European Integration, 1950–2003

Superstate or New Market Economy?

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The Liberal Project for an Integrated Europe

THERE *was* a liberal project for an integrated Europe, even one *avant la lettre.* Its author was the Austrian economist Friedrich A. Hayek.[1] He ranks alongside Jean Monnet and many others as one of the founding fathers of the new era. Hayek's work inspired both Ludwig Erhard, who turned West Germany into the engine and model of European economic growth, and Margaret Thatcher, the moving force behind the Single European Act, which restarted the integration process in the late 1980s, as well as many others who have followed their footsteps. Hayek discovered the logic underlying the integration process. It is as relevant now as ever. Hayek postulated that the competition principle, if allowed to operate, sets in motion a mutually reinforcing reciprocal process in which the market and self-government together reduce interstate conflict and promote economic growth. It is not only Hayek's devotees and admirers who hold that integration can proceed on the basis of such "negative integration." The argument has been restated and confirmed by many specialists and practitioners, some of whose work will be discussed in these pages. The result may, however, simply reflect the diffuse and pervasive nature of Hayek's influence. Not just economists but also political scientists, sociologists, and legal and constitutional scholars are all slowly becoming at least partly Hayekian, just as by the third quarter of the past century even President Nixon, as he famously announced, was a Keynesian.

THE LEGACY OF FRIEDRICH VON HAYEK

Friedrich von Hayek was born at the turn of the century and lived long enough to witness the fall of communism. His active career, begun after World War I, ended with the onset of senility in the mid-1980s. Hayek impressed people when still in his 20s as being serious beyond his years and, at 80, as being remarkably spry and alert. The sixty intermediate, grayish years of middle age were the most productive period of his life. Hayek was tall and slightly stooped, reserved, somewhat courtly, unmistakably donnish, and spoke English as a second language with accents that varied according to the time and place of his residence. The placid and unremarkable demeanor masked a personal life not always consistent with the image. Such matters are trifling by comparison to Hayek's ideas. Hayek never held public office but operated instead on (or close to) the intellectual plane. A great economist and social scientist, he was also a brilliant promoter of think tanks dedicated both to reviving the tradition of classical liberalism internationally and providing guidance to policy makers who shared his views. Hayek's influence has been both pervasive and enduring – not merely as a technical economist but as a political visionary with a deep understanding of the historical process. His gifts as a publicist and intellectual entrepreneur should not be overlooked in any assessment of his importance in the history of integration.

The Mont Pèlerin Society, which he co-founded in 1947, has served as a central point of diffusion not only for his own views but also for those of related schools influenced by them, such as monetarism, public choice theory, and the new institutional economics.[2] In addition, Hayek and other eminent members of the association have founded colonies of classical liberal intellectuals in the United States, throughout Europe, and, above all, in Great Britain. The Institute of Economic Affairs, despite its bland name, became a hotbed of policy formulation for the government of Margaret Thatcher, who – as has since been nearly forgotten – set in motion a new wave of liberal reform into the European Community in the early 1980s. The competition directorate (DG IV), the most influential branch of the eventually labyrinthine Commission bureaucracy, became its locus. Hayek also imprinted the thinking of the Freiburg School of so-called ORDO-liberals who devised the famous *Soziale Marktwirtschaft* (social market economy) associated with Ludwig Erhard and the German economic miracle of the 1950s. He thus played an important background role in turning the Federal Republic into the economic hub of the new Europe.

Friedrich A. *von* Hayek, as he was baptized, entered life in 1899 as the eldest son of a wealthy Viennese family of administrators and university professors ennobled, on both sides, in the late eighteenth and mid-nineteenth centuries. In 1919, the supposedly all-important three-letter particle disappeared by decree of the young Austrian Republic, to Hayek's apparent indifference. It should not be forgotten that Hayek spent a privileged youth as subject of the multinational and economically liberal Habsburg monarchy and belonged to the milieu of Karl Popper, the Polanyis, Ludwig Wittgenstein, the von Mises brothers, Hans Kelsen, Arthur Koestler, and Peter Drucker. Except for service as a lieutenant on the Italian front, where he received a minor head wound, Hayek never strayed far from the academy. The academies in question were located not only in Austria but also in Great Britain (London School of Economics), the United States (University of Chicago), and West Germany (University of Freiburg). Each of these great centers of learning had an impact on Hayek's intellectual development but was also, in turn, influenced by him. No thumbnail sketch can do justice to the complexity of the relationship between the man and the institutions, not to mention the individuals associated with each of them. The interplay of ideas was what bound them all together. Hayek's life centered on a continuous and immensely productive debate with other respected great minds – with none of whom he fully agreed and with many of whom, in certain respects, he fundamentally disagreed. Hayek's views also changed over time (as did those of many of his remarkably long-lived interlocutors), a welcome consequence of broadened inquiry. Hayek must be judged primarily on the basis of his importance as a thinker, but he was also a networker *par excellence* and both colleague and pupil of many prominent figures: from Vienna of the 1920s, Fritz Machlup, Gottfried Haberler, Josef Schumpeter, and his mentor Ludwig von Mises; from London of the 1930s, Edwin Canaan, Lionel Robbins, John Hicks, and Ronald Coase; from post–World War II Chicago, Frank Knight, Milton Friedman, and James Buchanan; and from Freiburg – both at the end of the war and in the last two decades of his life – Wilhelm Röpke, Walter Eucken, Alfred Müller-Armack, and Ludwig Erhard.[3]

Hayek's career witnessed plenty of ups and downs. His research arguing that business cycles stemmed from malinvestments due to the only partial liquidity of capital were hotly disputed at the time but, after his 1926 predictions of a coming financial crash, won him recognition as an economist of international stature by 1930. The following year he accepted a chair at the London School of Economics. Professor Lionel Robbins recruited Hayek for the specific purpose of counteracting the growing influence of John Maynard Keynes. Here he was a disappointment. The Austrian was bested during the Depression years, or so it seemed at the time, in successive and widely reported intellectual jousts – fought through the pages of academic journals – with his well-connected, better-known, and (since Hayek's English was not yet quite up to speed) far more articulate opponent. He was further denied any role in British wartime policy making because of his "suspect" origins. Hayek was drifting into obscurity until the sensational popular success of *The Road to Serfdom,* published in 1944 and excerpted the following year in the *Reader's Digest*.[4] The impact of this powerful and disturbing political tract – a warning that the mixed-economy welfare states of the Western democracies were headed down the same route taken earlier by Stalin and Hitler – made him many lifetime enemies. It also turned him into a celebrity, figured in his decision to leave Britain and accept a position at the University of Chicago, and marked a turning point in his career. Henceforth the technical economist in Hayek would give way to the political philosopher, the legal theorist, and the historian.

A Hayek revival began in the late 1970s as the economic and political consensus that had characterized the Western world disintegrated. The idea was no longer credible that economic growth, full employment, and a more or less stable price level could be achieved by macroeconomic management without fundamentally damaging both the micro-structure of a basically private enterprise system and the impersonal rule of law on which free economic transactions depend. The existence of the new consensus signaled the end of ideological disputes between advocates of collectivist and individualist forms of social and economic organization. The Austrian had won his battles of the 1930s with Keynes. Since the fall of communism, Hayek's reputation has continued to soar. According to the inevitably hyped-up blurb on a recent biography, "many of his ideas have been vindicated ... and Hayek's vision of a renewed classical liberalism – of free markets and free ideas in free societies – has taken hold in much of the world."[5] The findings of the present study, an investigation of a subject that cuts across only a portion of his life's work, adds to the weight and measure of his reputation.

An ambition to develop a universal science of society drove Hayek's intellectual inquiry, as it had done that of Max Weber, to whom the Austrian is often compared and with whom he had at one time hoped to study. Hayek's thinking also had important antecedents in the special traditions of the Austrian school of economics, in which he and Ludwig von Mises were recognized as leading figures. The Austrian notion of the market process provided Hayek with a precious insight into social and political development over time, a heuristic device for understanding the mechanisms of – to use an emotive word he would have avoided – *progress*. By any name, that is the end to which the Austrian concept of the market process points, a fact fundamental to it power and appeal.

The Austrian (as opposed to the classical or Walrasian) economist conceives of the market process as dynamic rather than static, as analogous to evolutionary biology rather than Newtonian physics, and as something that grows out of a discovery process. General equilibrium can never actually be reached in the Austrian view, as there is no such thing as pre-reconciling economic plans or "objective knowledge" of the market but instead only the personal and "subjective" competitive strivings of individuals entering into transactions. Transmitted through markets, price signals translate otherwise inexplicable and indigestible masses of data into the information needed to coordinate trade and production in a decentralized manner that then produces the greatest good for the greatest number and maximizes social adaptability. Markets create "spontaneous order" yielding sustained growth and optimizing positive welfare impact while embedding knowledge in institutions that in turn modify social behavior. Markets and institutions can thus be said to be both co-evolutionary and co-dependent, though the specific relationship between them in any given situation depends on the context.[6]

The Austrian theory has powerful implications. It posits that constructive economic and political change can be self-sustaining if allowed to operate within the framework of its own laws and if unimpeded by government (or other) interventions that supplant or otherwise distort it. The contention makes epistemological presuppositions that can be neither proved nor disproved empirically and that hence must rest on hypotheses about how institutions can and should function. "History," even a slice of it, does not offer acceptable evidence of its validity. But is it not more important to use history in order to understand economics than vice versa? Hayek's mentor, von Mises, made the point most eloquently: "Economics is not about goods and services, [but] about the actions of living men. Its goal is not to dwell on imaginary constructions such as equilibrium. These constructions are only the tools of reasoning. The sole task of economics is analysis of the actions of men, is the analysis of processes."[7] The question at hand is whether the Austrian theory of the market provides valuable insight into the historical process. European integration can be regarded as a test case.

The integration of Europe is not an overarching theme in Hayek's lifework. Yet it is a recurrent source of intellectual and moral concern raised by the problems of his age, which he tackled (at several different times in his career) with the formidable set of analytical tools at his command. Hayek developed the theory that is at the very core of the liberal project for Europe, but he remained vague about how the process of European integration could be set in motion. He did not delve deeply into specifics of implementation. Instead, one finds among the leading figures (ORDO-liberals) of the Freiburg School – men influenced by yet distinct from the "Austrians" – the clearest understanding of the fact that, in order to operate satisfactorily, the damaged economy of the war-torn continent had to be nested in a new set of "market-conforming" (*Marktkonform*) institutions that (a) guaranteed respect for property and contract, (b) was anchored in monetary stability, and (c) was designed to protect the competition principle. Such an institutional emphasis can be said to typify even liberal German economic thinking. ORDO-liberalism is also characterized by a profound moral revulsion to national socialism, deep ethical concerns and commitments, and a quite specific engagement with the problems of economic reconstruction in the remnants of the broken and occupied German nation. On the German issue, Hayek's Freiburg associates would "pick up the ball and run with it."

Hayek nonetheless first delineated the liberal integration project. In "The Economic Conditions of Interstate Federalism," which appeared in print on 1 September 1939 (a surely unintended accompaniment to Hitler's invasion of Poland), Hayek presents a compelling and, within his terms of reference, irrefutable explanation of why open markets and political union go hand in hand – that is to say, are both co-dependent and co-evolutionary. The logic of his explanation influences thinking up to the present.[8] He opens with a verifiable hypothesis – that no instances can be found of successful political federations without counterpart arrangements for the unimpeded movement of labor, goods, and capital – and then posits that the absence of trade barriers stands in the way of an identification of economic and political interests and so limits the pursuit of independent policies by member-states of a federation. Consequently, it is difficult for any such state to manipulate prices, adopt independent monetary policies, "discriminate" against one producer in favor of another, levy harmful taxes, or impose social or regional policies having differential impacts. It would, moreover, be even harder for a federation than for member-states to make invidious distinctions between producer groups; economic planning at a higher level would likewise be more difficult. Rather than legislate poorly, he suggests, a federation should limit itself to the proscription of antimarket policies. The weakening of federal and state power in a market-based union, he concludes, would result in the devolution of functions to the regional or local level, where they can be carried out more efficiently. Competition between these small units would, in turn, provide a salutary check on excessive growth and also encourage innovation.

Hayek's article describes a set of interdependent relationships that – if allowed to work themselves out – would reduce the threat of war, open up markets, stimulate innovation, bring about the devolution of political power to the level of government closest to the individual citizen, and in all these respects advance the human condition. But how should the process be initiated that would lead to such results? Here Hayek offered little more than a concluding plea for the abrogation of the "sovereignty principle" and the creation of an "international order of law" as "necessary complements and logical consummations" of his project. However, these preconditions for future integration are simply starting places.

THE CLASSICAL LIBERAL SOLUTION TO THE GERMAN PROBLEM

The "German Problem" was of immense concern to Hayek during the war. His thinking about it reflects an otherworldliness like that of the most widely read scholarly book on the subject, *The German Catastrophe,* by the great Berlin historian Friedrich Meinecke.[9] Hayek was an early advocate of political union as a solution to the German Problem.[10] "The future of England," Hayek told a King's College (Cambridge) audience of historians in a speech delivered on 28 February 1944, "is tied up with the future of Europe and, whether we like it or not, the future of Europe will be largely decided by what will happen in Germany." A federation would be needed. The war, he said, had shattered many worthy German intellectual traditions even as others, too deep-seated to perish, had contributed to the rise of Hitler. German historical consciousness must therefore be revived, and even re-created, so as to enforce the acceptance of moral standards prevailing elsewhere in Europe. Since it would be difficult to arrive at a single policy among nations, Hayek proposed adopting a "flag under which men who agree could unite."[11]

The "figure who fits the bill as perfectly as if he had been created for the purpose," he discovered, was the late nineteenth-century Anglo-German liberal Catholic grandee, Lord Acton, a man "half German by education and more than half German in his training as a historian [whom] the Germans almost regard as one of themselves ... [and who] unites, as perhaps no other recent figure, the great English tradition with the best there is in the Liberal tradition of the Continent." Hayek proposed to organize an " 'Acton Society' ... to assist in the task [of re-education faced by] historians of this country and of Germany and perhaps of other countries."[12] Unable to agree on whether to put the name of Acton, de Tocqueville, or some other hallowed figure on the masthead, the would-be founders of the proposed entity, something supposed to be "half-way between a scholarly institution and a political society," a kind of "International Academy of Political Philosophy," agreed to call it simply "The Mont Pèlerin Society" after the name of the site near Geneva where the first meeting was to be held.[13] The German Problem prompted Hayek's decision to create it.

Contrary to Hayek's intentions, neither historians nor political philosophers would have a major voice in the new discussion club. The policies and programs it generated would thus be almost exclusively the work of economists. Hayek himself set the unofficial discussion parameters for policy toward Germany: "The Allies [first of all] should make Germany a free trade territory ... [in order] to prevent a close re-integration of the [national] economic structure ... which would be the precursor of a future political re-integration." Germany should, Hayek thought, "become as closely as possible economically entangled with the surrounding world, the whole [being] as little self-sufficient [and] centralized as possible." The permanent solution to the German Problem would depend above all "on the development of some Western European federal framework into which the German states are individually received as they are emancipated from Allied control.... [T]he next step ... should not be complete independence and sovereignty, but ... partnership with the full rights of a minority in a larger European enterprise."[14]

Not Hayek but Wilhelm Röpke deserves to be remembered as the most serious liberal student of the German question. Nowadays almost forgotten as an economist save in the rarified atmosphere of the Freiburg School, this nostalgic, often despairing, impassioned, deeply principled, and profoundly insightful son of a Lutheran pastor resigned his chair at the University of Marburg only a week after Hitler came to power and left Germany – soon to be joined by Gerhard Kessler, Alfred Isaac, Richard von Mises, Ernst Reuter, Paul Hindemith, and the ORDO economist Alexander Rüstow as guests of Kemal Atatürk on the Bosphorus. In 1937 he accepted the offer of a chair at the Institute des Hautes Études Internationales in Geneva and remained there for the next thirty years.[15] Röpke's 1946 *The Solution of the German Problem,* which lives up to its title's promise, calls for "the application of a principle that in the world today surpasses every other in boldness and novelty."[16] It was, he announced,

> the principle of absolute and even, if necessary, one-sided free trade.... The Allies [should] impose on Germany virtually nothing more than a single measure of economic intercourse with foreign countries and ... [also] bring this German free trade into effect the moment the settlement of the most urgent currency and financial issues permits.... Germans will [thus be compelled] to bring into play exceptional resourcefulness, adaptability, and abstinence.

This free-trade policy will, Röpke continued, break down the excessive industrial concentration of heavy industry and so

> West Germany would be brought into entire dependence on international trade ... and converted ... into a region uniting an intense, highly developed agriculture dependent on the imports of foodstuffs, with a highly specialized industry, dependent on exports. It would become a sort of enlarged Belgium, and with its extreme dependence on foreign trade would have to abandon any idea of building up an "autarchic" war industry.

The solution would not entail the impoverishment of Germany, as envisaged in the more drastic of Allied occupation plans, but a return to "a prosperity that stands or falls with the interweaving of German industry with international trade."[17] Röpke emphasized that Germany should, in its own economic and political interests, eliminate tariffs regardless of what its neighbors did.

Röpke knew, contrary to public belief, that – in the absence of extreme forms of discrimination – mutual benefit can be expected to flow even from one-sided free trade. His conviction that German (and European) revival depended upon a unilateral initiative appears to be as deeply rooted in patriotic and religious conviction as in economic analysis, and it seems to stem from a belief that renewal must come from within and that economic and political federation must develop from the bottom up. According to Röpke's biographer, Razeen Sally, "national governments, not international organizations or international cartels are responsible for setting appropriate framework conditions for national order, out of which international order emerges as a by-product."[18] Röpke fervently hoped that a cleansed and reformed German nation would provide a beacon of light that "other governments would follow through competitive emulation."

Liberal economists could generate little in the way of illumination in those dank places the British publisher Victor Gollancz visited during a memorable 1945 inspection tour of what he called "darkest Germany."[19] Whether exiled like Wilhelm Röpke or marginalized within Germany like Ludwig Erhard, free marketeers had remained outsiders fully at odds with the fascist politics and the industrial and financial controls of the Third Reich. Its collapse did not bring them back into favor. Support for open markets was absent in both of the main parties that had been organized in the Western zones of occupation, the Social Democratic Party (SPD) and the Christian Democratic Union (CDU). Nor were the military governors prepared to relinquish authority over the economy unless absolutely necessary. Thick new layers of Allied regulation were superimposed over old networks of Nazi controls, which remained legally in effect. Orders and directives of the military governments regulated the collection and exportation of reparations goods but otherwise had little force in an economy whose miseries conjure up memories of *Trümmerfrauen, Kohlenklau, Zigarettenwirtschaft, Schwarze Markt,* and *Inflation* and whose population struggled to avert starvation by providing personal services to GIs and by securing emergency delivery of American foodstuffs.

Ludwig Erhard was the author of the June 1948 currency reform. It would both spark recovery and symbolically end the suffering of Germans who can remember the Occupation but would still prefer to forget. Erhard owed his unlikely rise, which started in January 1948, to an unexpected and unpredictable forced resignation, the inability of contentious German political factions to strike compromises, an apparent lack of any other suitable candidates for the position of director of the Economic Administration attached to the so-called Economic Council, and chance.[20] A politically unaffiliated, protestant Bavarian and consulting economist to an association of retailers, Erhard was a political outsider without support. He was indeed a man who had his moment in history and grabbed it.[21]

The Economic Council had been designed by the Anglo-American military governors of Bizonia to provide a depoliticized proto-government for a future West German state. Until Erhard arrived, the only reform its members envisioned was an updating and improvement of the rationing system and the elimination of "excess money" (*Kaufkraftüberhang*) as a first step toward the restoration of a future planned economy. After nearly fifteen years of Nazi and wartime overregulation, almost no German policy maker other than Erhard could contemplate "a jump into the cold water" of the marketplace. In the heated policy debates of early 1948, Erhard gained the upper hand as well as a token of valuable Allied support for a truly far-reaching currency reform plan, which would not only wipe out the internal debt and drastically curtail the money supply but also de-control prices.

There was simply no feasible alternative to what he recommended. The "steering mechanisms" inherited from the Nazis had broken down irreversibly and the existing price structure was meaningless. Only the restoration of open competition could send necessary and appropriate signals to buyers and sellers.[22] The currency reform of 18 June 1948 met with angry opposition from SPD economists and spokesmen for the labor unions, caused an increase in unemployment to over a million in 1949, reduced the forced equality of the hardship years, and at points even threatened to be inflationary. Yet it was the greatest success of any European economic policy of the twentieth century in both economic and political terms. Erhard became too popular for Chancellor Adenauer to fire – though he despised the chubby Bavarian and objected on moral grounds to the competition principle.

Adenauer first assumed office as chancellor of the new German Federal Republic in fall 1949, when hopes for integration in Europe in the form of a customs union appeared dim if not (in the words of the great Austrian Harvard economist, Gottfried Haberler) "utterly impossible." Haberler thought that, in an age of drastic government interference in the economic process, "a group of countries that wanted to create a free trade area would have to agree not only on a common tariff but also on all major phases of economic policy such as price policy and rationing, credit and development policies, monetary and fiscal policies and several others." Because such agreement was inconceivable, he concluded that "in a democratic Europe ... there will be either planning and no economic and political unification or ... unification [and] no comprehensive economic planning."[23] Equally skeptical was the celebrated Swedish economist and social theorist, Gunnar Myrdal (who, to his great displeasure, had to share the 1974 Nobel Prize with Hayek). In his 1954 book, *The International Economy,* Myrdal concluded after relentless analysis that "advanced welfare states" would, and in their own self-interest probably should, refuse to restore the mobility of capital, labor, and goods needed for integration. To promote something so "self-evidently desirable and economically necessary" as the growth of world (and intra-European) trade, he called for a heroic measure: transplanting the Scandinavian model to less fortunate parts of the world.[24] For his part, Haberler called for "a return to more liberal trading methods and a gradual elimination to the worst impediments to trade."[25] Both agreed that the embedded liberal postwar settlement, which rested on the interweaving of state and economy, constituted an immovable barrier to the integration of Europe. But neither had reckoned with Jean Monnet.