

VARIABLE INTEGRATION IN THE EUROPEAN UNION

by

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I. THE ISSUES

The European Community (EC) was conceived primarily as a trade bloc. The Treaty of Rome was virtually silent about economic and monetary union (EMU). Yet, EMU was elevated to an objective of the EC by European leaders in the Hague Summit of 1969, three years before the accession of Denmark, Ireland and the United Kingdom. Over the years the EC has invested a great deal of its political capital in EMU. Yet, the economic case for monetary union is rather marginal compared to the large, and relatively certain, net benefits of trade integration. But monetary union is more important for its political implications than its economic ones. History shows that monetary union and political union go together. A common currency carries the symbolic value of unity. For many European politicians, especially those in France and Germany, monetary union was understood to be a catalyst for political union.

The Treaty on European Union (TEU) represents a great leap forward with respect to the Treaty of Rome.¹ It imbeds the great aspirations of the EU to be not only an economic union, but also a monetary union and ultimately, although in an as yet unspecified way, a political union. The TEU charts the deepening of the integration process in the EU. Article B of Title I of the Treaty states the following objectives: "to promote economic and social progress which is balanced and sustainable..., to assert its identity in the international scene..., to strengthen the protection of the rights and interests of the nationals of its Member States..., to develop close cooperation on justice and home affairs..., [and] to maintain in full the *acquis communautaire*..." Of all the non-trade policies, EMU is the most clearly delineated. The TEU, in fact, establishes that EMU will be reached in three stages and that in the final stage the newly formed European Central Bank will operate at the center of a European System of Central Banks. The Treaty has created two other pillars, the Common Foreign and Security Policy and the Justice and Home Affairs, which are much less developed and clearly need the test of time. The former includes principles for a common defence and political cooperation; the latter deals with asylum, immigration, citizenship, and judicial cooperation.

The TEU has changed decision making as well; the changes favor centralization and represent

another step, albeit small, towards a federal structure. Qualified majority voting has been extended, although unanimity still applies to all critical decisions. The introduction of the co-decision procedure and the extension of the cooperation and assent procedures have given the European Parliament more power. The Court of Justice has been granted the power to fine member states.

Enlargement of the EU is bound to slow down the deepening process just described. The membership of the Community doubled from 1958 to 1986 with the accession of Denmark, Ireland, the United Kingdom (1973), Greece (1981), Portugal, and Spain (1986). It then expanded by an additional 25 per cent by 1995 with the new member states of Austria, Finland and Sweden. Another round of accession is in the making. Turkey applied for membership in 1987, Cyprus and Malta in 1990; the Czech Republic, the Slovak Republic, Hungary, Poland, Bulgaria and Romania have signed Association Agreements; Slovenia, Croatia and the three Baltic countries are following suit. The European Council, at the Copenhagen Summit of July, 1993, signalled its intention to open the EU doors to the six Central and Eastern European countries, specifying that the requirements of memberships are "stability of institutions, guaranteeing democracy, the rule of law, human rights and respect for and protection of minorities, the existence of functioning market economy as well as the capacity to cope with competitive pressure and market forces with the Union." (Baldwin 1994, p. 155).

In the early part of the 21st century EU membership could virtually double once more, and this time bringing much more heterogeneous and diverse countries than was true when the Community went from six to fifteen members.

In Table 1 I have listed two possible expansions of the EU: one to 20 members and the other to 29 members. EU-20 would add to the existing group of 15 members the four Visegrad countries and Slovenia. This is the expansion that is likely to occur before the other 9 countries are added. The few basic statistics shown in the table give a sense of the diversity of the aspirants relative to the incumbents. Three features emerge from the table. The first is the wide income dispersion between EU-15 and the larger groups. The ratio of the highest

to the lowest per capita income, based on recent data, would go from 3.6 in EU-15 to 13.7 in EU-20 and 23.5 in EU-29. The aspirants are much poorer than the four poorest incumbents (Greece, Ireland, Portugal and Spain) and have a relatively large fraction of the labor force working in agriculture; the two statistics tend to go together. This implies that the aspirants would be net recipients of transfer payments. Baldwin (p. 176) concludes that "an enlargement by 2000 that included only the Visegrad-4 would require an increase of the EU budget of about 70%." The prospects of raising revenues by this amount are minimal, in light of the fact that the bulk of the financial burden would fall on incumbents. The sober prediction is that the EU would be forced to drastically reform the Common Agricultural Policy and reduce other net transfers to poor regions.

The second feature that emerges from the table is the shift in the balance of power from well to do to poor members (Baldwin, Table 7.14). Assuming that aspirants would receive votes in the Council on the basis of population and holding unchanged existing voting rules, the four poorest incumbents plus Hungary and Poland could form a blocking coalition. The desire by many incumbents to integrate more deeply could be held hostage to more generous transfers from rich to poor members. The third and final feature of the table is that inflation rates are much higher among aspirants than among incumbents, in turn implying that the prospects for an enlarged EMU would have to be considered rather small.

The push for enlargement has more to do with politics and security matters than economics. Germany fears political instability in Central and Eastern Europe and believes that EU membership may be decisive in transforming the former socialist countries into viable market economies with stable democracies. Opposition against expansion to the East comes from two groups. The first group consists of poor regions --Greece, Ireland, Portugal, and Spain-- and protected sectors --e.g., agriculture-- which are net beneficiary of the EU redistributive policies and fear that the new entrants will take away from the pool of common resources.

The second opposition comes from the old EU members that would prefer deeper integration to a larger EU. The concepts of Europe à la carte, multi-speed, variable geometry, or more generally flexible integration have gained currency because they address the central issue of permitting some members of the

EU to go deeper in the integration process, without impeding an EU enlargement. This paper reviews such proposals to ascertain the most desirable path to integration in a larger and more diverse membership. Section II applies club theory to determine the optimal size of the club under different voting rules and policy areas. The greatest potential for enlargement applies to the Single Market Program. However, the massive redistribution in favor of aspirants limits the incentives of the incumbent to enlarge membership in the near future. Section III evaluates the relative merits of proposals such as Europe à la carte, multi-speed, variable geometry, and federation. Section IV proposes a variable integration method based on the distinction of a compulsory core club and voluntary periphery clubs. The Single Market Program and decision rules are included in the core, whereas all other policy areas fall into the realm of the periphery clubs. New members would be given immediate restricted membership, with no voting rights and no access to EU transfer payments, but full membership at a fixed future date. This would lower the disincentive on the part of old members to delay to an uncertain date the complete accession of the poor aspirants in the East.

[Table 1 here]

TABLE 1
ENLARGEMENT: BASIC DATA

Countries	Mid-93 Pop (mill)	GNP per capita 1993 \$	% labor force in agric.	Avg. infl. 1980-93	Votes in Council
Germany	80.7	23560		2.8	10
France	57.5	22490	5.7	5.1	10
Italy	57.1	19840	8.4	8.8	10
U.K.	57.9	18060	2.1	5.6	10
Belgium	10	21650	2.7	4	5
Luxembourg	0.4	26400	3.5	4	2
Netherlands	15.3	20950	4.5	1.7	5
Denmark	5.2	26730	5.4	4.6	3
Austria	7.9	23510	7.7	3.6	4
Finland	5.1	19300	8.2	5.8	3
Sweden	8.7	24740	3.2	6.9	4
Spain	39.5	13590	10.7	8.4	8
Portugal	9.8	9130	17.9	16.4	5
Greece	10.4	7390	23.2	17.3	5
Ireland	3.5	13000	14.9	4.8	3
EU-15 max/min		3.6	11	10	
Czech Rep	10.3	2710	21.6		5
Slovak Rep	5.3	1950			4
Hungary	10.2	3350	38.5	12.8	5
Poland	38.3	2260	27.9	69.3	8
Slovenia	1.9	6490			3
EU-20 max/min		13.7	18.3	40.7	
Cyprus	0.7	9700	14		2
Malta	0.4	8000	14.9		2
Croatia	4.8	1685			4
Bulgaria	8.9	1140		15.9	5
Romania	22.8	1140	28.5	22.4	8
Lithuania	3.7	1320		35.2	4
Latvia	2.6	2010		23.8	3
Estonia	1.6	3080		29.8	3
Turkey	59.6	2970	48.8	53.5	10
EU-29 max/min		23.5	23	40.7	

Source: World Bank (1995) and author.

Notes: the GNP per capita of Luxembourg, Cyprus and Malta were estimated relative to a benchmark; the votes in the Council of potential new entrants were based on population and existing rules.

II. OPTIMAL CLUB SIZE

International trade, monetary and defence arrangements can be treated in the first approximation as clubs. Clubs are voluntary agreements created to let the members share the benefits of an excludable public good (Buchanan 1965; Olson 1965; Fratianni and Pattison 1982; and Casella and Feinstein 1990). The ability of a club to exclude non-members from the activity of the club is never perfect, witness the positive externality provided by NATO to non-members. The incentives to free ride, however, can be minimized by specific clauses: a common external tariff in the case of a trade agreement, denying access to rediscounts, borrowing, and lender-of-last credit in the case of a monetary union, and mutual aggression pacts in the case of defence arrangement.

Let each nation be a unitary actor in the sense that the nation speaks with one voice. Define b_T and c_T as the club's total benefits and total costs, respectively, and Q as the flow of output or activity of the club.

The optimal size is given by:

$$(1) \quad \frac{db_T}{dQ} = \frac{dc_T}{dQ}$$

The extent to which club's marginal benefits, $\frac{db_T}{dQ}$, decline as membership rises depends on the type of

activity performed by the club. Consider the Single Market, which combines a common market (freedom of movement of goods, services, and inputs) with a set of uniform competition standards. The marginal benefits from enlarging this trade club decline because new members are more heterogeneous than old members. Heterogeneity raises the probability that various sectors of the economy will be impacted adversely, at least in the short run, from trade liberalization and market deregulation, in turn giving rise to demand for

redistributing income among members (Padoan 1994).² I have noted that enlargement is bound to drastically increase redistribution from old to new members and to declining sectors.

Total costs of the club rise with the level of club's activity and thus with membership. Two critical factors are at work. The first is that, for a given decision rule, the larger the membership the more difficult is to obtain agreement and to accommodate the objectives of different interest groups. Under existing voting rules, EU enlargement implies a loss of decision-making power of the large countries in favor of small countries. Blocking coalitions are easier to form in EU-20 than in EU-15, implying that agreement will be more costly after enlargement. The second factor is that marginal costs of decision making respond to different decision rules. Unanimity is the most costly voting rule for the club because this rule protects the minority of one. The larger the number of countries the more costly is unanimity in the sense that one small member can prevent all other members to implement a policy of their choice. Simple majority, on the other hand, is the least costly voting rule. Typically, voting rules within a nation state are either of two types: simple or qualified majority. Simple majority applies to ordinary laws, whereas qualified majority applies to higher-level laws, e.g., constitutional amendments. Unanimity, instead, applies to intergovernmental agreements where each member state wants to retain sovereign rights.

The EU is a mixture of intergovernmentalism and supranationalism, with the former clearly prevailing over the latter. Unanimity remains the dominant voting procedure. The European Council, the institution that decides on new policy areas, rarely departs from this rule. The Council of Ministers, which is the principal legislator of the TEU, also seeks unanimity if a member state considers a given decision vital to its national interest. Yet, over the years the pendulum has swung, albeit in a minor way, towards supranational decision making. The three institutions that best represent supranationalism are the Commission, the European Parliament, and the European Court of Justice. The Commission has agenda power on what the Council of Ministers decides and is a busy secondary legislator, regulator, and enforcer of EU laws. The European Parliament, the weakest EU institution, has gained influence relative to the Council

by virtue of the so-called cooperation, codecision, and assent procedures that have forced the Council to act more like a partner than as an autonomous body.³ Finally, the European Court of Justice has consistently decided in favor of integration whenever governments were reluctant to implement directives and regulations to protect national markets and specialized groups. Now, the Court is also able to fine member states for violations of EU legislation.

The gradual shift towards supranational characteristics implies that the marginal cost curve of the club has shifted to the right, implying an increase in the optimal size of the club (a movement from point c towards point b in Figure 1).

[Insert Figure 1 here]

The Single Market club

If the club were to be formed on the basis only of the Single Market, club membership could be easily expanded from 15 to a much larger number. The net benefits of economic integration are potentially high. Consider the decision of a country to join the Single Market club. The country in question, assumed to be a unitary decision maker, would attempt to maximize the net benefits, G_i , of the difference between benefits, b_i , and the costs, c_i , associated with club membership. Let $B = b/p$ and $C = c/c$, that is the share of the total benefits and costs, respectively, borne by country i . Maximization of the net benefits G_i implies:

$$(2) \quad \frac{B_i}{C_i} \frac{db_T}{dQ} = \frac{dc_T}{dQ} .$$

The optimum amount of club activities, or cooperation, for an individual country is reached where the share of the benefits going to the country divided by the share of the costs times the marginal benefits for the group as a whole equals the club's marginal costs (Fratianni and Pattison 1982, p. 249). A relatively small country (e.g., Slovenia) will not affect the club's total marginal benefits and costs; hence, the country's decision to join the club will be based on $\frac{B_i}{C_i} \frac{db_T}{dQ}$. Assuming that the club was already in equilibrium before small country

i joins, the value of B_i/C_i will be critical to determine whether club membership is worthwhile.

The Single Market combines the characteristics of a common market with a set of uniform competition standards. Traditional customs theory can guide us in evaluating a sizeable part of the B_i/C_i ratio. So long as trade creation exceeds trade diversion, country i will have an incentive to join the club. There is general agreement that static trade creating flows have outweighed trade diverting flows in the EC customs

union (Swann 1992, pp. 119-20). But the Single Market club goes much beyond a customs union. The estimates of the net gains from the completion of the Single Market range from a minimum of 2.5 per cent to a maximum of 6.5 per cent of Community GDP (Commission 1988, p. 19). The highest estimate includes the important but more difficult to quantify competition and restructuring effects, but exclude dynamic aspects such as the interaction between technological innovation and competition. The insights of the new growth theory suggest that integration (i.e., more competition) may lead to a permanent increase in the economic growth rate of the area through a positive interaction between innovation and integration. In sum, the net gains from the completion of the Single Market are large.

The fact that net club gains are large does not imply that every incumbent has an economic incentive to expand the club or that aspirants want to join. A large country like Germany enjoys a large share of the benefits of the Single Market club; but Germany also bears a large share of the costs. There is an amount of transfers from Germany to aspirants that would induce this country to oppose enlargement. On strictly trade flows, small countries would have larger incentive to join the Single Market club than large countries. For example, the EU market is much more important to the 4 Visegrad countries than the Visegrad market is to the EU (Bofinger 1995, Table 4). This in itself should give a great deal of bargaining power to the incumbents in negotiating accession. But trade is not the only reason for enlargement. There are two important reasons why incumbents may offer significant transfers to new entrants. The first is that the large members of the club desire political stability, without which the benefits of the Single Market risk to peter out. The second reason is similar to the motivation of the United States in launching the Marshall Plan to finance the reconstruction of Western Europe after World War II. Economic development to the East of Germany promises to raise standards of living dramatically. Rising standards of living, in turn, will spur larger trade flows and lessen the demand for intra-club income redistribution. So the costs borne today by the older members of the club, in particular Germany, will be financing a project with high expected returns. This translates into a rightward shift of the MPC curve in Figure 1 and a justification for a larger club size.

The expansion of the club size is a long-run result. In the short run incumbents may either delay access of new members or accept them under restrictive conditions. This issue is particularly relevant for the Eastern enlargement. As previously noted, the addition of the 4 Visegrad countries and Slovenia will change the character of the club, from one where the larger members could pursue deeper integration with "bearable" transfer payments to the poorest members to one where the poor members can block deeper integration unless "properly" compensated. For example, reform of the Common Agricultural Policy would become more difficult under EU-20 than under EU-15. I shall return to this theme in the last section of the paper.

The Monetary Union club

The case for a monetary union is significantly weaker than the case for economic integration. This suggests that a monetary union club or clubs will be smaller than the Single Market club. Let us see why.

The strongest argument for establishing a monetary union is to reduce transaction costs associated with converting one currency into another. The Commission of the EC (1990, p. 68) puts the direct savings in transaction costs between 0.3 and 0.4 per cent of Community GDP. The second benefit of MU is the elimination of the cost due to exchange rate uncertainty. Economic theory yields no clear prediction on this point. It is true that greater uncertainty of revenues due to fluctuating exchange rates lowers the utility of risk-averse firms and individuals who will have to incur the cost of hedging against exchange risk. This cost may hamper trade. On the other hand, a fluctuating exchange rate raises expected revenues, and thus utility, when firms are price takers. This is so because higher prices ensuing a depreciation of the home currency raise revenues more than an appreciation of the home currency reduces revenues. Similar considerations hold for the consumer (De Grauwe 1992, pp. 65-67).

It follows that there is no clear-cut connection between reductions in exchange rate uncertainty and welfare gains, unless one is prepared to argue that the pure risk-aversion effect dominates the expected revenue effects in the utility function. But even if one were to impose such a restriction, the welfare

implications remain ambiguous. Fratianni and von Hagen (1990) find that there is a trade-off between exchange rate uncertainty among EMS currencies and uncertainty between member and non-member countries of the EMS. EMS countries enjoyed greater stability but this stability came at the expense of less stability vis-a-vis the U.S. dollar, the Canadian dollar, the yen, and the pound. It is quite possible that, given the relative importance of intra-EMS trade, the intra-EMS exchange rate reduction dominates the effects of the more unstable external rate behavior. It is also plausible that a MU, run by a single monetary authority, would find it easier to enter into more global exchange rate agreements than it would be feasible under EMS-type arrangements. Yet, we cannot conclude that reductions in exchange rate uncertainty achieved by the EMS have led to increases in trade or improvements in people's welfare.

Will the single currency be successful in dealing with shocks? The more asymmetric the shocks, the more costly is a monetary union relative to a flexible exchange rate arrangement. The higher labor rigidity, the more costly monetary unions. The smaller the role of governments in redistributing resources from areas hit by favorable shocks to areas hit by negative shocks, the more costly monetary union. On all three counts a European MU would face larger costs than the United States. Eichengreen (1994, p....) summarizes his own research as follows:

"When one partitions Europe into a core (Germany and its neighbors: France, Belgium, the Netherlands, Denmark) a periphery (Italy, Spain, Portugal, Greece, and Britain), one finds that shocks to the core are distributed no more asymmetrically than shocks to the 8 U.S. regions. This suggests that the 5 core countries (plus Luxembourg) will not find it much more costly than the United States to run a monetary policy. The rest of the European Community, in contrast, may prefer opting out initially."

Not surprisingly, the 6 EU countries mentioned in the above citation are expected to form EMU by 1999. Several old members of the club will not even qualify for Stage III. The aspirants --with much higher inflation rates, fiscal difficulties, less reputable central banks, and no history to maintain a fixed exchange rate-- are much farther away in meeting MU conditions. Furthermore, with their economies in transition and subject to a variety of idiosyncratic shocks, they would have small incentives in participating in a MU dominated by

Germany.

The final potential benefit of a MU refers to the quality of monetary policy. More specifically, will a MU deliver a lower and more stable inflation rates than the best national monetary policy in the EU? The answer to this question is bound to be speculative, since we are comparing a yet to be born institution with well established national institutions. The Maastricht Treaty prescribes that the European Central Bank (ECB) will be independent of national governments and Community institutions and that its primary objective will be price stability.

It is clear that the drafters of the Maastricht Treaty were inspired by the successful model of the German Bundesbank. The ECB independence provision is as strong as that of the German Bundesbank; the price stability mandate is more precise than that of the Bundesbank, which is charged with "safeguarding the currency and providing for the settlements of the banking aspects of payments domestically and with foreign countries." (Fратиanni, von Hagen and Waller 1992, p. 31). Nonetheless, the very fact that an institution is supposed to pursue price stability does not mean that price stability will be delivered. Reputation is earned on the field and the ECB will start with much less of a reputation than the Bundesbank, clearly the best European central bank.

There are three reasons why the ECB may not duplicate the performance of the Bundesbank. First, preferences for inflation vs. stabilization are bound to be more widely distributed in the ECB's Council than in the Bundesbank's Council. This is because the ECB Council will draw from an economic "culture" which reflects different national propensities to inflate. Since each Council member has one vote, this consideration implies that the average ECB inflation rate will tend to be higher than the average German inflation rate. Using a model where (i) the inflation rate is determined by equating the marginal distortions from collecting the inflation tax and income taxes and (ii) each national representative votes according to his or her national interest, Frатиanni and von Hagen (1992, pp. 167-71) conclude that Spain would be the pivotal voter in a 9-member MU, and that the MU inflation rate would be one-third higher than the inflation rate preferred by

Germany. To be sure, this exercise is overly pessimistic for a future MU because it ignores that over time ECB Council members will tend to vote more as Europeans than national representatives. Nonetheless, it is instructive to keep in mind that the principle of one-country-one-vote and pure national representation is bound to raise the inflation rate relative to the country that has the lowest inflation record in the Community.

The second reason to expect different performances between the ECB and the Bundesbank has to do with the organizational structures of these two institutions. The ECB has clear objectives but vague instruments; the Bundesbank has clearer instruments than objectives. While there is no formal model that can discriminate outcomes according to the typology of objectives vs. instruments, the Bundesbank seems to have been served well by the specificity of instruments in shielding the institution from pressure groups that want higher money growth (Fратиanni, von Hagen and Waller, p. 32).

Finally, the ECB will be a less federalist institution --especially at first-- than the Bundesbank (Fратиanni, von Hagen and Waller 1992, p. 32). This reasoning has to do with the different roles played by the Board and Council in these two institutions. ECB Board members will represent Community interests, whereas central bank governors regional interests. Bundesbank Board members represent Federal interests, whereas the presidents of the land central banks represent regional interests. Both in Germany and the United States regional representatives tend to prefer active stabilization policies less than Board members (Vaubel 1991; Woolley 1984, p. 64). This is so because in a MU active monetary policy will affect union-wide output and employment more than regional output and employment. The ECB decision-making Council will consist of Board members and governors of the national central banks. Board members can be no fewer than four but no more than six. The governors on the Council will be from member countries that qualify for Stage III. Ultimately Board members will count for one third of the Council, a proportion which is smaller than the corresponding ratio of the Bundesbank Council. This implies that the ECB may pursue more conservative (i.e., price stable) policies than the Bundesbank.

In sum, the move from a world of multiple currencies linked together by flexible exchange rates to a

single-currency MU promises to yield two small benefits, one cost and one uncertain outcome. The small benefits relate to the lower transaction costs associated with one money and the saving from not having to cover forward contracts denominated in different currencies. The inability to vary the exchange rate represents a cost, which is higher the more unevenly distributed the shocks are in the MU area, the more rigid real wages and the less mobile is the labor force. For the Eastern countries that are undergoing a deep economic transformation the cost of fixing the exchange rate is potentially high. Finally, there is no a priori reason to believe that the quality of monetary policy in a MU would be better than in all of the separate regions. While the construction of an independent and price conscious central bank represents a positive development for the European MU, the strong possibility that national representatives in the ECB Council will vote according to national preferences tends to make a MU more inflationary than the lowest inflation region, which in the European context is Germany.

In sum, the MU club will not be as attractive as the Single Market club to some of the old members as well as to many of the new entrants. Given the fact that an EU of 20 or 29 will have members with vastly different economic structures, a German-style MU is not likely to suit the interests of all members.

The Political Union club

The Political Union club is the most difficult to analyze because it involves agreements over sensitive issues such as taxation, police, justice, foreign policy, and defence. The long and successful history of nation states has conditioned individuals to think in terms of national sovereignty and national character. Yet, the globalization of markets and crimes, and the emergence of nuclear power have reduced the power of the nation state to control or affect decisively economic and political events. In many areas nation states have had or will have to share their power or their sovereignty. A good case in point is defence. Technological changes, such as nuclear power, have transformed defence from a national to an international public good, in turn giving incentives to countries to form alliances or defence clubs. NATO is the most successful defence club;

yet, it does not run without difficulties. The biggest one comes from the tendency of the smaller members to free ride at the expense of the larger members (Olson and Zeckhauser 1966; Frey 1984, Table 7.1). This is so because the larger members enjoy the highest benefits from a peaceful world and, thus, are willing to bear a disproportionate share of the club's costs. This situation clearly fits the motivation of Germany to include the four Visegrad countries in the EU to protect her from political instability. This incentive leads other members of the EU to ask Germany to pay a disproportionate share of the cost of the new wave of annexation.

A couple of general comments can be made on political integration. The first is that the push for political integration has tended to follow economic integration. Second, there is much more resistance to political integration than to economic integration. This resistance exists because integration has been effected by policy makers and the people at large have not participated in the process. In addition, national and supranational political leaders have failed to formulate a clear and coherent view of what political union may mean in the EU. Fuzzy concepts and a lack of democratic participation have inevitably retarded progress towards political integration.

Given the current state of affairs, it may be more productive to talk about several areas of political cooperation than an all-encompassing political club. For example, France and Germany may desire to consolidate their cooperation on military matters with the ultimate objective of constituting a foreign policy club.

III. PROPOSALS OF FLEXIBLE INTEGRATION

We have seen that both old members and aspirants of the EU desire more choice and flexibility than there has been up to now. Some members prefer to speed up the process of integration, others opt for wider membership before effecting deeper integration; and others finally want both. The differences in objectives and the large discrepancy in economic structures between incumbents and aspirants have generated and justified proposals of flexible integration. These proposals range from "pick and choose" integration to a

supranational body that would decide integration for all members, that is from many clubs to one club. In this section I review and evaluate these proposals in terms of the degree of flexibility they provide and the ability to achieve the stated goals.

Europe à la carte

The maximum degree of choice would be provided by a scheme that would give a member country the right to choose the area in which it wants to cooperate. This is the proposal that is often referred to derogatorily as *Europe à la carte*. According to this scheme, there would be no restrictions on the number of policy areas or clubs to which the member could participate. Each club would be treated independently of the other. The attractiveness of this model lies in the fact that a EU member could not be constrained to join a club it dislikes. It would be free to pick and choose in what area of integration it would participate.

The drawback of the proposal is that it would not state a minimum degree of integration and each member would be tempted to free ride on the expectation that other members would provide and pay for the public good. The scheme would also permit to break down the Single Market Program into smaller areas, such as agriculture, industry, government procurement and so on. For example, Italy may decide to accept the Single Market Program except for steel; France may want to make an exception for cultural programs; and Greece may refuse to let other members' firms bid for Greek government contracts. National governments would be besieged by pressure groups to exempt their industry from the Single Market Program. The end result would be re-regulation and the ultimate demise of the Single Market (von Hagen and Fratianni 1995). While one cannot exclude that many member states would form a Single Market club, much of the **acquis communautaire** would be lost. Without the Single Market public good the EU would have betrayed the aspirations of the founding fathers of the Community and would have dilapidated the gains made over decades of painful and slow negotiations. It would be a victory for strong pressure groups and a defeat for consumers.

In sum, *Europe à la carte* would maximize flexibility, but it is unclear what this flexibility would buy. With few rules on the book, the attractiveness of the EU would be much diminished. The benefits that the Single Market club now bestows on its members would have disappeared and an aspirant could do just as well by adopting a "flexible" posture towards GATT.

Integration with different speeds

In the bargaining process over Maastricht two opposing views emerged, reminiscent of the controversy of the 1970s between "economists" and "monetarists" (Swann, pp. 192-942). Germany --with Belgium, Luxembourg, the Netherlands and Denmark-- was the leading exponent of the "economic" view of MU, namely that economic convergence must precede MU. France was the leading exponent the "monetarist" view of MU, namely that MU facilitates economic convergence. Germany favored a long transition period and formal convergence criteria before the final stage of MU; France, with Italy, on the other hand, wanted MU quickly and without strong preconditions. Both groups agreed on the desirability of the end state, but disagreed on the speed with which each member would reach the end state. The German position was consistent with a multi-speed approach to European MU (Garrett 1993); the French position with a one-speed approach.

In a formal sense, the German position prevailed. The Treaty, in fact, spells out an ECB that is completely independent of governments and the Community institutions and whose primary objective is to maintain price stability; entry conditions to Stage III for inflation rates, long-term interest rates, budget deficits, government deficits, exchange rate realignments, and independence of national central banks; and penalties on MU members that violate upper limits in budget deficits and public debts.⁴

Elsewhere (Fратиanni et al. 1992, Frатиanni 1994) I have argued that a two-speed MU is preferable to a one-speed MU. Reliance on fixed exchange rates to signal the political commitment to price stability and monetary union is a basic flaw of the Maastricht strategy for European MU. It has forced EMS participants to

give up valuable flexibility needed to adjust to country-specific shocks during the transition and has created a fragile environment because national policies are not yet coordinated; at the same time the safety valve of capital controls has been removed. These weaknesses could have been overcome by changing the EMS in two critical aspects. First, place the full burden of the credibility of the commitment to European MU not on the exchange rate but on independent national central banks. Second, widen the bands of the old Exchange Rate Mechanism for all participants and allow individual member to adopt voluntarily narrower bands. Interventions to defend the narrow bands would not be compulsory nor would there be eligible for the EMS financing mechanism. The narrower bands would be a signal that the hard-currency central banks would send to the market about their intention to maintain a low and compatible inflation rates. These central banks would not be forced to relax their monetary policy by acquiring foreign assets through exchange intervention at the limits of the narrow bands. Nor would speculators force the hand of the hard-currency central banks because speculation against one of their currencies would be subject to the risk of capital losses.

Despite pronouncements to the contrary, there is already a two-tier EMS. In the heated discussion of the ministerial meeting of August 2, 1993 the French proposed that Germany leave the EMS. The Dutch, Belgian, Danish and Luxembourg delegations protested very loudly and said that, if that were the case, they too would leave the EMS, leaving France in the system with Spain and Portugal (Financial Times 3rd August, 1993). The compromise was that the Exchange Rate Mechanism bands would be widened to plus or minus 15 per cent, except for the Dutch who voluntarily preferred the narrow to the wide bands. Within a few days Belgium, Luxembourg and Denmark signalled that they too wanted to return to the narrow bands very soon (Financial Times 10th August, 1993). This declaration was equivalent to the formation of a fixed exchange-rate club which France, Ireland, Spain, and Portugal elected not to join. Indeed these four countries formed a different kind of fixed exchange rate club, one which enjoyed more flexibility than the German-led club. A third group of member countries --Greece, Italy and the UK-- elected not to participate to either club.⁵

There are two positive consequences and two potential risks in a two- or multi-speed approach to

European MU. The first positive aspect is that the core group, having similar initial conditions, would find it easier to launch a common currency. Furthermore, this group would provide a good learning experience for the outer members on how a MU would function, e.g., the creation of the ECB, the selection of operating procedures, and the development of a European money market and an ECU payment mechanism (von Hagen and Fratianni 1993). The second consequence is to induce coordination of monetary policy between the club members and the outside countries. While the Maastricht Treaty does not address this issue, it would seem natural to entrust this coordination to the European Monetary Institute which could monitor exchange rate developments. If an exchange rate were to move outside the narrow band for more than a prescribed number of consecutive days, the Institute would issue a formal statement to either realign or stick with the old parities. The market would not consider realignments due to country-specific shocks as evidence of a weak commitment to MU. Shocks over time should become more symmetrical thanks to the increased pace of EU and policy coordination. At the same time, central banks' independence and the coordinating function of the EMI would favor lower and compatible inflation rates. Consequently, the premises would exist for progressively narrowing the bands. It also means that the MU club members would not be obliged to relax monetary policy to support outside countries' currencies. Convergence of inflation rates would mean convergence towards the level determined by the core MU and not towards an unknown average.

There are two potential risks with a multi-speed approach to European MU integration. The first refers to the risk of the core MU club wanting to exclude the outer countries from ever entering MU (Alesina and Grilli 1993). This risk could be lessened by renegotiating more realistic and explicit entry conditions for Stage III. Knowing ex-ante what are the rules of the game and impeding the core countries to renegotiate arbitrarily the terms of accession to European MU is a critical but not impossible task. The second risk is that politicians may object to two or multiple speeds because the electorate may associate slower countries as being inferior to faster countries, even though all of them will end up in the same point.

In sum, multi-speed integration retains the commonality of objectives among members, but allows

each country to pursue these objectives at different speeds, thus allowing national institutions to adjust and raising the chance that those ultimate objectives will be met. The danger that those who form the club early can close the door to late comers can be lessened by agreeing on the ex-ante rules of entry to the club. I shall return to this theme later in the paper.

Variable Geometry (VG)

The essence of the VG approach to integration is the distinction between a center and a periphery, a distinction based on countries rather than on functions. The center consists of those EU countries that want to achieve the deepest level of integration over a broad range of policies. The periphery consists of countries that want to cooperate on specific policies rather than a broad range of policies (von Hagen and Fratianni 1995). Two versions of the VG approach have been proposed so far: the German *concentric circles* (CDU, 1994) and the French *non-concentric circles* (Balladur 1994). There are two differences between these versions of VG and both have to do with the structure of the periphery clubs. The first difference deals with sequencing. The German version defines a precise sequence that would take a country from the farthest periphery club to the center. Thus, a subset of members may participate, say, in a common social policy; a smaller subset in MU; and an even smaller subset in a joint defence policy. In the French version of VG, instead, a member can join whatever periphery club for which it qualifies.

The second difference deals with the possibility of having multiple clubs for each area of integration. In the German version of VG this is not possible: there is at most one periphery club for each area of integration. A member can either join a periphery club or not join. For example, the Czech Republic could either join the German-led MU club or not participate in MU. In contrast, the French version allows the creation of different clubs pursuing the same policy objectives, e.g., the Northern MU club and the Southern MU club.

These differences in the two versions of VG lead to different institutional designs and decision

making. The distinguishing characteristic of the German version of VG is the rigidity of the integration sequence and the fact that clubs cannot compete for the same activity. It follows that the activity of a periphery club creates externalities for those countries that cannot or do not want to participate. This justifies, in turn, the principle that all EU members decide on the entry conditions and the operation of the clubs. Without such an ex-ante agreement, conflicts would emerge between those who belong to the club and those who are on the outside. The rigidity of the integration sequence and the monopoly that a club has on a given integration area severely restrict non-club members in completing the integration process. This concern was expressed during the negotiation over EMU and the TEU imbeds the principle that all members have a voice in determining entry rules to Stage III of EMU.

The ex-ante agreement over periphery clubs precludes the formation of exclusionary clubs. Rules of entry to a club are agreed before clubs are formed. Each member belonging to a given periphery club has to be given the opportunity to join the club closer to the center, even if the old club members do not deem it desirable. Members of a closer (to the center) club cannot prevent members of a farther club from joining a higher level of integration. Thus, entry requirements can at best delay countries to enter a periphery club.

Under the French proposal of non-concentric circles this type of externality does not exist. This is so for two reasons. First, more than one club can be formed for each of integration. Thus, an exclusionary club only incites other countries to form a different club with different rules of entry and operation. There is no need for an ex-ante agreement about rules of entry and operation of periphery clubs. The design and the membership of periphery clubs can be left entirely to those countries that decide to form them. Consequently, the objectives of the periphery clubs match the preferences of the members more closely than under the German version of VG. In the latter old and new members have potential conflicts; to prevent old members to discriminate against new members the EU had to settle on an ex-ante agreement. In the French proposal discrimination is accepted and tolerated, i.e. clubs can be exclusionary, but discrimination has no spillover because countries have the right to form their alternative cooperative arrangements. The only common

agreement required in the French proposal is that the activity of a periphery club must not interfere with the proper working of the center and must not damage other periphery clubs. Following current practices, such a decision could be made by the European Council and/or the European Parliament upon recommendation by the European Commission. It would prevent countries from forming periphery clubs that would reintroduce barriers to trade and mobility.

The Federation

The move towards a federation in the EU has been the dream of strong integrationists who have viewed the current mixture of intergovernmentalism and supranationalism, heavily tilted towards the former, as an impediment to economic, monetary, and political integration. Since the Treaty of Rome there has been a continuous struggle between member countries that wanted to preserve national sovereignty --de Gaulle's France and today's Denmark and the United Kingdom-- and others which were willing to shed nationalist clothes --Belgium, Italy, Luxembourg and the Netherlands (Nugent 1994, p. 80). It is not surprising that the TEU is neither a federal charter, nor a confederate, nor a strictly intergovernmental agreement. It is a mixture of several institutional structures, thus leaving ample room to ambiguity of roles.

Unanimity and the search for consensus, even when unanimity is not prescribed, are the norm in the European Council and the Council of Ministers. National governments still retain the final say in applying of EU laws. The EU has no independent police and the acceptance of EU laws ultimately depends on the willingness of member governments to respect such laws. A federal structure, on the other hand, implies more responsibilities to the center and a more agile decision-making process than exists at present in the EU. A federal structure, thus, would give member states the least amount of flexibility. Certainly, the principle of subsidiarity would leave many decisions at the national and sub-national level, but on issues where likely spillovers are presumed to exist, decisions would be taken at the center and be applicable to all member states at the same time.

IV. COMMON CORE AND FLEXIBILITY

We have seen that the expansion of the EU adds significantly to the heterogeneity of the membership. The existing tension between deepening and enlargement will be exacerbated. Additional flexibility is inevitable. The critical question is how much flexibility to put into the system without emasculating the acquis communautaire. The menu approach to integration is not acceptable because it creates too much flexibility. Member countries could choose and pick clubs without any respect to the degree of integration already achieved. The menu approach would be resisted by the original members of the Community, which would proceed with deeper integration any way. Much of the appeal of the EU to new entrants would disappear if the menu approach would prevail.

On the other hand, the federation approach would create too little flexibility. Several member countries, both old and aspiring, are not ready to accept the degree of centralization and the less restrictive decision-making process that are usually found in federal systems. So we are left with two possible choices: the multi-speed approach and the VG approach. The multi-speed adds flexibility only in the implementation stage. Ultimate objectives are common to all members. There is no question about a member joining a club, say the MU club; the flexibility lies in postponing entry into the club.

The VG approach differs from multi-speed Europe in the sense that integration is defined in terms of member countries which differ in their desire to pursue different areas of integration. Both the German and French versions of VG would divide the EU between a center and peripheries, defined in terms of countries rather than policy fields. A center would consist of a club whose members cooperate on an extensive range of activities, say economic, monetary and political union. Peripheries are clubs whose members cooperate on a specific policy area, e.g., social policy. The two versions of VG differ in the way the periphery clubs operate, interact with one another, and interact with the center. In the German version periphery clubs are ranked in a predetermined order. For example, in terms of location relative to the center, the MU club would be the

closest, a common payment system farther, and the Single Market would be the farthest. A member country would qualify to join the center club, i.e., maximum integration, only if it had qualified for all the periphery clubs in the specified sequence; hence, the label of concentric circles. Furthermore, for every area of integration only one club is operational. Clubs cannot compete for the same area of integration; for example, there is only one club for MU and only one club for social policy. This feature creates an externality that is eliminated by letting all EU member countries have a voice on the entry conditions and operation of the periphery clubs. In the French proposal, the exclusionary practices of a club do not harm those who have not joined because there is always the possibility for the outsiders to form a competing club. Furthermore, the road to the center is not predetermined as in the German version of VG. In sum, the French proposal has more flexibility than the German proposal.

The weakness of both proposals lies in identifying center and peripheries with countries rather than with policy areas. The center includes countries that want to cooperate on virtually all aspects of integration, without defining these aspects. The periphery includes countries that desire instead limited cooperation, again without defining what limited cooperation means. It would be more productive and less divisive to discuss variable integration in terms of policy areas and the requirements that countries must meet to join clubs with specified objectives (von Hagen and Fratianni 1995). Here the proposal in brief.

Integration with flexibility

A flexible approach to integration needs to preserve the minimum set of policies and decision rules without which the EU loses its distinctiveness. Thus, it is important to distinguish between a common *core* of integration, to which all EU members must adhere, and a set of *peripheries* or optional integration areas (von Hagen and Fratianni 1995). Using the language of this paper, all EU members must belong to the core club, while being free to join other clubs.

The core ought to include basic common values all EU members share. The Single Market is

undoubtedly part of the core. Without the Single Market the EU loses its most fundamental identity. We have also seen that the Single Market is expected to generate large net benefits. Those sectors or economic regions that stand to lose from the implementation of the Single Market may obtain compensation from other sectors or regions that stand to gain enough to compensate the losers. The process of compensating those who lose from integration is also part of the activities of the core club.

The Eastern enlargement, under existing EU redistributive policies, would raise dramatically EU budget expenditures. Many members of the EU would resist such an increase and would delay enlargement until the aspirants had reached a level of per-capita income that would imply much smaller EU budget expenditures. This delay could be long, perhaps long enough to jeopardize the economic transformation and the process of democratization in the East.⁶ It would be preferable to enlarge sooner, but restrict the benefits of club membership. Baldwin (ch. 8) and Bofinger propose restricted membership. In the Bofinger plan, the aspirants would have to meet the criteria of the customs union, but not those of the Single Market, which would trigger only at the time of full membership. Restricted membership would not entitle the junior members to vote in the Council, nor to have access to the Common Agricultural Policy and structural funds. Full membership would take place at a fixed future date with complete rights and obligations of the Single Market club. Junior membership would give the aspirants the advantage of locking a fixed date for full membership, a condition that is preferable to the alternative of full membership preceded by a long and uncertain delay. The incumbents would have an incentive to reform the Common Agricultural Policy before the new entrants acquired full membership.

Full membership implies participation in the core, that is in the activities of the Single Market. Other policy areas, such as MU and social policy, do not belong to the core for two reasons. The first reason is based on the fact that the EU has already granted "derogations" in these policy domains to some member countries.⁷ The second reason is that the economic case for both MU and social policy is much less clear-cut and more controversial than the economic case for the Single Market.

The core club should also be responsible for writing the constitution of the EU and setting forth and enforcing the "rules of the game" that would regulate the entry and operation of the periphery clubs. I have noted that in the German version of VG, exclusionary periphery clubs create externalities unless EU countries have agreed on a common set of entry conditions. In the French version externalities do not emerge because countries can form competing clubs and are not straight jacketed by a rigid sequence of integration. Regardless of the plan, periphery clubs cannot carry out activities that would endanger the integrity of the core, i.e., activities that would compromise the Single Market.

VG, defined over policies rather than over countries, introduces more flexibility than the multi-speed approach. The non-concentric circle version of VG clearly gives countries more choice than the concentric circle version, which prescribes a strict sequence in moving from one policy area to another and does not allow the formation of competing clubs. For example, members have the option to join a MU of their choice or not join one at all. In light of the wide heterogeneity of the future membership of the EU, there is no reason to expect that the conditions for a single MU will be satisfied. Homogeneous members will have an opportunity to pursue deeper levels of integration without being held back by others. On the other hand, those who want a more superficial form of integration do not feel threatened by countries that have a deep commitment to integration.

Despite the complexity of the issues, we can envision two alternative paths to integration. The first is the hierarchical model where members of the EU pursue same goals. Given the large and heterogeneous membership, common goals imply a relatively low level of integration. The alternative path envisions a union where members participate in the integration process with different intensities; that is the essence of VG or flexible integration. These are strategic choices that next year's Intergovernmental Conference will have to consider.

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ENDNOTES

1. The Treaty on Monetary Union was agreed upon by the Heads of State at the Maastricht European Council of December of 1991; signed by the Foreign and Finance Ministers in February of 1992; and came into force in November of 1993.

2. The European Agricultural Guidance and Guarantee Fund, the European Regional Development Fund, and the European Social Fund are examples of this type of redistributive activity.

3. The cooperation procedure makes life harder for the Council. Two readings are prescribed. The first reading is similar to the opinion stage in the consultation procedure. The Council adopts a common position by qualified majority. In the second reading the European Parliament has three months to take actions. If the European Parliament rejects the common position, the Council can go ahead with the common position by voting unanimously. If the European Parliament amends the common position, the latter is sent back to the Commission for revision. Within three months the Council can either accept the amendments by qualified majority or fail them to accept by unanimity.

In the both the co-decision and assent procedures the European Parliament has veto power. With respect to the cooperation procedure, the co-decision procedure starts after the Council approves the common position. The European Parliament can approve, modify or reject the Council's common position. Either one of the two last instances triggers a Conciliation Committee consisting of an equal number of Council's members and European Parliament's members. If the Conciliation Committee finds an agreement, the European Parliament and the Council must adopt the compromise, otherwise the compromise becomes null. If the Conciliation Committee does not find an agreement, the Council can approve the common position with the amendments proposed by the by European Parliament; alternatively the Parliament can reject the proposal.

As the name suggests, the assent procedure requires the European Parliament to approve the proposal.

4. A more careful reading of the Treaty reveals that the German position had been considerably watered down by the group led by France (Fратиanni et al 1992; Garrett 1993).

5. Italy and the United Kingdom left the Exchange Rate Mechanism, following the turbulent exchange market events of September, 1992. Greece never joined the Exchange Rate Mechanism.

6. Baldwin (Ch. 7) estimates that it would take at the minimum 20 years before the 4 Visegrad countries would reach a level of income that would not threaten the special interest groups of the old members.

7. The Maastricht Treaty grants derogations on MU to Denmark and the U.K.; and derogation to social policy to the U.K.