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# Integrity and Efficiency in the EU: The Case Against the European Economic Constitution*

by

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**Abstract**

The European Constitutional Treaty (ECT) was presented by its drafters as an explicit constitution for the European Union (EU 25). A possible explanation for its rejection by the French and Dutch citizens in the course of spring 2005 is that it did not sufficiently amend the implicit constitution of the EU 25, the European Union Treaty (EUT), which was truly the object of voters' aversion. Assuming this to be true, there should be a thorough debate on the relevance and viability of the *de facto* current constitution of the European Union. In this paper, we engage in this debate by identifying what is essentially wrong with the economic provisions of the EUT, which we designate as the "European economic constitution." Using a constitutional political economy approach, we first attempt to demonstrate that both what we define as the "principle of integrity" and the "principle of efficiency" of collective action appear to be violated by the European economic constitution. This occurs, respectively, because its provisions are not neutral, nor revisable, and because they do not sufficiently allow for the possibility of cooperative collective decision (leading to convergence in welfare) in a more than ever numerous and heterogeneous EU. Our essential argument in this respect regards the implications of the structurally different economic performances and incentives of small and large countries under the European economic constitution. Finally, since the present European trade-off between "integrity" and "efficiency" appears sub-optimal, we present two original ways of achieving potentially better ones in the EU, through a "Great compromise" or "Economic constitution(s)," expressing a preference for the latter.

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*"On s'est beaucoup trop accoutumé dans les gouvernements à immoler toujours le bonheur des particuliers à de prétendus droits de la société. On oublie que la société est faite pour les particuliers; qu'elle n'est instituée que pour protéger les droits de tous, en assurant l'accomplissement de tous les devoirs mutuels."*

Anne Robert-Jacques Turgot, Discours à la Sorbonne, 27 novembre 1750.

*"If all nations were small and none were large, humanity would surely be freer and happier. But one cannot prevent the existence of great nations."*

Alexis de Tocqueville, *Democracy in America*, Volume I, Chapter VIII.[1]

## 1. Prologue: Toward a unifying theory of European democracy

Over the last ten years or so, two apparently consistent related sets of arguments have been developed in European studies to account for the European Union's (EU) democratic shortcomings and unique "political system."[2]

The first ensemble constitutes in our view the *no-bridge theorem*: stripped to the essential, it states that while Europe is one thing, democracy as we know it in the member states is another, and that thinking otherwise amounts to a composition fallacy. Two versions of that theorem coexist in the literature. The first one is positive: the EU is as democratic as it can be. It was sharply presented as a "defense of the 'democratic deficit'" by Moravcsik (2002). The second one is normative: the EU should not be democratic. It was justified in Majone (1996) by the distinction between European Pareto-improving policies and national non Pareto-improving policies. In brief, the idea lying at the core of the *no-bridge theorem* is that since the EU, a non-state, is truly "new under the sun," no past or current political criteria can be accurately used to assess its qualities, least of all those devised to evaluate qualities of national liberal democracies.[3] According to Majone (2005), this "analogical fallacy" between national and European political regimes

[1] (New York: Library of America, new translation by Arthur Goldhammer, 2004) 182. We thank Art Goldhammer for the references of all Tocqueville quotations in this paper.
[2] This characterization is that of Hix (2005).
[3] Although apparently rigorous, the argument suffers from a problem of internal consistency not dissimilar to the parable of the borrowed kettle returned pierced narrated by Freud in *Jokes and their Relation to the Unconscious* (1905): (1) "I never borrowed a kettle from you" ("the democratic deficit does not exist"); (2) "I returned it to you un-pierced" ("it does exist but does not matter that much"); (3) "The kettle was already pierced when I got it from you" ("at least it is not worse at the EU level than within the member states"). The conclusion of Freud is that the kettle was returned pierced.

would be nothing less than the "most serious pitfall" threatening (s)he who studies the European Union.

The second set of arguments, that we label *the invisible hand theory*, comes down to the idea that Europe works best without politics. Here again, two distinct ideas have been developed in the literature, embracing two historical ages of the European project. "Market Europe," that was born out of pragmatic steps, is said to function more efficiently without the "fallacy of grand theorizing" – visions or "illusions" – and should steer clear of any conscious political integration, as undesirable as it is impossible (see Moravcsik, 2005a); [4] "Moral Europe," an anti-power in its essence, is a *grand dessein* for the world rather than for itself, a "civilian power" heir to Christianity's selflessness rather than Greeks' "democratic politicization."[5] The EU *raison d'être* in the contemporary period would thus be to benevolently spread democracy outward, integrating as many countries as possible even at the risk of centrifugal dissolution.[6]

In the light of the political economy shortcomings and failures of the European economic constitution, we reject both of those two sets of arguments. Europe and national liberal democracies can and must be reconciled through a political re-contracting between member states taking size into account, devised to improve accountability, efficiency and stability in the EU in years to come.

In the context of the growing economic literature on the peculiar brand of federalism the EU exemplifies,[7] we try to adopt an original perspective in two respects: first, we develop our arguments about the EU using the constitutional political economy approach as a reference – which is neither original nor new[8] – but applying it to the *economic* constitution of the EU; second, we consider the role of economic and political size in federal regimes, not from the external perspective – the question of *the size of the EU* (what is the critical size for the EU, what the EU

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[4] Here the external validity of the argument seems doubtful. The case for pragmatism on behalf of experience does not appear in line with some defining moments of European history. The conference of Messina (June 1955) actually witnessed the adoption of a global "grand plan" (the "Beyen plan") instead of piecemeal "small steps" (the "Spaak plan") and that approach framed the Treaty of Rome. It could be an example of how highly regarded European figures' historical role (like Jean Monnet) might have been overestimated (Milward, 1992). But it is hardly an illustration of how grand planning was overplayed by pragmatism in the course of European integration.
[5] The expression was used by the philosopher Slavoj Žižek in an interview with *Le Monde*, 8 May 2005.
[6] See Leonard (2005) for a recent non-academic formulation of the argument. The question of the limits or borders of the EU is not addressed in the present paper.
[7] See Hix (2005) for a survey.
[8] See Mueller (2005) for a very recent survey.

should do that the member states shouldn't, etc.., i.e. an *absolute* approach to size) – , but on the internal level, or the question of *size within the EU* (how does size matters within the EU, i.e. a *comparative* approach of size). Combining both perspectives, we are eventually able to propose some original ways forward for the EU out of its current political, economic and social predicament.

The paper is organized as follows: the second section presents an interpretation of the French and Dutch referenda results and a clarification of the failures of the ECT regarding citizens demands; the third section defines the integrity-efficiency trade-off and its application to the EU; Section 4 attempts to delimitate the historical, geographical and analytical reality of the European economic constitution; Section 5 focuses on the issue of integrity; Section 6 substantiates the question of efficiency and sheds some light on a possible "size nexus" in the EU; finally, Section 7 presents the ideas of the "Great compromise" and the "European economic constitution(s)" as ways to improve the European integrity-efficiency trade-off, expressing a preference for the latter.

## 2. The ECT as a constitution and a non-constitutional event

"The treaty includes no provisions for the economic rehabilitation of Europe...nothing to stabilize the new states of Europe...nor does it promote in any way a compact of economic solidarity amongst the Allies themselves...It is an extraordinary fact that the fundamental economic problem of a Europe starving and disintegrating...was the one question in which it was impossible to arouse...interest." Those words of John Maynard Keynes published after the Treaty of Versailles was made public[9] resound with force in the aftermath of the ECT rejection by France and The Netherlands (respectively on the 29th of May and 1st of June 2005).

While the fate of the European Constitutional Treaty (ECT) is still officially undecided,[10] the "war of interpretation" over the meaning of the two referenda's results is now well under way,

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[9] "Europe after the Treaty" in *The Economic Consequences of the Peace* (New York: Harcourt Brace Jovanovich, 1920).

[10] But it is legally settled by the unambiguous provisions of the ECT (see Article IV-447) and was politically confirmed by the decision of the British government to suspend the European Union Bill. The declaration issued at the end of the 16 and 17 June 2005 European Council, while implicit, is also straightforward. It states the (vague) need for a "period of reflection…used to enable a broad debate to take place" and asserts that "the recent developments do not call into question the validity of continuing with the ratification processes." But it makes clear that "the timetable for the ratification in different Member States will be altered if necessary in response to these developments and according to the circumstances in these Member States."

and many arguments have already made their way into the public debate.[11] Our position, which is the starting point of our reflection on the flaws of the European economic constitution, is that European citizens[12] wanted, and still want, a more democratic and efficient EU, but did not find in the ECT the answer to their concerns. The results of the July 2005 "Eurobarometer," partly reproduced on Charts I to V, seems to give some credit to this interpretation.

While the motives of French and Dutch citizens appear to be different, we draw three conclusions from the answers gathered: first, the rejection of the ECT can not be interpreted as the rejection of the European project or European integration, as shown in Charts I and II;[13]

[Charts I and II here]

One should note, beside the overwhelming approval that the EU as an historical achievement enjoys, that an impressive majority of the citizens that voted "No" do support their country's membership to the EU.

Second, the "economic voting", very clearly in the case of France (Chart III), in a more balanced way in the case of Netherlands (Chart IV), was dominant over sovereignty concerns (or "sovereignism"), which could indicate that citizens in both countries have reached a certain European political maturity, more than a decade after the Maastricht Treaty. French and Dutch voters now seem to make the EU accountable for what it should give them more than for what it can take away from them.[14]

[Chart III and IV here]

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[11] Some of which have been published in *Prospect*, n°112, July 2005.

[12] At least in France and the Netherlands where turnouts of respectively 70 percent and 62 percent made results all the more significant, not to mention the fact that both countries are among the founding members of the EEC and belong to the Euro area (see Section 6).

[13] Nor can it simplistically be interpreted as the expression of a xenophobic fear of Eastern Europeans and/or potential new member states like Turkey. The figure of the "Polish plumber" introduced in the French campaign by the ex-commissioner Frits Bolkestein is conspicuously absent from the portrait painted in Chart III & IV.

[14] In this respect another clarification is necessary. The argument according to which the predominant concern of citizens over *national* economic and social contexts would be unrelated to the EU does not hold. If citizens were convinced that the European project had little or nothing to do with the economic context of a founding member state participant in the Euro area, after close to five decade of economic integration and five years of monetary union, then they would be even more concerned about the EU.

Finally, this demand for Europe seems to take the form of a "demand for a constitution" (however general the term might be), which, when related to the actual results of both referenda, seems to point to the intuition that citizens are not happy with the current state of European institutions, a disaffection that was not appeased by the ECT (Chart V).

[Chart V here]

The results of the latest available edition of the Eurobarometer[15] point even more precisely in the same direction: while 63 percent of European citizens are in favor of *a* Constitution for the EU (60 percent believing it to be necessary to the good functioning of the EU), 49 percent of them thinks the ECT should be re-negotiated and 13 percent of them that it should be invalidated.

Summing up, the referenda results show in our eyes that French and Dutch citizens, standing as a democratically significant sample of European citizens, enthusiastically embrace Europe, reject its current institutional form and/or performance in terms of democracy and welfare and aspire to better ones. Following this informed intuition, the first task we undertake is to briefly evaluate the innovations brought about by the ECT and show how little it actually did to amend the EUT.

However tempted, one should not judge the text by its cover.[16] Of course, one could hardly help noticing on the first page of the draft version presented to the public in June 2003, later amended[17] before being signed by the 25 member states of the EU on October 29 2004 in Rome, that the term "Treaty" was much less visible than the word "Constitution." Yet, constitutional law scholars seem to think otherwise, generally interpreting the ECT as a Treaty. One way to close the debate on the democratic qualities of the ECT right away would indeed be to assert that the ECT is simply not a Constitution and, given the results of the French and Dutch referenda, should never have been labeled so. It is, just like the text signed in Maastricht, a plain (and not so) simple Treaty.

We don't subscribe to this view. The necessary ambiguity of the EUTC, not a pure Treaty nor a perfect Constitution, echoes exactly the necessary ambiguity of the EU (characterized by Jacques Delors as a "Federation of Nation-States" and by Joseph Weiler as the land of "constitutional

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[15] Eurobarometer n°64 "Public opinion in the European Union" Oct.-Nov. 2005, available at http://europa.eu.int/comm/public_opinion/archives/eb/eb64/eb64_first_fr.pdf

[16] The version of the ECT referred to in this section is the English final version of the "Treaty establishing a Constitution for Europe" published in the EU Official Journal C 310 of December 16 2004.

[17] In June 2004.

tolerance"). This ambiguity is apparently acknowledged by Weiler (2002) when the two criteria he suggests using to assess the "nature of the beast" each fall on one side of the fence.[18]

This ambiguity of the ECT can be demonstrated alternatively. Its Part I states the values and objectives of the Union, its Part II defines its institutions and the balance of their respective powers, its Part III comprises the whole set of dispositions of earlier European Treaties regarding public policies (some directly applicable in member states), its Part IV finally defines the unanimous procedures necessary to revise the text. Therefore, the ECT can be said to be a Treaty (Part III) embedded in a Constitution (Part I, II and IV), or a Constitution (Part I, II, and III) embedded in a Treaty (Part IV). A constitutional Treaty, the ECT thus appears to be a rather accurate portrait of what the EU has become in terms of political regime, whatever the theoretical denomination.[19]

In consequence, it seems fair to say that not only did the ECT present itself as an explicit constitution but it actually was one. Unfortunately, however, it was not a good enough constitution, that would have amended in depth the existing one, the European Union Treaty (EUT).[20] But the text framed by the European Convention[21] *seems* to mark a number of significant positive steps on the path of a much-needed democratization[22] and institutional reform of the European Union, now comprising 25 members.[23]

To begin with, the second part of the text, the so-called "Charter of Fundamental Rights" (or EU Bill of Rights), should not be treated lightly, especially by those who have been complaining for

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18 According to Weiler (2002) the unanimity required for its revision would make the ECT a Treaty, but the public and fairly democratic conventional process that led to its drafting makes it more of a Constitution (see footnote 21).
19 See Hix (2005) for a clear theoretical survey.
20 The version of the EUT referred to in this section and onward is the consolidated version of the Treaty of the European Community as of December 2002.
21 The European Convention, also known as the "Convention on the future of Europe," was convened by the Laeken Declaration of 15 December 2001 to make the EU "more democratic, more transparent and more efficient." It held its sessions from February 28 2002 until July 10 2003. It was composed of one president and two vice-president (nominated), fifteen representatives of the heads of state or government of the member states (one from each member state), thirteen representatives of the heads of state or government of the candidate states (one per candidate state), thirty representatives of the national parliaments of the member states (two from each member state), twenty-six representatives of the national parliaments of the candidate states (two from each candidate state), sixteen members of the European Parliament, two representatives of the European Commission, for a total of one hundred and five tenured members. Since one hundred out of them were elected members of parliaments (national and European) and national governments, we hold the European convention to have been a fairly democratic assembly, both as a "demos" and as a representative body of European peoples.
22 For a general assessment of the state of democracy in the EU, see Fitoussi & Laurent (2004) and (2005).
23 Since May 1 2004.

many years that the European project was exclusively about deregulating, liberalizing or privatizing. Neither, though, should it be see, as it was sometimes emphatically as a constraint on member states social legislation establishing mandatory new rights for workers. It has no such binding power, as the UK government made it very clear in the text in the course of the June 2004 negotiation and final agreement.[24]

The new enhanced role given in the text to the European Parliament (*elected* by European citizens since 1979) should not as well be underestimated, notably with regard to its relations with the European Commission, the most powerful body of the EU together with the European Central Bank (ECB) and the Court of Justice of the European Communities, all members of which remain *not elected* in the ECT.

Important institutional reforms of the executive branch[25] were also elaborated and proposed by the Convention's delegates. In the new system, the Presidency of the European Council of the EU[26] would be more stable and legitimate, a "Union Minister for Foreign affairs" would be nominated and finally, the power of the Eurogroup would be strengthened (cf. infra). Here again however, one should keep in mind that such reforms did do not go without serious limitations,[27] part of which were actually introduced in the course of the intergovernmental conference negotiations (ICG).

Whatever the limits of the ECT, inherent to any constitutional process implying bargaining and compromise, one should thus acknowledge that the delegates have sincerely tried to improve the EU system in the context of an unprecedentedly arduous negotiation. Symbolically, the ECT was a success. Some important reforms contained in it could actually well be implemented, even if the text as a whole will never come into force. But what the ECT left untouched, as Keynes

[24] One can refer on this point to the Article II-111 of the ECT: "1. The provisions of this Charter are addressed to the institutions, bodies, offices and agencies of the Union with due regard for the principle of subsidiarity and to the Member States only when they are implementing Union law. They shall therefore respect the rights, observe the principles and promote the application thereof in accordance with their respective powers and respecting the limits of the powers of the Union as conferred on it in the other Parts of the Constitution. 2. This Charter does not extend the field of application of Union law beyond the powers of the Union or establish any new power or task for the Union, or modify powers and tasks defined in the other Parts of the Constitution."

[25] This denomination is almost an abuse of language since the EU system actually relies on a confusion of powers and a separation of legitimacies, see Laurent & Le Cacheux (2003a).

[26] Not to be confused with the Council of Ministers referred to in the text as the "Council" (Article I-19).

[27] To mention just one, foreign affairs were still submitted in the ECT to the unanimity rule. It was thus hard to figure out what exactly would the "Union Minister" (ad)minister, see Laurent and Le Cacheux (2003a).

suggested for the Treaty of Versailles, was perhaps one of the greatest concern of European citizens and ultimately, as we have tried to show, the very reason of their discontent: the unfair and inefficient European economic constitution.

## 3. What should a democratic economic constitution do?

What, *fundamentally*, is a democratic economic constitution? What should it do? What essential features should it be given to guarantee citizens the greatest possible equity and welfare in the long run? The simple but powerful models that political economists have forged over the last century can be used to provide an answer to this question.[28] Constitutional political economy,[29] in particular, proves an inspiring theoretical framework to assess the qualities of economic fundamental laws.[30] We first follow the Buchanan & Tullock (1962) intuition of an "efficiency-integrity trade-off," which we then adapt to the EU. In doing so, we acknowledge doing much more than just adapting their original framework, which was not designed to account for collective constitutional choices within complex polities like the EU. Using it as a reference more than a framework, we really interpret it more than we apply it.[31]

If the question is the choice of a good constitutional rule, then the very first condition for a constitutional choice to take place is that individuals find it useful to replace private rules by collective rules, because the un-checked action of others can harm them. More positively, individuals engage in constitutional processes because they feel they can derive a benefit form it, as opposed to the situation of autarchy. In a democratic regime, where one is concerned by establishing the closest correspondence possible between citizens' preferences and policy outputs, economic constitutional provisions still have to reflect a trade-off between two partly contradictory requirements. The first is the necessity to allow for, and even encourage, a process of aggregating individuals' preferences. Such a process supposes the establishment and enforcement of rules that ideally prevent citizens from blocking the system at any time and give

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[28] The modern economic analysis of constitutions can be traced back to Wicksell (1896) and has been given a new impetus with the seminal work of Buchanan and Tullock (1962). Many contributions have enriched the field since, see Breton, Salmon & Wintrobe (2000) for an overview and a European perspective.

[29] The concept was coined by Brennan & Buchanan (1988).

[30] Although it was originally designed to assess the political fundamental laws qualities within the framework of economic analysis.

[31] This clarification appears necessary especially since the founding contributors of the constitutional political economy approach have themselves exposed their views on the European constitutional process (see for instance Blankart & Mueller, 2004). We try to explain why and how they sharply differ from ours in Section 5.

them strong incentives to opt for co-operative and mutually beneficial strategies, when they appear desirable for the political community formed by the interdependent members. Those rules should conversely deter participants from choosing individual interests over the common welfare, when their individual, opportunistic behaviors can have collectively harmful consequences. Such is what we propose to call the "principle of efficiency" of collective action in constitutional processes.

But this imperative does not stand alone. The related ambition of any fundamental law is to protect in the long-run minorities against possible abuses by deciding majorities. This implies designing limits to collective action, such as thresholds so high that veto power is always possible when vital outcomes are at stake, whenever the participant finds her/himself in the minority. We propose to call this property of constitutional rules the "principle of integrity."

It is well known that, for instance, the rule of unanimity allows every party to the political process to defend its interest at any time but does only exceptionally allow for collective action, actually limited to Pareto-improving choices provided they are perceived as such by individuals. Reciprocally, majority rules can make punctual decisions much easier, but expose minorities to majorities' arbitrary decisions.[32] Consequently, the "democratically optimal" constitution can be said to be the one that secures "efficiency in integrity."[33]

In order to precisely substantiate these two principles, we have to make another important clarification in our version of the constitutional political economy approach. To us, in the EU as it is, economic constitutional choices are originally and eventually made by States, not by citizens (even if they are afterwards offered the possibility to validate or reject them). Hence, the democratic unit of the EU in a positive constitutional perspective is the State, not the citizen. This is consistent with the fact that the "European people" (and therefore the "European sovereignty") does not exist, [34] and we do not intend in this paper to give it any theoretical content. Our concern is thus with the democratic and mutually beneficial coexistence of diverse national welfare states.

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[32] Not to mention the classical limitations of simple majority rules, such as the Arrow's (1951) impossibility theorems and the related literature on the risk of cyclical majorities (see, inter al., DeMeyer & Plott, 1970).
[33] Following Plott (1991), we can write down the "fundamental equation of politics" as "institutions x preferences = outcomes." *Integrity* then appears to be a condition of "x" and *efficiency* a condition of "=".
[34] Nor for that matter the "European social model" (see Laurent 2005).

The preferences aggregation process described in the previous paragraph therefore regards States and supposes that national political systems function so as to produce governments that are representative, on European policies as well as national ones, of national citizens' preferences. In other words, we adopt the view according to which the EU as it is aims at indirectly uniting peoples *through* States, or, daring to contradict Monnet, to "form coalitions of states" in order to "unite people."[35] For that matter, this unambiguous feature of the EU's political system, was acknowledged in the otherwise innovative ECT. As in the EUT, Europeans citizens did not exist as such but only through their national State (Article I-10). It is under this qualification that the EU should respect integrity and efficiency. We illustrate our position in Chart VI.

[Chart VI here]

Chart VI describes the implementation of the economic and social policies in the EU as a three-step game. First citizens elect governments, then governments choose the European economic constitution, and finally economic policies are implemented according to this constitution (the distinction between those last two steps being characteristic of the constitutional political economy approach).

In such a system, "integrity" can be defined as the principle according to which the economic constitutional provisions must not constrain the capacity of national welfare states to differ (see Section 5). Integrity essentially means protection of national diversity or in Scharpf's (2002) words, "legitimate diversity."[36] It supposes two distinct elements. First, that the economic constitutional provisions are neutral in the sense that they are sufficiently general not to systematically influence or constrain national models beyond a certain pre-agreed point; second, that these provisions can be revised to be adapted to the changing preferences expressed by national citizens when they elect their representatives at the European "table." A change in the majority of member states, provided they are able to converge after negotiation on the enactment of a new economic constitution,[37] should result in a change of the economic constitutional provisions. Integrity is in our view the essential clause of the Lockian or Hobbesian contract EU member states have formed in the state of nature of international relations, now dominated by globalization.

[35] Speech given in Washington (30 April 1952).
[36] As implicitly asserted in the motto of the EU: "United in diversity."
[37] This process can be eased by efficient constitutional provisions, cf. infra.

"Efficiency" seems more straightforward, but still requires some substantial adaptation/interpretation. In the original Buchanan & Tullock (1962) framework, it is the principle that enables individuals to act collectively even if their preferences differ for the mutual benefit of the parties which, otherwise, could resort to non-co-operative and harmful behaviors (see Section 6). Here, where member states act as individuals' agents, we add a substantial definition of efficiency to the formal one. The formal definition of efficient constitutional economic rules would be that, regardless of any judgment on the quality of the policies implemented, the provisions would be said efficient when collective decisions among member states that have a voice in the constitutional process are simply made possible.

Our interpretation is that constitutional economic rules should also be efficient in a substantial way. Skach (2005) for instance calls the "potential policy improvement and social co-ordination" that could result from a good constitutional text, "the most compelling reasons for a formal, written constitution for the EU." But even on this substantial basis, efficiency in the EU can still be assessed in many different ways. Upward convergence of economic welfare (namely high economic growth and low unemployment) is for the sake of simplicity the one we favor.[38]

By distinguishing integrity and efficiency as we have done, we nevertheless do not endorse in any way the "model of separation" between economic and social matters that was at the heart of the Treaty of Rome (see Laurent and Fitoussi, 2005). Nor do we subscribe to the "social protection as a productive factor" approach developed by EU institutions since 1997 in the context of the "New social Europe" (see Laurent & Le Cacheux, 2003b). Integrity and efficiency in the EU are strictly related in two ways. Diverse national models are financially sustainable only if efficient constitutional provisions ensure that member states collectively produce enough economic growth and employment. With less than 2 percent of GDP growth per year,[39] *no* social model is sustainable in the long-run. In turn, healthy social models are instrumental to the beneficial use of countries' "comparative advantages" (Hall & Soskice) and to sustainable economic growth itself (see Lindert, 2003 and Laurent, 2005a).

Going back to the framework described in Chart VI, it can be said to be integrated in the sense that citizens are at the beginning and at the end of the process. More importantly, it is integrated contrary to three alternative fragmented approaches.

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[38] See Section 6.
[39] Idem.

The first one is the "naming, blaming, shaming" approach. It concentrates on the final step of this process and infers institutional and/or personal responsibility from the economic policies implemented in the EU (putting the blame on the ECB, its governor, such government, its officials,…). This understanding of the functioning of the EU, that often finds its way into the official literature since the "Lisbon Agenda" drafting in 2000,[40] overlooks an important maxim of the constitutional political economy, namely that "good games depend on good rules more than they depend on good players" (Brennan & Buchanan, 1988). If policies implemented in the EU are systematically wrong (or unfair), the blame is probably better put on rules rather than on players. Our belief is that, since the European economic constitution does not respect the integrity and efficiency principles (see infra, Section 5 & 6), the "European game" is biased so that the policies level is not the relevant one for evaluation.

The second alternative approach tends to skip the first step of Chart VI. It puts side by side two seemingly contradictory models, the one resulting from the "no-bridge theorem" (see supra) and the direct legitimacy model. The former tolerates that once governments are regularly elected in the EU, a "black box" is substituted for what we have called "integrity and efficiency" and "constitutional discipline" so that European outcomes are reputed just and efficient even if the criteria to evaluate those qualities are lacking. The latter is concerned with the ways and means of establishing an organic direct link between citizens and the EU often to the expense, implicitly or explicitly, of the existing link between citizens and their national governments.[41]

The dynamics between the present state of the EU and the building of a European state or government remains unclear to us. More importantly, we note this approach, like the "no-bridge" model, overlooks the articulation of national democracies to the EU. We find it difficult to think of nation-states as mere nuisances in the European project. They are, possibly for another very long time, the natural locus of political legitimacy in Europe. As such, they are impossible to evacuate and necessary to integrate.

Finally, the broad political trade-off in the EU has been repeatedly described in recent years as one between "input legitimacy" and "output legitimacy" (Scharpf, 1990), i.e. between individual voice and common welfare (see Chart VI). The sacrifice of democratic accountability would be

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[40] For a good example, see *Facing the Challenge-The Lisbon strategy for growth and employment* (Report from the High Level Group chaired by Wim Kok), November 2004. See Creel, Laurent & Le Cacheux (2005) for a critical assessment.

[41] For a recent convincing attempt, see Collignon, 2003.

justified by the efficient provision of public goods. Siedentop (2002) also describes such a trade-off between legitimacy and efficiency. We think that this argument needs to be re-framed.

Our concern is not with the legitimacy of an existing or hypothetical European central power but with the integrity of the member states diverse regimes that gave birth to and are part of it. Furthermore, we attempt to show in the remainder of this paper that the trade-off between "integrity" and "efficiency" as we have defined them is sub-optimal in the current state of the European economic constitution. While integrity is truly sacrificed, it is for a dubious efficiency. We now turn to the demonstration of this point, starting with the historical, geographical and analytical characterization of the European economic constitution.

## 4. The European economic constitution, a definition

### *The two ages of economic constitutionalism in Europe*

Legally, the EU has no constitution. It exists through a complex collection of Treaties. In assuming the existence of a constitutional order regulating economic matters we follow Weiler (2003). He defines very aptly the EU's fundamental *Sonderweg* as the existence of a "constitutional discipline."

As is well known, economic integration was by no means a by-product of political integration in Europe. Actually, the opposite was intended to be true. The European economic constitution embedded in the Treaty of Rome was the original constitution of the European community, the "new legal order for the benefit of which the States have limited their sovereign rights" according to the famous words of the ECJ.[42] In this respect, "economic integration" was for the "organized and living Europe"[43] the same matrix for integration than "commerce" was for the USA.[44] It is no surprise then that it accounts now for the most integrated, quasi-federal part, of the current regime of the EU (the so-called "first pillar").

[42] Case 26/62 Van Gend en Loos.
[43] Robert Schuman, 9 May 1950.
[44] See Amar (2005).

"Economic constitutional law consists of the constitutional rules that deal with economic matters," this tautological definition given by J. Baquero Cruz,[45] while true, is not of great help for our inquiry. Two more precise definitions can be given to begin with in order to capture the reality of the European economic constitution: an historical one, and a related theoretical one.

The first European economic constitution, drafted in 1957 and almost un-amended until 1992 in its fundamentals is articulated around Article 30 of the Treaty of Rome which defines the general rule of free circulation of goods in what was later to become the internal market. It was identified by Maduro (1998) as the economic constitutional core of the European Community. This first European economic constitution can be said to be hierarchically ordered, according to a Kelsenian logic, defining three successive objectives: free trade, control of States aids and free competition (see Chart VII). Fully implemented in 1993, when the Single market became a reality after the 1986 Delorian *relance*, this first European economic constitution did not entail explicit constraints on macroeconomic policies.

[Chart VII here]

But European economic constitutionalism did not stop with the free movement of goods, services, capital and workers, as it is sometimes thought. Nor does its subsequent evolution naturally derive from it. Even if the Treaty of Rome explicitly paved the way for monetary union, 1992/1993 is in our view the true European constitutional rupture.

However, the second age of economic constitutionalism in Europe was already in genesis in the 1980s with the adoption of competitive disinflation policies as analyzed by Atkinson et al. (1993) and Fitoussi (1995). Those policies were to prove determinant in the framing of the convergence criteria defined by the Maastricht Treaty later constitutionalized by the Stability and Growth Pact.[46] Therefore, in the current constitutional pyramid of norms in the EU, once the completed objective of free competition became the basis, the fiscal discipline became the intermediary objective serving the "price" (or monetary) "stability" defined in Article 105 (see Chart VII).

[45] In *Between competition and free movement: the economic constitutional law of the European Community* (Oxford: Oxford University Press, 2002), quoted in Joerges (2004)

[46] The birth and development of this macroeconomic constitutional order is described in detail in Fitoussi (2002).

It is to be noted that this European economic constitution, which is arguably the most important achievement of European integration and is embedded in the European Union Treaty,[47] was not amended at all by the ECT.[48] This suggests that either the compromise it stands for is stable, i.e. beneficial for all parties (a Pareto equilibrium among member states) or that the economic performance it allows is satisfying (both points refuted in Section 6). It could also imply that it simply cannot be revised, which would be a motive to reform it (see Section 5).

In any event, those two ages of European economic constitutionalism were heavily influenced by their intellectual context, respectively the first and second school of ordo-liberalism.

### *From economic constitution to "anti-economic constitution"*

There is indeed a symmetry between the evolution of the European economic constitution and the intellectual dynamics of the ordo-liberalism school (originally school of Freiburg). As argued in Jorges (2004), the work of Weimar era thinkers like Walter Eucken, Alexander Rüstow and Franz Böhm was as post-socialist as it was post-laissez-faire. The State was in charge of the liberal order of the economy. Their original theory of the "economic constitution" meant that the legal order binds together the State and the market in a "social market economy." As is well known, those ideas were central in the framing of the Treaty of Rome as they were in its acceptance by German elites. An important argument to mention here regarding the relation between integrity and efficiency is that the first European economic constitution was thought as an un-political order because it left untouched the social national regimes. Their partial principles of redistribution balanced its own neutral imperative of free competition.[49]

Jorgens (2004) identifies in the Single European Act the shift from the concern with (private) market failures to the concern with (public) State failures as the sign that the European economic constitution was changing in nature. We think of this latter change as only a step in the realization of the program of the first European economic constitution.[50] The real change, influenced by the second school of ordo-liberalism,[51] is the framing of the Maastricht Treaty. With Maastricht, the concern is shifted from the necessary respect of the economic law by the

[47] See footnote 20.
[48] The only (negligible) exception is the proposition to institutionalize the informal Eurogroup.
[49] Hence the idea of the regulating European state developed by Majone (1996).
[50] More generally, we perceive the Single Act as a change in tactics (i.e. the adoption of the mutual recognition principle) but not in strategy (the realization of the Treaty of Rome program).
[51] Whose best known exponent was Friedrich A. von Hayek.

State (or the economic version of Humboldt's *Rechtstaat*) to the democratic dis-embedding of those very rules that become autonomous from the State and the polity, a theory in line with Hayek's conception of constitutionalism.[52]

The current European economic constitution that resulted from this movement can be said to have a "Declaration of independence" in Article 4 of the EUT, establishing its political philosophy and fundamental economic principles:

> 1. (…) the activities of the Member States and the Union shall include…the adoption of an economic policy which is based on the close coordination of Member States' economic policies, on the internal market and on the definition of common objectives, and conducted in accordance with the principle of an open market economy with free competition.
>
> 2. (…) these activities shall include the irrevocable fixing of exchange rates leading to the introduction of a single currency …and the definition and conduct of a single monetary policy and exchange-rate policy the primary objective of both of which shall be to maintain price stability and, without prejudice to this objective, to support the general economic policies in the Community, in accordance with the principle of an open market economy with free competition.
>
> 3. These activities of the Member States and the Community shall entail compliance with the following guiding principles: stable prices, sound public finances and monetary conditions and a sustainable balance of payments.

One of the problems of this "Declaration," as will be argued in the next Section, is that it is more political than philosophical. To a certain extent, it pre-determines the content of member states public policies as opposed to their general or formal orientation. When the issue of integrity will be examined, we will argue that this is a limit to the European economic constitution's principles of neutrality regarding national models.

## *The four pillars*

As for its practical organization, the European economic constitution is currently constituted by four pillars,[53] hierarchically ranked (see Chart VII). The first is the ECB,[54] which *de facto* manages

[52] See, inter al., "Constitutionalism in Europe" in *The Constitution of liberty* (London: Routledge & Kegan Paul, 1960).
[53] Other economic provisions are to be found in the EU "soft" law (such as the "broad economic policy guidelines"). But none of them attain constitutional status.

the Euro so as to achieve the primary objective of price stability. The second is the Stability and growth pact, which is a tool for achieving the primary objective by insuring that fiscal imbalance does not threaten monetary stability. The third is the Single market, which is the common law of all EU member states laid down by the original constitution (cf. supra). The fourth is the EU budget, of negligible macroeconomic size but symbolically and structurally important[55] (Table I).

[Table I here]

Contrary to what is often assumed, especially in the most recent period where the Stability and growth pact was often presented as a very soft constraint, the EU economic constitution is, by and large, well respected. It is especially true of its highest principle. The problem therefore is not so much the compliance of member states with those principles but rather how those principles perform when the criteria of integrity and efficiency are applied to them. It can hardly be argued in our view that economic performance of the EU or the euro area are unsatisfying because the European economic constitution is simply not applied as it should be (see Section 6).

To follow through with the example of the SGP, the announcement of its death by repeated violation seems premature. As noted by the ECJ in the 13 July 2004 Case C-27/04 - Commission of the European Communities v. Council, the constitutional provisions of the Pact were actually *respected* in November 2003. The majority required by Article 104 to implement the financial penalty provided for by the "excessive deficit procedure" has just not been reached. The decision to "hold in abeyance" the procedure can seem discretionary. But the Pact explicitly foresees the case in which the Commission and the Council can be in conflict and gives, under certain conditions, the advantage to the Council under the form of "discretion" of interpretation. Ultimately, the ECJ was to arbitrate between the two respecting the letter and spirit of the European economic constitution, and it found in favor of the Council. Moreover, all member states including France or Germany have continuously since 2003 implemented important fiscal and/or social reforms in order to comply with the SGP. This is not a clear signal that it has ceased to exist.

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[54] This institutional prevalence was clearly marked by the 1st December 2005 decision of the ECB to increase policy rates to 2.25% against the publicly expressed will of almost all member states and the Eurogroup Presidency.
[55] See next section.

As regards the operational structure of the European economic constitution, it is finally worth mentioning that it does not only apply to the euro area, even if this is where it applies the most. It is actually built in concentric circles, allowing us to focus on the euro area as the most accomplished area of integration under the European constitutional provisions in the following theoretical and empirical parts of this paper.

### *"Hard" and "soft" economic constitutionalism in the EU*

In the current age of the European economic constitution, the EMU process has defined three states of integration: the monetary integration (euro area), an intermediary state of integration or transit area, and a "soft" economic constitutionalism (Chart VIII).

[Chart VIII here]

Countries belonging to the euro area can be said to be submitted to the "hard" economic constitution, the one where monetary policy and exchange rate is federal in nature. But this is not to say that the rest of the 25 EU member states belong to a completely different economic order. They are subject to a soft European economic constitution which lays down their common law in the form of a less strict version of the SGP (that entails some monetary and exchange-rate dispositions) and the same Single market rules and EU budget that apply to the euro area members.

The point of this representation is to show that there is a continuum between the "hard" and the "soft" European economic constitution and that the same logic defines the two. Thus, our assessment of the qualities of the European economic constitution as it applies to the euro area (Section 5 & 6) is really an assessment of the whole process of economic and monetary integration in the EU. We focus on the euro area because it is the essence of the European economic constitution. One last point before turning to the examination of the principle of integrity concerns the ideological content of the European economic constitution.

## *The limits of the ideological interpretation of the European economic constitution*

One other way of criticizing the constitutional economic regime of the European Union would be to stress how much the rules chosen owe to the economic doctrine dominant at the time they were designed, i.e. the new classical macro-economy sometimes referred to in a pedestrian way as "neo-liberalism." Following Beard (1913), an "ideological interpretation of the Constitution" of the EU is thus possible, where ideological beliefs would replace class origin or economic interests. This perspective, in our view, is necessary but insufficient.

Such an interpretation, in which we partially engage in the next section, is part of the empirical validation effort of Keynes' intuition of the power of economic ideas. It certainly reveals convincing clues that a naïve monetarism, now considered outdated even by those who promoted it then, played a central role in the framing of the EMU rules. But as we try to show in this section, even from the ideological perspective, merely equating the European economic constitution to an institutionalized neo-liberalism appears far too simplistic.

Moreover, such a critique, when made outside of the constitutional political economy approach, misses an important point. It is primarily the lack of political legitimacy of non-elected institutions of the EU that drives their adherence to economic doctrine, and only secondarily ideological inclination. How orthodoxy has become, in economic matters, EU's legitimacy is an important question. Why this is not a good thing for the EU is our focus. In other words, our principal concern is not with the causes of the economic constitutional state of the EU but with the consequences that result form it.[56] It actually appears hard to identify the economic doctrine behind the European economic constitution as a pure ideology. If anything, the EU resembles a "theorycracy" rather than a conspiracy. As the rationale for European collective action, the economic doctrine embedded in its constitution is supposed to serve a purpose: to efficiently unite member states while preserving their differences. We now wonder whether such a goal has been achieved.

[56] For an analysis of some of the causes, see Fitoussi (2002a) and Le Cacheux (2003).

## 5. The constitutional political economy of the EU: The costly sacrifice of integrity

Political integrity, in its original version, can be simply defined as the preservation of individuals' preferences in the course of collective action. Those can be altered because of the existence of the "social interdependence costs" identified by Buchanan and Tullock (1962). They are the expected costs induced by the necessary interactions between rational individuals willing to minimize transaction costs by acting together. The elementary dynamics of those costs is easy to imagine: the greater the number of individuals whose agreements are needed to take action in the political process, the lesser the value of expected integrity cost faced by a given individual who can increasingly have the possibility to block collective action when s/he feels her preferences could be violated.

Interpreted in the EU context, as argued in Section 3, the principle needs to be redefined and this redefinition implies a choice over its substance. We have chosen to measure integrity of member states (agents of citizens here)[57] as their ability to: i) be assured that what they consider to be the essential features of their national models is preserved in the process of European integration (the collective action undertaken), or what we could call the "right to neutrality;" ii) be guaranteed that it is possible to change constitutional provisions through negotiation when the economic or political context calls for such a change. The schematic representation of the principle is given in Chart IX (the two polar cases of constitutional dictatorship, where only one agent chooses the constitutional rule and the case of unanimity, where all choose, are shown).

[Chart IX here]

### *Constitutional economic rules as neutral rules*

A very simple way to make sure that integrity in the sense of neutrality is always insured by the constitutional rule would be to impose, constitutionally, unanimous decision on each issue. This kind of constitutional rule was indeed supported by Wicksell (1896) for budgetary matters, first

[57] Without consideration to the problems attached to principal-agent situations.

because according to him such a decision-making process was possible (since public finances finance public goods, everybody should agree on voting them), and second because it was desirable (citizens finance public finances through universal taxes and should thus have a voice in the process of budgetary decisions).

But as noted by Buchanan (1987) and Phelps (1985), the simple unanimity rule of the kind advocated by Wicksell, because it makes the pursuit of individuals consents much too costly, is not suited to attain constitutional optimality defined here as the best possible trade-off between integrity and efficiency, or, to put it differently, the co-existence of the possibility of social choice and the right to oppose it. As mentioned supra, "the logical foundations of constitutional democracy" built by Buchanan and Tullock (1962) has made it possible to formalize it better. Interpreted by us, it measures the distance between the ECT and a normative model.

Contrary to everyday political choices, which belong in the short democratic run (and thus are submitted to the law of changing majorities), constitutional choices are inscribed in long run perspective. For a given EU member state to accept and live by an economic rule – a rule that sometimes can produce a negative outcome for it – it has to be as general or neutral as possible given the diversity of member states, and apply over a fairly long period of time, so that positive expected outcomes may balance possibly negative ones. It also has to be agreed on, in the first place, through a unanimous procedure (Buchanan, 1986).

In this respect, it is of crucial importance not to confuse a decision-making rule and a decision, i.e. a specific outcome of a public policy. The Buchanan and Tullock model makes it possible to overcome the political deadlock of constant unanimity, which would entirely favor integrity and sacrifice efficiency, by advocating a unanimous procedure leading to the choice of decision-making *rules*, not policy *choices*. Under this qualification, the analysis rejoins Rawls' model of formal democracy (Rawls, 1971), providing that the application period of the rule is long enough for member states to find themselves placed behind a "veil of uncertainty" (and not of mere "ignorance," see *infra*) at the moment of the constitutional choice.

The neutrality of this "original position" is the guarantee of their freedom in the course of an otherwise mutually beneficial political process. Each and every member of the political community (or their agents, that are in our case EU member state governments) chooses the rules of decision of the community considering the possibility of being, in terms of preferences,

on either side (favorable or adverse, in the majority or the minority) of different outcomes if the rule is implemented. Of course, the consideration determining this choice greatly depends on the domain of collective action considered (an argument that supports a differentiation of rules across the different domains of collective action, see last section).

The most interesting point of Chart IX is thus to show that integrity cost can be reduced if the political process becomes almost neutral in terms of individuals preferences. The more neutral the rule, the less collective action is going to be costly for a member state and the less it will be tempted to veto it. Integrity costs can be lowered by choosing neutral rules. On the contrary, the more substantial (i.e. not general) the rules, the higher the risk that member states' preferences will be violated. In other words, *rules* not *choices* are to be the object of constitutional decision. This analysis explains in our view the paradox of European constitutional rules which we see as simultaneously invasive and almost un-revisable (see infra).

In the light of the "principle of integrity" understood as neutrality, a first imperative appears: a constitution can not contain decisions but rules of decision of collective action. It can, if necessary, differentiate the rules from one domain of public action to another but it can not prescribe invariant choices for the minorities of the present and the majorities of the future in the form of the contents of public policies decided by past majorities. The application of this principle in the EU constitutional regime concerns the necessary neutrality of quasi-federal economic provisions concerning diverse national social models.

Here a distinction must be made between the first and the second European economic constitution. Contrary to what has sometimes been argued (see Hix, 2005), the Single market provisions alone, as they have been partially applied by member states for the last five decades, are almost neutral to national models, that is as neutral as international trade can be.

But, first of all, a completely different situation would be that of a freely circulating services[58] and workers area. Most importantly, in a context in which instruments of adjustments to economic shocks have been centralized, the mobility of capital is strong, the mobility of qualified labor equally strong and the mobility of unskilled labor weak (which is the current situation in the euro area), tax and social competition pose a serious threat to the integrity of national social models. Le Cacheux (2000), Le Cacheux and Saint-Etienne (2005) and Laurent (2005b) show how tax and

[58] As called for by the "Services directive", limited implementation of which is under negotiation between the European Parliament and the European Commission.

social competition has developed in the EU during the 1990s, where the European economic constitution was gradually implemented. In such a context of constraint and mobility, redistributive policies are submitted to the "shadow constitution" of tax and social competition (or constraint *by* mobility) and integrity through the neutrality of the Single market constitutional provisions is no longer assured.[59]

The second European economic constitution, while depriving member states of the means of autonomously responding to economic shocks and constraining macroeconomic policy by the sole monetary stability objective, is also un-neutral, but in a different way.

Actually, the provisions defining monetary policy, fiscal policy and competition policy in the European economic constitution (as defined in Table I) violate the principle of neutrality because they institutionalize, or embed, an economic doctrine. An important theoretical point must be clarified here. The European economic constitution, as mentioned above, has been strongly influenced by the new classical macroeconomics literature. This literature relies on the "rules rather than discretion" model developed by Kydland and Prescott (1977) that seems to favor the application of seemingly neutral rules over the erratic exercise of economic policy by possibly irresponsible governments.

Our view is that, beyond appearances, there is a strong contradiction between the requirements of "constitutional political economy" and the "economic constitutionalism"[60] formalized by Kydland and Prescott. In economic theory terms, inscribing the new classical macroeconomic framework in a constitution (an absolutely independent central bank like the ECB, sovereign over monetary and exchange rate policies, and a relatively independent administrative authority like the European Commission in charge of implementing the Stability and Growth Pact and the competition policy attached to the Single market) means choosing for present and future citizens the position along the Phillips curve (i.e. the trade-off between inflation and unemployment). In brief, there is a considerable difference between the specific rules that are designed to produce constantly similar outcomes and the general rules designed to allow for all possible outcomes to occur.[61] The first ones limit individuals' freedom. The second ones authorize it.

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[59] See Laurent (2006).

[60] See Brennan & Hamlin, 1998.

[61] Although this distinction, sharply established in Buchanan and Tullock (1962), is somewhat blurred in Brennan and Buchanan (1986) which explicitly support the kind of rules advocated by Kydland and Prescott (1977). Here a critical distinction must be made between the original constitutional political economy approach (developed in the context of the influence of Keynesianism over public policies

Our final argument about the current regime of the EU is that constitutional economic rules' neutrality depends on member states' heterogeneity. As we argue in the next section, it is important to consider that *large* and *small* member states *coexist* in the EU.

## *The necessary revision of contingent rules*

To link this section to the previous, a reference can be made to the work of Elster, and in particular to the evolution of his understanding of constitutions as a collective pre-commitment devices. As is well known, the first Elster (1979) strongly advocates the existence of institutional instruments designed to constrain the collective will, extrapolated from the necessity of binding individuals' potentially "self-defeating" rationality. But the second Elster (2000) acknowledges that going from private constitution to public constitution is problematic. Preventing oneself from doing something is acceptable because it is the "individual later" that is self-constrained by "the individual now." A public constitution is of completely different order: "individuals now" bind "other individuals now" and their "descendants later." Since, as Elster (2000) puts it, "No group has an inherent claim to represent the general interest. Society has neither an ego nor an id," a constitution must contain *general* rules and must allow for their revision.

In light of this second condition of integrity, the ability to revise rules, an element of complexity has to be added to the Buchanan and Tullock framework. Constitutional rules do not only concern the different ages of the present generation. They also rule the dynamic destiny of future generations. The Rawlsian "veil of ignorance" supposes that all members of the community are perfectly rational calculators that are able to sort out all social occurrences (i.e. social fates) the future holds but do not know what will be the realized one and choose criteria of social justice accordingly. What is lacking in both the Buchanan & Tullock and Rawls models is the perception of the true uncertainty defined by Knight (1921). In our view, what the economic constitutional rules have to deal with is not only complexity, but un-determination. The constitutional rules thus apply to a radically uncertain future that no calculation can describe, save decipher.

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making in the 1950s and 1960s) and the more ideologically-biased Public choice corpus developed afterwards. The latter views economic constitutionalism (as well as tax competition and more generally economic competitive federalism) as a way to constrain Leviathans' discretionary powers over citizens and institute an efficient liberal economic order. The belief expressed in this sub-section is that this second approach is in many ways orthogonal to the original one when it justifies pre-determined policies on behalf of efficiency. Order is then preferred over justice, contrary to the original concern of preventing majorities abuses on minorities.

This uncertainty, and the cautiousness it implies for constitution-drafters, becomes critical when constitutions rule economic matters, submitted to erratic fluctuations of partly mysterious business cycles. [62] As King (2004) puts it, "the core of the monetary policy problem is uncertainty about future social decisions resulting from the impossibility and undesirability of committing our successors to any given monetary policy strategy." In other words, it is undesirable and impossible to try "to foresee all the incidents in the life of a nation" (Tocqueville) in an economic constitutional text. The question of the possibility of revising economic constitutional rules once they have been adopted appears of decisive importance in this regard. Kydland and Prescott (1977), pointing the risk of "time inconsistency" of public policy, insist on the fact that there should be "institutional arrangements which make it a difficult and time-consuming process to change the policy rules in all but emergency situations." But what if the rules chosen appear to be ill-suited or simply inferior to another rule or set of rules, or become not wanted anymore by participants? This is where economic constitution should entail flexible revision provisions. Such provisions do not exist for the four pillars of the European economic constitution.

Actually, if none of the four pillars of the European economic constitution are democratically revisable, for instance by a simple super-majority rule, each has a degree of inertia that differs from the other. It is to be noted that the revision of economic constitutional rules could take two different forms: a qualitative one (member states could decide that there would not be any limit to public deficit anymore) or a quantitative one (the limit is now set at 4 percent instead of 3 percent of GDP). As a general principle, even if economic policies are supposed to belong to the "first pillar" of the EU and thus subject to the qualified majority procedure, all formal and substantial revisions of any provisions of the European economic constitution implying a change in the Treaty are *de facto* submitted to the unanimity of the 25 member states, while those regarding monetary and exchange-rate policy are in addition subject to the agreement of the ECB.

More specifically, the provisions regarding monetary and exchange rate policy[63] are the most intangible constitutional economic provisions in the EU, as they obey what could be called a "qualified unanimity" rule. Not only are they not democratically revisable, but they can not be

[62] The unforeseen evolution of the US economy during the second part of the 1990s is a recent spectacular example.
[63] Although exchange rate policy should legally be a shared competence and thus submitted to a different procedure (see Table I).

revised even by unanimous member states without the consent of the European central bank. That is why it is the ECB itself that revises its objectives when it feels it is needed (as in 1998 and 2003, see Table I), without any accountability procedure afterwards.

Competition policy and Single market provisions, as we have defined them (Table I), are only revisable by "simple" unanimity.

The provisions regarding national fiscal policy, the Stability and growth pact, have apparently been revised by the European Council of the 22 and 23 March 2005, which is sometimes thought of as showing that the European economic constitution entails some flexibility. Nevertheless, while many have consequently hailed the agreement detailed in the Brussels Presidency Council Conclusions, some even lamenting that it had denatured the SGP, a careful reading of the text reveals otherwise and points in the opposite direction. What appears is that fiscal rules contained in the European economic constitution can be revised in a very special way: they can be hardened (or expanded) but not softened (or restricted).

While the Council's Conclusions optimistically state that: "The amendments to the Stability and Growth Pact will...enable Member States to play a full role in re-launching long-term growth," one should refer to the detailed content of the Brussels agreement, which is very close to the line defended in the European Commission's Communication of 3 September 2004 "Strengthening economic governance and clarifying the implementation of the Stability and Growth Pact." The agreement relies on four major points, the balance of which leans more toward a renewed rigidity than added flexibility:

- "A strengthening of the preventive arm of the Stability and Growth Pact" through the development of "medium-term objectives, between -1% of GDP for low debt/high potential growth countries and balance or surplus for high debt/low potential growth countries."

- "A more symmetrical approach to fiscal policy," Member States being invited to "commit at a European level to actively consolidate public finances in good times" and to "pursue an annual adjustment in cyclically adjusted terms, net of one-offs and other temporary measures, of 0.5% of GDP as a benchmark."

- An attention "in order to enhance the growth oriented nature of the Pact", for "structural reforms ... when defining the adjustment path to the medium-term objective for countries that have not yet reached this objective and in allowing a temporary deviation from this objective for countries that have already reached it."

- A tolerance, "for other relevant factors in the steps leading to the decision on the existence of an excessive deficit, fully conditional on the overarching principle that the excess over the reference value is temporary and the deficit remains close to the reference value" and provided that "no redefinition of the Maastricht reference value for the deficit via the exclusion of particular budgetary items should be pursued."

This last point in particular is crucial in ruling out the possibility of regulating public finances in the EU by introducing a "golden rule" discriminating between government consumption and public investment. The "new flexibility" of the SGP seems to aim at temporarily relieving the burden on the euro area member states that don't abide by the Pact in the context of the European "soft growth" since 2001 (they formed a majority in 2005) at the cost of higher rigidity in the future, especially during economic booms, and hardened surveillance of the financial sustainability of social systems. In allowing for flexibility in the short-term but rigidity in the long run, this version of the SGP is even worse than the former with respect to integrity.

Finally, the EU budget, the most democratic of all constitutional economic provisions in theory, given the role the European Parliament plays in its decision, violates the principle of integrity in its very own way. It does so through the democratic inconsistency of the "financial framework" adopted in 1987 and enacted in 1988. Le Cacheux (2005a) makes the case against this inconsistency. In the mind of its promoters, Jacques Delors in particular, the adoption of a pluri-annual programming framework covering a long time (7 years) was designed to insure a certain stability to spending projects and a better transparency for financing bodies at the national and regional level generally involved in long-term schemes. This framework was also destined to allow the European Commission itself to launch important European projects, such as transport or research networks. The belief in the virtue of pre-commitment was strong.

The democratic failure of this framework lies in its inertia and the de-synchronization it implies: the financing timing being anterior to the democratic one, it ends up being predominant. For instance, the Barroso Commission budget submitted to the European Council in June 2005 (and

only agreed upon at the 15-16 December 2005 European Council in Brussels after a first disagreement in June) had actually been elaborated eighteen months earlier by the Prodi Commission, in contradiction with the principle according to which the budget presented by the Commission should also reflect the priorities of the newly elected Parliament (even if the Parliament enters the negotiations after the Council agreement).

According to the European economic constitution, with the budget adopted by the Council in December 2005, the financial perspectives would not come into force before 2007. But the composition of the Commission could evolve in the mean time and will apply until 2013, although the mandate of the Parliament will end in 2009. The new Parliament will then re-conduct the pre-committed budget for another four years, while preparing the next financial perspectives binding the following majority. The votes cast by EU citizens in 2004 for the European elections will therefore only, in any case, influence marginally European policies by 2007, but more probably constrain the decisions that the representatives they will elect in 2009 will take. In the face of such a democratic de-synchronization, the derailed budgetary negotiations in June 2005 actually appear as an opportunity, not seized, to re-synchronize finances and democracy in the EU. But it is our conviction that the exercise of democracy should not be accidental in the EU.

A critical example of this unsatisfying budgetary situation[64] is the much celebrated "Lisbon strategy," decided in March 2000. The financial framework under which heads of State and government launched the decennial strategy (2000-2010) had in reality been decided in 1998, adopted in 1999 in Berlin, and set to end in 2006. The discrepancy between the ambitions defined in Lisbon and the mid-term results attained in 2005 can be read, in the context of the general perspective presented here, as a problem of coordination between goals and instruments.[65]

Our conclusion is that, because the European economic constitution mixes rules or instruments with choices or predefined contents, it perverts the significance of the original unanimous constitutional choice[66] while not allowing for its revision. The argument according to which the

[64] That is all the more regrettable if one recalls that parliamentary democracies, or rather republics, where born in the 17th and 18th century out of the appropriation by parliamentary assemblies of the budgetary power.
[65] See Creel, Laurent and Le Cacheux (2005).
[66] Agreeing unanimously on predetermined choices annihilates the principle of integrity that unanimity is supposed to secure.

federal or pseudo-federal nature of the EU implies that one should know "who does what" does not appease this critique at all. "Who does what?" is a very different question from "What is done?"

Future economic evolutions are simply *not* foreseeable. This is why the longest-lasting economic constitutions are the shortest, i.e. those with the most general and less detailed provisions. If constitutions are detailed, then they at least should be revisable. To put it once again into King's (2004) phrasing, the reason why we should revise rules of economic decision is quite simple: "it is that we are unwilling to commit now never to learn from future experience." Such a question borders on the matter of the efficiency of the European economic constitution and leads to our next Section: is the sacrifice of integrity worth the promised efficiency?

## 6. The dubious efficiency: A "size nexus" in the EU?

Searching for consent is costly. How is it possible to minimize the decision-making costs for policies that are deemed mutually beneficial, given that decision costs increase with the number of parties involved, both because of increased heterogeneity of preferences and because of bargaining and other transactions costs? This interrogation led to the original formulation by Buchanan and Tullock (1962) of what we have called the "efficiency" principle. But, as in the case of integrity, a reformulation of the principle is necessary to shed some light on the EU constitutional political economy.

We define efficiency in the EU as the ability of European economic rules to insure both an upward coordination of European economies (high economic growth and full employment) and to avoid the choice of harmful non-cooperative strategies (such as "race to the bottom" tax and social competition). In doing so, we still acknowledge that efficiency cost increase with the number of participants that are involved in the process but we add that: i) those costs can be very low if constitutional economic rules are efficient enough (the benefit of upward coordination balancing the cost of the quest for good rules); ii) they have to take into account heterogeneity and especially size heterogeneity of participants in collective action. The simple dynamic of "efficiency" is illustrated in Chart X.

[Chart X here]

One should note that this adapted representation allows both for the formal definition of efficiency, leading to paralysis when all member states have a voice in the constitutional choice, and for the substantial definition, leading to divergence when the rules chosen do not sufficiently take into account heterogeneity, not only in preferences, but in characteristics of member states.

What emerges from the abundant economic literature on policy co-ordination is the generic idea that the need for co-ordination arises in contexts characterized by interdependencies: in such contexts, decentralized decision-making in the absence of co-ordination devices will lead to sub-optimal, non cooperative, Nash equilibria. In a monetary union with decentralized fiscal authorities, economic interdependencies may arise from different channels. They generally result from spillovers, i.e. unintended consequences of national macroeconomic policies on other member states economies, and such spill-over effects may be positive or negative.

While the economic rationales for policy coordination in a monetary union are quite numerous – but of unequal and debatable empirical relevance – they leave open the issue of how to design institutions at the constitutional level that would foster coordination, and also of the costs and benefits of the various tools that may be used to elicit favorable behavior from national governments of member states in a monetary union (see Laurent and Le Cacheux, 2004a). Fiscal policy rules, such as the SGP, constitute the minimum coordination devices: by setting limits on what national governments are allowed to do, they are meant to prevent them from embarking on behavior reputed harmful for the union as whole. But the provisions of the European economic constitution, by and large respected, appear insufficient to go further down the path of efficiency as we have defined it. Worse, they trigger opposite dynamics.

If European integration is the "invisible hand" described in the Prologue of this paper, then the key issue it faces is the economic incentives given to the member States toward reaching mutually beneficial equilibrium. In this regard, claiming that the EU has the "right institutions" but the "wrong policies" and chastising EU or member States officials accordingly (the naming, blaming, shaming approach) has a weak analytical foundation: policies are the outcomes of incentives produced by institutions. If policies are *systematically* wrong, institutions *must* be flawed.

## *The "European output"*

As was argued in Section 2, integrity costs could still be very high if efficiency costs are very low, i.e. if member states exchanged economic sovereignty for common welfare (the input-output trade-off defined by Scharpf, 1990). Even if one adopts this perspective, the problem in our view is that this promised trade-off has not been realized. European economic rules are not, or no longer, efficient in producing convergence and welfare in the EU.

There are two ways of assessing the efficiency of the European economic constitution. The first one is to assess the global performance of the EU. Since the euro area is the most integrated part of the EU (see Section 4), and thus the one part where the sacrifice of integrity is the most costly, one can try to assert its performance, then compare it to the EU (where the sacrifice is less costly, see next sub-Section) and to the rest of the world (where no integration of such scope has taken place). As it is now well established, the growth performance of the euro area under the European economic constitution is nothing less than dismal compared to that of the US and Asia, its main economic counterparts (see Chart XI).

[Chart XI here]

Our estimation of the surprising gap, given the gradual implementation of the European economic constitution and economic and monetary integration that resulted from it, is the following: during the 1990-2004 period, the growth rate of the euro area was approximately half of that of the US and a quarter of that of Asia. The result of this sustained dismal growth is respectively a 16 percent and 49 percent gap in terms of output at the end of the period regarding its two counterparts in globalization. The concern over this "growth gap" that strikingly seems to widen as the economic integration progresses, is reinforced by the decreases in standard of living and productivity from 1996 to 2003 (our period of reference, see infra Box I). In the meantime, unemployment maintained itself between 9 percent and 11 percent, barely decreasing in the late 1990s only to increase again in the early 2000s onward. Whatever the explanation, this performance has to be related to the considerable effort implied by European integration.

The second way to assess the efficiency of the European economic constitution is to measure the degree of coordination between European economies that the application of European constitutional provisions has allowed. The overall performance might not be that good, but this

could be explained by numerous factors (among them the much-maligned "social models," see following Sections), although, once again, the non-application of the European economic constitution could not be said to be one of them. A convergence among member states in nominal (the "Maastricht convergence" and EMU management) and structural terms (the "Lisbon strategy") would be the sign of the partial success of the EMU rules and the promise of a better growth and development performance for the future. Alas, this picture is also surprisingly disappointing (see Chart XII).

[Chart XII here]

Our estimation leads to the conclusion that nominal and real divergence in the euro area is roughly the same in 2003 as it was in 1996. Standard deviation in inflation rates has decreased from 0.98 to 0.95 while standard deviation in productivity levels has decreased from 18.2 to 17.9, the same negligible 0.03 convergence.

This general picture of the "European output" is of great importance for the relevance of the input-output trade-off. Two specific conclusions can also be drawn from it. The first one is that in spite of efforts during the transition phase to economic and monetary union, especially through the imposition of convergence criteria toward the Euro for almost a decade (1992-1999), the economies of the euro area have proven much more heterogeneous than what had been expected and, in a way, resistant to the convergence process chosen and implemented. This resistance has to be explained. Second, this resistance to convergence has very important consequences in terms of macroeconomic management, both with regard monetary and fiscal policies. While "social models" on the one hand, and monetary conditions and transmission mechanisms on the other have been pushed forward in the recent literature as candidates able to account for such differences, we offer another explanation, that we test, based on the heterogeneous size of European countries.

Our main argument can be summed up as follows: one of the major reasons why European economic constitution provisions have become increasingly inefficient is that they do not take into account a *structural* heterogeneity among member states, namely their sizes. To put it simply, European constitutional provisions are "size-blind" while size matters and therefore are systematically biased which is the worse a constitutional provision can be. The consequence of

this bias is far-reaching: heterogeneity in size in a monetary union means heterogeneity in structures, performances and incentives, eventually resulting in conflicting strategies that can become inefficient for all parties.

## *The "size nexus"*

The theory of collective action[67] has first identified a size issue in political economy dynamics. But our "size nexus" argument goes back to the very beginning of the modern understanding of the dynamic of international trade. It was John Stuart Mill, after the classical contributions of Adam Smith, his own father James Mill and David Ricardo, who first made the case for the role of size in trade and economic performance.

As it is well known, the point of departure of Mill is the idea that if trade is mutually beneficial, it is not *equally* beneficial to participants. As Mill (1844) puts it in "Of the Laws of Interchange between Nations; and the Distribution of the Gains of Commerce among the Countries of the Commercial World:" "it is the purpose of the present essay to inquire, in what proportion the increase of produce, arising from the saving of labour, is divided between the two countries," what he calls "the question of exchangeable value." In doing so, he goes on, "we must revert to a principle anterior to that of cost of production, and from which this last flows as a consequence,- namely, the principle of demand and supply." In other words, while Ricardo's comparative advantages, whatever their origin, determines pre-trade relative prices, Mill intend on explaining post-trade prices, that determine which country, or type of country, gain the most from trade, given that all countries' gains are assumed to be positive when compared to autarchy.

His theory, re-asserted in Mill (1848)[68] and later called "reciprocal demand," is formulated by him as follows:

> It may be considered, therefore, as established, that when two countries trade together in two commodities, the exchangeable value of these commodities relatively to each other will adjust itself to the inclinations and circumstances of the consumers on both sides, in such manner that the quantities required by each country, of the article which it imports from its neighbour, shall be exactly sufficient to pay for one another.

[67] See Olson (1965).
[68] "Of International values", chapter XVIII, book III.

The subtle and profound conclusion of Mill, directly leading to the idea of a structural advantage of small countries over large one in international trade is further explained in those terms:

> If the question be now asked, which of the countries of the world gains most by foreign commerce, the following will be the answer. If by gain be meant advantage, in the most enlarged sense, that country will generally gain the most, which stands most in need of foreign commodities. But if by gain be meant saving of labour and capital in obtaining the commodities which the country desires to have, whatever they may be; the country will gain, not in proportion to its own need of foreign articles, but to the need which foreigners have of the articles which itself produces.

Translated in modern economic parlance, this intuition means that the gain from international trade of a given country will be determined by the relative strength of the demand for its exports compared to its demand for imports. More precisely, the gain from trade between two nations will be distributed equally only if their terms of trade (the value of their exports in term of their imports) are equal. When the two nations are unequal in size (i.e. economic size, *cf. infra*), Mill thus showed that the small country could reap the benefit of trade since its needs in terms of internal demand could be satisfied by (labor saving) trade while its exports could be amply demanded to fulfill the consumption needs of the large country, unable to fully satisfy its internal demand.

On the contrary, the large country would only benefit in a limited way (the limit being the capacity of production of the small country) of trade, responding to its unanswered internal needs by a forced "production of commodities by more costly processes at home" and thus losing the corresponding specializing gains. In sum, while trade between two nations of equal size can produce terms of trade halfway to the pre-trade prices of each nation, and thus equal gains resulting from post-trade prices, trade between a small and a large nation is likely to produce an unequal outcome in the favor of the small nation, the post-trade prices being too close from the large nation pre-trade prices. How to make sense of Mill's argument in the euro area context without stretching it too far?

We have shown (in Section 4) that the European economic constitution can broadly be characterized by four essential provisions (called "pillars" in Table I), themselves resulting in two main features: a well-institutionalized Single market allowing for a strong (free) trade integration and a strong constrain put on macroeconomic instruments, reducing the ability to implement

stabilization policies. In this context, it is our belief that economic performances will systematically differ between small and large countries, which may account for a substantial part of the inefficient divergence observed *supra*.

To test our analysis and prove our point, we devise a very simple theoretical framework and empirical strategy. We first have to define what we mean by small and large European countries. The literature trying to stress the importance of size, in particular the one that focused on “small states,” while at least two decades old in its modern version (see Katzenstein, 1985), has recently gained momentum and is now in a state of fast-development in relation with European integration (see Archer and Nugent, 2002).

A crucial point of this literature with which we find ourselves in complete agreement is to show that while there is no consensual definition of size, it is because this notion is essentially relative in international relations. Depending on the context in which small states find themselves, their “smallness” can translate into very different power position. It is obvious that given the “over-representation” of small states in the EU, their power is considerably higher than equally small states not implied in such an a-typical regional organization.[69]

We make ours such a comparative definition of size: in the remainder of the paper, a “small” state, whatever the criterion used, is defined as one with a quantitative characteristic inferior to the fourth of that of the biggest or largest state. A “medium” state is defined as one with half (of the biggest state). “Large” states are those remaining. We then introduce two different definitions of size: demographic size (Table II) and economic size (Table III).

[Tables II & III here]

As shown in Tables II and III, in terms of demographic size, the EU as a whole can be said to be composed of 19 small states, 2 medium states and 4 large states. In economic terms, the count is almost identical, the EU being composed of 20 small states, 1 medium state and 4 large states (Poland logically being the “swing” state). Our definition is even more symmetrical for the euro area, which can be said to be composed, both in terms of population (demographic size) and GDP (economic size), of 8 small states (hereafter “the small 8”), 1 medium state (Spain) and

[69] We come back to this important point in Section 7.

three large states (hereafter "the big 3"). Equipped with this definition of size, we now turn to our theoretical framework. Using Mill's intuition, we build our model with the first block being demographic size (see Chart XIII).

[Chart XIII here]

The theoretical part of the Chart is straightforward. While demographic size (defined as the population level) logically determines economic size (defined as the GDP level), economic size determines whether a country will be open to trade (openness being measured by trade to GDP ratio), the traditional "small open economy" or, on the contrary dependent on its domestic market to grow ("the big closed economy"). This theory is then applied to the euro area and the reference to Mill follows: we wonder in what direction economic size determines the growth performance. Growth performance in turn determines inflation and public finance performance. It also determines unemployment on the one hand, and the ability/gain from implementing structural policies (or, conversely, the need for macroeconomic stabilization policies). This sequence finally determines the policy implication of our model: the relevance (or irrelevance) of the size-blind European economic constitution. Eventually, if our empirical analysis confirms our theoretical intuition, a reform in the European economic constitution as well as in the growth strategy pursued in the EU (the "Lisbon agenda") would be needed. [70]

The very simple empirical strategy we have chosen to test this set of hypotheses is explained in detail in Box I, as well as our main results and their implications.

[Box I here]

The results are presented graphically and numerically in Chart XIV to XVI.

[Charts XIV to XVI here]

In a nutshell, our conclusion is that "size matters" for growth and macro-management in the euro area in a similar geographic way that "borders matter" for trade. Theories of trade, however

[70] The signs and numbers shown on Chart XIII result form our empirical analysis (see Box I).

sophisticated, have to take into account the basic geographical determinant consisting of physical proximity. In the same way, macroeconomic management depends fundamentally on country size. Actually, in the EU case, size matters even more than borders matter; since the fact that European countries are geographically close explains a good deal of trade intensity which in turn determines size-related economic performance divergence. Focusing on monetary policy, we offer an empirical example of the consequences of the "size nexus" in Chart XVII, giving evidence of a "size penalty" in the euro area (the bigger the country, the lower the inflation rate, the higher the real interest rate).

[Chart XVII here]

In qualitative terms, we believe we have gathered evidence of the existence of a "Millian growth" (see Box I), systematically biased under the European economic constitution in favor of small states of the euro area. In quantitative terms, we present evidence of a *systematic divergence* between small states and large states that amount to 2.3 percentage points in real growth, 0.73 percentage point in inflation and 3.12 percentage points in public finance balance (see Charts XIV to XVI).

Our results, in addition to the evaluations presented in Box I (see next sub-section), are also to be confronted with the historical and geographical perspectives. This is done respectively in Table IV-A & IV-B and in Table VI.

[Tables IV-A, IV-B here]

Table IV-A shows that a certain convergence has taken place among EU 12 countries in terms of productivity. But the persisting differences can be attributed to the differences between small and large countries. It also confirms the idea that the gap in standard of living between the euro area and the US between 1975 and 1990 can not be attributed to a gap in productivity, but that this catch-up seems now over, the productivity gap beginning to increase again between 1990 and 1998. Table IV-B rules out the hypothesis of growth performances explained by a Solow type convergence (less capital per capita leading to higher productivity and higher growth) between small and large countries in the euro area. The convergence is already achieved by 1990. What is spectacular on the contrary, and the symptom of the "Millian growth" under the European economic constitution (see Box I), is the inversion of GDP per capita difference between small and large countries in the future euro area between 1990 and 1998. The increasing gap in terms

of GDP per capita between 1990 and 1998 relative to the US accounts for the well-documented difference between the American "glorious decade" and the European dismal one.

Table V, beside our basic argument that EU 12 member states diverge according to size, shows that our results are consistent, from a geographical perspective, on two different levels.

[Table V here]

During our period of reference, the small country under the economic provisions of the EU (as defined in Chart VIII) but not in the euro area (Sweden) does less well than small countries in the euro area (but better than large countries), while both are outperformed by countries outside the EU. The economic effects of the European economic constitution seems thus to follow a "U" curve for small countries, in relation to the degree of openness to trade that the Single market on the one hand and globalization on the other offer and to the macroeconomic stability provided by the monetary union. Symmetrically, the large country outside the euro area but in the EU (the UK) does better than large euro area countries, while large countries outside the EU do better than both. This time, the degree of macroeconomic autonomy seems to be the driving factor behind those differences in performance.

Our main finding is that small countries have substantially outperformed large ones in the euro area because they are more open to trade. The two groups thus exhibit systematic macroeconomic divergence in terms of inflation and public finances inconsistent with the present state of the European economic constitution as well as with the growth strategy entailed in the Lisbon agenda (Chart XIII). This result is in line with some of the recent literature relating economic performance to size.

On the one hand, Alesina and Spolaore (2005) show that country size matters for economic prosperity insofar as it is correlated with the country's degree of economic integration with the rest of the world. More precisely, the fact that small countries have prospered more than large ones in the EU seems related to the fact that the benefits of country size decrease as economic integration increases, or that benefits of trade openness and economic integration become larger for smaller countries. The fact that the European economic constitution gives small countries the

advantage of trade while not allowing large countries to compensate their handicap may therefore explain part of the divergence in their performances in the recent period.

On the other hand, the theoretical idea according to which small size favors the implementation of structural reforms while large countries are in need of macroeconomic stabilization (argument elaborated in detail in Le Cacheux 2005) has recently received empirical validation. Duval and Elmeskov (2005), who perform regressions for 21 European countries in the period 1983-2003, find for instance that the incentive to implement structural reform is strengthened for small countries, because "the up-front costs of structural reform may rise more as a result of moving to EMU in large, relative closed economies than in smaller, more open economies." "Simulations using OECD's macroeconomic model, Interlink, supports these conjectures" they add, arguing that "In the more open (Dutch) economy, improved competitiveness leads to market share gains that fairly quickly translate into a fall in unemployment …In the more closed (French) economy the process is much slower."

Furthermore, they note that: "The results concerning the influence of monetary autonomy and country size can be rationalized within a framework where structural reform is expected to create slack resources in economies. In small open economies such slack is more quickly taken up through changes in net trade and incentives to undertake structural reform are therefore stronger. In larger, more closed economies, by contrast, net trade is less powerful as a mechanism for taking up slack. Hence, such economies are more reliant on accommodation through monetary policy when they undertake structural reform, and when exchange-rate arrangements exclude such accommodation they undertake less reform." This line of reasoning is consistent with our finding that the monetary "size penalty" endured by large countries in the most recent period (see Chart XVII) is likely to slow even more their implementation of structural reforms.

In the light of this section, the present design of the European economic constitution which does not discriminates countries on the criterion of size, appears to be systematically biased against large countries. It thus might be ill-suited to promote high levels of growth, employment and convergence among member states belonging to the EMU. Moreover, the present constitutional economic provisions are likely to increase the risk that non-cooperative strategies will be chosen in the EU. Before coming to this point, we first have to show that our "size nexus" argument holds despite the widely held belief that European economic shortcomings are first and foremost the result of a "social nexus."

### *The size nexus vs. the "social nexus"*

Since the publication of the seminal work by Layard, Nickell and Jackman (1991) and the 1995 *OECD Job study*, the debate over European economic performances has been dominated by the idea that labor market quality (itself determined by the "flexibility" allowed by low levels of taxation and redistribution, i.e. a small "socio-tax wedge") fundamentally determines growth in Europe. While this partial equilibrium analysis is nothing new[71] and empirically doubtful (see Fitoussi and Passet, 2000, Fitoussi, 2002b, and Le Cacheux and Sterdyniak, 2003), the argument seems to exhibit an hysteresis of its own, at it is perpetually re-asserted as the starting point for diagnosing Europe's growth problem.

In Tables IV-A to VI-F and Charts XVIII and XIX, equipped with the framework of the "size nexus," we offer new evidence that its foundations seem weak.

[Tables VI-A to VI-F here]

While the coefficients for the "size nexus" presented in Tables VI-B, VI-E & VI-F remain strong and significant against the "social nexus," social transfers seem to contribute positively to growth. An analysis based on the relation between growth and social transfers and total expenditures must nevertheless consider the possibility of strong reverse causation, i.e. counter-cyclical behavior of those expenditures (due to "automatic stabilizers"), such that as growth increases, expenditures and transfers should fall. When social transfers enter significantly in the regression, however, the surprising result is that they are positively related to growth.

Here a reference can be made to the literature relating openness to the size of the government. Rodrik (1998) has argued that small open economies compensate the risk of openness to trade by large social transfers. Our results, as limited as they are by the very simple methods we have chosen, confirm this view in showing that social transfers are positively related to openness. Furthermore, they indicate that while small open economies need a strong welfare state to compensate the hazards of openness, large closed economies need autonomous macroeconomic

[71] The founding contribution of Jacques Rueff identifying unemployment insurance as the major cause of persistent unemployment was published in 1931.

policies to compensate their lack of openness and make the most of their domestic market in order to grow.

In any event, unemployment and long-term unemployment, do not seem related to either of these variables, while they are strongly related to size. We find that the gap between small and large countries in terms of unemployment and long-term unemployment is respectively of 3.9 and 2.2 percentage points. The "size nexus," both for growth and unemployment, seems stronger than the "social nexus" in the EU 12. Chart XVIII & XIX graphically confirm this result.

[Charts XVIII & XIX here]

While Chart XIX shows that the relation between size and unemployment seems strong, Chart XVIII gives some evidence of the weakness of the "social nexus." Two versions of the "social nexus" are confronted with reality with no success, the intra-model differences in unemployment being much more significant than inter-model differences, suggesting that another factor drives the divergence among EU 12 member states, namely size.

A final way to measure the apparent irrelevance of the "social nexus" is to pair EU 15 countries two by two, one small and one large, in the same social model category (the "nordic model" has only one small representative). This is done in Chart XX which once more seems to confirm that size trumps social in the euro area.

[Chart XX here]

As already observed in Table V, the performances of the UK among the big countries of the EU 15 are unambiguously the best. One has to keep in mind in this regard that the UK does not belong to the euro area and that, as such, its economic system is ruled by another economic constitution, namely a "golden rule" for public finances (while government consumption has to be balanced, pubic investment can be in deficit) and a subtle constrained discretion model for its central bank, independent in terms of means ("instrument independence") but not in terms of objectives and accountable to public authorities ("goal independence").

Having presented what we believe to be convincing empirical evidence of the existence of the "size nexus" in the euro area, we now turn to its consequences for the stability of the European monetary union under the current economic constitutional regime.

## *The ox, the frog and the road to tax and social competition*

In his famous fable, "The Frog who Aspired to Become as Big as the Ox," La Fontaine warned courtesans of the vital danger of trying to become, blinded by ambition, what they were not. We would like in this sub-Section to articulate the same warning in the EU case, although in the opposite direction. The EU is essentially a big closed economy. Its degree of openness is close to that of the largest of its members. Following our argument, it means that it should allow for macroeconomic policies in order to make the most of its domestic market. Otherwise, in pretending to be a frog while it is an ox, or in applying economic rules made for small economies while it is a large economy, it takes the risk of structurally jeopardizing its growth. "Millian growth" is not suited for the euro area in the long-run.

This is not to say that "Millian growth" has not produced some success. The case of Ireland presented in Chart XXI is nothing less than spectacular.

[Chart XXI here]

The country is EU' s greatest economic success and best argument for (small) new comers: the country was among the poorest among Western nations before joining the EU (and then the euro area) and is now only second to Luxembourg in terms of GDP per capita. There is no doubt that it was its integration into the Single market that explains its economic success, while its openness is the major feature of its economic structure. The economic constitutional provisions of the EU, the free trade and macroeconomic constraints they entail, fit (and actually shaped) Ireland's economic strategy perfectly well. The downside is that Ireland accounts for less than 2 percent of EU 12 total GDP, which is ultimately the Single market on which Ireland itself depends, along with all the other small states of the EU. Chart XXII shows how GDP is distributed in the euro area. The three largest countries represent 71 percent of the total. The

reason why the European economic constitution appears inefficient is thus straightforward in our view: it is ill-suited for 71 percent of the economic area it rules.

[Chart XXII here]

The paradox and the peril of the situation is that large countries are domestic-driven economies, as shown in Chart XXII, which small countries depend on, as shown on Table VII (while the opposite is not true), but that the European economic constitution is made of rules for small open economies.

[Table VII here]

Another way of looking at the problem is to say that a small country does not need macroeconomic stabilization instruments the way a large one does.[72] The tools available to adjust to a negative macroeconomic shock (recession and rise of unemployment) are not of the same essence, and thus of the same effects, than for a large one. Because its economy is largely open, regarding goods and services as well as foreign direct investments and other capital flows, a fiscal policy will have little effect on domestic demand for a small economy, since most of its impact will be absorbed through imports.

Hence, for a small open economy, traditional fiscal policy of the Keynesian kind will usually be of little efficiency, whereas all policies that improve the competitiveness of the national economy by lowering production costs of firms located in the domestic economy are relatively more powerful: this may explain why fiscal consolidations in small countries have been found to have "non-Keynesian" effects in the EU; it also suggests that tax competition, "structural reforms" and wage moderation policies will all have very powerful, positive effects for a small open economy, both because domestic demand represent a fraction of demand to domestic firms and because the elasticity of the supply of external capital – in particular foreign direct investments – is higher, the smaller and the more open the economy is. In addition, policies that lower production costs in a small economy do not harm domestic demand very much, and they have little incidence on domestic inflation, so that they do not raise real interest rates, as nominal rates in a monetary union tend to be uniform across countries and to be relatively less influenced by the policies of a single, small country.

[72] See Le Cacheux (2005b).

For large countries on the contrary, free riding is impossible and the various policies reviewed above tend to be more costly, or even counterproductive for the economic system. Keynesian-style demand-management policies, especially fiscal policies, are more efficient for large relatively closed economies than for small open economies. On the other hand, all policies tending to lower production costs are less effective, and they all tend to lead to a lower domestic inflation, which then results in a higher real interest rate, so that they tend to be costly in terms of economic activity and growth.

The fate of Germany over the past few years seems to be a perfect illustration of this difficulty of large countries in an economic and monetary union regulated by the rules of the kind of European economic constitution. The "frog strategy" adopted by the largest Euro area country (see Chart XXIII) consists in lowering its labor costs to gain export competitiveness. But its growth crucially depends on domestic demand. Hence Germany, against its economic nature, *behaves like a small country*.

[Chart XXIII here]

The incentive system devised by the European economic constitution is thus likely to damage growth performance in the EU even further. Small countries could be tempted, like Ireland, to engage in tax and fiscal competition, hoping that retaliation from the large countries will not come. Large countries, *behaving like small countries* and thus trying to compete using "social disinflation" rather than exchange-rate policy, would adopt competitiveness policies focused on labor cost reduction and welfare state roll-back policies. Since they are not small, they will trigger strategic reaction from other large countries, who in turn will engage in the race to the bottom. Some elements of this worst-case scenario have already appeared (see Laurent, 2006).

It should be noted here that social-tax competition acts as a "shadow constitution" for redistribution policies in the EU, as noted by Brennan and Buchanan (1980). It constitutes a set of invisible but effective rules imposed on social policies.[73] It should also be stated that, if this dynamic could be further influenced by the Eastern enlargement, it does not at all seem to result from it, but from the economic constitutional regime chosen by Western member states of the EU 25 when they were the EU 15.

[73] See Laurent (2006).

This system, if not reformed, could eventually lead to the transformation of the EU 12 into a low growth non-cooperative area[74] whose existence could quickly become uncertain, the fate of the small countries not being any better than that of the large.[75]

In the face of the evidence presented in this and the previous section, it is quite hard to believe that the EU has reached a "stable and attractive" "constitutional compromise" that it would be irresponsible to "upset" (Moravcsik, 2005b). On the contrary, one is inclined to search for solutions to the present and mostly future instability of the European polity induced by the unfair and inefficient European economic constitution. We finally turn to two possible ways of re-contracting the European economic constitution.

## 7. Economic democracy and federalism: The "Great compromise" *vs.* the "European economic constitution(s)"

In the previous Sections of this paper, we have attempted to show that the trade-off between integrity and efficiency in the EU was sub-optimal: while integrity costs seem very high, efficiency benefits seem very low. In our view, the serious crisis in which the EU is engaged since May 2005 has no other fundamental explanation. We believe, like Paul Romer, that "a crisis is a terrible thing to waste." We thus finally offer in this section two original ways out of the current European predicament, taking into account the necessity of reconciling unity in the EU with diversities in both social model and size.

We first try to formalize a starting point for policy, in the framework of the integrity-efficiency trade-off. The EU is confronted with four possibilities in the space defined by the integrity-efficiency trade-off (see Chart XXIV).

[Chart XXIV here]

74 The scenario of a competitive Europe was first presented by Fitoussi (1999). See also Le Cacheux and Saint-Etienne (2005) and Laurent (2005b).

75 Fontagné (2004) shows how the "Luxembourg model" has developed a fatigue of its own.

The first one is the status quo, which, given our arguments in Section 6, isn't really a possibility. An un-reformed European economic constitution would plunge the EU into tax and social competition and eventually result in des-integration (less integrity; less efficiency). Another choice would be to regain some integrity (i.e. national sovereignty) but, if un-coordinated, this risks jeopardizing the global efficiency of the EU (and euro area) and finally not be very different from the pseudo-status quo of tax and social competition (less efficiency; more integrity).

The two remaining choices imply political re-contracting, i.e. the drafting of a new European economic constitution. The first method on this path consists of acknowledging the discrepancy between the "size nexus" and the size-blind economic rules of the European economic constitution and the role it plays in diminishing the efficiency of the EU. It implies discriminating among European countries on the basis of size, and thus sacrificing some integrity (understood here as equality between member states with respect to the choice of economic constitutional provisions) to gain some efficiency. We call this solution the "Great (European) compromise" (less integrity; more efficiency, cf. infra).

The last solution is our preferred solution since it would allow progress both in terms of integrity and efficiency. It would consist of giving a full autonomy to the euro area inside the EU 25, thereby distinguishing between the EU 25 and the EU 12 in terms of choice of constitutional economic provisions. Furthermore, this solution implies what we call a "small compromise" among EU 12 member states, recognizing the importance of the "size nexus" (which explains why, graphically, the frontier between "Great compromise" and "European economic constitutions" is porous). The reason why this last solution would be able to improve both integrity and efficiency, is that it is likely to minimize both integrity and efficiency costs, or, to say it differently, to expand the trade-off frontier between efficiency and integrity.

Before developing these two ways out of the current European crisis in detail, we first have to characterize empirically the context in which they could be undertaken. That is, the spectacular rise of the number of small states in the EU, changing the democratic balance between economic and political power both in the EU 25 and EU 12. In other words, the "size nexus" to be taken into account in economic policies, has first to be taken into account in terms of policy-making.

## *The rise of the smalls in the EU*

To fully understand why size matters and is likely to matter even more in the future, one should actually keep in mind the spectacular contemporary evolution of the number of small and large countries in the EU (see Chart XXV).

[Chart XXV here]

Started in the 1950s with only six countries, three of which were "large" and three "small," the European integration process has progressively included more and more countries but mostly "small" states, that have come to represent 50 percent, 60 percent, 66 percent and finally 76 percent of the total. Chart XXIII shows that the tipping point of the contemporary European Union (and of the future euro area) in this respect seems to be 1995, when Finland, Austria and Sweden joined the EU (Finland and Austria later joining the euro area). As shown in Table II & III, the EU and the euro area respectively encompass now, at the end of this evolution, 19 and 8 small states, 2 and 1 medium state and 4 and 3 large states.

As noted in Alesina and Spolaore (2003), the emergence since 1945 of a large number of economically highly integrated and "small" countries is a global, and not only European, phenomenon, corresponding to a simultaneous "economic integration" and "political disintegration". The specificity of the EU "small" states however is that, being the product of the two former evolutions, they have then been able to re-integrate themselves in the framework of a political regime where they have acquired a power unrelated to their demographic and economic size. The idea of the "Great compromise" would be precisely to re-balance the EU in favor of the large states, in the name of "efficiency."

## *A "great (European) compromise"*

"The federal system was created in order to combine the various advantages of largeness with those of smallness"[76] argues Tocqueville in the Chapter VIII, Volume I of his *Democracy in*

[76] Op. cit., p. 182.

*America*. If that is so, given the degree of economic integration achieved in the EU, an agreement between small and large countries should be possible for the sake of mutual benefit.

But first, one should take the measure of the problem at stake, namely the imbalance of power between small and large states in the EU, or more precisely, between economic size and political size in the EU. While small European states are "magnified" by the EU decision-making system in the EU 12 and the EU 25, large European states appear to be "shrunk" when their economic and political size is compared in the euro area and in the EU (see Table VIII for the EU 12 and Table IX for the EU 25).

[Tables VIII & IX here]

This imbalance results in the fact that economic majority and political majority are far from being synchronized in the EU 12 and the EU 25 (see Table X).

[Table X here]

Table X shows that 74 percent of the economic size in the EU 25 corresponds to 38 percent to 48 percent of the political size depending on the measure chosen. In the EU 12, 71 percent of the economic size corresponds to 21 percent to 27 percent of the political size (the majority being at 30 percent). Conversely, a solid "economic majority" (56 percent of economic size) represents 23 percent to 32 percent of political size in the EU 25 and 14 percent to 18 percent (compared to a total of 60 percent) in the EU 12.

We should clarify the choice of economic size rather than demographic size for comparison with political size (even if when they are expressed in percentage terms, they only differ little).

The issue of size in the EU is almost always considered, in the political and academic field, from the strictly political point of view. The reason for this is that voting rights are legally distributed in the EU Treaty according to a "principle of population:" the larger the state in terms of inhabitants, the higher the number of votes. But this criterion does not fit in our framework. Our focus in this paper is the EU as an economic democracy between states (as we have tried to define it with the criteria of "integrity" and "efficiency"). While models to build political voice

and assess EU's democratic character typically rely on demographic size, we thus prefer the criterion of economic size, in relation to our argument in Section 6.

What would be the point of a "Great European compromise?" For scholars of the history of federal states and institutions, this reference is no surprise (see Laurent and Le Cacheux, 2004c) for the "Great compromise" was the name given to the agreement reached in July 1787 between small and large states in the Philadelphia Convention. The "Virginia Plan," devised by James Madison and presented by Edmund Randolph to preserve the interest of the large states in the Union, equated political power (in the Congress) with demographic size. As such, it was rejected by smaller states. They instead proposed the "New Jersey Plan," drafted by William Paterson, which would leave the structure of Congress unchanged, with each state having one vote. The famous solution later proposed by Roger Sherman, that eventually became the constitutional one, balanced the proportional ("apportioned") representation of the House of representatives with the equal representation in the Senate (one state, two votes). What form could such an agreement, designed to restore efficiency to the European economic constitutional provisions by reducing the power of small states, take in the European Union? Can one imagine a compromise between an "Ireland Plan" and a "Germany Plan?"

To have a clear idea of the possibility of reaching such an agreement, one can briefly look back at the tumultuous recent history of decision-making in the EU. The substantial efficiency, as we have tried to define it (see Section 2 and Section 6), was actually never considered with respect to size. But the formal efficiency of constitutional rules, i.e. the fact that they could allow (or not) for decisions to be taken (whatever their content) has been at the centre of a heated debate between small, medium and large states in the EU in the recent period.

Because they were aware of the increased difficulty of making collective decisions in a Union that was to become more numerous and more heterogeneous, the national governments of the EU15 countries had decided to reform the decision-making rules of the Council before enlarging the EU. Indeed, this reform was the major, if not only, objective of the Intergovernmental conference (IGC) convened in 2000 to draft what was to become the Nice Treaty.

But the weighting scheme and the triple threshold for qualified majority (72 percent of the votes in the Council, representing at least 50 percent of the member states and at least 62 percent of the EU population) agreed upon are highly complex and hardly transparent. They mostly make it

fairly easy for countries to form a blocking minority coalition, so that the decision-making process is most likely not to be efficient.[77] Adopted precipitously without any simulation of how it would actually function, this qualified majority rule immediately appeared to be too complex, inefficient and probably inconsistent in a Union of 25 or more members (Baldwin and Widgrén, 2004a). Realizing that Nice rules would not be sustainable, the European Convention tried to address this issue but did not eventually manage to propose a satisfying "great compromise" between European nations.

The Convention proposed a simpler and apparently more efficient rule: a double majority threshold, with 50 percent of the member states representing at least 60 percent of the EU population. But these lower thresholds gave more power – especially veto power – to "large" member states, thus relatively weakening the blocking powers of coalitions of "small" member states, but mostly that of the two "medium" countries – Poland and Spain – which benefit the most from the compromise reached in Nice (Laurent and Le Cacheux, 2004b and 2004c). In addition, the efficiency gain compared to the Nice decision rules, although real, was actually not very significant (Baldwin and Widgrén, 2004b).

Following the failure of the Brussels summit in December 2003, mostly due to the opposition of the Polish and Spanish governments to what was clearly a loss of influence of these countries compared to what they had gained in Nice, a new round of negotiations, this time within the Intergovernmental conference, led to the adoption of higher thresholds for the double majority rule in the Council. The majority rule adopted in the ECT (and presented in its Article I-25) was the following:

> 1. A qualified majority shall be defined as at least 55% of the members of the Council, comprising at least fifteen of them and representing Member States comprising at least 65 % of the population of the Union. A blocking minority must include at least four Council members, failing which the qualified majority shall be deemed attained.
>
> 2. By way of derogation from paragraph 1, when the Council does not act on a proposal from the Commission or from the Union Minister for Foreign Affairs, the qualified majority shall be defined as at least 72 % of the members of the Council, representing Member States comprising at least 65 % of the population of the Union.

[77] On the probabilities of reaching decision on collective issues with the qualified majority rules of the Nice Treaty, see Bobay (2001) and (2004).

3. Paragraphs 1 and 2 shall apply to the European Council when it is acting by a qualified majority.

Whereas the double majority rule that had been originally proposed by the Convention – 50 percent of the member states representing at least 60 percent of the EU population – could be regarded as both simple and potentially more efficient than the qualified majority rules of the Nice Treaty, the thresholds finally adopted represented actually a small progress. According to the calculations made by Baldwin and Widgrén (2004b), the probability of reaching collective decisions would have risen from about 5 percent under Nice rules to a little less than 10 percent under the new rules with the 25 present member states, and even slightly more with 27 or 28 (including Turkey, in this case).[78] With the already signed accession of Bulgaria and Romania, the double majority thresholds amount to 15 states and at least 310 millions EU citizens; and if Turkey were to join, the thresholds would be 15 states and at least 360 millions EU citizens.

An additional condition, adopted at the end of the IGC negotiations in Brussels in June 2004, stated that a blocking minority had to include at least four states, a condition that turns out to be binding only for "large" countries, but not for "small" ones. In order to illustrate the properties of this particular double majority rule, and especially the numerous possibilities of forming blocking coalitions, we may give a few examples. A coalition of the six founding countries (Germany, Benelux, France and Italy), or even one that would not include France or Italy, could oppose any decision in the Council; the same could be achieved by a coalition of the 12 new members in the enlarged Union at 27, or indeed any coalition representing at least 170 millions citizens; and in a situation like that prevailing in the Spring of 2003, Italy, Poland, Spain and the UK could have opposed any common decision on Iraq.

Now that the ECT is invalidated, the EU is back to the Nice Treaty rules, which are certainly worse in terms of efficiency than the first Convention compromise, but not that far from the second one, eventually proposed for ratification. The problem of efficiency, considered from a strictly formal point of view remains, and the risk of paralysis of the EU under the Nice rules are high.

[78] See also the calculations performed by Bobay (2004). The author reaches similar conclusions concerning the decision-making efficiency of the rules eventually included in the ECT and insists on the power gained by "small" states.

Furthermore, the sequence of bargaining on political size opened by the prospect of a new European constitution illustrate the difficulty of negotiating in a more numerous and diverse EU than ever before. Achieving a European "Great compromise" could thus prove very difficult for the very reason it is necessary: the imbalance between small and large states and the existence of medium ones as potential veto players. Table XI shows that one important reason why the US succeeded in reaching an agreement between small and large states was their almost perfect balance, reducing the veto power of the medium states.

[Table XI here]

But a more fundamental question is to determine, not if a "Great compromise" in the EU 25 is possible, but if it is desirable, i.e. whether a rebalance of power in favor of large states would be enough to insure that more balanced constitutional rules might be chosen. Here, one has to remember that the small economy rules that have been chosen for the EU 12 and that appear so harmful for its economic performances have been essentially pushed forward by France and Germany. So, ultimately, the reason why a "Great compromise" appears unlikely to trigger efficiency is because large states could well end up not choosing the good rules for themselves.

However, the growing opposition between large and small countries in the EU should not be understated. The vote of 25 November 2003 on the SGP can be read as a (nuanced) size-driven opposition between France and Germany (that did not take part in the final vote) on the one hand (supported by Italy and Portugal, Ireland, Belgium, Luxembourg and Greece), and The Netherlands, Finland, Austria and Spain on the other hand, which voted against the conclusions of the EU Council suspending the sanctions contained in the excessive deficit procedure.

Second, if a global reform appears unlikely, some incremental improvements toward a new balance between "large" and "small" states in the EU on the basis of economic size seem possible. An interesting reform in this respect regards the European central bank that modified its status in April 2003, introducing for the first time in relation to the enlargement of the euro area the criterion of economic size instead of population (or demographic size) and recognizing a specific status to the five countries with the highest GDP in the euro area (Art. 10.2):

> Each member of the Governing Council shall have one vote. As from the date on which the number of members of the Governing Council exceeds 21, each member of the Executive Board shall have one vote and the number of governors with a voting right shall be 15. The latter voting rights shall be assigned and shall rotate as follows:
>
> – as from the date on which the number of governors exceeds 15, until it reaches 22, the governors shall be allocated to two groups, according to a ranking of the size of the share of their national central bank's Member State in the aggregate gross domestic product at market prices and in the total aggregated balance sheet of the monetary financial institutions of the Member States which have adopted the euro. The shares in the aggregate gross domestic product at market prices and in the total aggregated balance sheet of the monetary financial institutions shall be assigned weights of 5/6 and 1/6, respectively. The first group shall be composed of five governors and the second group of the remaining governors.

In this respect, Table VIII and X show that beyond (or more accurately within) the question of the balance between small and large countries in the EU lies the question of the balance between the EU and the euro area. This leads us to our final argument: the constitutional differentiation of the euro area, or the implementation of the European economic constitutions.

## *The European economic constitution(s)*

Admiring the young states of the new American republic, Tocqueville (mistakenly) remarked in Chapter VIII, Volume I of his *Democracy in America* that "One is much like another. Their mores, ideas, and needs are homogeneous. Though some are larger than others, differences of size alone have not given rise to strongly opposing interests."[79]

Uniting the euro area countries enough by giving them a true economic sovereignty so that the difference in their sizes would not be a threat to the future of the EU is the idea behind the "European economic constitution(s)."

Going back to Table VIII and Table X, it appears that the euro area is heavily dependent on the EU for the implementation of its own policies. Given the concentric circles structure of the European economic constitution (see Chart VIII), this is not surprising. But the imbalance between the economic size and the political size in the euro area and the EU is as striking as that between small and large countries in the EU. Actually, members of the euro area only account for

[79] Op. cit., p. 134.

60 percent of its political size in the Council. While the Council makes decisions that allow for a certain degree of autonomy of the euro area on the *policy* level, the dependence of the euro area on the *constitutional* level is total. EU 12 countries can not choose their Economic constitution without the agreement of the 13 other countries and of the ECB (cf. Table I).

Furthermore, Table X shows that the consistency between economic size and political size is not better in the EU 12 than in the EU 25, or, to say the same thing differently, that the EU 12 is not more integrated politically than the EU 25, while it is much more integrated economically.

Two imperatives thus finally appear. The first is to better differentiate the EU 12 within the EU 25 in terms of economic constitutional choice; the second is to integrate the EU 12 politically at the level of its economic integration. This would provide the foundations for a sustainable economic and monetary union. These two ambitions can only be met through a differentiation between the two European economic constitutions corresponding to the EU 25 and the EU 12.

Alesina and Spolaore (2003) formalize the "optimal size" of countries in public economics terms as resulting from a trade-off between the efficiency of the provision of public goods (economies of scale) and the heterogeneity of preferences. This is a generalization of the classic argument of the economic federalism theory[80] on the optimal level of public policy within federations ("subsidiarity" in EU parlance). In the constitutional framework that we have chosen, this optimal trade-off is between efficiency and integrity. In theory, it should in fact be related to the issue of optimal (external) size. There should be a coalition of countries that, given their characteristics in terms of diversity both according to their social model and their size, makes it possible to minimize integrity and efficiency costs. Once more, we turn to Buchanan and Tullock (1962) to illustrate this idea of an "optimal constitution" in the EU (see Chart XXVI).

[Chart XXVI here]

How do we define the boundaries of this coalition of countries, or, to put it in Buchanan's (1965) terms, how do we justify an "optimal exclusion" (and inclusion) in the EU? There, we have to add to our normative framework an unmistakable positive reality: twelve EU countries have *already* decided to give up their monetary sovereignty to form the euro area. The question is thus not how to form the coalition of countries that would minimize integrity and efficiency costs, but

[80] See Oates (1999).

how to effectively reduce integrity and efficiency costs for this coalition given the fact that it exists. As argued, the two steps in this direction would have to be autonomy and integration.

Autonomy in the constitutional choice of economic policies rules implies that integrity and efficiency costs would be reduced simultaneously by respecting two conditions. The first is that the rules chosen in the euro area are general and take into account the size of member states. This means that euro area countries should reform the rules of monetary and fiscal policies in the course of a "small compromise" leading to an efficient and proactive macroeconomic framework. It should be easier than a "great compromise" because of the presence of only 66 percent of small states and 1 medium state in the euro area, instead of 76 percent and 2 medium member states in the EU as a whole. Only then would the large and small states be on an equal footing.

Since the UK and Poland remain outside the euro area, the latter comprises 4 of the 6 large countries of the EU. If the UK and Poland keep their macroeconomic autonomy and use it to compensate the handicap of their size in the Single market, giving the euro area an economic constitution respecting the integrity and efficiency principles makes it possible to ease the consequences of the "size nexus."

A further important question would be to know what kind of rules a European economic constitution for the euro area should have. There, a trade-off in the trade-off could appear between revision and neutrality, the euro area members being able to take the risk of political integration (with a revisable economic constitution) because preferences would become close enough under the effect of more neutral rules. In the classical terms of federalism, this idea means allowing for homogenous preferences to form at the level where externalities and economies of scale occur. An important step toward further integration once autonomy is gained would be to define "European public goods" financed by a real autonomous budget paid for by a unified corporate tax (see Laurent & Le Cacheux, 2004).

Two different economic constitutions should thus be implemented in the EU 25. The first one, the "EU economic constitution," would be submitted to the EU 25 member states and legally bind them. Including the main elements of the first historical economic constitution, it would combine the regulations of the Single market (and the competition policy attached to it) with a reformed EU budget (see Le Cacheux 2005). Member states should be left free regarding their macroeconomic policies.

The second economic constitution would really be the "euro area Constitution." Submitted only to the ratification of euro area members and amendable by them only, it would be revisable through qualified majority and include neutral and efficient provisions regarding monetary, exchange rate and fiscal policies taking into account size.[81]

In the end, the major reason why the "European constitution(s)" solution seems better suited for the EU is that it answers our "integrity" and "size nexus" concerns in a less costly way, in efficiency sense, than the "Great compromise."

## 8. Epilogue: 1955 or 1965?

The solutions proposed to the current predicament of the EU (which present crisis is a symptom of) rely ultimately on one possibly heroic assumption: that the EU has the political resources to invent innovative new political paths into the future. If the time is 1955, at the moment when the Messina conference opened the way for the Treaty of Rome after the European Defense Community crisis, then our optimism is justified. If the time is 1965, when the "Luxembourg compromise" blocked the way of European integration, that only the Single Act, 20 years later, revived, then it is simply, for now, misplaced.

[81] See Laurent & Le Cacheux (2004a), (2004b) and (2004c).

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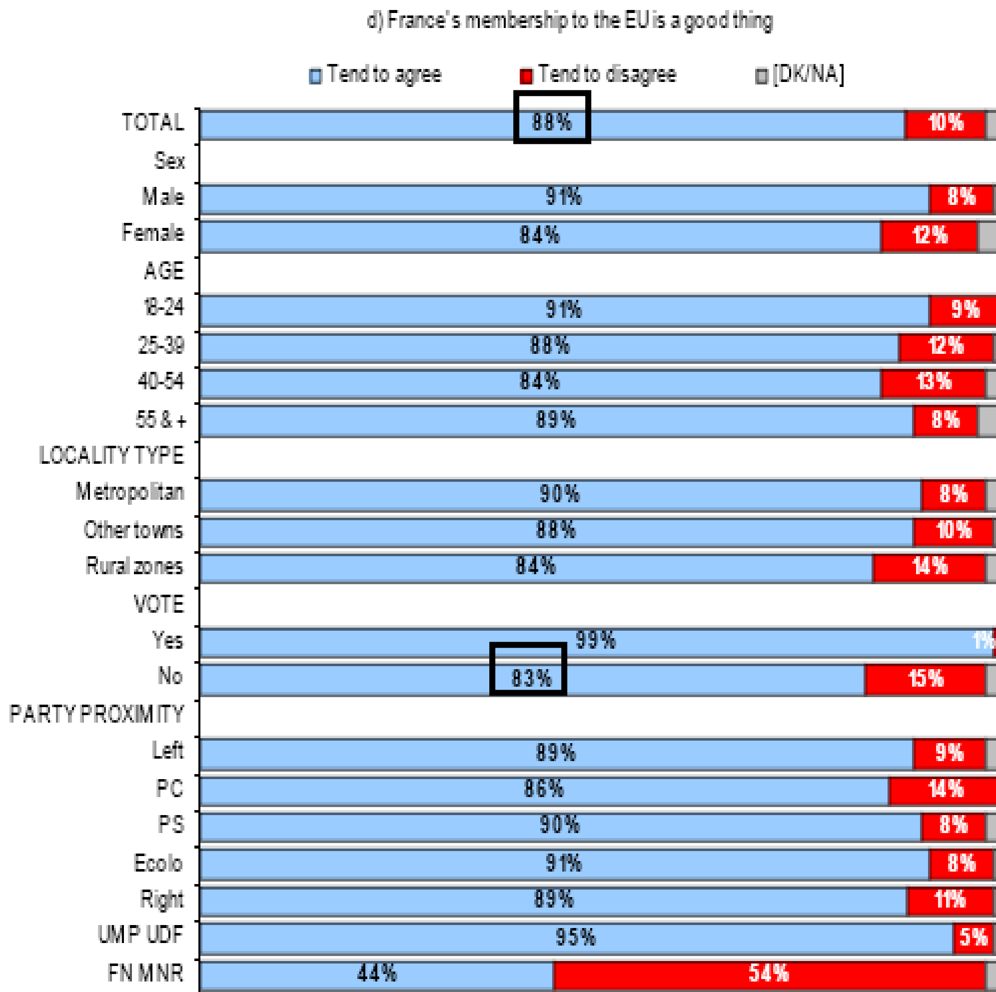
Chart I

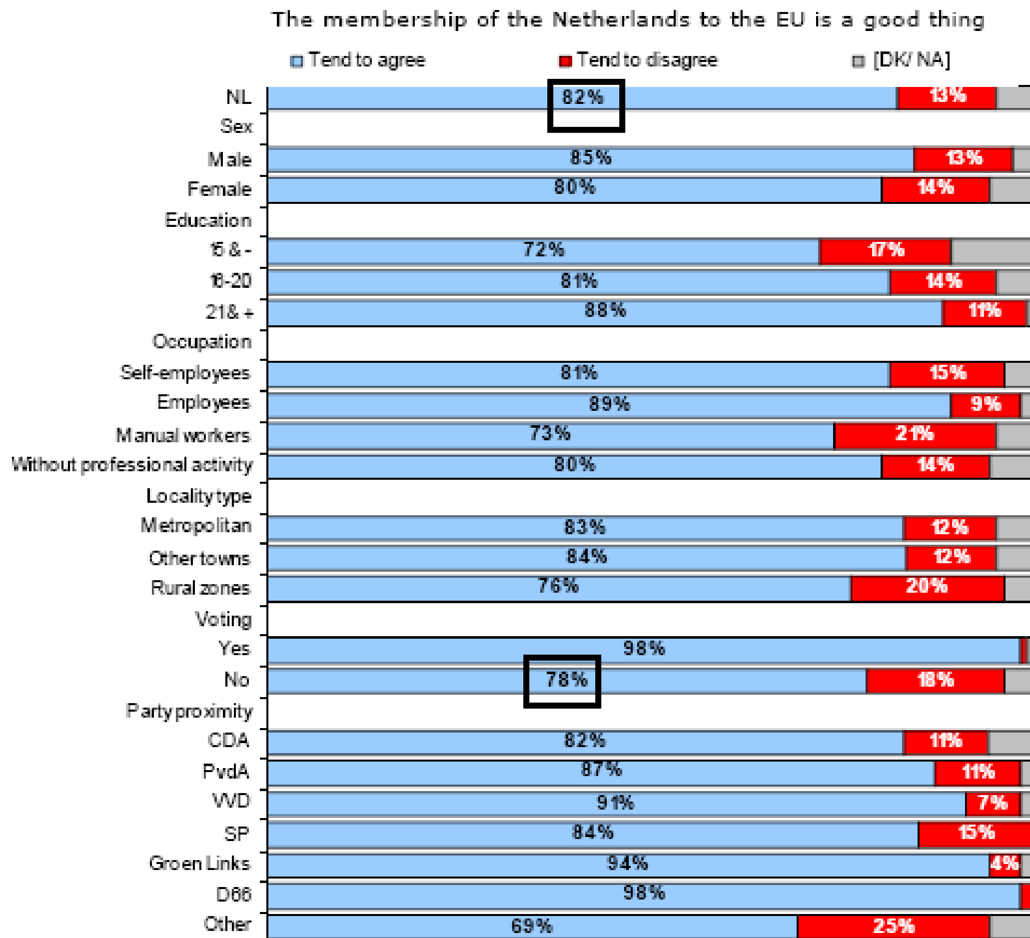
**A LARGE AND WIDESPREAD SUPPORT FOR EU MEMBERSHIP IN FRANCE**




*Source:* Eurobarometer 63 *carried out between 9 May and 14 June 2005, July 2005, available at* http://europa.eu.int/comm/public_opinion/archives/.

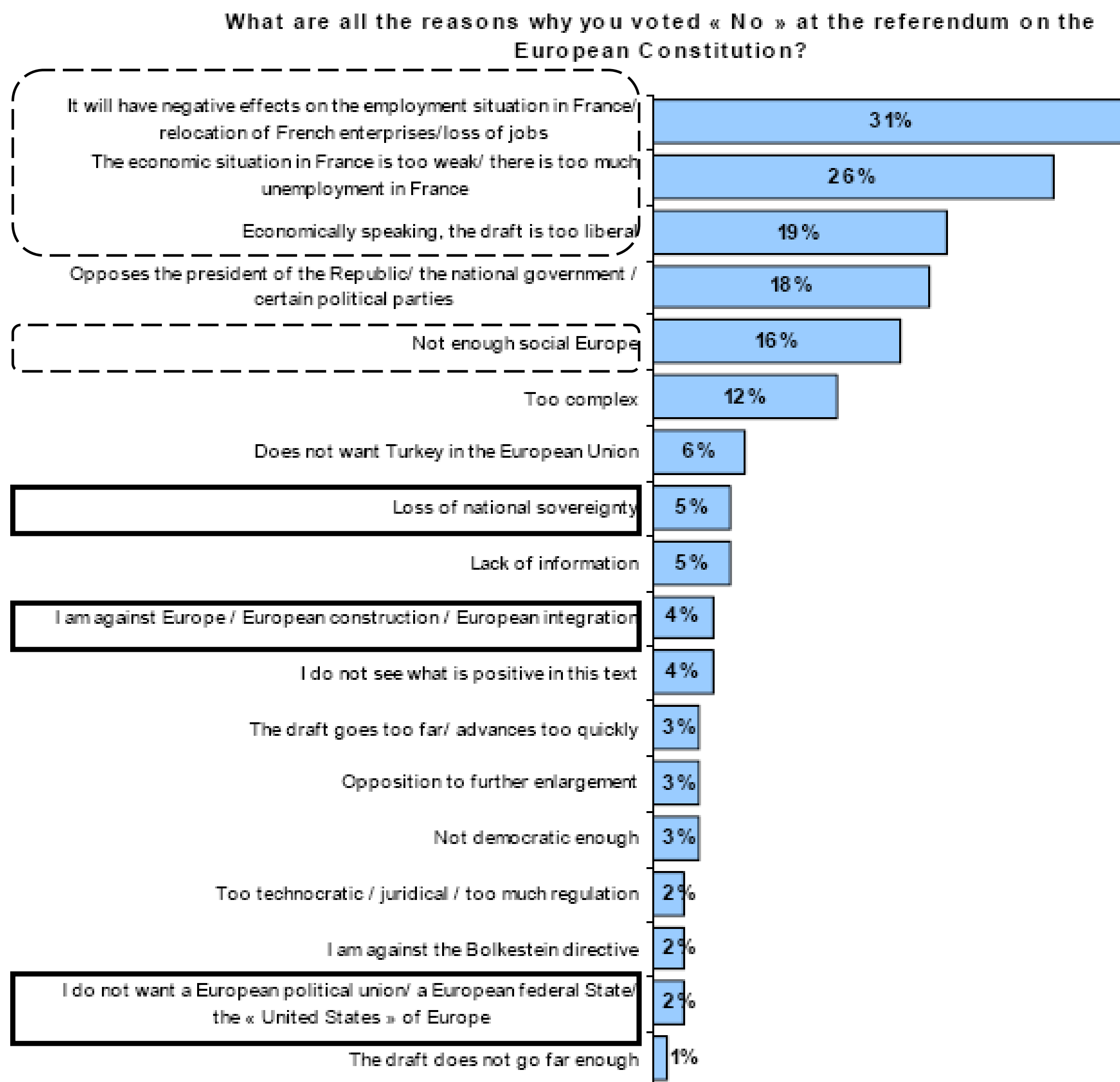
Chart II

**A LARGE AND WIDESPREAD SUPPORT FOR EU MEMBERSHIP IN THE NETHERLANDS**




*Source:* Eurobarometer 63 *carried out between 9 May and 14 June 2005, July 2005, available at* http://europa.eu.int/comm/public_opinion/archives/.

Chart III
## THE FRENCH *RAISONS*




"Economic voting" motives

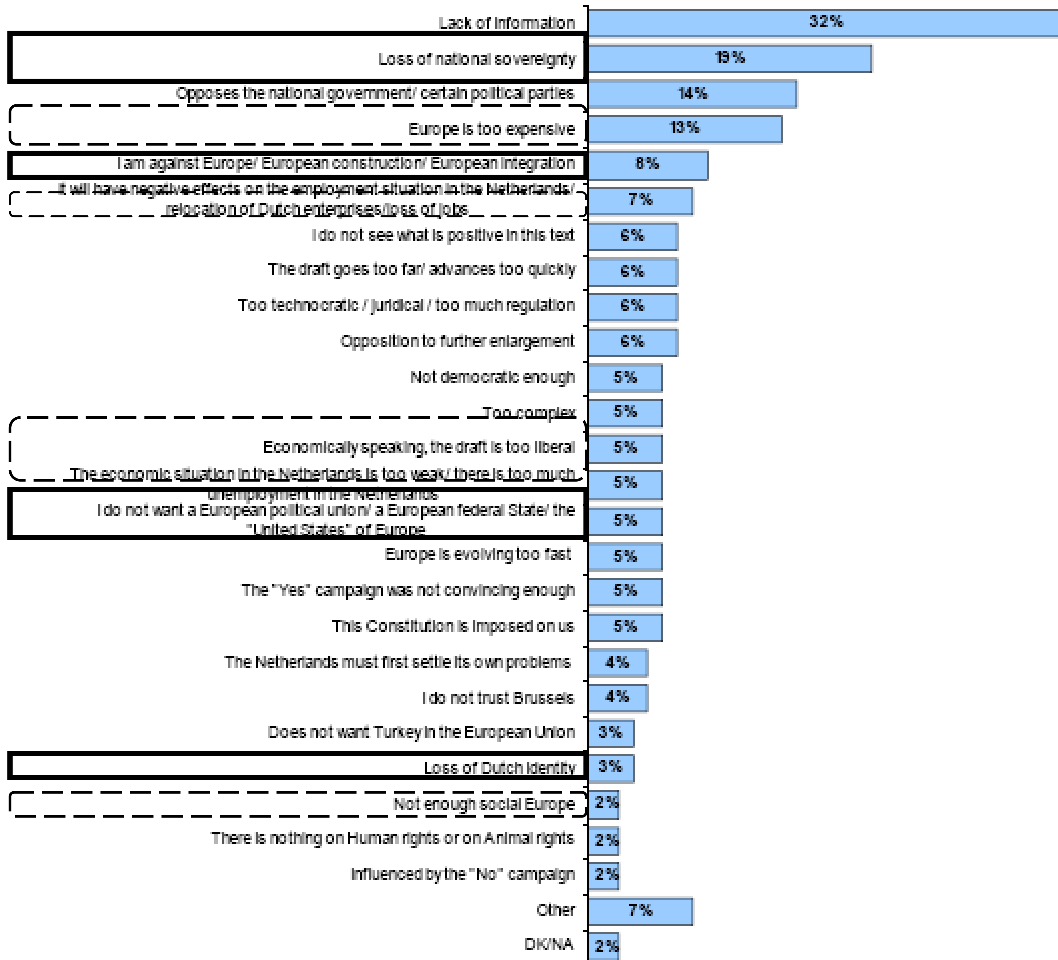
"Sovereignism" motives

*Source:* Eurobarometer 63 *carried out between 9 May and 14 June 2005, July 2005, available at* http://europa.eu.int/comm/public_opinion/archives/.

Chart IV

## EXPLAINING THE DUTCH "NEE"

**What are all the reasons why you voted "No" at the referendum on the European Constitution?**



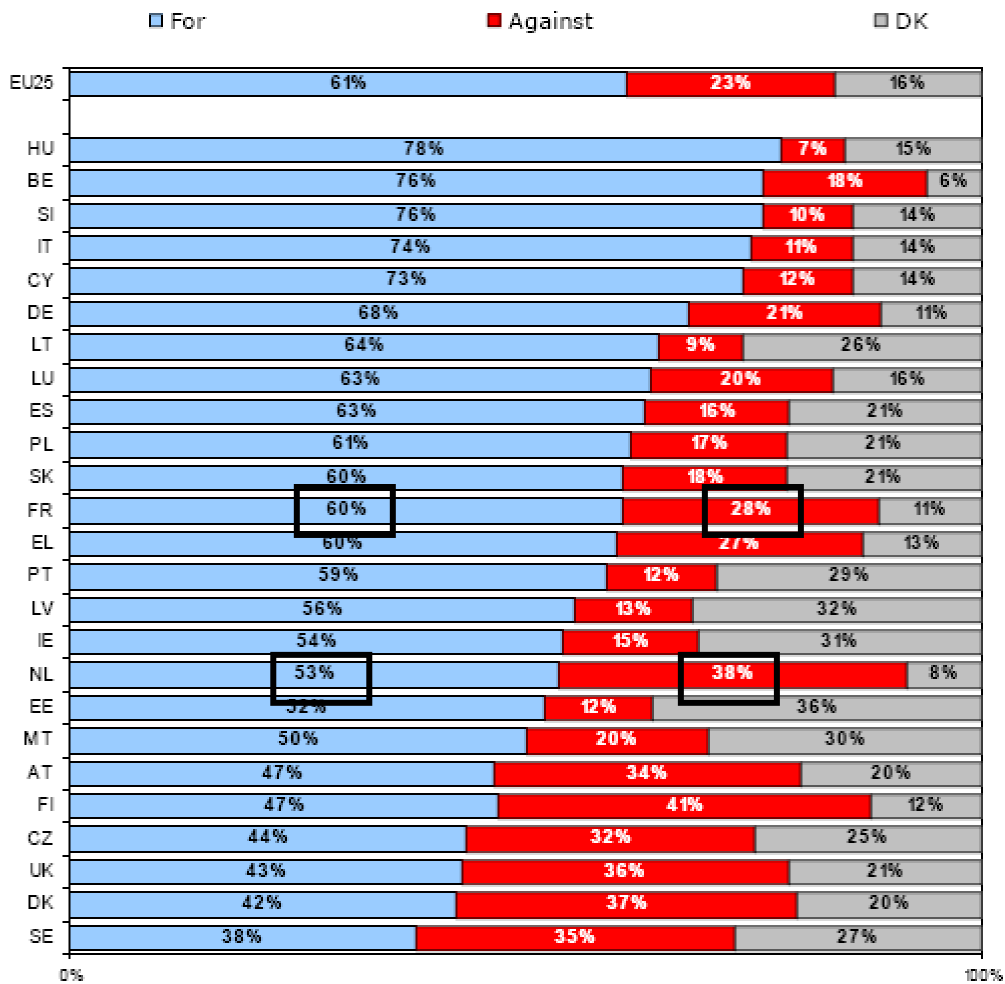

"Economic voting" motives

"Sovereignism" motives

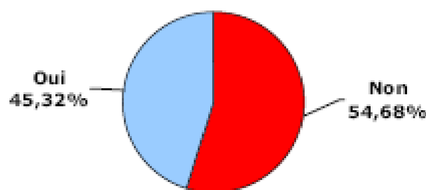
*Source:* Eurobarometer 63 *carried out between 9 May and 14 June 2005, July 2005, available at* [http://europa.eu.int/comm/public_opinion/archives/](http://europa.eu.int/comm/public_opinion/archives/).

Chart V

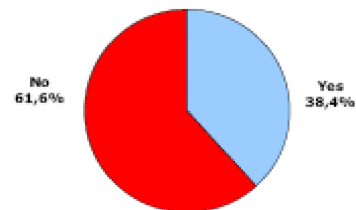
**THE BROAD SUPPORT IN THE EU FOR *A* EUROPEAN CONSTITUTION**




**France referendum result**




**The Netherlands referendum result**




"It is necessary to emphasise that this result must not be seen as an intention of how respondents would vote in a possible referendum in the countries which are considering or are planning to organise such a consultation on the Constitutional Treaty. It reflects only the extent to which respondents agree with the actual concept of a Constitution for the European Union."

*Source:* Eurobarometer 63 *carried out between 9 May and 14 June 2005, July 2005, available at* http://europa.eu.int/comm/public_opinion/archives/.

Chart VI
## EU POLITICS AND ECONOMICS: WHERE DO WE STAND

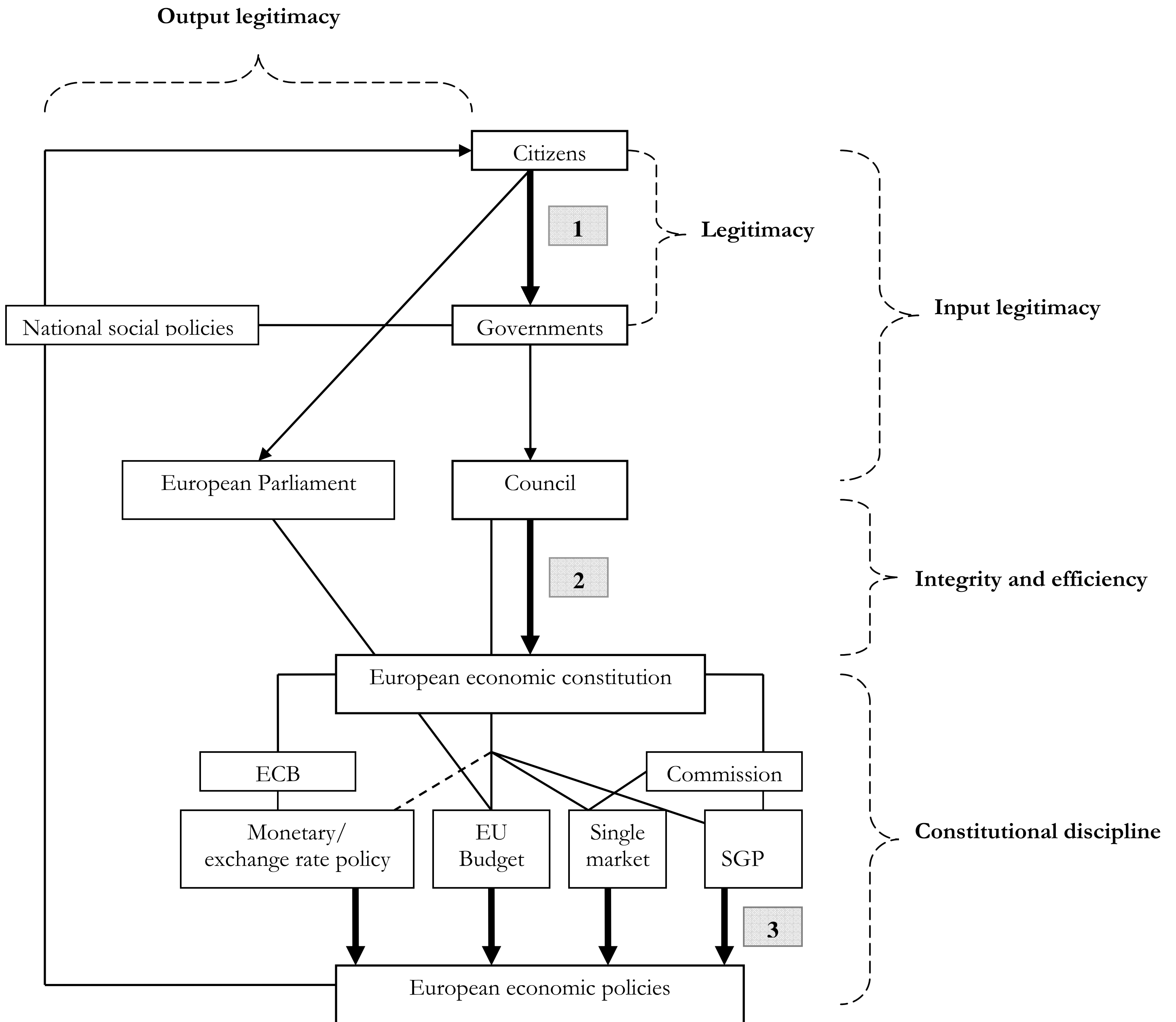
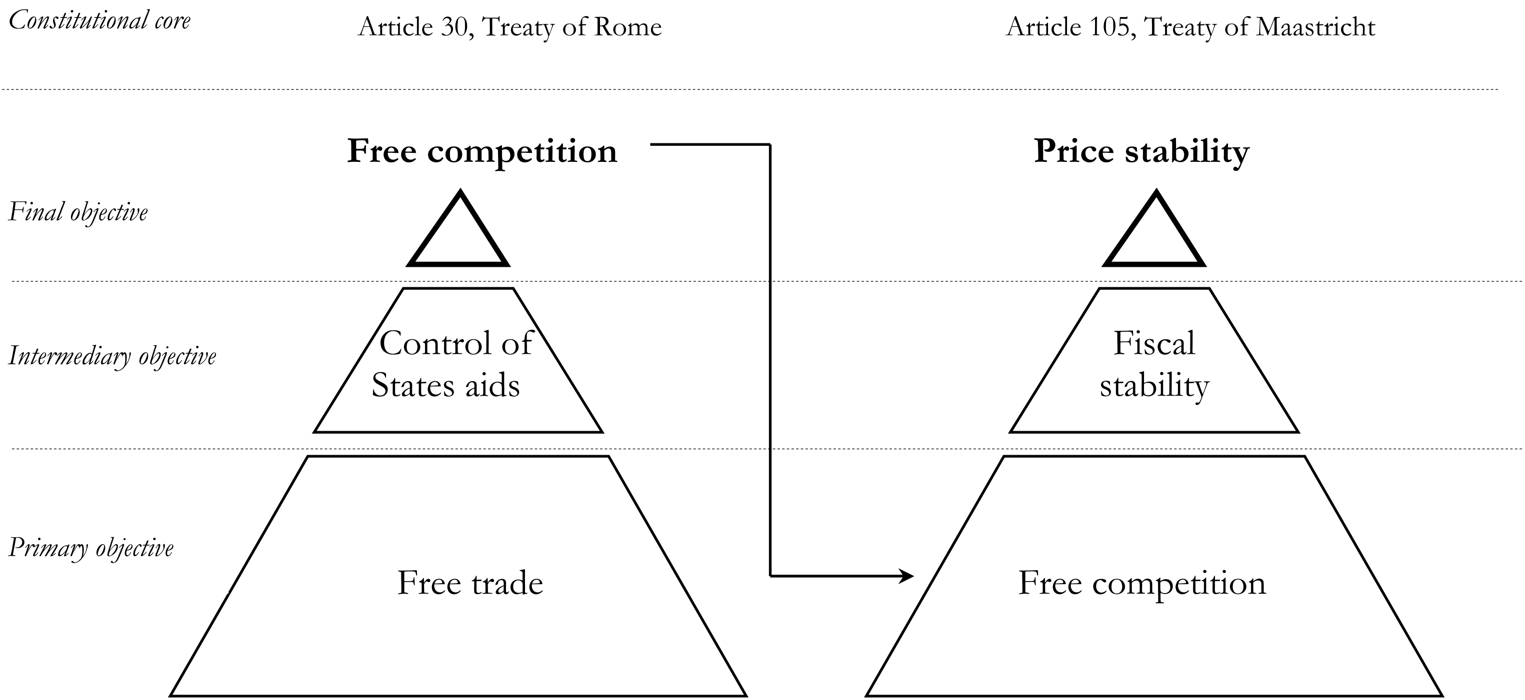


Chart VII

## THE TWO AGES OF ECONOMIC CONSTITUTIONALISM IN EUROPE




The European Economic Community (1957-1992/1993)

| | |
|---|---|
| *Primary objective* | 1957 |
| *Intermediary objective* | 1986 |
| *Final objective* | 1993 |

The European Union (1992/1993-2005)

| | |
|---|---|
| *Primary objective* | 1993 |
| *Intermediary objective* | 1999 |
| *Final objective* | 2002 |

Table I

**THE EUROPEAN ECONOMIC CONSTITUTION:[82] THE FOUR PILLARS[83]**

| ECONOMIC INSTITUTION | POLICY AREA | INSTITUTIONAL STATUS | CONSTITUTIONAL PRINCIPLE ("HARD" LAW) | CONSTITUTIONAL PROVISIONS ("HARD" AND "SOFT" LAW) | DATE OF CREATION/ ENFORCEMENT | PERFORMANCE (EU 12) | AMENDMENT PROCEDURE (SUBSTANTIAL OR FORMAL) | JUDGE |
|---|---|---|---|---|---|---|---|---|
| European central bank | Monetary policy | Full Delegation | "Price stability" and "without prejudice," "support the general economic policies in the Union" (Art. 105) | "Price stability shall be defined as a year-on-year increase in the Harmonised Index of Consumer Prices (HICP) for the euro area of below 2%. Price stability is to be maintained over the medium term" (self-assigned quantitative target in 1998); "to maintain inflation rates below but close to 2% over the medium term." (self-implemented reform in 2003). | 1992/1999 | **HICP (in % of variation)**<br>1999: 1.2<br>2000: 2.2<br>2001: 2.3<br>2002: 2.3<br>2003: 2.1<br>2004: 2.1<br>(1999–2004: 2.03) | Unanimity of EU 25 members + ECB agreement | ECJ |
| The euro | Exchange-rate policy | *De jure* shared competence (Council/ECB. Art. 111); *de facto* ECB exclusive competence since the euro is subordinated to the "price stability" principle. | Idem | None | Idem | **Real effective exchange rate (index)**<br>1999: 95.9<br>2000: 86<br>2001: 86.8<br>2002: 90.3<br>2003: 101.7<br>2004: 105.8 | | |

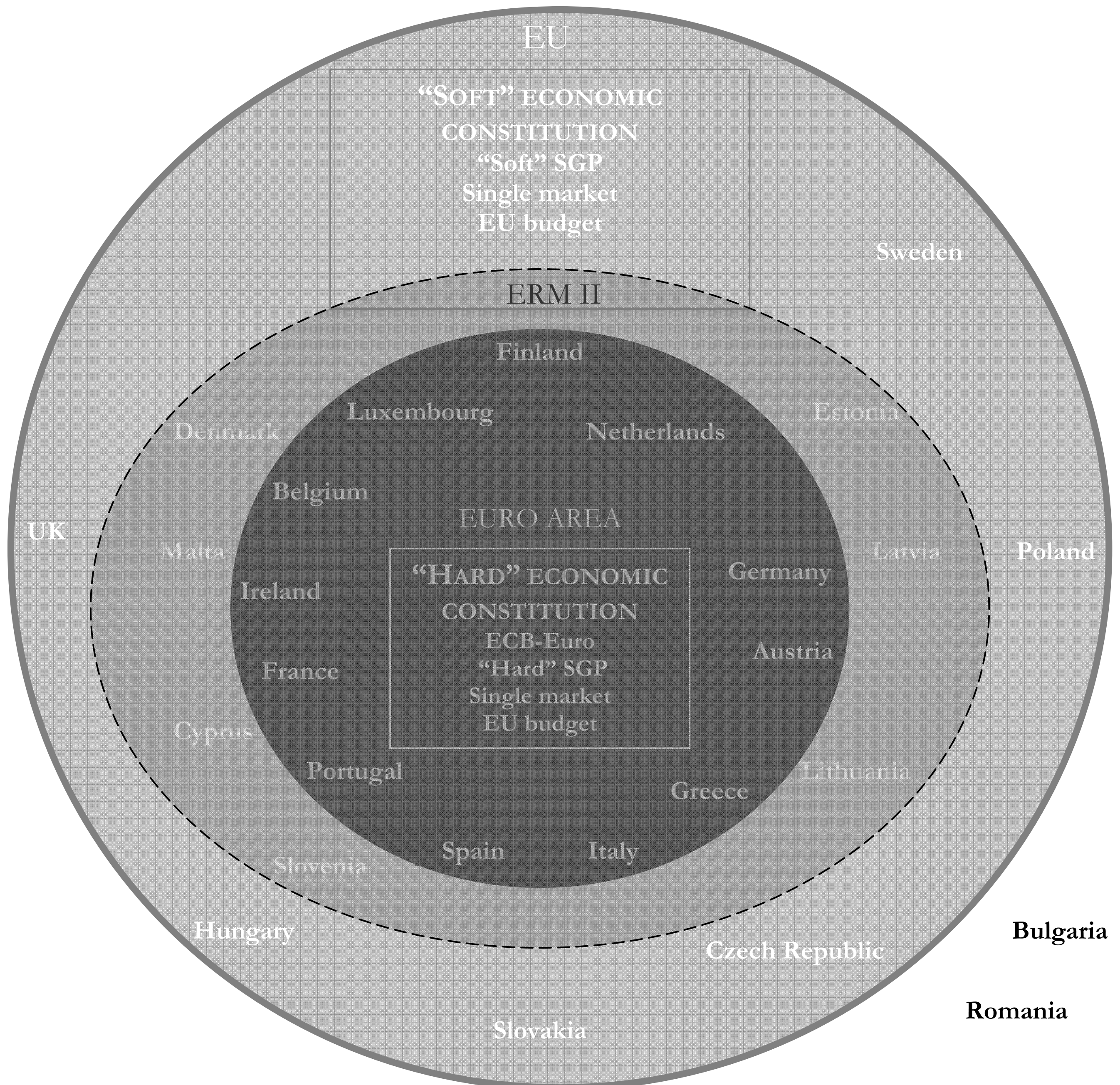
[82] Quotations and articles refer to the EUT, see footnote 20.

[83] The EU trade policy is not included here because it is an external policy. Nor are included the "strategy for employment" and the "open method of coordination" which both lack strong constitutional foundations.

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Stability and growth pact | Fiscal policy/ National level | Shared competence (Commission/Council) | "Member States shall avoid excessive government deficits." (Art. 104). | "3% for the ratio of the planned or actual government deficit to gross domestic product at market prices;" "60% for the ratio of government debt to gross domestic product at market prices." (Art. 1 of the "Protocol on the excessive deficit procedure"). | 1997/1999 | **Public deficit (% of GDP)**<br>1999: -1.3<br>2000: + 0.1<br>2001: -1.9<br>2002: -2.5<br>2003: -3<br>2004: -2.7<br>(1999–2004: -1.8)<br>**Public debt (% of GDP)**<br>1999: 72.1<br>2000: 69.7<br>2001: 69.3<br>2002: 69.2<br>2003: 70.4<br>2004: 70.8<br>(1999–2004: 70.2) | Unanimity of EU 25 members | ECJ |
| Single market | Competition policy | Full Delegation | "an internal market characterized by the abolition, as between Member States, of obstacles to the free movement of goods, persons, services and capital" (Art 3). | "Free movement of goods" (Title I); "Free movement of persons, services and capital" (Title II). | 1986/1993 | - EU trade=66% of trade in EU;<br>- Goods=80% of internal trade;<br>- Services=20% of internal trade;<br>- Capital/intra-EU FDI=4.5% of EU GDP;<br>- Migrants=1.5% of EU population. | Unanimity of EU 25 members | ECJ |
| The EU Budget | Fiscal policy/ Federal level | Shared competence (Parliament/Council) | "All items of revenue and expenditure of the Community, including those relating to the European Social Fund, shall be included in estimates to be drawn up for each financial year and shall be shown in the budget…The revenue and expenditure shown in the budget shall be in balance." (Art. 268). | "Financial framework" reform in 1988: the EU budget can not exceed 1.27 % of EU GNP. | 1957/1988 | **Budget level (% of EU GNP)**<br>1999: 1.12<br>2000: 1.13<br>2001: 1.12<br>2002: 1.18<br>2003: 1.19<br>2004: 1.15<br>(1999–2004: 1.14) | Unanimity of EU 25 members | ECJ |

Chart VIII

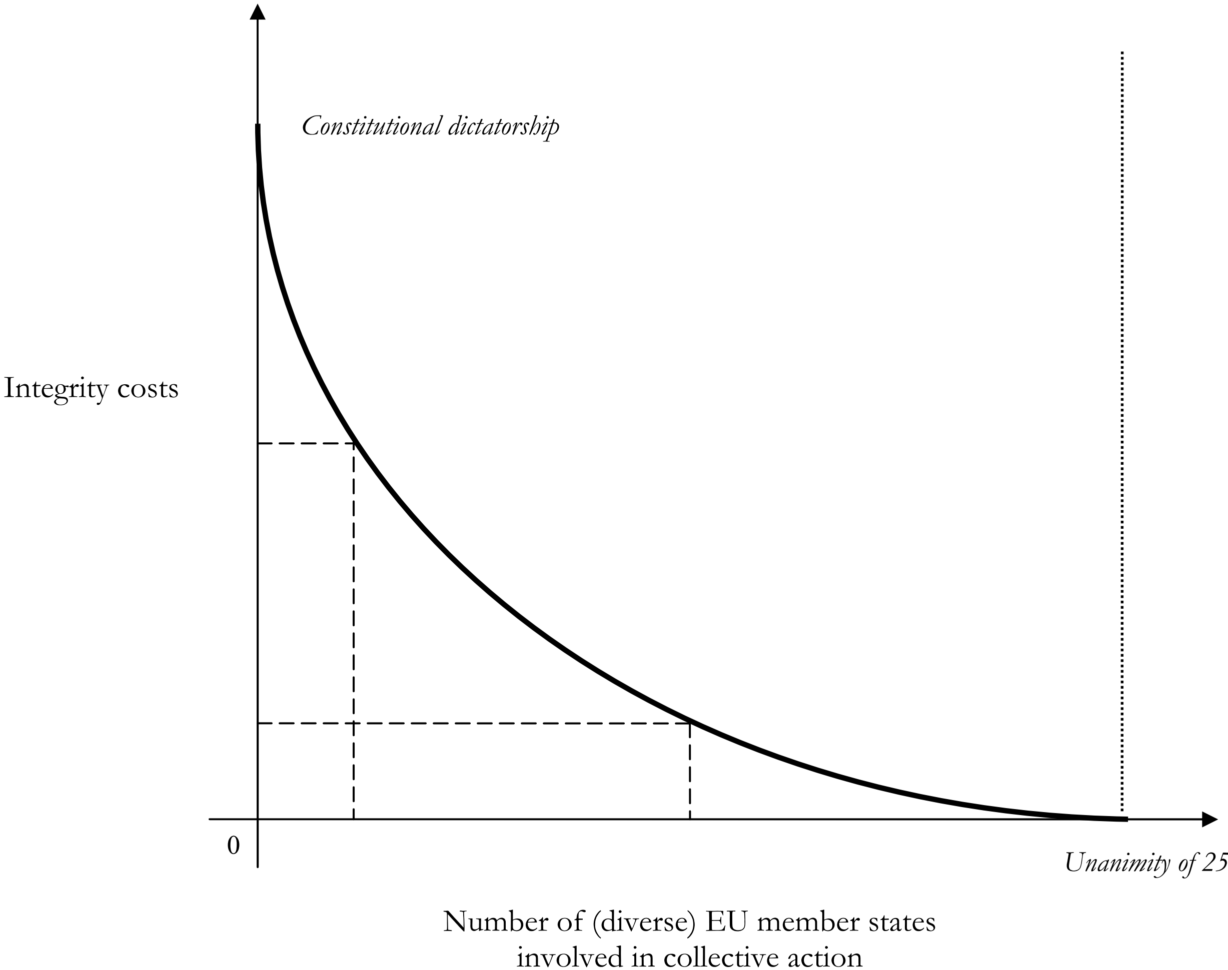
## "HARD" AND "SOFT" ECONOMIC CONSTITUTIONALISM IN THE EU[84]




*Note*: members of the ERM II (the exchange rate mechanism based on stable but adjustable central rates to the euro for the participating currencies) form an intermediary or transit area between the euro area and the EU 25 as a whole. EU countries outside the euro area (whether in the ERM II or not) must comply with the rules of the Single market and participate in the EU budget. In addition, they must present budgetary programs reflecting "convergence" (and not strictly "stability" as for the members of the euro area) of their public finances toward the criteria of the SGP. Convergence programs must also present the medium-term monetary policy objectives and the relationship of those objectives to price and exchange rate stability.

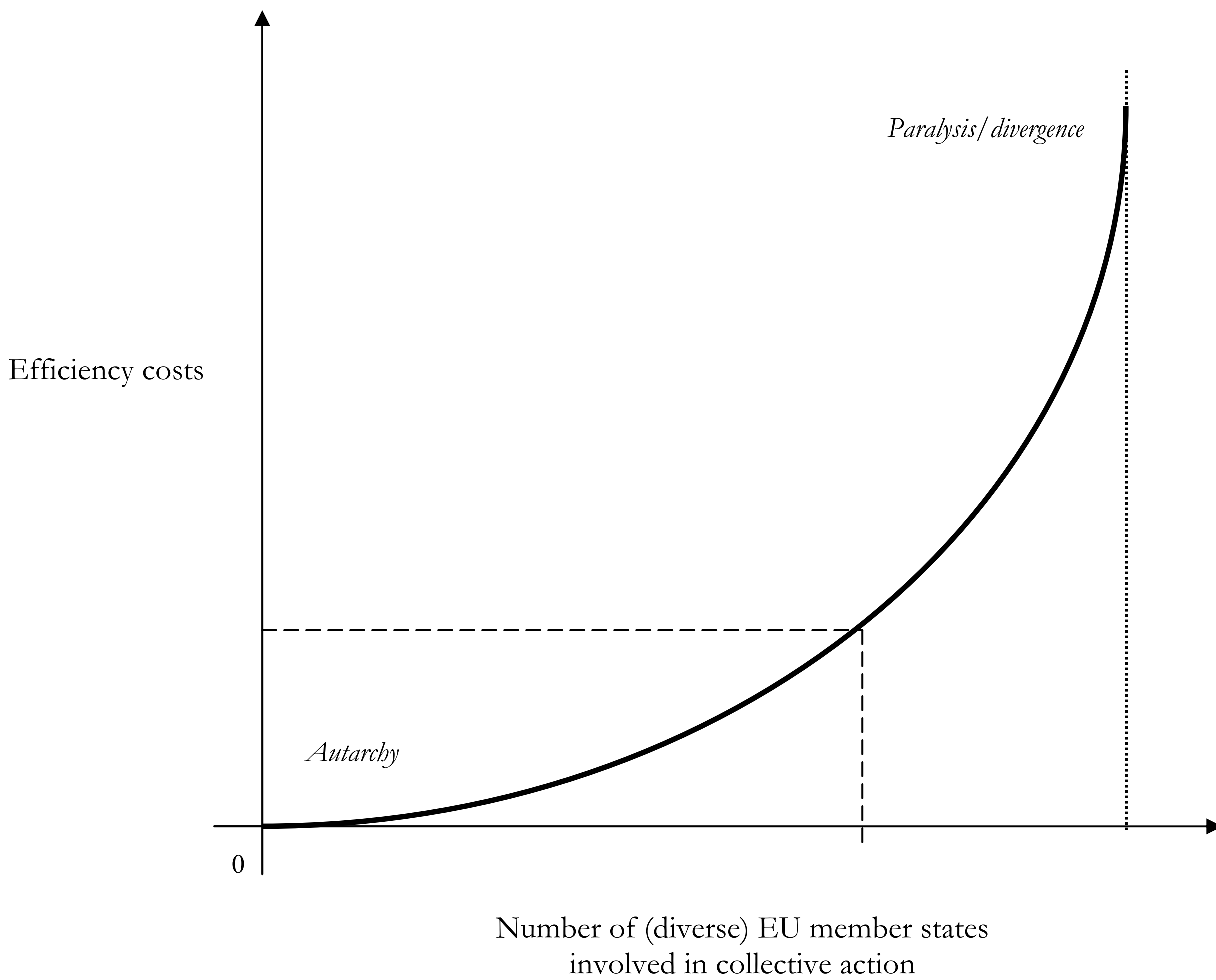
[84] As of March 2006.

## Chart IX
**THE "PRINCIPLE OF INTEGRITY"**




*Source*: Adapted from Buchanan and Tullock (1962).

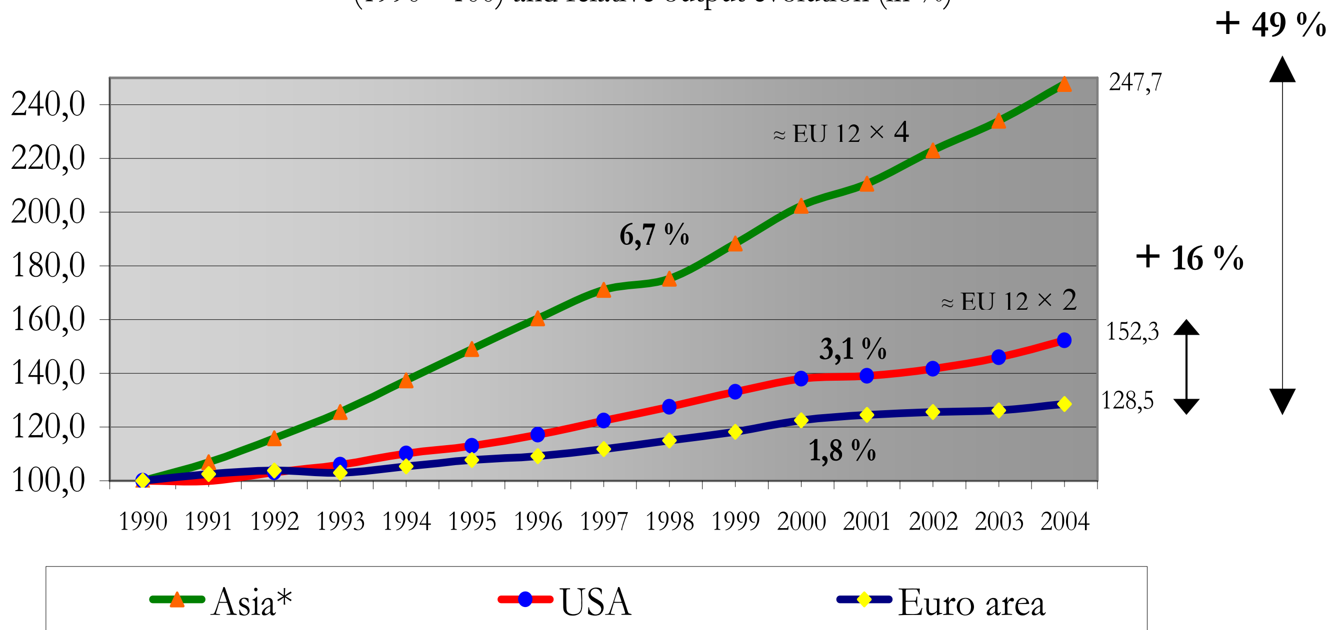
## Chart X
**THE "PRINCIPLE OF EFFICIENCY"**



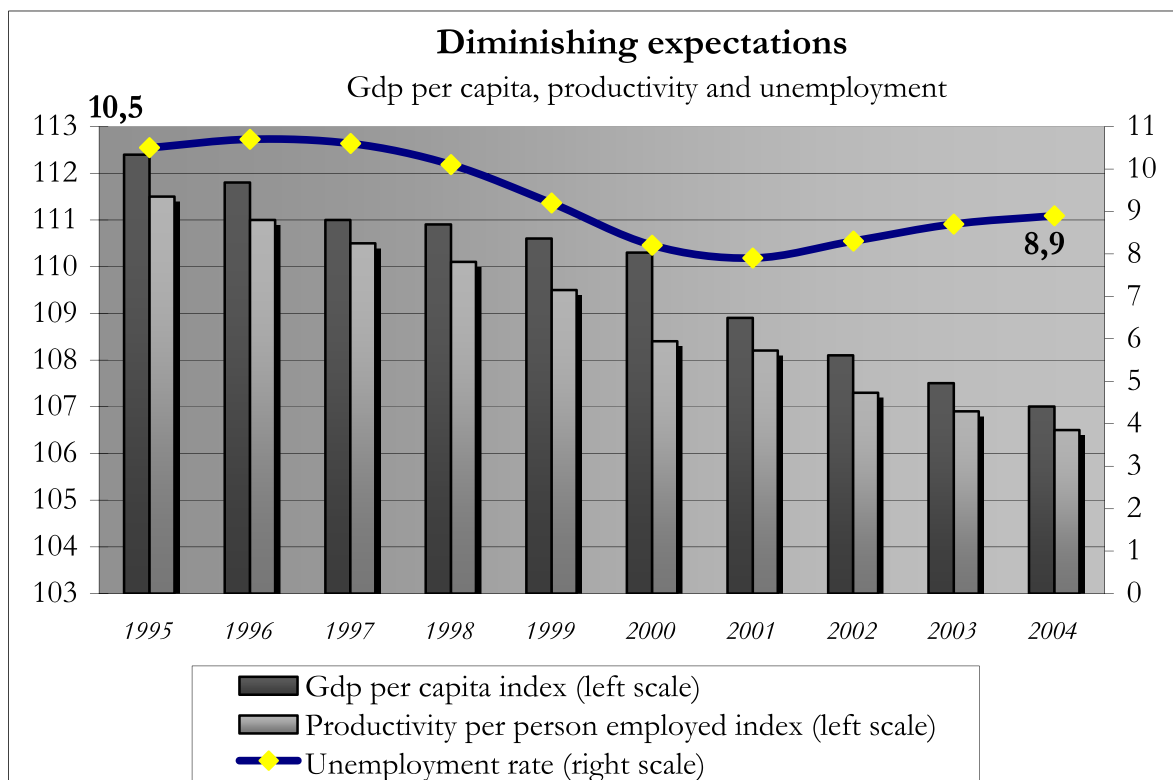

*Source*: Adapted from Buchanan and Tullock (1962).

Chart XI

**THE EURO AREA: NOT GROWING, NOR DEVELOPING...**



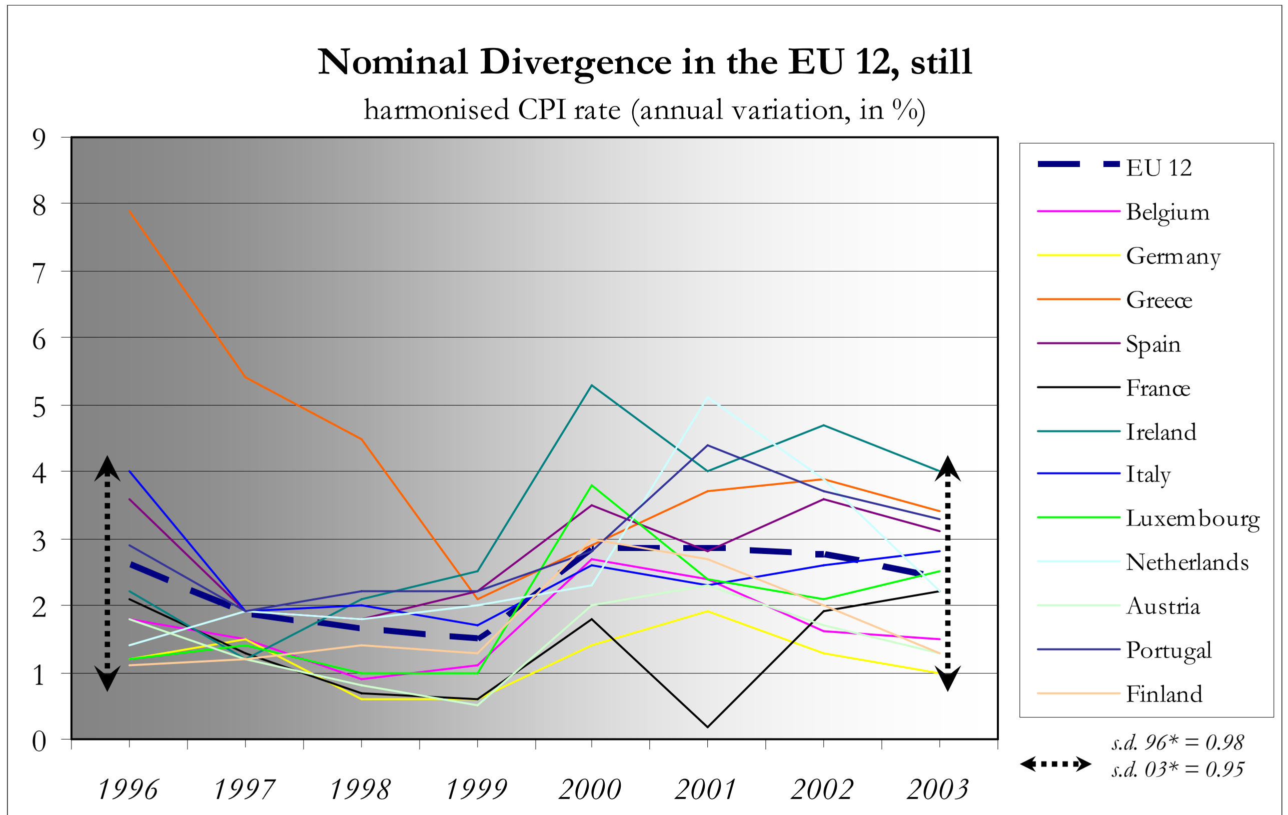

* Asia is composed of China, India, South Korea, Hong Kong, Taiwan and Singapore.
*Source*: Fitoussi and Le Cacheux (2005) and own calculations.



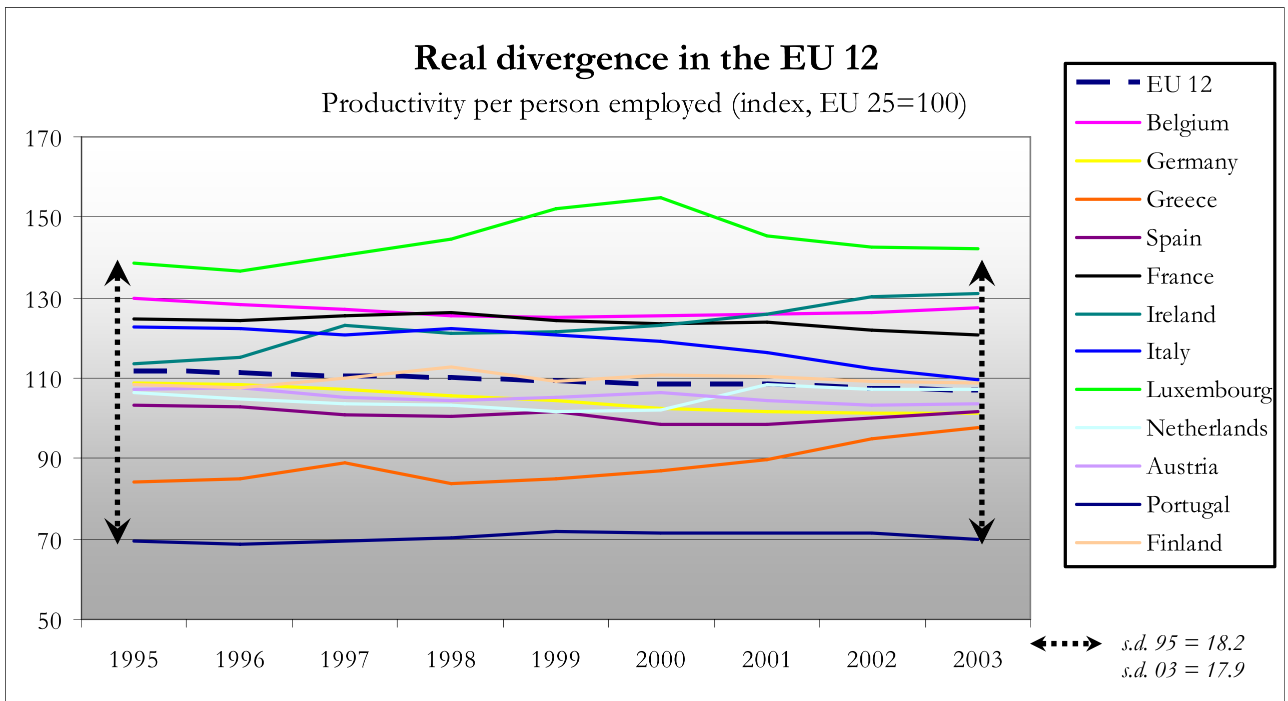

*Source:* Eurostat.

Chart XII

**...NOR CONVERGING.**




* excluding Greece.




*Source:* Eurostat.

Table II

**DEMOGRAPHIC SIZE IN THE EU 25 (AND EU 12) IN 2003**

| Country★ | Population * (*in million*) | |
|---|---|---|
| Malta | 0.4 | |
| **Luxembourg** | 0.4 | |
| Cyprus | 0.7 | |
| Estonia | 1.4 | |
| Slovenia | 2.0 | |
| Latvia | 2.3 | |
| Lithuania | 3.5 | |
| **Ireland** | 4.0 | |
| **Finland** | 5.2 | |
| Slovakia | 5.4 | |
| Denmark | 5.4 | |
| **Austria** | 8.1 | «SMALL» (19, **8**) |
| Sweden | 8.9 | |
| Hungary | 10.1 | |
| Czech Republic | 10.2 | |
| **Belgium** | 10.4 | |
| **Portugal** | 10.4 | |
| **Greece** | 11.0 | |
| **Netherlands** | 16.2 | |
| **20 m** | | |
| Poland | 38.2 | «MEDIUM» (2, **1**) |
| **Spain** | 40.7 | |
| **41 m** | | |
| **Italy** | 57.3 | |
| United Kingdom | 59.3 | «LARGE» (4, **3**) |
| **France** | 59.6 | |
| **Germany** | 82.5 | |

★ Euro area members in bold.

* As of January 1, 2003.

*Note:* A "small" state is defined as one with a population inferior to the fourth of the population of the biggest state. A "medium" state is defined as one with a population inferior to half of the population of the biggest state. "Large" states are those remaining.

Table III

**ECONOMIC SIZE IN THE EU 25 IN 2003**

(GDP AT 1995 MARKET PRICE)

*in million euros*

| | Country★ | | |
|---|---|---|---|
| | Malta | 3060.0 | |
| | Estonia | 4587.5 | |
| | Latvia | 6006.9 | |
| | Lithuania | 7473.4 | |
| | Cyprus | 9141.7 | |
| | Slovakia | 20157.2 | |
| | Slovenia | 20547.5 | |
| | **Luxembourg** | 20822.5 | |
| | Hungary | 45952.8 | |
| | Czech Republic | 49084.2 | |
| | **Ireland** | 94028.1 | **«SMALL»** |
| | **Portugal** | 100791.6 | (20, **8**) |
| | **Greece** | 120580.7 | |
| | **Finland** | 132971.4 | |
| | Poland | 141918.2 | |
| | Denmark | 161290.0 | |
| | **Austria** | 218603.4 | |
| | Sweden | 232715.9 | |
| | **Belgium** | 249184.9 | |
| | **Netherlands** | 386653.6 | |
| **539946** | | | |
| | **Spain** | 591615.8 | **«MEDIUM»** (1, **1**) |
| **1079892** | | | |
| | **Italy** | 944964.5 | |
| | UK | 1086470.6 | **«LARGE»** |
| | **France** | 1442220.8 | (4, **3**) |
| | **Germany** | 2159784.9 | |

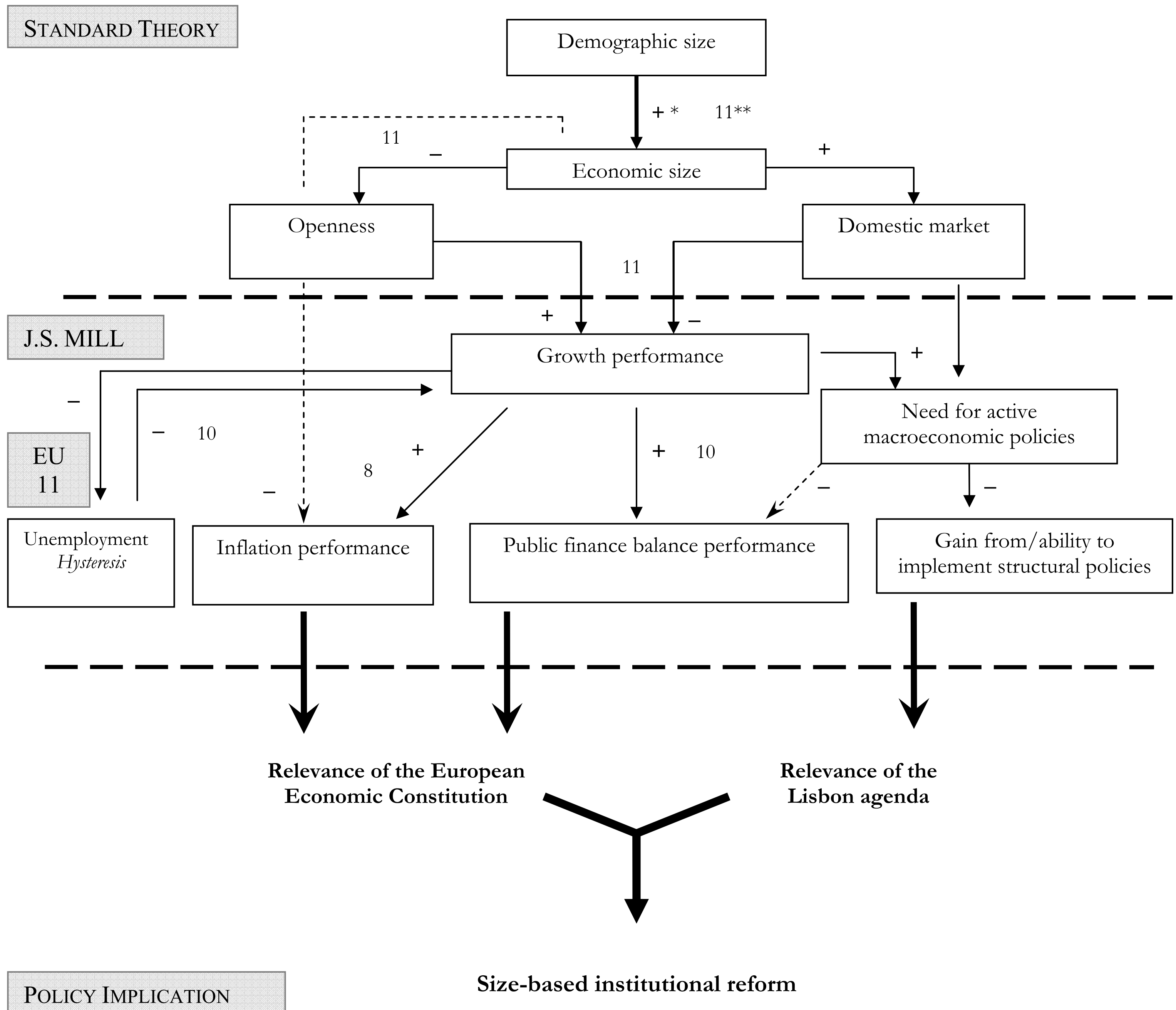
★ Euro area members in bold.

*Note*: A "small" state is defined as one with a GDP inferior to the fourth of the GDP of the biggest state. A "medium" state is defined as one with a GDP inferior to half of the GDP of the biggest state. "Large" states are those remaining.

*Source:* Eurostat.

Chart XIII

**THE "SIZE NEXUS" IN THE EU 12: A SIMPLE THEORETICAL FRAMEWORK**




*: Empirical sign of the relation (see infra).
**: Number of EU 12 countries for which a significant relation was empirically found (see infra).

Box I

## THE "SIZE NEXUS" IN THE EU 12: A BASIC EMPIRICAL STRATEGY

**— The data —**

Given the small number of countries belonging to the euro area (12 in 2006) and its young age (the Euro was launched in 1999 and became public in 2002), a lot of studies assessing the performance of the European economy crucially rely on "subjective data," following the concepts developed and publicized by the OECD. The most widely used are, quantitatively, the "output gap" (and its derivatives: "structural" growth, "structural" unemployment…) and, qualitatively, "labor market rigidity" indexes (such as "employment protection," "coordination," "centralization"…).

In order to test our hypotheses we have chosen instead to rely on (the most possible) "objective" and recent freely available data. They largely come from Eurostat (with the exception of "openness" data, which come from OECD). This choice has its own serious limitations.

Our data cover the 1996-2003/2004 period. This is the only timeframe where two conditions are satisfied in order to evaluate the effects of the European economic constitution and the related issue of (country) size. First, the European economic constitution, partly implemented in 1993 and renewed in 1992 (see Section 4), is in place by the beginning of the period and fully in effect by the middle of it. Second, a certain convergence has taken place before the beginning of our period (although we show that it was not deepened by the European economic constitution).

Our dataset comprises 11 of the 12 euro area countries. We have chosen not to include Spain because it is the only "medium" country of the EU12. Our results thus really shed light on the gap in performance between "large" (the "big 3") and "small" (the "small 8") countries of the euro area.

If size really matters, as we argue, then our results could be very fragile. The dataset on which we perform our estimations can indeed seem very small by the standard of contemporary econometrics. However, one should keep in mind that ours is not a sample, but the population itself. By the same token, the exclusion of one or more outliers in some regressions is in our view counterbalanced by their economic significance. None do encompass less than 94 percent of the EU 11 GDP, 62 percent of the small states and 100 percent of large states. Furthermore, even if the number of observations is obviously small, each is an average calculated on the 1996-2004 period. Finally, correlation coefficients and individual coefficients obtained are quite strong. To further allow the reader to test the validity of our methodology, we have added a table containing our data that we use to compare them to other countries outside the euro area (Table V and Section 6). It shows that "estimations" provided by means are close to those obtained by OLS regression.

**— The theoretical framework —**

The issue is to determine how our theoretical framework (described in Chart XIII) compares to standard economic theory. Two questions emerge. The first one is the relation between population and growth levels. We assume that the two are highly correlated and that population causes GDP levels and not the other way around. In doing so, we rely on the basic assumptions underlying the standard production function that relates population (labor, skilled or not), capital and technical progress to output. But one could then argue that population should be represented by the labor force and not total population.

However this measure would only account for production and not consumption, while we are interested in the size of the domestic market.

Another related question is how to avoid the reverse causation between size and macroeconomic performance. If GDP levels are used as the size variable, then high inflation and low public deficit could cause high GDP levels, and not the reverse. This is why we use demographic size as a proxy for economic size. Demographic size is almost perfectly correlated to economic size and the direction of this correlation is un-ambiguous. The direction of the correlation between demographic size and economic performances is also un-ambiguous.

A further assumption is that since demographic size is a proxy for economic size, economic size is mediated by openness, which effect on growth captures both the importance of openness and, conversely, the importance of the domestic market. We can indeed write approximately that GDP = domestic market + trade with the world. Hence that domestic market = GDP-openness (defined as the trade to GDP ratio).

Our measure of demographic size, in percentage of the total, is unconventional. As explained in Section 6, we wanted a comparative measure of demographic size and not an absolute one (like logs of population), i.e. a significant measure of the weight of each country in the euro area.

**— The models —**

We estimate four models:

1) The first one reveals approximations and mediations between demographic size, economic size and openness when regressed on real economic growth (Table VI-A);

2) The second one attempts to test the quality of the univariate regression of size on growth by confronting it to two other hypotheses: the "social nexus" and the endogenous growth theory (Table VI-B);

3) In the third, which is two-fold (Table VI-C & Table VI-D), inflation and public deficit regressions are tested to see if the only effect of openness on their variances runs through growth or if a direct effect of size exists on either or both;

4) Finally, size regressions on unemployment and long-term unemployment are tested against the "social nexus" hypothesis (Table VI-E & Table VI-F).

**— The results —**

**-** We first find, as expected, that size influences real growth in the EU 12. Economic size is proxied by demographic size and size is mediated by openness in influencing the real growth of GDP.

**-** Our results are also useful to understand the effect of size on the conduct of macroeconomic policy in the euro area. In particular, they reveal a systematic divergence between small and large countries in terms of inflation and public deficit. However, the inflation coefficient is weaker and more fragile than the public deficit coefficient, which appears on the contrary too strong. As regards inflation, the reason might be that the European economic and monetary integration has lowered the importance of domestic factors in predicting accurately inflation rates. Another explanation could be the consequence of competitive strategies undertaken by small countries in the European context. Whatever the reasons, the weakness of the coefficient must not lead to the conclusion that size and monetary policy are merely un-related. The consequence of a uniform restrictive monetary policy on large countries and on euro area weighted

growth appears very real (see Chart XVII). As for public deficits, the direct effect of size is positive: the bigger the economy, the larger the need for macro stabilization, the bigger the deficit.

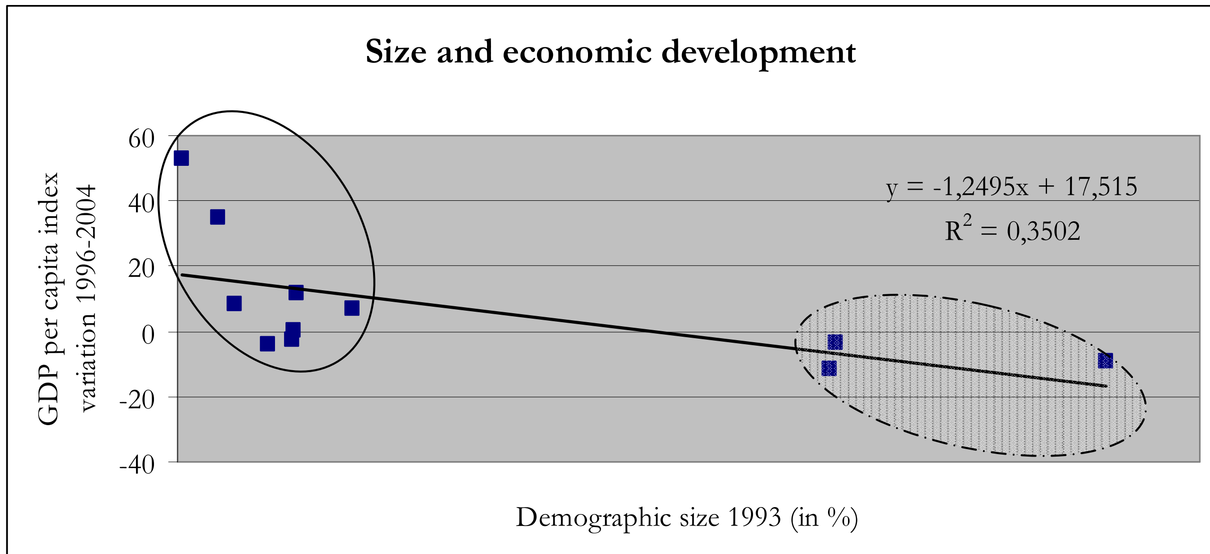
- We find that GDP per capita and real GDP growth are negatively correlated with size in the EU 12 and that openness is strongly and negatively correlated with size. Size, it seems, determines openness that in turn determines growth, inflation and public deficit performance. The results presented in Alesina and Spolaore (2003) suggest that GDP per capita and real GDP growth should be positively associated with size, but that openness*size should be negatively correlated with both, giving small open economies a comparative advantage in a globalized world. Our results being contradictory to this finding, we are able to interpret them as the symptom of the development of a specific kind of growth process in the euro area brought about by the implementation of the European economic constitution.

- Our results, as limited as they are, could thus shed some light on the nature of the European growth. One would expect, according to a standard result of the endogenous growth theory, that GDP per capita and GDP levels would be connected to growth rates and, from there, to macroeconomic performances. As noted in Alesina, Spolaore & Warcziarg (2005), "scale effects may be more present in the increasing returns, endogenous growth phase that characterises advanced industrialized countries." We find the opposite: GDP levels, represented by population levels, and GDP per capita levels, are negatively correlated to growth rates.

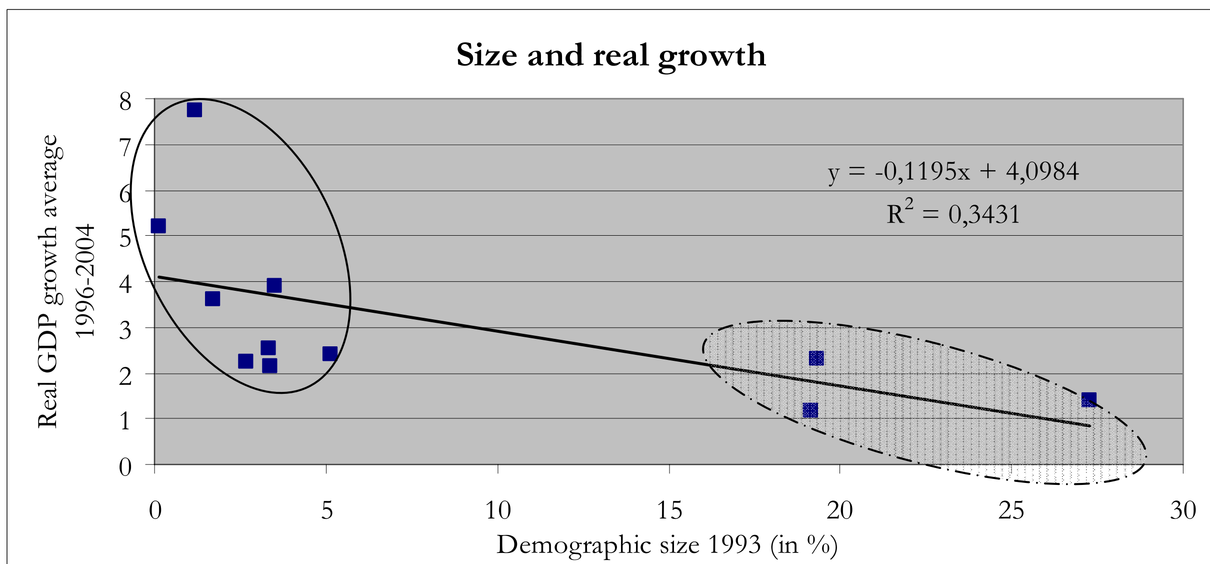
The growth process in the EU therefore appears more "Smithian" than "Schumpeterian" (Parker, 1984), but in a very specific way. We propose to call it "Millian" in reference to the arguments developed by J. S. Mill on the impact of country size on trade benefits (see Section 6). Hence, the "Millian" growth in the EU designates the bias of the growth process in favor of small open countries that end up doing systematically better than large ones under the European economic constitution. The (Solow) hypothesis of a simple catch-up by small member states should be rejected both because of the dynamic shown in Table IV-A and IV-B and of the results of the regression of GDP per capita level on growth.

- Finally, our last result regards the existence of a "social nexus" in the euro area. We find that the "size nexus" does a much better job at explaining differences in unemployment and long-term unemployment than a "social model" based explanation (see Charts XVIII to XX and Section 6 for an explanation).

Chart XIV
**THE "SIZE NEXUS" IN THE EU 12: DEVELOPMENT & GROWTH**

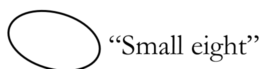



Difference between "small eight" and "big three" = 24.08
Coefficient significant at 5 %.




Difference between "small eight" and "big three" = 2.3
Coefficient significant at 5 %.

*Source*: Eurostat.

 "Small eight"

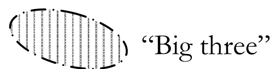
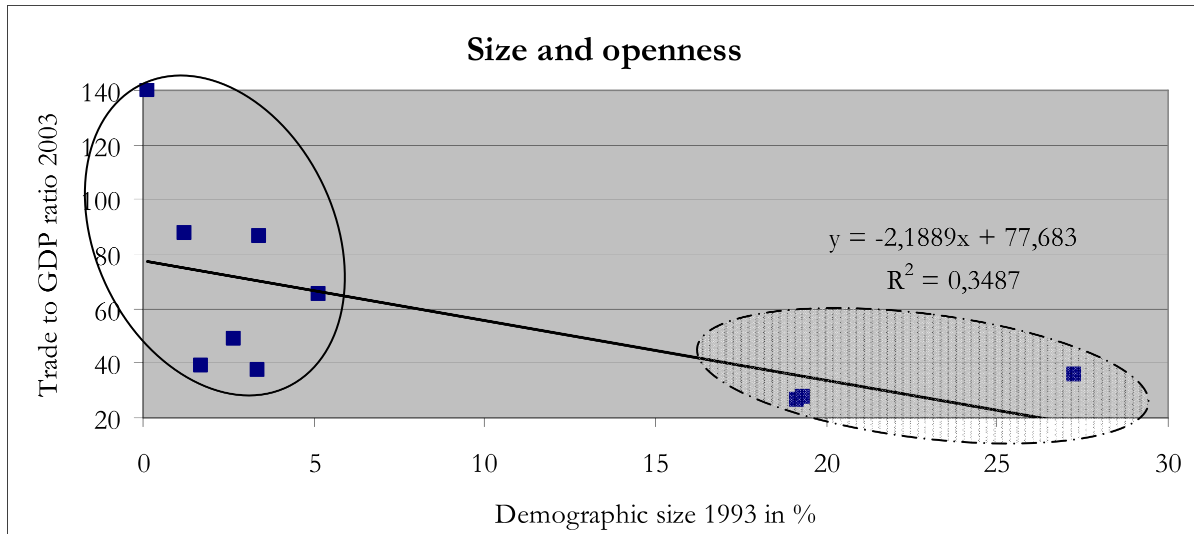
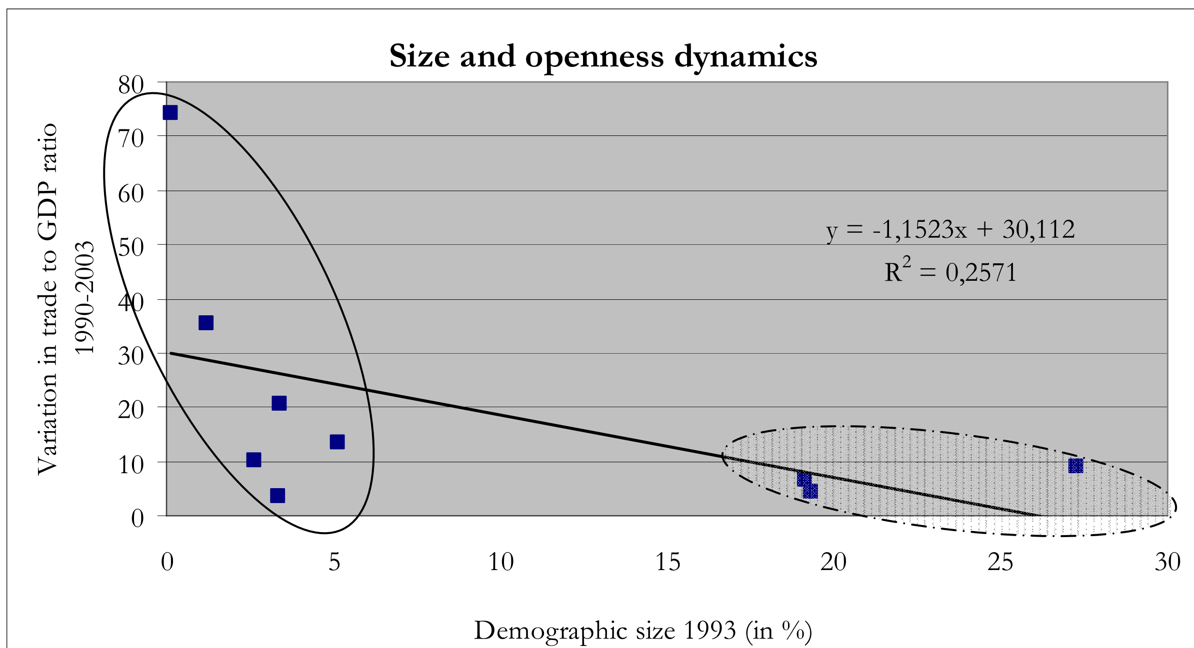
 "Big three"

Chart XV
## THE "SIZE NEXUS" IN THE EU 12: OPENNESS




OLS regression without Greece.
Difference between "small eight" and "big three" = 42.
Coefficient significant at 10 %.

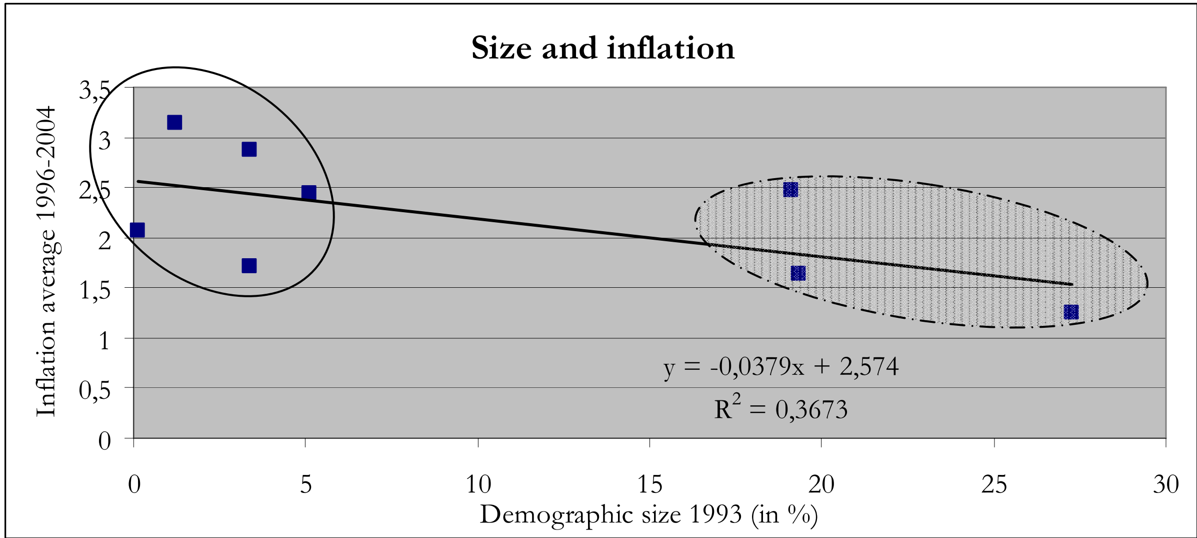



OLS regression without Greece and Finland.
Difference between "small eight" and "big three" = 21.
Coefficient significant at 10%.

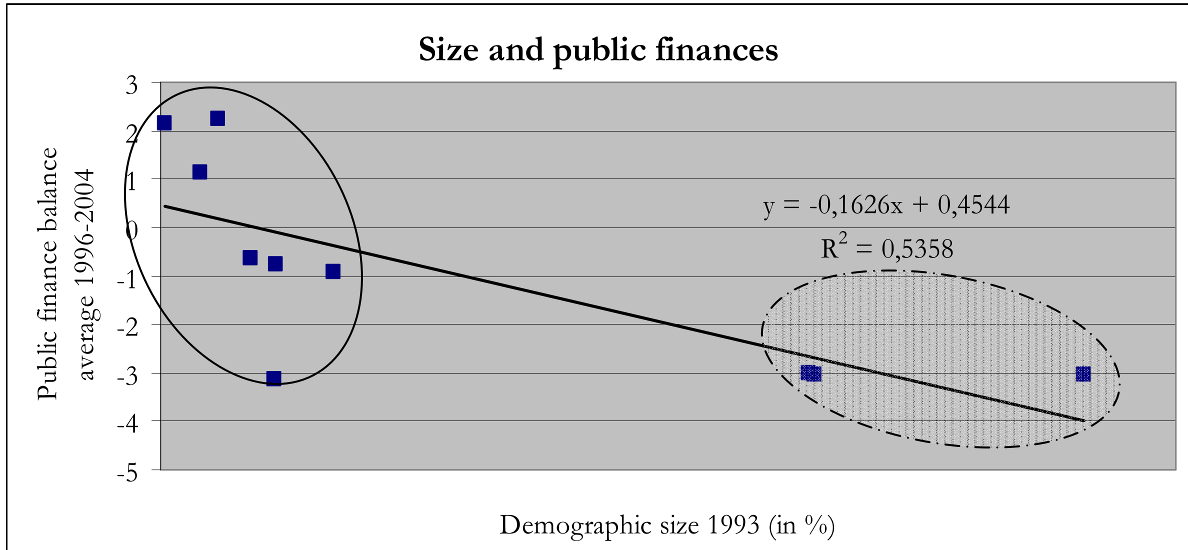
*Source*: OECD.

"Small eight" "Big three"

Chart XVI
**THE "SIZE NEXUS" AND MACROECONOMIC MANAGEMENT**



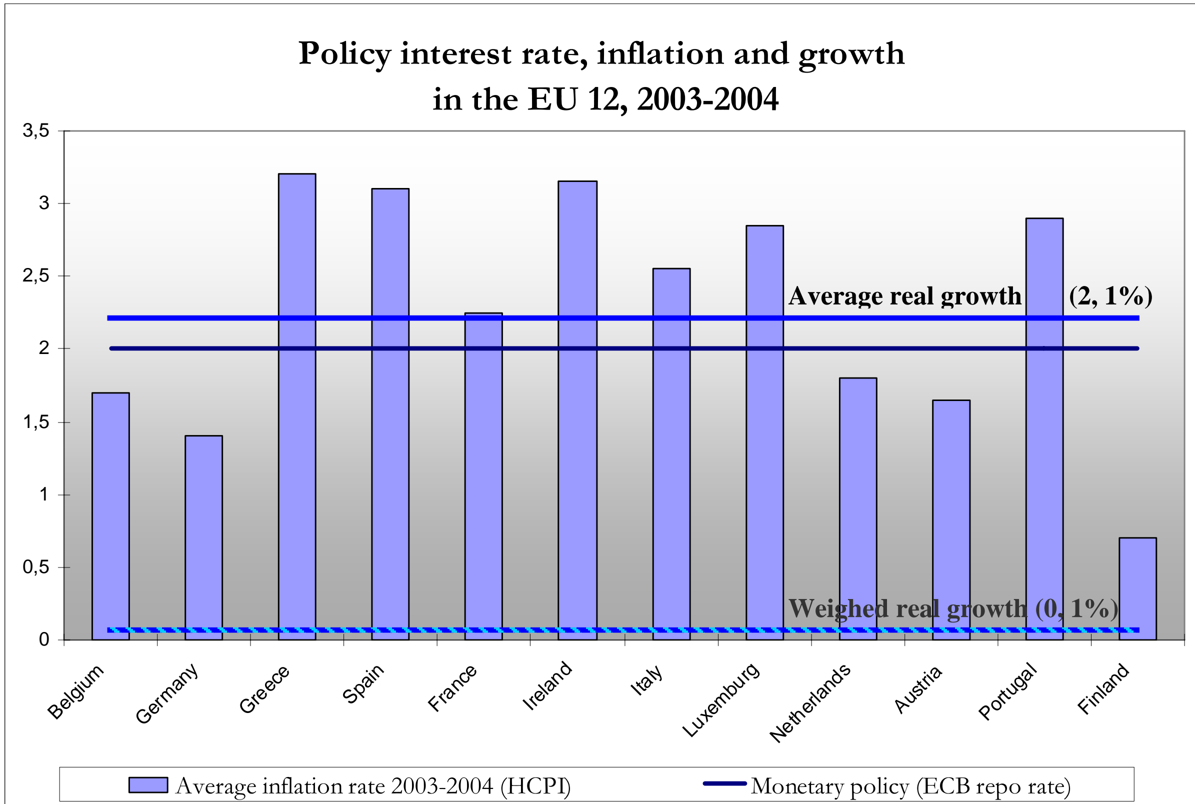

OLS regression without Greece, Finland and Austria.
Difference between "small eight" and "big three" = 0.73
Coefficient significant at 10%.

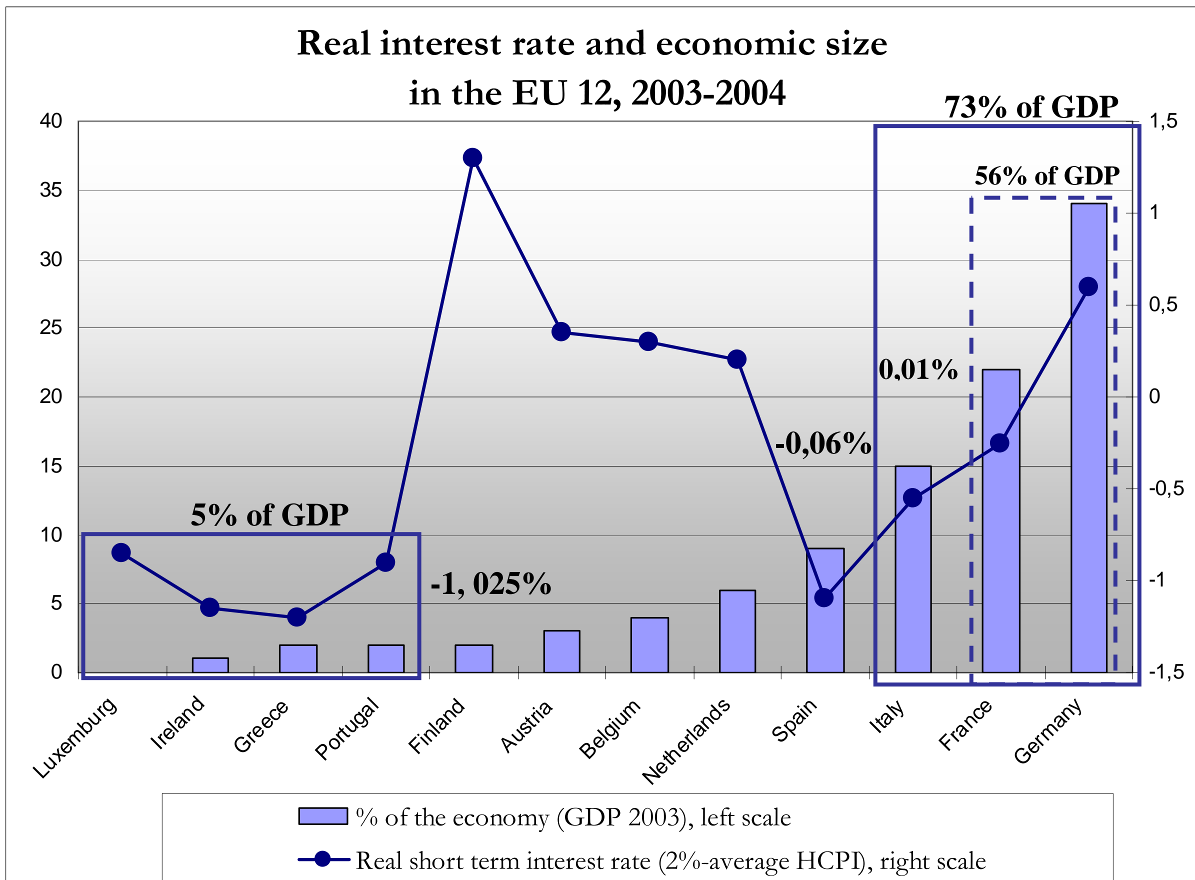



OLS regression without Greece.
Difference between "small eight" and "big three" = 3.12
Coefficient significant at 1 %.

*Source:* Eurostat.

Chart XVII
## THE "SIZE PENALTY" OF MONETARY POLICY




*Source:* Eurostat.

Table IV-A

## THE "SIZE NEXUS": AN HISTORICAL PERSPECTIVE

Productivity of labor
(GDP per hour worked, in 1990 $)

| | 1950 | 1973 | 1990 | 1998 |
|---|---|---|---|---|
| Austria | 4.05 | 15.17 | 24.05 | 27.07 |
| Belgium | 6.19 | 16.89 | 27.44 | 33.57 |
| Finland | 4.28 | 13.81 | 20.27 | 25.69 |
| Ireland | 3.73 | 9.84 | 21.66 | 27.05 |
| Netherlands | 6.67 | 19.49 | 30.15 | 30.62 |
| Average Small 5* | 4.9 | 15 | 24.7 | 28.8 |
| Italy | 4.38 | 15.92 | 24.08 | 27.9 |
| France | 5.82 | 18.02 | 29.47 | 33.72 |
| Germany | 3.99 | 14.76 | 21.94 | 26.56 |
| Average Big 3 | 4.7 | 16.2 | 25.2 | 29.4 |
| **Convergence** diff. Small(s)-Large(s) | 0.25 | -1.19 | -0.45 | -0.59 |
| **Convergence** (std. dev. EU 12*) | 1.15 | 2.93 | 3.72 | 3.19 |
| Average EU 12* | 4.89 | 15.49 | 24.88 | 29.02 |
| USA | 12.65 | 23.72 | 30.10 | 34.55 |
| **Catch-up** (diff. USA-EU 12*) | 7.76 | 8.23 | 5.22 | 5.53 |

* No data for Luxembourg, Portugal and Greece.

Table IV-B
**THE "SIZE NEXUS": AN HISTORICAL PERSPECTIVE**

GDP per capita
(in 1990 $)

| | **1950** | **1973** | **1990** | **1998** |
|---|---|---|---|---|
| Austria | 3706 | 11235 | 16881 | 18905 |
| Belgium | 5462 | 12170 | 17194 | 19442 |
| Finland | 4253 | 11085 | 16868 | 18324 |
| Ireland | 3446 | 6867 | 11825 | 18183 |
| Netherlands | 5996 | 13082 | 17267 | 20224 |
| Average Small 5* | 4573 | 10888 | 16007 | 19016 |
| Spain | 2397 | 8739 | 12210 | 14227 |
| Italy | 3502 | 10643 | 16320 | 17759 |
| France | 5270 | 13123 | 18093 | 19558 |
| Germany | 3881 | 11966 | 15932 | 17799 |
| Average Big 3 | 4218 | 11911 | 16782 | 18372 |
| **Convergence** diff. Small(s)-Large(s) | 355 | -1023 | -775 | 644 |
| **Convergence** (std. dev. EU 12*) | 993 | 1994 | 1919 | 903 |
| Average EU 12 | 4440 | 11271 | 16298 | 18774 |
| USA | 9561 | 16689 | 23214 | 27331 |
| **Catch-up** (diff. USA-EU 12*) | 5122 | 5418 | 6917 | 8557 |

* No data for Luxembourg, Portugal and Greece.

*Note*: according to Abramovitz (1989), "catch-up" is the narrowing of the productivity gap compared to the leading country and "convergence" is the narrowing of the gap among follower countries.

*Source: A. Madison*, The World Economy: A Millennial Perspective *(Paris: OECD, 2001) and own computations.*

Table V

**THE SIZE NEXUS: A GEOGRAPHICAL PERSPECTIVE**

| Country | Demographic size 2003<br><br>Population share in EU 12 (in %) | Economic size 2003<br><br>GDP level share in EU 12 (in %) | GDP per capita in 2003<br><br>Index EU 25=100 | Real GDP growth<br><br>Average 1996-2004 | Inflation<br><br>Average 1996-2004 | Public finance balance<br><br>Average 1996-2004 |
|---|---|---|---|---|---|---|
| Luxembourg | 0.13 | 0. 32 | 213 | 5.19 | 2.07 | 2.15 |
| Ireland | 1.2 | 1.46 | 136 | 7.73 | 3.14 | 1.13 |
| Portugal | 3.36 | 1.56 | 77 | 2.54 | 2.88 | -3.12 |
| Greece | 3.51 | 1.87 | 81 | 3.89 | 4.09 | -4.88 |
| Finland | 1.7 | 2.06 | 113 | 3.62 | 1.57 | 2.24 |
| Austria | 2.66 | 3.38 | 121 | 2.26 | 1.51 | -0.63 |
| Belgium | 3.39 | 3.86 | 117 | 2.16 | 1.71 | -0.78 |
| Netherlands | 5.13 | 5.98 | 126 | 2.41 | 2.44 | -0.92 |
| Mean/median "small eight" | 2.63/3.01 | 2.88/2.06 | 123/119 | 3.73/3.08 | 2.43/2.25 | -0.60/-0.70 |
| Sweden[Δ] | 2* | 3* | 114 | 2.73 | 1.51 | 1.82 |
| Iceland and Norway | - | - | 131.15 | 3.47 | 2.44 | 4.56 |
| Italy | 19.14 | 14.62 | 106 | 1.18 | 2.47 | -3.02 |
| France | 19.32 | 22.32 | 112 | 2.32 | 1.63 | -3.03 |
| Germany | 27.27 | 33.42 | 109 | 1.41 | 1.26 | -3.04 |
| Mean/median "big three" | 21.91/19.32 | 23.4/22.32 | 109/109 | 1.64/1.41 | 1.79/1.63 | -3.03/-3.03 |
| UK | 13* | 13* | 118 | 2.89 | 1.47 | -1.55 |
| USA and Canada[85] | - | - | 140.7 | 3.3 | 2.4 | -0.3 |
| Stand. dev. EU 11 | 9.33 | 10.97 | 35.70 | 1.90 | 0.86 | 2.37 |

*Source*: Eurostat

[Δ] Sweden was chosen as the typical non-Euro area small country over Denmark because the latter is a member of the exchange rate mechanism II (ERM II). As such it is closer to the third-phase of EMU (see Chart VIII).
* In the EU 25.
[85] 1996-2003 data.

Table VI

**THE “SIZE NEXUS”: MULTIVARIATE ANALYSIS**

## Table VI-A: size(s), openness and growth

| Dependent variable: growth rate of real GDP 1996-2004 | | | | | |
|---|---|---|---|---|---|
| | (1) DEMO. SIZE | (2) ECO. SIZE | (3) OPENNESS | (4) SIZE & SIZE | (5) OPEN * SIZE |
| Demographic size Population 1993 | -0.119467** ( 0.055102) | - | - | -0.295037 (0.337969) | - |
| Economic size GDP 1993 | - | -0.094372* (0.047522) | - | 0.149349 (0.283310) | - |
| Openness 1995 | - | - | 0.057511* (0.027953) | - | - |
| Openness * Demo. | - | - | - | - | -0.005718** (0.002303) |
| Number of EU 12 countries | 11 | 11 | 11 | 11 | 11 |
| Constant | 4.098371*** (0.655377) | 3.943648*** (0.641852) | 0.835909 (1.232896) | 4.236735*** (0.732038) | 4.449751*** (0.699296) |
| Adjusted R-squared | 0.34 | 0.30 | 0.32 | 0.20 | 0.40 |

## Table VI-B: size and growth

| Dependent variable: growth rate of real GDP 1996-2004 | | | | |
|---|---|---|---|---|
| | (1) SIZE NEXUS | (2) ENDOGENOUS | (3) SOCIAL | (4) GLOBAL |
| Demographic size Population 1993 | -0.119467** ( 0.055102) | -0.113155* (0.053887) | -0.099593** (0.042840) | -0.102224*** (0.032271) |
| GDP per capita level 1995 | - | -0.033993 (0.030799) | - | -0.042609** (0.016792) |
| Productivity average 1996-2004 | - | 0.066970 (0.043118) | - | 0.059866** (0.022038) |
| Social transfers by public administrations average 1996-2003 | - | - | 0.246975 (0.227024) | 0.337888* (0.194458) |
| Total expenditures by public administrations average 1996-2003 | - | - | -0.330765** (0.118488) | -0.361905*** (0.099215) |
| Constant | 4.098371*** (0.655377) | 0.444848 (2.967036) | 15.85544*** (3.328531) | 14.09211*** (3.367158) |
| Number of EU 12 countries | 11 | 11 | 11 | 11 |
| Adjusted R-squared | 0.34 | 0.30 | 0.66 | 0.82 |

## Table VI-C: size and inflation

| Dependent variable: inflation rate average 1996-2004 | | | | | |
|---|---|---|---|---|---|
| | (1)<br>SIZE NEXUS | (2)<br>OPENNESS | (3)<br>REAL GROWTH | (4)<br>ECO. SIZE | (5)<br>OPEN * SIZE |
| Demographic size<br>Population 1993 | -0.037899*<br>(0.020308) | - | - | - | - |
| Economic size<br>GDP 1993 | - | - | - | -0.035862**<br>(0.015536) | - |
| Openness<br>1995 | - | 0.011999<br>(0.012364) | - | - | - |
| Real GDP growth<br>Average 1996-2004 | - | - | 0.159782<br>(0.099710) | - | - |
| Openness * Demo | - | - | - | - | -0.001770*<br>(0.000935) |
| Constant | 2.573971***<br>(0.281189) | 1.667945**<br>(0.793440) | 1.701791***<br>(0.373803) | 2.582737***<br>(0.245088) | 2.702412***<br>(0.330068) |
| Number of EU 12 countries | 8 | 8 | 8 | 8 | 8 |
| R-squared | 0.36 | 0.13 | 0.29 | 0.47 | 0.37 |

## Table VI-D: size and public deficit

| Dependent variable: public finance balance average 1996-2004 | | | | | |
|---|---|---|---|---|---|
| | (1)<br>SIZE NEXUS | (2)<br>OPENNESS | (3)<br>REAL GROWTH | (4)<br>ECO. SIZE | (5)<br>OPEN * SIZE |
| Demographic size<br>Population 1993 | -0.162605***<br>(0.053515) | - | - | - | - |
| Economic size<br>GDP 1993 | - | - | - | -0.126605**<br>(0.049092) | - |
| Openness<br>1995 | - | 0.077691**<br>(0.032350) | - | - | - |
| Real GDP growth<br>Average 1996-2004 | - | - | 0.776517***<br>(0.267822) | - | - |
| Openness * Demo | - | - | - | - | -0.007558***<br>(0.002312) |
| Constant | 0.454360<br>(0.664916) | -4.214149**<br>(1.486222) | -3.293536***<br>(0.968026) | 0.243864<br>(0.695020) | 0.936114<br>(0.734719) |
| Number of EU 12 countries | 10 | 10 | 10 | 10 | 10 |
| R-squared | 0.53 | 0.41 | 0.51 | 0.50 | 0.51 |

## Table VI-E: size and unemployment

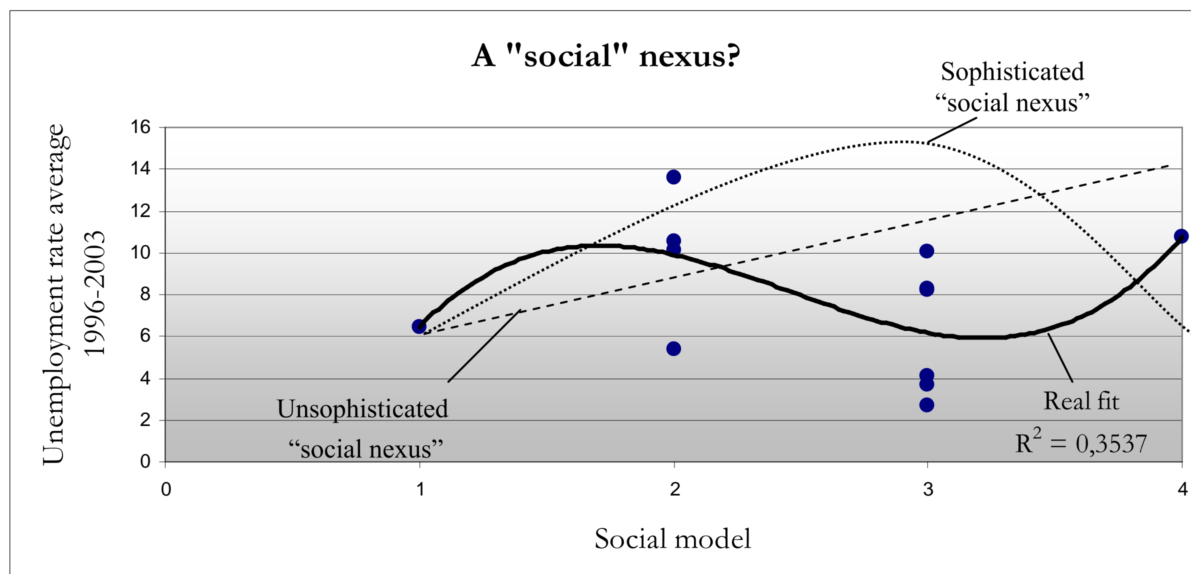
| Dependent variable: unemployment rate average 1996-2004 | | |
|---|---|---|
| | (1)<br>Size Nexus | (2)<br>Size nexus vs. social nexus |
| Demographic size<br>Population 1993 | 0.200113***<br>(0.066216) | 0.225346**<br>(0.091045) |
| Social transfers<br>by public administrations<br>average 1996-2003 | - | -0.360709<br>(0.439331) |
| Total expenditures<br>by public administrations<br>average 1996-2003 | - | 0.182733<br>(0.225272) |
| Constant | 4.754781***<br>(0.866414) | 1.451946*<br>(6.549308) |
| Number of EU 12 countries | 9 | 9 |
| Adjusted R-squared | 0.56 | 0.39 |

## Table VI-F: size and long-term unemployment

| Dependent variable: long-term unemployment rate average 1996-2004 | | |
|---|---|---|
| | (1)<br>Size Nexus | (2)<br>Size nexus vs. social nexus |
| Demographic size<br>Population 1993 | 0.114498**<br>(0.044705) | 0.124990*<br>(0.058325) |
| Social transfers<br>by public administrations<br>average 1996-2003 | - | -0.172626<br>(0.302924) |
| Total expenditures<br>by public administrations<br>average 1996-2003 | - | 0.092006<br>(0.158754) |
| Constant | 2.061090 **<br>(0.555452) | 0.286653<br>(4.477501) |
| Number of EU 12 countries | 10 | 10 |
| Adjusted R-squared | 0.45 | 0.22 |

All regressions were estimated using OLS and data from Eurostat and OECD. Standard errors are in parentheses. Individual coefficients *significant at 10% level; ** at 5% level or ***1% level. All Eurostat data are available at http://epp.eurostat.cec.eu.int/. OECD "openness" data are available at http://www.oecd.org/

## Chart XVIII
## A "SOCIAL NEXUS" IN THE EU 12?




| Country | Model | Degree of redistribution | Actual rounded coefficient[86] |
|---|---|---|---|
| Belgium | Continental | 3 | 1.8 |
| Germany | Continental | 3 | 1.8 |
| Greece | Mediterranean | 2 | 1.5 |
| Spain | Mediterranean | 2 | 1.5 |
| France | Continental | 3 | 1.8 |
| Ireland | Liberal | 1 | 1 |
| Italy | Mediterranean | 2 | 1.5 |
| Luxembourg | Continental | 3 | 1.8 |
| Netherlands | Continental | 3 | 1.8 |
| Austria | Continental | 3 | 1.8 |
| Portugal | Mediterranean | 2 | 1.5 |
| Finland | Nordic | 4 | 2 |

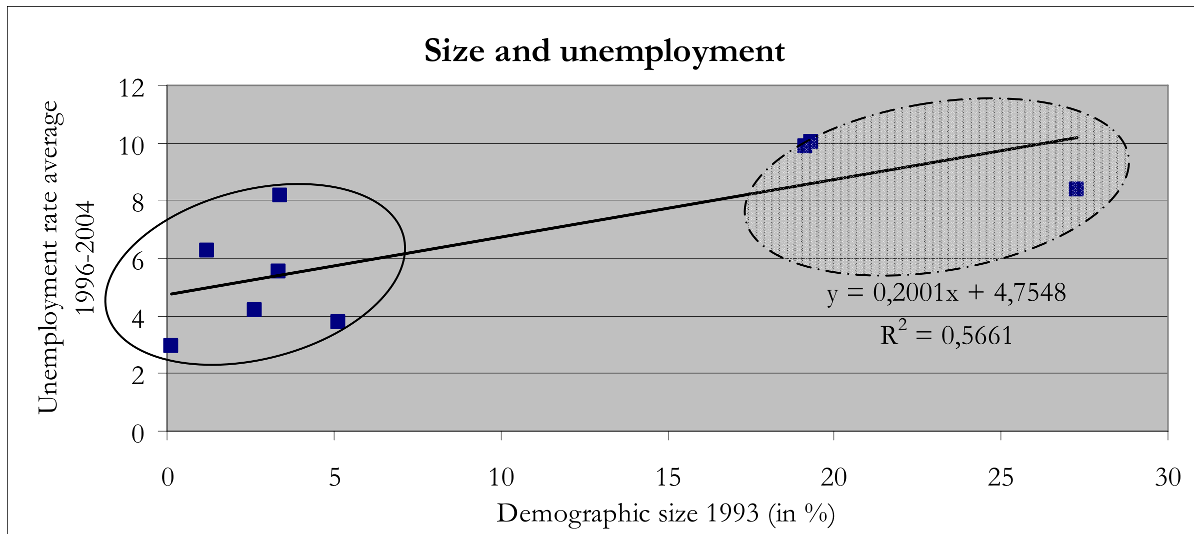
<table>
<tr><th></th><th>Model Average</th><th>Inter-model difference</th><th>Intra-model difference</th><th>Inter-model standard deviation</th><th>Intra-model standard deviation</th></tr>
<tr><td>Continental</td><td>6.1*</td><td rowspan="4">4.6</td><td>7.37</td><td rowspan="4">2.3</td><td>3.03</td></tr>
<tr><td>Mediterranean</td><td>9.9*</td><td>8.12</td><td>3.38</td></tr>
<tr><td>Liberal</td><td>6.4*</td><td rowspan="2"></td><td rowspan="2"></td></tr>
<tr><td>Nordic</td><td>10.7*</td></tr>
</table>

*Unemployment rate average 1996-2003, in %.

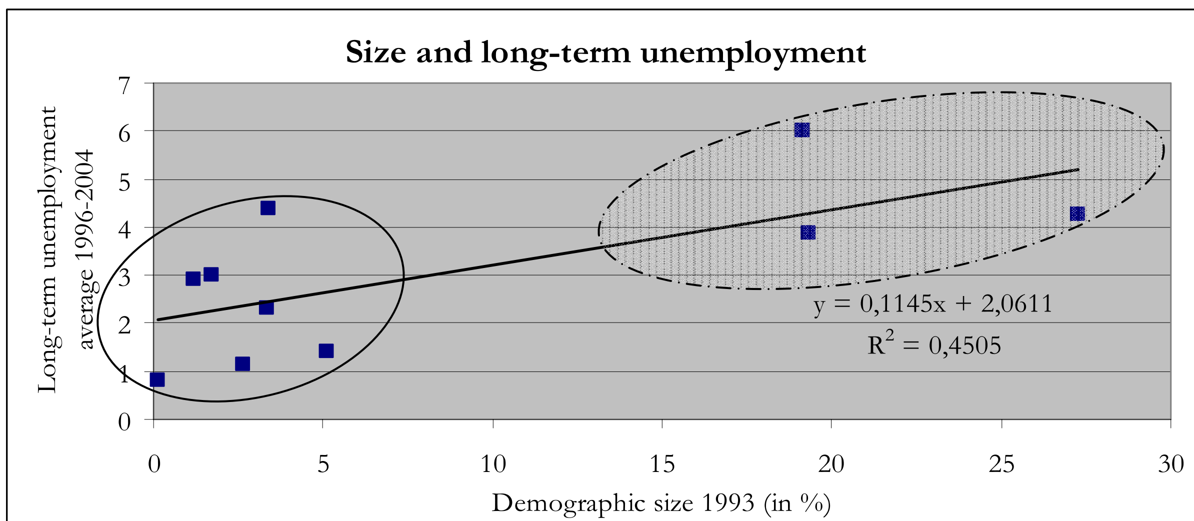
[86] Average social transfers by public administrations between 1996 and 2003, in % of GDP. Ireland=1, coefficient=model average.

Chart XIX

**THE "SIZE NEXUS" *VS* THE "SOCIAL NEXUS"**




OLS regression without Greece and Finland.
Difference between "small eight" and "big three" = 3. 9
Coefficient significant at 1 %.



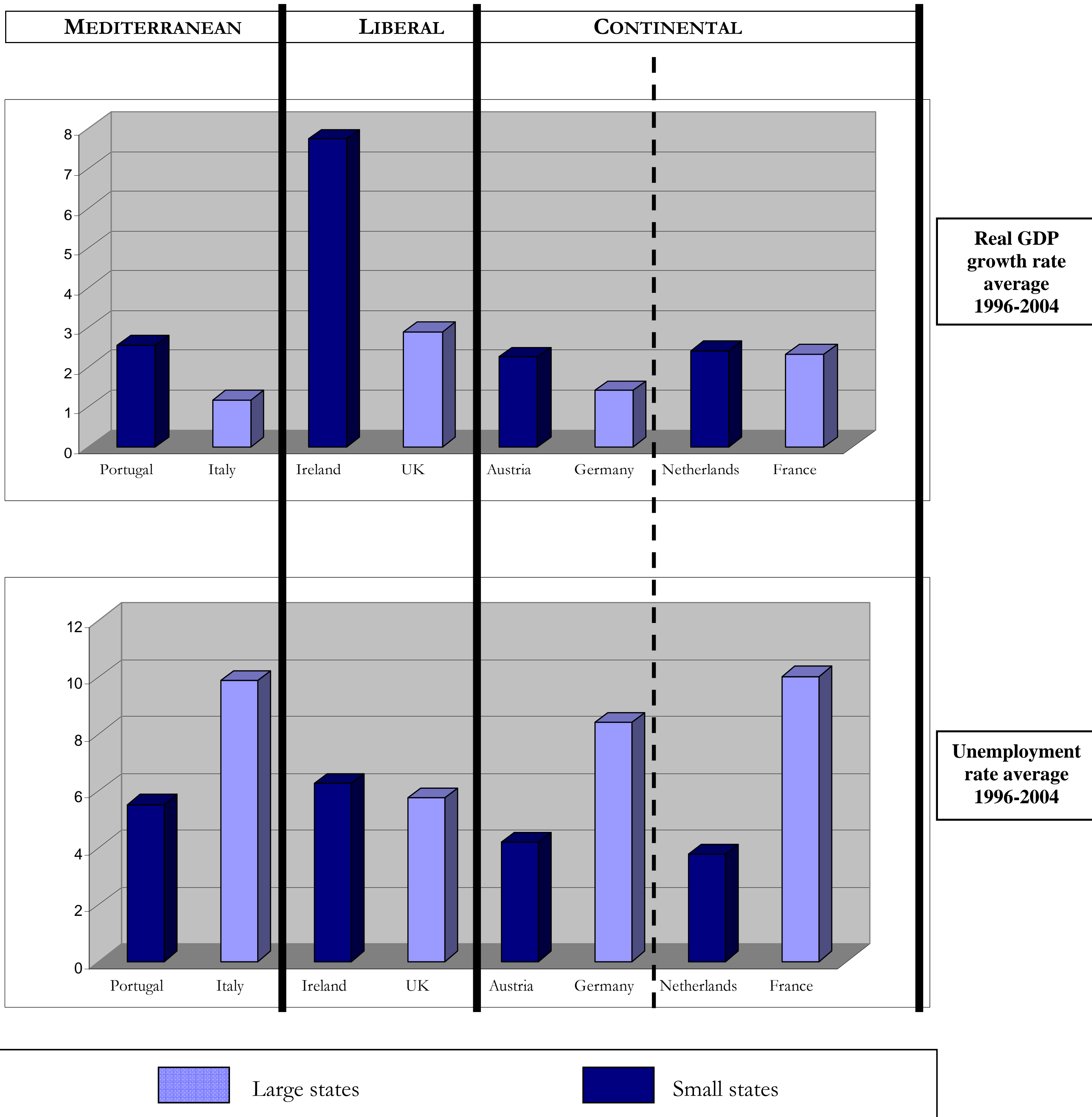

OLS regression without Greece.
Difference between "small eight" and "big three" = 2. 2
Coefficient significant at 5 %.

*Source:* Eurostat.

"Small eight" "Big three"

Chart XX

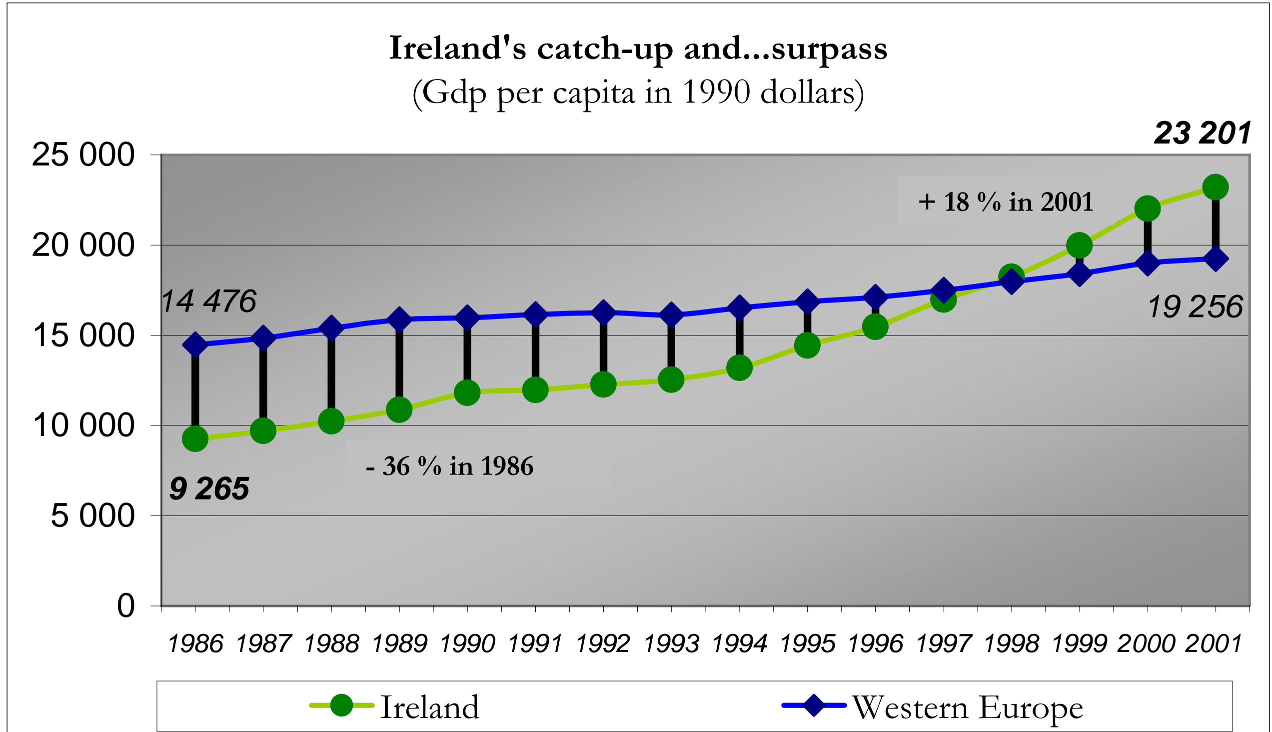
**THE "SIZE NEXUS" *VS* THE "SOCIAL NEXUS"**



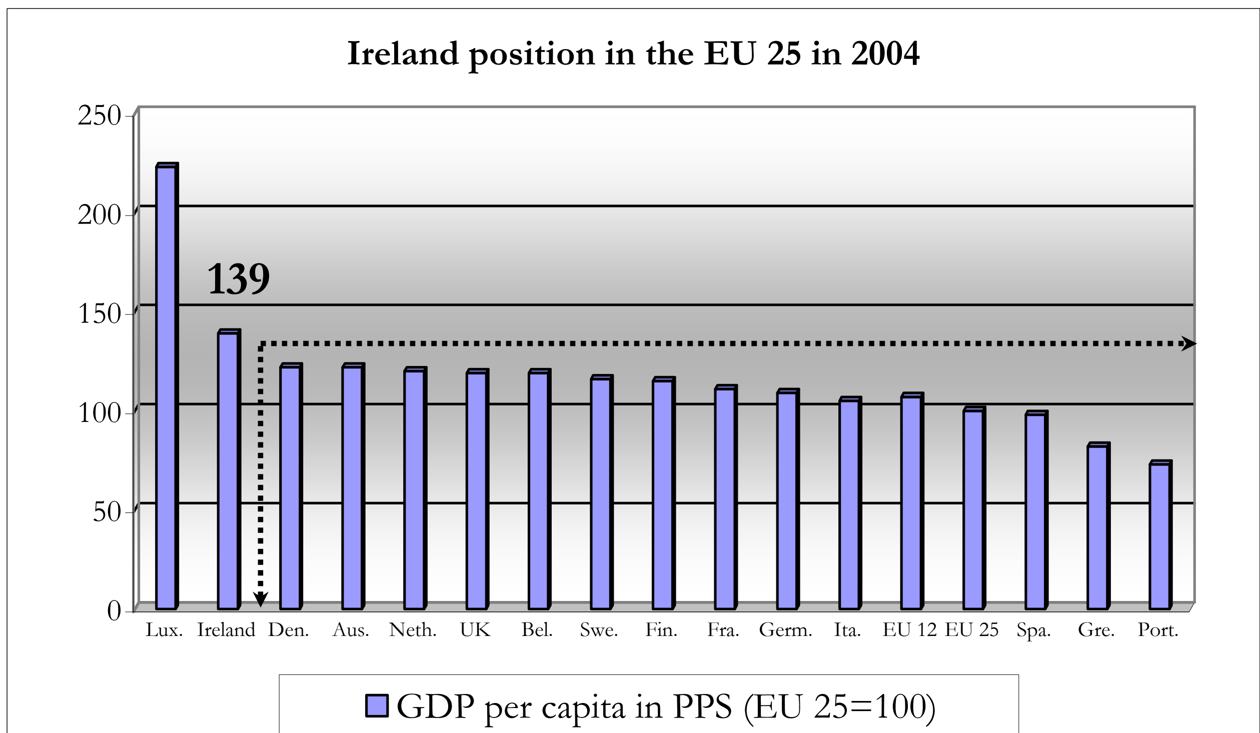

*Source:* Eurostat.

Chart XXI
**IRELAND: EU'S FINEST**

**The "rags to riches" European success story...**

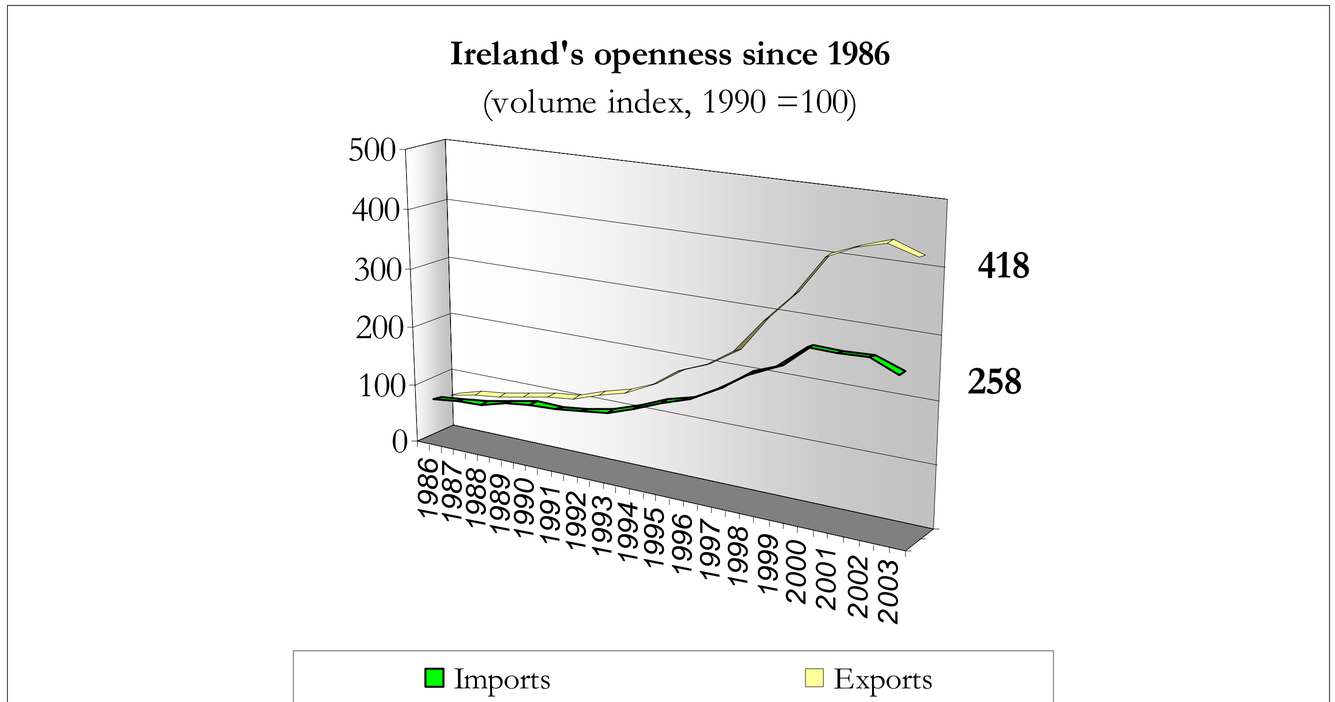


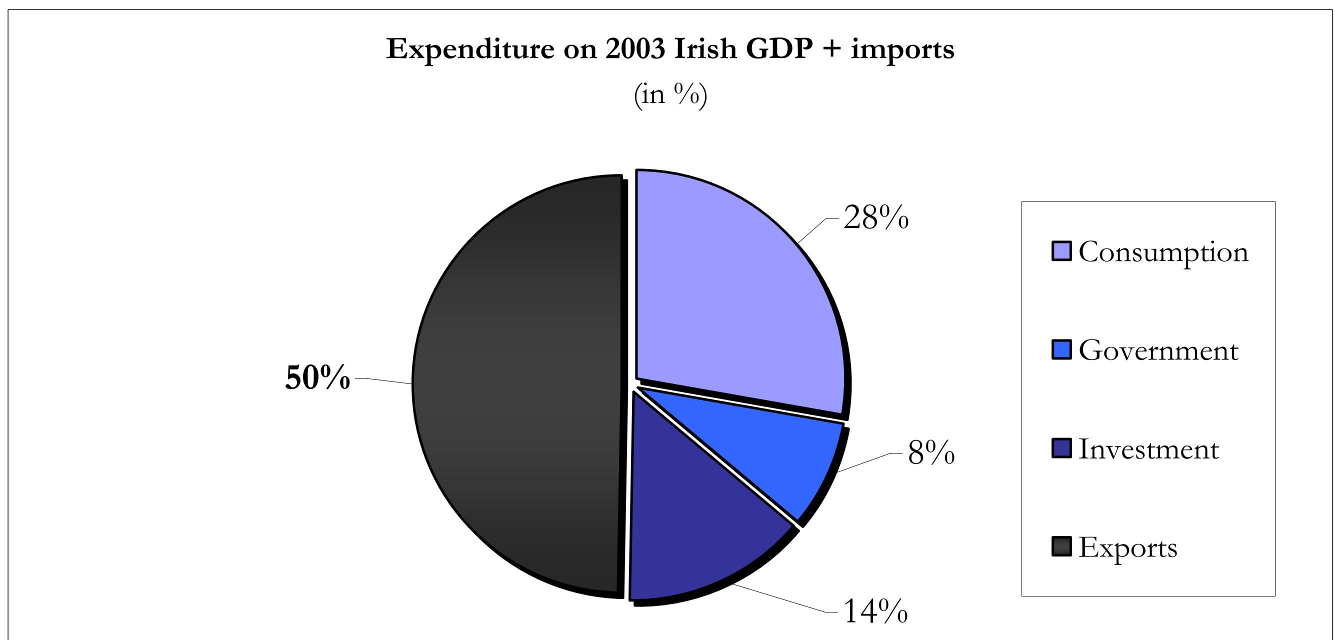

*Source: A. Madison*, The World Economy: Historical Statistics *(Paris: OECD, 2003).*




*Source:* Eurostat.

**...relying heavily on a flourishing single market driven external trade.**

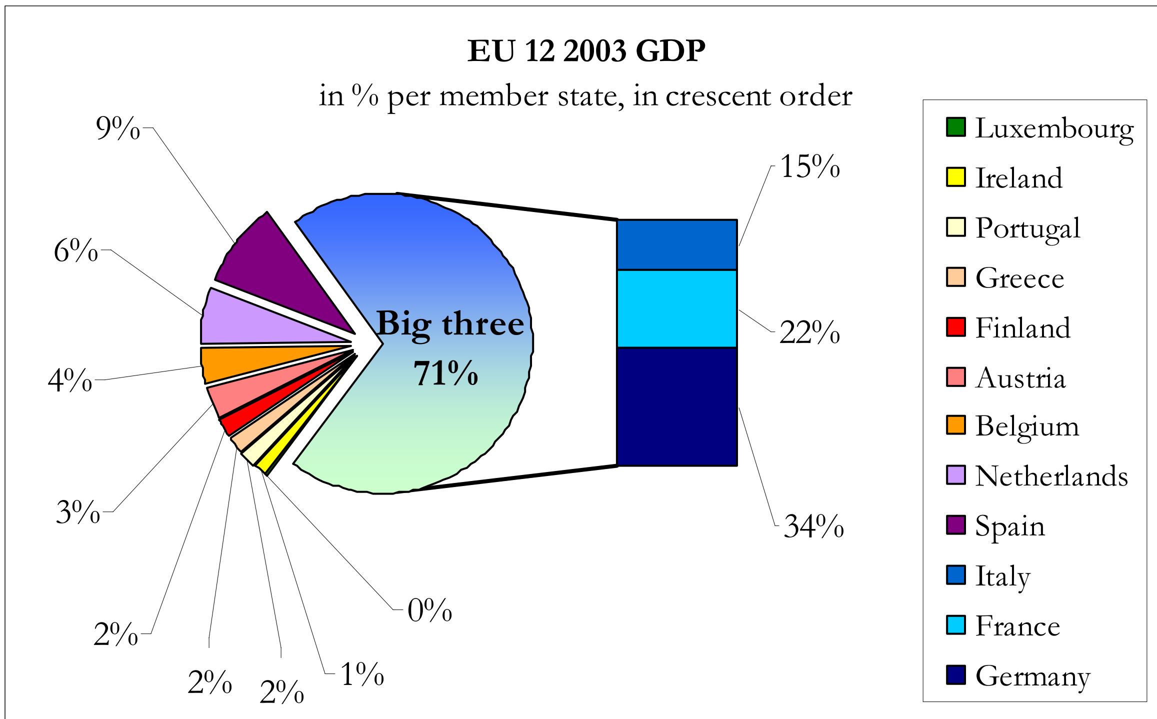


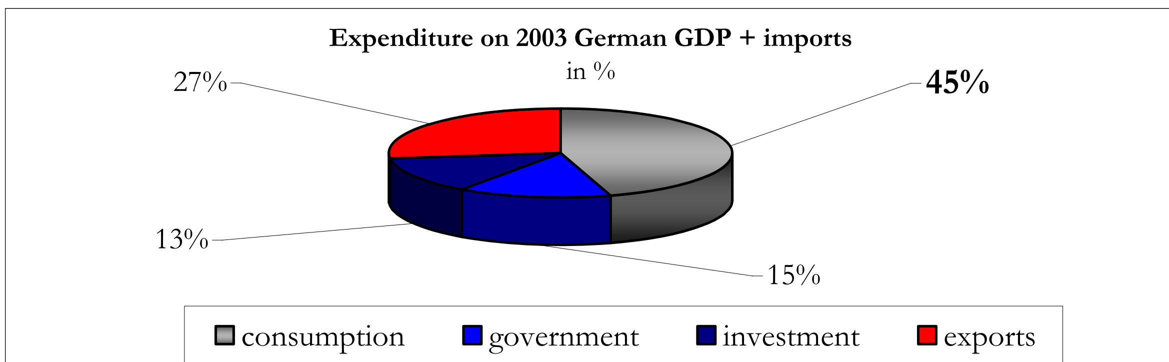



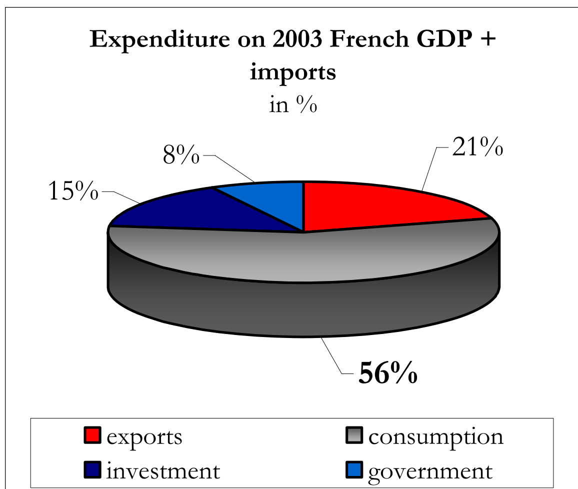

*Source:* Economic Review and Outlook 2004, *Ireland Department of Finance, accessed at* http://www.finance.gov.ie/documents/publications *and* Budgetary and Economic Statistics, *Ireland Department of Finance, April 2005, accessed at* http://www.finance.gov.ie/documents/publications.

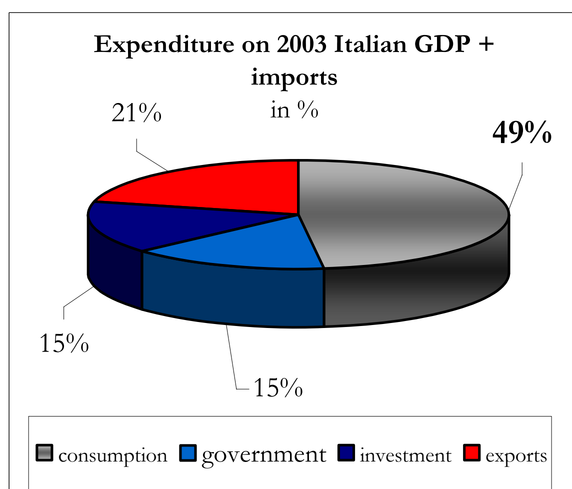
Chart XXII

## THE "BIG THREE" AND THE EU 12: A BASIC DECOMPOSITION



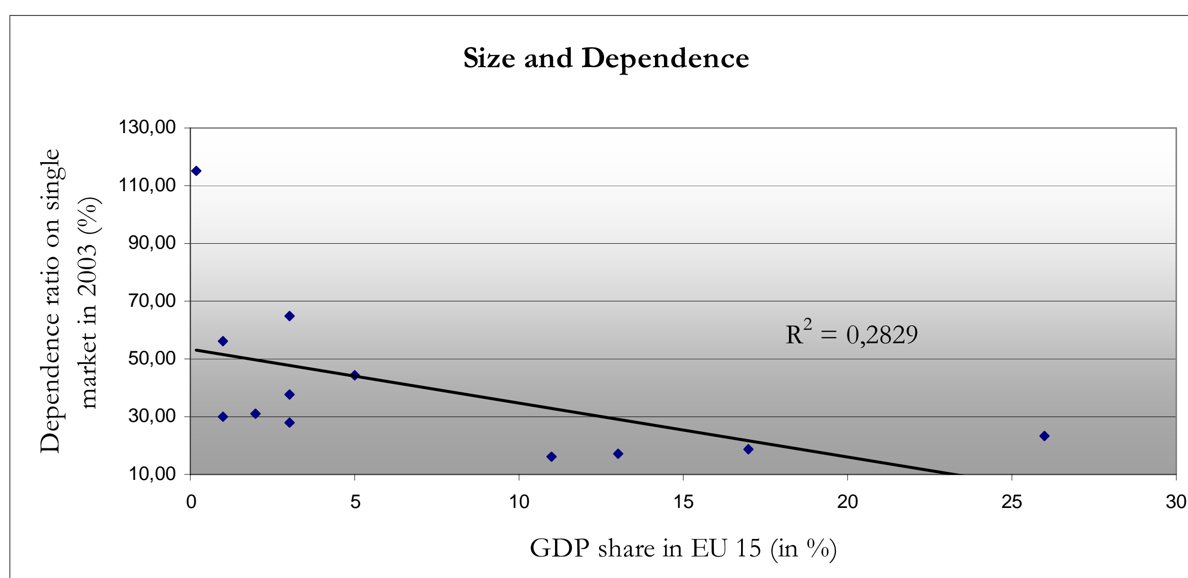




*Source:* DESTATIS, INSEE and OECD.

Table VII

**SINGLE MARKET DEPENDENCE RATIOS IN THE EU 15[87] IN 2003**

| Country | Total trade in GDP (2003) | EU trade in total trade (2003) | Dependence on Single market ratio | |
|---|---|---|---|---|
| UK | 29,9 | 57 | **17,02** | |
| Italy | 26,4 | 61 | **16,1** | **Independent** |
| France | 27,7 | 68 | **18,8** | |
| Germany | 35,8 | 64,8 | **23,1** | |
| Sweden | 43,5 | 64,4 | **28,01** | |
| Portugal | 37,5 | 79,9 | **29,9** | |
| Denmark | 43,7 | 71,5 | **31,2** | **Dependent** |
| Austria | 48,8 | 77,2 | **37,6** | |
| Netherlands | 65,5 | 68,1 | **44,6** | |
| Ireland | 89,8 | 62,4 | **56,03** | |
| Belgium | 86,3 | 75,1 | **64,8** | **Hyper-dependent** |
| Luxembourg | 139,8 | 82,4 | **115,1** | |

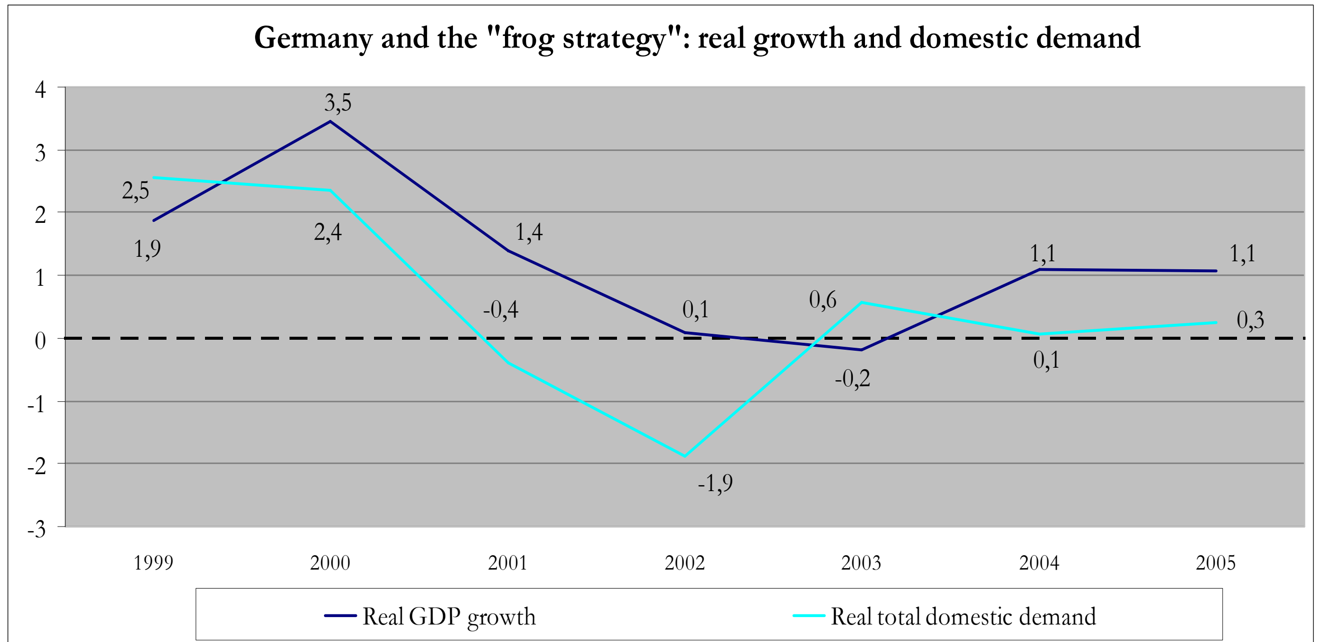


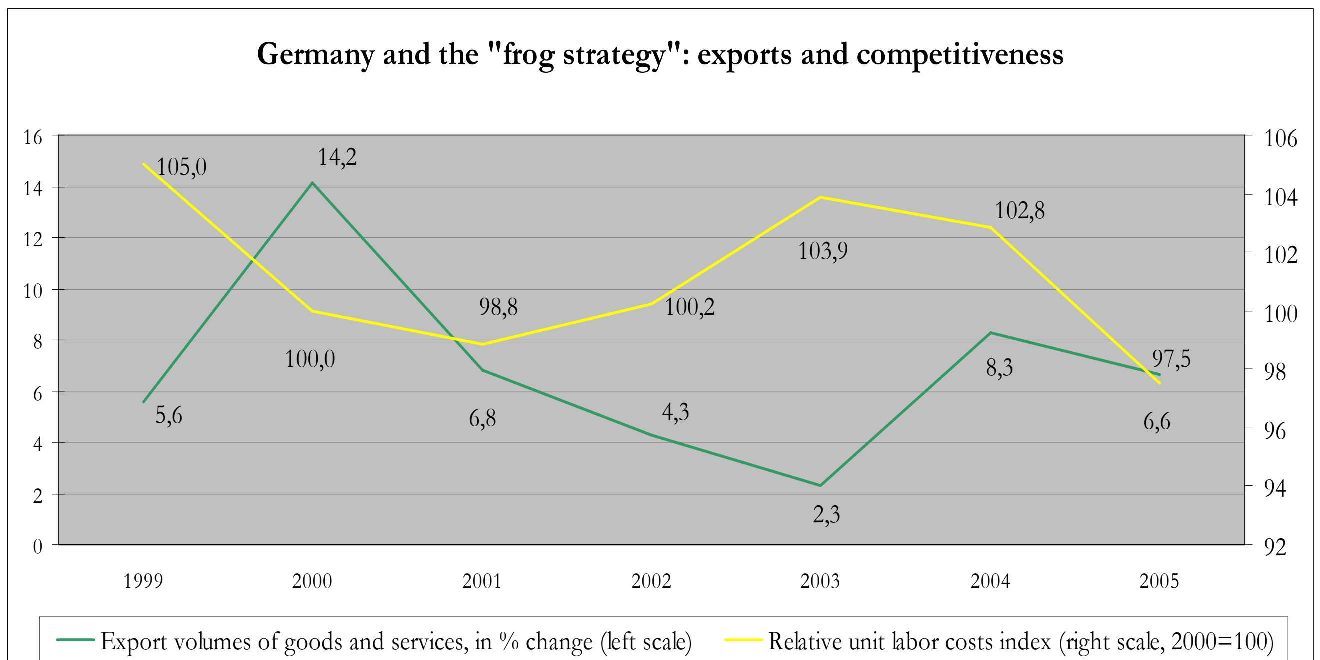

*Source*: Eurostat and OECD.

[87] Missing data for Finland. Spain and Greece are excluded.

Chart XXIII

**GERMANY AND THE "FROG STRATEGY"**




*Source*: OECD.

Chart XXIV
**INTEGRITY AND EFFICIENCY: OLD AND NEW TRADE-OFFS**

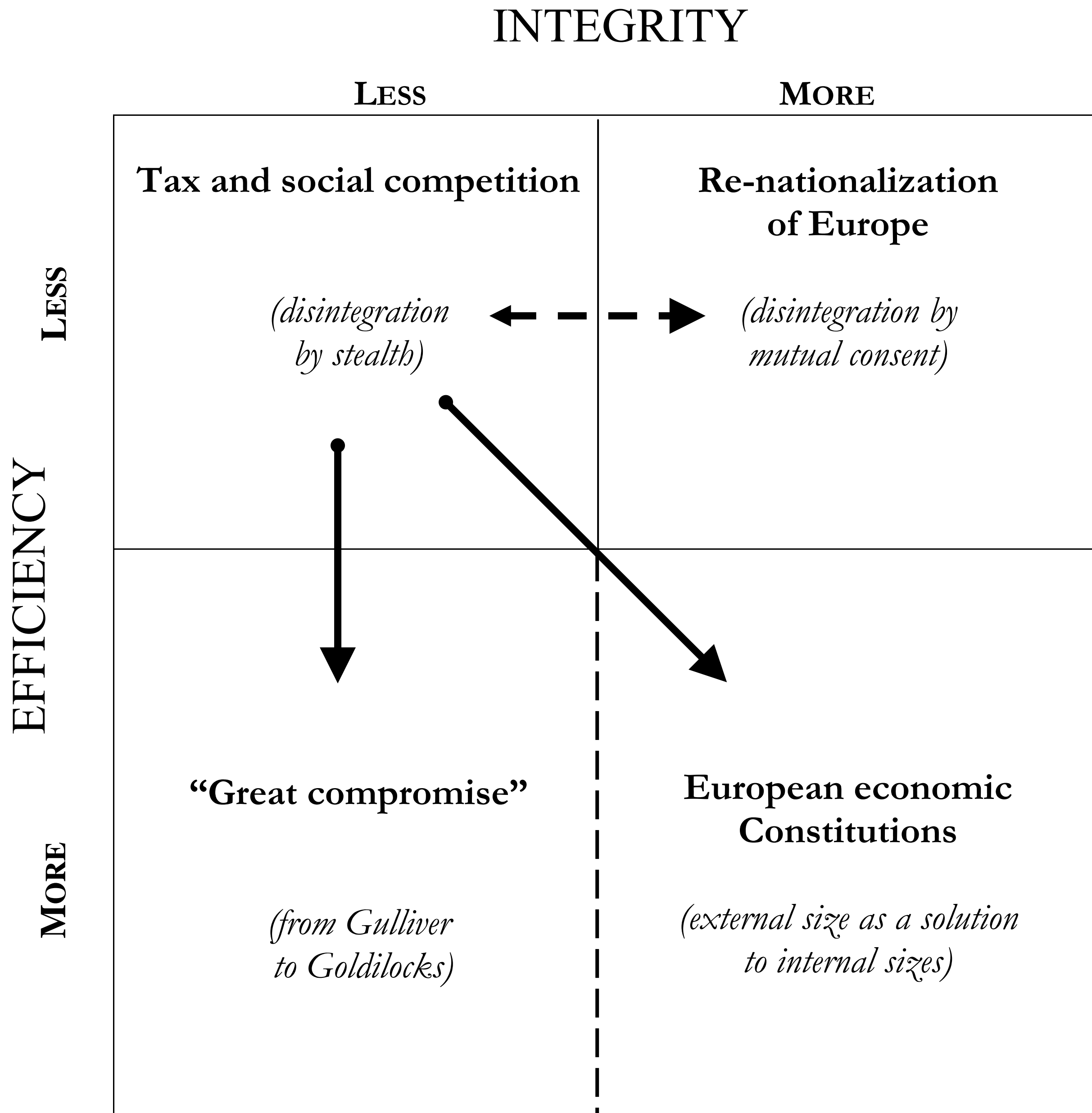
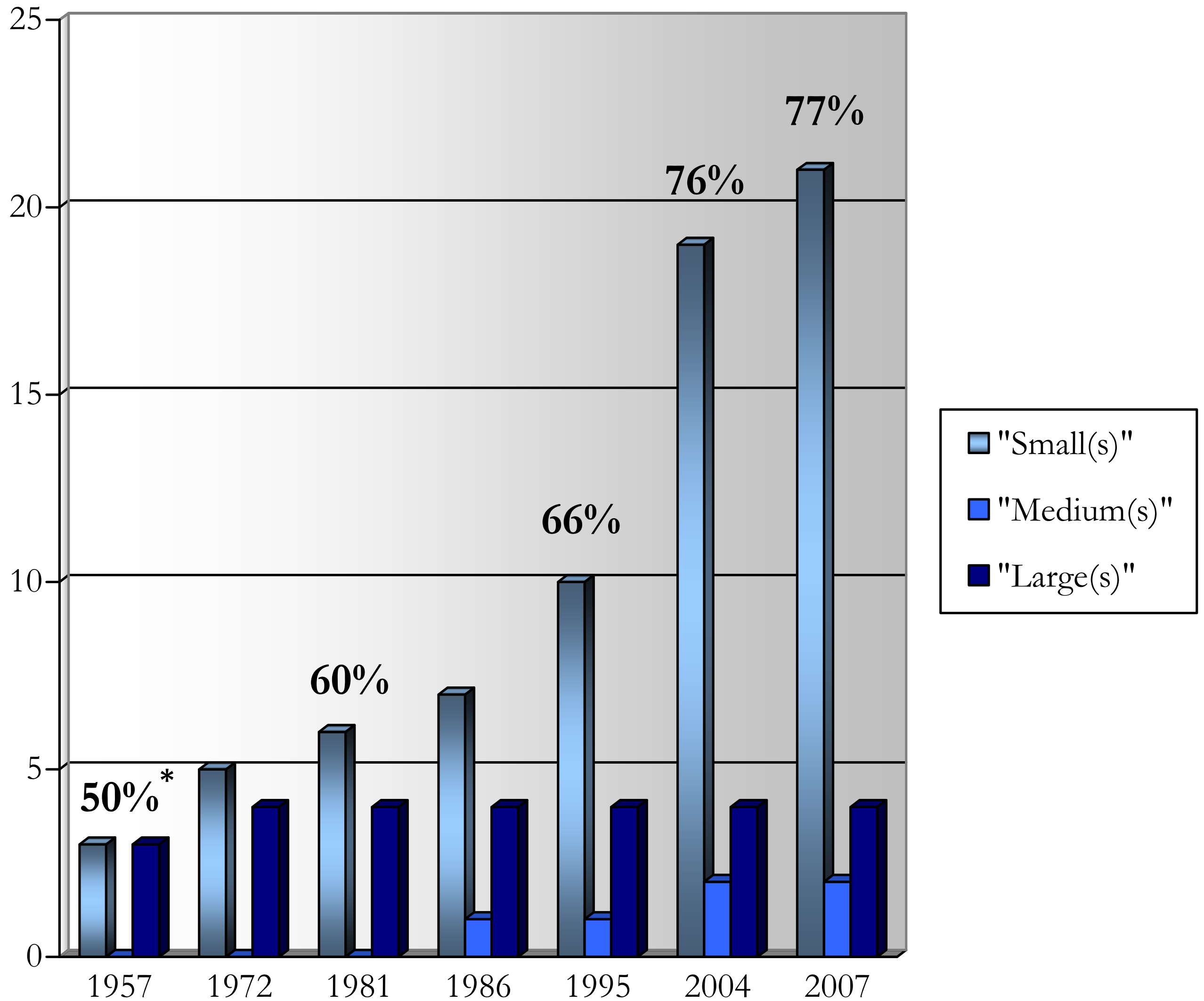


Chart XXV
**THE RISE OF THE "SMALLS" IN THE EU**
Number of states by size in the EEC and the EU




2007: If Romania and Bulgaria eventually integrate the EU then.
* Percentage of small states in the European Economic communities and EU.

*Note*: A "small" EEC and then EU member state is defined as one with a population inferior to the fourth of the population of the biggest state. A "medium" state is defined as one with a population inferior to half of the population of the biggest state. "Large" states are those remaining.

## Table VIII

### ECONOMIC SIZE *VS* POLITICAL SIZE WITHIN THE EU 12

| Country | Economic size (GDP in 2003) *in %* | Political size (voting rights as of 2005 i.e. Nice Treaty provisions) *in %* | | | | | ≈ Magnification (or minimization) Average political size / economic size (or the opposite) | |
|---|---|---|---|---|---|---|---|---|
| | | *ECB*[€] | *SGP*[%] | *EU budget*[‰] | *Comp. policy*[©] | *Pol. size*[Σ] | Laurent & Le Cacheux *vs.* (unanimity) | Using Banzhaf index[88] |
| Luxembourg | 0. 3 | 8.33-8.33 | 8.33-1 | 4-1 | 4-4 | 4.8 | X 16.2 (27.7) | 1.3 X 4.3 |
| Ireland | 1 | 8.33-8.33 | 8.33-2 | 4-2 | 4-4 | 5.1 | X 5.1 (8.3) | 2.2 X 2.2 |
| Portugal | 2 | 8.33-8.33 | 8.33-4 | 4-3 | 4-4 | 5.4 | X 2.7 (4.1) | 3.7 X 1.8 |
| Greece | 2 | 8.33-8.33 | 8.33-4 | 4-3 | 4-4 | 5.4 | X 2.7 (4.1) | 3.7 X 1.8 |
| Finland | 2 | 8.33-8.33 | 8.33-2 | 4-2 | 4-4 | 5.1 | X 2.5 (4.1) | 2.2 X 1.1 |
| Austria | 3 | 8.33-8.33 | 8.33-3 | 4-2 | 4-4 | 5.2 | X 1.7 (2.7) | 3.1 X 1.03 |
| Belgium | 4 | 8.33-8.33 | 8.33-4 | 4-3 | 4-4 | 5.4 | X 1.3 (2) | 3.7 ÷ 1.08 |
| Netherlands | 6 | 8.33-8.33 | 8.33-4 | 4-4 | 4-4 | 5.6 | ÷ 1.06 (X 1.4) | 4 ÷ 1.5 |
| Spain | 9 | 8.33-8.33 | 8.33-8 | 4-7 | 4-4 | 6.1 | ÷ 1.4 (1.08) | 7.4 ÷ 1.2 |
| Italy | 15 | 8.33-8.33 | 8.33-9 | 4-11 | 4-4 | 7.1 | ÷ 2.1 (1.8) | 7.8 ÷ 1.9 |
| France | 22 | 8.33-8.33 | 8.33-9 | 4-11 | 4-4 | 7.1 | ÷ 3.08 (2.6) | 7.8 ÷ 2.8 |
| Germany | 34 | 8.33-8.33 | 8.33-9 | 4-14 | 4-4 | 7.4 | ÷ 4.5 (4) | 7.8 ÷ 4.3 |

[€] The two numbers correspond respectively to the ability of amending and enforcing monetary rules. The six members of the Executive board (that form the Governing Council of the ECB together with the twelve national bankers) are not included in this count. Unlike for instance ECJ judges, they are not supposed to be nominated (or to act) on a national basis. Still, another way of calculating the votes would be to divide only 66% among the 12 member states (12 out of 18). However, we assume the remaining third to be "size-blind" as it should according to its mandate. This method would in any event be neutral for the value of coefficients in the last column.

[%] Idem, but with respectively the Council's ability to amend unanimously and implement by qualified majority the SGP. For the sake of simplification votes have been distributed among members of the EU 12. However, more than half of those votes actually belong to the other members of the EU 25, even the implementation of the "excessive deficit" procedure (a clear symptom of the lack of sovereignty of the EU 12 inside the EU 25, see Section 7). Romania and Bulgaria, included in the Nice Treaty agreement, are not taken into account here.

[‰] Ibidem, but with respectively the Council's unanimity and the Parliament's majority. The EU's annual budget is jointly determined by the Parliament and the Council. The Parliament debates in two successive readings, and the budget does not come into force until it has been signed by the President of Parliament. The budgetary procedure or the budget's content can not be amended without EU 25 members' unanimity.

[©] Competition policy is enforced by the Commission, where each of the EU 25 state has a representative.

[Σ] Average of ECB, SGP, EU budget and competition policy.

[88] See note 43.

Table IX

**ECONOMIC SIZE *VS* POLITICAL SIZE WITHIN THE EU 25**

| Country | Economic size (GDP in 2003) *in %* | Political size (voting rights as of 2005 i.e. Nice Treaty provisions) *in %* | | | | ≈ Magnification (or minimization) Average political size / economic size (or the opposite) | |
|---|---|---|---|---|---|---|---|
| | | *Commission* | *Council*† | *Parliament* | *Pol. size*Σ | Laurent & Le Cacheux *vs.* (unanimity) | Using Banzhaf index[89] |
| Malta | 0.03 | 4 | 1 | 1 | 2 | X 66 (133) | 0.9 X30 |
| Estonia | 0.05 | 4 | 1 | 1 | 2 | X 40 (80) | 1.3 X26 |
| Latvia | 0.07 | 4 | 1 | 1 | 2 | X 28 (57) | 1.3 X18.5 |
| Lithuania | 0.09 | 4 | 2 | 2 | 2.6 | X 29 (44) | 2.2 X 24 |
| Cyprus | 0.1 | 4 | 1 | 1 | 2 | X 20 (40) | 1.3 X 13 |
| Slovakia | 0.2 | 4 | 2 | 2 | 2.6 | X 13 (20) | 2.2 X 11 |
| Slovenia | 0.2 | 4 | 1 | 1 | 2 | X 10 (20) | 1.3 X6.5 |
| Luxembourg | 0.2 | 4 | 1 | 1 | 2 | X 10 (20) | 1.3 X6.5 |
| Hungary | 1 | 4 | 4 | 3 | 3.6 | X 3 (4) | 3.7 X3.7 |
| Czech Rep. | 1 | 4 | 4 | 3 | 3.6 | X 3 (4) | 3.7 X3.7 |
| Ireland | 1 | 4 | 2 | 2 | 2.6 | X 2 (4) | 2.2 X 2.2 |
| Portugal | 1 | 4 | 4 | 3 | 3.6 | X 3 (4) | 3.7 X3.7 |
| Greece | 1 | 4 | 4 | 3 | 3.6 | X 3 (4) | 3.7 X 3.7 |
| Finland | 2 | 4 | 2 | 2 | 2.6 | X 1.3 (2) | 2.2 X1.1 |
| Poland | 2 | 4 | 8 | 7 | 6.3 | X 3 (2) | 7.4 X3.7 |
| Denmark | 2 | 4 | 2 | 2 | 2.6 | X 1.3 (2) | 2.2 X1.1 |
| Austria | 3 | 4 | 3 | 2 | 3 | X 1 (1.3) | 3.1 X1.03 |
| Sweden | 3 | 4 | 3 | 3 | 3.3 | X 1.1 (1.3) | 3.1 X1.03 |
| Belgium | 3 | 4 | 4 | 3 | 3.5 | X 1.2 (1.3) | 3.7 X1.23 |
| Netherlands | 5 | 4 | 4 | 4 | 4.25 | ÷1.25 (1.25) | 4 ÷ 1.25 |
| Spain | 7 | 4 | 8 | 7 | 6.5 | ÷1.10 (1.75) | 7.4 ÷ 0.9 |
| Italy | 11 | 4 | 9 | 11 | 8.75 | ÷1.3 (2.75) | 7.8 ÷1.4 |
| UK | 13 | 4 | 9 | 11 | 9.25 | ÷ 1.6 (3.25) | 7.8 ÷1.6 |
| France | 17 | 4 | 9 | 11 | 10.25 | ÷ 2.1 (4.25) | 7.8 ÷2.1 |
| Germany | 26 | 4 | 9 | 14 | 13.25 | ÷ 2.8 (6.5) | 7.8 ÷3.3 |

† A qualified majority in the Council is reached under the Nice rules: if a majority of member states (in some cases a two-thirds majority) approve; if a minimum of 232 votes (72.3 percent of the total) is cast in favor; if the votes represent at least 62 percent of the total population of the Union.

Σ Average of Commission, Council and Parliament.

[89] Index built on population shares and representing the proportion of times a member state is pivotal in decision-making, see Bobay (2004). Romania and Bulgaria are not counted here.

## Table X
## ECONOMIC SIZE *VS* POLITICAL SIZE IN THE EU 12 AND EU 25

| | **Economic size** | **Political size** | | |
|---|---|---|---|---|
| | % of GDP | % of votes | | |
| | | **Council** | **Banzhaf indexes** | **Laurent & Le Cacheux** |
| **EU 25** | ≈100 | ≈100 | ≈100 | ≈100 |
| *Political majority* | **82** | **52** | **46.3** | **55.7** |
| | 79 | 48 | 42.6 | 52.2 |
| | 74 | 44 | 38.6 | 48 |
| | 67 | 36 | 31.2 | 41.5 |
| *Economic majority* | **56** | **27** | **23.4** | **32.7** |
| | 43 | 18 | 15.6 | 23.5 |

| | | | | |
|---|---|---|---|---|
| **EU 12** | ≈100 | ≈60 (majority 30) | ≈55 (majority 27.5) | ≈70 (majority 35) |
| *Political majority* | **80** | **35** | **30.8** | **27.8** |
| | 71 | 27 | 23.4 | 21.7 |
| *Economic majority* | **56** | **18** | **15.6** | **14.6** |
| | 34 | 9 | 7.8 | 7.4 |

Table XI

**THE US 13 IN 1787:**
**WELL BALANCED AND READY FOR THE "GREAT COMPROMISE"**

*in thousands*

| | State★ | Population* | |
|---|---|---|---|
| | Delaware | 59 | |
| | Rhode Island | 68.8 | |
| | Georgia | 82.5 | **«SMALL» (5)** |
| | New Hampshire | 141.8 | |
| | New Jersey | 184.1 | |
| **186** | | | |
| | Connecticut | 237.9 | **«MEDIUM» (2)** |
| | South Carolina | 249 | |
| **373** | | | |
| | Maryland | 319.7 | |
| | New York | 340.1 | |
| | Massachusetts | 378.7 | **«LARGE» (6)** |
| | North Carolina | 393.7 | |
| | Pennsylvania | 434.3 | |
| | Virginia | 747.6 | |

★ The first 13 American colonies.

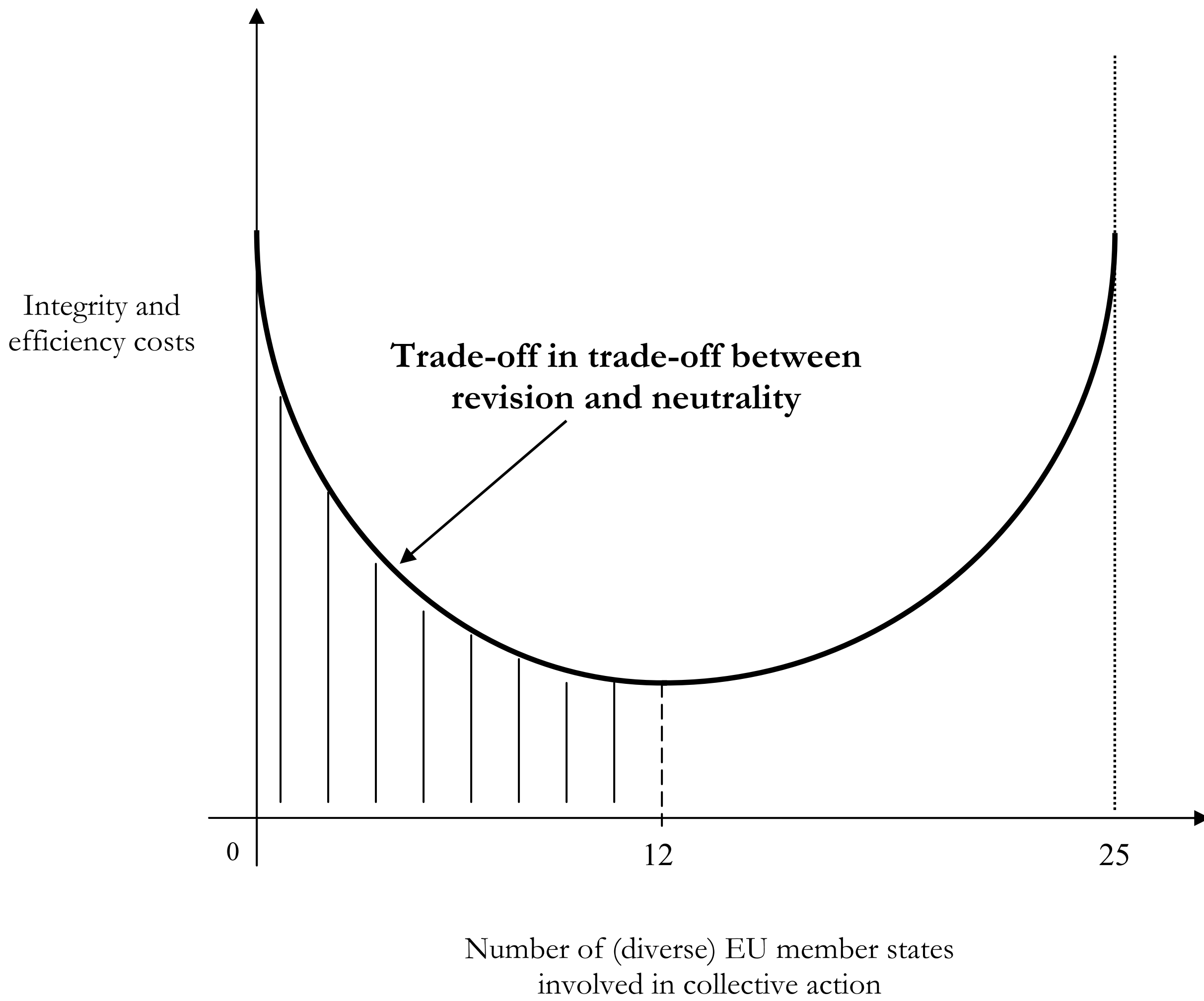
* As of 1790, the first US Census.

*Note:* A "Small" state is defined as one with a population inferior to the fourth of the population of the biggest state. A "Medium" state is defined as one with a population inferior to half of the population of the biggest state. "Large" states are those remaining.

*Source:* US Census Bureau, extracted from a table available at www.infoplease.com.

Chart XXVI

**THE OPTIMAL EUROPEAN CONSTITUTION(S)**




*Source:* Adapted from Buchanan and Tullock (1962).