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CONFIDENTIAL

NOTE FOR THE ATTENTION OF PRESIDENT DELORS

Working Papers on matters relating to the EMU

You requested, through Mr Dixon, that Michael Emerson drafts three papers on:

1. regional balancing mechanisms in economic and monetary unions;

2. macro-stabilising functions of budgetary policy;

3. the evolution of the theory and practice of regional policy.

I attach herewith the first paper. The second will be worked on in November. As regards the third, the views of outside experts are being solicited.

Attached you will also find a short draft by Mr Van Ginderachter which illustrates some of the issues to be dealt with in the third paper.

Costa

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REGIONAL BALANCING MECHANISMS
IN ECONOMIC AND MONETARY UNIONS

REGIONAL BALANCING MECHANISMS IN ECONOMIC AND MONETARY UNIONS

1. The conceptual framework

When monetary unification removes the instrument of exchange rate adjustment, the issue is posed how the new regime is to retain the quality of systemic equilibrium (e.g. not to be threatened with excessive tensions arising from diverging competitiveness, employment and economic welfare).

One framework for approaching this question is to consider the needs for systemic balance between the three main branches of public policy, which concern the EC in the following ways:

(i) the objective of efficiency in the use of resources, which for the EC is currently represented by the single market programme;

(ii) the objective of macroeconomic stability of prices and real activity, to which the EC's monetary integration would make a fundamental contribution, together, no doubt, with other non-monetary mechanisms of macroeconomic policy coordination;

(iii) the objective of equity and social solidarity, which in the EC context translates principally into the question of regional balance in employment levels and the distribution of the welfare gains generated under the other objectives.

The present paper is addressed to the third objective, taking for granted that the EC achieves its objectives as regards the other two. The specific premise is that valuable gains are to be generated for the EC as a whole under the first two objectives (through 1992 and monetary integration) but with some uncertainty and risks regarding the distribution of the gains.

The mechanisms for assuring regional balance can be discussed in terms familiar in international economics: the alternative paradigms of adjustment versus financing whose mix and time-paths represents the essence of the policy challenge. The same paradigms are relevant in the context of economic and monetary unions. Indeed, the explicit task of the present paper is to consider how the instruments of adjustment and financing, and their mix, may be expected to change as the regime switches from an international one to an economic and monetary union.

The analysis proceeds along these lines together with the specific constraint for the EC case in hand, that the search is for the most decentralised system that could adequately support the workings of a single market combined with monetary union, rather than for some abstract, ideal system.

2. Instruments of inter-regional adjustment and financing.

The instruments of adjustment and financing compare as follows, in international and union systems:

	international	economic and monetary union
adjustment		
1. exchange rate flexibility	yes	no
2. real wage flexibility	yes	yes
3. labour mobility	none/little	yes
4. budgetary macro-policy adjustment	yes	yes
financing		
5. balance of payments financing and exchange rate intervention	yes	no
6. capital mobility	maybe	yes
7. budgetary redistribution mechanisms i) tax and social security ii) general purpose equalisation iii) specific purpose grants	none/little	yes

The following analysis surveys how these mechanisms change in the move to monetary union, and draws attention to some of the issues that could arise in the event of different mixes in the use of these various tools.

Adjustment mechanisms

1. Exchange rate flexibility. By hypothesis, this is eliminated from the instruments of policy in the move to monetary union.

2. Real wage flexibility. The capacity for real wage costs (salaries and social costs) to adjust sufficiently to maintain competitiveness, and avoid problems analagous to over- or under-valuation of the exchange rate, will be one of the major conditions for the viability of an economic and monetary union. It has to be expected that increasing economic and political integration will lead to pressures in favour of greater wage equalisation or more rigid wage relativities between countries. The necessary degree of reliance, in any given regime, on real wage flexibility between regions will also depend in part on the properties of other parts of the system, for example the acceptability of labour mobility or budgetary transfer mechanisms.

Some examples may serve, first, to illustrate what real wage rigidity or flexibility means in concrete terms. These examples are not suggested as possible choices, but rather as indications of the present regime choices in different European countries.

At one end of the spectrum, one may have in mind some aspects of the Italian labour market, in which the social partners agreed in 1969 to abandon a regional approach to the collective bargaining of wage levels between the north and the south, with the result that wage differentials were reduced or eliminated, and at any event made more rigid. In order to mitigate the adverse effects on unemployment in the south, substantial wage subsidies were introduced, through applying a special social security tax regime. These implicit subsidies currently amount for industrial sectors to nearly 20% of wage costs. However, even combined with structural grants and loans from the central government to the south, this did not prevent the emergence of a very much higher unemployment rate in the south.

In fact, all EC countries have very limited inter-regional real wage flexibility, even Germany with its structure of regionalised wage bargaining. However, no country other than Italy has inter-regional wage subsidies at present, although the United Kingdom experimented with a system of this kind in the nineteen-sixties. (It was later discontinued).

At the other end of the spectrum, the EC does not contain at present an example of a very flexible and competitive labour market. However, nearby Turkey illustrates some of the conditions under which a labour market can function very flexibly, including the complete absence of unemployment compensation, and massive inter-regional migration (given constraints now on international migration).

The search for an acceptable formula to allow for adequate real wage flexibility without unlocking the door to a competitive devaluation of social achievements, is a doubly delicate matter: on the one hand it involves highly political issues, and on the other hand, it can only partly be influenced by government.

One broad approach, in line with recent developments in EC internal market doctrine, could consist of favouring the maximum reliance on decentralised (national or regionalised) wage determination within the constraint of minimum standards. Such minimum standards could concern universal rights to basic social security provisions and basic rights of labour to organise etc.

It could be helpful also to encourage collective wage contracts that had automatic adjustment features built into them, such as, for example, a more important element of profit-related remuneration. Another Italian example, and a more positive one, is relevant in this

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connection, namely the recent agreements reached in the FIAT enterprise to relate real wage advances essentially to a profit measure.

Such framework conditions would, however, hardly be able to guarantee that real wage evolutions kept in line with the requirements of reasonable labour market equilibrium. In establishing an economic and monetary union, there would need also, presumably, to be some kind of "historic understanding" as regards the responsibilities of the EC and its Member States for the different determinants of regional balance. If the needs for real wage adjustment between Member States were recognised to be essentially a national responsibility, then pressures in terms of the other possible instruments of adjustment and financing would be correspondingly moderate. If, however, the system moved towards a pattern of increasingly narrow and rigid real wage differentials between the Member States, then other parts of the adjustment and financing system would have to play bigger roles.

3. Labour mobility. Economic analysis usually regards labour mobility as an efficient, welfare-improving means of economic adjustment. Where a regional economy is not productive enough to support a satisfactory real wage level, labour migrates. Higher real incomes are earned as a result of migration, some of which is usually remitted to the region of emigration, and the labour may eventually return home with enhanced skills.

As between the Member States of the EC there are likely to be increasing flows of micro-economic migration (e.g. mobile managers and specialised professionals), but macro-economic migration (i.e. mass migration capable of reducing regional unemployment imbalances) seems likely to be relatively reduced. This is for two reasons: language barriers and the relative generosity in all Member States of unemployment benefit and other social security mechanisms. The recent example of Ireland, however, shows that economic conditions can still provoke large-scale migration, at least from a small country. In this case, the loss of human capital, purely in terms of past public expenditure on education, has been of significant proportions. This is relevant to financing mechanisms discussed below. Educational investment is typically supported by federal budgets in order to take care of this problem of "externalities" (i.e. compensate for these leakages, otherwise there may result under-investment in education).

More fundamentally, the EC would have to take a view politically on the acceptability of migration between countries as a labour market equilibrating mechanism. While this is an accepted part of the system in the United States, it is likely to remain subject to far lower tolerance levels in the EC, in view of specific social and cultural values, including the diversity of languages.

4. Budgetary policy. (Another paper is due to address the issue of the budget policy regime in a macroeconomic sense, i.e. the distribution of responsibilities between the centre and states essentially for regulation of budget balances).

Financing mechanisms

5. Balance of payments financing and exchange rate intervention. Transactions of these types cease in the switch to monetary union. Of course, other inter-regional financing mechanisms become more important instead, as follows.

6. Capital mobility. The amplitude of structural capital movements between countries is likely to increase, and the amplitude of speculative capital movements linked to exchange risks will decrease. However, the key point here is that the capital-importing, less-developed regions expose themselves to new risks as well as opportunities, in removing capital controls. If these countries allow their labour costs to become uncompetitive, or fail to establish sufficiently attractive conditions to attract mobile investment, then the potential for capital outflows becomes a more high-powered one. Capital mobility in this context is more likely to enhance either virtuous or vicious circles of economic development, rather than balance different trends. Since, in a monetary union, capital mobility

is a basic regime choice, not a policy variable, the implication is that the importance of getting the other variables right (real wages and budgetary mechanisms) is heightened.

7. Budgetary redistributive mechanisms. These are typically of three categories:

i) Central or federal taxation and mechanisms of social security
ii) General purpose equalisation mechanisms (see annex 1 for detail)
iii) Specific purpose grant mechanisms (see annex 2 for detail)

In most mature federations, there is a mixed use of all three categories of instruments.

The different economic functions of the three categories, from the point of view of contributing to regional balance in the distribution of economic welfare and (invisible) regional balance of payments financing, are as follows:

- income taxes and central or federal mechanisms of social security have automatically the effect of redistributing income progressively between regions and of absorbing to a considerable degree the impact on regional incomes of fluctuations in the fortunes of the regional economy (e.g. through changes in its supply competitiveness, or demand for its typical products). Since these mechanisms work with little or no time-lag, they act as automatic cyclical stabilisers for the regional economy, and automatic financing mechanisms for the regional balance of payments, as well as instruments of inter-regional income redistribution.

- general-purpose equalisation mechanisms are usually negotiated for multi-year periods, in order to allow states to finance approximately equal standards of public services. They are less sensitive, therefore, to the impact of short-term supply or demand shocks hitting the regional economy. However, over the medium-term, they redistribute income progressively, and finance regional balance of payments imbalances invisibly.

- specific-purpose grant mechanisms aim typically at equalising the quality of economic infrastructure between states or regions (e.g. transport, hospitals, universities, manpower training). They are usually framed in terms of medium-term programmes, although there are examples where they may be adapted to shorter-run and cyclical conditions. (The EC's structural funds fall into this category, whereas the EC has no significant instruments in the preceding two categories).

Comprehensive studies have been made on the pattern and amplitude of the inter-regional financing impact of these mechanisms (MacDougall Group of Experts, and Report(1)). This material was also reviewed more briefly and in a more up-to-date context in the Padoa-Schioppa Group of Experts and Report(2).

Two kinds of measure give an outline of the effective economic importance of these budgetary mechanisms:

- firstly, the absolute size of the public expenditure or transfers by the central or federal level of government as a share of GDP;

- secondly, the redistributive power of these mechanisms in terms of the degree to which they equalize differences in economic welfare between regions or states.

In four federations (Germany, Australia, Canada and the United States), general purpose equalisation grants average 1 1/4% of GNP (range of 0.4% to 3.1%), whereas specific purpose grants average 2 1/2% of GNP (range of 1.7% to 3.2%). These transfer mechanisms thus represent only a small part of the total public expenditures of the federal levels of government, which range from 20 to 25% of GNP.

The aggregate inter-regional redistributive power of all instruments together is typically around one-third in the mature federations (i.e. inter-regional income differences are reduced by one third as a result of the inter-regional impact of budgetary mechanisms). In the case of non-federations (such as France, Italy and the UK), where

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central taxes and social security are more important, and inter-governmental grants less important, the redistributive power is closer to one-half. These flows tend to finance very large balance of payments trade imbalances as between rich (surplus) and poor (deficit) regions. It is not uncommon for relatively small, peripheral and depressed regions to sustain trade deficits in this way of around 10 to 20% of the regional product (as seen in the Saarland, Brittany, Northern Ireland and Calabria, for example).

The relative importance of the three categories of mechanisms in terms of their redistributive power varies greatly between different federations. In Germany, the tax and social security system have the biggest impact, but general-purpose equalisation is also powerful. In Australia, the three categories are rather equally mixed. In Canada, both general and specific-purpose grants are important. In the United States, the tax system is predominant in impact, but the specific purpose grants are also of significant inter-regional redistributive importance.

The MacDougall Group made some purely mechanical calculations of the minimal size of the EC budget, in the case that its role was expanded in certain public expenditure fields such as research and development in industrial technologies, aid to developing countries, and also replicated the kind of inter-regional redistribution function found in the central or federal budgets of seven countries (Germany, France, Italy, UK, Australia, Canada and the US). The results were a range of 2 to 2 1/2% of GNP, a relatively small figure because of heavy reliance on selective grant mechanisms. The detailed premises behind this figure may be read in Volume 1 of the Group's report.

3. Recent developments in the EC budget and possible further steps.

Recent developments. The recent decision to double the size of the structural funds in real terms by 1993 invites a perspective on how these developments may relate to the future requirements of a monetary union.

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The EC budget is projected as indicated in Table 1.

Table 1: The EC Budget

Expenditure (commitments)	1988 bn ECU	1988 % GDP	1992 bn ECU	1992 % GDP
Agricultural guarantee expenditure	27.5	0.69	29.6	0.67
Structural funds (regional, social, agriculture guidance)	7.8	0.20	13.5	0.30
Technology, research, energy and industry	1.2	0.03	2.4	0.05
Administration and reimbursements	4.5	0.11	2.1	0.05
Other	4.3	0.11	5.2	0.12
Total	45.3	1.13	52.8	1.19
Revenues (payments)				
Customs duties and agricultural levies	11.4	0.29		
Value added tax	24.6	0.62		
GNP-key resources and other	7.8	0.21		
Total	43.8	1.12	51.9	1.17

Loan disbursements under the EC's investment financing facilities amounted to ECU 7 1/2 billion in 1987, of which the larger part came from the European Investment Bank.

Principle features of the new rules of the structural funds are as follows:

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- Priority objectives are:

  N° 1 Promoting the development and structural adjustment of lagging regions

  N° 2 Converting regions seriously affected by industrial decline

  N° 3 Combatting long-term unemployment

  N° 4 Facilitating the occupational integration of young people

  N° 5 Promoting agricultural adjustment and rural development

- Objective N° 1 regions cover the whole of Portugal, Greece and Ireland, substantial parts of Spain and Italy, and smaller parts of France and the United Kingdom.

- Objective N° 2 regions are not yet fixed, but will include many old industrial areas which face serious restructuring problems.

- The financial participation rates (matching ratios) are set at

  65% for regions falling under objective n° 1

  50% for regions falling under objective n° 2

  40% for other areas.

- The new rules provide for all Member States to submit regional and sectoral plans, with proposed financing needs, by 31st March 1989 for a five year period. The Commission soon after determine the "Community support frameworks" with Member States, which will define the Community's response to the plans.

In terms of the overall financial magnitudes of the structural funds and loans combined, it is likely that by 1993 the receipts of the three small countries wholly included under objective n° 1 (Portugal, Greece and Ireland) will amount to around 5% of GNP (these are indicative figures, since there exist no precise allocations by country at the present stage). Spain could receive amounts in the region of 1 to 1 1/2% of GNP. Other countries would receive much smaller amounts in terms of GNP share. For perspective, these amounts are, for the main recipient countries, comparable in GNP share to the Marshall plan assistance of 1948 to 1951.

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In terms of the preceding categories of public finance, these recent developments see the EC concentrating on specific purpose grants, without entering into the domain of general purpose equalisation or much expanding its direct tax instruments (such as its share in the VAT).

Possible further developments. The structural funds are, as their name implies, long-term instruments and are not adapted to short-term changes in the economic fortunes of different regions. With a view to adapting to the needs of a monetary union, a capacity to come more quickly to the help of regions or sectors in difficulty would be a natural development. An evolution in this direction would not be difficult to build onto the present mechanisms, either as regards public investments or manpower policy measures. (One may bear in mind the model of the German federal Finanzhilfen (Art. 104a GG) which allows for project support either for short-term stabilisation or long term development purposes). As regards investment measures, the criteria established under objective N° 2 of the structural funds go in this direction (where unemployment rises notably over a three year period, regions may become eligible). As regards manpower measures, it would not, in principle, be difficult to adapt the Social Fund to intervene in a larger and prompter way in regions experiencing severe unemployment problems. The justification of compensating for shorter-term problems could essentially be as social insurance from the EC in relation to economic accidents or misfortunes (e.g. "earthquakes", not only in the geological sense, but also in the sense of disastrous developments in a region's terms of trade).

At present, the structural funds are only of real macroeconomic significance in three small countries. There is an obvious difficulty regarding the larger countries. The size of each of them in relation to the EC as a whole is such that substantial transfers to one or two of them would translate into much bigger payments for the countries supporting the transfers. One response to this problem is to treat the bigger countries on a regional basis, which is what the structural funds do already to a large extent. However, this is not a completely satisfactory solution, if problems of tension between members of a monetary union originated, for example, in economic maladjustment at the national level. If, to take a purely hypothetical example, two large countries (say Spain and Italy or France or the UK) had to be aided on the scale of the EC's projected commitments to Greece, Portugal and Ireland in 1992, then this would require a further expansion of the structural funds by an amount of around ECU 20 billion, or 1/2% of EC total GNP.

On the other hand, a different constraint on the possible further expansion of the structural funds is already visible in the case of the three small countries mentioned. This is that the EC is now moving into a situation of co-financing a large share of these countries' economic infrastructure investments. Thus the scope for further expansion would be limited unless the eligibility criteria were considerably widened, introducing such areas as hospital, school, university and housing investment which are at present ineligible. At present, the structural funds are addressed to a relatively narrow category of economic infrastructure, investment and manpower projects. Where such grant mechanisms become wide-ranging in their coverage, it is not uncommon for decentralised systems to turn to general-purpose mechanisms with equalisation features, rather than to continue with the proliferation of specific-purpose grants. In the latter case, incentives for the lower levels of government become confusing, and the number of detailed governmental choices that have to be made at the central level becomes very substantial. General-purpose grant mechanisms can still be associated with specific obligations on the part of recipient states to maintain given standards of public services.

A particular complication for specific-purpose grants arises where three tiers of government are involved (EC, national level, and state or regional level) as is the case now in over half the Community (Germany, Italy, Spain, France and Belgium - see Annex 3). If the EC moves into the situation of co-financing a substantial number of sub-national public expenditure functions, then there may only be two real solutions to avoid a confusion of financial incentives: have greater recourse from the EC level to (a) the direct financing of sub-national projects, or (b) general-purpose grants to national governments.

Ideas that have been discussed in the past (for example in the Marjolin report of 1973 and MacDougall report of 1977), include the possibility of EC co-financing of unemployment benefits. This would have some of the properties mentioned earlier, namely to assure an automatic and quick response to fluctuations in the economic conditions of different regions. In the United States, the federal government co-finances the differing unemployment regimes of the states. The main disadvantage of this idea is that it could mean introducing the EC into the politically delicate area of determining unemployment benefit regimes.

At present, unemployment regimes are quite heterogenous, especially as regards the maximum length of benefits, and how they relate to other income-maintenance and pension benefits. Without greater harmonisation, a co-financing system would produce distorted results as between Member States.

Finally, there are a certain number of other public expenditure categories which could relatively naturally become EC budget competences to a higher degree than at present. This includes, for example, R&D programmes for science and technology, and aid to developing countries. However, the policy functions in question are, clearly, not strongly related to the issue of assuring the viability of monetary integration and are not further pursued.

4. Summary of the main issues

Where exchange rate changes are removed from the instruments of adjustment between the regions or countries of an economy, some new balance has to be struck in the functioning of other parts of the

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policy system. In practice, this means that particular attention has to be given to how real wage flexibility and inter-regional flows of public finance will, in some mix of the two, help avoid the emergence of unacceptable divergences in regional employment and income levels. Exclusive reliance on either real wage adjustment or financing by budgetary mechanisms would seem to be implausible solutions. Other instruments of inter-regional financing and adjustment will be in play, including the mobility of private capital and labour, but neither can be relied upon as adequate palliatives to all types of problem that may arise.

In principle, it might seem attractive to look for an incentive system, whereby the availability of significant budgetary assistance would be related to the willingness of the recipient to adjust real wage competitiveness in the desirable direction. Such a scheme would break new ground. It is no accident that there appear to be no precedents for a regime of this type. This reflects the fact that real wage evolutions hardly represent a policy instrument but rather a behavioural variable of the private sector. Conditionality in these circumstances would be extremely difficult to operate, especially for more than short-run periods.

Given difficulties of this kind, the search for a stable system may need to proceed under the following headings:

(1) At the time of monetary unification some kind of historic, social contract would need to be agreed, in which the responsibilities of the social partners and governments at the national level for appropriate real wage evolutions in relation to other countries would have to be clarified. A premature equalisation or rigidification of real wage levels between countries would need to be guarded against. On the other hand, it might be agreed that a decentralised determination of employment conditions should not lead to a downward spiral of competition with respect to basic social achievements, for example through recognising certain

categories of minimum standards in the areas of social security and labour law. A major reflection on forms and habits of wage contracts should, at any event, be undertaken, so as to encourage reforms that could help assure automatic adjustments of real wage levels to avoid the emergence of uncompetitiveness in labour costs.

(ii) At the same time there would need, no doubt, to be decisions on the evolution of the functions of the EC budget, notably through grant mechanisms that would help resist the emergence of economic tensions between different regions or countries in the union. Such mechanisms should, however, only be considered as very imperfect substitutes for adequate flexibility in real wage levels. This is because mechanisms that appeared to be close in nature to a wage subsidy would run the serious risk of having an unfortunate incentive effect on collective bargaining behaviour.

More positively, however, budgetary grant mechanisms can serve to equalise - to a varying degree - the opportunities for successful economic development of different regions or countries. Such mechanisms could also provide shorter-term compensation in the event of unpredictable economic accidents or misfortunes. They could thus form an intuitivly reasonable part of the social contract between countries forming an economic and monetary union.

The main types of grant mechanisms available to perform these functions can be observed in the practice of both federal countries and non-federal countries that have regional as well as local government. In particular the choice between, or mix of, general-purpose equalisation grants and specific-purpose grants will depend on the range of public expenditure categories brought into the domain of co-financing by the EC and the desired degree of decentralisation.

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(1) D. MacDougall et al. "Report of the study group on the role of public finance in European integration"; (Volume 1: General Report, Volume II: Individual contributions and working papers), Commission of the EC, Economic and Financial Studies Series, 1977.

(2) T. Padoa-Schioppa et al. "Efficiency, Stability and Equity: A strategy for the evolution of the economic system of the European Communities", Oxford University Press, 1987.

(3) D. King. "Fiscal Tiers: The Economics of Multi-tier Government", George Allen and Unwin, 1984.

Annex 1

General-purpose equalisation mechanisms

Budgetary equalisation mechanisms are often found in federal and central/local government systems. The common feature is that budgetary resources are redistributed by the centre between states (or regions), or directly between states (or regions), so as to equalise to a given degree the fiscal capacity of states to satisfy certain standards of need for public services. The payments relate to a basket of public servies (otherwise it would be a specific-purpose grant). The equalisation mechanism typically requires a two-stage calculation:

- fiscal capacity: the revenue per head that a state would obtain from application of a standard tax base;

- expenditure needs: the expenditure per head that a state needs to make to assure given public service standards.

The equalisation standard requires political choices. The objective may be, for example, to put poorer states in a position to finance the national average public service standards, or a given percentage of this average, or the standard observed in some reference states.

The mechanisms result in payments that may have any of three types:

(i) a clearing mechanism - i.e. the calculations result in a set of debit and credit balances which sum to zero, with the transfers made directly between states. The debits and credits in this case do not need even to appear as revenues or expenditures in the central or federal budget (the German Länderfinanzausgleich has features of this type).

(ii) payments by the centre to relatively poor states, i.e. the central or federal budget makes payments only to those states whose own resources have to be supplemented in order for them to be able to reach the chosen standards.

(iii) differential payments by the centre to all states, i.e. the richer states receive resources from the centre, but in relatively small per capita amounts, whereas the poorer states receive larger amounts.

One important implication of these different possibilities is that a given redistribution objective can be achieved with a wide range of outcomes for the size of the central or federal budget - even zero in the event that the clearing model (i) is chosen, with small and large central budgets required respectively for models (ii) and (iii).

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three stages: first VAT revenues are allocated between Länder according to an equalisation formula that corresponds to type (iii) above; second, supplementary grants are made to certain states (Ergänzungszuweisungen) according to type (ii) above; thirdly, the system is completed with a clearing mechanism of type (i) (Länderfinanzausleich) which raises the fiscal capacity of the poorer Länder. The first two stages result in flows from the federal budget, whereas the final equalisation stage relies on a clearing mechanism that does not enter into the federal budget.

Australia and Canada both have mechanisms of type (ii), whereby grants are paid to relatively poor states from the federal budget: to 3 out of 6 states in Australia, and to 7 out of 10 states in Canada.

The United States introduced in 1972 a Revenue-Sharing system of type (iii), whereby a fixed sum in the federal budget was allocated between all states according to formulae that had a progressive redistributive effect. The system is now discontinued.

Annex 2

Specific-purpose grant mechanisms

Specific purpose matching (or shared-cost) grant mechanisms are found in almost all federal and central/local government systems. The structural funds of the EC are also of this family. The common feature is that the central or federal budget co-finances specific types of state expenditures. The key variables in such mechanisms are:

- eligibility criteria: for example regional, sectoral or income criteria.

- variability of the matching ratio: if a redistributive effect is desired, the central budget may participate to the extent of, say, 75% of the total public expenditure in the case of a poor state, compared to, say, 25% in a rich state.

- open or closed-ended nature of the facility ("guichet ouvert" or not). The importance of this distinction is that an open-ended fund is certain to have an incentive-effect at the margin on the resource allocation preferences of lower-level government, whereas a closed-ended fund (allocating fixed sums to individual recipient governments) may lose its incentive effect and become in effect a general-purpose grant because of the fungibility of resources. "Additionality rules" may be used to try to overcome this latter problem, but are difficult to administer in the long-run.

The United States has relied most heavily of specific-purpose grants, the total number of separate programmes reaching 495 in the early 1970s. These programmes have been in the areas of public health, education, public welfare assistance, manpower training, job creation initiatives, unemployment compensation, and infrastructure such as highways and public housing. The extraordinary complexity of this system has led to its consolidation in recent years, with the discharge of some responsibilities of the federal government to the states, and the conversion of numerous small programmes into block grants (i.e. moving closer to the general-purpose grant model). The United States offered clearly an example of excessive-expansion and multiplication of specific-purpose grants, from which it has now moved back in some degree.

Canada has a relatively small number of shared cost mechanisms for public health, university education, welfare assistance and regional and cultural development.

Australia makes restricted use of specific-purpose grants, notably for hospitals, universities and highway infrastructure. Otherwise the

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general purpose equalisation system and federal social security are the dominant features.

Germany has several systems of specific-purpose grants from Bund and Länder:

- Common tasks (Gemeinschaftsaufgaben, art. 91a GG) which see the joint planning and financing of university construction, regional economic infrastructure, and the improvement of agricultural structures and coastal protection. Some of these expenditures link with the structural funds of the EC;

- Coordination between Bund and Länder in education and research (Art. 91b GG);

- Restitutions for federal functions delegated to the Länder (Art. 104a, 2&3 GG), including costs of military administration, student grants and housing and saving subsidies;

- Investment aids (Finanzhilfen, Art 104a, GG), which concerns projects aimed either at short-term economic stabilisation or long-term growth potential in the domains of local transport, urban development, housing grants and hospital investment.

Annex 3

Public finance systems in EC countries with federal or regional structures

Apart from the federal model used in Germany, there have been important acts of regional devolution in the last two decades in Italy (1970), Spain (1978) and Belgium. Regionalisation in Belgium was initiated in 1980, and will be completed with new reforms that are due to take effect on 1st January 1989. France created a regional tier of government in 1972, but their major responsibilities came with the reforms of 1982 and 1983. Other EC countries have little or no regional tiers of government between the central and local tiers.

The German federal constitution of 1949 with a revision in 1969, gives to the 11 Länder important competences in the area of justice and public order, public health, education, culture, housing and regional planning. Of total public expenditure by Bund and Länder, the latter account for 45%. The Länder's own resources consist 70% of taxes shared with the Bund; i.e. 42.5% of personal income tax revenues, 20% of the local business tax, 50% of corporation tax, about one-third of the value-added tax, and 100% of wealth, vehicle and beer taxes (all of which are collected by the Bund). The larger part of the remaining resources of the Länder consist of general- and specific-purpose grants from the Bund, as indicated in Annexes 1 and 2.

Italy introduced its present system of regional government in 1970. The 20 regions are responsible for about 17% of the total public expenditure, which is financed to the extent of 80% by transfers from the central government, the regions thus having only minor own resources fiscally. The region's principal expenditures are in the area of public health, followed by infrastructure investments. Their other main function is to transfer funds to local government for various public expenditure needs. The larger part of the transfers from central to regional government are in the form of specific-purpose grants, but there are some general-purpose transfers which are distributed with a somewhat progressive formula.

Spain's new constitution of 1978 gave important functions to the 17 "autonomous communities", whose role is greater than in the case of Italy's regions. Competences wholly or partly transferred to the autonomous communities include justice, economic regulations, employment, public works, education, culture, industry, transport and public health. The autonomous communities are financed, firstly, by their share in certain taxes (wealth, property, inheritance and real estate transaction taxes). This is complemented by further financial participation from Madrid, and an "inter-territorial compensation fund" which is allocated to capital expenditures and is based on a highly progressive formula. Total public expenditures accounted for by the autonomous communities amount to 4% of GNP.

.../...

Belgium's three-region regime, already quite substantive since 1980, will become close to a federal regime on 1st January 1989. With the new regime, the regions and communities will be responsible for culture, education, housing, public assistance and public health, aids to industry, public transport and public works. The central government retains monetary policy, defense, and the financing of social security. The financing of the regional and communities competences will gradually (over an 11 year transition period) move from the present grant system to one based largely on a share in personal income tax, with the regions to have freedom to set their own rates of surcharge on the national rate. They will also share in the revenue of several small taxes. There will, finally, almost certainly be an equalisation mechanism, bringing the revenues of a poorer region closer to the national average (details are not yet finalised).

France's system of regional government was introduced in 1972 with 26 regions. However, the direct election of regional representatives only came in 1982. Competences of the regions lie primarily in the areas of economic planning, professional training, the co-financing of regional public investment and aid to lower levels of government. The total resources of the regions are, however, small (17 billion Francs in 1985, or .3% of GNP), financed largely by regional surcharges on certain taxes accruing to other levels of government (e.g. property and motor vehicle registration taxes). The remaining resources come from specific-purpose grants from the central government and borrowing.

In conclusion, it may be judged that Spain and Belgium have installed, or are currently preparing, regional systems of government that are approaching the federal regime of Germany in the degree of devolved competences, fiscal resources and explicit inter-regional balancing mechanisms. Italy's regime is distinctly less decentralised, and France's less so than Italy's.