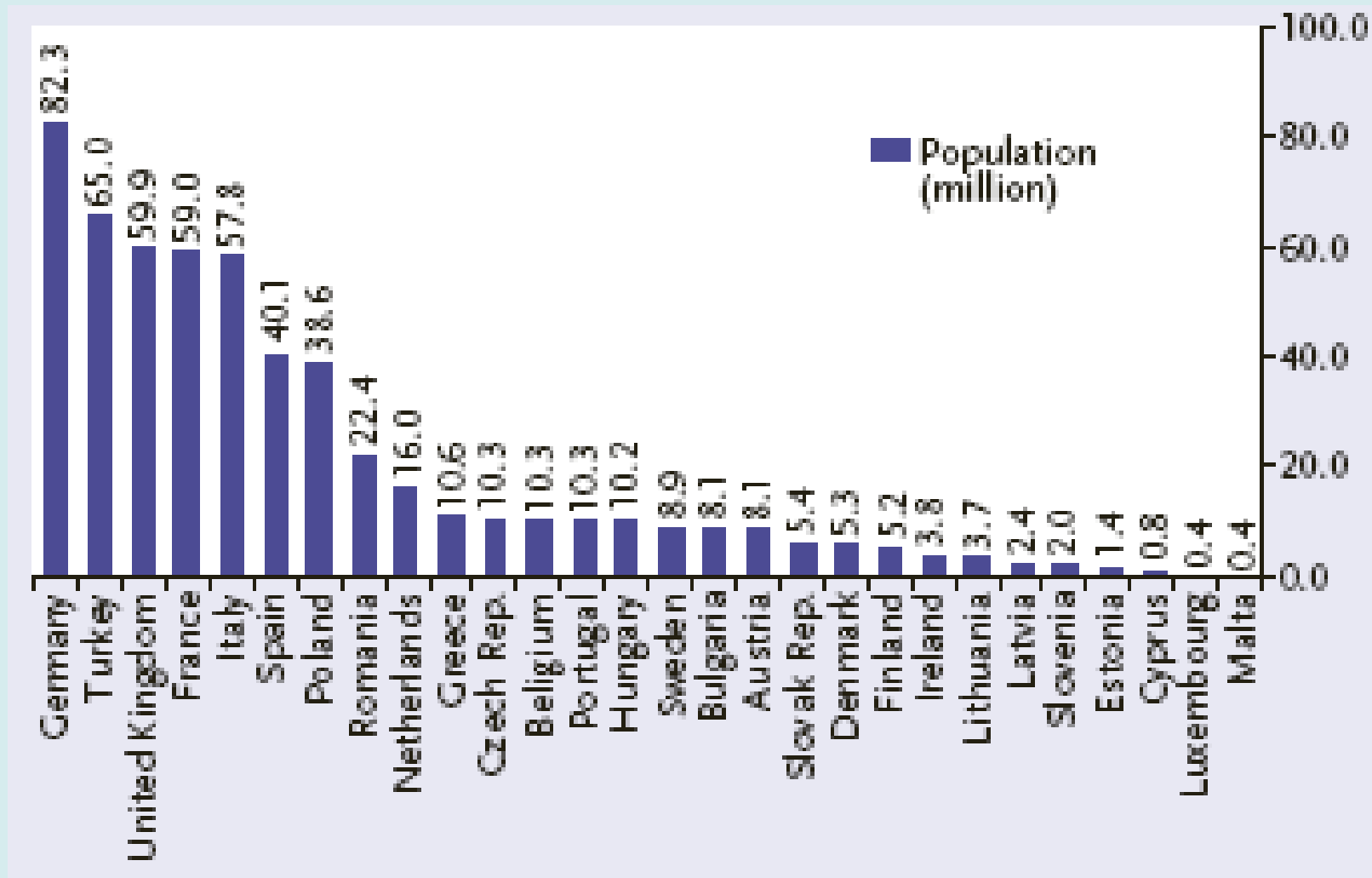


**Lecture # 3**  
**Economics of European Integration**

Spring Semester 2009

Gerald Willmann

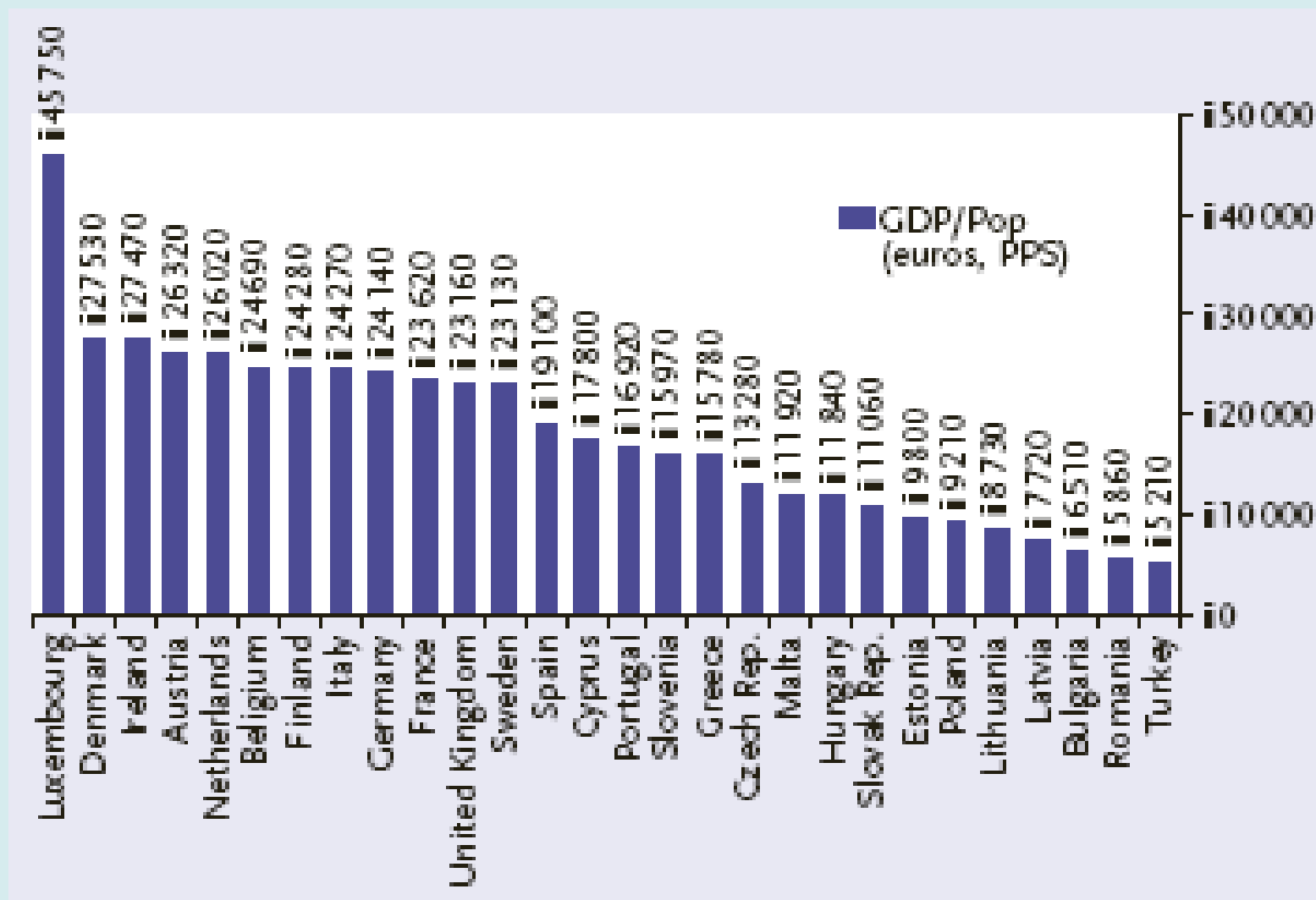
# Facts: Population



# Facts: Population

- 6 big nations:
  - > 35 million (Germany, the UK, France, Italy, Spain and Poland).
- Netherlands: 16 million people.
- 8 ‘small’ nations (size of a big city):
  - 8 to 11 million: (Greece, Belgium, Portugal, Sweden, Austria, Czech Republic and Hungary).
- 11 ‘tiny’ nations:
  - (size of a moderate to small city)
  - together make up less than 5 per cent of EU25 population
  - (Slovak Republic, Denmark, Finland, Ireland, Lithuania, Latvia, Slovenia, Estonia, Cyprus, Luxembourg and Malta.)

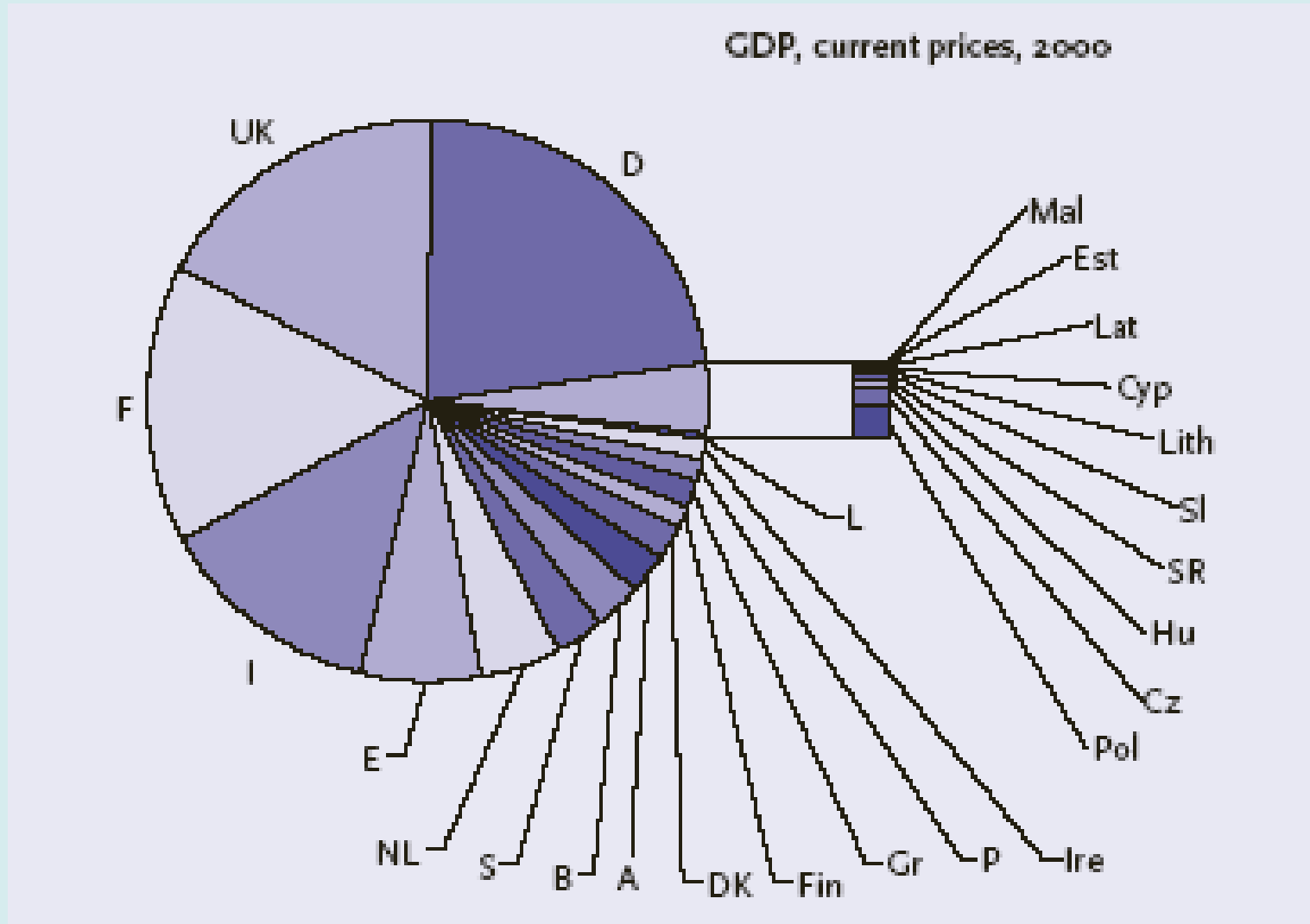
# Facts: Income per capita



# Facts: Income per capita

- 11 high income – over €20,000
  - Denmark, Ireland, Austria, Netherlands, Belgium, Finland, Italy, Germany, France, UK and Sweden.
- 9 medium income category – from €10,000 to €20,000
  - Spain, Greece, Portugal, Cyprus, Hungary, Slovenia, the Czech Republic, Malta and the Slovak Republic.
- 6 low income nations, less than €10,000
  - Estonia, Poland, Lithuania, Latvia, Bulgaria, Romania, and Turkey
    - NB: Turkey's income is half that of the richest-of-the-poor, Estonia.
- Luxembourg is in the super-high income category by itself.
  - per capita income is almost twice that of France
  - about 40% of Luxembourgers work so the *average* worker earns over €100,000 a year!

# Facts: Size of Economies



# Facts: Size of Economies

- Economic size distribution is VERY uneven.
- Six nations (Germany, the UK, France, Italy, Spain and the Netherlands) account for more than 80% of EU25's economy.
- Other nations are small, tiny or miniscule.
- 'Small' is an economy that accounts for between 1% and 3% of the EU25's output:
  - Sweden, Belgium, Austria, Denmark, Poland, Finland, Greece, Portugal and Ireland.
- 'Tiny' is one that accounts for less than 1% of the total:
  - Czech Republic, Hungary, Slovak Republic, Luxembourg, Slovenia, Lithuania, and Cyprus.
- Miniscule is one that accounts for less than one-tenth of 1%:
  - Latvia, Estonia and Malta.

# Facts: EU15's Global Trade Pattern

	EU Export shares by region		EU Import shares by region
Western Europe	67%	Western Europe	66%
North America	10%	Asia	12%
Asia	8%	North America	8%
CEECs and CIS	6%	CEECs and CIS	6%
Africa	3%	Africa	3%
Middle East	3%	Latin America	2%
Latin America	2%	Middle East	2%
Top 7 partners			
European Union (15)	62%	European Union (15)	61%
United States	9%	United States	7%
Switzerland	3%	China	3%
Japan	2%	Japan	3%
Poland	1%	Switzerland	2%
China	1%	Russian Federation	1%
Russian Federation	1%	Poland	1%

SOURCE: WTO's Annual Report, 2002.



# Facts: EU15's Global Trade Pattern

- The EU trades mainly with Europe, especially with itself:
  - about two-thirds of EU exports and imports are to or from other Western European nations
  - the EU's exports to North America amount to only 10 per cent of its exports
  - Asia's share is only 8 per cent.
- About 80 per cent of EU exports consist of industrial goods ('intraindustry' trade).

# Facts: EU15's Global Trade Pattern

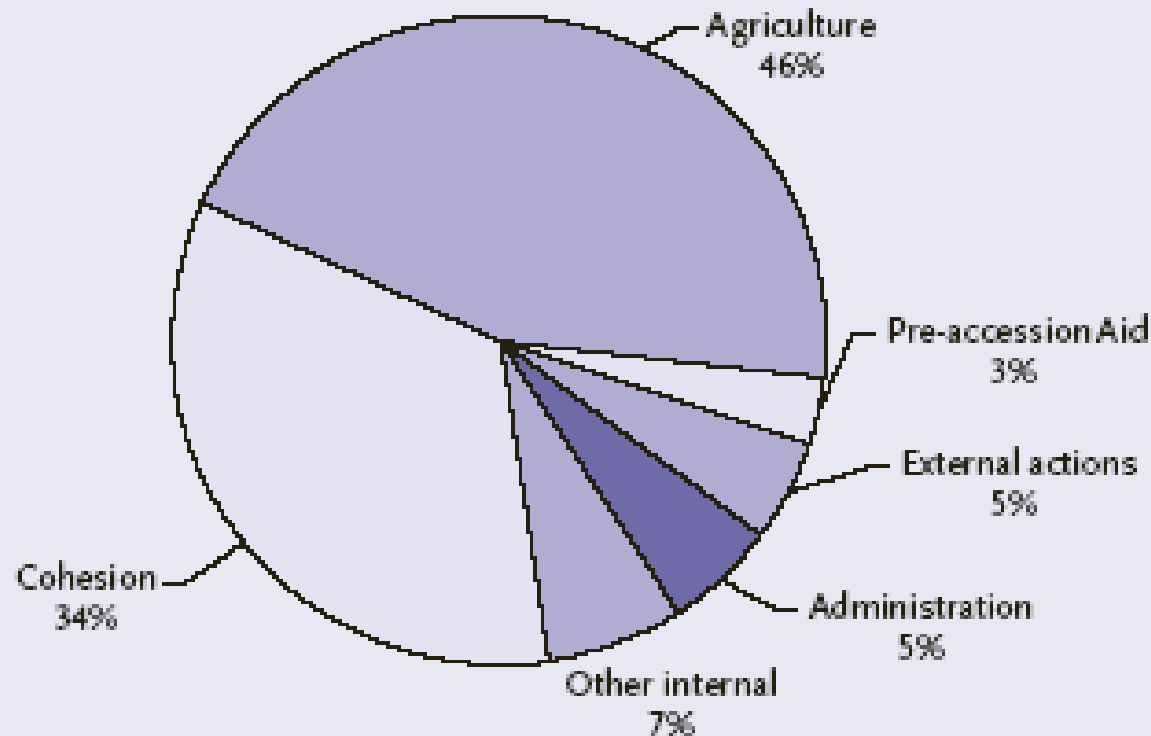
	Openness ratio	Exports to EU15 as % total exports		Openness ratio	Exports to EU15 as % total exports
Greece	17%	49%	Malta	44%	48%
Italy	22%	51%	Slovenia	25%	57%
Finland	30%	53%	Turkey	62%	58%
Sweden	33%	53%	Latvia	69%	59%
Germany	29%	53%	Bulgaria	56%	59%
United Kingdom	21%	54%	Slovak Rep.	45%	62%
Ireland	61%	57%	Lithuania	38%	66%
France	22%	58%	Cyprus	62%	67%
Austria	36%	59%	Romania	26%	68%
Denmark	29%	59%	Czech Rep.	36%	68%
Spain	23%	69%	Poland	51%	69%
BLEU	75%	75%	Hungary	67%	70%
Netherlands	55%	76%	Estonia	25%	70%
Portugal	29%	80%			

SOURCE: Eurostat and IMF Direction of Trade Statistics, 2002.

# Facts: EU15's Global Trade Pattern

- EU25 members are all comparatively open economies when it comes to trade in goods:
  - openness ratio for the EU15 ranges from 17 per cent for Greece up to 75 per cent for the Belgium-Luxembourg
  - figures for the 10 newcomers are higher than Greece's
    - figures for Japan and the US are 10 per cent and 8 per cent respectively.
- EU15 market is very important for all EU25:
  - share of exports going to the EU15 ranges between 50 per cent to 80 per cent.

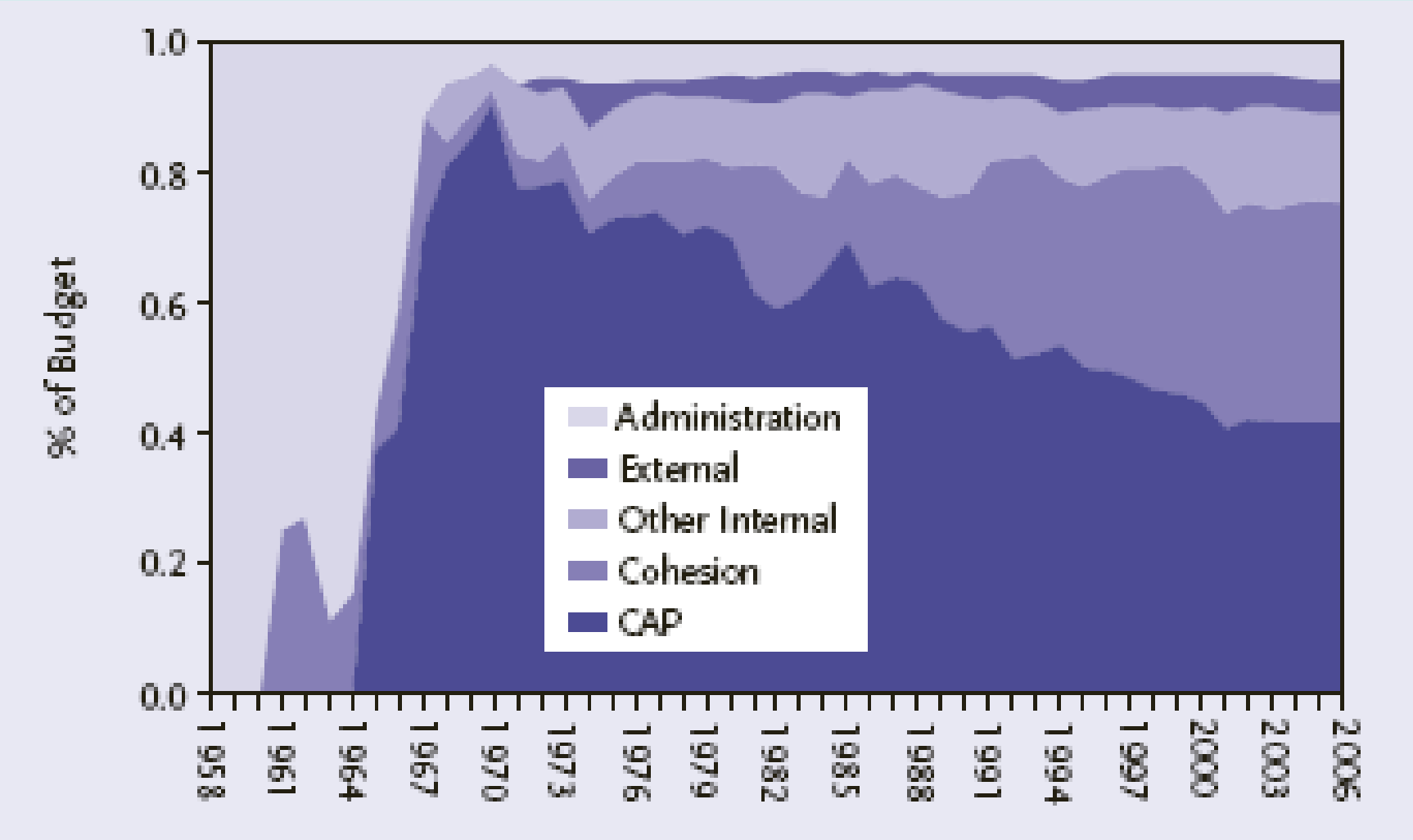
# The Budget: Expenditure



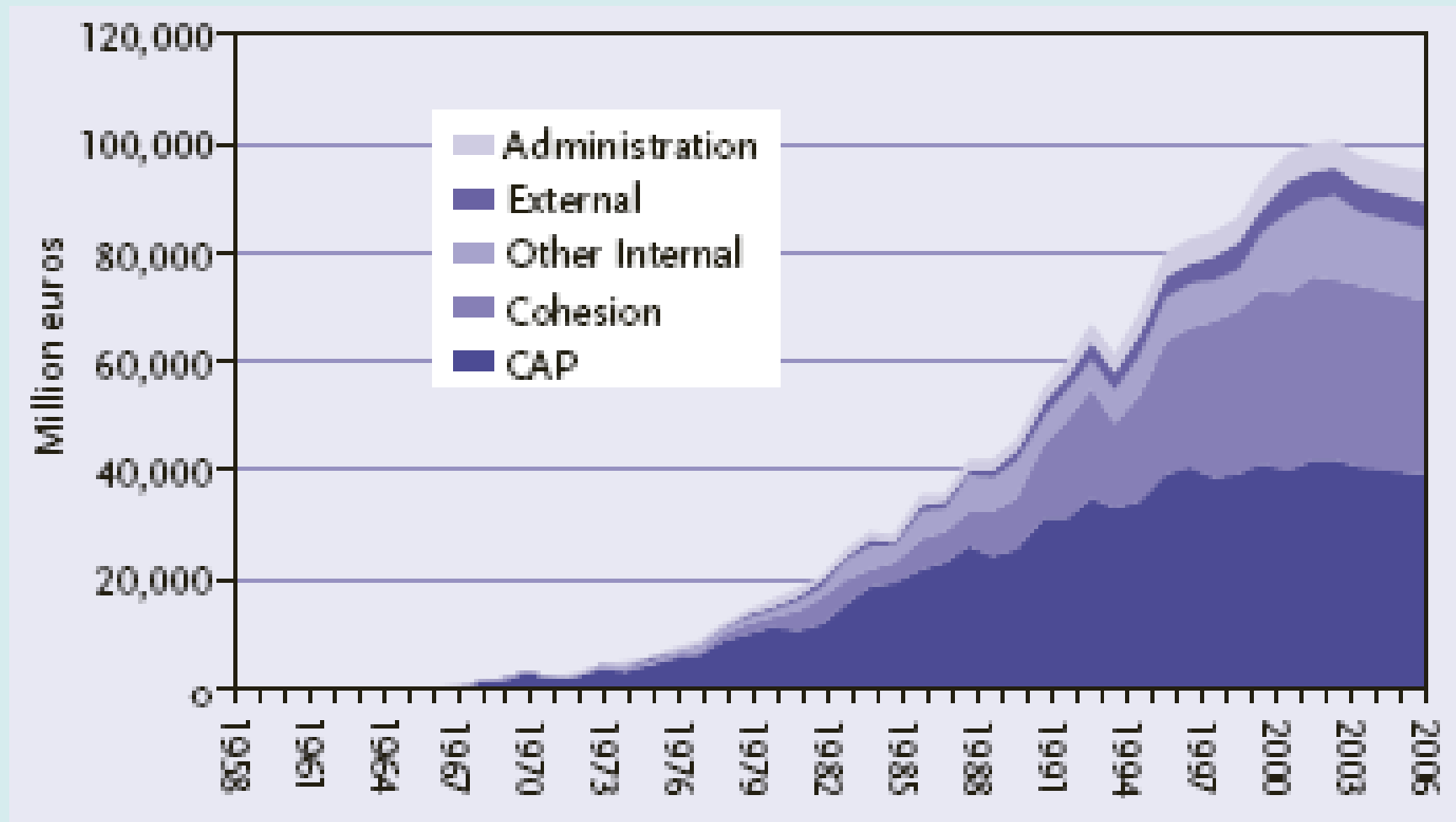
NOTE: Cohesion spending refers to spending on disadvantaged regions; this includes the Structural Funds (see Chapter 9) that can be spent on disadvantaged regions in any member, and the Cohesion Fund that can only be spent in Greece, Ireland, Portugal and Spain.

SOURCE: *General Budget of the EU for Financial Year 2003*, European Commission.

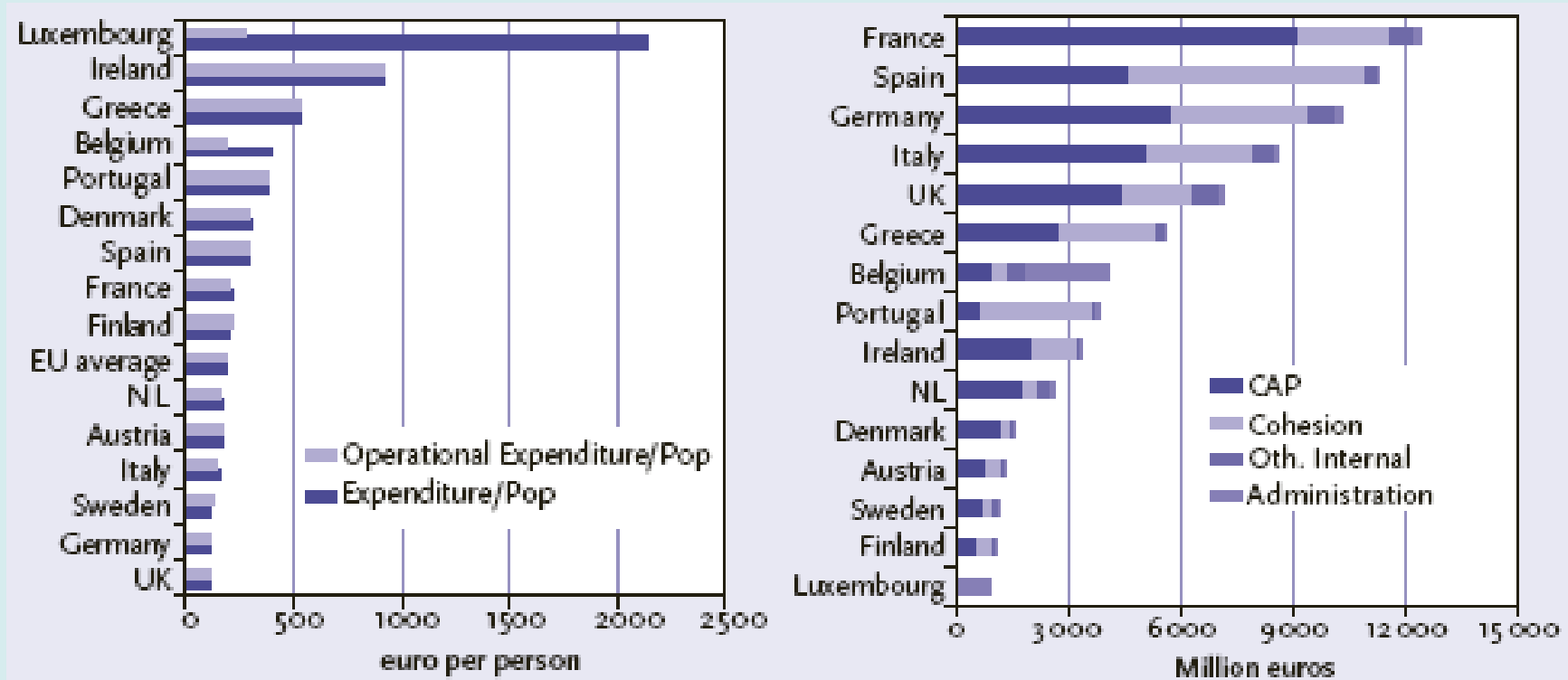
# Evolution of Spending Priorities



# Evolution of Spending, Level



# Evolution of Spending, Level



# Funding of EU Budget

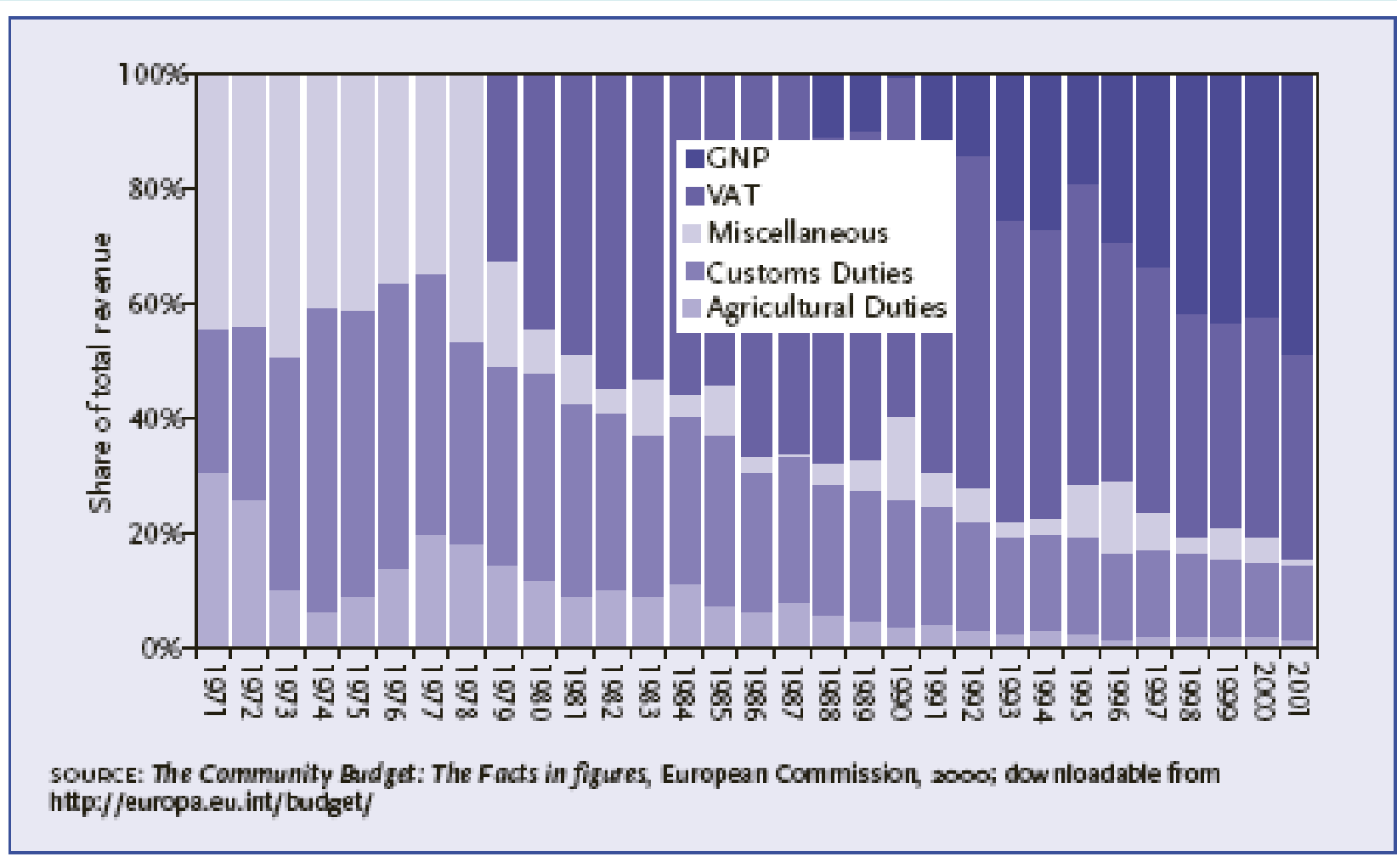
- EU's budget must balance every year.
- Financing sources: four main types:
  - Tariff revenue
  - 'Agricultural levies' (tariffs on agricultural goods)
  - 'VAT resource' (like a 1 per cent value added tax – reality is complex)
  - GNP based (tax paid by members based on their GNP).



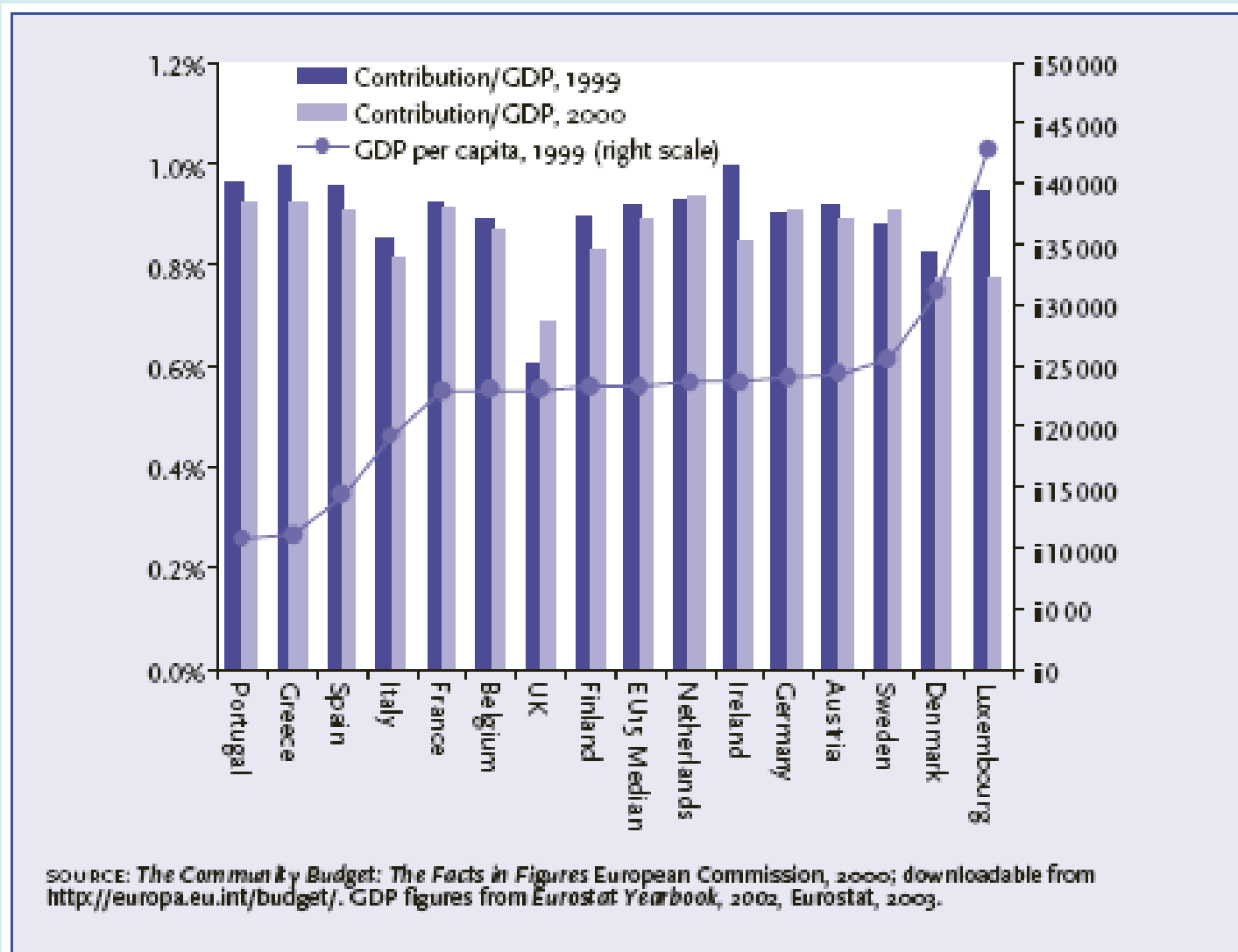
# Funding of EU Budget

- Miscellaneous
  - relatively unimportant since 1977
  - taxes paid by eurocrats, fines and earlier surpluses
  - pre-1970s direct member contributions.

# Evolution of Funding Sources



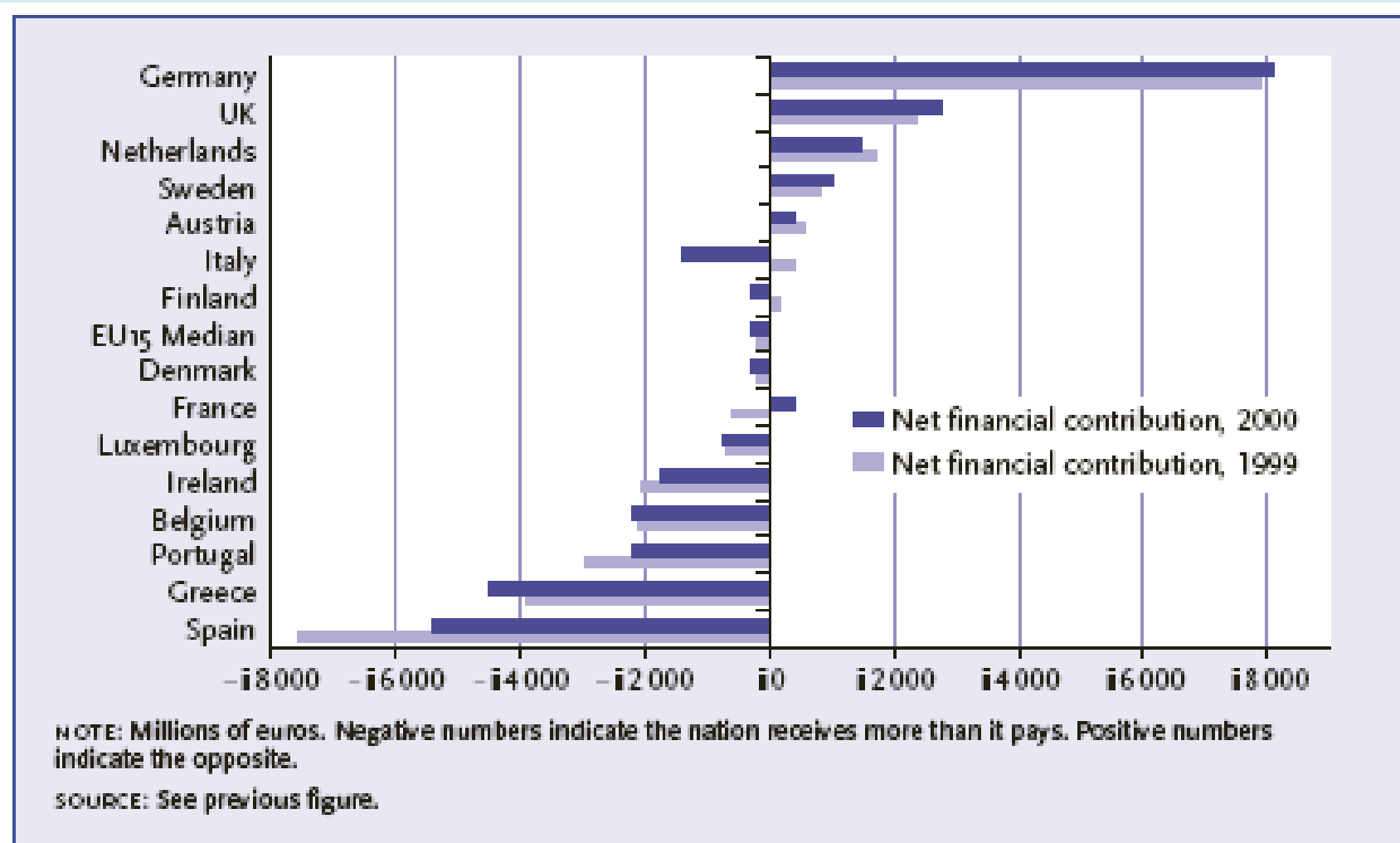
# Contribution vs GDP, 1999, 2000



# Contribution vs GDP, 1999, 2000

- Percentage of GDP per member is approximately 1 percent regardless of per-capita income.
- EU contributions are not 'progressive', e.g. richest nation, (L) pays less of its GDP than the poorest nation (P).

# Net Contribution by Member



# Chapter 3

# Decision Making



# Task allocation and subsidiarity

- Key question: “Which level of government is responsible for each task?”
  - Setting foreign policy
  - Speed limits
  - School curriculum
  - Trade policy, etc
- Typical levels:
  - local
  - regional
  - national
  - EU
- Task allocation = ‘competencies’ in EU jargon

# Subsidiarity principle

- Before looking at the theory, what is the practice in EU?
- Task allocation in EU guided by subsidiarity principle (Maastricht Treaty)
  - Decisions should be made as close to the people as possible,
  - EU should not take action unless doing so is more effective than action taken at national, regional or local level.
- Background: “creeping competencies”
  - Range of task where EU policy matters was expanding.
  - Some Member States wanted to discipline this spread.



# 3 Pillars and task allocation

- 3 Pillar structure delimits range of:
  - Community competencies (tasks allocated to EU).
  - Shared competencies (areas where task are split between EU and member states).
  - National competencies.
- 1<sup>st</sup> pillar is EU competency.
- 2<sup>nd</sup> and 3<sup>rd</sup> are generally national competencies
  - details complex, but basically members pursue cooperation but do not transfer sovereignty to EU.

# Theory: Fiscal federalism

- What is optimal allocation of tasks?
- Basic theoretical approach is called Fiscal Federalism.
  - Name comes from the study a taxation, especially which taxes should be set at the national vs sub-national level.

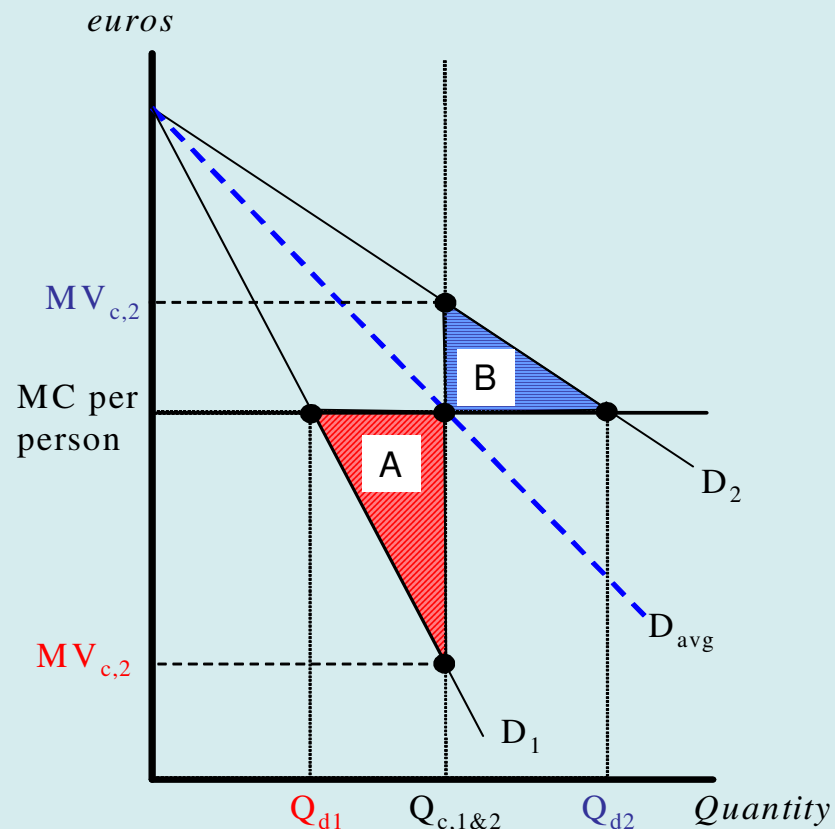
# Fiscal federalism: The basic trade-offs

- What is optimal allocation of tasks
  - NB: there is no clear answer from theory, just of list of trade-offs to be considered.
- Diversity and local informational advantages
  - Diversity of preference and local conditions argues for setting policy at low level (i.e. close to people).
- Scale economies
  - Tends to favour centralisation and one-size-fits-all to lower costs.
- Spillovers
  - Negative and positive spillovers argue for centralisation.
    - Local governments tend to underappreciated the impact (positive or negative) on other jurisdictions. (Passing Parade parable).
- Democracy as a control mechanism
  - Favours decentralisation so voters have finer choices.
- Jurisdictional competition
  - Favours decentralisation to allow voters a choice.

# Diversity and local information

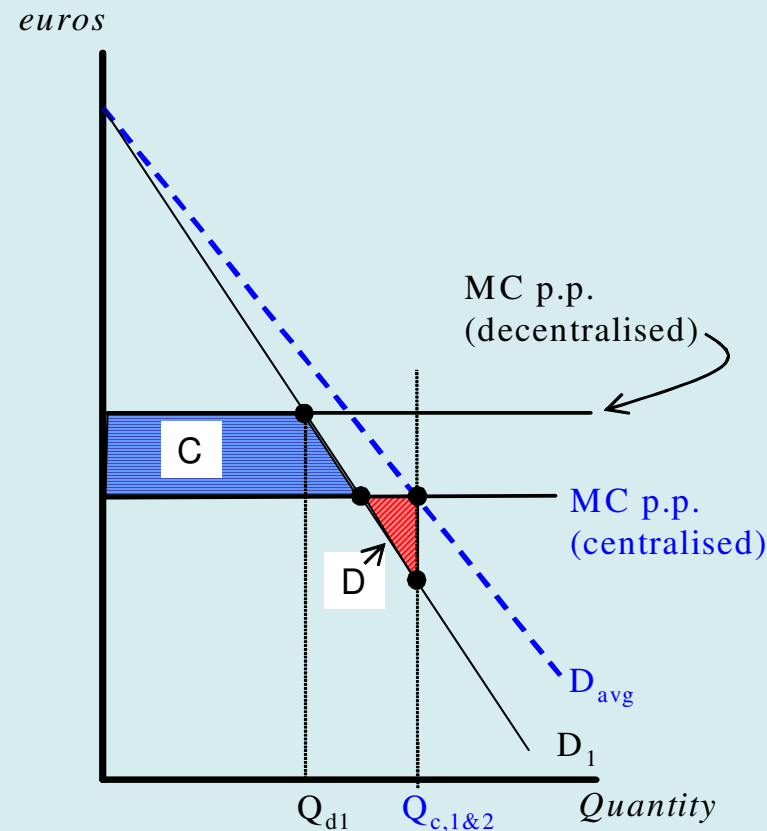
## • Closer look at the trade-offs

- One-size-fits-all policies tend to be inefficient since too much for some and too little for others.
- central government could set different local policies but Local Government likely to have an information advantage.



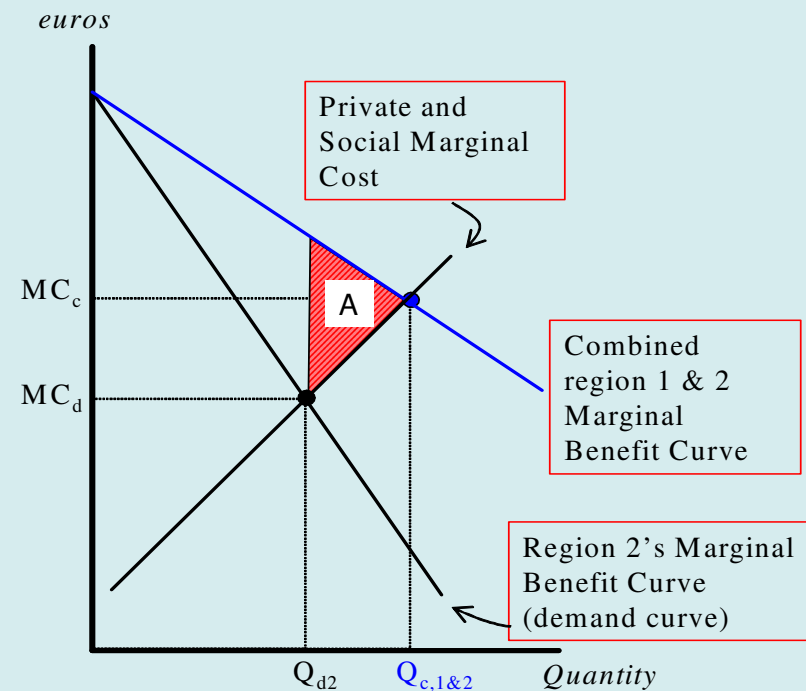
# Scale

- By producing public good at higher scale, or applying to more people may lower average cost.
- This ends to favour centralisation.
  - Hard to think of examples of this in the EU.



# Spillovers

- Example of a positive spillovers.
- If decentralised, each region chooses level of public good that is too low.
  - e.g.  $Q_{d2}$  for region 2.
- Two-region gain from centralisation is area A.
- Similar conclusion if negative spillovers.
  - $Q$  too high with decentralised.



# Democracy as a control mechanism

- If policy is in hands of local officials and these are elected, then citizens' votes have more precise control over what politicians do.
- High level elections are take-it-over-leave-it for many issues since only a handful of choices between 'promise packages' (parties/candidates) and many, many issues.
  - Example of such packages:
    - Foreign policy & Economic policy.
    - Centre-right's package vs Centre-left's package.
    - At national level, can't choose Centre-right's economics and Centre-left's foreign policy.

# Jurisdictional competition

- Voters influence government they live under via:
  - ‘voice’
    - Voting, lobbying, etc.
  - ‘exit’.
    - Change jurisdictions (e.g. move between cities).
- While exit is not a option for most voters at the national level, it usually is at the sub-national level. And more so for firms.
  - Since people/firms can move, politicians must pay closer attention to the wishes of the people.
  - With centralised policy making, this pressure evaporates.



# Economical view of decision making

- Using theory to think about EU institutional reforms.
  - e.g., Institutional changes in Constitutional Treaty, Nice Treaty, etc.
- Take enlargement-related EU institutional reform as example.

# EU enlargement challenges

- Since 1994 Eastern enlargement was inevitable & EU institutional reform required.
  - 3 C's: CAP, Cohesion & Control.
  - Here the focus is on Control, i.e. decision making.
- Endpoint: EU leaders accepted the Constitutional Treaty June 2004.
- Look Nice Treaty and Constitutional Treaty.
  - Nice Treaty is in force now and will remain in force until new Treaty is ratified.
- Focus on Council of Ministers voting rules.
  - See Chapter 2; these are the key part of EU decision making.

# Voting rules

- Voting rules can be complex, especially as number of voters rises.
- Number of yes-no coalitions is  $2^n$ .
  - Example: All combinations of yes & no votes with 3 voters Mr A, Mrs B, and Dr C;
- Example: EU9 when Giscard d'Estaing was President of France.
  - 512 possible coalitions.
- When Giscard considered Constitutional Treaty rules, it was for at least 27 members:
  - 134 million coalitions.

Yes	No
A, B, C	
A, B	C
A	B, C
B, C	A
C	A, B
	ABC
A, C	B
B	A, C

## 2 Formal Measures

- 1. “Passage Probability” measures ‘Decision making efficiency’.
  - Ability to act
- 2. Normalise Banzhaf Index measure Power distribution among members.
  - Many others are possible

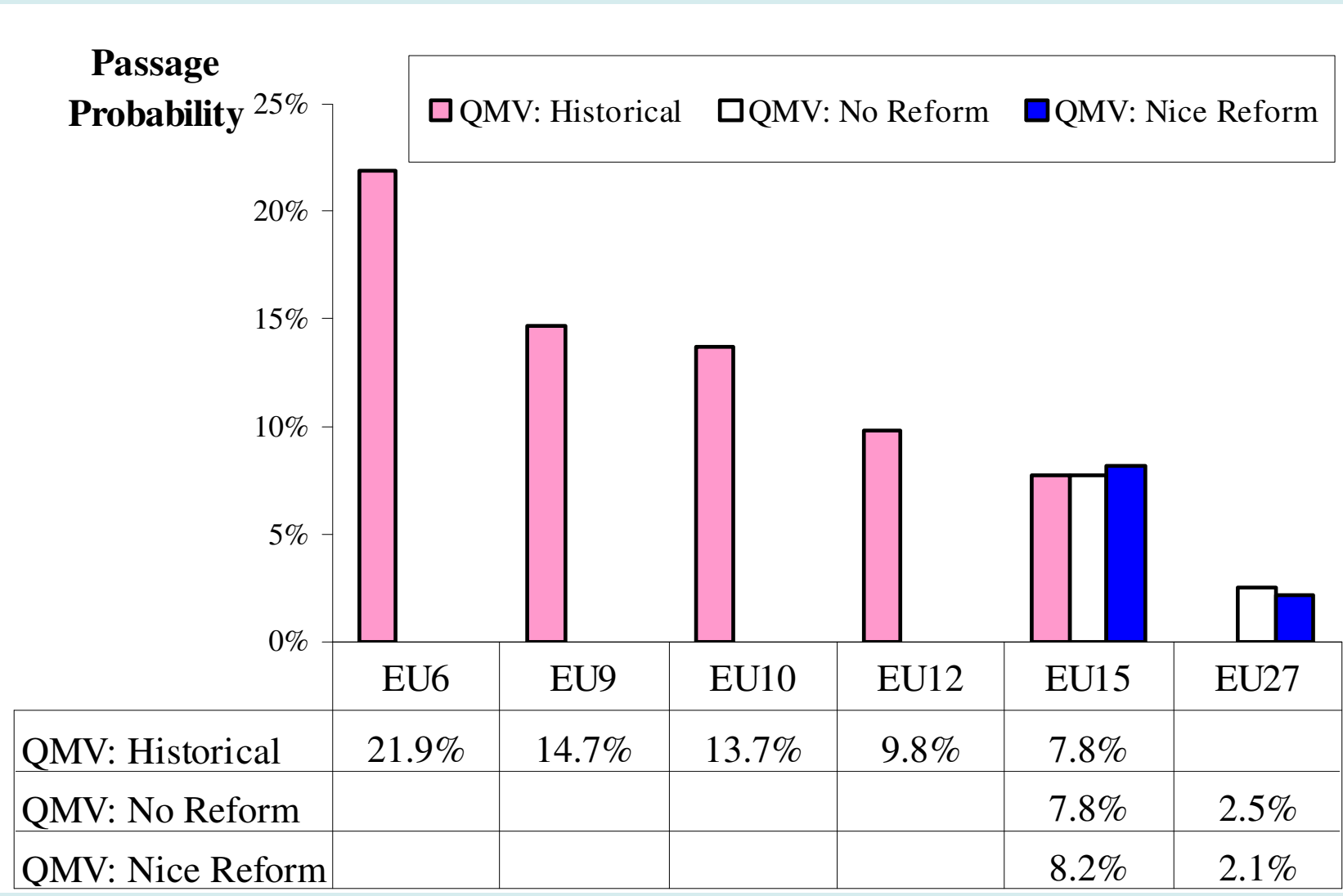
# Passage probability explained

- Passage probability is ratio of two numbers:
  - Numerator is total number of winning coalitions.
  - Denominator is total number of coalitions.
- Passage probability equals probability of win if all coalitions are equally likely.
  - Idea is that for a ‘random’ proposal, all coalitions equally likely.
  - Nations don’t know in advance whether they will ‘yes’ or ‘no.’
- Caveats: This is a very imperfect measure.
  - Not random proposals,
- But, still useful as measure of change in decision-making efficiency.

# Nice reforms: 1 step forward, 2 steps backward

- Step Forward:
  - Re-weighting improves decision-making efficiency.
- 2 Steps Backwards:
  - 2 new majority criteria worsens efficiency.
  - raising vote threshold worsens efficiency.
- The ways to block in Council massively increased.
  - EU decision-making extremely difficult.
- Main point is Vote Threshold raised.
  - Pop & member criteria almost never matter.
    - About 20 times out of 2.7 million winning coalitions.
  - Even small increases in threshold around 70% lowers passage probability a lot.
    - The number of blocking coalitions expands rapidly compared to the number of winning coalitions.

# Historical Passage Probabilities

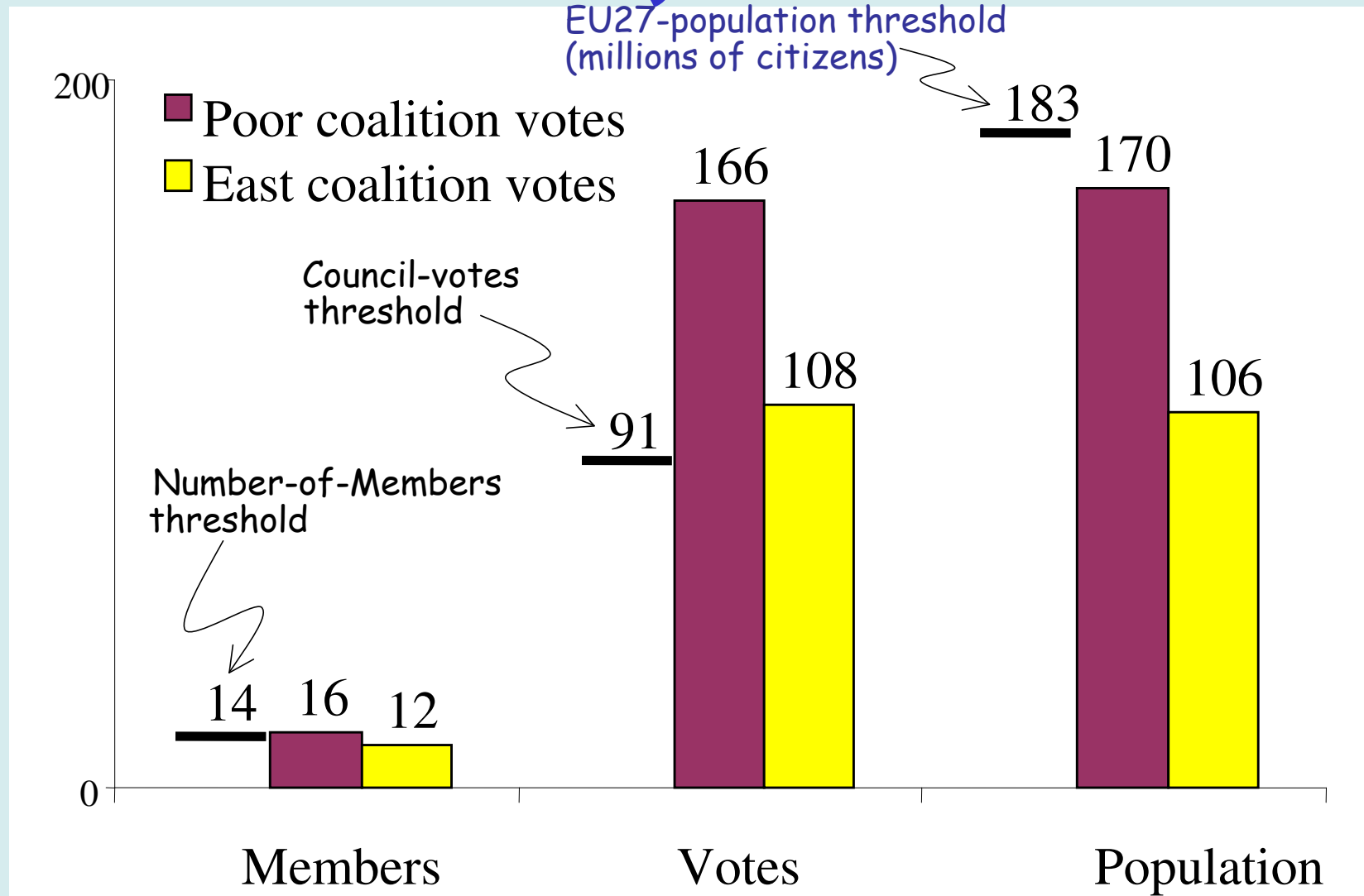


# Less formal analysis

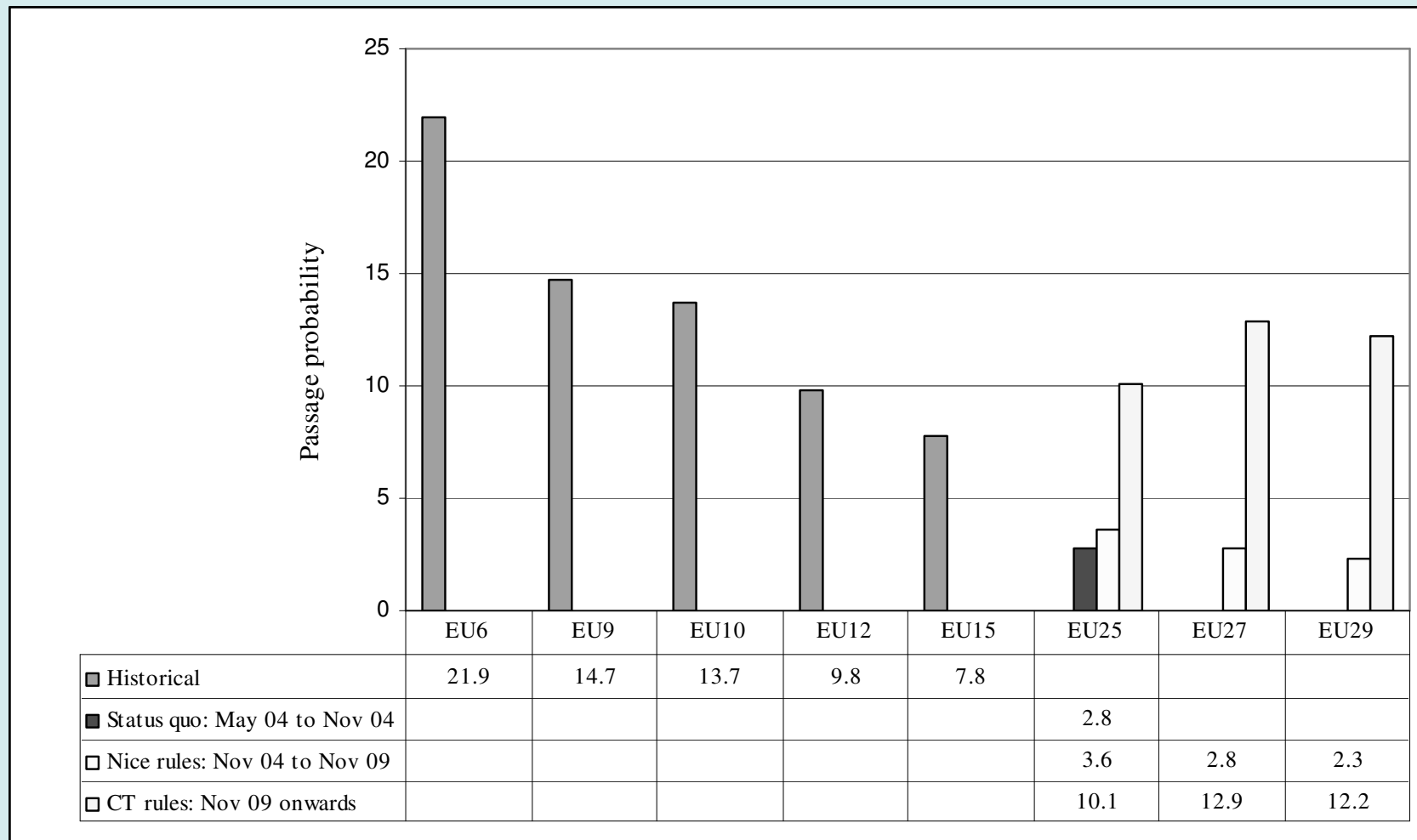
- Blocking coalitions.
- Easier to think about & probably what most EU leaders used.
- Try to project likely coalitions and their power to block.
- For example, coalition of “Newcomers” & coalition of “Poor”.



# Examples: 2 blocking coalitions, Nice rules



# Constitutional Treaty rules very efficient



# Power measures

- Formal power measures:
- Power = probability of making or breaking a winning coalition.
  - SSI = power to make.
  - NBI = power to break.
- Focus on the NBI.

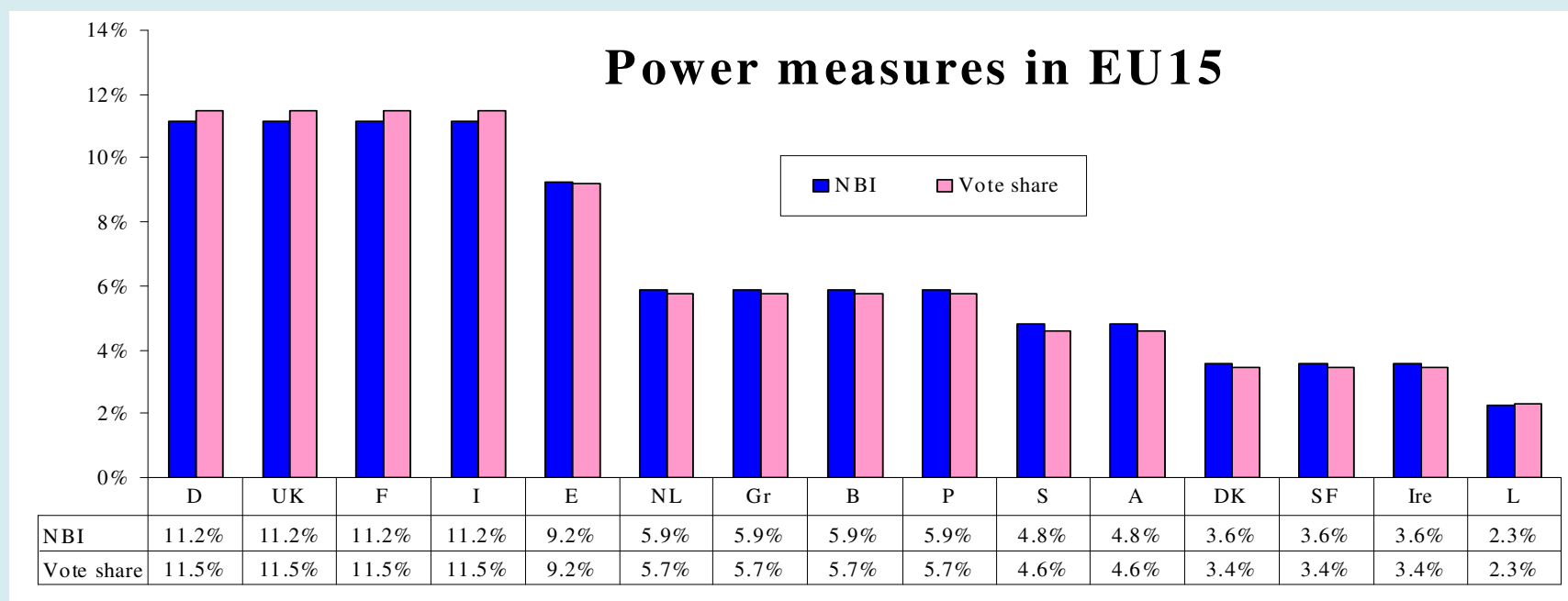
In words, NBI is a Member's share of swing votes.

# ASIDE: Power measures

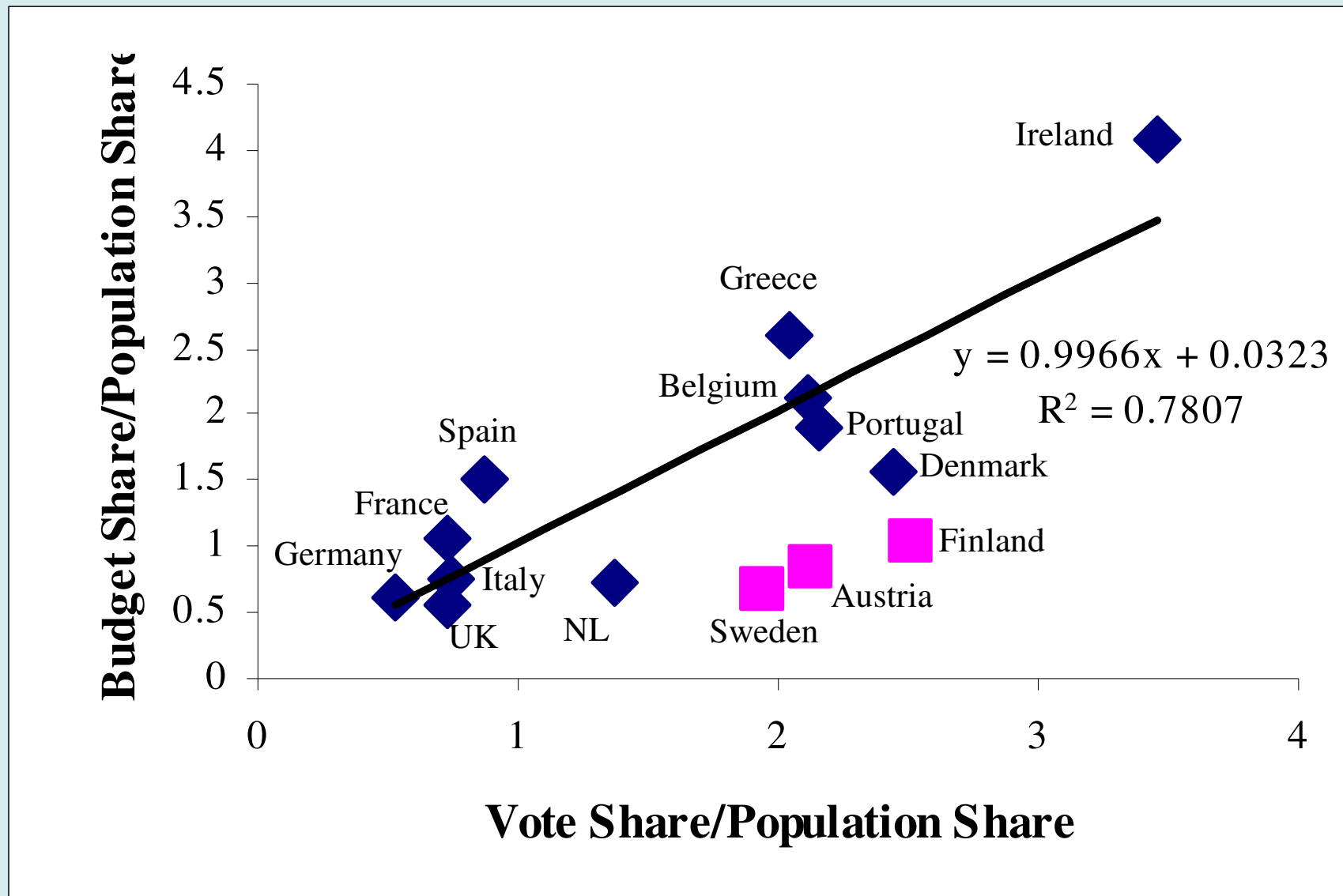
- Why use fancy, formal power measures?
- Why not use vote shares?
  - Simple counter example: 3 voters, A, B & C
  - A = 40 votes, B=40 votes, C=20 votes
  - Need 50% of votes to win.
- All equally powerful!
- Next, suppose majority threshold rises to 80 votes.
  - C loses all power.

# Distribution of power among EU members

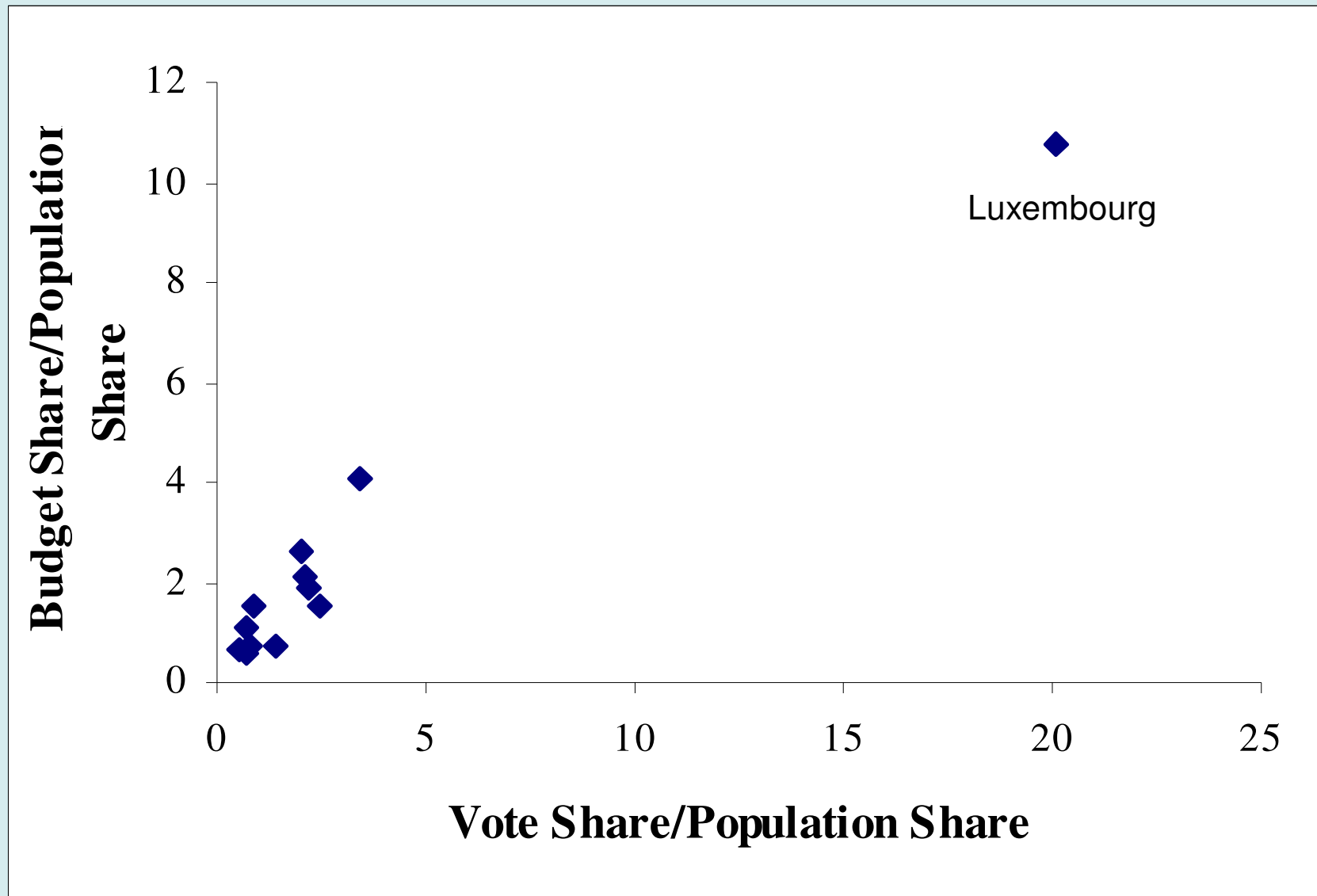
- For EU15, NBI is very similar to share of Council votes, so the distinction is not so important as in 3 country example.



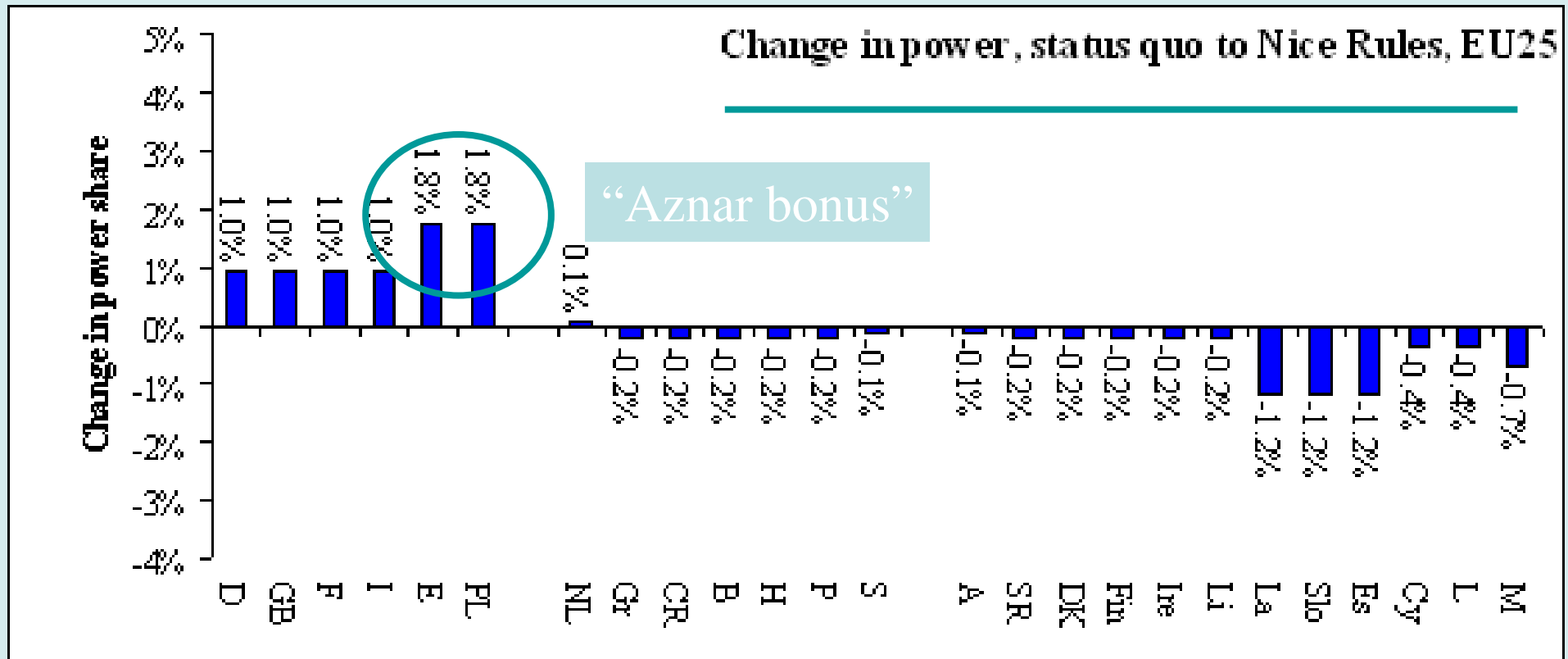
# Do power measures matter?



# Do power measures matter?



# Winners & Losers from Nice

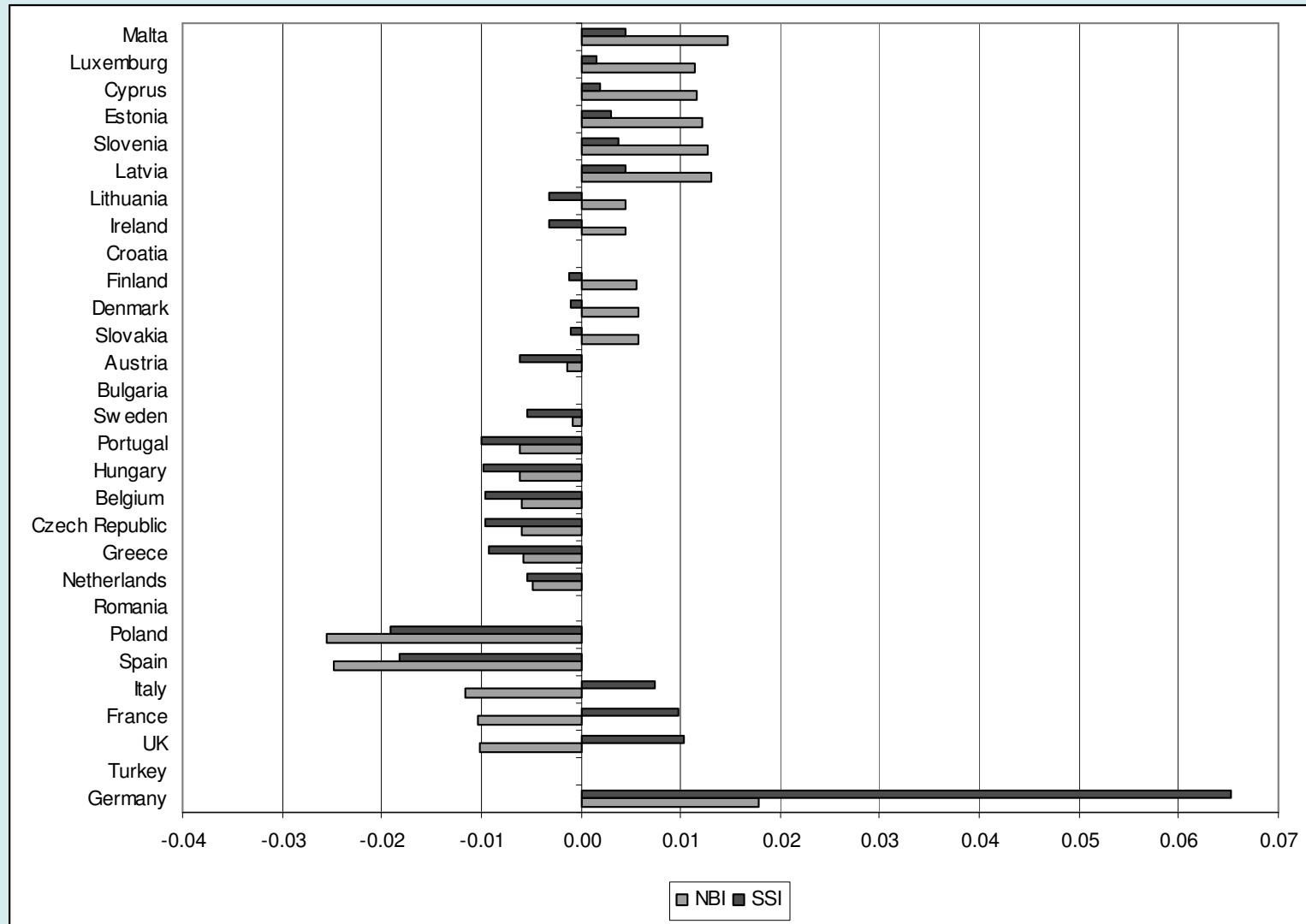


Poland  
Spain  
Italy  
France  
UK  
Germany



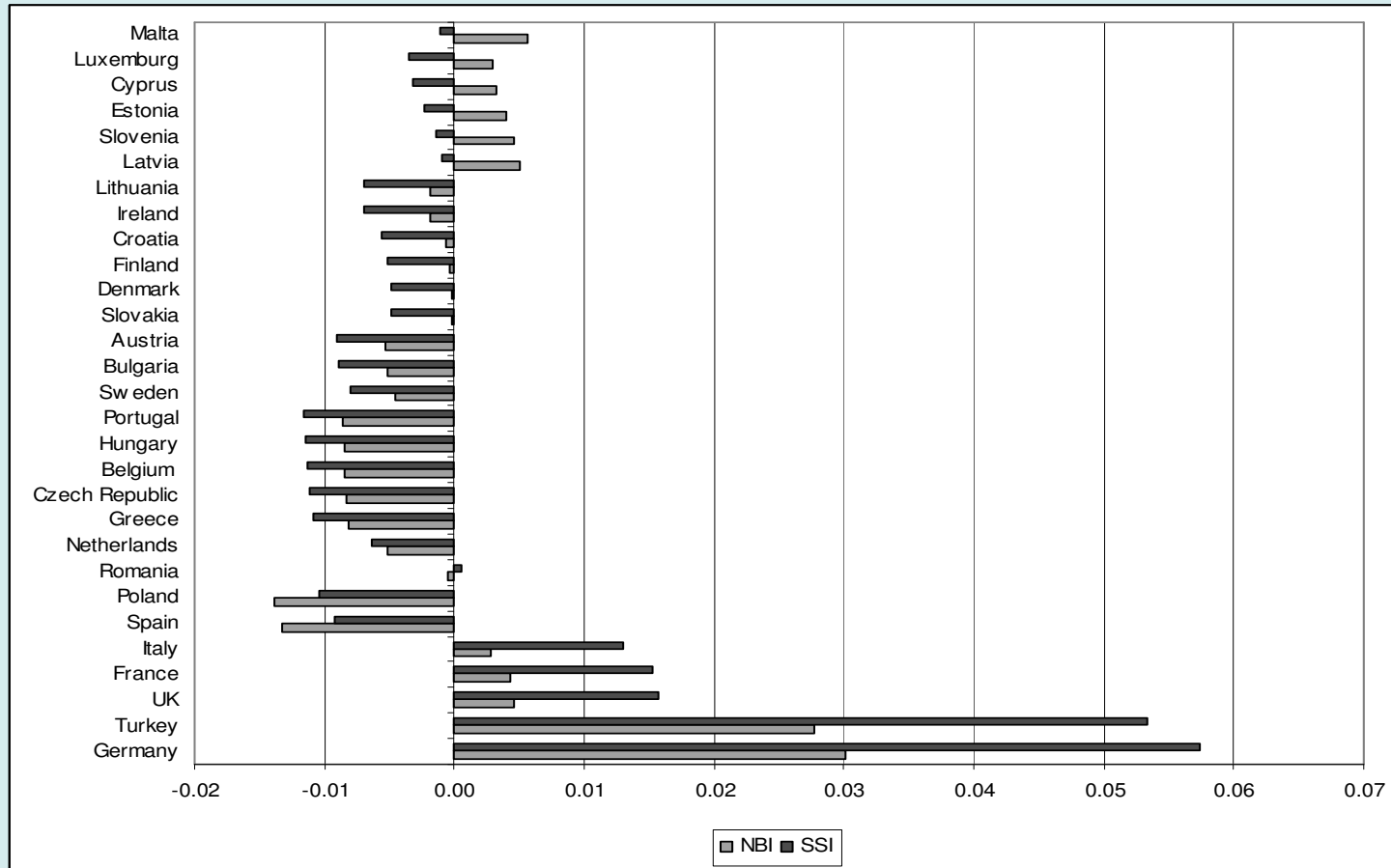
# Impact of Constitution rules

- Change in power in EU-25, Nice to CT rules, %-points



# Impact of Constitution rules

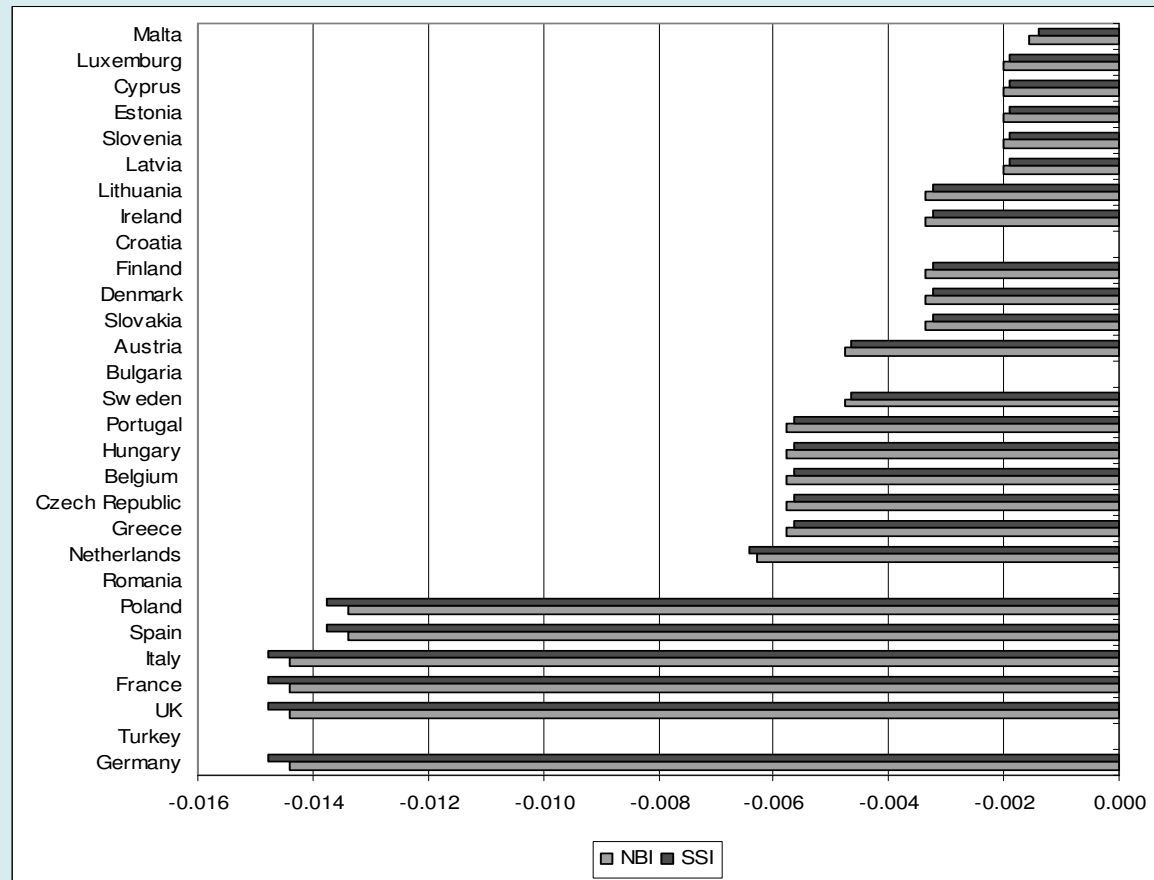
- *Power change CT and Nice rules in EU-29, %-points*



•Source: Baldwin & Widgren (2005)

# Impact of Constitution rules

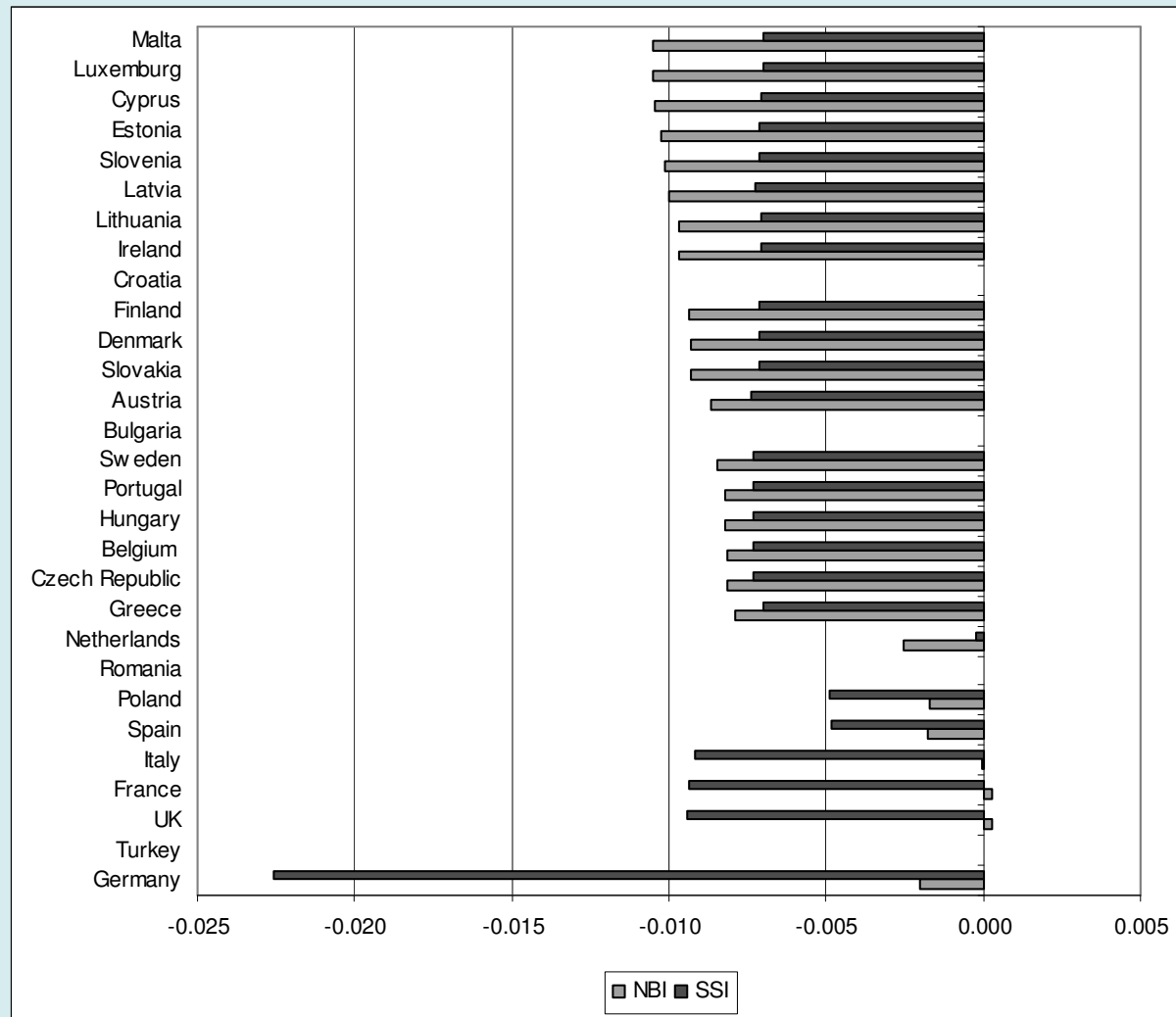
- Enlargement's impact on EU25 power, %-points, Nice rules



•Source: Baldwin & Widgren (2005)

# Impact of Constitution rules

- Enlargement's impact on EU25 power, %-points, CT rules



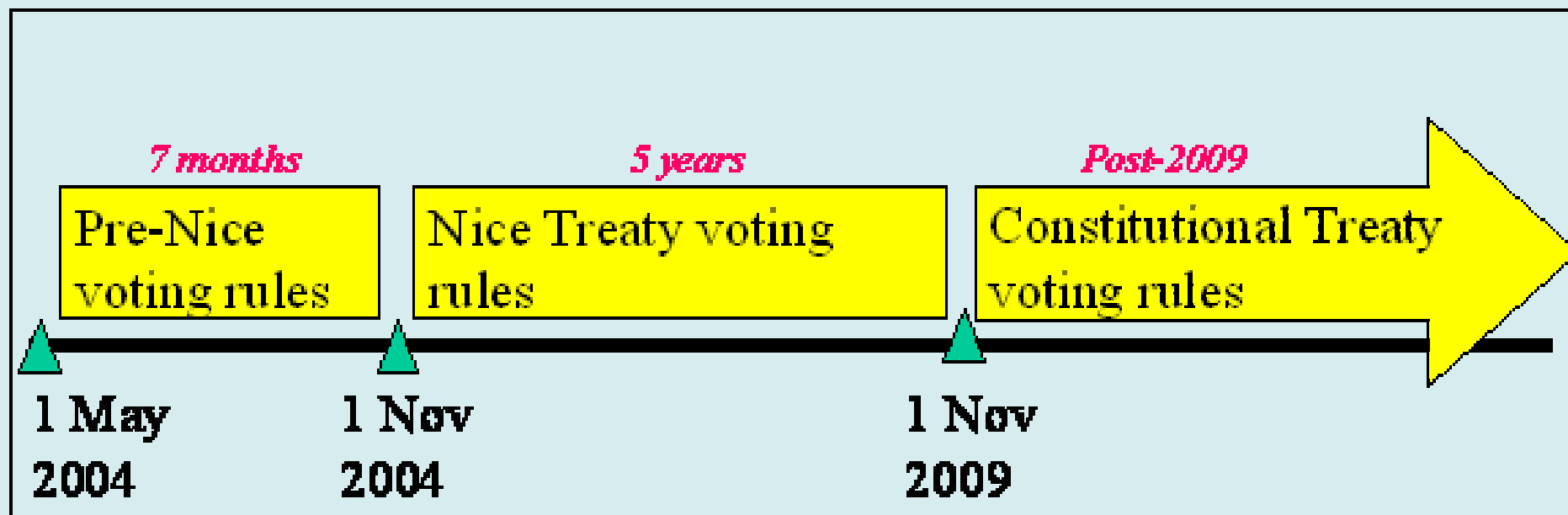
•Source: Baldwin & Widgren (2005)

# Legitimacy in EU decision making

- Legitimacy is slippery concept.
  - Approach: equal power per citizen is legitimate 'fair'.
- Fairness & square-ness.
  - Subtle maths shows that equal power per EU citizen requires Council votes to be proportional to square root of national populations.
- Intuition for this:
  - EU is a two-step procedure
    - Citizens elect national governments,
    - These vote in the Council.
  - Typical Frenchwoman is less likely to be influential in national election than a Dane.
  - So French minister needs more votes in Council to equalise likelihood of any single French voter being influential (power).
  - How much more?
  - Maths of voting says it should be the square root of national population.

# Voting rules in the CT

- Three sets of rules



# Pre-Nice Treaty Voting Rules

- No longer used since 1 November 2004, but important as a basis of comparison.
- “Qualified Majority Voting” (QMV):
  - ‘weighted voting’ in place since 1958,
  - Each member has number of votes,
  - Populous members more votes, but far less than population-proportional.
    - e.g. Germany 10, Luxembourg 2
  - Majority threshold about 71% of votes to win.

# Nice Treaty Voting Rules

- 3 main changes for Council of Ministers:
- Maintained 'weighted voting'.
  - Majority threshold raised.
- Votes re-weighted.
  - Big & 'near-big' members gain a lot of weight.
- Added 2 new majority criteria:
  - Population (62%) and members (50%).
- ERGO, triple majority system.
  - Hybrid of 'Double Majority' & Standard QMV.



# Post Nov 2009 rules

- If the Constitution is ratified, then New system after November 2009: Double Majority.
- Approve requires 'yes' votes of a coalition of members that represent at least:
  - 55% of members,
  - 65% of EU population.
- Aside: Last minute change introduced a minimum of 15 members to approve, but this is irrelevant.
  - By 2009, EU will be 27 and  $0.55 \times 27 = 14.85$
  - i.e. 15 members to win anyway.