European Integration: Some stylised facts

Jørgen Drud Hansen & Finn Olesen

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Finn Olesen
Department of Environmental and Business Economics
University of Southern Denmark, Esbjerg
Niels Bohrs Vej 9-10
DK-6700 Esbjerg
Tel.: +45 6550 1514
Fax: +45 6550 1091
E-mail: finn@sam.sdu.dk

Jørgen Drud Hansen
Department of Economics
University of Southern Denmark, Odense
Campusvej 55
DK-5230 Odense M
Tel.: +45 65502120
Fax: +45 66158790
E-mail: joe@sam.sdu.dk

Abstract

The European economic integration has been an ongoing process for nearly a half century. This article discuss initially the concept of integration and then gives an overall assessment of the development of integration on various areas. Evidence points to a remarkable process towards monetary integration especially in the last decades. The significant increase of the intra-EU trade also points to a more integrated Europe especially since the establishing of the internal market. However, the integration seems to have less impact on other areas e.g. synchronisation of the business cycles between Member States and convergence of living standards. Prospects for the future development of integration is also discussed in the article.

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1. Introduction

Is it fair to conclude that, in the last decades, the economies of the Member States have become more integrated so they now form one unified European economy? There is no immediate answer to this question, as there is no clear consensus concerning the meaning of the word integration. Loosely speaking, economic integration refers to a diversified process where formerly independent countries melt together to form a unity.

Economic integration may at least have two dimensions. Firstly, the concept of integration can be related to the degree of convergence with respect to formal and institutional frameworks. It is obvious that the EU co-operation has created such conditions for the economic environment in a number of central areas. For instance, The Internal Market has made the state borders less important. As a result of this, the institutional conditions for producers and consumers within the EU have become more uniform in several crucial respects. The Common Agricultural Policy is another example whereby EU has created a common institutional framework as the farmers in the EU all produce under the same set of market regulations. Finally, the EMU gives the institutional set up in the monetary area for the countries participating in the common currency. So by this measure - similarity of institutional and formal frameworks - integration has proceeded a great deal, and the EU must be said to be highly integrated.

Secondly, the concept of integration can be related to the degree of similarity in outcome measured, for example by uniform prices, interest rates, unemployment rates, and standards of living. These two aspects of integration - similarity in institutional and formal frameworks and similarity in outcome - do not necessarily lead to the same conclusions with respect to the development of the process of integration.

The complexity of the concept of integration is not the only hindrance to examining the effects of the EU process of integration because the removal of barriers also represents a global trend. Therefore, it is difficult to distinguish the specific effects of the European process from the global one.

Given this complexity of the concept integration the purpose of this paper is to evaluate the present stage of integration in the EU on various areas. The analysis will be based on stylised facts putting focus on trends of various indicators of degree of unification of European economies. The paper furthermore aims to discuss future prospects for the integration process in the next decades.

The paper is organised as follows. The integration experiences gained so far will be summaries in Section 2 trying to answer the question of whether the EU still consists of a club of economies or one fully integrated economy. Section 3 takes a look into the future by examining recent initiatives and discussing the prospects for further integration. Finally, section 4 concludes the paper.

2. Integration in Europe so far

2.1 The theory of optimum currency areas as a theory of integration

As it known from literature the process of economic and monetary integration seems to be prosperous if the countries participating in such a process all together by and large could be characterised as an optimum currency area. This concept, originally formulated by Mundell (1961), gives some important criteria in evaluating the successfulness of integration. These may be grouped under the following headings: 1) policy preferences, 2) industrial structure, 3) openness of the economy, 4) mobility of capital and labour, 5) wage and price flexibility, and 6) fiscal integration. To the extent that the countries in question are very similar in all these mentioned respects, one would expect the process to become very successful. The lesser the similarities the more troublesome and the less economic prosperous the process of integration is expected to become.

P*olicy preferences*: In order to obtain identical economic situations in individual member countries with respect to various macroeconomic goals there need to be a uniform perception of the preferable future economic development. If this precondition is not present; shocks (symmetrical as well as the more severe asymmetrical one) will provoke desires to implement different economic policies in different countries. It is therefore important to the participating countries to have similar goals or preferences if one wish to pursue a certain minimum of co-operation of economic policy. Looking upon the historical evidence such uniqueness in preferences between the EU member states is most likely not fully at place at present.

Industrial structure: If the industrial structures are very different between members of a union, as pointed out by Kenen (1969), changes in the composition of demand will influence the members differently and thereby create asymmetric shocks. The more alike the countries are with regard to structure the less the risk and magnitude of such an asymmetric shock will become. Regarding the overall distribution on main sectors, agriculture is still relatively important in Greece, Portugal, and Ireland, although this difference from the other member states is diminishing rather rapidly. At the same time the industrial structures in manufacturing between countries is also not uniform. Taken together these differences would though hardly make the emerging of an asymmetrical shock very likely. Rather it would be the limited mobility of goods and services that would account for such country specific shocks although its likelihood is difficult to measure precisely. Despite the establishment of the Internal Market, the relationship between most firms and their customers is still at least to a certain degree characterised by stickiness, and therefore it takes time for the firms to change their outlets.

Openness of the economy: The openness of the economy reflects the degree of integration of the goods markets. If these are highly integrated through trade the benefits of a common currency are relatively large. Members of the union, who are closely connected to each other through export and import, will experience significant aggregate demand spillovers. Even if the members are hit by an asymmetric shock, this will only to a limited degree lead to an asymmetric development in output and employment within the union. As shown later, the intra-EU trade, measured as a share of GDP, has increased quite a bit during the past 40 years. Regarding openness, the EU countries therefore seem to have become more open during the period of enhanced integration.

Mobility of capital and labour: Looking upon factor mobility capital has become more and more mobile in resent years in a European as well as in a global perspective. Thus lack of capital mobility represents no problem to the EU. Quite the contrary story has to be told concerning the mobility of labour. Within the union this mobility between members is remarkable low, and it seems fair to conclude that it will be impossible to solve any sincere problem of stabilisation in output and employment through migration between countries in the euro area. If labour mobility were much easier unemployed persons could migrate from regions and countries with failing demands to other regions and countries with increasing demands, thereby ameliorate the effects of an asymmetrical shock on the rate of unemployment and, as a consequence of this, the need for implementing an independent economic policy action (monetary and exchange rate wise).

Wage and price flexibility: If labour does not migrate, wage flexibility may dampen the negative effects of asymmetrical shocks, as pointed out by Friedman (1953) among others. By reducing the nominal rate of wage inflation, regions within the union with a higher rate of unemployment than average should be able to gain competitiveness vis-à-vis other regions and thereby be able to stabilise their level of employment. The absence of an independent monetary and exchange rate policy in the euro area therefore increases the need for flexible and well-functioning labour markets in the participating countries. Looking upon the evidence labour markets in several member states seems to be relatively inflexible compared to for instance the USA.

Fiscal integration: Considering the pros and cons of establishing a monetary union, Kenen (1969) has pointed out the importance of fiscal policy integration. If a strong element of federal fiscal policy is established, where the union as an institution can collect taxes and make expenditures, the negative effects of an asymmetric shock is minimised. For those regions that experiences negative effects steaming form asymmetric shocks, the federal tax payments to the union are reduced at the same time as the federal transfers increases. Such regions thereby become fiscal net-beneficiaries. The opposite is true for those regions that experience positive effects from asymmetric shocks, as their net payments to the union increases. Federal fiscal policy will thus add an element of solidarity to a monetary union, as demands is redistributed from countries experiencing an increase in output to countries experiencing a decrease in their activity. Within the union, however, this element is extremely small. No plan is decided upon which makes a symmetrical federal fiscal system work. On the contrary the Pact on Growth and Stability puts boundaries on the public deficit (a maximum of 3% deficit of the GDP). Within the EU there has thus always been a dilemma between the wish to retain an autonomous fiscal policy at the national level and the desire to give fiscal policy a more active role in the combat of the effects of slowdown in demands e.g. as a consequence of a asymmetrical shock.

In summery, the eleven countries participating in the euro area from the beginning of January 1st of 1999 all reaps microeconomic gains, but at the same time, they have become exposed to the risk of some level of macroeconomic instability. The theory of an optimum currency area lists some structural characteristics of importance to the ability to maintain a balance between the costs and benefits of a common currency. Bering the evidence of the initial eleven countries in mind reveals a rather mixed picture of such a balance. There is no strong indication that conforms the hypothesis that the euro area constitutes a perfect and fully-fledged optimal currency area. On the other hand the establishment of the EMU in itself can perhaps make the eleven different economies perform more unilaterally according to the lines of exactly such an optimal currency area through changes in behaviour (at the levels of households, firms as well of government).

Some empirical evidence

Giving an evaluation of the present stage of economic integration this could be done from a micro- as well as a macroeconomic perspective as shown in Table 1. In the following, we will expand further on the main findings of the table.

Table 1: Rating of the degree of integration

	Rating	Comments
Microeconomic convergence:		
a Markets for goods and services		
Tradeables	+++	intense intra-EU trade, nearly Full equalisation of prices
Partly tradeables	+	Increasing trade flows, some Equalisation of prices
Non-tradeables	0	By definition no trade flows, no Equalisation of prices
b Markets for factors of production		
Labour market	0	No mobility and hence, no Equalisation of wages
Market for real capital	++	Some mobility manifested through FDI flows, mergers and acquisitions - equalisation of real profit rates
Macroeconomic convergence:		
c Nominal convergence		
Price level	++	Labour intensive non-tradeables cheaper in poor countries, hence not full equalisation of price levels
Inflation rates	+++	intense intra-EU trade and stable exchange rates (especially the introduction of the euro) have lead to a convergence of inflation rates
Nominal interest rates	+++	massive cross-border financial activities in the framework of stable exchange rates has lead to a convergence of interest rates
d Real convergence		
Business cycle synchronisation	+	Member state specific business cycles because of different economic structures and lack of co-ordination of fiscal policy
Unemployment	0	No equalisation of employment because of country specific business cycles and different labour market structures
Living standards	+	Mixed trends of convergence of living standards because of ambiguous effects of mobility of goods and resources on spatial distribution of economic activity

Note: Rating of integration according to outcome, i.e. degree of equalisation between Member States. Ratings from 0 (no integration) to full integration +++++.

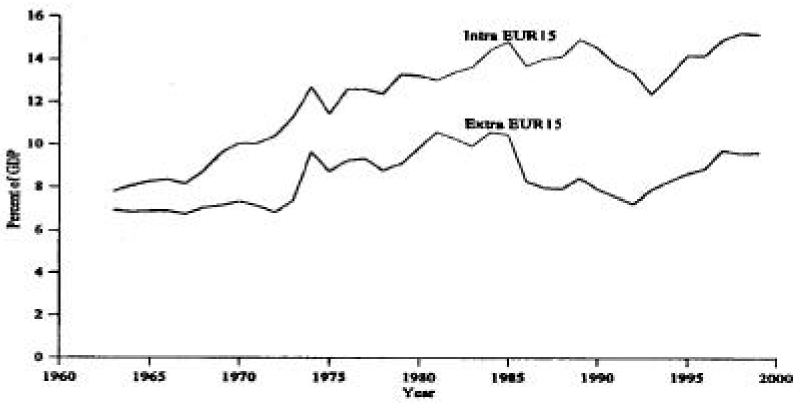
Source: Own adaption.

Markets for goods and services

The formation of the customs union and the Single Market has as expected increased the intra-EU trade as shown in Figure 1. Also the trade between the

EU and the rest of the world (extra EU trade) has increased over the years although admittedly at a much lower pace.

Figure 1. Share of intra- and extra EUR15 - trade of goods, 1963-99.

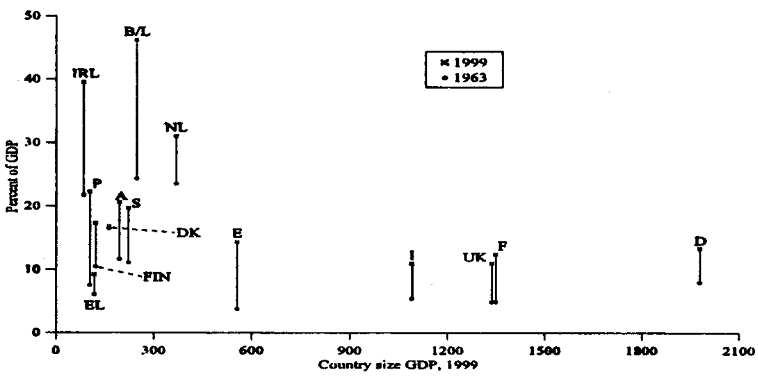


Note: Average of exports and imports in percent of GDP

Source: EU Commission (1999a). Annex: Table 38, 39, 42 and 43.

Looking closer upon how the intra EU trade shares has developed between 1963 and 1999 one finds that all countries - Denmark excluded - have significantly increased their share. Quite according to theory the development in the degree of openness is bigger the smaller the country size as Figure 2 seems to indicate.

Figure 2. Share of intra EUR15 - trade of goods 1963 and 1999.

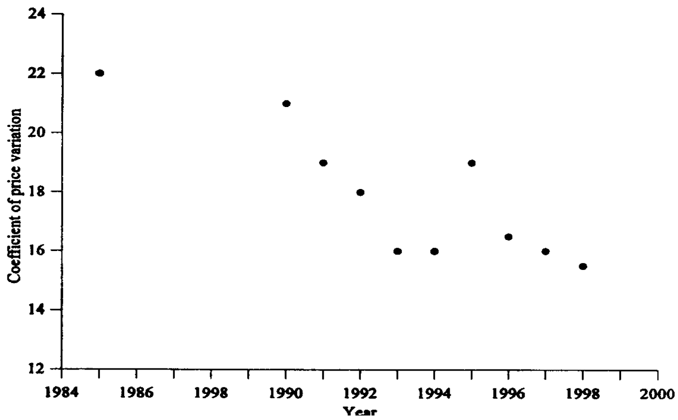


Note: Average of exports and imports in percent of GDP

Source: EU-Commission (1999a). Annex: Table 5, 38 and 42.

The illustrated remarkable increase of trade intensities between the Member States has at the macroeconomic level strengthened the spillovers of aggregate demand. At the microeconomic level the increased mobility of goods and services tends to equalise the individual prices for goods and services. However, the effect of trade liberalisation on price differences varies a great deal from one item of goods to the other. More precisely, the decrease in price dispersion depends on the size of transport and other trade costs after the elimination of tariffs and quotas. For those tradeables, where trade costs are low after liberalisation, the price dispersion is similarly low. For non-tradeables, on the other hand, trade costs after liberalisation are significant and, as a consequence, the markets are segmented. In this case, the formation of the customs union and the Internal Market has only reduced price dispersion to a limited degree. The distinction between tradeables and non-tradeables applies to both goods and services. Figure 3 illustrates the development in the price dispersion between the Member States for private final consumption from 1985 to 1998. The figure show a clear decrease of price dispersion during the years where The Internal Market was established as price dispersion was reduced from about 22-23% in 1985 to about 16% in 1998.[1]

Figure 3. Price dispersion among Member States, 1985-98



Note: The figure shows the coefficient of variance for prices of consumer goods between Member States. The coefficient of variance is defined by the spread divided by the mean in the statistical distribution of prices for consumer goods. Prices include taxes (excise duties and value-added tax).

Source: EU Commission (2000).

1 Also to the extent that taxes in the future are becoming more harmonised within the Union this should further narrow down the spread in prices.

To some extent it seems as if national markets have been replaced by a pan-European market. More competition on such a market improves the efficiency, or welfare, of the economy, as price convergence limits the differences in the consumers' marginal utilities of the consumption of specific goods. Furthermore, welfare will increase because the more fierce competition reduces the mark-up in the price formation.

However, Figure 3 also shows that a potential for further equalisation of the price levels in Europe still exists. Surveys thus indicate that the geographic price differences are larger in the EU than in the USA, i.e., in general, the markets for goods and services continue to be less integrated in the EU than in the USA.[2]

Markets for factors of production
Contrary to the markets for goods and services, the labour market, especially for unskilled labour, is much less integrated across the Member States. The mobility of labour across Member States has remained on a very low level leaving only marginal impacts on wage or employment dispersion. The reasons for this low mobility are mainly language and other cultural barriers, which, by and large, have remained unaffected by the endeavours to integrate the EU economies into one economy.

However, indirect integration effects have appeared on the labour market. The integration of the goods market and the introduction of the euro have emphasised the need for a more flexible labour market. As a consequence, the national trade unions have demonstrated more caution in their wage demands, because demand for labour in the national market has become more sensitive to wage claims, cf. EU Commission (1999b) and Buti & Sapir (1998).

Foreign direct investment (FDI) and mergers and acquisitions have expanded rapidly in the 1980s and 1990s and intra-EU FDI flows have significantly gained importance (see e.g. Commission, 1996). In some cases, where the mobility of goods is rather limited, the rationale for establishing subsidiaries

2 A survey by the EU Commission based on price data excluding taxes thus shows that the dispersion of aggregate price levels for goods and services is 14% in the EU, but only 11% in the USA for 1996 (EU Commission (1999a), p 217).

has been to circumvent the distance barriers and use the owner specific advantages of the firm to have consumer production in more than one location. In such cases, integration through foreign direct investment compensates at least to some degree for the lack of integration of the goods market.

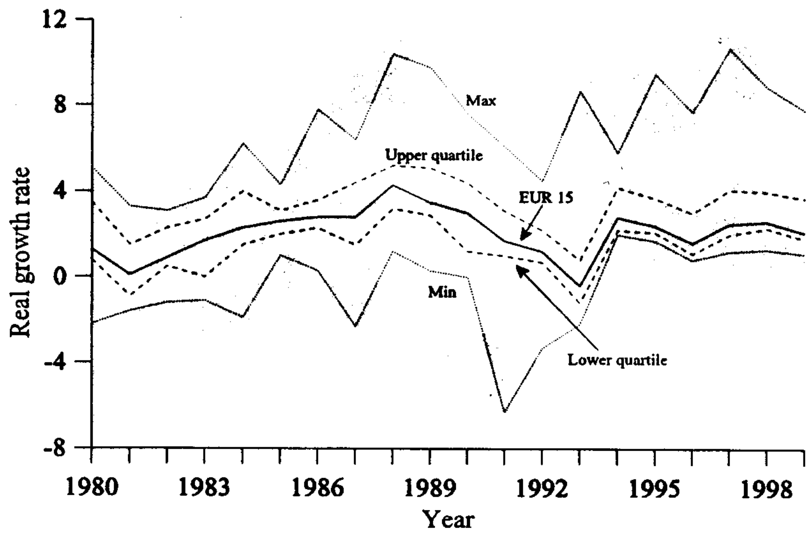
Significant restructuring and specialisation have taken place in European business. The home market oriented diversification strategies of individual firms have been replaced by strategies building on internationalisation and development of core activities. As underlined in an article in the Economist (2000), this has created a more competitive and dynamic environment in Europe, where company behaviour has changed from destructive caution to creative destruction. The upsurge in capital flows - real as well as human - in the EU has therefore been a contributor to the economic integration of the Member States and specifically, it has served to speed up the diffusion of technological know-how.

Nominal convergence

At the macroeconomic level, integration has quite clearly left its mark. Most importantly, the monetary integration has led to convergence of price levels, inflation rates, and interest rate levels between the Member States.

The development in differences between the Member States with respect to inflation rates is illustrated in Figure 4.

Figure 4. Rate of inflation in the EU Member States, 1980-99



Note: The upper and lower quartiles indicate the annual rate of inflation for the member countries with the third highest and third lowest rate of inflation, respectively, in the specific year.

Source: EU Commission (1999a), Annex: Table 24. Authors' calculations.

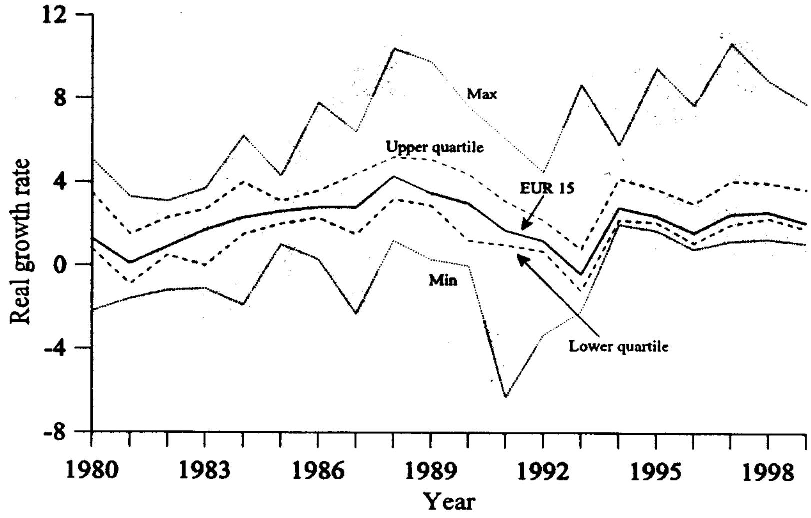
The middle curve (EUR15), indicated by a solid line, shows inflation in the EU as a whole in the period 1980-99. This period was characterised by a fixed exchange rate co-operation between most Member States. The top (Max) and bottom (Min) curves give a year-by-year account of inflation in the countries with the highest and lowest inflation rates, respectively, and the distance between the two rates thus visualises the maximum difference in inflation rates between the Member States. The curves of maximum and minimum inflation are, however, sensitive to exceptional events in individual countries. The figure therefore also indicates the development in inflation in the countries with the third largest and third lowest inflation rates. These quartile curves offer a more informative picture of the actual inflation spread, as they exclude outlier countries. Statistically the two curves approximately delimits the upper quartile and the lower quartile, respectively, in the distribution of inflation rates between countries for the specific year. It appears from the figure that inflation in EUR15 as a whole has decreased, and this is an expression of the increased emphasis on the objective of price stability; cf. the institutional set up of the EMU. Furthermore, the spread in inflation rates has visibly decreased

throughout the entire period, and looking at this macroeconomic variable alone, integration has proceeded very successfully.
The nominal convergence, measured by the convergence of interest rates, is even more explicit. Differences in long-term nominal interest rates essentially reflect differences between the expected inflation rates of the member countries. Confidence in the feasibility of the EMU project significantly influenced the differences in interest rates throughout the 1990s. After the breakdown of the fixed exchange rate co-operation of the EMS following the two currency crises in 1992 and 1993, there were widespread scepticism concerning the realisation of the EMU project, and as a consequence, there were huge differences in the exchange rate levels. This scepticism gradually disappeared concurrently with the political determination to realise the project from January 1, 1999 and compared with previous years, the differences in exchange rates were therefore reduced to a moderate level.

2.2 Business cycle synchronisation

Whereas the monetary integration within the EU is obvious, the macroeconomic results of the process of integration concerning total output and employment are less clear. The economic development thus often differs between the individual member countries, especially in the short run. There is therefore a lack of synchronisation of the business cycles between Member States. This fact has not changed markedly since the early 1980s as is shown in Figure 5 presenting annual real growth rates
In GDP since 1980.

Figure 5. Real growth rate in GDP in the EU Member States, 1980-99



Note: The upper and lower quartiles indicate the annual real growth rate in GDP for the member countries with the third highest and third lowest real growth rates, respectively, in the specific year.

Source: EU Commission (1999a), Annex: Table 10. Authors' calculation.

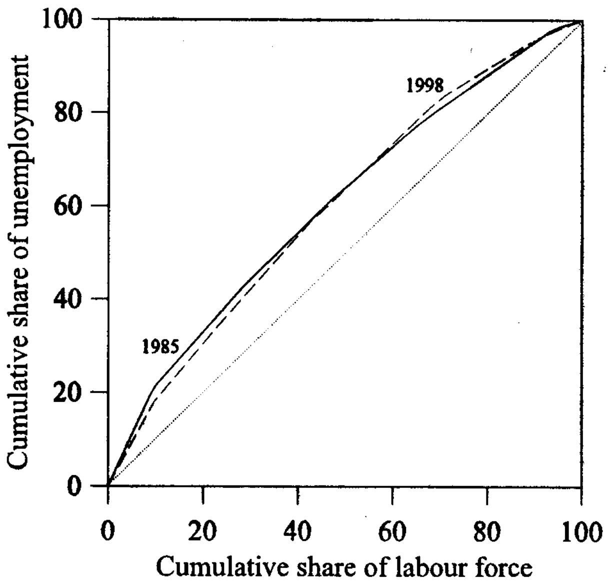
It is immediately apparent from the figure that the differences in growth rates vary a lot when the country with the strongest growth is compared with the country with the weakest growth in a specific year. A more precise picture of the real differences in growth appears by looking at the differences in growth rates for the upper and lower quartiles of the countries. The figure shows that there are significant differences between the upper and lower quartiles and the shown development does not indicate a greater synchronisation in business cycles in the 1990s compared with the 1980s.

At first sight, it may seem surprising that the development in business cycles has not been better synchronised in recent years given the tendency towards a more extensive trade between Member States in the last decades, cf. Figure 1. At the same time, exchange rates between most of the current members have been relatively stable as a result of their participation in the fixed exchange rate co-operation of the EMS. Under such macroeconomic conditions, there are strong links between the development in aggregate demand in individual Member States. A change in the aggregate demand in one country will lead to an increase in activity in the other countries, which in turn will lead to an increase in imports (and thus to export possibilities as well as higher activity in the other Member States). Extensive intra-EU trade under fixed exchange rates should thus contribute in a major way to increased synchronisation of the business cycles.

There may be various reasons for the lack of synchronisation in the 1980s and 1990s. Firstly, there are still significant differences in industrial structure between countries, and similarly, the functioning of the labour markets differs from Member State to Member State. It is obvious that such structural differences may mean that the economic development in the individual countries will not concur when external conditions change. Secondly, the economic policy of the individual Member States has been determined by internal considerations rather than by the consideration of a co-ordination of the general development in business cycles in the EU.

Looking at differences in unemployment figures, there is no sign of a development towards more homogenous employment structures between the members. Figure 6 illustrates the differences in unemployment via a Lorenz curve in 1985 and 1998 for the current 15 Member States. The countries are ranked according to their rate of unemployment, and from left to right, the Lorenz curves display co-ordinates of cumulated share of total unemployment and cumulated share of total labour force in EUR15. The curvature thus visualises the inequality in the distribution of unemployment and it is apparent that the inequality has not changed substantially between 1985 and 1998. More precisely, the inequality is expressed by the Gini coefficient which made up 0.11 in 1985 and 0.10 in 1998, i.e. in reality, the inequality is unchanged.

Figure 6. Unemployment in EUR15, Lorenz curves, 1985 and 1998



Note: The countries are ranked according to their rate of unemployment. The Lorenz curve illustrates distribution of unemployment, i.e. the functional relationship between the share of unemployment and the share of total labour force in the EU, when countries are ranked according to unemployment rate.

Source: EU Commission (1999b) pp. 127-142. Authors' calculation.

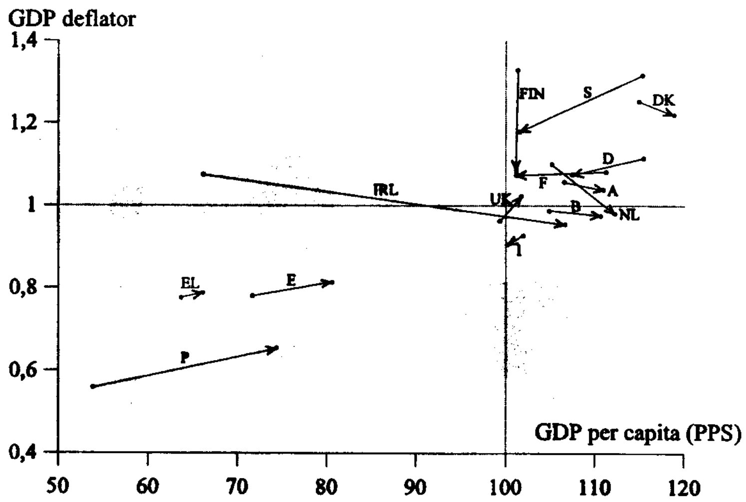
2.3 Real convergence versus price level developments

Although there has been significant differences in growth per capita, this has not lead to an equalization of the differences in standards of living between the individual member countries.

Figure 7 contrasts the development in real and nominal convergence measured in GDP per capita in PPS (purchasing power standard) with price levels of individual member countries from the mid-1980s until the end of the 1990s. In case of perfect integration, price levels as well as real GDP per capita will be equal in all member countries, i.e. all economies will converge at the point (100.1). Hence, if the EU integration were perfect, it would be expected that the countries would move closer to the point (100.1) over time. As it appears from the figure, generally, the relative price level increases concurrent with the relative standard of living. This correlation between price level and standard of living is particularly due to the fact that the wage level in the poor member countries is relatively low and as a result, non-tradeables, and service in particular, are relatively cheap.

For 6 Member States (Portugal, Spain, Greece, Sweden, France, and Germany) there is a clear convergence with the EU level of both standards of living and price levels. Belgium diverges both with respect to standard of living and price level, whereas the picture is more blurred for the remaining countries.

Figure 7. Convergence of standards of living and price levels, 1984-86 and 1997-99



Note: The arrows illustrate the change between the three-year averages 1984-86 and 1997-99. The GDP deflator is calculated as the ratio of GDP in euro and GDP in PPS. B = Belgium, DK = Denmark, D = Germany (1984/86 West Germany only), EL = Greece, E = Spain, F = France, IRL = Ireland, I = Italy, NL = The Netherlands, A = Austria, P = Portugal, FIN = Finland, S = Sweden, UK = United Kingdom (Luxembourg is unlisted).

Source: EU Commission (1999a). Annex: Tables 5, 6, and 9. Authors' calculation.

To sum up. The above has examined the question of whether or not the economic conditions in the EU member countries have become more similar. It is evident that the countries have forged closer ties in the past 40-50 years. The creation of the customs union and the Single Market has stimulated trade between the countries and thus contributed to more uniform prices of individual goods. Similarly, in the monetary area, the development has clearly been towards more homogeneous conditions with respect to inflation and interest rates, and the fixed exchange rate co-operation of the EMS, and later on the euro project, have been determining factors towards this end. With respect to synchronisation of the business cycles, unemployment levels, and standards of living, there are still differences between the countries, and it is questionable whether integration really has progressed in these dimensions. The evidence points to the conclusion that increased mobility of goods, services, persons and capital is no guarantee for a process of equalisation of living standards. As stated in the neo-classical economic theory. As outlined in the theories of the "new" economic geography (e.g. Krugman, 1991) removal of barriers may stimulate centrifugal processes leading to divergence and a centre-periphery structure of economic activity.

And finally, as pointed out by Rodrik (2000) the speed of the international process of economic integration is somewhat over evaluated. Often the size of "transaction costs" - in broad terms not only referring to pure economic costs alone - is underestimated. Especially Rodrik refers to the problems of contract enforcement. Could economies really become more integrated without a simultaneous process of international political integration.[3]

3. Prospects for the European Union in the years ahead

In the following, we will look at current development trends in the EU co-operation as well as at the perspectives for the development in the long run. Integration often in its self creates a need for further integration. This perception of integration as a politically dynamic process is the fundamental idea of neo-functionalist political integration theory (Laursen, 1995).

There are several examples in the history of EU integration, which support such a perception. The removal of the visible trade barriers, like tariffs and quotas, by the creation of the EU customs union led to an increase in various forms of invisible trade barriers, such as discriminatory public procurements, national technical standards, and abuse of the tax systems for national protectionism. This created a need for further integration, which in turn led to the creation of the Single Market. Unstable exchange rates are incompatible with the Common

3 "If the depth of markets is limited by the reach of jurisdictional boundaries, does it not follow that national sovereignty imposes serious constraints on international economic integration? Can markets become international while politics remains local?"; Rodrik (2000:180).

Agricultural Policy and may furthermore be perceived as a trade barrier in the Internal Market, as exchange rate insecurity hampers trade. Thus, both the CAP and the Single Market have created a need for stability in the exchange market; cf. EMS and later on the establishment of the EMU.

It stands to reason to estimate the future development from a similar procedural point of view. In the years to come, the following areas are, formally or informally, on the agenda of the political decision-makers of the EU:
Concerted efforts to improve employment in the Member States

Tax harmonisation

Enlargement of the European Union with several Central and Eastern European countries

Reform of regional policy related to the structural funds

Reform of the Common Agricultural Policy (CAP)

Institutional reforms of the decision-making process in the Union

In a longer time horizon, discussions may possibly also include:

Reform of the welfare state, since, once implemented, the above steps might affect the existing welfare system, as extensive legal and illegal migration must be expected

In the EU co-operation, the task to lower the level of unemployment has increasingly become more important. The concern about unemployment has been enhanced by the establishment of the EMU, which limited the autonomy of the Member States in drawing up an independent and individual national economic policy. As the European Central Bank is obliged to ensure price stability, the EU co-operation of recent years has put emphasis on a joint effort to increase employment. This had led to an incipient co-operation on the labour market and employment policies. The obligation to co-operate in this field is spelled out in the chapter on employment of the Amsterdam Treaty and subsequently elaborated by a decision of the European Council in 1997 and by the Employment Pact, cf. EU Commission (1999b). Co-operation has, however, been rather sketchy so far. It has thus mainly consisted of exchanging information, making joint analyses, and issuing recommendations without limiting the competence of the individual countries to carry out their own labour market and employment policies.

In the first instance, the objective of this co-operation is to increase employment and create a more flexible labour market. In the long run, the problem may turn out to be labour scarcity as a consequence of the demographic development and the aim of the employment and labour market policy co-operation will therefore also be to contribute to larger "employ-ability", i.e. increasing the job supply by increasing labour market association of individual generations.

There are similar dynamic policy spillover effects into other areas. This applies to the tax policy where the free movement of capital inside the Internal Market has created a need for a harmonisation of the taxation rules on the return on financial capital as well as on profits (corporate taxation). The geographic location of firms and especially of financial investment is sensitive to differences in taxation. Unless the taxation rules are harmonised, competition between the countries in these areas will either lead to a reduction in the tax rates or result in distortions in the allocation of capital and tax revenue between the countries. Differences in excise duties and value added tax on consumption might also induce consumers to make their purchases in countries with the lowest taxation level. Although several members (e.g. the UK and Denmark) are reluctant to give up their national competence concerning taxation, there is nevertheless a strong market pressure to introduce common regulations in the area. This pressure is enhanced by the increasing use of the Internet for trade in goods, which also calls for a solution at the EU level.

The most important, immediate challenge of the EU co-operation will arise if the current accession negotiations between the EU and a number of Central and East European countries are completed successfully. In the first instance, Poland, the Czech Republic, Hungary, Slovenia, and Estonia are expected to obtain membership, but several other countries, such as Slovakia, Latvia, and Lithuania are expected to rapidly succeed. The desire for enlargement of the European Union is especially politically motivated. The admission of these

countries will be the best bulwark against a renewed European political and economic split into an Eastern and Western block.
The financial and administrative implications of the expected enlargement of the EU are, however, impressive. For instance the applicant countries have a substantially lower standard of living than the poorest of the current EU members, and this will create a need for massive support from the EU structural funds. As several of the application countries are relatively large, measured by the size of the population, the fulfilment of this need may increase the requirements for EU expenditures on structural funds. It is unlikely that there will be political support to increase the total EU budget significantly, and the enlargement will therefore presumably lead to reforms of the principles governing the structural funds. Several of those countries, which have received substantial support from the structural funds, so far (Greece, Portugal, and Spain) are unlikely to be willing to accept that this support is redistributed to the advantage of the new, poor Member States. This may therefore in future lead to a redistribution of the structural funds according to national quotas so that those countries which, to a certain extent, have received this kind of support so far will keep this advantage.

But the true hindrance of a swift enlargement might well be the need for reforms of the CAP and of the political decision making process. Poland has a large potential for agricultural production, and accepting Poland into the EU will therefore increase the expenditures on the CAP. This may mean that new members will only be comprised by the CAP after a long transition period and concurrently with an enhancement of the efforts made so far of adapting the agricultural sector of the EU into the world market conditions.

Furthermore, it is likely that the political decision-making process will be changed in the nearest future. Again, it is especially the impending enlargement of the EU with several new Member States, which necessitates institutional changes. The aim of such reforms is to maintain a dynamic and effective decision making process in a future EU with more than 20 Member States. The considerations move in the direction of enhanced possibilities of majority voting in the European Council of Ministers, changed representation in the European Parliament, so that the number of members of Parliament from each country will reflect the size of the populations of the countries to a higher degree, and changed rules for the rotation system regarding the chairmanship of the European Council of Ministers. In this connection, it is possible that in future, groups of countries rather than individual countries will fill this post. There are also considerations of changing the practise of appointing the Commission. Until the present, the Commission has consisted of two citizens from each of the large countries (Germany, France, the UK, and Italy), and one from each of the remaining small countries. The persons in question are appointed by the Council of Ministers after prior nomination by the governments. If this principle, which is laid down in the Amsterdam Treaty, is maintained, the Commission will become unmanageably large. It is therefore being considered to change the rules so that the small member countries are not necessarily represented in the Commission.

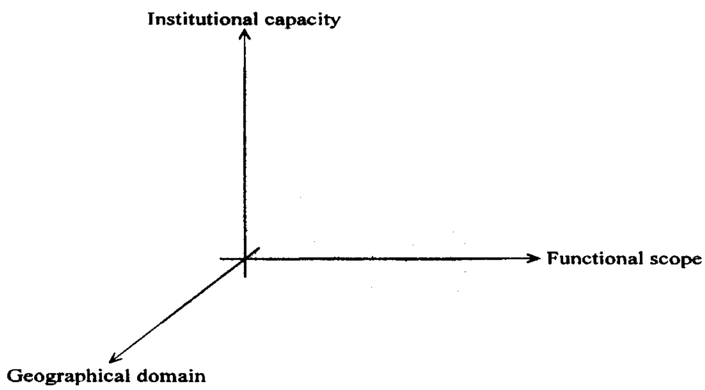
Also the so-called democratic deficit will be enhanced by the expected enlargement. This set of problems relates to at least three aspects. Firstly, it must be expected that in future, the Parliament will be accorded more powers and decision making competence vis-à-vis the Council of Ministers and, perhaps in particular, the Commission, just as it must be expected that the number of seats in the Parliament will be reallocated in proportion to the given number of Member States and may be extended to include more than the current 626 members. Secondly, the political decision making process in the EU may be democratised by making it more open in line with what is applicable to the national parliaments of the members. Thirdly, the Commission has been criticised for being subjected only to a limited form of parliamentary control. Admittedly, the entire Commission as a body may be dismissed by the Parliament, as it happened in 1999, but none of the Commissioners are subjected to any actual ministerial responsibility.

Finally, it must be assumed that the enlargement of the EU co-operation will bring about a need for a reform of the bureaucracy with a view to simplifying the functioning of the EU system. Bearing the integration efforts made so far in mind, such an organisational and administrative simplification may, however, prove to be a highly difficult task to solve in practise.

In the long run, the enlargement may lead to an inclusion of the social welfare systems of the individual countries into the integration process. The free mobility of persons may cause extensive migration from the new, poor Central and Eastern European member countries to the richer Western European member countries. With the current social benefit regulations, the contribution of the migrant towards the production in the host country will be smaller than the wage and social benefits received by the migrant after tax. This will result in a welfare loss (Sinn (2000)) of the current citizens in the host country. As the choice of destination country of the migrant in part will depend on wages and social benefits after tax, the individual country will have an incentive to offer the lowest social standards to make the country less attractive as a host country compared to the other member countries. Such competition between the members may lead to erosion of the welfare state. In order to avoid such a development, and at the same time preserve the principle that a citizen of the EU enjoys the same rights everywhere in the Union, it stands to reason to harmonise the social standards of the member countries. Social policy may thus become a new object of integration.

The above discussion of the perspectives of the future development in the EU co-operation illustrates the three dimensions of integration: functional scope, geographical domain, and institutional capacity (Laursen (1995)). These three dimensions are illustrated in Figure 8.

Figure 8. The multiface of integration



Source: Own adoption based on Laursen (1995).

Integration in functional scope consists of the transfer of policy areas from national decision making to decision making at the EU level. Integration in geographical domain captures the geographical dimension, i.e. the area where the rules of the integration apply. Finally, integration of institutional capacity

represents the establishment of institutional bodies for monitoring the development and decision making at the Union level.
EU integration has progressed in all three dimensions in the past. Increasingly more areas have been submitted to decision making at the EU level. The formation of the customs union and the EMU constituted significant steps towards increased integration in functional scope as each country transferred its national sovereignty in trade policy and monetary policy to the EU level. Integration in space has taken place as the number of Member States has increased from 6 in 1958 to 15 in 1995. Also institutional capacity has been increased. Especially the adoption of the Maastricht and the Amsterdam Treaty, have delegated more decision-making powers to the Council by limiting the cases requiring unanimous decisions. A new powerful institution has also appeared by the establishment of the European Central Bank.

The simultaneous integration in all three dimensions is hardly erratic but reflects linkages in the integration process, which may also appear in future. Integration of functional scope may lead to integration in the geographical domain. When the Internal Market was established, countries outside the EU got a stronger incentive to seek membership of the EU to get full access to this market. Similarly, if the euro project develops successfully, more countries will want to participate. A widening of the EU with more members creates a demand for efficient decision making, which points to the need of establishing more powerful, federal institutions instead of relying on intergovernmental co-operation. Enlargement without securing an efficient decision making mechanism through a strengthening of the federal institutions may bring the integration process to a stalemate.

In a Union with many Member States, there may be opposing views on the future course of the Union, and especially disagreement on the degree of federalism. If the stalemate scenario should be avoided, a possibility would be to open up for membership at different layers, where some Member States are allowed to proceed into deeper stages of integration without committing all members to be involved. However, allowing for such flexibility has its costs, as it will contribute to a weakening of the EU institutions and confuse the decision making process.

4. Closing remarks

Returning once more to the main question whether the European economies have evolved towards one European economy, the answer is yes, but there is still a long way to go before we can truly speak of one perfect integrated economy.

It is obvious that the economies of the EU Member States have become more integrated in recent years. Monetary integration is particularly advanced as the differences in interest rates and inflation between the countries have been almost eroded. Looking upon the changes in total output and employment the results are less clear. There are still substantial differences in the level of unemployment and standards of living, and there are no definite signs that the development in business cycles between individual Member States have become more synchronised. National characteristics have thus not been blurred, even if in a number of areas, the economic differences between the member countries have decreased.

The antagonism between unity and diversity still characterises the European Union at the turn of the century, also in the economic sphere. It makes sense to perceive Europe as one economy, but at a closer look, the individual economies of the Member States are still discernible.

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