Part I

The economics of the European Union

1 Old Europe, new Europe: the role of the European Union

In Athens, Greece, origin of the Western ideals of democracy and human rights, the heads of government of twenty-five European nation states gathered to sign the Treaty of Accession into the European Union on April 16, 2003. Fifteen nations were already member states of the European Union and they had unanimously agreed to accept all ten of the accession states into their club, out of the thirteen candidate countries that had applied. But the agreement was conditional on each of the ten applicants agreeing to accept all the existing rules of the club as explained to them and interpreted by the fifteen incumbents (the so-called *acquis communautaire* of the European Union). Further, each of the ten applicants had to demonstrate to the satisfaction of the incumbents not only that they accepted all the *acquis* but that they were capable of putting it into practice on their own, without extensive subsidies or technical assistance from the existing members. Throughout the rest of the year each accession state put the treaty to a referendum of their voters, and in May 2004 the European Union expanded its size to twenty-five member states, with a population of 454.5 million and an estimated gross domestic product (GDP) of $10.3 trillion, making it the largest economy in the world, surpassing the United States of America, with its fifty states, 280.5 million people, and GDP of $10.1 trillion.[1]

The terms on which the ten new members entered the European Union were extensive: 80,000 pages of existing rules, regulations, directives, and laws that the fifteen existing members had accumulated over the previous forty-five years were divided up into thirty-one separate chapters that each applicant had to transpose into its own legal and political system. The terms were also rigorous: the new members had to take on the obligations of full membership immediately but were forced to phase in gradually the benefits of access to the agricultural supports, regional funds, and the single market in goods, services, labor, and capital. Even before being considered as candidates for membership, the accession countries had to meet the so-called "Copenhagen criteria," criteria agreed on by the fifteen incumbents at the European Council meeting at Copenhagen in 1993. This meant that each applicant had to demonstrate to the satisfaction of the existing members of the European Union that:

(1) it had a functioning democracy, with the rule of law and respect for human rights;
(2) it had a functioning market economy capable of withstanding the competition from the more advanced market economies of the European Union without recourse to extensive subsidies or protective measures; and
(3) it had the administrative capability to implement and enforce the *acquis* of the European Union with its own civil servants.

Meanwhile, all twenty-five nations, incumbent and the accession states alike, were participating in a Constitutional Convention with the goal of replacing the existing institutional structure and operating procedures with a simpler, more coherent system that would enable the twenty-five to accomplish their common goals expeditiously and efficiently. The Constitutional Convention recognized that, with the major expansion of 2004, the European Union had outgrown its operational framework. Its set of institutions and procedures had been put together, piece by piece, over the past forty-five years on the basis of the shared goals of a much smaller number of countries, each led by a generation of politicians determined never to let something as terrible as World War II occur again on their land or with their people. With the collapse of the Soviet Union and the strong reaction of the central and eastern European countries against centrally planned economies and monolithic political control by the Communist Party, the division of Europe created after World War II could be undone at last. Once again, the vision of a united Europe, at peace within itself and with its neighbors, enjoying economic prosperity and unleashing the creative potential of its population, seemed within reach. But how could this be accomplished in a lasting way, not to be undone by provoking military responses from a threatened Russia or the Islamic world? The Constitutional Convention of the European Union was a concerted effort to build upon the proven accomplishments of the past half-century of recovery from World War II among the nation states of western Europe.

Unfortunately for the good intentions of the Convention delegates, both the French and Dutch voters rejected ratification of the proposed constitution in successive referendums held in May 2005. What this means for the future reforms of the European Union's institutions is unclear, but what is clear is that the failure of the referendums in two countries at the heart of Europe stemmed more from citizens' concerns about their economic future than from concerns about the effective operation of the European Union. The interplay of the economic policies of the European Union, operating as a supranational organization, with the economic policies of the individual member states, responding as sovereign nation states to the demands of their respective electorates, therefore, will determine the future of the political organization of Europe. Hence the structure of the present work, which analyzes first the economic policies of the European Union and then the economic results for the individual European economies.

This volume attempts to frame these economic issues in a coherent analytical framework found useful by economists, but especially by economic historians, in their efforts to understand the continuing interplay between economics and politics. The New Institutional Economics, first developed by economic historians Douglass North and Lance Davis, takes for granted that political institutions, which set the "rules of the game" for economic activity, are designed to protect and sustain the economic welfare of the governing classes. Institutions change only slowly in response to economic forces over time, but are forced to make more drastic changes the longer they delay in reform or the more troublesome their results are in the face of economic changes. At the heart of Europe's economic difficulties today are the desires of citizens in both the fifteen incumbent nation states and the ten accession nation states to maintain and improve their economic welfare in the face of rapid technological changes and the expansion of global economic markets for capital, labor, goods, and services. Moreover, globalization creates more frequent and more severe shocks economically than Europe has experienced since World War II. It is precisely the ability of Europe's economic institutions to respond effectively to the shocks of globalization that concerns European policy-makers and citizens.

The Constitutional Convention

The Constitutional Convention was motivated by a concern that building the enlarged European Union on the basis of the existing *acquis* will create institutional rigidities that will fail under the duress of future shocks, whether they arise from technological changes, military threats, natural disasters, or terrorist attacks. To date, the creation of the *acquis* has been cumulative; an institutional ratchet effect has been deliberately installed so that no reversals of course are possible. For example, there has never been an "exit clause" in any of the treaties forming the basis of the European Union, so that no country has the legal option of withdrawing from the European Union once it has entered. Moreover, there is no provision for expelling a member country even when its absence is heartily desired by the other members! The proposed constitution made explicit both that a member could withdraw and that a member could be expelled. It may well be that the vision of a united Europe, prosperous and peaceful, would be better served by a complementary process of *debarras communal* – regular removals of practices and policies that are no longer useful for Europe as a whole, even if particular interest groups have come to rely on them.

For political scientists, the fascination of the exercise of trying to formulate a written and durable constitution for the European Union is considerable; will these twenty-five sovereign nation states, each with a proud national identity and a history of frequent warfare with its neighbors, be able to devise a workable arrangement? The current organization is a set of ad hoc arrangements that have arisen to meet various challenges realistically, while maintaining the possibility that the ideal of a pan-European superstate might some day be achieved. Idealists characterize the existing structure as resting on three pillars.

Pillar 1, the European Community, which deals with the Common External Tariff and all trade issues with the rest of the world, the Common Agricultural Policy, structural funds, the single market, the common currency – in short, with all the matters that are discussed and analyzed in detail in part I of this book.

Pillar 2, the Common Foreign and Security Policy, which deals with European initiatives to develop a common stance on foreign policy issues, as well the creation of the military apparatus necessary to achieve the agreed policy goals.

Pillar 3, Justice and Home Affairs, which deals with maintaining a common border policy with respect to refugees, and creating a common European police force with common domestic security objectives, such as coping with drug traffic and terrorists.

The European Union considers that it is a *supranational organization* to date only with respect to Pillar 1, because it is only in these matters that the member states have formally ceded some of their sovereignty to the decision-making bodies of the European Union. Under Pillars 2 and 3, by contrast, each member state must agree if it is willing to cooperate with the others on any of the initiatives undertaken, which makes the European Union an intergovernmental organization in these matters, at least to date. To deal with all the issues that arise under each of the three pillars, the fifteen member states, as of 2003, had developed six basic institutions, each with unique characteristics that – in combination – make the European Union such a fascinating object of study for political scientists. They can be roughly thought of as comprising the executive (or administrative), legislative, and judicial branches of government.

The *executive branch*, charged with initiating legislation and then administering the operation of the European Union's activities, is the European Commission, headquartered in Brussels, divided into twenty directorates and overseen by the President of the Commission. The directors are allocated among the member states, each state being entitled to one director, with the largest five states entitled to two each. The President is nominated by the European Council and approved by the European Parliament. The Commission, while charged with drafting legislation and then managing and administering the competences of the European Union, has only limited enforcement powers, as it must call upon the police authorities of the member states to enforce its decisions. In case of continued non-compliance, it is confined to levying fines upon member states. Real power, however, can be and is exercised by the European Council, the heads of government of each member state. They have full police powers at their disposal within their respective countries, so if they agree upon a course of action it will usually be made effective. Because all member states are parliamentary democracies, in which the head of government is determined by the legislative majority in the parliament, the necessary legislation will also be enacted to carry out the consensus policy of the European Council.

The *legislative branch* has two components: the Council of Ministers, with real power vested in it by the governments of the member states as each country is represented by the relevant minister from its governing Cabinet; and the European Parliament, which has mainly symbolic power, based on popular elections of its members throughout the European Union's member states. The Council of Ministers is usually composed of the foreign ministers from each member state, but if the matter to be decided is agricultural policy, for example, the agriculture ministers will comprise the Council for agricultural legislation. Increasingly, over time, the European Parliament has taken a more substantive role in forcing modifications, or at least delay, in legislation passed by the Council. With the Treaty of Amsterdam, signed in 1997, the Parliament became a more powerful legislative partner, taking on co-decision authority over most of the EU's legislation. The power of the purse, which historically has determined the power of parliaments in the evolution of Western democracies, is kept by the Council, however, and each successive treaty has insisted that the European Union operate annually on a balanced budget. The constitution would, however, give the European Union legal personality, meaning that it could issue debt in its own name in the future. In the meantime, the European Council must decide the funding provided over a seven-year period, 2000–2006 and 2007–2013. The Parliament can, however, reject, the entire budget proposals of the Commission, even when approved by the Council of Ministers. As this would also mean cutting off the substantial salaries and expense accounts of Members of the European Parliament (MEPs) until the Council of Ministers came to terms, however, it is doubtful that this power would ever be exercised.

The *judicial branch* also has two components: the European Court of Justice, with a judge appointed from each member state and a Chief Justice elected among them; and the Court of First Instance. The Court of Justice is charged with ruling on matters of dispute between the European Union and any of its member states or citizens, including corporations and other non-governmental organizations, as well as interpreting the accumulated treaty provisions as they apply to the external relations of the European Union with non-member states. The Court of First Instance is devoted to dealing with an increasingly important aspect of European Union enforcement powers: competition policy. It has final say over disputes between individual firms or governments and the Commission over interpretation of the single market's directives and can levy fines as well as force divestitures by firms. An economist might want to add as well the Court of Auditors, which is charged with auditing the accounts of the Commission to ensure that balanced budgets are maintained and that expenditures are in accord with the legislative decisions of the Council and the European Parliament. It, too, can levy fines or require repayment of EU funds judged to have been ill-spent by the recipients.

To these basic political institutions, which can readily be divided into those that correspond to an intergovernmental organization (the European Council, the Council of Ministers, and the Court of Auditors) and those that correspond to a supranational organization (the Commission, the Parliament, and the Courts of Justice and First Instance), the European Union created the European Central Bank in 1999, charged with the creation of the common currency, the euro, the unit of account for all financial operations of the European Union and the national unit of account for initially eleven of its fifteen incumbent members, and then twelve, when it was adopted by Greece in 2001.

For economists the European Central Bank (ECB), the most recent institutional innovation of the European Union, is the most interesting, precisely because it has been made as independent as possible from the political institutions of the European Union (just described above) and, moreover, from the political institutions of the individual nation states. Not only is the European Central Bank located in Frankfurt, Germany, away from Brussels, Luxembourg, and Strasbourg, where the political institutions of the European Union are located, but its President is appointed for a fixed term of eight years by the heads of government in the European Council. Note that all heads of government of member states are elected, not appointed, and their term of office is always less than eight years, so the President of the European Central Bank has real political independence, as do the Vice-President and the four other members of the Executive Board, all of whom are appointed for fixed terms. While the Executive Board is responsible for the daily operation of the ECB, the strategic decisions are taken by the Governing Council, which consists of the six members of the Executive Board plus the governors of the national central banks that have adopted the euro. But each governor of a participating national central bank is also required to be independent of his or her government.

For economists enamored of the virtuous performance historically of politically independent central banks, the unprecedented degree of political independence of the European Central Bank augurs well for the future of the euro and the monetary policy of the eurozone. For historians, noting that monetary policy has always been driven in the past by political considerations, the lack of political support for the ECB other than international treaty is bothersome. How will the ECB be able to withstand popular discontent if its pursuit of price stability is seen as damaging to the achievement of other goals, such as full employment, or economic growth? By treaty, the European Central Bank is charged with maintaining price stability within the European Union and has been given complete control over the supply of the common currency. To date, however, it has not been given regulatory authority over the financial sectors of the member states, which means that financial innovations may occur that will disrupt the relationship between the rate of growth of the money supply and the rate of inflation within the EU.

Adventurous as this innovation in monetary policy is, economists also find the efforts to wrest control of fiscal policy from the hands of political authorities even more interesting, even bizarre. Prior to adopting the common currency and ceding control of monetary policy to the European Central Bank, each participating government was required to meet the so-called Maastricht criteria. There were five criteria:

(1) maintain inflation rates within one percentage point of the average of the three lowest rates of inflation within the European Union;
(2) maintain interest rates within one percentage point of the average of the lowest rates of interest on long-term government bonds within the European Union;
(3) maintain the exchange rate of the national currency within 2% of parity with the euro (known as the European Currency Unit, or ECU, prior to 1999) for at least two years;

(4) maintain a government deficit equivalent to less than 3% of gross domestic product; and
(5) maintain a ratio of government debt to GDP of less than 60%.

The Maastricht criteria were designed to ensure that each participating country was already committed to, and capable of, achieving price stability on its own. The first three criteria are really three different, and redundant, ways of measuring price stability. If the third criterion was achieved – maintaining a stable exchange rate with respect to the common currency – then the inflation targets and interest rate targets should follow as a matter of course. To the extent that long-term interest rates reflect inflation risk, they should fall as inflation is controlled within a country. Only if a country's inflation rate is close to that of its trading partners will its exchange rate be stable as well. The three criteria were presumably intended to protect against a country using special interventions for a limited period of time to maintain exchange rate stability or low inflation rates, or reduced interest rates, while letting one or more of the other measures of price stability absorb the pressures of inflation.

The final two measures, however, went a step further, and were presumably designed to ensure that a country did not build up pressures to increase the quantity of money in order to finance excessive government expenditures. Inflationary potential would then be indicated by persistent large deficits on the part of the government and by a mounting size of government debt relative to gross domestic product. Weak governments faced with such situations have typically resorted to forcing the central bank to supply it with fresh money, leading to inflationary spirals. In the event, any number of governments exceeded the debt limit when the deadline for monetary union approached in 1999, but if they had succeeded in meeting the monetary goals (the first three Maastricht criteria) it turned out that they met the deficit criterion as well and therefore could show progress toward meeting the debt, and final, criterion. Was this a temporary effect, created mainly by refinancing existing debt with lower interest-bearing debt, or a permanent result of institutional reform? Just to make sure that there would be no backsliding by new governments, a supplementary agreement was signed, called the Stability and Growth Pact.

The *Stability and Growth Pact* has less authority than a treaty, but pledges each member state of the eurozone to keep future government deficits below 3% of gross domestic product, with a penalty assessed on any country that violated this limit. Rightly labeled by Romano Prodi, President of the European Commission, as one of the dumbest economic arrangements ever made, the Stability and Growth Pact has been violated persistently by France and

Germany, precisely the two countries most insistent on creating the pact in the first place. After both countries had violated the 3% limit of government deficits for three years running, with no end in sight, the Council of Ministers in 2005 worked out a "reinterpretation" of the Stability and Growth Pact, designed to make it more workable without shelving it entirely.

In the future, governments violating the 3% limit due to special circumstances that made unusual funding demands upon the government could exclude those expenditures from the calculation of the deficit. Germany was especially successful in arguing that the reunification expenses required to bring the infrastructure of the former East Germany up to West Germany's standards should not be included when calculating its deficits. These have continued for fifteen years, however, so a cynic might argue that Germany was able to define away a self-imposed expenditure. Other countries, seeing the opportunity to make similar self-serving definitions of parts of their expenditures, such as disaster relief, construction of large infrastructure projects (e.g. the Olympic facilities constructed by Greece for the 2004 games), went along. Essentially, this compromise solution eliminated the Stability and Growth Pact as a commitment mechanism to keep the budgets of member states in line.

The budget of the European Union

The fastidious concern of the EU over the possibility that some sovereign nation states might abuse their access to a common pool of resources, the supply of money in the case of the eurozone, is the outcome of experience with financing the European Union itself. By treaty, the European Union is required to operate on a balanced budget from year to year, and it is not allowed to issue bonds of any kind. For the first twelve years of its existence the European Union, then known as the European Economic Community (EEC), with the European Coal and Steel Community (ECSC) and Euratom affiliated with it, subsisted on annual grants from the member states, although the ECSC had its own source of revenue from a commission on sales of coal and steel.

The original six founding members agreed that the EEC should have its "own resources," derived from the tariff revenues it collected under the Common External Tariff (CET) agreed upon by all member countries of the EU, plus – later – the levies imposed on agricultural imports under the Common Agricultural Policy (CAP). For reasons explored in detail in chapter 4, these own resources proved increasingly inadequate to finance the expenditures required by the price support programs of the CAP, so they were expanded to include a