

## **A Question of Survival? Curbing regional divergences in the eurozone.**

Sebastian Dullien / Daniela Schwarzer

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*This article studies regional cyclical divergences in the European Monetary Union that have recently fuelled political debates on a break-up of the eurozone. It identifies two country clusters (the stagnation-and-low-inflation-countries and the growth-and-inflation-countries) and situates Italy along with Portugal in between the two groups. These cyclical divergences do not reverse in the EMU as quickly as text-book models have predicted, because financial and labour markets react with less flexibility than expected. The authors suggest an approach which could complement the ongoing efforts of market liberalisation to overcome the structural weaknesses of the European Monetary Union: An inter-regional transfer mechanism would help re-balance cyclical imbalances in either direction (overheating and stagnation) to ease tensions building up in the EMU. A European corporate tax scheme or a form of European unemployment insurance system- each of which would complement their respective national counterparts- would have the desired effect without increasing contributions. These steps inevitably require an explicit commitment to economic and political integration by the member governments, but they may prove a very valuable add-on to the Lisbon process, which risks being slowed down by member governments' increasingly protectionist and hostile attitudes towards reforms and market liberalisation, especially if their country is locked in a prolonged bust cycle under the conditions of EMU.*

### **1. Economic and political tensions in the European Monetary Union**

In debates on the future of the EU, the eurozone used to be held up as a stable core element whose members could potentially deepen cooperation across further policy areas. These times seem to be over. Undoubtedly, the 12 EMU Member States have a keen interest in maintaining and consolidating the European Monetary Union as a framework for stability and growth. However, in the seventh year of its existence, debates were kicked-off about whether individual member countries could have reasons to leave the EMU to return to a national currency. What may seem as mere political populism -e.g. the Italian case- does have a real economic background: Regional economic cycles are putting serious pressure on some regions or countries in the eurozone. Indeed, although the political odds for a break-up of the eurozone in the foreseeable future look rather low, the debate about single countries such as Italy or Spain<sup>1</sup> leaving the EMU has for some time

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<sup>1</sup> See i.e. Connolly (2005), Munchau (2006), Lachman (2006) or Roubini (2006).

reached the field of economists who point to the risks of diverging economic developments in the monetary union.

The economic data of the past years show clearly that in macroeconomic terms, the eurozone is functioning markedly worse than had been expected prior to the introduction of the single currency. While during the first years of EMU most potential problems were just covered up by the New Economy boom and a strong global economy, first problems became apparent when the economy slowed in late 2000. The global end of the New Economy boom, followed by the increase in investors' risk aversion after the September 11, 2001 terrorist attacks and the looming war in Iraq, has hit the EMU economies to very different degrees: While economic growth in Spain only slowed to an annual rate in 2000 of 5.0 percent to 2.7 percent in 2002, Italy, Germany and the Netherlands went into outright recessions.

Since the economic recovery began in 2003, regional economic cycles have been drifting further apart. In fact, the eurozone has been splitting up into blocks, one comprising countries like Spain and France (which are growing rapidly but experiencing relatively high inflation), and another comprising countries like Germany and the Netherlands, which have been experiencing very little growth and low inflation.<sup>2</sup> Italy and Portugal, as a third block, now experience low growth but an inflation rate which is slightly above the European Central Bank's (ECB) target of under two percent. Given the degree to which the aforementioned economic cycles are drifting apart, the base lending rate of the European Central Bank is no longer appropriate for all countries. Instead, it is exacerbating the economic problems of some eurozone states.

## **2. Boom vs. Bust: Different Perspectives on the Common Monetary Policy**

In Germany's view, the ECB's interest rate has long been too high and constituted an additional obstacle to growth. Indeed, in 2002, a downward spiral had set in, with weak demand and particularly muted income dynamics leading to virtually no underlying inflation. (Only increases in energy prices, indirect taxes and administered prices are keeping inflation above 1 percent.) As a result, for those companies making sales primarily in the German market, financing costs (which are influenced by the ECB base rate) were relatively high. This trend has been undermining investment, triggering more redundancies and further weakening the economy. Meanwhile, continuing low demand and slack in the labour market has been exerting additional pressure on prices and wages.

This line of argument still held true in spite of the -by historical standards- low nominal short-term interest rates over the years 2003 to 2005: Over the last few years the world

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<sup>2</sup> At the beginning of 2006, there are tentative signs that the German and the Dutch economies are finally recovering after years of very slow growth. However, the argument of diverging cycles still holds true as there are some indicators that the improvement of German growth comes at the expense of other eurozone countries. Thus, it is well possible that the upturn in Germany marks a shift in the diverging cycle with Germany outperforming the rest of the eurozone for some years while other countries suffer sub-par growth.

economy has suffered some severe blows (such as the stock market crash, the terror attacks of 11 September 2001, the war in Iraq and soaring oil prices). These events have prompted central banks around the world to lower their interest rates aggressively. For some time interest rates in the USA, for instance, were significantly lower than the ECB's rate. So bearing in mind the unusual global situation, the ECB base rate even in 2005 should not be regarded as particularly low. Furthermore, econometric estimates based on past experience indicate that given the rate of inflation and economic development in Germany during 2004 and 2005, the Bundesbank (the German central bank), using a Taylor rule, would have lowered interest rates much further (Enderlein 2005). Consequently, the real interest rate for Germany during these years should still be considered high.

But whilst companies targeting the domestic market are suffering under such circumstances, export-oriented companies are benefiting from the situation. Their wage costs are rising more slowly than those of their foreign rivals, making them gradually more competitive. Moreover, as they are providing for markets where prices are rising, their financing costs are less of a burden. Thus, Germany has been expanding its market share abroad, especially in the rest of the eurozone.

Some of the negative effects outlined above are thus being compensated, albeit only to the extent of the relevant country's economic integration into the remainder of the eurozone. Although Germany is highly dependent on exports to the EMU, this dependency is nowhere near as great as that of smaller countries (like the Netherlands or Belgium). A large proportion of SMEs in particular are continuing to produce goods and services exclusively for the German market. As a result, the impulse from external demand has long been insufficient to kick-start the struggling domestic economy.

The situation has been very different in countries like Spain or France, where pay increases and inflation have been clearly higher than in the Federal Republic. Corporate financing costs, which are influenced by the European Central Bank, have been favourably low compared to the conditions under which sales are effectuated in companies' domestic markets. As a result, investment and domestic demand have been stronger, which in turn has kept inflation and pay increases relatively high.

This mechanism has been receiving an additional boost from an ongoing property boom. Sizeable pay increases and higher inflation have given people a larger disposable income. Moreover, the low nominal cost of borrowing has made buying a house or flat seem more appealing. This in turn has fuelled demand for property and the construction of new housing and pushing up prices. Households were feeling increasingly wealthy because of the higher value of their property. Consequently, they were able to take out higher mortgages, and were more willing to spend. In the years since 2002 this mechanism has been the key to robust consumption growth in France, Spain and Ireland, whereas exports contributed little towards economic growth in these countries.

### 3. Italy's Specific Problems: Competitive Pressure from German Wage Restraint

The Italian economy covers the middle ground between the economic slump in Germany and the boom in countries such as Spain and France: With inflation continuing to run at a moderate rather than at a low rate, financing costs have not been as burdensome for domestic firms as in Germany. At the same time, there was no property market boom in Italy, so the economy has not experienced a boost equivalent to that of the economies in Spain, Ireland or France.

However, the adjustment processes in Germany have put a large burden on the Italian economy: since weak demand in Germany has produced a strong downward pressure on German wage growth, Italy has continuously lost competitiveness relative to an important share of the eurozone (of which Germany comprises around 30 percent). This in turn has exacerbated Italy's economic problems, as it hurt the Italian export industry at a time of rather sluggish domestic demand caused by the adjustments resulting from the bursting of the Dotcom bubble in 2000 and the strong euro appreciation from 2002 to 2004. While part of the loss in competitiveness of Italian firms clearly results from domestic problems such as slow productivity growth (GGDC 2006), this problem has been made worse by the strong increase in German competitiveness.

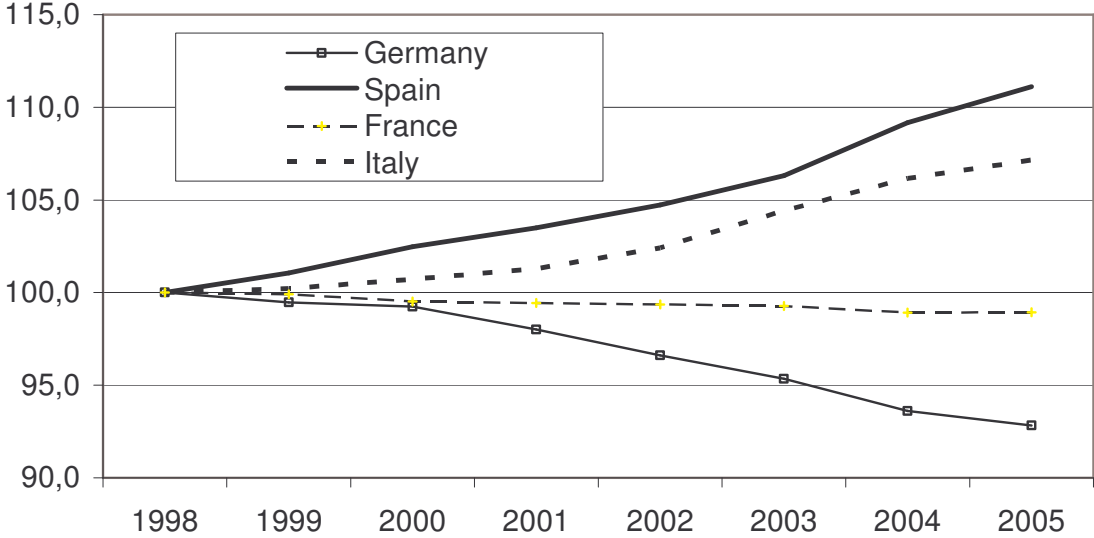
Figure 1 shows the development of the competitiveness position of different EMU countries since 1998 relative to the rest of the Monetary Union, measured in nominal labour costs in the whole economy. While France has been able to keep its competitiveness rather constant over the past years, the robust growth in Spain hides a strong loss of competitiveness. Since 1998, unit labour costs in Spain have grown more than ten percentage points quicker than in the eurozone on average. For Italy, the development is only slightly better than for Spain. Relative unit labour costs rose by 7.2 percent. At the same time, Germany was able to improve its competitive position by 7.2 percent. The relative situation for Italy may be even worse than these numbers suggest, as Italy experienced a strong nominal appreciation just prior to 1998, wiping out most of the improvement of competitiveness experienced after the 1992 lira depreciation.

The result of these developments can clearly be seen both in the details of GDP figures as well as in the development of unit labour costs across EMU (all data from Commission 2005): since the beginning of EMU in 1999 external demand has been a drag on economic growth in Italy, France and Spain, while it has been the main driver of GDP growth in Germany (figure 2). On average, the deterioration in the trade balance shaved one percentage point off Spanish GDP growth and 0.3 percentage points off Italian GDP growth each year. As this period comprises a number of years with very strong global growth, this development can be safely assumed to have its roots in a relative deterioration of the competitive position of Italy, Spain and France relative to Germany.

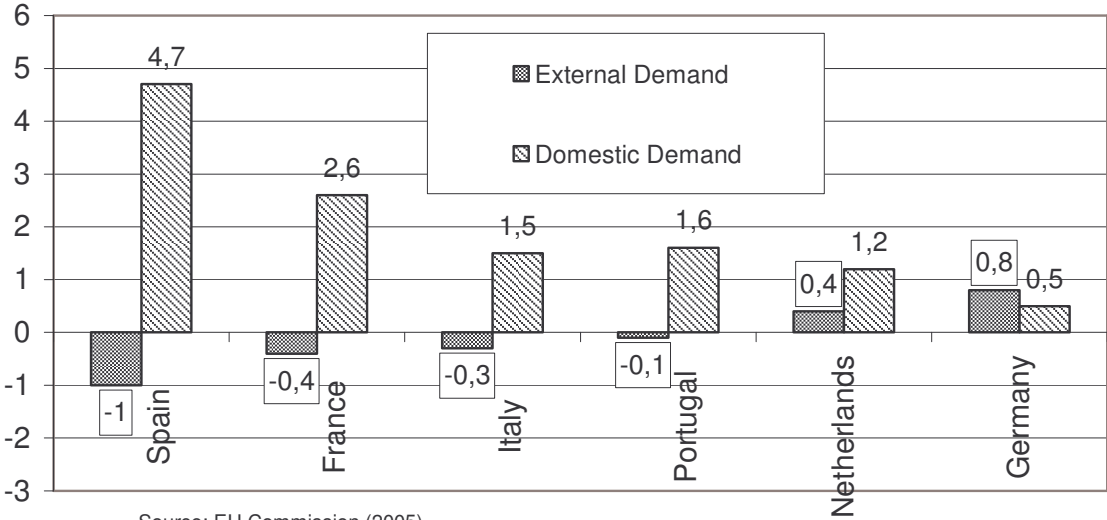
At the same time, domestic demand has been the main driver for growth in Spain or France, while it has been almost flat for Germany. This contrast between the different eurozone countries becomes even more evident if we only look at the economic development since the end of the New Economy boom in 2000. From 2001 to 2005,

internal demand on average did not contribute at all to German growth, while external trade provided an annual boost of 0.9 percentage points.

**Unit Labour cost relative to EMU-12, 1998=100**



**Average contribution to GDP growth 1999-2005, in percentage points**



Source: EU Commission (2005)

#### 4. Long-Term Consequences of Regional Booms and Busts

Thus, the data shows very different economic developments in the different clusters of EMU. In some countries such as Spain, the ECB's monetary policy has led to strong growth and rising inflation; while stimulating growth in the short and medium term, it has thus eroded competitiveness. In other countries such as Germany, the ECB's monetary policy has led to a prolonged slump, putting deflationary pressure on wages and prices. This again has spilled over into Italy which had to compete with German small wage increases

The problem about prolonged boom- and bust-cycles is that they might have permanent negative effects on economic performance. In a country in the bust cluster, workers are forced out of the labour market and are kept unemployed over an extended period of time. As has been observed in Germany, long-term unemployment rises. In consequence, qualifications deteriorate and human capital is lost. Some of the unemployed might even lose basic employment skill, pushing them permanently out of the labour force. This *hysteresis* effect leads to an increase in structural unemployment. Moreover, some research even suggests that prolonged deviations from an economy's potential output (measured as an increased volatility in GDP) might even lead to less investment in research and development by private firms (Aghion/Hewitt 2005). This might help to explain the very poor Italian productivity growth in the past years.

In the boom countries, a different risk exists: With financing conditions very lax, capital might be misallocated. A typical example is the real estate boom in Spain: With nominal interest rates very low compared to expected wage growth, housing prices have increased strongly, more than doubling since 1997. These rapidly increasing house prices have led to a large increase of residential investment. In this process, residential construction has reached a share in Spanish GDP above that in Germany at its height after reunification. As has been experienced in Germany, such an oversized construction sector implies the danger of becoming a burden to economic growth once the construction boom slows: laid-off workers from the construction sector seem to find it hard to shift to other sectors.

Moreover with real estate prices rising rapidly, the risk increases that bubbles develop which might later lead to an outright crash in the housing market. This might have serious consequences: households might end up over-indebted, loans might turn bad and the banking sector might consequently be forced to cut back lending to the whole economy. According to an empirical investigation of the IMF, housing busts always lead to a very pronounced slow-down in growth, often even to outright recessions. In addition, their effects last about twice as long as that of stock market crashes and dampen growth by about twice the rate (IMF 2003). A former boom country might thus be pushed into the bust cluster by the end of a real estate boom, then experiencing all the problems of a bust country as set out above.

## 5. Obstacles to Smooth Adjustment of Regional Cycles in EMU

Economic theory holds that, in time, these differences in the Monetary Union should reverse.<sup>3</sup> If price increases make a country like Spain less competitive (and therefore make it lose some of its share of the global market), economists would expect a regional economic decline to set in. This in turn would result in lower inflation and smaller wage increases than elsewhere in the eurozone, prompting more burdensome financing costs, paralysing consumption and investment, and boosting unemployment.

By contrast, competitiveness in countries facing economic problems (like Germany or the Netherlands) should eventually improve sufficient for export growth to turn around the labour market, raise the wage bill and kick-start consumption. Nominal wages and inflation should then rise again. In such a situation the previously stagnating country would benefit from a relatively favourable cost of borrowing and the national economy would enjoy above-average growth.

This is what the economic textbooks on which the construction of the European Monetary Union was based claim should happen. As the experience over the past years has shown, this view is overly optimistic. The theories fail to take account of all the damaging consequences of the very low (or in an extreme case negative) rate of inflation and weak domestic demand.

Any economic downturn leads to bankruptcies associated with loan defaults, which in turn undermine banks' equity position. If a downturn persists for an unusually long time (as is currently the case with Germany's domestic economy), the associated balance sheet adjustments place a very heavy burden on the affected banks. This, in turn, can hamper—or in the worst-case scenario even block—economic recovery. For once the banks' equity position has been weakened, they will set about continuing to consolidate their balance sheets again before awarding fresh loans, meeting standards set both by banking regulation and prudent best practice. Such a credit crunch was one of the reasons for the persistence of the Japanese economic crisis in the 1990s. Moreover, there has been an ample debate whether the German economy experienced a credit crunch in the long slump after the end of the New Economy Boom and has thus been slow to emerge from (?) the period of weak growth (Nehls/Schmidt 2004). In an extreme scenario, a national banking crisis could occur if the amount of non-performing loans grew big enough to cause solvency problems in one or more of the major banks in a specific country. Complaints by many German SMEs about restrictive lending practices and the problems faced by German banks which have lost substantial amounts of their capital show that over the past few years the continuing economic downturn in Germany aggravated the difficulties faced by the banking sector, and vice versa.

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<sup>3</sup> For a more technical discussion of this argument, see Arnold/Kool (2003).

The sheer duration of regional boom-and-bust cycles in the eurozone can be explained by the fact that improving competitiveness (compared with the constrictive effects of high regional real interest rates) is having significantly less impact on economic growth than anticipated.

Empirical research suggests that even in the USA, which is more advanced than the EU in terms of market integration and flexibility, it can take around nine years for half of the inflation differential between two American cities to even out (Arnold/Kool 2003). In that process, a higher rate of inflation can stimulate a region in the short term, while the consequences of weaker competitiveness only start to become apparent after three or four years.

In the eurozone, it will probably take even longer to reverse competitive imbalances between regions, because the markets for labour, goods—and above all financial services—in Europe are not very well integrated. Banks still prefer awarding loans to their national or even sub-national constituency. When the European Monetary Union was designed in the early 1990s, this was not anticipated by the majority of negotiators. Those analysts who did anticipate that the market mechanism in the EMU may not function sufficiently well to ensure that regional divergences even out rapidly, either argued against the creation of a Monetary Union as such (and were hence sidelined by the political and administrative elites), or put forward ideas for adjustment mechanisms to complement monetary integration, which were equally ignored as there was no political consensus at the time to complement the market-driven EMU with a component which might be interpreted as a pillar of a *political* union.

The main reason why the risk of regional divergences was not seen was that a liberalised internal market for goods, services and people (including the working population) was supposed to be attained by the end of 1992. This had been set out in the Treaty of the time—the Single European Act. However, unlike the situation in the USA, today the European Monetary Union still has no truly integrated market for financial services: most companies rely on their principal banks, with which they usually have a year-long business relationship. These banks in turn are badly hit by regional downturns as their credit portfolios are heavily concentrated on the regional economy. Consequently, they may tend to ease their lending criteria during regional booms and tighten them during downturns, thereby exacerbating and prolonging regional upswings and downturns.

In addition, integration of national labour markets has been slow. Obviously, there are natural barriers to integration in the labour market. While employees in certain sectors of the labour market (i.e well-paid professionals or managers) have increased their cross-border mobility strongly over the past years, most parts of the labour market are still fragmented along national borders. Language, customs, but also complications in shifting from one national social security system to another, make it hard for medium-qualified workers to move from one country to another. While in the United States, workers might move from a bust into a boom region, thus alleviating both upward and downward wage pressure, in EMU this is only the case to a very limited extent.

## 6. How to Eliminate the Structural Weaknesses of the Monetary Union

The fact that individual countries, like Italy, Spain or Germany, find themselves faced with the problems described above as a result of the ECB's interest rate conditions does not mean that they would gain from leaving the eurozone. Back in pre-EMU days, the latest decrease in the value of the dollar (which is likely to continue in the future) would have led to a highly fluctuating exchange rate within Europe, impacting substantially on Germany's exports, which account for 40% of the country's GDP.

For the southern European countries, which have been enjoying extremely expansionary monetary conditions thanks to a booming housing market and higher inflation, a break-up of the eurozone could reverse monetary convergence and raise long-term inflation expectations. Long-term interest rates would probably rise steeply and the catching up done by their economies in real terms could come to a standstill. In addition, each Member State would find the cost of restoring a national currency very high, just like the loss of political influence in the European Union that would go along with leaving the eurozone.

For highly indebted countries like Italy with a debt-to-GDP ratio of more than 100 percent, an exit from the eurozone might even be enough to push the country into default: With a sudden return of high risk premia and –as a consequence– steeply rising long term interest rates, interest payments on public debt might well raise to a level which makes it virtually impossible to service the debt anymore.<sup>4</sup> Such a financial crisis would, without any question, lead to disturbances in economic activity and trade which might quickly spill over into the other EU countries given the degree of trade and financial integration achieved so far. So it cannot be in the interests of any country to leave the eurozone or dissolve it altogether.

Instead of speculating about pull-out scenarios, it makes far better sense to analyse the structural flaws built into the European Monetary Union. Discussing the processes and institutions required by the Monetary Union to work more efficiently is not an admission of failure. It is rather a sensible 'post-hoc' adjustment which does not run the danger of discrediting EMU.

One way of preventing economies from drifting apart too much would be to press ahead with transborder economic integration as intended with the decision on the single market programme and the 'Lisbon Agenda' of economic reform launched in 2000 . If competition between national players and their rivals from the rest of the eurozone could be enhanced in the markets for goods and services, changes in regional competitiveness would impact sooner on (national) economic growth. For this reason, measures such as legislative alignment and the mutual recognition of licenses and approvals (as planned in the Services Directive) would probably make the European Monetary Union function

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<sup>4</sup> This is what almost happened to Brasil in the run-up to the 2002 elections: When it became clear that the left wing candidate Luiz Inácio Lula da Silva might win the presidential election, interest rates rose so much that servicing the debt became almost impossible (see Williamson 2002). Only a record loan from the International Monetary Fund was able to calm the markets.

better. Consequently, measures like the Lisbon objectives entailing the transposition of all directives to do with the internal market mark steps in the right direction. However, the recent trend towards national protectionism and the political quest to stop market-liberalisation rather than pulling down all barriers raises the question of what the likelihood is that the liberalisation and flexibilisation programme of the Lisbon Agenda concerning labour, goods and services will be implemented by national governments. Regular assessments of the progress under the Lisbon agenda points to the fact that the objectives agreed at the EU level are by no means automatically adopted as domestic policy preferences (Wanlin 2006). In order to establish a closer link between EU objectives and domestic reform programmes, the EU Council agreed in March 2005 that each government should draw up “National Reform Programmes” on measures taken to meet the targets. Their impact will be assessed in a few years’ time. Measures for the modernisation of education, research and development programmes, and ongoing programmes designed to promote cross-border cooperation between companies in the EU are less politically costly for member governments to implement. However, here sufficient funding remains a problem to date.

The Lisbon agenda likewise includes the goal of creating genuine cross-border capital markets in the EU by 2005. While the Financial Services Action Plan (FSAP) is a success on paper with virtually all of the plan’s 42 measures agreed on, a single market in financial services is still far from realisation as many countries have not yet transposed the measures into national laws, and where they have, businesses still need time to adapt (Murray/Wanlin 2006). While the wholesale market has made comparatively good progress, the retail market remains fragmented. The banks—which have in the past often tended to be just regionally or nationally active—must be induced to diversify their credit portfolios more and become pan-eurozone players. Mergers could help in this respect, reducing the effect of banks’ regional orientation which in turn amplifies regional economic cycles. The European Commission White Paper published in December 2006 (European Commission 2006) is an important milestone along this road. It discusses the most pressing problems and needs for action, especially in the private consumer sector which still lacks transparency and reliable rules. This includes new measures in areas such as cross-border payments, and clearing and settlement services, just like investigations into how to remove barriers to competition in retail financial services. The remaining obstacles to a fully functioning single market in financial services are hence both a matter of properly implementing and enforcing measures decided in the framework of the FSAP, and a matter of defining appropriate rules, including for common regulatory and surveillance mechanisms.

## **7. Transfer Mechanisms to Stabilise Regional Cycles**

This brief analysis shows that while the need to push forward market flexibilisation is perceived, the political implementation is not guaranteed. And even if *de facto* market integration and liberalisation proceeds to an unexpected degree, this may not entirely

solve the problem of regional cycles. Other federal systems' experience with a single currency (especially the USA, but also Canada, Brazil or the Federal Republic of Germany) show that even a very high level of integration is not sufficient to rein in the problem of regional boom-and-bust cycles altogether. Consequently, the United States for instance has embarked on a successful path, endorsed by economic research pointing at the consequences of rigidities and shortcomings in labour, capital and goods markets, by stabilising its regional economic cycles both through national income tax and public sector spending and via unemployment insurance contributions and payouts. When one state in the USA is booming, it contributes more tax revenue to the central budget. When a regional economy is in difficulty, unemployment benefits are paid. Empirical research suggests that in this way around 15 to 20% of regional economic downturns are offset (Atkeson/Bayoumi 1993). The success of monetary union in the USA, on the one hand, and the described problems of the eurozone, on the other, suggest that a similar stabilisation mechanism could make sense for the eurozone.

By definition, the EU's regional and structural policies do not guarantee such compensation because the distribution of resources and contributions to the Union's budget are fixed years in advance. They do not respond to economic fluctuations but pursue other goals such as structural or social cohesion.

Using national finance policy to offset the problem of demand is no solution either. For although the reformed Stability and Growth Pact offers countries with precarious economies (like Germany) a wider range of options for using intervening financial policy instruments, now that a swift budget consolidation is more closely dependent on the economic situation, the countries in question have greater leeway to combat the downward spiral by lowering taxes or increasing public spending at times when inflation is low.

Nonetheless, there are growing doubts as to whether the Member States of the Monetary Union are genuinely capable of preventing a national downturn in a 'bust phase' merely by wielding national fiscal policy instruments. Many countries' national debt and deficits are so huge and their current rate of growth is so muted that it is questionable whether fiscal measures adopted by one country on its own can still generate sufficient economic momentum.

In 2004, Germany's general government deficit was clearly above 3% of GDP—without any additional measures to support the economy. If we currently assume that prices will hardly rise over the coming years (going up roughly 0.5% per annum) and postulate a trend towards real growth of 1.5%, a deficit of a mere 3% of GDP would mean the stock of debt stabilising only at 150% of GDP, a value that is clearly not sustainable. Any expansion of the national deficit would lead the country in question to stray further off the path to sustainability. The latest experience gained in the USA show that a Keynesian demand-oriented policy does effectively get the economy moving. Yet above a certain deficit or level of indebtedness the possibility cannot be ruled out that a further increase in the budget deficit will dent consumer and corporate confidence to such an extent that only minor economic momentum will remain.

This argument is even truer for Italy. With public net financial liabilities running above 100 % of GDP and a deficit to be projected at about 4 % of GDP in 2006, there seems to be very little room for a counter-cyclical fiscal policy. Italy has lost competitiveness strongly since 1999. If it is to regain competitiveness relative to the rest of EMU, this would imply a lower rate of inflation. If it just managed to bring underlying inflationary pressure down to Germany's annual 0.5 %, given a GDP growth trend of 1.5 % annually would imply a doubling of Italy's debt towards 200 % of GDP. A further increase of this deficit might well lead to a loss in consumer and business confidence more than eliminating all positive short-term growth effects arising from an expansionary fiscal policy.

If neither the EU budget nor national fiscal policies are apt to compensate regional imbalances, while capital, labour and services markets are insufficiently integrated and likely to remain so at least for some time, it makes sense to assess alternative stabilisation mechanisms. The remainder of this paper hence discusses two ideas: firstly, a European corporate tax, and secondly a European unemployment insurance. Both fulfil three criteria: Once in place, they ensure automatic stabilisation of regional imbalances without the need to take political decisions and can hence impact without politically caused delays or distortions, they do not imply an increase of the tax burden for individuals or companies, and they can both be devised either for the EMU-12 or the EU-25 countries.

In the case of a European corporate tax, the EU could collect tax at a rate of around 10% on all profits made in the Union. This tax revenue could be used to finance the EU budget. As a result, individual Member States would no longer have to pay contributions to the EU institutions out of national budgets. The exact rate of taxation should be fixed in such a way that the revenue generated by the tax corresponded roughly to the present-day EU budget. Each country would have the further possibility—just like individual states in the USA—of levying additional tax on companies' profits. Some countries would desist altogether from using such an option, whereas others might levy a supplement that would make their tax burden more or less comparable to their current commitment. Since the burden on national budgets would simultaneously be eased, there would be no reason to expect companies and citizens to be subjected to higher taxes overall.

In this way, a minimum corporate tax would be set within the European Union, but fiscal competition would not be prevented. Since an EU tax would require a common EU tax base, the situation would also be rendered more transparent for companies.

The most important consequence would be to establish regional automatic stabilisers via revenue, as corporate profits are usually particularly high during economic booms. During such a phase a country would contribute a particularly high amount to the EU budget. On the other hand, the respective national government's tax revenue would be less voluminous, which would probably prevent politicians from stepping up spending pro-cyclically or lowering taxes.

By contrast, profits are usually very low when the economy is troubled, so the payments sent to Brussels would diminish correspondingly. In such a situation national

budgets would be subjected to a lesser burden than previously, and pro-cyclical spending cuts would be unlikely.

The second pillar of the stabilising mechanism could be a form of European unemployment insurance. The safety nets designed to protect unemployed people differ in the individual euro countries. However, most such countries levy social security contributions on wages which they then use to pay out unemployment benefit. Some of this insurance could be collected at European level.

The problem associated with the existence of different levels of benefit in the various countries is far less serious than it may appear at first glance. Of course, it would make little sense for, say, an unemployed Portuguese worker to receive the same unemployment benefit as a skilled worker in Germany, i.e. in this case a payout that was higher than the normal wage in Portugal. As with national unemployment insurance schemes, the level of benefit awarded should depend on the previously earned income. Moreover, to prevent individual countries from shying away from unpopular reforms that would reduce their national employment figures and thereby from passing on the social costs to the European unemployment insurance, the maximum duration of the support provided out of the European system should be limited to a year.

As with the corporate tax discussed above, unemployment insurance at EU level would not impose the same standards on all countries. Instead, only a minimum level of security would be established, and each individual Member State could then make its own more generous arrangements via an additional national system.

The system could also be organised in the form of a safeguard for national unemployment insurance schemes, which would cede a certain proportion of their national wage bill to a European re-insurer. This re-insurer would then pump funds back into the relevant national insurance whenever an insured worker became jobless. Such a set-up would prevent national governments from having to raise their contributions in times of economic gloom or draw funds out of their state budget to feed into their unemployment insurance scheme. In economic boom times, national purchasing power would be skimmed off and paid out to those countries whose rate of growth was slower via the European insurance scheme.

## **8. Potential Scenarios and Prospects for Realisation**

A European corporate tax and European unemployment insurance scheme would not just stabilise the European economy, but would also give the EU a ‘more social’ component, which might make the notion of European integration more palatable to the Union’s citizens. At the same time, neither the scope of the European Commission’s power to dispose of funds, nor the burdens on national budgets would increase. Consequently, despite their political reach, these proposals are not doomed to fail.

Both ideas could either be implemented for the EU-25 or for the today 12 Member States of the European Monetary Union. For the European unemployment insurance it

would be immaterial whether or not the countries signing up to it coincided exactly with the membership of the European Union, since it could function totally independently of the existing EU institutions. By contrast, introducing a European corporate tax scheme that applied only to countries with the euro would be more complicated, since it would require a special arrangement whereby they paid their contribution to the EU Budget out of the Monetary Union's corporate tax and, to make up for this, paid less into the Community budget out of their respective national budget.

For the twelve euro countries the economic arguments in favour of such a step towards further integration are far more compelling. Their political motivation will probably also be greater. After all, they are locked into the Monetary Union together and have learned a great deal from each other since 1999. Today in the Euro Group there is something akin to a culture of politico-economic debate, a common framework of analysis and a realistic awareness of mutual interdependency. Consequently, these proposals have better prospects of being realised within the eurozone today than comparable initiatives had in the past. The basic idea is not entirely new: back in 1970 the Werner Plan—the first draft of a European Monetary Union—already contained the idea of a transfer system, as did the call in the 1990s by (the then President of the *Bundesbank*) Hans Tietmeyer for a 'political union' to complement the Monetary Union.

After the failed referenda in France and the Netherlands, a joint initiative of this kind could initially fill the resulting political vacuum in a manner that was both politically convincing and made economic sense. However, quite apart from whether or not the Constitutional Treaty is ratified, the consequences of failing to take action need to be thought through. Latest data suggest that even the steps towards liberalisation contained in the Lisbon agenda and the extension of the scope for national budgetary policy will not suffice to set problem countries like Italy, Germany or the Netherlands back on track towards growth.

One consequence would be the continued rise of unemployment in economically depressed countries. Yet in view of the intimate links between the Member States, other partners within the Monetary Union would also have to brace themselves for the negative impact on their growth and unemployment of failure by some (major) EU Member States to find their way back towards robust growth. Some countries may indeed run the risk of finding themselves trapped in a downward spiral with low growth and high unemployment hindering necessary reforms and liberalisations, which may be perceived as politically too costly by national decision-makers. In addition, this sentiment of insecurity may translate into a protectionist and anti-EU and anti-globalisation reflex, likely to be pushed into the political debate by left- and right-wing extremists who are gaining political grounds in most EU countries. The history of Europe shows that societies in economically troubled situations tend to bend to the influence of populists, protectionists or even nationalists. Such nightmare scenarios may still seem a long way off, but there is nonetheless a danger that public sentiments stirred up by rising unemployment may turn them against further integration, or even against the headway made so far down the path towards that goal. There have been modest indications of such

stirrings, amongst other things in the debate about the liberalisation of the services sector (the Bolkestein Directive).

The implementation of the proposed transfer system would not entail risks and would not have negative effects if the problem of diverging regional economic cycles turns out to be less serious in the long run. If a European corporate tax was adopted, only the source of funds fed into the EU budget would change, not their amount or the financial burden on European citizens and companies. Within the European unemployment insurance scheme, there would be no transfer of funds whatsoever between the individual countries, if national economic cycles within the Monetary Union were in synchrony.

Furthermore, both proposals would have no impact on the expenditure rate and public deficits of eurozone countries. Consequently, contrary to the fears expressed by some economists regarding the reform of the Stability Pact, there is no reason to anticipate the financial markets being jeopardised by any resulting changes—quite the opposite. A transfer system aimed at cyclical stabilisation would not only bolster the sustainability of the European Monetary Union and thereby make the scenario of a break-up less likely. It might even further push down risk premiums on euro securities, leading to lower long-term interest rates. This should in turn help consolidate growth in Europe.

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