European Integration from Washington's Perspective

Since the start of the euro crisis and the Greek crisis in 2010, the US perception of the economy of the European Union has been dismal, probably worse than ever. EU GDP has not risen from its 2008 level. To many Americans, Europe appears as a historical theme park rather than a modern, dynamic economy. This sense of malaise lingers, but there are several reasons that this picture may change for the better.

The Obama administration's dominant foreign policy slogan has been its "pivot to Asia." China is widely perceived as the new, great emerging economy, but as Chinese economic growth slows and the edifice of the Chinese growth wonder is increasingly questioned, perspectives may change. Indeed, slowing growth is not limited to China, as it seems that most of the top emerging economies are getting into trouble.

Since 2010 US macroeconomists have overwhelmingly opposed the eurozone's policy choices, calling for more fiscal and monetary stimulus in Europe. My suspicion is that they have been wrong on both accounts. European countries have had large budget deficits, driving their composite public debt to almost 90 percent of GDP, and no less than eight out of 28 EU countries have had IMF programs. The monetary stimulus has been extraordinary but its positive effect minimal. The problem has rather been that the very existence of the Economic and Monetary Union has amounted to a moral hazard. Crisis countries rightly presumed they would be bailed out, and thus they held back their fiscal adjustments and reforms.

To Americans living in a big closed economy, exchange rate fluctuations are no threat. In the early 1990s, European countries suffered a number of devastating exchange rate crises that these mostly small countries do not want to go through again. Therefore, most small European countries have opted for pegged or fixed exchange rates or ultimately the euro, the strongest guarantee against excessive currency fluctuations.

Fortunately, the euro crisis has abated, and the euro persists in spite of many predictions to the contrary. That the low economic growth persists should make evident that Europe's growth problems are not primarily macroeconomic but structural, which is poorly understood among American economists, since the United States suffers much less from such concerns.

Traditionally, the European Union has talked about four freedoms: of the movement of goods, capital, services and people. The greatest and indisputable achievement of the EU is the single market for goods. It has led to a high degree of economic integration and efficiency.

The integration of the goods market has had important effects on European taxation. The customs union has been accompanied with ever lower import tariffs. All kinds of subsidies have been minimized. The Common Agricultural Policy used to lead to mountains of butter and milk, but it is no longer very protectionist. Such distortions and the associated costs have evaporated. In parallel with customs tariffs, value-added taxes are collected, and they have become standard throughout the continent. The greatest concern with the VAT is that it is too efficient, driving up the overall tax pressure. Still, the economic integration has also driven tax competition, which has particularly impacted the corporate profit tax rates. These rates have halved over the last two decades, but at the same time, corporate tax revenues have increased as tax administration has been greatly simplified. Both companies and treasuries have benefitted.

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Another great EU accomplishment is the free movement of people. The Schengen zone allowed people to travel freely between all but five of the 28 EU member countries without even showing an identity document. Unfortunately, this is no longer quite true. The massive inflow of refugees and migrants, mainly from the Middle East, has swiftly compelled one country after the other to introduce identity checks on the previously wide open border. The EU must quickly determine whether it will be able to secure its external border or whether all member countries will feel compelled to reintroduce border controls.

Yet, some markets are incomplete or even missing. The European capital market remains fragmented, and the euro crisis has both helped and hindered it. The big step forward has been the formation of a banking union with joint bank supervision and a single resolution mechanism. Yet, at the same time, the many bailouts of banks have been carried out nationally, and rather than expanding abroad, European banks are now largely withdrawing to their home territories. In particular, West European banks are withdrawing from Eastern Europe because of increased EU demands for capital. Nothing has been done to better integrate stock and bond markets.

The worst shortfall in the four freedoms is the absence of free trade in services, and services now account for about 70 percent of EU GDP. Only in 2006, the European Union adopted its Services Directive as a first step towards opening intra-EU trade. The directive aims at removing obstacles in service markets by facilitating the establishment of service companies in other EU countries and by requiring all European countries to set up one-stop shops, allowing companies to enter any EU country's market by registering with one single agency. Unfortunately, the Services Directive has made little headway. To begin with, it covers only about 60 percent of all services. Even for those services, the directive has been likened to Swiss cheese because of its many loopholes. In effect, the service market remains highly fragmented at great cost to the welfare of Europe's population. No single measure would have greater economic impact than a real opening of the European service market.

Increasingly, people talk about five freedoms. The current European Commission has added energy, while others focus on digital trade. Energy has always been at the center of EU development, since its very origin was the European Coal and Steel Community. Yet, the markets for natural gas and electricity remain incomplete after years of serious endeavors. The European Commission is more tenacious than forceful, and the intended showpiece of the current Commission is the formation of an energy union for natural gas and electricity. Its success remains at issue, but at least the Commission is firm in its intention. The Commission also aims at the creation of a single digital market, but clear designs have yet to emerge.

Many influential Americans see China and other emerging authoritarian powers, which do not share Western values of democracy, freedom, market economy and rule of law, as a threat to the West. They want the West to unite. A common statement is that the question is whether the West or China will set the standards. The US-inspired Trans-Pacific Partnership among twelve transpacific countries was an important first step. The situation in Europe is of concern to the US administration. The worst nightmare would be a Brexit, which in all probability would paralyze EU policymaking for years. Strangely, the current administration has said very little on how damaging it would be, which reflects the limited official American interest in Europe. Yet unrest and warfare to the south and east of Europe will presumably attract the attention of the next US administration.

Fortunately, the Obama administration has launched a major European initiative, the Transatlantic Trade and Investment Partnership (TTIP), between the EU and the US. TTIP could help Europe solve many of its problems, notably the completion of missing markets for services, digital products and energy. Europe is too important to the United States to be as ignored as has been the case in recent years.