FOUR FUTURES OF EUROPE

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Preface

In 1992 CPB published the study "Scanning the Future". It offered four long-term scenarios for the world economy, based on a thorough assessment of current trends, strengths and weaknesses. A number of follow-up studies used these scenarios as a tool for analysis of particular policies with long-term implications.

The underlying study develops four new scenarios. Again, the aim is to use them in subsequent studies. Moreover, the current study elaborates on policy challenges that the European Union and the member states will be facing during the coming decades in light of a number of trends.

The study focuses particularly on Europe. The next enlargement of the European Union in 2004 marks a new era for European integration. It has triggered a renewed debate on Europe's future. At the same time, European leaders have an ambitious agenda to combine strong economic growth with social cohesion, more employment and a clean environment. How can European societies best deal with these challenges in the coming decades? What role should the European Union play?

The current study addresses questions of this kind. Part I focuses on the process of internationalisation and the role of international organisations therein. Part II deals with social-economic trends within European countries. These have important implications for the public sectors in Europe and render reform of institutions necessary. In part III, uncertain trends and policy responses are combined to develop a set of scenarios for the future of Europe.

The study was written by Ruud de Mooij and Paul Tang. A number of other CPB economist have provided useful contributions and comments on various parts, including Maarten Cornet, Sjef Ederveen, Joeri Gorter, Henri de Groot, Pierre Koning, Nico van Leeuwen, Arjan Lejour, Ton Manders, Richard Nahuis, Maarten 't Riet, Herman Stolwijk and Henry van der Wiel. We thank Ton Brouwer and Simone Pailer for support in the final stages of the project. When developing the scenarios, we held interviews with a number of experts in international affairs and the European Union. We thank in particular Frans Andriessen, Marko Bos, Lans Bovenberg, Tom de Bruyn, George Gelauff, Ben Geurts, Glen Harisson, Alexander Italianer, Andre de Jong, Jacques Pelkmans, Rick van der Ploeg, Bart van Riel and Paul Schnabel. Members of the Rijksbreed Strategieberaad, the Central Planning Committee of CPB, the Commissie Sociaal Economische Deskundigen of the SER, and participants of workshops at the CPB, the Ministries of Finance, Social Affairs and Employment and Economic Affairs, and the RIVM are acknowledged for useful discussions.

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Executive summary

Europe is at a crossroads. The enlargement with ten new members forces the European Union to reform its process of decision making and to reconsider sensitive issues such as the common agricultural policy and cohesion policy. At the same time, some EU-member states – especially larger countries like France, Germany and Italy – hesitate to reform their welfare state arrangements, including pensions, even though unemployment rates are persistently high and the burden of ageing will only grow further.

It is hard to predict how the European Union and its members states will look like ten years from now, let alone twenty or thirty years ahead. Yet, policy makers must take decisions today that have long-lasting consequences, for example about infrastructure projects, welfare state reforms, and a transfer of control to international organisations. How should policy makers deal with the uncertainty about the (distant) future when taking such strategically important decisions? Here, scenarios are useful instruments; they provide different backgrounds against which policy makers can consider and reconsider decisions and their implications.

Scenarios bring together various uncertain developments. This study identifies two groups of the “key uncertainties”. The first concerns *international cooperation*: to what extent are nation states willing and able to cooperate within international organisations like the WTO and the European Union? The second key uncertainty concerns *national institutions:* to what extent will the mix of public and private responsibilities change? Combining the two key uncertainties leads to four different scenarios in part III of the study. The preceding analysis of international cooperation and national institutions, in part I and II respectively, not only elucidates the relevant uncertainties, but also gives broad ideas for policy agendas.

International cooperation: living apart or together?

The benefits of further economic integration are still not exhausted. However, international cooperation, necessary for economic integration, will not be easy in the coming years. In some areas, such as global climate change, capital flight to tax havens, AIDS and poverty, cooperation is weak or even non-existent. In relatively successful areas, organisations such as the WTO and the European Union are nowadays under pressure. In particular, these organisations face three problems.

1. Increasing heterogeneity

   When membership of the WTO and the European Union increased, their heterogeneity increased as well. Within the WTO, the views of developing and developed countries are often different; within the European Union, there are different perspectives between, for instance net-contributors and net-receivers of EU funds, and small and large countries. Increasing the size and heterogeneity of the organisations will undoubtedly further complicate decision making in the future.

2. Increasing scope

The WTO and the European Union have started as single-issue clubs. But negotiations about multilateral trade liberalisation no longer concern just manufacturing, but also extend to agriculture and services. Moreover, some parties want to extend the negotiations to labour standards, investment rules and environmental policies. The competences of the European Union have already expanded enormously over the years. A broader range of issues is a mixed blessing for decision making. On the one hand, it can make it easier to reach agreements if losses in one area can be compensated by gains in another area. On the other hand, package deals run the danger that negotiations become extremely complex and time-consuming, especially when more and more countries get involved.

3. Lacking legitimacy

Popular support for the WTO and the European Union is not always strong: the protests at trade summits or the low turn-out at European elections are signs of that. A prominent reason is that decision making is complex and intransparent. Besides, the accountability of decision makers is poor. Even in the European Union, the democratic control is often indirect. Legitimacy of the international organisations is often questioned.

The first key uncertainty in the scenarios is to what extent international organizations succeed in overcoming these problems during the coming decades.

Policy agenda

To reap further gains from economic integration and accommodate international coordination problems, effective and legitimate international organisations are essential. These organisations should focus on an appropriate scope of issues, both globally and in the European Union.

- Global cooperation

  Effective frameworks for international cooperation are global 'public goods'. They are currently undersupplied, for instance in the case of global climate change, cross-border diseases such as AIDS, and poverty alleviation. At the same time, the globalization of economies has increased the need for them. Effective cooperation in these areas is therefore desirable.

- European integration

  For the European Union, the situation is different. Its competences have expanded over the years. The subsidiarity principle, however, is not applied consistently. For instance, this study argues that the case for harmonisation of corporate taxes, in some form, is stronger than the case for Social Europe. Yet, corporate taxation is still almost the exclusive domain of the member states, while the European Union is involved in a number of areas of social policy. Moreover, the question is not only in what area the European Union has a role to play, but also how it plays that role. The Stability Pact is an example: uniform limits on government deficits take no account of the heterogeneity across countries. Perhaps other forms of cooperation involve lower costs and still adequately deal with possible coordination failures.

A more consistent application of the subsidiarity principle – indeed one of the aims of the Convention – may help the European Union to overcome some of its problems. It can build trust with the public as well as with policy makers, that the European Union is more than just another layer of bureaucracy. This will add to the credibility of European institutions.

National institutions: retreat or reform?

In the late nineties, the US economy combined fast productivity growth with low unemployment rates. The contrast with Europe was strong. Europe's Lisbon agenda seeks to change this. The aim is to increase productivity growth, while maintaining social cohesion. This will not be easy. Many policy instruments give rise to a trade-off: increasing efficiency is often bought with less equity. Four developments make the agenda even more difficult to realise, as they put the public sector under growing pressure.

1. Ageing
   Ageing populations raise public expenditures on old-age pensions and health care. Besides, relatively slow productivity growth and high income elasticities will lead to extra demand for publicly provided services. Without changes, for example in pensions system, the tax burden on the young, working generations will rise significantly in the future. For some countries, the projected increase in the tax burden exceeds 5% of GDP. This will hurt economic efficiency by increasing equilibrium unemployment and reducing the incentives for labour supply, investment and human capital formation.

2. A division between low-skilled and high-skilled workers
   The position of high-skilled workers on labour markets is steadily improving relative to low-skilled workers. That the income differences between the two groups have not grown (fast) in the recent past is a result of an increase in the supply of high-skilled workers. When this levels off, as is expected for the coming decades, the income differences may grow. For the Netherlands, calculations suggest that the growth differential between low-skilled and high-skilled wages can easily be more than 2% per year. Redistribution at a larger scale is then needed

to maintain the same, current degree of after-tax income inequality. By increasing the tax burden, more redistribution will further reduce economic efficiency.

3. Increasing social heterogeneity
Society has become more heterogeneous due to individualisation and immigration. More heterogeneity makes redistributive policies less effective: income transfers not only benefit those who need support, but also those with high incomes. Moreover, heterogeneity raises the demand for diversity, which the public sector often fails to deliver.

4. Increasing costs of taxation
Part-time work and flexible contracts have expanded the choice set of individuals in supplying labour. This increased the labour response to income taxes and income transfers, thereby amplifying the distortionary consequences of taxation. Adding to this is the increasing mobility of capital and firms. With further integration of capital and good markets, this mobility will only increase in the future. This adds to the welfare costs of taxation.

The second key uncertainty in the scenarios is how European governments will respond to these trends, given their ambition to increase productivity and maintain social cohesion.

Policy agenda

The four developments all point in the same direction: they put the public sector in EU countries under growing pressure. Expenditures increase but become less effective and more costly to finance. This hurts both efficiency and equity. Governments can follow two routes to prevent this: retreat or reform.

- Retreat
Governments can scale back the public sector and give private initiative more leeway, in line with social preferences for individual freedom and diversity. A lower tax burden and stronger incentives increase efficiency. It comes, however, at the expense of equity.

When retreating, governments need to find a new demarcation between public and private responsibilities. In this connection, it is important to note that the welfare state not only redistributes income, but also provides an insurance against several risks. This enhances economic efficiency since it allows individuals to undertake risky but profitable investments. The free market cannot deliver all forms of insurance. Regulation can be required to ensure that retreat will indeed improve efficiency.

- Reform

  To achieve better combinations of efficiency and equity, policy innovations are required. These may involve a partial retreat of public responsibilities. The key to policy innovations is more information about individual characteristics. Governments need to target redistributive instruments better to those in need of income support, such as individuals with little skills and talent. At the same time, active labour market policies may be helpful to reduce the poverty trap. Abolishing redistribution among the rich could substantially reduce the collective burden. For those with more skills and talent, stronger incentives are necessary to avoid moral hazard and improve efficiency. Governments should also provide stronger incentives in the public sector for efficient production. Again, this requires more or sometimes a different type of information, namely about (relative) performance of public organisations.

  Using more information about individual characteristics will make policy instruments more complex. This puts a strain on the implementation by governments. Furthermore, it raises serious concerns regarding individual privacy and equal treatment. These concerns limit the opportunities for policy innovation and may block the route of reform.

In addition to a better targeting, governments can adopt three other types of measures to enhance efficiency, without reducing equity. First, they can broaden the tax base – including a more consistent application of the benefit principle in taxation. Second, they may encourage innovation. Finally, they may succeed in reducing the burden of ageing on working generations. These three measures could be part of both the route of retreat of public responsibilities and the route of reform.

Four futures for Europe

Even more uncertain than long-run developments in, for instance, demography, ICT and individualisation, are the responses to them by societies. Both at an international and at a national level, institutions are under pressure. International organisations must find ways to improve their decision making. Whether they succeed depends on both the ability and the willingness of member countries to cooperate, which renders the outcome uncertain. National governments can maintain strong public responsibilities or move towards more private initiatives. It is uncertain which choices countries will make and whether they are able to avoid potential pitfalls along each of these routes.

Four scenarios

The figure below, showing Europe's crossroads, combines the two key uncertainties. The vertical axis ranges from successful international cooperation at the top, to an emphasis on national sovereignty at the bottom; the horizontal axis ranges from a strong role for the public sector at the left, to private responsibility at the right. The combination of the two key uncertainties yields four scenarios for Europe and its countries.

- *Strong Europe*
  In the first scenario, reforming the process of EU decision-making lays the foundation for a successful, strong European Union. The enlargement is a success and integration proceeds further, both geographically, economically and politically. Europe is the driving force behind broad international cooperation – not only in the area of trade, but also in other areas such as climate change and poverty reduction.

  European countries maintain social cohesion through public institutions, accepting that this course limits the possibilities of improving economic efficiency. Nevertheless, they cannot prevent that some groups in society lose (in relative terms). The reason is that governments respond to the growing pressure on the public sector by undertaking selective reforms in the labour market, social security and public production. Combined with early measures to accommodate the effects of ageing, this policy helps to maintain a stable and growing economy.

- *Global Economy*
  Economic integration in the second scenario is broad and global. As countries find it in their mutual interest, the new WTO round succeeds and economic integration in an enlarging European Union intensifies. Closer cooperation in non-trade areas is not feasible; international organisations in these areas cannot overcome the problem of conflicting interests and free-riding. The problem of climate change intensifies.

National institutions become increasingly based on private initiatives and market-based solutions. European governments concentrate on their core tasks, such as the provision of pure public goods and the protection of property rights. They engage less in income redistribution (not only between rich and poor but also between young and old) and public insurance. Incomes become more unequal, but grow relatively fast on average. Besides, social-economic mobility is high.

- *Transatlantic Market*
  In Transatlantic Market, countries are reluctant to give up their sovereignty. Reforms of EU decision making fail. Instead, the European Union redirects her attention to the United States; they agree upon transatlantic economic integration. This yields welfare gains on both sides of the Atlantic. This, however, sharpens the distinction between the club of rich countries and the group of developing countries.
  Following social preferences for individual freedom and diversity, European countries limit the role of the state and rely more on market exchange. This boosts technology-driven growth. At the same time, it increases inequality. The heritage of a large public sector in European countries is not easily dissolved. New markets – e.g. for education and social insurance – lack transparency and competition. The elderly dominate political markets. In this scenario, they effectively oppose comprehensive reforms of the pay-as-you-go systems in continental Europe.

- *Regional Communities*
  In the last scenario, the European Union cannot adequately cope with the Eastern enlargement and fails to reform her institutions. As an alternative, a core of rich European countries emerges. More generally, the world is fragmented into a number of trade blocks, and multilateral cooperation is modest.
  European countries rely on collective arrangements to maintain an equitable distribution of welfare and to control local environmental problems. At the same time, governments in this scenario are unsuccessful in modernizing welfare-state arrangements. A strong lobby of vested interests blocks reforms in various areas. Together with an expanding public sector, this development puts a severe strain on European economies.

The scenarios serve two purposes. First, they provide a structure for discussing the uncertain future of Europe in a comprehensive framework. In this way, the scenario's may yield early warnings to policy makers about particular challenges in the future, e.g. with respect to necessary reforms of the public sector and the need for effective international cooperation. Second, the scenarios serve as a tool for policy analyses with a long-term character. Examples are environmental policy, infrastructure, energy, spatial issues and ageing. In particular, one can make a cost-benefit analysis of particular policy measures by thinking through its implications in each of the four scenarios. As the scenarios provide a broad range of possible outcomes for economies, the desirable policies may be quite different among them. Specific questions are left for future studies. For instance, follow-up studies at CPB are planned with respect to the economy and its physical surroundings and ageing. Policy makers are challenged to think through their strategic policies in order to get a grip on the uncertain world in the future.

1 Introduction

Europe's future is uncertain. Globalization, international migration and technological breakthroughs will continue to change the economic and social setting. Moreover, the next enlargement, ageing of the populations and individualisation will impose new challenges on national and supranational institutions within Europe. Attaching probabilities to different events and uncertain trends becomes too complex, especially when the time horizon is more than a few years.

How can policy makers most effectively deal with uncertainty about the long-term effects of their decisions? One way is to develop and use a set of alternative scenarios. Scenarios are feasible and consistent views on the world in the near and distant future. The set of scenarios provides a background against which policy makers can consider their strategic, long-term decisions. In 1992, CPB published its first comprehensive scenario study on the world economy, called "Scanning the Future". The present study fits into this tradition and focuses on four scenarios for Europe.

This study serves two main purposes. The first objective is to contribute to the discussion about the future policy challenges for the European Union and its member states. Taken in isolation, most of these challenges are probably well known to policy makers. By combining various developments, this study aims to provide a more comprehensive view on these challenges. In particular, different developments tend to reinforce each other, thereby increasing the pressure on public sectors to reform. The second objective is to provide input for a range of studies that will subsequently be conducted by CPB. These studies will deal with strategic policies in the Netherlands, in the areas of energy, infrastructure, environmental and spatial planning.

The underlying study consists of three main parts. Part III describes the four scenarios. Parts I and II provide the necessary ingredients, elaborating in particular, on two key uncertainties that are vital for the future of Europe. Part I deals with (the degree of) international cooperation. This uncertainty originates in the unknown ability and unknown willingness of countries to deal with the challenges facing international organisations such as the World Trade Organisation and the European Union. Part II emphasizes the pressure on public sectors in Europe. It discusses a number of trends in European countries that make it more difficult for societies to combine an efficient economy with an equitable income distribution. The key uncertainty is how governments will respond to this. The scenarios in part III combine the two key uncertainties to develop four different perspectives on the future of Europe.

Parts I and II each serve a second purpose as well. Apart from raising challenges for European governments, they offer a framework for analysis on how to deal with these challenges. In particular, chapter 7 in part I discusses an adequate allocation of responsibilities between national governments and international organisations. It illustrates this by means of three examples: Social Europe, fiscal coordination and corporate tax harmonisation. Chapter 14 in part II assesses the options for policy innovations in order to combine equity and efficiency more effectively. It emphasises the role of information and incentives in developing more efficient public policies, using the case of disability insurance as an illustration.

Part I - International Cooperation

The events surrounding September 11 2001 illustrate how fast international cooperation can change. Take the relationship between the United States and Europe. Although their political, economic and cultural settings have strong similarities, they do not always act jointly in the international arena. With the end of the Cold War, political and military cooperation has become less self-evident. The war against terrorism after September 11th has done nothing to restore that cooperation: it is probably more an American than a western war. In fact, the current American administration seems to follow a unilateral course in which American interests come first: it did not sign the non-proliferation treaty, withdrew from the Kyoto Protocol, installed high tariffs on steel imports and set its own course in the war against Iraq. The unilateral course could be temporary – a trademark, for example, a trademark of the Bush administration. But it could also reflect a tendency for the United States and Europe to set their own courses in international affairs. The future cooperation between the European Union and the United States is thus uncertain.

Uncertainty with respect to international cooperation is more general, however. It holds also for multilateral cooperation, e.g. within the WTO or the European Union. Part I of this study argues that especially three issues complicate international cooperation in the coming decades: increased size and heterogeneity, a broader scope of issues, and problems with legitimacy. In these three respects, there is an important parallel between the WTO (discussed in chapter 3) and the European Union (discussed in chapter 4). Both organisations face similar problems, which renders the future of international cooperation between members uncertain. Chapter 5 elaborates on areas in which appropriate international organisations are lacking and international cooperation is weak.

International cooperation is one of the two key uncertainties that provide the basis for our scenarios in part III of this study. At the end of part I, chapter 7 provides an analytical framework to assess the issue of the scope of international organisations. Thereby, subsidiarity is taken as the guiding principle for the delegation of powers between nations and international organisations. We assess the current degree of global coordination and the cooperation between member states in the European Union in various fields.

2 Internationalisation: an ongoing process?

Rapid technological change has reduced transport costs and other natural barriers to the international movement of goods, services, capital and people. At the same time, cooperation between governments has removed policy-induced trade barriers, thereby stimulating the integration and liberalisation of markets in Europe and globally. Yet, future economic integration is not self-evident. International cooperation has become more difficult because international organisations are increasingly heterogeneous in character, have to deal with an expanding set of policy issues, and suffer from a lack of legitimacy. This renders the future of internationalisation uncertain.

2.1 Trends in economic integration

In August 1999, José Bové drove a tractor into a McDonalds restaurant that, at the time, was still under construction. The protest was triggered by a high import tariff on Roquefort that the United States had introduced to retaliate against a ban on hormone beef in the European Union. The wider aim of the protest, however, was to oppose the assault on local culture and tradition. The golden arches of McDonalds are often seen as the symbols of globalization. Measured by the number of restaurants, the process of globalization takes place at a breath-taking pace. Table 2.1 shows the growth in different areas of the world in five years' time. Whereas in the United States, and in some other countries such as Canada and Australia, opportunities to expand are exhausted and growth is modest, outside the United States growth is often remarkable.

Table 2.1 Number of McDonalds restaurants and Dutch flower exports 1996-2001
Cumulative growth rate (in %)

	McDonalds	Dutch flowers
United States	8	107
Canada/Australia/New Zealand	21	131
European Union	68	29
Japan	91	12
Latin America	126	95
Asia (excl Japan)	144	79
Europe (excl EU)	146	72

Source: McDonalds, Dutch Central Bureau for Statistics

McDonalds is only one, well-known corporation that has expanded on a global scale. But also the numerous, unknown Dutch flower farmers and traders have expanded. The growth in their exports is no less impressive and shows a similar geographical pattern (i.e. the growth in distant markets is larger than in nearby markets).
The growth in McDonalds restaurants and Dutch flower exports reflects better opportunities to trade and produce internationally. Opportunities have expanded for two reasons. First, technical

improvements have led to significantly lower transport and communication costs. Second, successive multilateral agreements have significantly brought down barriers to trade. While in 1930 the average ad-valorem import tariff for manufacturing was 21% in Germany, 30% in France and 48% in the United States, after the Uruguay Round in 1994 it fell to 4.8% for the European countries and to 3.0% for the United States (Bordo et al., 1999, table 3). For these two reasons, world exports have consistently outpaced world production after the Second World War (see figure 2.1). In 1820, world exports represented only 1% of world production. This measure for openness increased to 9% in 1913 and to 17.2% in 1998. Clearly, countries have become more integrated in the world economy over the centuries. But this has not been a continuous process. With the Great Depression in the 1930s came an era of protectionism in which countries raised import tariffs and economies became less, rather than more integrated.

Figure 2.1 Openness has increased drastically

Source: Maddison (2001)

European integration has contributed to the internationalisation of European economies. In 1952, a group of six European countries founded the European Coal and Steel Community with the aim of preventing another war. Subsequently, the Treaty of Rome in 1957 marked the start of a broader economic integration among the club of member states in the European Economic Community. Since the Treaty of Rome, Europe has gradually deepened its economic integration, widened its competences, and expanded its membership to a club of 15. The main achievements were recorded in the Single European Act of 1985, which paved the way for the internal European market, and the Maastricht Treaty of 1991, which launched the EMU.[1]

The achievements of European integration can be illustrated by intra-EC trade and investment flows. Table 2.2 reveals that the share of intra-EC trade as a percentage of all EC trade (measured by exports) grew from 37% in 1958 to 56% in 1980 and to 61% in 1998. This reveals a substantial integration of EU product markets. The share of intra-EU foreign direct investment (FDI) flows in terms of total FDI almost doubled during the past two decades, which illustrates the substantial integration of European businesses.

Table 2.2 Intra-EC exports and FDI 1958 - 1998, % of total EC-exports and FDI

Year	Exports	FDI
1958	37	n.a.
1980	56	30
1990	61	55
1998	61	57

Source: Sapir (1992); IMF Direction of Trade Statistics; OECD International Direct Investment Statistics Yearbook
The EC does not include Austria, Finland and Sweden.

2.2 The welfare gains of economic integration

In theory, economic integration yields various benefits. Lowering trade barriers allows countries to specialise according to comparative advantage, allows firms to exploit economies of scale and offers consumers a wider variety of products. Economic integration may also offer dynamic benefits such as higher productivity (growth). One reason is that the exchange of goods and services helps the exchange of ideas and knowledge. A relatively open economy is better able to learn and adapt foreign, state-of-the-art technologies than a relatively closed economy. The empirical support for this idea is strong (see Coe and Helpman, 1995; and Keller, 2001).

Also regional economic integration in Europe yields substantial welfare gains. In terms of the Balassa stages of economic integration, the EMU involves a much deeper form of economic

[1] Note that the European Union has remained a rather closed trade block. For instance, the European Union exports less than 10% of its GDP to countries outside the European Union, with only 2% to the United States. The export share of the United States is also modest at around 10% of GDP.

integration than many other regional trade agreements, such as EFTA, NAFTA or Mercusor.[2] The welfare implications of this economic integration were analysed in the Cecchini Report of 1988. The European Commission undertook a major effort to assess the economic impact of the Single Market Program that was to be completed in 1992. The report concluded that the internal European market would increase trade intensity in the European Union and cause welfare gains associated with the exploitation of increasing returns to scale and rising investment. Overall, the report predicts an increase in European GDP by around 6.5% as a result of the Single Market Program. Ex-post analyses are consistent with this prediction. For instance, the 38 studies for the European Commission lead to the conclusion that the creation of the internal market has resulted in more intense competition in Europe, thereby reducing price-cost margins and X-inefficiencies.[3]

As demonstrated by the large-scale protests in Seattle in 2000 and more recently in Cancun, not everyone shares the view of many economists that economic integration yields welfare gains. The discontent about globalization is not confined to a small number of outspoken activists. Also the eminent English writer Julian Barnes complains that the World Trade Organisation (WTO), the European Union and other international institutions are "*creating an ever bigger pool of docile consumers for transnational corporations*" (J. Barnes, 2000). Not only is there a McDonalds restaurant almost everywhere, but also almost everyone seems to prefer that over the local caterer.

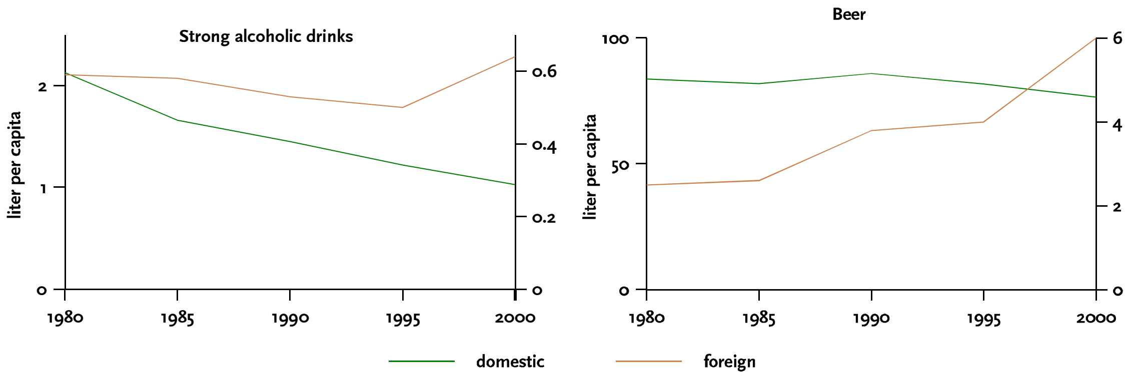
The discontent does not always find strong support in the facts, however. For instance, international integration has significantly increased the variety of choice. Although global, often American, products like McDonalds, Coca Cola and Nike have displaced some local varieties, other local products have seen their popularity increase and have gone global. For example, consumption of Dutch jenever, a strong alcoholic beverage, has declined dramatically during the past decades. At the same time, consumption of Scottish whiskey and Russian vodka has grown spectacularly (figure 2.2). Similarly, Belgian beers have partly replaced Dutch lager (figure 2.2). Hence, although some local varieties have disappeared, the range of *available* varieties to consumers has expanded. Keynes highlighted this aspect when he described the heyday of

[2] Balassa (1961) distinguishes the following successive phases in international economic integration: (i) Free trade area: removal of bilateral tariffs and quota; (ii) Customs union: free trade area in which common external tariffs are applied; (iii) Internal market: customs union with the free movement of goods, services, labour and capital; (iv) Economic union: internal market where some competences are centralised, e.g. competition policy; (v) Monetary (political) union: economic union where monetary (political) decision making is centralised

[3] Apart from trade creation, regional economic integration also causes trade diversion. In particular, the rise in intra-EC trade during the past decades has to some extent come at the expense of trade with non-EU countries. Nevertheless, the studies for the European Commission (1996) suggest that, although the share of intra-EU imports increased, imports from the rest of the world increased in absolute terms as well.

globalization in the 19th century: *"The inhabitant of London could order by telephone, sipping his morning tea in bed, the various products of the whole earth, in such quantity as he might see fit, and reasonably expect their early delivery upon his doorstep; (. . .). Most important of all, he regarded this state of affairs as normal, certain, and permanent, except in the direction of further improvement."*

Figure 2.2 More variety at the expense of local products
Dutch alcohol consumption according to origin



Source: Productschap voor gedestilleerde dranken

2.3 Prospects for further integration

The WTO has succeeded in removing a number of major trade barriers in manufacturing, while the Single Market Programme in the European Union has gone beyond that by removing technical barriers to trade. This does not imply that integration cannot proceed much further. Perhaps somewhat unexpectedly, national borders still exert a large impact on trade. McCallum (1995) was the first to report this. He found that trade within Canada was a factor 20 larger than trade between Canada and the United States, even if controlled for other factors affecting trade such as GDP and distance. Brewer et al. (2001) finds similar results for Europe. He calculates the impact of EU internal borders on trade flows and finds that trade between two regions within countries is around 80 times more intense than is trade between two European regions in different countries (controlling for other factors affecting trade). The creation of a single currency in the European Union may help to make borders less important as a barrier to trade – an effect that has not yet fully materialised.[4]

The impact of national borders is consistent with other facts of international trade. Bilateral trade flows halve when distance doubles, and decrease by roughly 80% if the main language of

[4] Frankel and Rose (2002) are optimistic about this effect. They find that EMU will involve a tripling of trade flows between the participating countries.

the two countries is different.[5] This indicates that transaction costs are still important barriers to international trade. It also suggests that the process of international economic integration has further prospects.

Integration is on the agenda of today's international organisations. In Doha, at the end of 2001, a new round of trade talks was agreed upon in the WTO. This should lead to trade liberalisation in services and agriculture. In Europe, the deepening of the internal market is high on the agenda. As part of the Lisbon strategy to become the most dynamic and competitive economy in the world in 2010, the European Union has an ambitious agenda for the internal market in various fields. New directives and actions are suggested in energy markets (gas and electricity), postal services, transport (rail and the Single European Sky), and government procurement. The integration of the market for financial services should be completed in 2005 and is estimated to raise economic growth in Europe by around 1% annually during the next ten years (Gianetti et al., 2002). Next to liberalisation, the European Union aims to reap productivity gains by developing a European patent and through measures to encourage international technology spillovers. Finally, the European Union aims at abolishing the institutional barriers to cross-border labour mobility in order to stimulate the integration of its labour markets.

2.4 Issues in international cooperation

The WTO and the European Union started as single-issue clubs with a limited and relatively homogeneous membership. The two have been successful in their respective missions to guide international cooperation and encourage economic integration. One could even argue that the organisations have become victims of their own success. Their ability to provide a framework for successful international cooperation is now under pressure. We discuss three reasons behind these problems: increasing heterogeneity, increasing scope of issues, and problems associated with legitimacy and effectiveness in decision making.[6]

Heterogeneity

Many new members have joined the WTO over recent years, including a number of developing countries. This has increased not only the size of the organisation, but also the heterogeneity of its members in terms of history, culture, institutions and economic structure – thus further complicating the already complex negotiations. For instance, in the recent Doha summit of 2001, developing countries flexed their muscle, turning the new trade round into a "developing

[5] The numbers are derived from gravity equations presented in Hummels (1999).

[6] Note that an important difference is that the European Union is a form of political cooperation, based on the community approach. This differs from the WTO, which involves intergovernmental cooperation to remove the barriers to economic integration.

round". Moreover, the ministerial meeting in Cancun ended in failure because developing countries were unhappy with (among other things) the support to American cotton farmers.
A similar story applies to the European Union. Since the foundation of the Union, the number of member states has increased from six to fifteen. After the next enlargement with ten new member states, the European Union will consider the accession of another three candidate members and perhaps even more thereafter. The enlargement increases the heterogeneity of the European Union. This raises the question of how to ensure that the decision-making process in Europe remains effective in the future. In general, it becomes more difficult to find shared interests in a more heterogeneous club of countries. Hence, there typically seems to be a trade-off between expansion of membership and expansion of competences.

Scope

In a more open world – which is partly the success of the WTO and the European Union in the first place – policy issues become more intertwined. As a result, the WTO faces a discussion on whether it can remain a single-issue club. There is great pressure to link trade liberalisation to international environmental problems and to labour standards.

The European Union is already involved in multiple issues. Internationalisation of markets and increasing mobility of production factors can make the centralisation of powers in new areas attractive – for instance, to the extent that international spillovers of national policies increase. Moreover, debates about justice and home affairs, as well as foreign and security policy, are high on the political agenda.

With a broader range of issues discussed in one international organisation, it can be easier to reach agreements about cooperation. For instance, by linking various issues, expected losses for a country in one area of the cooperation can be offset by expected gains in another area. Indeed, package deals may increase the opportunities to reach an overall agreement on cooperation. However, package deals run into the danger that negotiations become extremely complex and time-consuming. Already, multiple-issue clubs suffer from a lack of accountability, transparency and legitimacy. Moreover, a broader range of issues in a larger club of countries could stall progress in achieving tighter integration.

Legitimacy and effectiveness

The protests in Seattle in 1999, the violent clashes between protestors and the police at the tops of the G7 and the IMF, the low turnout in European elections; they are all signs that international institutions face opposition and that they do not always carry popular, widespread support. This is partly because the organisations suffer from a lack of legitimacy. Decision making in the European Union, for instance, is overly complex, is not transparent and suffers from a democratic deficit. Accountability of the WTO is lacking, and this institution is blamed for the lack of international cooperation on issues that are outside its own competences. This undermines the credibility of these institutions.

Whether the WTO and the European Union will succeed in embodying further international cooperation depends on a number of other issues: trust between countries, adequate commitment mechanisms in the cooperation agreements, the legal power of the international institution to enforce the cooperation, possibilities for free-riding, the reputation of the international institution and the countries participating therein. This renders the future of these organisations uncertain.

2.5 Internationalisation: a key uncertainty for the future

Economic integration during the past decades, both in Europe and globally, has contributed to substantial growth in the economies of the developed world. Still, there is room for further internationalisation in light of the various barriers to integrated markets. A key uncertainty is whether international organisations will succeed in stimulating and accommodating further integration. These organisations are currently under pressure due to the increasingly heterogeneous membership, the call for an expansion of policy issues with which they must deal, and the lack of legitimacy and effectiveness of decision making. The next two chapters elaborate on these issues for the WTO and the European Union, respectively. Chapter 5 deals with non-trade issues, where international cooperation is relatively weak today.

3 Global trade liberalisation through the WTO

The General Agreement on Tariffs and Trade (GATT) – the predecessor of the WTO – was successful in removing trade barriers between participating countries. It served as a vital mediator in guiding the internationalisation process. A new round of trade talks, which was agreed upon at the end of 2001 in Doha, seems more complex than previous ones. Membership of the WTO is now more heterogeneous and the scope of issues is broader than in the past. This calls for an effective institutional framework, which also carries legitimacy. Will the WTO succeed in its mission?

3.1 Increased heterogeneity: east-west and north-south

Before it has even started, the next trade round in the WTO is already burdened with a number of trade conflicts between member countries. Not only do the new, less developed member countries have interests different from those of the old, more developed members, but also the developed world faces a series of disputes.

Conflicts between the European Union and the United States

The list of trade conflicts between the United States and the European Union is expanding: from bananas and genetically modified soybeans to tax relief for exporters and anti-dumping duties on steel. These conflicts do not give the impression that the different perspectives of the European Union and the United States will be easily reconciled, or that the countries will work towards a successful conclusion of the Doha round.

Yet, it is not true that the European Union and the United States have very different perspectives on free trade in general. Hufbauer and Neumann (2002) drew up a list of trade conflicts and conclude that the majority of disputes are not between the United States and the European Union. Sapir (2001) reports a rise in the number of EU-US conflicts that are brought before the arbitrage committee of the WTO, but this is part of a general rise: in relative terms the European Union and the United States are not more involved in arbitrage cases than they used to be. Broadly speaking, the trade conflicts between the two economic superpowers are largely confined to agriculture and steel. These are the sectors that have political clout at both sides of the Atlantic but contribute less than 5% to overall production. Moreover, as also Hubauer and Neumann put forward, the European Union and the United States have much to gain from trade with each other. This provides a good incentive for these developed countries to resolve their disputes.

Conflicts between rich and poor

The disagreements between developed and developing countries may jeopardise the new trade round. A number of developing countries were disappointed in the Uruguay Round. The countries had the feeling, for example, that they were often excluded from crucial deliberations and that they lacked resources and expertise to influence the rather complex negotiations. For that reason, developing countries have now been promised technical assistance during the negotiations in the Doha round. Another reason for disappointment is due to the perception that developing countries have lost from the Uruguay round. For instance, many believe that markets did not open for products that would most benefit poor countries. Using a CGE model, Harrison, et al. (1997) indeed find that some of the poorest countries in Sub-Saharan Africa have experienced terms-of-trade losses due to reciprocal tariff reductions.

Wobbly Washington consensus

Both are eminent, well-known economists: Joe Stiglitz is a Nobel Prize Winner and former chief economist of the World Bank; Kenneth Rogoff has done outstanding research in international economics and is Director of Research at the International Monetary Fund (IMF). The two are in conflict about the policies of the IMF.

"*Food and fuel subsidies for the poor in Indonesia were drastically cut back, and riots exploded the next day. (...) It was not just that IMF policy might be regarded by softheaded liberals as inhumane. Even if one cared little for those who faced starvation, or the children whose growth would be stunted by malnutrition, it was simply bad economics. Riots do not restore business confidence.*" Joe Stiglitz on page 119 in his book 'Globalisation and its discontents'

"*In the middle of a global wave of speculative attacks, that you yourself labelled a crisis of confidence, you fuelled the panic by undermining confidence in the very institutions you were working for. Did it ever occur to you for a moment that your actions might have hurt the poor and indigent people in Asia that you care about so deeply?*" Kenneth Rogoff in his opening remarks at a discussion meeting about Stiglitz's book

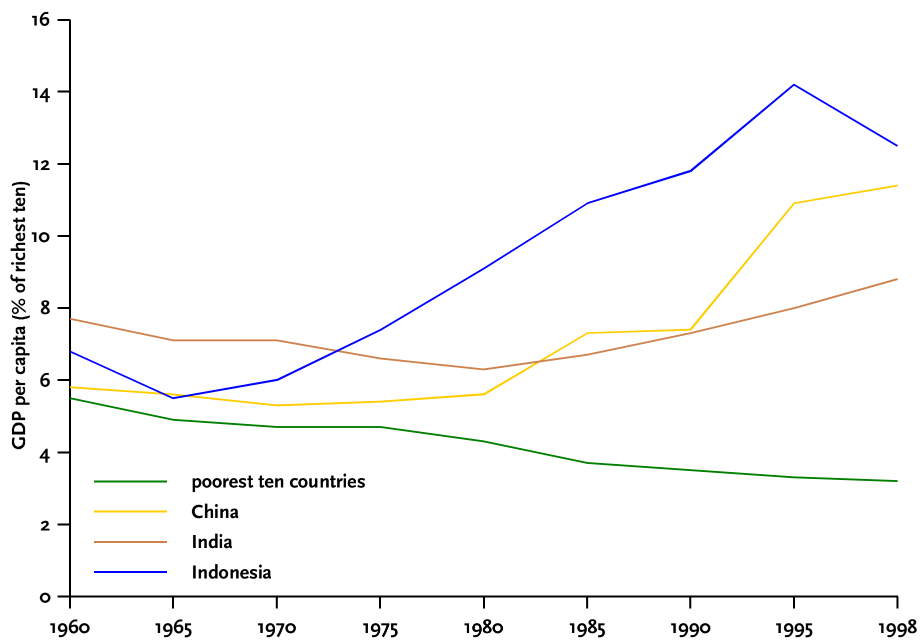
The aggressive tones make it hard to hear the important debate about economic policies in developing countries. When a country is temporarily in distress, it can turn to the IMF. However, a country must fulfil several conditions to receive funds. In this way, the IMF has a big impact on the development in poor countries that receive funds. Joe Stiglitz has criticised these conditions. His main point is that the IMF has too eagerly promoted the liberalisation of capital markets. This liberalisation was believed to bring gains since funds will flow towards investment projects with the highest rates of return. However, this argument may not hold for developing countries. Capital markets are prone to speculation. Strict regulation may be necessary to avoid the self-fulfilling expectation that financial institutions will not withstand a speculative outflow of capital. Large outflows may wreak havoc on the economy of a developing country.

Yet, Joe Stiglitz does not disagree with every aspect of the IMF. He supports trade liberalisation, but adds that the ensuing job destruction is not automatically followed by job creation. In an environment of high interest rates and low investment rates, trade liberalisation may lead to unemployment. Broadly speaking, Stiglitz' main concern is the combination of policy measures: capital market liberalisation should be accompanied by a proper regulatory framework; and trade liberalisation should come along with good conditions for job creation.

For the new Doha round, 'development' has been placed explicitly on the agenda. The 'development' round should thus bring developing countries, especially the poorest among them, better access to the large markets in developed countries. Already in Doha, developing countries were successful in their fight against pharmaceutical companies that charged high prices for medicines against HIV/AIDS. The countries were allowed to produce their own, cheap versions of patented treatments, rather than having to buy the Western-produced, expensive originals. In Cancun a group of developing countries, including Brazil, China and India, clashed with the European Union and the United States. The ministerial meeting consequently failed to produce an agreement of some sort.

The general feeling in developing countries is that trade liberalisation is not in their own interest, but rather in the interest of the developed world and their big multinationals. This feeling contrasts with the view that openness is essential for growth and development. This latter view is part of the Washington Consensus among the IMF, World Bank and the American Treasury. It receives strong support from a large group of economists, in which Bhaghwati is one of leading voices. He consistently argues that trade liberalisation, unilateral if not multilateral, is in the interest of developing countries. However, this relationship between openness and growth is not undisputed among economists. Recently, Joe Stiglitz (2002) launched a book in which he attacks the Washington Consensus (see box *Wobbly Washington consensus*).

Figure 3.1 Per capita income in developed countries relative to the 10 richest countries 1960 - 1998



Source: own calculations based on Heston, et al. (2002)

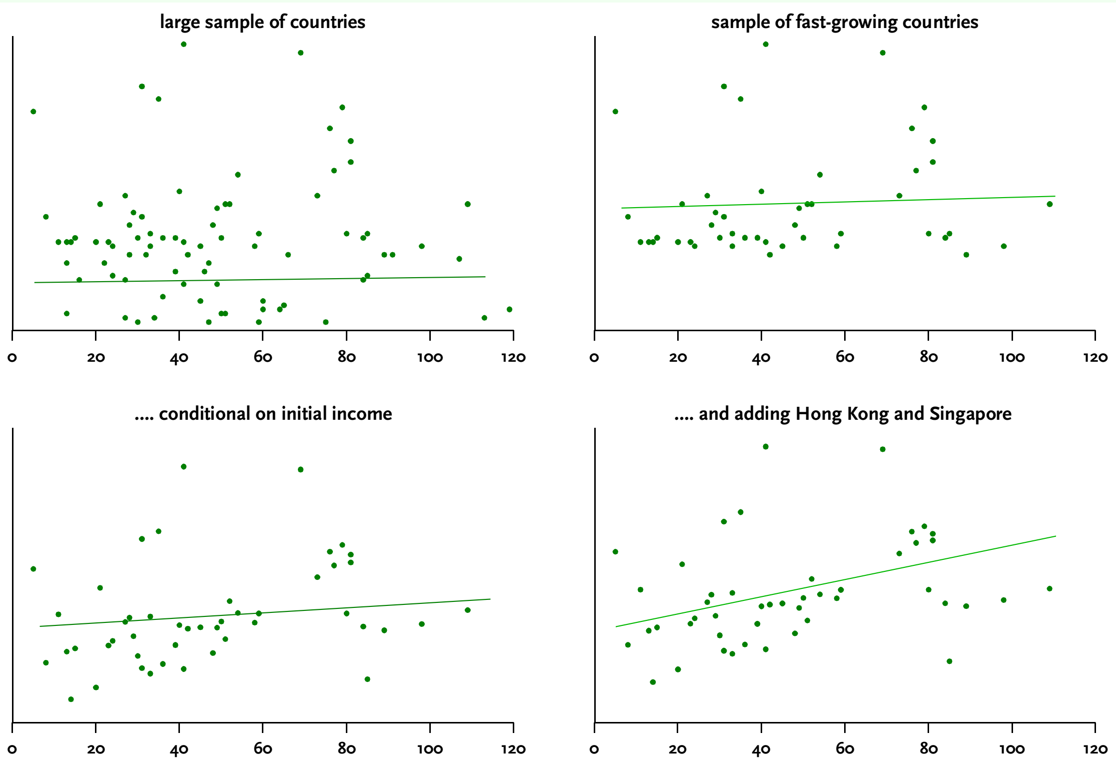
The discrepancies in views may arise from the somewhat conflicting, unclear evidence on trade and growth. Over the years, economies across the globe have become more integrated and more open. However, globalization has not spurred economic growth equally across countries. In fact, the income per capita in the poorest ten countries in the world as a percentage of that in the richest ten countries has declined from 5.5% in 1960 to 3.2% in 1998 (see figure 3.1). Anecdotal evidence reinforces this view. Especially in Africa, where AIDS is wreaking havoc, a number of countries have seen their standards of living deteriorate rather badly. This leaves the impression that globalization has not brought the benefits that have sometimes been promised.

Yet, there are also grounds for optimism. A number of countries seem to have found the path of development and have been able to sustain a high pace of growth over a long period. Figure 3.1 shows that income per capita in China, India and Indonesia, relative to the income of the richest ten countries, has risen. The increase is largest for Indonesia, from 6.8% to 12.5%, and smallest for India, from 7.7% to 8.8%. There are strong indications that the exchange of goods and services facilitates the exchange of ideas and technologies. The potential to learn about new technologies is particularly large for developing countries. Moreover, there are indications that freer international trade improves governance. For example, Bonaglia et al. (2001) find that import openness diminishes corruption. The reason is that a consistent policy of free trade eliminates the incentive for domestic producers to lobby for higher protection. Nevertheless, the evidence on the relationship between openness and growth is inconclusive and contradictory. Perhaps this should not come as a surprise. Trade theory does not predict that every country will gain from free trade in goods and services. However, it does predict aggregate gains. Hence, the winners should, in principle, be able to compensate the losers. In reality, however, such compensation never occurs. The consequence is that some countries may lose rather than gain.

Cross-country evidence on growth and openness

Cross-country analyses generate ambiguous results on the relationship between openness and growth. To illustrate this, we take a sample of 114 countries and exclude the small trading nations Hong Kong and Singapore for their exceptional degree of openness. By simply regressing growth to openness (measured by the share of imports and exports to GDP), we do not find a significant correlation between initial openness and average per capita growth over the period 1960-1998 (upper left panel). This result does not change when the sample is restricted to those 50 countries with the highest growth rates in the sample (upper right panel). Once we include initial per capita income in the regression as a control variable, we arrive at a positive relationship (bottom left panel). This becomes even stronger when Hong Kong and Singapore are included in the sample (bottom right panel). The last regression suggests that increasing openness by 10 percentage points implies an increase in the growth rate of 1.5%. Our thumbnail sketch of openness and growth illustrates the problem with cross-country evidence. In particular, the results are not robust as they differ between samples and specifications. This is in line with Rodrick and Rodriquez (1999), who evaluate existing empirical work and conclude that the relation between openness and growth is not robust for changes in various definitions.

Growth and openness: four simple regressions



Source: own calculations based on Heston et al. (2002)

3.2 Increased scope: new issues on the WTO agenda

Up to now, multilateral trade liberalisation has concentrated on industrial products. Successive rounds have reduced tariffs considerably. According to the WTO (2001), tariffs in industrial countries have fallen by at least 33 percentage points on average in each of the last three rounds. With the exception of textiles and steel, tariffs are now close to zero and cannot be reduced further. Liberalisation must therefore concentrate on other sectors:

- agriculture, where vested interests are well organised and government interference is strong;
- services, where non-tariff barriers are important. These are much harder to measure and to negotiate over.

Trade in agriculture

The Uruguay Round already accomplished a milestone in agricultural trade. First, it reduced trade-distorting measures. For example, developed countries reduced import tariffs by 36% on average, with a minimum cut per product of 21%.[7] A second achievement of the Uruguay round was a framework for agricultural support that allowed existing agricultural policies to be embedded in the WTO. The framework distinguished three types of policy instruments, the so-called boxes:

- *amber box* - distorting measures such as guaranteed prices, export subsidies and import levies
- *blue box* - less distorting measures such as income support
- *green box* - measures with hardly any distortion such as agricultural education subsidies

The Doha Round should be the next step in the liberalisation of trade in agriculture. There are certainly a number of disagreements between countries on what distortions should be reduced. Despite these disagreements, the general feeling is that the gains from liberalising agricultural policies can be large. For instance, CPB (2003a) discusses five different simulation studies on the welfare implications of full liberalisation in agriculture. The results suggest a wide range of estimates of the welfare gains, somewhere between 31 and 586 billion US dollars. Three conclusions from these studies are especially worth noting. These points are all illustrated by table 3.1, which presents model outcomes of Anderson (1999). First of all, the studies show that the welfare gains for the high-income countries exceed those for the low-income countries.

[7] The impact of these and other reductions was, however, modest because the reductions in trade distortions were vis-à-vis reference period with high protection rates. The Uruguay agreement also provided for special and differential treatment for developing countries. Reduction percentages agreed upon for developing countries were about one third smaller than for developed countries; the least-developed countries did not have to reduce tariffs and subsidies at all.

Second, the welfare gains from trade liberalisation in agriculture probably exceeds the gains of liberalising trade in manufacturing goods. The reason is that current trade and production patterns in agriculture are more distorted than in manufacturing. Finally, the economic gains from trade liberalisation in agriculture mainly accrue to the region that actually pursues the liberalisation. Hence, developing countries would gain most substantially if they would liberalise themselves. The impact of trade liberalisation in the developed countries for the welfare in the developing countries is estimated somewhere between 3 and 99 billion US dollars, i.e. between 0.04% and 1.56% of their national income.

Table 3.1 Effects of removing all formal trade barriers: results from model simulations for 2015

In billions of 1995 US$

		Agriculture & Food	Textiles & Clothing	Others	Total
Liberalising region	High Income				
Benefiting region	High Income	111	–6	–8	97
	Low Income	11	9	22	43
Liberalising region	Low Income				
Benefiting region	High Income	11	11	28	50
	Low Income	31	4	30	65
	total	165	17	73	255

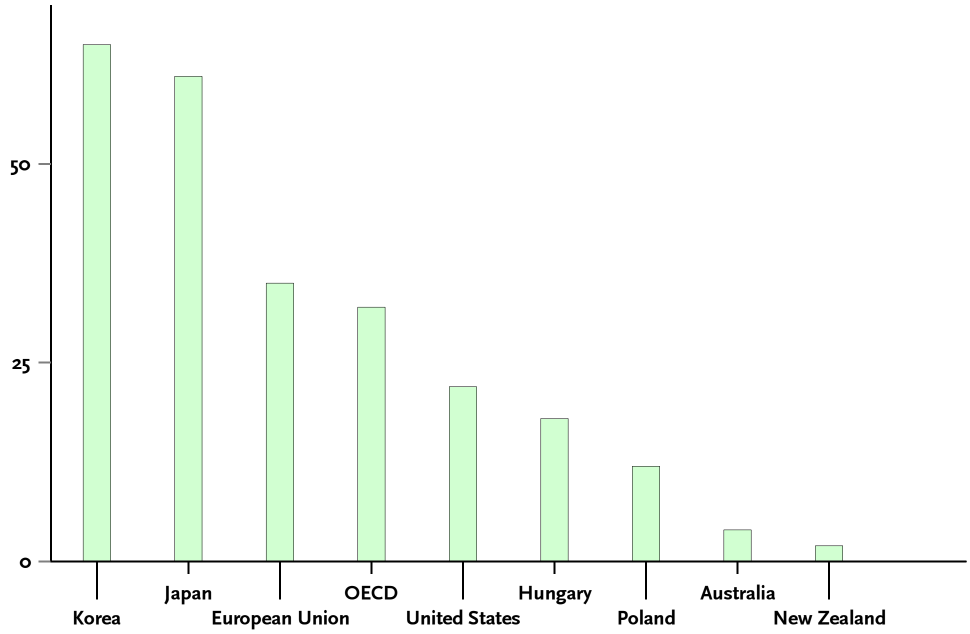
Source: Anderson (1999)

Although liberalising and reforming agricultural policy in developing countries may bring gains, this does not ensure it will meet broad support. The main problem is that farmers in developed countries receive substantial support from their governments. This is illustrated in figure 3.2, which shows an aggregate measure for producer support to farmers in a number of countries.[8] It reveals that agricultural support in Japan, the European Union and the United States constitutes a significant part of the income of farmers. This explains their resistance to any plan of reform. Besides, farmers are well organised and have different ways to affect political choices. They are always determined to fight policy changes and their protests could easily disrupt political and social life. All these factors make it difficult to reform and liberalise agriculture in developed countries. In fact, most developed countries have, until now, hardly opened their domestic markets for agricultural products. Imports from developing countries are often tropical

[8] The aggregate measure in figure 3.2 hides widely different percentages for different crops and animal products. In general, support to arable crops and (dairy) cattle and sheep is much higher than support to horticulture and the pigs and poultry sectors.

products which hardly compete with domestic products. High import tariffs and export subsidies remain and invoke criticism.

Figure 3.2 Producer support to farmers in developed countries
% of gross farm receipts, average for the period 1999-2001



Source: OECD (2001a)

For many developing countries, matters are complicated. Notwithstanding the relative importance of the agricultural sector, many of these countries are net food importers. Sub-Saharan Africa is good example. Although agriculture contributes about 35% to the region's GDP, only three out of the 47 countries in Sub-Saharan Africa (South Africa, Uganda and Zimbabwe) have been self-sufficient in grain in recent years. This means that, *ceteris paribus*, higher world market prices for grain will raise their food bill. For two other reasons developing countries may lose rather than gain from reforming agriculture in developed countries. First, food aid programmes become more expensive and are possibly more difficult to sustain. Many countries in Sub-Saharan Africa rely on food aid to meet at least 20 percent of their grain imports. After reforming agriculture, rich countries will no longer have food surpluses. Food aid has to be bought on the world market then, at higher prices. Second, the poorest countries will see the benefits of preferential access to the European market erode. Not only will they lose the advantage of high prices in the European Union for some of their products, but they will also face competition from exporters who, at present, do not enjoy preferential access. For this reason the poorest developing countries ask for compensation in WTO negotiations.

From this discussion, one should not infer that free trade will not improve welfare in developing countries. Many studies have shown otherwise. Many poor countries will in the longer term probably benefit from a more open trading system. However, in order to reap these benefits, it is not enough to simply abolish agricultural trade distortions in the developed world. Liberalisation will become an instrument for development only if it is accompanied by an alleviation of distortions on domestic markets in developing countries and reforms of institutions that are necessary for a properly functioning market economy.

Non-tariff barriers

Various trade restrictions fall under the heading of non-tariff barriers (NTB), such as anti-dumping and countervailing actions, non-automatic licensing and (voluntary) export restraints. The Uruguay round was aimed at reducing these barriers in manufacturing and was fairly successful. WTO (2001) shows that the share of all goods affected by NTBs has been reduced from 22.1% to 13% in the European Union and from 23% to 16.7% in the United States. Most of the NTBs apply to food processing, beverages and tobacco, and textiles and apparel.

The definition of NTBs could be extended to include intentional and unintentional restrictions on international trade that stem from regulating product characteristics and production methods. Concerns for health, safety, environment and consumer protection are legitimate grounds for member states to restrict imports from other member states. These obstacles to trade are often referred to as technical barriers.[9]

In the European Union, a number of product standards and regulations have been harmonised in order to remove technical barriers to trade. More recently, the European Union adopted the principle of mutual recognition to achieve this goal. Further attempts to liberalise trade in manufacturing through the WTO could rely on these forms of technical harmonisation or mutual recognition. However, not every country may have the capacity to deal with a variety of standards or the capacity to implement and guarantee a common standard. The possibility arises that developed countries will liberalise their mutual trade by reducing technical barriers, while developing countries are excluded. This would violate the most favoured nation principle of the WTO and could be dangerous for the WTO itself and the success of future trade rounds.

In services, import tariffs have never been important. Trade in services, however, is hampered by three other types of barriers (Hoekman et al., 1997). The first is quotas and prohibitions. For instance, landing rights for aeroplanes. Secondly, price regulations form an

[9] Baldwin (2000) gives the example of the Swedish standard for wipers on car headlights. This product standard is a safety precaution, since Swedish roads are often rather dusty and visibility in traffic is essential. Swedish car makers have integrated the installation of wipers into the production process. Foreign car makers have not, since Sweden is only a small market. As a result, the installation of wipers is relatively expensive for foreign car makers, thus raising the price of imported cars. Alternatively, foreign car makers offer only luxury models on the Swedish market for which headlight wipers are already an option.

impediment to trade(airport and tourist taxes, for example, reduce the demand for tourist services). Finally, there is sometimes discriminatory access to distribution networks. This not only hampers trade, but also reduces competition. With respect to network sectors such as electricity and railways, Nicoletti (2001) argues that competition in Europe is indeed weak and markets are dominated by incumbents. There are, however, changes in some sectors. For instance, in 1990 the market for fixed telephony was highly regulated in about 80% of the OECD countries. In 1998, this was reduced to 20%. For mobile telephony, regulation is even more liberal.

Summing up: future trade liberalisation refers to agriculture and services and the elimination of non-trade barriers. These forms of trade liberalisation are more difficult to pursue than the removal of tariff barriers in manufacturing in the past. The future of global trade liberalisation is therefore difficult to foresee.

3.3 Legitimacy and effectiveness: how to deal with non-trade issues?

The recent trade summits in Seattle and Doha on a new WTO round were the focal points of protests against (some of) the consequences that may arise from liberalisation and globalization. The protests came from an alliance of diverse groups, ranging from environmental action groups to trade unions, and from non-governmental organisations to French farmers. These protest actions stem from the broad concern that free trade is not the same as fair trade.

A major concern is that trade and non-trade issues have grown interdependent. For instance, liberal trade means that market participants have the freedom to exploit comparative advantages, even if they stem from lax regulations in particular countries. Trade liberalisation has therefore come along with concern for environmental policy, labour standards and the like. In particular, if one country has lower environmental or labour standards than its trading partners, it will, for the sake of competitiveness, resorts to so-called ‘ecological dumping’ or ‘social dumping’: it supplies goods at too low, unfair prices. This warrants tariffs as anti-dumping measures.

However, ecological or social dumping are not always compelling arguments against free trade. Differences in standards usually reflect differences in social preferences and initial conditions. A rich country may want to tax labour to support a social security system, restrict working hours, and impose tough environmental regulation. A poor country is likely to make different choices. Robert Lawrence et al. thus conclude that ‘if national tastes or conditions lead to different laws, the playing field of international competition will not, and should not, be level’ (Lawrence et al., 1996).

Globalization of markets nevertheless calls for regulation at a global level. Trade liberalisation requires a strong international organisation that maintains incentive-compatible agreements, i.e. agreements that countries do not want to deviate from. Ideally, international organisations should also deal with other coordination failures, i.e. outside the field of trade. The problem is that effective global organisations do not exist. Accordingly, the WTO is 'burdened' with these issues. For more about cooperation in non-trade issues, we refer to chapter 5.

3.4 Key uncertainties in globalization

The next WTO round is scheduled to conclude at the beginning of 2005. But this seems unlikely. In fact, earlier rounds took far longer than three years to complete: the Tokyo round lasted six years, and the Uruguay round took even one year longer.

At the meeting in Doha, countries agreed upon an agenda, but that seems to be about the only thing that they could agree upon. The ministerial meeting in Cancun should have resolved the impasse in negotiations, but did not. At this stage of the negotiations, countries do not have to agree. But the current round seems more complex and more daunting than previous ones. This is especially because of the more heterogeneous membership of the WTO, which leads to a wider variety of interests. Moreover, the agenda contains more difficult areas such as agriculture and services while, at the same time, the agenda on free trade is linked to non-trade issues. Clearly, one of the uncertainties for the future is whether the WTO negotiations will eventually come to a successful conclusion.

4 European integration and enlargement

European integration has brought political stability and economic growth to the member states of the European Union. The next enlargement will probably yield additional benefits to Europe. But it also puts a strain on the progress in the integration process. Moreover, the integration process faces a number of new issues on which member states maintain different views. Fundamental reforms in EU institutions and EU policies seem necessary to keep the European Union manageable and to improve its legitimacy. Will Europe succeed?

4.1 The economic impact of the next enlargement

In 2004, the European Union will expand from a club of 15 countries to a club of 25. Enlargement will take place with eight Central and Eastern European Countries (CEECs) and two island states, Cyprus and Malta. The EU population will increase by 20% to almost 450 million. The accession countries are much poorer than the current member states. As table 4.1 shows, production per capita in the accession countries is only US$3 600, which falls far below the European average of US$22 400. Consequently, the contribution of enlargement to GDP in the European Union is modest: it rises by only 4%. These averages hide important differences among accession countries, though. Whereas production per capita in Slovenia , Malta and Cyprus is almost at par with Greece and Portugal, the Baltics and Slovakia lag far behind.

After 2004, Bulgaria and Romania are likely to be the next entrants to the European Union. Currently, the European Union is negotiating with these two countries on the terms of accession. Table 4.1 reveals that the level of welfare in Bulgaria and Romania is below the average of the countries that accede to the European Union in 2004. In the somewhat longer term, say after 2010, the European Union may enlarge even further. For instance, Norway, Liechtenstein, Switzerland and Iceland may decide to apply for membership; the countries of former Yugoslavia and Albania may join the European Union; and Turkey may accede.

Especially Turkey is an important candidate, both because of its geographical location, with borders to the Middle East and the former Soviet Union, and because of its large population (see table 4.1). If Turkey were to enter the European Union now, the population would rise by another 17% and GDP by 2.2%. The Turkish population will, moreover, rapidly grow during the coming decades. According to demographic projections, Turkey could even become the largest country of the European Union in 2020 – exceeding 80 million. Whether and when Turkey will accede is difficult to predict. In 2004, the European Union will decide on the basis of political criteria whether a starting date for negotiations with Turkey will be given. If the political, economic and institutional developments in Turkey are judged to be inadequate and the European Union is unwilling to negotiate with Turkey, the country might alternatively shift its attention towards eastern regions, rather than the European Union.

Table 4.1 Key economic indicators for 13 accession countries in 2000

	Population (millions)	GDP (billions US$)	GDP per capita (1000 US$)	Labour in agriculture (% of total labour)
Poland	38.6	157	4.1	18.8
Hungary	10.0	47	4.7	6.5
Czech Republic	10.2	52	5.1	5.1
Slovakia	5.4	20	3.7	6.7
Slovenia	2.0	20	10.0	9.9
Latvia	2.4	6	2.5	13.5
Estonia	1.4	5	3.6	7.4
Lithuania	3.7	10	2.7	19.6
Cyprus	0.8	9	11.3	9.2
Malta	0.4	4	10.0	1.9
10 accession countries	74.9	330		
Bulgaria	8.2	12	1.5	8.3
Romania	22.4	33	1.5	42.8
Turkey	65.3	187	2.9	34.9
all accession countries	170.8	562	3.6	14.2
EU-15	371.0	8325	22.4	4.9

Source: Worldbank World development indicators; European Commission DG for Agriculture

The possibility of Turkish accession has also sparked a debate about a European identity. The Chairman of the European Convention Giscard d'Estaing expressed the clear opinion that "Turkey has a different culture, a different approach, a different way of life" and "its capital is not in Europe, 95% of its population is outside Europe". Do geographical, political and cultural differences put a boundary on a further expansion of the European Union or not? A similar discussion arises with respect to the new border regions of the enlarged European Union in Eastern Europe, the Middle East and Northern Africa. Around 500 million people live in these regions. They earn an average per capita income of about one-fifth of that in the enlarged European Union (see table 4.2). Economic integration with a number of countries in these regions (especially around the Mediterranean) is foreseen in the form of bilateral association agreements, which imply free trade by 2010. But could these countries ever become members of the European Union? At the very least, the political relationship with these regions is important, especially since a number of countries are not stable democracies.

Table 4.2 Population and income per capita in border regions of the enlarged European Union in 1999

	Population in millions	Income per capita[a]
Eastern borders		
Russian Federation	146	32
Belarus	10	32
Ukraine	50	16
Moldavia	4	10
Croatia	4	34
Albania	3	15
Southern borders		
Algeria	30	22
Morocco	28	15
Tunisia	9	26

[a] Measured in purchasing power parities, in terms of EU average
Source: Worldbank World development indicators

Below, we elaborate on three aspects. First, we discuss the benefits of further integration and the prospects for income convergence between new and current members. Second, we analyse the consequences of enlargement for the sectoral structure of the economies of new and old members. Finally, we elaborate on the possible migration flows towards Western Europe.

Integration and convergence

A number of studies have explored the economic implications of the next enlargement with twelve candidate countries (i.e. including Bulgaria and Romania, but excluding Turkey). They reveal that a substantial part of the economic gains have already been obtained through the Europe Agreements that have been effective since the early 1990s and which provide for the removal of formal trade barriers on manufactured goods. As a result, trade between the European Union and the transition countries has already shown forceful growth over the last decade. To illustrate, the value of exports from the CEECs to the European Union has quadrupled between 1988 and 1998, compared to a doubling of the value of exports within the European Union during the same period.

Yet, a number of other effects of EU enlargement are still to be realised. For instance, accession to the European Union implies that candidate countries will have to conform to the common external tariffs. Moreover, the new countries will have to conform to the standards and regulations of the internal market. This will eliminate the costs arising from customs formalities and will remove technical barriers to trade. Various studies have analysed the economic implications of these further steps in the integration with the CEECs. Table 4.3 presents the results from a representative selection of studies. It suggests that current member states may expect small economic gains, while the new member states will gain much more. Note, however, that the immaterial gains in terms of increased safety and stability in the European continent are not captured in these figures and could very well exceed the economic benefits.[10]

Table 4.3 Long-run effects of EU enlargement on GDP per capita (in %) according to a selection of studies

	Effect on EU	Effect on CEECs
Baldwin et al. (1997)	0.2	1.5
Brown et al. (1997)	0.1	3.8
European Commission (2001a)[a]	0.2 - 0.4	n.a.
Lejour et al. (2001)	0.1	7.8
Breuss (2001)[a]	0.2	7.2

[a] Excluding the impact of migration on GDP per capita

The estimated benefits of integration are not nearly enough to close the income gap between the new and current members of the European Union in the coming decades. Table 4.4 shows for various countries income per capita in terms of the current average within the European Union. Most of the entrants do not earn half the average income, and the poorest among them less than one-third. Even if GDP in the accession countries were to increase by 8%, as predicted by some of the studies in table 4.3, the income gap with the rest of Europe would remain large.

Within the club of 15 EU countries, income differences are also significant. Table 4.4 shows that income per capita in Europe ranges from 72% of the average in Portugal and Greece to 116% in Belgium and Denmark. However, these income disparities have gradually become smaller over time. To show this, figure 4.1 plots GDP per capita in 1977 (measured in purchasing power parities) against its growth rate between 1977 and 1996 for twelve countries. It reveals a clear pattern of catching-up: countries with initially lower income levels have grown faster than richer countries. The rate of this so-called beta-convergence is 2.1% per year. It implies that it takes about 33 years to cover half the initial gap between a poor and a rich country. This rate of convergence of two percent per year is consistent with the findings in the empirical literature (Sala-i-Martin, 1996). A plausible explanation for convergence is that backward countries feature a high marginal product of capital and can copy new, advanced technologies. This allows them to improve their productivity relatively easy and quickly. Catching up may also occur in the candidate countries.

[10] Moreover, the studies in table 4.3 concentrate on the implications of intenser trade relations. The effects of EU accession via more efficient domestic institutions, technology spillovers, or more stable macroeconomic policies are typically not included. Hence, growth in the accession countries may well be larger than suggested by these studies, although not all these growth effects can directly be attributed to the accession to the EU.

Table 4.4 Income disparities in Europe in 2000 and 2030 in the presence of 2% beta-convergence[a]

	2000	2030		2000	2030
Austria	111	105	Bulgaria	23	62
Belgium	116	108	Czech Republic	58	79
Denmark	116	107	Estonia	37	69
Finland	102	101	Hungary	50	75
France	104	102	Latvia	28	65
Germany	107	103	Lithuania	29	65
Greece	72	86	Poland	38	69
Ireland	102	100	Romania	27	64
Italy	100	99	Slovak Republic	47	74
Netherlands	111	105	Slovenia	73	86
Portugal	72	86			
Spain	81	90			
Sweden	100	100			
United Kingdom	101	100			
Mean	100	100		38	71

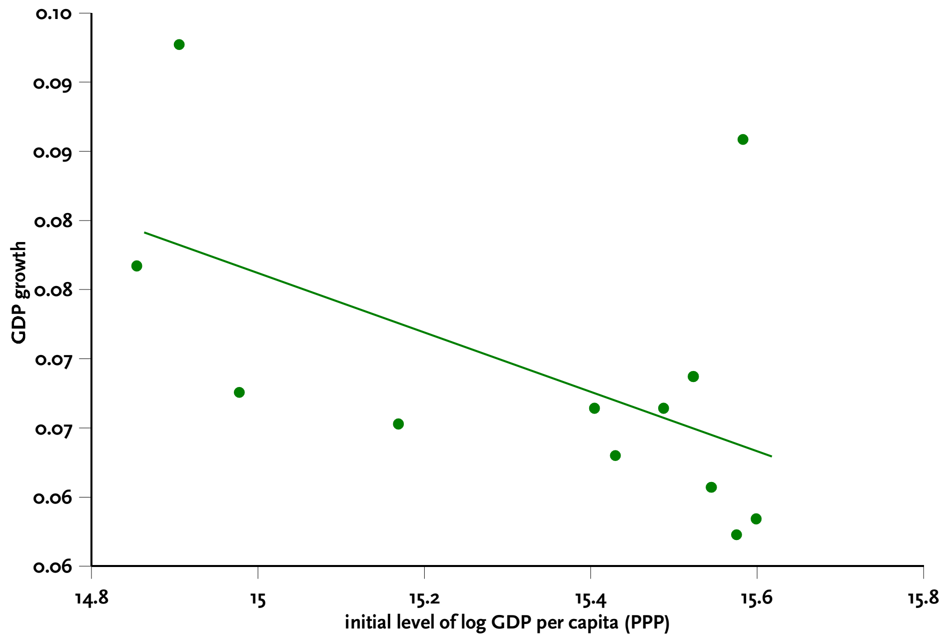
[a] Income measured by GNP per capita (in purchasing power parities) in % of EU average

To give an indication what catching up would imply for the accession countries, table 4.4 presents the income levels in Europe in 2030 in the presence of 2% (unconditional) beta-convergence during the entire period. We see that the poorest countries, Portugal and Greece, would arrive at 86% of the average income in the current EU-15, compared to 72% today. In the CEECs, today's income per capita is only 38%, but this would rise in 2030 to 71%. This is almost similar to today's level of income in Portugal. Of course, the improvement from 38% to 71% is considerable, but the income difference remains significant, even up to 2030.

Although the aggregate economic impact of European integration is positive, the benefits may not accrue equally to regions. Some benefit more than others, and a few may even lose from integration. To maintain public support for further integration in Europe, it is necessary to prevent large or increasing income disparities among regions. The European Union therefore explicitly aims at economic and social cohesion among regions.

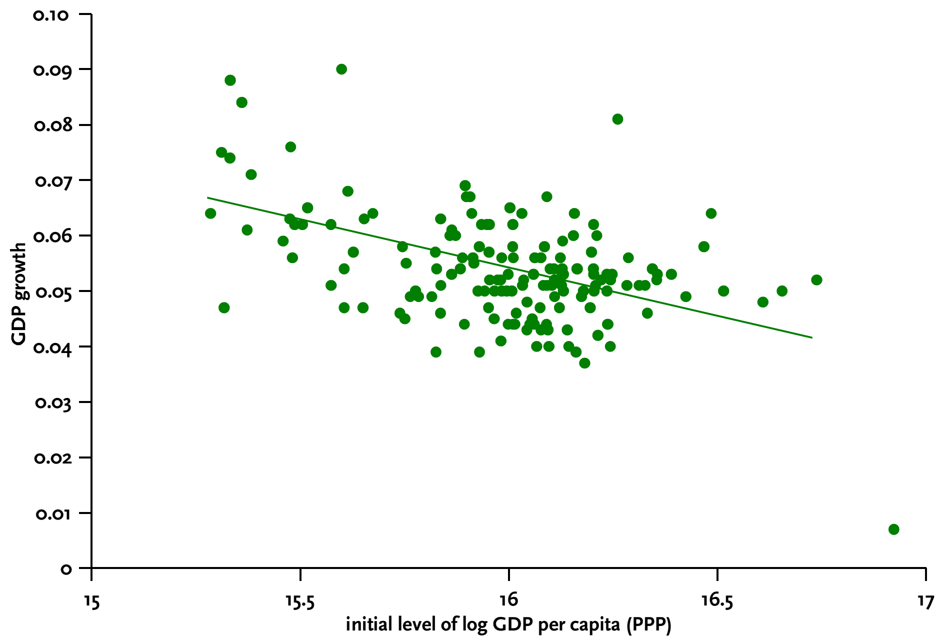
From this perspective, it is reassuring that the pattern of income converge applies not only to countries but also to regions. Figure 4.2 depicts the same scatter as in figure 4.1, but now for 160 regions in the European Union. Specifically, it explores the relationship between the 1984 level of GDP per capita and its growth rate between 1984 and 1996. Again, it reveals a negative relationship with a similar degree of convergence. Hence, the income levels among regions tend to converge, as they do among countries.

Figure 4.1 Convergence among EU countries 1977-1996



Source: Ederveen et al. (2002)

Figure 4.2 Convergence among 160 European (NUTS 2) regions 1984-1996



Source: Ederveen et al. (2002)

That regions (on average) catch-up to the mean level of income, does not imply that they all do. For instance, figure 4.2 shows that some of the backward regions have not experienced an above average growth rate. This can be explained by less efficient institutions in some of these regions or by poor economic policies. An alternative explanation is that integration strengthens the forces of agglomeration. The box *Agglomeration economics* gives a more detailed explanation of this. Braunerhjelm et al. (2000) argue that agglomeration economies can indeed polarise Europe into advanced core regions with high income and low unemployment, and depressed peripheral regions with low income and high unemployment. This is especially likely if labour is immobile across regions, which is typically the case in Europe. Hence, if only the core regions reap the benefits of agglomeration, immobile unskilled labour gets trapped in a depressed periphery.

Agglomeration economies

Agglomeration economies are positive spillover effects between agents that locate close to each other. What comes readily to mind are knowledge spillovers, reduced search efforts on pooled labour markets, and the emergence of specialised markets for intermediate goods. The influential 'new economic geography' literature (Fujita et al., 1999) highlights the benefit for firms from geographical proximity because, in addition to having access to pooled markets for labour and final products, they save on transport costs in local markets for intermediate goods.

A salient quality of agglomeration economies is that they are reinforcing. If a firm decides to locate close to other firms it becomes more attractive for the next firm to do so as well. A snowball effect arises, which may lead to different production structures of initially similar regions.

Localisation economies (or MAR economies after Marshall, Arrow and Romer) are agglomeration economies that are confined to firms of the same industry. It implies that although it pays off for banks to locate close to each other, there is no reason for textile plants to also be where these banks are. On the contrary, centrifugal forces such as congestion and high living expenses give an incentive to locate elsewhere. Thus, localisation economies drive the European economy towards a possibly large set of economically significant regions, each hosting a limited range of industries.

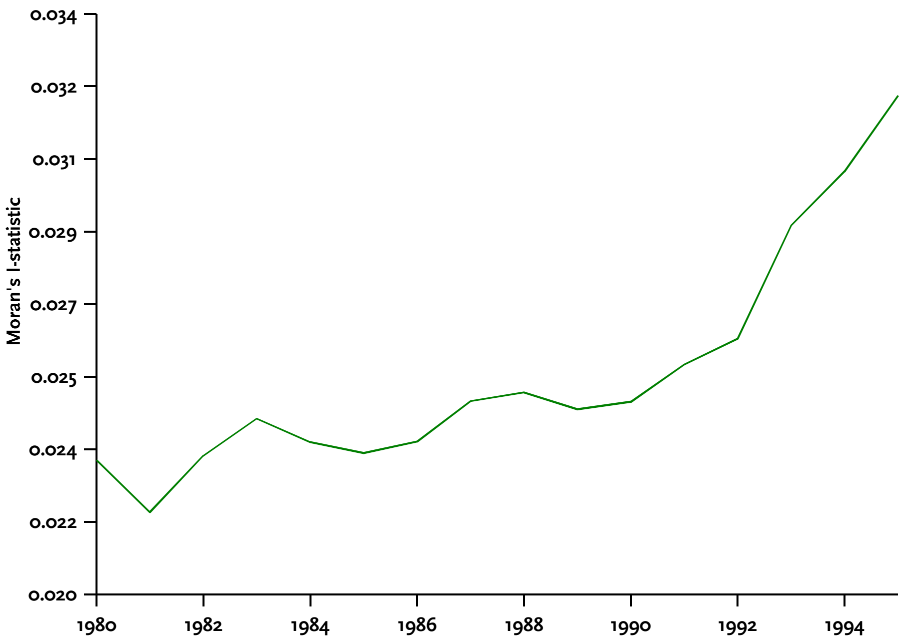
Urbanisation economies (or Jacobs economies) extend to firms from different industries. This implies that it pays off for a variety of firms to locate close to each other. Thus, urbanisation economies drive the European economy towards a situation in which core regions attract business activity at the cost of the periphery. To the extent that urbanisation refers to regions, it can be seen as a large scale variant of a drift to the city.

Figure 4.3 shows the trend between 1980 and 1995 in an index that captures the core-periphery pattern of economic activities, referred to as urbanisation.[11] The figure suggests that industries indeed drift towards a few growth poles. This sharpens the contrast in the density of economic activity between clusters of core regions and peripherical ones. Note that there is a temporal

[11] It is referred to as Moran's I-statistic, a spatial correlation coefficient. A higher value of the index suggests that regions with a high (low) value-added per square kilometre are located more closely to one another. See Gorter (2002) for more details.

contiguity between an acceleration of urbanisation and the implementation of the Internal Market through the Single European Act of 1986 and the Maastricht Treaty of 1992. This acceleration suggests that regional income convergence is not self-evident and that further integration may not contribute to it.

Figure 4.3 Urbanisation in Europe



Source: Gorter (2002)

Whether lagging regions will indeed catch up with richer ones depends – apart from urbanisation economies – on numerous other factors, including the regional developments in institutions, education, and so on. Also European cohesion policy could play a role in reducing regional income disparities in Europe. The evidence, however, does not support the claim that cohesion policy has played a significant role in reducing regional disparities in Europe, as the box *How effective is cohesion policy?* reveals.

How effective is cohesion policy?

The economic literature suggests that cohesion policy is potentially a powerful instrument to reduce the welfare differences between regions in Europe. For instance, Ederveen et al. (2002) review the literature on the impact of cohesion policy on regional growth. Model simulations, which report the effects of funds that are properly spent on public investment projects, show on average that 1% of GDP cohesion support stimulates growth in a region by 0.18%. This is, however, in sharp contrast to the evidence from econometric studies. The latter can be interpreted as evidence on the actual impact of cohesion support on growth. This evidence is mixed at best: some studies report a positive, some insignificant, and some even negative effects of cohesion support on growth. On average, econometric analyses report no significant impact. Ederveen et al. (2002) explore the factors that may explain the difference between the potential effectiveness of cohesion support and its actual effectiveness. They conclude that rent seeking, moral hazard and crowding out render cohesion policy ineffective in practice. This challenges European policy makers in their discussion about reform of cohesion policy.

A more effective cohesion policy indeed calls for reform. First, it requires that support is better targeted to the poorest member states. More than half of today's cohesion support is allocated to countries with a GDP per capita that exceeds the EU average. Especially in light of the next enlargement with substantially poorer member states, targeting of cohesion support becomes increasingly important. An effective targeting to poor regions also requires that the administrative costs for local governments are reduced. Indeed, with today's administrative requirements, poor regions tend to have severe problems to absorb support that is allocated for them. Second, cohesion policy may gain effectiveness if there were better incentives for local governments to spend funds on projects with a high rate of return. The current rules allocate funds to regions first, and then the regions absorb these funds according to strict rules. This procedure runs the risk that regions select low-productive projects which just meet the criteria of the European Commission but which are not primarily focussed on promoting regional growth. A system where regional governments of the poor regions compete for funds on the basis of project proposals may yield better incentives for regional governments to develop projects that yield a high rate of return (Ederveen et al., 2002).

Sectoral restructuring: who fears enlargement?

Newspapers put it on their front page when a Western company moves to Poland to benefit from lower wages or laxer regulations. Such headlines fuel anxiety in Western Europe about economic integration in general and EU enlargement in particular. Inevitably, enlargement will cause industrial restructuring, especially in sectors that employ low-skilled workers such as agriculture and textiles. This could – at least in the short term – hurt particular groups of workers. This section considers the impact of enlargement on the (re)location of European industries. The experience of Spain and Portugal is used as an example to sketch possible developments.

Using an indicator for the degree of specialisation, table 4.5 shows that Spain and Portugal are more specialised than other European countries in agriculture and textiles.[12] Between 1980 and 1995, the agricultural sector lost ground in both countries. In Spain, also textiles contracted. The textile sector flourished, however, in Portugal after accession: while the size of this industry in the economy was almost three times as large as the EU average before accession, it increased to a factor four after accession.

These Spanish and Portugese experiences demonstrate that accession may induce different developments in specialisation. It raises the question what the impact will be of the next enlargement on the industrial structure in Europe. Is the Spanish or the Portugese experience more relevant? To give an indication of the degree of specialisation in the agricultural and textile sectors, the lower part of table 4.5 shows the value-added of these sectors in Hungary and Poland (as a fraction of the European average). It appears that, similar to Portugal and Spain before their accession, the two candidate members are relatively specialised in agriculture and textiles.

Lejour et al. (2001) use a CGE model for the world economy to explore the sectoral implications of the accession of the CEECs to the internal market. Their results imply that accession will cause a decline in the share of agricultural production in terms of total value added in Hungary and Poland. Accordingly, the indicator in table 4.5 drops by 0.11% and 0.12%, respectively.[13] The share of the textile sector in total value added relative to the EU average expands from 2.2% to 2.75% in Hungary and from 1.9% to 2.65% in Poland. This resembles the experience of Portugal after their accession. The expansion of the textiles sector in the CEECs comes at the expense of that in Southern Europe. The index in table 4.5 therefore falls for Spain and Portugal.

[12] We have divided gross value added of two sectors 'Agricultural, forestry, and fishery products,' and 'Textiles and clothing, leather and footwear' in Spain and Portugal between 1980 and 1995 by total value added, and expressed them in the corresponding average shares in Europe. Since the value of this indicator exceeds unity, the industries are over-represented in Spain and Portugal, i.e. these countries were relatively specialised in both sectors.

[13] These predictions are consistent with recent trends in the CEECs. In particular, agricultural production fell substantially during the last decade and is currently still below the pre-transition level of 1989. See CPB (2002) for more details.

Table 4.5 Relative importance of two industries in Spain and Portugal, Hungary and Poland

	1980[a]	1995[a]	simulation 2020
Spain			
Agricultural, forestry, and fishery products	1.66	1.22	1.21
Textiles and clothing, leather and footwear	1.23	1.12	1.09
Portugal			
Agricultural, forestry, and fishery products	2.53	1.73	1.72
Textiles and clothing, leather and footwear	2.92	4.00	3.90
		1997	simulation 2020
Hungary			
Agricultural, forestry, and fishery products		1.84	1.73
Textiles and clothing, leather and footwear		1.69	2.12
Poland			
Agricultural, forestry, and fishery products		2.11	1.99
Textiles and clothing, leather and footwear		1.46	2.06

[a] Share of the industry of gross value added divided by the share of the industry of European gross value added.
[b] Difference between quotient of shares in 1995 and 1980.

Migration from accession countries

Accession to the European Union implies free movement of people between the current and new member states. It is sometimes believed that this will bring about substantial flows of immigrants to the richer parts of Europe. Can we really expect a large inflow of immigrants after enlargement?

When Greece, Portugal and Spain acceded to the European Union, similar fears with respect to immigration were put forward in Northern EU countries. After the accession, however, migration flows remained surprisingly small (Straubhaar, 1988).

The experience with the Iberian countries, however, cannot be readily applied to the CEECs for two main reasons. First, unlike the CEECs, migration from the Iberian countries was already unrestricted in the period before the accession. Hence, the majority of immigrants arrived long before these countries acceded to the European Union, particularly in the 1960s. Secondly, measured in purchasing power parities, income per capita in the Iberian countries was between 55% and 70% of the EU average. This is higher than the corresponding figures for the CEECs, as we saw in table 4.4. Migration pressure might thus be larger after the accession of the CEECs.

Although forecasting the migration effect of EU enlargement is difficult, a number of researchers have made an attempt. These studies estimate the effect of income disparities (and other explanatory variables such as unemployment or distance) on international migration from previous experiences. These estimates are then applied to the income differentials between the

EU and the CEECs to derive an estimate of the migration effect of EU enlargement. We have collected twelve such studies, the results of which are summarised in table 4.6. The table shows the long-term stock of migrants from the CEECs to the current EU countries, where the long-term is interpreted as the migration effect after 15 years.[14]

Table 4.6 Summary estimates of migration after EU enlargement on the basis of 12 studies

	Millions of people
Mean	3.8
Median	2.9
Standard deviation	3.1
Highest estimate	13.6
Lowest estimate	0.6

Source: De Mooij and Nahuis (2003)

The median of the sample suggests that 2.9 million migrants will move towards the European Union in the long term. There is, however, quite some variation among the studies. The highest estimate predicts more than 13 million immigrants while the lowest estimate is less than 1 million. The majority of estimates, however, are somewhere between 1 and 4 million. This corresponds to a long-term migration effect between 1% and 4% of the total population in the CEECs or, equivalently, between 0.25% and 1% of the EU population.

If Turkey were to accede to the European Union, a further flow of immigration may occur. Up to now, however, there are no estimates available on the migration effect of the Turkish accession to the European Union. For an educated guess, we used the implicit elasticity from the studies in table 4.6 to make such an assessment. In particular, Turkish GNP per capita measured in purchasing power parities in 1999 is 31% of the EU average, which is somewhat below the average of the CEECs. Applying the implicit wage elasticity of migration to the income differential with Turkey yields an estimate of the migration potential from Turkey to the European Union. Thereby, we take account of the demographic development in Turkey. In particular, the Turkish population is expected to increase from 65 million inhabitants in 2000 to more than 83 million people in 2020 and more than 100 million in 2040. Taking the Turkish population size in 2020, we obtain an expected migration from Turkey to the European Union of 2.7 million immigrants. Applying the Turkish population of 2040, the central estimate increases to 3.4 million.

[14] The figures refer to permanent migration. The estimates of the various studies cannot be directly compared, as they differ in the selection of the source and destination countries, and in whether they predict annual flows or long-term stock of immigrants. To construct table 4.6, we derive comparable estimates by using the migration shares for individual CEECs and EU countries from Boeri et al. (2000) and their time-structure of immigration flows. See De Mooij and Nahuis (2003) for more details about the underlying studies.

The destination of migrants from the CEECs and Turkey is not expected to be equally distributed across the European Union. In particular, the migration literature reveals that the destination of migrants primarily depends on network effects, i.e. new migrants go to places where previous migrants have settled.[15] Table 4.7 presents the destination of migrants based on the current distribution of immigrants from the CEECs and Turkey in the European Union. Around 65% of all CEEC-migrants have settled in Germany, while more than 12% reside in Austria. The remaining 23% is spread across the other EU countries. The destination of Turkish migrants in Europe is different. A large share of Turkish migrants resides in Germany (76.5%), but France (7.5%) and the Netherlands (3.8%) also host a relatively large share of Turkish immigrants. Based on this distribution, one may expect that Germany will receive 1.8 million CEEC migrants and a similar number from Turkey. Almost 350 thousand CEEC migrants would reside in Austria and only 31 thousand in the Netherlands. France may expect 214 thousand Turkish migrants, Austria another 112 thousand, and the Netherlands some 104 thousand.

Table 4.7 Expected destination of EU immigrants based on stocks in EU countries in 1999

	CEECs	Turkey
	thousands	
Total	2878	2752
- France	74	214
- Germany	1871	2105
- Netherlands	31	104
- United Kingdom	132	44
- Austria	348	112

Source: Trends in international migration, OECD, SOPEMI 2001 for data on current destination; own calculations for expected destination of migrants from CEECs and Turkey

4.2 New political challenges for the European Union

The achievements of fifty years of European integration are spectacular. The development of the internal market, the monetary union, and political cooperation between nations have brought peace and stability in Europe and contributed to economic growth. For the future, a number of new areas of cooperation appear on the agenda of the European Union. This involves reforms of existing policies in the European Union, a possible expansion of competences, and various forms of policy coordination among members. Among current EU member states, there exists a

[15] Differences in job opportunities between countries or possible transitional periods with respect to the free movement of labour, as for instance agreed upon in the negotiations between the European Commission and some of the CEECs, can redirect the destination of immigrants in the European Union.

variety of views on many of these issues. Enlargement may add even more views, thereby further complicating integration and cooperation. This section elaborates on some of the issues that will remain on the EU agenda in the coming decades.

Reforming EU policies

In the future, European funds will probably flow towards the relatively poor new member states. Cohesion support should help them to converge towards the average level of income in the European Union. Support from the common agricultural policy (CAP) should contribute to the restructuring of the agricultural sector. Among the current members of the European Union, however, net contributors resist increases in the European budget. At the same time, net beneficiaries resist lower funds. This spells conflict on future negotiations on the size and the distribution of the EU budget.

The reform of the CAP already started in the 1990s with the McSharry reforms and Agenda 2000. It was triggered by the criticism from third countries regarding the trade-distorting character of the CAP, as well as the internal criticism on the growing budget claims. With the reforms, price support was transformed into less distortionary forms of direct income support and export subsidies were cut by nearly 80%.

Further reforms of the CAP are now underway. In discussions on a new WTO agreement, criticism has been levelled at direct income support to European farmers, which keeps too many production factors artificially tied to the agricultural sector. Therefore, reforms have been proposed to reduce gradually direct income support and to decouple it from production. Part of the budget could then be allocated to rural development measures, as is also suggested in the recent proposals of the European Commission. In that case, however, questions about the role of the European Union become even more important. Some have argued that it would be more appropriate to re-nationalise the CAP.

The accession of the CEECs to the European Union makes reforms of the CAP even more urgent. In particular, applying the current CAP to the new member states implies that the financial costs of the CAP would increase. This has induced member states to agree upon an upper bound on the CAP-budget: until 2013 the expansion of the budget in nominal terms is limited to 1% per year. With an inflation rate above 1%, the CAP will thus decline in real terms. This budgetary restriction can only be achieved if the CAP is reformed further.

Cohesion policy attempts to reduce differences in welfare between European regions by subsidising a wide range of programmes to develop infrastructure, restructure industries, or modernise education. Most of these programmes are geared towards regions that lag behind in economic development. As GDP per capita in the CEECs is currently about one-third of the present EU average, enlargement will involve a net transfer of funds towards the candidate countries. These funds seem particularly important in the light of the substantial costs for the CEECs to comply with the acquis communautaire, i.e. the set of rules and regulations that comprise the first pillar of the European Union.

Cohesion support to the CEECs will cause either an expansion of the EU budget, or a reallocation of existing funds towards the new member states, or both. The question dominating the current debate about cohesion policy is who will pay for the cohesion support to the new member states. Southern EU countries firmly argue that they want to maintain cohesion support for their lagging regions in the future; Northern EU countries argue that they want to keep the overall budget limited. This sets the stage for a conflict during the negotiation round in 2006 when the allocation of funds for the new financial planning period 2007-2013 will be decided upon.

To resolve the political deadlock, one option is to move towards a system of net fiscal transfers in the European Union from rich to poor countries. This would minimise the costs of administration and compliance and also would help to avoid problems with crowding out, moral hazard, rent seeking and the difficulty for poor regions to absorb funds. The cohesion budget would thus serve as a transparent instrument in the political negotiations about the net fiscal position of countries with respect to the European Union.

Scope of the European Union

The Maastricht Treaty introduced the term subsidiarity as the guiding principle for assigning policy prerogatives in Europe among national and supranational authorities. The principle suggests that powers should be decentralised unless there are good reasons for coordination. Chapter 7 elaborates in more detail on the costs and benefits of (de)centralisation. Assessing these costs and benefits involves an important political component since preferences play an important role. Countries may, for instance, assign a high or low value to their national sovereignty in specific areas. Harmonisation of EU policies is then to some degree a matter of willingness of the individual governments to transfer powers to a supranational level. In this respect, fundamentally different views exist on the competences of the European Union, both across countries and across policy issues. With respect to foreign and security policy (second pillar) and justice and home affairs (third pillar), for instance, some countries favour a development towards a political union with supranational powers. They believe that this is in the interest of the member states in bringing peace and stability in Europe and in encouraging social cohesion among countries. Others, however, maintain that cooperation in these areas should be based on intergovernmental deliberation. They regard the European Union as an economic (and monetary) union, not as a political union.

Also with respect to economic policies, such as fiscal policy, labour-market policy, and policies regarding the functioning of product and capital markets, countries have different views on the role of the European Union. Some argue in favour of stronger coordination of these policies in order to complement the common monetary policy of the ECB. Others maintain that such coordination is unwelcome since it would reduce the flexibility of individual countries in dealing with local developments and circumstances. There are, however, different forms of coordination (see Italianer, 1999). Countries have recently created non-binding forms of policy coordination under the heading of the broad economic policy guidelines. This type of coordination does not require the transfer of powers to the central level: it involves information exchange, discussion of best practices, policy dialogue, peer review and policy experimentation. In Lisbon 2000 the European Council added the open method of coordination, which involves defining common EU-wide goals, translating these into national policies and evaluating them on the basis of indicators and benchmarks. The question is how effective these non-binding forms of coordination will be in the future. On the one hand, the guidelines may create a mutual learning process that induces governments to change particular institutions or policies. It may create a natural bottom-up process of convergence of institutions in the European Union, without having to force harmonisation top-down. On the other hand, the non-binding character may involve too little commitment for governments to reform policies.

Enlargement increases the heterogeneity of the union, thereby making it more difficult for members to agree upon common standards and policies. Hence, there is typically a trade-off between enlargement of the number of EU members and expansion of the number of EU competences, although it may be sharper in one policy area than in another. It is difficult to predict where the European Union will be assigned powers in about twenty years from now. Will there be intensified cooperation in areas such as direct taxation, social policy and immigration and asylum policy? And how will countries cooperate in areas of the second and third pillars of the European Union?

4.3 Legitimacy and effectiveness: the need for institutional reform

Since the six founding fathers created the European Economic Community (EEC), the institutional framework of the European Union has not been fundamentally altered. Many commentators argue that this institutional framework is overly complex, not transparent and insufficiently democratic. They fear that enlargement of the European Union will make the framework even less effective, less accountable and more costly to administer. Therefore, EU leaders concluded at the Cologne summit in June 1999 that EU institutions need to be reformed so that the EU can work efficiently after enlargement. A new Treaty in Nice in December 2000 intended to make the EU ready for enlargement (i.e. to improve its democratic legitimacy and its ability to act). There are, however, a number of issues that have been only partially resolved, or were reformed in the opposite direction (see box).

Nice leftovers

Nice did not succeed in resolving some of the problems it tackled. First of all, EU leaders have recognized that a European Commission of more than 30 members is destined to become ineffective. Nice limits each member to one Commissioner after 2005. This includes the larger countries that currently have two Commissioners. However, the tough question whether some member states should be left without a Commissioner has been postponed until the 27th member joins the European Union.

Secondly, the larger and more heterogeneous the union is, the more difficult it is to unanimously agree upon policy changes. Therefore, Nice was supposed to move a number of issues from unanimous voting to qualified majority voting (QMV). Out of 75 provisions under unanimity, 27 were indeed transformed into QMV. These include areas of trade in services and commercial aspects of intellectual property. Cohesion policy was shifted to QMV, but only after 2007 when the new financial budget is determined until 2013. A veto was kept for a number of important policy issues such as taxation, social policy and the major elements of the policy on asylum and immigration.

A third issue addressed in Nice was EU decision making by QMV. This should be legitimate, transparent and effective. Before Nice, passing a proposal required a majority of 71% of all votes in the European Council. Small countries are given a large weight, relative to their population. This aims to prevent a too dominant position of a few large member states. The European Union, however, is a union of states and a union of people. To improve legitimacy, Nice added two requirements for proposals to be passed: it must represent at least 50% of all member states; and it should represent at least 62% of the population. Furthermore, Nice changed the weights in the Council in favour of bigger nations. The new voting scheme, which should take effect in 2005, has three disadvantages. First, it is less transparent than the current system, despite the aim to reduce complexity. Second, it actually diminishes the ability to act in the enlarged European Union, contrary to what was intended. Indeed, Baldwin et al. (2001) have shown that Nice increases the number of blocking minorities in the enlarged European Union compared to the current rules. Finally, Nice shifts power from small to large nations, despite the requirement of at least 50% of all member states votes. In particular, the latter requirement is typically overshadowed by the vote-share criterion that was changed in favour of large nations. More specifically, Baldwin et al. show that the five largest EU countries (Germany, UK, France, Italy and Spain) gain power at expense of the 10 smaller countries in the European Union.

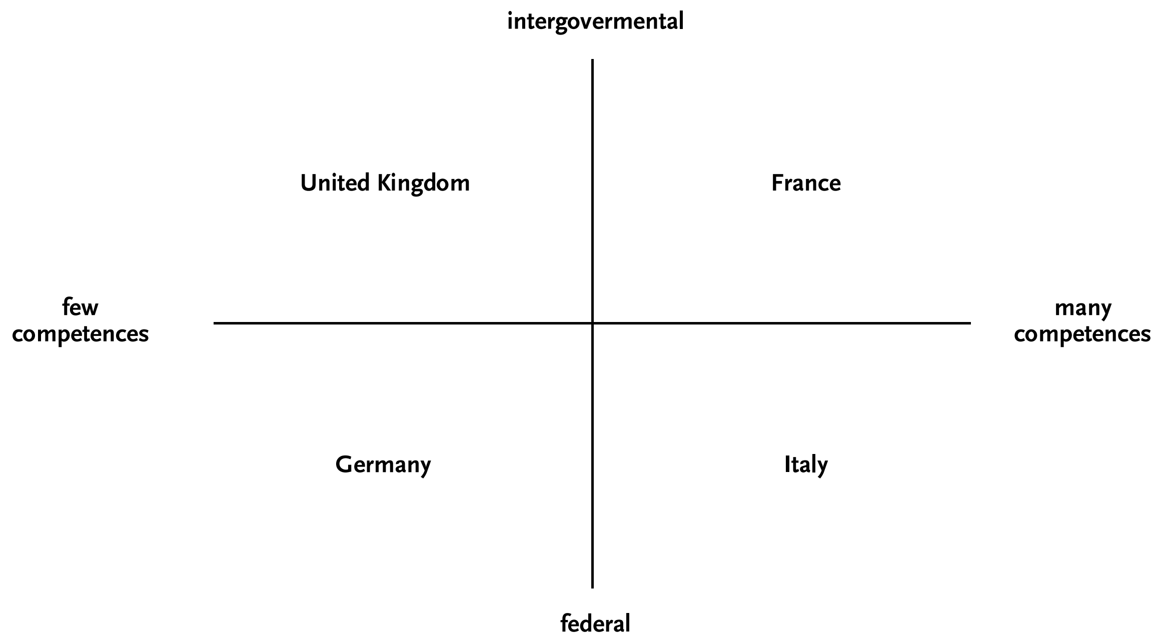
The general impression after Nice is that it does not ensure that EU institutions can work efficiently after enlargement and that legitimacy and transparency are insufficiently improved. Hence, further reforms are necessary. A continuation of the reform process was announced after Nice when European leaders agreed upon a new IGC in 2004. To prepare for this, the European Council in Laken launched a Convention in 2001. On June 18th of this year, this Convention launched a draft constitutional Treaty for the European Union, containing several proposals for reform. For instance, the draft proposes a simpler rule for qualitative majority voting: for a winning coalition, one should have at least 50% of the member states, and represent at least 60% of the population. Compared to the Nice proposal, the weighted majority criterion has thus been abolished. This has two major implications (see Baldwin et al., 2003). First, the European Union's ability to act improves considerably as it becomes much easier to form a winning coalition of countries. Second, the proposal shifts substantial power towards large countries, especially Germany with its large population.

The draft of the Convention is a compromise between people with different views and different interests. One important dispute runs between large and small member states. This is largely parallel to the distinction between an intergovernmental and a community approach. The small member states fear domination of the large member states. To avoid this, small countries are over represented (as measured in terms of population), the votes in the European Council are weighted in favour of the small members states, the presidency rotates on an equal basis bi-annually, and each country takes at least one seat in the European Commission. For the small member states, the European Commission is especially important in preventing domination by the larger member states. It has a somewhat apolitical, technocratic role, and provides a counterweight to the political machinations in the European Council. The small countries want to maintain the position of the European Commission or perhaps even expand its powers. They receive support from Germany (which aims at a federal structure of Europe in accordance with the German federation), the European Commission and many members of the European Parliament. The large member states (such as France, Spain and the United Kingdom), aiming to preserve the primacy of intergovernmental decision making, want to strengthen the position of the Council. The Convention has now proposed that the European Council will elect a Chairman who takes office for two and a half years, with a possibility for re-election.

Another important dispute is the scope of the European Union. In one view, it is more or less limited to the economic domain: the European Union is first and foremost an instrument to achieve economic integration. Therefore, the European Union should not play a leading role in the political domain: a common foreign and defence policy would be a step too far. In another view, the European Union should play a leading role in the social and political domain. It should be an economic as well as political superpower, next to the United States. This should evolve from, as well as contribute to, an European identity that is clearly different from that of America. The European Union could have a say in global affairs and could for example help to realise a world in which the environment is better protected and world income is more equally distributed.

The two disputes give rise to four different combinations. They reflect four different perspectives on the future of Europe, all reflected in views of different countries. Figure 4.4 illustrates these views. The vertical axis runs from intergovernmental decision making on the top, to a federal structure at the bottom. The horizontal axis runs from few European competences at the left, to many at the right. We put the UK perspective at the bottom left quadrant, favouring intergovernmental structures but few European competences. The French view is also characterised by intergovernmental decision making, but is typically in favour of more European competences than the UK view. Germany usually favour a federal structure with few European competences. The combination of federalism with many European competences is found in Italy, for example.

Figure 4.4 Four perspectives on the future of Europe



The question is whether European leaders will be able to come to an agreement about the new Constitution. Will they take over the draft from the Convention, which is already a compromise among the different views? Or will the discussion about a new Constitution start all over again? In any case, reform of the European institutions seems vital for the future of Europe. It will determine the legitimacy of the union, its ability to act, and the scope for future integration. If Europe does not succeed, perhaps the only way for further integration would be through enhanced cooperation (see the box *A way out: enhanced cooperation*).

A way out: enhanced cooperation

A successful and important reform that was agreed upon in Nice is the increased opportunity for enhanced cooperation arrangements. In a larger and more heterogeneous union, deeper economic integration and broader policy coordination among all members is more difficult to achieve. With enhanced cooperation, a subgroup of members may push ahead with the integration. This may create the conditions for other members to join at a later stage. Enhanced cooperation may become a powerful method of integration in an enlarged and increasingly diverse union. It may also relax the problems imposed by the complex and confusing institutional framework. The Nice treaty relaxes the conditions under which enhanced cooperation agreements can be concluded. In particular, members no longer have a veto over the creation of an enhanced cooperation agreement, both in internal market issues (first pillar) and in justice and home affairs (third pillar).

Enhanced cooperation has two potential pitfalls, however. First, it may lead to a *divided Europe*, consisting of a core group of members that deepens and broadens the economic and political integration, and a peripheral group of members that lags behind. If this division into frontrunners and laggards is maintained for a longer period of time, Europe may become politically fragmented and fail to achieve its objectives. A second risk associated with enhanced cooperation is that it leads to a *Europe a la Carte*, i.e. a Union of diverse and variable coalitions of countries. This will probably erode the consistency of integration and perhaps even the economic benefits of an economic union. As long as these pitfalls can be prevented, however, enhanced cooperation can be a successful engine for further integration.

4.4 Key uncertainties on the future of Europe

European integration has brought about significant welfare gains during the past decades. Whether the next decades will bring similar gains depends on several factors, including reform of EU institutions and policies. The Convention is supposed to provide the ingredients for a new Treaty that should bring the necessary reforms. The increased heterogeneity after enlargement will severely complicate future integration. Furthermore, the future agenda contains a number of challenges on which member states have very different opinions. These are hard to reconcile. How future integration and cooperation will evolve is therefore unpredictable. Different scenarios can be thought of, as we will discuss in part III of this study.

5 Emerging global issues

Policy cooperation with respect to international non-trade issues has advanced less than it has in trade, at least in global issues. Cooperation can nevertheless be desirable – in the case of cross-border pollution, poverty reduction or financial markets, for example. A framework for effective international cooperation is, however, difficult to establish.

5.1 The link between trade and non-trade issues

The WTO and the European Union have been successful in tearing down barriers to international economic integration. At the same time, better communication and transport technologies have made national communities part of 'one global village'. The globalisation of economies and societies increased the need for international coordination and cooperation in non-trade areas. For example, controlling cross-border diseases such as AIDS or SARS calls for a coordinated action; grappling with cross-border pollution requires coordinated environmental policies; fighting international crime can be done more effectively through joint action; minimizing the threat of computer viruses via the Internet can be done effectively only when there is appropriate international framework for cooperation. With regard to these aspects, the current framework for global cooperation and coordination is woefully inadequate. Indeed, there exists no commonly agreed-upon framework within which globalization can evolve.

A reason for the lack of international cooperation in non-trade areas is that individual countries do not always perceive a multilateral approach to be in their own national interest. In general, the more the benefits of international cooperation have a global public good character, and the more disjoint national interests are, the harder it is to accomplish a multilateral agreement. This is because the benefits of a global public good accrue to all countries alike, while the costs are borne entirely by the participating countries. In the absence of a powerful global organisation that is able to enforce common rules, global public goods will be under provided. Especially free-rider behaviour forms a serious impediment to the provision of global public goods. To illustrate, the United States do not want to ratify the Kyoto Protocol, which hampers effective global policies to save the global environment. Switzerland wants to maintain its banking secrecy, which limits the opportunities of other countries to tax capital income.

Free-rider behaviour thus impedes forms effective international cooperation in non-trade areas. The key to the WTO's success is that free rider behaviour is not a problem. Although trade liberalisation imposes a cost on members (at least in terms of less national sovereignty), it also delivers clear economic benefits that accrue directly to the individual countries. WTO membership is therefore perceived to yield a net gain for every member. As a result, countries come forward to apply for membership, while none of its members decides to withdraw. Hence, the WTO is a successful multilateral framework, exactly because tariff barriers on imports are powerful instruments to discipline countries. Authorised, punitive tariffs threaten to partly exclude countries from the multilateral trading system and have been effective in forcing countries to obey the rules of the trading system. Thanks to its success, the WTO can play a constructive role in pursuing non-trade objectives, without seriously compromising its main objective of free trade. For example, it could support systems for certification (monitoring multinational companies to see whether they follow particular codes of conduct) and labelling (allowing consumers to differentiate between goods: for example, dolphin-unfriendly tuna).

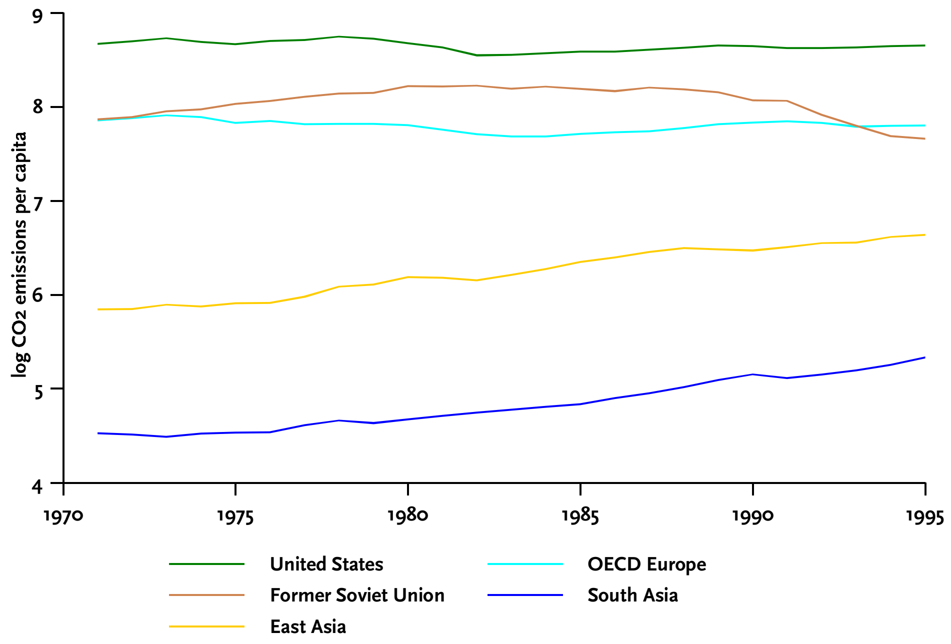
5.2 Kyoto and other non-trade issues

Below, we elaborate on three broad themes where global policy coordination could be attractive but where this cooperation has not advanced: the environment, regulation of international financial markets, and poverty.

Kyoto

The process of development and growth that started with the Industrial Revolution has raised standards of living, increased life expectancy and contributed to the well-being of many people. Not all aspects of life have improved, however. One major concern is the atmospheric concentrations of greenhouse gasses. Since the Industrial Revolution, carbon dioxide concentrations have increased nearly 30%, methane concentrations have more than doubled, and nitrous oxide concentrations have risen by about 15%. These gasses have the property to trap heat. How this will affect the earth's climate is not entirely certain, but it is likely that the temperature on earth will rise. Precipitation will then increase and sea levels will rise. Global warming also raises the probability of catastrophic events, ranging from hurricanes to floods.

Figure 5.1 Carbon emissions per capita in 5 world regions, 1971-1995

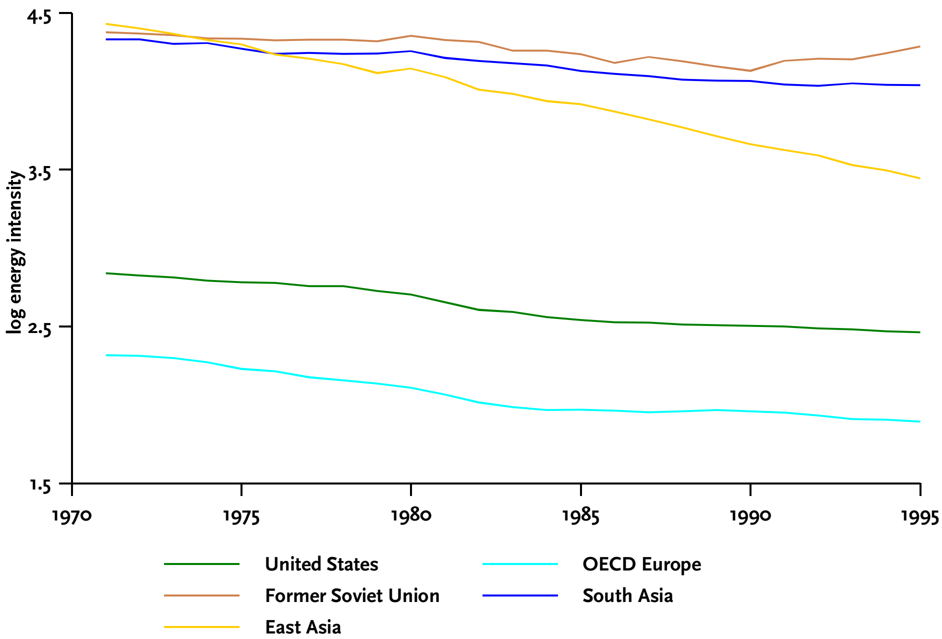


Source: RIVM (2001)

Without intervention, further economic growth will lead to even more emissions of greenhouse gasses and higher concentrations in the future – especially in developing countries, as they are catching up rapidly with industrialised countries and experience high economic growth. The concern is that this will increase the use of natural resources, especially fossil fuels, which can put a severe strain on the climate. Figure 5.1 illustrates this concern. It shows (the logarithm of) carbon emissions per capita between 1970 and 1995 in a number of regions. The emissions in Europe and the United States are far higher than in East Asia (which includes China) and South Asia (which includes India). There is, however, a tendency of convergence. While the emissions per capita in the richer regions were roughly constant over the period, the Asian regions experienced an increase by around 3.5% per year.

Carbon emissions per capita in Europe and the United States did not grow between 1970 and 1995, despite an increase in per capita income. This suggests that production does not feature a one-to-one relationship with emissions. Production, in particular, tends to become more energy efficient over time. Figure 5.2 shows that the (logarithm of) energy intensity of production is steadily decreasing in Europe and the United States due to energy-saving technical change. This process does not occur in other regions, however. This is worrying since strong economic growth is predicted for the future in these regions. However, developing regions often use outdated, inefficient technologies so that the scope for improvement in energy efficiency is huge.

Figure 5.2 Energy intensity of production in 5 world regions, 1971-1995



Source: RIVM (2001)
Energy intensity is measured in Giga Joule per constant dollars of 1995.

In the nineties important initiatives were taken to reach a global agreement to limit the emissions of greenhouse gasses. In 1997 in Kyoto, the industrialised countries agreed upon the specific goal to bring back their emissions below the level of 1990. In successive climate conferences, the details of this deal have been worked out, and an infrastructure has been developed to enable countries to agree on more ambitious goals in the future. This is especially important as the Kyoto targets are still not nearly enough to stabilise concentrations at safe levels. To achieve a stabilisation of the concentrations of greenhouse gasses, countries should create more incentives to save on energy use. That incentives matter is illustrated by figure 5.2. Europe already pursues policies to curb energy use, such as excise duties on fuels, and is more efficient than the United States where such policies are absent.

The American government has decided not to ratify the Kyoto Protocol, which leaves one of the largest emitters in the world outside the 'global' agreement. Moreover, there is a difference in responsibilities between developing countries and developed countries. Developed countries have a larger responsibility for the problem of global warming and therefore have stricter and binding targets for their carbon emissions. Eventually, however, developing countries must participate as well. Without them, the goal of stabilising global concentrations will not be obtained. Moreover, measures to reduce emissions in developing countries are much cheaper than they are in developed countries, which makes the participation of developing countries even more important.

The position of the United States and the developing countries illustrates the fact that global climate change policies are complicated by the free-rider problem: there is an economic incentive for countries not to participate. The reason is that preventing climate change is a public good: all countries benefit from efforts to stop climate change, even if they do not themselves impose measures. The costs, in contrast, are borne by the countries that join the cooperative effort. An effective mechanism to overcome the free-rider problem does currently not exist.

Financial markets

Today, huge flows of money move across the globe and react to even the smallest differences in profitability. Although not every country has access to international capital markets and arbitrage is generally still imperfect, the international mobility of financial capital is indeed fairly high. This gives rise to two issues. First, capital owners (especially those with large portfolios) in developed countries evade taxes by allocating a significant amount of their funds in tax havens, such as the Bahamas and the Cayman Islands. Even within the European Union, an agreement on information exchange and/or a source tax on interest income has long been blocked by countries such as Austria and Luxembourg, which aim to maintain their banking secrecy. Reaching such an agreement with a broader coalition of countries is even more difficult, as a world tax organisation simply does not exist. International cooperation with respect to taxes on financial capital returns is especially difficult since tax havens act as free riders and thus refuse to join any coalition.

A second issue is that the flows of short-term capital can suddenly change direction and lead to wild fluctuations in exchange rates. Recent years have shown a number of prominent examples: Mexico in 1994/1995, Asia in 1997/1998, Russia in 1998, and Argentina as well as Turkey in 2001. Apparently, the International Monetary Fund (IMF) has been unable to find a cure for debt-ridden countries and collapsing currencies, which fuels the critique on its legitimacy.

Labour and poverty

Global income and wealth are unequally distributed across populations. In 1998, roughly one-quarter of the world population was estimated to live on less than one dollar a day. The United Nations have formulated the Millennium Development Goals according to which this number must be reduced to 14.5% in 2015. Whether this goal is realistic or not depends on the economic growth in developing countries and on development aid from developed countries. The World Bank is responsible for a number of programs to help developing countries in their development.

Poverty is a concern in itself. But it goes beyond that: in a more integrated world economy, poverty in developing countries has direct economic consequences for rich countries. First, an unequal distribution gives rise to migration flows. Without exception, rich countries want to fend off economic refugees. Their concern is that, with falling prices of communication and transportation and with lasting income differences, the pressure to migrate from developing countries will continue to grow. Second, poverty complicates the campaign against epidemic diseases. The prime example in this context is AIDS. Hence, one could argue that global spending on AIDS research is too low because of an international coordination failure.

5.3 Conclusions

International cooperation should not be restricted to the area of trade liberalisation and economic integration, but could be desirable in a number of non-trade areas. In particular, global externalities appear in the case of unstable international capital markets and poverty in developing countries. The global environment constitutes a global public good that is threatened by pollution across the globe. These non-trade issues call for joint action. International cooperation in these areas is lacking, however, or is not sufficiently effective. Developing an appropriate framework for effective international cooperation is difficult due to potential free rider problems. Perhaps linking issues may be a way out: package deals may render effective cooperation more likely. Linking issues puts a strain, however, on areas of international cooperation that have been successful, such as the WTO and the European Union and tends to reduce the transparency and the legitimacy of these organisations.

6 International cooperation: a key uncertainty for the future

The development of international cooperation at various levels is a key uncertainty for the coming decades. How will the negotiations under the umbrella of the WTO evolve? What will be the scope and institutional structure of the European Union? How will cooperation in non-trade areas develop? The answers depend on both the willingness and the ability of countries to cooperate internationally.

International cooperation involves costs and benefits for participating countries. The costs refer to, for instance, the loss of national sovereignty, painful restructuring of national economies, or direct costs to comply with an agreement. The benefits from international cooperation can be either material or immaterial. For example, trade liberalisation is expected to raise income, while more stable political relations are immaterial.

Whatever the character of the costs and benefits of international cooperation, a net aggregate surplus is not sufficient in order for countries to agree upon cooperation. Also the distribution of the surplus is vital for reaching an agreement. If the benefits accrue to a subset of countries, then countries outside this group are unlikely to join. A condition for international cooperation is that all participating countries have an interest in the agreement. The political opinion must prevail that it is in their national interest to give up part of their national sovereignty.

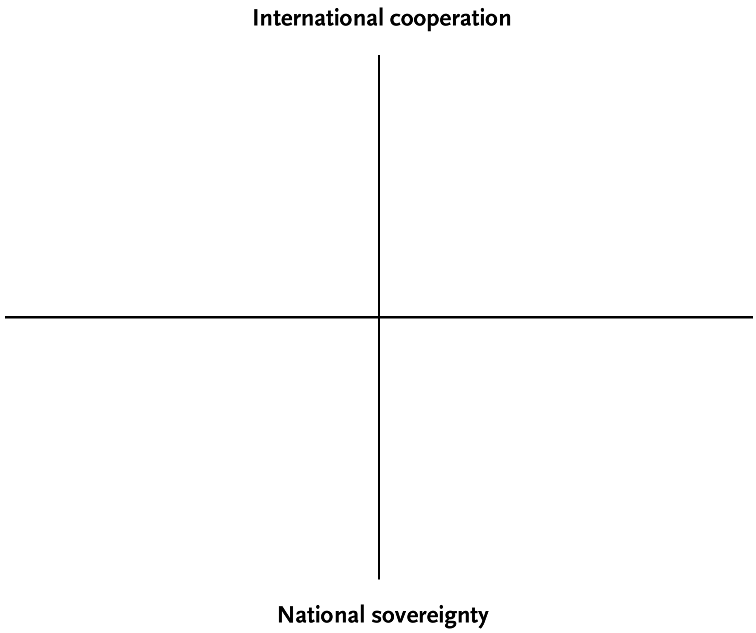
The *willingness* of countries is still not a sufficient condition for international cooperation to be effective. This also requires that appropriate mechanisms can be designed to make the cooperation work. It is not clear that such mechanisms exist. For instance, can credible compensation schemes be developed to compensate countries that lose from an agreement? And can free rider behaviour be prevented by designing incentive-compatible schemes?

If countries are both *willing* to sacrifice national sovereignty, and *able* to develop the appropriate institutions to enforce agreements, then international cooperation can materialise. Increasing heterogeneity in the group of participating countries, however, may put a strain on ability. It makes it more difficult to reach an agreement since some members may not find it in their interest to join. This could be resolved by linking various coordination issues in one organisation, such as in the European Union. Package deals may increase the scope for reaching an agreement that is in the interest of all member states. The problem is, however, that this tends to reduce the transparency of the decision making process and increase complexity. The problems in the institutional framework of the European Union illustrate this problem.

How international cooperation evolves during the coming decades is a key uncertainty. In the extreme, we could arrive in a world in which international cooperation flourishes in various fields: trade liberalisation, the provision of global public goods (such as the environment), European policy coordination, and so on. Although such an extreme situation is difficult to imagine, it serves as a useful benchmark. The extreme situation is ranked at the top of figure

6.1, which presents the outcomes for international cooperation in the future on a one-dimensional scale.

Figure 6.1 The scope for international cooperation



In another extreme, we arrive at a situation reflected at the bottom of the one-dimensional scale in figure 6.1. In this extreme, either international organisations fail entirely to agree upon international cooperation, or countries are simply unwilling to cooperate. For instance, countries can be unwilling because they assign a high value to their national sovereignty or because they focus on national issues alone.

Between the two extreme cases in figure 6.1, more subtle forms of international cooperation may occur. For instance, there can be international cooperation between smaller (and more homogeneous) groups of countries; cooperation may involve fewer issues; or cooperation in Europe may flourish while global cooperation lags behind. The scenarios in part III of this study incorporate some of these possibilities.

7 Policy options: how much coordination is desirable?

We apply the principle of subsidiarity to discuss to what extent countries should strive to cooperate. There appears to be a need for more global coordination among countries. The European Union, in contrast, seems to coordinate too much in certain areas.

7.1 In need of policy coordination?

As argued in chapter 2, increasing heterogeneity, problematic legitimacy and expanding scope further complicates international cooperation. The expansion of membership in international organisations is a fact. They can, on the other hand, address the problem of legitimacy, mainly through changes in institutional structure. This applies in particular to the European Union. There are several ideas to improve the bond between Europe and its citizens, ranging from an elected president to more competences for European parliament. We prefer not to discuss these ideas for political reform here, but rather focus on the scope of international cooperation. Does cooperation occur in areas of social-economic policy where it should or where it should not? This question is about the need for cooperation. At the same time, answering this question may to help to improve the legitimacy of international institutions. Legitimacy not only derives from the political process to reach decisions, but also from the effects of these decisions. For example, a central bank may have widespread popular support when inflation is modest and under control, even though the democratic control on it is only very indirect. However, supranational powers in areas where the case for cooperation is weak, inevitably lead to doubts about the legitimacy of these powers.

Subsidiarity

The European Union explicitly endorses the autonomy of national governments; it has adopted the principle of subsidiarity according to which powers are decentralised unless good reasons for centralised decision-making prevail. The predominance of decentralisation is motivated by several arguments. Policy makers at the decentralised level have better access to information about local preferences, circumstances and developments; they can more easily be held accountable for local policies or local public goods; decentralised decision-making also allows for experimentation and stimulates a mutual learning process. And last but not least, policy competition among decentralised governments provides a mechanism to discipline bureaucrats. Lack of accountability and strong lobby groups may otherwise lead to inefficient policies. Although there are some differences, there is an analogy with the demarcation between market and state. The market is often considered more efficient than the state, except when market failures apply that exceed government failures. Similarly, competing decentralised administrations are considered more efficient than a central authority, except in the case of coordination failures. Only in the presence of such coordination failures will intervention by a supranational authority be desirable.

One type of coordination failure is related to scale economies. For instance, a central policy is efficient in the presence of high fixed costs (e.g. in the case of defence). Scale may also be important if a common policy saves on transaction costs. To illustrate, harmonisation of product standards reduces technical barriers to trade, thereby improving the functioning of the single European market.

A second type of coordination failure follows from international spillovers of national policies. If the allocation of productive factors is responsive to differences in policies, governments may compete with their institutions and policies in order to attract these mobile factors. By attracting mobile factors, however, they may accidentally reduce economic welfare in neighbouring countries. Since individual governments do not take account of this adverse effect of their actions on neighbours, policy competition then entails an externality. Coordination could raise welfare as it enables the internalisation of the international spillovers.

Subsidiarity thus imposes a necessary condition on policy coordination. In particular, there should be failures of decentralised decision making, either in the form of economies of scale or in the form of international spillovers. This condition is not sufficient, however. For coordination to be justified, the gains of alleviating the failures of decentralisation should outweigh the costs. These are reflected in the benefits from decentralisation (i.e. more heterogeneity and accountability). Hence, there exists a trade-off which takes the following form:

Failures of decentralisation	↔	*Benefits of decentralisation*
• *International spillovers*		• *Heterogeneity*
• *Economies of scale*		• *Accountability*

If countries are heterogeneous in their preferences or circumstances and coordination failures are small, competences should be at decentralised levels of government. If coordination failures in the form of externalities or scale economies are large relative to the benefits of decentralisation, European responsibilities become attractive. Ultimately, the trade-off requires a political assessment because it depends on preferences.

In assessing the trade-off, one must consider alternative options for coordination. Apart from centralisation or harmonisation, one can also think of minimum requirements or targets, a ban on some types of (harmful) policy competition, or non-binding agreements. In general, coordination should be proportional to the coordination failure. In this way, it keeps as much diversity as possible while the benefits of policy competition are maintained. In light of this, one could draw an analogy to the market. Competition is usually believed to be an efficient allocation mechanism as long as there are adequate rules of the game and appropriate regulations imposed by the government. Similarly, policy competition is an efficient mechanism to develop policies as long as there are adequate rules of the game and regulations enforced by a supranational authority. Whereas market failures do not necessarily call for public production or supply, coordination failures do not necessarily call for centralisation or harmonisation of policy. In fact, policy competition that is embedded in a common set of appropriate rules and regulations is conducive to efficient policies.

Chapter 5 argued that global rules and regulations are largely absent. Institutions to enforce these are absent. Policy competition can take place, but there are no rules and regulations that determine the boundaries within which this can take place. Examples of a lack of rules are found in financial markets and international environmental problems.

The European Union is involved in substantial policy coordination, harmonisation and centralisation. How does this fit with the principle of subsidiarity? Alesina et al. (2001a) elaborate on this question in more detail. They develop indicators for the number of legal and other non-binding acts emanating from the European Union in various fields. They put them to the test of subsidiarity. Their conclusion is that Europe does too little in some areas, but too much in others. In particular, responsibilities seem properly allocated at the EU level in areas of international trade, the common market, competition policy and state-aid regulations. EU involvement is justifiably limited in education, research, culture, and sectoral policies. In some areas, EU involvement seems too limited. To illustrate, in international relations there are clear arguments for further centralisation of powers due to economies of scale and specialisation, e.g. in defence and diplomacy. In other areas, EU intervention is typically too strong. For instance, agriculture absorbs the lion's share of EU financial resources without a clear justification on the basis of externalities or scale economies. A recent High-Level group chaired by Sapir arrives at a similar conclusion (Sapir et al., 2003). It proposes, among other things, a radical shift in the EU budget away from traditional areas such as agriculture and rural development towards new areas such as innovation, growth, and convergence.

Below, we assess the principle of subsidiarity in two other policy areas in the European Union that have received much attention in recent policy debates: social policy and budgetary policy. Is Europe going too far in these fields?

7.2 Social Europe

The Treaty of Rome of 1957 already expressed the aim of European member states to harmonise social policy. The underlying reason was the fear for social dumping as a result of increasing economic integration. But only in the 1970s did this lead to the first Social Action Programme. EU directives were introduced dealing with safety and health regulations and equal treatment between men and women. In the eighties, when the European Union enlarged with a number of Southern European countries, fears for social dumping intensified. In the eighties and nineties, further directives were imposed, including regulations on employment protection, a maximum weekly working time (48 hours), a minimum paid annual leave (4 weeks), minimum daily and weekly rest periods and the like. In Amsterdam in 1997, social policy was finally included in the Treaty of the European Union. The Social Chapter includes directives for the role of social partners, employment protection, labour regulations, parental leave, and equal treatment of part-time and full-time work. The Treaty of Maastricht, however, underscores that subsidiarity also prevails in the European Union with regard to social policy. The unanimity rule with respect to many aspects of social policy ensures that they largely remain a matter for the nation states.

In 2000, the Treaty of Nice reaffirmed the social dimension of Europe, as a complement to the Lisbon agenda. Since then, the open method of coordination applies to social policy. In particular, the aim is to develop comparable indicators about social policies and outcomes. These will be evaluated on a regular basis, so that benchmarking, peer pressure, and policy experimentation may contribute to more effective and efficient social policies in the European Union. Moreover, countries define common objectives with respect to social indicators, which include financial poverty, income inequality, regional variation in unemployment, life expectancy and health. The European Union does not, however, prescribe how countries should achieve these objectives. Instead, member states are supposed to implement two-year national action plans in which they show how they will fight poverty and social exclusion.

Social Europe thus comprises binding directives on labour standards as well as the open coordination method with respect to social policies that have remained the responsibility of each nation. It is an open question whether the latter form of coordination will be effective in guiding social policies in Europe. Potentially, it may serve as an effective backstop to the possible competitive downsizing of social protection. However, the lack of binding agreements may also render coordination of social policy ineffective. In that case, fears for social dumping may again lead to calls for harmonisation. Would that be justified on the basis of the subsidiarity test?

International spillovers

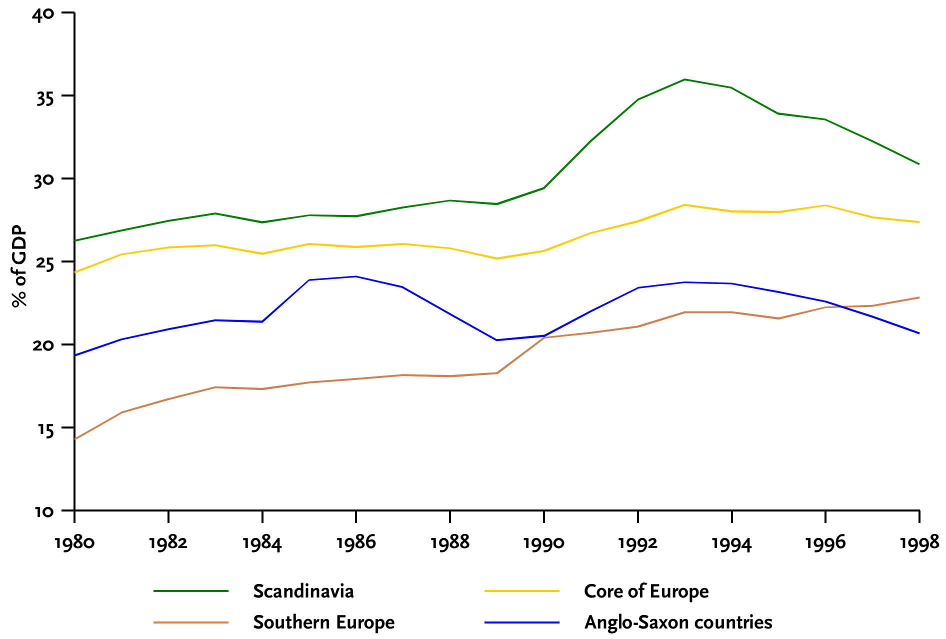
Non-wage labour costs associated with social security premiums, sickness payments and other costs of labour market regulations comprise around 40% of the total labour costs in Europe on average (Chen and Funke, 2003). Differences in these costs can affect the location decisions of firms. Moreover, talented workers who feature few labour-market risks may be encouraged to look for jurisdictions with small non-wage labour costs as this allows for higher after-tax wages.

Governments thus face an incentive to cut back social policies. Accordingly, they could reduce the non-wage labour costs, in an attempt to attract mobile production factors. When governments start competing intensively with each other, they may end up in a process of social dumping. This involves an externality, since individual governments do not take account of the implications of their policies on neighbouring countries. To solve this coordination problem, harmonisation may yield a better outcome for all countries.

Social dumping can be measured by the decline in social spending in the European Union. Figure 7.1 illustrates the development of social spending as a percentage of GDP in Europe between 1980 and 1998 in four groups of countries: Scandinavia, Southern Europe , the Anglo-Saxon countries and the countries in the core of Europe. We observe that social spending has gradually increased from 20.1% of GDP in 1980 to 23.8% in 1998, on average. Especially the Mediterranean countries have seen their social expenditures increase: from 13.8% to 21.4% of GDP. Only the late 1990s shows a modest decline in social expenditure in the Anglo-Saxon and Scandinavian countries. This primarily reflects the economic boom during that period, which reduced unemployment levels.[16] Figure 7.1 does not provide support for a process of social dumping. One could infer that the externalities in social policies are small. The reason is twofold. First, social policies involve not only a cost for mobile factors, but also a benefit. For instance, De Grauwe and Polan (2003) empirically explore the impact of social expenditures in OECD countries on indicators for competitiveness. They find no significant effect, suggesting that social expenditures may well be reconciled with a good competitive position of countries. A second reason for small externalities is that production factors are less mobile than is often believed. European labour mobility is on average rather low across borders. Also firms may be less mobile than is often thought, because agglomeration benefits and other location-specific rents lock firms in at particular locations.

[16] The correlation coefficient between social expenditures and unemployment is 0.7.

Figure 7.1 Social expenditures (% of GDP), 1980 - 1998



Source: OECD Social Expenditure Database
Scandinavia includes Denmark, Finland and Sweden, Southern Europe comprises Greece, Italy, Portugal and Spain, theAnglo-Saxon countries are Ireland and the United Kingdom and Austria, Belgium, France, Germany, Luxembourg and Netherlands are the core of Europe.

Economies of scale

Economies of scale in enforcement or administration of social policy seem absent (CPB/SCP, 2003). They are perhaps more important for insurance of macro-economic risks. For instance, individual countries may be subject to national macro-economic shocks. Capital markets and monetary policies may not be able to absorb these shocks. In the EMU, the ECB takes account of the European-wide developments, rather than nation-specific shocks. The European Union could provide insurance against such risks by means of a European stabilisation fund. This fund could be linked to the unemployment rate, which is closely linked to the business cycle. In particular, in a European unemployment insurance scheme, countries that suffer from a negative shock and see their unemployment rise will receive transfers. These are paid in the form of unemployment benefits by countries that do not suffer from this shock. As with all insurance, however, such a stabilisation fund will suffer from moral hazard problems. Moreover, problems with the implementation may arise in such a system (see e.g. Beetsma and Oudshoorn, 1999). The benefits of fiscal insurance may also become smaller in EMU, to the extent that idiosyncratic shocks lose importance in EMU (Frankel and Rose, 1999).

Heterogeneity

The case for diversity in social policy is strong. Esping-Andersen (1999) divides Europe into four groups of countries, which feature very different types of welfare state. He suggests that heterogeneity of preferences is important among member states. With a large degree of heterogeneity, the case for harmonisation is weak. There is, however, a tendency of convergence in social policies over time. The coefficient of variation in the social expenditure share in GDP among countries declined from 0.26 in 1980 to 0.19 in 1998. Although heterogeneity has thus declined somewhat, important differences remain in both social expenditure levels and their composition.

The enlargement of the European Union will further increase heterogeneity. The Central and Eastern European countries are much poorer than the current member states and thus have different preferences for social policies. The countries will have severe problems in complying with harmonised rules and regulations of the European Union. By allowing for lower social and labour standards, these countries would be able to keep labour costs low. They would then be better able to catch up with the richer countries. Current member states may also benefit from this, via trade and specialisation. Once convergence has materialised, the new member states will be able to develop a mature welfare state, if this fits with their preferences.

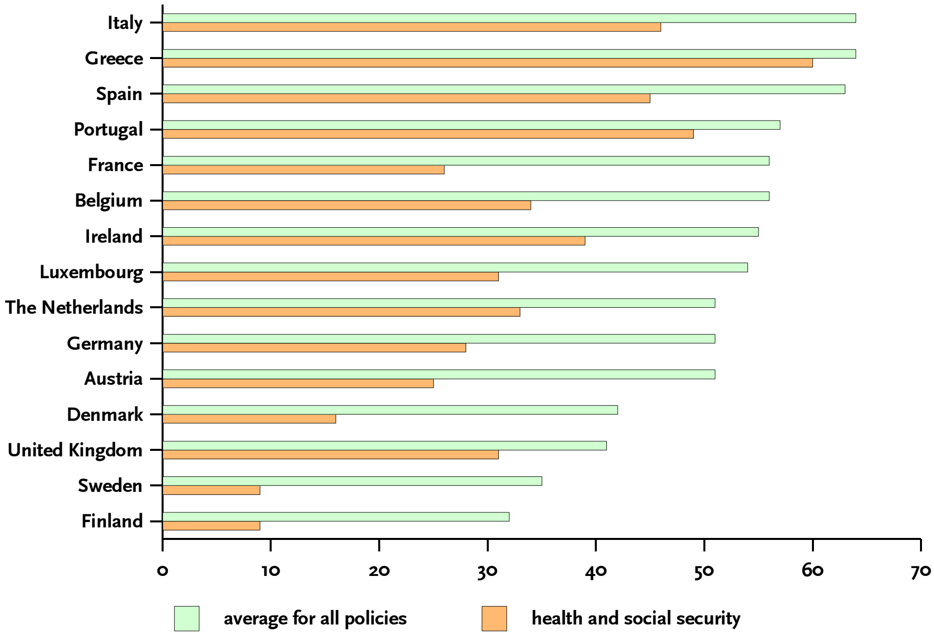
Assessing the trade-off: do we need a Social Europe?

Subsidiarity calls for an assessment of the costs and benefits of harmonisation. We have argued that the coordination failures in social policy are weak: externalities seem unimportant while economies of scale are largely absent. Only with respect to fiscal stabilisation, can one make a case for European responsibilities – although such a scheme also meets serious drawbacks. At the same time, heterogeneity in social policy is important and will only grow once new member states enter the European Union in 2004. Based on the subsidiarity test, the case for harmonisation of social policy is therefore weak.

This assessment is consistent with the preferences of European citizens on the role of Europe in social security. Figure 7.2 shows the scores of the Eurobarometer on the question whether people believe that the European Union should decide about policies regarding “Health and social security”. It is compared to the average score for seventeen policy areas. The latter gives information about the general view of a country with respect to European responsibilities. We find that Europeans have on average a strong preference for national social security, rather than a European responsibility. Especially countries with the largest welfare states, such as in Scandinavia, favour national systems. Countries with smaller welfare states such as the Southern European ones, feature the highest preferences for a European social security system. Still, Greece is the only country in which the majority of the people are in favour of a European social security system. Compared to other policies, the preference for European responsibilities in social security is much weaker.

Figure 7.2 No majority among Europeans for a European social security system

Percentage of people in 15 member states in favour of European responsibility



Source: Eurobarometer 58.1 (October-November 2002)

7.3 Fiscal policy

The monetary unification in Europe was felt to require stronger fiscal coordination. This led to the Stability and Growth Pact. The fear was that fiscal profligacy of individual states would undermine stability and the strength of the common currency. The Pact therefore stipulated, among other things, that members of the euro-zone were not allowed to run a fiscal deficit of more than 3% of GDP (for three successive years), or to have a government debt of more than 60% of GDP.

But truth is stranger than fiction. Four years after the introduction of the euro, it is Germany, the most fervent proponent of the Pact, that fails to meet its obligations. Faced with an economic downturn and full of plans for welfare state reforms and tax reductions, the German government is unable to, or does not want to, bring the budget closer to balance. The critique on the Stability Pact is harsh. It has in fact been growing ever since the introduction of the euro. Even the president of the European Commission, Romano Prodi, called the Pact 'stupid'. Now that Germany and other countries such as France and Portugal are not able to comply with the Pact, it is in serious trouble. There are many ideas for reform but also pleas to abolish it all together.

Either way, the key question is what the rationale for fiscal coordination is: are there important spillovers of budgetary policies among EMU-members? Or are there important economies of scale? This section considers these reasons for cooperation on the basis of the principle of subsidiarity.

International spillovers

Fiscal policy plays a role in the *stabilisation* of the economy. Typically governments run a deficit during an economic downturn and (should) have a smaller deficit or even a surplus in an upturn. In this way, (public) consumption remains more stable and does not aggravate swings in economic activity. This is partly automatic: government revenues react stronger to the business cycle than government expenditures. But it can also be a choice to run an anti-cyclical fiscal policy: governments have the discretionary power to give an extra boost to the economy in a recession by cutting taxes or raising expenditure.[17]

In a setting with a national central bank, a government deficit may lead to an increase in the interest rate, which tends to offset the initial expansionary effect of the deficit. The fiscal authority should take this increase into account when deciding to give the economy an extra boost. The increase in the interest rate could reflect worries among investors about a higher deficit and rising debt – increasing the risk premium – or could follow from a response of the national central bank that chooses to tighten the money supply in order to maintain price stability. [18]

In a monetary union, with a supranational bank, the link between fiscal and monetary policy becomes blurred. The European Central Bank does not respond to a situation in one specific country, but to the average economic condition in the euro zone. A weakened link gives the national fiscal authorities a stronger incentive for the discretionary use of the budget deficit. The EMU may then end up with bloated deficits and a higher interest rate. The fundamental reason is that the national authorities overlook the negative effect of their budgetary policy - through its effect on the common interest rate on other countries. This is exactly the effect that the Stability Pact seeks to address (see for example Beetsma and Uhlig, 1999). The empirical evidence for a negative effect of national budgetary policy on the interest rate is not very strong though (see Eichengreen and Wyplosz, 1998). The reason is that Europe is fully integrated in the world financial markets, so that a single country's borrowing hardly affects international interest rates. The sign and the size of the external effect is not clear though. Expansionary fiscal policy in one country also has the effect of raising (export) demand in other countries. The other countries may benefit from this. In fact, the monetary union is likely to have increased the demand

[17] Discretionary fiscal policy to stabilise the business cycle has a number of drawbacks, see e.g. Zalm (1999).

[18] Alesina et al. (2001b) give a more thorough account of the interaction between fiscal and monetary authorities.

linkages among its members; Frankel and Rose (2002) find a strong effect of a common currency on the bilateral trade flows.

Probably, the externalities of fiscal stabilisation policies would not attract much attention if the interest rates were generally low and government deficits were modest. The serious concern is, however, that governments may not be able to control their deficits and debts, especially since the ageing of their populations requires them to take early and unpopular measures to keep tax rates on the working generations from rising too quickly. The discussions among the member states in the euro zone are focussing more and more on fiscal *sustainability*.

If one member state goes to the brink of default, the repercussions for the other member states are not entirely clear. At least two scenarios seem possible. In the first, the ECB could come under pressure to pursue an accommodating monetary policy. A hike in the interest rate (e.g. as part of the everyday job of the ECB to keep the inflation in the euro zone low and on target) would push this one member state over the brink. In the second scenario, a member state has no alternative but to repudiate its public debt. In the other member states, this could bring banks into trouble and trigger a catastrophic chain of events in their banking systems. In both scenarios, fiscal profligacy in one member state has clear repercussion on other member states. Fiscal coordination could help to prevent this from happening.[19]

Economies of scale

Fiscal coordination aims to prevent a member state from imposing costs on other member states when pursuing an unsustainable fiscal policy. It does not, however, address the reason(s) behind a country's path of rapidly accumulating debt. For many, the fundamental reason is an imperfection on the political market: politicians seek re-election every four or five years and in the process tend to spend too much public money. This imperfection is compounded by the problem of an ageing population. This may require higher taxes on the working generations to pay for their pensions. Even politicians without interest in re-election may find it hard to sell this to the electorate.

A European framework of rules for fiscal policy may help national politicians to stick to a policy of sustainable debt and automatic stabilisers. If this framework has acquired a good reputation (i.e. it is believed to work now and later), it can include other, new countries without much cost. In a sense, there are economies of scale in building and maintaining a reputation.

[19] See Uhlig (2002) for a more detailed discussion of the second scenario. Note that a more direct instrument to reduce this problem is stricter bank supervision. This can prevent risky public debt from being overrepresented in the portfolios of banks.

Heterogeneity

National sovereignty in budgetary policy is valuable to the extent that countries need heterogeneity. First, individual countries may want to use their budgetary policy in the presence of asymmetric shocks. With a common fiscal policy on top of a common monetary policy, countries have no macroeconomic tool left to stabilise their economy, either automatically or on a discretionary basis. A second reason to allow for diversity is that national budget deficits and debts reflect preferences of countries regarding the distribution of income across generations. Countries can in various ways deal with the problem of ageing and ensure sustainability of the government budget . As these preferences differ across countries, this calls for diversity in fiscal policy. The Stability Pact with the uniform rule for the budget deficit and government debt does not do justice to the differences in economic circumstances and social preferences.

Assessing the trade-off

The advantage of externalities and scale must be set against the advantage of flexibility and heterogeneity. The Stability and Growth Pact seeks to combine the two. One may question though, whether the rules laid down in the Stability and Growth Pact are the preferable safeguard against a lack of fiscal discipline. Clearly, there are costs involved with the Pact. National rules for fiscal policy would be preferable as they are more legitimate than international rules enforced by an international organisation. Hence, such rules run the risk of weakening the legitimacy of the European Union.

Fiscal discipline is primarily in the self-interest of member states. Therefore, national frameworks to ensure that politicians stick to a policy of sustainable public finances should be feasible. Still, coordination may be necessary to avoid potentially dangerous international spillovers and to maintain confidence in the EMU. Alternatives for the Stability and Growth Pact should allow for more flexibility. They can perhaps be found in rules for the structural deficit or for the level of debt. Such rules, however, raise new problems with respect to their practical implementation (e.g. how to measure them).

7.4 Corporate taxation

The debate on harmonisation of company taxes has a long history in the European Union. Already in 1962 there was a proposal to harmonise company taxes with differential rates for retained profits and dividends. In 1975 this was followed by the suggestion to introduce a band for the statutory corporate income tax rate in EU members of 45% and 55%. The so-called Ruding report made a more elaborate proposal in 1992 to both harmonise the tax base and introduce a minimum statutory tax rate of 30%. None of these proposals ever left the drawing table.

Today, the European Union plays a minor role in company taxation. There exist two directives, one on mergers and one on the removal of international double taxation. More recently, the European Union has taken a different route towards coordination. It agreed to a non-binding code of conduct with respect to harmful tax practices. This code attempts to curb marginal administrative practices intended to attract particular kinds of business activity. More specifically, the code defines harmful tax practices as measures that (1) “affect, or may affect, in a significant way the location of business activity in the Community”, and (2) “provide for a significantly lower effective level of taxation, including zero taxation, than those levels which generally apply in the Member State in question”. The code adds that “Member States commit themselves not to introduce new harmful tax practices, and to re-examining their established practices” (European Commission, 1998). In order to promote peer pressure, a code of conduct working group blacklisted 66 harmful tax practices in 1999. There are signs that peer pressure is successful. The Netherlands, for example, took the edge off their advance ruling system, while Ireland scrapped the reduced corporate income tax rate for manufacturing companies.

Still, counties have substantial freedom to shape their own national tax systems. This has led to a variety of tax structures on companies in the EU. The European Commission (2001), for instance, shows that the difference in statutory and effective tax rates in the EU runs up to over 30%-points. This may create severe distortions in the internal market, as the allocation of capital is driven by differences in tax rates, rather than by differences in productivity levels. It has triggered a renewed debate in Europe whether or not to harmonise company tax systems. In particular, the European Commission (2001b) launched an extensive report in which it explores several options for company tax harmonisation in the European Union. Does tax harmonisation agree with the subsidiarity principle?

International spillovers

If high-tax counties see capital move to locations with low tax rates, the governments in these countries may cut their rates in order to avoid a further capital flight. If low-tax countries respond by further reducing tax rates, tax competition may cause leapfrogging, which ends up in a race to the bottom. Reductions in tax rates ultimately force countries to either cut public spending or to raise taxes elsewhere. This process of tax competition involves fiscal externalities: countries do not take into account the adverse effects of a lower tax rate on the welfare in neighbouring countries. This fiscal externality may justify tax coordination.

Do recent developments suggest that tax competition in Europe indeed leads to lower tax rates? As argued by Devereux et al. (2003), statutory rates have been declining in both Europe and other OECD countries. While the average rate in sixteen OECD countries was 48% in 1982, it fell to 35% in 2001. In recent years, a number of EU countries have further reduced their rates.

Despite this fall in statutory corporate tax rates in EU countries, the effective tax rates on companies have declined to a much smaller degree. In fact, average tax rates declined only

moderately during the 1980s, and remained remarkably stable during the 1990s. Devereux et al. (2003) report a small decline in average tax rates in recent years.
These observations can be understood by a combination of lower statutory tax rates and a broadening of the tax base. Many countries have indeed financed lower statutory tax rates by less generous fiscal depreciation rules, thereby maintaining the overall effective tax rate. Such a process of *rate cutting cum base broadening* can be explained by competition for paper profits. Multinational companies are able to shift their profits between affiliates at different locations (e.g. through manipulating transfer prices or through debt contracts). Statutory tax rates determine the tax liability in each of these locations. Therefore, low statutory tax rates may attract substantial profits from multinationals and thus broaden the tax base. This provides incentives for governments to compete with their statutory rates. With the increasing importance of multinational companies, a rising share of intangible investment and developments in ICT, this competition for paper profits may have intensified during the past decades.

Yet, locational decisions of firms are driven by effective tax rates. The minor reduction in these rates suggests that tax competition for real investment has only been moderate. Apparently, the responsiveness of capital to tax rates has not increased substantially. The absence of a strong declining trend in effective tax rates does not imply, however, that tax competition is absent. Competition may have led to a lower tax burden on internationally operating firms and higher tax burden on firms with a domestic orientation. Indeed, Devereux et al. (2002) and Altshuler and Goodspeed (2002) find that countries do respond to each others' effective tax rate. This is consistent with tax competition. The recent decline in effective tax rates may suggest that the process of the tax race to the bottom is just taking off. Especially if capital mobility rises in the near future and tax competition intensifies in light of the enlargement of the European Union, a gradual decline in effective tax rates in Europe cannot be ruled out.

Economies of scale

Firms and governments face substantial administrative and compliance costs of corporate income taxation. To illustrate, under separate accounting, multinationals have discretion over the international allocation of joint costs such as research expenditures, advertising, and general management. Tax authorities attempt to gain a foothold by closely examining transfer prices. The result is a game of cat and mouse between multinationals and tax authorities: the former engage in expensive tax planning in order to let paper profits precipitate in low-tax countries without breaking the transfer pricing rules; the latter engage in expensive monitoring of multinationals' accounting behaviour in order to enforce these rules and to receive a fair share of the tax base. The cost of compliance is also high for businesses, which face a complex set of tax rules and regulations that vary country by country. For instance, countries adopt different accounting principles, use different definitions of income and expenses, and adopt different methods to determine transfer prices. These administrative and compliance costs may be reduced by harmonising company tax systems in Europe. In a sense, the European Union may reap scale effects by imposing a common tax base and perhaps by a common European tax administration. Proposals of the European Commission (2001) and the European employers organisation UNICE (2000) therefore aim at harmonising company taxes for multinational firms in order to reduce compliance costs.

Heterogeneity

Tax diversity refers to distinct elements of taxation, including the rates, the definition of tax bases, and tax administration. Even in mature federations, such as Canada, the United States and Switzerland, we observe tax diversity across local jurisdictions. Differences in (effective) tax rates may reflect heterogeneity in preferences for public consumption, partly financed from corporate taxes. They may also reflect attempts to tax location-specific rents, which are related to geographical positions, public investments in infrastructure and human capital and other location factors. In any case, governments assign a high value to their tax sovereignty. In Europe, this is reflected in the unanimity rule with respect to tax matters.

Assessing the trade-off

Tax diversity distorts the international allocation of resources, creates fiscal externalities, and entails high administrative and compliance costs. Hence, there are substantial costs involved with tax diversity. An appropriate application of the subsidiarity principle would seek the optimal trade-off between these costs and the benefits of tax diversity.

Compared to social policy, the assessment of this trade-off suggests a much stronger case for harmonisation of company tax systems: both externalities and economies scale appear to be important. Yet, one should take account of the benefits of tax diversity. Therefore, a common European corporate income tax is probably a bridge too far. More moderate forms may strike a better balance between the costs and benefits of tax coordination (see Gorter and De Mooij, 2001).

7.5 Do we need more policy coordination?

Competition between firms typically yields an efficient allocation, except when there are market failures. Government intervention is then justified if market failures exceed potential government failures. In analogy to this, policy competition among governments will typically yield an efficient policy, unless there are coordination failures. Delegation of powers to a supranational authority can be desirable to address these failures. Delegation should be proportional to the underlying coordination failure. In fact, competition among governments usually remains desirable, but only if it is embedded in an appropriate set of common regulations that form the rules of the game.

On a global scale, coordination failures are not always properly addressed by a supranational organisation. There seems to be room for intenser cooperation within an effective international organisation (e.g. in the field of international environmental problems, international financial markets and poverty reduction).

In the European Union, countries have already delegated substantial powers to Brussels. The subsidiarity principle, however, is not applied consistently. For instance, this chapter argues that the case for harmonisation of corporate taxes, in some form, is stronger than the case for Social Europe. In the last case, the need for policy coordination is weak as decentralisation failures are small. At the same time, the decentralisation benefits are large, since heterogeneity of preferences is important. The opposite holds true for the case of tax harmonisation. Yet, corporate taxation is still almost the exclusive domain of the member states, while the European Union is involved in a number of areas of social policy. A related question is how the European Union should plays its role. With the Stability Pact, for example, uniform limits on government deficits take no account of the heterogeneity across countries. Perhaps other forms of cooperation involve lower costs and still adequately deal with the possible coordination failures.

A more consistent application of the subsidiarity principle – indeed one of the aims of the Convention – may help the European Union to overcome some of its problems. It will build the trust with the public as well as with policy makers, that the European Union is more than just another layer of bureaucracy. This will add to the credibility of European institutions.