The UK and the Euro – better out than in?

IoD Research Paper

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April 1999

ISBN 1 901580 24 5

Published by the Institute of Directors
116 Pall Mall, London SW1Y 5ED

COPIES AVAILABLE FROM:

Director Publications
Publications Department
116 Pall Mall
London
SW1Y 5ED
Tel: 0171 766 8766
Fax: 0171 766 8787

Price £5.00

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Executive summary

- Euro participation is an irreversible decision, a permanent marriage. Do we really want to commit ourselves to such a relationship whilst holding so many reservations? The truth is that we don't know whether the euro will work for the rest of the EU, but for the UK the uncertainty and fears are far far greater.
- Euro participation is not politically inevitable. Whilst opposition to the euro is volatile, large groups in society are very strongly opposed, particularly the C2DE socio-economic groups and tabloid readers. Even the AB socio-economic groups and broadsheet readers are only marginally in favour of the UK joining the euro.
- Euro participation is not economically inevitable. The UK economy is significantly different from Euroland. Across a large range of economic variables the UK stands at the end of the spectrum. The UK has the highest levels of outstanding mortgage debt as a proportion of GDP, the highest levels of variable interest rate debt as a proportion of total mortgage debt, the highest employment-population ratio, the lowest unemployment rate of the largest EU economies, the highest proportion of pension funds, the lowest share of public spending to GDP, the lowest share of gross public debt to GDP, the lowest share of taxes and social security contributions as a proportion of GDP, the lowest proportion of state aid to manufacturing and the highest share of private sector financial assets as a proportion of GDP.
- The failings of the EU economic model, particularly the performance of the labour market, are widely recognised. Over recent decades the UK has made significant productivity gains and is the largest market for inward investment into the EU. The more flexible Anglo-American economies are role models not laggards – 18 million people are unemployed across the EU. The proportion of Europe's working age population with jobs stands at just 60.5%, compared with 70.8% in the UK. Comparing the United States with Europe, we see that since 1970 the US economy has created over 50 million jobs, the overwhelming majority of which were in the private sector. Less than one tenth as many jobs were created in the EU, and many of these were in the public sector.
- The more open an EU economy is to intra-EU exports – as a proportion of total exports – then the more likely it is to gain from participating in the euro. Only 14% of UK GDP is accounted for by trade with Euroland. In the case of Ireland intra-EU goods exports account for 64% of total exports, in Germany the proportion is 57% and in France 64%. In the UK the proportion is just 52%. Only 46% of total UK export earnings are with Euroland.
- There are real concerns that both monetary and fiscal policy in Euroland may have set a course for deflation. Very many eminent commentators have highlighted the economic and political risks of the euro, and why it is a 'treaty too far'. Euro participation is like a giant game of snakes and ladders. It may ultimately result in a

scenario whereby economic gains ascend the ladder of deeper political integration. More likely however is a snaky descent towards political and economic tension.

- The theory that the UK will make huge economic gains from lower interest rates within Euroland is flawed. UK interest rates are higher than elsewhere in Europe because the UK is at a different stage in the economic cycle. At one stage in the early 1990s UK rates were below German levels. The gap at the long end has narrowed considerably, and now that the independent MPC has been established in the UK, there is no theoretical reason why the UK shouldn't close the gap completely with Euro interest rates. There are no free lunches in economics. If monetary policy is eased, by cutting interest rates 3% points, then fiscal policy will need to be tightened, requiring £20 billion spending cuts and/or higher taxes. The UK economy is desynchronised with the Euroland economic cycle. The UK economy is more sensitive to short term interest rate movements than those on the continent. Structural unemployment on the continent is much higher than in the UK. As a result, inflationary pressures could emerge more quickly than in the UK, in response to an easing in policy.

- The UK's experience with fixed exchange rate regimes such as the Gold Standard and the ERM is not good. There remains an important role for independent monetary policy in the face of shocks – such as the boom-bust in the housing market at the beginning of the 1990s. The majority of the UK's total export earnings are from outside Euroland. The pound has traded within a narrow range against the dollar over many years. In the future the euro-dollar cross rate may well be volatile.

- The euro is not necessary to complete the internal market. Canada is deeply integrated with the US economy without requiring a common currency. Within Europe, Switzerland and Norway are more deeply integrated with Euroland, than is the UK, and yet they are outside of the euro and the EU. They also enjoy some of the highest per capita incomes in the world. The debate over the single currency has overshadowed the debate over the regulatory burden in the EU. The EU regulatory burden on business is massive and needs to be reduced. Companies need to ask why left of centre parties used to oppose EMU as a capitalist plot, but now see it as a socialist opportunity.

- The euro will only have a marginal impact on inward investment – indeed it is possible to argue that remaining outside will help the UK economy from an FDI perspective. It was clear in 1997 that the UK was staying outside the euro, possibly indefinitely, and yet inward investment rose 40% year on year. These are not the actions of companies concerned over the UK sitting on the sidelines of EMU. 70% of inward investment is domestic orientated, going into the UK services sector. Surveys of manufacturing inward investors suggest UK euro participation is not significant.

- The Treaty of Rome, the Single European Act, the Treaty of Maastricht and the Uruguay Round of the GATT talks ensure continued open access to EU markets whether the UK is in or out of the euro. The UK's very large trade gap with Euroland shows that it is in the interest of the rest of the EU to ensure continued open access to UK companies.

- The issue of the Withholding Tax shows how the City can be damaged by deeper European integration. The City remains the world's largest centre for international financial transactions. That dominance has been recognised in recent years by the establishment of a number of German financial institutions in London. London's major activities are international and it is the only true global financial centre. This point was made in the City Research Project at the London Business School. The

LBS report showed that the City was just as likely to gain as lose from the UK staying outside the euro. Viewing financial services competition as between monolithic centres is flawed. Improvements in communications technology allow existing financial centres to serve wider hinterlands.

- The pressures for fiscal harmonisation have accelerated as a result of the euro – the E in EMU stands for economic and monetary union. The Growth and Stability Pact is intended to prevent fiscal free-riding – increasing the budget deficit, safe in the knowledge that the particular national economy would be too small to trigger a general run on the euro. The geographical asymmetry between Euroland wide monetary policy and national fiscal policies will also increase pressures for fiscal federalism. EU politicians have made it very clear that the next step in EU integration is tax harmonisation. Many commentators, including the Bundesbank, have also made it clear that within Euroland it will be very difficult for states to hold on to their autonomy over taxation policy. The tax harmonisation debate is complex. However, what is clear is that because of much higher social security contributions on the continent, the UK share of taxes in GDP is the lowest in the EU – 36% of GDP in the UK versus 45% in the EU. Harmonisation would raise the tax burden in the UK by more than £50 billion (1999 prices).

- The euro is likely to lead to far greater centralised disbursement of regional transfers within Euroland. The MacDougall report back in 1977 suggested that such flows would need to rise to at least 5-7% of GDP. If the UK had to find an extra 5% of GDP for regional transfers, this would amount to around £37 billion (1999 prices). However, the long term impact of tax harmonisation could be even greater. The unfunded public pension liabilities on the continent are massive. In an environment of tax harmonisation, the so called no bail-out clause in the Treaty of Maastricht would be rendered effectively useless. The unfunded pension liabilities could raise the tax share across Euroland by 8% of GDP – almost £60 billion (1999 prices). This is not to say that such a situation will develop – in aggregate these fiscal effects would raise the tax share in GDP to Swedish levels of around 60%. These figures are shown so as to illustrate the scale of the fiscal imbalance between the UK and Euroland, and the future competitive advantage to the UK of staying outside the euro.

- The euro will accelerate the forces for political union as a result of fiscal harmonisation, together with the democratic deficit and the lack of political accountability of the ECB. Introduction of the euro has vast political implications. This report presents quote after quote from EU Presidents and Prime Ministers that monetary union is intended to lead to political union – a United States of Europe. The arguments that the euro will not move the EU towards a far deeper political union are flawed. The political classes across the EU are way ahead of the electorates in their support of deeper political integration. This risks serious political tensions in the years ahead. The nation state is not dead and any sense of EU identity is very weak.

- EMU is portrayed as ‘Alice in Wonderland’ economics, but risks creating ‘Malice in Blunderland’.

1. Introduction

"if ever there was a bad idea, EMU is it"

Professor Rudi Dornbusch (MIT)

"so much of barbarism, however, still remains in the transactions of most civilised nations, that almost all independent countries choose to assert their nationality by having, to their own inconvenience and that of their neighbours, a peculiar currency of their own"

John Stuart Mill (Principles of Political Economy)

The decision whether to join the euro is the central geo-political issue of our age. As we stand on the edge of the twenty first century it is as though 2,000 years of history are being compressed into a few short years. The Financial Times has written that "EMU is not a narrow technical operation ... it has vast political implications".

Despite the fundamental issues surrounding the euro, far too many companies and consumers have only a cursory understanding of the issues. A recent FT/MORI poll found that only 9% of companies felt well informed about the euro. Consumer research shows even lower proportions, and suggests that the average person perceives the euro as little more than decimalisation with a few knobs on top! This is a serious problem.

The general public across the EU are disconnected entirely from the integration process and the political classes. Many don't understand the introduction of the euro and only the Club Med electorates are in favour of it. Euroscepticism is not confined to the UK. This is not to say that companies should not prepare for the euro. Far from it. But the installation of new accounting and IT systems is a world away from openly lobbying for the demise of sterling.

Euro participation is an 'irreversible' decision, it is a permanent marriage. Do we really want to commit ourselves to such a relationship whilst holding so many reservations? The truth is that we don't know whether EMU will work for the rest of the EU, but for the UK the uncertainty and fears are far far greater.

This paper advances four key arguments:

- EMU is not inevitable for the UK.
- For each argument in favour of UK participation in the euro, there is a more robust counter argument.
- Monetary union will also lead to fiscal union. When combined with the unfunded pension liabilities of the public sector in the rest of the EU, this will lead to much higher taxes in the UK if we participate in the euro – and possibly if we don't. The pressures for greater fiscal harmonisation are already in place – extending the Single

Market. The introduction of the euro accelerates this process and pushes additional forces behind it.

- Even if the economic arguments for entry were strong – which they aren't – there would still be a case for remaining outside the single currency. This is because monetary union is aimed at creating a political union.

The case for and against

We examine the case for UK participation in the euro, and why for each argument in favour, there is a more robust counter argument. The arguments in favour of UK participation can be divided into three distinct groups. The first group contains the so called 'inevitability' theories that the UK has been outside European integration in the past, only to subsequently come on board later on less favourable terms. The second group contains 'positive' theories, and the alleged benefits – such as lower interest rates – euro membership will bring. The final group contains 'negative' arguments, and the alleged costs – such as lower foreign direct investment – EMU membership will avoid.

Inevitability theories

Politically inevitable
Economically inevitable

Positive theories

Lower interest rates
Exchange rate stability
Single market completion

Negative theories

Maintaining foreign direct investment
Avoiding protectionism
Protecting the City

2. Inevitability theories

Politically inevitable ?

One of the most used arguments in favour of UK participation in the euro is the assertion that we will ultimately join, and so might as well do it now, on more favourable terms. The most obvious immediate response to this argument is to state that even if something is inevitable, it doesn't necessarily mean that it is good. One is reminded of the quote by JM Keynes, that "the only certainty in life is death and taxes".

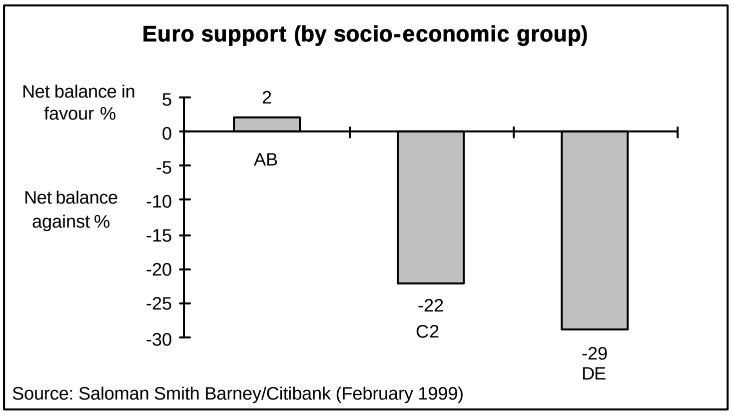
The inevitability argument draws on postwar history, asserting that the UK prevaricated over membership of the Common Market, instead of being at the heart of European integration from the outset. With the euro now underway in 1999, added momentum has been given to this argument. Indeed, Government Ministers have spoken openly of the potential for so called 'eurocreep' – the increasing use and awareness of the euro by UK companies and consumers, which it is suggested will lead to reduced opposition towards the death of the pound.

This argument has some support. The monthly MORI UK euro attitudes survey tracking poll commissioned by Salomon Smith Barney/Citibank has shown a sharp fall in opposition to the euro in early 1999. This in turn has led to increased speculation that the Prime Minister might be tempted to hold a referendum prior to the General Election, in order to exploit division in the Conservative Party. This scenario draws on the referendum experience of the 1970s, when two years before the referendum the electorate was sceptical of UK membership, but a concerted referendum campaign then swung public opinion overwhelmingly in favour.

Those seeing euro participation as inevitable, argue that opposition to the euro is 'soft', and unable to withstand the massed ranks of the Government, Liberal Democrats, a few leading Conservative MPs, the CBI and the TUC. Those battling to save the pound appear somewhat weaker; the majority of the Conservative Party, a proportion of Labour MPs, Business for Sterling, New Europe and the IoD. The truth is that we don't know how hard or soft opposition to the UK joining the euro is. Joining the euro is a significantly greater step than joining the Common Market was. It is therefore wrong to assume that the electorate will fall meekly into line.

A survey by The Henley Centre in 1998 found that only 22% of UK consumers agreed that there should be a single currency. A similar survey in 1998 by the Abbey National found that only 32% of UK consumers thought the euro was a good idea. More generally, The Henley Centre's survey found that only 18% of UK consumers felt 'almost as European as they do British'. Only 27% of UK consumers felt 'we will only prosper if we have a united Europe'. Eurobarometer polls have shown that only 2% of consumers feel well informed and understand the euro. This cocktail of scepticism and lack of knowledge means that the Government is likely to proceed very cautiously, aware that there is a real risk of a reactionary political backlash. However, the launch of the euro, and the fact that the UK may fall to the bottom of the EU GDP growth league in 1999, suggest referendum speculation will intensify.

Opinion remains volatile. In December, the Saloman Smith Barney/Citibank poll showed a sharp rise in hostility to the euro, in the wake of the row over tax harmonisation. Following the launch of the euro, opposition declined in January. Despite the recent pick up in sentiment towards the euro, the Government still faces serious euro scepticism across different socio-economic groups. Michael Saunders, UK economist at Saloman Smith Barney/Citibank has pointed out that "the upper income AB socio-economic group is slightly pro euro, with 45% in favour of EMU and 43% against (balance of plus 2%). The skilled working class C2s and lower income DEs are strongly against, with balances of minus 22% and minus 29%. Among tabloid readers the balance of opinion against the euro is 28%, whilst among readers of the broadsheet dailies there is a balance of 7% in favour. Labour voters show a balance of 9% against the euro, with a balance of 44% against among Conservatives".



The Government may also note that the English language 'European' newspaper folded at the end of 1998. In the final editorial it was noted that "it is, perhaps, the ultimate paradox that as Euroland achieves birth The European faces its nemesis". This provides continued anecdotal evidence of lukewarm attitudes and interest in the European ideal in the UK. As de Tocqueville pointed out long ago "the language tie is often the strongest and most durable element that binds men together".

Economically inevitable ?

It is argued that in order to retain economic influence in the EU, the UK will inevitably see membership of EMU as the only option. The economic influence argument has two strands. Firstly, that because of global free capital movements, the individual nation state has already relinquished monetary sovereignty. Secondly, by being outside Euroland, the UK loses influence by not having a seat on the ECB or the Euro X group of finance ministers. These assertions are flawed.

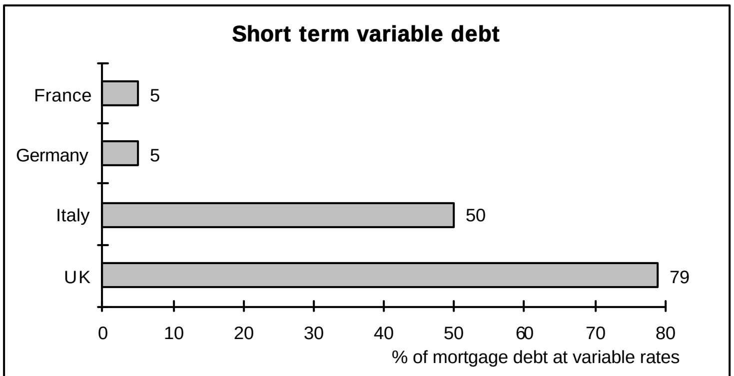
In the case of global free capital movements one only needs to cite the experience of sterling's departure from the ERM in 1992, to show that national monetary policy remains a very powerful tool for stabilising the domestic economy. Devaluations can work, and they do not necessarily end in an inflationary wage-price spiral.

The institutional argument is weak. The ECB Council currently has 17 members, 6 executive board members and 11 national central bank governors. Against this influence, the UK would have just a single vote.

Those arguing that it is economically inevitable that the UK will join the euro, see recent economic history as a continuum. The continuum runs from free trade area to customs union to single market to single currency. Because the UK has participated in the first three stages, then it is seen as inevitable that it will ultimately participate in the fourth. However, the economics of a single currency is a quantum leap compared with the integration stemming from the Treaty of Rome and the Single European Act. If UK participation in a single currency is to work, then the UK will need to display significant convergence with Euroland, beyond that required under the Treaty of Maastricht, and prescribed in the Chancellor Gordon Brown's five economic tests.

Comparisons with Euroland show the UK economy is very different from that on the continent. Consider the following:

- Outstanding mortgage debt – The UK has the highest proportion in the EU, at 61% of GDP. In contrast, the proportion in Germany is 48%, in France 20% and Italy 7% (Source: OECD Economic Outlook, December 1997).
- Short term variable debt – The UK has the highest proportion of short term variable mortgage debt as a proportion of total mortgage debt. In the UK the proportion is 79%, in contrast to 50% in Italy and only 5% in Germany and France (Source: European Mortgage Federation, CML 1998).



Source: European Mortgage Federation (CML 1998)

- Owner occupation – The UK has one of the highest owner occupation rates in the EU, at 67%. In contrast, the rate is only 54% in France and 38% in Germany (Source: Housing Futures, The Henley Centre, 1996).
- Employment-population ratios – The UK has the highest employment-population ratio in the EU, at 71%. In contrast, the ratio is 64% in Germany, 60% in France and 51% in Italy (Source: OECD 1996).
- Unemployment rates – The UK has the lowest rate of unemployment in the EU's largest economies, at 6.2% (ILO standardised definition). In contrast, the EU average is almost 10%, with the rate at 12% in France and Italy and 9.5% in Germany.
- Pension fund assets – The UK has the highest proportion of pension funds in the EU's largest economies, at 75% of GDP. In contrast, the proportion in Germany and France is 6% and in Italy 3% (Source: Group of Ten, April 1998, quoted by NAPF).

- Public sector – The UK has the lowest share of public spending in the EU's largest economies, at just under 40% of GDP. In contrast, the proportion is 54% in France, 50% in Italy and 47% in Germany (Source: OECD Economic Outlook, June 1998).
- Gross public debt – The UK has the lowest share of general government gross public debt in the EU, at 53% of GDP (Maastricht definition). In contrast, the proportion was 122% in Italy, 61% in Germany and 58% in France (Source: OECD Economic Outlook, June 1998).
- Taxes and social security – The UK has the lowest share of taxes and social security contributions in the EU, at 36% of GDP. In contrast, the proportion in France is 46%, in Germany 43% and in Italy 43% (Source: Eurostat, Taxes and Social Contributions 1983-1994). In the UK an employee needs to work until mid June in order to pay off total taxes and stop working for the government. In the EU the so called 'freedom day' is the end of July, and in Germany is towards the end of August.
- State aid – The UK has the lowest proportion of state aid to manufacturing in the EU, amounting to only 1.5% of GDP. In contrast, a recent survey showed the proportion was 9% in Italy, 3% in France and 2% in Germany (Source: European Commission Fourth Survey on State Aid in the EU, 1995).
- Financial liabilities of the household sector – The UK has the highest proportion in the EU, at 79% of GDP. In contrast, the proportion is 56% in Germany, 50% in France and 24% in Italy (Source: OECD balance sheets of non-financial sector).
- Private sector assets – The UK has the highest proportion of total gross private sector financial assets in GDP, amounting to around 330% of GDP. In contrast, the proportion is around 200% in Italy, 191% in France and 137% in Germany (Source: Intersec/Merrill Lynch 1996).
- Liabilities of non-financial enterprises – The UK has the lowest proportion in the EU, at 38% of total assets. In contrast, the proportion is 76% in Italy, 61% in France and 60% in Germany (Source: OECD non-financial enterprises financial statements).
- Long term bank credit – The UK has one of the lowest shares of long term bank credit to the private sector, amounting to only 24% of total credit. In contrast, the proportion is 79% in Germany and 63% in France (Source: BIS, 1994).
- Overseas assets – The UK has the highest proportion of private sector assets overseas (Netherlands excluded). In the UK the proportion of private sector financial assets held overseas is around 15% of GDP. In contrast, the proportion is around 6% in Italy, 5% in Germany and 4% in France (Source: Intersec/Merrill Lynch, 1996).
- Corporate bonds outstanding – The UK has the lowest proportion in the EU, at 2.9% of GDP. In contrast, the proportion is 61% in Germany, 14% in Italy and 12% in France (Source: Merrill Lynch, The Size and Structure of World Bond Markets, October 1996).

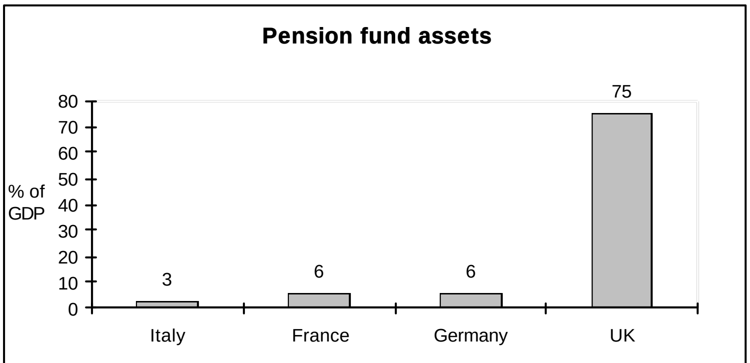
Individually non of these contrasts provides a conclusive case against UK participation in EMU. However, in aggregate, they show a UK economy very different to the rest of Euroland. And an economy in which only 14% of GDP is accounted for by trade (goods and services) with Euroland.

The more open an EU economy is to intra-EU exports – as a % of total exports – then the more it is likely to gain from participating in the euro. In the case of Ireland intra-EU exports account for 64% of total exports, in Germany the proportion is 57%, in France 64%. However, in the case of the UK, intra-EU exports account for just 52% of total goods exports (European

Commission estimates for 1997). Professor Duncan Maclennan (EMU and the UK housing and mortgage markets, CML 1997) has written "the export markets of Britain …are predominantly outside the EU, so have less to gain from currency union". The UK is the second largest exporter of services in the world (ONS press release, February 1999), with only one third of services exports destined for Euroland. Under 40% of our overseas investment income comes from Euroland.

Those businesses advocating the euro in the UK, need to ask why there has been a shift in left of centre political views towards the EU. Over the past two decades left wing politicians have shifted from seeing the EU as a capitalist plot towards that of a socialist opportunity. Can such views, epitomised in the New European Way, be reconciled with the interests of the corporate sector?

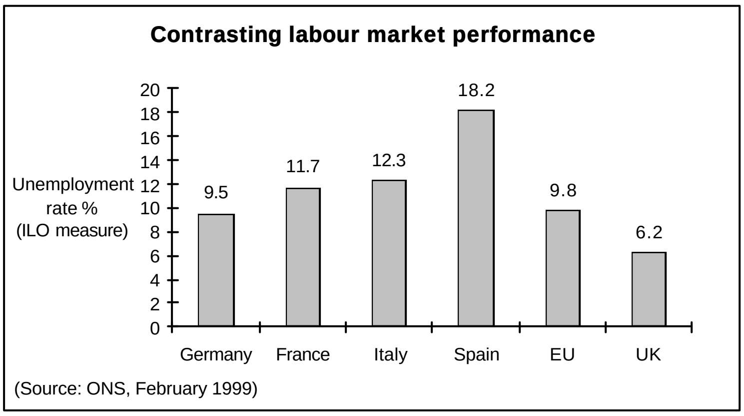
Some of those advocating euro entry are all too often guilty of Britoscepticism, a view that unless Britain integrates fast and deep with Euroland, then it will be destined to permanent economic decline. This view is also flawed. It is also a view of certain political classes that is not shared by the population as a whole. An EU survey undertaken by The Henley Centre in 1998, asked people's responses to the statement 'my children will be less prosperous than I am'; 59% of UK respondents disagreed, whilst only a third of French and German respondents disagreed.



(Source: NAPF/Group of Ten, April 1998)

Research published by the IoD (Lies, Damned Lies and Productivity Statistics, IoD, 1998) shows that the UK's competitive position is far better than generally understood, and that it is even possible that UK productivity levels are second only to the US. Indeed, it is quite possible that over the course of the next two decades the UK will surpass the French economy as the fourth largest in the world. The UK has the second largest stock market in the world and there is a general acceptance that the Anglo-American model will outperform the European corporatist model in the future. However, it must also be pointed out that the EU remains competitive when considering its trade surplus with the rest of the world. Though this may be more a reflection of persistently deflationary policies and structural labour market rigidities, than any improvement in long run competitiveness.

The failings of many EU labour markets have been highlighted by the OECD Jobs Study and many others. A recent report (Unemployment, a trans-Atlantic perspective, D Cohen, A Lefranc and Gilles Saint-Paul, Economic Policy 25, CEPR 1997) showed that unemployed French workers take five times longer than US workers to find new jobs, and at the same time French workers are five times less likely to become unemployed. The IMF estimate (The case for fundamental labour market reform, D Coe and D Snower, IMF Staff Papers volume 44, no 1 1997) that over the past decade structural unemployment has fallen from 9% to 6% in the UK, whereas in the EU it stands at 9%. The authors argue that piecemeal reforms in the EU are doomed to failure, because of the way labour market rigidities reinforce one another.



The lack of structural reform is deeply worrying because within the Euroland zone problems will arise because of the lack of wage flexibility, labour mobility and fiscal transfers. As The Economist has pointed out (EMU Survey, April 11th 1998) "the theory [of optimal currency areas] concludes that for a currency area to have the best chance of success … there should be no cultural, linguistic or legal barriers to labour mobility across frontiers, there should be wage flexibility and there should be some system of stabilising transfers". The absence of these instruments raises serious questions as to the viability of EMU.

However, it is possible that one can over emphasise this particular point. A recent study (Redistribution versus insurance: Does Europe need a fiscal federation? Antonio Fatas, Economic Policy 26) suggests that nowadays only 10% of any fall in state GDP in the US is compensated by the Federal Government – earlier estimates in the 1980s suggested the figure was 40%. Also, labour mobility is extremely limited not just between EU countries, but within them as well, but a single national currency is still able to function. In another paper (EMU countries or regions, A Fatas, CEPR discussion paper 1558) Fatas also makes the point that "the correlation of regions across national borders has been increasing over time while the cross regional correlation within countries has decreased. As a result, the economic significance of national borders has been greatly reduced".

However, there is still concern. An INSEAD paper (Regional Labour Market Dynamics in Europe, A. Fatas and J Decressin, INSEAD 1996) revealed that "in the US when a state undergoes a recession, one generally sees US workers uprooting themselves and moving themselves to those states in economic boom. In contrast, European workers drop out of the labour force and tend to stay in the depressed region … this result is discouraging for the future of EMU, because given the low level of labour mobility, there is no natural mechanism of adjustment … different national currencies and exchange rates could help with these disparities".

Since 1970 over 50 million jobs have been created in the US economy, the overwhelming majority of which were in the private sector. Less than one tenth as many jobs were created in the EU, and most of these were in the public sector. Gerard Lyons, Chief Economist at DKB International has stated (Politeia lecture, EMU and the Labour Market, November 1998) that "this poor jobs performance in Europe has not been a short term development. It has been a sustained problem …EMU will make Europe's jobs problem worse. EMU stands for Even More Unemployment".

This striking comparison reveals one of the fundamental economic differences between the Anglo-American and EU labour market models. In the US employment has increased at the expense of real wage growth, whilst in the EU the maintenance of real wages has been at the expense of employment growth.

The combination of labour market inflexibility and deficient demand has led to the situation whereby 18 million people are unemployed in Europe. The classic example is Spain, where the economy has doubled in size over recent decades, and yet employment is flat compared with twenty years ago. The Delors Commission in 1993 stated an aim of creating 15 million new jobs by 2000, but the reality has been a fall in employment. Moreover, the actual unemployment rate flatters the efficiency of EU labour markets – because of unregistered unemployed. The proportion of Europe's working age population with jobs stands at 60.5%, compared with 70.8% in the UK and 74% in the US (Europe's dismal jobs record could undermine the euro and is a strong reason to deter the UK from joining, DKB International, November 1998). The UK unemployment rate is much less than that in Euroland.

A number of worrying future economic scenarios have been suggested:

- The crash of 2003: an EMU fairy tale (David Lascelles, CSFI 1996) – This scenario argues that in response to heavy falls on Wall Street, world and EU GDP growth slows sharply in 2000-2001. The Stability Pact rules then cause Euroland governments to cut spending, further reinforcing the deflationary spiral. Faced with the choice of an EU federal treasury or the break up of EMU, nations opt for the re-introduction of their old currencies in order to benefit from devaluation. This would cause a massive political crisis in Europe, since it would be a clear breach of the 'irreversibility' enshrined in the Maastricht Treaty.
- Walter Eltis (EMU's irrevocable mess, Prospect, July 1997) has pointed out that over the 1999-2002 transition period, if speculation as to an EMU breakdown were to arise, the possibility could induce holders of, for example, lira notes to pile into deutschmarks. This would not change overall Euroland money supply, but it would radically alter its composition and create tensions with the Bundesbank. What is clear is that in a crisis situation, the choice could become one of disintegration or far deeper integration.
- Writing in the Financial Times (Could EMU collapse?, March 23rd 1998) Walter Munchau argues that "under conditions of distress, EU leaders would be far more likely to opt for what the French call economic government – a system of tax co-ordination, perhaps even an EU wide finance ministry and a system of fund transfers to smooth the cyclical swings … the irony is that the conditions for the break up of EMU are exactly the same as those that could lead to even more political and economic integration and centralisation".
- Kiel Institute of World Economy (1998) – KIWE have reported that "Problems in the labour market could reach such a scale that some countries might want to go back to national currencies … but since the Treaty does not give the possibility of secession, this could lead to serious political tensions".
- Euro Futures (David Smith, 1997) – In this book examining the future of Europe, the Sunday Times Economics Editor attaches the following probabilities: Apocalypse 10%, Dark Ages 20%, Plus ca change 35%, Les Etrangers 25% and Renaissance 10%. In other words there is a one in three chance that the eventual economic impact of the euro could be very bad or worse.
- The risk of deflation (The Risk of Deflation in the Future EMU: Lessons of the 1990s, P De Grauwe, CEPR Discussion Paper 1834, 1998) – De Grauwe argues that institutional factors mean that monetary and fiscal policy will be biased towards deflation in Euroland. This is a serious concern in view of the fact that the electorate in Euroland are unprepared for economic pain post Maastricht convergence.

De Grauwe points out that because of structural problems in the labour market, monetary policy needs to be set in order to prevent mild recessions turning into deep ones. He points out that measurement bias in inflation – because of quality improvements – suggests that there could be an upward bias of up to 1%, and that as a result, a 2% plus inflation target would be quite acceptable. Given the current Euroland inflation rate is around 1%, then monetary policy is acting in a deflationary manner. De Grauwe also argues that the need for greater real wage flexibility – post euro – is helped when there is a little inflation – because of money illusion. However, when inflation is zero, real wage reduction is only obtained by a decline in nominal wage growth – which is far more difficult to achieve.

With regard to fiscal policy it is argued that the Stability Pact is also deflationary. The traditional argument against this view is that sanctions wouldn't apply in the case of a fall in GDP of 2% or more. It is also argued by the European Commission that once the steady state of budget balance has been achieved, then the 3% of GDP ceiling on budget deficits should allow ample room for the exercising of automatic fiscal stabilisers. There are two problems with this view. Firstly, what happens during the transition period? Secondly, the outstanding debt position of the public sector – increased from 55% to 75% over the 1990-1997 period in Euroland – will force continued budgetary austerity, unless of course the Pact is ignored.

- Charles Goodhart (member of the Monetary Policy Committee, writing in Prospect magazine, December 1995) – He writes that "the risk of moving to EMU …is that adverse shocks will cause persistent pockets of unemployment. Politicians are then bound to blame it all on the abandonment of national sovereign control over the key levers of economic policy. A move to EMU in these circumstances could generate a backlash towards an even more aggressive nationalism, even fascism"
- Martin Feldstein (former Chairman of the President's US Council of Economic Advisers, writing in Foreign Affairs, November/December 1997, 'The Euro and War' and NBER working paper 6150) – He has written that "EMU would be an economic liability. A single currency would cause at most small trade and investment gains but would raise average unemployment, and increase the risk of protectionism. EMU is nevertheless being pursued in order to create a political union. Fundamental disagreements among member states about economic policies, and the sharing of political power are likely to create future intra-European conflicts …with uncertain consequences for world stability and peace". This is a frightening 'outside' perspective from a very eminent American observer.

UK participation in the euro is not an economic inevitability, especially given the diverse motivations for a single currency. Emeritus Professor of Economics at the London Business School, Sir James Ball, has written that "The supporters of the single currency lack coherence. They include bureaucrats and ex bureaucrats, academics, labour leaders, multi-national businessmen and politicians ... they do not for the most part include ordinary people. The one thing they all have in common is a profound disbelief in the nation state, for different reasons. Bureaucrats think they can run societies better than governments. Academics believe in the universality of academic relationships. Labour leaders of today believe that they can get more from a bureaucracy in Brussels than they can from their respective governments. For multi-national business, nation states and individual currencies are a nuisance, whilst politicians in many of the European countries paradoxically see the possibility of greater influence for the nation state from integration rather than separation."

With such diverse motivations, and a UK economy so different from the rest of Euroland, EMU is not an economic inevitability, it is not la pensée unique. Rather, common sense suggests that the only inevitability should be UK exclusion from the euro for the foreseeable future. Euro participation is equivalent to a giant game of snakes and ladders, it is possible to envisage a virtuous scenario whereby economic improvement ascends the political ladder of deeper integration towards a popular United States of Europe. More likely, however, is a snaky descent towards political and economic tension.

3. Positive theories

Lower interest rates

The most commonly advanced argument in favour of UK participation is that because of the anti-inflationary resolve and credibility of the new European Central Bank, the UK will be able to benefit from significant reductions in interest rates. With the launch of the euro, short term interest rates in Euroland stand at 3%, compared with over 5% in the UK. The gap in mortgage rates is much less because the UK borrows at short term rates whilst the rest of the EU tends to finance house purchase at long term interest rates. The UK is at a different stage in the economic cycle to Euroland. Back in 1993 UK short term interest rates stood below the level in Germany. In the late 1980s the shadowing of the deutschmark resulted in interest rates being set too low for domestic conditions in the UK – with the resulting house price boom. In the early 1990s membership of the ERM resulted in interest rates being set too high for domestic conditions in the UK – with the resulting house price bust.

But even if the UK was to join the euro tomorrow, and slash interest rates to 3%, this would not be the end of the story – there are no free lunches in economics. The monetary stimulus would need to be counteracted by a fiscal tightening. Sir Alan Budd, a member of the MPC, in evidence to the Treasury Select Committee (November 1998) has spoken of the 1% rule. Essentially this is a rule of thumb that for each 1% change in interest rates there would need to be a fiscal offset of roughly 1% of GDP. Cutting spending and/or raising taxes by £20 billion is surely politically impossible?

However, even this simple comparison ignores the role of nominal versus real returns and short versus long term rates. At the beginning of March 1999 three month money market rates in the UK stood at 5.5% with those in Euroland at around 3% – a nominal interest rate gap of 2.5% points. The gap on ten year government bonds was far less, with rates at 4.2% in the UK and 3.7% in Euroland – a nominal interest rate gap of 0.5% points.

We would face the situation in Ireland where despite the highest rate of economic growth in the world, interest rates have been cut in order to squeeze into EMU. The resulting monetary stimulus has been manifested in a housing boom which will almost certainly lead to a bust. Wim Duisenberg has suggested that fiscal policy needs to be tightened, but with tax revenues overflowing the Government instead opted to reduce taxation – such are the mismatches created by EMU.

Moreover, because UK inflation is around 1.6% higher than that in Euroland, the gap in real interest rates is considerably lower. At the short end, real interest rates stand at around 3% whilst in Euroland they are currently stand at just over 2% – a gap of roughly 1% points. At the long end the real interest rate gap favours the UK over Euroland. Real long term rates stand at 1.5% in the UK compared with just over 2.5% in Euroland.

Now that the Bank of England's Monetary Policy Committee has been granted independence in the setting of interest rates, there is no reason why it should not earn the same anti inflation credibility as the ECB. Consequently, from a theoretical perspective, UK rates could converge on Euroland rates – or even go below – without needing to join EMU. Given the plethora of quotes from French and German politicians regarding wider growth and employment objectives, then with very high unemployment in Euroland there must be questions over the long term independence of the ECB – and with it anti-inflationary resolve.

The democratic deficit with regard to political accountability – discussed below – strongly suggests that over time the inflation objective may well be downgraded in favour of GDP growth and employment. Over the long term there is also the additional consideration of unfunded public pension liabilities and the impact this will have on outstanding government debt and bond yields. As we discuss below, the trillions of pounds of liabilities will so undermine the public finances, that it is almost inevitable that bond yields will rise. The UK, with far less exposure, will not face upward pressure on long term interest rates from this source.

From an economic perspective, there is also the NAIRU to consider – the unemployment rate below which inflationary pressures start to rise. Whilst this is a controversial area as to whether it can be identified, there is a broad consensus that the NAIRU is higher in Euroland than in the UK. Consequently, in the wake of any pick up in GDP growth, inflationary pressures could emerge more quickly in Euroland than in the UK – depending of course on the initial starting point. Structural unemployment has increased across the EU in the 1990s (source: OECD estimates), but fallen in the UK.

The UK economy is desynchronised from that of Euroland. Figures from HM Treasury (Membership of the Single Currency, HMT October 1997) show that the UK had a negative correlation coefficient for GDP growth with Germany during the 1980s and early 1990s. In other words, when the UK needed higher interest rates, Germany needed lower, and vice versa. The correlation coefficient with Germany over the 1982-1993 international cycle was –0.3. The IMF (EMU and the World Economy, World Economic Outlook, October 1997) have shown that over the 1964-1990 period the UK economy had the lowest correlation coefficient with Germany, of any EU country. The results of one study (Shocking Aspects of European Monetary Integration, T. Bayoumi and B.Eichengreen, in Adjustment and Growth in EMU, CUP 1993) are particularly illuminating. With reference to demand and supply shocks the study suggested that in 87% of cases there would be significantly different effects in the UK.

Some might argue that convergence will intensify within Euroland and reduce the impact of asymmetric shocks. This will only occur over a very long time frame, and in the long run, as Keynes stated "we are all dead!" The obvious concern is that long before structural changes have taken place, an external shock will undermine EMU. But even if this view is incorrect, for example, because Euroland's economies are more diverse than the US's regions (as argued in Geography and Trade, P. Krugman, MIT Press 1991), there will still be a problem. This is because, as Krugman recognises, a single currency is likely to accelerate single market forces, and thereby increase country or regional specialisation in the EU. In other words, the problem of asymmetric shocks could increase, not decrease in the future. This view has also been advanced by Dr Gerard Lyons, Chief Economist at DKB International: "there is a common perception that EMU will result in convergence across Europe. Nothing could be further from the truth … expect significant regional disparities and pockets of high unemployment". Paul Krugman has written that "we actually have no particular reason to suppose that Europe is the right size for a monetary union … but it is perfectly possible to make a case that Europe is too large for monetary union to be desirable".

Even within the UK, regional disparities in performance provoke tensions. For example, in the late 1980s interest rates were raised to suppress a South East dominated boom, when little of the effect had spread north across the border into Scotland. This probably helped fuel demands for devolution: precisely the opposite of what European integrationists seek. In 1998 there was a political furore in the UK when the Governor of the Bank of England was reported as having said that unemployment in the north was a price worth paying for bringing down UK inflation.

There is a considerable economic literature showing that interest rate movements have a different effect on the UK economy than for Euroland. For example, the OEF model simulations (reported in Strainspotting, HSBC James Capel, November 1997) "show that the impact on UK GDP [from a rise in interest rates] is considerably higher than for other countries". The CEPR, in reporting a number of studies (The ostrich and the EMU – policy choices facing the UK, CEPR 1997) have reported that " a country where changes in interest rates have effects similar to those in other EMU members will be a country that has less difficulty in living with a common monetary policy. The transmission mechanism of monetary policy in the UK is however, far from average ... unless UK balance sheets become more European, inside EMU, the UK would be more sensitive to changes in short term interest rates". A recent paper, reviewing a survey of large econometric models by the BIS found that "the UK and Italy appear to be the countries where monetary policy has the strongest impact on output ... [in response to a rise in interest rates] ... in the UK the fall in output is twice as large as in Germany in the first year of monetary contraction, three times as large in the second".

This paper has reviewed the differential impact of monetary policy changes and shows that large econometric models tend to support the argument that the monetary transmission mechanism is significantly different in the UK, whilst smaller VAR models show a much smaller gap. The contrasting performance of large econometric models has been analysed by the Bank for International Settlements (Financial Structure and the Monetary Policy Transmission Mechanism, BIS, 1995).

Recent research (Asymmetries in housing and financial institutions and EMU, Maclennan, Muellbauer and Stephens, Oxford Review of Economic Policy, Autumn 1998) analysed the contrasting behaviour of the UK housing market and how institutional characteristics influence asset prices and thereby produce "substantially different responses both to interest rate changes and to world-wide equity price changes... the UK represents one extreme in many dimensions".

The authors argue that "simulations with large macromodels show large interest rate effects on output in the UK, consistent with these findings predicted by economic reasoning. The fact that research using VAR methodology has arrived at less conclusive results has persuaded some economists that these are minor issues. However ... research using VARs is seriously flawed". The limitations of VAR models and their dubious conclusions, have been highlighted by the European Commission (Economic Policy in EMU – a study by the European Commission, OUP 1998).

One of the key factors accounting for the different monetary transmission mechanism in the UK is the structure of the mortgage market. There are very significant differences in the structure of the UK market. Moreover, the differences will take a long time to erode. Even if 70% of new mortgages each year were at fixed rates, it would still take 20 years for half the stock to be at fixed rates, and almost 10 years if all new lending was at fixed rates. Across the EU differences in housing finance systems, housing policies and patterns of economic growth have produced wide variations in the weight of mortgage debt in GDP.

Having established that the monetary policy transmission mechanism works differently in the UK, it is important to then analyse on which sectors the differential impact will be most felt. Two factors suggest that consumers are more likely than companies to be disproportionately effected.

Firstly, bank loan liabilities of UK companies are the lowest in the EU (49% of total liabilities, versus 85% in Germany, 90% in Belgium, 80% in France, 77% in Spain and 95% in Italy –

Source: BIS 1995), because a much higher proportion is in securities. UK consumers have the highest proportion of personal sector liabilities in the EU (102% of disposable income in the UK, versus 78% in Germany, 51% in France, 65% in the Netherlands, 58% in Spain and 31% in Italy – Source: BIS 1995), the overwhelming majority of which is held at variable rates (90% of total household credit in the UK, versus 36% in Germany, 8% in the Netherlands, 18% in Belgium, 13% in France and 59% in Italy – Source: BIS 1995).

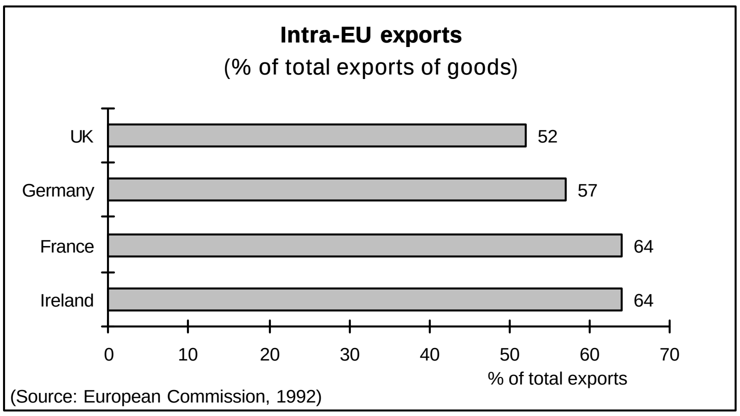
Secondly, companies can raise finance on international capital markets with the result that the more sensitive monetary policy transmission mechanism in the UK will tend to impact most on the personal sector. The proportion of variable rate credit for UK companies is comparable with other EU countries (48% of company credit is at variable rates in the UK, versus 40% in Germany, 56% in France, 37% in the Netherlands and 67% in Belgium – Source: BIS 1995).

Exchange rate stability

Obviously, if the UK were to join EMU, then we would enjoy complete exchange rate stability within Euroland. This has obvious benefits for companies who could plan and manage their trade within Euroland more easily. This obvious attraction is blinding many companies to the fact that the same arguments were used to advocate membership of the ERM. The withdrawal of sterling from the ERM highlights the fact that companies need to consider not just the issue of exchange rate stability, but also the wider economic ramifications of a fixed exchange rate regime. If sterling had not been forced out of the ERM, the housing market in the UK would have imploded.

Gavyn Davies, Chief International Economist at Goldman Sachs has stated "it may be true in the very long run that output and employment are both determined by non monetary factors ... nevertheless there can be an important role for changes in monetary policy to stabilise ... economies in the EU in the face of temporary shocks ... a temporary shock, might for example, include German re-unification or the housing induced boom-bust in the UK".

History provides little comfort. The UK's experience of operating with fixed exchange rate regimes is not good, in fact it is uniformly bad when examining the Gold Standard and the ERM. EMU is an irrevocable, irreversible decision. Do we really want to enter into such a marriage, when we have so many reservations?



There is also the wider question of whether the UK needs a fixed exchange rate with Euroland. The media tend to cite statistics that two thirds of UK exports are with Europe and that as a result the benefits of a single currency are obvious. This view is wrong. The facts are that only 48% of UK exports of goods and services are to Euroland, and if one factors in overseas earnings credits the proportion is lower still. Moreover, the EU share has been falling over time. Looking at services exports, only just over one third are with Euroland.

There is no guarantee that the euro will be stable against the dollar or the yen. The re-weighting of asset allocation portfolios and reserve currencies into the euro may produce a sharp appreciation in the currency. Professor Richard Portes (Capital Markets and the International Role of the Euro, RIIA EMU conference, November 1998) estimates that the medium term portfolio shift into euro denominated assets could be of the order of $475-950 billion. In the long term political factors might produce a depreciating currency. The key point here is that we don't really know what will happen, but stability against the dollar is probably the least likely option.

Given the importance of dollar related transactions to UK trade, it is reassuring that of the major currencies over the past six years, sterling is the least volatile – measured as a percentage change against the US dollar (BMDF memorandum, February 1999).

Completing the single market

Lord Simon, Minister for Europe, has argued that the price transparency afforded under the euro will trigger a competitive boost to the UK economy within EMU. This view has been taken up by Time magazine as well, which has written that "a single currency across the continent will bring irreversible changes ... a Trojan horse containing the warriors of supply side reform and de-regulation".

Many of the mergers and corporate restructurings would have occurred without EMU. Martin Feldstein has argued that it is possible to have all the benefits of a free trade area without a common currency. The transaction cost savings of EMU, on the European Commission's own calculations, are very small, around 0.5% of GDP – a figure swamped by the conversion costs of moving to the euro. Shadow Chancellor Francis Maude has estimated that by treating savings as an annuity – because they can recur – and capitalising its value, the transaction costs are equivalent to a one-off gain of around 2% of GDP. He then points out that the estimated costs of changing over to the euro range between 3% and 7% of GDP (first speech as Shadow Chancellor to the BCS and Engineering Council).

Price transparency will influence prices but the impact can be exaggerated. UK exporters and importers have not operated blind up to now – they have obviously converted each foreign market price into one common currency, namely sterling. For consumers, price transparency may well encourage more overseas purchases, but price equalisation will be limited owing to transport costs, indirect taxes and cultural influences.

The crucial point is surely that competition is the key to maximising efficiency. If one creates a single currency area that is still weighed down by regulatory burdens, then the competitive stimulus will be small. The resulting policy prescription is that there needs to be more deregulation and a more effective single market, not a single currency. Recent unpublished research (Working Man's Burden, The Economist, February 6th 1999) supports the OECD Jobs Study report that far greater labour market flexibility is required across the EU.

The European Policy Forum has produced a report on the costs of regulation on business (The Hidden Costs of Regulation in Europe, EPF, September 1995). The report states that "if unemployment in Europe is to be reduced and manufacturing and services are to remain competitive in world markets the place to start cutting the costs of doing business is with regulations. It is ironic that so much effort is spent on the single currency where the cost savings are estimated at less than half of 1% of GDP, while costs many times larger are imposed on business through regulation ... studies demonstrate persuasively that contrary to popular assumption these costs are very big indeed ... when direct and indirect costs are added together the cost rises to 8-9% of GDP ... these figures pertain to the US from where most data exist. We know, however that most, if not all European countries are more heavily regulated. It is therefore likely that similar studies on Europe would reveal figures at the top end of the range or of even greater magnitude".

Companies need also to be aware of one very key change over the past decade. Left of centre political parties used to oppose EMU as a 'capitalist plot'. They now support it as a 'socialist opportunity'. This turnaround must surely raise alarm bells in the business community.

A single currency is not a requirement of a single market. Canada is far more deeply intertwined with the US economy, than is the UK with Euroland, and yet retains its own currency. Within Europe, Switzerland and Norway are more deeply integrated with Euroland than is the UK, and yet they are outside EMU and the EU. They also enjoy some of the highest per capita incomes in the world.

If the single market is to operate effectively, then Euroland will have to reform labour markets. The European model continues to be characterised by a high level of labour market rigidity and a high level of social protection. EU labour market are over regulated with red tape and employment costs. Over recent decades the US economy has created tens of millions of jobs. In contrast, the EU economy has generated only a few million, and most of these have been in the public sector. However, there is little evidence that EU governments are committed to reform. Indeed, the introduction of the 35 hour week in France suggests that if anything the recent election of left of centre governments across the EU, has moved policy in the other direction. The New European Way has all the signs of the old socialist way. The reform route, offering less regulation and lower social protection remains an anathema for EU governments who see it as 'social dumping'. EU governments are worried that if social dumping went unchecked – in order to attract inward investment – the end result would be a race to the bottom, with lower social protection all round.

4. Negative theories

Maintaining foreign direct investment

Britain has gained large foreign direct investment over recent decades. It is argued that this inward investment has been attracted because of our position within the European Union, and that for the flows to continue at a high level, we will need to be in the heart of the EU, in Euroland.

It is certainly true that in 1997 (latest figures) the UK was the third largest destination for FDI in the world – after the USA and China. Direct investment by foreign companies in the UK increased to almost £22 billion in 1997, the highest ever recorded figure and an increase of £6 billion on the previous year. At the end of 1997 the level of overseas direct investment in the UK stood at £157 billion.

The most immediate response to these figures is to say that in 1997, it was absolutely clear that the UK would not be participating in the first wave of EMU, and that there were strong reasons for believing that the UK might never participate. And yet, despite these reservations, overseas investors increased their flows to the UK by 40% (year on year). These are not the actions of inward investors worried at the UK sitting on the sidelines of EMU.

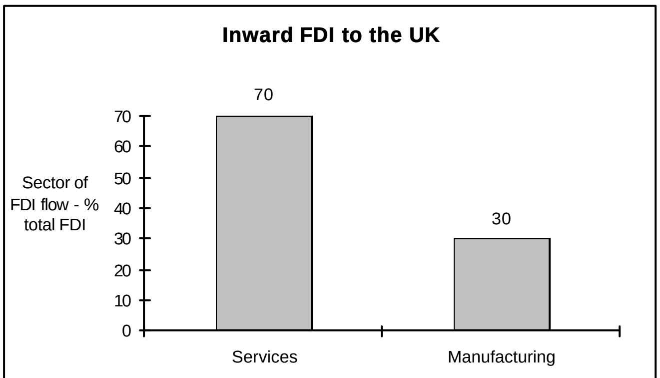
A recent report (The facts about FDI, I Milne, June Press Occasional Paper No. 5, November 1998) argues that the truth about FDI into the UK is that it has very little to do with the EU, let alone EMU. The author's estimates suggest that only 4% of FDI is influenced by access to the single market. This almost certainly means that an even lower proportion will be dependent on EMU. The report estimates that 70% of inward investment goes into services – which means inward services investment is overwhelmingly orientated towards serving the UK market, not Euroland. British inward investment is overwhelmingly with other English speaking countries.

With regard to manufacturing, it is true that certain trade restrictions have in the past encouraged inward investors to establish in the UK. The most obvious example being quota limitations on Japanese car imports. However, when the Uruguay Round is completed early in the next century, the tariffs on 60% of EU imports will be nil, and the remainder will average 3.8%. With regard to product standards, it is fairly clear from the plethora of US and Asian goods available in the EU, that product standards are not having a large impact on market access.

Milne states that "the DTI regularly asks foreign investors why they invest in the UK .... neither 'UK membership of the EU' nor 'access to the single market' has ever figured in the ten most frequently cited reasons for investing in the UK'. Overseas investors say they like our work-force, our infrastructure, the absence of corruption, our language, the business friendly climate, our low taxes and so on".

Japanese economists agree. Writing in the Sunday Times (5th May 1996) Haruko Fukuda, deputy Chairman of Nikko Europe, stated "the argument that inward investment into

Britain is all about Europe appears flawed ... those who believe that Britain has been a magnet for inward investment .... because of EU membership have misunderstood the motives ... it has been attracted to Britain because of lower costs, a low level of corporate taxation, political and social stability and comparatively honest public administration". Noriko Hama, Director of the Mitsubishi Research Institute, has stated that "the more Europe pushes towards further integration, the greater the risk of serious economic and political dislocation, which would be the biggest threat to such investment".



(Source: The Facts About Foreign Investment, Ian Milne, 1998)

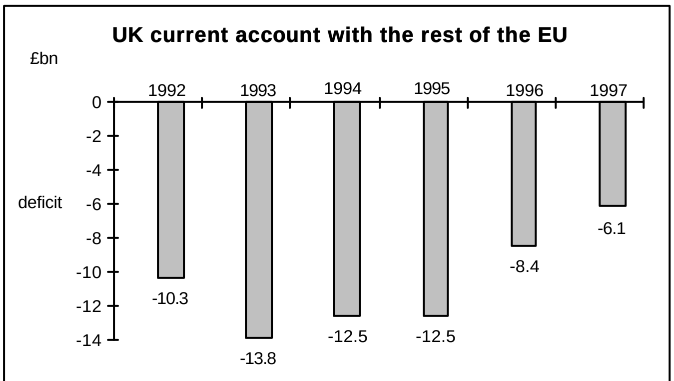
In early 1997 newspaper reports splashed with the headlines 'Toyota says Britain must join EMU'. These reports were based on comments by Toyota's President Hiroshi Okuda at a press gathering in Tokyo. However, the explanation soon became clear, namely that Toyota were considering building a plant in France, but required a significant subsidy in order to allow for the higher costs versus the UK. It seems that a political fix became obvious. The European Commission would not necessarily veto the 'competitive subsidy', and in return the Commission received the payback that the UK should be in EMU (Toyota in Europe – a monkey on a string, Keio Business Review, 34-4, 1996). A few months later Tatsuo Takahashi, managing director of Toyota Motor Europe, issued a statement saying that he believed "British industry might gain from staying out of the single currency".

From an inward investor perspective there could be a further 'bottom-line' advantage to the UK staying out of the euro. This is because of the opportunity to use the UK as a base for exports to a stronger currency area: "Quite simply, so long as an overseas company can prevent its labour costs from rising - over and above that in competing countries - by more than the amount of any currency depreciation then the weakening currency economy is the place to base one's production" (Economic Review, Kleinwort Benson, December 1991). There are some caveats to this assertion, but the basic story is correct: "so long as the UK retains all the other trading advantages of the single market, then avoiding EMU could actually give sterling a particular attraction in the eyes of overseas investors".

The risk of protectionism

Following on the heels of the foreign direct investment debate is the purported threat of some form of protectionist response from the EU if the UK stays out of EMU. This view is wrongheaded. The Treaty of Rome, the Single European Act, the Maastricht Treaty and the Uruguay Round of the GATT talks provide the UK with international treaties guaranteeing access to EU markets. Moreover, with the exception of the GATT, US and Asian companies do not have the same level of assured access, but nonetheless compete very effectively in the EU.

Countries such as Switzerland and Norway, despite remaining outside the EU, are more deeply linked by trade with the EU, than is the case for the UK. One final consideration provides the most persuasive assurance of all. Over the past decade the UK's cumulative current account deficit with the rest of the EU has increased to around £130 billion. In other words, we buy far more from the rest of the EU, than it does from us. It is overwhelmingly in the EU's economic interest to ensure continued open access to UK companies.



(Source: Economic Trends, December 1998)

Protecting the City

Deeper European integration hasn't been good for the City. The threatened Withholding Tax could destroy the eurobond market (see: Serious Damage – The impact of the Withholding Tax on the City of London, CPS, Richard Baron, March 1999). If they are to be competitive, eurobonds must be issued free of Withholding Tax. This proposal shows that there is a tension between what's right for the City, and what's right for these markets on the continent. Having seen the attempted, and then abandoned introduction of a Withholding Tax in Germany in 1988, the European Commission is aware of the consequences of such a tax, but seems intent merely on damaging the City.

The economic importance of the City is obviously immense as the world's largest centre for international financial transactions. The net overseas earnings of UK financial institutions in 1997 was £25 billion. Fourteen of the fifteen largest law firms in Europe are based in London. The fees of the six largest UK accountancy practices exceed those in Germany, France and Italy combined.

In 1998 London overtook Tokyo in the size of stock market capitalisation. Across banking, insurance, securities, fund management, maritime services, derivatives, foreign exchange, bullion and advisory services London remains a financial superpower. London is also the most important global source for advice on privatisation. London is a world centre for professional and business services.

Recent figures (International Financial Markets in the UK, British Invisibles, December 1998) show that over the past decade London's share of the international market has increased for cross border bank lending, foreign exchange dealing, exchange traded derivatives and over the counter derivatives. Latest figures show the UK had 19% of the global market for bank lending (France 8% and Germany 7%), 59% of foreign equity turnover (France 1%, Germany 2%), 32% of foreign exchange dealing (France 4%, Germany 5%), 36% of OTC derivatives turnover (France 9%, Germany 7%) and two thirds of the international bond market.

London is the largest OTC derivatives market in the world and the second biggest outside Chicago for exchange traded futures and options.That dominance has been recognised in recent years by the establishment of a number of German financial institutions in London. The City has an unrivalled depth and width of experience. There are more US banks in London than there are in New York. The 540 foreign banks located in London are more than in any other financial centre. In 1998 there was record office investment in London. London has the largest concentration of support services to the financial sector in the world, with around 237,000 skilled employees providing $80 billion of financial, technical and information services. The so called agglomeration economies of scale from such a network are immense.

When combined with the UK's language, time zone, corporate history and light financial regulation, the continued attraction seems strong. London has more corporate headquarters than any other European city. Over 60% of the Fortune Global 500 are represented in London. More foreign companies are listed on the London Stock Exchange than any other exchange. In terms of trading shares, the predominance is even greater.

A recent report (The City's importance to the European Union economy, CEBR/Corporation of London, June 1998) stated that "the City of London is one of the world's three major financial centres. It is unusual, however, in that whereas the other two centres, New York and Tokyo, are primarily financial centres for their domestic markets, London's major activities are predominantly international."

There are many uncertainties surrounding the future of the City in the wake of EMU. However, at one level matters are clearer. Intra-European foreign exchange dealing, together with associated swaps activity, will clearly disappear. Interest rate futures activity will also focus on one rate. The leading Government bond markets may also increase in depth and liquidity. However, commenting on such changes, the City Research Project (The City Research Project, Final Report, London Business School/Corporation of London, March 1995) stated: "these represent a relatively small proportion of London's business, and its loss could well be more than outweighed by the concentration in London of transactions between the euro and other currencies".

More generally the same report noted that "London is preeminently an international centre and can be regarded as the only true world centre ... the pervasive and persistent pressures for financial services to concentrate in a small number of centres .... and London in particular, have several sources of competitive advantage .... these advantages are not easily replicated. Moreover, many of the benefits derive from external economies, so that each firm derives benefits from the proximity of others. These external economies help to reinforce the position of established financial centres ... it has been suggested that developments in telecommunications will lead to a dispersal of financial services. We do not share this view. Indeed the principal effect of improvements in communications has been to encourage centralisation of activity by allowing centres to serve wider hinterlands .... we believe that there are strong economic pressures for such services to concentrate within Europe, and London as the major established international centre should benefit from this .... continental financial centres such as Paris and Frankfurt have taken measures to protect or improve their financial sectors and this has led to much recent discussion as to whether London will lose its advantage .... we should also warn against the view that the future for London's financial services hinges on the outcome of competition between monolithic centres".

Two future EU developments should work to greatly boost European investment flows and thereby enhance the strongest capital market in Europe – the City – whilst also helping the Frankfurt and Paris markets to grow from a much lower base. Firstly, there will be a surge in private sector pension investment as EU citizens attempt to provide for retirement. As yet, in Germany and France, private pension funds are virtually non existent. The total assets of pension funds account for around 75% of GDP in the UK, but only 6% in France and Germany (Group of Ten, April 1998). This suggests massive future investment flows into private pensions and a surge in capital market liquidity, which has been apparent over recent years. Secondly, prior to the launch of the euro, currency matching requirements have imposed a home country bias to investments. In the UK around 16% of financial assets were foreign, as compared with just 4% in France and 6% in Germany.

Two very recent reports provide additional confidence. Research produced by the NIESR, for the London Chamber of Commerce, concluded that "the City of London will prosper whether or not the UK joins the single currency" (NIESR/LCC, March 1999).

Another report (Le Prix de l'Euro, CSFI, February 1999) concluded that London will have tough years ahead, but "provided the race is run fairly, being 'out' should be no handicap".

5. Monetary policy won't affect fiscal policy ?

In the UK supporters of a single currency tend to assert that a single monetary policy does not mean that there will ultimately be a single fiscal policy also (harmonised public spending and taxation). This view is flawed. The E in EMU stands for economic and monetary union. The pressures for harmonisation have accelerated as a result of the euro, and the single currency has created additional new forces as well. These new forces include:

- The Growth and Stability Pact.
- Geographical asymmetry – between Euroland monetary policy and national fiscal policies.

Yes, it is true that various ideas regarding tax harmonisation have been around for many years, and haven't yet been implemented, but the key point is that EMU will – and is meant to – provide added momentum towards fiscal harmonisation. Tax harmonisation was the centrepiece of the Austrian Presidency of the EU in 1998. Jean-Claude Juncker stated in late 1997 that he expected "the harmonisation of EU business taxes".

The combination of EMU and new left of centre Governments across the EU has recently seen the publication of the New European Way. The document refers to "further efforts to avoid harmful tax competition". Professor Rudiger Dornbusch (MIT) has written that it is "a sharp tilt to the left, not just for Germany, but continental Europe as a whole". Commenting on the New European Way, Sunday Times economics editor, David Smith (Sunday Times, 22nd November 1998) has written that "The endgame, Europe wide budgetary policies to balance Europe wide monetary policy, may not be that far away". Press reports of one survey of Labour MPs suggested around 60% wanted all fiscal policy handled at the EU level.

It is not just EMU that has recently accelerated moves for greater tax harmonisation. The launch of the euro has cleared a hurdle so that the rest of economic integration can go ahead. The European Foundation (EU tax harmonisation plans – Moving on up, EF, October 1998) has recently highlighted the role of the European Court of Justice. KPMG's D. Evans and A. Munro have stated that "the possible impact of EU law on UK direct taxation cannot be overestimated". Increasingly the European Court of Justice is applying the non-discrimination principle – which is accepted and implemented in the field of indirect taxation – to the area of income tax, as a logical extension of the Single Market. The Court has recently used a Single Market provision, Article 59, to attack Sweden's insurance company tax legislation, and in so doing use existing legislation to end distortions. This development will work to accelerate demands for tax harmonisation and the abolition of the veto in this area. In 1997 the European Parliament's Economic and Monetary Affairs Committee called for majority voting on tax matters, no less than three times, stating "harmonisation ...will ultimately render the principle of unanimity superfluous". There is a classic pincer movement at work.

Elements of fiscal harmonisation are already in place. Firstly, as a result of the Growth and Stability Pact. Secondly, as a result of the formation of the Euro 11 Group of Finance Ministers. It is sometimes argued that because the Growth and Stability Pact relates to the size of deficits and not the levels of public spending and taxation, then sovereignty is retained. This is absurd. OECD estimates suggest that a 1% shortfall in GDP growth normally pushes up the budget deficit by half a percentage point. This creates problems since over the past ten years low GDP growth meant that Germany would have had to pay fines in three years and France in four years (EMU Survey, The Economist, April 11th 1998). OECD calculations show that automatic stabilisers generally increase EU budget deficits by 2% of GDP in a downturn. This suggests a structural deficit limit of 1% of GDP for deficits normally.

There can be little doubt that, in the words of Professor Tim Congdon "a fundamental shift in power is in prospect". Moreover, the Stability Pact needs to be considered alongside moves towards tax harmonisation. It is not operating in isolation, but instead in tandem, towards fiscal harmonisation.

In the future we are likely to see further moves towards fiscal harmonisation as a result of the need for regional transfers. The CEPR has pointed out that the Growth and Stability Pact "may lead to the loss of automatic stabilisers whereby deficits widen during recessions and thus cushion the decline in demand" (Instability Pact? B. Eichengreen and C. Wyplosz, European Economy Perspectives Special Issue, September 1998).

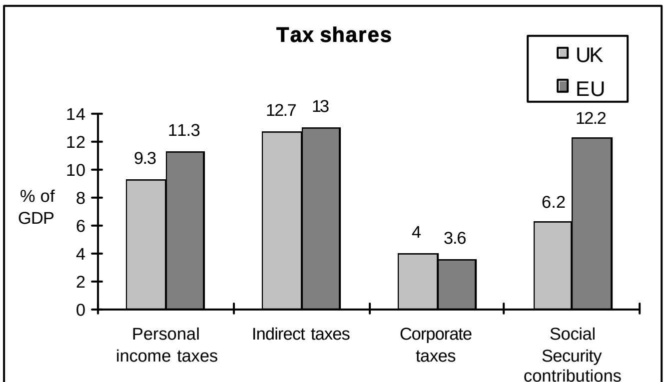
Following the introduction of the euro, lagging regions will face added competitive pressures as a result of the removal of the devaluation option. This will almost inevitably raise demands for greater regional aid. At present, the European Commission's budget amounts to less than 1.5% of Euroland GDP. Alexandre Lamfalussy, the first President of the European Monetary Institute believes EMU will require a much bigger EU budget (reported in The Economist, April 11th 1998). The MacDougall Report (European Commission, 1997) noted that existing monetary unions disbursed around 20% of GDP centrally, and that any EMU would need at least 5-7% of GDP. Prominent EMU supporters in the UK, such as Lord Haskins, have stated that they believe the EU GDP share would need to rise to around 5% of GDP. Whether this does or does not lead to extra taxation, it will involve a centralisation in fiscal policy at the European Union level.

Following the SPD's election victory in Germany, in recent months we have seen far greater emphasis on tax harmonisation. Before Christmas, the comments of the ex-German Finance Minister, Oskar Lafontaine, were front page news for almost a week, as a heated debate ensued as to whether there would or wouldn't be tax harmonisation in the future. As yet there are few firm proposals on the table. But for the future, The Economist has written (The Economist, December 5th 1998) that "stories that the EU may bully Britain into raising tax levels are exaggerated in the short term. As for the long term ....". There were a number of angles to the debate, which we will now consider.

Certainly in the short term the threat of tax harmonisation is limited because to some extent the harmonisation of taxes will need to await the harmonisation of expenditure. Andrew Dilnot, Director of the Institute for Fiscal Studies (Public Finance, December 11th 1998) has stated that "we are in danger of looking down the wrong end of the budgetary telescope ... we will have higher taxes only if we first decide to have higher public spending. People do not raise taxes frivolously and then decide how to spend the money".

Harmonisation to date has varied by tax. Clearly the fact that the EU is a customs union means ex-EU imports pay the same duties regardless of country. VAT is also affected by EU law, with countries having to levy a standard rate of at least 15% (with a lower rate permitted on certain items). We have also seen an EU agreement on the end of duty free. There is also fierce controversy over German proposals to introduce a Withholding Tax on Eurobonds.

With regard to the 'old story' assertion, surely the key point is that EU politicians wouldn't be raising these issues now if they didn't want to see something happen. Tax harmonisation was the centrepiece of the Austrian Presidency of the EU in 1998, and politicians such as Oskar Lafontaine have merely taken up the baton and continued running. Both Oskar Lafontaine and Dominique Strauss-Kahn have alluded to the desire to set minimum levels of corporate taxation across Europe to prevent harmful tax competition. Kahn has stated that "fixing minimum corporate tax rates was the whole idea behind tax harmonisation". The motive being to maintain the European social model and prevent what the EU left sees as social dumping across borders.



(Source: Lombard Street Research, February 1999)

Both Germany and France want to see real progress here in order that more flesh be put on the code of conduct on harmful tax competition that was agreed in December 1997. The Economist Intelligence Unit (Business Europe, January 27th 1999) have reported that "Mr Lafontaine wants to see enough progress on this, and related measures on savings taxation and on interest and royalties, to allow a comprehensive tax deal to be made ahead of the Helsinki summit in December ... other tax issues which Germany hopes to advance during its Presidency include ... work on harmonising and simplifying VAT systems." The December 1997 code of conduct on business taxation – which identifies 80 measures to combat 'harmful tax competition' – focuses on areas such as artificial incentives for location, tax subsidies etc – but it is clear that France and Germany see this as only the beginning of tax harmonisation. They think that low overall corporate tax rates should also qualify as unfair tax competition. Le Monde (28th January 1999) has reported that the New European Way manifesto for the forthcoming European elections reaffirms the need to strengthen the code of good fiscal behaviour in order to avoid 'fiscal dumping' – politician speak for tax harmonisation.

This is clearly only the beginning. Over time harmonisation is likely to evolve from unified regulations to unified rates. Bundesbank President, Tietmayer, has written that "it is an illusion to think that states can hold on to their autonomy over taxation policy". The Bundesbank has long argued that all previous monetary unions in history had collapsed because of a lack of centralised control over the national budgets of participating states – the so called free rider problem.

In response to such views, some commentators have argued that in the United States, despite a monetary union, there are differences in tax rates between states. This is a straw man. The overwhelming tax share in GDP is accounted for by taxation at the federal level (personal income and corporation tax). There are differences in state sales and income taxes but these represent a much lower proportion of GDP. With regard to the EU, The Economist has written that a minimum Withholding Tax could be "the first foray by the EU into income tax" (The Economist, November 28th 1998). As yet there is no attempt at placing income tax on the European Commission's agenda.

What does this mean for the UK? As in the case of Ireland, it is clear that low tax rates have attracted inward investment into the UK. Lower taxation should also have encouraged a more dynamic economy over the past two decades. Maurice Fraser (LSE) has written that "the idea of higher and harmonised rates of corporation taxation go right to the heart of Britain's supply side revolution and what the last 20 years are supposed to have been about". In contrast, Oskar Lafontaine has stated that "unfair practices - such as attracting foreign companies with very low tax rates - are rightly criticised at the EU level" (Financial Times, December 17th 1998).

Ireland also provides a very recent case study. The European Policy Forum states "… the positive impact of tax incentives is quite clear. However, in a new interpretation of EU state aid rules, the EC has decided that Ireland's preferential business tax regimes no longer comply. In response the Irish Government has announced the introduction of a new single rate". It could be argued that the Irish agreement with the EC shows the continuation of sovereign fiscal policy. However, this would be an erroneous interpretation. As yet the unanimity requirement regarding taxation means that no change could have been forced on Ireland. Instead, the EU has used alternative competency to interfere. If a future EU agreement on tax harmonisation is reached, entailing a switch to qualified majority voting, then Ireland's tax attraction will almost certainly be further undermined.

Simple comparisons of tax rates across countries can be misleading – for example due to the availability of legal provisions and depreciation allowances which influence the amount of tax actually paid – since the share of corporate profits subject to tax also tends to be higher in the UK. In other words the total tax liability is a function of the tax rate and the tax base.

Research by Paine Webber (quoted in The Independent, by Diane Coyle, Economics Editor, December 7th 1998) shows that effective taxes on capital (average effective tax rate on capital taking account of allowances, includes property taxes and capital gains tax) are not low in the UK.

Very recent provisional figures (OECD estimates for 1997, published in Sunday Business, 14th February 1999) show that corporate taxes in the UK contributed 4% of GDP, compared with 2.7% in the US, 1.8% in Germany, 2.1% in France, 2.2% in Italy and 2.6% in Spain – these are provisional figures. Confirmed data for 1996 show the UK corporate tax contribution at 3.8% of GDP. Commenting on these figures, Sunday Business Economics Editor, Martin Essex, stated "while much comment so far has suggested that if business taxes are harmonised, UK companies would suffer, the latest data suggests that if both tax rates and reliefs were harmonised they would in fact benefit".

However, the issue is somewhat more complicated than a simple GDP share analysis suggests. Firstly, because it is possible that if one used very punitive tax rates, such as a marginal rate of 90%, then tax evasion would be high and the share of taxes in GDP low. Secondly, it may be the case that company profits are higher in the UK than France, because employees take a lower share of GDP in the UK. In other words because the share of labour in GDP is smaller, the share of profits will be higher.

Notwithstanding such influences, the UK clearly has a lower overall tax burden that the rest of Euroland. The UK standard rate of corporation tax is amongst the lowest in the EU. Figures from Ernst and Young (UK employees suffer least pain on Europe's taxing misery index, Sunday Business, December 6th 1998) show that when account is made of individual income tax, corporate income tax, employee social security and employer social security contributions, then the UK has the lowest tax misery index in the EU. The misery index (UK=100) peaks at 180 in France, stands at 140 in Italy and 139 in Germany.

Tax harmonisation can only mean higher tax rates in the UK (because of the current and future costs of the EU social welfare model). Taxes and social security contributions account for 36% of GDP in the UK, compared with 43% of GDP in the EU. Germany pays 45% of GDP in taxes, Italy pays 43% and France pays 46%. Virtually all of this gap is explained by far higher social security contributions on the continent.

Part of the reason EU governments want to push ahead with tax harmonisation is a realisation that without it, they may well end up having to tax their citizens substantially more. The reason is that within Euroland, foreign direct investment is likely to gravitate towards the lowest tax areas, such as Ireland. Because capital is generally more mobile than people, this will mean that there are intense pressures to cap any growth in corporate tax rates, in favour of higher rates on consumers. This has obvious unpleasant political consequences. However, if tax harmonisation produces a levelling up in Euroland tax rates to similar levels, then the intra-Euroland divergence of capital will be far less, and the burden could more easily be passed on to business.

EU politicians are clearly aware of the damaging effect of higher employer social security taxes on employment. Instead of seeing the solution to this problem as lower public expenditure, it seems that instead they have chosen to re-shuffle the pack, by merely cutting taxes in one area only to raise them in another. Time will tell. The Commission's logic is wrong. In 1996 the EU Single Market Commissioner, Mario Monti submitted a discussion paper (Taxation in the EU, EC, April 1996) to EU finance ministers. The paper pays lip service to the principle of subsidiarity, whilst at the same time making clear the EC's aim to tackle this area of national sovereignty. The EU's view seems to be that higher taxes in the EU have arisen because certain countries exploited lower taxes – unfair competition – in a non-communautaire manner. It is alleged that lower taxes attract the relocation of taxable bases. The theory runs that in response to this, Governments have been forced to tax labour more, because it is less mobile. The final stage of the argument is that labour has then been driven into the black economy, further eroding the overall tax base.

The theory that falling corporate taxes have forced up social security taxes is fundamentally flawed. Corporate taxes account for around 3% of EU GDP and are too small to account for the substantial shift in the tax burden on labour. In fact, the corporate tax share has increased not decreased over recent decades. The EPF state that "the EU countries that have increased the total tax burden …on their labour forces in particular, have done so for their own reasons, not because they were driven to do so".

The argument for harmonisation is based on the idea of a single EU tax system. But that would destroy the clear accountability of each national government to its own electorate for its own taxation decisions. Tax harmonisation will undoubtedly mean higher rates for the UK. However, this is by no means the end of the story.

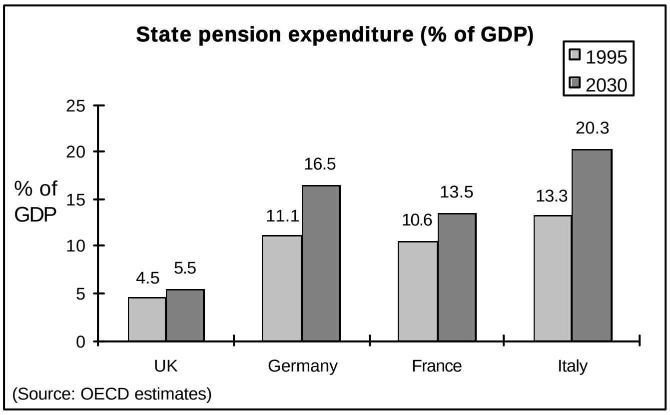
Unfunded pension liabilities

The unfunded pension liabilities on the continent are enormous, and whilst future projections are sensitive to a number of parameters, the basic story remains the same. The unfunded liabilities extend into the trillions of pounds – even with planned reforms such as higher contributions, higher retirement ages and lower payouts. The House of Commons Social Security Select Committee, having reviewed the evidence, reported that "[British taxpayers] could find themselves subsidising the large unfunded pension liabilities of other member states". Article 104b of the Maastricht Treaty (the no bail-out clause) specifically rules out the sharing of liabilities. However, in an environment of tax harmonisation, this clause would be rendered meaningless, because there would be an across the board upward levelling of tax rates.

The following OECD estimates illustrate the magnitude of the expected liabilities and the future competitive advantage to the UK. The end year chosen is 2030, because it is reasonable to assume that in order to ease the problem then, higher social security and taxation will be required in the first decade of the new millennium. Elderly dependency ratios – population aged 65 plus as a % of working population – in Germany will rise from 21.7% in 1990 to 49.2% in 2030, in France from 20.8% to 39.1%, in Italy from 21.6% to 48.3% and in the UK from 24% to 38.7%.

Moreover, future dependency projections are notoriously unreliable (Older getting wiser, P Johnson, IFS/ICA, 1998) with the errors tending to be in one direction owing to the under prediction of the numbers of elderly as a result of improvements in mortality. Moreover, declining participation rates in the male 50-59 age group over the past decade provide an added concern, because participation rates are held constant in the OECD projections.

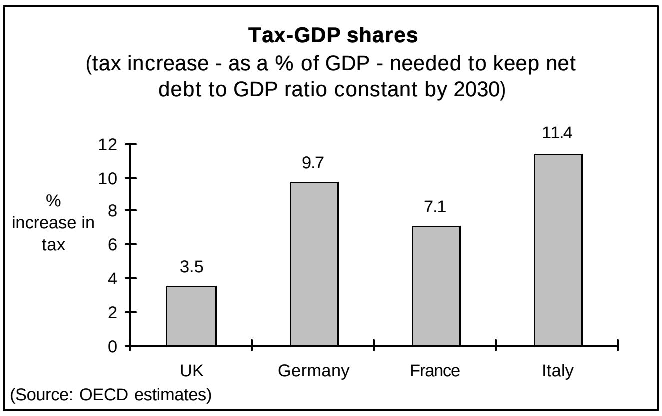
With this in mind the fiscal implications of recent scientific discussion are horrendous (Today's babies can expect to live to 130, Sunday Times, 14th February 1999). Reporting on a survey of 150 leading scientists the article stated that they believed that by 2050 scientific advances will be adding 50 years to the current average age of 75 for men and 79 for women.



However, it is not just demographics, but the inherent flaws in the design of unfunded schemes that are so serious. State pension spending in Germany – as a % of GDP, 1995 base year – is projected to increase from 11.1% to 16.5% in 2030, in France from 10.6% to 13.5%, in Italy from 13.3% to 20.3% and in the UK from just 4.5% to 5.5% of GDP (OECD estimates, published in Crises in public pension programmes in the OECD, R Disney, University of Nottingham Discussion Papers in Economics, November 1998).

What does all this mean for the ratio of taxes to GDP by 2030? The OECD estimate that in order to keep the net debt to GDP ratio constant – remember that it is already very high across most of the EU, as shown by the number of EU countries which failed to satisfy the outstanding debt criteria laid down in the Maastricht Treaty – the tax share will need to rise by 9.7% of GDP in Germany, 7.1% in France, 11.4% in Italy and only 3.5% in the UK. IMF estimates (Ageing populations and public pension schemes, IMF occasional paper no. 147, 1996) tell a similar story, although because they exclude additional health care costs, the total estimated fiscal adjustment is less than shown by the OECD.

These projections are sensitive but the central message is not. The future unfunded liabilities are huge. If anything the estimates may underestimate liabilities because they don't fully capture public sector employee occupational pension liabilities which also tend to be unfunded and met from current revenues – the public sector is a much larger employer in the rest of the EU than in the UK.



One final issue is that higher financial liabilities will tend to raise real interest rates, but the simulations do not account for the subsequent knock on effects on GDP growth – and the implications for pension spending as a proportion of a lower GDP level. Despite the uncertainty associated with projections over a long time horizon, there are grounds for believing that the alarming deterioration could in fact still be too cautious.

The Swedish scenario

There is the so called Swedish model to consider – and this one is far from attractive. In October 1998, Ericsson moved part of its business to London, because of the difficulty in getting high paid executives to work in Sweden, owing to high rates of taxation. This is a lesson we should remember.

The Swedish model refers to the fact that Swedes pay around 60% of GDP in taxes. Tax harmonisation could ultimately lead to the same impact in the UK. In the ultimate extreme scenario the impact of tax harmonisation could mean the equivalent of almost £150 billion in extra taxes each year (in today's prices) – around 20% of GDP. We are not stating that this will occur. Instead, it is presented as an illustration of the future fiscal imbalance in Euroland, and how it provides a huge potential competitive gain to the UK. There are various stages to this argument:

- Stage one – The tax share goes up to EU levels (from 38% - 45% of GDP). Cost £52 billion (1999 prices)
- Stage two – Implementation of the MacDougall report on fiscal transfers. In order to finance enhanced regional aid, the UK taxpayer has to find an extra 5% of GDP. Cost £37 billion (1999 prices)
- Stage three – Unfunded pension liabilities (increasing Euroland's tax share by around 8% of GDP). Cost £59 billion (1999 prices)

6. Political union?

Time after time domestic supporters of UK participation in monetary union assert that it will not entail political union – even though deeper political integration is happening and has done ever since the UK joined the EEC/EU. As in the case of fiscal harmonisation, the introduction of the euro accelerates the process of political union. The euro accelerates political union as a result of:

- Fiscal harmonisation
- The democratic deficit and the ECB

The denials are not surprising for domestic political consumption, but are quite ridiculous when set alongside the clearly stated aims and intentions of EU leaders. In the words of the Financial Times "EMU is not a narrow technical operation …it has vast political implications".

The EU's motto, enshrined in the Treaty of Rome, is "ever closer union". The EU also has a flag and an anthem. Paul De Grauwe, Professor of Economics at the Catholic University of Louvain and a member of the Belgian Parliament, has stated that "not a single monetary union in the past came about because of a recognition of economic benefits … in all cases the integration was driven by political objectives".

Before examining the geo-political consequences of EMU, it is worthwhile reminding as to the views of many leading figures. Sir John Coles (Permanent Secretary at the Foreign and Commonwealth Office until December 1997) has stated "How likely is it that we shall see a single state of Europe? By this I mean a single political entity with a central government, possessing significant central powers and other normal attributes of statehood. My belief is that the EU is now clearly headed in that direction and that, while nothing is inevitable, the best working assumption is that if current trends continue, within 15-20 years from now this state will come into being" (Oxford University European Affairs Society EMU debate, February 1999). When Britain's most senior former diplomat expresses this view, we should surely take note.

Coles also noted that sovereign foreign policy is useless without the threat of force. However, as Professor Tim Congdon has pointed out (The single currency project and European political union, Lombard Street Research Monthly Economic Review, May 1998) "a fundamental shift in power is in prospect …after the Stability Pact had become effective …the most drastic case is war. In that event any government would want to increase defence spending and, almost inevitably, to raise the budget deficit. Under the Stability Pact the government concerned would have to seek the approval of other European governments before it could react to foreign aggression".

ECB board member (and former Bundesbank Chief Economist) Otmar Issing, has stated that "there is no example in history of a lasting monetary union without a state entity".

Wim Duisenberg, President of the ECB has stated "the process of monetary union goes hand in hand, must go hand in hand, with political integration and ultimately political union. EMU is, and always was meant to be, a stepping stone on the way to a united Europe". Hans Tietmayer, President of the Bundesbank, has stated that "a European currency will lead to member states transferring their sovereignty over financial and wage policies as well as in monetary affairs. It is an illusion to think that states can hold onto their autonomy over taxation policies".

Chancellor Gerhard Schröder has spoken of "the introduction of the euro is probably the most important integrating step since the beginning of the unification process … it is certain that the times of individual national efforts are definitely over … the internal market and the common currency demand joint coordinating action … to bury finally some erroneous ideas of national sovereignty … national sovereignty in foreign and security policy will soon prove itself to be a product of the imagination".

German Foreign Minister, Joshka Fischer has spoken of "transforming the EU into a single state, with one army, one constitution and one foreign policy is the critical challenge of the age".

The former Spanish Prime Minister, Felipe Gonzalez has stated that "the single currency is the greatest abandonment of sovereignty since the foundation of the European Community … it is a decision of an essentially political nature … we need this united Europe … we must never forget that the euro is an instrument for this project".

Ex-German Finance Minister, Oskar Lafontaine, believes there should be a European economic government to act as a counterpart to the ECB (Keine Angst vor der Globalisierung, Dietz Verlag, Bonn 1998). He has also stated that "the United States of Europe has been the aim of the [German] Social Democratic Party all along".

Former Chancellor Kohl stated in the Financial Times "an economic union will survive only if it is based on political union". The political nature of EMU was most famously highlighted in the former Chancellor's remarks that EMU was all about "war and peace".

Karl Lamers, spokesman for former Chancellor Helmut Kohl has stated "economic and monetary union is the central part of the project for European unification".

Viktor Klima, Chancellor of Austria, has stated that "a signal must be sent …that a single market and a single currency is not the end of the EU journey".

Moreover, even if EU politicians hadn't stated so powerfully that political union is the raison d'être of EMU, it is very straightforward to show how economics and politics will combine to bring about a political union – a future United States of Europe. In the words of Lord Keynes, "he who controls the currency controls the government".

What is the link between monetary and political union? By political union we mean the transfer of national sovereign power in policy to the EU level. Generally Popitz's law tells us that federal states tend to centralise on a secular basis. For example, despite the 10th Amendment to the US constitution, the Federal Government in Washington has accumulated great power. It is argued that EU treaties provide far less constraint on the centralisation of political power. Moreover, EMU is intended to coordinate policy in the sense of preserving the EU social welfare model. It is hoped that the single market and a single currency will create the economic gains that will continue to finance high government spending. Without EMU governments are seen as more likely to pursue individual national agendas and engage in a competitive race to the bottom.

In the previous section we described the forces working towards fiscal harmonisation. Fiscal harmonisation is a central pillar of political union – since it means centralised decision-making over what is spent and how that is financed. Fiscal harmonisation, regional aid transfers and the Growth & Stability Pact all centralise fiscal control.

Moreover, to be truly effective, monetary and fiscal policy need to operate over the same geographic area. In the UK or the US, the government has a fairly clear idea that if it tightens fiscal policy then there will be an offsetting monetary easing. Individual governments in Euroland cannot be sure that the ECB will respond according to their wishes. This significantly changes the perception of national sovereign fiscal power.

There is also a paradox to EMU which will work to encourage deeper political union. The ECB has been established as the most independent central bank in the world. Whilst this centralises monetary policy, of itself it does not facilitate political union, since there is obviously no political control – yet. The key issue is whether this independence can be maintained.

Cart before the horse

The German population supported an independent Bundesbank because of the legacy of Weimar, hyperinflation and all the terrible consequences. It had a legitimacy because it was associated with stability. In the case of the Federal Reserve, the independence had a legitimacy because of the constitutional checks and balances elsewhere. Federal Reserve Chairman Alan Greenspan testifies on Capitol Hill and politicians feel they have the power to break the independence of the Fed. Both examples are characterised by the fact that the central bank followed the country. In the case of the ECB the cart comes before the horse. As a result there will almost certainly be immense pressure to put in place some form of political accountability over the ECB. This French view of EMU has surely been reinforced with the election of an SPD Chancellor and Finance Minister in Germany. Politically this is very exploitable because those favouring deeper integration can point to the obvious democratic deficit.

Paul De Grauwe has written in the Financial Times that "in democracies all power is delegated power, politicians delegate power to specialised institutions. In order for this pyramid to work well, at each stage there must be a strong mechanism which ensures that those who receive power remain accountable. These principles were not taken into account when the ECB was being set up … political independence can only exist when politicians as stakeholders believe it is in their interest to continue to defend that independence … the design of the ECB is flawed and will have to be changed".

The central uncertainty is how the electorate will respond in the UK and the EU. As we have seen, general awareness and understanding of EU issues is very low. Berkeley economist Maurice Obstfeld has written that Europe has "taken a gamble in placing monetary unification so far ahead of political unification". Electorates could continue to be led by opinion formers. Alternatively there could be a backlash with unpleasant consequences. The potential sources of this backlash are varied, but one obvious source is discontent at continued fiscal austerity. Much of the EU electorate is under the mistaken impression that the economic pain ended when the convergence criteria for budget deficits were met. Continued austerity in order to meet the Growth & Stability Pact may well become very unpopular – especially with moves towards budget balance. We must also remember that the convergence criteria were aided by two transitory gains. Firstly, fudging the national accounts. Secondly, for countries such as Italy, interest rate reductions have provided substantial fiscal gains via lower debt interest payments.

If EMU doesn't lead to EPU, it will probably be because of a reactionary political backlash. Individual nation states have a high degree of legitimacy. Professor Cohen (The geography of money, Cornell University Press, 1998) has pointed out that in order to succeed EMU will need a sense of community. Obviously people will oppose their government and vote for change, but once that decision is made, then there is an acceptance and legitimacy. In the case of the EU however there aren't even pan European political parties.

However, even in this example, there are problems. Fiscal legitimacy can be questioned in terms of the scale of transfers. Monetary legitimacy can be questioned if one region suffers for the overheating problems of another – or is stuck with high unemployment. One only has to remember the furore in the UK when the Governor of the Bank of England was reported as saying that unemployment in the north was a price worth paying to cure inflation. There is an inverse relationship between legitimacy and the scale of reactionary forces.

There is an alternative scenario recently described in The European by Jaques Delors "as soon as there is a serious economic crisis, public opinion will treat the ECB as a scapegoat and rebel against la construction europeenne. Realising there is no prospect of undoing the whole EMU enterprise, the same public will then demand that 'the European Council consider the question of political integration and democratic accountability". In other words, those favouring political union have identified different economic roads to the same end.

As an aside, the long term fiscal consequences of the unfunded pensions crisis are almost certain to be deeply unpopular – because of higher taxation. It is difficult to predict the political fall-out from this issue intertwining with EMU. Such are the scale of the debts there will be enormous pressures to gain political control of the ECB in order to gain the benefits of seigniorage, what Charles Goodhart calls "the revenue of last resort".

Subsidiarity or superstate ?

Writing in Prospect magazine, Lord Currie (Does EMU need political union? David Currie, Prospect, June 1998) has presented a measured analysis of why he believes monetary union need not entail political union.

Currie however does acknowledge that "no doubt there will be pressures towards a common fiscal policy". Currie describes the various possibilities between an American or German fiscal model, and a top down or market led process of tax convergence. He acknowledges the uncertainty but states that Emu participation is necessary because these alternatives are likely "to be debated within the Euro X or Euro-11, in which Britain has no voice …Britain's enforced absence …is likely to favour the advocates of greater fiscal centralisation".

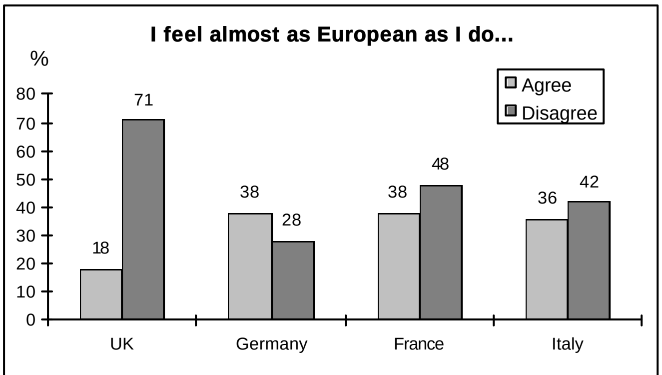
Surely the response to this must be that the UK will not have the voting power to change the outcome. Indeed, Currie writes that "the increase in qualified majority voting … makes it harder for individual states to choose the parts of the EU they prefer". Currie acknowledges that Euroland is as yet a long way from either the US or German models. This is surely a recognition that far deeper political integration will occur with or without the UK. Currie argues that the future debate is all about the degree of federalism. He also acknowledges that the outcome might be 'limited' Swiss style centralism or it could go in a highly centralised direction.

Drawing on the examples of the US, Germany, Italy and Switzerland in the 19th century, Currie argues that "monetary union can precede political centralisation, and the degree of political centralisation required can be limited". When one examines the evidence presented by Currie it is possible to state that it actually proves the case that EMU will lead to political union. In the first instance, the question of whether monetary union can precede political union is irrelevant – the issue is whether one can have EMU without EPU. In the US and Germany political union preceded monetary union. In the case of Italy monetary union preceded political union. In all cases, there was a political union.

With regard to the second assertion, that there could be limited political centralisation, Currie actually refutes his own argument when he states that "[in the 19th century] monetary union operated …without significant transfers through a central budget. This is not surprising, given that governments in the 19th and well into the 20th century were small and taxes were low".

EMU works against the grain of late twentieth century history. Over the post war period, and particularly following the collapse of communism, there has actually been an increase in the number of countries. The American commentator Michael Lind has pointed out that the nationalist ideal has survived one universalist assault after another, particularly in the twentieth century. In his book the Century of War, Raymond Aron has written that "the European idea is empty ... it was created by intellectuals, and that fact accounts for its genuine appeal to the mind and its feeble appeal to the heart". For a very long time intellectuals have claimed the death of the nation state. In 1771 Voltaire stated that "there are no longer French men, German, Spanish or even English men, but only Europeans". The dilemmas and difficulties associated with European identity and integration are not new: " ... the broad sweep of European history from the Romans, through the eras of Charlemagne and Napolean, to the 20th century, shows the continued potency of a Europe wide concept ... yet at the same time, Europe also has to be regarded as the home of the nation state, each country jealous of its sovereignty" (Nationalism, D Smith, 1989).

It is possible that over time the concept of European identity might develop. Three aspects could drive this change (EMU – the impact on national identity, Consumer & Leisure Futures, The Henley Centre, 1997). Firstly, generational replacement. Secondly, the growth of postmodernism and a so called multiplication of identities, whereby people are European on some issues, global cosmopolitans on others, nationalist in some areas and city or locally loyal in other directions. Thirdly, the future development of new multi-national political parties.



(Source: The Henley Centre, Frontiers 1998)

However, in all cases the arguments are very weak. Across the EU, only one in three citizens claim to 'feel almost as European as they do a citizen of my own country'. For the 16-24 age group only a fraction more – 35% – felt European (Planning for Social Change, The Henley Centre, 1996-1997). In the UK only 18% of the population felt as much European as they did British. For the 16-24 age group the proportion was marginally higher. However, market research by the European Commission does find "a strong correlation between feeling European and being young" (Is there a European Public Opinion?, JM Spence, European Commission, MRS 1996 Conference Papers).

According to The Henley Centre's annual Planning for Social Change survey, 70% of British people have no confidence or not very much confidence in the European Commission.

Qualitative research by MORI has found that "familiarity with institutions such as the European Parliament is almost non existent". Other MORI research (reported in The Economist, October 3rd 1998) shows two thirds of the UK's population feel not very or not at all European.

The nation state is not dead, and when compared with sensible criteria for a constituted stable creation, Euroland fails the test. For example, J Hutchinson and AD Smith (Nationalism, OUP 1994) suggest the following criteria; a common language, a common territory, a common economic life, a common psychological make-up and a common culture.

As regards the potential development of pan European parties, that must be treated with caution. At the national level parties are divided across the laissez faire-dirigiste economic spectrum, and across the libertarian-authoritarian politico-social spectrum. Adding a third EU dimension only further complicates the situation, at least for the foreseeable future.

It is true that the cumulative legacy of classical thought, Christianity, the Renaissance, the Enlightenment, industrialisation and democracy have created many compatible ideals across Europe. It is claimed Europe also has a myth and a telos – the myth being an emotional desire never to repeat the mistakes of two world wars and a telos of 'ever closer union'. Against this view – that an EU identity can be constructed – is the argument that Europe lacks ethnic affiliation. An alternative sceptical argument is that even if the ethnic affiliation view is wrong, and identity can be constructed, the limits may have already been reached at the nation state level, and cannot be transferred to the EU. In their analysis of the political dynamics of the EU (Legitimacy and the European Union, D Beetham and C Lord, Longman 1998) Professor David Beetham and Jean Monnet Senior Lecturer Christopher Lord summarise the academic literature by stating "all of this leaves the Union conspicuously vulnerable to nationalistic counter-mobilisations or to disintegration in moments of stress".

The geography of language tends to coincide with that of national boundaries. The same is true for currencies.