Introduction

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Over the last fifty years Europe has gone through a unique historical process of economic and political integration, sharply contrasting with the tragic first half of the twentieth century. The last fifteen years, in particular, have brought remarkable progress. The Single European Market and the common currency (euro) have significantly deepened the prior integration, which was limited to little more than trade. Meanwhile, the European Union (EU) has gone through subsequent enlargements. The latest and biggest enlargement of the EU in May 2004 expanded the number of member states from fifteen to twenty-five.[1] As a consequence, the EU's economic and geopolitical importance has increased. Most of Europe's nations and population are now contained in the Union.

Several other countries are in various stages of EU accession (Bulgaria, Romania, Turkey, and Croatia) or would like to start this process in the not too distant future (western Balkans, Ukraine, and Moldova).[2] The Rome Treaty established that all European countries have the right to apply for EU membership, signaling that future EU borders will move farther to the east and southeast.

Despite the obvious achievements of integration, the European economy and European institutions face serious challenges. This volume concentrates on five big ones. The first task for the EU is to find a new legal shape and adopt a European Constitution. The EU decision-making process is ineffective and

[1] EU-15 refers to Belgium, France, Germany, Italy, Luxemburg, the Netherlands, Denmark, Ireland, the United Kingdom, Greece, Portugal, Spain, Austria, Finland, and Sweden, which formed or joined the EU in five waves. The ten additional members were, from north to south: Estonia, Latvia, Lithuania, Poland, the Czech Republic, Slovakia, Hungary, Slovenia, Cyprus, and Malta. Of the ten new member states (NMS), eight, all but Cyprus and Malta, are former socialist countries.

[2] Sometimes the expression EU-28 is used. It refers to the current twenty-five members of the EU plus Bulgaria, Romania, and Croatia, whose entry is mostly seen as a given.

lacks sufficient democratic legitimacy on the European level. The summer 2005 referenda in France and the Netherlands, which rejected the proposed European Constitution, re-opened this question.

At present twelve countries use the euro, and Euroland is supposed to expand to the new member states in due time.[3] But the management of the European finances and the euro is a second major challenge. The 2005 reform of the Stability and Growth Pact will seriously undermine European fiscal discipline. Moreover, the crisis of the overextended welfare state is going to deepen in the future as the European population ages.

The need to boost economic growth is a third formidable European test. Three of the four big European economies are close to stagnation, and Europe as a whole is losing out in competition with the United States, Asia, and the Pacific region. The Lisbon Agenda, an ambitious EU program that aims to revitalize the European economy, has been little but a dead letter.

A fourth challenge is to face up to competition from new member states and countries farther east. Many old member states are hesitant to continue deepening the Single European Market, especially in the service sector, and want to impose stifling regulations and taxes on new member states as well as neighbors. The risk of protectionism looms, as always.

Finally, the EU must form a cooperative and productive relationship with countries on the European periphery. The Union has neither a clear vision of further enlargements nor a plan to help less developed countries on Europe's periphery to close the development gap and modernize their economic and political systems. Many Western European societies are increasingly critical of further EU enlargements, trade liberalization, and immigration, which they fear will undermine their very high standard of living.

The rejection of the European Constitution in the French and Dutch referenda should serve as a warning signal that at least a part of Europe is not ready to meet the challenges facing our continent. This makes both further enlargement and deepening of the EU more difficult, because the Constitutional Treaty would have consolidated the prior accomplishments of integration and made the EU decision-making process more efficient.

The first two chapters in this volume discuss aspects of the draft European Constitution. In the first chapter – "Has Europe Lost Its Heart?" – Charles Wyplosz argues that enlargement and deepening are not substitutes but complements. Enlargement does not necessarily dilute the EU, but it requires adjustment of the decision-making process. Contrary to many assertions,

[3] Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Luxemburg, the Netherlands, Portugal, and Spain.

the EU is growing closer through enlargement, because the new members tend to be the greatest champions of common European values. A new acceleration of European integration is now required, but it needs to be carefully prepared.

In chapter 2, "Economic Implications of the Social Provisions of the Stalled EU Constitution," Georges de Ménil analyzes the Charter of Fundamental Rights of the Union (a part of the Constitutional Treaty) and, particularly, its Title IV ("Solidarity") containing social entitlements. He shows that if an activist European Court of Justice interprets these constitutional commitments generously, they could harm European productivity and competitiveness. Such a court interpretation could force national governments to increase the level of social and labor protection and put Europe in a social welfare trap.

The next thematic bloc analyzes the fiscal policy rules of the enlarged EU. Vito Tanzi 's chapter 3, "Fiscal Policy and Fiscal Rules in the European Union," provides devastating criticism of fiscal activism in the Keynesian tradition. He illuminates numerous conceptual, methodological, and political traps associated with a countercyclical fiscal policy and fiscal discretion. Tanzi concludes that countercyclical fiscal policy is justified in depressions, but doubts whether countries already suffering from precarious fiscal conditions, as are numerous EU countries, should try it. Therefore, the EU Stability and Growth Pact should be not softened but rather reinforced.

Fabrizio Coricelli takes this discussion further to the new member states in chapter 4, "Design and Implementation of the Stability and Growth Pact: The Perspective of New Member States." He suggests that the standards of the Stability and Growth Pact are neither relevant nor sufficient for the new member states. They cannot allow themselves such large debts in relation to GDP, because their domestic financial markets are shallower and the volatility of their output growth and public finances is likely to be greater. But fiscal discipline is key to high growth and their swift economic convergence with the old member states. He warns that the recent loosening of the Stability and Growth Pact and the growing arbitrariness in its implementation reduce the incentives for fiscal adjustment in the new member states, which is particularly harmful for these countries.

This book also scrutinizes Europe's low economic growth and slow structural reforms. In chapter 5, "Perspectives on the Lisbon Strategy: How to Increase European Competitiveness," Daniel Gros deals with the complex issue of the Lisbon Agenda's failure, as reflected in the rather poor recent performance of the European economy. He focuses on three questions – demographic deterioration, the productivity slowdown, and the crumbling of both fiscal and structural policies – and underlines how profound Europe's economic problems are. Alas, the reform of the Stability and Growth Pact indicates that policy makers are moving in the wrong direction, looking for excuses not to undertake necessary reforms.

Chapter 6 by Patrick Lenain, "Is Europe Reforming? Evidence from Cross-Country Structural Indicators," concurs with this somber tone. However, according to Lenain, the real picture is more mixed. He undertakes a careful analysis of labor market developments in the whole of the EU, finding that some EU members have at least partially deregulated their labor and product markets, and most countries are moving in the direction of less regulation. Although developments are tardy, these observations arouse the hope that the second half of the Lisbon Strategy decade may be less disappointing than the first.

The rest of the book moves to the east of the EU. One group of chapters discusses the development challenges facing the EU's eastern neighbors. In chapter 7, "Recovery Growth as a Stage of Post-Socialist Transition," Yegor Gaidar analyzes recovery growth in transition economies after a prolonged output decline in the final stage of communism and the first years after its collapse. He warns that such growth tends to arrive unexpectedly after some disarray, and it is usually strong, but that growth potential can be exhausted if it is not reinforced by structural reforms that stimulate investment.

Chapter 8 by Anders Åslund, "Comparative Oligarchy: Russia, Ukraine, and the United States," addresses the controversial topic of "oligarchs" and their property rights in some post-communist countries. The author claims that Russian and Ukrainian oligarchs differ little from the "robber barons" in the United States in the second half of the nineteenth century. Åslund argues that the emergence of the super-rich is nearly inevitable under the conditions of large economies of scale and ineffective legal systems. He analyzes the policy options for dealing with this phenomenon in a way consistent with the market-oriented reforms.

The final thematic group contains two studies on the external relations of the enlarged EU. Chapter 9, by Susanne Milcher, Ben Slay, and Mark Collins, "The Economic Rationale of the 'European Neighbourhood Policy,'" concentrates on future EU relations with the post-Soviet countries. Their main concern is whether the EU's European Neighbourhood Policy will be sufficiently attractive to induce the Commonwealth of Independent States (CIS) governments to adopt the economic and governance reforms that were implemented in the EU new member states during their accession. Consequently, the authors reckon that the uncertain perspective of eventual EU accession is the main weakness of the European Neighbourhood Policy.

The tenth and final chapter, by Johannes Linn and David Tiomkin, "Economic Integration of Eurasia: Opportunities and Challenges of Global Significance," takes a broad perspective. It explores the opportunities for increasing economic cooperation across the entire Eurasian supercontinent, a possibility opened by the collapse of the communist system in the former USSR. The authors analyze energy and non-energy trade and transport, illicit drug trade, investment and capital flows, migration, and communication and knowledge sharing. They find ample opportunities for development, but the obstacles remain significant.

When looking at present-day Europe, observers are struck by two contrary impressions. On the one hand, much has been done to bring Europe closer together. The expression "Europe whole and free" has acquired a real meaning. On the other hand, the frustration with the remaining problems is growing to a crescendo. The EU decision-making system works poorly; the revision of the Stability and Growth Pact may endanger fiscal stability; the old EU countries are failing to undertake the necessary structural reforms of tax systems, social benefit systems, and labor market regulations to stimulate economic growth; low nativity combined with resistance to immigration reduces growth potential; and the EU appears to see predominantly danger rather than opportunity to its east.

Yet, as this book demonstrates, this critique has reached a new acuteness. A new restlessness is spreading through Europe. Criticism of fundamental European problems is no longer swept under the carpet. An understanding has matured that these problems will not go away and can no longer be passively accepted. In many cases, the cures are known, and their application cannot be indefinitely delayed. Importantly, the new member states are challenging one another as well as the old EU members with tax competition and the successful deregulation of labor markets. While the EU delivers a stage for competition through its single market, national governments both inside and outside the EU use this large stage to prove the competitiveness of their economic policies. Sooner or later, the *acquis communautaire* may adjust.

This resolute criticism of European economic policies gives hope that Europe is becoming ready for truly radical reforms.

ONE

Has Europe Lost Its Heart?

Charles Wyplosz

Introduction

Once upon a time Europe was a small group of like-minded countries, determined to integrate politically and economically in order to eliminate war. After centuries of recurrent devastation, this was an ambitious project. It was built on Jean Monnet's prudent step-by-step strategy, now called neo-functionalism.[1] Integration always progressed in fits and starts, but achieved amazing results. Not only is war all but ruled out, but also economic and political integration has deepened to a degree undreamt-of even by most Euro-enthusiasts. More amazing still, the project has spread. Nearly the entire continent is now part of the Union, and Turkey might join by the end of the decade. Two hundred million people share the same currency and enjoy borderless travel.

But success has its price. Twenty-five countries do not cooperate as six used to. Each enlargement gives the impression that the undertaking is being diluted, resulting in more weight given to national interests and less willingness to take the next integrative step. This perception is misguided. The EU-25 group is considerably more integrated than the original EU-6 ever was. Enlargement does not cause dilution, but it brings to the fore institutional failures that were present all along.

Now Europe needs to clean up its institutions and practices. Fifty years of negotiations have led to agreements both good and bad. Some of

[1] Classic references on neo-functionalism are Haas (1958) and Mitrany (1975).

This chapter draws in part on joint work with Erik Berglöf, Barry Eichengreen, Gérard Roland, and Guido Tabellini, but I alone am responsible for the views presented here. I am grateful for useful comments provided by CASE conference participants, especially my discussants Erik Berglöf, Josef Zieleniec, and Anders Åslund.

the old *acquis communautaire* is outdated. The European Constitutional Convention offered a unique opportunity to sort out this legacy, but this opportunity has been squandered. The Convention refused to open the Pandora's box of past agreements and fix them. Its wholesale adoption of all the *acquis communautaire*, good and bad, left many of the important issues untouched. Then the ratification process was managed badly in France and in the Netherlands. These two countries' rejection of the Constitution has opened a new window of opportunity, however. Will the European leaders now concentrate their efforts on a more modest but deeper project? A changing of the guard is under way and it remains to be seen what the next generation will deliver.

This chapter reviews a number of political-economic issues. The second section sets the scene by offering a broad review of task allocation principles. The third section examines the links between widening and deepening, concluding that the two are not substitutes, but rather possible complements. The fourth section presents some solutions that go beyond current debates.

Task Allocation in the EU

Principles from Fiscal Federalism

As summarized in Berglöf et al. (2003), the theory of fiscal federalism provides the starting point for allocating tasks (the provision of public goods) to the EU level –"centralizing" them. The theory develops two criteria to recommend centralization, and two to discourage it. Centralization is appropriate for (1) public goods subject to increasing returns to scale or scope and (2) public goods subject to externalities. The first criterion against centralization can be broadly defined as "heterogeneity." If national preferences differ, some countries will dislike any "one size for all" policy. The second is information asymmetries. The center typically knows less about local needs than national or subnational levels of government. Centralized decisions and implementation procedures may rest on a faulty appraisal of end-user needs.

Real-Life Governments

The previous reasoning assumes national governments are benevolent, striving only to maximize their citizens' welfare. Difficulties start when we allow for citizens to hold differing opinions. The simple fix is to assume that democracy provides an elegant solution: elections determine how collective preferences emerge from individual disagreements. Unfortunately, the recent literature shows this assumption is too simple.[2]

To start with, elections are not one-dimensional. European issues fly below radar in domestic political debates, particularly in larger countries. As a result, governments are not really accountable for decisions made and positions taken in "Brussels."[3] Moreover, according to one view, governments are not benevolent but captured by special interest groups.

What do such political failures imply? Does centralization mitigate or enhance these political distortions? There is no general answer. Under decentralized policy making, only (or mainly) domestic lobbies distort national policy. Under centralization, foreign lobbies also wield influence. As argued by Bordignon et al. (2003), the economies of scale created by centralization can actually encourage political lobbying. If the foreign and domestic lobbies have the same interests, then policy is doubly distorted. If instead the two lobbies have opposite interests, then they offset each other and the distortion is mitigated.

As soon as political failures are recognized, a new consideration emerges. The public choice literature has emphasized that one of the best responses to political capture is political competition.[4] Checks and balances among different levels and branches of government can increase political competition. Economic competition can raise the costs of political capture.

Europe's Way

The decision to allocate a particular task to the EU level is rarely black and white. The four benevolent-government criteria – economies of scale, externalities, heterogeneity, and information asymmetries – often send different signals, and political distortions must be factored in as well. In the end, any decision will necessarily involve hard-to-evaluate trade-offs. Different people are likely to reach different conclusions not because they fundamentally disagree, but because they may weigh the relevant considerations differently.

Whether by design or by luck, European integration has proceeded in steps. It has first centralized those tasks for which the fiscal federalism criteria were the least ambiguous, where capture by interest groups was more limited

[2] For a general survey, see Persson and Tabellini (2000).

[3] Direct democracy, in particular single-purpose referenda, deals with this problem. Unsurprisingly, perhaps, Switzerland, the country that has the most extensive direct democracy system, has not joined the EU. Similarly, Sweden, which has an open-government practice, is not too pleased with collective decision making in Europe.

[4] The classic reference is Buchanan and Tullock (1962). The other response from the public choice school is to keep government small. Openness is yet another recommendation.

or likely to be reduced by economic competition. The common market is the relevant example. Economies of scale and scope characterize modern industry, so developing a large internal market was a natural step. In this area, preference heterogeneities are minimal and there are few information asymmetries, at least in the long run.[5] Political capture is a serious issue, but the presumption is that economic competition is the right antidote. As the recent debates on state subsidies and industrial policies show, these aspects linger, but the burden of proof has now been reversed. Now special interests have to make a case for exemptions from single market principles. Since such interests are rarely aligned across EU member countries, their power has declined precipitously.

The creation of a monetary union also illustrates these principles and further shows that integration has a dynamic of its own. Increasing trade integration made EU member countries more similar, including in the timing of their business cycles. It reduced the ability of countries to use the exchange rate as a policy tool. By reducing national heterogeneities and alleviating information asymmetries, trade integration made it desirable to exploit the economies of scale and scope that a single monetary policy provides. At the same time, the emergence of independent central banks – partly inspired by the superior performance of the Bundesbank – underscored the desirability of reducing special interest influences on monetary policy. The adoption of a single currency became natural.

Europe's pragmatic approach has not led to centralization of the other tasks for which the balance of arguments is less clear cut. Having dealt with the most straightforward cases – the single market, a common trade policy, the single currency – Europe finds itself considering more contentious areas. New initiatives emerge in part because previous integrative steps changed the balance of arguments for and against centralization in areas such as taxation, labor mobility, common security policy, and common foreign policy. They also emerge because partisans of an "ever closer union," including the structurally pro-integration European Commission, seek to further their goals. It should not come as a surprise that the debates are becoming more contentious. Europe has lost its heart, but it has already done the obvious things. Further integration will be more difficult because it is less obviously justified. In addition, with a few important exceptions, economic integration is nearly complete. The next steps either tackle the hard economic core

[5] Transitions are different, though, since they involve deep restructuring. While transition costs are likely to be small in relation to long-term gains, the existence of losers and winners implies redistributive politics that play out very differently at the local level.

(agriculture, services, labor mobility, environment, taxation) or concern other areas (education, diplomacy, internal security, defense, culture) where heterogeneities loom large. In addition, enlargement challenges a number of established practices. This is the issue that is considered in the rest of this chapter.

Widening Versus Deepening

One often hears that Europe's current difficulties spring from the enlargement process.[6] Decision making has become more difficult, it is argued, because of the larger number of voices and increased heterogeneity (Baldwin and Widgrén, 2003). In this view, Europe can overcome this problem by allowing "clubs of pioneers" that may decide to deepen integration among themselves, leaving the door open to currently reluctant countries. This would mimic the previous evolution, when a core of "pioneer countries" created the European Community and nearly the entire continent gradually joined later (Moravcsik and Vachudova, 2003; Grabbe, 2005).

Another view derives from the observation that economic integration is now nearly complete (Berglöf et al., 2003). Does this mean that the EU should focus on eliminating the last barriers to the four freedoms (mobility of goods, services, capital, and people) and then consider its aims achieved? This view, which clashes with the "common house" views of the founding fathers, used to be popular before the "re-launch of Europe" in the 1980s. It aimed at the establishment of a perfect common market unencumbered with wider political objectives. Today we have passed this stage. Having fulfilled most of the economic integration objectives, Europe is asking itself how to move on to non-economic integration. Even though the issues at stake include areas such as internal security, foreign affairs, research, and education, the principles developed in the previous section remain relevant.

Costs of Enlargement

Decision making does not have to become more difficult as the number of countries grows. The EU voting rules have always been arcane, relying on qualified majority voting (QMV) rules, where member countries receive weights that are the result of deft bargaining and where the threshold required to adopt a decision does not seem to respond to any other logic than the need to conclude a negotiation. These rules reflect a standard feature of federal systems: they magnify the weights of the smaller entities,

[6] See, e.g., Gilbert (2004).