come together to build a New European Community. It does not deal with any of the political problems involved nor with any of the political or economic aspects of the relationship between the New Europe and the rest of the world. Within these limitations it is argued that there is a potential clash of far-reaching importance between two distinct major objectives. On the one hand, it is maintained that there are at present exceptionally strong reasons for preserving a large measure of freedom for the various countries of Europe to experiment in different diverse forms of liberal economic policies and institutions. On the other hand, it is maintained that there are powerful arguments in favour of building a strong centralised union structure to control and unify certain economic policies and institutions in order to attain certain clear communal objectives. Some clash between these two principles is inevitable. But must one of these principles be for practical purposes abandoned in favour of the other or is some set of workable arrangements possible which will achieve the main advantages of both principles?

II. THE DEMISE OF COMMUNISM

In this paper it is simply assumed that the New Europe should be built so as to be capable of incorporating the ex-communist countries of Eastern Europe, including perhaps ultimately Russia itself. The incorporation of such countries would, it is generally agreed, be dependent upon their having successfully switched from basic dependence upon a command-economy structure to basic dependence upon a structure of competitive free-enterprise market arrangements.

In discussing the economic implications of this requirement that members of the New Europe should promote competitive free-enterprise market structures, it is useful to distinguish between the advantages of free enterprise and the advantages of competition. Free enterprise implies that there are certain risk-bearing entrepreneurs who are free to take decisions to maximise the profit which they can obtain from the enterprise which they direct. One way of increasing profit is to reduce the cost of producing whatever is being produced. Free enterprise may thus be welcomed as offering high incentives to produce efficiently in the sense of getting as large an output of products as possible from any given input of factor resources.

Competition strengthens this incentive to produce efficiently since otherwise the profit of the enterprise may be threatened by the lower cost and selling price of competitors' products. In addition a competitive search for profit brings with it a quite different social advantage in so far as it attracts resources into the production of goods for which consumers express the highest values by offering the highest prices and into methods of production which employ the plentiful and thus the cheaper rather than the scarce and therefore more expensive factors of production.

Such are the economic advantages of a free-enterprise competitive market structure. But in certain situations serious monopolistic conditions are inevitable. In the case of a free-enterprise monopoly, such as a privatised national railway network, profit may be increased, not only by using a given amount of resources as efficiently as possible but also by restricting the input of resources and the output of products in order to enjoy an excess profit by raising the selling prices of the products and squeezing the prices paid for the factor inputs. In this case the social advantage of using inputs efficiently may be more than offset by the social disadvantages of restricting the inputs and outputs of the monopolised concern. If the business had been nationalised and run by official managers under instruction to produce as much as possible subject to being able to sell the product at a price which covered the market cost of the factor inputs, outputs of products and inputs of factors might be increased more nearly to the socially optimal levels; but the profit incentive to maximise output per unit of input would be weakened. In such a case is a privatised free-enterprise market or a nationalised socialist market structure to be preferred?

Subject to some basic questions of this kind one may in general greatly welcome the extension throughout Europe of competitive free-enterprise market structures wherever they are possible. From this it is very often implicitly if not explicitly inferred that a restriction of membership of the New Europe to countries which effectively promote competitive free-enterprise market conditions removes any need for diversity in the national economic policies and institutions in the New Europe. Capitalism, it is contended, has knocked Socialism out. All members of the New Europe will have familiar capitalist market economies. We can, therefore, concentrate attention on building a centralised union structure which helps these more or less uniform national capitalist structures to work harmoniously and efficiently together.

I believe this conclusion to be totally false. It is clear that, even in the absence of the problems raised by integrating the ex-communist countries into a New Europe, there is need for much experimentation in developing liberal capitalist economies. Neither the extreme Thatcherism of the United Kingdom nor even the successful Social Market of Germany can be regarded as the end of the road in a search for the best form of liberal economy. It would be a grave obstacle to progress if changes in these structures could be tried out only on a uniform basis in every European country simultaneously.

But the transition of the ex-communist economies of Eastern Europe from a 'Socialist' to a 'Capitalist' way of life does raise these issues in a very clear way. When 'Capitalism' versus 'Socialism' is the subject of political discussion in the countries of Western Europe 'Socialism' is normally held to exhibit one or more of the three following features: (1) the State Ownership and Planned Management of the Land and Capital resources of the community together with extensive State regulation of, and intervention in, many activities which remain in private hands, (2) a great emphasis upon State measures to ensure a more Equal Distribution of income and standards of living, and (3) Social Security, including the certainty of earning a living in conditions of Full Employment.

III. THE OWNERSHIP, MANAGEMENT AND REGULATION OF THE COUNTRY'S CAPITAL WEALTH

There is in fact almost an infinity of various diverse ways in which the production of goods and services may be organised, planned and managed. I will mention only six typical varieties.

Variety one may be called Command Socialism, where there is a central economic plan instructing production units what to produce and what resources to use for their production and how to allocate their output to consumers. It is not competitive; it does not rely on free enterprise; and it makes no use of a market.

Variety Two may be called Market Socialism. With this system there is no competitive free enterprise, since all productive enterprises are State owned and established or disestablished by the central authority, the State owning all the capital invested in the various firms. But the managers of the firms are instructed to produce as much as they can, subject to covering their costs at current market prices of their imports and outputs, prices being adjusted so as to clear all markets.

The remaining four varieties of productive structures could meet the full requirements of a competitive free-enterprise market structure.

Variety Three may be called the Capitalist Company structure and is the familiar textbook pattern for the discussion of

Capitalism. There is private ownership of capital resources with freedom to establish a new firm. In the firms the owners of the capital resources appoint the management. Labour is hired by the Capitalist Company at an agreed fixed rate of pay and the employer-owners of capital bear the risk by receiving what income is left over from the market sale of the output of the firm after the payment of labour and other hired factors of production.

Variety Four is the Profit-Sharing Capitalist Company in which the text-book Capitalist Company is modified by granting to workers, in addition to any element of fixed wage, a share in the residual profits of the firm, but with the owners of the Capital still engaging the workers and making the main decisions about the working of the firm.

Variety Five may be called the Labour Cooperative in which Capital and Labour reverse their roles. The workers hire the capital resources used in the firm; they manage the firm and take all decisions about its policy; and they bear the risks by accepting as their pay what income is left over from the sales revenue of the firm after paying the agreed sums for the hire of capital, land, and other productive resources.

Variety Six may be called the Labour-Capital Partnership. The firm is run by partners some of whom contribute work to the firm and some risk-bearing capital The partners share in the management and risk-bearing of the firm and they divide the residual profit of the concern between them in predetermined shares according to the amount of work and/or risk-bearing capital which they put into the firm. In this structure neither capital hires labour nor labour hires capital, but worker and capital partners together decide on the management of the firm including decisions about the terms on which new worker or capital partners should be engaged by the firm.

There can, of course, be many mixtures of these various forms of competitive free-enterprise market structures. In any one economy there may be some Capitalist Companies, some Profit-

Sharing Capitalist Companies, some Labour-Managed Cooperatives, and some Labour-Capital Partnerships. Moreover a single firm may be constructed on a mixture of forms. For example in a Labour-Capital Partnership some workers may be hired by the partners at a fixed wage and some capital funds may be lent at fixed interest to the partnership by outsiders who are not partners.

The existence of certain Socialist elements in the production processes adopted by the members of a New Europe cannot be ruled out of court. Thus a nationalised railway network could be operated on full Market Socialist principles, selling its products and buying its inputs in an uncontrolled free market. Even elements of Command Socialism will inevitably exist in socialised activities producing such public goods as Defence and Law and Order and may well by choice be adopted in other activities such as those of a National Educational System or a National Health Service in which the outputs are not subject to market sales but are produced and allocated according to a central plan, but in which various degrees of Market Socialism or indeed of full competitive free-enterprise may be adopted for the supply of various ingredients into these services.

Moreover, so-called socialist intervention in the management of a country's economic resources can include not only those cases in which the resources are owned and/or operated directly by some State organisation. It covers also many forms and instances of State intervention by means of regulation and control of private concerns operating otherwise in a free market. Town and Country Planning, the control of Monopolistic Mergers between private companies, the setting of maximum prices, and the quantitative restriction of the output of pollutants are examples of such interventions.

Clearly not all elements of State ownership, management, fiscal interventions and direct regulation of industrial and similar activities can be ruled out in the economies of New Europe.

There are many possibilities for legitimate diversity and experimentation in mixtures of different forms of structure within an economy which is generally based upon the principles of competitive free-enterprise markets.

IV. THE DISTRIBUTION OF INCOME AND WEALTH, SOCIAL SECURITY AND FULL EMPLOYMENT

The other main features with which the ideology of the old Socialist countries of Eastern Europe may be associated are the Distribution of Income and Wealth, Social Security and Full Employment. These ideas are so closely interconnected that it is convenient to discuss them together.

All European governments take some measures to relieve the poverty of those citizens who are destitute and indeed to effect some measure of general redistribution of income and wealth. But there are a number of questions to be asked. First, there is the question of degree. At what point, if any, do egalitarian measures become such a soaking of the enterprising rich and subsidisation of the idle poor as to prohibit membership of a community built on the principle of free enterprise? Second, can the measures normally employed in the present Capitalist countries be usefully supplemented by measures of a more Socialist type? Third, how far can any diversification of national experiments in redistributive and other social policies be accommodated in a New European economic community?

The varieties and the implications of different redistributive and other social measures are so numerous that it is impossible to present a *catalogue raisonnée* of all possible experiments. I intend, therefore, to describe one country's particular experiment in combining a reliance on competitive free-enterprise markets with a somewhat socialistic apparatus for a more egalitarian distribution of income and wealth and for greater social security and fuller employment. I raise the question whether it would, in principle, be possible for this particular country, without any basic reformulation of these social policies, to join an economic community composed of the existing Western European countries. One can in this way well illustrate all the main problems of integrating different social objectives and experiments into a single economic community based on competitive free-enterprise markets.

The country which I have in mind is the Island of Agathotopia which I visited in 1988 and whose attempt to combine a reliance on competitive free-enterprise markets with a radical emphasis on these social objectives I greatly admired.[1]

The Agathotopians accept the fact that they cannot rely on competitive free-enterprise markets working efficiently unless they allow the markets to determine the price of the factors of production, that is to say, of capital, of land of different qualities in different regions, and of labour of various skills and training. It is only if the producers of goods and services can compete for the hire or purchase of the various factors of production that free markets will have the effect of attracting the factors of production into the industries and the methods of production that will produce the greatest amount of what the competing purchasers of the final products most desire to consume. The result will determine the incomes of the various owners of different resources of land and capital and of the various workers of different skills, training and localities. In particular the distribution of the revenue from the sales of manufactured

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[1] A more detailed account of my visit to Agathotopia may be found in J.E. Meade "Agathotopia: The Economics of Partnership". Hume Paper, No 16, published by the Aberdeen University Press for The David Hume Institute, 21, George Square, Edinburgh, Scotland EH8 9LD. An Italian edition, "Agathotopia L'Economia della Partnership", is published by Giangiacomo Feltrinelli, Editore Milano, 1989. For the purpose of the present paper it is not necessary to enquire into the details of the island's existence and other institutions nor to ask whether any European country would in fact ever be likely to act quite like the Agathotopians. The only relevance for the present paper is to provide a list of many measures any one or combination of which a European country might wish to adopt.

products between return on capital and income of labour will depend upon the relative scarcity of labour and of capital resources, the degree to which consumers want goods and services which are capital-intensive or labour-intensive in their production, and the extent to which new technologies are relatively labour-saving or capital-saving. In their own economy the Agathotopians recognise the fact that these conditions are such that for the general range of industrial workers, apart from those with special skills or abilities, full employment depends upon the acceptance of a relatively low income from work. The demand for a higher rate of pay would involve a restriction of the demand for the labour, leaving some unfortunate workers in unemployment.

They have reacted to this situation in two ways.

First, they have taken a number of far-reaching measures to ensure that rates of pay are very responsive to labour market conditions and are very flexible in particular in a downward direction if that proves to be necessary to preserve full employment.

Second, they realise that it would have been impossible to move seriously in the direction of such flexibility in rates of pay if they had not taken equally far-reaching steps in providing for every citizen a basic income in addition to his or her income from work or from the ownership of wealth. Such a basic income constitutes a major instrument in the redistribution of income as well as being an essential element in mitigating the otherwise universal insistence on receiving a rate of pay sufficiently high to provide a given real standard of living.

To deal with the first of these two sets of problems the Agathotopians have a very extensive set of rules and institutions to promote competition through the outlawing of every kind of combination between individual productive units for the purpose of dividing the market, of maintaining prices or of preventing the entry of new competitors. Where any marked monopolistic power is unavoidable, as in the case of many public utilities, they set maximum levels for selling prices and other charges. They apply these same principles relentlessly to the labour market making it in effect very difficult for combinations of workers to take industrial action in order to prevent the management from employing additional workers at lower rates of pay.

In addition they have instituted a system of compulsory arbitration to settle any dispute about rates of pay in any sizeable productive unit, the arbitrators being required to set the wage at a level which will promote employment. This is designed not merely as an additional safeguard against pressures by inside employed workers for the raising of rates of pay above the level necessary to attract outsiders to the concern, but also to prevent employers with monopsonistic powers from keeping rates of pay below the level necessary to attract new labour to the concern.

The Agathotopians realise that none of these wage-fixing institutions can prevent capitalists and workers in any successful business from getting together to share an increase in their prosperity by raising simultaneously the wage rates and the dividends received by the firm's insiders rather than by reducing prices, selling a greater output and employing more workers to the advantage of deprived outsiders. They have tackled this problem in two ways.

First, to put some curb on such inflationary agreements among insiders they have introduced a scheme, covering all sizeable firms, under which any rise in the average rate of pay in excess of a given moderate norm is subject to an inflation tax.

Second, they had promoted a widespread structure of what they call Discriminatory Labour - Capital Partnerships. The Agathotopians have a great preference for the partnership form of structure in which the worker's reward takes the form not of a contractual rate of wage but of a share in the concern's profit or rather in the net value added by the concern. They encourage it by means of extending certain tax privileges to such forms of industrial organisation. But the danger is that any such partnership which is especially successful and whose members are for that reason receiving returns on their partnership shares which exceed the market rates of return which are being earned elsewhere in the economy will have no incentive to expand their successful enterprise. To expand indefinitely by offering to additional partners the same share of profit which the existing partners are themselves enjoying would lead to a reduction of the incomes of all partners down towards the outside competitive levels.

The Agathotopians have met this problem by insisting that a Labour-Capital Partnership should receive favourable tax treatment only if it were ready to adopt what they call the principle of discrimination in their plans for expansion. In the case of a successful Discriminating Labour-Capital Partnership, this requires the partnership to offer to new partners whatever terms of membership are needed to attract them without any obligation to offer them terms which are as high as those already enjoyed in the existing exceptionally successful partnership. By this means a successful partnership, which ought in the public interest to expand, can attract new partners without any reduction of the incomes enjoyed by the existing partners. However, this principle of discrimination between the terms of engagement for existing and for new additional partners implies the abandonment of the principle of equal pay for equal work.

The Agathotopians have managed to operate a reasonably successful Full Employment policy by accompanying the measures for the downward flexibility of money wage payments so long as any substantial number of workers were unemployed with a combination of monetary and fiscal policies designed to maintain a steady 5 per cent per annum rate of growth of their money GDP, i.e. of the total of money expenditures on their domestic products.

They recognised that it was impossible to put into effect the general measures just discussed unless pay was supplemented by another source of income to offset the prospect of possible low and risky rates of pay. This purpose was in part achieved by the familiar means of State provision on an equal basis to all citizens of education and health services. But in addition to this they rely on two less familiar arrangements.

First, they devised their structure of taxation in such a way as to encourage a more equal distribution of ownership of private wealth and so of the receipt of investment income. For this purpose they exempted all net savings from their income tax base by the simple process of adding to the tax base all sales of capital assets and exempting from the tax base all purchases of capital assets. But they combined this with a moderate annual wealth tax on all holdings of capital assets above a given level together with heavy taxation on transfers of wealth by gift *inter vivos* or by bequest on death. The result was that citizens with little wealth could accumulate savings up to a given level free of tax, while further accumulations by savings or by transfers of wealth from other citizens were penalised.

Second, there are no personal or other tax-free allowances under their income tax (other than the exemption of tax on net savings). But in place of such personal allowances the State pays free of tax to every citizen a Basic Income which depends solely upon the age of the citizen, a distinction being drawn between the payment to a child or to an adult of working age or to a pensioner.

This Basic Income is paid at a generous rate to every citizen, rich or poor, and it thereby imposes an extremely heavy burden on the Agathotopian government's budget. They have been prepared to accept the need for a relatively high and progressive schedule of tax for their Savings Exempt Income Tax and for their duties on transfers of wealth *inter vivos* and at death. But such sources of revenue could not be sufficient to finance the hideous expense of paying a substantial tax-free benefit to every citizen, rich or poor. They have supplemented their tax revenue by three exceptional measures.

First, the Agathotopians are very Green and have taken far-reaching steps to curtail every form of pollution. They have refrained in every case from doing this simply by issuing restrictions on the amount of any polluting element which any producer or other economic agent is permitted to emit. Still less are they willing to use the methods of subsidising non-polluting competitors of any polluting activity. They have in every case acted by imposing a tax or other charge on polluting activities at a rate sufficient to achieve the desired reduction of that activity. In those cases where more direct quantitative regulation of a pollutant seems necessary they have acted by auctioning to the highest bidders the quota rights to produce the pollutant. They have in addition imposed an important tax on advertisement of different kinds on the grounds that the extensive promotion of unnecessary consumerism is a form of social pollutant. They have raised a very substantial revenue by these taxes and charges which are not merely revenue-raisers but whose indirect effects are wholly desirable.

Second, they have imposed a Surcharge on the first slice of each citizen's taxable income. The reason is as follows. Much the cheapest way of guaranteeing a minimum income to every citizen is to pay a Conditional Basic Income to every citizen but to withdraw the payment pound for every pound of other income received by the citizen. In this case no one receives any payment above whatever is needed to supplement his or her other income up to the basic minimum. The revenue needed for guaranteeing a Basic Income is minimised, but all incentive to earn additional income at the bottom of the scale is removed since such income is docked pound for pound as it is earned. An Unconditional Basic Income with no Surcharge, on the other hand, does not penalise earnings at the lower level, but it is intolerably expensive if it is paid at an adequate rate to every citizen, rich or poor. A Surcharge on the first slice of other income is a compromise. The need for other revenue is reduced at the cost of a partial, but only partial, extra disincentive against earning income at the bottom of the income scale.

Third, in marked contrast with the representative capitalist economies of Western Europe, the Agathotopians have no State National Debt. On the contrary they have a State National Asset. Over the past years by heavy taxation of a form which is paid out of private savings or private holdings of wealth they have managed to pay off any original National Debt and in additional to accumulate for the State a National Asset. The surplus capital funds thus accumulated are invested by the State through investment trusts and similar private financial institutions indirectly in private competitive free enterprises. The State does not manage these enterprises. It, like many a private rentier, merely enjoys the beneficial ownership of the profit made by private enterprise of one kind or another. The net result is that the State, instead of having to raise tax rates to pay interest on a National Debt, receives indirectly a substantial proportion of the yield on privately managed capital assets without having to raise tax rates for that purpose.

To reach this position the government in any capitalist country with an existing National Debt would have to go through a process of what may be called Topsy Turvy Nationalisation. If a private company is nationalised with an issue of National Debt to raise the funds to compensate the previous private owners, the State takes over the management of the concern but does not benefit financially from the ownership in so far as the interest payable on the National Debt is raised *pari passu* with the profits earned by the nationalised enterprise. But if on the contrary the capital funds are raised by an annual levy on private wealth and are then used to redeem the National Debt or are invested by the State on the Stock Exchange indirectly in part ownership of a range of businesses which remain in private management, the State does not nationalise the management of any private enterprise but does acquire a partial beneficial ownership in a range of otherwise private concerns. It is to be noted that this process of Topsy Turvy Nationalisation would present a formidable fiscal problem for the Capitalist countries of Western Europe starting off with a large National Debt, whereas in the case of a Socialist country of Eastern Europe the result might well be achieved merely by refraining from selling the whole of the beneficial ownership of all the State-owned assets to the private sector.

There could clearly be a very great variety of experiments in this catalogue of institutions and policies for the promotion of flexibility of prices and rates of pay, for the maintenance of Full Employment, and for the redistribution of income and wealth in a competitive free-enterprise market framework, which I have illustrated from the Agathotopian experiment. The question arises whether diversification in this sort of experimentation would be compatible with the requirements of an effective economic union of the countries concerned. It is to the requirements of such a union and to the question of the degree to which such requirements would preclude national experimentation that I will now turn.

V. THE ROLE OF POLITICS AND OF EXTERNAL RELATIONS

This paper is confined to a discussion of the distribution of **economic** functions **inside** a European Community between the national governments and the central community authorities.It purports therefore to exclude all considerations of political matters and of relations of the Community and its members with other parts of the world. These distinctions between the political and the economic and between the internal and the external problems of the New Europe are inevitably artificial. In fact in the final choice of designs for a New European Community both political and external aspects must play a very significant role.

No doubt it will, and should, be a requirement of the New Europe that the governments of the member countries, as well as the governmental authorities of the community itself, should be based on the political principles of liberal democracy. The design of such liberal democratic structures presents great problems and is of the utmost importance. But for the purpose of this paper in discussing the distribution of internal economic functions between the national governments and the central community authorities we may simply assume that appropriate efficient governmental institutions exist at both the national and the central level to carry out the relevant internal economic functions.

But there are other important objectives of the political arrangements in a New Europe The political structure may well be designed so as to produce what may be called Internal Cohesion between the member nations and External Influence vis-a-vis the nations of the outside world In the present century two World Wars have arisen as a result of the nations of Europe fighting each other; the cohesion that a political union might create can thus be very highly valued even if it carries with it little or no economic advantages - indeed even if it carried with it only economic disadvantages. Moreover political union can enhance the influence and power which the constituent members can exert in world affairs; and for this purpose it may be argued that it is not politically sufficient simply to promote a single market within Europe, but that political arrangements should be such as to enable Europe to exert a powerful unified influence over world political and economic institutions and policies.

These aspects of a New European political structure,namely their effects on Internal Cohesion and External Influence, inevitably have effects upon internal economic developments which in turn have implications for the distribution of economic functions between the national governments and the central authorities within a New European community. Defence arrangements provide an outstanding example. Suppose that Defence became a direct function of the New European Community. This (1) would promote Internal Cohesion by giving the various member nations a function which they had to perform jointly together, (2) would increase their power and influence vis-a-vis the rest of the world, and (3) by necessitating a large increase in the central authority's budget would greatly affect the internal distribution of economic functions between the national governments and the central community authority.

There are many other political and external institutional arrangements which have internal economic implications of this kind. The following are three examples. (1) The choice of a Customs Union rather than a Free Trade Area basis for a European Single Market, (2) the Common Agricultural Policy of the European Community, and (3) the proposals for a single currency in a European Monetary Union. All three of these institutions have two very important features.

First, they give the central political authority a task for the member countries to decide and administer jointly:- a single set of imports levies in the case of the European Economic Customs Union; a single set of support prices and subsidies in the case of the Common Agricultural Policy; and a single structure of money rates of interest in the case of the European Monetary Union. Second, all of them draw a sharp distinction between the inside members and the outside foreigners, the insiders sheltering behind the common tariff against foreigners' products, or enjoying the agriculture subsidies which are not available to foreign farmers, or dealing in a single money which is distinct from the foreigner's money.

These features in all three cases promote the Internal Cohesion of the community and increase its bargaining power and other forms of External influence vis-a-vis the rest of the world. But they also have important implications for the distribution of economic functions within the community: the Customs Union determines a single set of uniform harmonised imports duties and shifts revenue from the national budgets to the central budget; the Common Agricultural Policy implies, like Defence, a heavy centralised fiscal burden; and a Common Currency shifts the determination of monetary policies, such as the setting of rates of interest, from national central banks to a central monetary authority.

Thus in fact a complete disregard of political and external considerations is not really possible in considering the distribution of economic functions between national and central authorities within the New Europe. However, having looked this problem squarely in the face, we will pass on to consider that distribution with the minimum possible reference to the implications of political and external factors.

VI. THE PRINCIPLE OF SUBSIDIARITY AND THE PARABLE OF THE AMBIDEXTROUS ECONOMIST

In the current discussion of economic decisions about European Union much reliance is often put on the principle of subsidiarity, namely the principle that, in the ascending hierarchy of authorities from paterfamilias to neighbourhood council to regional council to national government to European Community, anything which can be done well at a lower level should be left to that level and only those things which cannot be done well at the lower level should be assigned to decision and administration by a higher level of authority. This sensible Federalist doctrine can no doubt in many cases be of great help. I take environmental control as an example. Certain forms of pollution - or more generally of what economists would call external diseconomies - may be very local in their incidence, such as the noise emitted by various local activities. Other forms of pollution may be very widespread in their effects, such as the chemical pollution of the atmosphere or of sources of water, in which case a polluting activity in one locality may have its effect over a wide territory of a continent or even of the whole world. The principle of subsidiarity can then clearly point to the assignment of the control of the former type of pollution to a local or national authority and of the latter type to a European or World authority.

Much lip service is paid to this doctrine of subsidiarity. But it is in fact in direct opposition to the idea described in the previous Section that the Internal Cohesion of a New Europe can be strengthened by finding positive tasks for the central Community authorities to perform. On occasion one feels that the principle has for this reason been reversed and that the assignment of a given function to a Community authority is recommended provided that it can be efficiently performed at the centre and regardless of the question whether it could be equally well or even better performed at the national level.

But even in the absence of any anti-subsidiarity tendency of this kind, the application of this comforting principle of subsidiarity does not present a simple solution to the great majority of problems of clashes between the relative advantages of national diversification and continental unification. It will be my purpose in what follows to point out that time and time again there are certain clear advantages in leaving a matter to the unfettered choice of a national government and at the same time there are certain quite different but equally clear advantages in devising a uniform continental solution for the problem. In such cases the pros and cons of the various possible solutions must be weighed up against each other in making the final choice, the principle of subsidiarity playing the very minor role of suggesting that if the other pros and cons seem to be evenly balanced the chairman's casting vote, as it were, should go in favour of the national authority.

At this point I introduce the parable of the Ambidextrous Economist. President Truman, we are told, instituted a search for a One-Armed Economist so that when he sought advice on an economic decision he would not be told that on the one hand there was a case for,but on the other hand a case against, a particular decision. I believe that President Truman was at fault in this desire. Indeed, that very great President himself had, I believe, on his desk a placard which read "The Buck Stops Here". There is almost always a case for and a case against an economic decision; in such cases it is the duty of an economic adviser to explain the economic technicalities of the case for and of the case against; it is the duty of the President to decide between the two. In a number of instances where the case for or the case against a particular proposal seems to me to be overwhelming I will play the role of the President and decide what should be done. But I shall frequently play the role of the Ambidextrous Economist and will describe a number of cases where there is a much more evenly balanced clash between the case for national diversification and the case for continental uniformity. It is for the reader then to play the political role of the President and make the final choice between alternative solutions. One must not fall into the vulgar error of believing that an economic adviser is useless because he or she confines his or her advice to a statement of the economic case on the one hand for, and on the other hand against, a particular policy.

On this principle I shall proceed to discuss such possible clashes under two main headings which cover, I think, the two basic sets of problems which are the subject matter of current debate about European Economic and Monetary Union, namely the formation of a Single Economic Market and of a Single Monetary Unit.

VII. THE GENERAL NATURE AND ECONOMIC OBJECTIVES OF A SINGLE EUROPEAN MARKET

The general purpose is to remove all direct and indirect obstacles to the free movement of goods, services, capital and labour between the separate competitive free-enterprise market economies of the European countries so as to transform the whole into one uniform competitive free-enterprise market. The economic advantages expected from such a transformation are those so well expounded long ago by Adam Smith and Ricardo.

First, free trade in products between countries with different factor endowments will enable each constituent country to concentrate on the goods and services in the production of which it has a comparative advantage with the result of an increase in the total output of goods and services.

Second, free trade will extend the size of the total market for goods and services and thus enable a greater advantage to be taken of the reduced costs of production which may result from Adam Smith's division of labour in a large scale of production. In some cases a market of an extent no less than that offered by the whole European continent may be required to enable any one European producer to take full advantage of the economies of large-scale production. In other cases each separate European national market might be of sufficient extent to enable one or at the most a very limited number of national producers to take full advantages of the economies of scale. In such a case the organisation of a single market covering the whole European continent could ensure that there was much more effective competition in what would otherwise be a structure of national enterprises, each able to exploit monopoly powers in its own protected national market.

Finally, the freedom of movement of labour or capital from the localities in which it is relatively plentiful and cheap to the localities in which it is relatively scarce and expensive will supplement the cost-reducing effects of free trade in increasing the output of the products of labour and capital.

The action needed to construct such a single market would seem to be obvious, easy and straightforward. Remove all national or continental governmental obstacles to freedom of movement of goods, services, capital, and labour and the problem is solved. There is much truth in this simple prescription; but, alas, for reasons to which I have already alluded in earlier sections of this paper, the answer is a good deal more complicated than that. There are at least three groups of basic reasons why simple laissez-faire is not enough.

The first general set of complicating factors can be grouped under the heading of those resulting from monopolistic conditions. Where economies of scale are so large relatively to the market that there is room for only one or two productive units to service the given market, free competition cannot be relied upon to produce the optimum output of the product. Producers will have some incentive to restrict output and to raise prices above cost because there is no room in the market for new competitors producing on a scale which would make their entry profitable. This phenomenon can take many forms ranging from that of a single railway network covering the whole geographical area to that of a small local producer protected by heavy cost of transport of products into his area from outside sources or protected by the attraction of a special brand name of the product.

A second general set of complicating factors can be grouped under the heading of external economies or diseconomies. By the term external diseconomies economists describe situations in which a private producer or consumer imposes a social cost on society for which he or she makes no payment, the most obvious cases being those in which the activity causes some form of pollution the social cost of which does not enter into the market cost of the good as it is produced or consumed. By external economies the economist describes a situation in which some economic activity produces a social good for which the private producer or consumer obtains no market benefit, an example being the invention of some new unpatented product or method of production of which competitors can take advantage without making any market payment to help to meet the cost of the initial research involved in perfecting the invention. A single market will be working efficiently only if some means can be found of bringing these external social costs or benefits into account in determining what are the real benefits to society of producing one product instead of another or of using one method of production rather than another. But this involves some form of state intervention to tax or otherwise restrict activities with high external diseconomies and to subsidise or otherwise promote those activities with high external economies.

The third general set of complicating factors can be grouped under the heading of Distributional Effects. As has already been argued at length in Section IV of this paper, an economy which is based on competitive free-enterprise market arrangements will lead automatically to a given distribution of income and wealth among the citizens of the community which may not be considered acceptable.

In all of these three cases of monopolistic conditions, of environmental pollution and of the distribution of income and wealth, State intervention in the market may be needed. In all three cases the questions arise:- How unacceptable must the adverse effects become for positive intervention in the market to be legitimate? What forms should such interventions take? And should any such interventions be operated on diverse national principles or by a continental authority on a uniform basis?

In the next Section I will try to illustrate the possible answers to these questions by applying them, very superficially I fear, to a select number of issues which are currently debated in connection with the building of a New Europe. In examining these specific questions I shall, on the principle of subsidiarity, assume that the starting point is that the Continental Authority should do nothing; it should rely upon laissez-faire to construct an effective Single Market. Starting from this basis I shall then ask whether in any particular instance there is an economic case for active intervention at the continental level, bearing in mind that such active continental intervention may take a positive or negative form. By negative continental intervention I mean that the continental authority merely prohibits the national use of certain policies or institutions e.g. it prohibits a national government from discriminating in favour of its own nationals in making contracts for governmental purchases of goods and services. In the case of such negative continental interventions the central authority must, of course, have certain powers and procedures for ensuring that these prohibitions are respected by the national authorities. By positive continental intervention I mean the design by the central authority of a policy or institution which requires the relevant positive action to be taken by the continental authority itself, as in the case of a common tariff of import duties or a common set of subsidies in the case of agriculture. It is not easy to draw a sharp distinction between negative and positive interventions by the continental authority; but the distinction is, I think, sufficiently sharp to be a useful one.

The basic objective of a Single Market is, as has already been discussed, to promote competition through freedom of movement of goods, capital and labour. In the case of positive interventions in the Single Market which are left to the decision of the national authorities, I shall draw a distinction between what may be called uncompensated and compensated freedom of movement. The idea behind this distinction can be made clear by a simple example. There is a tax of 10% in country A on a particular product. In country B there is no tax. Uncompensated freedom of movement of the good from B to A would mean the absence of any tax on the import of good by A from B, and this would give the producers of B a 10% "unnatural" tax advantage over the producers of the good in A. A 10% duty on the import of the good from B would represent what I would call compensated free entry for the good into A. This has real meaning because a 20% duty which would give A's producers a 10% advantage over B's producers would in my terminology mean that there was not freedom of movement of the good, even though there might be no quantitative quota restriction on the amount of the good that was permitted to move from B to A. The application of the idea of compensated freedom of movement is not at all easy, as I hope to show; but as a means of clarifying some of the basic underlying issues in the discussion of the treatment of clashes between national diversity and continental uniformity it can, I believe, be useful.

VIII. SOME SPECIFIC SINGLE MARKET ISSUES

(1) **Agriculture.** Many relevant issues are raised by the Common Agricultural Policy, but I shall not discuss them in this paper. My official reason for not doing so is that it is impossible to consider the CAP without discussing the commercial relations of the members of the European community with outside non-member countries; and I am strictly excluding relations with outside countries from the scope of this paper. An additional personal reason for excluding the CAP from this paper is to avoid the apoplectic fit which I might suffer if I started to do so. I can claim to be one of the founding fathers of the GATT; I have always worked for movements towards freedom of trade on a world-wide basis and have abhorred the construction of tight regional discriminatory protective devices. That the governments of the EC members should have risked endangering the whole future of the GATT for the sake of the political votes of a group of uneconomic farmers seems to me to be an unspeakable outrage. At this point I break my promise not to discuss the external relations of the European Community by asking the question whether the so-called Capitalist countries could not be enlightened enough to apply to their mutual trade the principles of competitive free-enterprise markets, the application of which they are welcoming so heartily for the ex-Communist countries.

(2) **The Social Charter and the Redistribution of Income and Wealth.** On the principle of subsidiarity, as already explained, I start the examination of this wide range of labour market and other social interventions in the market on the assumption that such interventions should be left to the national governments and that the function of the European community

in these matters is to ensure the free competitive movement of goods and of factors of production between the member countries. On examination there is much to be said for continuing to rely in the main on this principle in the case of these social measures.

There are great differences in the standards of living in the various member countries. Any attempt to lay down a meaningful minimum wage for all workers in the community as an equalising device at the lower end of the income scale would have disastrous effects. If such a regulation were strictly confined to the wage for labour it would be extremely unfair to a country which adopted the Agathotopian policy of tackling unemployment by combining a low wage with a high Basic Income from other sources or which adopted the profit-sharing principle of combining a low fixed rate of wage with a high share of profit for the workers. If an attempt were made to set a meaningful minimum, it would at least be necessary to include receipts from a Basic Income, from a share of profits or from other similar sources in the definition of the "wage". This together with other problems such as the treatment of part-time work through the decision whether it was the hourly rate of pay or weekly earnings to which the minimum referred would raise great administrative problems, the regulation and policing of which would require a considerable central bureaucratic staff.

But the basic argument against such central intervention does not depend upon these administrative problems. A minimum rate of pay which had any meaning for the member countries with existing high standards would be a device which protected them from being undercut by the products of member countries whose uncontrolled rates of pay would be below the minimum. As far as real differences in the productivity of labour in different European countries are concerned, it is freedom of movement of goods, of capital, of enterprise, and of workers between the countries which could provide a really effective equalising factor. The concentration of production on labour-intensive products in those countries where labour is plentiful and on capital-intensive products in those countries in which capital equipment is plentiful, together with free exchange of the products between the two types of country, would promote total production as well as helping to equalise earnings. And a similar tendency would result from the free flow of capital from economies in which it was plentiful into economies in which it was scarce and from the free migration of workers from economies in which labour is cheap to economies in which it is expensive.

There is a similar strong argument for leaving questions affecting the choice of institutions and other arrangements for wage-fixing and of the structure of competitive production units to the decision of the national governments rather than to attempt to devise central regulations covering the participation of workers in the management of such units. Different countries may produce different mixes of what I have called Market Socialism, Capitalist Companies, Profit-Sharing Companies, Labour managed Cooperatives, and Labour-Capital Partnerships with different arrangements about wage-fixing and about labour participation in the management of the concerns. By ensuring free competition between them, the central European authority can make its best contribution to the choice of the most appropriate structures.

There remains, however, one very important set of problems in this field with which the simple attribution to the national governments of these social policies does not cope satisfactorily. Where differences in standards of living are due to differences in real underlying economic conditions, the proposed laissez-faire attitude of the central authority is likely to be the appropriate answer. But such differences may themselves well be the result of differences in national regulations, institutions, and policies rather than of differences in the underlying supply, demand, and productivity of the available economic resources. Suppose that countries A and B are very similar in their real underlying economic resources; that A has adopted a wide range of institutions and policies to redistribute income and wealth in an egalitarian direction; but that B has interfered very little with the distribution of income and wealth which results from the free play of the competitive markets. Low-paid unskilled workers might migrate from B to A to enjoy the favourable tax, social security, basic income advantages in A, while highly-skilled high-paid workers and successful entrepreneurs might migrate from A to B, carrying their capital fund with them, to enjoy the relatively favourable tax treatment which they would receive in B. At the extreme such a situation could lead to a most inefficient and undesirable concentration of all the poor low-productive factors in one country with all the rich high-productive factors in the other.

One result might be that country A would decide to abandon or to modify its egalitarian interventions. Free competition between A and B in the Community market would have induced a convergence in national policies, in this case probably in the direction of scrapping egalitarian experiments.

A second possibility is that the central Community authorities should introduce regulations for the harmonisation of the relevant national institutions and policies. This would imply that some egalitarian intervention should take place but on the same scale and by the same means in all the national economies. This solution raises the great problems of deciding what the uniform scale and methods should be and implies the building of an effective central bureaucratic apparatus to administer and enforce the harmonised procedures. It also has the disadvantage of eliminating the possibility of diverse experimentation in the different national arrangements.

A third possibility is that the central Community authority should allow free national experimentation in these policies but should itself introduce and administer a positive form of egalitarian intervention of its own. For example it might itself raise a general community levy or tax of some form and use the proceeds to pay a modest Basic Income to all the citizens of the member countries. The national governments could be left to top this up with their different national schemes. Movements of people and capital would as before put a brake on the most extreme egalitarian experiments; but the existence of the modest Community scheme would mean that the outcome of the competition between the national experiments would be less markedly inegalitarian than would otherwise have been the case. This solution would permit more national experimentation and would involve a less complicated central bureaucratic apparatus than the solution through centrally administered full national harmonisation.

A fourth possibility is to allow complete national freedom of experimentation in this field but to attempt to offset the effects of competition between the different national schemes by modifying the forces of competition through the introduction of what I have called compensated freedom of movement of goods, capital, and workers. Workers would be free to migrate from country B to country A, but they would not enjoy the extra egalitarian benefits which were offered in A over and above those that were offered in B. Capital could flow from A to B but would remain subject to any extra egalitarian tax or other treatment to which it was subject in A.

I will return later to the question to what extent such compensated freedom is a practical possibility.

Meanwhile I claim the privilege of the Ambidextrous Economist and leave the choice between these solutions of the problem to the reader's Presidential decision.

(3) Norms and Standards of Health, Safety and Similar Reasons

The formation of a Single Market for the European Community clearly requires the removal of national regulations of particular activities which are designed simply to protect national producers, or traders, against the competition of the producers and traders of other members of the community. But often the problem is not as simple as that. Thus imports of goods may be controlled on the grounds that the foreign goods may carry with them a threat to the health or safety of the consumers. Regulations excluding foreign banks or other financial institutions from providing their services in the domestic market may be imposed in order to protect local standards of operation for the financial security of the creditors of the institutions. Medical, legal, or other practitioners may be required for similar reasons to have acquired recognised national qualifications, often obtainable only by lengthy and costly training.

Some national procedures may be protective of national producers without any other important justification, such as regulations which require governmental procurement to give preference to national supplies. But many regulations, while they have an important, perhaps a predominant, protective effect, may also have a legitimate and important purpose in the protection of the consumer. This is a field in which there is a clear need for Community action to ensure that necessary regulations exist to protect the health, safety and security of consumers of goods and services without imposing unnecessary protection to local suppliers. In fact a great deal of tedious and detailed work has been done and is in the process of being done to apply this principle to a large number of particular activities.

I shall not attempt to discuss these individual cases in this paper because this is a field in which,if one assumes that all are agreed on the basic principle of a single market, there is no basic inevitable clash between national and community interests. The only problem is to search for a method which prevents the use of such regulations for national protective purposes with the minimum of detailed community regulation. Wherever possible, the best method for this purpose is the rule that member countries should recognise the national norms and standards of each other. Country A should allow free import of goods and professional services and personnel from country B, provided these goods and services satisfy the norms and standards which country B lays down for the consumption of country B's products in country B. This rule would have to be accompanied by some basic Community minimum requirements which each country's national norms and standards would have to satisfy. But subject to that provision, the method allows the maximum possible national diversity of norms and standards with the minimum amount of central bureaucratic administration.

(4) **Control of Monopolies**. Another closely related but more difficult set of problems arises in cases in which important monopolistic structures are inevitable. In fact we live in a world of imperfect competition in which monopolistic elements are to be found in most, if not all, markets. Everyone is familiar with the danger that a monopolist may restrict output in order to raise the price of the product and to make an undue profit at the expense of the consumer. The basic weapon against such monopolistic action lies in a competitive economy in which there is freedom for new suppliers to enter the monopolist's market to take advantage of the monopolistic profits with the result of increasing supplies and bringing the price of the product down.

Why then does freedom of competition not suffice to remove all monopolistic activities? The answer lies in the phenomenon of "increasing returns to scale"; in order to produce a good or service at a low cost one must have a sufficiently large market to be able to produce on an economically large scale. This principle applies over the whole range of activities from the village shop to the gigantic industrial combine. The village shop operates in a market which enjoys a modest protection due to costs of transport and of customer movements. The villager finds it cheaper to walk round to the village shop to buy a loaf of bread rather than to take the train or bus to the nearest large shopping centre. The village shop is thus able to charge a somewhat higher price than the neighbouring large shopping centre. No competing village shop enters a small village market because there is not room for two to be able to conduct the business on a scale which is sufficient to reduce the costs to a tolerable level. The same set of considerations on a very different scale will explain why there is room for only one or two producers of, say, cars, each able to preserve some degree of monopolistic profits. Low costs of production may require an assembly line which will handle a very large output; and the demand for cars may be such that there is room for only one or two assembly lines producing on an economic scale.

So long as the separate nations of Europe could take steps to protect their industries from competing imports, a good might well be produced separately in each country on a scale which was not sufficient to enjoy all the available cost-reducing advantages of a large-scale production. The removal of national trading obstacles by the formation of the single market would then enable one country's productive unit to undercut and expand at the cost of another country's productive unit or to merge voluntarily with another country's productive unit and to concentrate the two national productions into one production unit. In other words it might well result in the concentration of the national units into one or two much larger units. The result could be a real saving in cost for the Community as a whole combined with a concentration of activity and profit in one central locality at the cost of the other nations whose production units had been absorbed into the concentrated central unit. Here is the possibility of a very real clash of interest between the production of the good at the lowest possible cost for the Community as a whole and the desire of a nation to avoid the danger of becoming a deindustrialised depressed region and to maintain some diversity in its industrial structure. In view of these considerations what should be the policies of the member nations and of the community?

A merger will have two effects. On the one hand, it will increase the monopolistic powers of the merged concerns; on the other hand, the merger by increasing the scale of operations of the single concern may well reduce the costs of production of the combined output. Whether or not the merger should be permitted must depend upon whether or not it is judged that in the particular case the disadvantage of increased monopolistic power is or is not outweighed by the opportunities for real cost reductions. But should the judgement and control be a function of the national authorities or of a central Community authority?

In so far as the proposed merger is confined to two or more concerns operating in, and providing services for, a particular country it would seem clear that on the principle of subsidiarity the decisions should remain with the national authorities. It is arguable that even in the case of a proposed merger between concerns operating in a number of national markets - and it should be remembered that many large concerns are in any case multinationals operating in many national markets - each nation should have the power of preventing a merger of a concern located in its territory, even when the merger concerns businesses located in other territories. Such a power may be needed to preserve its industrial base and the diversity of its enterprises. But on the other hand it would appear that in such cases there should be a central Community authority to judge whether the whole balance between increased monopoly power and reduced costs was such as to make the merger desirable for the community as a whole. But in this case the questions remain how far and by what means should the Community authority take into account national interests in the diversity of their productive activities. The present Ambidextrous Economist does not know the answers and once more leaves the Presidential decisions to the reader.

Where a large-scale productive structure is needed in order to attain low and economic costs of production, a limitation of the misuse of the inevitable monopolistic power may be attempted through the control of the monopolist's selling price. A similar result may be achieved even more directly by the nationalisation of the enterprises concerned (as, for example, in the case of a country's generation and distribution of electricity), the managers of the nationalised concern being instructed to produce on as a large a scale as is compatible with setting prices at a sufficiently high level to cover costs plus a moderate rate of profit. In such cases there is a wide range of systems for price-fixing which may be available. Where increasing returns to scale are still operating, the average cost of producing a unit of the product will be higher than the marginal cost, that is to say, than the extra cost incurred by adding some additional units to the total output. The average cost will be lowered because the additional units of output add less to the total cost than the existing average cost. In such cases there is a strong case for charging prices on a discriminatory basis which allows some or all units of production to be sold at the low marginal cost while the average cost is covered by charging additional sums on some other basis.

Two examples may be given. The electricity supplied by a nationalised concern may be sold at a low marginal cost when it is exported to consumers in other countries where it can compete with and undercut the local producers and at a higher price to the domestic consumers. Alternatively the electricity may be sold to all consumers at the low marginal cost while a fixed standing charge based on some criterion other than the amount of electricity consumed is added to the electricity bill of each domestic consumer. The foreign importing country may be charging a single average cost price for all its output. It may, therefore, argue that discriminatory prices of the kind outlined in these two examples represent a case of dumping in which the exported electricity is sold at a lower price than that charged in one form or another to the domestic consumer. The question therefore arises whether there should be Community regulation over such national pricing systems even though they are designed to increase the sales and so to reduce the costs of the monopolistic producers. If so, should some Community action take the form of prescribing such pricing systems or of allowing the importing countries of such products to impose a compensating import duty equal to the excess of the export's average cost of production over the price charged for the export? The latter solution would allow a diversity of national experimentation in that a system of charging low marginal-cost prices to the units sold to its own domestic consumers could be applied in the exporting country while tax-inclusive average prices were charged in the importing country.

Finally, one may note that the monopolistic powers of some producers are positively maintained and reinforced officially by patent laws. Such arrangements are justified by the fact that the great costs of research and development of new products and of new methods of production would not be undertaken if the results could immediately be used by all competing producers without making any contribution to the cost of producing the invention. Patent rights give the inventor a monopoly of the use of the invention for a given period of years. The longer the period during which the monopoly profit from the protected use of the invention can be enjoyed, the greater the incentive to produce such inventions but the longer the period during which other producers and consumers cannot make use of the new knowledge. The question arises whether there should be any special Community regulations to prevent the misuse of the patent system by one member country at the expense of others through granting strict patent rights for excessive periods to its national inventors of what may be very simple innovations. It is questionable whether the situation needs any special Community regulation over and above the existing general international arrangements in this field.

(5) **Externalities and Environmental Problems**. Interventions of one kind or another in the workings of competitive free-enterprise markets are needed in those cases in which there are social costs or benefits involved in the activity which are not charged or paid in the workings of the private price

mechanism. The cost of pollution of the air or the sea or river water by the discharge of deleterious gases or chemicals of one kind or another is a most important example which is of great topical interest.

Where it is possible without too much difficulty, there is great merit in controlling such pollution by a system of taxes or other charges or levies on the amount of pollution which each individual polluter is causing. If the polluter is taxed at so much per unit of the socially harmful gas or chemical which his or her activity causes it is equivalent to a simple supplement of the private production costs - of capital, raw materials, and labour - which the activity entails. Such a form of intervention has all the merits of competitive free-enterprise market arrangements. It leaves private producers and consumers in competition with each other to choose what they will produce and consume, including in the costs and prices in the market the social as well as the private costs of production. The social costs are charged on those who are doing the social damage and this gives them an incentive to change their methods of production which matches the social need for them to do so. But at the same time it allows for the fact that some polluters will be able to change their methods of production more easily and with less loss of output than others. To avoid the tax, those who can change easily will change more than those who can change only at a great private cost; and it is economically sound that, if the discharge of a harmful element is to be reduced to a given tolerable level, the reduction of the discharge should be undertaken by those who can most easily do so.

Finally this method of control of pollution has an outstanding advantage over other methods of direct regulation; it raises tax revenue for the government in question. All governments need tax revenue. Most forms of taxation carry with them some undesirable disincentive effects such as the possible effects of a progressive income tax on the incentives and opportunities of entrepreneurs to expand their businesses. But levies on pollution constitute a method of tax which not only raises revenue but does so in a way which improves economic incentives in competitive free-enterprise market conditions.

Unfortunately, however, the application of the method of taxing the polluter can present grave administrative costs and technical difficulties. It requires some physical and administrative means for measuring the amount of pollution caused by each polluter. Such measurement may be technically difficult or even impossible. In such cases it may be possible to restrict the amount of pollution by more crude means. For example, it might be laid down that one particular polluting method of production should in all cases be prohibited. Such a regulation might reduce the polluting element to an unnecessarily low level and would make no distinction between those who could reduce pollution at little cost and those who could do so only at great cost. Direct and crude regulation of this kind should be employed only where the administrative and other costs of charging pollution taxes are too high.

So much for the methods of environmental controls. One must also draw a distinction between the cases in which a private polluting activity affects only the social costs in a local region of one country and those cases in which the polluting activity affects social costs over a wide area which includes many countries. We may start with a sharp distinction between an activity which affects only one member country of the European Community and an activity whose social costs affect all the countries of the Community.

The principle of subsidiarity suggests that in the case of a purely local environmental social cost (as in the case of Town and Country Planning of the use of land resources or of noise abatement in a given locality) the responsibility of control should lie with the national government, which would be free to use whatever method of control it chose to use. In the case of an activity which pollutes on a European continental scale the argument for using a Community pollution tax is very strong in all cases in which such taxation is a practical possibility. For the reasons already given it would represent the appropriate method for supplementing a European continental structure of competitive free-enterprise market arrangements. It would also have the great advantage of providing the central Community with a tax revenue. But where a continental pollution could not be controlled by a continental pollution tax, the function of the central Community authority could be reduced to a determination of the quantitative extent to which each member should reduce its emission of the pollutants, leaving it to each national government to determine the means by which its quantitative target should be attained.

But the scope of polluting activities is not confined to those which affect one member country alone and those which affect all the European member countries. Some polluting activities (e.g. the discharge of chemicals into a river) may affect some but not all of the member countries of the Community, or may affect a group composed of one or more member countries together with one or more non-member countries (e.g. the discharge of chemicals into a river flowing through a number of different countries). This suggests that schemes of pollution control may be best devised between groupings of countries which may differ in their composition and which may or may not contain countries which are, as well as countries which are not, members of the European Community.

This subject of environmental control is, as everyone now knows very well, of the greatest importance but it is at a very early stage of discussion and application. I myself feel unable to say more than that those forms of environmental pollution which affect all or a majority of the European countries raise problems of the kind which I have described and which certainly call for appropriate treatment by a central Community authority.

(6) **Harmonisation of Taxes and Subsidies**. It is in the setting of taxes and subsidies that the most difficult and important

clashes between national and continental interests can occur. The general problem is clear. If one decides to build a perfect Single Market in which no governmental interventions have any effect in distorting the relative advantages of producing or consuming one nation's product rather than another's or of working or of holding capital or of living in one national area rather than another, there must be complete harmonisation of all taxes or subsidies throughout the area of the Single Market. Otherwise there will inevitably be some distortion of choice. On the other hand such complete and perfect tax harmonisation would remove all possibility of effective diversity in the national designs of economic institutions and policies.

The problem of finding an appropriate balance between legitimate and illegitimate diversity of national fiscal arrangements raises an extremely wide range of very complicated issues. It is possible in this paper only to scratch the surface of the problem by giving a few simple examples of the sort of issues involved.

Taxes which are laid simply on a nation's import or a nation's export of a particular good or service should be clearly ruled out by a general Community regulation against such national protective devices. But indirect taxes on the whole national consumption or on the whole national production of a commodity are not in the same way obviously protective.

An indirect tax which is levied on all domestic production of a product with exported production paying no tax but all imports being subject to the tax, is clearly a tax on domestic consumption regardless of the source of the taxed good. Similarly an indirect tax which is levied on all production whether it is consumed domestically or is exported but without levying any tax on imports of the products is clearly a tax on domestic production of the taxed good regardless of its destination. In order to prevent the most obvious protective uses of indirect taxation it is clear that a national indirect tax should be either a tax on the national consumption whatever the source of the good or a tax on the national production whatever the destination of the product.

But such a simple rule would not suffice to rule out the design of structures of indirect taxes which in fact had a very marked protective effect. For example, in the case of VAT which is a tax on national consumption, harmonisation would mean that the tax must be imposed on all items of consumption at the same uniform rate of tax. But in the interests of diversification it can be argued that the different nations should be permitted to differentiate between their scales of VAT and of other indirect taxes as between one class of goods and another. The legitimate grounds for such differentiation might be (1) on distributional grounds (i.e. to tax expenditure on luxuries more heavily than expenditures on necessities) or (2) on environmental grounds (i.e. on the grounds that the consumption of the good caused an environmental evil). However, if complete freedom of choice of tax scales were permitted, there would be nothing to prevent all goods which were imported in large quantities by the nation being taxed at exceptionally high rates which would give an incentive to the home consumers to shift their purchases away from foreign on to domestic products. For example, in the UK a heavy consumption tax on wine and a low tax on beer could encourage the British habit of swilling home-brewed beer instead of sipping French wines.

A similar problem arises with the indirect taxation of production. If a nation levies particularly high rates of tax on products which it does not export and particularly low rates on products which it does export, it would in fact be paying the equivalent of a subsidy on its exports.

Considerations of this kind raise the question whether and, if so, how and to what extent the member nations should be required to consult with, and possibly to acquire the consent of, some Community authority with regard to the structures of their indirect taxes. One conceivable procedure would be (1) to allow freedom to the constituent member countries to impose their own rates of indirect taxes, (2) to require them in any case to define and treat each such tax as either a tax on consumption regardless of origin of the good or as a tax on production regardless of destination of the production, (3) to allow other member countries to appeal to some Community body on the grounds that a member's structure of indirect taxes was in fact having an undue discriminatory effect on the offending member's imports or exports, (4) to require the accused member to justify its structure on certain clearly defined grounds such as a desirable redistribution of income or the protection of income or the protection of the environment, (5) to produce an award by the Community body as to the degree of unjustifiable tax or subsidy there was on the complaining members' imports or exports of particular types of goods and (6) to allow the injured members on the basis of "compensated freedom of movement of goods" to offset the effect of the unjustifiable tax or subsidy by an offsetting subsidy or tax on their own imports from or exports to the offending country. But the question remains whether or not any procedure of this kind could possibly be made workable.

I turn now from Indirect to Direct Taxes and Subsidies. In this category one may include Taxes on Income, on Wealth, and on Capital Transfers and Subsidies to income such as the payment of Social Benefits of one kind or another. In so far as these taxes or subsidies are levied on, or paid to, residents of a given nation and in so far as persons never change their residence, there are no insuperable problems involved in failing to harmonise the structure or rates of the various national regimes. There would need to be an agreed Community system of double tax relief which ensured that it was the tax regime of the country in which the taxpayer was resident which was operative in the case of any transaction. Thus if a taxpayer resident in country A received income in respect of work done or capital invested in country B, the income would be subject to A's Income Tax and would not be charged under B's Income Tax regime. Similarly Wealth held in B by a resident of A would be subject to A's Wealth Tax and would not be charged under B's Wealth Tax; and Country A's Social Benefits would be paid to residents of A and B's to residents of B. However in the case of a Capital Transfer Tax there could be a problem. Suppose some capital were transferred from a resident of A to a resident of B. If the Capital Transfer Tax of A was payable by the benefactor and that of B was payable by the beneficiary, there would be a case of double taxation. Whereas if the Capital Transfer Tax was payable by the beneficiary in A and by the benefactor in B both parties would be exempt from tax.

In this last case there would need to be some Community agreement about the way in which this kind of situation should be treated; and there could be other cases for which special rules would have to be agreed, for example for the treatment of the income of a Discretionary Trust some of the potential beneficiaries of which might be residents of A and others residents of B. But in general the principle of applying the tax regime of the country of residence of the person liable to pay the tax would be clear in its application. The problem would be simply that of avoiding evasion. For this purpose Community procedures for co-operative action between the various national revenue-collecting authorities could be most helpful. In the extreme, if there was a single Community revenue-collecting administration applying the various national regimes on behalf of the various national governments, the opportunities for tax evasion would be greatly reduced.

So far so good. But as has been already shown in the discussion of social problems, differences in fiscal arrangements for the redistribution of income and wealth may give rise to very serious problems in a Community in which there is free movement of persons between the various member countries. Egalitarian country A with a high Basic Income might attract all the poor inefficient, or idle citizens while incentive-minded country B attracted all the rich, efficient and active members of society together with their capital resources.

Movement from one place of residence to another is, of course, not costless particularly in a continent in which languages differ from country to country. Some degree of diversity in tax regimes would be possible without leading to great movements of taxpayers. But if fully free uncompensated changes in residence were allowed, this would set a very effective limit to the degree of diversity in national tax regimes which was practicable. Those who advocated egalitarian measures on a large scale would have to persuade all - or at least the most important - nations of the Community to make more or less simultaneously the same sort of tax changes, the extreme version of which would imply complete tax harmonisation and the complete disappearance of experimental national diversity.

But may there not be some form of compensated freedom of movement of persons which would increase the feasibility of national diversity in tax regimes? Theoretically there is one simple rule which would solve the whole problem, namely a rule that while persons were free to change their actual residences they could not change their legal residence for purposes of direct-tax regimes. Thus a national of A who had migrated to B would still be taxed under A's tax regime. If such a rule were possible, the problem would disappear. Citizens would still have an economic incentive to move from A to B if and only if their pre-tax incomes were greater in B than in A. The taxes which they would pay would depend upon A's tax schedule, but presumably the actual revenue would accrue to B's government, since the persons concerned would now for all intents and purposes be citizens of B enjoying the advantages and responsibilities of that country. It is perhaps not inconceivable that in the end, particularly if there were a single Community administration for the collection of the member countries' direct taxes, a solution somewhat on these lines might be possible. But it does not sound like a political possibility at the moment. I must leave it to the reader to consider whether there are more feasible methods of introducing some rough compensatory measures which would offset in part or whole some of the undesirable effects of diverse direct-tax regimes. Or would the existence of large diversities in national fiscal policies for redistribution of income and wealth necessitate the continuation of direct controls over migration between the member nations?

Such undesirable tax effects are to be expected not only as a result of the differences in the redistributive effects of taxation which I have just discussed. If country A exempts all net savings from its Income Tax and thereby turns it into a tax on consumption expenditures, while country B operates a straightforward Income Tax, there will be an incentive for citizens to be residents of A while they are saving for the future and their expenditure is low and to become residents of B when they are living on their past savings and their expenditures are greater than their income. Does this mean that A and B must jointly decide to operate either an Income Tax or an Expenditure Tax? Or could the citizens be treated as not having changed their legal residence for tax purposes when they move from A to B? Or could some rougher form of tax compensation be devised so that they pay some penalty on what they have saved tax free in A, when they move to B?

There are other forms of tax which I have not discussed and which raise similar problems. For example, a Corporation Tax is a tax on profits, i.e. on a form of income, which is payable not by a person but by a corporation. Differences in rates and structures of such a tax may thus affect incentives to expand production in one plant in A rather than in another plant in B and in the case of a multinational company operating both plants it will give rise to incentives to keep the companies' accounts in such a way as to concentrate the profit return in the lower-taxed plant, for example, by selling intermediate products at an exceptionally high price when they move from the low-taxed to the high-taxed plant. Once again the question arises whether tax harmonisation is on balance desirable in order to remove these unwanted incentives.

This discussion of tax harmonisation has been very superficial, but it is hoped that it has served to show how basically important the question is in the search for a balance between the requirements of national diversity and continental uniformity.

IX. EUROPEAN MONETARY UNION

A very special case of possible conflict between the merits of diversity and uniformity arises in the monetary field in choosing between a single European currency and a European set of national currencies with variations in the rate of exchange between them.

There are certain clear advantages in having a single European currency. The most obvious and familiar of these is the saving of the cost and inconvenience involved in having to change a domestic currency into a foreign currency for purposes of foreign trade, tourism, capital investment and other forms of transaction with foreigners, together with the ease of making comparisons between domestic and foreign prices and costs. Closely allied to this is another advantage, namely the removal of the uncertainty as to what the future rates of exchange will be between a domestic currency and various other currencies. The exporter of goods from A to B who contracts to produce them at a given price in B's currency will bear no exchange rate risk if B's currency is the same as A's, but will bear a serious risk if B's currency may depreciate in terms of A's currency over the period of the contract; and in the absence of offsetting measures foreign exchange rates are notoriously volatile in their fluctuations.

For some countries membership of a Community with a single currency - or with monetary arrangements like the ERM which greatly restrict exchange rate variations - may enable the country to resist inflationary pressures. For example suppose that a country is threatened with a high rate of inflation because of upward thrusts of money wage costs due to its wage-setting institutions. It may find it politically easier to take the necessary restrictive monetary and fiscal measures to fight such inflation if these measures are essential to maintain a given agreed exchange rate for its currency in terms of its competitor's currencies than if the restrictive measures are taken merely to avoid the rate of national inflation from rising above some nationally determined target level. There may be little or no real economic difference between the two methods. A given degree of restriction of money expenditures with the same consequential degree of recession and unemployment may be needed in both cases to break the wage cost-push inflation. The difference is basically a political one. The preservation of an internationally agreed exchange rate mechanism may be a more persuasive and credible argument than the prevention of a national index of inflation from rising above a target level and may thus have a greater effect in inducing wage bargainers to set less inflationary wage rates.

But probably the strongest argument in favour of a single European currency has little or no economic content but is straightforwardly political. A single currency gives the Community authorities a very important positive function to perform jointly - namely, the issue and administration of a single non-inflationary currency - in a way which distinguishes the countries concerned sharply from the outside world. Thus, like a flag it presents to the world a great symbol of unity. Such considerations may well be by far the most important ones in the case of a European Monetary Union with a Single Currency, but they are not basically economic.

But a structure of separate national currencies with the possibility of variations in the rates of exchange between them also has certain clear advantages. The first of these is the much greater case of making any necessary adjustments between the general level of money prices and costs in one country and in another. Such situations may arise in a number of ways. Suppose that countries A and B concentrate on two different types of tradeable products, A concentrating on the manufacture of consumer goods and B on machinery and similar capital equipment. Suppose that the world demand for A's product falls and for B's product rises. Equilibrium in the world markets will require a general fall in the price of A's products relatively to B's products. Or suppose that A and B are producing very similar manufactured goods in competition with each other, but that A's money wage costs have risen more rapidly than B's. Such a development might occur through a higher rate of increase of output per head in B than in A or from a difference in institutions and customary procedures for the fixing of money wage rates, leading to a higher rate of increase of money earnings per head in A than in B. In either case a reduction of the general level of money prices and costs in A relatively to those in B is needed to restore A's competitive position.

If A and B share the same currency, the process of readjustment requires an absolute reduction in A's and/or an absolute rise in B's money prices and costs. Such adjustments will be brought about in the markets by a slow and piecemeal procedure with the fall in the demand for A's products causing reduced output and unemployment separately plant by plant in a whole range of industrial plants and companies. This process must continue on a scale sufficient to lead gradually to the necessary reduction in the general level of money prices and costs, while the rise in the demand for B's products gradually causes a plant-by-plant rise in B's money wages and policies. If, however A and B have different currencies, the whole adjustment can be achieved without a prolonged period of plant-by-plant adjustment and without unemployed resources in A by means of a single once-for-all depreciation of A's currency in terms of B's.

In deciding whether A and B should share a single currency or should retain separate national currencies the merits of exchange-rate variations as an instrument of adjustment between the two countries must be set against the merits of a single currency in reducing costs and uncertainties in transactions between the two countries. There are at least four important factors to be considered in assessing the relative merits of the two exchange-rate mechanisms.

First, the greater is the size of any national or regional economy, the greater is likely to be the value of its internal transactions relative to the value of its transactions with the outside world. For this reason the relatively small economy will suffer relatively bigger transactions costs from having a separate currency of its own, monetary transactions with outsiders being large relatively to monetary transactions with insiders. A separate currency is more appropriate, the larger is the volume of internal transactions relative to external transactions.

Second, in deciding whether to join a monetary union sharing a single currency with other countries, a country should take into account the structures of its own economy and of the economies of the other members of the monetary union. The smaller the probability of a need for the real terms of trade between its products and the products of the rest of the union to be adjusted from time to time (i.e. for the price of its products to vary relatively to the price of the products of the rest of the union), the smaller would be the relative merits of retaining its own separate national currency.

Third, the greater the flexibility of its own money costs and prices in response to changes in demand and supply, the smaller would be the advantages of retaining its national currency. A particular and important example of this is the ease with which its wage-fixing institutions and procedures allow money-wage costs to rise and fall in its various industries and occupations as a result of an increase or decrease in the demand for labour at each point in the economy. The greater the flexibility, the less the need for exchange-rate variations as a means of adjustment of a general disequilibrium.

Fourth, the greater the ease of movement of labour and capital from regions in which there is an inadequate demand for their services to regions in which they are scarce and fully employed, the less need will there be for a reduction in the prices of the factors of production in the former regions relatively to their prices in the latter regions and the less, therefore, the need for a depreciation of the former currency in terms of the latter.

There is one other important merit in having a set of different national currencies. A currency must be managed by the relevant monetary authority with some set of financial objectives in view. One such objective - and it is often considered to be the only objective - will be the prevention of inflation or at least the prevention of the rate of inflation from rising above a moderate target level. But there are many ways of measuring the degree of inflation. The commonest measure is the rate of increase of a price level. But there are many different price levels. To take the ordinary cost of living index has grave dangers. For example, suppose there to be a sharp rise in the price of imported oil which enters into the cost of production of the economy's consumer goods and services. In order to prevent an inflation of the cost of living, wage costs will have to be reduced absolutely by an amount necessary to offset the rise in the cost of the oil inputs. It would be difficult enough to resist an absolute rise in wage rates to offset the rise in the cost of living due to the increased cost of imported oil. But to obtain an absolute reduction in money wage rates sufficient to offset the rise in the price of oil might well need a restrictive financial policy on a scale which would cause a very large recession and growth in unemployment in order to cut wage rates sufficiently. Exactly the same problem would arise if it was decided to raise the rate of VAT or of other indirect taxes as a means of raising revenue. To offset the resulting rise in the cost of living would require an absolute reduction of money wage rates.

A more appropriate price index might be an index of the costs of production of the economy's output of goods and services exclusive of costs of imported raw materials and of indirect taxes (i.e. a GDP deflator). Such an index would not require an absolute reduction of wage costs to offset any rise in the price of imports or in indirect taxes. But it might still be liable to lead to serious recessions and unemployment. Suppose there were a rise in the price of imported oil which was allowed to lead to a rise in the cost of living rather than needing to be offset by an absolute reduction in wage rates. It would still be necessary to prevent the rise in the cost of living from leading to the absolute increase in wage rates which might be demanded in order to offset the rise in the cost of living. To prevent such increases in money wage costs there might have to be a serious recession and cutback in the demand for labour. To obtain an immediate reversal of a 1 per cent rise in wage demands might involve an immediate cutback of, for example, 5 per cent in the demand for labour.

There is another measure of wage inflation which would call for a much less drastic cutback in the demand for labour in such conditions. This alternative would be to control the rate of rise in the total value of home production of goods and services exclusive of imported materials and of indirect taxes instead of controlling the rate of rise in the price per unit of such output (i.e. to substitute the total money GDP for the GDP deflator). Any undesired increase in money wage rates by raising the money price of output would, of course, raise the total money value of the output by a corresponding amount. But to obtain an immediate reduction of 1 per cent in the value of total output could not at the worst lead to more than a 1 per cent reduction in the demand for labour. A 1 per cent reduction in the value of total output would be brought about by a 1 per cent reduction in the level of output and employment even if there were no response at all in reducing the money wage rate and the money cost-price of output. For this reason taking the money GDP instead of a price level would be liable to cause much less sudden and sharp variations in the levels of output and employment. It would thus reduce the risks involved in joining a full monetary union with a single currency for a country whose institutions and procedures led to rather rigid wage-rate settlements.

There are thus many possible measures of inflation. A set of different national currencies would thus make room for a greater diversity of national experiments in the control of inflation, not only by allowing for different levels for any given inflation target but also by the choice of different methods of measuring inflation. In particular it would not rule out an experiment with an index of money GDP instead of a money price index as setting the inflation target. But if different countries were maintaining different inflation targets, there would have to be a possibility for at least moderate adjustments in their exchange rates.

There is one other important set of financial considerations which have important implications for the choice between a single uniform European currency and a set of independent national currencies. It should be the objective of the financial authorities not only to keep the economy on a given Inflation Target (whether this be a Price Target or a Money GDP Target), but also to keep the economy on what may be called a Wealth Target. This latter target might take the form simply of maintaining a certain Budget Balance between the government's tax revenue and its current expenditures on goods and services, in order to avoid the possibility of the government simply eating up the country's Wealth by borrowing all private savings to finance a governmental excess of current spending. Alternatively, the Wealth Target might aim at keeping the level of Public plus Private Savings at a given target level. Whatever precise indicator is chosen for the Wealth Target - and there is every reason to regard diversity of national experiment in this sphere as being in itself a desirable feature - there will then be two policy instruments (namely, Monetary Policy controlling the Rate of Interest and Fiscal Policy controlling the Rate of Tax) available to aim at the two financial targets, (namely the Inflation Target and the Wealth Target, whatever precise form these may take).

It is often taken for granted that the obvious course is to assign the use of the monetary weapon solely to the control of the monetary target(e.g. to raise or lower the rate of interest as it is desired to lower or to raise the rate of Price Inflation) and the use of the fiscal weapon solely to the control of the wealth target (e.g. to raise or lower the rate of tax as it is desired to raise or lower the Budget Balance). But this is a mistaken idea. Monetary restriction will reduce the amount of expenditures on goods and services. This reduction in demand will help to reduce prices, but it will also reduce the incomes of those producing the goods so that not only the revenue from indirect taxes will fall as the result of lower sales but the revenue from direct taxes will also fall as a result of lower expendable money incomes. Thus monetary restriction will lower the Inflation index and will also lower the tax revenue and thus the Budget Balance indicator. Fiscal restriction in the form of a rise in the Rate of Tax will raise the Budget Balance but it will also lead to a fall in demand for goods and services and thus to some fall in the rate of Price Inflation. Thus both financial weapons will affect both financial targets. The way to use them efficiently so that both targets are maintained simultaneously is to use them jointly and simultaneously to produce the jointly desired effect on both targets. To use them with separate assignments, setting monetary policy to control Price Inflation without any consideration of its effect on the Budget Balance and setting fiscal policy to control the Budget Balance without any consideration of its effect on Price Inflation is at its best a very clumsy and inefficient procedure which will enable the two targets to be reached only after a prolonged process of adjustment and readjustment. At the worst if Fiscal Policy is relatively more effective as a controller of Price Inflation and Monetary Policy relatively more effective as a controller of the Budget Balance, the independent operation of monetary policy to control Price Inflation and of fiscal policy to control the Budget Balance will lead to a disastrous instability of the system.[2]

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[2] The dangers and disadvantages of assigning Monetary Policy exclusively to the control of Inflation and Fiscal Policy exclusively to the control of

The first solution would be to settle for a system of independent national currencies so that each national authority could control both its monetary and fiscal policies for the joint control of its own Inflation and Wealth targets. This would necessitate some degree of flexibility between the nations' exchange rates, though it would be perfectly possible and desirable to devise a set of European rules and institutions for the conduct of foreign exchange policies which prevented unnecessary volatility in exchange rates but allowed for those moderate exchange rate variations which will be needed to harmonise the diverse national financial targets.

The second solution would be to institute a single European currency to be shared by all the member countries with a single European Central Bank to administer its issue, but at the same time to centralise a sufficient part of the fiscal operations of the European Community in a centralised Community budget in order to enable Community monetary and fiscal authorities jointly to design a joint monetary - fiscal policy for the control of Inflation, while paying proper regard

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Budget Balances are increased by the formation of a Monetary Union with a single currency. The formation of the Union will cause much of the foreign trade of each constituent member nation to be transformed into the domestic trade of the Union so that the ratio of foreign to domestic trade is much reduced. This has a double effect. (1) The fall in leakages of expenditures on imported goods causes the multiplier to be higher in the Union. This means that both Monetary Policy and Fiscal Policy are more effective in controlling domestic expenditures and so in controlling both Inflation and the tax base. But Fiscal Policy unlike Monetary Policy becomes less effective in controlling the Budget Balance. With a higher multiplier, a given rise in the rate of tax will have a larger effect in decreasing consumption expenditures and thus in restricting the tax base; and this will reduce the tax yield from any given rise in tax rate. (2) When interest rates are raised to fight Inflation, any consequential appreciation of the rate of exchange will have a smaller effect in reducing the cost of living in the Union in which the price of imports is a smaller component of the cost of living price index. This factor will reduce the effect of Monetary Policy on Inflation. For these reasons the relative effects of Monetary Policy on Inflation and of Fiscal Policy on Budget Balances will both be reduced by the formation of the Union, so that the case for exclusive assignment of Monetary Policy to the control of Inflation and of Fiscal Policy to the control of Budget Balance is doubly weakened.

to the need not to upset national fiscal plans for the maintenance of their wealth targets. Such a situation might automatically result if for other purposes the European Community needed to develop its own considerable budget and tax revenue, as for example would be the case if joint expenditure on a single defence force became part of the Community's function. But in the absence of such a development one would need to endow the Community with a Community rate of tax (such as a Community VAT) which it could vary in order to help to regulate the total of money expenditures in the Community, but the revenue from which would be assigned to the various countries in which the revenue was raised. What needs to be avoided is a European Central Bank issuing a single European Currency with the sole object of maintaining an Inflation Target in terms of that currency but without regard to any fiscal effects, the independent national budgets being subject to a scattered set of independent fiscal authorities acting without any regard to the inflationary or deflationary effects of their decisions.

I will cease the Ambidextrous waving of my two arms and reveal my Presidential decision which is to advocate something on the lines of the British proposal for the issue of an additional European currency which, following their notation, I will call a Hard Ecu. It seems to me to be a good way of reconciling as well as one can the conflicts which I have mentioned between the merits of a single European currency and of a set of independent national currencies.

Let me quickly state the main features of the proposals as I would like them to be made.[3] Let there be a European Central Bank with the responsibility of issuing a new currency, the Hard Ecu. Its duty would be to control the issue so as to stabilise in terms of the Hard Ecu an index of the rate of Price Inflation or alternatively, as I would prefer, an index of the

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3 The basic features of these proposals are described in the Appendix to this paper.

rate of growth of the Community's total Money GDP. Any member country or group of member countries could adopt the Hard Ecu as their national currencies thus forming a full monetary union with the European Central Bank as their single operative central bank. Any other member country would be free to link its currency to the Hard Ecu in a way designed to rule out unnecessary fluctuations in the Hard Ecu value of its national currency but to permit such exchange rate variations as were planned to maintain equilibrium between its own plans for Inflation Control in terms of its own currency and the European Central Bank plans for its Inflation Control in terms of the Hard Ecu. Such planned variations would need to have the agreement of the European Central Bank authorities. Personally I think that they might often take the form of a planned crawling peg between the national currency and the Hard Ecu, changes in the rate of crawl being agreed from time to time with the European Central Bank.

Such a system would allow for the early formation of a full monetary union by those countries which were ready and desired immediately to do so, for a period of adjustment for those who wished to do so but were not ready to do so, and for a continued use of a suitably controlled but variable linkage with the Hard Ecu for those countries who wished to maintain indefinitely the experiment of having one currency for domestic purposes and another currency for foreign transactions for one reason or other, such as a choice of different forms of Inflation or Wealth Target or a continuing divergence in wage and price setting mechanisms. The whole system would be a remarkable example of a new monetary experiment without, one would hope, nations which opted for one form of use of the Hard Ecu being regarded as superior or inferior to those who opted for another.

APPENDIX

THE BASIC FEATURES OF AN INDEPENDENT HARD ECU

The following are 12 basic features of the Hard ECU arrangements described in the last two paragraphs of the main text.

(1) Every currency system requires a Legal Tender by means of which obligations expressed in terms of the currency must in the last resort be met. The Legal Tender consists of Hard ECU bank notes.

(2) These bank notes are issued by a European Central Bank (ECB) with a strong independent Governor and Board of Directors.

(3) The initial assets and liabilities of the ECB are constituted in the following way. The National Central Banks (NCBs) pay into the ECB a proportion of their holdings of Gold and Foreign Exchange in return for Hard ECU deposit liabilities of the ECB. The assets of the ECB are further augmented by the payment into the ECB of Bonds or Bills denominated in Hard ECUs and issued by the National Governments and/or the NCBs of the constituent member countries in return for holdings of ECB Hard ECU deposit liabilities. The constituent governments guarantee the solvency of the ECB.

(4) All accounts, transactions, assets and liabilities of the European Community and of all its institutions and organisation are denominated in Hard ECUs. All tax payments or other payments by the National Governments to the Community's budget are thus payable in Hard ECUs.

(5) At the outset the existing ERM obligations of the National Governments are continued with the exception that the existing exchange-rate grid is

abolished and is replaced by an obligation to peg each national currency to the Hard ECU with the existing permitted margins of fluctuation. The grid which sets a separate linkage between each pair of national currencies is a clumsy method of controlling exchange rates. It was preferred to a direct linkage of each national currency with the existing Soft ECU because the grid required no currency to depreciate unduly in terms of any other currency (including the hardest currency in the group), whereas a linkage with the Soft ECU required only a performance no worse than the average of the currencies in the group. The existence of a Hard ECU makes the grid system unnecessary.

(6) The ECB sets an interest rate structure at which it will negotiate to borrow or lend Hard ECUs in transactions with the NCBs, the National Governments, the Community Organisations and a wide range of other financial institutions both inside and outside the Community.

(7) The obligation of the ECB is to raise or lower its interest rate structure in terms of the Hard ECU so as to stabilise an Inflation Index measured in terms of Hard ECU prices. This index could be a Price Index covering the total output of goods and services of all the member countries, or, preferably, an Index of the Money Value in terms of Hard ECUs of that total output of goods and services. For the construction of such indices national values would be converted into Hard ECU values at the current market rates of exchange.

(8) The obligations of the NCBs would be to preserve their ERM pegs on the Hard ECU by appropriate adjustments in their interest rate structures in terms of their own National currencies.

(9) The Governor and Board of Directors of the ECB

would not include the Governors of the NCBs. There would thus be no grey area of mixed responsibilities. The ECB would be responsible for setting Hard ECU interest rates to control inflation in terms of the Hard ECU. The NCBs would be responsible for setting national currency interest rates to maintain their pegs on the Hard ECU.

(10) It is essential that the ECB should be aware of the inflationary or deflationary effects of current fiscal policies and that Fiscal Authorities should be aware of the inflationary or deflationary effects of current monetary policies on their tax bases and so on their budgetary revenues. For this purpose there would be a process of continuous consultation between the monetary and fiscal authorities of the Community in order to coordinate monetary and fiscal policies so as to devise a joint strategy in control of inflation and of Budget Balances.

(11) The setting up of this ECB structure could be regarded as Stage Two of the Delors Report. The member countries which were ready and wished to do so could fix their pegs on the Hard ECU rigidly and irrevocably and could then adopt the Hard ECU in place of their national currencies. The NCBs of such countries would then become the local offices of the ECB. The system would be so flexible that not all member countries need adopt this full EMU solution at the same moment. Indeed a single country could at any time elect in agreement with the ECB to adopt the Hard ECU as its national currency.

(12) Any member country which wished to do so could continue indefinitely to link its currency with the Hard ECU without ruling out any possible future changes in the exchange rate between its national currency and the Hard ECU. For example, it could simply maintain its existing ERM obligations under which

any change in its peg would have to be agreed with the ECB. New forms of linkage with the Hard ECU could be devised to replace the ERM type of linkage. For example, a crawling-peg type of adjustment might be appropriate in certain circumstances. But the overriding rule would be that membership of the ECB group would be conditional upon the member country maintaining a linkage of its currency with the Hard ECU on terms which were accepted as suitable by the ECB.

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Books

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edited by Richard Dale, Woodhead-Faulkner, London, 1986

Governments and Small Business
Graham Bannock and Alan Peacock, Paul Chapman, London, 1989

Hume Reprints

1 The 'Politics' of Investigating Broadcasting Finance *Alan Peacock*

2 Spontaneous Order and the Rule of Law *Neil MacCormick*

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