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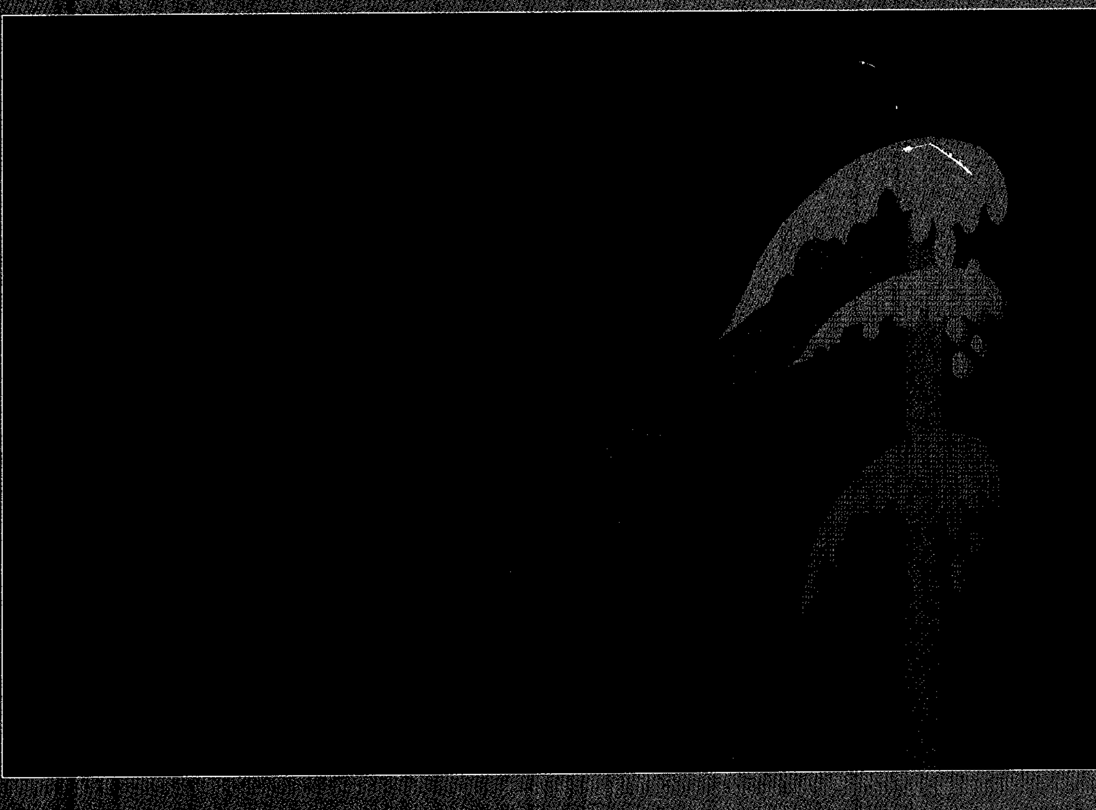
# PROCEEDINGS OF THE WORKSHOP ON ECONOMIC POLICY IN EUROPEAN INTEGRATION

*Edited by*
*Pekka Alajääskö   Seppo Leppänen*



VALTION TALOUDELLINEN TUTKIMUSKESKUS
*Government Institute for Economic Research*

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**ABSTRACT:** This issue of VATT-publications contains papers and comments presented in the workshop held on the 7th of November 1991 in Helsinki. In the first paper Reino Hjerppe analyzes European integration from the perspective of a small country. The second paper by Kari Puumanen and Antti Suvanto considers the role of the national stabilization policy and institutional flexibility in the Economic and Monetary Union. In the third paper by Peter van den Berg perspectives on economic growth, economic policy and European integration are outlined. The fourth paper by Rudiger Soltwedel studies structural policy reforms in the OECD countries. The fifth paper by Pekka Kosonen takes a look at the social dimension in the integration from the Scandinavian welfare states' point of view. Finally the panel discussion based on the papers is summarized.

**KEY WORDS:** European integration, economic policy, structural reform, social dimension.

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**TIIVISTELMÄ:** Valtion taloudellisen tutkimuskeskuksen 7.11.1991 järjestämässä seminaarissa tarkasteltiin yhdentyvän Euroopan vaikutuksia yksittäisen maan talouspolitiikkaan. Aluksi Reino Hjerppe analysoi Suomen talouden institutionaalisia puitteita tilanteessa, josta edetään ETA-vaihtoehdon kautta EY-jäsenyyden edellyttämiin muutoksiin. Kari Puumanen ja Antti Suvanto arvioivat kansallisen stabilisaatio-politiikan mahdollisuuksia talous- ja rahaliitossa. Peter van den Berg tarkastelee talouden kasvunäkymiä, talouspolitiikkaa ja integraatiota 1990-luvun Euroopassa. Rudiger Soltwedel tutkii muutospaineita talouden rakenteissa siirryttäessä integraation voimistamaan kilpailutilanteeseen. Pekka Kosonen valottaa integraation sosiaalipoliittisia ulottuvuuksia Pohjoismaisen hyvinvointivaltion näkökulmasta. Lopuksi raportoidaan yhteenveto käydystä paneelikeskustelusta.

**ASIASANAT:** Euroopan yhdentyminen, talouspolitiikka, rakennemuutos, sosiaalinen ulottuvuus.

## FOREWORD

The Government Institute for Economic Research periodically arranges workshops on current economic issues. The purpose of these workshops is to create a dialogue between research fellows from administration, universities and research institutes. In order to get international views for the discussion, prominent international experts are invited to participate in the workshops. The workshop on economic policy in European integration held on the 7th of November 1991 was the third of its kind. The subject is topical in Finland taking into consideration the controversy caused by the EC membership application. Hopefully the proceedings of the workshop provide valuable information for further debate on the subject matter.

On behalf of the Government Institute for Economic Research I wish to thank all the authors and discussants in the seminar. I owe special thanks to research director Seppo Leppänen and research officer Pekka Alajääskö for their conscientious work as editors, and to senior research officer Timo Hämäläinen for his indispensable help.

Helsinki, March 1992

Reino Hjerppe

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WORKSHOP ON ECONOMIC POLICY IN EUROPEAN INTEGRATION

Place: Paasitorni, Paasivuorenkatu 5 A, room numbers 302 - 304
Time: 7th November, 1991

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|---|---|---|
| 08.30 - | 09.00 | Coffee |
| 09.00 - | 09.05 | Opening remarks - Seppo Leppänen, VATT |
| 09.05 - | 10.00 | European Integration from the Perspective of a Small Country<br>- Reino Hjerppe, VATT<br>- Comments by Esa Härmälä and Pekka Sutela |
| 10.00 - | 11.00 | Stabilization Policy and Institutional Flexibility in an Integrated Europe<br>- Kari Puumanen and Antti Suvanto, Bank of Finland<br>- Comments by Pekka Sauramo |
| 11.00 - | 12.00 | Perspectives on Economic Growth, Economic Policy and European Integration in the 1990s<br>- P.J.C.M. van den Berg, Central Planning Bureau, The Netherlands<br>- Comments by Pentti Vartia |
| 12.00 - | 13.00 | Lunch |
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| 14.00 - | 15.00 | Social Dimension in Integration<br>- Pekka Kosonen, University of Helsinki<br>- Comments by Peter Boldt |
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## OPENING REMARKS

by Seppo Leppänen

The third workshop organized by the Government Institute for Economic Research will deal with the effects of changes in the international economic environment on the policy strategy of a small country. This issue is highly relevant from the Finnish point of view.

Finland has experienced in the past and will experience in the coming years substantial changes in the economic environment. The Finnish Markka was pegged to the ECU last summer in order to strengthen the fixed exchange policy, although there were many people in Finland who thought that the Markka was overvalued when linked to ECU.

Finland will tighten its foreign trade relations with the EC within the framework of the EEA agreement. I suppose that we will make an application to begin negotiations on full membership in the EC. The Soviet economic and political crisis will affect Finland more than any other Western European country. In addition the recession in our most important Western trading partners, especially in the UK and Sweden, has been deeper than on average in the OECD countries.

During the 1980s the relative size of the manufacturing industry has decreased substantially, and the size of the sheltered private and public sectors has correspondingly increased. Currently Finland is experiencing a deep recession characterized by high current account and government budget deficits. At the same time the rate of unemployment has reached a level never matched before. Although the long-term economic fundamentals are not bad at all, the economic recovery and the whole adjustment process will be long and difficult due to structural rigidities in the Finnish economy.

Many of the abovementioned issues are under debate in Finland. This workshop will partly intensify this ongoing discussion and the leading theme will be the European integration. I appreciate that besides our Finnish speakers Reino Hjerppe, Pekka Kosonen and Antti Suvanto we have two foreign guests, Peter van den Berg from the Central Planning Bureau of the Netherlands and Rudiger Soltwedel from the Kiel Institute of World Economics. We will get international experience and views for the Finnish discussion. I am sure we will have an interesting, inspiring and busy day.

# EUROPEAN INTEGRATION FROM THE PERSPECTIVE OF A SMALL COUNTRY

by Reino Hjerppe, Government Institute for Economic Research

## 1. INTRODUCTION

The recently concluded agreement between the EC and EFTA on the European Economic Area (EEA) will no doubt be of central importance for the Finnish economic policy framework during the 1990s. Participation in most parts of the EC Internal Market changes the general external economic framework in fundamental ways.

Finland's 1974 free trade agreement with the EC has already abolished tariff restrictions of the foreign trade in goods since 1984. The most important exception to this free trade principle has been the trade in agricultural products.

The EEA will extend the trade agreement between Finland - as a member of EFTA - and the EC to cover the trade in services (including the freedom of establishment in accordance with the treaty of Rome), capital movements and the free movement of labour. But even in the trade of goods there will be an important change in principles: non-tariff barriers, notably technical standards and norms, can no more be used as restrictions on trade.

Compared to EC membership the EEA agreement still leaves outside some very important economic issues. These include participation in the policy formation and decision making, participation in economic and monetary policy coordination, common external trade policy, common agricultural policy, tax policy and frontier controls and policy towards developing countries. In this paper these issues will be touched upon.

But before we go further it is advisable to take a brief look at the structure of the Finnish external trade, which may be helpful in understanding the Finnish external trade policy since the second world war.

## 2. STRUCTURE OF THE FINNISH FOREIGN TRADE

It is sometimes stated that EFTA is very important to the EC since it is the largest external trading partner of the EC, more significant than for example the United States or Japan. This is, however, to some extent misleading. This can be seen if we theoretically imagine that the world consisted only of the EC and EFTA countries, the EFTA trade would be 100 percent of the EC external trade and nothing would change otherwise. This would not imply that the EC is dependent on the EFTA trade since most of its trade would in that case be internal trade in the EC.

Strictly speaking EFTA cannot be compared directly with the US or Japan since EFTA is not a single country, but each EFTA country has its own independent trade policy towards third countries (Hamilton, 1991).

According to Hamilton a more realistic way to look at the situation is to remember that the EFTA countries' share of the EC's home demand was 3.5 percent in 1985. Of this 3.5 percent Sweden accounted for approximately 1 percentage point and Norway 0.3 percentage points. Finland's share lies between that of Sweden and Norway. On the other hand, the EC provided 12-13 percent of the Finnish home demand in the latter half of the 1980s. There is no doubt that - compared to the EC - EFTA is a "small country". In practically all cases the external demand and prices are given for an economy like Finland. Even in some of the most specialized export goods in the paper industry the Finnish share of the world trade is less than 30 percent.

From the Finnish point of view it is important to notice that the trade relationships have always been dominated by four countries: Sweden, Germany, the Soviet Union or Russia and the United Kingdom (See figures 1 through 4 in the appendix; see also Hjerppe, Riitta, 1989). At times there has been remarkable changes in the share of these countries, but in the long run they appear to remain dominant countries in the Finnish external trade. The combined share of these four countries has accounted for at least 50 percent of the Finnish exports and imports until the end of the 1980s, when the share of the Soviet trade started to decline considerably. Since these countries - especially after the Second World War - have belonged to different trading blocks, this is an important fact to recognize in order to understand the orientation of the Finnish external trade policy.

After the recent collapse of the Soviet trade the EC now accounts for more than 50 percent of the Finnish exports. In the future when Sweden joins the EC, this share will probably rise to around 65-70 percent (figures 1 and 2).

For example when EFTA was formed, Finland found it necessary to discuss the FINEFTA agreement closely with the Soviet Union. When the UK joined the EC at the beginning of the 1970s there was a strong need to strengthen economic ties with the EC. Because of the importance of the eastern relationships, however, there was political pressure to strengthen the eastern trade at the same time and Finland concluded trade agreements with several small socialist countries. These agreements have had minor significance in the later developments.

Looking to the future it is obvious that in the 1990s the Finnish trade relationships with the EC will be of crucial importance. On the basis of trade flows, further integration steps can be predicted.

## 3. EFFECTS OF THE EEA AGREEMENT

The EEA agreement opens an important possibility for the EFTA countries to participate in the EC Internal Market from the beginning of 1993. The principal effects of this agreement concerning trade in goods were already touched upon above.

One might have thought that the free trade in goods had already led to a situation where relative price levels converge in different countries. The empirical evidence now available shows quite clearly that this is not the case. Relative prices in Finland differ significantly from the average price structure of the EC countries (see figure 5 in the appendix). But perhaps more interesting is the fact that the price structures in Finland and Sweden, neighbouring countries with extensive economic ties, differ also remarkably (figure 6). Notable relative price differences also exist inside the EC and they indicate that free trade is not enough to remove price differences which seem to far exceed the differences due to e.g. the transportation costs.

Non-tariff barriers, like different technical standards, are obvious candidates to explain differences in relative prices. But these differences reflect also oligopolistic and monopolistic market structures and loose competition policies. For example, Kramer (1991) found that the price of passenger cars exported from Germany was clearly higher in the EFTA countries than in the EC countries. The market for passenger cars seems to be a seller's market, especially as far as the EFTA countries are concerned. In Austria Kramer found that the prices of imported consumer goods, especially of durables and technical equipment are further inflated by lack of competition in the domestic distribution networks. This has also been shown by an important EFTA study on "Price differentials in the European Economic Space" (Wieser, 1989). Although no studies have been undertaken in this area in Finland so far, there is some casual evidence that prices charged in the domestic market by firms in monopolistic situation are higher than their export prices. Inside the EC it was found that price dispersion of the durables in the German market was smaller than the price difference between different member countries. It seems that there exists a lot of possibilities for increased efficiency even in the trade of goods in the EEA. Since national norms can no longer be used as trade restrictions, one would expect the competitive pressure to increase considerably.

One of the important conclusions of the so-called new trade theory is that the potential benefits of the economic integration are greater in a situation of oligopolistic and monopolistic competition compared to fully competitive markets (Baldwin, 1991, see also Richardson 1989). Intuitively this sounds very reasonable if one assumes that less than full competition leads to inefficiencies and to waste of resources compared to competitive markets.

There are various reasons for this result. One of them is overinvestment in the domestic industries due to the import protection or noncompetition. Another reason is the deviation of relative prices in the domestic market from the world market prices. A third reason could be the transfer of extra profits and economic rents gained by multinational enterprises in the domestic market due to the lack of competition.

All these cases seem more or less relevant to a small, relatively isolated country like Finland. If this is so, one would in theory expect larger gains from the EEA in Finland than e.g. what is predicted in the Cecchini report, which is basically using the assumption of the fully competitive economies.

This kind of conclusion would seem, however, oversimplified. First of all the EEA does not include certain important elements of an internal market like a common agricultural policy and abolishment of the internal borders. These will be discussed later in connection with possible membership. EEA is still a kind of "halfway house" or rather a "two-thirds way house" to the Internal Market.

Secondly, the new trade theory has yet to give clear and exact predictions what will actually happen in integration with imperfect markets. The situation gives possibilities for strategic behaviour, the result of which depends on the specific circumstances which prevail on the market. The economic effects of integration cannot therefore be predicted on the basis of the theory, but remain an empirical issue.

Opening up the trade in services is a historically important innovation in the EEA agreement. The main areas include financial services, transportation and audiovisual services. The EFTA study concerning trade in financial services (EFTA, 1990) justifies the expectation of increased efficiency in banking and insurance sectors, which corresponds to the magnitudes found in the EC by the Cecchini report.

It is therefore interesting to see how competitive situation actually changes already in the EEA, for example in the service sector in Finland. In the services cultural factors, like language, are an important feature. Many services are therefore mostly locally produced and regional features are important. This may limit the pressure of foreign competition. In some of the services the scale economies are not very important. Due to the relatively limited market size foreign competitors may not be very interested in the Finnish market.

An important fact is also that the domestic competition law seem to remain more lenient towards noncompetitive practices than the EC legislation. The EC competition law applies only to the cases, where there exists a noticeable effect on the trade in the EC market. Many of the Finnish cases remain outside this effect and the less stringent national competition legislation may allow the old practices to continue.

Transport costs are very important to Finland situated far from the main markets of its export products. In the transport sector there is perhaps considerable room for increased effectiveness and structural changes. As long as this sector remains inefficient the domestic factor income generated by exports has to remain at a lower level in order for the exports to remain competitive.

The 1980s were already a remarkable period for the liberalization of the capital movements in Finland. The EEA will bring the abolishment of the last remaining restriction of any importance, that on foreign ownership, after a transition period. This is an important factor for future capital formation.

Free movement of labour will extend the traditional open labour market in the Nordic countries to the EEA. According to some estimates this is not expected to create large movements of labour to or from Finland (see e.g. Parviainen, 1991). The experience of the EC shows that labour movements have already stabilized to a considerable extent. For instance, an unemployed English car worker does not easily move to work in Germany. Like in other countries it is to be expected that there will be more movement in the management positions and this may apply also to Finland.

In any case the EEA creates historically one of the largest changes ever in the Finnish economic environment. To what extent this potential will be exploited remains to be seen. That depends essentially on the speed of the reactions of the economic agents, and about this we know relatively little so far.

## 4. TOWARDS MEMBERSHIP

In recent discussion the EEA has been more and more considered only as a temporary arrangement. The present Finnish government has not yet, however, determined its position towards the membership. On various occasions it has pointed out that it will do so in the near future.

In the following we consider some of the most important economic features of the EC membership compared to the EEA. These were already listed at the beginning.

### 4.1. Decision making

A problematic feature of the EEA agreement is that essentially the EFTA countries have to adjust to the developments in the EC without having influence on the decision shaping and decision making. The EC is a "Club" and in order to have a say in this club you have to be a member. In this respect the membership is by far superior to the EEA. The whole issue here is, however, relatively sensitive to the EFTA countries, which traditionally have emphasized their sovereignty. This has even been seen as an important hindrance historically for closer cooperation between EFTA and EC (Wijkman, 1990).

Most of the decisions in the EC are nowadays made by qualified majority voting. Even though the voting power of all the EFTA countries would remain rather modest, one has to notice that currently small countries have more votes in the EC Ministerial Council than what their size of the population would warrant. For example Finland would need only about 1.7 million citizens per EC vote - like Denmark - whereas Germany needs more than 8 million citizens for one vote and France needs 5.5. million for one vote.

Hamilton (1991) has made an interesting exercise regarding what would happen to the EC policy orientation if all the Nordic countries were members of the EC and if these countries behaved as a block (which is a big if). Hamilton considered three issues: attitude towards supranational authority, external trade policy of the community and attitude towards environmental protection policy.

Hamilton assumed that the Nordic countries would join the UK, Denmark and Ireland in a block against supranational authority. In this case the Nordic countries would change the policy direction, since they would form together with the abovementioned 3 countries a blocking minority.

In the external trade policy - assuming that the Nordic countries follow a liberal trade policy as opposed to the protectionist policy favoured by France, Spain, Italy and Portugal - there would be no change in power coalitions.

In the environmental policy the Nordic countries - assuming that they would favour more stringent environmental policy - could also be able to form a blocking minority together with Germany, Belgium, the Netherlands, Denmark, Luxembourg and Austria. In none of the three cases would the Nordic countries change the position of the qualified majority inside the community. The examples of Hamilton are illustrative even though rather theoretical.

## 4.2. External trade policy

A member country would need to adopt the EC common policy on external trade and join the EC customs union.

In general that would require a rise in the average level of tariffs in the EFTA countries from an average of 2 - 3 per cent to the 4 per cent existing in the EC (Hamilton, 1991). According to the recent estimates of the Finnish Customs Bureau, the structure of the Finnish customs border will closely resemble that of the EC. In Finland the level of tariffs is higher in the processed goods and lower in raw materials than in the EC. At the macro level this probably would not have any major impact. It might, however, have some important micro effects. On the other hand, the rules of origin would be simplified.

More important would perhaps be that the EFTA countries should adopt also the possible remaining quantitative restrictions which remain after 1993 towards third countries. These may include consumer durables and cars from Japan and other newly industrialized economies. These may create some loss of consumer surplus.

Common trade policy will bring also common policy towards associated members like Turkey, Cyprus and Malta, towards Mashreg and Maghreb countries, as well as towards Israel and developing countries.

It is interesting to note that in spite of the common trade policy there even seems to remain some room for an independent national trade policy (Winters, 1991). This applies, especially, to the agricultural policy where the "green ecu" is used and where there are some special arrangements like hillside farming for the UK.

### 4.3. Economic and Monetary Union

EC is moving towards Economic and Monetary Union (EMU) at a speed which only a few years ago would have been considered as quite breathtaking. A country applying for membership has to consider the EMU seriously.

There is little doubt that the overall benefits of the EMU in Europe would be substantial. EMU is a logical consequence of the development of the Internal Market, because a truly real Internal Market with different currencies is quite a cumbersome construction. The EC Commission does not want to quantify the effects of EMU - unlike the effects of Internal Market, which was done in the famous Cecchini report. The Commission estimates, however, that the effects of EMU are probably at least as great as those of the Internal Market. One of the major effects, the abolishment of the exchange rate risks inside Europe is of great importance for the investment and other activities of the enterprise sector. This is confirmed by the opinion polls carried out by the Commission. But the EMU will fundamentally change the economic policy environment of individual countries in many different ways. The Commission has evaluated effects of 16 different types. (One market, one money, 1990).

The recent pegging of the Finnish markka to an ecu-basket has revealed, that there is still a need for considerable adjustment process in the Finnish economic policy formation. Especially, this concerns the adjustment to the "German" inflation norm of 2 - 3 percent. The need for adjustment is seen quite clearly by looking at the Finnish inflation history: during the past decade the annual inflation rate has been more than 6 percent. The time for adjustment is very short if one assumes that the EMU will be realized already in 1997. At that time the rate of exchange should be at a long-term equilibrium level and the expectations of the economic agents should be consistent with the low inflation target set by the European Central Bank. Adjustment problems in the EMS have been discussed e.g. by Haaparanta (1991) and with special reference to the Finnish case by Sauramo (1990). Both authors find critical arguments against the EMS. Due to the lack of factor movements Finland may not function very well as an optimum currency area. Some also see the wide fluctuations in the terms of trade as a problem (Korkman, 1989). But the recent experience with uncertainty about the exchange rate policy has also clearly shown that it will be extremely costly for a small country to try to live under a flexible exchange rate regime in an larger environment which aims at the fixed exchange rate. The difference between the 3-month interest rates in Finland and Germany has varied during the recent years from 4 to 7 percentage points, which clearly surpasses the corresponding difference in inflation. This level of real interest rate seems quite unbearable in the long run.

### 4.4. Common agricultural policy

One of the central issues of the possible EC membership is the participation in the common agricultural policy, CAP.

According to the most pessimistic views participation in CAP would be catastrophic for Finnish agriculture. According to these views the geographical situation in Finland allows no comparative advantage in agriculture.

Obviously this is an issue which needs very careful study. Some remarks can be, however, made already now.

First of all one has to remember that CAP is carried out in a protected environment. Looking at the price levels of the food CAP seems to have generated a kind of "middle level" solution (see figure 5). The lowest food prices can be found in the most efficient producer countries, like the USA, Australia and New Zealand in addition to some developed countries. CAP seems to have spawned a somewhat higher price level, which is , however, clearly lower than the price level in the EFTA countries, which have followed purely national agricultural policies. The CAP has therefore been from the consumers' point of view clearly more advantageous than a purely national policy.

It is interesting to notice that in some products - according to recent studies - the Finnish producer prices were even somewhat lower than German prices in 1980. In 1990 the Finnish producer price level was , however, about two to three times higher than the German one. The development of the 1980s went clearly along a very different path in Finland compared to that of the EC. But one has to realize that concurrently with the rise in the price level also the costs went up, so that the opening up of the market would reduce not only the prices but also the costs. In any case the adjustment problem in agriculture seems to be larger now than ten years ago.

Roughly speaking the relative competitive position of Finnish agriculture is better in livestock production than in crops. This is shown already by the OECD calculations of the agricultural support. This comparative advantage situation also prevailed already in the 19th century agriculture, according to studies of economic history (Hjerppe, Riitta, 1989).

Even though the adjustment problem for the CAP is great, one could still expect to find some competitive branches even in Finland. On the other hand, there is some pressure for reforms in the CAP. At the moment it is difficult to know to what extent the reform plans will be carried out.

## 4.5. Taxation

In taxation there is a need for harmonization of indirect taxes. This applies to both VAT and excise taxes. The future harmonization needs for capital income taxation and corporate taxes are at the moment an open question. Income taxation is left outside the tax harmonization.

Even if the geographical distance allowed some variation in the levels of indirect taxes, there is, however, a strong competitive pressure for tax levels to approach agreed minimum levels. On the other hand, the current situation in the EC seems to allow widely different tax structures even among the present members. One could therefore expect, that it will take some time before tax levels will be very close to each other. In any case, taxes explain only a relatively small part of the differences in the relative prices.

## 5. CONCLUDING REMARKS

Evaluations regarding the effects of EC membership for Finland have gained increasing attention in political discussions. Above we have reviewed some of the major issues which are relevant when considering the membership compared to the EEA. In principle differences between EEA and EC membership can be listed in a relatively straightforward manner. It also seems plausible, that e.g. in agriculture the producer's surplus would diminish, but the consumer's surplus would be increased. There are also considerable adjustment problems due to the changes in economic policy framework and public finances. One interesting question is how big adjustments in relative prices will already happen owing to participation in the EEA. There are reasons to believe that some of the expectations of the EEA concerning e.g. the competitive situation discussed above may not materialize. In that case the effects of the Internal Market will be realized fully only in the membership alternative, when the market will become "truly" homogeneous. For example, membership may be highly relevant for possible direct investments from the EC area to Finland. If this is so, the overall benefits of the membership are bigger than a static comparison of alternatives would indicate.

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**Appendix**

**Figure 1.**

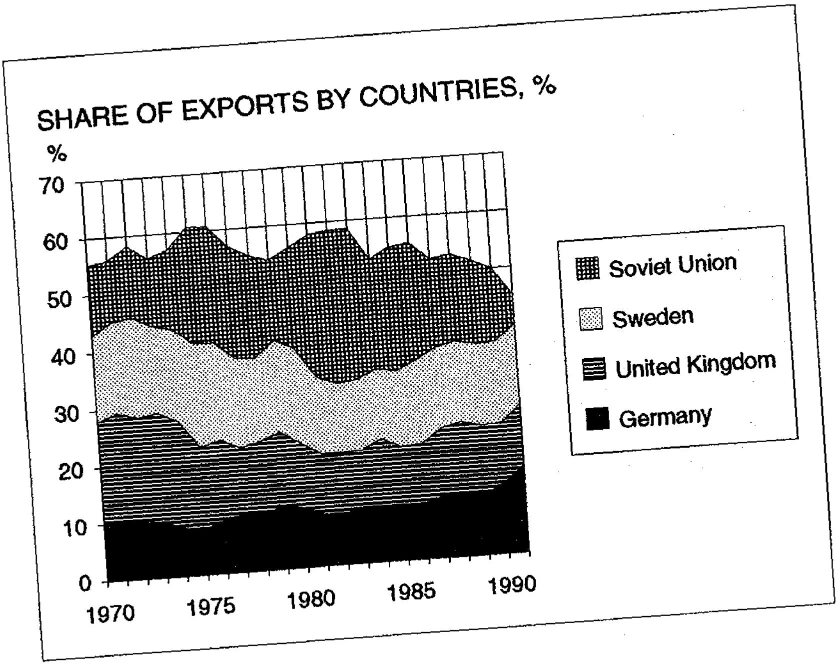



**Figure 2.**

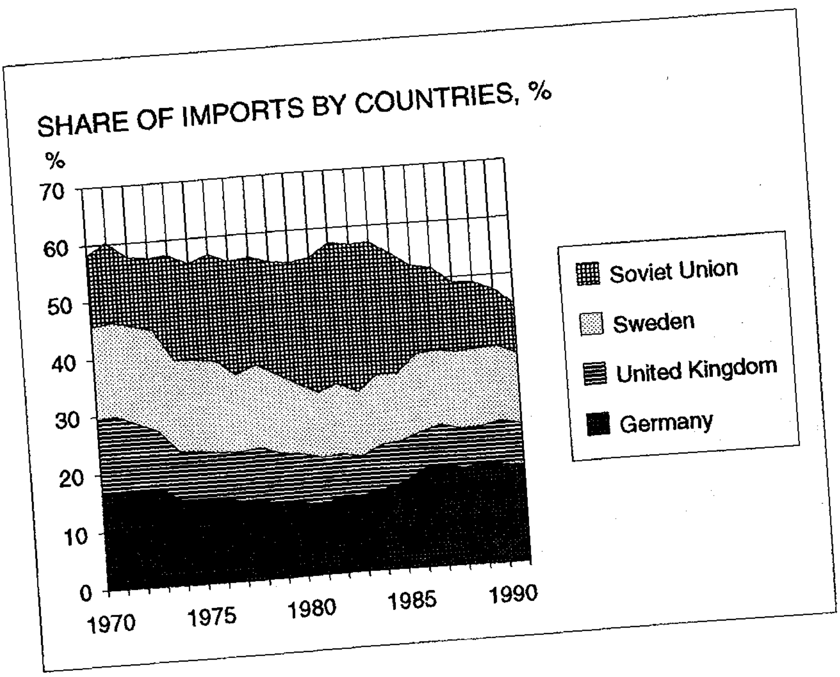


Figure 3.

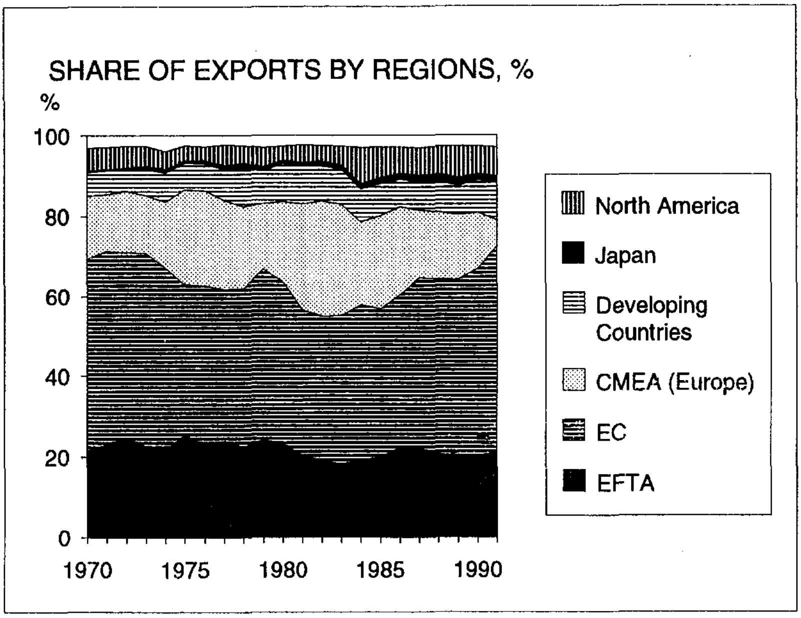



Figure 4.

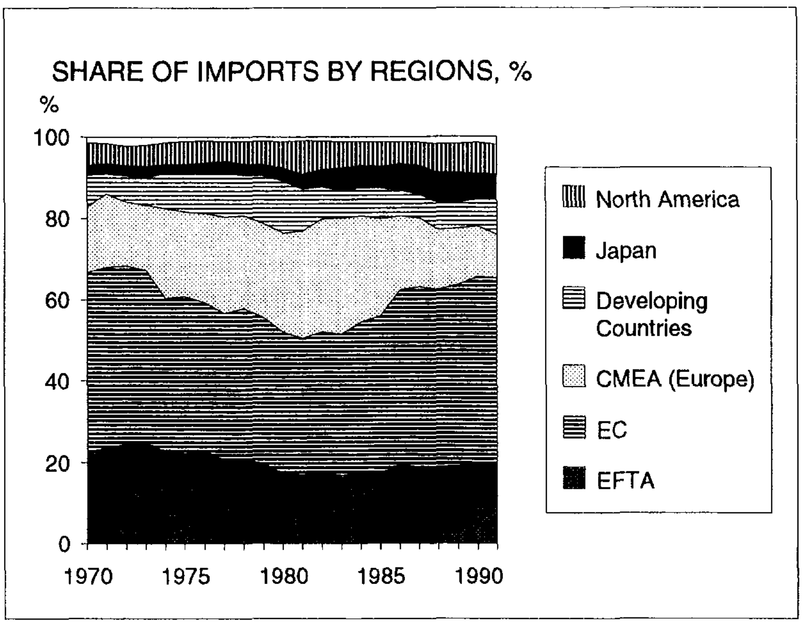
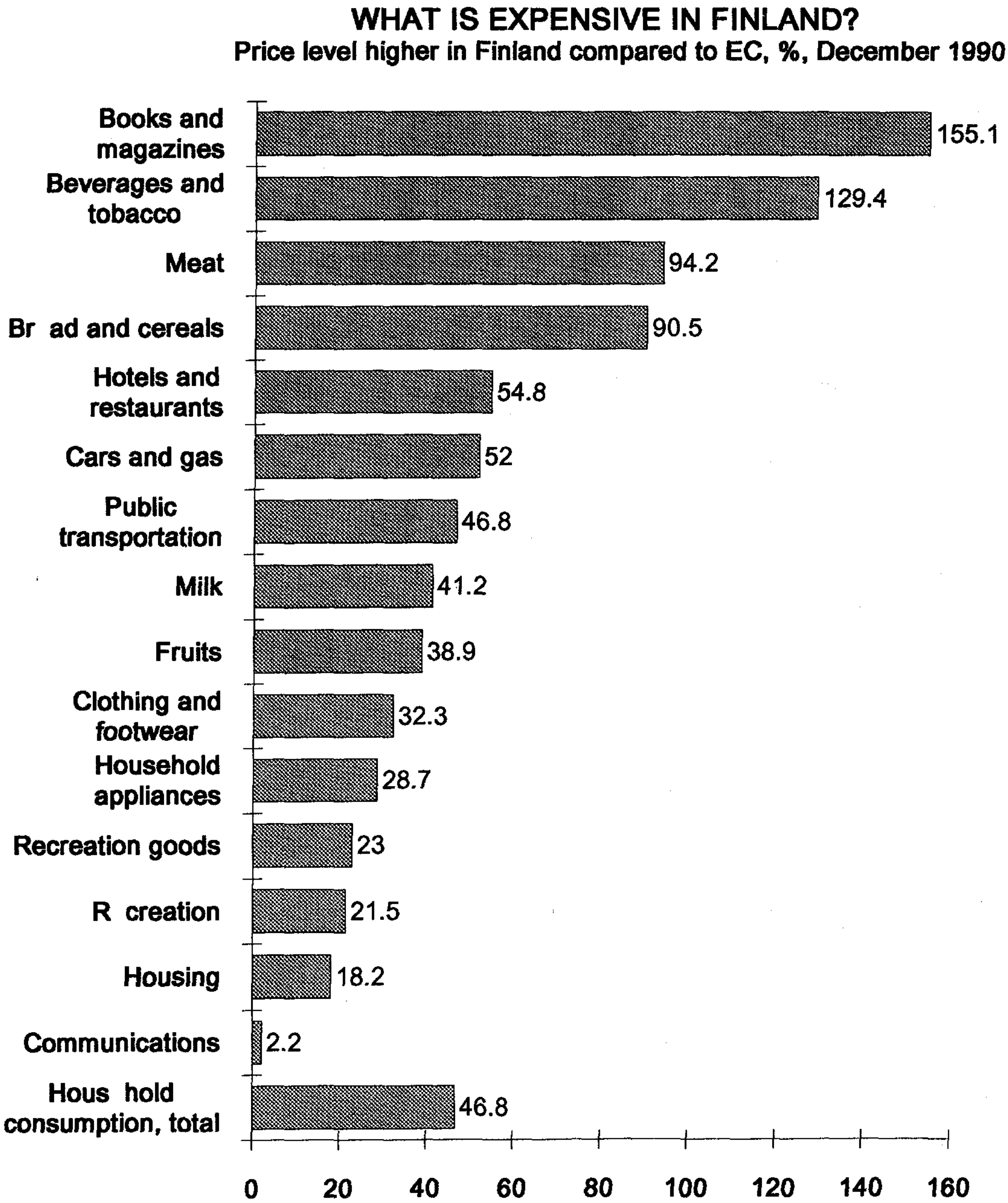
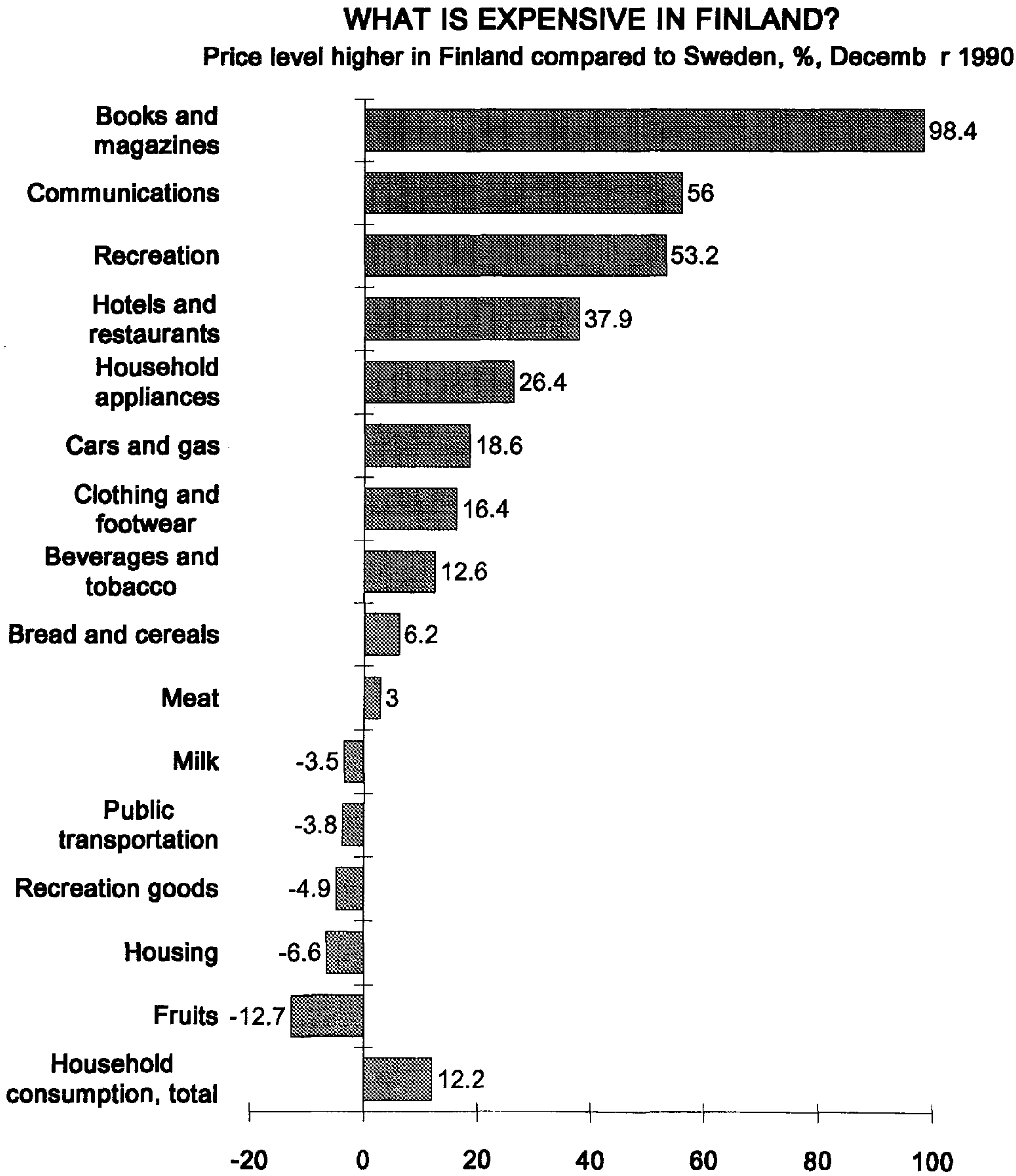


Figure 5.




Source: CSOF

Figure 6.




Source: CSOF

## COMMENTS AND DISCUSSION

**Esa Härmälä:**

Härmälä made three comments on Hjerppe's paper. Above all he was worried about Finland's role in the EC decision making. He agreed that full membership would increase Finland's influence on the EC decision making to some extent, especially if the matter was considered from the theoretical point of view. However, he stressed that Finland would be a decision taker rather than a decision maker even if Finland were a member of the EC. He was of the opinion that the membership inevitably would lead to a loss of policy autonomy in virtually all relevant areas, especially in economic policy.

Secondly, he pointed out that EC membership would oblige Finland to learn to act in accordance with a German type of a disciplined economic environment. He also pointed out that there was a free trade arrangement between the Soviet Union and Finland and maybe in the future this agreement was of some value. There may be new chances to increase the Finnish-Soviet trade, especially the trade with the St Petersburg area in Russia. EC membership would create a trade barrier between Finland and the Soviet Union, and maybe this trade barrier would make it more difficult to take advantage of these possibilities.

Thirdly, Härmälä considered the role of agriculture in Finland. History has taught us that without exception every country that has joined the EC has been forced to accept the EC's common agricultural policy. This would doubtlessly bring great changes and adjustments in the Finnish agriculture, especially in crop growing. On the other hand, special arrangements might be possible in order to facilitate adjustment of the national agricultural policy to the common EC agricultural policy. For example, Portugal and Spain have been granted long transition periods and in addition they get subsidies from the EC's structural funds.

**Pekka Sutela:**

First, Sutela commented on Härmälä's idea that as a member of the EC our interests in the Soviet markets might be in danger. Sutela maintained that even the Soviet Union might seek EC membership already within the next five years. Even if the Soviet Union does not do this, there is little risk of jeopardizing our interests in the Soviet markets provided that they kept on modernizing their society and creating a new market structure in the Soviet Union so that it would be a more open society in the future. If they decided to reverse the direction of the progress in the Soviet Union, it would not in that case be a market area of great importance to anyone according to Sutela.

Secondly, Sutela pointed out that considering the future role of the Central East European countries one had to remember that historically these countries had been an essential part of Europe excluding the period after the Second World War until now. Thus an ultimate goal for these countries is full membership in the EC. This sounds natural from the historical point of view and also since these countries need a nominal anchor of stability.

Sutela also noted that the small share of votes that Finland would have as a member in the EC decision making would be of minor importance for Finland, since it would almost always be possible to form coalitions with the countries of similar interests to affect unfavourable decisions.

**General discussion**

Pentti Vartia did not agree with Sutela's assertion that the Soviet Union as a whole would join the EC any time in the near future. The Soviet Union could probably rather ensure its interests inside the EC by some free market area type of agreements. He thought that a more likely influence coming from the Soviet Union and from the other former eastern block countries on Finland would be an inflow of labor in high numbers and we should be ready to cope with this.

Rudiger Soltwedel pointed out that in the near future the EC's agriculture would be under great pressure from the east since big farms in the former eastern block countries were better suited for efficient farming than the small size farms in the EC. As an example he mentioned the cheap meat coming from Poland to the EC markets. These countries according to Soltwedel have a considerable comparative advantage not only in agricultural products but also in the production of textiles and chemicals. He wanted the EC to be more willing to assist and less protectionistic in the difficult transformation process.

Soltwedel also made a comment on the Finnish discussion concerning the exchange rate policy. He noted that the Economic and Monetary Union (EMU) would lead to the reduction in the exchange rate risk of the currencies in the union. He also noted that if the goal was to have stable economic conditions in Finland, why not start immediately to pursue a stability-oriented policy, since sooner or later inflation and productivity growth in Finland would have to be in line with those of the EC if Finland is planning to seek EC membership.

On the other hand, he warned not to peg the Finnish Markka to the ECU at a wrong level. The UK pegged its currency to gold at a too high a level after the First World War. Pegging at a wrong level can create considerable economic costs when adjusting to the stable economic conditions.

Kari Alho asked what kind of trade restrictions were currently in use between the EC and the Soviet Union. He wondered if, for example, tariffs were used.

Reino Hjerppe commented on Alho's question by noting that there were no free trade arrangements between the EC and the Soviet Union. In addition, he pointed out that tariffs are only used when the trade is between two market economies, i.e. when the trade is based on market determined prices. It is difficult to say what effects a tariff has when prices are determined administratively.

# STABILIZATION POLICY AND INSTITUTIONAL FLEXIBILITY IN AN INTEGRATED EUROPE

by Kari Puumanen and Antti Suvanto, Bank of Finland

## 1. INTRODUCTION

We define stabilization policy as the use of monetary or fiscal policy instruments to stabilize cyclical fluctuations in economic activity. The fluctuations may arise from external shocks, such as changes in foreign demand and foreign inflation, internationally determined changes in relative prices and production technologies. Internal shocks, such as productivity changes, labour market disturbances and political changes may be equally important.

Economic policy itself has frequently been cited as being a major source of economic instability. Macroeconomic forecasts may be wide of the mark or benevolent but misinformed politicians may make grave errors or be misled by powerful pressure groups. Politicians, in seeking votes, may be tempted to step on the accelerator as the next election approaches. There may be wide disagreement among politicians and the public at large as to the weights in the objective function.

Because shocks and the induced reactions of politicians come in many forms, it is impossible for a policy planner to find workable solutions for all possible macroeconomic imbalances. On the other hand, some strategies and regimes may be more conducive to stability than others. It is up to the politicians to decide upon the strategy and the regime under which the economy operates. The choice may not be an easy one because the options may be few and none of them may be what the politicians might prefer as such, given their prior experience and the vested interests of their constituencies. The *status quo* might be the first choice of many, but it might not be one of the available options.

The EC countries have made a political commitment to achieve, within a relatively short time, an internal market and monetary union. The EFTA countries have negotiated an agreement on close economic integration with the EC, and some of these countries have already applied or announced their intention to apply for full membership of the EC. These commitments have been made without firm knowledge of what the future environment will be like. There is wide belief that deeper integration will bring about important benefits, but nobody is quite sure how large these benefits will be. At the same time, there is wide agreement that the adjustment may be difficult for some groups and that a loss of policy autonomy in many important areas will be one of the costs of integration.

In the following, we will discuss some traditional themes related to stabilization policy in an integrated Europe from the point of view of the Nordic countries. Our starting point is that Europe will in the foreseeable future be characterized by high and increasing degrees of monetary integration (fixity of exchange rates) and financial integration (free capital movements), while economic integration, though still deepening, will remain incomplete in some important areas, such as labour markets and government services and transfers. It is these differences in the degree of integration in various areas, and the tensions that result, that make it meaningful to consider stabilization policy issues in Europe to be somewhat different from those encountered among countries in less integrated areas or within federal states, such as the U.S. and Canada.

We will be selective, and we do not claim to have definite answers to any of the issues raised in the paper. We do not regard an integrated Europe as a paradise, nor need it be an optimal arrangement from the theoretical point of view.

To the extent that deeper integration and monetary union provide a more stable environment and enhance policy discipline, the need for activist stabilization policies may be reduced. On the other hand, the complete loss of monetary policy autonomy may make it more difficult to accommodate certain asymmetric external shocks, such as country-specific terms-of-trade changes. On the other hand, one could argue that monetary and exchange rate policies have not been conducted in an optimal fashion in the past; in fact, they have frequently been held to be a source of policy-induced asymmetric shocks. A wide range of issues remains open as regards the role of national fiscal policy in an integrated Europe. Fiscal autonomy will not be completely lost, although it will face new constraints. On the other hand, economic and monetary union combined with non-federal fiscal policies may aggravate the difficulties arising from asymmetric shocks.

## 2. A CURRENCY AREA AND ASYMMETRIC SHOCKS

That irrevocably fixed exchange rates put an end to independent monetary and exchange rate policy is not disputed. Indeed, it is one of the stated objectives in the proposals for creating EMU. To some extent, the regime shift as such (via stabilizing expectations) may reduce the need for stabilization policies. But the likelihood of external shocks and cyclical variations in the equilibrium real exchange rate remains.

It is frequently stated that the EC does not fulfil the preconditions of an optimum currency area as defined by Mundell (1961). Although the evidence is somewhat mixed, on balance it indicates that the real exchange rate variability seems to be greater and factor mobility lower than in large federal economies, such as the U.S. and Canada (Eichengreen 1990a, 1990b; De Grauwe and Vanhaverbeke 1991). This argument as such would suggest that some exchange rate flexibility is advisable for EC countries, which, in fact, is permitted by the present ERM arrangement.

In the early years of the EMS, the potential for flexibility was exploited by frequent realignments. It has, however, not been documented that France, Italy, or Denmark suffered from adverse asymmetric shocks in the early 1980s, when their currencies were devalued in ERM realignments. The OPEC II shock was a fairly widespread and symmetrical shock for all the ERM countries. Neither do the later realignments, nor the minor exchange rate movements within the permissible fluctuation ranges, point to asymmetric external shocks. Therefore, the greater observed variability in real exchange rates in Europe than in North America to a large extent reflects either domestic policy-induced disturbances or stubborn differences in inflationary expectations and in the social preference for price stability as revealed e.g. by the behaviour of the labour market institutions.

Asymmetric policy disturbances may thus partly reflect differences in policy preferences, which in turn may reflect differences in political and economic institutions and structures. Those countries in which the institutions and structures remain unchanged and which repeatedly experience domestic policy-induced disturbances will face difficulties by being members of a currency union. The ultimate choice, therefore, is whether to accept policy convergence and the required institutional and structural changes or whether to stand alone. Neither option may be desirable, given the political preferences, but the choice cannot be escaped.

Asymmetric exogenous shocks may be large or small, temporary or permanent. If they are comparatively small and temporary, it should be possible to manage the adjustment problems within a currency union by means of fiscal policy measures or by automatic stabilizers. If they are large or permanent, the country will have to adjust in any case. There is no optimal stabilization rule for such cases even in theory. It is nevertheless true that in most cases a change in the real exchange rate is a necessary part of adjustment. If nominal exchange rate movement is prevented, then the effect must come through price changes. In many cases, a change in the real exchange rate is not sufficient. Some important relative prices (across industries or sectors) may have to change as well.

Large and permanent asymmetric disturbances are not very common, but they do occur as a result of, for instance, technological innovations or major political changes. German unification is one recent example of a major permanent shock within the EC area. Its impact is greater for Germany than for other countries, but given the present state of integration and the present commitment to fixed exchange rates within the ERM, the impact is being transmitted to other members in a manner which from their national point of view may not be optimal.

Unification requires a resource shift in Germany from net exports to domestic use, which in turn implies a real appreciation of the Deutschemark. With flexible exchange rates, this could have been achieved by tight monetary policy in Germany and unchanged monetary policy in other EC countries, which would have led to the nominal appreciation of the Deutschemark *vis-à-vis* the other EC currencies. Given the very limited scope for exchange rate flexibility in Europe, the adjustment has been confined to some exchange rate changes between Europe as a whole and the rest of the world with the result that inflationary pressures in Germany and in her vicinity and deflationary pressures elsewhere in Europe have increased. The consequent tensions within the EMS may be regarded as a test of the system's robustness.

Depending on fiscal policy reactions, the pressures within the EMS may be reversed in the future because of reduced wealth accumulation in the unified Germany. At the same time, a major new challenge to stability will be presented by the incorporation of the former socialist countries into the European economy. Unlike the case of German unification, a commitment to fixed exchange rates *vis-à-vis* these countries is not a constraint on adjustment. But the mere liberalization of trade with the former COMECON countries may affect the equilibrium real exchange rate structure in western Europe to an extent that requires painful adjustments in nominal incomes. For these reasons, the envisaged convergent path to monetary union now looks more bumpy than it did a few years ago.

As pointed out by Melitz (1991), the Commission report *One Market, One Money* (EC 1990) puts too much stress on the symmetry of the high-income member countries, as well as on the role of intra-industry trade. Although it is true that the terms of trade between these countries have been fairly stable over longer periods, there have been important changes in relative prices between sectors. These changes require resource reallocation in a number of countries, although the degree of required adjustment may vary across countries depending on their initial positions and differential wage and price responses, as well as on their tax structures. For this type of adjustment, exchange rate changes would probably be counterproductive.

One can draw the conclusion that what is needed is greater institutional flexibility, which facilitates changes in relative prices, both across countries and across industries. It is as yet unclear how this could be achieved because, depending on the situation, the governments of individual countries may face the temptation to resist such changes through subsidies and distortionary taxes.

## 3. A NORDIC PERSPECTIVE

Recently, Norway, Sweden and Finland have all linked their currencies to the ECU. By these unilateral decisions, the governments concerned have wished to reinforce their commitment to fixed exchange rates, although the width of the fluctuation range varies across the countries. The three countries are in the process of moving towards deeper integration in the EC, as evidenced by the EEA agreement. Sweden has already announced her intention to apply for EC membership.

In the past, all these countries have shown large real exchange rate variability *vis-à-vis* the ERM currencies, owing to difficulties in controlling inflation and to large discrete devaluations. There is evidence that many of the shocks in the past have been policy-induced, although in a number of cases one can trace their origin to some external event.

In the 1980s, all three countries, but notably Norway and Finland, were hit by asymmetric external shocks. The sharp decline in oil prices in early 1986 hit not only the oil-producing Norway but also Finland because of the effects of oil prices on her bilateral exports to the USSR. In the subsequent years, Finland benefited from improving terms of trade in her western trade as export prices rose at a rapid rate. More recently, Finland has been severely hit by the collapse of the Soviet economy.

Finland and Norway, but also Sweden to some extent, are resource-based economies, and hence they are likely to be vulnerable to asymmetric disturbances in the future as well. As such, they do not appear to be the best candidates for currency union membership. But what are the options?

According to currency area literature, Finland and Norway should adopt a floating exchange rate regime. Under conditions of free capital movements, the fixed exchange rate regime with occasional discrete devaluations and revaluations is not an easy alternative, because of potentially huge speculative capital movements. For example, if the terms of trade improved and the economy started booming, interest rates would decline in anticipation of a discrete revaluation. The effect would be strongly procyclical, and it could only be prevented by a sufficiently early (over)adjustment in the exchange rate, which would hardly be politically acceptable. After the revaluation there would soon be an expectation of a discrete devaluation, which would push interest rates higher, probably just at the time when the slowdown was already at hand. The overall result might well be highly destabilizing.

Floating might do the job in a more stable fashion, but the precondition for it is that the central bank should have some nominal anchor for inflation expectations. Furthermore, such an anchor (e.g. the money supply) should be credible in order for it to stabilize expectations. In countries where the exchange rate has traditionally served as the intermediate target for monetary policy, credibility and general acceptance of monetary targeting would be difficult to achieve. One could also argue that in countries with centralized labour market organizations the exchange rate is a more transparent norm for wage settlements than the money supply. In addition, the small size and thinness of the domestic and international markets for the Nordic currencies, as well as the potentially unstable demand for money functions, imply that clean floating with monetary targets is not an available option in practice. This arrangement would most likely result in very volatile monetary conditions. Thus only heavily managed floating would be possible, which in turn would make the system liable to destabilizing speculation similar to the fixed exchange rate system with discrete changes.

As a counterfactual illustration, if, in the early 1980s, Norway had had long experience of floating with a credible monetary anchor, it would have experienced a strong and timely nominal and real appreciation during the oil price hike. Similarly, it would have witnessed strong depreciation in early 1986, when oil prices collapsed. Instead, what happened was a real appreciation in the form of accelerating inflation (which was further fuelled by a discrete devaluation in 1982). The discrete devaluation in 1986, although justified by terms-of-trade movements, did not boost competitiveness in the traded sector, because its impact was felt almost immediately in inflation.

An almost identical counterfactual story applies to Finland for the period 1986 to 1990. If there had been a floating exchange rate regime with a credible nominal anchor, the Markka would have appreciated strongly in 1987, inflation would have remained low and interest rates would have risen. The process would have been reversed in 1989 or in early 1990, when the first signs of weakening external demand started to have an effect.

An anchor for inflation expectations can be created by constraining the floating to a currency band, but again the precondition is that the band is credible. If the band is credible, then the position of the exchange rate within the band should be negatively correlated with the expected future exchange rate, thus allowing some autonomy for monetary policy (Svensson 1991). As a credible arrangement, it should serve as an automatic stabilizer, because the exchange rate would appreciate automatically as demand pressures gathered momentum. In theory, such a currency band system, or more generally, any type of monetary policy commitment that gives rise to recursive exchange rate expectations could be considered to be an ideal countercyclical device for small economies with structurally volatile export sectors. A positive shock in the external sector, leading to an appreciation of the currency, would also give rise to an expected future depreciation and thus a rise in domestic interest rates. A cyclically overvalued currency would help relieve excessive pressures in the export industry while the rise in interest rates would check the spill-over of excess demand to the sheltered sectors. But all depends on expectations behaving in a specific, predetermined way. The experience so far in this respect is not very encouraging.

The three Nordic countries each have a currency band and a unilateral commitment to defend it. The experience shows that the autonomy created by constrained exchange rate flexibility is very limited (Kontulainen *et al.* 1990). In addition, each country, most notably Finland, has experience of lack of credibility in the band.

Whatever the degree of exchange rate flexibility under constrained floating, successful stabilization policy cannot be achieved by monetary policy measures alone, if fiscal policy is not attuned accordingly. If for any reason, good or bad, fiscal policy is loose and monetary policy is restrictive, the outcome will be a combination of high interest rates and an overvalued currency. This would eliminate, wholly or partly, the expansionary effects of fiscal policy, but also lead to a structurally unfavourable outcome by crowding out exports and investment. If monetary policy could not be tightened further because of the band constraints, fiscal expansion would lead to external imbalance and overvaluation through inflation and thereby, sooner or later, to growing unemployment.

The governments of the three Nordic countries have already announced that their strategy is to move towards deeper integration with the EC, including monetary integration. They have also tied their hands as far as monetary policy is concerned. It may, therefore, be too late to speculate on whether or not the strategy is an optimal one, except as an academic question.

As the above examples illustrate, the stabilization policy experiences of these countries hardly represent optimal policies.

Resource-dependent countries, such as Finland and Norway, are likely to face asymmetric terms-of-trade shocks in the future as well. The question therefore arises as to whether there are any instruments left which national authorities can use to adjust to such shocks.

First, it is important to note that the countries concerned are not entirely specialized in production and generalized in consumption. Only a part of the traded-goods sector is resource-based, while the rest of industry is more or less similar in structure to that of the EEA. There may, nevertheless, be relative price changes, which are determined internationally, but which affect the terms of trade of these countries asymmetrically. It is also a typical feature of capital-intensive industries that variations in global excess demand not only give rise to relative price changes but result in cyclical variations in capacity utilization as well. Therefore, in terms of income generated in the resource-based industries the disturbances can be quite sizeable. Since these disturbances often occur because of global under- or overinvestment in new plant, the timing of the shocks is industry-specific and need not coincide with the general cyclical pattern in Europe.

Assume, for instance, that the relative price of forest-industry products rises and the terms of trade in Finland improve. This requires real appreciation of the currency, though the change in the equilibrium real exchange rate is proportionately less than the terms-of-trade improvement (Suvanto 1982). If the exchange rate is flexible and money supply is kept constant, real appreciation takes place through nominal appreciation. If the exchange rate is fixed, it takes place through higher inflation. In both cases the outcome is the same: the resource-based sector experiences a boom while other traded-goods industries suffer from deteriorating competitiveness ("Dutch disease" problem). What happens to employment depends on wage flexibility and cross-sectoral factor mobility, as well as on fiscal policy reactions.

The point here is that aggregate stabilization measures do not solve all the problems when the shocks hit various sectors of the economy asymmetrically. This holds equally for countries which want to stand alone and let the currency float and for countries which decide to join a currency union.

While wage flexibility and factor mobility will alleviate the adjustment process if the shock is permanent, it is unlikely that sectorial resource movements would be quick enough when the shocks are known to be temporary. In principle, fiscal policy could be used in the case of temporary shocks. It could also be used to even out asymmetric sectorial effects by introducing temporary special taxes and subsidies. In this respect, Norway is in a better position than Finland, because of the important role played by the State in the oil industry and because the oil sector is significant for government finances. In Finland this option appears less applicable, because it would imply further distortions in the tax system and, at least on some occasions, would be regarded as a protectionist measure by foreign competitors.

## 4. THE FUTURE ROLE OF FISCAL POLICY AND THE NEED FOR INSTITUTIONAL CHANGES

The Economic and Monetary Union raises a number of questions concerning the future role of fiscal policy in the European economy. Depending on one's point of view, these questions easily lead to conflicting answers. The basic source of analytical confusion is the pronounced lop-sided structure of EMU: a combination of complete monetary integration and high and increasing financial and economic integration with almost no integration at all of national public sectors and budgetary policies. The tensions arising from this state of pre-federal budgetary policies may also prove to be the main threat to the stability of EMU.

The plans for the Monetary Union, which place much emphasis on the independence of the future European central bank, aim at a more exclusive assignment of price stability to monetary policy than has generally been the case in Europe hitherto. At the national level, the option of using monetary policy as a countercyclical device will disappear totally. Other things being equal, there would for both these reasons appear to be a need for an increasing role for budgetary policies that stabilize activity.

However, all the traditional arguments that restrict the usefulness of fiscal policy as a countercyclical device (time-inconsistency, rigidity, distortive sectorial effects etc.) are still valid. In some cases fiscal policy is a rather poor substitute for monetary and exchange rate autonomy. In particular, in countries that are highly specialized in foreign trade, there is little scope for boosting domestic demand to compensate for an adverse export shock. Automatic fiscal stabilizers may nevertheless be useful in diminishing the multiplier effects emanating from the volatile export sector.

It has been argued that increasing economic integration and the growth of intra-industry trade will in the future decrease the significance of asymmetric regional shocks and that therefore the need for national demand management will be reduced. This argument may not be valid, however. The removal of the remaining barriers to trade could reinforce the existing comparative advantages and therefore in some cases lead to increased specialization towards cyclically sensitive export production. This would increase the sensitivity of some countries to global market disturbances. At the same time the internal market may result in reduced volume of intra-industry trade to the extent that such trade has so far been based on barriers to direct investment. This again would make employment in those countries more responsive to export-induced variations in domestic demand. It is thus conceivable that the asymmetric shock problem will be bigger rather than smaller in the future.

It is also unlikely that the internal market as such will increase labour mobility between regions and countries to any significant extent. Anyway, it is certain that labour mobility in Europe with all its cultural and language barriers, will remain much smaller than in federal states like the United States and Canada. Automatic stabilizers built into the federal tax and transfer system have been estimated to offset some 40 per cent of region-specific income shocks in the United States (Sachs and Sala-i-Martin 1989), and yet these shocks are still regarded as some kind of problem. Why then should there not be a problem in pre-federal Europe with its much smaller labour mobility and other rigidities?

One consequence of the widening and deepening economic integration in Europe will be that the already large international spill-over effects of national budgetary policies will increase further still in the future. For a country that is on the receiving end of such spill-over effects, these may be regarded as unwelcome external disturbances to domestic stability and in extreme cases as a potential threat to the financial stability of the whole system. These considerations have led to the establishment of disciplinary norms for national budgetary policies. For the country from which the spill-over effects originate, these imply a deteriorating cost-benefit relationship for at least expansionary fiscal policy. Why run a budget deficit and increase the future tax burden of your own citizens, if the new jobs thus created are spread out all over the continent? Or why push up interest rates by maintaining a high public debt for the benefit of financial wealth owners in other countries and to the disadvantage of your own tax-payers?

A third factor that will tend to reduce the room for manoeuvre in fiscal policy is increasing tax competition, which is likely to lead to a contraction in the size of public sectors and to a reduction in social transfers. The outlook for fiscal policy in Europe is thus one of diminishing overall importance with a conservative bias. From the point of view of structural efficiency this may well be a welcome development but it will probably also aggravate the vulnerability of the European economy to country- and region-specific cyclical disturbances.

In order to lessen the risk of cyclical instability, some degree and form of federal fiscalism in Europe would be desirable. It should not be too difficult to design a common European unemployment insurance system or some other type of automatic stabilizer in such a way that national net transfers balance over time. Such a purely countercyclical device should not be confused with the existing arrangements that serve to even out differences in economic development among member countries.

The diminishing scope for national stabilization policies highlights the importance of greater flexibility in the basic structures and institutions of the economies. In particular, labour market institutions should be developed towards greater downward flexibility of nominal wages and acceptance of shifts in relative wages among industries. It is, after all, the rigidities in nominal costs and prices that make the adjustment to cyclical disturbances painful. A smoother absorption of industry-specific external shocks would also be facilitated by greater regional and occupational labour mobility within the European countries. This calls for a change in public policies and attitudes towards labour mobility so that the institutional set-up as a whole would promote mobility rather than discourage it.

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## COMMENTS AND DISCUSSION

### Pekka Sauramo:

Sauramo's main concern was about the possibility of an individual country to use fiscal and exchange rate policies for stabilization purposes in the EC. He wondered if the only alternative in the EC was that a government's hands were tied and market forces were allowed to function freely without any control as was happening in Finland. He also reminded the participants of the welfare gains which stabilization policies could bring about. Where do the welfare gains come from if it is not possible to use the stabilization policies to reduce cyclical fluctuations?

Sauramo also questioned the possible benefits from the free foreign ownership in Finland. He was of the opinion that the only negative impact resulting from the restrictions on foreign ownership was that portfolios were poorly managed and diversified in Finland.

### General discussion

Hjerppe pointed out that Finland was vulnerable to shocks that change the nominal terms of trade. An interesting question is whether these shocks will become more symmetric in the common currency area. In the common market intra-industry and intra-firm trade will increase, which should lessen the probability of country specific asymmetric shocks. He also noted that Finland has a lot of intra-industry trade with Sweden. If Sweden joins the EC earlier than Finland, it will create problems for the Finnish industry. In addition, he commented on Sauramo's notion about the effects of the foreign ownership in Finland. He maintained that Finland's experiences regarding foreign ownership were mostly positive, at least so far.

Alho commented on Suvanto's presentation by pointing out that most of the shocks originate from policy errors made by individual governments. He said that a possibility to use an exchange rate option could be important to lessen unfavorable effects of policy errors. However, it is very important for the government to pursue a stable fiscal policy in the first place. Alho also noted that the origin of nominal domestic shocks could often be traced back to excessive wage claims and to the rigidities in the labor markets.

Airaksinen stressed that often when the question was about shocks one referred to price shocks. He pointed out that there were also real shocks that affected the total demand or supply. As an example he mentioned the recent collapse of the Finnish-Soviet trade. He thought that one needed different policy measures to deal with such shocks.

Suvanto answered first to Sauramo's question about the possibility to use fiscal policy in the EC. Suvanto thought that it could be used even in the EC. However, he noted that there was not much room for active fiscal policy to bring about the welfare gains Sauramo wanted. On the other hand, there are cases in which the use of active fiscal policy can create welfare losses instead of gains.

Suvanto called for more institutional flexibility to cushion the unfavourable effects of the shocks. He noted that governments' hands were already tied. If one tried to control the financial markets, that would only lead back to regulation. Concerning the symmetry of shocks, Suvanto was of the opinion that the forest industry was in the key role in our economy and hence the future shocks would probably be mostly asymmetrical. Suvanto did not oppose fiscal federalism, but he thought that it could not take the role of national fiscal policies or the current exchange rate system. Finally, Suvanto reminded the participants that Finland would not have complete freedom to pursue whatever policy mix it wished even if we decided to stay outside the EC. On the contrary, in that case our hands would be fairly tied as well.

# PERSPECTIVES ON ECONOMIC GROWTH, ECONOMIC POLICY AND EUROPEAN INTEGRATION IN THE 1990S[1]

by Peter van den Berg, the Central Planning Bureau

## 1. INTRODUCTION

Reflection on objectives and instruments of economic policy should start with trying to answer the preliminary question of what are the driving forces behind the process of economic development.

Secondly, we have to analyze the current position of the various regions of the world economy in the light of these perspectives. In other words, what are the strong and weak points of each region.

A third preliminary question relates to long-term trends and changes in the international environment which can strongly influence economic development and economic policy during the next ten years.

I will be rather short in section 2 and 3 concerning the first two questions. With respect to the third question of long-term trends and changes in the international environment I will confine myself in section 4 to the trend of European integration.

Subsequently I will pay attention to the question of the remaining scope for economic policies of national authorities in an integrating Europe. Monetary policy, fiscal policy and tax policies will be the main subjects of section 5.

## 2. PERSPECTIVES ON ECONOMIC DEVELOPMENT

### 2.1. The need for a theoretical framework

Reflection on objectives and instruments of economic policy should start with making explicit a vision of the driving forces behind the process of economic development. Such a view is inevitably an eclectic one. We distinguish between three perspectives which concur, in principle, with three schools of economic theory. These perspectives are both competitive and complementary. Together they give us a more or less complete picture of the process of economic development.

### 2.2. The Equilibrium perspective

The first perspective, called the equilibrium perspective, is based on the neo-classical theory and goes back to Adam Smith. The basis for this line of thought is a well-functioning price mechanism which coordinates the decisions of various economic subjects. Prices are the information carriers which steer economic agents towards optimal decisions. They lead to a balance between supply and demand in the various markets. The economic subjects are rational and possess 'perfect foresight' or, in a somewhat weaker description, they have rational expectations. Whenever preferences or circumstances change, adjustments in relative

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1 The first part of this contribution is based on work by André de Jong for the international part of the CPB long-term scenario-study, which will be published by the Spring 1992.

prices will result in the establishment of a new equilibrium in the various markets. From this perspective, the resulting *level* of prosperity hinges on the production factors available: natural resources, availability and quality of labour supply and size of the capital stock. *Growth* of prosperity is caused by changes in these variables. In addition to the increase in quantity and quality of the labour force, the level of savings is crucial. By means of the price mechanism, savings result in an expansion of the capital stock, subsequently creating a greater supply of goods and services. Although technology is also important, within this tranquil perspective it is a continuous source of new findings, 'given by God and the engineers' and further affected by relative prices.

In this perspective, the government plays a modest role. This is not because of any negative attitude towards government, but because within this perspective, a rational government confines itself to matters which cannot develop by means of the price mechanism: the production of so-called purely public goods, such as infrastructure. In addition, the government should adjust prices via levies and subsidies, should there be any question of negative or positive external effects.

### 2.3. The Coordination perspective

The second perspective, the coordination perspective, is based primarily on the views of Keynes. The main idea here is contradictory to that of Smith: rational behaviour on a micro level can lead to significant imbalances on the macro level. These imbalances do not necessarily result from rigidities in wage and price setting, but are linked to *fundamental uncertainties* under the influence of which economic actors must take decisions. When the future is fundamentally uncertain, people are not so likely to act like rational, calculating bookkeepers. Decision making, collectively as well as on an individual basis, will be susceptible to changes in 'moods and spirits'. As a result, expectations of the future, crucial to investment decisions, can at times be very unstable, leading cumulative disturbances. The economic process then no longer slides smoothly from one equilibrium to the next, but can remain in *disequilibrium* for quite some time, resulting e.g. in high unemployment situations. Of course, the textbook example is the depression during the 1930s.

Keynes's significant contribution is the idea that a balanced economic development can be promoted by stabilizing volatile expectations. A somewhat broader interpretation of this perspective is that the pursuance of private interest *alone* may fail to bring about a stable economic development and that in order to achieve it some degree of *cooperation* and *coordination* is required. In this perspective, government can play an important positive role. It not only concerns an anti-cyclical budgetary policy, but also other types of stabilization policy in the broadest sense, varying from exchange rate agreements and commodity market interventions to policy discussions with employers' organizations and labour unions.

### 2.4. The Free-Market perspective

Finally, there is the free-market perspective which goes back to the neo-Austrian school of economic theory, of which Schumpeter and Hayek are two important representatives. This perspective stresses that growth is never painless. Companies and sectors, even countries and regions rise and fall, and in the process new technologies play an important role. There will always be *winners and losers*. And both the will to win and the fear of losing drive to a significant degree the dynamics of a market economy. Entrepreneurs as inspirators and organizers of technological innovation, play an important role in this perspective. In a world where uncertainty looms large, entrepreneurs will have different views about which course should be followed. As a result, different companies will follow different innovation strategies. Fierce market competition will then determine which innovations survive. In this way the market also determines in what direction and at what rate the economy will develop.

In this perspective, entrepreneurs cannot be considered as so-called 'representative agents', all showing similar behaviour and hardly recognizable as individuals. Instead, the entrepreneur in particular and man in general is seen as a vital, intuitive and creative person with individual talents, one who defies damage and disgrace, growing wiser in the process. In order to achieve this, he does, however, require assurance that he will be the one to pick the fruits of his labour. By the same token, he must accept that he will also be the one to suffer the consequences of his failures.

An adequate incentive structure is essential in this perspective. As far as the entrepreneurs are concerned, it involves a well-developed system of property rights and the absence of political intervention. It is equally essential that employees are rewarded for their achievements and penalized for poor performance. This would necessitate low taxes and a frugal system of social security.

## 2.5. The prosperity circle

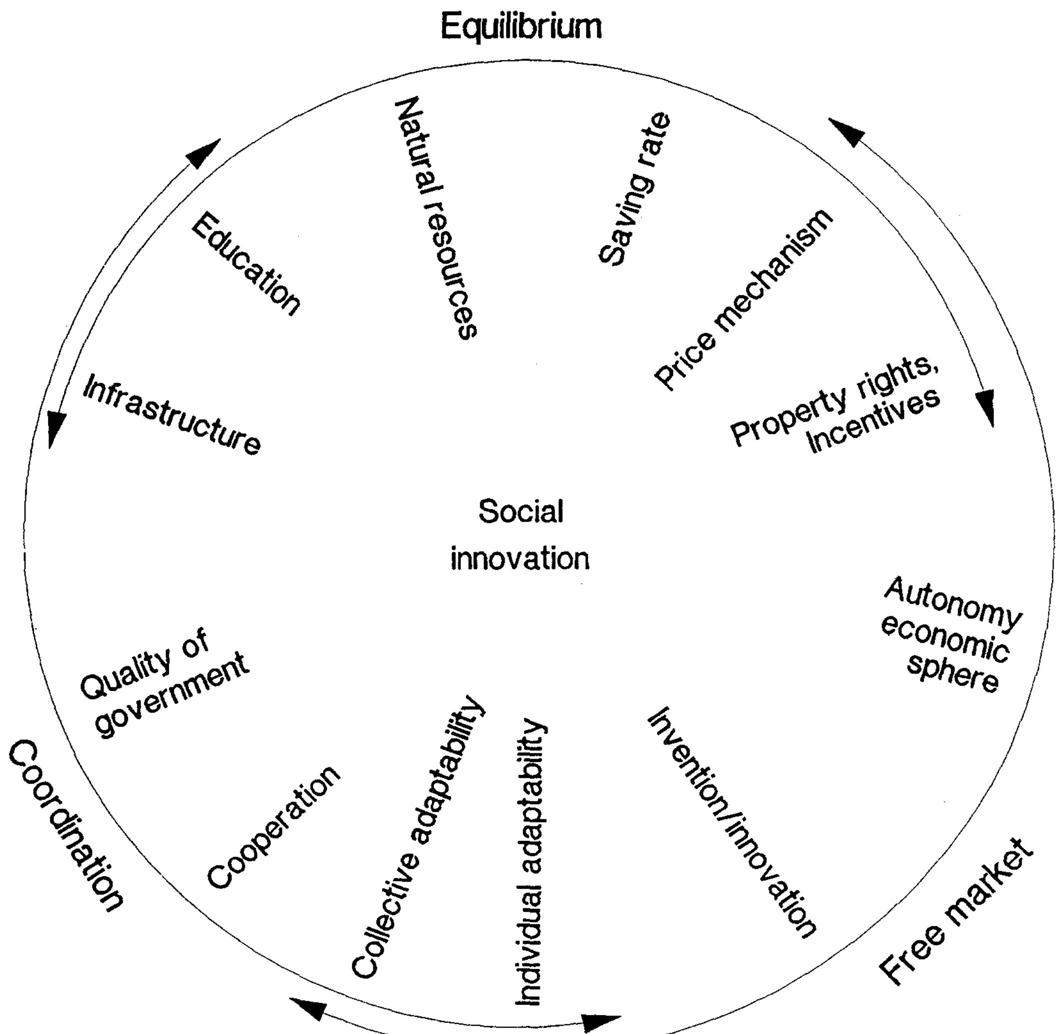
The driving forces behind the three perspectives are summarized in the prosperity circle. The free-market perspective and the equilibrium perspective share the vision that a very important role is played by a well-functioning price mechanism. The free-market perspective does not, however, adhere to the metaphor of Walras, that the price mechanism is like an auctioneer who balances market supply and demand. In the free-market perspective the market is no quiet auction, but a permanent battlefield full of uncertainty and risk. Good and bad decisions are taken and today's winners may be tomorrow's losers.

What the coordination and free-market perspectives have in common is the notion that the future is fundamentally uncertain and that expectations are very volatile. This does not, however, mean that in the free-market perspective an important role is given to the government. On the contrary, with a fundamentally uncertain future there is no reason whatsoever to assume that the government has a better insight in the future than do individuals. Furthermore, the government is not homogeneous. Actual policy is the result of a power struggle between all sorts of groups pursuing their own interests: civil servants, lobby groups, advisory bodies, politicians of different political parties, etc. Finally, the skeptical attitude towards government is prompted by the idea that various types of support, protection, collective insurance and regulations have a paralyzing effect, thereby weakening the dynamics of the economic process.

## 2.6. Some illustrations from economic history

Is it possible to derive *the* formula for success from the prosperity circle? We do not really think that is the correct approach. The formula for success strongly depends on place and time. Success-stories from economic history coincide with different emphases on the three perspectives.

# Driving forces of economic progress



The rise of England during the second half of the 18th century and the success of the United States in the first half of the 20th century figure particularly prominently in the free-market perspective. Entrepreneurship and innovation were stimulated, business encountered little government interference, individual responsibility was held in high esteem, property rights were guaranteed and there were sufficient financial incentives.

The successful post-war reconstruction of the Netherlands in the 1950s, sometimes referred to as 'The Dutch Miracle', was greatly influenced by the coordination perspective, although the other perspectives were not neglected. The government played a major role: spending a great deal on infrastructure and education and adhering to a wage-control policy. That period is also in other ways characterized as being one of cooperation and stability, rather than fierce competition.

The successful post-war development of Japan can also be explained to a large extent by the coordination perspective: there was for example close cooperation between government and business in mapping out new business strategies; industrial relations within large companies were, and in many cases still are very harmonious. Elements of the equilibrium perspective, however, also heavily contributed to Japan's rapid catching-up. Here the high savings rate and the high level of education of the labour force come to mind.

All in all, the conclusion seems to be that countries, depending to a certain degree on national culture, are able to stress in their own ways different perspectives in order to be successful. Completely *neglecting* one of the three perspectives is very dangerous, as the history of the Soviet Union and Eastern Europe makes clear.

Finally history also teaches that again and again firms, sectors and whole economies often push their success formulas too far, for too long. Even when strong incentive structures exist and clear signals are sent that limits are being reached, the inability to adjust to new circumstances is often striking. Here we define the capacity and willingness of a firm or society as a whole to continuously challenge the ruling paradigms and to strike a new balance between the driving forces of economic development, as *social innovation*. It explains why social innovation has been placed at the heart of the prosperity circle. Especially for the developed countries striving for continued economic growth and development, social innovation is extremely important and, as history shows, time and again very difficult. Failure to achieve it leads to institutional sclerosis and ultimately relative economic decline.

## 3. A COMPARATIVE STRENGTH ANALYSIS OF THE CURRENT STATE OF THE WORLD ECONOMY

For briefness' sake I confine myself to the United States, Japan and Western Europe

### 3.1. The United States[2]

In terms of growth perspectives, it appears that factors from the free-market perspective are still the great strength of the United States. Autonomy in the economic sphere is guaranteed, a well-functioning price mechanism is present, there is a strong incentive structure (with low

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2 For a broad and detailed analysis in the same spirit can be referred to Dertouzos, Lester and Solow, Made in America, The MIT Press, Cambridge MA (1989).

tax rates and a frugal welfare system), leading to a competitive climate, a flexible labour market and an individualistic culture promoting entrepreneurship and inventiveness.

The strong emphasis on the free-market perspective, however, tends to undermine the driving forces of the other two perspectives. The skeptical view on the role of government and the dislike of taxes which are typical for the free-market perspective, have led to underspending in the fields of education and infrastructure and an impotence to solve the budget deficit problem. The shadow side of the key-words competition, flexibility and individualism, also seems to be a lack of cooperation. Lack of cooperation and loyalty between management and labour, between separate organizational units of a firm, between producers and suppliers, etc. Exaggerating the free-market perspective may also cause a certain shortsightedness, manifesting itself in a high discount rate, a low savings rate and an overwhelming attention to short-term profits.

The result is a relatively sluggish growth of labour productivity. Because of this, American industry has lost ground in many sectors during the last years. A notorious example is consumer electronics.

### 3.2. Japan

Nowhere in the world has prosperity increased as dramatically as in Japan since World War II. Considered from the standpoint of the prosperity circle, growth-determining factors such as the high savings ratio, effort expended by and quality of the labour force, innovative potential and finally, the ability to adapt and cooperate, all score exceptionally high. The Japanese incentive structures are also adequate, although they tend to be of a much less financial nature than those of the West. The only low-scoring factor is the physical infrastructure. Other factors reveal a more mixed picture, the sectors' international orientation being the discriminating factor.

In the exposed sectors, the quality of the government (MITI), and the operation of the price mechanism are strong points. During the last decade Japan has also gathered a great deal of momentum in the high-tech sectors. No longer just a 'copycat', Japan is now actively trying to develop its own inventive potential.

As far as the domestic sectors are concerned, however, these factors score low. In a few sectors this is the result of almost completely screening out foreign competition, which is the case for agriculture and the building industry. Powerful pressure groups perpetuate the archaic distribution system. Productivity levels in the sheltered sectors are low.

### 3.3. Western Europe

Until a few years ago, prospects for West European economies were generally believed to be bleak. This gloom was prompted by Western Europe's inability to react flexibly to the oil crises of the seventies. In the mid-eighties it even looked as though Western Europe had become trapped in high unemployment and low productivity growth. At the same time Western Europe was steadily falling behind in the technology race against the United States and Japan.

The contrast with the period between 1950 and 1972, when the West European economies enjoyed a period of unprecedented growth in prosperity, was striking. Factors prominently present in the coordination and equilibrium perspectives, such as education, infrastructure, government quality and savings, played an especially important role in achieving this. The setback between 1973 and 1985 can generally be explained by the fact that growth-determining factors from the free-market perspective were neglected. There was a relatively strong tendency in Western Europe to protect citizens and companies from the harsh effects of adjustment processes in a market economy. Distribution of wealth got more attention then creation of wealth. Because of this, structural adjustment in the labour market and technological renewal progressed at a very slow rate. This continued until the second oil crisis after which there was no longer any escape.

Since then, many believe the prospects for Western Europe have drastically changed: from 'Eurosclerosis' to 'Europhoria'. The reversal in opinion can be traced back to:

- the unmistakable economic recovery during the second half of the eighties;
- the new enthusiasm for European integration (Europe '92, the EMU, EPU);
- the anticipated opening up of Central Europe, and the German unification in particular.

There is no denying, however, that even after years of economic recovery, unemployment still remains very high (about the same level as that of 1982). Moreover, it appears that the 1985 judgement about the threatened position of West European high-tech industries is still adequate[3].

In summary, although we do not wish to underestimate the importance of positive developments, especially the favourable effect on business confidence and animal spirits, there is still doubt as to whether Europe has actually overcome Eurosclerosis and whether the driving forces from the free market perspective are sufficiently represented.

## 4. TRENDS AND CHALLENGES IN THE 1990S: SCENARIOS FOR EUROPEAN INTEGRATION

### 4.1. Introduction

Several trends and challenges will strongly influence economic development and economic policy during the next decade. Especially noteworthy are: growing concern for environmental problems, further, and possibly accelerated, diffusion of new technologies, increasing internationalization and international cooperation. In this paragraph I will only pay attention to possible developments in the field of European integration.

The recent policy discussions about the draft treaties on EMU and especially on EPU make clear, that in Europe different ideas exist concerning further European integration. Connected with the three perspectives on economic development discussed in section 2, three scenarios come to mind:

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3 A recent report by the U.S. Department of Commerce provides fresh evidence supporting this view U.S. Department of Commerce, Emerging Technologies, Washington, D.C. (February 1990). For *three* out of every *four* emerging technologies, Western Europe lags behind both Japan and the United States in information science, advanced materials and biotechnology. Computer-integrated manufacturing is the exception. Another indication is provided by the Global Report 1990/91 by the United Nations Industrial Development Organization (UNIDO): table II, 15. Here, based on Japanese research, the relative positions in twelve industrial sectors are determined for Western Europe and Japan; Western Europe's position is considered 'somewhat inferior' to 'inferior' in eight of the twelve sectors.

- a free-market oriented scenario
- a coordination oriented scenario
- a no-consensus scenario: Eurosclerosis in a new form

### 4.2. A free market oriented scenario

One of our scenarios for the world economy is characterized by rapid internationalization, strong technological dynamics and very competitive market structures. Competitive market structures stimulate innovation, which in an open and liberalized environment leads to a rapid diffusion of technological potential. Small, technologically highly dynamic companies play an important role in this process.

Such a scenario will also affect the character of the West European integration. The process of integration in this scenario is driven by market forces and policy competition. The internal market and the monetary union are the institutional context within which market forces are free to operate. The transfer of national sovereignty to Brussels remains modest in this scenario and is - in principle - limited to what is needed for the free movement of people, capital, goods and services. In view of the technologically very dynamic nature of this scenario a further transfer might even prove to be counterproductive. No binding rules for public borrowing requirements and tax policies will be imposed by the European Commission or the European Council, nor will they regulate, for example, social policies of member states.

The process of policy and market competition will determine to what extent differences between member states can be maintained, for example with respect to welfare state arrangements. For countries with a strong economic performance, this will not pose any problems; countries with a poor performance, however, may be forced to adjust. For these countries *the sovereignty to act* is still quite extensive, *the capacity to act* has, however, significantly decreased.

In this decentralized view of the integration process, it is also natural that the European Free Trade Association (EFTA) countries and Central European countries become full members of the European Community fairly quickly. At the same time, the perspective of rapid entry is also an important psychological factor strengthening the resolve of the Central European countries' in implementing difficult parts of their transition programmes. Striving towards *political* unification is relegated to the background in this scenario. Many countries consider it to be an unnecessary strait-jacket which is stifling the countries' individual national and cultural identities.

### 4.3. A coordination oriented scenario

A second scenario for the world economy is characterized by a less dynamic and more smooth technological development. New entrepreneurship encounters more barriers. Huge funds are needed for research and development, involving large risks and uncertainties. Increasing returns to scale, in finance, marketing and R & D continue to be very important. Global competition increasingly leads to worldwide oligopolies and strategic alliances. These alliances seek support from governments in order to reduce uncertainties. Strategic technology, industrial and trading policies gain in significance.

Judged from the prosperity circle the emphasis falls on the coordination perspective. As reflected in the comparative strength analysis in section 3 this scenario concurs best with European and Japanese traditions. For the United States, this scenario implies a relative setback. Protectionism stretches out further, even affecting technological know how. Trading blocs emerge. The technology race especially with Japan and the DAEs increases.

Besides this external pressure several other challenges of a real European character, such as the embedding of Germany in Europe and the necessity of cooperation with Eastern Europe, lead to a call for European cooperation and coordination. Despite many doubts, this stimulates member states to a relatively centralized integration process. The integration process is directed with a relatively strong hand from above, both by the European Council and by the European Commission.

The internal market program is implemented loyally and without a significant delay. The European Monetary Union, with an independent central bank and price stability as its main objective, in the year 2000 not only includes all current twelve EC-member states, but also the current EFTA-members. Poland, Hungary and Czechoslovakia have a special relationship with the Community with the prospect of full membership.

The successful implementation of the White Paper and the EMU creates a fruitful climate for an enlargement of European technological and industrial policies; a necessary European answer to the great efforts of Japan and the DAEs in this area.

The intertwined problems of securing West European energy supply in the long term, the West European interest in tackling the severe environmental problems in Eastern Europe and the political and economic necessity for aid for Eastern Europe, make a success of the European Energy Charter. Within this context, a European $CO_2$-tax is levied and it generates the funds for a transfer to Eastern Europe of technology and know how in the environmental and energy field. A major plan for infrastructure is implemented in which gas from West Siberia is transported to Western Europe.

Also cooperation in the field of foreign affairs and defence takes place in the context of the European Political Union. The democratic deficit of the Community more and more calls for extension of powers for the European Parliament.

### 4.4. A no-consensus scenario; Eurosclerosis in a new form

The scenarios discussed so far have one common element: they both contain a positive answer to European challenges. Less unanimous and unclear answers are also a real possibility.

In a scenario with strong technological dynamics, vigorous entrepreneurship, adequate incentive structures and market competition are essential preconditions for benefitting from these dynamics as well as sustaining and reinforcing them.

Despite steps taken in the direction of an internal market, in this scenario Europe generally appears ill-prepared in light of the great innovative and competitive power from the Asian-Pacific region. No political agreement is reached concerning some important, final parts of the internal market program. Other measures are implemented half-heartedly or not loyally due to effective resistance by pressure groups.

An EMU with all current twelve EC-members does not arise in this decade. Market fragmentation in Europe does not decrease significantly; the costs of non-Europe remain.

Economic reforms during the 1980s intended to promote market competition in, for example the labour market, prove to be insufficient when a less favourable economic development occurs. Eurosclerosis does not seem to have been conquered. The European bias towards security, stability and risk-averse behaviour prevails again. Important industrial sectors (cars, computers, chips) are quickly loosing ground. Strong competition especially from Japan and the DAEs is seen as 'unfair'.

Several countries, France for example, will not allow their main industrial sectors to be wiped out. They advocate giving subsidies to vital industries, and introducing 'temporary' non-tariff barriers. Other countries, with different national interests, want to reap the benefits of lower world market prices for their consumers and they oppose protective measures.

The conflict inflames the ongoing dispute about what kind of political-economic model should be followed by the Community: the decentralized, free market oriented model or the more centralized, coordination oriented model. The Community once again is split, the integration process bogs down. Protectionism increases and Fortress Europe is in the making. While the capacity for national policies erode further and further, no consensus of opinion arises concerning a common approach of cross-border problems.

# 5. ECONOMIC POLICY IN AN INTEGRATING EUROPE

## 5.1. Introduction

The purpose of the internal market program is to remove physical, technical and fiscal impediments to the free movement of goods, services, capital and labour.

The EMU eliminates exchange rate uncertainty, reduces transaction costs and, more important, makes markets and relative prices more transparent. Both EMU and the internal market programme promote competition and trade and fit quite well in the free market perspective as sketched in section 2.

In this section we focus on the consequences of EMU and the internal market program on economic policy, especially for a small open economy like the Netherlands.

## 5.2. Monetary policy

Member countries in the proposed EMU loose their monetary autonomy and the exchange rate as an instrument of national economic policy. In EMU there will be a common, and quite centralized monetary policy. It will largely be the responsibility of the - independent - European System of Central Banks, with national central banks serving mainly to execute centrally agreed policies.

The primary aim of monetary policy will be to maintain price stability. As in other large economies, like the USA, policies will focus mainly on money supply and domestic credit to influence interest rates and thereby to control effective demand. To combat inflation, exchange rate policies in an EMU will be less important, because the direct effect of a change in the (common) exchange rate on inflation is very modest[4].

Because in Europe the influence of interest rates on private expenditures appears to be lower than in the United States, it may be important to support the common monetary policy with adequate fiscal policy.

The conclusion is that a significant role for the national monetary authorities can only be maintained in the supervision of domestic banks' liquidity and solvency and as a money market player in order to prevent unintended fluctuations in interbank rates.

Referring to our European scenarios in the previous section we can state that both in the free market scenario and in the coordination scenario a common, centralized monetary policy of all EC-members will emerge.

In the free market oriented scenario the EMU will be restricted to a pure monetary union. The coordination between monetary and fiscal policy will be weak. Guidelines concerning fiscal policy are considered as unnecessary, ineffective and undesirable.

In the coordination oriented scenario, monetary policies and fiscal policies are coordinated at the European level. In the no-consensus scenario, the foundation of EMU reaches a deadlock. Only a small EMU with 4 or 6 members emerges. The other EC-members do not join for economic reasons (Southern countries) or for political reasons (United Kingdom).

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4 The imports of goods and services from outside the EC amount at present to about 10% of GNP, while a small open economy like the Netherlands has an import share of 50% of GNP.

*Dutch experience*

For the Netherlands, decreasing monetary autonomy will not be a new experience. Already within the framework of the European Monetary System (EMS), a systematic reduction of monetary autonomy took place since 1979. During the last decade the main objective of Dutch monetary policy was to maintain a stable exchange rate vis-à-vis the German mark. Germany is our biggest trading partner, maintains a low rate of inflation and it has a sound reputation in financial markets. For the Netherlands, linking to the DM proved to be an effective way to realize a low inflation rate and a low nominal interest rate.

In the very open and highly indexed Dutch economy, a devaluation of our currency leads - as long as interest rates do not change - only to a temporary and rather modest improvement of the competitive position and along those lines only to modest and temporary positive effects on production and employment. For the ultimate macro-economic consequences expectations in exchange rate and interest rate formation are the crucial factor. The impression is that in the Netherlands the adverse effects of a devaluation on exchange rate expectations and interest rate formation outweigh the positive effects of the temporary improvement of the competitive position. So the conclusion is that a deterioration in competitiveness must be corrected by a process of real adjustment; devaluation is no alternative in a small and indexed open economy.

Because of the current debate in Finland, I will elaborate a little more on Dutch discussions and experiences in the 1980s.

During the realignments in the EMS-system the Netherlands only once, in 1983, decided not to follow the DM completely. A positive interest rate differential vis-à-vis Germany for many years was the consequence. This relative devaluation against the DM created uncertainty in financial markets and probably generated expectations of further downward exchange rate adjustments. In this respect the 'imported credibility' theory, seems to be relevant. In an exchange rate system it takes time to establish a credible reputation and it appears necessary to defend and to strengthen such a reputation by consistent policies.

The same picture seems to hold true, for instance, for France. Although the last realignment between the French franc and the DM dates from 1986, and there is no unfavourable difference in inflation rates anymore, the decline in the interest rate differential is rather slow and it still amounts to approximately 1%.

In the beginning of this year, a policy debate in the Netherlands discussed a possible revaluation of the guilder against the DM. The idea was put forward to protect the Netherlands from Germany's increasing inflation and interest rates which were a consequence of the German unification.

The conclusion was that it would only be a sensible policy if a revaluation of the guilder would succeed in creating expectations of further revaluations of the guilder in the future. Only under these circumstances interest rates would decline. And declining interest rates are a precondition to outweigh the adverse effects on the competitive position. However, further revaluation expectations do not seem credible when an EMU is coming.

### 5.3. Fiscal policy[5]

In this subsection we focus on the question: will an EMU in the 1990s leave room for national fiscal sovereignty? With respect to this question two visions can be sketched. The Delors Committee in 1989 recommended binding rules to impose effective upper limits on the budget deficits in the member states. This proposal fits very well in the more centralized, coordination oriented integration scenario, sketched in the previous section.

Other ideas, fitting well in the free market scenario, suggest that binding rules are neither a necessary nor a sufficient condition for monetary stability. They stress that EMU will strengthen market discipline and that - within the context of a credible no-bail-out-option - financial markets will discipline governments.

With regard to these two visions I would like to make the following remarks:

- Coordination of fiscal policy would be a novelty in European economic relations. During the 1980s EC member states witnessed substantial convergence of their economic performances without formal budgetary cooperation. Convergence is clear in terms of economic growth and inflation rates, although differences in public finance (deficits, debt ratios) have not been reduced during the 1980s.
- Uniform, binding rules for budget deficits disregard institutional differences in saving behaviour between countries (e.g. methods of financing and fiscal treatment of pensions). The correlation between the level of a country's budget deficit and its external position or rate of inflation seems to be rather weak. The Netherlands combines a rather large budget deficit and public debt with the largest surplus on the current account in the EC and the OECD and with a low rate of inflation. At the end of the 1980s the United Kingdom combined a government surplus with a deficit on the current account and a rather high inflation rate.
- Binding rules cause problems in absorbing supply shocks in member states and tend to work procyclically.
- Binding rules directed at maximum budget deficit *levels* do not prevent large *changes* in a government deficit. The changes in a deficit are relevant for community-wide interest rate developments; the German unification is an example in this respect.

EMU strengthens discipline in some respects:

- Deficits can no longer be financed through central bank credit, nor can debt positions be eroded through inflation (e.g. created by currency depreciations). Rules privileging governments in financing their deficits have to be abolished.
- EMU will sharpen credit-risk discrimination by shifting the markets' attention from inflation and current account imbalances to budget deficits and public debts. The North American experience indicates that local governments and states in the United States and Canada face increasing cost of finance when deficits and debts increase. The interest rate spread in the United States between state and municipal bonds is approximately 0.5 à 1%.

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[5] For a more elaborate treatment of the policy questions in this paragraph and the next, see: Van Hoek and Groot', Economic and Monetary Union in Europe: implications for economic policies', Central Planning Bureau Research Memorandum, nr. 85, The Hague (1991).

With no difference in nominal inflation rates, this also implies higher real interest rates, which creates an incentive for adjustment.

- National fiscal demand management policies become less and less effective in an integrating Europe. So a tendency to a 'loose' fiscal policy will diminish.

In summary, binding rules for the levels of budget deficits seem to have few economic grounds and do not appear to be particularly useful for the common goal of price stability in Europe. Nevertheless, it will be desirable to realize a greater degree of coordination and cooperation in accordance with commonly agreed medium term objectives, respecting institutional differences. Without budgetary coordination, monetary policy will be subject to great tensions; price stability can not be realized efficiently by monetary policy alone. Besides fiscal policy also wage developments are important. National demand management policies become less and less effective in an integrating Europe. Although we do not believe in fine-tuning, severe shocks which force to a policy reaction require a coordination and cooperation mechanism to prevent free-rider behaviour.

The preceding remarks concern sovereignty in the field of fixing budget deficits. It does not touch the core of fiscal sovereignty: determining the level of spending and taxes and the distribution of spending and taxes amongst taxpayers.

## 5.4. Tax policy

Although national budgetary policy becomes increasingly less important from a demand management point of view, the extent and quality of public facilities and their price become highly important as a factor determining the location of business, investment and labour. Public facilities, like physical infrastructure, education and health also determine the competitive position and may justify a relatively high tax burden. The price-to-quality ratio is the deciding factor.

Tax policies of individual states will be increasingly influenced by those of other member states. The current differences in the taxation of production factors may well prove to be excessive in an EMU.

In the free market integration scenario, market forces - in the form of policy competition - will play a role in confronting governments more vigorously with the costs and benefits of tax-financed government programs and the allocation effects they bring about.

In the coordination oriented integration scenario, negotiations and agreements may support the integration process and bring more symmetrical adjustments than policy competition alone.

Considering the differentiation in tax rates in the EC it is tempting to compare the European situation with the degree of fiscal harmonization in the United States and Canada. Although differences in language barriers and socio-cultural relations should be taken into account, it can be observed that differences in the overall tax burden are clearly more pronounced in Europe than in the United States and Canada. The total tax burden amounts to approximately 35 per cent of GNP in the Southern member states and the United Kingdom and 40-50 per cent in continental Western Europe (see appendix for the data).

Comparing in more detail EC-countries with American States and Canadian provinces gives the following impressions:

- Differences in VAT rates are substantial in Europe but also substantial among American states and Canadian provinces
- Corporate income tax tariffs seem to be reasonably harmonized, both in Europe and North America. That does not deny that further adjustment of differences in fiscal treatment of components of capital income may be useful.
- For income tax and social security taxes the current differences between EC-member states are wide, much wider than those observed in the US and Canada. So in an EMU some reduction in differences in income tax rates and social premiums can be expected. Experiences of federations like the US and Canada demonstrate, however, that even in a federation without language barriers fiscal harmonization does not have to lead to a full equalization.

Concerning economic policy in the Netherlands the main conclusion is that the Netherlands appear to stand out in the area of social security taxes. The disappearance of internal frontiers and production factors becoming more mobile, strengthen domestic labour market considerations to streamline the social security system with its relatively high benefit rates, its easy accessibility and the long duration of claims.

## 6. CONCLUDING REMARKS

The internal market program and the EMU will promote competition, trade and economic growth. In the comparative strength analysis of Western Europe in section 3 we doubt whether the driving forces from the free market perspective are already sufficiently strengthened. EMU and the internal market program can deliver a positive contribution to this process.

Increased integration not only means strengthened competition in the market sector, but also between national governments. As opportunities for macro-economic demand oriented policies diminish at the national level, policy competition in policy areas concerning the supply-side of the economy become increasingly important. The quality and price of the labour force and the quality and price of public facilities will be the deciding factor for a country's competitive position in an integrating Europe.

## Appendix

***Table 1 Tax differentiation in the United States 1985***

| | (Top)tax rates | | | | Tax burden[a] | |
|---|---|---|---|---|---|---|
| | Income tax[b] | Corporate tax[b] | Sales tax[c] | Gasoline excises[b] ($c per gallon) | Direct | Indirect |
| New England | | | | | | |
| average | 32.1 | 39.9 | 4.6 | 23.3 | 2.4 | 7.2 |
| max difference | 7.2 | 2.3 | 7.5 | 8.0 | 3.4 | 2.2 |
| standard deviation | 3.1 | 0.8 | 2.3 | 2.4 | 1.1 | 0.9 |
| Middle Atlantic | | | | | | |
| average | 33.6 | 39.8 | 8.1 | 18.3 | 3.6 | 7.2 |
| max difference | 6.7 | 0.3 | 6.3 | 4.0 | 3.2 | 2.4 |
| standard deviation | 2.8 | 0.2 | 2.9 | 1.9 | 13.0 | 1.0 |
| East North Central | | | | | | |
| average | 32.4 | 37.5 | 5.6 | 24.3 | 3.2 | 7.6 |
| max difference | 5.0 | 4.5 | 3.5 | 7.0 | 1.9 | 0.4 |
| standard deviation | 1.8 | 1.8 | 1.2 | 2.4 | 0.9 | 0.2 |
| West North Central | | | | | | |
| average | 32.6 | 37.2 | 6.7 | 23.7 | 2.2 | 6.9 |
| max difference | 6.5 | 6.3 | 3.5 | 7.5 | 4.2 | 2.7 |
| standard deviation | 2.1 | 2.1 | 1.1 | 2.9 | 1.2 | 0.8 |
| South Atlantic | | | | | | |
| average | 31.6 | 38.8 | 5.2 | 22.3 | 3.2 | 6.2 |
| max difference | 5.4 | 2.6 | 12.0 | 14.5 | 4.9 | 5.8 |
| standard deviation | 2.0 | 1.1 | 2.9 | 4.6 | 1.3 | 1.6 |
| East South Central | | | | | | |
| average | 30.9 | 37.6 | 7.9 | 24.0 | 1.8 | 6.5 |
| max difference | 4.5 | 2.6 | 6.0 | 6.0 | 2.4 | 2.1 |
| standard deviation | 1.7 | 0.9 | 2.5 | 2.4 | 0.9 | 0.9 |
| West South Central | | | | | | |
| average | 30.8 | 37.6 | 9.3 | 24.1 | 1.5 | 6.8 |
| max difference | 5.0 | 4.0 | 5.0 | 2.5 | 2.4 | 1.7 |
| standard deviation | 1.8 | 1.6 | 1.9 | 1.0 | 0.9 | 0.8 |
| Mountain | | | | | | |
| average | 31.5 | 37.3 | 6.7 | 24.5 | 1.7 | 8.1 |
| max difference | 6.1 | 5.3 | 11.0 | 12.0 | 2.8 | 6.6 |
| standard deviation | 2.5 | 2.0 | 3.2 | 3.5 | 1.1 | 1.8 |
| Pacific | | | | | | |
| average | 31.7 | 37.5 | 3.7 | 23.3 | 2.6 | 6.6 |
| max difference | 7.2 | 6.1 | 9.0 | 14.5 | 4.3 | 2.0 |
| standard deviation | 3.2 | 2.6 | 3.7 | 5.5 | 1.9 | 0.9 |
| Average of all states | 31.9 | 38.1 | 6.3 | 26.3 | 2.4 | 7.0 |
| Standard deviation of all states | 2.5 | 1.9 | 2.9 | 3.5 | 1.3 | 1.4 |
| Maximum difference between all states | 9.3 | 7.6 | 12.3 | 20.0 | 5.4 | 9.8 |

[a] Tax burden state and local governments as a percentage of state income.
[b] Effective rate of federal and state taxes.
[c] The federal government does not collect a general sales tax.

Source; Bureau of Census: Statistical Abstract of the United States 1988 and Governmental Finances 1988.

*Table 2 Tax differentiation in Canada 1981*

| | (Top)tax rates | | | | Tax burden[a] | |
|---|---|---|---|---|---|---|
| | Income tax[b] | Corporate tax[b] | Sales tax[c] | Gasoline excises[b] (in %) | Direct | Indirect |
| Newfoundland | 67.1 | 52.8 | 11.0 | 22.0 | 5.0 | 8.0 |
| P.E. Island | 65.6 | 47.8 | 10.0 | 22.0 | 3.6 | 6.8 |
| Nova Scotia | 63.5 | 50.8 | 8.0 | 16.0 | 6.7 | |
| New Brunswick | 65.6 | 51.8 | 8.0 | 16.0 | 4.9 | 7.2 |
| Quebec | 67.9 | 50.8 | 8.0 | 20.0 | 8.9 | 6.3 |
| Ontario | 62.8 | 51.8 | 7.0 | 20.0 | 5.0 | 6.8 |
| Manitoba | 66.2 | 52.8 | 5.0 | 20.0 | 5.1 | 7.3 |
| Saskatchewan | 67.8 | 51.8 | 5.0 | 20.0 | 4.8 | 6.8 |
| Alberta | 59.6 | 48.8 | 0.0 | 0.0 | 5.0 | 2.6 |
| British Columbia | 63.8 | 53.8 | 6.0 | 20.0 | 5.4 | 6.6 |
| Maximum difference inside convoys | | | | | | |
| Atlantic provinces | 4.5 | 5.0 | 3.0 | 6.0 | 1.5 | 1.3 |
| Central Canada | 5.1 | 1.0 | 1.0 | 0.0 | 3.9 | 0.5 |
| Western Canada | 8.2 | 5.0 | 6.0 | 20.0 | 0.6 | 4.7 |
| Standard deviation inside convoys | | | | | | |
| Atlantic provinces | 1.6 | 1.9 | 1.3 | 2.8 | 0.6 | 0.5 |
| Central Canada | 2.6 | 0.5 | 0.5 | 0.0 | 2.0 | 0.3 |
| Western Canada | 3.1 | 1.9 | 2.3 | 8.7 | 0.2 | 1.9 |
| Average | 5.1 | 51.3 | 6.8 | 17.8 | 5.3 | 6.5 |
| Maximum | 67.9 | 53.8 | 11.0 | 22.0 | 8.9 | 8.0 |
| Minimum | 59.6 | 47.8 | 0.0 | 0.0 | 3.6 | 2.6 |
| Standard deviation of all provinces | 2.6 | 1.7 | 2.9 | 6.5 | 1.3 | 1.4 |
| Maximum difference between all provinces | 8.4 | 6.0 | 11.0 | 22.0 | 5.3 | 5.4 |

[a] Tax burden of provinces and local governments as a percentage of provincial income.

[b] Effective rate of federal and provincial taxes.

[c] Only the provinces levy general sales taxes and gasoline excises.

Source: Canadian Tax Foundation: Provincial and Municipal Finances 1981.

*Table 3 Tax differentiation in the EC*

| | Tax rates (1989)[a] | | | | Collective Burden (1989)[b] | | | |
|---|---|---|---|---|---|---|---|---|
| | Income tax Marginal rate £200.000[c] Percentage | Corporate income tax rate on withholded profit | VAT Normal rate | Gasoline excises In Dfl cents per litre[c] | Taxes Indirect (1) | Direct (2) | Social security charges (3) | Total burden (1+2+3) |
| | | | | | As a percentage of GNP | | | |
| Germany | 53.0 | 50.0 | 14.0 | 64 | 12.3 | 12.4 | 16.9 | 41.6 |
| France | 56.8 | 37.0 | 18.6 | 95 | 14.2 | 9.1 | 21.1 | 44.3 |
| United Kingdom | 40.0 | 35.0 | 15.0 | 71 | 15.7 | 13.6 | 6.4 | 35.7 |
| Italy | 40.0 | 36.0 | 19.0 | 134 | 10.4 | 14.3 | 14.1 | 38.9 |
| Netherlands | 60.0 | 35.0 | 18.5 | 79 | 12.5 | 14.2 | 18.9 | 45.6 |
| Belgium | 55.0 | 41.0 | 19.0 | 48 | 11.7 | 16.4 | 14.2 | 42.3 |
| Denmark | 40.0 | 40.0 | 22.0 | 107 | 18.5 | 31.1 | 2.2 | 51.8 |
| Ireland | 56.0 | 43.0 | 25.0 | 89 | 19.1 | 17.0 | 6.1 | 42.2 |
| Luxembourg | 56.0 | 34.7 | 12.0 | 48 | 15.6 | 19.0 | 12.4 | 46.9 |
| Spain | 56.0 | 35.0 | 12.0 | 67 | 10.1 | 12.1 | 12.9 | 35.1 |
| Portugal | 40.0 | 36.5 | 17.0 | 93 | 17.4 | 7.3 | 9.9 | 34.5 |
| Greece | 50.0 | 40.0 | 16.0 | 41 | 16.0 | 5.5 | 10.6 | 32.1 |
| Maximum | 60.0 | 50.0 | 25.0 | 134 | 19.1 | 31.1 | 21.1 | 51.8 |
| Minimum | 40.0 | 34.7 | 12.0 | 41 | 10.1 | 5.5 | 2.2 | 32.1 |
| (Unweighted) average | 50.2 | 38.6 | 17.3 | 78 | 14.5 | 14.3 | 12.1 | 40.9 |
| Standard deviation | 7.6 | 4.7 | 3.7 | 26 | 2.9 | 6.3 | 5.2 | 5.6 |

[a] Source: International Bureau of Fiscal Documentation: Supplementary Service to European Taxation.

[b] Source: OECD Economic Outlook. For Luxembourg and Portugal: 1986 on basis of OECD National Accounts.

[c] Dfl/DM = 0.89..

Source of all tables: Van Hoek and Groot, 'Economic and Monetary Union in Europe; implications for economic policies', CPB-Research Memorandum, nr. 85, The Hague (1991).

## COMMENTS AND DISCUSSION

### Pentti Vartia:

Concerning the first chapter of the paper Vartia raised a question whether there were other perspectives for the economic development in Europe than the coordination and the non-coordination between countries.

In chapter three there was a good discussion of the strengths and weakness of the US, Japan and some of the Western European economies. Vartia raised the question of Japan's role in the long run. He wondered if it was possible for Japan to maintain a higher growth rate than the other regions like the US and the Western Europe also in the future. Vartia also asked how well growth perspectives matched with different scenarios of the European economic development. What really are the fundamental differences between the various scenarios? Vartia suggested that maybe technological change was slower in the coordinated economy than in the free market economy.

Vartia agreed with van den Berg's opinion about the usefulness of the exchange rate policy in the EMU. What might be the right exchange rate for the whole community? World market prices are probably determined to a large extent outside the EC and the structure of economies within the EC varies. He noted that since the Finnish Markka was overvalued it probably would have been better to devalue it before pegging it to the ECU.

Vartia said that in van den Berg's paper the discussion about the role of the fiscal policy in the EC was good. He was of the opinion that the coordination-oriented integration scenario might lead to more efficient and symmetrical use of tax policies within the EC. Finally, he asked about the Netherlands' experiences of the decision making in the EC. With which countries have the Netherlands formed coalitions and what kind have they been?

### General discussion

Van den Berg responded to Vartia's question by saying that the coalitions the Netherlands had joined have varied depending on the subject matter. Van den Berg agreed with Vartia that maybe the devaluation of the Markka would have been an appropriate thing to do, though the efficiency of that policy would have depended on how the wage-price mechanism worked in the future. However, van den Berg wanted to stress that in an indexed economy like the Netherlands there were no good experiences from devaluations.

**STRUCTURAL POLICY REFORM IN OECD COUNTRIES**[1]

by Rüdiger Soltwedel, Kiel Institute of World Economics

## 1. INTRODUCTION

The disappointing economic performance in the OECD area through most of the 1970s and the early 1980s gave rise to a broad reconsideration of the course of economic policies. The gap between outcomes and expectations partly reflected developments over which policy makers in the OECD area had little control - most obviously the successive oil price increases which precipitated the sharp recessions of 1974-75 and 1980-82.

But the importance of the external shocks should not be exaggerated. Rather, the sources of the broader deterioration and of the national differences must be sought primarily within the OECD economies: in factors which limited individual capabilities and collective outcomes. These factors are eminently structural. They refer to the capacity of economies, institutions and societies in general to exploit fully existing opportunities, to adjust to changing circumstances, to create and exploit new opportunities, and on that basis deploy and redeploy resources. It is not possible to put a number on this capacity; and its relation to macroeconomic performance is clearly one of interaction, rather than mechanical causation. Yet it seems reasonable to believe that this capacity was strong and contributed to the rapid growth of post-war decades. But why might this capacity have declined? And, even more importantly, how can it be restored?

The OECD (1987) report on **Structural Adjustment and Economic Performance** examined broad trends in the structural characteristics of the OECD economies, the effects which microeconomic policies have had on these, and the implications for economic performance; and it advanced recommendations for policy reform: for how policies could be reoriented to best contribute to the goal o job-creating, non-inflationary growth. In its reports "**Surveillance of Structural Policies**" (1989) and "**Progress in Structural Reform**" (1990) the OECD looked at the developments in the continuing process of microeconomic reform within the OECD area. These three reports are synoptically summarized in this paper.

Firstly, microeconomic factors are examined that contributed to the outstanding performance of the 1950s and 1960s, but that waned in later years (Part 2). Principles reforming microeconomic policy across a broad range of areas are set out (Part 3), followed by an assessment of the progress in structural reform that has been made to date (Part 4). A concluding chapter will try to chart some problems ahead that are mainly related to the threat of mass migration (Part 5).

## 2. STRUCTURAL FACTORS AND ECONOMIC GROWTH

The years 1950 to the first oil price shock in 1973 were a "golden age", the heyday of economic growth. Real GDP in the OECD area increased by an average of nearly 5 per cent a year, two and a half times more rapidly than in the four preceding decades and almost twice as rapidly as in the years from the oil price shock to today. A number of microeconomic

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1 A previous version of this paper has been presented at the International Conference on Migration, Rome, March 1991, organized by the Republic of Italy and the OECD.

factors bolstered this performance (Section 2.1) - factors which either eventually ceased to operate, or came to operate less fully (Section 2.2).

## 2.1. The main sources of strong growth

Over the longer term, economic growth arises from the interplay of **incentives** and **capabilities**. In the advanced economies, the capabilities refer primarily to the supplies of human capital and of the existing capital stock, as well as to the technical and organization skills required for their use; the incentives largely determine the efficiency with which capabilities are used and the readiness to invest in an expansion of fixed assets and human capital. Both incentives and capabilities operate within an institutional framework: institutions set rules of the game, as well as directly intervening in the play; they act to alter capabilities and change incentives; and they can modify behaviour by changing attitudes and expectations.

An institutional framework that put emphasis on freeing market incentives and strengthening capabilities was a critical factor in the exceptionally strong growth of the first post-war decades. Many barriers were swept away in the process of trade liberalization; quantitative restrictions were largely removed and tariffs declined by some 10 percentage points on average. The formation of the European Economic Community and the EFTA, and the Kennedy Round of multilateral trade negotiations provided further impetus to the dynamic of opening markets. Liberalization also extended to capital movements and foreign direct investment. Freer trade, together with actual or potential entry of new competitors through foreign investment, reduced the importance of domestic and international cartels - a process accelerated by the shift in many countries to more active competition policies.

Not only did these changes bring price signals more closely into line with world market opportunities, they also intensified competition. This was partly because open markets drastically reduced the leeway any producer had to ignore change and postpone adjustment. But it was also because liberalization created powerful new incentives: incentives to build larger, more efficient plants; to shift to more specialized products; to invest in developing new products and processes.

Capital and labour markets had also been reshaped. The efficiency of capital markets was harnessed (i) by the early post-war success in bringing inflation under control and (ii) by the recovery and extension of financial systems. The changes in labour markets were even greater.

- Following initial turbulence, industrial relations moved to a more settled pattern, broadly supportive of moderate wage growth and of improved labour utilization.

- At the same time, and virtually throughout the OECD area, domestic and international migration made labour not only abundant but mobile - facilitating the growth of new firms and industries in the host countries and easing the problems of unemployment in disguise and underemployment in the source countries. Between 1950 and 1973, there was net immigration of nearly 10 million people into Western Europe, compared with a net outflow of 4 million from 1914 to 1949.

- The shift out of agriculture alone swelled the urban labour force in the OECD area by more than 15 per cent.

Together, labour mobility and buoyant investment raised productivity - including investment in infrastructure and human capital - and led to a rapid rise in living standards. Inflationary pressures were eased by the opening of markets to international competition. This in turn made it possible for macroeconomic policy to permit or sustain high levels of demand - creating a climate of confidence which further increased the incentives to invest.

## 2.2. The deterioration in economic performance

By the end of the 1960s, these "virtuous circle" effects were weakened and after 1973 they largely disappeared. In retrospect, it is clear that many of the impediments to continued strong growth had developed during the period when performance was good. The changes were partly **macroeconomic** in origin: (i) the belief that aggregate demand policies could and would guarantee full employment may have lulled firms and workers into a false sense of security, slowing the adjustment to changing circumstances and accentuating inflationary wage and price increases; (ii) repeated applications of stabilization policies, giving rise to alternating surges of inflation and episodes - however moderate - of recession, further confounded market signals and made a steady course of wage growth and capital formation more difficult to maintain. But long after the first signs of a deterioration in performance governments and observers remained over-optimistic about what policies could achieve and this created strong pressures for a continued expansion of entitlements, the acceptance of restrictive measures in product and factor markets, and the extension of public spending commitments well beyond the margin provided by economic growth. At the same time, complacency in the face of the emerging difficulties was compounded by shifts in attitudes, and in particular, by a spreading perception - under the influence of the Club of Rome's report on "The Limits to Growth" - that economic growth was not an entirely desirable goal of policy.

Constraints on economic performance became increasingly tight. In particular, the two oil shocks led to a loss in countries' real national income as a result of the worsening in their international terms of trade. The fundamental task was to absorb these income losses while maintaining a level of profitability and capital formation sufficient to preserve employment and allow industry to adjust to changed energy market and competitive conditions. And it was in this respect that labour market institutions, and notably the wage formation process, proved most wanting - though the difficulties proved far more acute in some countries than in others.

These adverse impacts on the efficiency and responsiveness of markets would have been smaller had the stance of **microeconomic policy** been different - had microeconomic policy generally facilitated rather than hindered change.

Pervasive interventions in **product markets** distorted the price signals facing firms and further undermined the predictability of the competitive environment, most strikingly in trade policy. The distorting effects of these changes in trade policy were compounded by policy measures in domestic markets for agriculture and industry, where governments responded to increased competition pressures, notably from newly industrialized countries which on the basis of their comparative cost advantages became effective competitors mainly in sectors with standardized technologies. Governments directly assisted firms, sectors and regions in difficulty, and became increasingly involved in promoting new areas of activity, frequently associated with high technology.

The effects of measures which distorted the signals and incentives coming from product markets were aggravated by policies which eroded the capability of **factor markets** to respond. The trends in this respect were most pervasive in the microeconomic functioning of labour markets. The problems were multidimensional; and they arose not only from government policies narrowly defined but also from the operations of collective bargaining and, indeed, of secular economic and social trends. Changes in labour markets tended to segment employment opportunities, increase firms' difficulties in adjusting employment levels - not only downward but upward as well - and make the efficient use of labour within enterprises more costly to achieve. Labour market developments became more and more complex: persistent unemployment coincided with lack of workers, both skilled and unskilled labour; firms sought to increase their flexibility by subcontracting and hiring labour on the basis of nonstandard employment contracts; the shadow economy soared.

Three facets, primarily of relevance to Europe with its pronounced unemployment problem, were of particular importance:

- First, from the early 1970s to the early 1980s, a fairly widespread compression of occupational, industrial and regional wage differentials occurred. This was hardly in line with the emerging sectorial and regional reallocation of labour in major European countries.
- Second, particularly in the mid- to late 1970s, legislative and regulatory restrictions were imposed in a number of countries on retrenchments, notably in larger firms. Though these measures subsequently were eased, their legacy proved longer lasting.
- Third, restrictive work practices, clashed with a need for greater flexibility and mobility in firms' international labour markets.

Finally, the growth of the **public sector**, both as an economic agent in its own right and as a pervasive influence on incentives in the economy as a whole had far reaching effects on the efficiency of resource use. There is certainly no simple correlation between economic performance and the scale of transfer payments - or indeed any other single indicator of the size of government. Where the incentive effects of transfer payments were most significant, this was a result of their interaction with the tax system; and it is through the concomitant rise in the burden of taxation that the growth of public spending probably imposed its greatest economic costs. Marginal and average tax rates in many countries became very high. As tax rates rose, tax systems became increasingly complex and in many cases discriminated quite arbitrarily between different categories of taxpayers. High marginal tax rates in the labour market encouraged the spread of tax avoidance (giving incentive for the shadow economy) and tended to reduce the supply of labour, not only among the more highly paid, but also among the poor, for whom taxes in combination with decreased social payments often created high effective marginal rates (sometimes known as a "poverty trap"). The taxation of capital income, by imposing quite different rates on competing investment prices, distorted the allocation of investment resources among alternative uses.

In short, a broad range of microeconomic policies acted in such a way as to distort incentives and reduce the efficiency of individual markets and slow the recovery from internal and external shocks.

## 3. THE PRINCIPLES OF STRUCTURAL REFORM

Many countries have, in the 1980s, sought to systematically review microeconomic policies and reduce distortions to the functioning of markets. The thrust of the reform programmes aimed at actions to increase competition in product markets (Section 3.1), to strengthen the responsiveness of factor markets (Section 3.2), and to secure increased efficiency and effectiveness in the public sector (Section 3.3).

### 3.1. Increasing competition in product markets

Competition in product markets not only stimulates an efficient use of existing resources but is essential for rational investment decisions and provides incentives for the development of new products and processes. Whether firms respond to the opportunities arising from technological advance, as well as to broader changes in economic circumstances, depends largely on the intensity of competition - and on the incentives this creates for the firms which successfully adjust, and the penalties for those which do not. **Competition policy** has an essential role to play in strengthening these incentives and penalties, domestically and internationally.

Market rivalry contributes to economic and social pluralism and encourages firms to concentrate on achieving greater competitiveness, rather than to dissipate resources in rent-seeking. Moreover, an active competition policy can provide an efficient means of achieving public objectives - and notably that of securing reliable and cost-effective service - in areas which have traditionally been subject to more direct and constraining forms of government intervention, for example, through regulation. In all of these ways, the legal framework for competition policy can increase the efficiency of market outcomes - making direct government involvement all the less necessary.

Fulfilling these functions requires that competition policies adapt to changing circumstances. It is increasingly recognized that many forms of corporate behaviour once thought unacceptable are rational and indeed desirable responses by firms to opportunities for achieving greater efficiency through horizontal and vertical co-operation. As mergers and co-operation between firms may facilitate collusion, concentrate resources and increase the difficulties a new supplier would have to face, the effective degree of exposure to international competition is all the more important. In the long run, a policy against restrictive business practices, however vigorous it may be, can do little to promote efficiency in an economy where firms benefit from government interventions which shield them from market realities, domestically and internationally.

#### 3.1.1. International trade

The single most effective means of securing responsiveness to changing opportunities is through exposure to **international trade**. The efficiency gains of trade are most visible in product markets. But openness to international trade is also important in reshaping factor markets - and notably in ensuring that collective bargaining is exposed to market signals. For all of these reasons liberal trade is more than a means of reallocating economic resources - rather, it is the key to securing the consumer interest providing all goods and services on the best terms.

The scope for improving living standards through international trade is, if anything, likely to increase. Action to strengthen and extend the open, multilateral trading system - both by the OECD countries and by the developing countries - is the key to securing those gains. The objective of granting foreign competitors a treatment no less favourable than that accorded domestic producers should remain paramount.

The full benefits of interdependence will not be secured if the world trade regime is not brought into line with the changing character of trade flows. Three areas stand out in this respect:

- First, challenges associated with the importance which technical norms and standards and the protection of intellectual property have in encouraging the rapid diffusion of goods based on new technologies.
- Second, there is great scope for specialization in services: for example, in telecommunications, where new technologies are broadening the range and diversity of services which can be provided; but exploiting these gains will require an important extension of multilateral trade liberalization.
- Third, ensuring an open international environment for foreign investment is an important component of a strategy for sustaining the trading system.

### 3.1.2. Agriculture

Most immediately, the distortions currently affecting **agricultural trade** not only impose significant economic costs - they breed tensions which threaten open trade as a whole. Though these distortions are largely the products of domestic agricultural policies, a multilateral and multi-commodity approach to improving agricultural markets can play an important role in easing and sustaining the process of change.

The **agricultural policies** pursued by the OECD countries are unsustainable. They have encouraged enormous over-production, forcing prices down on the relatively narrow markets open to international competition while accentuating protectionist pressures on others. Yet the policies have hardly met their stated goals: the subsidies they provide have largely been capitalized into land values and almost everywhere have overwhelmingly gone to the largest producers; by increasing the intensity and intermediate input usage of farming they have created a range of environmental concerns; and far from stabilizing the sector, they have encouraged over-capitalization and increased vulnerability to market shocks. Current agricultural policies reduce OECD GNP by as much as one percentage point.

There is no good reason for sheltering agriculture as a whole from the operation of market forces. The aim must be to increase the role of international market signals in the sector's decision-making and this requires price adjustments so as to reduce the incentives which current support levels give for over-production and to bring prices on major markets into line with those prevailing on the markets open to international competition. Any policy for providing continuing income support to poorer farmers, or for farming in environmentally or strategically significant areas should as far as possible "decouple" the provision of income support from production incentives.

### 3.1.3. Industrial djustment

There is a clear-cut case for reducing industrial subsidies, be it assistance to firms and industries in difficulty or aid in order to promote new, more promising areas of activity, frequently in industries associated with "high technology".

Experience highlights the limits of these policies. Subsidies to firms and industries in difficulty have kept capacity no longer viable in operation; and they have hindered industrial adjustment by confusing the signals which influence corporate decision-making. Severe constraints also bear on policies aimed at promoting new, "high-technology" activities. The results have frequently been disappointing - and especially so of policies which have sought to replace market signals and "create" comparative advantage in a broad range of sectors considered strategic. These policies have exercised their major influence in sectors dominated by public procurement. But even when they have achieved their proximate technological goal, they have frequently led to an excessive concentration of technical capabilities in activities geared to the public sector, thus adversely affecting the competitiveness of other industries.

The outcomes of industrial policies have frequently been disappointing because the goals set were too broad and the priorities too diluted; and because the policies themselves were inconsistent with government action in other areas. The costs imposed by these more general weaknesses have been compounded when policies have sought to go against the fundamental course of comparative advantage; have provided assistance on a basis which, in practice, is open-ended, despite initial intentions for its progressive phasing out; have failed to assess carefully the displacement effects which assistance granted to any particular firm or sector has on others; and have been subject to little effective monitoring of outcomes against intentions.

## 3.2. Improving the responsiveness of factor markets - the case of labour markets

Adjusting efficiently to the incentives and signals coming from product markets requires a capacity to redeploy resources: to move labour and investment towards new opportunities - and to ensure that they are used effectively where they are employed. This capacity hinges on the efficiency of **factor markets**. Here, too, there is important scope for policy reform. It seems appropriate to focus on labour markets since they are at the heart of an economy and the principal source of income for most of the population; thus distortions and rigidities in these markets can have high costs in terms of overall economic performance and widening disparities of opportunity among individuals.

Labour markets serve a broad range of economic and social functions, as do the mechanisms through which employers and employees regulate their relationships. These functions reflect a mix of distinct but interrelated objectives: the search for a balance between wage levels and capacity to pay, which is an indispensable basis for maintaining high levels of employment; the need to obtain sufficient flexibility in labour allocation to be able to shift human resources towards the activities with greatest promise; the widely held aspiration for stability and security in employment, and the recognition that longer-term employment relations may contribute to the development and effective use of skills; the desire by employees to "have a say" in setting and implementing the conditions of employment and work; and last but by no means least, objectives with respect to the distribution of incomes.

These objectives are not always mutually consistent; both the institutions through which they are pursued and the emphasis they are given in different countries reflect a wide range of economic, social and political factors, many of them rooted in national history and aspirations. As a result, the process of institutional change is complex, constrained, and in some respects, controversial. Yet it must also be recognized that in some countries, notably in Europe, improvements in the way labour market institutions function are essential if unemployment is to return to, and remain at socially acceptable levels. A durable improvement hinges on the evolution of labour market institutions and in particular, of collective bargaining.

Improving the functioning of the labour market requires more than changes in pay determination - it is intimately linked to improvements in the microeconomic processes by which labour is allocated among competing uses and by which the efficiency of labour utilization is set: that is, to labour market flexibility. It is clear that long-term relations between firms and their employees can make an important contribution to the efficient development and deployment of skills; and that even the most efficient labour market, far from operating on a "hire and fire" basis, will be characterized by mutual commitments between employers and workers as each makes costly and largely sunk investments in competence and understanding. But the experience of the 1970s shows that many government-imposed restrictions on and distortions to the flexibility of labour markets do nothing to bring these efficiency gains closer; they merely aggravate segmentation in employment, lulling those with jobs into a false sense of security, while worsening the hardship of those who are out of work.

Restricted work practices and inefficient labour utilization reduce the internal and external labour mobility. These impediments are perpetuated even when not legally imposed because they are in the immediate interests of employers and their present employees. But it needs to be recognized that these immediate interests may be met at the eventual cost of deepening segmentation between the "insiders", who benefit in higher wages and greater job security from the economic rents restrictions on competition create, and the "outsiders" who bear the costs. Therefore it is important to develop a broader consensus between and with unions and employers about the desirability of adjusting to change - not only in terms of wage-setting, but in terms of adapting working practices and developing a policy dialogue.

Over the longer term, the capacity of individuals and indeed of labour markets as a whole to respond to changing circumstances is greatly affected by the adequacy of national **education and training** systems. In virtually all OECD countries there is scope for increasing the adequacy of training and retraining facilities for adults. The educational system itself will have to expand its role as a provider of recurrent education; and it is particularly important that it do so, because in an economy undergoing rapid structural change, but where the working population is growing very slowly or even declining, additions and retirements from the labour force will no longer provide an effective means of adjusting the supply of skills. However, efficiently discharging this function will require greater openness in the formal educational system to the growing amount of training activity which takes place in other settings.

### 3.3. Enhancing the efficiency and effectiveness in the public sector

Overall, the interaction of enhanced incentives in product markets and increased responsiveness in factor markets should provide a sound basis for improving performance overall; yet the gains in performance are likely to be considerably greater insofar as they are accompanied by improved efficiency and effectiveness in the public sector.

This is most obviously because the public sector now accounts for so large a share of societies' use of resources - and yet the processes by which these resources are allocated and the efficiency with which they are employed very largely escape the control of market processes. But it is also because the functioning of product and factor markets is so strongly influenced by the conduct of the public sector - not only directly, through the purchasing, spending, taxing and regulatory functions of government, but also indirectly, as in the linkages between public and private sector collective bargaining.

What is required is a continued search for cost-efficiency in public management: for ways of attaining public objectives at an acceptable resource cost. This requires greater emphasis on **incentives** for improving the quality and grade of service, eliminating unnecessary expense, reallocating resources more flexibly, achieving greater transparency and accountability, and for more carefully weighing the costs of a course of action against its benefits. Such an emphasis is important both in the internal conduct of the public sector's affairs by increasing the use of **market mechanisms** in the provision of public service and in its relations to the economy more generally by improving the balance of activities between the public sector and private provision. And it is important to review where the functions are carried out in the public sector. These of course vary greatly from country to country; but in all countries the burden on public management could be eased both by more broadly **decentralizing** the implementation process within government to regional and local authorities.

The need of reviewing the role of government is particularly great in the area of **regulation.** There are strong arguments for reforming the economic regulation of industries and firms. These arguments are based on visible inefficiencies in the way regulated industries operate, set prices and decide on investment. But they are also based on the fact that liberalizing regulations yields benefits which go well beyond the measurable costs of regulation - benefits in the form of technological and organizational innovation and of enhanced dynamism in the economy as a whole.

Overall, the reform of regulation does not in general imply the abandonment of long-standing public objectives - it simply involves recognizing that these objectives can better be met in a modified framework. This need to adapt the institutional framework most efficiently to meet the objectives of governments also underlies the reform of **social policies** i.e. health care systems, public pension schemes, and unemployment compensation schemes.

Here too, the strengthening of incentives must play a key role. This is firstly because the services these policies involve are now such large industries in their own right. But it is also because the present policies are in numerous instances simultaneously incompatible with demographic trends and limited capacity to raise taxes.

Improving regulation, reducing its scope and reviewing the framework for the provision of social services should significantly increase the effectiveness of government; but some of the most adverse impacts of the public sector on economic efficiency in the private sector come from the structure and level of **taxation**. The problems arise from high marginal tax rates, which create incentives for evasion and avoidance, distort the allocation of resources, notably for investment, and reduce the supply of labour, and from tax provisions which discriminate more or less arbitrarily between broadly similar activities.

## 4. PROGRESS IN STRUCTURAL REFORM

### 4.1. The general perspective

Throughout the last decade, substantial progress has been achieved in structural reform - and all Member countries have participated in the process. Not surprisingly, the extent of progress has varied from country to country, because of different points of departure as well as differing reform efforts.

As to the main areas of policy, progress has likewise been uneven; and here three broad categories can be distinguished:

i) Areas where each country's policies impinge on the situations of others - so that there is a strong policy interdependence - and where there has been continuing and substantial progress in reform: the most notably instance is financial markets, but others to be included under this heading are foreign direct investment, taxation, and competition policy;

ii) Areas of policy interdependence where comparatively little progress has been made: here the leading instances are trade policy and agricultural policy - with industrial policy as a less conspicuous case;

iii) Areas where domestic policies are more self-contained, and in which the extent of recent change has varied quite considerably from one country to another: labour markets and the public sector.

A common feature in the first group is that growing interdependence has served to give momentum to reform, even though reforms often originated from a recognition of the inefficiencies arising from domestic policies. Thus:

- Technological change and deregulation in telecommunications have substantially reduced information and transaction costs, fostered the competition for internationally mobile resources, in particular investable funds, and have brought national markets (especially, but not only, financial markets) closer together;
- Ever-intensifying competition in world financial markets amplified, within each country, the need to modernize national financial systems, to adapt regulatory frameworks to a more competitive environment, and - for market operators - to form financially stronger and more competitive organizational structures;
- Closer integration of financial markets has pointed to the need for complementary reforms in areas such as taxation, the regulations governing direct foreign investment, and competition policy.

In short, even those countries which might have preferred to move more slowly have had to join the process of reform in order to avoid compromising their competitiveness. The process thus acquired a strong momentum, which even now is far from being exhausted.

By contrast, there has been no similar cross-country stimulus to reform of policies relating to industry, agriculture, and international trade. This is in spite of international agreement on the direction which policies need to take. Indeed, insofar as considerations of competitiveness have influenced governments in these areas, policies have sometimes changed in the direction of greater interventions in markets - through (for example) export subsidies, support for "sunrise" industries and activities, discrimination in public procurement, and weakening or suspending domestic competition in order to establish "national champions" (or "European champions"). Insofar as considerations other than competitiveness - such as concerns arising from the costs of structural adjustment to particular industries, firms or regions - have been dominant, these have often, as in the past, pushed governments in the direction of maintaining or even increasing protection and support for specific firms and industries. Thus, progress towards more market-oriented policy regimes has been very limited.

### 4.2. An assessment by areas

Two policy areas shall be analyzed here in some more detail, namely international trade and labour markets; the former because the openness of the trading system is of decisive importance for the competitive process, the latter because the labour market conditions provide political justification or wide-ranging interference with market forces.

#### 4.2.1. International trade

Trade continues to be an important source of growth. During the 1980s, the volume of world trade has risen consistently faster than that of world output. But at the same time, the open multilateral trading system continues to be weakened by both specific actions and more general policies adopted by national governments (and the EC). The main responsibility for this trend of events rests with the OECD countries. OECD countries' trade regimes have on balance become less liberal over the past decade, thereby hindering adjustment in domestic markets and imposing heavy costs on consumers. Reductions in tariff protection have been accompanied by growing recourse to non-tariff barriers (NTBs), which are often non-transparent, non-market conforming, and discriminatory. The international rules of the game are being increasingly challenged by ambiguously defined concepts of reciprocity, fairness and managed trade.

- There has been an increasing resort to anti-dumping actions in a number of OECD countries - in particular the EC and the United States. The popularity of anti-dumping measures reflects the fact that they can be applied selectively - by product, country and enterprise - thus giving scope for tailor-made protection. Under present legislation and practice in the countries concerned, substantiating both injury and dumping claims has not proved difficult. At the same time, the coverage of anti-dumping laws has been expanded, e.g. to counter circumvention of anti-dumping duties on certain products by assembling them in the importing countries.

- At the same time, most Member countries are continuing to make widespread use of non-tariff barriers which are likewise specific and discriminatory, notably through (so-called) voluntary export restraint agreements. It is a worrying aspect of the present situation that measures which force trade into bilaterally regulated channels are widespread, chronic and increasingly taken for granted. Managed trade is viewed by many governments as here to stay - despite their oft-repeated commitments to the multilateral trading system.

- Following the adoption of the U.S. Omnibus Trade and Competitiveness Act of 1988, the United States Trade representative has initiated a number of investigations under the so-called "Super 301" provisions of this Act. U.S. trading partners have expressed concern on the unilateral character of the measures than can follow from the application of the provisions of the Act. However, so far the investigations have not led to concrete action, but the potential is clearly there and has contributed to worsening the climate for trade negotiations.

Concerns have been raised about the possible development of "trading blocs" in both Europe and North America, and their adverse effects on non-participants. On present evidence, there is little basis for such concerns. Much depends, however, on the future evolution of trade policies in both areas, and in particular on the nature of the Community-wide trade restrictions from 1992 which are due to replace the remaining national trade restrictions still imposed by individual countries within the EC. Regional integration should be in line with the objective of maintaining and strengthening the open, multilateral trading system and in conformity with international obligations.

All these developments underline the need for a successful outcome of the Uruguay Round negotiations. At present, this is the main channel through which multilateral trade liberalization can be pursued and expanded, despite the fact that the Brussels Ministerial meeting in December last year has failed to conclude the negotiations. While noteworthy progress has been made during the Brussels meeting on a variety of subjects such as services, textiles, market access, safeguards, although not committing any delegation, agricultural reform has been the fatal stumbling block.

### 4.2.2. Labour markets

There has been widespread recognition that the path to lower unemployment rates lies neither in reducing labour supply, nor in public-sector job creation nor in subsidizing private industry with a view to protecting employment. Hence, in practically all OECD countries' labour-market policies have gradually been re-oriented towards improving efficiency of these markets. Governments have tried, in varying degrees and each in its own way, to increase: i) the extent to which the markets are subject to competitive pressures; ii) the qualification of workers; iii) the incentives for workers to search for jobs; and iv) the incentives for business enterprises to hire workers. The corresponding measures, which had not been easy for governments to take, include:

- Allowing statutory minimum wages to fall in relation to average earnings;
- Paring down statutory restrictions on the freedom of businesses to reduce their work force thereby reducing the risks of hiring;
- Facilitating short-term employment contracts and part-time work;
- Promoting and re-orienting specific income transfer programmes towards linking eligibility increasingly to job search, education and retraining in order to enhance prospects for employability.

In a large number of European countries it has increasingly been recognized that the "permanent" job as an entitlement to secure income in return for performing the same unchanging tasks does not provide an universal model for societies which seek to mobilize their full talents in response to evolving technologies and markets. In order to match the requirements of firms with the demand for jobs of the long-term unemployed and new entrants to the labour force, new avenues of mobility between "non-standard" forms of participation and full-time regular jobs have been developed, e.g. in the form of temporary employment.

Efficiency enhancing labour-market policies can play an important role in mitigating opposition to structural reforms and in reducing the transition cost to individuals. They can then help to lower domestic pressures for subsidies and trade protection. Measures to increase the efficiency of labour markets depend to a considerable degree on the particular ways in which labour-market institutions and practices have evolved. However, the broad directions of future reforms can be outlined in general terms:

- A legal and institutional framework for wage negotiations which ensures that wages adjust to structural changes of demand and supply in industries, regions and skills.
- Social transfer programmes which continue to tighten links between income support and participation in education and employment programmes, so that they lead to reinsertion of workers into the labour market and not to a fall of the most fragile categories of the labour force into dependency or "new poverty".
- Increased efforts of employers and unions to promote opportunities for training and re-training in order to improve life-long learning processes.
- More flexibility in employment contracts and lowering costs of dismissal protection, thereby reducing disincentives for expanding the work force.

### 4.3. Structural reform and future growth perspectives

The general attitude of OECD governments towards structural change has become more supportive in the course of the 1980s. The **role of governments** in the economy has come under close scrutiny with a reconsideration not only of how tasks are carried out, but also of the tasks themselves, and hence where the division between private and public sector activity should lie. The **role of competition** has been enhanced, in particular in several service markets that hitherto had been broadly sheltered against market forces; greater reliance is put on the **role of price signals** to guide individual economic action. The **role of incentives** for the strength of individual efforts has clearly been recognized and gave rise to reforms in tax systems and income maintenance schemes.

Though it has been possible to represent the channels of interaction between microeconomic policy measures and the broader relationships characterizing macroeconomic performance and to evaluate their likely relative importance for a specific country (see, for instance, "Economies in Transition", OECD, 1989), it has not generally been possible to quantify these direct links. To become effective, a policy of encouraging structural change often requires substantial changes in sometimes deeply-ingrained attitudes and behaviour. Furthermore, the state of the art in economic analysis, when applied to broader issues of structural adjustment, does not straight-away allow establishing quantitative micro-macro links. While, or example, applied general equilibrium modelling is well developed and sheds light on the economy-wide consequences of many micro-economic policies, the micro-macro linkages remain a matter of controversy, not to mention the empirical foundations of the models themselves. Furthermore, they do not really grasp the dynamics of the market processes even though this question (i.e. the efficient functioning of the market mechanisms) lies at the center of many structural reforms.

Nonetheless, one may conclude that the conditions have been improved for a more effective interplay between the capabilities and the incentives in a more competition oriented institutional framework. On the basis of the disappearance of several negative factors which have eroded the driving forces for economic growth, the assessment of future growth prospects is one of cautious optimism. In major policy areas, where markets have been opened up and economic incentives redressed and strengthened, increased competitive pressures will erode rents and inefficiencies and stimulate a positive-sum game of "creative destruction". The enhanced international mobility of capital is of particular importance in this process. Market liberalization - such as, for example, the completion of the Single European Market - will harness competition and give rise to dynamic efficiency gains.

Yet, there is no room for complacency: recent events have underlined the need for economies to be flexible in order to adjust rapidly to disturbances in product, labour and financial markets. It is therefore all the more important to maintain the momentum of structural reform.

This applies particularly to issues of trade policy, both in and beyond the Uruguay Round. Trade policy impinges on virtually every area of structural reform, since freer trade - as it has already been highlighted above - stimulates competition and promotes the efficient functioning of all elements of the economic system: hence the importance of clear progress on the large number of issues covered in the Round. Looking ahead, trade policies must be kept as one of the priorities on the structural reform agenda beyond the conclusion of the negotiations.

## 5. PROBLEMS AHEAD - THE THREAT OF MASS

Reduced costs of information have increased the awareness about present and likely future differences in the standards of living between geographic regions. At the same time, reduced transportation costs have given an additional incentive to increased international migration. Political turmoils may strongly contribute to its strength. In general, it is expected that OECD countries, and in particular the European countries, will witness far stronger immigration pressures in the 1990s than they did in the 1980s.

Such pressures are likely to meet rising social resentments - all the more so since the European OECD countries were struck by high and persistent unemployment in the 1980s. Particularly widespread is the feeling that migrants take jobs away from native workers. Furthermore, anxieties about possible anti-social behaviour by immigrants, such as welfare dependency or crime, lead to the politically powerful perception that immigration has already reached a critical level in some countries and that every further increase would reduce welfare. Immigration is thus perceived to be a negative-sum game. Any evaluation of the costs and benefits of international migration has to take into account these social factors.

There is one major reason for increased resistance against immigration, i.e. why more people than before have the feeling that they have something to lose: the prevalence of the welfare state and the dominance of distributional coalitions - to use Olson's term - have made modern labour markets, more rigid and segmented than before. In the environment of heavily protected labour markets additional immigration may be a threat to some distributional coalitions. Given the huge real income differentials between potential emigration countries and the OECD countries, the broad scope of redistributional objectives of government policies in many of the latter makes immigration more likely and, at the same time, more contentious. Free-rider issues and associated budgetary problems are often mentioned in that context.

Economic analysis can help to unmask some misconceptions about the economic implications of immigration. In order to assess the benefits of immigration, it is worthwhile to recall what has been said above about the role that immigrant labour played in the "golden age" of economic performance in OECD countries in the 1950s and 1960s. Not only was the inflow of additional labour absorbed without worsening the position of the incumbents in absolute or even relative terms; it contributed to the strength of the expansion of the standard of living. Immigration was not a negative-sum game, it was rather a positive "supply shock".

All this being said, too much of a "good thing" at a time may finally turn it into a "bad". A "migration of nations" would most probably exceed the absorptive capacity of even the most forthcoming countries. In order to avoid an upsurge of mass emigration, policies that aim at improving the economic prospects in the emigration countries should be pursued. The design and implementation of policies that are conducive to such a development, clearly is in the responsibility of the emigration countries: they have to improve the conditions in their economies in order to attract internationally mobile, investable funds, in particular foreign direct investment, which will in turn help increasing the basis for sustained productive employment. A stable macroeconomic environment in those countries is a necessary condition for this to occur. A reform of structural policies along the lines described in this paper is equally important for lasting success. But the needed reforms in most of these countries, particularly in as yet centrally planned economies, have to go even further. In many instances the basic ingredients of markets such as clear definition of property rights and a legal infrastructure for the establishment of markets do not yet exist. It would go beyond the scope of this paper to sketch out what is needed even in general terms.

The OECD countries could strongly assist in this transition to a market economy in various ways. An important avenue for the industrialized countries to effectively help improving living standards in potential emigration countries is by strengthening their own reform endeavours in those policy areas concerned with direct economic links to the economies of those countries and where to date only limited progress has been achieved - e.g. in international trade and agricultural policies. These could strongly contribute to the birth of new firms and jobs in emigration countries. At the same time, the industrialized countries would also stand to gain from such policies in terms of economic welfare.

In this context it is worth noting that for the first time in recent economic history, the main impetus to trade liberalization is at present coming, not from the industrialized countries which profess to accept liberal norms, but from countries whose past traditions has been to question or reject them. While most of the OECD countries have been continuing to drift in the direction of managed trade, there is now a clear possibility that trade liberalization will become an officially accepted goal in a substantial and growing number of non-OECD countries. The changes that are now under way or in prospect relate to both of the two main groups outside the OECD - the developing countries, and the nations of central and eastern Europe.

In order to support these efforts and to sustain the expectations for a lasting improvement in economic well-being both as a target in itself but also as a prerequisite to reduce migration pressures, OECD countries compliance with the rules of the open, multilateral trading system, including reduced support for agriculture, is important not only in the long run. To bemoan the emerging threat of immigration and, at the same time, sustain a protectionist policy stance is an inconsistent position.

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## COMMENTS AND DISCUSSION

### Timo Airaksinen:

Airaksinen stressed that few economists would disagree with the Soltwedel's presentation and that it was easy to agree with the conclusions and recommendations made in the paper. However, he pointed out that reality and theory were often far apart so he was not quite convinced that a greater opening up of trade would increase competition as radically as suggested. He also asked whether there were differences in the efficiency of the public sector in various countries and whether state-owned firms acted differently compared to private ones. He was of the opinion that Finland was a late-comer with respect to many ideas Soltwedel raised in his presentation.

In addition Airaksinen was concerned about the relative size of the open sector in Finland. He wondered whether the relative share of the total output produced in the open sector was too small in Finland. He asked if Soltwedel had any rule of thumb for the problem of the "right" relative size of each sector. He further asked that since we were in the middle of a major crisis in Finland, what one could do to improve the economic situation. What kind of policy measures are needed to change the trend of a declining relative share of the exposed sector?

### General discussion

Soltwedel responded to Airaksinen by noting that he did not consider it particularly fruitful to worry about the relative share of the total output produced in the open sector. The size of the open sector is related to competition policy issues. If trade were opened up more widely and there were free access of foreign direct investments to Finland, we would find out the "right" relative size of the open sector. Though the manufacturing sector seemed to be rather concentrated and firms in the sheltered sector seemed to have strong monopoly power in Finland, Soltwedel believed that the greater opening up of trade would increase competition considerably. In addition, he thought that the most effective way to find out the relative share of each sector was to let the market forces determine it. He added that even services would be part of the open sector if trade were opened up more widely. There is no fundamental difference between the behavior of state-owned firms and private ones. On the contrary, a public firm should act in a competitive way if it faces the risk of bankruptcy. The bail out possibility only leads to inefficiencies in the market.

Antti Romppanen asked about the possibility to harmonize subsidies within the EC.

Soltwedel did not think that the harmonization of subsidies would be an answer to the problems subsidies were creating in the community. He was of the opinion that in general one should reduce subsidies and increase competition in an economy. He thought that the best thing to do was to get rid of subsidies and transfers altogether. However, he saw a great risk that the trend in the EC might be in the opposite direction. He mentioned three reasons behind his fear. First, the focus of regional policy is shifted from national level to community level, thus the problems are multiplied and the system of transfer payments and subsidies may become even more inefficient. The current use of the structural funds in the EC seems to support this view. Also the EMU creates a tendency to increase transfers. Secondly, a common social policy may lead to increasing transfer payments from the EC's common funds to poorer member countries. Soltwedel thought that increased transfers means an increased burden for the EC. Thirdly, the community's technology policy has increased and will further increase subsidies. As an example Soltwedel mentioned subsidies paid to high-tech projects like TGV and Concorde. Finally, Soltwedel said that if the EC developed the way Leon Brittan wants, there was no big risk that the EC would be a highly regulated market area. Brittan wants the EC to be a free market area in accordance with the EC principles so that the EC would only take care of functions in which it is far superior to individual governments. On the other hand, if the EC evolves the way Martin Bangemann prefers, the direction of the development can be the opposite one.

# SOCIAL DIMENSION IN INTEGRATION

by Pekka Kosonen, University of Helsinki

## 1. 1992 AND THE NEED FOR A SOCIAL DIMENSION

The structural problems with which Western Europe was struggling in the early 1980s were diagnosed as 'Eurosclerosis'. As we know, sclerosis refers to an induration or hardening of the arteries, a condition which is often fatal. Flexibility and deregulation, subsequently, became fashionable. In this atmosphere the European Community launched its internal market programme in order to make possible the free mobility of commodities, capital, services and people within the entire EC area. The 1992 rhetoric has had strong neo-liberalist overtones: free mobility of commodities and capital will solve all the problems of economic growth and stability.

New strategies have been developed not only in the EC, but in other organizations and areas as well. After a period of regulation and state intervention, neo-liberalism gained favour. Neo-liberalism embodies also a profound transformation in the mechanisms for governing social life. The public provision of welfare no longer appears as a vital part of a programme for political stability and social efficiency. In place of collective provision and social solidarity, the new rationality of government proposes notions of social security provided through the private purchase of insurance and health care by individuals. Here as in other respects the new accumulation strategy is based on market forces.

However, I shall argue that also this new accumulation system must have its social and political preconditions, even though these may be very different from what they were earlier. Deregulation as such does not fulfill the need to generate new types of flexible production. Like all production systems, it should be based on a coherence of financial and labour markets as well as innovations. From the social point of view, the neo-liberal programme may lead to rather traditional types of competition, where low labour costs are decisive, rather than to the creation of new innovative and flexible production systems.

The ongoing *debate on the so-called social dimension* of the internal market can be interpreted to highlight the need for new social and institutional arrangements within the EC, although the shape of these arrangements is still an open question. To compensate for the social and political consequences of the establishment of the internal market, first the European trade union movement and subsequently also the European Commission have given increased attention to issues such as unemployment, regional differences and social cohesion of the internal market.

The background to this attention is the fact that differences in the quality and style of social policy within the European Community are great. The systems differ in the scope and level of benefits, the stringency of protective labour legislation, the mode of financing -- whether by employer/employee contributions or by the public sector --, and according to whether they are based on law or collective agreement. The southward expansion of the EC in the 1980s made it even more heterogeneous (Mosley 1990).

The discussion on the social dimension has also been spawned by the view that the internal market might lead to a situation where the member states compete among themselves with social costs in order to bring their national businesses in a favourable market position. It is also anticipated that a strengthening of the conditions of competition may lead to a situation where labour moves to areas where welfare policies are relatively generous, while capital moves to areas where obligations, fees and social costs are relatively low. These are the questions and fears which are connected with the so-called social dumping. In response to these thoughts, it has been pointed out that differences in social costs also reflect different productivity levels, which offset part of the comparative advantage of low cost areas; high cost economies have compensating advantages, in particular, in technology-intensive industries.

The term 'social dimension' when applied to European integration denotes no precise concept with clearly defined substance. Rather, it is a catch-word which loosely refers to questions of employment, social security and regional disparities. For instance, an interim report of the EC on the subject only lists the main aspects of the social dimension, which are (a) guaranteeing conditions for genuine freedom of movement of persons within the EC, (b) anticipating and coping with the social changes brought about or speeded up by the completion of the internal market, and (c) a European system of industrial relations. (The Social Dimension... 1988, 11-13.) Characterizations may differ depending on the situation and context.

In addition, there are different opinions on the scope and content of the social dimension in the EC. These, in turn, reflect opposing viewpoints on the integration process, sometimes called negative and positive integration.

According to John Pinder (1991), the removal of barriers may be called '*negative integration*' and the making of common policies beyond that termed '*positive integration*'. Examples of positive integration provided in the Rome treaty are the European Investment Bank and the Social Fund for the purpose of economic and social cohesion, and the common agricultural policy with its aim of a better life for farmers. Also the internal market programme includes targets such as suitable standards of health, safety, environmental and social protection. Economic and monetary union likewise combines negative with positive integration.

Even if positive and negative integration are intertwined in the 1992 programme, it is evident that positive integration has remained weak, at least in social issues (Leibfried 1991). In the case of negative integration, European unification will take place without a social foundation, but will rest, on the contrary, on a market-oriented foundation of 'possessive individualism'. In the more uncertain case of positive integration European unification would instead attempt a synthesis of civil, political and social rights on a European level.

The effort to enlarge social rights in the EC is weakened by the fact that there are various and partly opposing opinions on the need for such regulation (Hagen 1990). These opinions may first be divided into two groups, termed market optimists and regulationists; furthermore, these groups are also internally heterogeneous.

(a) The first part of market optimists seems to think: "*the social dimension is undesirable*". This is so because all forms of regulation imply market rigidities and diminishing efficiency. National autonomy and diversity should be allowed for in social policy matters. This opinion is best represented by the British government.

(b) "*The social dimension is unnecessary*", is the viewpoint of another group of market optimists. National differences in social entitlements reflect, or at least should reflect, national differences in productivity and economic resources. This has been the leading ideology in the EC social policy thus far. It can, furthermore, be justified by the opinion that the functioning of markets, rather than political regulation, shall harmonize differences in wages and social entitlements in the long run.

(c) "*The internal market should be complemented by a social market economy*" thinks one part of the regulationists. Markets alone are not able to solve social problems; on the contrary, they may deepen. In a social market economy workers' rights should be established by clear regulations in order to avoid social competition between countries. This is the opinion of the European trade union movement, in particular in the Northern part of Europe.

(d) The slogan of the second group of regulationists might be: "*from national welfare states to a European welfare state*". According to this point of view, a comprehensive and coordinated social policy on the EC level is needed in order to ensure that the benefits of the internal market shall not be divided too unequally between areas and societal groups. This social dimension should include not only workers but also people outside the labour market.

There are inherent problems in all the viewpoints mentioned above. The market optimists tend to forget the social and institutional foundations of market forces, and therefore they do not see the importance of social rights in the establishment of the internal market. On the other extreme, the idea of a European welfare state is very far from existing realities, examples of which are the national diversity and the labour market orientation of the EC social policy. Finally, the social market economy seems to acknowledge these realities, but it would leave many essential social problems outside the labour market unresolved.

In any case, the shape of the social dimension will depend on the outcome of some hard political bargaining, if not outright political confrontation between the market optimists and the regulationists -- or minimalists and maximalists --, which are not very ready to compromise on the issue (Taegue 1989).

Thus, Social Europe and the social dimension of integration are still very much catch-words in symbolic politics pointing at the social foundation of integration without really building its structural preconditions. Some steps have nevertheless been taken in the EC social policy.

## 2. NEW ISSUES IN THE EC SOCIAL POLICY

Since each European social security system has been established in a different set of historical circumstances and inherited different sets of traditions and priorities, a complete harmonization of these systems within the European Community has been regarded impossible. The main emphasis has been on the free movement of workers. However, there have been increasing demands to create some kind of common social legislation in the EC in order to formulate some minimum standards concerning workers' rights. In 1974 the European Commission launched the Social Action Programme which set out three broad principles to guide future Community action in the social sphere: full employment; the improvement of living and working conditions; and participation of workers in economic and social decisions. Economic and political difficulties prevented the achievement of these targets, but social legislation has been extended in at least three social policy issues: equal opportunity for women, labour law and reform of the structural funds (see Teague 1989; Mosley 1990).

*Equal opportunity for women* has been the area in which EC social policy has perhaps had its greatest impact. This is partly the result of decisions of the European Court of Justice. In addition, a number of EC directives on sex discrimination in employment have been adopted since the mid-1970s, including the equal pay directive and several equal treatment directives prohibiting discrimination in social security programmes and occupational benefit schemes and with regard to access to employment. Despite these important directives, in reality the position of women in employment is uncertain in many EC countries.

The EC has also adopted several directives regarding the field of *labour law*. These include directives on occupational safety and health as well as directives on the approximation of the laws of the member states relating to collective redundancies and transfers of businesses or parts of businesses. However, a number of labour law directives proposed by the Commission have not been approved by the Council because of the requirement of unanimity in these issues.

In the late 1980s, a major *reform of the structural funds* such as the European Social Fund, the Agricultural Fund and the European Regional Development Fund was implemented. These funds have focused on regional disparities within the EC and on youth unemployment and long-term unemployment. The current reform is a response to increasing regional disparities and the prospect that the internal market programme may unfavourably affect the economies of the less developed regions. The funds shall be integrated in order to concentrate on a few specific objectives rather than on a number of heterogeneous ones, as has traditionally been the case. The expenditure of the structural funds shall be expanded, and channeled in particular to the less developed states as well as to the regions 'seriously affected by industrial decline' within the EC.

The Commission made also many other proposals, e.g. on working time and worker participation in the 1980s. These were rejected in the name of flexibility, although the Commission argued that some form of worker involvement (even if limited to information and consultation) was essential to the success of enterprise flexibility, and that there was no inherent contradiction between greater flexibility and EC regulation to ensure the social welfare of the labour force (McDaid 1991, 55). The major clash was between the deregulation stance of the British government and the social protectionist aims of the Commission. These contrasting views resulted in a complete impasse on the social legislation in the early 1980s.

Thus, some expansion of the EC social policy was made already before the 1992 programme and before the debate on the social dimension of the internal market. Yet many initiatives were rejected in the 1970s and 1980s, and social legislation in the EC has remained rather ineffectual in many fields. A new phase in the EC social policy may be opened in the 1990s with the help of the Social Charter and the Social Action Programme.

In order to resolve the stalemate on whether or not there should be a legal dimension to EC social policy, Jacques Delors put forward the concept of *l'espace sociale* (social area), which generated many different interpretations. In any case, it helped to initiate a 'social dialogue' between employers and trade unions, the so-called social partners, with the purpose of establishing common agreements on various employment and work-related issues. A first step in this direction was the Val Duchesse experiment, entailing joint opinions on economic policy and new technology. On the other hand, discussions on the social dimension of the internal market intensified, and various proposals to develop a social area in the EC were made in the late 1980s. (Teague 1989, 68-86.)

The centerpiece of the EC social policy came to be the so-called *Social Charter*. The Community Charter of the Fundamental Social Rights of Workers was adopted by the European Council in December 1989. However, it must be remembered that the British government refused to adopt the Charter, and that it is a political declaration which is legally non-binding, a 'solemn declaration of intent'.

The Charter asserts the fundamental social rights of workers in the following fields: freedom of movement; employment and remuneration; improvement of living and working conditions; social protection; freedom of association and collective bargaining; vocational training; equal treatment for men and women; information, consultation and participation for workers; health protection and safety in the workplace; and protection of children and adolescents, the elderly and disabled persons.

The European Commission made also a detailed Action Programme relating to the implementation of the Charter. The Action Programme contains 13 chapters corresponding to the various sections of the Charter. Thus, it is obvious that the Commission intends to develop new social and labour legislation in the near future.

For the Commission, 'coherence' has been a more appropriate term than 'unification' or 'harmonization' to explain the main objectives in the social field. Recently, the Commission has placed emphasis on three principles guiding its action in social policy (Spyropoulos 1991):

- first, the need to propose realistic and convergent objectives, i.e. objectives which may get unanimous support from both member states and the social partners;
- second, using the most appropriate instruments when seeking coherence in the social field;
- third, avoiding the resolution of any question at the EC level which could be better dealt with at lower levels. This is generally called the '*subsidiarity principle*' in the EC. The idea of subsidiarity implies an emphasis on decentralization, diversity and national sovereignty. In a wider socio-political usage, subsidiarity is based on a view of society in which responsibilities are conditioned by the closeness of people's relationships and networks; this principle is generally attributable to the influence of the Catholic Church, which still is strong in many countries of Southern and Continental Europe (Spicker 1991). In the EC, the subsidiarity principle has been accepted as a compromise in order to facilitate negotiations between various countries and social partners.

However, it is a matter of dispute in which issues in the social and labour field the Council should act according to a qualified majority and in which issues unanimously. The possibility to act according to a qualified majority was introduced in the Single European Act in questions of establishment and functioning of the internal market, excluding however issues relating to the rights and interests of employed persons. In addition, a qualified majority was accepted in questions of the health and safety of workers. Beyond safety and health at work, most directives in social policy and labour law should thus be adopted unanimously, which explains that there has not been very much progress in these fields. Of course, a wider interpretation of the Single Act has been suggested, and there are also plans to modify once again the EC treaty (Spyropoulos 1991). This modification was made to some extent in Maastricht in December 1991, but in the social field the situation remains rather unclear.

In any case, in 1990 and 1991 the Commission has prepared many drafts corresponding to the initiatives in its Action Programme. These include draft directives concerning certain forms of 'atypical' work, extending the rights of part-time and temporary employees; a proposal to create a uniform level of social security for pregnant women; a proposal to establish a European Works Council in Community-scale undertakings, etc. Many initiatives have been made, but the adoption of them depends on the degree of unanimity within the EC.

One issue of concern in the EC is related to *poverty and marginalization*. The first poverty programme in the 1970s and the second programme in the 1980s have at least revealed the severity of the problems. In 1990 the Commission launched a new programme towards the 'integration of the least privileged groups in society', Poverty-3. It is a programme to combat poverty by establishing about 40 projects within the local communities. These projects should build on a partnership between public and private institutions, and they should involve an active participation from the poor themselves. These principles are in congruence with the newest social policy ideas such as public-private mix in social welfare (Abrahamson 1991).

One of the reasons for the establishment of these poverty programmes has been the acknowledged fact of increasing poverty rates in the EC. An insufficient income is of course only one of the aspects of poverty, but it is the common denominator of all poverty situations and can therefore serve as an indicator of the extent of poverty. The poverty line is often defined as 50% of the average disposable income per head in the country in question. According to the newest estimates of the Commission, there were 50 million poor persons in the EC in 1985, corresponding to 15% of the total population, a very high figure indeed. There is, however, wide variation between the member states. The poverty rate of Belgium was 6% and that of Denmark 8%, while the rate of Portugal was as high as 33%. (Final Report... 1991.)

These proportions change if the poverty line adopted is the EC average instead of the national average. The income of each individual is then compared with the average disposable income per head in the twelve member states as a whole rather than in the country concerned. Using these definitions, 70% of the Portuguese population but only 2% of the Belgian population in 1985 was poor (Final Report... 1991.)

What these estimates prove, irrespective of the exact figures and definitions used, is that the debate on the social dimension of integration is related to actual and factual problems in the face of deepening integration in Europe.

## 3. FINLAND, THE EC AND THE SOCIAL DIMENSION

What impacts shall the European integration then have on Finland and in particular on the Finnish welfare state? It is by no means an easy task to analyze this impact, since there are many structural and political factors which may have an effect on the welfare state development, but some viewpoints can be given.

*Poverty rates* may exemplify the differences between welfare state systems. Unfortunately, the poverty rates of the EC study cannot be directly compared with those of Finland. However, some international comparisons show that poverty rates are lower in the Nordic countries, especially in Norway, Sweden and Finland than in the EC group. In the early 1980s, Norway and Sweden had a low poverty rate of 5%, while Finland had a somewhat higher rate, close to the level of Germany, but lower than in Britain (Gustafsson & Uusitalo 1990).

What, then, explains differences in poverty rates? Because relative poverty is an aspect of income distribution, poverty can be diminished by redistribution of incomes. International comparisons show that the redistributive impact of transfers and direct taxes is stronger in the Nordic countries than in Central and Southern Europe, and this is the decisive explanation for the divergence in poverty rates.

Currently, the Finnish welfare state may thus be equated with the Scandinavian welfare states. Historically, however, Finland was a late-comer in the welfare state development. True, minimum pensions were adopted in the late 1930s, and many social reforms were established after the second world war. Yet the level of social expenses remained low by international standards until the 1960s or 1970s, and some important reforms were accepted late. In fact, Finland was the last Western European country to legislate sick-leave provisions. In the 1970s and 1980s then the Finnish welfare state reached the level of other Western European countries, although, for example, social expenditure in relation to GDP remained much lower than in some highly developed welfare states such as Sweden or the Netherlands.

Some 'Scandinavian' features of the Finnish welfare system may be mentioned. In Finland, as well as in the other Nordic countries, public employment as a proportion of total employment is much higher than in the EC. The Nordic countries may therefore be designated as public service states, whereas the EC member states are mostly transfer states with a predominance of cash benefits and other transfers. Another difference concerns the universality of social insurance in Western Europe. In the EC, social entitlements are more connected to one's labour market position than in Finland and the other Nordic countries, where all citizens are entitled to basic social security independent of their position in the labour market. In addition, the Nordic welfare systems offer more generous schemes than the British, which are basically universal, but modest; and the Nordic systems are more socially redistributive than the German system which tends to be more status-preserving (e.g. Palme 1990).

In the 1990s, however, *the Finnish welfare state seems to face great problems* concerning mainly the financing of social policy during a period of economic recession. The slump cannot be traced back to high social expenses in Finland, since their level is not very high by international standards; however, a weak economic development shall certainly have an impact on social security arrangements.

In this situation the European integration process creates another challenge to the welfare state development in Finland. Participation in the EC integration is regarded important in order to safeguard the interests of the Finnish economy. There are, however, open questions concerning the consequences of integration for the welfare state. Two important issues are: the contradiction between social security and competitiveness, and the harmonization of indirect taxation.

The relation of social security and competitiveness refers to the importance of labour costs, including social benefits, on open markets. As mentioned earlier, high cost economies may have compensating advantages in technology-intensive industries. In any case the question of labour costs is very topical in Finland at the moment. In addition, the growing internationalization of enterprises will improve their bargaining power, and with their 'exit option' they may exert downward pressure also on social costs. Second, harmonization of taxation may lead to a reduction in public revenue from indirect taxation, in particular in countries with high tax rates and excise duties such as Finland.

In the long run, *the social dimension of integration might be connected to a convergence of welfare systems* in Western Europe. The decisive issue would then be the direction of this convergence.

Responsibility for the development of social policy will very likely continue to be placed at the national level in Western Europe. Despite this fact, some common trends may be discerned. One major trend seems to be in the direction of the Continental or German welfare model, including earnings-related welfare schemes closely linked to employment and status on the labour market, and schemes based on own contributions rather than tax financing.

It can be argued that this 'German model' gained ground in the Nordic countries already in the 1980s (see Kosonen 1991). There have been pressures to differentiate universal services in health care and day care. Another example is the expansion of occupational welfare, i.e. insurance and welfare service systems associated with the workplace. Substantial groups of income-earners have also received large amounts of welfare benefits in the form of fiscal welfare, mostly as deductions of interest on loans (although these deductions have been reduced in Finland somewhat). All this means that public and private systems are more and more interwoven in the Nordic welfare states.

This change of the Nordic models may be intensified in the new Europe in the 1990s, leading to some kind of convergence of the European welfare models. This would, however, not be an outcome of intentional harmonization policy within the EC, but rather a result of an interplay of external and internal pressures.

This kind of convergence may nevertheless embody an interesting contradiction from the point of view of the internal market programme (Kuhnle 1991). If welfare schemes are more closely tied to occupation and firm, welfare rights are not so easily transferable. But if this is the case, it will curtail the free movement of labour which is regarded as one of the fundamental principles of the internal market. This convergence seems to imply a reduced role for the state in welfare issues and to entail an increased role for occupational company-based welfare, which subsequently may lead to less labour mobility because of more fragmented and complex systems of welfare rights. This would be a contradictory development indeed.

## 4. TOWARDS A FLEXIBLE FUTURE

It is certain that there is need for greater flexibility not only in production and distribution of commodities but also in production and distribution of public provisions. This challenge is felt in the 1990s in Finland as well as in other European countries. European integration is likely to accelerate this development towards increasing flexibility. As mentioned above, flexibility entered the political agenda when the 'Eurosclerosis' diagnosis gained favour, and the establishment of the internal market after 1992 can be seen as a part of the cure for this disease.

In the beginning, the neo-liberal conception of flexibility dominated discussions. Recently, however, more nuanced conceptions of flexibility and more consensual approach to flexibilization have gained prominence. The neo-liberal thinking conceptualizes flexibility as responsiveness of market agents to price signals; institutions that restrain these responses are seen as rigidities. This thinking fails to see the fact that institutions are needed to reduce uncertainty and guide expectations in order to make individual adaptation possible and that technological innovation requires institutions for learning. In consensual approaches to flexibilization, especially the role of socio-political innovations is emphasized. (Nielsen 1991.)

The ongoing debate on the social dimension of the internal market may be interpreted against this background. Since the late 1980s there has been an increasing awareness of the importance of stability and security as preconditions for increased flexibility, and in the EC this awareness has been termed the social dimension. It is, however, a matter of long disputes between the social partners what this dimension really will incorporate.

New strategies and flexibility are sought also in Finland and in the other Nordic countries. Instead of neo-liberalism these countries have followed some kind of neo-corporatist strategy, where social security arrangements and public services have been seen as significant preconditions to economic development. In the new Europe of the 1990s these countries will follow the EC countries in many respects, but it is likely that they will not totally dismantle their welfare systems; instead they will strive to maintain and reorganize them in order to create institutional preconditions for economic development.

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## COMMENTS AND DISCUSSION

### Peter J. Boldt:

First, Boldt wanted to make clear that the whole concept of the social dimension of integration, as linked to the 1992 programme and the internal market, was a trade union idea. Early in 1986 the European Trade Union Confederation ETUC asked for a red paper in order to develop a social dimension in parallel with the white paper in the internal market. Without strong trade union pressure and widespread support in the European Parliament there would be no debate about the social dimension, nor any Community Charter on Fundamental Social Rights for Workers, or its work programme.

Boldt was of the opinion that the free market forces and the profit maximizing enterprises did not by themselves produce goods that were usually connected to the social dimension, i.e. better working conditions, more industrial democracy, lower unemployment, cheaper and better goods, further development of the welfare state, further improvements in the environment and so forth. These can be guaranteed only through common decisions, by law or agreements, which set out the rules of the game for the market forces.

In addition Boldt thought that security created flexibility but fear promoted rigidities. Most people are afraid of changes but in a rapidly changing world the faster a firm reacts to changes the better are its possibilities of success. In the Nordic countries, the employees are less afraid of changes, as they know that unemployment, at least for those who are members of the unions, usually does not lead to economic catastrophe. This is due to unemployment benefits, the social security network, and welfare services which cover all citizens and are mainly financed jointly, from the tax revenues. Also active labour market policies help people gain the new skills needed and make regional and occupational mobility easier.

According to Boldt it is clear that in many circumstances deregulation at the national level must be followed by regulation at the community level. There was a need for common minimum rules in such areas as the taxation of capital gains, because the free movement of capital and market forces would lead to competing tax reductions between the countries in order to attract foreign capital and retain domestic capital. Also for many unions, especially in the Nordic countries, the natural thing would be to arrange labour market questions through collective agreements at the community level. This is also called double subsidiarity.

The trade union movement in Europe has been advocating coordinated action for growth and employment. However, there is still need for national anti-cyclical policy. The ups and downs in the Finnish economy, which is heavily dependent on pulp and paper in its exports, are clearly different from, for instance, the business cycle in Germany. If wage negotiations were conducted at an European level, Boldt wondered if there would be room for nothing but contractive economic policies at the national level.

Boldt agreed with Suvanto's view in the morning session that the room for economic policy at the national level was already limited. Especially, this concerns the exchange and interest rate policies. In addition given the free movement of capital and persons and the possibilities to move production from one country to another, there is not much room for increasing taxation. The trend in tax policy will in fact go in the opposite direction. Thus the main burden falls on fiscal policy. However, as the French experience shows an economic policy for growth and employment in one country is doomed to fail. But if economic policy is backed by the wage policies - an incomes policy - the room for maneuvering can increase. If the trade unions correctly understand the link between wages and employment and get rid of money illusions, low nominal wage increases may create the necessary confidence in the business community so that interest rates can be stable despite an expansionistic fiscal policy.

## General discussion

Soltwedel wanted to know who provides social security for example during shocks. He was of the opinion that an individual flexibility was in a key role. He added that since social security was a public good it was also a society's responsibility to provide a basic insurance for the citizens. However, this can be done only in a society which is not already overburdened before the shock. Soltwedel agreed that it was possible to deploy economic tools to achieve social goals, but he wanted to stress that one could always use inappropriate and inefficient tools and thus make things worse.

Soltwedel pointed out that efficiency and equity could go hand in hand so that the economic efficiency did not exclude the social security. He commented on the concept of poverty Kosonen used in his paper by noting that there were other definitions for the poverty line. In addition he wanted to stress that one should know how long people stay in lower income brackets. If there were a lot of people trapped in lower income brackets, one should really pay attention to breaking up the segmentation. If there is a strong upward mobility of people from lower income brackets to upper ones, the poverty line problem is not a very severe one.

## PANEL DISCUSSION:

Chairman Seppo Leppänen and participants Peter van den Berg, Reino Hjerppe, Sixten Korkman, Pekka Kosonen and Rudiger Soltwedel.

Seppo Leppänen opened up the discussion and asked all the participants to address the meeting in alphabetical order. In the first round he asked the participants to bring up special topics which were not sufficiently dealt with earlier in the workshop and which the participants found interesting and relevant from the seminar's point of view.

**Van den Berg** got back to the devaluation problem. He realized that the current economic crisis in Finland is a severe one and that the collapse of the Soviet trade is one of the main reasons behind it. He noted that if there is a decrease in economic welfare in Finland there is also a need to adjust real wages downward. If this adjustment is done by devaluing the Markka, which easily leads to a price-wage spiral, it is not the right strategy to follow. On the other hand, if it is not possible to decrease nominal wages because of social and political reasons, then a devaluation is the only possible way to reduce real wages, provided that one is able to control price and wage increases even though import prices increase after the devaluation. To be useful, this option requires a presumption that economic agents suffer from money illusion to some extent.

**Suvanto** repeated his remarks from the morning session by saying that one can lower real wages by using devaluations and it usually helps in the short run. However, there is always a risk of wage and price increases so that there is no permanent decline in real wages. In this case a devaluation is not useful alternative to lowering real wages.

Today financial market reactions are an important factor to be considered. Suvanto reminded the participants about the earlier realignment cases within the ERM, which van den Berg mentioned in his presentation, noting that these realignments were fairly modest and still they created considerable interest rate differences among the member countries. In addition he noted that it would be very difficult to make a commitment to fixed exchange rate credible after the devaluation. The devaluation increases import prices and the precondition that consumer prices are not affected is that some other prices have to decline. Usually, the devaluation does not affect the price level immediately, but rather over a longer period of time. It starts an inflation process, which in turn affects wage demands, interest rates and so forth.

**Hjerppe** noted first that the discussion earlier in the workshop had been very interesting and fruitful, and especially the foreign guests had made suggestions and brought up topics that are very relevant and useful in the current Finnish economic discussion. For example, he found it very interesting to hear about the experiences from the Dutch devaluations van den Berg brought up in his presentation. Hjerppe thought that expectations play a central role in the devaluation process, but it seems that there are people in Finland who put less emphasis on this aspect. They obviously think that the economic situation in Finland is such that it would not generate expectations of further adjustments if the Finnish Markka were devalued. He noted that van den Berg made it very clear that the devaluation generates expectations of further adjustments of the currency and that these expectations seem to prevail for a surprisingly long time. Finally, Hjerppe pointed out that the EMU would bring an end to exchange rate speculations and change the economic environment. Economic agents would be forced to change their behaviour, especially in a country like Finland.

**Korkman** made some general comments on the orientation of macroeconomic and stabilization policies in Finland, and particularly the role of fiscal and incomes policies. In the past decades full employment was one of the main goals of the economic policy in

Scandinavian countries. This was to be achieved through active labour market policy or active fiscal policy or discrete devaluations, whichever was considered to be the most effective way.

Now we are moving away from this so-called Scandinavian economic model and related features, partly because of the European integration, but also because of other reasons, some of them ideological. The model we are moving towards puts less emphasis on the social welfare state. Most European countries have already for a decade been fighting with the process of fiscal consolidation and trying to constrain the growth of public expenditure and to reduce the relative size of the public sector. Further tax competition will without a doubt lead to tax reductions. More emphasis will be put on the flexibility of markets; labour markets and other markets as well. Well functioning markets are considered to be the key to success in the future. As far as the stabilization policy is concerned less emphasis will be put on discretion. Instead one wants to have a stable macroeconomic framework with the emphasis on rules. Stable macroeconomic conditions can be realized, for example, through fixed exchange rates or the EMU. On the whole, key concepts in the future will be well-functioning markets and a stable macroeconomic framework.

Korkman noted that all this happened in Europe back in the 1980s, and Scandinavia has been lagging behind. However, during the 1980s in many respects Scandinavia was very successful, especially the level of employment was much better than in Western Europe. This is partly because the public sector was growing strongly during the 1980s in the Nordic countries. This rapid growth can only be a temporary phenomenon. It seems that now the growth has reached its limits and the size of the public sector has become a problem in Scandinavia. We must reverse the direction of the development and it will be a very painful process.

The second reason behind the favourable trend in employment was the deregulation of the financial markets. This deregulation took place in Finland during the second half of the 1980s and it created a very strong domestic boom. Although it created all kinds of trouble, it sustained investments, consumption and employment at a high level. A third reason behind the favourable progress during the 1980s was that Scandinavian countries have devalued their currencies whenever needed to improve their competitiveness. It is questionable if this has been a successful strategy. Korkman thought that Scandinavian countries have been able to improve their competitiveness and profitability to some extent by combinations of devaluations and fairly strict incomes policies. But all these temporary means have been exhausted and we have to alter the course of the economic development in Scandinavia. It is probable that, since the policy measures used in the 1980s are not applicable anymore, the high unemployment rate we are currently experiencing will be a persistent feature throughout the 1990s in Finland. How effective the incomes policy can be in more difficult economic circumstances in the future remains to be seen.

**Soltwedel** noted that one of the main reasons behind the structural policy reform was the budget pressure, the need to consolidate and the recognition that the course of the public sector development needed to be changed. For example, it was not possible to pursue full employment policy at neither the micro nor macro level. Budgetary pressures certainly play a crucial role if there is no more money to spend. New ways to proceed must be found, privatization probably among them. Use of market mechanisms should be increased and the incentive structure strengthened.

Soltwedel asked about the revision of the employment act in Finland. If the act stands and the measures called for by the law are carried out, it would spur budgetary pressure in the public sector. Indeed the public sector is obliged to do something if the regional spread of unemployment is uneven or the youth unemployment increases. However, this law means that the public sector buys unemployed workers out of the market and it is very probable that this would lead to budgetary problems in the public sector. Soltwedel considered this law as an old-fashioned labour market policy. He asked if there were any plans to change the law and what the policy stance will be after the probable changes.

According to Soltwedel the maintenance of the social policy objectives is becoming far too expensive also in Scandinavian countries. As an example, he mentioned the health care system and housing subsidies paid in Sweden. He wondered what the situation in Finland is and whether we will respond to the need to increase the public sector efficiency in these areas.

He also noted that migration will be without a doubt a major problem for Europe in general, and particularly for Germany and Southern Europe. For example, the figure of people seeking asylum in Germany is skyrocketing. Generally the migration will probably be from east to west and from south to north. He wondered what the situation is in Finland and how it will be changed in the future. He asked if the Finnish people consider the probable immigration to Finland as a positive or a negative sum game. As a positive sum game he found the strong immigration to Europe during the 1950s and 1960s which speeded up the economic growth. Immigrants were the flexible part of the labor force and thus a major source of the economic growth. In an economy one needs labor mobility to be able to exploit growth possibilities. Migration is one way to increase mobility, while at the same time it challenges old-fashioned attitudes. Soltwedel himself took the immigration to be a positive-sum game. He added that if one looks at the demographic features in Finland, it seems that in the future Finns will have to give up a bit of their inclination toward a homogeneous society and accept more heterogeneity.

**Hjerppe** asked Soltwedel's opinion about the claim that one of the reasons behind the success of German export sector during the past decades was the fact that Germany consistently and intentionally kept the D-Mark undervalued. Secondly he agreed with Soltwedel's notion of the efficiency of the public sector. He noted that the efficiency of the public sector was becoming very important also in Finland. In Finland we used to think that the public sector spending was relatively controlled, its relative share of the GDP was around 40 percent. During the current economic slump this share jumped quickly up to 50 percent level since the private sector's share of the GDP went down. This is of course mostly a cyclical phenomenon. However, it is not certain that we can get back to the 40 percent level very quickly. It seems that in the future more emphasis will be put on the effectiveness of fiscal policy since there will be no role for monetary policy. A careful cost-benefit analysis will a typical feature of the public sector functions in the future.

Hjerppe considered migration as a positive factor for the Finnish economy and took it to be a positive-sum game. Taking into account the demographic factors in Finland it is likely that we will need labour from abroad in the future. On the other hand, Hjerppe was rather skeptical about the benefits of the foreign labour force since we are very inexperienced in dealing with it in Finland. As a matter of fact currently the share of the foreign labour force in Finland is the smallest among the western European countries. Thus he warned us not to be too active in the immigration policy or it would create problems for practical reasons and because of the attitudes in Finland. He nevertheless saw immigration as a positive factor for the Finnish industry. For example, there is a tremendous amount of inexpensive and educated labour available near Finland. He considered this as a big competitive advantage for us and it will probably be exploited in the future.

**Korkman** agreed with Soltwedel's view of the need to consolidate government budgets in Finland, which is facing what the rest of Europe experienced a decade ago when various countries ran into severe financial difficulties in the public sector. These countries found it necessary to consolidate budgets and to turn around the trend of the development. This very difficult process is ahead of us in Finland. We have to put much more emphasis on the efficiency of the public sector in the coming years. As a matter of fact various measures are already being implemented in Finland. For example, a steering system has been developed for funding local government expenditure via revenue sharing so that these authorities get better incentives to increase economic efficiency.

Fiscal policy is incurring some difficulties because of the need for budget consolidation. At the same time the fiscal balance is deteriorating due to the deep economic slump. All this implies that we need to have an incomes policy pact. It remains to be seen whether the Sorsa proposal materializes. Unfortunately, to achieve the agreement the government was asked to spend a few billions here and there and this increased the deficit of the general government by about 1 percent of GDP. This year state-owned and also private firms will have sizable losses and the government is going to cover some of these losses through the budget, further increasing the budget deficit. All this works against the process of budget consolidation, but anyway it will not detract us from the general trend that in the coming years the public sector's share of the GDP must decrease and we have to get a better control over the large budget deficit.

Korkman found migration to be a positive-sum game for Finland, from both the immigration and the emigration points of view. It is a benefit for Finns to go to Europe or some other places to work and gain experience and bring it back to Finland. He also agreed with Hjerppe's view that the well educated people in the nearby areas in Russia and in the Baltic countries offer a competitive advantage for Finnish firms already in the near future and also in the long run when we probably need labour force from abroad. About the employment act Korkman noted that there are people in the Ministry of Finance who thought that it was a problem that would be solved by itself simply because we could not afford it any more. There is no way we can retain that act. As a matter of fact there are already municipalities who can not do what the law says. There is a proposition made by the government to change the law to reduce costs caused by the law. However, the drastic increase of the unemployment rate this year will further increase public sector expenditure.

**Soltwedel** responded first to Hjerppe's notion about the undervaluation of the D-mark. He noted that it was always difficult to make an assessment whether you were overshooting or undershooting or whether you were at the equilibrium. For the time being he thought that, instead of an undervalued D-mark, the current risk was an overvalued D-mark.

However, if you look back at history, Germany did not repeat the mistake the UK made after the First World War when it returned to the prewar gold parity. Germany instead apparently had a relatively weak currency during the 1950s. The growth record and the productivity increases were so high compared to other countries that the result was an undervalued currency. This phenomenon became to known as currency dumping in the 1960s. Germany's targets for stability were narrower than, for example, the inflation changes in the trading partner countries. These countries' higher inflation rates created a continuous pressure on the D-mark. This was a problem from Germany's point of view and it led to several appreciations of the D-mark. Thus the question in Germany was whether a flexible exchange rate was better than a fixed one. The Kiel Institute and the German experts council took a fierce position in the question. They argued that German had to opt for the flexible exchange rate to maintain the stability objectives. Looking back over the past couple of decades there have been recurrent periods of an undervalued currency in Germany and an export led growth in that context, but this was no longer a problem for the current exchange rate relations in the ECU basket. Recently, there has been quite a strong real effective appreciation of the D-mark.

**Kosonen** called attention to the social and institutional foundations of the so-called Scandinavian economic model. Social and institutional foundations include a rather stable political environment, strong labour movements with centralized wage negotiation processes and highly organized interest groups in all areas of social life. These strong institutional foundations are behind the Scandinavian welfare model Kosonen described in his presentation.

He wondered what the integration process would mean for these foundations. It seems that these foundations are already going through radical changes in the Scandinavian countries: for example, the recent election in Sweden brought about substantial political changes. If the capital is going international very rapidly, it is not interested in finding "domestic" solutions to welfare issues in Scandinavia anymore the way it used to be earlier. Changes in these foundations may be as radical as the changes in economic policy issues which were outlined by Korkman. Some of the changes in economic policy issues may be temporary, but changes in the social and institutional foundations are probably not just temporary phenomena but rather very decisive in the long run. This would certainly mean a rather different model for the Nordic countries compared to the current welfare model.

Kosonen asked van den Berg to elaborate a little bit on the role of the social innovations in the integration process he brought up in his presentation. He wondered whether van den Berg was of the opinion that no one formula should be taken to be the key to the success in the integration process but rather a combination of two or more formulas. In addition he thought that it was in the social dimension where the coordination type of formula was needed more than before and probably there were areas where the free market formula was more suitable. In some areas maybe a combination of these two formulas would work well. Finally, he wondered if van den Berg could name social innovations that were needed during the process of integration and innovations that were needed in the future if and when Europe was integrated. Or is it so that the emphasis will be on the freedom of individuals and on the free functioning of the markets?

**Korkman** agreed with Kosonen's notion about the importance of the role the highly centralized interest groups and the centralized wage negotiations in the labour market had played in our economy. He was of the opinion that these groups would have an important role also in the future and they would be very vocal, as well. However, Korkman thought that some of the lobbying groups would move to Brussels and we would get rid of them here in Helsinki. This is a change Korkman personally will not regret.

If one looks at the criticism often raised in Finland concerning the economic integration, various sectorial interest groups fear that they will be hurt by the integration and that there is not much we can do about it here in Finland. On the other hand, some people argue that it would be a good idea to be part of the integrated area since all the pressure groups would have to accept the rules of the game specified by the central authority, which they could not manipulate to same extent they can the local authority.

Korkman wondered why incomes policy and the central wage negotiations are considered to be so important for our well-being. This tradition has played a much more important role in Finland than in almost any other country in Europe. It is part of the mythology in Finland. Korkman did not agree with the argument that the strong economic performance of the 1980s was based on the consensus-based incomes policy. He thought that this very common interpretation was false. There are people who think that since it is not possible to use exchange rate policy anymore, we need an even more centralized consensus-based incomes policy to ensure or maintain our competitiveness. However, Korkman thought that we needed incomes policy today because wages adjusted in the open sector but they did not in the sheltered sector and this created frictions in the economy. To get everybody to take part in the adjustment process we need agreements to reduce wages also in the sheltered sector. It has been difficult, for example, for the government employees to accept wage reductions the way it happens in the exposed sectors, in which market forces reduces wages no matter what the employees say. If integration implies that competition will impinge on the whole economy much more, market forces will affect the behaviour of the labour force and the unions so that we probably do not need the rigid centralized mechanism but instead direct wage negotiations at the local level, i.e. a decentralized negotiation system. The free mobility of capital will probably enhance the development in this direction since if you do not create conditions which are favourable enough for the companies, they will move out. As a matter of fact they are already doing so. If the competition increases and the effect of market forces is felt in all sectors of the economy much more than earlier, this may change the role that the centralized incomes policy has had in the past.

**Soltwedel** made a reference to the point he made in the earlier session. When the European integration continues and if Finland takes part in this process, the sheltered sector will and must be increasingly exposed to market forces. The best thing to do is to start right away to put more market pressure on the sheltered sector. He also noted that there was a lot going on in companies without government participation or government initiation as far as the institutional and social innovations were concerned. For example, if one looks at the division of labour at a company level, it is not only a division of hands but also a division of brains, knowledge creation and knowledge diffusion that is in a state of dramatic change. This all is going on internationally and of course this has an influence on the internal organizations of the bargaining process. This puts the collective partners into some difficulties. Trade unions as well as employers associations have a common interest to keep up the collective activity (wage bargaining process) despite of the need to develop more flexible and individual approaches in the labour markets, simply because they are collective organizations and they have organizational interests. However, there may be scope in these organizations to develop new forms of incomes policy: not income distribution policies, but policies to increase and enhance the income earning potential of individual workers. In this context there was a lot on the way in the form of social and institutional innovations. As an example he mentioned the educational policies and the adult retraining programs. It seems that the need to be flexible in the labour market has been realized by the trade unions and by the employers associations.

**Hjerppe** asserted that the Finnish consensus worked quite well during the period 1977 - 85. The period after 1985 until now can be characterized as a period when the Finnish consensus has been unable to make necessary policy changes. However, he did not blame only trade unions for this crisis of the consensus, because the "Finnish consensus" was a broad concept. The economic environment during the 1990s will be totally different than the 1980s. The beginning of the decade is fairly ominous and it seems that we will have to cope with the high unemployment rate for quite some time. He asked van den Berg about the Netherlands' experiences of the high and persistent unemployment rate they incurred in the late 1970s and early 1980s.

**Van den Berg** first responded to Hjerppe's question by saying that they pursued very solidaristic and centralized incomes policy in the Netherlands from the end of the Second World War until 1982. In 1982 the unemployment rate in the Netherlands was the highest among the OECD countries (around 15 percent). At the end of the year 1982 the wage negotiation system was decentralized, since there was a strong and common belief that the centralized wage negotiation system did not work anymore. As a matter of fact the economic performance of the Netherlands was poor already during the 1970s, and the centralized system was unable to moderate wage demands. At the same time the labour income in proportion to the national income rose very sharply. Because of the decentralization there was a period of moderate real wage development after 1982. This was mainly due to the fact that the unemployment rate was high in the Netherlands. The labour income in proportion to the national income is nowadays again at the same level as in the 1960s. The growth in employment was one of swiftest in Europe during the 1980s, in sharp contrast to the development of the 1970s, when the increase in the unemployment rate was one of the fastest in Europe. Van den Berg thought that the centralized wage negotiation system was the formula for success during the 1950s and 1960s, but it did not work in the 1970s. Simultaneously with the decentralization the Netherlands choose very firmly to pursue a fixed exchange rate policy with respect to the D-mark.

Concerning the social and institutional foundations of a single country in the future van den Berg responded to Kosonen by saying that he does not think that there was only one formula for success and he added that the choice of the perspective depended on the place and time. He thought that probably in the future countries like the Netherlands and maybe also Finland would have more elements from the free market perspective in their economic policy cocktail. However, this does not have to mean that the free market perspective is the only formula for success. On the contrary, if one considers issues like the environmental problems or the security of the Western European energy supply, there is room or rather need for coordination. He agreed with the Soltwedel's view that often industrial subsidies were a waste of money, especially if one considered subsidies paid in Europe in the 1970s. However, van den Berg thought that Japan was very successful with its industrial subsidy policy during the 1960s and 1970s. Thus there are circumstances and policy settings in which industrial and technology policy coordinated by a government can be a source of success.

**Soltwedel** stressed that there certainly was a need for cooperative policies, particularly in the case of negative externalities like pollution, since almost always these problems were not confined to only one country. All the cases where you have so-called spill-over effects you cannot really internalize these externalities and find the optimal solution to the problem if you do not use a cooperative approach. Environmental problems certainly are issues that need cooperation. For example, the reduction of $CO_2$ emissions is a problem that needs to be solved at a global level: it simply can not be done efficiently at the European level. According to Soltwedel it would probably be much cheaper to subsidize countries with high $CO_2$ emissions or to subsidize, for example, Brazil not to cut down its rain forests than to reduce $CO_2$ emissions notably in Europe.

Soltwedel claimed that Japan did not use a lot of money to subsidize its industry in the 1960s and 1970s. There are many examples where MITI advice was not good and, for example, if the auto industry had followed the MITI advice, it would not be in its current position in the world market. Certainly in some cases public interventions and activities are appropriate in technology and science; the problem is how to do it efficiently. Soltwedel saw two alternatives in this respect: one could intervene directly in specific projects or one could do it indirectly on a broader basis. It is very difficult to distinguish between basic research and specific applied research. Soltwedel nevertheless found it more promising to take care of existing externalities with more indirect and unspecific approaches. However, he added that the EC was still in favour of direct and specific subsidies which unfortunately had a great potential to fail and turn out to be a waste of money because the government did not necessarily have superior knowledge (not even) in these fields.

**Leppänen** noted that the discussion has not dealt with trade policy issues which were closely related to more efficient use of resources. He found it peculiar that the EC and the Western European countries were recommending and advising the Eastern European countries to enhance the functioning of the market mechanism but at the same time these countries were restricting the exports coming from the Eastern Europe to the Western Europe. There are immigration restrictions, as well, and it seems that they are building up a fortress of the EC instead of a free market area. Leppänen added that it was good that Soltwedel brought this subject up in his presentation.

**Hjerppe** said that earlier he was of the opinion that the incomes policy would be important also in the future if it were carried out in a decentralized manner the way it was done in the Netherlands. Actually this was a policy recommendation that VATT was about to give a little while ago. However, Hjerppe thought that if the decentralized system is applied to Finnish labour markets, we would probably make structural problems even worse, since in Finland there was a large sheltered sector with very little competition. Thus he found some kind of centralized system better for Finland for the time being. Finally, he asked van den Berg if in the Netherlands there was a sheltered sector, which had monopoly power and in which workers were able to raise their nominal wages more than productivity increased.

**Van den Berg** noted that one of the problems in the centralized wage negotiation system in the Netherlands was that it paid specific attention to the minimum wage level. The minimum wage level had increased faster than the average wage level in the Netherlands. This fast increase in the minimum wage affected the sheltered sector in particular. If one has a more decentralized negotiation system, the employment situation in the sheltered sector can have an influence on the wage formation in this sector. In most economies unemployment is a problem of the low skilled workers who have to get a job in the sheltered sector. It would be useful to have a wage differentiation between the two sectors so that wages in the sheltered sector rise less than in the exposed sector. The disadvantage of the centralized system is that these kinds of arrangements are very difficult to make. He noted that the productivity growth and the profitability in the exposed sector determined the wage increases in this sector. In the sheltered sector workers tend to demand more than their "fair" share of the wage increases in the exposed sector. This can be problem, especially during an economic slump when one has to create jobs in the sheltered sector to improve employment.

Chairman Leppänen thanked all the speakers and commentators of the panel discussion, and the participants of the seminar. He noted that the presentations and the discussion in the seminar had been very interesting and useful from an economic policy perspective.

**VALTION TALOUDELLINEN TUTKIMUSKESKUS**

Reino Hjerppe    Ylijohtaja

**Kansantalouden linja**

| | |
|---|---|
| Seppo Leppänen | Tutkimusjohtaja |

**Verotuksen ja tulonsiirtojen linja**

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|---|---|
| Iikko B. Voipio (vv.) | Tutkimusjohtaja |
| Rolf Myhrman | Vs. tutkimusjohtaja |

**Julkisten palvelujen ja investointien linja**

| | |
|---|---|
| Heikki A. Loikkanen | Tutkimusjohtaja |

**JOHTOKUNTA**

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|---|---|
| Valtiosihteeri Eino Keinänen | Puheenjohtaja |
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| Pääjohtaja Markku Mannerkoski | |
| Ylijohtaja Reino Hjerppe | |
| Erikoistutkija Pirkko Valppu | |

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