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## Europe - quo vadis? Reflections on the future institutional framework of the European Union

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**Kiel Working Paper No. 1064**

**Europe — Quo Vadis?  
Reflections on the Future Institutional  
Framework of the European Union**

**by**

**Horst Siebert**

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# **Europe — Quo Vadis? Reflections on the Future Institutional Framework of the European Union\***

Abstract:

With twelve new members the decision making in the European Union via intergovernmental cooperation will become ineffective. In order to avoid a Stagno-Europe the EU has a choice: Either it looks for the very essentials in the common institutional frame or the member states agree in ceding national sovereignty to the European level. This, however, requires that the democratic deficit at the EU level is reduced. The Treaty of Nice has failed to solve these issues.

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Almost one hundred years ago, in 1914, the gloomy situation in Europe was characterized by the now famous dictum of Lord Grey of Fallodon:

“The lamps are going out all over Europe;  
we shall not see them lit again in our life-time”.

After two world wars in the first half of the last century, Europe experienced a continuous process of economic and political integration and a steady increase in welfare. What began with the Community of Six in 1957 and the alternative of the EFTA, continued with the northern enlargement in 1973 (Denmark, Ireland and the UK),<sup>1</sup> the southern enlargement in the 80s (Greece 1981, Spain and Portugal in 1986) and the addition of the neutral states in 1995 (Austria, Finland and Sweden). Now, the European Union of 15 will be enlarged to a Union of 27, including ten Middle and Eastern European nations.<sup>2</sup>

European integration has been compared to a bicycle that must be moved forward, otherwise it falls to the ground. This analogy (which does not imply that Europe is a tour de France) intends to illustrate that integration is an ever-moving process that needs new stimuli because otherwise the retarding and disintegrating forces will gain the upper hand. Eastern enlargement is expected to represent such a needed stimulus. In theoretical terms, the bicycle analogy raises the issue whether for the EU of 27 we are

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<sup>1</sup> Two referenda failed in Norway.

<sup>2</sup> In the future, Croatia and other ex-Yugoslavian countries may join; Turkey is a candidate.

analyzing a future institutional steady state including a continuous flow of institutional innovations and institutional changes or whether we are studying a very long transition path to a future institutional steady state that may never be reached. A union of 15 sovereign states already raises many issues including the question how Europe can become a dynamic region of the world economy moving on a higher growth path and how it can solve its structural problems. These issues will be accentuated with the addition of twelve new members.

In analyzing this question I start from the premise that there is no alternative to an Eastern enlargement, and that is for three reasons. The first argument is historic: Budapest, Prague and Warsaw are European cities. They are part of Europe. The second argument is geo-political. In light of a political crisis in Russia, that cannot be excluded with certainty, countries in Middle and Eastern Europe can be stabilized by integration into the EU.<sup>3</sup> The third argument is an economic one: All countries will benefit.

## **I. Europe at the Cross Roads — What changes with Eastern Enlargement?**

Adding ten new members from Middle and Eastern Europe to the existing 15 member states represents a major change of the European Union.

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<sup>3</sup> An additional issue is that the new border regions of an enlarged EU are to be stabilized in economic terms, for instance with Europe agreements with the new Eastern neighbors.

*No Major Changes in Trade and Capital Flows*

One would think that a major area of change is in trade. This, however, is not the case (see Table A1). On average, the EU candidate countries export 65 percent of their exports to the EU as existing EU members do. This is a result of the Europe Agreements that were concluded in the early nineties. Thus, from the trade perspective, the accession countries are already de facto EU-members. Trade between these countries and the EU is not only inter-sectoral trade but also already to a large extent intra-sectoral trade, albeit with some vertical structure (Heitger, Schrader, Stehn 1999). Trade of the EU with the new members will only increase in proportion to income convergence and other determinants of commodity exchange that apply in a general way to other countries as well. There will be no spectacular changes in trade.<sup>4</sup>

There will also be no radical change with respect to capital flows. The potential new members have experienced a sizable capital inflow in their transition period. For instance, in Hungary foreign direct investment accounted for 50 percent of gross investment in 1995 (or 10 percent of GDP). For the Czech Republic foreign direct investment made up between 8 and 36 percent of gross investment or between 2 and 10 percent of GDP in the period 1995–1999. For Poland the figures are a range between 14 and 18 percent and 3 and 5 percent respectively. It can be argued that foreign direct investment will tend to increase since the political risk premium will be reduced once these countries are members of the EU. However, the most

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<sup>4</sup> This is an implicit answer which stimuli for more dynamics in the EU are to be expected in the future.

profitable investment projects have already been undertaken in the first phase of the transformation process. Consequently, the level of foreign direct investment flows is unlikely to change markedly. Moreover, the extension of the Monetary Union to the new members (entailing efficiency gains on the capital market) should take time.<sup>5</sup> What is more important, EU foreign investment in Middle and Eastern Europe was only 7.5 percent of total EU foreign direct investment (in the period 1993–1998). We therefore do not have to expect a major change in capital flows from the point of view of the EU.

*Mass migration unlikely*

What about labor migration, an issue that is especially relevant for Austria and Germany? The migration decision of people depends — among other factors — on actual and expected income differences and on opportunities for employment (and therefore on unemployment). Income differences between the accession countries and the EU are still high. Poland reaches 39 per cent of the EU per capita level of GDP when purchasing power parity is used (Data for 2000). For Hungary the relative level is at 52 per cent, for the Czech Republic at 58 and for Slovenia 72 per cent. In contrast, Romania reaches only 27 per cent and Bulgaria 24 per cent of the EU level. When GDP per capita is compared in current prices and nominal exchange rates, the Czech Republic is at 27 per cent, Hungary at 22 and Poland at 18 per cent of the EU average.

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<sup>5</sup> See Siebert (2001a).

Some regions in some of the accession countries reach income levels that are not too far off from the EU average or are even higher. Thus, the region of Prague is at 115 per cent of the EU level, Bratislava at 99 and the region Közép Magyarország in Hungary at 72 per cent. For people in these areas, on average outmigration is unlikely to pay.

Besides actual income gaps, unemployment in the accession countries relative to the EU can be a reason for migration. Unemployment has increased in the accession countries and in most of the countries is running at higher rates than in the EU countries (Table A1).

It is, however, not actual income differences and actual differences in unemployment rates that drive migration but expected income and employment gaps. Like in an investment decision of the firm, in migration decisions the future stream of income is compared to the costs; the present value of the additional income in future periods net of migration costs must be positive. Therefore expectations on future income play an important role. If people expect that the income gap will be leveling in over time they tend to stay at home. In a model with uncertainty, for instance with a Brownian motion on future income, the option value of waiting is a relevant variable (Siebert 1993). If the option value of waiting is positive, people will stay at home. We know from many empirical studies<sup>6</sup> that convergence takes a long time; nevertheless the expectation of convergence implies a positive option value. How relevant convergence is can be illustrated by anecdotal

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<sup>6</sup> On the European experience see for instance Siebert (1999), Figure 4.12. See also Dluhosch (2000) who shows that centripetal forces dominate in integration.



evidence. At the beginning of the nineties, Polish doctors would come to the grape harvest along the River Rhine during their holidays according to press reports. At the end of nineties, it was busdrivers from Warsaw. For the doctors, this job had become unattractive.

These evaluations are derived from analytical considerations; they are hypotheses only. Alternatively we can attempt to gain information on potential migration from historical experience. Looking at the German experience and the Mediterranean countries, immigration surprisingly occurred in the late sixties and early seventies, way before the enlargement in the eighties. Immigration from Greece, Spain and Portugal reached its maximum in 1970 with 2 persons per thousand of the German population. As a matter of fact, there was negative immigration from these countries in the period after southern enlargement (Dicke and Foders 2000, Table 10). Moreover, Southern enlargement may not be a relevant analogue, anyhow, because historically people have not migrated from the south to the north, except for the tribes of the Angles and the Saxons from northern Germany, whereas migration from the East to the West was more normal.

Empirical studies attempt to explain the number of immigrants in Germany as a function of income differences, past migration and of estimated prospects for the future (Brücker 2001, Flaig 2001). The results depend on whether all emigration countries are thrown into a pool of data and a general migration function is searched for or whether country-specific factors are accounted for and specific migration functions are determined for each country. As far as EU enlargement is concerned, a general function tends to predict a higher migration volume.

In the German case, there was a strong immigration in the late eighties and early nineties, but it is surprising that net immigration to Germany from the seven major Middle and East European countries (Bulgaria, the Czech Republic, Hungary, Poland, Romania and Slovakia) has been less than 20 000 per year since 1995; this is about one person per four thousand of the German population. In 1993, a year of recession, net immigration from these countries was negative, in 1994 it was slightly negative. Admittedly, a free movement of people did not exist during that period but determined people are likely to develop an infinite imagination to overcome legal hurdles.

Looking at the analytical considerations and the empirical experience my tentative conclusion is that we will not see a major wave of immigration from the new EU-members except in the event of a political shock. A larger migration from these countries can, however, not be ruled out if a massive disturbance occurs, for instance if a major political risk arises from Russia. Migration from the very low-income countries like Romania and Bulgaria will be more important. These countries, however, will be admitted to the EU at a later stage. Commuters in the border regions of Austria and Eastern Germany may reach sizable numbers.

## **II. The institutional deficit of intergovernmental decision making and the democratic deficit**

The major potential for change coming about through Eastern enlargement should be in the institutional framework of the European Union and its decision making structure. The EU represents a multilateral contract by which

autonomous nation states cede elements of their sovereignty to supranational decision making. The EU is more than a (non-committal) league of nations (Staatenbund) but less than a (structured) federal state (Bundesstaat). It is a form of integration that relies on the method of inter-governmental cooperation where most of the decisions are taken in the European Council by reaching agreements between the heads of state or between the ministers of specific portfolios.

The European Council is therefore the core institutional arrangement. Important questions are dealt with by the heads of state, specific issues by the ministers.<sup>7</sup> The democratic legitimacy of the Council is limited; it exists only in so far as the national governments have been democratically elected. A democratic legitimacy going beyond that, especially one in a European context, is not given. The decisions of the Council are rather removed from the voters in Europe, but as these decisions intervene into the daily life of people more and more directly, the actual form of intergovernmental cooperation exhibits a serious democratic deficit. What is more important: The Council cannot be sanctioned by the voter. And a national government cannot be sanctioned by its voters if a qualified majority applies.<sup>8</sup>

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<sup>7</sup> The Council of heads of states dominates the many councils in the form of ministers for two reasons: Ministers will have to follow the concepts of the heads of states; the heads of states can bundle together more issues for their decision making than specific portfolios. The European Council meets in 23 different forms. An example is the Ecofin, the Council of the economics and finance ministers.

<sup>8</sup> A national government can only be sanctioned if unanimity applies.

The basis for intergovernmental cooperation is the European Treaty, which has developed in different stages from the Treaty of Rome to the Treaties of Maastricht and Amsterdam. It has been ratified by the national parliaments or by referendum in some countries; the Treaty of Nice is still to be ratified. In the European Treaty being in force, member states have agreed to respect the decisions of the European Council and abide by them. This holds for decisions with simple and qualified majority. In other areas where unanimity is required each member state has a veto. In addition, a vital interest procedure has been practiced in the past when a qualified majority applied. Whenever a national government declared an issue as one of vital national interest, the member state was not out-voted.<sup>9</sup>

Unanimity is required in very basic decisions. The most important areas are: admitting new members (Article 49), indirect taxation (Article 93), direct taxation (Article 95), the budget of the European Union (Article 269) and fundamental rules (Articles 94, 95). Unanimity is also required in special aspects of international treaties of trade policy (Article 133), cultural policy (Article 151), industrial policy (Article 157), in social cohesion policy including structural funds (Articles 157, 161), research and development policy (Article 166) and environmental protection (Article 175 section 2). Asylum policy while respecting international Agreements is under national authority and has required unanimity so far. As of 2004, the procedure of codecision with qualified majority will apply if agreed upon by the heads of

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<sup>9</sup> The so-called Luxembourg compromise.

state.<sup>10</sup> Of course, the unanimity principle in the area of taxation is at the heart of national sovereignty or of political union.

For a qualified majority in the EU-15, 62 of 87 votes (71,26 per cent) are needed. This holds for decisions which are taken by the European Council with respect to proposals of the European Commission. In all other cases, it is additionally required that 62 votes represent the approval of at least ten member states (Article 205). The blocking majority is 26 votes. The Treaty of Nice changes these numbers for the case of enlargement (see below).

The European Commission is the operative arm of the EU und represents the administration. Its main task is to implement policies, to launch initiatives and to be the arbiter between member states as the guardian of the treaty. The Commission has the right to propose new laws; it can create derived or secondary law according to article 308. The Commission has a legislative monopoly. A set of decisions of the European Council presupposes recommendations by the Commission. Changes of the treaty require approval by national parliaments.

The European Parliament participates in the different forms of approval, joint decision and hearing. The approval of parliament is needed in declarations of fundamental violations of the treaty. The proceedings of joint decisions according to article 251 apply to proposals of the Commission to which parliament submits a statement. On the basis of this statement, the proposals of the commission become enacted by the Council. If the

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<sup>10</sup> This refers to measures according to article 62 sect 2 lit a and 63 sect 3 lit b.

parliament alters the Commissions' proposals in joint decisions, rules specify how to proceed. The Parliament does not have the right of initiative.<sup>11</sup>

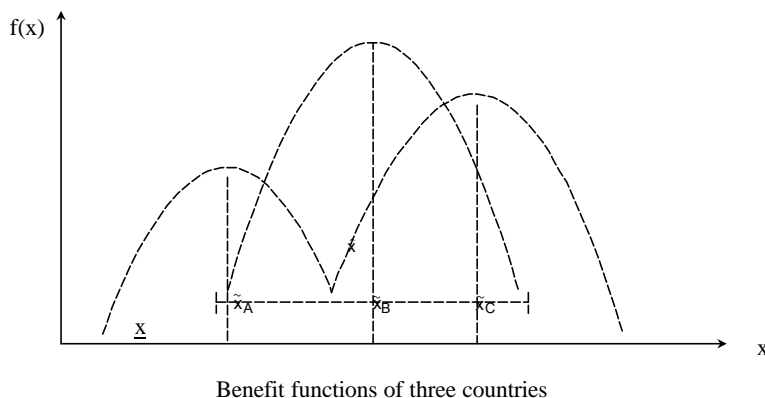
Enlarging the EU by 12 member states in the near future and leaving the institutional arrangements of decision making by intergovernmental cooperation unchanged, raises the question of whether the system can function. An important issue is that the democratic deficit that already exists in the Union of 15 will be aggravated because the decisions in a Council of 27 heads of states or ministers are even further removed from the citizens and the voters. Another important issue is to what extent the form of intergovernmental cooperation will effectively lead to decisions or whether decisions will be blocked.<sup>12</sup> It is already difficult to come to decisions in a Union of 15 member states, because important elections are about to be held in some member state almost all the time so that national governments must fear electoral defeat as a consequence of an unpopular decision taken on the European level. This relates to unanimous as well as qualified majority decisions. The procedure to respect the national vital interest would restrict decisions even further.

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<sup>11</sup> The European Court is responsible for the interpretation of the EU Treaty and EU law. Actions against a member state can be brought to the court by member states and by the Commission.

<sup>12</sup> Consider three countries. Take an instrument variable  $x$ , i.e. a European standard or another policy instrument like expenditures at the EU level. The benefit functions  $f(x)$  of the three countries are likely to differ. Individually, these countries would choose  $x_A$ ,  $x_B$  and  $x_C$ . A minimum level  $\bar{x}$  of the instrument variable would allow these optimal solutions. This also holds for a band width of the instrument  $\hat{x}$  being allowed. If a common level of the instrument is desired, the decisions become extremely complicated, especially if the benefit functions differ considerably. In principle, an envelope of the individual envelope functions must be constructed (not shown in the diagram). Side payments must induce losers to support a solution. In the case of unanimity, a solution may not be found. If a qualified majority applies, the concept of pivot voter gains relevance.

We therefore have to take into account a speculative scenario of Stagno-Europe: Decision making in the EU will be blocked, economic dynamics and vitality will be lost, the integration process comes to a halt and Europe's position in the world economy will erode. Institutions matter: Does the given institutional setting of the European Union imply sclerosis and immobilization for the coming decade? This issue is similar to the question of to what extent the German consensus approach including cooperative federalism and the cooperative-collective framework of the labor market implies that structural problems appear to be unsolvable in Germany. It is also similar to the issue of the extent to which the institutional framework of Japan, for instance the heavy distortion in the electoral representation in favor of rural voters relative to urban voters, means that structural adjustment cannot be performed when negative internal and external shocks hit the economy, while working fine when the economy is expanding rapidly. It is safe to conclude that a “rebus sic stantibus” approach, that is leaving the institutional framework unchanged (as the Nice treaty more or less does, see below) will not work. In order to prevent an outcome of erosion in efficiency, Europe has two ways out:



- (1) To cope with the increased heterogeneity of 27 members, a much larger spectrum of variety in the rule system must be allowed. In this strategy, one has to look for the very essentials in common European rules.
- (2) The integration process is to be pushed forward politically.

The two options are discussed in the following sections.

### **III. To look for the very essentials**

Eastern enlargement increases the heterogeneity of the EU. Whereas a political union and a common market require a uniform frame of reference to prevent major distortions in competition, increased heterogeneity needs a more flexible and less strict institutional framework. This is especially relevant as long as the democratic deficit is not reduced. A way to solve this is to look for the very essentials in the institutional framework.<sup>13</sup> The question before us is: Which aspects of the 31 areas of the *acquis communautaire* are indispensable? And which elements in the institutional arrangement of political decision making are indispensable?

#### *Some non-essentials*

There are many examples of regulations that are unnecessary. Is it really essential that the EU determines that the minimum diameter for leeks is 10 mm (where sizing is determined by the diameter measured at right angles to

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<sup>13</sup> The following can be seen as an attempt to specify Jospin's statement: "L'Europe est d'abord un projet politique, un >>contenu<< avant d'être un >>contenant<<".



the axis above the swelling of the neck) as specified in the Commission Regulation (EEC) No 1292/81 of 12 May 1981 (laying down quality standards for leeks, aubergines and courgettes (annex I, III, i))<sup>14</sup> Or is it important to regulate that 'Extra' class cucumbers are to be well shaped and practically straight, that class I cucumbers be reasonably well shaped and practically straight (maximum height of the arc: 10 mm per 10 cm of the length of cucumber) and that in Class II crooked cucumbers are allowed only if they have no more than slight defects in colouring and have no defects or deformation other than crookedness whereas slightly crooked cucumbers may have a maximum height of the arc of 20 mm per 10 cm of length and crooked cucumbers in Class III may have all the defects allowed in Class II for straight and slightly crooked cucumbers, but they must be packed separately?<sup>15</sup> There are many other examples,<sup>16</sup> many from agriculture.<sup>17,18,19,20,21,22</sup> Product regulation also includes technical

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<sup>14</sup> Official journal NO. L 129, 15/05/1981 P. 0038 - 0047.

<sup>15</sup> Commission Regulation (EEC) No 1677/88 of 15 June 1988 laying down quality standards for cucumbers (annex II, B, i-iv); Official journal NO. L 150, 16/06/1988 P. 0021 - 0025.

<sup>16</sup> For the sizing of aubergines by diameter, the minimum diameter is fixed at 40 mm for elongated aubergines and 70 mm for global aubergines. For sizing by weight, the minimum weight is fixed at 100 grams. (Commission Regulation (EEC) No 1292/81 of 12 May 1981 laying down quality standards for leeks, aubergines and courgettes (annex II, III, A-B); Official journal NO. L 129, 15/05/1981 P. 0038 - 0047).

<sup>17</sup> The minimum diameter for onions is 10 mm. (Commission Regulation (EEC) No 2213/83 of 28 July 1983 laying down quality standards for onions and witloof chicory (annex I, III); Official Journal L 213, 04/08/1983 p. 0013 - 0021).

<sup>18</sup> Cherries must have the following minimum sizes (Sizing is determined by the maximum diameter of the equatorial section): 'Extra' Class: 20 mm, Classes I and II: 17 mm, Class III: 15 mm. (Commission Regulation (EEC) No 899/87

standards.<sup>23</sup> It is highly questionable whether all these regulations are necessary.

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of 30 March 1987 laying down quality standards for cherries and strawberries (annex I, III); Official journal NO. L 088, 31/03/1987 P. 0017 - 0024).

- <sup>19</sup> Strawberries must be of the following minimum sizes (Sizing is determined by the maximum diameter of the equatorial section): 'Extra' Class: 25 mm, Classes I and II: 18 mm, Class III: 15 mm. (Commission Regulation (EEC) No 899/87 of 30 March 1987 laying down quality standards for cherries and strawberries (annex II, III); Official journal NO. L 088, 31/03/1987 P. 0017 - 0024).
- <sup>20</sup> In the case of carrots green or violet/purple tops are not allowed in 'Extra' Class; Class I: Green or violet/purple tops up to 1,0 cm long for carrots not exceeding 8 cm in length, and up to 2,0 cm for other carrots, are allowed; Class II: Green or violet/purple tops up to 2,0 cm long for carrots not exceeding 8 cm in length, and up to 3,0 cm for other carrots, are allowed. (Commission Regulation (EEC) No 920/89 of 10 April 1989 laying down quality standards for carrots, citrus fruit and dessert apples and pears and amending Commission Regulation No 58 (annex I, II, B, i-ii-iii); Official Journal L 097, 11/04/1989 p. 0019 - 0039).
- <sup>21</sup> For Tomatoes the size of tomatoes is determined by the maximum diameter of the equatorial section. The following provisions shall not apply to "cherry" tomatoes: Minimum size: For tomatoes classified in the "Extra" Class and Classes I and II, the minimum size is set at: 35 mm for "round" and "ribbed" tomatoes, 30 mm for "oblong" tomatoes. (Commission Regulation (EC) No 790/2000 of 14 April 2000 laying down the marketing standard for tomatoes (annex III); Official Journal L 095, 15/04/2000 p. 0024).
- <sup>22</sup> Duck livers shall weigh at least 250 g net, goose livers shall weigh at least 400 g net. Commission Regulation (EEC) No 1538/91 of 5 June 1991 introducing detailed rules for implementing Regulation (EEC) No 1906/90 on certain marketing standards for poultry (article 1, 3); Official Journal L 143, 07/06/1991 p. 0011 - 0022).
- <sup>23</sup> The maximum dimensions of a tractor are as follows: width: 2,55 m. Commission Directive 2000/1/EC of 14 January 2000 adapting to technical progress Council Directive 89/173/EEC as regards certain components and characteristics of wheeled agricultural or forestry tractors (annex, annex I,

Europe will not become a dynamic region of the world economy via such regulations. It is difficult to see how they can be enforced anyhow in Palermo or in Rantasipi and to what extent they reduce transaction costs. A beaurocratic Europe is not a viable concept.

### *Institutional competition*

In quite a few areas, the concept of institutional competition is a promising approach to a more heterogeneous union. The concept is to accept different national institutional arrangements and let them compete with each other. It is a sheer impossibility to harmonize all legal rules that have developed so differently in the history of European countries and that are moreover the result of diverging legal philosophies.

The legal basis for this approach of institutional competition is the *Cassis-de-Dijon* case decided by the European Court of Justice in 1979. The Cassis-de-Dijon, a fruit liqueur, is widely in use in France as an ingredient for the Kir Royale, Archeveque, Bourgeois or Ordinaire. It was not allowed, however, to be marketed in Germany. The German regulation, the monopoly law on spirits (*Branntweinmonopolgesetz*) of 1922 required fruit liqueurs to have an alcohol content of at least 32 percent; thus the lower alcohol content of 17 percent in the Cassis-de-Dijon was ‘verboten’. The European Court of Justice ruled that a product legally brought to the market

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2.1.2) (Text with EEA relevance); Official Journal L 021, 26/01/2000 p. 0016 - 0022).

in one country of the European Union also has to be accepted by other countries. This verdict then allowed the export of beer from Belgium that was not brewed in accordance with the German beer purity regulations of 1516, and it allowed pasta to be exported to Italy that was not made from Italian buckwheat. It was also extended to financial products and services. According to this principle, different regulations are de facto mutually recognized and coexist.

The competition between different national institutional systems determine which of the existing national rule systems will survive and which will have to adjust. The country-of origin principle and institutional competition lead to a discovery process in the sense of Hayek (1968) bringing about ex-post harmonization as needed. It is a market-driven process of harmonizing differing norms, standards and regulations between member states.

Institutional competition and the country of origin principle find their limit where issues of public health are concerned; recent examples are mad cow disease and foot and mouth disease. Here Article 30 of the EU-Treaty allows national measures to protect health. In these cases, the functioning of markets would be violated (see below); minimum standards may help to prevent market disruption.

Institutional competition also applies to taxation. As in product regulation, competition in taxation can bring about harmonization ex post; ex ante harmonization is not necessary. An example are taxes on corporate profits and business taxes that have been brought in line between the European countries in the last fifteen years without ex ante harmonization, but as a

political reaction to locational competition for the mobile factors, both in the European Union and world wide. Fears that competition in taxation will lead to a downward spiral of tax revenues because mobile factors of production leave if taxes are too high, are exaggerated. Infrastructure provided by the government including the educational and research system of a country represent positive location factors (Siebert 2000). Extreme cases of distortions<sup>24</sup> may be solved with minimum standards of taxation.

*The criterion of functioning markets*

A more fundamental answer to our issue is that the criterion for a rule to be essential is that without such a rule one of the four freedoms – the free movement of goods, services, people and capital – is seriously impaired. Thus, whatever is necessary for markets to function belongs to the category of being essential. In answer to the question what is essential we should, however, not apply a static interpretation but look at the issue in a result-oriented way including dynamic processes that lead to a new equilibrium. Essential elements in this interpretation are a common institutional frame for the product markets through commercial policy and competition policy.

National subsidies can distort competition, and therefore some type of subsidy control is necessary in a common market. However, one may question whether control by the EU of subsidies on the regional level is also mandatory. The EU should not be concerned with each regional aid, especially those that occur in the non- tradeable area. It would be much better to

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<sup>24</sup> For instance in defining the tax base or in discretionary rulings of the tax authorities granting tax exemptions.

let regions and municipalities find out themselves that subsidies may very well represent an inefficient way to spend tax revenues because money is wasted. In no case should the EU prevent locational competition for instance by means of local or even regional infrastructure outlays. Thus, it should be possible that communities engage in developing site-locations in order to attract firms and then join them as venture capitalists by providing the locations space. Only if local and regional subsidies are used to hide national subsidies in a sizable way is subsidy control at the European level required. Co-financing should not be a vehicle for the EU to stipulate conditions for government spending on the national and regional level. In any case, co-financing should be cut back in order to make responsibility of the different layers of government more explicit.

The criterion of functioning markets implies that abrupt national measures according to Article 30 disrupting the functioning of markets should be prevented. An important remedy is minimum standards (see above) that, however, should not do away with institutional competition.

The criterion of functioning markets also relates to factor markets. On the capital market, institutional conditions must be such that capital can go to the best use. This means that segmentations should be abolished. For the financial sector, the common market increases interdependence including the risk of contagion; therefore rules must attempt to prevent a banking crisis from spreading. Some standards such as capital adequacy requirements must be uniform in the EU. Banking regulations can be done by national supervising agencies; however, these agencies have to coordinate their activities (Padoa-Schioppa 2001).

*Public goods, fiscal equivalence and the subsidiarity principle*

Another aspect of the functioning of markets are public goods, defined as goods being consumed in equal amounts by all (Samuelson 1954) like safety in the streets or the Ozone layer. Motivating governmental activities by the existence of public goods, the different spatial dimension of public goods implies that according to the subsidiary principle, these should be provided on that spatial level that is best equipped to organize their supply. This implies that public goods of a limited dimension in space should be provided on the local or regional level, those of a larger spatial size should be supplied on the national level and that Europe-wide public goods are to be dealt with on the European level. The concept of allocating competencies according to the dimension of the public good ensures that the different layers of government are best informed on the specific conditions relating to their function and that the political expression of the preferences of voters can best be organized on the different levels.

The allocation of competencies according to the dimension of public good is analogous to the principle of fiscal equivalence (Olson 1969) according to which the spatial dimension of users, payers and decision makers should be identical. If the spatial delineations of these three groups differ, distortions arise. A similar result is obtained by the principle of subsidiarity. The main message of this principle is that a transfer of competences from a lower to a higher political level leads to neglecting individual preferences if the higher level does not correspond to the spatial dimension of the public good (Oates 1972). If all public services are supplied by a central government body, the volume of the supply always reflects a compromise between varying needs

of different regional groups of consumers. Thus, as a consequence of a transfer of competences in favor of the EU Commission, some groups of consumers become “forced riders”, i.e. they are forced to consume a higher quantity or quality of public goods and services than they prefer, while other groups of consumers will suffer from welfare losses because of an undersupply with public goods and services.<sup>25</sup> Besides this Oates effect, there is another welfare loss in case of a centralization of competences: The opportunity costs of supplying the public good become blurred when competences are centralized on a higher government level. The free rider problem is aggravated. Demand may become less elastic relative<sup>26</sup> to the true price if part of the costs are shifted to a higher level. Prices get distorted.

As a general rule, the economic principle of subsidiarity recommends that economic competences should be transferred to the lowest possible government body. Only if a transfer of competences to the supranational level leads to efficiency gains that exceed the welfare losses due to a centralization, national and regional responsibility should be replaced by supranational competences. This concept of fiscal federalism presupposes not only an optimal allocation of different tasks; it also implies that different layers have the instruments in their hands to fulfill their task, i.e. the right to spend and the right to tax.

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<sup>25</sup> See footnote 12.

<sup>26</sup> Stehn (1997) attributes this to higher information costs of the consumer.



*Which public goods to the central level?*

The public goods concept leads to similar results as the criterion of the functioning of markets (which corresponds to the four freedoms). The common institutional frame should guarantee the openness of markets. Trade policy and competition policy therefore are to be organized on the European level.

Another candidate for common policy is the environment. Here, a more delicate analysis is required. In the case of environmental media, a common institutional arrangement at the European level only becomes relevant if the public good, i.e. the environment, is of a Europe-wide dimension, or of an even larger dimension like the global atmosphere. If the environment has a national spatial dimension only, a European approach is not well founded. National regulations can then compete with each other, minimum standards may be a way to prevent disruptions of markets by unilateral measures. Transfrontier pollution through rivers or pollution of environmental media jointly used such as the Mediterranean or the Baltic Sea do not have a Europe-wide spatial dimension in a strict sense and therefore should be dealt with on a bilateral or multilateral level of the countries concerned. The EU can develop a frame of procedure. Positive spillovers in other areas such as railroad networks or energy networks do not represent a public good in the strict sense. Here coordination helps to reduce transaction costs; however, a European approach and European financing are not needed.

It is important to clearly distinguish public goods from merit goods that are considered as meritorious and desirable by some or even quite a few. What applies to public goods does not hold for merit goods. The provision of these merit goods should be left to the regions or nation states as long as Europe has not developed a democratic method of aggregating individual and national preferences by voting. Merit goods should be decided on a European level only when the democratic deficit is reduced.

In the case of networks, some coordination may be needed so that networks are not hindered by borders. Thus, the network should have similar physical characteristics. This, however, does not mean that networks are public goods of a European dimension and should be financed on the EU-level. Take rail-road tracks. Not every transfrontier track is a European public good. Where the benefit of transfrontier connection accrues overwhelmingly to only two countries financing should be done by these countries (Bröcker 2001).

In the area of research policy, a transfer of certain competences to the supranational level might be in accordance with the economic principle of subsidiarity. The argument is that basic research, especially with a view to high-technology R&D, can be expected to generate considerable cross-border spillovers giving rise to an almost free dissemination of basic knowledge; basic knowledge is hardly codifiable and thus cannot be patented. In this case, cross-border externalities can lead to an underinvestment in basic research activities that can only be prevented by a transfer of responsibilities from the national to the supranational level. However, dissemination of basic research cannot be limited to the EU; thus

the argument of underinvestment holds on a world-wide scale. Moreover, competition in basic research may be an important driving force to expand the technological frontier. Then duplication of research efforts is necessary to obtain results.<sup>27</sup>

It is hard to see that industrial policy can be justified as being related to a public good of European size. Where is the public good aspect of industrial policy? Moreover, there are some serious stumbling blocks. First, the Commission does not have the knowledge which new products and sectors will flourish in the future that is necessary if sectors are to be targeted. Second, the concept of strategic trade policy may prove to be extremely misleading. Third, subsidies used to promote specific sectors may be wasted in the end.

#### *Decentralization of wage formation*

With respect to the labor market, only rules securing the free movement of labor are needed on a European level. All the other rules must remain national. As a guiding principle, we have to start with how market processes would work. Looking at wage formation, wages should be found in the different segments of the labor market, be it by qualification or by region,

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<sup>27</sup> This argument of spillovers is not to be mixed up with the longstanding debate about the implementation of fair criteria for the distribution of funds among the member states. One school of thinking argues that research funds should flow overproportionally to rich countries because these countries would realize the highest technological potential and subsequently the highest gains from research funds. Another school of thinking points to the fact that a distribution of funds in favor of rich countries would counteract the objective of the common regional policy because the implementation of a basic technological potential is a necessary prerequisite for a successful catching-up process of the less developed regions in the EU.

such that a near- or full employment equilibrium is found. Labor productivities exhibit a marked divergence between the members of the European Union, both with respect to the level as well the rate of change. It would make no sense at all to harmonize wage formation in the European Union as is sometimes suggested. If countries practice collective wage bargaining on the national or sectoral level, they should make sure that wage increases in real terms do not surpass the national productivity growth. This, however, is only instrumental in securing a given employment level; unemployment remains constant with such a rule. If countries want to reduce their unemployment rate, wage increases should remain below the productivity trend of the past or should reflect the future productivity increase that is in line with full employment. In an economy with heavy unemployment, such a productivity increase is lower than the past trend since the workers to be integrated into employment will exhibit a lower productivity than the average of the employed and thus reduce productivity growth. Moreover, national economies must find a way to differentiate the wage structure.<sup>28</sup>

Employment being a national responsibility, employment policy must be national as well. To organize employment policy on the European level and use national contributions to the EU budget or tax revenues for this purpose, would allow the governments of the member states to shift responsibility to the European level and to use the EU as scape goat thus hurting the European cause if unemployment actually rises. National contributions and

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<sup>28</sup> This is also necessary in order to reduce the adjustment cost from Eastern enlargement due to immigration.

tax revenues would be used in favor of the countries that perform poorly. Countries which reduce unemployment would pay the contributions. Such an approach would represent the wrong incentives.

*Social union simply not feasible*

A social union, that is a common European framework of social insurance systems for health, unemployment and retirement as well as social welfare is simply not feasible. Actually, these systems have different levels of benefits in the different countries, and consequently their costs differ considerably. Whereas in all countries social welfare is financed by taxation, the other systems are financed by a tax on labor with different percentages paid by the workers and the firms. For instance, in the UK the costs paid by the employer are only half of what German employers have to contribute. Labor productivity being divergent between the European countries is already a sufficient reason not to harmonize social security systems. They must be organized according to the territorial principle in national systems: benefits are provided by the national system to those who have contributed to that system. This does not preclude that the issue of portability of claims in order to allow the mobility of people is to be solved.

*Agricultural policy not essential*

Eastern enlargement accentuates the problems of common agricultural policy. In agricultural production the European Union reaches high levels of self-sufficiency of above 100 percent in important areas, for instance 132 percent for sugar, 112 percent for wheat, 105 percent for meat (poultry, beef, pork, data before the mad cow and mouth and foot crises) and 106 to 104 percent for butter, milk and cheese. The common agricultural policy

uses price supports, import tariffs<sup>29</sup> and export subsidies. In order to reduce the role of price supports and export subsidies the EU has introduced production quotas, for instance the milk quota, and has compensated farmers by direct transfers instead of production oriented subsidies. Agricultural policy involves expenditures of 44 billion euro and accounts for 46 percent of the EU budget in 2001.

Even without an Eastern enlargement the common agriculture policy comes under severe pressure: From a global perspective Europe's agricultural protection cannot be justified because it takes away growth opportunities from other economies especially the developing countries. Their production and markets cannot evolve and expand if agricultural exports of developing and newly industrializing countries are prohibited to enter the EU market. What is even worse is that the EU dumps its subsidized agricultural products on the world market reducing prices for agricultural exporters. In the context of the next WTO round the EU is in an untenable position. Therefore, agricultural policy on the European level becomes less and less essential.

In the concept of the very essentials, the agricultural market must be Europe-wide. Border controls cannot go together with a single market. This, however, does not imply that agricultural policy must take place on the European level and that it has to be financed on the European level. A distinction of different aspects of agricultural policy becomes necessary

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<sup>29</sup> Variable levies that in the case of imports adjust the lower world market price to the higher European level have been substituted by fixed import tariffs after the Uruguay Round. Variable levies still apply in the case of cereals.

(Wissenschaftlicher Beirat beim Bundesministerium für Ernährung, Landwirtschaft und Forsten 1988):

Market policy in the narrow sense (import duties, export subsidies and intervention prices) — the so-called first pillar of agricultural policy — relates to the function of markets and therefore has to be assigned to the European level. However, these measures lose importance. The more Europe's agriculture is integrated into the world economy, the less is the need to have agricultural policy instruments on the European level. That aspect of agricultural policy is not essential. Other aspects of agricultural policy such as consumer protection, prevention of cruelty to animals, environmental issues and structural as well as regional policies for the countryside — the so-called second pillar — do not represent essentials and can be decentralized. They may even be financed on a regional level.

For the politician the simple argument may be more convincing, that the CAP can simply no longer be financed if it is applied to the new EU members in the existing form. These countries do have a high production potential for agricultural products. This will be stimulated by price supports and export subsidies. Older estimates indicate that EU expenditures for agriculture will increase by 13 to 15 billion euro per year in a first wave of EU enlargement (Tangermann 1997). This would correspond to an increase in current CAP expenditures of about 40 percent. Additional costs in the same range would accrue following a second wave of Eastern enlargement. More recent estimates indicate somewhat lower figures.<sup>30</sup> However, at this

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<sup>30</sup> I owe this information to Stefan Tangermann.

moment it is unclear how the system of direct transfers that are not coupled to production is to be applied to the new members; applying the system of direct transfers to the new members would raise the costs estimates. To sum up, the EU has not done its homework in agricultural policy for Eastern enlargement.

*Structural funds have to be redesigned*

In regional policy, regions of the EU are actually subsidized with 33 billion euro in the structural funds accounting for 34 percent of the EU budget (2001). The transfers are intended for areas where GDP per capita is below 75 percent of the EU average. Although the Structural Funds are designed above all to support the development of backward regions, almost 50 percent of the funds were directed towards member states with per a capita GDP at or above the EU average. However, a more detailed analysis of the distribution scheme which takes into account different country sizes reveals that per capita transfers increase as per capita GDP declines. The same holds true for the share of transfers in national GDP (Stehn 1998, Tables 3 and 4).

In an enlarged union the distributional target has to be defined differently from a smaller union because of a larger heterogeneity in GDP per capita (see below).<sup>31</sup> Consequently, it is necessary to reduce the threshold value of 75 percent and work with lower subsidies relative to the pre-enlargement status. If regional funds are continued in their existing form additional financial means will be needed. According to the official financial forecast

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<sup>31</sup> In the candidate countries the threshold of 75 percent actually is only surpassed in the region of Prague and Bratislava (1998).



of the EU, in the year 2006 an additional 13 billion euro are necessary. If one assumes a continued distribution of Structural Funds according to member states' GDP, other estimates yield an estimated financial burden of about 20 billion Euro a year as a result of the first wave of Eastern enlargement. This would correspond to an increase in Structural Funds expenses per year of almost 76 percent and a share in the GDP of the 15 EU member states of 0.34 percent. According to the report of the budgetary commission of the European Parliament the additional costs of enlargement in the areas of agriculture and structural funds could amount to 390 billion euro up to the year 2015. The additional cost of extending the Structural Funds to the ten Middle and Eastern European states could easily reach 0.7 percent of the GDP of the 15 EU member states, absorbing more than 50 percent of the EU's total current budget. The above estimates show that full membership of the young market economies in Central and Eastern Europe will push the EU budget out of balance. Under these conditions, an increase in the financial contributions of the "old" member states would be unavoidable.

Changes in the Structural Funds have to be made before Eastern enlargement because afterwards the new members in Middle and Eastern Europe will have a blocking minority. How difficult it is to change the structural funds becomes apparent in the cohesion funds, originally conceived to help countries like Ireland and Spain to prepare for monetary union; the cohesion fund continues to exist with a volume of two billion euro per year even after these countries have successfully joined the monetary union. In Nice, unanimity in the case of structural funds (article 161) could not be abandoned because of strict Spanish opposition.

Any successful reform would strengthen the basic objective of the Structural Funds, that is, the promotion of the EU's most backward regions, in order to secure the acceptance of the integration process as a whole. This could be achieved by restricting access to the Structural Funds to those member states with per capita GDP below the EU average. As a consequence, only Spain, Portugal, Greece and the new members Slovenia, Czech Republic, Estonia, Hungary and Poland would be eligible to regional transfers in a wider EU-20. The size of the transfers should vary according to per capita GDP and should decrease steadily in line with a growing income level in these countries. In order to partially compensate for lost access to the funds on the part of the richer member states, the total budget should be fixed at the current level so that national contributions to the EU budget can be reduced as the poorer member states catch up with their richer partners. It is to be feared that the conflict will be solved by an expansion of expenditures.

It is difficult to see how the upper limit for EU expenditures of 1.27 percent of GDP of all member states will not be surpassed in the future.

*On the issue of an optimal macroeconomic policy mix*

On the macroeconomic level, the issue arises to what extent macroeconomic policies should be coordinated. This question is especially relevant since monetary policy now has been Europeanized whereas the other areas of macroeconomic policy are still national. One approach is to limit negative spillovers between the different macroeconomic policy areas. Thus, the stability pact is intended to control excessive fiscal deficits and in this way

to protect the ECB and the Euro against free rider behavior of individual nation states. A rule that real wage increases in the different countries should not exceed productivity growth<sup>32</sup> would help to prevent a negative spillover in the sense that national unemployment is not aggravated. Other attempts of coordination represent a form of atmospheric coordination including mutual information.<sup>33</sup>

With respect to generating positive spillovers between policy areas, we have many models which prove that coordination among the macroeconomic policy areas is Pareto efficient. Alas, these models very often start from simple assumptions. The problem is that responsibility of policy actors becomes blurred and that one actor can put the blame on the other, including the other member state or the European level. In my evaluation, macroeconomic policy coordination will only be of a limited scope. One positive aspect is mutual information so that national policy makers are informed on what is intended elsewhere and start from a common frame of reference. Partly, coordination will have to rely on moral suasion for instance if a country with high growth rates benefits from the low interest rates of the ECB and is not willing to reduce its governmental absorption. Within the model of bare essentials, national parliaments are sovereign; binding coordination is unlikely. Finally, most of the coordination

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<sup>32</sup> This rule seems to be implicitly followed by European trade unions.

<sup>33</sup> This relates to the Cardiff-Process which is intended to foster economic reforms in the labor market, the Luxembourg process which is intended to increase employment, and the Cologne process whose purpose is intended to deepen the macroeconomic dialogue. These process represent declamatory coordination.

philosophy is based on extremely simple and naive Keynesian ideas of controlling and fine-tuning aggregate demand over the cycle; inside and outside lags are neglected. Moreover, the political process is unable to smoothen government expenditures over the cycle. While additional spending in a recession is grabbed wholeheartedly by the political process, reducing demand in a boom is unlikely to take place. A Jospin fund for stabilization policy at the EU level also stems from a misleading concept.

#### *Allowing variety*

Looking beyond Eastern enlargement, there are more serious questions than the ones we just discussed. For instance, Norway and Switzerland — not yet members of the EU — are characterized by special conditions. Norway heavily depends on the fisheries and its oil reserves.<sup>34</sup> Switzerland has a long tradition in a well established direct democracy that should be accommodated adequately in a European framework of decision making. A European institutional framework should take into account these special conditions and not plough them under a common European set of rules; the framework of the EU should be adequate for both countries.

#### *Essentials enforced by locational competition*

The strategy of looking for the very essentials of a common market is enforced by Europe facing locational competition in the world economy (Siebert 2000). As any other region of the world, the EU competes for the mobile capital, the mobile technical knowledge and the mobile highly

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<sup>34</sup> Norway may esteem its autonomy especially since it became independent in 1905 only.

qualified workers. The institutional frame of the economy (including taxation) must be such that these factors are attracted and kept at home. Benchmarking is a necessary element of locational competition.<sup>35</sup>

*Economic dynamics via market processes*

To look for the very essentials in the framework of an enlarged European Union implies saying “No” to a transfer union. In any case, enlarging an economic union necessarily means accepting a larger dispersion in income per capita.<sup>36</sup> This becomes apparent if we look at a function between equity being defined as some aspect of income distribution on the one hand and economic size on the other. With a larger size, the equality target has to be lowered. It is even lower than in the EU if we consider the whole world. An enlarged union can not have the same distributional target as a smaller union. In addition, the democratic deficit does not give a legitimate basis for sizable transfers on a European level. A distributive federalism cannot be the road for Europe if Europe wants to be a dynamic region of the world economy.

Following the concept of looking for the very essentials and leaving space for decentralized solutions, Europe’s economic dynamics comes from the

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<sup>35</sup> Note however, benchmarking only attempts not to fall behind others. It is not a vehicle to take leadership in innovation.

<sup>36</sup> This is in contrast to the Jospin (2001) concept of Europe which stresses the distributional aspect between nations in the EU without being prepared to cede national sovereignty. This means that distribution is done without democratic legitimacy.

markets and not from politics. The politicians who would like to see a strong Europe in the world economy make use of the markets to gain increased dynamic efficiency. Europe then would apply a similar strategy as the US which relies heavily on the efficiency of markets. For such a strategy, we do indeed need a discussion on the essentials.

#### **IV. In search of a Constitution-Like Arrangement**

To look for the very essentials of an enlarged European Union follows from the democratic deficit. The alternative is to reduce the democratic deficit. This means to search for a transition to some constitution-like arrangement in which the national member states cede some their national sovereignty and in which the European level receives an improved democratic legitimacy. As Winston Churchill put it: “We must build a kind of United States of Europe”. This raises complex issues.

##### *Constitution building — A visionary frame of reference*

A rough picture would imagine an improved democratic legitimacy of the European level as follows: More decision power is given to the European parliament.<sup>37</sup> This implies that national parliaments cede some of their competencies. The European parliament can be conceived as a two- chamber system. For the first chamber representatives would be elected, for instance by a majority rule for each election district; a second chamber would represent the member states. The electoral districts for the election of the members of the first chamber should be delineated such that each district

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<sup>37</sup> See the German proposals by Fischer (2000), Rau (2001) and Schröder (2001).

represents a similar percentage of the population. The second chamber should represent the member states, ideally by electing the representatives of the member states directly (as in the US Senate). The Commission represents the European government. A constitution-like system of rules would define the competencies of the European parliament, its two chambers, the Commission, the member states and the regional level in the member states.

To describe the future road in this way exhibits all the problems that an enlarged Europe faces.

With respect to the basic concepts, different historical experiences in the countries of Europe exist. This means that the concepts are diverging widely and that even words have different meanings. For a German, a federal state (Bundesstaat) implies the sharing of responsibilities and also some control of central power by the regions. In the UK, the term itself seems to have a negative connotation and is associated with an agglomeration of power at the center and a loss of individual freedom. In France, the concept of L'Etat is not seen as a combination of somewhat autonomous regions and a central layer of government but as a hierarchical order with centralization.<sup>38</sup>

Talking of a constitution-like arrangement (Verfasstheit instead of Verfassung, Mestmäcker 2000) is difficult to understand in the United Kingdom where a written constitution does not exist and does not need to exist. But

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<sup>38</sup> Compare Jospin's plan (2001) of an upgraded European Council and a *Conseil Permanent des Ministres*.

even with an explicit constitutional approach in the German or French interpretation, a democratic state and therefore a constitution presupposes that there is a people as the sovereign. But a European people does not (or does not yet) exist. Moreover, a European public opinion does not exist as well. Thus, the role of a European parliament must necessarily be limited in scope. Consequently, giving up national sovereignty must be limited as well. The concept of a European people is immediately relevant when burden sharing for a common cause is at issue. In a political sense, solidarity seems to be defined mainly within the national boundaries. From this it follows that the preparedness to give up some national sovereignty will be a function a European people evolving, in other words of national identities becoming weaker.

At the core of this debate is taxation. Ceding national sovereignty would imply shifting the power to tax, the power to spend and the power of the budget to the European level. This would mean that a European institution such as the European parliament would be authorized to decide the type of tax, the tax base and the tax rate for the individual tax payer; it would also be able to decide that a tax collected in country A can be spent in Country B, either explicitly or implicitly. For instance, tax revenues could be used for infrastructure or to finance a Europe-wide tax-transfer mechanism that has as its strategic variable the level of personal income.

From historical experience we know that the principle “no taxation without representation” is the basis of democracy. In a European Union I doubt that the citizens will be prepared to accept a system in which a European institution has the power to tax and the power to spend the tax revenues if this



institution lacks a democratic legitimacy, that is if it cannot be held responsible by the voter. Here is the crucial point in the future development of Europe.<sup>39</sup>

It is indeed hard to image how the process of ceding national sovereignty will look like in the next twenty years. Barring unnecessary regulations, some common rules guaranteeing the functioning of the product and factor markets are likely to be accepted by the population, for instance rules relating to the access of new firms to the telecommunication sector or to capital requirements for banks. The disadvantage that these matters can no longer be regulated on the national level is more than compensated by the obvious benefit of common procedures in a larger market. One can also imagine that in the future a consensus is found on some common rules concerning the type of tax system such as the relevance of indirect taxation versus direct taxation, and the definition of the tax base. Minimum tax rates are another example. In these areas, the loss of sovereignty is limited especially since unanimity is still required in issues of taxation.

In questions going beyond these issues a further evolution in the existing system of intergovernmental decision making is hard to imagine. This also holds for new taxes like the ecotax if it would be raised on the European

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<sup>39</sup> Politics will try to find hybrid solutions. An example is an ecotax along the German concept as a tax revenue for the European level. I fear that such taxes if not accompanied by adequate representation of the citizen will backfire in that the support for the European cause is lost. A true ecotax would favor the countries that rely on atomic energy and the sunshine state that can substitute fossil fuels by solar energy. The tax burden would be with the other countries.

level. Therefore, it is correct that the EU does not have its own right to tax and that the budget of the EU is coupled to the contributions of the member states as long as the control by parliament and the democratic control by the voter of government spending is not established.

An additional issue is to what extent the European parliament, if more power was given to it, would be able to control expenditures. Under given conditions, it would be normal that the European parliament is inclined to promote the European cause. How easy to do this with additional expenditures. Moreover, conflicts between spatial interests can most easily be solved by increasing spending. From this it follows that the propensity to spend will be systematically higher in a parliament of regional integration. Therefore, exogenously given and explicit constraints on spending and taxation are needed. It is an open question how these constraints can be defined.

We cannot expect that the European Union will spontaneously find a new constitutional-like arrangement in a unique and single enthusiastic awakening of the population. The time in which the young people have torn down the border posts as after the war are gone. A movement supported by the enthusiasm of the people to a new shape for Europe is not visible. The societal, cultural and political space of the Europe of 27 is likely to be too heterogeneous for such enthusiasm; Europe seems to be less of a dream and more a technical solution to the problems of the day.

The lack of support of the population illustrates the dilemma for future European development and at the same time the difficulty of the post-Nice process which should clarify the next constitutional-like steps.

The preparedness to give up national sovereignty varies considerably between the European countries. There seems to be some willingness to give up national sovereignty in the Benelux countries and in Germany. This seems to barely be the case in the UK and also not in France. For many citizens on the British isles it is simply not conceivable that major decisions are shifted to the European level even if the institutions there have a democratic legitimacy. France has a strong historically grown national identity which it is very reluctant to give up.

In a way I have described the difficulties that lie ahead without really providing a very specific answer to what should be or can be done.

Taking the lacking preparedness to cede national sovereignty as given we are back to the question what are the essentials to be solved on the European level. A first answer has been to look for the very essentials for the functioning of a single market.<sup>40</sup> A second, albeit related answer is the concept of fiscal federalism already discussed. This concept is a necessity anyhow, even if a democratic legitimacy can be obtained on the EU level. In order to give some flesh to this concept of fiscal federalism, it is promising to look at historical and practical experiences where competencies have been defined for the different layers of a political entity. The writings of Alexander Hamilton (1787/88) in the Federalist Papers on the constitutional problems of the young United States provide illustrations of many issues for

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<sup>40</sup> Some see the hope in Stagno-Europe which once it becomes apparent requires a process of developing the “essential“ vision discussed in Part III of the paper more explicitly.

which solutions have to be found in the European context; admittedly these will have to be solved in a different way in Europe. Analogies may also be found in nation states with a strong federal structure, where important aspects of political and economic decision making like taxation are decentralized and where the central layer of government is kept weak deliberately. Switzerland may serve as an example, albeit without its direct democracy.

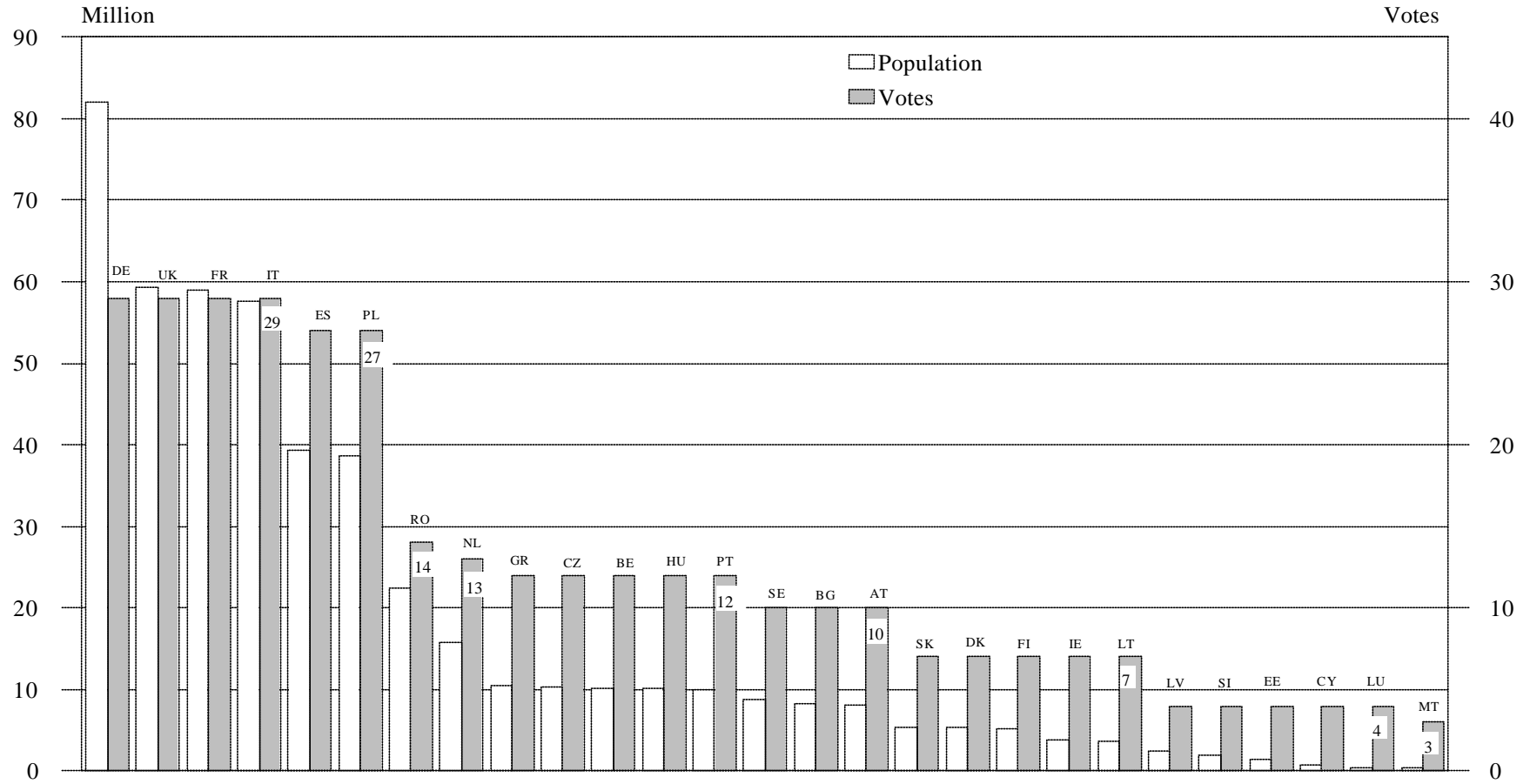
*The deficiency of the Treaty of Nice*

The Treaty of Nice is an attempt to prepare the Union of 15 for the Union of 27, to find an answer to the issues raised by enlargement. Except for new rules on how to organize the European Commission and the ECB council (Baldwin et al. 2001) the weighting of votes in the European Council has been altered. 29 votes are allocated to the four larger countries Germany, the United Kingdom, France and Italy, 27 to Spain and Poland and the remainder graduated to the other countries (Figure 1).<sup>41</sup>

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<sup>41</sup> The abbreviations are as follows: AT: Austria, BE: Belgium, BG: Bulgaria, CY: Cyprus, CZ: Czech Republic, DE: Germany, DK: Denmark, EE: Estonia, ES: Spain, FI: Finland, FR: France, GR: Greece, HU: Hungary, IE: Ireland, IT: Italy, LT: Lithuania, LU: Luxembourg, LV: Latvia, MT: Malta NL: Netherlands, PL: Poland, PT: Portugal, RO: Romania, SE: Sweden, SI: Slovenia, SK: Slovak Republic, UK: United Kingdom.

Figure 1 — Population and Nice-Allocation of votes



The EU of 27 will have 345 votes. Then a qualified majority, now at 68 of 87 votes or 71,26 percent, requires 258 votes (or 74,79 percent) and the majority of members.<sup>42</sup> The blocking minority is 88 votes. If not all candidates have joined the European Union when the new weighting becomes effective by January 1, 2005, the threshold for the qualified majority will be moved up from a value below the actual level of 71.26 percent to a maximum of 73.4 percent. Then the blocking minority will be 91 votes<sup>43</sup> and qualified majority will be 255 votes (73.91 percent) instead of 258 votes. Regarding a veto, three large countries cannot block a decision. They can be overruled. In order to prevent this, they would have to win another country for their position. The traditional core countries Germany, France and Benelux do not have a blocking majority. If France is considered to be a Mediterranean country, this group has a veto. The Middle and Eastern European countries also have a blocking minority.

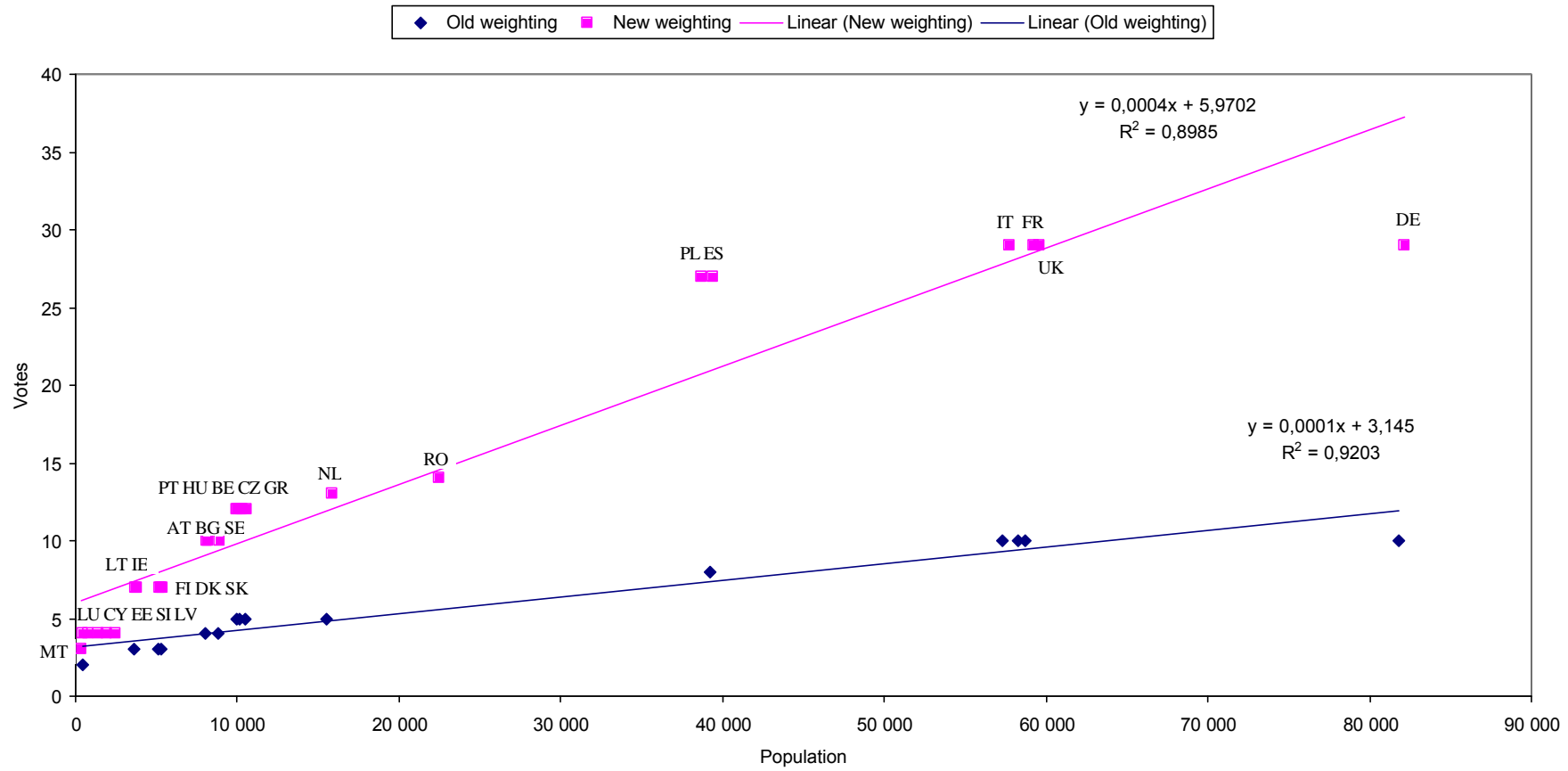
The slope of the regression lines between votes and population indicates that a little bit more weight was given to the size of population (Figure 2). But in contrast to the weighting in the EU-15, more distortions have been introduced. Thus, Spain and Poland now have a weight of 27 votes that is not proportional to their population. Germany with 82 million people has

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<sup>42</sup> In the Amsterdam Treaty, the allocation of votes is dealt with in Article 205. The Nice allocation of votes is treated in Article 3 of Protocol A of the Nice Treaty (Declaration 20 Official Journal of the European Communities, 10.3.2001, C80/80 und 82, Table 2). As an academic being used to disentangle more complex issues I must state that it is a pity how little care the EU takes to explain a New European Treaty to the citizen of Europe. This is not the spirit from which support for the European cause can arise.

<sup>43</sup> Declaration 21, Ibid 80/85.

Figure 2 — Pre- and Post-Nice Allocation of votes and Population (with linear regression)



only marginally more votes than each of these countries with half the population size. In the case of Germany, there is also a distortion relative to the three other larger countries. In order to mitigate that problem, a member state can request that a qualified majority also must represent the majority of the population, specified as 62 per cent of the population. However, such a demand may have the bad odor of disturbing the friendly atmosphere and may appear extraordinary. In contrast it is self-evident in a democratic setting that a qualified majority must represent the majority of the population.

Applying the two-point equation for straight lines shows that taking the four smallest countries (Malta, Luxemburg, Cyprus and Estonia) and France as well as Italy as the two coordinates, the medium sized countries (from Slovenia to Romania) have received an overproportional share of the votes (Figure A1 in the appendix). Admittedly, it would be correct that votes in the European Council should not be proportional to the population if the Council develops into a second chamber, because a second chamber should have an integrative function. But this is a long way to go. It seems that national interests have played a major role in determining the Nice-weighting.

The change of the weighting of votes of member states does not mean an improvement in the sense that the weighting of votes now would more adequately represent the size of the population. It is to be feared that it will become more difficult to reach decisions in a union of 27 and that blockades become more likely. One reason is that the threshold for a qualified majority has been raised while at the same time the number of members



has been increased. This means that the system moves more towards unanimity; it becomes more difficult to reach a decision. A second reason is that coalitions blocking a decision become more likely. Baldwin et al. (2001) argue that the Council's ability to act will be massively slowed. They use passage probability of a proposal being defined as the number of winning coalitions to all possible coalitions. Their result is that passage probability will be reduced considerably by the new voting allocation (Baldwin et al., p. 12). An open question is whether the allocation of votes may even be a source of future internal conflict.

Above all, with respect to the important aspect of changing intergovernmental cooperation, Nice has not changed this institutional arrangement. This means that the democratic deficit has not been reduced, it continues to exist and has been aggravated in an enlarged union. A correction of the Nice weighing of votes in the future seems to be extremely difficult especially after the new members have entered. Nice has tied down vote allocation. It has failed to grasp the opportunity to give integration an additional push.

### *Variable Geometry*

The European Treaty allows member states to form special clubs that intensify their cooperation in specific areas such as border controls (Schengen countries) or Monetary Union. Countries may move at different speeds of integration. According to this approach, the dynamics of integration is provided by a subset of the member countries. Member countries may be given the right to opt out. Opting out, that is granting an exception, may be a dangerous strategy for a union because it leads to a greater heterogeneity in the institutional arrangements. An opting out clause can be

granted only in most unusual circumstances when otherwise the union can not be held together. The EU is a single undertaking, and the net benefits come in a package.<sup>44</sup>

Different speeds and variable geometry cannot, however, relate to the essentials of a union. They must refer to additional steps that one may consider as desirable but not strictly necessary. A variable geometry also cannot solve the core issue of a democratic void; it is simply not conceivable that a European Club as a subset of member countries develops a separated constitutional arrangement diverging from the other members, including for instance parliamentary voting and taxation. Thus, the strategy of multiple speeds can only be applied in the context of intergovernmental decision making. It is not suitable for a more intense form of integration. Variable Geometry or separate speed can only be an intermediate step of integration.

## **V. Conclusions**

I draw the following conclusions:

1. Intergovernmental cooperation is unlikely to work in a European Union of 27. It will become more difficult to reach decisions.
2. Europe has a choice: Either it looks for the very essentials and trims the *acquis communautaire* accordingly allowing more variety in an enlarged

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<sup>44</sup> Compare the concept of single undertaking in the WTO.

union. Or it develops an institutional arrangement by which national sovereignty is — partly — shifted to the European level.

3. The condition for an intensified political integration is that the democratic deficit must be overcome.

4. If both solutions cannot be implemented, we have to take into account a speculative scenario of Stagno-Europe: Decision making in the EU will be blocked, dynamics and vitality will be lost, the integration process comes to a halt and Europe's position in the world economy will erode.

Coming back to the sombre dictum of Lord Grey of Fallodon, Europe has moved forward in the second half of the last century. This may encourage us with with Thomas Jefferson:

“I like the dreams of the future better than the history of the past”

More realistic is the assessment of Paul Henri Spaak, the Belgian European<sup>45</sup>: “Only those can be discouraged who think that Europe could be created by a >>Sesam open<< or by a huge wave of enthusiasm. No such thing will happen. An organized and united Europe will be the result of long and hard labour.“

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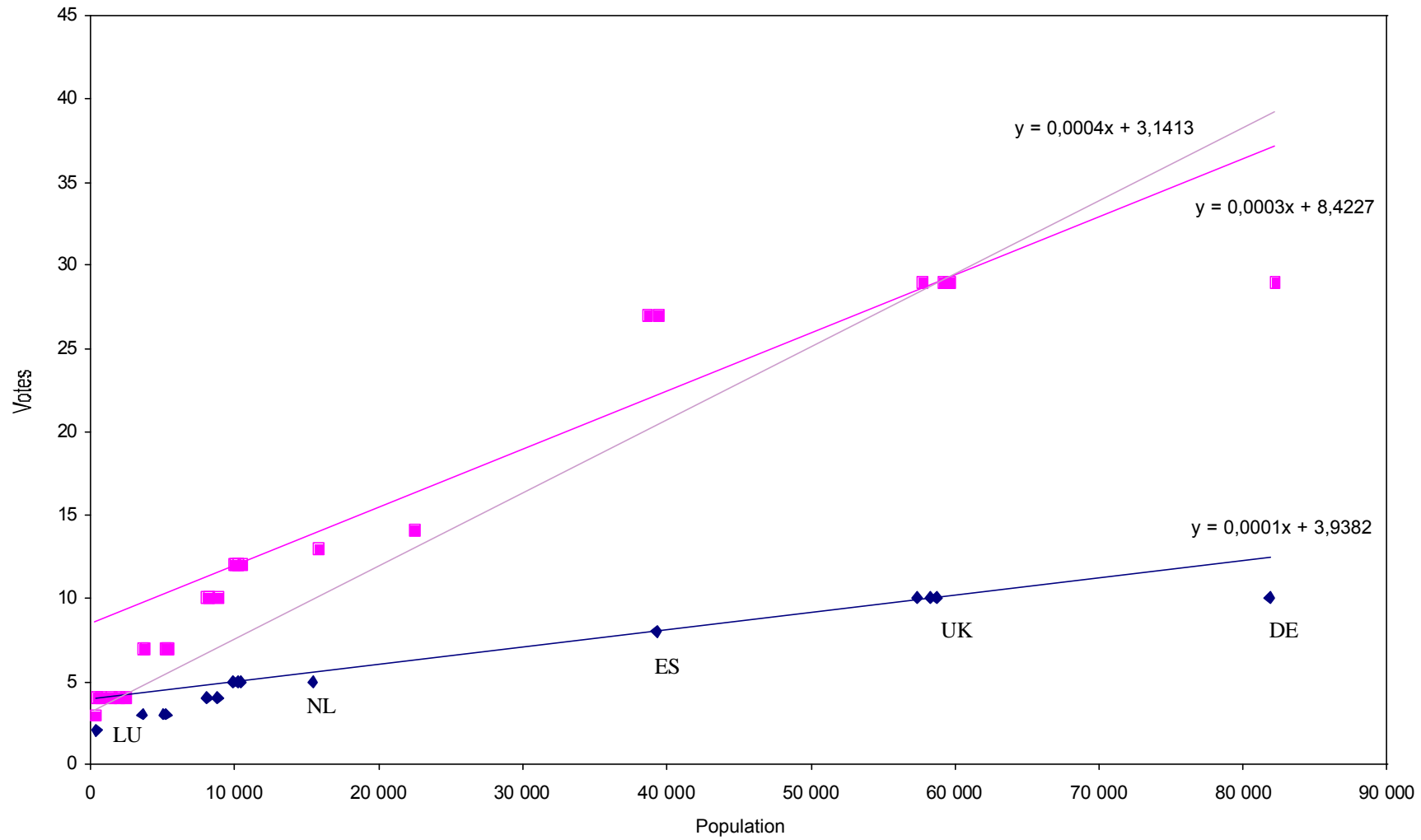
<sup>45</sup> Translation of the Author.

Table A1 — Candidate Countries 2000

	Bulgaria	Czech Republic	Estonia	Hungary	Latvia	Lithuania	Poland	Romania	Slovakia	Slovenia
GDP per capita in current prices and exchange rates <sup>a</sup> in percent of EU-average	7	23	16	21	11	13	18	7	16	44
GDP per capita in purchasing power in percent of EU-average	24	58	37	52	29	29	39	27	48	72
Unemployment rate <sup>a</sup>	17,8	8,7	13,2	6,5	14,4	14,7	16,7	8,4	18,9	7,2
EU share of total exports of each country <sup>a</sup>	52,6	69,2	72,7	76,2	62,5	50,1	70,5	65,5	59,4	66,0
Share of EU inward FDI as percent of gross investment <sup>b</sup>	4,4	4,9	10,9	4,3	5,9	8,6	4,0	5,0	2,7	1,0
Share of EU inward FDI as percent of GDP <sup>b</sup>	1,6	3,0	6,1	3,4	0,9	3,3	2,7	1,1	1,2	0,9
a1999. — b1998.										

Source: Silke Stapel: The GDP of the Candidate Countries. In: Statistics in focus, Economy and Finance, Theme 2, 18/2001. Eurostat. – Paolo Passerini: EU FDI with Candidate Countries: an Overview. In: Statistics in focus, Economy and Finance, Theme 2, 26/2000. Eurostat. – European Commission. Enlargement Strategy Paper 2000. Report on Progress Towards Accession by each of the Candidate Countries. – European Commission: Economic Developments in the Candidate Countries in 2000. In: European Economy. Supplement C. No. 3, November 2000. – Eurostat Yearbook 2001.

Figure A1 — Allocation of votes in the EU (straight lines calculated with the two-coordinate formula)



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