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EC

European Integration as a Financial Adjustment Problem

by Klaus-Dirk Henke, Hanover*

The European summit in Dublin has shown that any further European integration will be determined in great measure by agreement on the financing of future Community budgets and by the EC's expenditure policy. This article shows how the political controversy about the Community's budget expenditure and receipts can be raised to a more rational level by the adoption of an economic approach.

The advantages and disadvantages of European integration have not been subjected to a systematic examination from the point of view of either the member states or the newly acceding countries as yet. It need cause no surprise therefore that, instead of starting from such worth-while analyses, the representatives of the member countries are drawing on so-called net transfer calculations – which remind one of the cameralistic ideas of a bygone age – as a basis for decisions in connection with the advancing integration. Analyses of the flow of payments are used in the political discussion in an attempt to spot the "winners" and "losers" from integration. Depending on the findings of these analyses, member countries show themselves more or less eager to forward the integration. There are many reasons why the beneficiaries from integration cannot be identified by simply striking a balance from the member countries' point of view of in-payments (outflows) and out-payments (inflows). A few of them shall be mentioned here.

Since the EC's "own resources" resolution of April 21, 1970 and the implementation of the value-added tax (VAT) provision by more than three member states in 1979 it is no longer reasonable to regard the outflows to the Community budget as national contributions. The EC has a legal claim to the resources concerned, just as in Germany the Federal Government is by virtue of the "revenue equalization" entitled to certain receipts from the total public revenue. This line of argument does however not rule out the possibility that analyses the starting point of which is a simple payments flow analysis (regional incidence of payment commitments) may be wanted for an inquiry into the interregional redistribution effects of the Community budget, for instance. But even if in furtherance of such studies customs duties and agricultural levies are "debited" to individual member countries, this method is the correct one only in the exceptional case of imported goods being consumed within the country in which the import dues are payable.

The customs revenue for instance is determined by the geographical conditions pertaining to the importation of goods: a country without ports would have a relatively small resource outflow to the Community budget in the form of collected customs revenue and thus – ceteris paribus – a relatively larger net inflow. Distortions which have to be straightened out and require a more detailed incidence analysis will thus occur even when outflows are falsely interpreted as national financial contributions. In connection with the requisite inquiries into the regional

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incidence of the Community budget it may also be asked why the regional boundaries should be supposed to coincide with the national frontiers and whether it would not be more relevant if they were delineated according to economic criteria.

Against the Community Spirit

An equivalence of financial flows to provide a "just return" is neither implied in the letter nor in the spirit of the EEC treaty or the merger treaties. If a "just return" in the sense of an offset between in-payments and out-payments is nevertheless put forward by the individual nations as a guiding financial principle for the everyday application of integration policy, this is bound to impair the scope for redistribution between member states which, it may be inferred from the preamble and article 2 of the EEC treaty, is a Community task. Notions of equivalence, which suggest a lack of solidarity or a reluctance to a more far-reaching integration of the member countries, furthermore tend to jack up the spending covered by the Community budget[1].

Looking at single years by themselves – a practice typical of the discussion on net transfers – leads to false conclusions because of frequent structural breaks in the development of the EC (e. g. the basing of the EUA[2] on market rates instead of fixed parities and the recurrent green currency adjustments). In many instances it is not made clear whether figures relate to authorizations for payment or commitment and whether planned or actual financial flows have been used in ex post facto analyses.

Distortions also result from the fact that the net transfer calculations take in the outlays on administration and materials of the EEC and the European Atomic Energy Community (EAEC) as well as the administrative expenditure of the European Coal and Steel Community (ECSC) and the European Development Fund (EDF) but not the latter's expenditure on materials or the finances of the European Investment Bank (EIB). The Community budget to which the net transfer calculations related hitherto is only an inadequate indicator of the EC's finances and even more so of the financial flows induced by the EC.

Integration effects which are connected with the creation and/or diversion of trade flows must also be included in a realistic assessment[3], and consideration must be given in this connection to benefits and burdens ensuing from the minimum price orders for agricultural products or from prohibition of tariff and non-tariff obstacles to trade and the obstruction of labour mobility. The repercussions of progressive integration on the legislative and administrative opportunities open to the countries were also hitherto disregarded. Regulations already existing in member countries are often enforced generally, with the result that the newly acceding countries bear the costs of adjustments (e. g. in the context of tax harmonization or the introduction of VAT in countries willing to accede as a prerequisite of the levying of a VAT share for the EC).

As regards the booking of the monetary compensatory amounts accruing within the framework of the Common Agricultural Policy it is a matter of dispute whether the financial flows involved should be regarded as a benefit to exporters or importers. Great Britain in particular is adamant that the monetary compensatory amounts for agricultural products imported from other EC countries should not be counted as an inflow into the importing country. The "advantage", so the British argue, accrues to the EC

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[1] Cf. in regard to this thesis K. Reding: Zur Problematik eines Finanzausgleichs in der Europäischen Gemeinschaft (On the problems of financial adjustment in the European Community), in: H. v. d. Gröben, H. Möller (eds.): Möglichkeiten und Grenzen einer Europäischen Union, Vol. 2, Baden-Baden 1977, p.203ff.

[2] EUA = European Unit of Account.

[3] Cf. B. Balassa: Trade Creation and Diversion in the European Common Market: An Appraisal of the Evidence, in: B. Balassa (ed.): European Economic Integration, Amsterdam 1975.

countries which supply agricultural products to Great Britain and not to the British population.

In the face of all the arguments put forward against the use of payments flow analyses the fact must not be overlooked that similar points are being raised in discussions on marginal changes in the financial constitution on the national level, too[4]. However, the mentioned objections to the "paymaster theory" likewise apply to the national sphere. Here, too, it would sometimes be advisable to consider financial adjustment arrangements from a more economically oriented viewpoint.

In addition to the urgently needed evolvement of the net transfer calculations into more comprehensive incidence and cost-benefit analyses it is desirable that simulation exercises should be carried out concerning the effects of alternative procedures by the EC. We do not know enough about the differential effects of various integration measures on agricultural, social and regional expenditure and on aspects of finance. As it is certain that any modification of the parameters of the economic order, simulated or effective, affects the allocation and distribution of goods in the common market, it has finally to be asked which situation is to be assumed in simulation exercises as being normal – a state of complete national sovereignty, the present legal order in the EC or a hypothetical state of integration. An overall view reveals that there is at present a danger of political decisions having to be made on the basis of insufficient data for such decisions.

Approach from the Theory of Federalism

The economic theory of federalism is only rarely brought to bear on the controversy about the net transfer calculations. This theory provides a means of translating the issue of the competence for expenditure and receipts in the pre-federalistic stage of integration into considerations of suitability. This approach allows the search for appropriate spheres of competence and financing arrangements in the common market to be interpreted as a question about the optimum degree of centrality or decentrality in the allocation of European tasks and revenues. For this purpose it is necessary to segregate local, regional, national and European public activities. Allocative, distributive and stabilizer effects are regarded as the so-called centrality criteria; they furnish indicators for a suitable organizational structure. The MacDougall group examined for instance whether the criteria of "economies of scale", "spillover" and "political homogeneity" warrant participation of the Community in public sector functions or not[5].

This line of argument has been given little attention yet in the political discussion although it can help to elucidate the comparative cost advantages when a political measure is carried out either by the individual

[4] The views of the Länder of the Federal Republic of Germany on the reform of Art. 91a and 104a Basic Law are influenced by their net positions in the internal financial adjustment arrangements in the Federal Republic. In the light of the arguments on net transfer calculations recipient countries could be expected to favour the continuation of the Community tasks while donor countries would oppose it.

[5] Cf. Report of the group of experts for the investigation of the part of public finances in the European integration, Vol. I, General Report, Brussels 1977, 75.49ff and Vol. II, Individual contributions and working papers, Brussels 1977, p.377ff. (In the following quoted as MacDougall group).

[6] Cf., e. g., F. Forte: Grundsätze der Zuordnung öffentlicher ökonomischer Funktionen im Rahmen von Gebietskörperschaften (Principles of the allocation of public economic functions within the framework of territorial authorities), in: MacDougall group, Vol. II, Brussels 1977, p.333ff.

Chart
Criteria For and Against Decentralization

	On balance favouring centralization (allocation of powers to the top)	On balance favouring dezentralization (allocation of powers to the lower level)
1. Allocative criteria		
Citizens' preferences (proximity, extrinsic rationality)		*
Protection of minorities		*
Innovation/competition/ initiatives/transparence, dynamic efficiency		*
Positive/negative inter-regional cost/benefit spillovers (spreading of benefits, lack of fiscal equivalence)	*	
Lack of supply divisibility in the production-technical sense (production at minimum cost, intrinsic rationality, economies of scale, optimum production unit size)	*	
Information, consensus and control costs		*
Coordination requirements (e. g. road-building)	*	
Finance (equivalence financing arrangements for territorial authorities)	*	*
2. Distributive criteria		
Personal and regional distribution of monetary incomes	*	
Personal and regional distribution of goods and services (incl. minimum equipment)	*	
3. Stability-oriented criteria		
Cyclical stability	*	
Financing	*	

show which criteria could be adduced in support of different centralities. The question of who is to have the power of decision does not become any simpler when a certain functional sphere, e. g. agricultural or regional policy, is singled out for consideration. It has therefore to be admitted that such theoretical considerations are more suitable for a discussion about the fundamentals of the allocation of functions in the future than for finding solutions for clearly identified functional spheres. The necessary reform of the European agricultural policy can certainly not be deduced at present from the theory of federalism.

It emerges clearly from the line of argument pursued here[7] that the question how the burdens of integration can be distributed equitably has many facets. The answer to this question must on the one hand allow for financial adjustment and on the other hand take the Community's prospective finance requirements in 1980 into account[8]. Looking beyond the financial requirements in the immediate future, a correlation can be shown to exist between the size of the Community's budget and the state of integration (see the Table). It is

Table
State of Integration and EC Share of GNP

State of Integration	EC Share of GNP (in %)
State in 1977	0.7
Prefederalistic integration	2.0– 2.5
Federation with small public sector	5.0– 7.0 (excl. defence)
	7.5–10.0 (incl. defence)
Federation with large public sector	20.0–25.0

Source: Compiled from MacDougall group, Vol. I, p. 14; cf. also Notice from the Commission to the Joint Council of Foreign and Finance Ministers and to the European Parliament, 1978, p. 5.

being emphasized by official quarters that the tabulated figures indicate a functional substitution between different levels and not an enlargement of the public share in the Community. It is however virtually impossible to prove *a priori* that this process is "only" an increase in the degree of centrality ("Popitz effects") and not an expansion of the public sector ("Wagner effects"). In the practice of integration this problem manifests itself indirectly, namely, when it has to be decided whether prospective financial requirements can be reduced by a different expenditure policy or whether the EC's spending pattern with its own dynamism in the agricultural sphere must be regarded as an absolute fact. If the former is the case, the discussion must centre on a reform of the European spending on agriculture which accounts for about three-quarters of the Community budget. In the latter case consideration must be given to new possibilities of financing the Community budget in the framework of a changing scheme of financial adjustment between the member countries. Changes will probably have to be made in both areas in order to achieve a more permanent solution of the transfers dispute through an amended financing and allocating system.

[7] Cf., on this espec., D. Biehl: Zur Rolle der öffentlichen Finanzen in der Europäischen Integration (On the part of public finance in the European integration), in: Integration, No. 2, 1978, p.35ff.; G. Denton: Finanzföderalismus und der Haushalt der Europäischen Gemeinschaften (Financial federalism and the budget of the European Communities), in: Integration, No. 1, 1979, p.11f.

[8] Cf., for details, the contributions of D. Biehl on European regional policy, K.-D. Henke on the financing of the European Community and C. Thoroe on agricultural policy, shortly to be published in: D. Pohmer (ed.): Probleme des Finanzausgleichs III. Der Finanzausgleich der Europäischen Gemeinschaften (Problems of financial adjustment III; the financial adjustment arrangements of the European Communities), in: Schriften des Vereins für Socialpolitik (being printed); E. Reister: Haushalt und Finanzen der Europäischen Gemeinschaften (Budget and finances of the European Communities), Baden-Baden 1976; R. Peffekoven: Internationale Finanzordnung (International financial order), in: H. Gröner, A. Schüller (eds.): Internationale Wirtschaftsordnung, Stuttgart, New York 1978, p. 134 ff.