

# SMALL STATES AND THE FUTURE OF INTERNATIONAL INTEGRATION

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LE GOUVERNEMENT  
DU GRAND-DUCHÉ DE LUXEMBOURG  
Ministère de l'Économie

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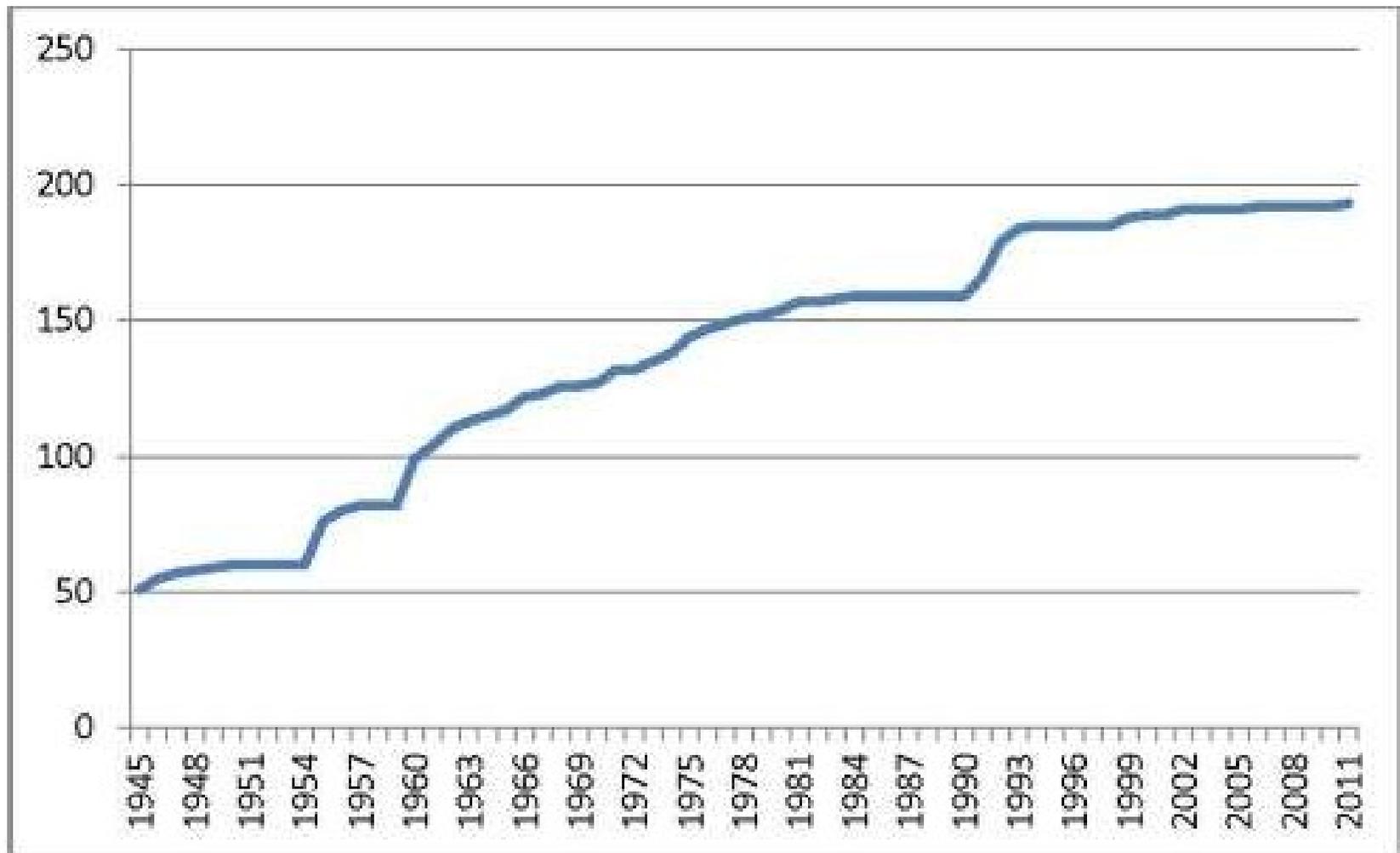
UNIVERSITÉ DU  
LUXEMBOURG

LU<sup>+</sup>EMBOURG  
LET'S MAKE IT HAPPEN

## Numerous **new independent states** have been formed in recent decades

- In 1945 there were 74 independent countries (of which 51 were UN members)
- Today the **United Nations** has **193 members**
- Over **thirty new member states** have joined the UN since the end of the Cold War.
- About **half of the UN member countries** have **less than 8 million** inhabitants.

## Number of UN Member States between 1945 and 2011



# **Small states have benefited from increasing international openness**

- **Small states thrive in an economically integrated world**, while they are disproportionately hurt by barriers to international exchanges.
- Thus, **small states have benefited from** the trend towards increasing **international openness** over the past few decades.

# International Openness and Economic Growth

- **Conditional correlation** between International Openness (Trade/GDP) and **Economic Growth**:
  - for larger countries: 0.150 small and positive
  - for **smaller** countries: **0.641 large and positive**
- International Openness is beneficial on average for countries of all sizes, but **especially** for small countries

# Country Size and Economic Growth

- **Conditional correlation** between **Country Size** (Population) and **Economic Growth**
  - for closer countries: **0.454** large and positive
  - for open countries: **-0.116** small and negative
- **country size** matters for **closed** countries but not for **open** countries
- **smaller open countries** on average grow a bit **faster** than larger open countries

# **But international integration is under threat**

- **Political backlash against international integration** both globally and within Europe
- E.g., Brexit, the rise of anti-European political movements
- What's the matter with international and European integration?
- In the rest of this talk we'll discuss these issues in light of recent research in the field of political economy

## References

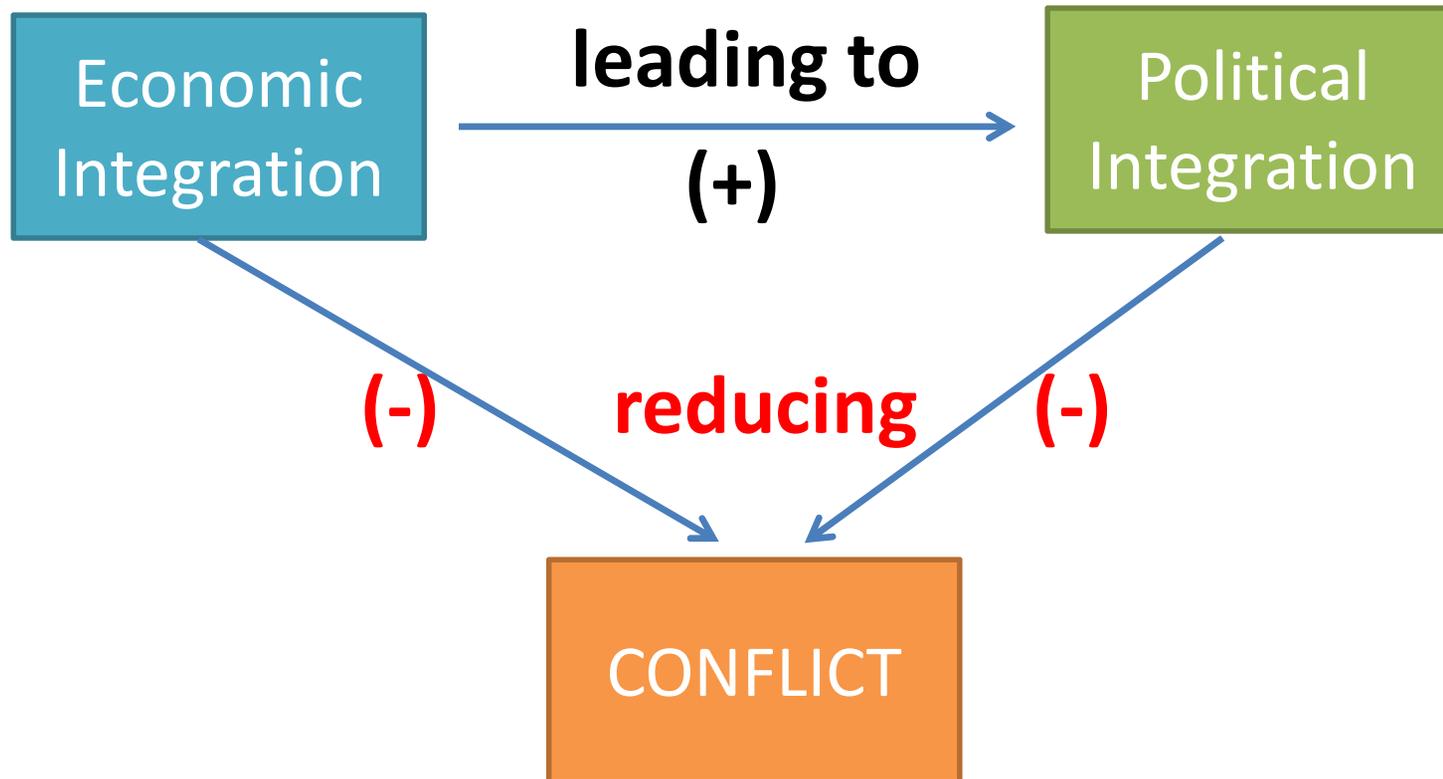
(available at <http://sites.tufts.edu/enricospolaore/>)

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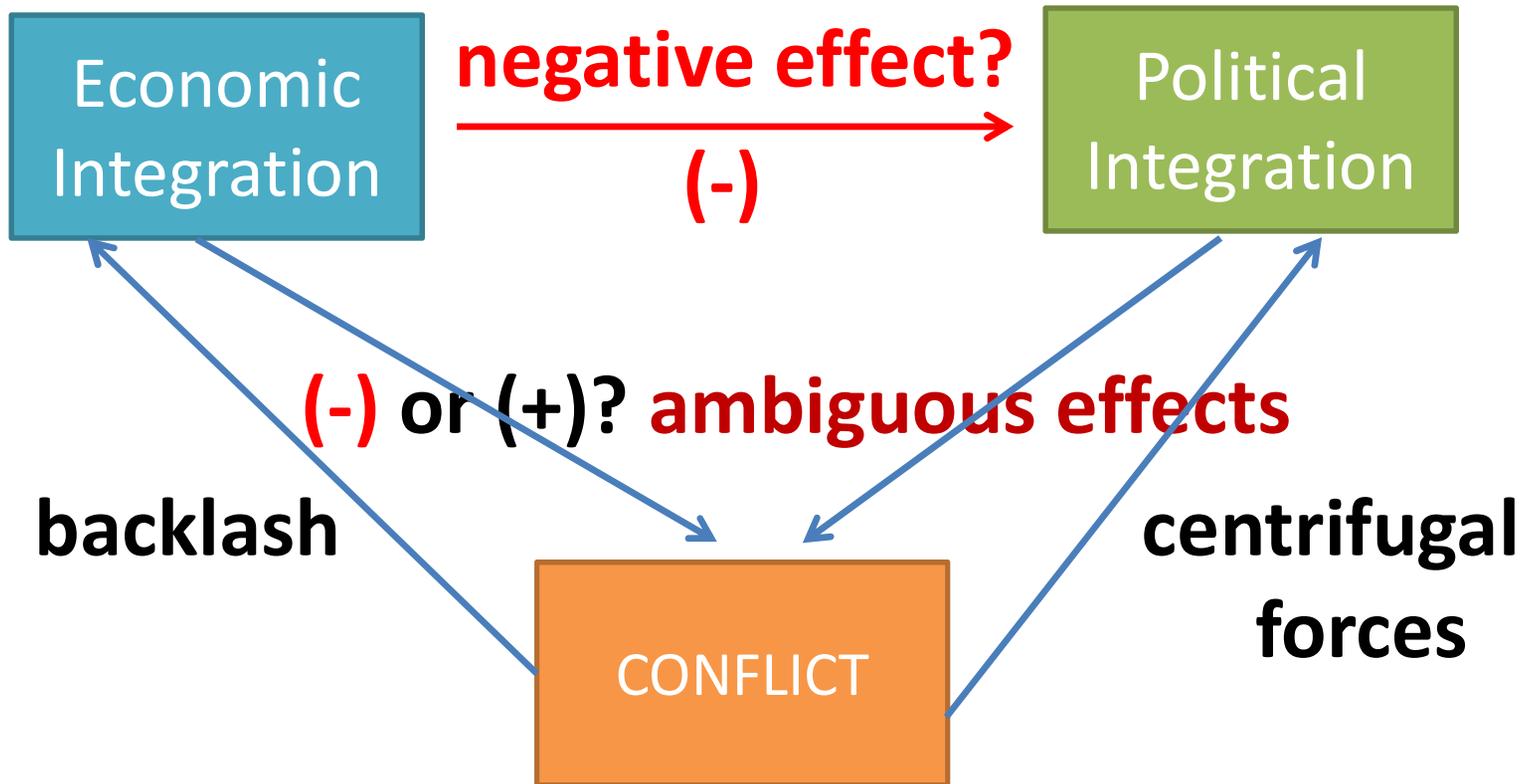
# European Integration: Too Much or Too Little?

- Critics have argued that institutional integration in Europe has gone **too far** and that the **euro has failed**.
- Some observers view **Brexit** as the first step towards **European disintegration**.
- Others fear that the **immigration crisis** may lead to the return of permanent barriers *within* Europe.
- Supporters of European integration attribute the current economic, financial, and political crises to **incompleteness** (a “half-built house”), and ask for **more integration** (banking union, fiscal union, full political union)

# The Original European Project



# However...



# The European Dilemma

**high economies of scale  
from integration**

(commercial integration, common immigration policies,  
common legal system, common defense and security)

but also

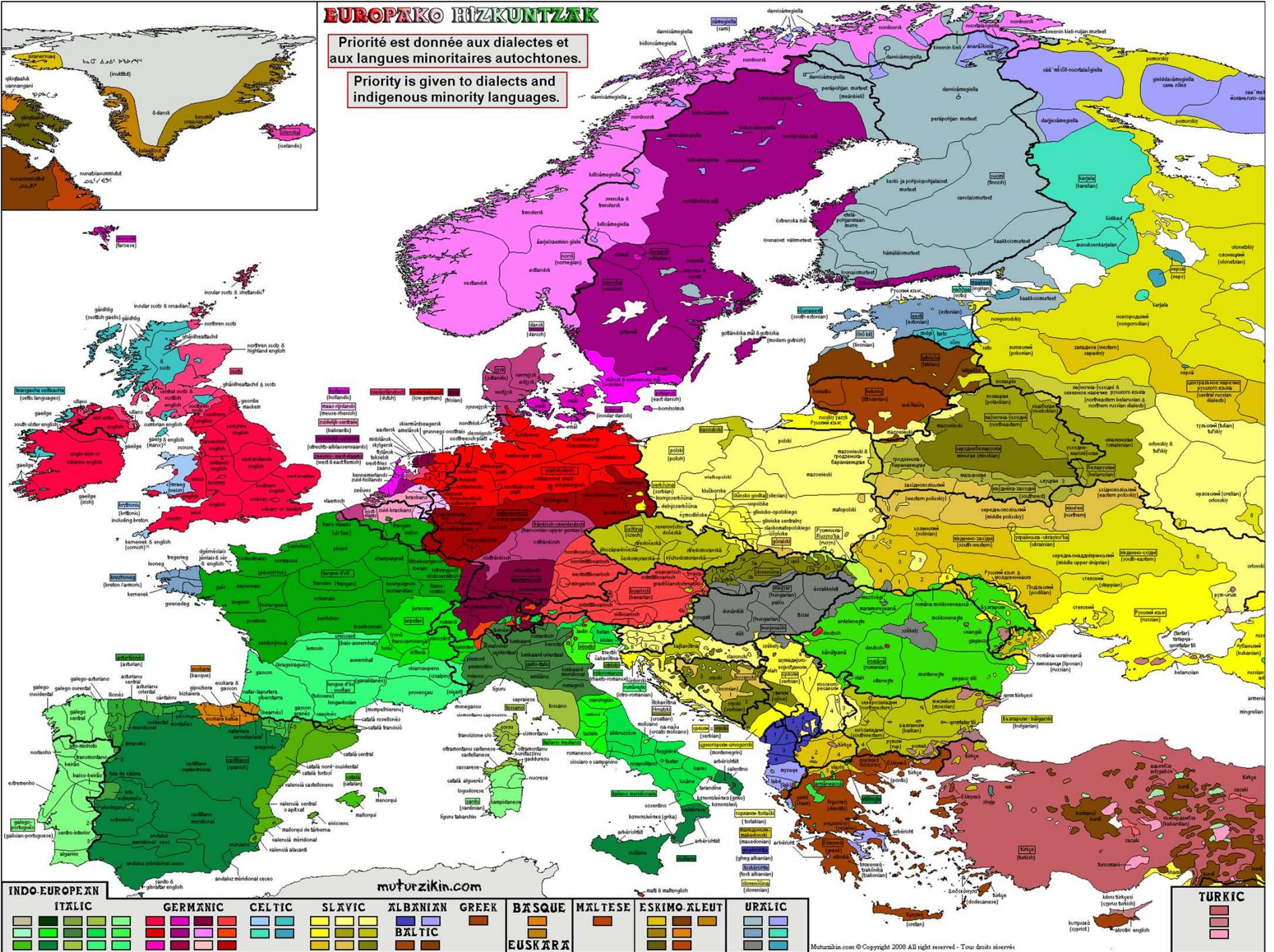
**high heterogeneity**

different preferences, beliefs, values  
in large, diverse populations

# EUROPAKO HIZKUNTZAK

Priorité est donnée aux dialectes et aux langues minoritaires autochtones.

Priority is given to dialects and indigenous minority languages.



**INDO-EUROPEAN**

**ITALIC**

|             |             |             |             |             |             |             |             |             |             |
|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|
| Green       | Light Green | Light Green | Light Green | Light Green | Light Green | Light Green | Light Green | Light Green | Light Green |
| Light Green |
| Light Green |

**GERMANIC**

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| Red |
| Red |
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**CELTIC**

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|------|------|------|------|------|------|------|------|------|------|
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| Blue |
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**SLAVIC**

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**ALBANIAN**

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| Brown |
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**GREEK**

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| Orange |
| Orange |
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**BASQUE**

**EUSKARA**

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**MALTESE**

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**ESKIMO-ALEUT**

|        |        |        |        |        |        |        |        |        |        |
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| Orange |
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**URALIC**

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| Purple |
| Purple |
| Purple |

**TURKIC**

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- **Economies of scale** are easier to quantify and have received more attention by economists studying economic and political integration
- **Heterogeneity** is harder to define and measure, and is often left out of the analysis
- However, there is a **growing empirical literature** on the effects of cultural/linguistic/ethnic **heterogeneity** on economic and political outcomes

# Costs and Benefits of Heterogeneity

## Key Distinction:

### **Public Goods** vs. **Rival Goods**

- Heterogeneous preferences **negatively** affect the provision of **public goods** - which are **non-rival** in consumption and must be shared by all within a jurisdiction.
- In contrast, diversity of preferences and traits comes with **benefits** when considering interactions about **rival** goods.

# Empirical Evidence

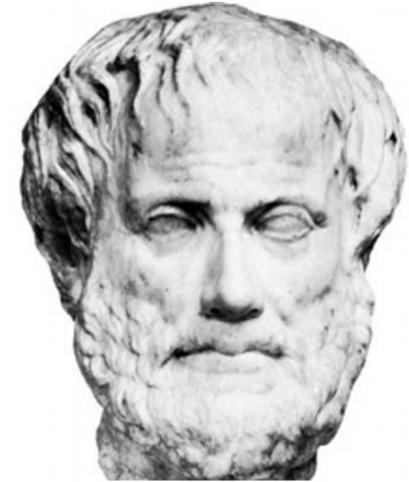
**Civil and ethnic conflict** (intrastate conflict) more likely in **more heterogeneous** societies, especially when it is over control of **public goods** (government)

- Montalvo and Reynal-Queirol (2005) and Esteban, Joan, Mayoral and Ray (2012): *ethnolinguistic polarization and ethnic conflict*; Desmet, Ortuño-Ortín and Wacziarg (2012, 2017): *linguistic cleavages and civil conflict, cultural distance and conflict*.

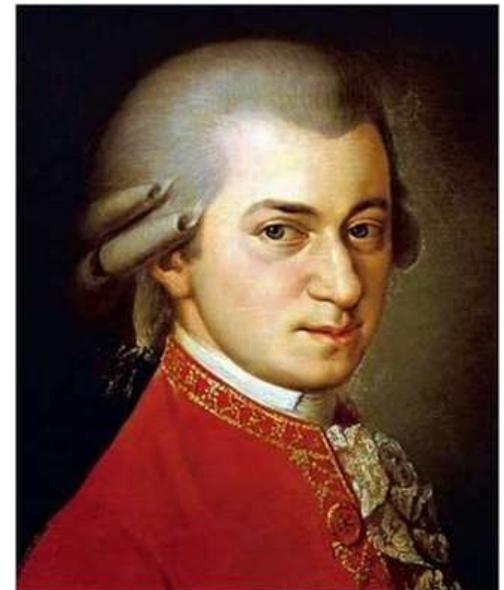
**International conflict** over **rival goods (territory)** more likely between populations that are *more closely related along historical, linguistic and religious lines*, even after controlling for numerous measures of geographic distance and other factors that affect conflict (Spolaore and Wacziarg, 2016)

# The traditional solution to political heterogeneity costs: small states

*“Experience has shown that it is difficult, if not impossible, for a populous state to be run by good laws”* Aristotle, IV Century B.C.



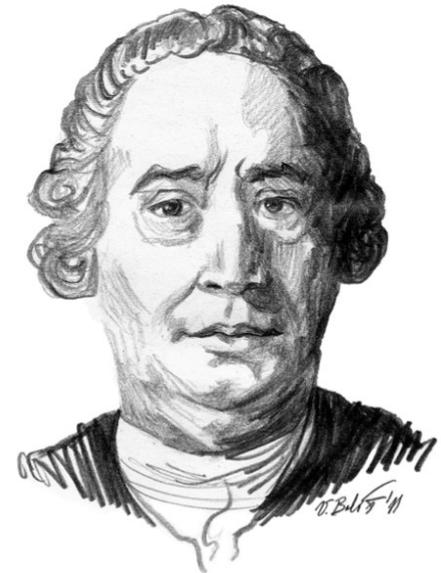
*“In a small republic, the public good is more strongly felt, better known, and closer to each citizen”*  
Montesquieu, 18<sup>th</sup> Century



However, Enlightenment thinkers also stressed **international integration**

*“Nothing is more favorable to the rise of politeness and learning than a number of neighboring and independent states, connected together by commerce and policy.”*

David Hume, 18<sup>th</sup> century



*David Hume*

# Back to the European Dilemma

High economies of scale

from institutional integration

High benefits from diversity

when interacting over rival goods

but

high heterogeneity costs

from different preferences

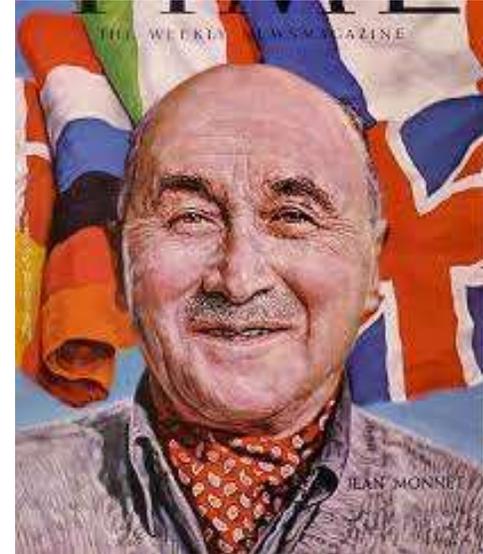
over public goods and policies

|                                | <b>Low Heterogeneity Costs</b><br><b>Heterogeneity Benefits</b>  | <b>High Heterogeneity Costs</b>   |
|--------------------------------|--|---|
| <b>Low Economies of Scale</b>  | <b>Local/regional policies</b> about rival goods or less controversial public services (e.g., water, sanitation, garbage collection) | <b>Local/municipal policies</b> about more controversial public goods (e.g., natural parks/monuments) |
| <b>High Economies of Scale</b> | <b>Commercial integration</b>  | <b>Common currency</b><br><b>Common defense</b><br><b>Full political union</b>                        |

- The European project is an attempt to **sidestep the political constraints imposed by heterogeneity** of preferences through a strategy of **partially integrating** policy functions in a few areas, with the expectation that **more integration** will follow in other areas.
- This gradualist strategy became the main approach to European integration in the 1950s, after the **failure** of a more ambitious attempt to create a defense and political community.

# The Monnet Strategy

From the successful creation of the Coal and Steel Community and the rejection of the Defense Community, Jean Monnet learned **a lesson in political realism.**



**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.

# Monnet's Chain-Reaction Method according to his collaborator George Ball

“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.”

# Successes and limits of Monnet's chain-reaction approach

- On balance, the gradualist strategy was successful when applied to areas with **large economies of scale** and relatively **low costs from heterogeneity** of preferences and traits across different populations – for example, **commercial integration**.
- However, the gradualist approach, based on the **unwarranted expectation that more integration could solve the issues created by the previous steps**, and that economic integration would lead to political integration, is also at the **roots of Europe's current institutional problems**.

# The darker side of Monnet's chain reaction

- Partial integration can lead to more integration by generating problems and crises.
- Important complementary functions are missing at each step. For Monnet and followers, such **incompleteness is not a bug but a feature**, because it creates pressure for further integration
- *“L'Europe se fera dans les crises et elle sera la somme des solutions apportées à ces crises”* Europe will be made in crises, and will be the sum of the solutions adopted for these crises.

Jean Monnet, *Mémoires* (1976)

# EMU: the Chain Reaction at Work?

“[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).”

Tommaso Padoa-Schioppa

# Incompleteness of the EMU

- Helmut Kohl in 1991: "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: 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 an unavoidable feature of partial integration in Monnet's functionalist tradition.

# Europe as an incomplete house in the *Report of the Five Presidents*

- The metaphor of Europe as an **incomplete house** is echoed in the *Report of the Five Presidents* (Juncker et al., 2015).
- The Report's central message is Europe's economic and monetary union is "like a house that was built over decades but only partially finished" and that "it is now high time to reinforce its foundations" by moving towards a **financial union** - including the completion of the banking union and the creation of a European deposit insurance scheme - a **fiscal union**, and "finally towards a **political union** that provides the foundation for all of the above" (Juncker et al. 2015, pp. 4-5).

# Limitations of Monnet's Chain Reaction Method

## I. Overestimation of Role and Power of Supranational Institutions

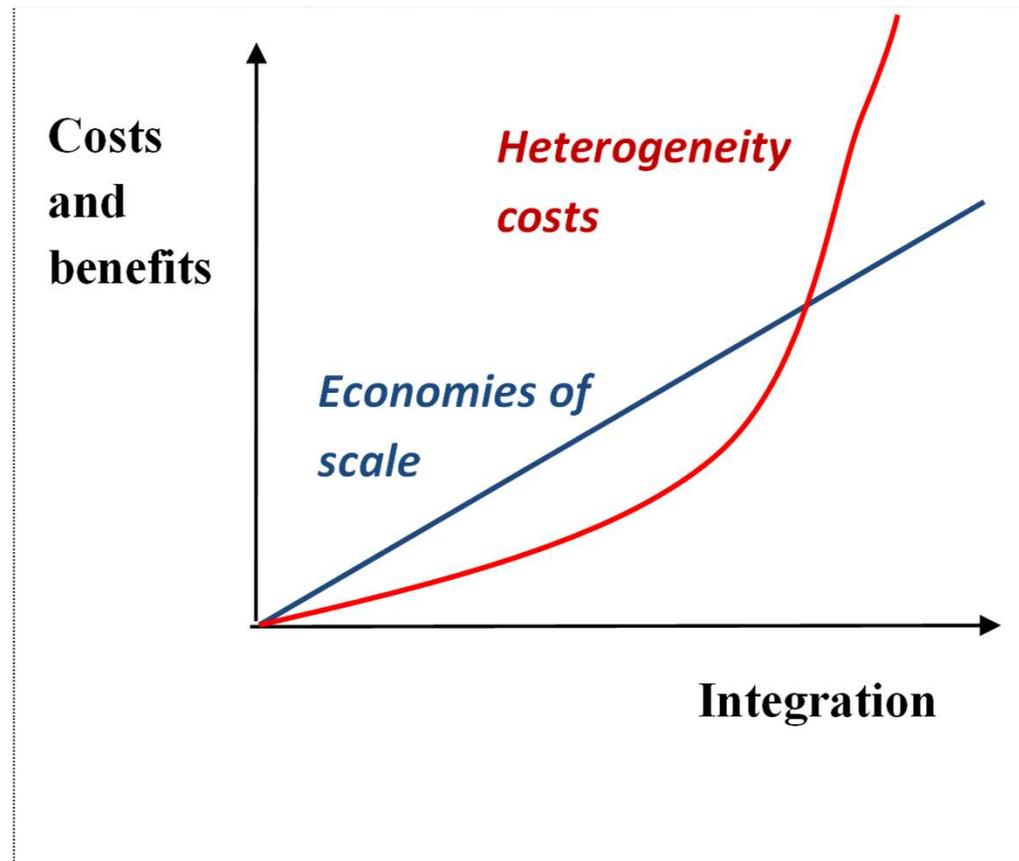
- Supranational agents' ability to take autonomous decisions can only be sustained in matters where the *extent of disagreement among national governments over policy outcomes is relatively low*, like the enforcement of trade liberalization agreements.
- Success in those areas does not imply that supranational rules could also trump national interests in other areas with much *higher heterogeneity of preferences and interests*, like fiscal policies and immigration policies.

# Limitations of Monnet's Chain Reaction Method

## II General problem: underestimation of the costs from heterogeneity

- Successful integration is more likely to take off in areas 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 prohibitive, and the pressure from spillovers, inefficiencies and crises no longer leads to further integration, but only to losses, and possibly even the collapse of the whole system.
- **Incompleteness is a bug after all.**

# Heterogeneity costs and economies of scale as a function of institutional integration



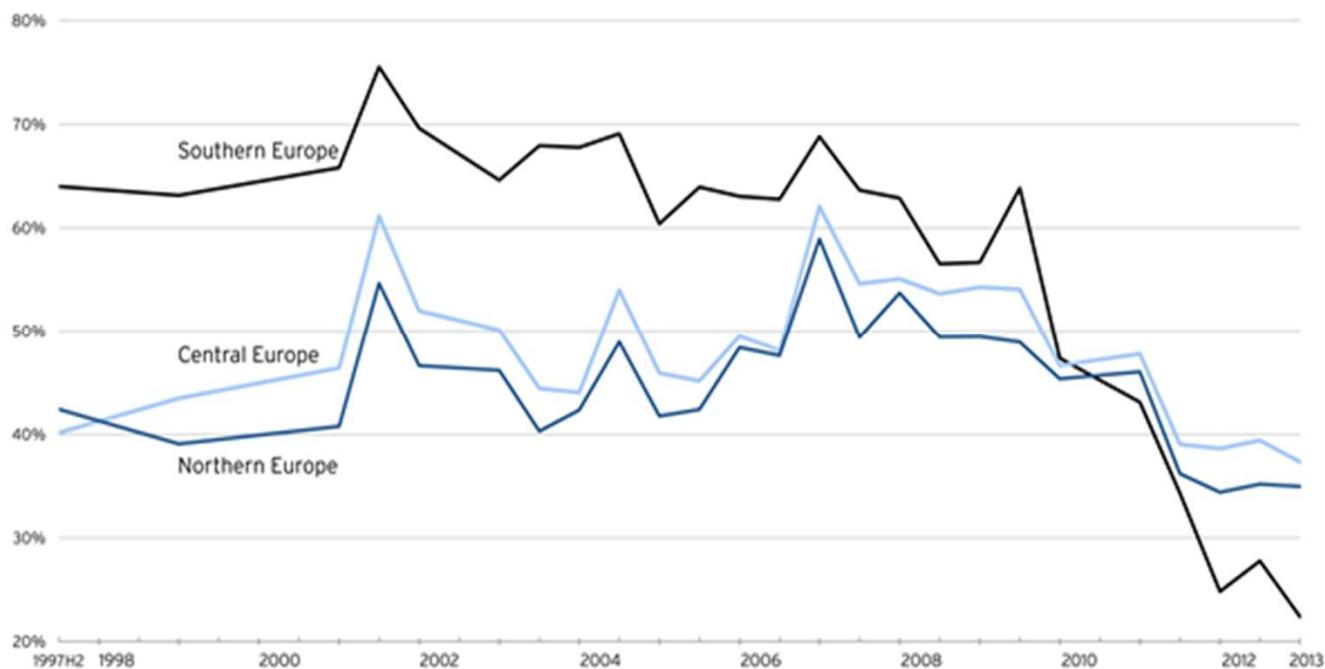
# Empirical Evidence

Partial steps toward European integration have not generated more support for further steps

Evolution of trust toward the European Union, arranged by geographic subdivisions of the EU 15

Share of respondents who answered *Trust/Tend to trust* to the question:

*"I would like to ask you a question about how much trust you have in certain institutions. For each of the following institutions, please tell me if you tend to trust it or tend not to trust it... The European Union"*



Source: Eurobarometer surveys 1997-2013

Northern Europe: Denmark, Sweden, Finland, United Kingdom, Ireland

Central Europe: Austria, Germany, France, Belgium, The Netherlands, Luxembourg

Southern Europe: Italy, Greece, Spain, Portugal

From the BPEA paper "Monnet's Error?" by Luigi Guiso, Paola Sapienza, and Luigi Zinagles

BROOKINGS

# Political backlash against integration

## BREXIT

- Britain's pre-Brexit situation (*de facto* “partial membership”) was probably optimal for Britain overall. The British had one foot inside – in the lower heterogeneity-cost areas (commercial integration) -, and a foot outside – out of the higher-heterogeneity-costs areas (euro, Schengen).
- Nonetheless, Brexit happened. Voters with heterogeneous preferences can and do break up even efficient unions (Alesina and Spolaore 1997, 2005)
- It was the **Revenge of Heterogeneity**
- Other current instances of political backlash against integration within and outside Europe stem from a **political underestimation of heterogeneous preferences** over public policies.

# What Future for Integration?

- European integration has been **greatly beneficial overall**, as economies of scale and benefits from diversity have tended to offset heterogeneity costs
- There is still **great potential for progress** if **heterogeneity costs** are taken into account in the institutional design.
- In other words, **integration can be saved** if we build institutions that **maximize the benefits from economies of scale and diversity without denying/underestimating the costs from heterogeneous preferences** over public goods and policies.

# Conclusion

- Sustainable progress much more likely, and less costly, if pursued by **abandoning the chain-reaction's approach**, and focusing on reforms that make economic and political sense by themselves and are democratically supported by voters.
- **Small states can and should be at the forefront of this process**, because they are the ones who have the most to benefit from **economic integration** while, historically, they have been the **most effective at keeping heterogeneity costs low**.

# **Back to the Wisdom of the Enlightenment:**

**FOSTER “THE RISE OF LEARNING  
AND POLITENESS” BY CONNECTING  
INDEPENDENT STATES THROUGH  
“COMMERCE AND POLICY”**

**THANK YOU**