

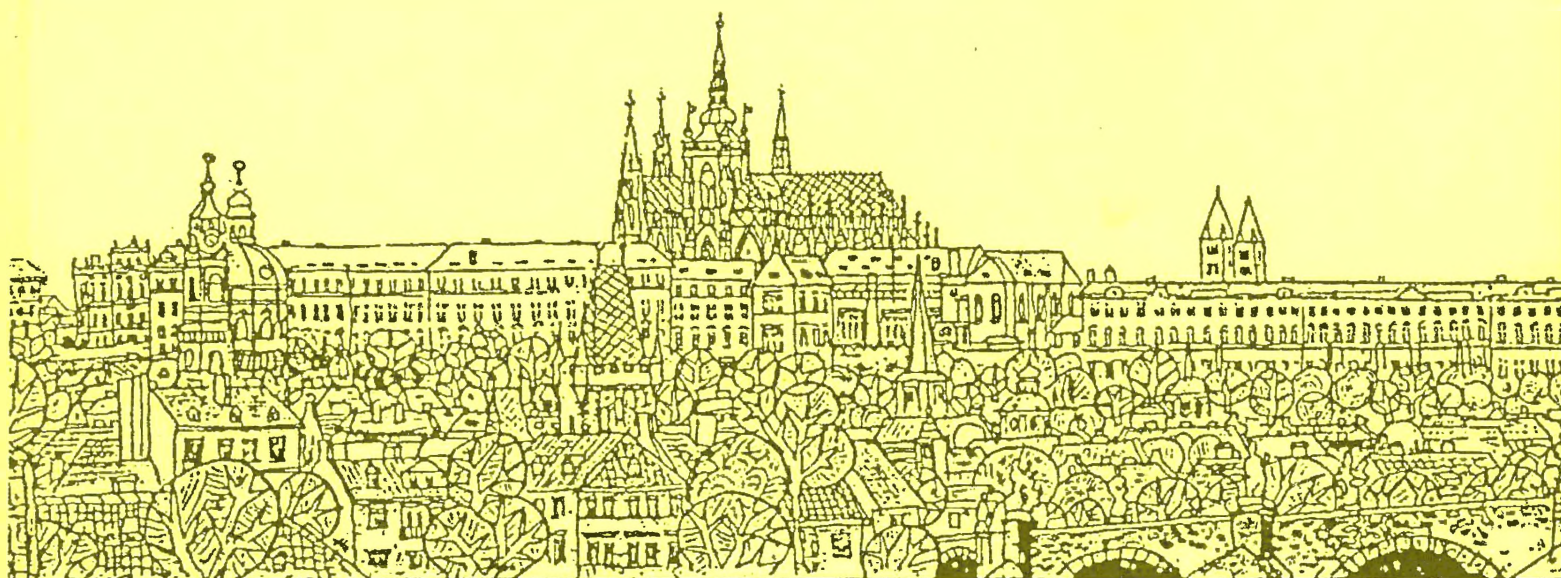
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IN SEARCH OF A TRANSITION

TO A FREE SOCIETY

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In Search of a Transition
to a Free Society

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THE ROAD TO FREEDOM:

THE MARKET BEFORE POLITICS

In Search of a Transition to a Society
That Is Less Unfree

by

Gerard Radnitzky

Session 6: The constitutional Framework for the Transition Period

Speakers: William Niskanen

Gerard Radnitzky

Discussant: Gordon Tullock

The road to Freedom: The market before poillitics

In search of a transition to a society that is less unfree

"That freedom can be preseved only if treated as
supreme principle ... was fully understood by the
leading liberal thinkers of the nineteenth century ...
Such is the chief burden of their warnings ... about
'pragmatism that contrary to the intentions of its
representatives inexorably leads to socialism'."

Friedrich von Hayek*

"Political liberty is good only so far as it produces
private liberty."

Dr. Samuel Johnson**

"Democray's last dilemma is that the state must, but
cannot, roll itself back."

Anthony de Jasay***

The friends of the Free Society will be willing to make efforts to bring about, to facilitate and to support, a transition from the *status quo* – which nowhere exemplifies a paragon of freedom – to a society that is less unfree. Reflections on the project will include: a clarification of the *destination*, of the idea of a Free Society; an analysis of the point of departure, i.e., a diagnosis of the current situation, which involves a typological description of the societies we are interested in; and assessment of possible routes to the goal, of the *means* that can be used to increase the chances that the attempts to bring about a transition will be successful. Among the means a *Constitution of Liberty* plays an important role.

* 1973, Vol. I, p. 57. Hayek refers to Carl Menger's *Probleme der Ökonomie und der Soziologie*, German original 1883.

** As quoted in Boswell 1924, p. 351.

*** 1985, p. 232.

However, it would be a dangerous illusion to think that a Constitution of Liberty can alone bring about freedom or preserve it.

1. The destination of the transition process – Explication of our intuitive idea of freedom

Clarification is important because our intellectual environment is polluted by much of misleading freedom-speak like, e.g., the twaddling about "positive" freedom (which confuses freedom and power and functions as a password to levelling and coercion), the confusion of option rights and so-called "social rights", etc. For an adequate explication of the intuitive idea of Freedom we need a theory of the free society, a restatement of liberalism. I am taking inspiration from the recent outline of "strict liberalism" by Anthony de Jasay (1991a *Choice* ...). In classical liberalism the concept of freedom is a multi-place relationship. An individual x (i.e., chosen at random) in a society S at a particular time t is *free to the extent* to which his rights to exercise (choose) the options available to him at t , i.e., within his budget of resources (financial and material resources, knowledge and know-how, time, etc.), are secure in S at t , i.e., enforceable at moderate costs. These options include the meta-option of acquiring option rights (entitlements) by contracting for them (*Vertragsfreiheit*). Hence the degree of freedom that a particular society provides cannot be changed by transferring option rights from one individual to another or from one group to another. That the individual is "chosen at random" entails that only those restrictions are legitimate that are "necessary" for ensuring the same option rights for other. The explication of "necessary" is an unresolved problem because taxes are in many cases legitimized by claiming that a particular level of taxation is necessary to enable the state to carry out its protective function – and many other functions as well.

The core of the *ideal type of a Free Society* is a society in which individuals peacefully can live their own lives, i.e., a society in which it is *deontic postulate to REFRAIN from IMPOSING Pareto-inferior*, "dominated" choices on other people. Thus, in the ideal type of a Free Society it would be a moral imperative to respect the "non-domination" principle, which puts an obligation on the State and on other holistic group entities (though the latter may perhaps be less bad because they may compete among each other). In such a Society also the principle that property is private informs social life.¹

¹ The expression 'collective property' is an oxymoron since the core of the idea of Property is the identity of decision-maker, cost-bearer and benefit-receiver. 'Collective ownership' is a usage parasitic on the correct use of the expression and the concept of Property. Cf. Jasay 1991, ch. 4.

Using the ideal type as a foil we can propose a comparative concept of Freedom. The degree of freedom exemplified by a particular society is clearly a function of the obstacles to attaining the ends individuals choose for themselves. Hence, the degree of freedom expresses itself in *the size of sector of individual decision relatively to the sector of collective decision*. It is convenient to use as auxiliary concepts the complementary concepts of Capitalism and of Socialism. I propose the following usage: A society *A* is *more socialist* and hence less capitalistic (free, private market order oriented) than a society *B* if in *A* the sector of collective decision relatively to the sector of individual decision is larger than in *B*. If to that statement we add the definition of 'freedom' in terms of the "non-domination" principle, it follows that *A* will be less free than *B*.² **The most important characteristic of a society is the balance between private and collective decisions. Compared with it the distinction between elected and non-elected government is insignificant.**

To avoid conceptual confusion it is important clearly to distinguish between a concept (explication, definition) and the methods of ascertaining whether a particular real system exemplifies the property designated by the expression we use for the concept (and, if so, to what extent). (Consider as an example the concept of absolute truth in the sense of correspondence and the always fallible methods of finding out how close a particular statement comes to the truth, how "truth-like" it is.) A crude but handy indicator of the degree of freedom prevalent in a given society is the proportion of taxes in the GNP, which roughly indicates the extent to which decisions about material resources are made by individuals as individuals.

2. We are always en route to a "better" state of affairs in intellectual as well as in political life.

An idea can function as regulative principle in spite of being unattainable. To disarm the normal objection to normative political theory, i.e., that it is "unrealistic", making a comparison of intellectual and political life can be helpful.

² 'Private rights' and 'privacy ethic', terms used by Jack Hirshleifer, are very appealing. Yet perhaps it should be pointed out that strictly speaking 'private rights' is a harmless pleonasm useful in communication. There are no collective rights. The same holds for the expression 'private property'. Strictly speaking, it is a pleonasm used to emphasize the core of the concept. Cf. the preceding footnote.

"It is criticism that, recognizing no position as final ... creates that serene philosophic temper which loves truth for its own sake, and loves it not less because it is unattainable."

That quotation could be from Protagoras, Popper or Bartley, but it is from Oscar Wilde. If you love knowledge for its own sake or for its instrumental value you will always make efforts to come "closer to the truth", though knowledge is in principle fallible. The immediate objective of research is scientific progress, and thus research is an unending process – transition in permanence. The objective is clarified by a special discipline, the methodology of research or philosophy of science. It also provides some rough guide lines for the permanent transition process. They are intended to increase the chances of success but do not offer any guarantee of success. To engage in research is the outcome of a *subjective* decision. But, if you have opted for it, respecting the rules of the game, the rules of rational problem solving in research is one of the necessary conditions for the possibility of success.

If you love freedom for its own sake or for its instrumental value for material or intellectual "wealth", you will *always* make efforts to get closer to the ideal type of a Free Society, though that ideal is unattainable, given human frailty. *From the viewpoint of strict liberalism all contemporary societies need to make efforts to come closer to the ideal*, though the urgency of the need of a transition from a less free to a more free society varies widely. The societies of East-Central-Europe that have recently emerged from a centrally-regulated dictatorship make great efforts to de-socialize. The Western democracies, the so-called capitalist societies have almost for a century suffered from the growth of government, the growth of state expenditures as a share of the national product (e.g., in Sweden, the model welfare state, the public sector exceeds 64 percent of GNP), an insatiable appetite for publicly provided goods and services, and so forth. They are increasingly beset by welfarism, state activism and interventions in the economy. So far the wealth-creating potential of capitalism has not been realized anywhere (cf., e.g., Seldon 1990, p. xii). A few countries have made timid attempts to go into reverse over some nationalized industries, carried out some deregulations, etc. However, "there is little sign of any contemporary society really trying to kick off the welfare habit", in spite of the recognition of the perverse effects of the redistributive welfare state (Jasay 1991b "A stocktaking ...", p. 538). All Western democracies need to roll back the tide of socialism, to embark on a transition to a society that is less unfree. Thus, wherever you are, if you love freedom, you will be *en route* to a better state of affairs in political life no less than in intellectual life.

In political life committed to the Free Society the counterpart to the methodology of research is that part of political philosophy that presents the theory of "strict liberalism". It explicates the objective, the idea of a protective state, of a *Privatrechtsstaat*. That idea then guides the drafting of the Constitution

of Liberty. As counterpart to the methodological rules in research the Constitution of Liberty offers guide lines that increase the chances of getting closer to the ideal type of a Free Society. As in the case of the methodology of research the Constitution *per se* cannot offer any guarantee of success. Ignoring the guide lines provided by the Constitution of Liberty precludes success in the strive for a less unfree society in the same way as ignoring the methodological rules of rational problem solving precludes success (scientific progress) in the case of research.

There is yet another positive aspect to the analogy alluded to here. Wishing to live in a free society and being prepared to make efforts to get closer to the ideal is as much a *subjective* decision as the decision to engage in research. Those with a taste for life as a slave or as a slave holder will not take that option. Some philosophers consider refraining from imposing Pareto-inferior, "dominated" choices on other people to be a moral imperative. I do not follow them because there is no way of ultimately justifying any moral precept (as there is no way of ultimately justifying truth claims with respect to concrete statements). There is no answer to the question "Why should I be moral?". We can produce rational arguments in favor of opting for a free society and of a "Privacy Ethic", but such arguments can never be "compelling" in the sense in which pointing out an inconsistency in a system is and not even in the sense in which falsifying an empirical statement is (though falsification is itself fallible since it is relative to the epistemological status of the set of falsifying premises in a falsificatory argument).

As in any analogy we can discover also some negative aspects of the analogy. In the case of science it would be unreasonable to try to convince as many people as possible that they should opt for a life as researcher. Scientific progress has always been achieved thanks to a small minority of individuals. By contrast, a free society can exist and a transition to a society that is less unfree can only be successful if these ideas get sufficient supporters. For the friends of the Free society it is rational to invite everybody to join them in their efforts for a transition to a society that is less unfree and, in particular, to win a critical set of the population for supporting the Constitution of Liberty. What about the rest? In so far as it is free-riding while not opposing the transition it does no harm. If it does oppose the transition and cannot be convinced that more freedom and prosperity is a good thing, it constitutes a serious practical problem. Appeal to the "authority" of collective choice or the use of force are certainly not attractive options. Probably the best remedy is *competition between states* combined with free movement of human capital and capital (at relatively low costs). Then people could choose between "more freedom, higher prosperity, more responsibility and less security" and "less freedom and prosperity combined with more equality of outcomes and more security".

3. A typology of starting points in the hopeful transition to a Free Society

3.1. Limiting the tour d'horizon

I shall focus on the *Western democracies*, notably the EC, and on the *ex-Communist-countries of East-Central-Europe* ('ECCs' in short). But a few passing remarks about some other countries may be worthwhile. There are socialist dictatorships like, e.g., Red China or Cuba, and other totalitarians that, at present, seem to be stuck with the *status quo*. At most they use the market the way a drunk uses a lamp post – for support not for light. It is a trivial truth that for the Third World the fastest way out of its misery is to introduce capitalism. But there is little sign of any of these states making serious efforts. The ideal type of the Totalitarian State offers an interesting contrary opposite to the Free Society. In it all life is politicized, at least officially. It is a state where social choices can always override individual rights, simply because (private) property rights are declared not to exist. Hence, there is a centralized command (enforced) economy based on quasi-slave labor, and, typically, wholesale socialism is used as legitimizing ideology.

The Soviet Union is a special case. Socialism there has a longer history than for the ECCs, and it is an endogenous development, while for the ECCs it had been forced upon them by Soviet Russia through "armed-cars socialism". The Soviet Union has so far not been able to solve the problem of the constitutional position of the Communist Party in the Union nor the constitutional problem of union or confederation. The key disadvantage appears to be that the engineers of perestroika are identical with those who would have to bear the costs: in a society based on free, private market economy the nomenclatura cannot retain its power. The Party remains centralistic and dirigistic and even twaddles about a *renewal* of socialism. Economically, the USSR has been reduced to the status of a Third World country.³ Some of the republics will have a greater chance than others to make the transition to a society that is less unfree, if only they are allowed to go it on their own.

³ In the West the prevailing academic opinion does not appear to have turned around. It is amusing to read in the 13th edition of 1989 (sic!) of Paul A. Samuelson's famous textbook *Economics* that "... the Soviet economy is proof that, contrary to what many sceptics had earlier believed, a socialist command economy can function and even thrive." (p. 837). This dictum sounds like a late echo of Thomas Balogh (who became Economic Advisor to Harold Wilson in 1964) who wrote: "In Russia, the Communists have succeeded brilliantly ... It is this challenge which must in the end enforce modifications in our present policies". (*New Statesman* 12 December 1959).

I will not deal with Japan, Taiwan, Singapore and Hong Kong either. They have achieved high and sustained rates of growth, are more market-oriented than the Western democracies, and have apparently suffered little from democratization. Yet, their situation and historical background are very different from those of the European countries and the USA. These successful countries appear to have at least one thing in common with the unsuccessful socialist countries: in their history they do not have an ideological tradition of classical liberalism. Very likely, they have taken to capitalism simply by learning from experience in daily life.

3.2. The Western democracies – they too would need to embark on the march toward more market in a society that is less unfree

All of them are suffering from creeping socialism, though in different degree. The United States and Britain are in this respect much better off than, for instance, Sweden.⁴ In the model welfare state collective decisions have progressively crowded out private decisions and hence freedom of choice. The public sector takes over 64 percent of GNP. But Sweden turns out to be an interesting special case; its situation may be epitomized by the formula "Enterprises are free, individuals are socialized". You are free to start a factory, to sell commodities inside or outside the country; but you are not allowed, e.g., to start a school or a radio station, and you would find it very difficult to start a free-paying private alternative to the state health care. The daily life of the citizen has been submerged under a gigantic insurance system, and the welfare system has almost abolished private choice. Sweden illustrates that a maximum of political freedom, democratic institutions throughout, is compatible with very little individual choice and thereby also that social-democratic values and freedom are incompatible. It is not "socialist" in the sense of a centrally-regulated economy; it is a transfer state legitimized by an egalitarian ideology. The lack of freedom has slowly eroded economic growth and efficiency. In 1990 the OECD expected that Sweden will be at the bottom of the list of per capita GDP growth.

Sweden is generally recognized to be an extreme example of the high tax society. Yet, sceptics (or realists?) ask whether countries like the United States and Britain can be rescued from the creeping paralysis caused by the ever-growing intrusion of the state into all walks of life. We cannot be sure that the Thatcher episode – which for many symbolized the march toward a free market in a free society – may not turn out to have been an interlude in a long history of decline. In 1990 the social expenditure of the FRG measurable in monetary units exceeded 700 billion DM, i.e., almost 30 percent of the GNP – the largest section of public expenditures. Their continuous growth progressively reduces the resources left to

⁴ Even Switzerland, often juxtaposed to the Swedish high tax society, has increasingly been suffering from creeping socialism. Cf., e.g., Moser 1991, Schwarz 1991, pp. 221-240.

households for private use. To the direct transfer the expenditures of enterprises for social benefits have to be added as well as the costs (scarcely measurable in monetary units) of various regulations like protection against dismissal.

For the Western democracies to embark on a transition to more market in a free society would mean recovering some of the ground they have lost. It is well-known that at least from the last third of the 19th century – neatly coinciding with the gradual democratization of politics – *we observe in the West a trend of shifting the public-private balance more and more in favor of collective decisions*: the share of total government expenditure in GDP grows, and, publicly provided goods tend to crowd out private ones. (cf., e.g., Jasay 1989). *The state turns into a vast engine of overt and covert redistribution*. "The costly failures of welfarist redistribution and their corrosive effects on the fibers of society are not seriously in dispute" (Jasay 1991b, 538). Yet, there is little sign of any society searching for a transition to more market and less politics, really trying to roll back the tide of creeping socialism. Public choice can easily explain why this is so (cf., e.g., Tullock 1983 and 1986). "Majoritarian" democracy tends to maximize the scope of redistributive legislation because of the expected gains from politics. Politicians in such a system are dependent on public opinion. Adherents of creeping socialism staff government-owned media, they are influential in Western universities, the mainline Churches (who have lost their normal customers and attempt to attract a new clientele), the welfare administrative apparatus, the educational system, etc. Socialism, nowadays in creeping or furtive form, remains the justifying ideology of the New Class, the actual and would-be *nomenclatura* of redistribution. This is an earthbound reason why in the Western democracies socialism remains an acute threat to freedom.

The assorted social democrats, Christian democrats and the liberal democrats call the system they recommend by various names according to focal electoral tactics 'social democracy', 'democratic socialism', and so forth. The label that has been canonized and that best expresses the current mood in Western Europe is 'social market order'. *Social democrats and most, if not all, of the Christian democrats in Western Europe, particularly in West Germany, have made the concept of "Social Market Economy" their guiding star*. In Germany it has become (the great sacred cow). No political party would allow its think-tank to conduct a critical analysis of the concept. Such topics are tabooed. And the Londoner *Economist* of 25 May 1991 (p.28) reports that the Conservative Party's new chairman, Chris Patten, has proclaimed "his interest in the German idea of a 'social market'". The idea of a "Social Market Economy" is also exportable. On 17 July 1991 the *Collegium Budapest* was founded. It is claimed to be the first Institute for Advanced Study in East-Central-Europe and is sponsored by a combination of state agencies and private foundations in an inter-European cooperation. One of its main projects is "*the transition from a centrally-planned economy to a Social Market Economy*". Hence, those who in the ECCs are searching for a transition to a free society need critically to examine the doctrine of "Social Market Economy".

What is the content of the concept of "*Social Market Economy*"? It consists of a set of descriptive and evaluative premisses, whose implications show that they are inconsistent (see, e.g., Radnitzky 1991 "Marktwirtschaft..."). The *descriptive* premisses are: (1) The free, private market order is as a means of wealth-creation superior to all other economic orders. (2) Interventionist measures, redistribution, regulation, etc. in principle reduce the efficiency of the market order and hence growth and wealth-creation. The *value* premisses are: (3) Prosperity, material wealth, growth, etc. are valued. (Hence, freedom is valued for its instrumental value, but it is not given supremacy in political life.) (4) "Social Justice" in the sense of more equality of outcomes for all groups is valued for various reasons – because it is required for "Social Justice" or for "Social Peace", or for the reduction of the pain of envy, or because of the moral imperative of "Compassion" or "Caring" (which now means spending other people's money). Originally, helping the poor referred to the really needy, and "poverty" was defined in absolute terms, later it was redefined as the relative distance to the average income.

Premise (1) implies that the allocation of resources should be entrusted to the decentralized decisions of the resources owners themselves – otherwise no "free-market efficiency". Premise (4) implies that the resources should be redistributed by collective choice. Demi-literate but assertive socialists deny that there is a tension between premise (1) and the consequences of premise (4), i.e., they believe or claim to believe *that you can eat your cake and have it*. Others, having examined the logical consequences of the set of premisses, recognize that the system is inconsistent. Since from an inconsistent system you can deduce anything, such a system is worthless. They try to remedy the situation by adding an additional premise, a value judgment: (5) The tradeoff between efficiency and redistribution should be balanced "in the right way". Now the system should be acceptable to all parties because (5) is empty and can be filled with content at your discretion. There is no natural or agreed stopping point how much tradeoff is permissible, except the implicit suggestion from premisses (1) and (3) that you should stop before the market's efficiency is destroyed – something which you can find out only with the benefit of hindsight. Thus, *in an advanced, in an aging Social Market Economy the free market order will fade away like the Cheshire cat*. The inherent dynamics of the concept leads to creeping socialism. In the end the social-democratic compromise will lead to bankruptcy and leave little room for freedom. Ludwig von Mises foresaw this development as early as in 1940.⁶

⁵ Hayek has always warned against the "destructive effect which the invocation of 'social justice' has had on our moral sensitivity" and told us: "... I have come to feel strongly that the greatest service I can still render to my fellow men would be that I could make the speakers and writers among them thoroughly ashamed ever again to employ the term 'social justice'." Hayek 1976, p. 97.

⁶ That means even before the label 'Soziale Marktwirtschaft' was coined. In 1940 he called the idea 'behinderte Marktwirtschaft', 'hampered market economy' (English edition 1949, p. 714). And in the 1966 edition of *Human Action* he concluded: "Thus the doctrine

Can the EC provide a model for countries who wish to embark on the march towards a Free Society? 1992 the EC will be at a crossroads. The future is open. But we can discern two main possible scenarios: Europe's future may evolve through evolutionary competition or it may be the result of constructivist design, of *ex ante* artificial "harmonization". We could epitomize the two as a 'Hayekian Europe' and 'Europe Delorienne' – a Europe of free societies or a centralistic, dirigistic and protectionistic "fortress Europe". At the moment the tide appears to go rather in the latter direction.⁷ If in a European federation or confederation national regulations were replaced by regulations generated by a European Parliament by means of artificial "harmonization", the system would become increasingly sensitive to interest-group blackmail. (The Common Agricultural Policy (CAP) is a drastic example already. It consumes over 90 percent of the EC budget, though the interest group profiting from it accounts for only a few percent of the EC's population.) A Eurocentralist superstate, an old-style nation state writ large, would have much to offer and be sensitive to transnational interest groups. A transnational corporatism would soon develop.

The climate of opinion tends to move toward faith in the benevolent state, the *panem-et-circenses* welfariat.⁸ If a "European Constitution" were designed now, it very likely would be "federal" much more in the sense of centralism, *dirigisme* and *étatisme* as represented by the socialist Delors than in the sense of Peter Bernholz or Denis de Rougemont (Petroni 1991).

In summary, *it would be a most dangerous illusion to believe that in "the West" socialism has been overcome. The ex-Communist countries who are on the march towards a Free Society would be ill-advised if they took the EC as paragon to imitate or to emulate or simply wished to join it, since the EC suffers from creeping socialism and its future – whether evolving or constructed – is highly uncertain.*

and practice of interventionism (whose most recent variety is the German 'soziale Marktwirtschaft') ultimately tend to abandon what originally distinguished them from outright socialism" (p. 723 of the 1966 edition of *Human Action*). For the history of the German concept see, e.g., Peacock and Willgerodt (eds.), 1989, Radnitzky 1991a.

⁷ Sir Alfred Sherman, who was advisor to the Thatcher government, pointed out that the electoral contest that brought her down "was precipitated by her defense of Britain's sovereignty against European importunities" (Sherman 1991, p. 517).

⁸ Thus the *Eurobarometer* (Brussels: EC Commission, June 1990) reports that the "Community Charter of Social Rights" is considered to be "a good thing" by 75% in Holland, 60% in Germany, 67% in England, that 92% were in favor of EC regulations in health and safety work, 80% in favor of EC regulation on minimum income, 81% for workers participation ("Mitbestimmung" – a German invention and coinage like "Soziale Marktwirtschaft").

3.3. The ex-Communist countries

The ECCs (to my knowledge Antonio Martino coined that acronym 'ECCs' to juxtapose it to 'EC') could also be labelled *East-Central-European countries* ('ECEs') since by history, tradition and intellectual climate they are an integral part of Europe. (This can scarcely be said of the other countries of the former East bloc.) It appears that many of those who have lived under "really existing socialism" have, through *personal experience*, been immunized against the lure of the idea of a "social market". In contrast to the West, there is in the ECCs an incipient ideological mass movement that believes in "a market without adjectives", i.e., in the free, private market. This movement is led by practical politicians like, e.g., Václav Klaus in the CSFR, Leszek Balcerowicz in Poland and the Hungarian ex-Communist leader Imre Pozsgay. Many in the ECCs appear to realize that for relatively wealthy countries the fastest way to the economic backwardness of the Third World is to implement social-democratic values. Hence, they can withstand the temptation of the "Third way". If they made vigorous attempts to realize as much of capitalism as possible – which also means reducing the role of politics to a minimum – *they could become a paragon for the Western democracies to imitate*. In capitalism in its most developed form the importance of the State decreases since the State is trimmed, in scope, to its protective function, to minimal government.

Each historical situation is unique. But this does not preclude that *sometimes one may learn something from historical precedents*. It is a safe claim that *the economic reorganization and revival in the ECCs would require the same sort of political framework conditions that Ludwig Erhard profited from in 1948*. It follows that the chances of success in the ECCs will roughly correspond to the extent to which the decision makers can replicate some of the essential features of the situation in which the so-called "German Economic Miracle" took place. The salient features of that turn are that it was an *imposed solution* and that the solution was executed *in one full swoop*, almost over night. Erhard introduced his sweeping liberalization almost single-handedly and against the wills of the Social Democrats and the labor unions, of most of the Christian Democrats and of the Free Democrats, and against the will of the Allied Administration.⁹ Erhard himself stressed that he could never have carried out the sweeping liberalization if he had been dependent on a democracy or a bureaucracy.

The most important of the political framework conditions that made possible the "Economic Miracle" were the following: (a) Erhard was practically independent from democratic decision making, from the parliament, etc. The solution was

⁹ Mr. J. K. Galbraith (later famous television economist and Professor at Harvard) then Chief of the Division of Occupied Areas in the U.S. State Department declared in March 1948 that "there never has been the slightest possibility of getting German recovery by this wholesale repeal (Erhard's repeal of central planning and command economy) and his recommendation that "the German economy should be freed from ... price controls ...". Cf. Galbraith 1948, pp. 94ff.

imposed, i.e., a solution that need not buy off the wage-earners, the government managerial class, the pensioners, and so forth. (b) The particular climate of opinion. People knew that there was nothing to be gained from redistribution because there was nothing to redistribute so that only work ethic and old-fashioned virtues could achieve an improvement of the desperate situation.¹⁰ The Marshall plan facilitated the development. However, it was relatively small, West Germany was only the fourth recipient, and, since it went from government to government and not to enterprises, it lost much of its potential efficiency. It was but a small help to self-help. (c) There were no powerful interest groups, labor unions and employers unions, entrenched bureaucracy, etc., that could effectively sabotage Erhard's liberalization. (The National Socialist German Workers Party had destroyed practically all the formerly existing organizations, and then the Allies abolished the organizations established by the National Socialists.) There was a temporary vacuum, and Erhard acted too quickly for any effective resistance to his plans to get organized.

Another interesting historical example might be Chile's transformation of a socialist, centralized economy that was bankrupt to a relatively well-functioning free-market economy. Its economic success is not in dispute despite the derision by the Left of the Chicago economists who emerged in Chile as ministers under General Pinochet. *De-socialization* reduced the share of the public sector from 40 percent in 1973 to 24 percent in 1981. From 1985 on a second wave of *de-socialization* took place involving 24 state enterprises, in particular *telecommunication, air traffic, electric energy production and distribution*. (From this the EC could learn a lot.) Chile soon achieved the highest growth rate in Latin America and the lowest national debt per caput. However, only now successful efforts are being made to privatize (and in part to liquidate) the most important part of the remaining inefficient state sector, the Corporación del Cobre, which accounts for almost a quarter of the total export income. Chile's case also shows that free, private market order is compatible with autocracy, something which is often disputed.

4. The Constitution of Liberty

Only the market can tame Leviathan. Capitalism can fully develop its wealth-creating potential only if the political process is confined to the minimal duties of the State. Among the various possible means that might keep Leviathan's mandate

¹⁰ In a lecture delivered in Antwerp in 1947 Erhard reported that the statistics showed that the purchasing power per caput in Germany was such that it permitted the purchase of a plate every 5 years, of a pair of shoes every 12 years, and of a suit every 50 years. The context of the turn of 1948 is described and analyzed in Lenel 1991. Cf. also Vaubel 1991.

limited but at the same time make sure that he is sufficiently strong to fulfill his protective function liberals (in the classical sense) see first and foremost to constitutional limitations of the area of collective choice – to minimal rather than to "limited" government (which is much too vague).

A constitution is basically a system of meta or master rules for rule making in collective decision. It sets out the "deontology of the State", outlining what the State *must*, *may* and *must not* do. There is no neutral constitution. Any constitution favors certain identifiable interests (Jasay 1989 "Limited government ..."). The Constitution of Liberty is intended to increase the chances that the society keeps moving in the direction towards the ideal type of a Free Society. Designing a constitution of liberty is relatively easy compared with the practical problem of making it likely that the constitution will be respected and even defended. (For a Hayekian designing a constitution may perhaps smack too much of social engineering, of constructivism, and it might seem a better alternative to look for ways to make room for spontaneous orders to emerge.)¹¹ Nonetheless when reflecting on a constitution of liberty we will have to face such tough questions as "When is it legitimate from the viewpoint of "strict liberalism", if ever it is, for some people (princes or parliaments) to coerce others into accepting their choices, e.g., the tax burden they have decided on?

The regulative principles guiding the design of a constitution of liberty are not in dispute. (1) *Minimize the need for collective choice!* This will at the same time reduce the temptation to refer matters to the political process in order to further one's own interest, and thereby reduce the incentives to invest in the political process rather than in productive activities. (2) In the domain of collective choices that appears indispensable avoid any method of collective choice making that has a built-in-bias that automatically will make the domain of collective choice grow! This implies that the democratic method of collective decision making has to be used with the greatest caution (see below). (3) Redistribution should be permitted only to those in need and not as means of levelling, and it should be done in overt form, not in the covert form of publicly provided goods and service, subsidies or other protectionist measures. In summary, *the constitution should ensure the sovereignty of the individual not only as consumer, but also as earner, saver, investor, etc.* (4) Changes to the constitution are permissible only if they do not reduce the private rights, the property rights, freedom of contract, etc.

The rough outlines of such an *ideal* constitution are likewise well-known. (1) The constitution should prohibit (or at least "sufficiently" restrict) budget deficits and financing them either by borrowing or by printing money. Ideally, the monetary constitution should remove government influence from the monetary system and from controlling the stock of money. (2) Taxation should be treated as

¹¹ Of course, there is no guarantee that a spontaneous order is the best solution for the individual, the species or for a free society; but for a rule system that has evolved "spontaneously" the probability that it will foster freedom is greater than for a rule system that has been designed.

a constitutional matter. (3) Constitutional limits to revenues (in times of peace revenues must not exceed a shared percentage of the national income). (4) Constitutional limits to borrowing, i.e., to capital projects that constitute productive social investments. (5) Ideally, the constitution should prohibit direct taxation of income. (6) Government should balance the national budget and cover all expenditure by explicit taxation. (7) Redistribution is allowed only to citizens in need ("poverty" being defined in absolute terms). It should be tackled by constitutional means and not left to democratic decision making (to avoid blackmailing by rent-seeking interest groups). (8) The constitution should secure the free movement of goods and services, of capital and human capital anywhere. (9) The constitution should outlaw all sorts of protectionism like, e.g., quotas or subsidies.

If the system in question is a confederation of states, the competence of the federal government should be strictly limited to the following tasks (cf., e.g., Bernholz 1990). (1) Enforcement of free intra-community movement of human capital, capital, goods and services, anti-cartel and anti-monopoly policy. (2) Community or "federal" activities (limited mainly to defense and foreign policy) should be financed by a value added tax, and increases in the tax rate should be subject to unanimous consent of the member states. (3) A centralized "harmonization" of national tax, of social security system and of national regulations is forbidden. To secure competition at all levels each member state must be free to make its own jurisdiction in taxation, labor regulations, currency, social policy, company structures, courts, etc. Only such a diversity can make possible the evolutionary competition that can lead to innovation and improvement of quality. Ideally, a federal or confederal system should provide a free market of states. (4) If there is a Central Bank it must be fully independent, and its only goal must be the preservation of a stable currency. However, a competition of currencies is by far preferable because of its disciplining effect. (5) Each member state and even each province of the federation or confederation should have the right of secession. This is not only an important limitation of the power of the central system, but a threat of secession is a disciplining force on the central system in the same way as the threat of emigration is a disciplining force on each state (it becomes afraid of losing good customers, taxpayers, etc.).

From the viewpoint of "strict liberalism", the ideal would be an open world order with free trade. Under an advancing "strict liberalism" there would be a progressive reduction in the relevance of all government; sovereignty and frontiers would become increasingly less important. Ideally, frontiers should serve exclusively to keep out unwanted elements, those among the would-be immigrants who are likely to free ride on the welfariat.

5. Constitutional change – the durability of the constitution

Constitution, socialism and democracy

Creeping socialism is a permanent threat to liberty if only because large segments of the "intellectual class" (who in Europe staff government-owned media, and everywhere are influential in the universities, the mainline churches, etc.) favor the growth of government, because the more the market replaces politics the less their influence. However, if – *mirabile dictu* – socialism had disappeared, there still would remain a serious threat to freedom, i.e., from democracy or at least from the way we conduct it now.

If people are not disposed to keep to its rules, the constitution will be circumvented or changed. (cf., e.g., Jasay 1985 *The State*, 1991 "Stocktaking ..."). A constitution of liberty will have a chance of being respected and "lived" only so long as the political climate of the country is congenial with its thrust. Society in the 19th century, particularly in the Anglo-Saxon world, functioned well (in spite of democracy), achieved great things while leaving individuals a good deal of autonomy, *not* because countries had good constitutions, but because people believed in the right set of norms – what Anthony de Jasay calls "taboos" (cf., e.g., 1991a *Contract ...*, p. 124). An ethic based on traditional virtues: work ethic, spend only what you have earned, no deficits, do not "print money", help only the "deserving poor", and so forth – the contrary to social-democratic values and "social rights" (demands addressed to the taxpayer or to unspecified addressees). Democracy worked well in the early American democracy thanks to a very strong independent proprietary sector in whose interest it was that the government remained minimal.

In the framework of a democratic constitution a decisive coalition can get redistributive *direct* payoffs through collective decisions (when shaping legislation and imposing policies). Redistributive *indirect* payoffs become available from amending the constitution, changing the meta rules with respect to the domain (what policies may be imposed) and with respect to the size of the decisive coalition (who is entitled to impose them). Majorities will soon learn to choose a constitution that maximizes the scope for redistributive legislation. Assuming that voters act as rational players maximizing payoffs, the outcome will be an "unlimited" democracy, popular sovereignty with bare majority rule and unrestricted domain, the choice rules operating over the entire set of possible alternatives. In unlimited bare-majority democracy "no minority right subsists without majority consent",¹² and "no potential winning coalition can hope to

¹² For instance, according to the School of Swedish Realism (Hägerström, Lundstedt, Undén, Hammarskjöld) the individual has exactly those property rights that the majority of the day thinks he should have. No wonder that the Swedish Social Democratic Party has adopted the philosophy of that School as its intellectual basis and developed the doctrine of "socialism of function" (*funktionssocialism*).

augment its redistributive spoils by getting agreement to change the rules (the constitution) any further" (Jasay 1991b "A stocktaking ...", p. 542). Yet, I am still not sure whether a redistributive pattern may not necessarily be unstable, whether there really is a core under a democratic constitution (e.g., the poorer 50% + 1 vote) whose exploitation of the richer 50% - 1 vote is a stable state of affairs. At any rate the individual members of the decisive coalition may change.

Jasay has likened a constitution to a chastity belt of which the lady herself possesses the key. Perhaps one can also view it as something like a fortress: a normal garrison with a good fortress has a better chance than what would be the case without the fortress (*ceteris paribus*), while the fortress makes no difference if the garrison is not willing to defend it.

In summary, *it may be a dangerous illusion to believe that constitutions can protect liberty against creeping socialism and "creeping democracy"*. Rather than accepting the false sense of security provided by this illusion, it behoves us to seek ways, if there are any, for developing non-illusionary defenses of liberty.

Witness the example of the US Constitution. Originally it was a rule system classical liberals used to admire. In our century it has been transformed into a constitution where "modern American liberalism has all the elbow room it may desire for its redistributive exercises" (Jasay 1991b, p. 543). In all cases the constitutional rules must be interpreted to some degree. Whether or not a Constitutional Court is an advantage will depend upon the integrity of the judges and their commitment to liberty. It may be naive to assume that they and the people who select them will for long remain unaffected by the climate of opinion. In the case of the USA, the Supreme Court has helped to transform American politics from "constitutional" to "majoritarian" democracy and eroded property rights and the constitution (cf., e.g., Dorn and Manne (eds.). 1987, Niskanen 1988, Dorn 1991). The FRG, for instance, is not much better off. However, there are also cases where constitutional courts have made interpretations informed by legal scholarship and integrity. In particular, the sentences of the European Court have so far been the most effective way of preserving the four freedoms of the EEC Treaty and hence of implementing a free market in Europe (Petroni 1991, pp. 24f.). The rulings of the Court pleasantly contrast with the decisions of the Commission and the Council, which were mostly informed by a dirigistic view of the economy and by compromises of national interests.

6. Are there other means of keeping society on the road to freedom?

The practical problem is how to achieve a change in the climate of opinion, in "the tides in affairs of men". *Educating the educable section of the public about the political economy of the Free Society* is urgently needed. (Publications like

Seldon's *Capitalism* are invaluable.) Free-market think-tanks deliver here an educational service that the universities do not provide. Pointing out the consequences, the costs of practicing the democratic method the way we have done it so far is part of the task.

Another, perhaps even more important means, is moral education. Respect for truth, for "Promises shall be kept", for property, and so forth, constitute a social capital for the society in which they are internalized by many. ("Un curé vaut vingt gendarmes.") Hence, those who wished to undermine property rights like, e.g., the School of Swedish Realism, which forms the intellectual basis of Swedish Social Democracy, consistently derided the "taboos of property and contract". Hayek mentions Gunnar Myrdal as an example (cf. Hayek 1988 *The Fatal Conceit*, p. 50). Very likely the only efficient remedy against creeping socialism and creeping democracy putting us on the road back to serfdom is a *deontological rule that in the political arena gives priority to freedom, to the "non-domination" principle*, and hence accepts responsibility for one's actions and risk taking. A deontological rule is a rule that prohibits actions of a certain kind independent of the imagined consequences in the particular instance (cf., e.g., Hayek 1978, *New Studies*, p. 8). If a deontological rule guides our behavior, it is psychologically impossible to do certain things (a "taboo" on certain kinds of actions such as, e.g., stealing). The rule overrides pure utility calculus. "Do not try to decide on the merits of the case", just exclude certain types of political actions – simply because it is "psychologically impossible" to break the rule. (For instance, "Budget deficit is impossible", it is not done.) Jasay is probably right when he claims *that only such deontological rules can save us*.

7. On the democratic method of collective decision

"... political democracy is not enough. The market is a better guarantee of popular freedom ... Yet, if capitalism is to yield its best results, *so far* unrealized anywhere, the political process must be confined to the *minimal* duties of the state."

Arthur Seldon (1990, p. xii) *ital. supplied*

The possible constitutional rules can be classified into voting procedures and non-voting procedures. There is a spectrum of voting procedures ranging from "oligarchic" (a committee of at least two persons – as opposed to a "committee" of all persons in the set for which decisions are made) to unlimited democratic method (unqualified franchise, bare majority rule, unrestricted domain). If a "democratic" constitutional rule is practised only a few times, any outcome is

possible. The longer it is practised the clearer its built-in bias will come through. In the absence of a deontological rule that gives primacy to freedom, the democratic method has as an inevitable by-product creeping socialism. Creeping socialism will progressively hamper and eventually destroy the free, private market order and abolish the freedom that goes with it. Since the free market order is one of the necessary conditions for the existence of democracy, the method is, in the long run, self-destructive.

Only a change in the political and moral climate could abolish the taboo on questions about the costs of democracy and about possible alternatives. (A taboo on questions is always obscurantist; it must not be confused with a taboo on certain types of actions.) Such a change might make it possible to reform the way in which we practice the democratic method. However, talking about the way seems to imply that it is a contingent fact that we have practised democracy this way rather than that way. More caution appears advisable. It cannot be excluded that democracy has an internal logic which commands that there is only one equilibrium way of practising it, namely unlimited majority rule. If so, we would have to concede that the problem of distributing decision rights in a way favorable to the Free Society has not yet been solved. A systematic cost-benefit analysis of competing methods of collective decision making, for various problem areas, would be a first step to be taken.

Very likely in the countries that today are the ECCs democratization-speak was extremely valuable, perhaps indispensable, as one of the means of getting rid of the Communist rulers. The holistic myth of the "Divine Right of the People" was successfully opposed to the holistic myth of the avantgarde of the Party. Moreover, it may be that for many "democracy" functioned much like a Cargo Cult. For instance, the inhabitants of the former Soviet Germany or GDR observed daily life in West Germany through television. They associated prosperity (economic democracy of the market), civil liberties (freedom of movement, etc.) with political democracy (vaguely defined as the myth of active citizenship or undefined). Masses and opinion leaders may have made the hypothesis that it was $\longleftrightarrow$ the democratic method that was the main cause of the two afore-said benefits. In addition their worship of "democracy" (undefined) secured them the sympathy of Western media and gave them an ideological weapon against bankrupt wholesale socialism.

An unhurried view of democratic constitutions might prompt one to submit the following proposals for consideration. (1) No representation without taxation (related to the accountability of elected bodies). (2) No right to vote without a certain experience of life including the experience of having participated in production or trade, in the positive-sum social game of any political structures. To my knowledge the only argument in favor of *unqualified* franchise is that the method of head counting is simpler than any other method of "selection". (3) For each problem to be solved by means of collective choice the question should be raised what qualifications of the participants in the decision process, the "voters", are relevant and required for increasing the chances that the decision will be

"rational" or reasonable. (4) Recommendable is a second chamber that, as proposed by Hayek, is instituted in such a way as to counteract the shorttermism of today's parliamentary democracy and as well as possible shielded off from the blackmailing potential of rent-seeking interest groups.

In particular for the *transition* period the constitution of liberty should be kept at a distance from the democratic process. Otherwise the inevitable hardships of the transition to a free market will lead to attempts to push through changes of the Constitution of Liberty that would function as gates giving access to redistributive direct payoffs.

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THE ROAD TO FREEDOM: THE MARKET BEFORE POLITICS

IN SEARCH OF A SOCIETY THAT IS LESS UNFREE

Abstract

A constitution is a set of (meta) rules for rule making in collective decision. It is a means for increasing the chances that society develops or maintains certain characteristics that are evaluated as desirable. If the aim is a transition to a free society, we have to clarify the destination and the point of departure before approaching constitutional problems.

From the viewpoint of "strict liberalism" all existing societies need to make efforts to come closer to the ideal of a Free Society. Section 1 clarifies the ideal type of a Free Society. It can function as a regulative principle even if it is unattainable. To disarm the normal objection to normative political theory, i.e., that it is "unrealistic", political life is compared with intellectual life (2). The urgency of a transition to a society that is less unfree than what happens to be the case at present varies widely. The paper focusses on Western democracies (EC, Efta, USA) and the countries of East-Central Europe that recently emerged from centrally-regulated dictatorship, the ex-Communist countries or ECCs. The West is suffering from creeping socialism, and it is likely that in an advanced social market economy the free market will fade away like the Cheshire cat. The EC cannot serve as a paragon for the ECCs. On the other hand, it appears that in the ECCs many have, through personal experience, been immunized against socialism in any form and can withstand the temptations of the "Social Market". If they made vigorous attempts to realize as much of capitalism as possible, the ECCs could become a paragon for the West. The economic revival in the ECCs would require roughly the same sort of political framework conditions that Ludwig Erhard profited from in 1948 (an imposed solution carried out in one full swoop) (3.3.). Capitalism can fully develop its wealth-creating potential only if the political process is confined to the minimal duties of the state. The main instrument for keeping Leviathan's mandate limited, or preferably minimal, is the Constitution of Liberty (4). It sets out the "deontology of the State", outlining what the State must, may and must not do. However, if people are not disposed to keep to its rules, the constitution will be circumvented or changed (5). It may be a dangerous illusion to believe that constitutions can protect liberty against creeping socialism and "creeping democracy" (the trend towards "unlimited" democracy). The main additional means of keeping society on the road to freedom are educating the public about the political economy of the Free Society, and, through moral education, introducing a deontological element that in the political arena gives priority to freedom, to the "non-domination" principle (6). The democratic method of collective decision poses some delicate problems in this connection (7).

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POLICIES OF THE EUROPEAN COMMUNITY
TOWARD NEWLY LIBERATED COUNTRIES

by

Holger Schmieding

Session 8: Policies of European Community Toward Newly
Liberated Countries

Speakers: Holger Schmieding
Lord Harris of High Cross

Discussants: Ljubomir Madzar
Vladimír Rudlovčák

Policies of the European Community
toward Newly Liberated Countries

I. Hazards and Opportunities of an Institutional Revolution

The peaceful revolution which swept East-Central Europe in 1989 has so far been a marvellous success. Politically, democracy is taking hold in Hungary, Poland and Czechoslovakia; economically, a courageous transition to capitalism is well under way. Nonetheless, the task is still daunting. The newly liberated countries have to re-specialize according to their genuine comparative advantages in the international division of labour and to become attractive locations for foreign investors. For both reasons, they need free economic exchanges with the advanced countries of the West. Because of geographic proximity, this means most of all an unimpeded flow of goods and services, capital and skills, ideas and technologies between Eastern and Western Europe. The demise of trade between the former Comecon members underlines the importance of free access to their major Western market. However, given the political and economic risks which the transformation process entails, Western Europe's contribution to freedom and prosperity in the eastern part of the continent needs to go even beyond liberalisation: Western Europe ought to search for ways to lend institutional stability to the emerging market economies (EMEs for short).

The essence of the systemic transformation in Central and Eastern Europe is an institutional revolution: the old high-cost institutional setting (socialism) vanishes to make way for a far superior low-cost one (capitalism). However, the emergence, establishment and consolidation of the new and ultimately far superior institutional arrangements takes time. The institutional void which characterizes the first phase of the transformation process presents a grave hazard and a splendid opportunity at the

same time. The hazard is obvious: the length and depth of the transformation crisis depend on the rapid emergence and on the credibility and stability of the new and market-conformable institutions. The less certain economic agents are about future institutional arrangements, the less will they be willing to engage in an extended division of labour, to invest resources into specific uses and to conclude contracts which bind them over time. This aggravates the transformation crisis - which in turn adds to the widespread doubts about the stability of the new institutions. The emerging market economies may in the worst case fall victim to an institutional *circulus vitiosus*.

The corresponding opportunity is enticing: as the old system had shaped almost every aspect of the body politic and the body economic, its collapse has created a situation which may be as close to an institutional vacuum as mankind may ever get. The spontaneous emergence and the conscious design of new institutions thus face comparatively few restrictions. In a similar vein, the weakness of the previous elites and of the nascent new distributional coalitions facilitates the choice of coherent first-best solutions.

Consider the opportunity for a sweeping liberalisation of external economic relations. With respect to the standard determinants of protectionism, the emerging market economies are in an almost uniquely favourable position:

(1) The political transformation has shattered the existing distributional arrangements. Hence, inherited claims to special treatment which make liberalisation such an arduous undertaking in mature Western market economies (take the EC's Common Agricultural Policy as an example) are initially of comparatively little importance.

(2) As the need for a drastic break with the previous super-interventionism is obvious, liberal-minded politicians can get around the "rational ignorance" (Downs 1957) of voters comparatively easily. They need not try to attract attention to the

arcane issue of changing a single policy to which the electorate has grown accustomed and which the few beneficiaries defend vigorously. As a thorough change in external economic policy is clearly on the agenda anyhow, politicians merely need to explain the overall merits of a liberal regime.

(3) In a similar vein, the uncertainty about how the individual welfare will be affected in the medium and long run by a liberalisation is likely to be much more pronounced during the general upheaval of the transformation process than would be the case in an established market economy. Hence, the EMEs are as close as one may ever get to a state in which decisions on allocational efficiency can be taken behind a "veil of uncertainty" (Brennan and Buchanan 1985) about the precise distributional consequences.

(4) Special interest groups (lobbies) play only a minor role in the immediate aftermath of the revolution. The old elites are so discredited as to wield little political influence; new special interest groups are not yet strong enough for major collective action; new distributional coalitions are still in the process of organizing themselves.

However, lobbies will more and more overcome their organizational problems over time and turn into lobbies which are as powerful as their Western counterparts. Protectionist pressures are thus likely to grow stronger, jeopardising the liberal regime which may have been introduced in the early phase of the transformation process. Poland's recent tariff increases underscore this danger. Liberal-minded governments in the newly liberated countries are thus engaged not only in a race against time to beat the growing impatience of large segments of the electorate but also in a race against the emerging special interest groups. If governments do not succeed in firmly entrenching liberal principles before the lobbies have gathered strength, the consequences may be grave: After the revolutionary transformation of the entire body politic and economic, governments and administrations are likely to be weak for quite some time. The less credible the government is and the more it appears to be prone to pressure, the more will

special interest groups test its resolve to the limit and pursue protectionist negative-sum games. Those economic agents who do not join the lobby-game run the risk of being the ones on whom a disproportionate share of the overall costs is shifted. If the transformation process founders because of the lack of firmly entrenched institutions, the Central and East European states may in the worst-case scenario go down the slippery road towards the awkward political authoritarianism and the stiffling economic interventionism under which major parts of Latin America suffered in the past decades (this spectre was raised i.a. by Crook 1990).

II. On the Importance of Joining Western Europe

Given the weakness of the nascent local institutions, a unilateral commitment to liberal economic principles does not suffice to make the new regime sufficiently stable, credible and resilient against the emerging interest groups. Ideally, the newly liberated countries would need to find

- a way to turn the liberalisation progress which can be attained now into a lasting achievement and
- a method of ensuring that occasional deviations from the non-intervention rule which are perhaps politically inevitable in the transition period cannot turn into permanent protection and do not cast doubt on the general commitment to a liberal regime.

This is what the newly liberated countries could gain from joining an appropriately reformed European Community. If the EMES used their present scope for radical liberalisation to subject themselves lastingly to the EC discipline on external protection and to an enhanced EC code on internal subsidies, the final design of their commercial policy would not be in serious doubt anymore - at least as long as the assumption holds that they would be highly unlikely to incur the political, economic and perhaps even psychological costs of leaving the EC once they have got in. The genuine popularity which the idea of "returning to Europe" enjoys in Central and Eastern Europe implies that politicians and administrators in the EMES will be particularly

reluctant to seriously breach the rules of a European club to which their country has been admitted. If the EMEs can enter such an international club which puts comparatively sweeping demands on its members and for which the exit costs would be high, the incentive for time-inconsistent behaviour on the part of the government and the public uncertainty about the future institutional arrangements would be dramatically reduced. Naturally, a treaty of accession could define a transition period. The precommitment to fully accept the EC discipline a few years hence lends credibility to the announcement that any transitional protection beyond the EC norm will actually be phased out.

A similar argument applies to monetary policy. The new local central banks do not have the anti-inflationary reputation which arises from a history of resisting short-term temptations for loosening the monetary reigns. Lacking credibility, they are ill-posed to exert a lasting discipline on economic agents. For this purpose, the emerging market economies would de facto have to adopt a Western currency, say in the form of an ECU-based currency board managed by the Banque de France.¹⁾

By proposing an agreement on the de facto introduction of a comparatively stable Western currency, Western Europe would in effect offer the emerging market economies the most efficient technology for making a credible precommitment to external and internal monetary stability and full currency convertibility. This would have various advantages: (i) The process of establishing a modern financial system would be much quicker and smoother; (ii) convertibility could be extended to all capital account transactions immediately; (iii) as the anti-inflation policy would be highly credible, the complete monetization of the economy would proceed rapidly; (iv) real interest rates would not contain an above-average premium for macroeconomic risks. (v) For the same reason the EMEs would have scope for non-inflationary

1) On the currency board issue see also Bofinger (1991), Hanke and Walters (1990), Schmieding (1991) and Steinherr (1991).

budget deficits, i.e. for deficits which up to a point would have no negative repercussions on macroeconomic stability. The EMEs could thus run such deficits at the very time when they need to incur them most, namely in the social upheaval of the transformation process (Schmieding 1991).

III. The Present EC Approach

The EC has reacted to the demise of political and economic totalitarianism in Central and Eastern Europe by offering somewhat better market access and financial support to the newly liberated countries. Between 1988 and 1990, the EC and the emerging market economies concluded "first generation" trade and cooperation agreements. These accords ended those import quotas which the EC used to apply specifically to products from Europe's centrally planned economies, suspended some non-specific restrictions and extended the EC's tariff preferences for developing countries to East-Central Europe.

Presently, the EC is negotiating association agreements with Hungary, Poland and Czechoslovakia. The "second generation" accords are supposed to come into force at the beginning of 1992. The EC intends to lift most tariffs and import quotas within five years (in some cases within ten years). However, the fine print of the draft which the EC proposed to Poland in March 1991 reads like a liberal's nightmare: special arrangements shall severely restrict market access for textiles, coal and steel, and agricultural products, i.e. for products which the EC deems sensitive and in which Poland's export potential is particularly promising. Furthermore, the EC anti-dumping policy will be applied and a variety of safeguard clauses against an unwarranted increase in Polish exports will enable the EC to unilaterally "adopt the measures it deems necessary to remedy the problem" (Art. 31,3,b). Safeguard measures may for instance be taken "where an increase in imports ... occurs in quantities or under conditions which are, or are likely to be seriously detrimental to any production activity ... (or) to cause serious disturbances in any sector ...

or difficulties which bring about serious deterioration in the economic situation of a region" (Art. 29). In other words, imports may be restricted if they threaten to do what inter-industry trade is supposed to do, namely to induce a noticeable welfare-enhancing (re-)specialisation in production according to comparative advantages. No wonder that the Polish government noted that "should this proposal be implemented, there would be practically no improvement in the current conditions of access to the EC market" (Republic of Poland 1991, p.2).

The draft makes no reference to an eventual accession to the EC; instead it suggests regular political consultations and some further technical and financial assistance. In the words of Martin Wolf, the EC aims for "exclusion with side-payments". With regard to the free movement of labour, the EC intends to be most restrictive. The Community merely wants "to examine ... the possibility of improving the situation of Polish workers" which are already legally employed in the EC (Art. 38). After five years, "ways of improving the movement of workers" may be examined "provided that economic and social conditions in Poland have been largely brought into line with those in the Community" (Art. 39).

The migration issue illustrates how ill-conceived and even contradictory the EC stance is. One of the best-established economic theorems states that factor movements can be a substitute for trade in goods; the more trade is subject to restrictions, the greater the incentive to relocate factors of production. By objecting to free trade in those goods in which the newly liberated countries have a clear comparative advantage, the EC may inhibit the very economic and social progress which the EC stipulates as a condition for being more open to the East. The EC may thus trigger what it wants to avoid: It may force people yearning for opportunities to earn a decent living to go West.

The migration policy toward the newly liberated countries seems to be inspired by the fear that Western Europe would be swamped by an undesirable influx of workers from the East if it were to

open its gates. This view is anti-liberal - and probably mistaken. The recent German experience points to the opposite: In the 1980s, West Germany has attracted 1.5 million immigrants. In the same period however, more than 80.000 people left Germany for Portugal and Spain, i.e. for those traditional emigration countries who had joined the EC and succeeded to put their economies on a sound footing in this decade. Even in 1989 when strong growth and some political factors served to draw in 600.000 people into West Germany in a single year, only 200 of them came from the Iberian peninsula.

The statistics on Polish-German migration corroborate the view that opportunities for future economic progress at home matter more than present differences in the level of living standards for the entrepreneurial and mobile segments of the population. Migration from Poland into Germany had soared to 212.000 in 1988 and even 309.000 in 1989. Once the transition to a market economy opened up a wealth of new opportunities in Poland itself, the number dropped to 150.000 in 1990 and an estimated 25.000 in the first seven months of 1991 (all migration figures in this paper are net of immigrants and exclude east Germans).

If the EC does not modify its stance on trade and migration, the Community will deny to the people in East-Central Europe the two major ways in which Europe's diversity and the East-West differences in factor endowments can be turned into mainsprings of prosperity: the free movement of goods and people. Under the impact of protest from Poland, Hungary and Czechoslovakia, the EC may be about to correct its position in the negotiations and offer somewhat enhanced market access (the eventual elimination of steel quotas and a rise in textile quotas) and at least acknowledge in the preamble the right of East-Central European countries to eventually accede to the EC. By mid-August 1991, however, the EC was still not ready for a substantial liberalisation.

An assessment of the EC's policies toward the newly liberated countries cannot be confined to the present bilateral

negotiations. As the EC is more and more emerging as Europe's pole of attraction, its internal evolution matters to neighbouring non-members almost as much as to the members themselves. The EC intends to abolish its internal frontiers completely by the end of 1992. The internal rules and regulations which the EC adopts now in the run-up to 1992 create facts which the neighbouring non-members will by and large be forced to accept if they want to get free access to their major market.

The completion of the internal market has two very different aspects, namely a genuine opening of national markets and an adjustment of national regulatory systems to the abolition of internal frontiers. Despite a liberal-sounding rhetoric of mutual recognition of national practices, the construction of the internal market 1992 proceeds mostly via harmonization. Mutual recognition would allow members to maintain their diversity; the respective norms, regulations, tax systems and public services of the various countries would be put to the test of the market, the search for welfare-enhancing institutional innovations would not be restrained. A harmonization by decree tends to restrict the choice of consumers and producers, may be misused as a protectionist tool and necessitates a higher degree of political cohesion. The harmonization approach turns economic issues into matters of politics. The more such decisions have to be taken and the more local affairs are settled by a supranational body in Brussels, the greater is the need for a tight political consensus which becomes less feasible if the number of members increases further. Hence, the reluctance of the club to admit new members grows with the number and importance of the economic matters to be decided at the club level. By the same token, the need for the neighbouring non-members to join the EC becomes more pressing.

Initially, almost all members of the second West European integration club, the European Free Trade Association EFTA, would have preferred to partake in the EC internal market without joining the political club. The model for such an arrangement would have been the agreements on free trade in manufactures which the EFTA countries and the EC had concluded in 1972.

Because of the EC's harmonization approach to the internal market 1992, this option has lost its appeal. Most EFTA countries now want to get into the EC as soon as possible so that they can at least marginally influence the future evolution of the rules of the internal market. A further reason for EFTA countries to apply for membership are the EC demands for substantial contributions to its costly redistributive policies as a price for non-discrimination. Spain and Portugal are insisting on annual grants of 1.5 bn. ECU from EFTA. If the EFTA countries have to pay anyhow, they might as well join the EC and participate in the decisions on how the money is used.

Whereas the comparatively rich members of the present EFTA may ultimately be able to afford all the follies of common Euro-regulations, the much less advanced countries of Central and Eastern Europe might be the real victims of Euro-harmonization. If the newly liberated countries were forced to adopt the entire "acquis communautaire" in order to partake fully in the internal market, they would have to choose between two great evils, namely between staying outside despite the great advantages of membership outlined above - or accepting the costs of even the worst-suited EC regulations. Admittedly, common accounting standards and banking regulations may not be very harmful. The EMEs may anyway want to adopt such rules which are at least familiar to foreign investors. However, any step towards harmonized social policies and labour laws might have devastating consequences for the newly liberated countries. They need labour market flexibility and low non-wage labour costs even more than more advanced regions.

In a similar vein, the newly liberated countries may be hurt by any link between free market access and participation in the EC redistributive policies. The more firmly the EC insists on such a link in the present negotiations with the rich EFTA countries, the more wary may the EC become of granting poor outsiders from the East free access to the internal market - who might then be entitled to further financial support according to the Community's own criteria.

IV. Toward a New Europe

The abortive putsch in Moscow in August 1991 may well be a major turning point in the history of Europe. It has accelerated the dissolution of the erstwhile Soviet Union and may finally shock top politicians in Western Europe to think again about the future shape of Europe. Given the importance which the West may now attach to economic progress and political stability in the eastern half of the continent, it is even conceivable that the objections of Scottish raspberry growers and German coal miners against competition from the East may no longer be the major arguments that count in the EC. Change is on the agenda. Even the number of sovereign states in Europe increases. The more complex Europe thus becomes, the greater is the damage which a simple continuation and extension of old fashioned interventionism would do and the greater is the need for an abstract order which enshrines the negative liberties of citizens. The time has come to discuss liberal visions of the new Europe.

(1) From the very beginning in the 1950s, economic integration in the EEC had been supposed to be an intermediate step toward a political union. This blurring of politics and economics had two rather unfortunate consequences: (i) As economic decision-making was seen as a trial-run for uniform politics, harmonization usually prevailed over more liberal approaches to integration. (ii) The political aspirations served as a hurdle for outsiders who would otherwise have liked to partake in the common market. With the increasing numbers of sovereign countries in Europe and the growing desire of European non-members to join the club, this approach becomes ever more untenable. Europe needs a clear separation of economics and politics. More precisely: it needs two distinct clubs, a somewhat narrow political club and a broader economic club.

(2) The citizens in a number of European states seem to genuinely favour the evolution of a common foreign and defense policy in the context of the EC and within NATO. Hence, those EC members who want to do so should turn the EC into such a political club -

and define the terms on which those EC non-members who are willing to go along with this political deepening can join them.

(3) Independent of this political club, the present EC members and all other European countries who can subscribe to some common economic principles should establish a purely economic club. A revised and enlarged "internal market 1992" could be the basis for such a European Economic Area EEA. An arrangement of this kind would offer all European countries two different options of enjoying the benefits of free economic exchanges in Europe, either within the emerging political union (the revamped EC) or without having to coordinate foreign policy with other European countries. The political rationale of this separation of economics and politics is that no country should be compelled by considerations of market access to join a political club. If some countries, say Sweden, Poland or Latvia, want to enter the new political EC, they should do so for the proper reason: because they want to become part of an emerging political union about to develop a common foreign and defence policy. Without such an arrangement, the present EC would either have to dilute its own political substance by admitting new members who do not favour such a political cooperation - or deny to its citizens the advantages of free economic exchanges with those European countries which remain outside the political club.

(4) The typical European nation state in which all decisions ranging from the economic order to the closing hours of shops are taken at the national level cannot serve as a model for the future economic integration of Europe. Instead, the parallel processes of geographic widening and economic deepening necessitate an appropriate assignment of tasks to the various levels of decision making within Europe (supra-national, national, regional and local). The European Economic Area would have to be quite different from the present EC. The less the supranational institutions of an EEA meddle with the content of a Euro-jam and the width of the driver's seat on Euro-combines, the more will they be able to concentrate efficiently on their proper duty, namely the evolution and enforcement of common basic principles on the

free movement of goods and services, capital and labour in Europe, including minimum principles of external economic policy, an internal anti-subsidies code and the mutual recognition of the various national, regional or local regulatory systems.

(5) The power to shape tax and regulatory systems should be allocated to the lowest conceivable level in the European Economic Area. Europe's traditional strength is its diversity; the more local and regional units have the freedom to choose their own mixes of taxes, regulations and public services, the more can the ensuing competition for internationally mobile resources serve as a discovery procedure for optimal institutional arrangements (to borrow a term from Hayek 1968).

(6) The Common Agricultural Policy of the present EC is a major stumbling block on the way toward European economic integration (and multilateral liberalisation in the GATT framework). The recent attempts of the EC commission to move from price support to income support already point into the right direction. Ideally, all meddling with prices and production quantities should be ended in a European Economic Area; the regions of Europe should be free to design - and finance - their own alternative schemes to support farmers if they want to do so.

(7) If the members of the economic club do in fact favour some redistribution of income from the richer to the poorer regions, a panoply of regional and structural policies and further implicit transfers would be an inefficient and paternalistic way of doing so. Instead, members may agree on a general and transparent rule for a limited redistribution between regional authorities, for instance with each region paying or receiving (per capita) a fixed percentage of the difference between its own per capita GDP and the overall average. Remember however that any redistributive scheme is an excuse to keep poor outsiders out.

(8) The systemic changes at least in Hungary, Poland and Czechoslovakia have progressed far enough to make them eligible for full participation in an EEA on economic grounds and a revamped

EC on political grounds. Others like Slovenia and the Baltic states are set to follow soon. Once the major steps toward democracy and a market economy have been taken, there is no further economic rationale for any discrimination against the newly liberated countries. They should in principle be treated like Western European states. The oft-cited differences in the level of economic development are no valid counter-argument. On the contrary: such differences - once economic agents are allowed to take full advantage of them - are a major source of economic progress. The present EC already includes regions as diverse as Amsterdam and the Algarve, as Edinburgh and Extremadura. The example of Spain and Portugal shows that freer economic exchanges with the more developed parts of Western Europe offer the poorer regions the best opportunity for catching up.

(9) The liberal vision outlined above may well turn out to be politically infeasible for the time being. In this deplorable case, Western Europe should still offer EC membership or at least full economic inclusion in the internal market. The newly liberated countries would then need special arrangements though. Remember that the institutional credibility and reliability and not the precise content of the EC and its "acquis communautaire" makes the EC so attractive for the newly liberated countries. Hence, these countries should at least be allowed to benefit from the negative freedoms which EC membership entails (liberal aspects of 1992, binding of external economic policy, internal code on subsidies, enforcement of obligations via the European Court of Justice) without having to adopt all EC norms and regulations. Such a solution need not be restricted to a period of transition. Instead, it could then constitute a first major step toward a lasting deregulation within the EC.

(10) In a similar vein, the emerging market economies need the opportunity to opt for a considerably simplified and liberalised version of the EC laws and regulations, i.e. for the basic content but not necessarily for the complicated details of these arrangements. The East German experience underscores the importance of this point. The very region of the former socialist camp

which by courtesy of German unification became part of the EC and adopted wholesale the institutions and the money of a successful West European country is engulfed in a slump which - in terms of the decline in production - is far deeper than the crisis in Poland, Hungary and Czechoslovakia. The major reason lies in the substantial increase in East German production costs. Sparked by premature political promises to quickly narrow the gap in living standards between East and West Germany, East German wages - measured in convertible currency - have risen roughly five- to sixfold. As the high level of labour costs has rendered most existing capacities for the production of tradable goods unprofitable, the East German economy has to be rebuilt largely from scratch. Unfortunately, the intricate complexities of West German laws and regulations which have been introduced in East Germany severely impair this process.

(11) As long as the present EC is unwilling to admit new members from East-Central Europe, well-designed agreements of association could be a valuable intermediate step. If they were to impart almost as much institutional credibility on the EMEs as immediate EC membership would, such agreements would need to spell out that the EMEs will finally be admitted to the EC (or to the broader and non-political EEA) and to specify a date at which the EMEs become eligible for full membership.

(12) In the coming years, European politicians will have to devise a way in which Russia and the other European successor states of the erstwhile Soviet Union can be incorporated into the European mainstream. The argument that integration with the West is a major factor to ease the pains of adjustment to market conditions and reduce the hazard of political turbulences applies to Russia, the Ukraine and Belorussia as well as it does to, say, Hungary, Poland and Latvia. As the rest of Europe may be unwilling politically to welcome the atomic superpower Russia (or a slimmed-down Eurasian Union) to a political EC even in the long-run, it would be convenient to have at hand a second option of enjoying free economic exchanges with the West: the European Economic Area.

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The Mont Pelerin Society - Regional Meeting 1991

In Search of a Transition
to a Free Society

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THE EMPIRE OF BRUSSELS OR ADAM SMITH?

by

Lord Harris of High Cross

DOES THE EUROPEAN COMMUNITY

WANT FREE TRADE?

by

Brian Hindley

Session 8: Policies of European Community Toward Newly
Liberated Countries

Speakers: Holger Schmieding
Lord Harris of High Cross

Discussants: Ljubomir Madzar
Vladimír Rudlovčák

First draft for MPS Meeting at Prague

POLICIES OF EUROPEAN COMMUNITY TOWARDS NEWLY-LIBERATED COUNTRIES

'Europe is not the creation of the Treaty of Rome. Nor is the European idea the property of any group or institution... The European Community is one manifestation of the European identity. But it is not the only one. We must never forget that east of the Iron Curtain, peoples who once enjoyed a full share of European culture, freedom and identity have been cut off from their roots. We shall always look on Warsaw, Prague and Budapest as great European cities...

It would be a betrayal if, while breaking down constraints on trade within Europe, the Community were to erect greater external protection... We have a responsibility to give a lead... particularly directed towards less developed countries. They need not only aid; more than anything they need improved trading opportunities if they are to gain the dignity of growing economic strength and independence.'

Margaret Thatcher: Bruges, 20th September 1988

PART 1 The Empire of Brussels or Adam Smith?

by Lord Harris of High Cross

The panacea of free trade

The purpose of the founding fathers of the European Economic Community was so to unite France, Germany, Italy and Benelux as to make any repetition of the civil wars of 1914 & 1939 not merely inconceivable but logistically impossible. The chosen method of the Treaty of Rome was to supplant the national socialism of Hitler & Mussolini by the classical liberalism of Adam Smith & Hayek.

Thus if the prime purpose of European unity was political, the chosen method was the economic panacea of unhindered trade and investment. It seems that Jean Monnet understood, as it former French socialist finance minister, Jacques Delors, never did, that when Adam Smith inquired into "the causes of the wealth of nations" he suggested that the chief explanatory variable was specialisation in human & material resources, coordinated by trade and guided spontaneously by the "effort of every man to better his condition."

Indeed, if we must name the primary source of the continued multiplication of output, it is not investment, technology, physical investment, human capital. Rather it is the ceaseless intensification of the specialisation of labour, etc, and its extension to wider markets which make all such supporting means possible.

The truth of which we have to remind jaded European leaders is that free trade brings three-fold blessings. Firstly, it spreads increased prosperity among countries with widely differing natural & acquired endowments. Secondly, it enlarges individual liberty by widening opportunities to consume, work & invest. Finally, trade transmutes the base metal of impoverishing national rivalry into the pure gold of peaceful, mutual enrichment through micro-competition, which leads to macro-co-operation. But does free trade require further federalism?

Federal: freedom or control?

At the MPS meeting in Munich last year, I found myself pitted in unequal contest, like a David against the two Goliaths of Buchanan & Bernholz. The role assigned to me by Professor Giersch had been to defend the concept of a "Europe of nations" against their model of a fully-fledged federal constitution for a benign "United States of Europe without Leviathan," which Buchanan's draft paper boldly predicted would be established in the 1990s, following what he saw as the end of "the naive faith in collectivist nostrums" in the East as well as the West.

Not for the first time, this European issue was to prove bitterly divisive even among liberals. Thus in his platform presentation, our distinguished Nobel Laureate acknowledged that the persistence of dirigiste delusions in Delors' Europe led him to "temper" his optimism. Many were therefore surprised when the IEA published Buchanan's paper under the question-begging title "Europe's Constitutional Opportunity" in its original draft without any hint of this crucial revision. Nor did the Editor find space for my brief rejoinder in a symposium that accommodated three slippery orations by Herr Pohl on his former hobby-horse of full monetary union - in some form, somehow, sometime - soon! Not surprisingly, one reviewer interpreted this contrived offering as evidence of a "European U-turn by IEA".

This unhappy episode perversely serves to underline the practical danger of a federal Leviathan hostile to free trade within the EEC, let alone its extension to the newly-liberated nations. In an impressive review of the European constitutional outlook at a Symposium in Interlaken last May, Dr Angelo Petroni distinguished between "faith in collectivism" which Buchanan rightly judged to have been "substantially displaced in the public consciousness of the 1990s", and what Petroni calls "faith in the benevolent state" which he concludes is likely to shape a federal constitution "much more in the sense of Delors than in the sense of Rougemont, Buchanan or Bernholz."

Alas, this danger is no longer a debatable, distant prospect. It is now emerging in the new draft treaty before the Inter-Governmental Conferences on political and economic union. Centralisation and coercion are proposed almost indiscriminately in the name of such vague aims as "reducing disparities", "avoiding the distortions of competition" and "strengthening social cohesion."

The Social(ist) Charter

The pretext for the "social dimension" is sufficient to damn its authors from the outset. They repeat like union-programmed parrots that, since the Single Market gives capitalists the benefit of increased efficiency, it's only fair to give the employees a "Social Charter". The result is nothing less than a strait-jacket of proposed regulation, ranging from a minimum "equitable wage" and maximum working day, week and year, to uniform rules for part-time employment, retirement, pregnancy leave, overtime, week-end and night work.

However plausible & politically profitable this pretext for "social protection", it is of course (almost) wholly fallacious to market economists. It would also prove fatal to hopes by newly-liberated countries to qualify for membership of the EEC in the foreseeable future.

How can producers alone be said to benefit from a larger market in which keener competition compels them to minimise costs & prices? Are not consumers themselves, as Hutt used to teach, the ultimate beneficiaries of all productive resources? Where there is short-term conflict of policy, should not the widely-shared, impartial, consumer interest prevail over the narrow, partial interest of producer groups?

Anyway, have we forgotten that all trade depends on differences in comparative advantages and costs of production? So why try to equalise costs at the outset? Is not freedom of trade, investment & mobility the best way of reducing scarcities and sharing abundances, thereby tending to even-up differences in costs & real incomes? Since we cannot know the optimum methods of employment, taxation, distribution to meet ever-changing circumstances, should we not shun imposed uniformity and welcome the discovery procedure of competition to guide our choice between differing jurisdictions?

Above all, is not the Social Charter like a hammock inducing workers to reduce adaptability to new opportunities, thereby raising costs against themselves as consumers? And if labour (and other) costs are raised throughout the Single Market (as under the Common Agricultural Policy), how will domestic EEC production survive against the exports from the lower-cost, newly liberated countries, except by burdening them also with the Social Charter, etc, or extending to them (as to Yugoslavia) "voluntary" quotas, ceilings, "technical standards," "anti-dumping" duties and all the other divisive, mercantilist paraphernalia of "Fortress Europe"?

Adam smith to the rescue

Three years after the Bruges speech, Mrs Thatcher at least deserves credit for prescience in warning:

"We have not successfully rolled back the frontiers of the state in Britain, only to see them re-imposed at a European level, with a European super-state exercising a new dominance from Brussels."

The dirigisme of the CAP and Social Charter is far from the end of our troubles. By December at Maastricht, in the absence of Thatcher, the new Treaty on political & economic union could include a single European currency (explicitly opposed by Buchanan & Bernholz), the extension of federal competence (through qualified majority voting) over energy, transport and industrial policy, research & development, social security, national budgets, development funds, as well as defence & foreign policy.

We glimpsed the Napoleonic tendency when Jacques Delors, a non-elected President of the Commission, pontificated: "I can manage 12 countries, but not 15 or 24." I was reminded of Friedman challenging an MPS meeting in Switzerland to name the President (or PM?) of that country. When no-one could answer, he said: "This is the place for me!"

Must we then abandon hope of moving towards wider free trade with the newly-liberated countries of Europe, including even the republics of the Soviet (dis)Union? It need not be so. Not for the first time, we may draw hope & inspiration from Adam Smith who demonstrated that such grandiose politicisation was completely unnecessary for the spreading of a free trade world. Ponder deeply his profound insight which I commended on this subject last year at Munich:

"Were all nations to follow the liberal system of free exportation and free importation, the different states into which a great continent was divided would so far resemble the different provinces of a great empire."

There you have the key to unlock Delors' fortress. We do not need to create a new European or North Atlantic Empire ruled from Brussels or anywhere else. Acceptance of the simple principle of free trade gives us the best of both worlds. By removing barriers to trade & investment, we can all enjoy the benefits of full economic integration as though we were part of a great empire. At the same time, we preserve the advantages of political decentralisation through nation states, sovereign in all respects save a binding commitment to the removal of barriers to trade & commerce. If the European Economic Community persists in clogging free trade by needless regulation, it may be left for what we once knew as the USSR to create the invisible empire of Adam Smith.

(1,450 words)

PART 11 DOES THE EUROPEAN COMMUNITY WANT FREE TRADE? -

A case study

by Dr Brian Hindley (LSE)

If the EEC were open to the world, there would be no substantial question about EC policy towards trade with that part of the world we call eastern Europe. The question before us is the terms on which these states are to be allowed into Fortress Europe.

This case study examines the current negotiation with Poland, Czechoslovakia & Hungary (THE THREE), with Rumania & Bulgaria to follow. *In principle*, the negotiation is intended eventually to lead to free movement of goods, services, capital & labour, as in the EEC's Single Market. The italicised qualification raises the question of what the exceptions will be *in practice*.

Details on the negotiations are scarce, partly because THE THREE are wary of offending the Commission by releasing information it regards as sensitive. The general course can be tracked through two instructive reports in the Financial Times. The first (19th April) under the headline "Brussels opens its doors to trade with eastern Europe" almost certainly reflects Commission thinking:

"The eastern Europeans will get more time to erect tariffs which they will then spend the next ten years dismantling... they have removed all the non-tariff barriers of central planning without yet replacing them with a transparent tariff system. Thus, in many cases they are left with markets more open and *vulnerable* than the EC, contrary to the agreed aim of phasing-in free trade so as to benefit the eastern Europeans faster than the EC. A further complication is that a long-standing member of the GATT like Czechoslovakia will need its GATT partners' agreement to raise its very low "bound" tariffs of 4-5 per cent on average."

(*my italics*)

Thus negotiations with THE THREE are not based on the usual principle of reciprocity whereby each side makes "concessions" of equal value. Instead, the EEC has adopted the principle that its markets will be opened to imports from THE THREE more rapidly than their markets are opened to imports from the EEC. From the perspective of EEC trade policy officials this is a benevolent act. Some of them would not be shocked by Flaubert's Dictionnaire des idées reçu which defines "imports" as "the canker at the heart of trade."

The EEC commitment to open its market more than THE THREE open theirs in return, has led to bizarre consequences. Protection in THE THREE is already low and the Polish government, perhaps taking seriously all our talk about the efficacy of free trade and free markets, last year eliminated all quantitative restrictions on imports and reduced tariffs, more than half of them to zero.

But according to the EEC's benevolent negotiating principle, the EEC must start by being more open to imports from THE THREE than they are to the EEC. How can this be achieved when THE THREE are already so open? One way would be for the EEC to become even more open than them. But much of what THE THREE have to export (e.g. agricultural produce, textiles, coal, steel, ships) fall into categories of imports regarded as "sensitive" by the EEC.

So if the EEC is to be relatively more open, the obvious solution for a Brussels bureaucrat is that THE THREE must become more closed! Note the phrasing of the ET report, probably direct from the lips of a Commission official, that the eastern Europeans had removed non-tariff barriers "without yet replacing them with a transparent tariff system" thereby being "more open and vulnerable than the EC."

What a give-away! "Yet" neatly suggests that the failure of THE THREE to put up tariffs is a mere oversight, not a sensible, principled, courageous choice. Who would want his country's markets to be more "vulnerable"? Surely it's in everyone's interests that THE THREE should increase protection, if only to allow the EEC to wreak its benevolence, rather than pushing it to the embarrassment of reneging on its commitment to initially-asymetric openness!

On such grounds, therefore, the Commission suggested THE THREE should increase tariffs, and not surprising the tactic has been at least partially successful. In no eastern European country is there unanimous support for low protection, so that the EEC invitation strengthens existing protectionist lobbies. Accordingly, on 1st August, the Polish government obligingly raised its tariffs.

Of course, there are politicians and certainly economists in THE THREE who do understand the costs of increased protection. (Such people are no doubt regarded by the Commission as perverse theoreticians who are too new to the real world to understand the practicalities taken for granted by the sophisticated aborigines.) But even for such people, the emerging arrangements with the EEC offer the potential gains for THE THREE of a larger share of EEC quotas and lower tariffs.

So the agreement the EEC visualised in April would now include concessions on textiles & steel, although coal was a special problem for the Germans who insisted on keeping their "emergency" protection (since 1958!) against imports. Moreover, in the ET's words:

"EC members over-ruled Spain in promising extra concessions on farm exports. East Europeans will probably be able to sell more fruit, vegetables, pork, game, rather than main-line items like cereals, beef, lamb, dairy products that will continue to get the full protection of the Common Agricultural Policy."

The story has a further twist. The subsequent reductions in the tariffs of THE THREE under the association agreement will be towards the EEC alone, not a general reduction in duties on imports from other sources. For exports from the EEC, the increase in the tariffs of THE THREE urged by the EEC would be temporary, while for exports from elsewhere it would be permanent.

Article XXIV of the GATT allows tariffs that vary according to the source of imports, as in customs unions & free trade areas (like EEC-THE THREE), according to the condition that the arrangement eliminates duties and other restrictions on "substantially all the trade between the constituent territories in all the products originating in such territories." In various association agreements the EEC has already expanded the meaning of "substantially all" to something more accurately described as "most". Accordingly, the US has threatened to complain in the GATT if the arrangement with THE THREE does not cover "substantially all" relevant trade, including agriculture.

Although the US threat has helped push the EEC to widen the "concessions" offered THE THREE, they are far from going the whole hog, as shown by the latest ET report (21st August):

"The association accords, due to be signed by the end of the year have become bogged down because of EC barriers to the eastern countries' most competitive exports - farm produce, steel, coal, & textiles. Mr Jacques Delors, the Commission President, made it clear that there would now be 'reasonable and realistic' Community concessions to unblock the negotiations."

What M. Delors regards as "reasonable & realistic" concessions are still likely to be a long way from free trade. Anyway the President of the Commission is not in a position to make any kind of concessions, which under Article 238 of the Rome Treaty require unanimous approval of the Council of Ministers for association agreements. Hence the stubborn difficulty over farm products, steel, coal and textiles.

This dilemma creates a moral challenge for M. Delors. In recent years he has ridden a wave of vague, idealistic talk about the "European identity," which must, as Mrs Thatcher declared at Bruges, encompass Poland, Czechoslovakia and Hungary. Yet, if even the minimal association now being discussed is blocked by petty parochial interests within the EEC, what becomes of such fine talk?

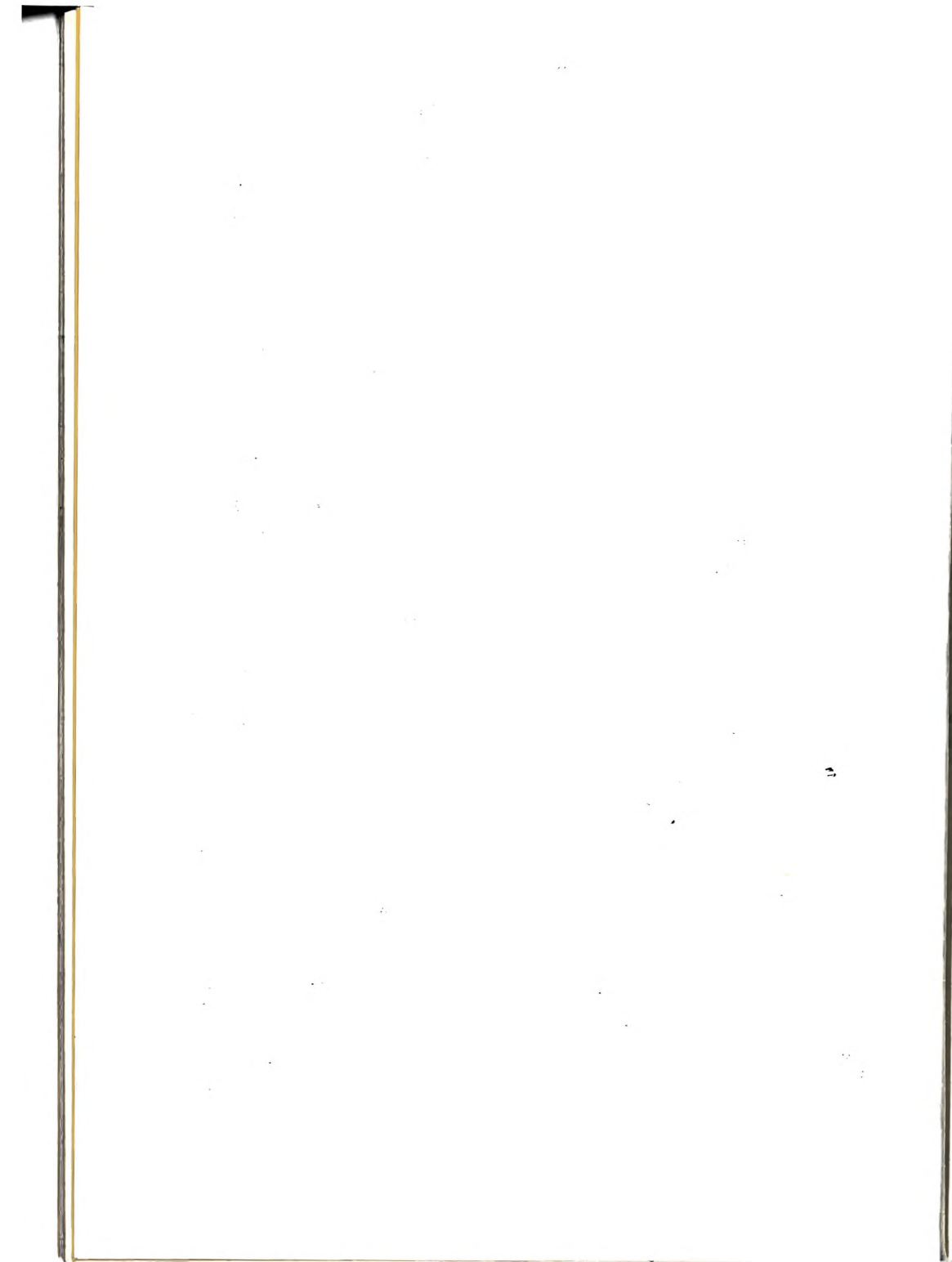
The performance of the EEC over the past year gives no cause for optimism that Mrs Thatcher's wider vision will be followed. Far from giving a lead, as the world's largest trading block, its attachment to the CAP has been a primary cause of the breakdown of the GATT Uruguay Round.

The truth is that the commitment to free trade principles is less strong in the EEC than in the USA. When US spokesmen announce another derogation, they at least sound apologetic and reaffirm their ultimate free trade goal. EEC spokesmen on such occasions, so far from being apologetic, sound as though they are making proud affirmations of the existence of the EC and its importance in the world. Policy-makers in the US at least feel they ought to think in terms of a wider interest than their own, whereas policy-makers in the EEC do not naturally think of any such wider interests.

If the EEC is ever to be won over to Mrs Thatcher's vision of a wider Europe, it must rise above the interests of week-end Bavarian farmers or Portugese textile workers and use its power to create a more desirable rather than a less desirable world. The outcome of negotiations is, therefore, important for the EEC no less than for THE THREE. Must the outcome be higher tariffs surrounding THE THREE and limited concessions from the EEC with some aid & technical assistance thrown in for cosmetic effect? Or can it raise its sights and take account of the interests of its eastern neighbours, of its ability to influence their development, and of its own interest in that development?

If the EEC were able to raise its sights that high, perhaps it could raise them further to take account of its impact on the world trading system. But if it cannot raise its sights high enough to accommodate even Poland, Czechoslovakia & Hungary, the outlook for Europe and the world is gloomy indeed.

1580 words



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