Europe's "France" Problem

By Roland Vaubel

With the British out of the picture, Germany will be hard-pressed.

French President Emmanuel Macron has started a major European offensive. He is calling for a eurozone budget on top of the EU budget, more transfers to countries experiencing high unemployment, more subsidies for European "champions," a softer anti-trust policy, tighter labor market regulation, the mutualization of bank losses, and majority voting on taxation. When the European elections are over and the new Commission takes office in November, the battle for Europe will begin. The British will be out of the way. However, in Germany a federal election is looming in September 2021. Chancellor Angela Merkel, a weak and willing partner, will step down. Macron knows that 2020 is his narrow window of opportunity.

France has always tried to export its social and economic model to the rest of Europe. According to the index of economic freedom published by the Heritage Foundation each year, France occupies the third but last rank among the 36 OECD—that is, industrial—countries. The French share of government spending and of social spending in GDP is the largest among all OECD countries. As for the level of labor market regulation—for example, regulation of dismissals and the minimum wage relative to market wages—France ranks second after Turkey in the OECD. No wonder that, despite very low interest rates, the French unemployment rate stands at 8.8 percent and is the fifth highest in the OECD.

The French have little confidence in the market. In an opinion survey conducted by the University of Maryland (as part of its Program on International Policy Attitudes), people in twenty industrial and emerging economies were asked whether they are for or against free markets. The

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support for free markets was lowest in France (36 percent). For comparison, it was 65 percent in Germany, 66 percent in the United Kingdom, 71 percent in the United States, and, at the top, 74 percent in China. Why is France so *"étatiste"* and anti-market?

The roots are historical and ultimately geographical. Looking back at European history since the middle ages, France was the first large language area to be permanently united in a centralized state. In the twelfth century, the crown land had been limited to the small area of the Îsle de France—comprising Paris and Orléans. By 1488, Charles VIII had become the sole ruler over the whole of French-speaking France. "La Grande Nation" was born.

Why was France unified four centuries ahead of Germany? Geography played an important part. France has natural borders in the north, west and south—Germany only in the south.

French kings were now so powerful that, in the following centuries, they could invade neighboring countries and add to their territory. This may explain why people in France tend to regard political centralization as the key to success—also at the European level.

French President **Emmanuel Macron** *applies the strategy of raising rivals' costs.*

At the same time, however, the power of the state turned inward, against the citizens. The king refused to assemble the "estates," consisting of the nobility, the clergy, and the bourgeoisie. The Reformation was brutally suppressed. The economic regime relied on state enterprises, restrictions on the mobility of craftsmen, and mercantilist protectionism.

The tradition of the large centralized state explains the French penchant toward big government—lavish public spending and very restrictive regulations. The rulers tell their subjects that the market does not work. Moreover, the primacy of politics runs counter to the rule of law and to keeping the rules of the game. A market economy and a federal decentralized system of government cannot function without the rule of law, while a command economy can.

A large centralized state has a strong executive and, as part of it, a well-trained and interconnected elite bureaucracy. Parliament is weak, so protesters often turn to the streets.

A large economy is less dependent on imports. This contributes toward explaining French protectionism. In April 2019, for example, France alone voted against opening negotiations for a EU-U.S. free-trade arrangement. When a country like Britain wants to escape from EU regulation, protectionism, and net contributions, it is confronted with the external tariff and other EU barriers to trade. Protectionism keeps the European Union together. It is a necessary condition of French leadership.

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A country whose economy is highly taxed and tightly regulated can improve its competitiveness by exporting its tax rates and regulations to other countries. In the political economy literature, this is called "the strategy of raising rivals' costs." It requires an international organization or federation in which decisions are taken by majority voting. The idea goes back to the late George Stigler, professor of economics at the University of Chicago. Examples abound, notably in the history of the United States and Bismarck's Germany. In the 1920s, France was the main advocate for founding the International Labor Organization in Geneva. The ILO voting record reveals that the delegates from the

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most restrictively regulated countries are the staunchest supporters of ILO conventions.

In the European Union, majority voting on regulations was introduced in 1987 under the Single European Act. At that time, Jacques Delors was president of the Commission and Margaret Thatcher was prime minister in the United Kingdom. According to the Act, majority decisions on EU labor market regulations were confined to health and safety. But to the surprise of the British, these provisions were also used to limit working time. The British government filed a complaint with the European Court of Justice. It was turned down. More than fifty EU labor market regulations have been introduced since 1987.

Moreover, majority voting about regulations was admitted for completing the "internal market" defined as "an area without internal frontiers in which the free movement of goods, persons, services, and capital is ensured." In 2003 the British, to their great surprise, found that this legal provision was used to impose EU financial regulations on the City of London. This was made possible by the European Court of Justice which in 1989 changed the meaning of "internal market" to "conditions of competition which are not distorted." While diversity in financial regulation is perfectly consistent with the free movement of capital, it is not consistent with a level playing field. The Court's reinterpretation was later legalized in a protocol to the Lisbon Treaty (2009).

The Financial Services Directive of 2003 was rejected by the United Kingdom, Ireland, Luxembourg, Sweden, and Finland in the final vote, but they could not block it. In 2010, also against British resistance, France assembled a Council majority in favor of founding three EU financial regulatory agencies with the express purpose of transferring the French system and level of financial regulation to the City of London. One of these European agencies, the European Banking Authority, is entitled to give directions to the national regulatory agencies and close individual banks. Among the three agencies, the European Securities and Markets Authority ought to be mentioned as well. Its seat is in Paris. The United Kingdom questioned the legal basis for ESMA at the Court of Justice. The Finnish Advocate General sided with the United Kingdom but the majority of the judges did not. The British were not

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amused. This was not what Margaret Thatcher had agreed to in 1987. EU regulation of the City of London played an important role in the vote for Brexit in the referendum of 2016.

Another example of the strategy of raising rivals' costs is the so-called "Droit de Suite" Directive of 2001. It obliges art galleries and auction houses to pay a certain percentage of the resale price to the artist or the (often distant) heir. *Droit de suite* is a French invention. It had been copied by most other member states but not by the United Kingdom, Ireland, the Netherlands, and Austria. The minority was outvoted in the EU Council of Ministers.

President Macron applies the strategy of raising rivals' costs to taxation proper. He wants majority decisions on the "harmonization" of taxes—in particular corporate taxes. He is trying to persuade a group of EU countries to adopt the French system of taxing share purchases under the label "financial transaction tax." The proposed "Investment Stabilization Function" and "Unemployment Insurance Fund" would grant subsidized credits to eurozone countries experiencing high unemployment. If the so-called "European Stability Mechanism" becomes the "backstop" of the bank resolution fund of the eurozone, the badly managed banks will be bailed out by foreign taxpayers and ultimately by the well-managed banks of all eurozone countries. The proposed scheme of a European deposit insurance would be far from actuarially fair and differ markedly from the Federal Deposit Insurance Corporation of the United States. Macron's proposal that national minimum wages ought to be set jointly at the EU level is another instance of the strategy of raising rivals' costs. The French minister of labor has already expressed the hope that the German federal minimum wage would be raised to the French level. The Scandinavian countries do not have minimum wages but would have to introduce them.

2020 will be an exciting year in the history of European integration. ◆