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The Future of European Growth Policies: Resetting Integration

The Great Recession in Europe has coincided with a multitude of crises. Closing this difficult period will require policies that help revive and accelerate economic growth throughout the EU.

This is a difficult period because the European integration project remains in poly-crisis mode: the financial crisis, the debt crisis, the Greek crisis, the populism crisis, the productivity crisis, the terrorism crisis, the refugee crisis, the leadership crisis, the democratic deficit crisis and, of course, the Brexit crisis. Although Brexit is one of many, it is unique.[1] Brexit is a different type of crisis because it raises fundamental questions about the integration project. This was a one-way process toward a well-defined goal, but the UK vote for Brexit challenges the very notion of "ever closer union". Brexit is different because it asks questions about the value of being in the union, questions about the value of membership, about the value of being integrated and interconnected in the world, about the dynamics and distribution of the benefits and costs of trying to do so, and about the type of integration that can sustain (and hopefully increase) the substantial benefits we have seen since the start of the project in the 1950s. These are existential questions, and they must be answered if the EU is to endure after this crisis.

Whether Europe needs more or less integration is a much less consequential discussion than whether Europe needs better, more effective integration. Yet, future European growth policies cannot be based entirely on only one element. In an important contribution, Bartelsman et al. argue that one way to understand the productivity gap between Europe and the US is to concentrate on the interaction between technology and institutions.[2] Future growth policy will need to evaluate and redress the contrast between how the private sector has led the diffusion of information and communications technologies (ICT) in the US and how this role in Europe seems to have been mostly played by the public sector. This is to say that technology matters, but in this note we focus on the other fundamental element, namely institutions, and specifically on the many different (and mostly under-researched) ways integration has promoted institutional change in Europe. By better and more effective integration, we mean integration that is deep (in the parlance of economists) or genuine and fair (as per the Five Presidents' Report.)

This article presents three examples in an attempt to illustrate the reasons why we believe deep integration should be placed at the very centre of European growth policies. They are presented in chronological order and reflect key moments in the European integration process, namely the EEC and EU enlargements of 1973, 1995 and 2004. The first of these, the 1973 enlargement, is an examination of the United Kingdom's experience in joining the European club in the first place. It shows how the battle between integration modes or models was fought in the 1960s and how the debate between deep and shallow integration (that is, between the EU and EFTA, the European Free Trade Association) was won by the former.

The second example looks at the Norwegian experience of 1995, which generated a discontinuity that allows us to make a credible estimation of the causal productivity effects of deep integration. The contrast can be drawn between purely economic integration (membership in the European Economic Area) and joint economic and political integration (membership in the EU) by contrasting the experience of Norway with that of Finland, Sweden and Austria in the aftermath of the 1995 EU enlargement.

The third and last example discussed below is based on the experience of the Central and Eastern European countries that sought to become candidates to join the EU after the collapse of communism in the early 1990s. It illustrates how deep integration, specifically progress towards EU membership since the 2004 enlargement, can engender institutional change.

Lessons from the United Kingdom experience for future European growth policies

Did EU membership significantly improve UK economic performance? And if so, how? One prominent area of

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1 R. Baldwin: Brexit Beckons, London 2016.

2 E.J. Bartelsman, P.A. Gautier, J. de Wind: Employment protection, technology choice, and worker allocation, in: International Economic Review, Vol. 57, No. 3, pp. 787-826.

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economic history scholarship is “British relative economic decline”,[3] where economic historians offer a detailed understanding of key turning points in British economic history since the early 1800s. However, this long-term perspective fails to give WWII and European integration (including gains from liberalisation and increased competition) due credit.[4]

An examination of European economic history provides valuable insights. The unprecedented destruction of WWII resulted in a similarly unprecedented recovery effort, which was largely completed by 1950. The following period, until 1973, was the golden age of European economic growth. Reconstruction and catch-up with pre-war levels were broadly completed by 1950, so other factors were at play, chiefly structural change due to labour shifting out of agriculture towards manufacturing and, ultimately, services.

A requisite for Marshall Plan aid after WWII was economic coordination for recipient countries. It was clear at the outset that there were many areas of agreement but one of discord. The French favoured a customs union, the British a free trade area. The differences are substantial: customs unions entail deeper integration and require institutional change. Also worth noting is that “the United States supported the idea of a customs union in 1947, and continue to give backing to French schemes for West European regional organizations”.[5]

The UK decided not to participate in the European Coal and Steel Community (ECSC), which was a result of the proposed Schuman Plan in 1950. The ECSC created a set of institutions to coordinate and integrate coal and steel production, including a High Authority to monitor compliance with the terms of the agreement, an Assembly to hold the High Authority accountable, and a Court to adjudicate disputes. By 1950 per capita GDP in the UK was about 28% above the EU6 average. By the time the Treaty of Rome was signed by the EU6 in 1957, that figure was reduced to 15%.

In previous research I have argued that a fundamental yet relatively unappreciated feature of the relationship between the UK and the EU is the concept of a structural break.[6] The ratio per capita GDP in the UK compared to that of the EU founding members declined steadily from 1945 until 1972 but remained relatively stable between 1973 and 2010. Such a prominent structural break (and to the best of our knowledge one not previously detected and analysed) suggests substantial benefits from EU membership, especially considering that the UK joined too late, at a bad moment in time and at a larger cost.

Figure 1 displays the ratios of total factor productivity (TFP) in the three countries that joined the EU in 1973 (UK, Denmark and Ireland) to TFP in the six founding members for the years 1950-2011. If one is searching for turning points, the contrast between the UK-to-EU6 ratio for per capita GDP and the ratio for TFP is extremely revealing. The structural breaks for TFP are much clearer than they are for per capita GDP. Although the turning point for productivity in Ireland is much later, those for both the UK and Denmark seem to have taken place when they joined the EEC in 1973.

The conventional view for the UK is that this turning point occured in the mid-1980s as a result of Margaret Thatcher’s package of far-reaching structural reforms. The fact that Denmark shows structural breaks at a similar date already suggests that such an explanation has limits. Econometric evidence also does not support the structural break explanation.[7] An alternative hypothesis is thus suggested: this turning point actually occured in 1973 when the UK finally joined the European Union. Using the whole range of structural break tests, substantial econometric support for this turning point is found.

If membership has indeed made a substantial difference, the next logical question is how? To answer this, we discuss the key potential mechanisms through which these benefits took root. The chosen mode of integration (deep instead of shallow) may have played a key role. While international trade may have been the most important driver until the implementation of the Single Market in the early 1990s, foreign investment may have taken on this role since then.[8] Another contributing factor is that EU accession marked the victory of the business groups that wanted to compete at the high-tech end of the quality-demanding common European market against those business groups that wanted to compete in the comparative advantage-obsessed, price-driven Commonwealth market that mostly consisted of the UK’s former colonies. These pro-Europe business groups later become the

3 C. Bean, N. Crafts: British Economic Growth Since 1945: Relative Economic Decline... and Renaissance?, in: N. Crafts, G. Toniolo (eds.): Economic Growth in Europe Since 1945, Cambridge 1996, Cambridge University Press.

4 A notable exception is N. Crafts: British Relative Economic Decline Revisited: The Role of Competition, in: Explorations in Economic History, Vol. 49, No. 1, 2012, pp. 17-29.

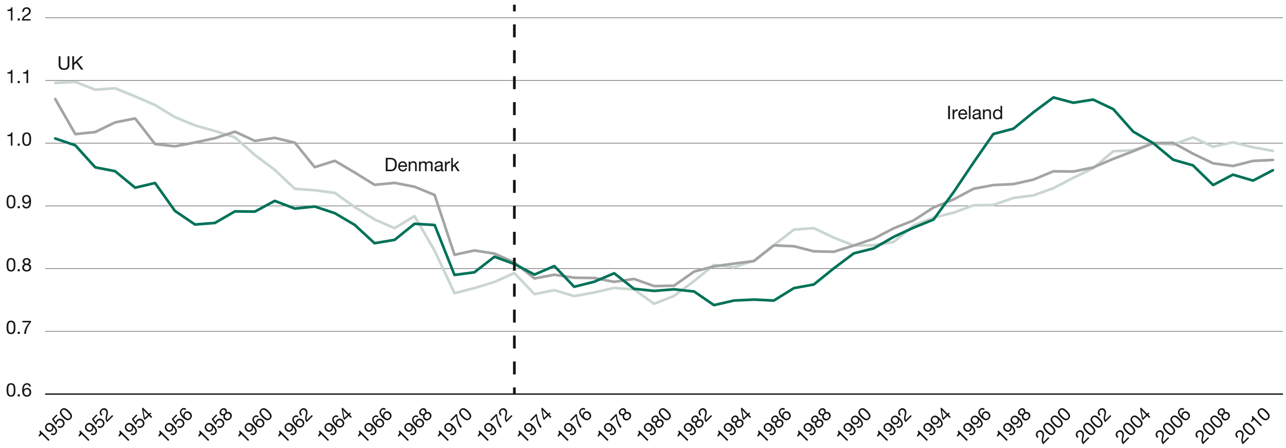
5 S. George: An Awkward Partner: Britain in the European Community, 2nd edition, Oxford 1994, Oxford University Press.

6 N. Campos, F. Coricelli: Why Did Britain Join the EU? A New Insight from Economic History, VoxEu, 3 February 2015.

7 Ibid.

8 N. Campos, F. Coricelli: Some unpleasant Brexit econometrics, VoxEu, 11 December 2015.

Figure 1
Ratios of total factor productivity in the 1973 enlargement countries to the EU6
2005 = 1



Source: N. Campos, F. Coricelli: Mrs. Thatcher's Reforms or European Union Membership: What Drove the Great British Reversal?, Mimeo, 2016.

constituency that supported Thatcher's reforms – without which, we argue, they would not have been nearly as successful.[9]

The debate about the value of EU membership for the UK is of broad relevance, because if one can show that European integration played an important role here, it is likely it played a substantial role everywhere else. Moreover, it strongly suggests that the benefits from deep integration are broad (that is, they are not restricted to poorer countries that see their catch-up efforts complemented by deeper integration) and, in addition, manifest themselves mostly in terms of TFP (as opposed to mostly or exclusively in terms of per capita GDP).

Lessons from the Norwegian experience to future European growth policies

The EU-Norway relationship demonstrates it is possible for a country to be economically associated with and, at the same time, politically disassociated from the EU. One question is whether the "economic only" type of membership that Norway enjoys is superior to the "economic plus political" type of membership held by the 28 full-fledged EU members. Disentangling the net benefits from "economic only" (shallow) and "economic plus political" (deep) membership is difficult.[10]

The identification strategy takes advantage of a unique natural experiment: Norway fulfilled all of the EU's entry requirements, completed accession negotiations and accepted founding membership in the European Economic Area (EEA), which gave the country unrestricted access to the Single Market; however, in a national referendum in 1994, it decided to reject full-fledged EU membership.[11] According to the European Commission, Norway was as ready to join the EU in 1994 as the other candidates at the time (Sweden, Finland and Austria).

Campos et al. use differences-in-differences and synthetic control methods with regional annual data from Norway, Austria, Finland and Sweden from 1985 to 2000 to estimate the consequences in productivity terms (output per hour worked) of a hypothetical EU entry by Norwegian regions, before and after the 1995 EU enlargement.[12] They estimate that the average change in the level of productivity in Norwegian regions before and after 1995 was €1.60 and €2.00 (or about eight per cent) lower than the average change before and after 1995 in regions of the three countries that joined the EU in 1995.

These results provide new evidence suggesting that the net benefits from deep integration significantly outstrip those from shallow integration.[13] Norway would have

9 N. Campos, F. Coricelli: Mrs. Thatcher's Reforms or European Union Membership: What Drove the Great British Reversal?, Mimeo, 2016.
10 D. Brou, M. Ruta: Economic Integration, Political Integration or Both?, in: Journal of the European Economic Association, Vol. 9, No. 6, 2011, pp. 1143-1167.
11 C. Archer: Norway Outside the European Union: Norway and European Integration from 1994 to 2004, London 2005, Routledge.
12 N. Campos, F Coricelli, L. Moretti: Norwegian rhapsody? The political economy benefits of regional integration, CEPR Discussion Paper 10653, 2015.
13 A. Tatham: Enlargement of the European Union, Amsterdam 2009, Kluwer European Law Collection.

benefitted from full EU membership – if it had joined the EU in 1995, its productivity levels in the first five years would have been on average six per cent higher. Since Norway already enjoys economic integration benefits (via the EEA), this result suggests substantial additional benefits from political integration through EU membership. The identification of such politically driven payoffs from integration challenges the conventional wisdom that benefits are mostly related to economic integration while the costs are mostly due to the political dimensions of EU integration.

Of the seven Norwegian regions, only Oslo shows lower productivity with hypothetical full EU membership. This exception reinforces our interpretation of these effects as politically driven benefits from integration. Even without full membership, the "economic only" integration boosts the productivity of the capital city region thanks to its high level of human capital, growing financial sector and efficient public sector. In contrast, other regions remained shielded from competition through generous subsidies and the protection of traditional Norwegian economic sectors such as fisheries and agriculture, which full membership would not have permitted. Further corroborating evidence is provided by the high correlations across regions between the foregone benefits from deep integration and the employment shares in sectors such as oil and fisheries, on the one hand, and finance and the public sector on the other.

These results also have implications for the broader European project. They show that deeper integration pays off in productivity terms. European integration has always explicitly been both a political and an economic process.[14] The choice of a customs union model instead of a free trade area, enshrined in the Treaty of Rome, underscores the agreed upon direction of European cooperation as one towards deep integration. The consideration of different types of membership weakens the ideals encapsulated in the Treaty of Rome. These results suggest that attempts to dilute these ideals should be resisted – not just for moral or political reasons but also on economic grounds. "Ever closer union" is often considered to be (and often criticised for being) a soft and exclusively political argument. These results suggest that by being at the heart of deep integration, "ever closer union" embodies a powerful economic argument, which is not good news for proponents of a "two-speed Europe" or advocates of "associated membership".

14 O. Issing: On the Relation of Monetary and Political Union, in: Intereconomics, Vol. 51, No. 1, 2016, pp. 16-20.

Lessons from the Central and Eastern European experience for future European growth policies

While the UK experience demonstrates that the choice of deep over shallow integration pays off economically, and does so more in terms of productivity than in terms of per capita GDP in the case of rich countries, the Norwegian experience allows one to move one step further and generate a credible estimate of these productivity gains. It shows that deep integration generates significantly larger increases in productivity than other forms of integration. The next natural question is the so-called mechanism question: how and why are these productivity gains generated? Foreign direct investment, international trade and financial liberalisation have been extensively discussed before as potentially important channels. Our third and last example suggests a mechanism that has received considerably less attention so far: the experience of the Central and Eastern European (CEE) countries that became EU members after 2004 shows that these productivity gains can emerge because deep integration increases state capacity and supports inclusive institutions.[15]

It remains vastly underappreciated that deep economic integration (which, as shown above, goes beyond free trade agreements) can also induce powerful actors to support increasing general state capacities, such as enforcing law and order, regulating economic activity and providing public goods.[16] An important issue is whether and under what conditions deep economic integration can yield increases in state capacity.

Bruszt and Campos measured institutional change in 17 CEE countries (EU membership candidates) exposed to similar challenges of deep integration.[17] Eleven of these countries had already joined the EU; another six are still in the process of meeting the requirements of membership. Using the annual monitoring reports produced by expert teams for the European Commission, the authors quantify changes over time in state capacity and find large variation in the evolution of these capabilities. The EU, eager to defend the integrity of its internal market, uses regular standardised monitoring of progress in institutional change in all the institutional arenas that could affect the capacity of the applicant countries to implement the rules

15 T. Besley, T. Persson: The Origins of State Capacity: Property Rights, Taxation, and Politics, in: American Economic Review, Vol. 99, No. 4, 2009, pp. 1218-1244.

16 D. Acemoglu, C. García-Jimeno, J. Robinson: State Capacity and Economic Development: A Network Approach, in: American Economic Review, Vol. 105, No. 8, 2015, pp. 2364-2409.

17 L. Bruszt, N. Campos: Does Deep Economic Integration Increase State Capacity?, Mimeo, 2016.

of the Single Market. These roughly correspond to the various individual chapters of the *acquis* that need to be successfully negotiated before accession. The Commission's yearly monitoring reports offer an exceptional basis for the analysis of the single largest natural experiment in the simultaneous deep integration of a large number of countries.

These countries were exposed to the same set of requirements in domestic institutional change, encompassing more than 30 policy fields, ranging from environmental regulation to transportation. More importantly, the CEE countries were supposed to make considerable upgrades to three key groups of state institutions that determine the possible scope of change in all the other institutional arenas: the judiciary, the bureaucracy and competition policy. In each of these institutional arenas, the Commission has data regarding each country's path toward meeting the institutional requirements of EU membership, from the transposition of EU regulations to the creation of EU-conform regulatory organisations endowed with the expected powers, resources and personnel.

Bruszt and Campos not only attempt to show that deep integration does indeed generate increases in state capacities, but they also shed some light on how it does so.[18] They document large variations in both the sequencing and the outcomes of domestic institutional change. While several of the countries have succeeded in achieving considerable change across a wide range of state institutions, some have made only modest changes in a few institutional arenas. It emerges that the effects of deep integration on domestic change vary, with some sequences of institutional change being more effective than others. They find a small number of key implementation sequences, chief among them the independence of the bureaucracy, which seems driven by judiciary capacity, competition policy and administrative capacity. Their results suggest which policy implementation sequences are the most important: they highlight the central and intricate relationship between bureaucratic independence and judiciary capacity that seems to play a key role driving institutional convergence.

As discussed above, one key way deep integration matters in terms of institutional change is through the building up of state capacity. However, there are other ways in which it matters. One is that deep integration can create a constituency for "integration", and in this case the UK experience is again illustrative if one considers that the success of Thatcher's reforms may have required EU integration. Those structural reforms could not have taken place without a large and powerful constituency. In this case, these were British entrepreneurs who would benefit from a much larger, more innovative and more demanding marketplace (contrast the EU and the Commonwealth in this respect). These entrepreneurs also realised that to be competitive they would need to tap in to mobile capital and labour and would need a clear set of common standards and regulations so as to guarantee a level playing field. Without the support of such powerful constituencies, Thatcher's reforms would not have been proposed or fully implemented, and they clearly would not have been nearly as successful or influential. Moreover, this explanation draws clear parallels to the French experience in the post-World War Two period.[19] Between 1945 and 1957, there was a conflict between powerful groups of French entrepreneurs – those against and those in favour of furthering European economic integration. Those against tended to export mostly to the former French colonies. Yet these groups lost influence in the run-up to the Treaty of Rome and found themselves locked in to the project even after regaining considerable political influence with the appointment of Charles De Gaulle to the French Presidency in 1958. At that point, they could slow down but not reverse the process.

Concluding remarks

This note argues that one should lay the focus of future European growth policy on integration and technology. This focus should be on maximising the growth effects of their interaction, with an emphasis on the importance of deep integration. The note provides three examples that show how deep integration has contributed to stop the relative economic decline in the UK vis-à-vis the EU founding members; how deep integration increased productivity in Sweden, Austria, and Finland compared to that in Norway; and how a key mechanism to advancements in the new EU member states has been the capacity of deep integration to generate institutional change. Given the severity and length of the Great Recession, whether Europe needs more or less integration is a much less consequential discussion than the recognition that Europe needs better and more effective integration and adequate policy actions that can deliver it.

18 Ibid.

19 W. Adams: Restructuring the French economy: Government and the rise of market competition since World War II, Washington DC 1989, Brookings Institution Press.