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# EUROPEAN INTEGRATION,

## DEEPENING AND WIDENING ECONOMIC ANALYSIS

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The European Union can be said to be 52 years old, or 47 or 12. The seminal Paris treaty of 1951 establishing the European Coal and Steel Community has already expired in 2002 but is meanwhile incorporated into the EC treaty. The Rome treaty of 1957 is still alive and kicking after no less than four revisions. Legally, the EU was founded in Maastricht in 1991 and encompasses the other treaties. Soon , all this might be overtaken by what is called a “constitution”. In a nutshell this illustrates the seemingly incessant, inner dynamics of European integration. The EU has been deepening its integration in a regular though somewhat cyclical fashion. It has widened the scope of powers in the economic arena and beyond. And it has enlarged its membership already five times, not counting the inclusion of East Germany. Next year May the Union will count 25 members and three official candidates will remain deeply involved in so-called pre-accession reforms. Another group of countries is waiting in the wings and the first one – Croatia - has already officially applied for EU membership. However, the economic influence of the EU spreads beyond the club. Norway and Switzerland are de facto members of the internal market, with some firm exceptions, and even collaborate with the Schengen system of persons controls over frontiers. The MED agreements have begun to spread regulatory and competition elements to the southern neighbours. The Commission has just proposed a new , ambitious “near neighbours “ policy as a corollary of enlargement which might well have wide-ranging implications for countries such as Russia, Ukraine and Georgia.

In a conference of eminent specialists on Global Economic Analysis it would seem to be appropriate to pause and reflect a little on this curious and ever changing creature called the European Union. I shall assume a broad economic perspective and raise a number of , what are in my view, critical analytical questions for further research on European integration. This

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approach does not mean to disregard a well-known premise that focus and well-formulated research questions are necessary conditions for good analysis and verifiable results. Indeed, the economic library of specific studies on all kinds of aspects of the EU has meanwhile reached an enormous size. Nonetheless, a collection of many too-partial approaches might not necessarily add up to a better understanding of the whole and the underlying processes. Already in 1970 Charles Pentland, trying to understand European integration as a political scientist, likened it to an elephant touched by many blindfolded analysts who each described the small part they scanned by hand. Perhaps there may be some benefit in getting a generalist to go beyond “pars-pro-toto” and attempt to think about a wider picture. I shall venture to do this today, with all the caveats you might imagine.

I shall very briefly touch upon what is probably the starting point for you as applied trade analysts, the EU as a customs union with a centralized trade policy, only to switch quickly to the internal market. Yet, the internal market is so vast a subject area that there seems to be no practical way to address it in a single step, not even in the inevitably superficial and selective treatment for a speech. So, in section 2 there is a reminder of the stimulus the single market initiative has given to more advanced empirical analysis and a selection of wishes which are not yet fulfilled. Section 3 inspects a little closer the main ‘business’ of the Union today which is regulation, of course always in combination with liberalisation. The EU is essentially a regulator, only the CAP and ‘cohesion’ is about money. This implies that it is crucial for the EU to get it right in terms of liberalisation and regulation. Unfortunately, economists have done precious little empirical analysis about this core ‘business’ of the Union. I hope to provide indications that the design of today’s EU regulatory regime helps to keep the costs in check and that further initiatives in this respect ought to be encouraged, including firm analytical economic underpinning. Section 4 addresses the macro-economic design of the Union, that is EMU and Euroland. This design combines federal and pre-federal properties and the queries are whether it is stable and whether or not it is costly and for whom. The final section will look at constitutional issues, in particular the economics of subsidiarity and a few institutional issues.

## **1. Regionalism and the EU**

For this distinguished gathering of international economic modelers and empiricists the European Union presumably represents a major, if not the major, instance of “regionalism”. And indeed it is. Regionalism would then be defined as a preferential mode of organizing trade policies in an otherwise multilateral framework of world trade. In this perspective the research agenda for GTAP would typically consist of the economic impact of the Association Agreements ( “Europe agreements”) for Central Europe and the subsequent impact of enlargement or indeed the subsequent impact of subsequent enlargements. Similarly, the effects of the customs union between Turkey and the EU-15, initiated in 1996, and of the various bilateral free trade areas or other preferential arrangements the Union has concluded or is in the process of reforming would be important elements of the research agenda, not least the changing patchwork of Euro-MED agreements. One can easily extend this to simulations of possible free trade areas with, for instance, Russia or the Ukraine, or, still more boldly, with MERCOSUR or even with AFTA, the ASEAN Free Trade Area, now that their political leaders have begun to encourage this idea. Empirical analysis of EU agricultural trade policies and market access will remain important for decades for the unsurprising reason that its protection of temperate zone agricultural products is not going to be reduced very rapidly, even though export subsidies might.

Your research agenda is rich and you are well placed for it.

However, in order to appreciate the demands on economic analysis which arise from the deepening, widening and enlargement of the European Union itself we shall have to move *far beyond these basics of "regionalism"*. This is what I intend to do.

## 2. The nature and impact of the internal market

Nevertheless, the Union is so much more than a customs union with centralized trade policies. It is an internal market without internal frontiers, as the treaty calls it ( see Figure 1, appendix). This extremely ambitious notion is actively pursued since 1986 and it raises many difficult analytical questions, both theoretical and empirical. The work induced by the Cecchini report of 1988 and the ex-post Monti report of 1996/7 has greatly helped to increase awareness amongst economists that the deepening and widening of economic integration in the EU requires a range of tools quite different from conventional trade analysis<sup>1</sup>. Other than the monumental work by the Macdonald Commission for Canada in the mid-1980s,<sup>2</sup> I know of no comparable attempt to come to grips with the expected and actual economic impact of such a complex set of micro-economic changes in rules and freedoms. Probably leading in this work is the paper by Allen, Gasiorek & Smith ( 1998). It stylizes the single market initiative as a reduction in ( intra-EU) "trade costs" and attempts to establish both the direct and the competition effects in a sophisticated approach employing both econometric and CGE methodologies. The work is supported by the numerous case- studies and other background analyses of the Monti exercise. The commendable efforts notwithstanding, it turns out that technical and data problems as well as timing ( too early ?) and difficulties of reconciling changes in trade patterns with the competition effects give reason to doubt the robustness of the results.

This suggests another *challenging research agenda*. But if you were to take it up, please note a few queries from a professional consumer of your work. How appropriate is it to merely regard the single market as a reduction of intra-EU trade costs? For one, Smith & Venables (1991) have rightly pointed out that there could well be a positive 'market access effect' facilitating also third countries' suppliers as regulatory regimes in the EU converge. Should the emphasis in the single market on the opening of services markets not receive explicit analytical attention ( Allen et. al. is only about manufacturing)? Besides the fact that intra-EU services trade has become sizeable and is growing relatively fast, it is likely that precisely in previously shielded services the exposure to competition should boost productivity. Another major element of the single market consists of the common regulation of intellectual and commercial property so as to root out a range of expensive and anti-competitive practices. Not only was a patent in Europe roughly five (!) times as expensive as in the US ( the EU benchmark being a coverage of at least 8 countries under the European Patent Office) it also gave rise to opportunities for market segmentation despite the case-law of the European Court of Justice.

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<sup>1</sup> See EC,1988 and Cecchini,1988 as well as 20 volumes of background reports in the Documents Series of the EC Publications Office (Luxembourg) under the title : Research on the costs of Non-Europe (1988). For the ex-post exercise led by EU Commissioner Mario Monti, see European Economy, special issue of the Reports & Studies, December 1996 no. 4 as well as Monti, 1996 ; in addition see the 38 background reports published in the course of 1997 and 1998 jointly by the Office For Official Publications of the EC (Luxembourg) and Kogan Page, London, under the overall title: The Single Market Review.

<sup>2</sup> The Royal Commission on the Economic Union and Development Prospects for Canada, Collected Research Studies, 72 volumes, published by the University of Toronto Press, 1986.

However, it is worth exploring whether even such a richer approach does sufficient justice to what is going on in the internal market. I would venture, probably not. I shall provide two important examples and a warning. First, about standards and conformity assessment, a less esoteric topic than you might believe. Industrial and to some extent services markets can function at many levels of efficiency, and standards, if properly written and driven by identified needs, are critical in fostering better functioning. If standards incorporate the state of the art, focus on performance rather than design (so as to leave maximum scope for innovation), have been subject to public scrutiny (so as to pre-empt anti-competitive effects), are widely adopted and accompanied by credible and trustworthy conformity assessment, the costs of B2B and B2C arms-length transactions fall considerably whereas the opportunities of deepening the division of labour are greatly enhanced. European standardisation as developed since 1985 (and for electrical standards, since 1973) and conformity assessment that followed a decade later has, in and by itself, been of tremendous help to foster intra-EU trade and production. Initially, these standards – voluntary, by definition – were developed as a corollary of EC directives specifying the health and safety objectives. Meanwhile, however, thousands of European standards have been developed without there being a compelling regulatory reason; the motives are purely those of efficiency and information. The same goes for conformity assessment where the voluntary track aims at efficiency and (reliable) information about quality. In the regulatory track the details of old and new approaches go too far for today's purposes but it might be illustrative to mention that compulsory conformity assessment has been transformed from a national (and often protectionist, monopolistic and hence costly) assignment to a competitive European business with accreditation based on objective ISO quality standards for certifiers. Although there is a lot of fragmented case research on standards (see the survey by Swann, 2000 and ISUG, 2002) overall impact studies are scant. *This instance of "deep" market integration awaits a broader study.*

Second, the case of capital market integration forms another powerful illustration of the great scope for welfare gains which, until recently, were simply hardly inspected. During EC-1992 capital market integration was thought to be realised by the combination of the liberalisation of financial services, the so-called investment services directive (which was half-baked in that it left some degree of host country control in place) and the abolition of all exchange controls. Today, at the height of the 'second wave' of liberalisation, stimulated by the Lamfalussy report, there is a profound awareness that better market functioning as well as financial development are required, beyond mere liberalisation. The Giovanni report (2002) identified no less than 15 barriers to efficient cross-border clearing and settlement in Europe, 10 of which were due to national differences in technical requirements or market practices (the other ones to tax and legal certainty questions). The cost of cross-border equity transactions in Europe is, on average, 7 times that of those in the US. It was discovered that anti-competitive practices persisted which had never attracted the attention of the European Commission. Stronger still, Cruickshank (2001) even argued forcefully that the function of a CSD (a central securities depository) is a natural monopoly for the entire EU just as it had proved to be in the US. Apart from the direct cost savings it would have some knock-on effects in lowering the cost of capital. Giannetti et al. (2002) showed that financial development, of course strongly promoted by deepened capital market integration, could give a boost to annual growth of value added in the EU manufacturing industry as a whole of between 0.75 to 0.94 percentage points a year. All in all, this second wave of *deepening financial market integration deserves your analytical attention.*

The warning refers to labour markets. There is no such thing as a European labour market. The treaty speaks of the 'free movement of workers' (art. 39, EC) but it is more like a

notional freedom. Several factors conspire to strongly discourage cross-border labour flows and language or socio-cultural linkages are not as preponderant as you might be led to believe. Think of the severe difficulties of the cross-border portability of pensions ( and, not least , the tax breaks when saving for pensions with non-domestic pension companies), complexities and uncertainty about health insurance and care, complications for some other aspects of insurance ( including disability), legal and de-facto problems of diploma recognition, social security hiccups (despite harmonisation for migrants), access to social housing ( for unskilled), and other fiscal and administrative issues. Many barriers are man-made and , almost like the pre-1995 variable levies of the CAP, heightened as soon as any threat perception amongst vested ( labour) interests or social affairs ministers emerges. The present cross-border mobility of workers in Europe is very low and hardly economically determined – it is largely a rest-mobility. There exists a tiny group of frontier workers and a modest stock of non-local resident workers from other EU countries who are often there already for years. The economically most inimical barrier is the so-called “host country control” principle which works out the more protectionist the greater the wage gap between sending and receiving country. Once the free movement of workers will apply to Central Europe as well, their migrant workers will either have to avoid the application of ‘host country control’ ( that is , they contract illegally hence remain uninsured and vulnerable) or there will not be much demand for them unless there are bottlenecks. Curiously, I have not seen any empirical study about future labour migration in the EU-25 which explicitly takes this into account.

Moreover, the fact that workers are more or less ‘locked-in’ in their countries has other repercussions such as EPL tending towards greater restrictiveness ( lacking competitive discipline) and social security getting biased towards greater generosity. Of course , interdependence of national product markets and their exposure to competition dictates the limits of this discretion but even here Boeri, Nicoletti & Scarpetta (2000) and others have provided empirical evidence that, to some degree, the restrictiveness of regulation in product markets in Europe is a corollary of the restrictiveness of EPL, hence reducing this indirect competitive exposure !

The internal market is therefore in several ways *much “deeper” than typical single market studies indicate, yet hardly to be taken serious with respect to labour*. The single market for goods may well be the ‘deepest’. However, even there we run into a puzzle, an empirical finding ( e.g. Head & Mayer, 2000) about a so-called home bias of buyers of around 14 (!) measured for 1985. It is true , since 1985 the deepening of the internal market has probably been very strong but how “integrated” is the market if home bias and price dispersion would have remained high ?

### **3. Making the EU a better regulator**

Until today , empirical economists would seem to have shied away from studying the “core business” of the Union , that is , regulation. Since the 1990s there is some specialized interest in the economics of regulating the liberalized network industries in the EU ( Pelkmans, 2001 for a survey) but the far more important overall regulatory regimes in goods and services markets have received scant analytical attention. This is curious in itself given its central importance. It is also remarkable in the light of irregular anecdotes about funny aberrations of EC harmonisation or the predictable culprit role of the EU as bureaucratic or ‘overregulating’. Is the EU undoing much of the benefits of liberalisation and market size by imposing unjustifiably costly regulation, indeed more costly than at national level ? Is harmonisation

often unnecessarily burdensome for the EU economy? This is becoming more and more a key question for the economic performance of the European economy. Is it probable that the EU, as is sometimes asserted (e.g. in the Doorn report of the European Parliament in 2000), could gain several percent of GNP when making “better regulation”?

To make a long story short , *we don't know , simply because little quantitative empirical economic research is available*. Later, in passing , I shall call attention to new incentives the EU is preparing in order to begin remedying this dramatic lack of information. Nevertheless, it is crucial for economists interested in the single market and its common policies to understand that the EU of today has already successfully introduced principles and incentives limiting the volume of EU regulation as well as its costs, and beyond that, even disciplining to some degree the Member States which are the worse regulatory machines of Europe. But it is also true that there are several islands of intrusive European regulation which deserve scrutiny. And all this does not mean that the Commission, the committees of the European Parliament and / or certain sectoral Councils of ministers will never be ‘captured’ by vested interests. Indeed, capture of politicians or regulators is of course possible at both levels of government. However, when ignoring capture or undue influence of certain pressure groups on the entire Council or the EP, there has long been a special worry in European integration , namely, that the institutional mechanisms of approximation (harmonisation) tend to generate more costly regulation due to unanimity ( the last country giving up a regulatory barrier might require costly exceptions or rigid details as a price for dropping the veto, or, demand as a quid-pro-quo some other set of rules, good or bad, which favour its vested interests) or the cumulation of all kinds of national rules which are not justifiable from a cost/benefit perspective. Over time this has caused some mistrust in European regulation.

There are two fundamental reasons – admittedly, little understood - why EU regulation is automatically held firmly in check. First, the treaty only allows the EU to regulate if it is directly related to the internal market or has a clear legal basis for a common policy or treaty-specified action. EU regulation is limited by the *principle of conferral*. Thus , the Union cannot regulate a lot of matters which, at the national level, many legislators routinely do regulate. Since it is very hard to observe what does *not* happen, this intrinsic discipline ( and its benefits) often escapes attention. Recently, the European Court of Justice annulled a directive banning tobacco advertising because it was of the view that the EU legislator ( the Council and the European Parliament jointly) misused the legal basis. This case will undoubtedly lead to even greater prudence before the internal market is used as a legal basis, hence put an effective break on regulatory output. Second, both the EU and the Member States are subjected to the *principle of proportionality*, that is , regulation and its effect should go no further than necessary to attain the objective. This innocuous principle has had and continues to have a forceful influence in decreasing the restrictiveness of regulation. The Court has been highly influential in enforcing this notion consistently, often with spectacular results. The example that comes to mind is that of the German Beer Purity regulation which had the extremely protectionist effect of an import ban whereas the Court ruled – in 1987 - that proper labeling should do, a measure with no additional cost yet restoring potential cross-border competition. But this famous example is illustrative for a great deal of routine case-law which has, by now, deeply influenced market conduct and possibly structure for very many food and beverages products as well as some other ones. Another example of far-reaching significance is the proportionality test for “exclusive rights” in network industries. Since (national) exclusive rights fragment the internal market they will be regarded as disproportional unless the objective (e.g. an overriding one like a Universal Service obligation



, or , energy security) can solely be attained with these means. The upshot is liberalisation with appropriate regulation which was long held impossible at the EU level.

It should also be emphasized that , since the early 1980s , the EU exhibits a continuous *trend reduction of the costs of EU regulation*. In the early days of the Community only goods markets were regulated. To simplify, a small number of goods markets were regulated (harmonized) with bad, detailed, rigid and costly overspecification. This so-called “old” approach was the combined result of mistrust amongst the Member States ( fueled by protectionist lobbying) with costly procedures ( unanimity, even on details, no references to standards, and difficult to amend for reasons of technical progress). The cases at hand were cumbersome in the sense that countries had to align their national rules with all the adjustment costs or strategic disadvantages that this entailed. It is from those days that the horror stories about “euro-bread” or euro-beer originate even though such ideas were never even proposed. Since 1979 and especially 1985 a complex whirlwind of new incentives and principles raged over the Union regulatory landscape which has facilitated market integration at what could be suspected as ever lower regulatory costs. I shall spare you the intricacies of these changes and merely mention a few key aspects. The most innovative one is the *principle of mutual recognition*. It guarantees free movement of goods or services in the presence of ( usually) justifiable regulation, but *not* EU regulation. This principle applies if the objectives pursued by national regulation are “equivalent”. In Europe this is the case in an overwhelming majority of cases for health and safety regulation. The double advantage is that lots of EU directives that might have come about under the ‘old’ approach, at high costs, simply do not exist whilst national rules ( for an equivalent objective) are exposed to import-driven competition. Economists generally praise mutual recognition as innovative in the right direction but *analytical or empirical economic literature about its advantages or effects is tiny*<sup>3</sup>. Some economists feel inspired by mutual recognition in going one step further and advocate regulatory competition ; unlike fiscal competition the regulatory literature is weakly developed and empirical work on the issue in the EU merely consists of a few case-studies.

Two other key aspects deserve to be mentioned. One is the realisation that the cost of **Union** regulation should be reduced as a matter of strategy, for greater flexibility and innovation in the single market but equally for competitiveness and consumer responsiveness. Over the years the EU has taken several initiatives such as the new approach for directives on health and safety ( doing away with detail and rigidities by virtually only focussing on the objectives and some procedures , and referring to European standards linked to those objectives), an array of actions aiming at greater discipline and predictability for the EU legislator<sup>4</sup> and recent proposals for systematic Regulatory Impact Assessments(= RIAs) with a view to “better regulation”. The new approach is a success but I am not aware of even a ‘guesstimate’ of its considerable benefits. The ‘better regulation’ initiatives were mainly rhetorical and EU impact assessment still has to be introduced ( despite a Declaration attached to the Maastricht treaty confirming that EU regulation should be subjected to cost/benefit analysis). The potential benefit of RIAs is huge and Europe is well-advised to extract it for EU regulation. At the moment all we know is that six reports of the OMB to the US Congress ( from 1997 to 2003) set an enviable benchmark that the Union is still very far removed from<sup>5</sup>.

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<sup>3</sup> For a survey of the issues and an attempt to provide a ‘soft’ cost/benefit analysis, see Pelkmans, 2002.

<sup>4</sup> For a detailed survey and critical assessment , see Pelkmans, Labory & Majone, 2000

<sup>5</sup> See e.g. OMB, 2003, Draft report to Congress on the costs and benefits of federal regulations, Federal Register 68; 5492 – 5527; see also Hahn & Litan, 2003 and more generally Viscusi, 1996.

The other one is the more systematic containment of the regulatory machines of the **Member States**. Here, a strong and a weak mechanism exist and, ironically, the former receives no attention at all from economists despite its remarkable effectivity in reducing or pre-empting costly regulation. For goods markets which are not covered by harmonisation directives national draft regulation is scrutinized at EU level by a special committee before it is even enacted, with the purpose of discovering potential barriers to intra-EU trade. EU countries are obliged to incorporate mutual recognition (equivalence) clauses in such laws and other Member States and the Commission will formally object in the case of suspected new barriers. This astonishing device leads annually to the cleansing of around 700 national laws (!) in the EU-15. In practically all these instances EU regulation is not reverted to, barriers are pre-empted, mutual recognition is assured and regulation (insofar as cross-border aspects are concerned) tends to become less restrictive<sup>6</sup>. The weak mechanism is the so-called Cardiff process of ‘open coordination’ between Member States for peer review of domestic structural reforms which has not yielded verifiable results.

The Union has islands of bad or unduly restrictive regulation. One should think of areas such as quality laws for agricultural products receiving subsidies or are subject to differential tariffs (which, for that reason, have to be described in quality classes<sup>7</sup>, a classical by-product of an already interventionist policy). Another strand is that, in EU consumer protection, there are forces striving for “maximum harmonisation”, an idea that better be analysed in RIAs. A third example is a set of EU directives concerning health and safety at the workplace (in the US called, occupational health and safety) where a kind of ‘old’ approach has been opted for with a great many restrictive details. RIAs would be useful and illuminating here.

Overall, one is left with a sense of mystery. Regulation being the core business for the EU, if its internal market is to function properly and its common policies are to be effective at low cost, the (net) benefits of many improvements are unknown and their even approximate quantification has apparently never been attempted. The gradual improvements over the last two decades have attracted no interest from empirical economists. *Better and less EU regulation combined with deeper market integration deserves much more attention of skillful empiricists.*

#### 4. The macro-economic design of the Union

Not only is the EU so much more than a customs union, it has also moved beyond the already so ambitious notion of an internal market. It built up an Economic & Monetary Union since the early 1990s and has a single currency with an independent, centralized monetary agency, at least for 12 countries. In principle, the arrangement is a little more complicated since all Member States are in EMU but the “outs” only in ‘stage 2’ (with Denmark in EMS-II) and the eurozone countries in ‘stage 3’. This subtlety has a policy meaning though: the doctrine is that the ‘outs’ have a ‘derogation’ and are expected to come in, one day; moreover, stage 2 does imply obligations such as having an independent central bank (quite a change for the UK). The new Member States (as of May 2004) do not get a derogation and must enter Euroland but it is completely open what date they might (individually) choose. Last but not least, and too often neglected, *all* Member States must pursue “stable prices” and “sound public finances”.

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<sup>6</sup> For details and data see Pelkmans, Vos & di Mauro, 2000.

<sup>7</sup> Hilarious stories such as rules about the curvature of bananas originate here.

*At first sight EMU is awesome.* Monetary union amounts to a uniquely strict monetary constitution, one that one would never expect a club of independent countries with long histories of their own currencies to come up with and ratify. Whereas the desire for strictness is well explained with Barro/Gordon-type political economy models of time inconsistency and credibility, given that Germany could serve as a benchmark, and the corollary that the Germans were bound to demand a set of provisions closely corresponding to its own set of preferences before it would give its D-mark away, the full acceptance and ratification by all other countries has not been rationalized theoretically by anyone, as far as I know. I should remind you of Harry Johnson's irony in 1973 : "one can flirt interminably with monetary union without ever losing one's technical virginity". Few economists in the 1970s and 1980s believed that a currency union would ever come about in Europe, like Harry. How come he and most of us were proven wrong by the Maastricht treaty? But EMU is amazing for other reasons as well. To mention a few, the incentives to join were both politically and economically powerful and worked very well in terms of disinflation and badly needed budgetary consolidation ; the infrastructural and technical prerequisites for a eurozone monetary policy have successfully been put in place (e.g, the TARGET real-time interbank clearing and payment system); the introduction of notes and coins went well despite the risks and psychological hurdles of a new fiduciary money ; the broad macro-economic stability of the eurozone has been maintained during the first 3 ½ years and the credibility of the price stability priority is firm.

Upon further reflection, however, there appear to be *minor and major design questions*. The minor ones are much discussed in Europe such as the reform of decision-making in the ECB Board ( so, not all countries having a vote at all times since the Board is becoming too unwieldy with, in future, more than 30 members) and the lack of effectiveness and clarity of the ECB two-pillar monetary policy ( should it switch to inflation-targeting, for example?).

For the purpose of this conference it is much more interesting, I submit, to identify the two *major* design questions. One flaw is obvious : the eurozone does not overlap with what is supposed to be its solid foundation , namely, economic union. The 'outs' of Euroland , including for quite a while the new EU countries from Central Europe, are of course fully 'in' the economic union. It is very unclear what exactly that means in economic terms. The current debate on the possible entry of the UK to Euroland underscores this. A critical argument the UK government employs is that "Europe" (what they mean is the continent) has a too inflexible economy. This is another way of saying that the economic union is not functioning properly because , for Euroland, the economic union should ( a la Mundell) be organized in such a way that the costs of having a single currency in general ( "one-size-fits-all") and in case of shocks are minimized. We have seen above that the internal market has much improved but that possibly EU and almost certainly national regulation should become less restrictive , while labour markets are neither integrated nor deeply reformed in a number of EU countries. The incentives to address the latter are extremely weak and slow whereas the progress on the former is very hard to even be firm about. A close reading of the so-called Broad Economic Policy Guidelines as well as their implementation reports confirms this , once one begins to look behind the veil of diplomatic language.<sup>8</sup> The deep roots of this flaw are rarely discussed , however. *Do we really know what the "economic union" is ?* There is no definition or implicit notion in the treaty, in sharp contrast with that of monetary union. How can we assess whether the economic union functions properly when we have only a vague idea of what it is? I suggest that Figure 2 illustrates reasonably well what is nowadays

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<sup>8</sup> See The 2002 Broad Economic Policy Guidelines, in : *European Economy*, no. 4/2002 ; and Report on the implementation of the 2001 Broad Economic Policy Guidelines, in: *European Economy*, no. 1/2002.

regarded as the EU's economic union. The left-hand side is strong and deepening but suffers from the lack of labour market integration, of critical importance for monetary union, and the right-hand side is decentralized, with only very soft coordination on the micro issues ( and no sanctions whatsoever). However, a credible tightening of coordination at the micro level would imply a highly sensitive shift towards *centralization* for which the Union is not ready. The alternative of far-reaching regulatory and policy competition ( e.g. Sinn, 2003) not only entails a complex cost/benefit picture but it is perceived politically as just as intrusive and *restricting countries' autonomous choices unduly*. Repairing this design flaw of EMU will be difficult and slow.

A second design flaw is less obvious although the roots are the same. It is the budgetary plank of EMU. In Figure 2 you see that I have subsumed budgetary disciplines under monetary union, and not economic union, for the simple reason that such disciplines have the purpose of making *monetary* union function properly. I shall not set out the details of these arrangements given the time constraints.<sup>9</sup> Suffice it to notice that the disciplines appear to be strict and sanctions are possible. The disciplines consist of certain prohibitions in the treaty ( e.g. no bail out), the so-called excessive deficit procedures ( threshold at 3 % ) and the infamous Stability & Growth Pact setting a medium term target of 'close to balance'. There are minor design problems which are hotly debated in Europe such as a shift to an emphasis on debt ratios rather than deficits, a greater role of the Commission and early warnings also in the boom phase of the cycle. However, the true design problem is the *ultimate credibility of the sanctions* when faced with recalcitrant eurozone countries. The financial sanctions are large but not credible : the Council has to decide upon them and it is bound to be far too hesitant. Even if it would impose them it might be counterproductive and prompt a crisis in the Union. If it does not impose them, the Pact turns out not to have teeth and the ECB might be forced into moral hazard, eventually, or Euroland might end up with an adverse policy mix. The euro might suffer, too. The rigidity of the Pact cannot be explained by economic rationality as many economists have argued convincingly. Its explanation is much more simple : the awkward dilemma's when sanctions come in sight ought to be avoided at all costs. A very tough Pact is 'good' because it lowers the probability that sanctions ever have to be decided upon. Again, repairing this flaw is throwing up other dilemma's. Were one to centralize decision-making (say, the Commission) or even to de-politicize it in a kind of 'budgetary agency' ( e.g. as Wyplosz, 2002, proposes) one effectively *introduces a "budgetary constitution"* besides the prevailing "monetary constitution". Quite apart from the complexities of assessing strict budget rules as they exist in the US ( rule design matters a lot, see Besley & Case, 2003, in particular section 7.5), this would be resisted on the double grounds of de-politicisation ( with the lack of legitimacy it implies) and centralisation. The only other fundamental solution, it seems, would be to radically alter the set-up of the EU into a more federal direction, that is, greatly bolster the EU's central budget by shifting expenditures ( and taxes) away from the Member States to the centre so that the Union budget could begin to assume macro-economic stabilisation functions and the fiscal stance of Euroland be determined far less by national budgets. It should be said that, for the foreseeable future, this is a no-go route, whether for economic or political reasons, if not for both.

Let me end these reflections on EMU by posing a few questions :

- i. (ignoring, for the moment, design problems) are the *benefits* of setting up a currency union not much greater than the savings in transaction costs as calculated in various

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<sup>9</sup> A detailed and careful presentation is in EURO Papers no. 45, European Commission, DG EcFin, July 2002.

Commission studies? I give two reasons. One is the induced dynamic effects on the internal market , especially financial services and capital liberalisation and compatibility and facilitation of clearing and settlement? This deepening is a clear and explicit response to the actual emergence of the euro. Another reason is the flood of articles by Andy Rose ( Rose, 2000 ; Rose, 2001; Persson, 2001; Rose & van Wincoop, 2001 ; Thom & Walsh, 2002 ; Glick & Rose, 2002) resulting in an empirical observation without a theory : in currency unions intra-trade eventually rises by as much as a factor of 2 or perhaps even more. Thus far , the debate has focussed on the robustness of his methods, not on the underlying explanation. Would home bias reduce significantly in monetary unions? This is suggested by the impact of the break-up of monetary union of Czechoslovakia between 1993 and 1997 ( Fidrmuc, Horvath & Fidrmuc, 1999). But the determinants of home bias are equally unknown although Head & Mayer (2000) argue that taste differences is the main one in the EU (without firm evidence).

- ii. What are the *costs* of monetary union when the “economic union” is suboptimally designed with respect to micro-economic issues of market integration (e.g. labour) and degrees of flexibility ? Can one distinguish degrees of suboptimality and use this ranking for a rational decision to join or not to join, or, conversely, employ it to agree on a reform agenda in Euroland?
- iii. What are the true costs of design problems with the Pact or other budgetary disciplines ? Perhaps the political costs may be counted but the economic costs seem *trivial* up to now. One could argue that these costs are largely a matter of credibility and hence only begin to matter once financial markets are getting nervous. After all, the direct cost of larger deficits or debt falls on the country itself, or its future generation, unless interest rate spill-overs could be found empirically ( but this is not the case see e.g. Gros & Hobza, 2002). The political fuss about the Pact during the last year or so has had no impact whatsoever on financial markets. On the other hand , credibility is difficult to acquire, yet lost swiftly. This calls for prudence :the costs of persistent troubles with the Pact may be very high.

## 5. Does a European constitution matter ?

When this conference was held the deliberations about a European draft constitution were finalized in Brussels. Even though strictly legally, this constitution takes the form of a “constitutional treaty”, there is no doubt that the agreement goes far beyond the inevitable rhetoric and has a number of characteristics of a constitution. It is yet another proof that the European Union has long transcended what one might call “regionalism” , without , on the other hand, being or becoming a country , or, a United States of Europe. The EU is unique , perhaps no less than the USA were after 1776 or following the Philadelphia Convention.

The European Convention is interesting for you for two reasons. First, it turned out to be an excellent occasion to *understand and test the preference sets* of a wide variety of politicians from all 25 countries of the larger Union. Given the work methods, the full public exposure of all discussions and documents, the first-class support from the Secretariat , the intensive

expert debates in seminars, on websites and otherwise, and the ( 16 months) duration of the Convention, we have a much more precise view of the nature and structure of political preferences about all kinds of EU powers, institutions and issues than ever before. This is very significant. In normal times, the revelation of preferences in the EU is far more imperfect than it already is in national political contexts. The Eurobarometer (simple polls) is not only highly superficial in its questions, one has no idea about the respondents' information or experience and there is no 'learning'. The Convention was like a crash course where sloganism was punished and arguments and constructive ideas were awarded a premium while the learning curve was steep. In particular, the intense process of tabling amendments to draft texts forced accountable politicians time and again to argue and position themselves. We now know that in a range of policy domains the EU appreciates the status quo while in others a surprising dynamism has developed , often ahead of the representatives of government leaders, even though they have moved far beyond narrow positions or vetoes in Nice in 2000.

The second reason why the Convention is interesting is that it achieved results which can be readily understood. The two treaty review processes in Amsterdam (1997) and Nice (2000) did not accomplish much and failed outright in the most difficult issue area , the EU institutions. I shall confine the summary by itemizing four striking elements:

- The EU has far more clearly expressed the idea that the Union consists of a community of *fundamental values* and one for *policy action*. The community of values is formulated in part II of the draft and adherence to it is an absolute condition of membership. The economic significance of the Union is of course still of enormous importance but it is explicitly overarched by values and the political role they play in European society. The question the EU struggles with is *how far it wants to go in promoting and defending* such values inside and outside the Union. EU foreign policy, thus far largely a failure, should become more pronounced but no-doubt with hiccups and setbacks. The taboo about 'core' groups in security and defense is likely to be lifted and this might , in due course, lead to a strengthening of European defense in NATO. However, the EU has four neutral countries and far from uniform perceptions on these issues amongst the other ones so one should count with a time scale of many years.
- the policy actions now go decisively *beyond the economic domain* , especially "domestic security" ( crime, drugs, asylum, illegal immigration, gun trade, etc.) and the police and border cooperation it takes. Note that , in Europe, the move towards a common immigration policy does not arise from labour markets but from these security concerns.
- a range of *institutional provisions* has been agreed to move European politics closer to the people, while strengthening in a cautious manner the EU decision-making machinery and its leadership. A possibly risky proposal is to permit the right of exit (secession) which could invite opportunistic and strategic behaviour .
- On the main *economic and social issues* the revealed preferences indicate the *status quo*. There is no attempt to increase the very limited role of the EU budget ; the legal basis for an EU right to tax was proposed by many Conventioneers but is unlikely to make it ; EMU will hardly or not change though the Commission might get a slightly stronger role in the Pact ; the powerful inhibitions to assign more powers in the social field to the EU level have been confirmed so that labour market integration will neither be boosted by harmonisation nor by intense labour migration.

The Convention has underlined and enhanced the significance of the *principle of subsidiarity*. Here, it seems, economists can contribute more analysis. Subsidiarity is an assignment principle. The question is :what powers should be assigned to what level of government? The

underlying idea is that local ( or national ) government is best capable to read and respond to local preferences and that accountability would work best there as well (due to information and clarity about responsibility). If correct it would mean that policy would closely correspond to the preferences of voters and principal/agents problems could be minimized. Only if policy at this level would be ineffective or (too) costly , should cooperative solutions be sought. If the degree of binding to the higher level rules increases and/or if substantive powers are transferred , one might begin to speak of a second layer of government. In the EU this second layer surely exists and there is widespread awareness that subsidiarity could be a useful tool to “integrate where necessary, remain autonomous where possible”.

The economics of subsidiarity , as applied to the EU, has largely been borrowed from the fiscal federalism literature (e.g. Oates, 1999). Any significant degree of “centralisation” in the EU can be subjected to a subsidiarity test, starting with the criteria for the “need to act in common” in Europeak. They include economies of scale and scope , and cross-border externalities. Against these can be held the elements of heterogeneity of preferences, information and accountability. If the criteria for action-in-common are fulfilled, the next step is whether this can be achieved in a credible and efficient way via cooperation or coordination (allowing scope for local autonomy) or whether it is more efficient and/or effective to centralize at the EU level via regulation , common policies, the EU budget or autonomous (or even independent) agencies. In some cases , not the EU but the world or ad-hoc cooperation ( e.g. the European Space Agency) is the right level.

On an occasion like this, it is not possible to go into details of assignments suggested by the literature ( e.g. Padoa Schioppa et. al. , 1987 ; CEPR, 1993 ; CEPR, 2003 ; Calmfors et. al. , 2003; Pelkmans, 2001 ; Pelkmans, 2003). However, a few observations can be made. First, the Convention remained deaf for pleas by economists to give substance to the “subsidiarity test” to be applied by the Commission for new draft directives or regulations, and soon by national parliaments in a new form of extra scrutiny. The new Protocol includes an ambitious test and even explicitly asks for ‘quantification’, yet nowhere is the slightest indication of how such studies should perform the test and what methodology is appropriate. Politicians regard subsidiarity as “political” and not, as economists do in the literature, as a *functional* principle. Second, although there is considerable overlap between the typical wish list of central public functions in the economic literature and the assignments in the EU ( especially, the internal market, and the common competition and trade policies), the practicality of this insight is very limited due to its generality. The Convention has shown once again that the many hundreds of internal market aspects ought to be analysed on their own merits e.g. with competition or harmonisation ( or, as the Convention has decided, even ‘coordination’) of all kinds of taxes, the subtleties of differentiating mutual recognition, etc. There is very limited research experience at this level of detail and what there is, is often controversial (e.g. what is “harmful tax competition” ? ; the cost of too-high thresholds for EU merger control ; should prudential supervision of banks be cooperative or fully centralized ?). Third, what economists dismiss may be analytically correct but is often regarded by politicians in Europe as an echo of known opinions. Two examples suffice. Subsidiarity in the EU does not suggest the public function of redistribution to be centralized . So, economists are quick to suggest “re-nationalisation” of the CAP (after reform) and a drastic curtailment of cohesion funds or a reform to ‘general purpose grants’ to poor EU countries( at the moment transfers are conditional). Fourth, what economists have strong opinions about e.g. the centralisation of foreign policy and defense , is about as difficult and sensitive a topic as one might choose in Europe. Such policy areas cannot be merely approached from a functional perspective since they are deeply political ( values and power). What the economic literature has ignored for a long while is

infrastructure. It might be a suitable EU issue insofar as cross-border questions are concerned ; in particular, the latter should not be merely regarded as bilateral but also in EU-wide terms (e.g. multi-country transit ; missing links ). Yet, the sensitivities at Member States' level are enormous and this systematically hinders the emergence of truly continental infrastructure unlike the US and Canada where (rail and road) infrastructure was a *prerequisite* for intra-national integration. Equally, there has been next to no serious attention for the byzantine EU budget system that will , after the Convention, at least be partly improved.

## 6. Conclusion

The economic research agenda in the domain of European integration is potentially extremely rich and diversified. The inner dynamism of the European Union shows no sign of abating. Your interest in this domain would be fascinating for you and , as I see it, very helpful for the EU and its policy-makers.

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## Appendix

Figure 1 Understanding the Internal Market

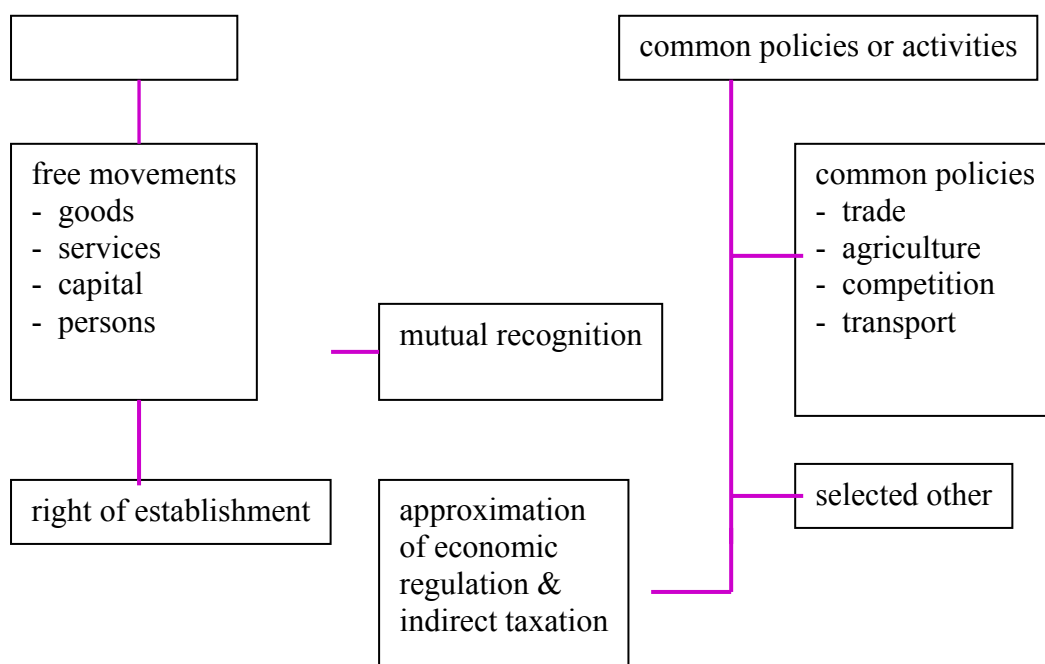


Figure 2 The Design of the EMU

### MONETARY UNION

- the euro
- price stability
- ECB
- entry conditions
- budgetary disciplines

### ECONOMIC UNION

wide & deep integration			incentives supply side / coordination MS
INT. MARK.	approx./ reg.l. common policies freedoms mutual recognition	cohesion - policy - transfers	Cardiff Luxembourg Lisbon processes automatic stabilizers