

# ALTERNATIVE POLITICAL AND ECONOMIC FUTURES FOR EUROPE

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Defeat of a proposed constitution for the European Union by voters in France and the Netherlands in 2005 should have provided an opportunity to reflect on a broader range of alternative political and economic futures for Europe. But it did not. For the Lisbon Treaty, which became effective in December 2009, implemented most of the provisions of the proposed constitution that the voters rejected more than four years prior. It was important to reconsider the major *current* European political and economic institutions as well as alternative steps toward further European integration. For the major current institutions were created under different conditions, and the experience suggests that they may not best serve the peoples of Europe under current and expected future conditions.

The major alternative political and economic futures for Europe are nationalism, selective functional integration, an association of European states, and a European state. This article addresses the considerations that bear on the choice among these alternatives. Václav Klaus, the president of the Czech Republic, may have

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William A. Niskanen was Chairman Emeritus of the Cato Institute prior to his death on October 26, 2011. This article is a revised and updated version of a lecture he first presented in Bratislava, Slovakia, on December 8, 2005, which appeared in Niskanen (2008). The current version was written for a lecture the author planned to give in Madrid in the summer of 2011. He was unable to do so. The sponsor of that lecture, the Fundación para el Análisis y los Estudios Sociales (FAES), published the lecture in Spanish in their journal *Cuadernos de Pensamiento Politico* (Niskanen 2012). References have been added.

provided the best general guidance on how Europeans should make this choice:

We must first make clear what kind of Europe we want. Using understandable language, we have to say what the future Europe should look like and what costs and benefits such a solution would have. It must not be about turning in on ourselves. It must not be about hindering spontaneous integration or globalization processes. No costly, freedom-constraining uniformity, harmonization, and centralization should be part of it, nor any obligatory “European” ideology [Klaus 2005].

## Nationalism

For understandable reasons, Europeans have become wary of nationalism because, for too long, conflicts among national states made Europe a field of blood. And the first selective measures of European integration after World War II were primarily designed to reduce the prospect of another such holocaust. I will use the word nationalism merely to describe a system of independent national states. I need not remind you of the potential dangers that are inherent in such a system. At the same time, however, it is important to understand the reasons why national states have been the basic building blocks of most political orders.

First, the *political* loyalty of most people is to the state of an area with a common language, culture, and history. One should not dismiss this condition based on wishful thinking, for example, that the creation of a European state would create a European political identity. The breakup of the Soviet Union and Yugoslavia are only two of the many examples of the fragility of states without a common language, culture, and history.

Second, there are very few government services for which there are any significant economies of scale. There is no significant relation between per capita income and the area and population of a state. The per capita incomes of Singapore and Switzerland, for example, are about the same as that in the United States and are far higher than in the much larger states of China and India. Specifically, there are no significant economies of scale in the provision of such major domestic government services as education, the courts and police, public health, and transportation.

Third, the only major government services for which there are significant economies of scale over some range are defense, environmental policy, trade policy, monetary policy, and scientific research. Most of these economies, however, can usually be realized by voluntary alliances among national states without the problems of creating and maintaining a broader multinational state.

In summary, I suggest, Europeans should take nationalism—by which I mean a set of independent national states open to selective *voluntary* integration processes—as a serious alternative to what Klaus termed the “costly, freedom-constraining uniformity” of a European state.

### Selective Functional Integration

As mentioned above, there are only a few government services for which there are significant economies of scale over an extended range. Moreover, in each of these cases, there is already a specific institutional arrangement among most of the European states, although the list of member states differs somewhat among these arrangements. But some changes in these existing arrangements should also be considered as part of the process of choosing a political and economic future for Europe.

#### *Agriculture*

One common function of the European Union, however, serves *no* common purpose: the common agricultural policy. There is no reason to coordinate agricultural policies across governments and no economies of scale in providing this function. One cost of this common agricultural policy is that it has delayed the prospect for of the Doha round of multilateral trade negotiations, since many of the poorer nations of the world have little reason to accept the exports and investments by the industrial countries if they cannot sell us their agricultural products. The common agricultural policy now costs nearly one-half of the budget of European Union. The first step toward making the European Union a serious regional government would be to eliminate the common agricultural policy.

#### *Defense*

The North Atlantic Treaty Organization (NATO) was organized to defend Western Europe against the Soviet-dominated Warsaw Pact.

It is now much less clear how to describe NATO, following the breakup of the Soviet Union and the Warsaw Pact and the addition of eight other NATO member governments. The other major change is the increasing concern of some member governments about terrorist threats originating outside Europe. For all of these changes, there has been no change in the NATO Charter.

Article V obligates every member government to respond to an attack on any NATO country. This probably *increases* the risk of a NATO war with Russia, now that the three small Baltic countries on the Russian border are NATO members. Each of these countries includes a substantial number of ethnic Russians, and a dispute with Russia over their treatment or a minor border issue increases the risk of a war with Russia over issues that are not of general concern to the other member governments; the three Baltic countries clearly add more liabilities than assets to NATO. That is probably also the case with respect to considering the Ukraine or Georgia as a potential NATO member.

NATO has also long had a vague implicit “consensus” rule for approving out-of-area military operations. This rule has generally been interpreted as meaning that the participation of any member government in military operations, such as in Afghanistan, is dependent only on the approval of that government. The continuing viability of NATO under conditions that are now very different from those when NATO was established, I suggest, will be dependent on reconsidering both Article V and the consensus rule.

### *Environmental Policy*

Many environmental effects, of course, have little respect for national borders. For that reason, some regional alliance or government should set *common* standards for all environmental conditions that have significant cross-border effects. In this case, a multifunction alliance or government would probably be better than a voluntary environmental alliance, because it is important to include upwind and upstream countries that may not otherwise join a voluntary environmental alliance.

The European Union already has a complex system of environmental regulation of two forms: A *regulation* is binding on all parties and is directly applicable without any further action by the national governments. A *directive*, in contrast, is binding on the member states as to the goal to be achieved but leaves them the choice of the

form and method they adopt to realize the EU goal within the framework of their internal legal order. This is an adequate framework for environmental regulation but presents two challenges: As much as possible, European environmental regulations should specify goals but not means. And, it is very important to limit such regulation to environmental conditions with significant cross-border effects, leaving such issues as drinking water standards, forest management rules, etc. to the national governments.

### *Trade Policy*

A larger area subject to common rules of trade generates economies of scale for a reason first recognized by Adam Smith: the potential division of labor is dependent on the extent of the market. For this reason, the original and most valuable government role of the European Union has been to set the rules for a large regional customs union with no internal constraints on the movement of goods and labor; moreover, these rules have been extended to four nonmember countries.

For all of that, there are two major problems of the European Union trade area. One problem is common to any bilateral or regional free trade agreement relative to either a multilateral agreement or a unilateral reduction of trade barriers: both create a preference for the most efficient producer in the region relative to the most efficient producer in the world—a preference that is equal to the common external tariff, an effect that was first recognized by Jacob Viner in 1950. For this reason, any bilateral or regional free trade agreement involves a tradeoff between trade expansion and trade diversion, where the amount of trade expansion relative to trade diversion is dependent on the size of the external tariff and whether the most efficient producer in the world is included in the region.

The major problem specific to the European Union trade area, however, is that it is difficult for a government to join this area without bearing a proportion of the costs of all EU activities. The North American Free Trade Area (NAFTA), for example, has about the same aggregate GDP as the European Union, but it has operated smoothly with only a few dispute-settlement committees—no budget, no bureaucracy, and no Brussels! Most of the governments that had been in the European Free Trade Area (EFTA), however, chose to join the European Union—decisions, I suggest, that may

not have been in their interest. If I were an official in a European government, one of my priorities would be to restore or maintain membership in a European-wide free trade area that does not require membership in the European Union. Since the defeat of the proposed EU constitution, EU officials have dismissed this alternative with contempt, claiming that continued integration is necessary to avoid making the EU, in their words, “a mere free trade area.”

### *Monetary Policy*

The economies of scale from adding a country to a common currency are a result of reducing the transactions costs on exchanges with that country. These economies of scale, however, are ultimately limited by the increasing probability of a major asymmetric shock, the costs of which are substantially higher without a flexible exchange rate. The primary problem of the European Monetary Union is that it does not have *any* of the attributes of a well-functioning currency union: the economies and economic policies of the EMU countries are too heterogeneous not to be subject to a major asymmetric shock, and there is very little labor mobility among the EMU countries.

The potential problems of the EMU were first illustrated by the breakdown of the European Exchange Rate Mechanism in September 1992. At that time, the major asymmetric shock was the reintegration of Germany, which redirected West Germany's net capital exports to the rebuilding of East Germany. As a consequence, the currencies of all of the perimeter countries of Europe from Finland around through Greece were devalued substantially against the deutsche mark, in some countries following the imposition of very high interest rates or a major commitment of reserves in a futile attempt to maintain their exchange rate. At that time, I forecast that the unemployment rates in those countries that devalued against the mark would decline relative to the rates in those countries that maintained their exchange rate with the mark, and that proved to be the case.

In 2005, I forecast that the European Monetary Union would not survive 10 years. Britain, Denmark, and Sweden continued to reject membership in the EMU. There had already been grumbling among senior officials in some of the member governments about the EMU restrictions on monetary and fiscal policy. A major prospective asymmetric shock was the difference among the public pension and

healthcare systems of the member governments. Governments that had promised generous pension and healthcare benefits in countries with a declining population would be the most vulnerable, and this became increasingly apparent when the first post–World War II baby-boomers began to retire; these governments necessarily face some combination of tax increases and reductions in the promised pension and health-care benefits. On the other hand, those governments with smaller or more completely funded benefits and a relatively young and growing population will have a much less severe problem. At great cost, the bailout of the governments of Greece, Ireland, and now Portugal has been temporarily sufficient to maintain the euro exchange rates, but I do not understand how the EMU could survive such a major asymmetric shock by a larger country such as Spain or Italy.

### *Scientific Research*

The economies of scale from scientific research are a result of inherent limits on both private and public institutions that prevent them from capturing all of the benefits of research. In that sense, much research is a worldwide public good and would be undersupplied by any person, company, or government that bore the full cost.

The European Union's main instrument for the funding of research and development in science, engineering, and technology has been the Framework Programme. Since its inception in 1984, this program has grown considerably in scale and scope. Any legal entity within the member states and certain other countries may apply and receive support. I have not had the opportunity to evaluate the record of this program, but it is surely more valuable, for example, than the outrageous and larger EU subsidies to agriculture.

### *A Concluding Comment*

The membership of a European national government in one or more of these five forms of selective functional integration may or may not be valuable to its own population. Moreover, there is no reason to believe that the value of membership in most of these forms is dependent on membership in one or more of the other forms; in other words, there are few obvious economies of cross-functional integration. For that reason, there should be no expectation or requirement that participation in any of the functions should be dependent on participation in other of these functions. The one

exception to this conclusion is that environmental policy should be addressed by the broadest regional association or government, probably the one that sets the trade rules, in order to include all those countries in the region that may be net exporters of environmental problems.

### An Association of European National States

The next step toward regional integration would be a multi-functional association of European national states, which Václav Klaus proposed to name the Organization of European States. The members of this association would be the individual national states, and the association would be governed by representatives selected by these states. There would be no common citizenship in the association or direct popular election of those who govern the association. The basis for representation might best be by population. The association would have no direct power to tax, and the grants from the member governments would be proportional to their representation. The initial powers of the association would be limited to those defined in the treaty establishing the association, and any *addition* to these powers or to the member governments would be subject to the approval of *all* of the then current member governments. Finally, any government needs some check on the abuse of its enumerated powers. This would be best achieved by two measures:

1. Any majority of the member governments should have the authority to nullify any action of the association, regardless of the balance of support of this action by the representatives. In effect, every action by the association would have to be approved by both a majority of the representatives and a majority of the member states.
2. Any member government should have the authority to secede from the association by an authorized procedure that does not require the approval of the other member governments.

The first of these measures would prevent the association from being dominated by its largest member states. The second measure would protect every member government against measures that would eliminate the net benefits of membership in the association.

The major steps to move from the current structure and powers of the European Union to this form of limited association would be



to repeal the several treaties since the Single European Act, change the basis of representation in the Council of the European Union from equal representation by member state to representation in proportion to population, allow the Council to initiate legislation, and abolish the European Parliament.

### A European State

The proposed constitution for the European Union would have been a major step toward a European state. I do not understand the case for a European state, but that is for Europeans, not a friendly American, to decide. The conditions most likely to lead to a European state may be international developments that lead to a shared European concern for a unified foreign and defense policy that is independent of the United States. In that case, the primary intellectual challenge would be to design a constitution for a compound European republic, in which the European state protects the constitution from an abuse of powers by the member states, and the member states protect the constitution from an abuse of powers by the European state (Niskanen 1999). The latter objective should be adequately protected by the Council of the European Union with its double majority rule, but several major changes to the proposed constitution for the European Union should be considered before it is again submitted for ratification (Niskanen 2004).

First, the relation between the Union and the member states is not adequately defined. One article, for example, states that “Competences not conferred upon the Union in the Constitution remain with the member states.” Fine. But the next sentence states that “in areas which do not fall within its exclusive competence, the Union shall act only if . . . the objectives of the proposed action . . . can rather, by reason of the scale or effects of the proposed action, be better than [those of] a member state.” This is an open invitation to an increase in the powers of the Union.

Second, the Commission is much too powerful. One article states that “Except where the Constitution provides otherwise, Union acts can be adopted only on the basis of a Commission proposal.” This is a dreadful provision. The executive has no comparative advantage in recognizing the need for and formulating new legislation, and this provision gives the Commission a large first-mover advantage. Another article also magnifies the role of the Commission: “In the

discharge of their duties, the members of the Commission shall neither see nor take instructions from any government or other body.” One wonders why anyone would want to serve in the European Parliament.

Third, the entire Charter of Fundamental Rights should be replaced by a list of political and economic rights *against* the state, a list more like the U.S. Bill of Rights. The Charter is a detailed list of claims on the state for such services as education, a free placement service, paid maternity leave, social security benefits and social services, housing assistance, preventive health care, services of general economic interest, and high levels of environmental and consumer protection. (I may have missed a few.) Unless the member states have the independent authority to determine the composition of welfare services and the requirements for access to these services, the European Union would become a massive harmonized welfare state, relegating the member states to such limited roles as “ensuring the territorial integrity of the State and for maintaining law and order and safeguarding internal security.”

## Conclusion

As I have written elsewhere, if I were a European, I would share some of the reasons to hope for a more perfect union. But be careful about any major political structure that is being presented for your approval. Do you really want a constitutional treaty among the member states? Or what looks more like a proposed constitution for a European government? Even if you favor the major provisions of the proposed constitution, be especially careful that the constitution limits the authority of the European Union to define its own powers, because all governments seek broader powers than first authorized. Over time, a demonstrably imperfect Europe of national states may be a better protection of your liberty than approving the proposed constitution in the hope for a more perfect European Union.

The issue whether to transform the Lisbon Treaty into a European constitution, of course, should be decided by Europeans based on the accumulating experience with this treaty. I am intrigued, however, that three member governments have already refused to consider the Lisbon Treaty as a constitution.

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