The Political Economy of European Integration*

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Abstract

This chapter discusses the process of European institutional integration from a political-economy perspective, linking the long-standing political debate on the nature of the European project to the recent economic literature on political integration and disintegration. First, we introduce the fundamental trade-off between economies of scale associated with larger political unions and the costs from sharing public goods and policies among more heterogeneous populations, and examine the implications of the trade-off for European integration. Second, we describe the two main political theories of European integration - intergovernmentalism and functionalism - and argue that both theories capture important aspects of European integration, but that neither view provides a complete and realistic interpretation of the process. Finally, we critically discuss the successes and limitations of the actual process of European institutional integration, from its beginnings after World War II to the current crisis.

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1. Introduction and Summary

The process of European integration is based on a time-honored strategy of partially integrating policy functions and institutions in a few areas – such as coal and steel, trade, or, later, a common currency - with the expectation that more integration will follow in other areas over time.

This strategy became the main approach to European institutional integration in the 1950s, after the collapse of a more ambitious attempt to create a defense and political community, which would have included a common army, a common budget, and common legislative and executive institutions (basically, a European federation). Faced with the failure of direct attempts to form a full political union, supporters of European integration pursued an alternative path of gradual and partial integration. The process took place mostly in technical and economic areas but with the expectation that deeper, more "political" integration would follow, in part as a result of the pressure from inefficiencies and crises associated with incomplete integration. From this perspective, incompleteness was not seen necessarily as a bug but as a feature, as it was expected to lead to further integration down the road.

This gradualist strategy was mostly 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, the creation of a common market. The approach, however, also led to the creation of dangerously incomplete and inefficient institutional settings. Most notably, the euro was introduced in the absence of other institutions historically associated with a successful monetary union, resulting in a "half-built house" (Bergsten, 2012). A widespread rationalization of the imperfections and shortcomings of European institutions was based on the expectation that the problems associated with previous steps could always be fixed by more integration: commercial integration and monetary integration would in due course be followed by more institutional and political integration, such as a banking union, a fiscal union, or even a fully-fledged political union, in what has been described as a "chain reaction" towards an "ever-closer union."

A fundamental problem with this "chain-reaction" approach is that it underestimates the costs and constraints associated with heterogeneity of traits and preferences over public goods and policies in populations with diverse societal structures, cultures and identities. In fact, the trade-off between benefits from integration and heterogeneity costs is at the center of a vast and growing literature on the political economy of integration (and disintegration). An analysis of the implications of such trade-off can shed insights on the successes and limits of the actual process of European integration, as well as on the theories that have been developed over the decades to understand the objectives and strategies behind the European project.

This chapter provides a discussion of the process of European institutional integration from a political-economy perspective, linking the long-standing political debate on the nature of European integration to the more recent economic literature on political borders.[1]

The rest of this chapter is organized in three parts. Section 2 briefly discusses some concepts on the political economy of integration and their implications for the European project, with an emphasis on the basic trade-off between economies of scale and scope associated with larger political unions and the costs from sharing public goods and policies among more heterogeneous populations. Section 3 covers the two main political theories of European integration, intergovernmentalism and functionalism, and argues that both theories capture important aspects of European integration, but neither approach provides a complete and realistic interpretation of this complex process. Finally, the actual process of European institutional integration, from its beginnings after World War II to the current crisis, is critically discussed in Section 4. Section 5 concludes.

2. The Political Economy of Institutional Integration: A Fundamental Trade-off and Its Implications for Europe

A useful starting point to study the political economy of institutional integration is the fundamental trade-off between *economies of scale* and *heterogeneity costs*.[2] When larger and diverse groups form common institutions and pool public functions and policies - such as a common legal and judicial framework, a common currency, fiscal policies, defense and security, and so on -, they can benefit from economies of scale in the provision of public goods, which are non-rival in consumption and therefore cheaper on a per-capita basis when the costs are spread over a larger population. Larger jurisdictions may also allow policy-makers to internalize externalities over a broader area, and to provide insurance against shocks, such as natural disasters or regional economic crises.

Larger and more diverse jurisdictions, however, tend to face higher heterogeneity costs stemming from different political, economic and cultural traits and conflicting preferences over public goods and policies. The relations between various measures of heterogeneity (ethnic and linguistic fractionalization and polarization, measures of genetic and linguistic

[1] The chapter heavily builds on Spolaore (2013). General discussions of the economic approach to political borders and integration are provided in Alesina and Spolaore (2003) and Spolaore (2006, 2014). For overviews of the large literature on European institutional integration by political scientists and political economists, see for example Gilpin (2001, chapter 13), Eichengreen and Frieden (2001), Eichengreen (2006 and 2012), and Sadeh and Verdun 2009.
[2] E.g., see Alesina and Spolaore (1997, 2003) and Spolaore (2006, 2014).

distance, and other measures of historical and cultural diversity) and a series of political outcomes (provision of public goods, quality of government, redistribution, conflict within and across states) have been documented in a vast and growing empirical literature, including for instance Alesina et al. (2003), Alesina and La Ferrara (2005), Montalvo and Reynal-Querol (2005), Esteban, Mayoral and Ray (2012), Desmet, Ortuño-Ortín and Wacziarg (2012), Spolaore and Wacziarg (2012), and Arbatli, Ashraf and Galor (2013). This empirical literature is still in its infancy, and there are numerous open questions about the definitions and methods to be used in order to measure the effects of heterogeneity on different outcomes.[3] Nonetheless, a general finding is that more heterogeneous populations tend to face higher political costs in the provision of public goods and a higher likelihood of civil conflict. It should be noted that, in principle, heterogeneity can be a source of benefits as well as of costs for societies. In communities where agents have diverse preferences and characteristics, individuals and groups can benefit by specializing in the production of different goods and services, while also learning new ideas from each other. Benefits from heterogeneity, however, are mostly about interactions over *rival* goods, which cannot be consumed simultaneously by several people. In fact, *low* heterogeneity may lead to conflict if different individuals and groups share very similar preferences over the *same* rival goods, such as specific territories and resources (Spolaore and Wacziarg 2012). The opposite relation holds for diverse preferences over *non-rival* goods - such as a common government, legal system, and public policies - which must be shared by all within a given political jurisdiction, whether they like them or not. In the area of public goods, therefore, different preferences mean higher political costs and a higher likelihood of domestic conflict. In sum, heterogeneity of traits and preferences is mostly beneficial when different individuals and groups interact about rival goods but costly when the interaction is about non-rival goods. Consequently, heterogeneity of preferences over types of governments and public goods is a major limit to the integration of institutions that provide common public goods and policies to large and diverse populations within a common jurisdiction.

Up to a point, the trade-off between economies of scale and heterogeneity of preferences can be addressed through decentralization at different layers of administration. Public goods with higher heterogeneity and lower economies of scale can be more efficiently provided at lower administrative levels (e.g., municipal and regional governments), while public functions with higher economies of scale and externalities, relative to heterogeneity costs, can be centralized at increasingly higher levels.[4] These ideas are partly reflected in the legal documents at the basis of European integration. For instance, the Maastricht Treaty of 1992, which

[3] In particular, an important question is the extent to which ethnic and cultural divisions are endogenous, and respond to political and institutional change - an issue on which we will return in Section 4.

[4] These issues are at the center of the large literature on fiscal federalism - e.g., Oates, 1999; for a discussion from a political-economy perspective see Alesina and Spolaore, 2003, chapters 2, 9 and 12.

reorganized and redefined European institutions, specified the following "principle of subsidiarity" (Article 3b): "In areas which do not fall within its exclusive competence, the Community shall take action, in accordance with the principle of subsidiarity, only if and in so far as the objectives of the proposed action cannot be sufficiently achieved by the Member States and can therefore, by reason of the scale or effects of the proposed action, be better achieved by the Community."[5]

Nonetheless, the creation of layers of distinct and overlapping jurisdictions, each organized around a subset of public functions and policies with different economies of scale and heterogeneity costs, faces limitations and challenges both in terms of economic efficiency and political stability. A key issue for disentangling different functions at different levels is that the provision of public goods comes not only with significant economies of scale, but also with *economies of scope*. It is usually more efficient to provide several public goods together, rather than through separate authorities. A particularly important kind of "economies of scope" is associated with the exercise of fundamental *sovereignty* and monopoly of *legitimate coercion*, which is a prerequisite for the provision of a vast range of public goods and policies. In fact, even when different public goods are decentralized at lower administrative layers, modern federal systems tend to centralize sovereignty – which can be defined as the residual power to take fundamental decisions over domestic and foreign relations for a state or federation, after all other specific rights and powers have been assigned to various layers of authorities. In practice, the centralization of sovereignty is often achieved through the pooling of the means on which the ultimate monopoly of legitimate coercion depends, including explicit military power. Consequently, the formation of a sovereign polity tends to go hand in hand with the integration of defense and security under one authority, which exercises the ultimate monopoly of coercion within a territory. In turn, such power of coercion can be used to collect resources and finance a broader set of public goods, on which different groups and individuals may have different preferences. Therefore, ultimate political integration - the formation of a sovereign state or federation - has historically been associated with the pooling of defense, security and foreign policy – public functions with very high economies of scale and scope but also very high heterogeneity costs across large and diverse populations. It is not clear how the "principle of subsidiarity" would apply to the fundamental issue of centralizing sovereign power and control over means of coercion in those areas.

Over the centuries, the formation of large and heterogeneous states, federations and empires has taken place as the result of actions by non-democratic rulers (Leviathans) interested in maximizing their own rents while ignoring the preferences of large part of their subjects,

[5] http://www.eurotreaties.com/maastrichtec.pdf.

and/or in response to significant external security threats.[6] In contrast, there are very few historical examples – if any – of consensual formation of sovereign states or federations by large and diverse populations under democratic and peaceful conditions.

In this respect, the history of European institutional integration so far has been no exception. A founding document of the process of European integration is the Schumann declaration of 1950 (named after France's foreign minister), which defined the pooling of coal and steel production as "the first concrete foundation of a European federation indispensable to the preservation of peace." Nonetheless, no European federation was formed. In 1952 the six founders of the European Steel and Coal Community signed a treaty for the establishment of a European Defense Community and a European Political Community, which would have included a common army, a common budget, and common legislative and executive institutions - basically, a European federation. The project was abandoned, however, after the treaty failed to be ratified in the French parliament. Instead, the supporters of European integration focused on the creation of a European common market, which was established with the Treaty of Rome of 1957. The Treaty of Rome no longer mentioned a European federation, but stated the vaguer objective of laying the "foundations of an ever-closer union among the peoples of Europe."

Consistently with the analysis of this Section, those earlier successes of European integration took place in areas - e.g., commercial integration - where economies of scale are very high, while heterogeneity costs are relatively low and partially offset by benefits from diversity. In contrast, failure occurred in areas – such as defense and security - with the highest political costs from heterogeneity of preferences. The subsequent history of European institutional integration stems from the lessons (both learned and not learned) of those early successes and failures, as we will see in the rest of this chapter.

3. Political Theories of European Integration: Intergovernmentalism vs. Functionalism

Europe's political economy is notoriously complex and controversial. Over the decades, scholars and commentators have emphasized different motivations, strategies and interactions among the several actors involved in the process of European integration, from national governments and voters to supranational technocrats and domestic interest groups.

[6] For a classic analysis of federalism from this perspective, see Riker (1964). Conflict and political borders are studied in Alesina and Spolaore (2005, 2006) and Spolaore (2012). For a discussion of the attempts to integrate defense and security in Europe see Spolaore (2013, pp. 128-131).

A traditional distinction in the political literature on European integration is between the "intergovernmentalist" view and the "functionalist" view. The two views differ in their answers to two basic questions: what are the objectives of European integration, and who is in charge?

Intergovernmentalists believe that the European project is in the hands of national governments who pursue domestic interests, mostly in the economic area. For instance, Moravcsik (1993, 1998), a leading proponent of this theory, argues that national governments have built European institutions in order to pursue the economic interests of their domestic constituencies, and views the euro as an economically-motivated project, mainly reflecting the interests of German exporters and other powerful economic agents (Moravcsik, 2012). This line of analysis is part of a broader political-economy literature that stresses the connections between domestic economic interests and national attitudes and policies towards European integration (for example, see Frieden 2002).[7]

From an intergovernmentalist perspective, the European Union is just a particularly complex international organization of sovereign states. In this respect, European supranational institutions, such as the European Commission and the European Court of Justice, are only instruments and commitment devices that nation states have built and use in order to pursue their own objectives, while their national governments retain all fundamental power about key decisions.

Functionalists, in contrast, believe that supranational institutions and agents are distinct from national governments, and fully in charge of specific functions (hence the term "functionalism").[8] According to this view, "supranational actors" such as Jean Monnet (head of the European Coal and Steel Community in the 1950s) or Jacques Delors (head of the European Commission in the 1980s and early 1990s) played an autonomous role and provided impetus to the process, independently of national governments' "narrower" interests.

Perhaps even more important is the functionalists' different emphasis on the long-term objectives and dynamics of European integration. The process of functional integration, while starting within specific and relatively narrow economic functions (coal and steel, trade), is expected to move to broader and more "political" areas. In the long run, economic

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[7] The intergovernmentalist view of European integration is sometime qualified as "liberal" intergovernmentalism to distinguish it from "realist" approaches that also emphasize the central role of nation states, but stress power and military interests rather than domestic economic goals achieved through international cooperation (e.g., see Garrett 1993 and Gilpin 2001).

[8] The leading functionalist theorist of European integration was Haas (1958, 1964). The view of Haas and his followers is sometime labeled as "neo-functionalist," to distinguish it from Mitrany's pre-existing theory of international integration (see Mitrany 1975). A critical reconsideration of functionalism was provided by Haas (1975). For more recent analyses from a functionalist perspective see for instance Pierson (1996), Sandoltz and Stone Sweet (1998), and Stone Sweet (2000).

integration is expected to lead to political integration – either to a fully-fledged sovereign federation ("the United States of Europe") or to a "post-modern" political community in which traditional sovereign states have become much less powerful or even obsolete.[9]

From a functionalist perspective, building partial and incomplete institutions is not a shortcoming, but a natural feature of a dynamic process, whereas crises and problems associated with previous integration can be solved through further integration. In this respect, the creation of the euro can be seen as the ultimate example of functionalist integration. From this perspective, commercial integration and capital mobility could be maintained within Europe only by forming a monetary union, which, in turn, might be sustained in the long run only through further institutional integration: a banking union, a fiscal union, possibly full political unification.

Both the intergovernmentalist view and the functionalist view capture important aspects of European integration. However, neither view provides a complete, realistic and satisfying interpretation of this complex process.

Intergovernmentalists are fundamentally correct when they stress the central role of national governments and national interests in the actual process of European integration. The history of the European Union (and of its predecessor, the European Community) shows that Europe's supranational institutions – such as the European Commission or the European Court of Justice - cannot move far against the fundamental interests of national governments. Supranational institutions and procedures, while playing an important role in the daily functioning of Europe, "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).

Moreover, by emphasizing and analyzing the interactions between national governments and domestic economic interests, this line of research provides very useful insights on the details of the political economy of European integration.[10]

Intergovernmentalist analyses, however, with their sharp focus on domestic economic interests, tend to miss the central role of long-term political goals and strategies that have historically determined the process of European integration. At its roots, the European project is motivated by broader political considerations. Since the very beginnings right after World War II, the paramount goal of the European project has been to build, through gradual

[9] For an early critical discussion from a political perspective see Hoffman (1966).

[10] For example, see Frieden (1998, p. 33) for prescient insights on the political economy of European integration and the euro.

integration, a political and institutional system that would prevent the tragedies of the first half of the 20th century, when independent and unconstrained nation states had pursed unilateral and costly protectionist policies during the Great Depression and engaged in two enormously destructive wars. Even though economic interests have certainly played an important role in the actual process of European integration, the overall design and strategy would not be comprehensible without considering its long-term political and strategic motivations.

Insofar as it emphasizes the ultimate political goals of the process and its dynamic aspect, functionalism is much closer to capture the political and ideological framework and long-term strategy behind much of the European construction, from the earlier steps by Jean Monnet and his followers in the 1950s to the new impetus provided by Jacques Delors and his collaborators in the 1980s and 1990s. Nevertheless, the functionalist interpretation is not fully adequate to capture the actual process of European integration either. A problem with the theory is that it tends to overestimate the role and powers of supranational agents and institutions - in this dimension, as already mentioned, the intergovernmentalist view is much more realistic.[11]

The overestimation of supranational actors is a symptom of a deeper issue with the functionalist view, which is related to its dual nature of *positive* description of the ideology and goals of the supporters of European integration and *normative* theory of how European integration should actually proceed. While the functionalist analysis is a very useful description of the political objectives of European integration, it is also an involuntary mirror of its problems and limits. As a normative strategy of integration, the functionalist approach tends to *underestimate* the obstacles and limitations that would eventually affect a dynamic process of gradual integration towards an “ever-closer” union.

As highlighted in the previous section, in order to understand the political economy of European integration it is crucial to consider the implications of the fundamental trade-off between benefits from integration and heterogeneity costs. A central problem with the functionalist strategy of European integration, based on gradual integration of specific functions, has indeed been the lack of a realistic assessment of the *increasing costs and constraints* imposed by heterogeneity of preferences over the provision of public goods and policies when populations have different traits, cultures and identities.

As we already mentioned in Section 2, 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, heterogeneity costs continue to increase and become politically prohibitive. The functionalist approach

[11] For a more extensive discussion of this point, see Spolaore (2013, pp.136-138).

does not anticipate that heterogeneity costs and constraints will eventually become binding and may 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.

Hence, as we will see in more detail in the next section, the functionalist perspective can provide a useful interpretation of the earlier successes of European integration, but its optimistic implications are not a good guidance to the problems and limitations that the process is bound to face as functional integration moves from lower-heterogeneity areas to higher-heterogeneity areas.

4. The Actual Process of European Integration: Successes and Limits

The history of European institutional integration started with an early success (the formation of a coal and steel community, proposed with the Schuman declaration in 1950 and established with the Treaty of Paris in 1951), and a dramatic failure (the collapse of the defense and political community in 1952, discussed in Section 2). Those two different experiences motivated the subsequent strategy of European integration. The fathers of European institutions, such as Jean Monnet and his collaborators, came to believe that the creation of an ambitious federal structure with major political functions faced insurmountable political obstacles, at least in the shorter run. Instead, they hoped to proceed towards increasing political integration through a gradualist and dynamic strategy, basically along the "functionalist" lines described in the previous section. That is, specific functions could be delegated to supranational institutions in relatively narrow areas, mostly technical and economic (coal and steel, common market, later a common currency), but with the expectation that this would lead to more institutional integration in other areas over time. In other words, Monnet and his followers shared the functionalist view that partial integration would gradually lead to an "ever-closer" union over time, by creating pressure for more functional integration.

The strategy was partly motivated by the hope that, in the long run, national politicians, voters and interest groups would learn about the benefits of integration, and would therefore demand broader and deeper integration in more areas. Even more important was the expectation that different European populations and policy-makers, by learning to interact and cooperate in economic and institutional matters, would gradually converge in values, norms, and preferences. Over time, this would lead to an "endogenous" reduction in what we have called "heterogeneity costs," therefore facilitating further integration in more sensitive and political areas.

These optimistic expectations have been fulfilled only in part. There is no doubt that the European project has greatly expanded from its early beginnings, dramatically growing both in member countries - from the initial six to twenty-eight as of July 2013 - and in the extent of functions involved - from a European Coal and Steel Community (ECSC) to a European Economic Community (EEC) to a European Union (EU) including an economic and monetary union (EMU).

It is however much less clear that European policy-makers and populations have converged in values and preferences over public goods and policies, along the lines expected by the supporters of European integration. In principle, cultural traits and preferences can indeed change and adapt in response to economic and political changes.[12] There is little evidence, however, that the kind of economic and political cooperation associated with the building of European institutions is bringing about a significant convergence in national preferences, characteristics, and behaviors or the formation of a unitary "European identity."[13]

Nevertheless, the builders of European institutions did not rely only on positive mechanisms, such as an increasing demand for integration due to learning and convergence of preferences. In addition, Jean Monnet and his followers also expected that partial integration might lead to further integration, more paradoxically, because of its own shortcomings and limits – in a word, because of its own "incompleteness." This is clearly explained by one of Monnet's collaborators (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."

More recently, the functionalist argument that partial steps in integration would create need and pressure for further integration, in a sort of "chain reaction," was explicitly echoed by

[12] For example, see Fearon (2006) for a discussion of the political literature on how ethnic and linguistic divisions and their relevance can be affected by political and institutional changes. Bisin and Verdier (2010), Spolaore and Wacziarg (2013) and Spolaore (2014) provide discussions of the growing economic literature on culture and economic outcomes.

[13] Analyses of the political economy of "nation-building" are provided in Alesina and Spolaore (2003, pp. 76-78) and Alesina and Reich (2013).

Tommaso Padoa-Schioppa (2004, p. 14), a close collaborator of Jacques Delors and a key architect of the euro[14]:

"[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)."

In fact, the economic and monetary union (EMU) was seen by its creators not in purely economic and technical terms, but, in 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). The same idea was stressed by the first President of the European Central Bank (ECB), Wim Duisenberg, according to whom EMU was a "stepping stone on the way to a united Europe."[15] And this "stepping-stone" role could be played in spite of (or even *as a consequence of*) its institutional shortcomings. In the functionalist tradition, the fact that EMU lacked institutions historically associated with a successful monetary union - such as a fully-fledged lender of last resort, a banking union, a fiscal union, and so on - could be rationalized as part of a dynamic path that, in the longer term, would necessarily lead to a political union. For instance, in 1991 German Chancellor Helmut Kohl said: "It is absurd to expect in the long run that you can maintain economic and monetary union without political union."[16] In Monnet's "chain-reaction" tradition, Kohl's statement was not meant as a damning assessment of the long-term viability of EMU, but as an optimistic prediction that, eventually, political union would "have to" follow economic and monetary union.

The recent crisis in the Euro Area certainly confirms the risks and inefficiencies associated with incomplete institutional integration. Up to a point, recent events have also confirmed that such inefficiencies and crises can create the pressure for more institutional integration. It is indeed possible (but far from guaranteed) that Europe will come out of the current crisis with stronger and more deeply integrated institutions. Nonetheless, the current economic, financial and political crisis has also illustrated the very high costs, dangers, and limitations associated with the "chain-reaction method" of partial integration.[17]

As already mentioned, a fundamental problem with the functionalist "chain-reaction" approach - both as a theory of European integration and as a policy strategy - is that it

[14] For a detailed analysis of the negotiations leading to the Economic and Monetary Union see Dyson and Featherstone (1999).
[15] Quoted in Overtveldt 2011, p. 63.
[16] Quoted in Marsh 2011, p. 301.
[17] For a more detailed discussion of these issues see Spolaore (2013, pp. 138-139). For an interesting diagnosis along partially similar lines see Mody (2013).

underestimates the *heterogeneity costs* from integration – that is, the costs and constraints involved when political integration is attempted among populations with different preferences, cultures, and identities.

Successful integration is more likely to take off in areas such as trade, where heterogeneity costs across populations are relatively low, and partly offset by the benefits from diversity. As integration proceeds to other areas, after low-hanging fruits are picked, steeper heterogeneity costs are encountered. At some point, such costs may become politically prohibitive, and stop the process, or even lead to a collapse of the whole system. The risks are particularly high if the previous steps towards more integration have not been taken with the broad democratic consensus of all populations involved.[18]

Consequently, successes in areas with lower heterogeneity costs (such as commercial integration) do not necessarily imply further successes in integrating more "political" areas with higher heterogeneity costs (such as fiscal policies or defense). Therefore, the functionalist approach to European integration is really based on a misconception: the expectation that *economic* integration will lead to *political* integration. While political unification historically has been used to foster economic integration within a unified domestic market, the opposite does not typically hold. On the contrary, economic integration reached through international cooperation is a *substitute* rather than a *complement* of political integration. If countries can manage to lower barriers to trade among themselves without full political integration, they will face *lower* incentives to form a political union with a unified domestic market, because such union would generate smaller additional gains from trade. In fact, both theoretical considerations and empirical evidence suggest that international economic integration is associated not with political integration but with political *dis*integration (Alesina and Spolaore 1997, 2003; Alesina, Spolaore, and Wacziarg 2000).

In sum, the method of gradual and partial integration can be successful when applied to areas with lower heterogeneity costs and higher economies of scale, but there is no guarantee that it can lead to further integration in areas with much higher heterogeneity costs, or that those costs would endogenously decrease as a consequence of integration.

The formation of a common market, as already mentioned, is an excellent instance of the appropriate and effective use of partial integration. Overall, the reduction of barriers to economic exchanges was in the general interest of European populations, even though specific sectors within each country benefited from protectionism. As it has often been noted (e.g., Eichengreen 2006), institutional integration in different areas allowed "linkages"

[18] For a discussion of the "democratic deficit" in European institutions see for example Alesina and Spolaore (2003, chapter 12).

between issues and credible side-payments. For example, Europe's Common Agricultural Policy (CAP) - originally introduced in 1962 and amounting to a substantial share of the European institutions' budget - can be explained as part of a deal between France and Germany, whereas German taxpayers subsidized French farmers whereas German exporters gained access to the French market.

The creation of a common European legal framework and common supranational institutions has provided national governments with a credible "commitment technology," going beyond the institutional framework of traditional international organizations. For example, in a landmark case in the early 1960s[19], the European Court of Justice decided directly in favor of a Dutch importer of German chemical products that had objected to a tariff charged by the Netherlands in violation of article 12 of the Treaty of Rome. In fact, the European Court of Justice in this and other cases went beyond the legal provisions 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 standpoint (Weiler 1991; Krasner 1999). These novel legal doctrines, however, were established not in conflict with national governments, but exactly in order to enforce norms consistent with national goals, such as trade liberalization. Therefore, the expansion of powers of the European Court of Justice illustrates the success of the strategy of supranational institutional integration insofar as it is directed areas with relatively low heterogeneity cost and high economies of scale and externalities.

In contrast, supranational integration and centralization has faced increasingly binding constraints when attempting to move to more sensitive and political areas. For instance, in recent years Germany's Constitutional Court has elaborated the legal theory of *conditional* acceptance of the supremacy of European norms, which can be accepted only insofar as they are consistent with "fundamental German rights." In an important ruling on the Lisbon Treaty in 2009,[20] the German Constitutional Court has 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."[21] Again, this is an example of the limits of the European institutional integration when attempting to move from areas with lower heterogeneity costs – such as trade liberalization – to deeper forms of political and legal integration.

Many supporters of the European project believe that economic integration has benefited Europeans not only directly – through gains from trade – but also indirectly, by reducing the risk of a European conflict. The hypothesis that international trade reduces the risk of war has a long pedigree, going back at least to Montesquieu (1748/1989) and Kant (1795/2006),

[19] *Van Gend en Loos v Nederlandse Administratie der Belastingen* (26/62)
[20] *BVerfG, 2 BvE 2/08* of June 6, 2009
[21] Quoted in *Spiegel*, 2009.

and is part of the broader theory of “liberal peace” brought in by democracy, trade, and international organizations (e.g., see Oneal and Russett 1999). Recent empirical studies ((Martin, Mayer and Thoenig 2008 and 2010) cast doubt on a positive relation between multilateral openness (globalization) and peace. On the contrary, the ability to trade with third parties is likely to reduce the costs of going to war between pairs of countries. *Bilateral* trade, however, by increasing the opportunity cost of war between two countries, reduces the likelihood of conflict between them, even when controlling for the degree of historical, linguistic and religious similarity between their populations (Spolaore and Wacziarg 2013). Overall, these studies suggest that regional trade agreements between “old enemies” – such as the formation of a European common market – have probably decreased the risk of conflict among European countries after World War II. A broader – and open - question is whether European integration has played a major or only a minor role in securing peace in Europe, when compared to other factors, such as the role of the United States and NATO.

5. Conclusions

This chapter has discussed the political economy of European integration in light of the implications of the fundamental trade-off between benefits from integration and political costs associated with heterogeneous preferences over public goods and policies.

High heterogeneity costs have so far prevented Europeans from forming a full political union. Attempts to integrate sensitive political functions –such as defense and foreign policy – have not been successful. Instead, Europeans have adopted a gradual strategy of pooling and delegating functions and policies to supranational institutions in a relatively limited set of areas, mostly economic, while maintaining other prerogatives at the national or sub-national level. In spite of supranational rhetoric, ultimate sovereign control and the monopoly of the legitimate use of coercion have firmly remained in the hands of national governments.

This strategy has provided significant benefits to Europeans when appropriately implemented in areas with relatively low heterogeneity costs and high economies of scale and scope. However, serious problems and crises have their roots in the expectation that incomplete and partial integration could always be overcome with further integration, in a “chain-reaction” towards an “ever-closer union.” The euro, with its institutional incompleteness and shortcomings, is a child of this strategy.

A more realistic political-economy analysis naturally suggests a different, more effective strategy, whereas, if any further step is taken towards European integration, it should be taken *only if* it is economically beneficial and politically stable on its own merits, and openly and democratically supported by the populations involved.

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