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# **Alternative Political and Economic Futures for Europe**

by

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Defeat of the proposed constitution for the European Union by voters in France and in the Netherlands opens an opportunity to reflect on a broader range of alternative political and economic futures for Europe. It is 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 to date suggest 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. My remarks today address the considerations that bear on the choice among these alternatives. Vaclav Klaus, the president of the Czech Republic, may have 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 solutions 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 (because the market for ideas must remain open for future political developments on the left-right spectrum of individual European countries.<sup>2</sup>*

## **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 term 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. Or, similarly, that the creation of a new Iraqi state would create an Iraqi political identity. The breakup of the Soviet Union is only one of 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 Luxembourg, Singapore, and Switzerland, for example, are about the same as that in the United States and far higher than in the much larger states of China, India, and Russia. 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.

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<sup>2</sup> Vaclav Klaus, Why Europe must reject centralization, *Financial Times*, 30 August 2005

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. These economies, however, can usually be realized by voluntary alliances among national states without the problems of creating and maintaining a broader multi-national 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 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 some 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. The Swiss government manages to do enough mischief with its own agricultural policy without being a member of the European Union. One other cost of this common agricultural policy is that it may destroy the prospect for success 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 about one-half of the European Union budget. The first step toward making the European Union a serious regional government would be to eliminate the common agricultural policy, maybe in exchange for increasing expenditures for those functions for which there are significant economies of scale.

### ***Defense***

The case for a traditional defense alliance is based on geometry: The cost of defense increases with the perimeter of the defended area. The number of people defended increases with the size of the defended area. And the ratio of the perimeter to the area declines with the size of the area. (For a square, for example, the ratio of the perimeter to the area is equal to four divided by the length of each side.) So the cost of defense per person declines with the number of people in the defended area.

In that sense, the North Atlantic Treaty Organization (NATO) was a traditional alliance, 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 shared concern of member governments about military or

terrorist threats against non-member governments. 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 Baltic countries on the Russian border are now 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 major 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 the Ukraine.

NATO has also long had a vague implicit “consensus” rule for approving out-of-area military operations. This has sometimes been interpreted as meaning that any member government – now including, for example, Slovakia -- that is strongly opposed to an out-of-area NATO military operation may veto this operation, although this rule has generally been interpreted as meaning that the participation of any member government, in such military operations 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 changing both Article V and the consensus rule. My suggestion is that approval of a NATO response to an attack on a member country or an out-of-area military operation be subject to the same dual super-majority rule: Approval of either type of NATO military response would require the approval of four of the six governments of the largest member countries and two-thirds of all other member governments; approval by this rule would then bind all member governments. This would protect NATO against an obligation to defend any member country without the approval of most of the large and smaller member governments. This would also protect NATO from the ability of one or a few member governments to veto a NATO out-of-area military operation. In the absence of this or a similar change in the approval rules, I would personally endorse the withdrawal of the U.S. Government from NATO and to let the Europeans choose the defense alliance that best serves their interests.

### ***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 result to be achieved but leaves them the choice of the form and method they adopt to realize the EU objectives 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 service by the European Union has been to set the rules for a large regional customs union with no internal constraints on the movement of goods, services, labor, and capital; 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: they create a preference for the most efficient producer in the region relative to the most efficient producer in the world that is equal to the common external tariff, an effect first recognized by Jacob Viner in 1950.<sup>3</sup> 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 agreement. For this reason, the proliferation of bilateral free trade agreements by the United States Government makes no economic sense because they are likely to create much more trade diversion than trade expansion.

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, choose to join the European Union – decisions, I suggest, that may not have been in their interests. 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.

### ***Monetary Policy***

The economies of scale from adding a country to a common currency area 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 (EMU) 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,

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<sup>3</sup> Jacob Viner, *The Customs Union Issue*, 1950.

- There is very little labor mobility among the EMU countries, and
- There is very little fiscal redistribution among the EMU countries that is a function of changes in the relative unemployment rates.

This should not be surprising; the United States did not have a well-functioning common currency for 150 years – not until federal unemployment insurance was created in the 1930s and the demand for labor during World War II broke the barriers on the movement of labor from the south to the north.

The potential problems of the EMU are best illustrated by the breakdown of the European Exchange Rate Mechanism (ERM) 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. Somewhat to my surprise, moreover, there was no significant increase in the relative inflation rates in those countries that devalued against the mark.

My own guess is that the European Monetary Union will not survive 10 more years. Britain, Denmark, and Sweden have continued to reject membership in the EMU. There is already grumbling among senior officials in some of the member governments about the EMU restrictions on monetary and fiscal policy. The major prospective asymmetric shock is the difference among the public pension and health-care systems of the member governments. Governments that have promised generous pension and health-care benefits in countries with a declining population will be the most vulnerable, and this will be increasingly apparent after the first post-World War II baby-boomers begin to retire in the next few years; these governments will 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 during the next few decades. I do not understand how the EMU could survive this asymmetric shock.

For those governments that have recently joined the EU but have not yet joined the EMU, my advice would be to delay this decision as long as possible. Those governments that are already in the EMU should consider their alternatives in response to a major asymmetric shock. Those governments that have not yet developed the expertise, institutions, and reputation for a responsible independent monetary policy, are best advised to create a currency union with the best currency among the country's major trading partners. Most countries, in summary, are best served by a responsible independent monetary policy and a flexible exchange rate.

### ***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 world-wide 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. For the four years ending in 2006, the EU budget for this program was 19 billion euros. The budget for the subsequent four years has not yet been determined, but the European Commission has proposed a doubling of the current budget. 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 much larger EU subsidies to agriculture.

### ***A Concluding Comment***

The membership of a European national government in any one 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 that which 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, what Vaclav 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 could be equal among the member governments or, more realistically, 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:

- 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.

- 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 be 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 primary condition that might lead to a European state would 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.<sup>4</sup> The latter objective should be adequately protected by the Council of the European Union, with equal representation among the member states and 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<sup>5</sup>:

1. 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.*” (Article I-11-2) 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 intended action ... can rather, by reason of the scale or effects of the proposed action, be better achieved at the Union level.*” (Article I-11-3). This sentence suggests that the Union might exercise some competence outside its exclusive authority if some undefined body decides that the Union could do it better than a member state. This is an open invitation to an increase in the powers of the Union.

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<sup>4</sup> William A. Niskanen, On the Constitution of a Compound Republic, *Constitutional Political Economy* 10(2), 1999.

<sup>5</sup> William A. Niskanen, Advice by a Friendly American on the Proposed Constitution for the European Union, *Revista di Politica Economica*, July-August 2004.

2. 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.”* (Article I-26-2). 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 members of the Commission shall neither see nor take instructions from any government or other body.”* (Article I-26-7). One wonders why anyone would want to serve in the European Parliament.

3. And 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. 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.”* (Article I-5-1)

## **A Final Word**

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 to me 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.