JĘDRZEJ KRAKOWSKI

The Future of the European Union: Conclusions from an Economic Analysis of the Integration Mechanism

Debate on the future of Europe and the progress of integration within the European Union usually tends to rely on analyses and categories derived from political science.[1] Simplifying, its participants can be divided into advocates of a federal Europe and proponents of a Europe *des patries*, a union of nation states. The former believe that the way to deepen integration is by strengthening supranational institutions, the Commission and the European Parliament. The latter contend that integration is best pursued through intergovernmental co-operation within the Council of Ministers and the European Council. Those who prefer to hedge or want to mask national self-interest with verbal pledges of support for integration maintain they favour building a "political Europe."

To explain the course and dynamic of integration processes under the European Economic Community (EEC) and subsequently the European Union it is worth recalling an approach to integration known as the "Monnet method." Jean Monnet, called the founding father of the European Community, believed that the benefits reaped from initiating integration processes would be an incentive to keep deepening these processes, which would then inevitably result in ever-growing interdependence and political integration. A federalist, Monnet was aware that it would be very difficult to persuade the majority of Europeans to accept the idea of federation by means of political arguments. He concluded, therefore, that first it was necessary to demonstrate the benefits of economic integration and thereby win broad approval for solidarity among Community members, the overarching principle of a federal state. The course of integration

---

[1] See, for example, G. Andreani, *What Future for Federalism?,* London: Centre for European Reform (Essays), 2002 and *Europe's Uncertain Identity*, London: Centre for European Reform (Essays), 2000; H. Grabbe, U. Guerot, *Could a Hard Core Run the Enlarged EU?*, London: Centre for European Reform (Briefing Notes), 2004; "The Future of the European Union: French and British Perspectives," Report of a Seminar, Franco-British Council, June 2003, www.francobritishcouncil.org.uk; H. Persson, *Scenarios for the Future of the European Union*, Copenhagen: Copenhagen Institute for Futures Studies, 2003.

within the European Coal and Steel Community (ECSC), EEC and EU showed Monnet's prediction to have been right. The positive effects of intra-ECSC sectoral integration and the economic successes of the Benelux customs union helped pave the way to establishing the EEC. Since 1958 the Community has moved by stages from simple to increasingly advanced forms of integration: from customs union through single market to economic and monetary union. The Treaty of Maastricht established the European Union, the political superstructure of the economic community. Earlier the EEC Parliamentary Assembly had been replaced with the European Parliament whose members are directly elected. In the draft Constitutional Treaty the powers of the Parliament were significantly enhanced. The EU has set up a framework for developing co-operation in the fields of justice and home affairs and protection of civil rights. Policies on visas, asylum and immigration and judicial co-operation in civil matters are covered by joint decision-making procedures. Over a steadily widening range of issues qualified majority voting is superseding unanimity.

Given the mechanics and dynamic of Community integration processes it can reasonably be said that the best starting point for debate about the future of Europe is analysis of the consequences of the present state of economic integration.

The process of EU economic integration is well advanced but not of a piece. The Union rests on a customs union and common market of 25 countries with differing economic structure and levels of development. A customs union entails having a common external trade policy. Putting in place a single internal market comprising structurally and developmentally disparate countries necessitated establishing a common agricultural policy and a policy of cohesion to level upwards the poorer beneficiaries of integration and laying down uniform rules to ensure the smooth functioning of the single market, i.e. free movement of goods, services and production factors, as well as protect competition and consumers. Other preconditions for the efficient functioning of the single market are co-ordination of member states' economic policies, harmonization of indirect taxation and adoption of common standards in many areas. A common policy has also been established for protection of marine resources.

Pursuing common policies, enacting co-ordination measures and maintaining the requisite institutional infrastructure requires solidarity in financing these activities. To this end the Community established a common budget. Taxation, industry, research, environmental protection, transport, energy, social security, healthcare, education, sport, culture, justice, foreign policy and defence remained in the hands of member governments. In some of these areas the Union exercises partial authority, in others it has auxiliary, co-ordinating or supplementary powers. Its members are required to comply with all common decisions. The Treaty on European Union (TEU) and the Treaty establishing the European Community (TEC) defined the decision-making procedures.

European integration did not, however, stop at creating a single, common internal market. At Maastricht it was decided to move towards a more advanced form of integration, namely economic and monetary union (EMU).

At this point a terminological observation is in order. Economic and monetary union implies a common economic policy. Economic policy consists of two components: monetary policy and fiscal policy. Under the EMU arrangements set up in 1999 fiscal policy remains in the hands of the member states and is subject only to co-ordination. Hence in its present shape the eurozone should be called a monetary union (MU).

At Maastricht only two member states, Britain and Denmark, were granted opt-outs allowing them to decide for themselves whether they wished to join MU. The rest of the EU countries, including new members, are required to conduct economic policies oriented to eventual participation in MU.

Aside from Britain and Denmark, Sweden, which did not belong to the European Monetary System,[2] also remained outside MU; as did all the countries which joined the EU in 2004. With the establishment of MU the Union ceased to be a uniform integration arrangement. The integration of countries participating in MU is deeper.

Uniformity also ceased to be a principle of EU integration with the formation of the Schengen group to which neither Britain and Ireland nor any of the new member states belong. The Amsterdam and Nice treaties allow “enhanced co-operation” in integration to be undertaken by a minimum of eight countries provided it does not infringe any treaty provision and the rest of the members express their assent. Accession to the enhanced co-operation group must be open to other member states subject to fulfilment of the entry criteria.

Establishment of MU has far-reaching implications for the further evolution of EU integration processes. The participating states introduced a single currency, the euro, and entrusted overall direction of monetary policy to the European

---

[2] At present, following a “no” vote in a referendum on joining the eurozone, Sweden has de facto the same status as the United Kingdom and Denmark.

Central Bank (ECB), an institution of a federal nature. They thereby ceded sovereignty in the filed of money creation and regulation of interest rates and the exchange rate to a supranational body. National authorities retained responsibility for fiscal policy, that is enactment of budgets and taxation.

The situation of MU members is similar to the situation of regions in a unitary state with a varied economic structure but a one-size-fits-all monetary policy. But there the resemblance ends and a fundamental difference appears. If a region is hit by economic difficulties the national government can ease these by lowering its tax liability or allocating bigger financial transfers from the central budget. MU has no such mechanism as the EU budget is not the MU budget; it amounts to barely c.1% of the gross national income (GNI) of the whole EU-25 and is used solely to finance common policies and the activities of EU institutions. There is no provision under MU for fiscal transfers to countries which have slid into recession. If overtaken by recession or other structural shocks eurozone states are left to cope with their problems on their own and only with the help of fiscal mechanisms since introduction of the single currency has deprived them of the option of employing such adjustment instruments as monetary or exchange-rate policy. They are also constrained by certain agreed fiscal restrictions.

Establishing both a common budget and a common currency was not politically feasible. Pragmatic arrangements were, therefore, adopted as safeguards against the risk of MU states running excessive budget deficits. To qualify for participation they had first to attain a high level of economic stability as defined by five indicators—budget deficit, public debt, inflation, long-term interest rates, and exchange rate—which cannot exceed specified ceilings. The durability of MU in its present shape, depends, however, not only on fulfilment of the stability criteria at the time of entry (to MU) but also on compliance with the agreed fiscal regime (agreed fiscal constraints) by all the participant states. This condition is known as convergence. Even before the move to full MU it was thought that some countries, Italy and Spain, for example, might have very serious problems with meeting the rigorous stability criteria over the long term. To prevent MU monetary policy breaking down a Stability and Growth Pact (SGP) was concluded in 1997 which provides for severe sanctions in the event of non-compliance with the fiscal convergence criteria.

The structural differences within the eurozone mean that the economic cycle is in different phases in different countries and that they respond in differing ways to changing external circumstances. Thus, at any one time their interest-rate expectations may also vary. For instance, one group of countries may be facing inflation while in another what is required is to stimulate economic activity. When such an unfavourable situation arises a single interest rate only makes things worse. Higher inflation in one country makes the real interest rate there even lower and that has the effect of generating additional inflationary pressure. If the ECB takes the situation in this country into account and raises the interest rate difficulties in other countries will intensify. Efforts to keep budget deficits and public debt in line with the convergence criteria may then, in the absence of the interest rate as a means of adjustment to local conditions or the option of devaluation, result in prolonged and profound recession and high unemployment. Conversely, reduction of interest rates can help states at risk of recession but is likely to stoke inflationary tendencies in others and, by the same token, across the whole MU.

Acute imbalances within the MU were averted, until mid-2003, by the relative weakness of the euro against the dollar, which boosted the competitiveness of the exports of all the MU countries in external markets. Undervaluation of the euro was estimated in 2001 to be over 40% in terms of the dollar and over 20% in terms of the yen. But the trouble with distorted relationships in the exchange rates of the principle currencies is that they are liable to depress economic activity worldwide. The degree of the euro's undervaluation undoubtedly impacted damagingly on the economies of Japan and the United States. The worsening of the economic situation in America and the lack of improvement in the economic situation of Japan has had the effect of driving up the value of the euro. The result is that contracting demand for goods exported by EU countries locks in economic stagnation in Europe and increases social tensions in the eurozone countries.

As long as the imbalances within the MU were minor and infringements of the fiscal rules confined to countries of relatively little significance economically, problems could still be swiftly resolved under the provisions of the SGP. When the Council of the EU concluded in February 2001 that Ireland's deviation from budgetary restraint might trigger an inflationary spiral it required only the adoption of a common position to persuade the Irish government to adjust its budget accordingly.[3] But when budgetary strains appeared in the big countries consultations and political pressures were no longer enough.

---

[3] Cf. R. Baldwin, C. Wyplosz, *The Economics of European Integration*, Part V, *Monetary Union*, London, New York, 2004, p. 395.

In the years 2002–2004 it was found that in near-recession conditions keeping budget deficits below 3% of GDP was not feasible in Portugal, France, Italy and even Germany which, incidentally, had categorically demanded stiff fiscal rules as a precondition of MU. The SGP began to come in for criticism on the grounds[4] that it prevented pursuit of a counter-cyclical policy to stimulate growth and reduce unemployment. The upshot was that under pressure from France and Germany the rules were relaxed, which many economists believe could increase strains within the MU.[5] In mid-2005 the EU's constitutional and budget crises further weakened the euro and gave rise to speculation about the possibility of the currency union falling apart. According to analysts at HSBC (one of the world's biggest financial services and banking groups) the single interest rate policy has damaged Italy, Germany and Holland and may incline these countries to leave the eurozone. "If economic differences in the eurozone worsen further," said a HSBC report in July 2005, "some countries may start pondering the costs of staying in the single currency arrangement."[6] Most analyses point out that in Germany, France and Italy permanent reinstatement of the required fiscal regime calls for reforms that cut back public spending, primarily in the social sphere. The political situation in these countries rules out speedy and radically liberal reforms. Reform of, for instance, the social security system, essential for demographic reasons, will take a long time. Reform of public spending would facilitate improvement of the economic situation. But if the economic policy in the biggest MU states fails to galvanize growth and reduce budget deficits severe imbalances will build up in the eurozone. Further infringements of the GSP raise the spectre of inflation and a currency crisis. Anchoring the functioning of MU to the GSP will no longer be enough. Other arrangements will be needed.

Economic theory has defined the characteristics of the optimum area for the functioning of a single currency. They include uniform economic structure, high labour mobility and high wage flexibility. The eurozone does not fulfil these criteria.[7] That being so, without a common fiscal policy MU is in the long run

---

4 Cf. L. Oręziak, "Polityka budżetowa na obszarze euro (cz. II)," *Bank i Kredyt*, 2002, no. 7.

5 See, for example, D. Gros, T. Mayer, A. Ubide, "The Dog that Lost Its Bark," *CEPS Policy Brief*, 2004, no. 58.

6 As quoted in EuroPAP, 13 July 2005.

7 For a condensed but exhaustive survey of the literature on this subject see Cf. R. Baldwin, C. Wyplosz, *op. cit.*

unsustainable. Convergence is not a shield against the effects of economic asymmetry.[8] Intensification of asymmetric recession phenomena (i.e. ones that affect only some of the MU states) will make it necessary to introduce common stabilization mechanisms of a fiscal nature in order to prevent a meltdown that would have incalculable consequences.[9]

No doubt we cannot expect an early, but sooner or later inescapable, decision that clearly follows through on the political design which underlay the idea of MU, i.e. transfer of responsibility for fiscal policy to supranational MU institutions, in other words—establishment of a common budget and complete harmonization of taxes. Were this to happen, the whole of macroeconomic policy would become the domain of supranational institutions[10] and that would necessitate the formation of common representative, legislative and executive authorities, in other words, formation of a political union, a federal state composed of the MU states.

Politicians have long been aware that formation of a monetary union must inevitably lead to political integration. However, the publics in both the eurozone and the other EU states are not yet ready to approve such a radical political change. Witness the critical reactions in many European countries to the German and Belgian federalist proposals. This is not, of course, a final and irrevocable situation. Eventually supporters of a federal Europe may carry the day in many MU member states. So, interim arrangements will have to be found.

One such answer might be to create a stabilization fund, a common quasi-budget to be used to cushion "asymmetric shocks" and pursue a counter-cyclical

---

[8] It has long been held that the co-ordination of economic policy under Monetary Union is inadequate and that a common economic policy will have to be established. See, for example, P. Jacquet, J. Pisani-Ferry, "Economic Policy Co-ordination in the Euro-zone," CER, January 2001; L.M. Pacheco, "Fiscal Federalism, EMU and Shock Absorption Mechanisms: a Guide to the Literature," *European Integration Online Papers*, 2000, vol. 4, pp. 5–6.

[9] Some interesting reflections and a review of the literature on this subject can be found in the following articles: K. Szeląg, "Federalizm fiskalny a Unia Gospodarcza i Walutowa," part I and II, *Wspólnoty Europejskie*, 2003, no. 11, 12; idem, "Polityka gospodarcza w strefie euro: koordynacja czy centralizacja?," *Bank i Kredyt*, 2004, no. 5; L. Oręziak, "Aktualne i przyszłe kierunki rozwoju obszaru euro," *Bank i Kredyt*, 2000, no. 12; G. Paluszak, "Euro jako szansa czy zagrożenie Europejskiej Unii Walutowej, federalizmu fiskalnego i unii politycznej?," *Wspólnoty Euroejskie*, 2003, no. 2.

[10] That the European Monetary Union would evolve in this direction was foreseen, even before it came into being, by Martin Feldstain in "The Political Economy of the European Economic and Monetary Union: Political Sources of an Economic Liability," *Journal of Economic Perspectives*, 1997, no. 4.

policy.[11] It would enable financial transfers to regions at risk of recession or forced to restructure. This would require the eurozone countries to levy a tax from which to finance the stabilization fund.[12] To prevent disputes among the member states over the size of payments into the fund and its distribution it would be necessary to level the competition playing field, which means harmonization of VAT rates, harmonization of corporate taxation and adoption of common labour standards.[13] At a rough estimate an effective stabilization fund would have to constitute no less than 1% of the GNI of the MU states.[14] Operationalization of the fund would require tightening GSP rules. Monetary union would then become effectively, and not only nominally, economic and monetary union (EMU). Its members would retain their own budgets for financing policies still within the competence of nation states.

Establishment of a stabilization fund and harmonization of taxes and welfare standards is not at odds with Eurotreaty provisions on enhanced co-operation, provided that EMU remained open to other EU members.

Twelve "old" EU states have so far joined MU. That the other three "old" members are likely to remain outside for the foreseeable future is evidenced by the "no" votes in Danish and Swedish referendums. The citizens of these countries were aware that EMU is as much a political as an economic project[15] which is why, according to many observers, they voted against joining. There are even more opponents of accession in Britain and the date of referendum on this matter has consequently yet again been shelved "ad Kalendas Graecas."

All new member states are obliged under their accession treaties to pursue policies oriented towards participation in monetary union and have declared such intent. However, if and when full EMU comes about the entry provisions would have to be amended leaving accession to be decided by the EU member state.

---

[11] As early as 1993–1995 it was anticipated that a fund of this sort would have to be set up and many proposals were put forward. See K. Szeląg, *op. cit.*

[12] Cf. L.M. Pacheco, *op. cit.*, pp. 5–6.

[13] Cf. K. Szeląg, "Jednolita polityka budżetowa w strefie euro—realna wizja czy utopia?," *Bank i Kredyt*, 2003, nos. 11–12.

[14] Cf. K. Szeląg, *op. cit.*

[15] Cf. G. Andreani, *op. cit.*; H. Grabbe, U. Guerot, *op. cit.* (comments on the Maastricht conference).

If MU states find themselves compelled to deepen integration there arises a question of how the EU will function. We would then have a two-speed European Union: the inner circle would be formed by EMU, the outer by countries linked to it by a customs union and single market. Some of the latter might aspire to EMU membership and gain admission once they had fulfilled the set criteria. There would, however, be no such obligation.

The EMU states would probably want the EU budget to be adapted to the requirements of the newly formed dual integration structure. They would doubtless demand an overhaul of EU cohesion policy. Cohesion policy is of fundamental significance for EMU since it weakens the asymmetry of economic processes inside EMU. The EMU members might decide to co-finance structural policy in the EMU area through payments from the stabilization fund. They would, however, have to agree to keep in place the EU's structural and cohesion funds and after what are likely to be difficult negotiations define their contributions to these funds. After all, one of the preconditions for forming an enhanced cooperation sub-group is facilitating accession by other EU member states. Since improving cohesion across the whole Union would be in the interests of EMU single-market logic would enjoin preserving the common agricultural policy which, whatever the evolution of integration processes, will be modified. The EU budget would include all the other items that are currently covered by joint financing arrangements. Developing the right economic and institutional relationships between the EMU states and the other EU members so that they benefit both the inner and outer circles would, however, be beset by all sorts of complications. Harmonization of the rules governing the market, competition and social standards within an EMU operating a common economic policy would be fuller than at present in the EU. Under single market conditions the EU states which did not belong to EMU would have to adopt the same rules if they wished to compete in the EMU market on equal terms or else accept—in the case, for instance, of services—the principle of compliance with the labour standards in force in the EMU area.

Agreement would also be difficult to reach on the institutional framework in which the dual EU structure would function. It would require establishing a common EMU institution responsible for economic policy, a kind of "economic government"[16] which would be a partner of the European Central Bank and whose powers would include disbursal of the stabilization fund. Setting up such

---

[16] A proposal along these lines was put forward as early as 2000 by French Prime Minister Lionel Jospin.

an institution would require altering the remit and competences of the European Commission and laying down the principles of co-operation between the two executive bodies. Additional complications would almost certainly be created by modifications of EU decision-making procedures. The scale and complexity of all the outstanding problems would entail concluding a "treaty within the treaty"[17] (within, that is, the TEC and TEU or the Constitutional Treaty if ever adopted).

It can be expected that securing the approval not only of the MU states but also all the EU states for enhanced co-operation in the EMU framework in its suggested shape will prove very difficult. Some might be led to withhold approval by rejection of the political implications—in effect, a clear commitment to a path leading to some form of federal state; others by what would probably be more difficult criteria for accession to EMU than at present.

The political model of intra-EMU enhanced co-operation would, however, be a subject of debate and the resulting arrangements could allay the fears of opponents. A different scenario is also possible. If strains arose within the present MU severe enough to threaten its break-up and agreement on arrangements of a federal nature was not forthcoming, some of the members might decide to deepen economic and, consequently, political integration outside the Eurotreaties.[18] The idea of a federal Europe is still vibrant in France, Germany and Belgium.[19] Some of the new member states would doubtless also be interested in joining a new integrationist grouping in the hope of obtaining greater development support. After all, the cornerstone of a federal state is solidarity.

Jürgen Habermas has called for a debate on the notorious concept of *finalité*, that is the ultimate goal of European integration and asked whether Europe can be strong enough to influence the international economic order or is it to allow the headlong rush to globalization to snatch the possibility of seeking its own path out of its hands.[20]

A positive answer to this fundamental question will be possible if Europe's nations agree to continued cementing of economic and political ties and adopt a

---

[17] A phrase originally used by Jacques Delors and, echoing him, Joschka Fischer. Cf. G. Andreani, *op. cit.*, p. 17.

[18] It is worth quoting an observation by Heather Grabbe and Ulrike Guerot in the Briefing Note cited earlier: "So core Europe, if it happens, is more likely to be created outside the treaties."

[19] Cf., for example, G. Andreani, *op. cit.*; H. Grabbe, U. Guerot, *op. cit.*

[20] Cf. J. Habermas, "Koniec konstytucji czy Europy?," *Europa*, 22 June 2005 (translation of article in *Süddeutsche Zeitung*, 6 June 2005).

common strategy on the global stage. Deepening integration within EMU as outlined above would make it easier to define common interests and enhance the ability to protect them. EMU would become one of the strongest world market players and acquire a greater capacity than the EU today to secure in global negotiations the desired trade and investment agreements supplemented by protocols on workers' rights and the environment. The euro would assert an ever-stronger position as a reserve and transaction currency, which would facilitate control over speculative capital and prevent currency and payments crises. In this way European states would jointly reinforce economic and political sovereignty and democratic control of the economy. They would also be capable of effectively initiating the rightfully proposed transformation of international institutions—the International Monetary Fund, the World Bank and the World Trade Organization—into instruments of global equity.[21]

If no major economic shocks occur inside the currency union the road to economic and political union will lengthen. For in the face of threats it is easier to take radical decisions. In normal conditions rallying public opinion behind far-reaching reforms is much harder.

But if approval of integrationist approaches of clearly federal nature is a precondition of solving economic problems in the eurozone opponents will have to be made to realize that the alternative is the prospect of MU unravelling and integration processes in Europe foundering and, in consequence, its loss of a strong position in the world economy. This argument will no doubt carry conviction with the necessary majority of the public. Fred Bergsten, a well-known American economist, once observed that the Europeans subscribe to a bicycling theory of integration: you have to keep pedalling; stop and you take a tumble.

Only a politically integrated Europe can effectively defend its model of civilization of which an integral part is the social market economy. In a globalized world preserving this model is beyond the powers of the nation-state. The European social market model, which enables social exclusion to be radically reduced and consists in protecting democracy, fundamental human rights, workers' rights, common goods and common public space from being turned into commodities and upholding social services such as healthcare and education, is a great civilizational and cultural achievement. It should remain an example to the world.

---

[21] Cf. B.R. Barber, "Skazani na globalizację," *Gazeta Wyborcza*, 1–2 October 2005.