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What Is European Integration Really About? A Political Guide for Economists

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Abstract

Europe's monetary union is part of a broader process of integration that started in the aftermath of World War II. In this "political guide for economists" we look at the creation of the euro within the bigger picture of European integration. How and why were European institutions established? What are the goals and determinants of European Integration? What is European integration really about? We address these questions from a political-economy perspective, building on ideas and results from the economic literature on the formation of states and political unions. Specifically, we look at the motivations, assumptions, and limitations of the European strategy, initiated by Jean Monnet and his collaborators, of partially integrating policy functions in a few areas, with the expectation that more integration will follow in other areas, in a sort of chain reaction towards an "ever-closer union." The euro with its current problems is a child of that strategy and its limits.

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As an economic and financial crisis unfolds across the European Union, critics argue that European institutional integration has gone too far, blame misguided political motivations, and assert that the monetary union has failed (for example, Feldstein 2012). On the other side, supporters of European integration attribute the euro crisis to institutional incompleteness—what Bergsten (2012) called a "half-built house." They argue that the solution to Europe's woes should be sought in additional integration: a banking union, a fiscal union, or perhaps even a full political union and the formation of a federation.

Tommaso Padoa-Schioppa (2004, p. 1), the economist and central banker who played a key role in the birth of the euro, wrote: "[T]he euro was the result of a long-term development that started in the aftermath of World War II. After experiencing political oppression and war in the first half of the twentieth century, Europe undertook to build a new order for peace, freedom, and prosperity. Despite its predominantly economic content, the European Union is an eminently political construct. Even readers primarily interested in economics would hardly understand the euro if they ignored its political dimension."

This political guide for economists takes a step back and looks at the creation of the euro within the bigger picture of European integration. How and why were European institutions established? What is European integration really about?

The history of European integration is complicated, with a big cast of actors including governments, technocrats, interest groups, and voters, who in turn pursue a range of economic and political goals. This complexity is reflected in a variety of interpretations by political scientists and political economists (for overviews, see Gilpin 2001, chapter 13; Eichengreen 2006; and Sadeh and Verdun 2009). This article discusses facts and theories about European integration from a political-economy perspective, building on ideas and results from the economic literature on the formation of states and political union (for overviews, see Spolaore 2006, 2012). Specifically, we look at the motivations, assumptions, and limitations of the European strategy of partially integrating policy functions in a few areas, with the expectation that more integration will follow in other areas, in a sort of chain reaction towards an "ever-closer union." The euro with its current problems is a child of that strategy and its limits.

A European Federation?

The idea of a new sovereign federation across Europe goes back a long time, but it received a big push from the first half of the twentieth century. At the end of World War II, the promoters of European integration looked back at the previous decades and saw a continent fragmented in independent and unconstrained nation states, which had pursed costly beggar-thy-neighbor policies during the Great Depression and engaged in two major wars. The goal

of European integration was to create a system where nation states would no longer follow such unilateral and destructive policies.

In 1943 a group led by Altiero Spinelli founded the European Federalist Movement. In 1946, Winston Churchill argued for the creation of "the United States of Europe" (which in his view did not include Britain). By definition, a federation would have eliminated national borders and international conflict (but not civil conflict) among Europeans. However, no European federation was created immediately after World War II.

Instead, the founding document of European integration is the Schuman declaration of May 9, 1950, named after France's foreign minister Robert Schuman and inspired by Jean Monnet, a businessman and civil servant who played a crucial role in starting European institutions in the following years. The declaration proposed that "Franco-German production of coal and steel as a whole be placed under a common High Authority, within the framework of an organization open to the participation of the other countries of Europe." The plan was motivated by security, as a way "to make it plain that any war between France and Germany becomes not merely unthinkable, but materially impossible." The pooling of coal and steel production was ambitiously defined as "a first step in the federation of Europe."

The Schumann declaration led in 1951 to the European Coal and Steel Community (ECSC) among six countries.[1] The ECSC was then used as the institutional template for two proposed communities: the European Defense Community and the European Political Community, which included the formation of a common army, a common budget, and common institutions with significant legislative and executive powers. It would have basically amounted to a European federation (Moravcsik 1998; Rector 2009). A treaty was signed among the six countries in 1952 but failed to obtain ratification in the French parliament, and never took effect. In 1955 several politicians, including Jean Monnet, created an "Action Committee for the United States of Europe." But, again, no United States of Europe actually formed.[2]

The fundamental reasons behind these failures to form a federation have bedeviled the supporters of a United States of Europe, then and since. There are two issues which are key to understanding the beginning of the integration process, its setbacks, and the following path of European integration. One issue is a general problem in political economy: the trade-off between costs and benefits when heterogeneous groups are politically integrated under a

[1] France, West Germany, Italy, the Netherlands, Belgium, and Luxembourg.

[2] Subsequent less ambitious attempts to integrate European defense and foreign policy have not been very successful either. For instance, see Alesina and Perotti (2004) for a critical discussion of the more recent experience of the European Union in these and other areas.

common authority. The other issue involves the particular role of Germany, the country that played a central role in World Wars I and II.

The Political Economy of Heterogeneous Populations

The formation of a European federation across heterogeneous populations, which share diverse social and economic structures, languages, cultures and identities, would come with several benefits but also with high costs. The trade-off between such costs and benefits is central to the political feasibility and stability of institutional integration among those populations (Alesina and Spolaore 1997, 2003).

Potential benefits from full political unification include economies of scale in the provision of federal public goods, such as defense and security, and the ability to internalize positive and negative externalities over a large area. A European federation with its own budget and redistribution policies could also provide insurance against asymmetric shocks that only affect some of its regions, whether natural, like an earthquake, or man-made, like the bursting of a housing bubble. These benefits from fiscal federalism are often stressed when comparing Europe to the United States (for example, Sala-i-Martin and Sachs 1992; Krugman 2012), and are now at the forefront of the debate about the European sovereign debt crisis (Lane 2012).

However, political unification comes with significant costs when various groups speak different languages, share different cultural norms and identities, and have different preferences for public policies and institutions that cannot be decentralized at the sub-federal level (Alesina and Spolaore 1997, 2003). Among those institutions is the ultimate "public good": the federal government itself, with all its constitutional and legal traits, policies, official language(s), and so on, about which German or Dutch people may have very different views from those prevalent in France or Italy.

A growing literature has explored the links between measures of heterogeneity and political outcomes, such as the provision of public goods, the extent of redistribution, the quality of government, and the likelihood of civil and international conflict. Microeconomic evidence links ethnic heterogeneity to underprovision of public goods at the local level (Alesina and La Ferrara 2005). There is also macroeconomic evidence of negative correlations between ethnolinguistic fractionalization and government performance, although causality and robustness are less clear-cut (Alesina et al. 2003). In addition, Montalvo and Reynal-Querol (2005) and Esteban, Mayoral and Ray (2012) find that ethnolinguistic polarization is associated with civil conflict. Desmet, Ortuño-Ortín and Weber (2009) show that once distances between languages are accounted for, linguistic diversity has a significant negative effect on redistribution. Desmet, Ortuño-Ortín and Wacziarg (2012) find that deep linguistic

distances are good predictors of civil conflict and redistribution, while even finer distinctions between languages, such as those among different dialects, matter for economic growth and public goods provision. The bottom line of this literature is that measures of ethnic, linguistic, and cultural diversity have significant effects on policy outcomes, redistribution, and the provision of public goods. A European federation would be quite heterogeneous by most of these measures, and likely to face significant political costs when choosing common public goods and policies at the federal level.[3]

The example of defense and security – which played a fundamental role in Europe's early attempts to integrate - can serve to illustrate these issues. These are public goods with high economies of scale, but also high heterogeneity costs stemming from diverse preferences across populations. Military power has historically been a central tool to ensure a government's monopoly of legitimate use of coercion over a territory. Integration of defense and security under one authority usually goes hand in hand with the centralization of this monopoly of coercion – that is, with the formation of a sovereign state or federation (Alesina and Spolaore 2003). However, different populations with different histories, cultures and identities are likely to disagree over the type of government in charge of such a federation. Moreover, coercion can then be used to collect taxes, finance a larger set of other public goods and redistribute resources across different groups. This redistribution is more likely to be resisted when groups are different not only economically but also along ethnic and linguistic lines. For instance, Western Germans may be more willing (or less unwilling) to redistribute resources to Eastern Germans than to Greeks or Italians. Consequently, centralized provision of defense and security across large and diverse populations usually takes place when dictatorial rulers are able to ignore the heterogeneity costs of the populations they conquer, and/or when there are overwhelming benefits of scale from defense that offset high heterogeneity costs (Alesina and Spolaore 2005, 2006). The two most successful federal republics, Switzerland and the United States, emerged in response to external security threats, and the unification of Germany in the nineteenth century resulted from conquest by Prussia (Riker 1964; Gilpin 2001).

Military and political union is not the only way to deal with security threats. Heterogeneous sovereign states can benefit from economies of scale in defense by forming military alliances, while still maintaining their political and fiscal independence. But military alliances, where each state can autonomously decide its own level of military spending and pay for it, can lead to undersupply of defense from the perspective of the whole alliance because of free riding (for a discussion, Spolaore 2012). Western Europeans failed to form a

[3]Fractionalization is maximized when each individual belongs to a different group, while polarization is maximized when there are only two large groups of equal size. A larger European federation formed by many groups would be more fractionalized but less polarized than a smaller federation dominated by a couple of groups (e.g., Germans and French).

federation even when faced with an existential threat from the Soviet Union, and relied instead on an international alliance (NATO), where issues of undersupply and free riding were in part addressed by the dominant role of the United States.

If heterogeneity can explain failures to integrate in the past, does it need to be an obstacle to future political integration? Over time, couldn't a federal Europe change political and social interactions and affect cultures and identities among Europeans, leading to a shared identity within a "European nation"? After all, nineteenth century France famously turned "peasants into Frenchmen" through public policies and modernization (Weber 1976).

This question is part of the broader debate on the persistent political and economic effects of historical and cultural traits, and the extent that culture itself can be changed by policies and institutions (for recent discussions, Bisin and Verdier 2010; Spolaore and Wacziarg 2013).[4] In the long run, people can learn new languages, modify their cultural traits and identities, and transmit different traits to their children in response to changing incentives, including public policies. However, it is at best a gamble to hope that political integration of modern democratic nations will lead to cultural integration. Historically, nation-building and attempts to "homogenize" populations were implemented by rulers of undemocratic societies who had an interest at reducing heterogeneity costs in order to maximize their own rents (Alesina and Spolaore 2003, pp. 76-78) or pursue their own preferences (Alesina and Reich 2013). Realistic supporters of European integration understand that convergence of political preferences through reduction of linguistic and cultural barriers, if it is going to occur at all, will be a slow and gradual process, which should take place naturally and consensually.

For Europeans, heterogeneity has been a source of benefits as well as of costs. When people have different preferences and traits, societies can benefit economically and culturally through specialization, learning, and exchange of goods and services, as well as ideas and innovations. Benefits from heterogeneity, however, are mostly about interactions over *rival* goods, not public goods, which are non-rival. *Similar* preferences over the same rival goods can lead closely related groups to conflict and war (Spolaore and Wacziarg, 2012), while *different* preferences over rival goods can facilitate peaceful exchanges and a better allocation of resources. In contrast, diverse preference over public goods, like a federation's government, laws, and public policies, will be much harder to reconcile because one kind must apply to everyone within the federation, whether everyone likes it or not. As a result, heterogeneity of preferences is mostly beneficial when people interact about rival goods but costly when sharing non-rival goods. This is an important reason why, as we will see, the European project has been much more successful when fostering economic exchanges and a

[4] There is also an extensive political literature debating whether the social and political relevance of ethnic and linguistic divisions can be altered by politics and institutional change (for a discussion, Fearon 2006).

common market, while it has stalled when attempting to pool "federal" public goods, such as defense and security.

The Role of Germany

In hindsight, as we look back at the 1952 treaty that would have established a European Defense Community and a European Political Community, what's perhaps more surprising is not that France rejected it, but that the other states ratified the treaty. A reason is that the other two largest states at that time, West Germany and Italy, had just emerged from a severe military defeat, and faced significant constraints to their own defense and foreign policy. West Germany was the more extreme case: a divided country, technically under military occupation until 1955. In those circumstances, the costs of constraints on German sovereignty by pooling defense and security were low and could be traded against other political and economic benefits. As Germany's status as a sovereign state "normalized" over time, its incentives to join a security-based federal union decreased.

The agreement for a European Coal and Steel Community is often interpreted from a similar perspective. According to Milward (1984), France proposed the coal and steel community to constrain German control of its own industry, in response to U.S. plans in 1949 to allow a Germany relatively free of allied supervision. Germany agreed to the Schuman plan because, by sharing management of its coal and steel, it could obtain important concessions, such as "the removal of ceilings on permissible levels of industrial production" (Eichengreen 2006, p, 802). According to Berger and Ritschl (1995), French access to German coal was "the most important element of the Monnet Plan for France's reconstruction."

These examples illustrate a continuing issue in the history and politics of European integration: the extent to which European supranational institutions can be interpreted as tools to constrain German power in the interest of its neighbors, especially France. This theme has come to the forefront again with the creation of the euro. A popular view is that giving up its currency was the price that Germany had to pay to overcome France's opposition to German reunification (Garrett, 1993; Marsh 2011), a deal summarized by the witticism quoted by Garton Ash (2012, p. 6): "[T]he whole of Deutschland for Kohl, half the deutsche mark for Mitterrand." Literally taken, as a quid pro quo, this interpretation is not held by most scholars (Sadeh and Verdun 2009). It is questionable that a French threat to veto the reunification of Germany could be credible. Moreover, key decisions about the single currency had already been taken before the fall of the Berlin Wall in 1989, and German politicians and interest groups (like exporters) had other strong reasons to favor a monetary union (Moravcsik 1998; Frieden 2002).

However, it is not fully coincidental that the implementation of the euro took place during and right after German reunification and the opening of political and economic relations between Western and Eastern Europe. Germany's chancellor at that time, Helmut Kohl, viewed the euro as a big step in the broader process of European integration, which he considered essential to reassure Germany's neighbors about his enlarged country's commitments to peace, security, and economic cooperation (Garton Ash 2012). And even though the process leading to economic and monetary union had started before the fall of the Berlin Wall, a detailed analysis of the interactions among key participants in the negotiations show that German reunification led to a reassessment of the relative payoffs from economic and monetary union, and was used "to reshape […] negotiations" (Dyson and Featherstone 1999, p. 16).

The increase in Germany's potential power might also have affected the borders of the future euro area, making it much larger than predicted by efficiency criteria, such as the theory of Optimum Currency Areas. For example, Eichengreen (2012, p. 125) mentions the view that France and others pushed for the inclusion of many countries at the "periphery," like Southern Mediterranean countries, to "balance" Germany's larger size and influence within the monetary union.

Whether these *Realpolitik* interpretations are fully persuasive, the French government saw a close link between German reunification and European integration. According to an adviser to the French President, "Mitterrand did not want [German] reunification without advances toward greater European integration, and the currency was the only topic that was open to debate" (*Spiegel*, 2010).

How had a monetary issue become "the next step" in the process of European integration? What was (and is) such a process about? To answer these questions we need to go back to what happened after the rejection of the defense and political communities in the mid-1950s.

From the Common Market to Economic and Monetary Union: Jean Monnet's Chain Reaction?

From the successful creation of the European Coal and Steel Community and the rejection of the European Defense Community, Jean Monnet and the other supporters of European integration learned a lesson in political realism (Duchêne 1994). Partial integration in narrowly defined areas, such as coal and steel, was feasible, while more ambitious integration in broader areas such as defense and policy coordination would meet too much political opposition. Their next step was the creation in 1957 of a community similar to ECSC for civilian atomic energy (EURATOM), and, more importantly, a European

Economic Community (EEC) to set up a customs union: the "common market." The institutions of the three communities were later merged and became known as the European Community. The treaties of Maastricht (1992) and Lisbon (2009) reorganized and replaced the European Community with the European Union.

The Treaty of Rome of 1957 establishing the European common market no longer referred to steps "toward a federation," but included the vaguer objective of laying the "foundations of an ever-closer union among the peoples of Europe."[5] The signatories' main stated goal was "to ensure the economic and social progress of their countries by common action to eliminate the barriers which divide Europe," while claiming that this would strengthen peace and security. To foster those goals, European states created two sets of institutions: supranational institutions such as the European Commission, Parliament, and Court of Justice, and intergovernmental institutions, such as the Council of Ministers and, later, the European Council, formed by the heads of state or government of the member states.

Over time, policy functions have been delegated to European institutions in an increasing range of areas. Nonetheless, national governments have kept control over fundamental decisions, and must decide unanimously on all changes to the international treaties that set Europe's informal "constitution." An attempt to establish a formal "Constitution for Europe" failed when it was rejected by French and Dutch voters in 2005.

The history of European integration reflects this tension between the role of supranational institutions and the power of national governments. The conflict is also mirrored by the two most influential political theories about European integration: functionalism and intergovernmentalism. This terminology is rather confusing for the uninitiated.[6] In a nutshell, the theories are distinguished by how they answer the question: who is in charge of European integration?

Intergovernmentalists believe that national governments are in charge, and that supranational institutions are tools of the national states, which use them to pursue their own goals. Moravcsik (1993, 1998), an influential proponent of this theory, believes that national governments have built European institutions in order to pursue the economic interests of their domestic constituencies. In this spirit, Moravcsik (2012) views the euro as an economic gamble, mostly reflecting the interests of powerful national producers. This interpretation fits within a broader literature emphasizing the link from domestic economic interests to national attitudes and policies towards European integration (for example, Frieden 1998, 2002). The

[5] http://ec.europa.eu/economy_finance/emu_history/documents/treaties/rometreaty2.pdf

[6] The jargon is furthermore complicated by "neo" prefixes and other qualifications. Haas (1958,1964), the father of the functionalist approach to European integration, called his theory "neo-functionalism," to distinguish it from a previous theory of international cooperation developed by David Mitrany. Moravcsik (1993, 1998) calls his approach "liberal intergovernmentalism" to distinguish it from "realist" theories that also place national states at the center of the analysis, but emphasize power and interstate rivalry rather than domestic economic interests. In this article I only use the simpler terms.

political-economy approach to regional integration based on domestic economic interests is familiar to the economics profession, and therefore I will not say more here. I will focus instead on the alternative theory of functionalism, which is much less known among economists, even though it has played a significant role in the ideology and practice of European integration and the creation of the euro.

Functionalists believe that European integration is not primarily driven by national governments and their voters, but mostly pushed by elites and interest groups that transcend national boundaries. They stress the role of supranational entrepreneurs and civil servants like Jean Monnet in the 1950s and Jacques Delors in the 1980s and 1990s. The theory is called "functionalism" because it is about the dynamic effects of transferring specific "functions" to supranational institutions – for example, regulation of coal and steel production to the European Coal and Steel Community or monetary policy to the European Central Bank. Although this integration starts in economic areas, integration in one area may well lead to further integration in many other areas, not only economic but also political (Haas 1958, 1964; Pierson 1996; Sandholtz and Stone Sweet 1998). In sum, while intergovernmentalists believe that European integration is rooted in the pursuit of national economic interests, functionalists believe that it is about economic integration as a path towards political integration.

The theory of functionalism was directly inspired by Jean Monnet's strategy to delegate specific functions to supranational institutions in relatively narrow areas, mostly technical and economic, with the expectation that it would lead to more institutional integration in other areas over time. Functionalists believe that moving only some policy functions to the supranational level, while leaving other functions at the national level, creates pressure for more integration through positive and negative mechanisms. A positive mechanism would work through learning: as politicians and interest groups observe the benefits of integrating a few functions, they will want more. This idea is implicit in the Schumann declaration, stating "Europe will not be made all at once, or according to a single plan. It will be built through concrete achievements." Another positive mechanism is assumed to work by changing people's preferences. As groups cooperate on specific functions, barriers to communication and interaction would decline, which would bring an "endogenous" convergence of values and norms and a demand for more integration. This rather optimistic outlook was inspired by Karl Deutsch's (1964) influential research on communication theory and political integration.

A darker mechanism through which partial integration could lead to more integration is, paradoxically, by generating problems and crises. Because integration is only partial, important complementary functions are missing at each step. For the functionalists, such

incompleteness is not a bug but a feature, because it creates pressure for further integration. Monnet's method was explained by his collaborator George Ball (1994, p. 10):

> "There was a well-conceived method in this apparent madness. All of us working with Jean Monnet well understood how irrational it was to carve a limited economic sector out of the jurisdiction of national governments and subject that sector to the sovereign control of supranational institutions. Yet, with his usual perspicacity, Monnet recognized that the very irrationality of this scheme might provide the pressure to achieve exactly what he wanted - the triggering of a chain reaction. The awkwardness and complexity resulting from the singling out of coal and steel would drive member governments to accept the idea of pooling other production as well."

A challenge for this story is to explain why national politicians don't anticipate Monnet's chain reaction. Implicit assumptions here are that integration is irreversible, and that national politicians or voters would prefer limited integration to either more integration or no integration. But then, if politicians see that limited integration will lead to more integration, they should either agree to the outcome of more integration right away, or they should object to starting the process at all. What factors could allow elites and supranational technocrats to move ahead with initiatives leading to outcomes that national politicians or voters would not have approved in advance? A first possible explanation proposed by functionalists is that national politicians have short horizons: they approve the first step, but do not care about the next steps. A second explanation is asymmetric information. The initial steps of functional integration are taken in narrow and technical areas, such as coal and steel in the 1950s or, later, anti-trust regulations and monetary issues. In those matters, national politicians and voters are much less informed than technocrats, political elites, and supranational entrepreneurs. Hence, it is difficult for them to monitor these agents and anticipate the consequences of their actions (Pierson 1996; see Eichengreen 2006 for a discussion). A third, even less flattering reason why the mechanism may work is that European supranational institutions and bureaucracies have been set up (on purpose?) with little democratic accountability—the so-called "democratic deficit"—reducing the opportunities of national voters to monitor the technocrats (for a discussion, Alesina and Spolaore 2003, chapter 12).

Functionalism was the dominant theory of European integration in the 1950s and 1960s, then came to seem less plausible (Haas 1975) following a series of political setbacks to integration. A major setback was the "Empty Chair Crisis," when French President Charles de Gaulle boycotted European institutions because he objected to their plans for more supranational integration. The crisis was resolved in a truly "intergovernmentalist" way with the Luxembourg compromise of 1966, in which *de facto* veto power was given to every member state on issues of "very important national interest." However, the functionalist view

returned in fashion with the revival of European integration in the 1980s and 1990s when Jacques Delors was head of the European Commission. Functionalism continues to be very influential not only academically but also among European policy-makers and supranational civil servants (perhaps not surprisingly, given that they play the main role according to the theory).

In 1992 the members of the European Community signed a Treaty on European Union at Maastricht, which reorganized European institutions and designed an Economic and Monetary Union (EMU),[7] establishing the institutional foundations for the euro. Jacques Delors and his Committee for the Study of Economic and Monetary Union, also known as the "Delors Committee," played a crucial role, as documented in a detailed analysis of the negotiations leading to the economic and monetary union (Dyson and Featherstone, 1999). The design and rationale for the European economic and monetary union, as laid out in official documents and studies (Committee for the Study of Economic and Monetary Union, 1989; Commission of the European Communities, 1990), was deeply influenced by the functionalist view of European integration (Sadeh and Verdun 2009, p. 283).

An important functionalist argument was based on the "inconsistent quartet:" the mutual incompatibility of free trade, mobility of capital, fixed exchange rates, and independence of national monetary policies (Padoa-Schioppa 2004). Assuming that fixed exchange rates were essential for Europe's single market, then moving from commercial integration to liberalization of capital movements had to lead to the loss of national monetary autonomy.[8] In fact, Padoa-Schioppa (2004, p. 14), one of the architects of the economic and monetary union and key member of the Delors Committee, explained the path to the euro in terms that explicitly echoed the chain-reaction metaphor:

> "[T]he road toward the single currency looks like a chain reaction in which each step resolved a preexisting contradiction and generated a new one that in turn required a further step forward. The steps were the start of the EMS [European monetary system] (1979), the re-launching of the single market (1985), the decision to accelerate the liberalization of capital movements (1986), the launching of the project of monetary union (1988), the agreement of Maastricht (1992), and the final adoption of the euro (1998)."

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[7] "EMU" is a confusing acronym. It does *not* stay for "European Monetary Union" (a widespread and understandable confusion). Instead, it means "Economic and Monetary Union," including both the monetary union *and* the single market (for the official definition, http://ec.europa.eu/economy_finance/euro/emu/). In the 1990s, some even referred to EMU as short-hand for the whole Maastricht agreement, which included several other provisions besides those about economic and monetary union. In contrast, many now use EMU in a narrower sense, only for the monetary union. Given such ambiguities, I avoid the acronym EMU and spell out "economic and monetary union" whenever possible in this article.

[8] Fixed exchange rates were viewed as essential for free trade within Europe not only for economic reasons, but also and perhaps chiefly for political reasons, because of the fear that competitive devaluations could trigger a protectionist policy reaction by other member states, leading to the eventual unraveling of the single market (Eichengreen and Frieden 2001, pp. 12-13).

Also, in the functionalist tradition, each step in this chain reaction was viewed as irreversible. A joke attributed to Padoa-Schioppa refers to how EMU, the economic and monetary union, like the Australian bird with the same name, could not walk backward.

Not only was the path to the euro explained in functionalist terms from a technical perspective, but was also viewed, in Schumann and Monnet's tradition, as "a further step—and as a prerequisite for yet other steps—in the political unification of Europe" (Padoa-Schioppa 2004, p. 6). Wim Duisenberg, the first President of the European Central Bank, said (as quoted in Van Overtveldt 2011, p. 63): "EMU is, and was always meant to be a stepping stone on the way to a united Europe." German Chancellor Helmut Kohl famously said in 1991 (as quoted in Marsh 2011, p. 301): "It is absurd to expect in the long run that you can maintain economic and monetary union without political union."

From the perspective of Monnet's method, such an "absurd" economic and monetary union without political union should create pressures for still more integration. The euro area lacked many institutions historically associated with a successful monetary union: for example, a central bank that could really act as market maker and lender of last resort, a banking union, and a fiscal union. But this incompleteness could be rationalized as a natural and unavoidable feature of partial integration in the functionalist tradition. Even though present political constraints prevented the immediate implementation of a more comprehensive design, the launching of an "incomplete" monetary union would set the steps for further integration in due course, as predicted by functionalist theories. For example, people would learn with time about the large benefits from economic and monetary union and ask for more integration in other areas. Also, supporters of the euro embraced two arguments mirroring the long-standing functionalist view that preferences and behavior endogenously converge *following* integration. One argument was that regions become economically more homogeneous *after* they share a common currency (Frankel and Rose 1998).[9] Secondly, the economic and monetary union was supposed to provide discipline to governments, including those that used to pursue erratic policies. As a result, all member states would eventually converge to common values and policies emphasizing macroeconomic stability. Supranational institutions could provide the necessary sanctions if national governments deviated from agreed rules of stability. No-bailout rules would also be enforced. If, in spite of these positive effects and precautions, future crises were to occur, they could be resolved with more institutional integration.

Assuming that such logic could really work – and events of the last few years certainly sound a skeptical note - where would Monnet's chain reaction lead to in the long run? Jean Monnet himself was ambiguous about his long-term vision of European integration (Hoffmann 1966;

[9] In contrast, the anti-functionalist argument that integration can lead to specialization and *more* heterogeneity (Krugman and Venables, 1996) received much less attention in Brussels.

Duchêne 1994). He oscillated between two visions. One was the original federalist dream of the United States of Europe, in which Europe was an "incomplete federation" to be completed. The other vision was of a "post-modern" world where traditional sovereign states, including classic federations like the United States of America, would play a marginal role compared to supranational institutions and norms, which would represent a novel way to organize interdependence among individuals and groups: Europe as a "post-federation." This same ambiguity is present in the conflicting views about the euro among its supporters: is it a currency without a state *yet*, or is it a currency without a state *ever*?

The Limits to Monnet's Chain Reaction

Since the Schumann declaration of 1950 which launched the Monnet strategy of partial integration, European institutions have grown from a coal and steel community of six countries to a European Union of 28 countries (as of summer 2013), building along the way a customs union, a single market, an economic and monetary union, and much more. This list of achievements has brought several benefits, to which we will return. Nonetheless, the "functionalist" view, deeply embodied in the ideology and practice of the European Union, that each step is part of a chain reaction leading to ever closer integration has serious limitations.

As a starting point, the functionalist emphasis on the rising power and autonomy of supranational institutions compared to national governments must be taken with a grain of salt. National governments do agree to delegate responsibilities to supranational institutions as commitment devices to achieve collective goals which are in each government's long-term interest. To be credible, those institutions must have some autonomous power and independence; the rules for the autonomy of the European Central Bank come to mind. In addition, as in all complex organizations, supranational agents cannot be perfectly monitored by their principals (in this case, national governments and voters), and some principal-agent slack always exist. However, none of this means that Europe's supranational institutions can go very far against the ultimate interests of national governments. While supranational institutions and procedures are important in the day-by-day working of Europe, they "could not work for a week in the absence of the will to cooperate of the member states, especially the largest ones – Germany and France above all" (Gilbert 2012, p. 3).

A well-known illustration of how centralized discipline does not work when ultimate power is in the hands of sovereign governments is the spectacular failure of the Stability and Growth Pact, which came into force in the late 1990s and included mechanisms to ensure that member states would hold their annual budget deficits below 3 percent of GDP and their accumulated government debt below 60 percent of GDP. The Stability and Growth Pact was never credible, and became moot after 2003, when France and Germany used their political

power to prevent sanctions against their own violation of the pact's fiscal rules. In general, the success of supranational agents' ability to take autonomous decisions can only be sustained in matters where the extent of disagreement among national governments over policy outcomes is relatively low, like the enforcement of trade liberalization agreements. But success in those areas does not imply that supranational institutions and rules could also trump national institutions and rules in other areas with much higher heterogeneity of preferences and interests, like fiscal policies.

The role of the European Court of Justice is instructive. In a series of landmark cases, the Court enunciated the doctrine that European Community norms have direct effect in member states and trump domestic law, and that individuals can directly invoke European law before national and European courts. For example, the 1963 case of *Van Gend en Loos v Nederlandse Administratie der Belastingen* (26/62) was decided in favor of a Dutch importer of German chemical products that had objected to a tariff charged by the Dutch authorities in violation of article 12 of the Treaty of Rome, which forbids member states from raising customs duties between themselves or introducing new ones. The aggressive interpretation of its role by the European Court of Justice in this and other cases went beyond the legal framework that had been formally agreed with the Treaty of Rome, and, according to some scholars, brought Europe close to a federal system from a legal perspective (Weiler 1991; Krasner 1999), expanding supranational powers beyond the control of national governments (Pierson 1996; Stone Sweet 2000). However, these new legal doctrines were established to enforce norms consistent with national governments' own collective objectives, such as trade liberalization. The acceptance of these decisions by national governments and courts did not imply that *any* European norms would be as easily accepted in the future. In more recent years the German Constitutional Court has elaborated the legal theory of *conditional* acceptance of European Union norms, according to which Germany only accepts the supremacy of EU law insofar as it is consistent with fundamental German rights. In a famous decision on the constitutionality of the Maastricht Treaty (*BVerfGE 89,155* of October 12, 1993), the German Court ruled that there is a legal limit to the powers of EU norms, defined by their effects on national democratic sovereignty. In a landmark ruling on the Lisbon Treaty (*BVerfG, 2 BvE 2/08* of June 6, 2009), the German Court explicitly stated that the national states are "the masters of the treaties," and "therefore must see to it that there are no uncontrolled, independent centralization dynamics" within the EU (quoted in *Spiegel*, 2009), a clear and explicit brake on functionalist dynamics.

In general, the central problem with the chain-reaction method is the unwarranted expectation that gradual integration, which has been successful in low-heterogeneity-costs areas, can continue unabated when moving to areas with much higher heterogeneity costs. This problem stems from the lack of a realistic assessment of the increasing costs and

constraints imposed by heterogeneity of preferences. Successful integration is more likely to take off in areas such as commercial integration, where heterogeneity costs are relatively low, and partly offset by the benefits from diversity. As integration proceeds to other areas, after low-hanging fruits are picked, heterogeneity costs continue to increase along a convex curve. At some point, those high costs become politically prohibitive, and the pressure from spillovers, inefficiencies and crises will no longer lead to further integration, but just to losses, and possibly even the collapse of the whole system. The chain-reaction approach does not anticipate that heterogeneity costs and constraints will eventually become binding and stop the process for good. Followers of this approach are therefore prone to setting up incomplete and inefficient arrangements, relying on the overoptimistic expectation that such inefficiencies can always be addressed at a later stage through additional integration.

For these reasons, there is no guarantee that regional integration in economic areas, such as a common market, should lead to political unification down the road. The example of the German customs union (*Zollverein*) in the nineteenth century, often mentioned in this respect, is misleading, because the main force behind commercial integration was political integration pushed by Prussia's military power (Gilpin 2001). In fact, international cooperation and political unification can be viewed as *substitute* ways to lower barriers to trade. If two regions can already agree to reduce their trade barriers with each other while remaining independent, they are going to obtain *smaller* additional gains from trade if they also form a political union with a unified domestic market. Empirically, this direct negative effect of economic integration on the incentives to form a political union is likely to be larger than possible indirect effects of economic integration on the costs of political integration, such as those stressed by Monnet and his followers (for example, a possible reduction of communication and coordination costs). The historical record up to now indeed suggests that international economic integration is more likely to go hand in hand with political *dis*integration (Alesina and Spolaore 1997, 2003; Alesina, Spolaore, and Wacziarg 2000).

The euro is a child of the functionalist method. The method of partial integration provided the institutional framework and rationale for monetary integration. Without Monnet's idea of delegating specific policy functions and prerogatives to supranational institutions, the euro would not have come into existence. Of course this does not mean that the euro was created exclusively for "functionalist" reasons and goals, or that the decision-makers were only supranational civil servants and elites. There would be no euro without the actions of powerful national politicians pursuing their own geopolitical and domestic objectives or without the backing of powerful economic interests (like German exporters). However, statesmen with political goals and producers with economic interests exist elsewhere, but do not end up with a "currency without a state." Such a currency was only possible — politically, technically, and intellectually — in the exceptional institutional framework provided by European integration.

By creating the euro, the chain reaction crossed the border between "pure" economic integration which can be achieved through international cooperation, in the form of liberalization of trade and capital flows, and the form of monetary integration that, historically, had only been obtained by a sovereign state using its power of coercion to establish one currency within its borders.

The exceptional nature of the euro does not mean that Europe's monetary union is unsustainable in the long run, or only sustainable if Europe becomes a sovereign federation. The parameters of the questions have been well stated by Mario Draghi (2012), the head of the European Central Bank, who said that "those who claim only a full federation can be sustainable set the bar too high." Instead, Draghi focuses on the "minimum requirements to complete economic and monetary union." In such framework, the future of the euro depends on a key political variable: the heterogeneity costs associated with the minimum set of functions that must be pooled or delegated for a currency union to work.

If heterogeneity costs were small, the euro area crisis of the last few years could perhaps be addressed with deep fiscal and political integration. This outcome seems out of reach at present given the historical experience of European integration. In principle, monetary union could lead to a fiscal and political union even if heterogeneity remains high, if the costs from leaving the euro are even higher, and fiscal and political integration are perceived by national governments and voters as the only solution. That outcome could be seen as a vindication of the darker version of Monnet's chain reaction: heterogeneous Europeans would have been "trapped" in a fiscal and political union because they took an irreversible decision to enter a monetary union without anticipating the spillover to further integration. However, political union on those grounds would hardly be a solid start for a European federation; it would be very unlikely that such political union could trigger the positive cultural changes that would be the only sustainable foundation for a cohesive federation in the long run.

A more promising way to ensure the stability of monetary union in Europe is to focus on a narrower set of minimum requirements, as suggested by Draghi (2012). High priority is likely to be given to banking and financial integration. Those gains could in part be secured with tools and institutions similar to those already profitably employed in areas where the European Union has been most successful, like commercial integration, antitrust regulation, and the formation of a single market (for instance, Enderlein et al. 2012). At the same time, though, the close links between banks and sovereign states in Europe can create dangerous spillovers, crises, and clashes between supranational authorities and national governments.

Back Where We Started: The Benefits from European Integration

European integration in the aftermath of World War II started to counteract war and protectionism. We saw the timid beginnings with coal and steel, the defeat of the ambitious

plan to pool defense, the establishment of a common market, and the building of ever more complex and ambitious supranational institutions—eventually including monetary union. We discussed the serious problems with the expectation that this would necessarily be a chain reaction towards ever closer political integration. Now, it is time to offer a few final comments on the sources of strengths of the European integration project.

While the chain-reaction method can be carried too far, key aspects of Monnet's strategy have in fact contributed to the concrete successes of the European project, when the tools of integration have been applied to the appropriate areas: those with lower heterogeneity costs and higher economies of scale. These aspects include: partial integration with a focus on economic areas; deep "institutionalization," with the delegation of substantial prerogatives to supranational institutions, going well beyond the institutional framework of more traditional international organization; and integration of several functions, creating useful "linkages."

Trade integration is a good example of the effectiveness of partial integration in economic areas. Trade is an area where costs of heterogeneity are offset by benefits from heterogeneity and large economies of scale. The removal of trade barriers was in the general interest of Europeans, even though specific sectors and groups within each country benefited from protectionist policies. European supranational institutions provided a way to coordinate trade liberalization and to lock in the commitment not to raise barriers unilaterally when faced with domestic political pressure. In this respect, European integration was one of the earliest and most successful examples of regional arrangements set up to solve coordination problems and to provide credible commitments (Eichengreen 2006). Partial institutional integration in different areas also allowed "linkages" between issues and provision of credible side-payments to potential losers from commercial integration. For instance, the notoriously wasteful Common Agricultural Policy has been often explained as a political compromise between France and Germany: German manufacturers gained access to the French market, and German taxpayers helped subsidize French farmers.

Trade integration within Europe has also benefited peace and security. The view that international trade can reduce the risk of war goes back to Montesquieu and Kant, and has spurred a large empirical literature. Multilateral openness (or "globalization") does not reduce the risk of war between pairs of countries. However, *bilateral* trade, by increasing the opportunity cost of conflicts between two partners, reduces the probability of conflict between that pair of countries (Martin, Mayer and Thoenig 2008), even when controlling for historical, linguistic and cultural similarities between populations (Spolaore and Wacziarg 2012). In fact, Martin, Mayer and Thoenig (2010) find that country pairs with a high frequency of old wars are more likely to sign regional trade agreements, which can be explained as a consequence of the complementarity between economic and political gains

from trade. They also show that multilateral trade openness reduces the opportunity cost of bilateral conflict, thereby increasing the risk of war between pairs of countries which can trade with third partners. Therefore, globalization also increases the political incentive to sign regional agreements for security reasons.

This interaction between economic and political factors can explain important aspects of European integration. For instance, it can shed light on why Konrad Adenauer, the Chancellor of West Germany from 1949 to 1963, pushed for a geographically narrower but institutionally deeper customs union with France, Germany's old enemy, therefore reducing the risk of war between the two countries. Adenauer overruled his economic minister Ludwig Erhard, who was primarily interested in economic benefits and would have preferred a broader free-trade area, which France would have been unlikely to join given its own commercial and political interests (Garton Ash 1993; Moravcsik 1998).

An open question is whether European integration has played a central or only a marginal role in securing peace in Europe. Skeptics of the "pacifying" effect of European institutions stress the crucial involvement of the United States and NATO in Europe during the Cold War and afterwards, and the Europeans' failure to deal with the breakup of Yugoslavia on their own. Moreover, peace has also held between Japan, the other loser of World War II, and its neighbors, and trade has prospered among them in the absence of Asian institutions analogous to the European Union. However, the Cold War ended in Europe with the fall of the Berlin Wall, Germany is now unified, and European institutions have played a very significant role in the process of democratization and integration of Eastern and Central Europe. In contrast, the relation between a still formally communist China and Taiwan remains tense and unresolved, and Korea is still divided and even at risk of a nuclear war, which could spread to Japan and other neighboring countries. On balance, whether because of European integration or other factors, in recent decades Europe has fared quite well in terms of peace and democracy relative to other areas of the world

In general, pooling and delegating functions and policies to supranational institutions to take advantage of economies of scale and scope, while maintaining other prerogatives at the national (or sub-national) level, has brought substantial benefits to Europeans when appropriately implemented in areas with relatively low heterogeneity costs. Those benefits have been obtained while keeping ultimate sovereign control and the monopoly of the legitimate use of coercion at the national state level. A centralized European authority could provide a broader range of public goods with large economies of scale and scope, while using coercion to prevent free riding. But that would come with much higher heterogeneity costs. Europeans have probably been wise not to travel all the way to a sovereign federation so far, given their existing differences in preferences and cultures. If those preferences

change, Europe may benefit from a reorganization in a federal direction, but of course that should be decided only through broad and democratically expressed consensus.

At the moment, Europeans are sticking to the current system of cooperation among sovereign states within a supranational organization. Within those boundaries, and in spite of the serious limitations that we discussed, European institutions have provided useful commitments to overcome some (but not all) problems from free riding and beggar-thy-neighbor policies. European cooperation has at least turned out better than the alternative system of destructive unilateral national policies plaguing European history until 1945. In this respect, Moravcsik (2012), a leading "intergovernmentalist" scholar of European Integration, is hopefully not far from the truth when he writes: "Whatever the outcome of the crisis, the EU will remain without rival the most ambitious and successful example of voluntary international cooperation in world history."

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