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ALICE IS NOT MISSING WONDERLAND. THE EASTWARD ENLARGEMENT OF THE EUROPEAN UNION

Miroslav Prokopijevic *

Summary

In this paper I will try to show that the EU enlargement of 2004 was not a good economic move for the eight newcomers from Central and Eastern Europe (CEECs). It is unlikely that the newcomers will get larger FDI, speed up their economic growth and catch up with richer EU countries, although this was broadly advertised both academically and by the EU "propaganda for happiness." The EU subsidies, intended to offset accession costs, have turned out to be useless if not damaging for acceding economies, because they change the structure of incentives. So, instead of being rewarded for accession, accession countries are going to be punished twice. Firstly, by lower FDI and a persisting GDP gap. Secondly, by getting subsidies which worsen the

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situation. CEECs would be better off staying outside the EU and continuing to improve economic freedom and the rule of law. But even after having acceded, there is still some space for reasonable objectives of the CEECs, due to unintended consequences of the socialist enlargement design.

Introduction

After more than 10 years of transition from communism to constitutional market democracy, eight countries from Central and East Europe (CEECs) became members of the European Union (EU) on May 1, 2004.[1] Even before the transition countries joined the Union, the main bulk of academic production in the field recommended integration by saying it was a good thing both for the Union and for these countries – in a political, economic or any other sense.[2] One group of academic writers conceptualized full membership as a panacea for all CEEC problems – like Alice's trip to Wonderland. This probably had to do with the prevailing mentality in the CEECs and the rational constructivism of the European official academia. The EU bodies contributed to such a picture with their own "propaganda for happiness", which ignored or diminished problems and glorified the allegedly positive aspects of accession – a practice well known from the communist past. People with a strong interest cannot produce a balanced view. Intellectuals from acceding transition countries and the EU profit due to a higher demand for their services before, during and after accession. Eurocrats from Brussels profit from being paid well, for extending their rule to ten additional countries and running the game of EU25, which is less accountable than ever before. And some interest groups get subsidies.

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[1] By working on this study I have enjoyed the generous hospitality of the ICER. I would like to thank Enrico Colombatto (ICER & Turin university), Svetozar Pejovich (Professor emeritus at the Texas A & M University), Slavisa Tasic (Free market center), Simon Titel (Simon Titel and Associates) and several participants at the EACES 2004-conference for helpful comments. Usual caveat applies.

[2] "It is a commonly accepted view that further integration with the European structures will be beneficial to the CEECs in a political and economic sense." Maliszewska 2004, p. 6.

The main finding of this paper is that for economically successful transition countries it would have been better to stay outside the EU, and to continue to improve the rule of law and economic freedom. This would have been the "first and best" choice for the CEECs. But even after some CEECs have joined the Union they need not be delivered at the mercy of the Eurocrats, since there is some scope within the Union for pursuing the above-mentioned reasonable objectives, either due to the nature of integration or due to some unintended consequences of the "fifth enlargement" of 2004. Acceding to the EU and fighting from inside for more economic freedom emerges as "second best" choice. Inferior to "second best" is to accept heavy regulation and rent-seeking policies in exchange for subsidies and to join the over-regulated economies of the EU15.

In what follows, I will first consider the main economic reasons in favour of the CEECs joining the Union.[3] So, the advocates of the eastward enlargement pointed out that the CEE entrants would profit in economic terms for a number of reasons by:

i) attracting more investment and especially FDI;[4]

ii) increasing their growth rates and bridging the gap with the rest of the Union;[5]

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[3] "The enlargement of the European Union will have a positive impact on the economy of acceding countries. […] EU enlargement is expected to provide a significant further boost to economic growth and prosperity in acceding countries." European Commission 2003, p. 5-6.

This view strongly dominated the field and is supported by larger think-tanks (Tinbergen institute, EUI, CESifo, WIIW, Jean Monet Center, ZEI, Robert Schuman Foundation, British CPS), the most frequently used textbooks on the EU (see books by D. Dinan, A. M. El-Agraa, Feldman & Watson, N. Nugent, Schneider & Aspinwall, D. Swann, W. & H. Wallace), by material at the university departments for European studies and by the most important non-market funds like IMF, WB, EBRD.

[4] "…it is obvious that integration does have a positive effect on trade and foreign direct investment (FDI) flows". Kaitila 2004, p. 26. Breus (2000) estimated that, with full EU membership, FDI into CEECs could increase by up to 1.5 percentage points per year.

[5] "Full membership [of the CEECs] is expected to accelerate economic growth via increased foreign direct investment (FDI), new trade within the enlarged EU, and aid from the EU budget, and other channels."

iii) receiving subsidies in order to offset accession costs.

None of that is true as we are going to show below (in the same order).

1. Higher FDI

Let us first consider the question of FDI. This will be divided into two steps. In step one I will consider what happens with FDI[6] for selected newcomers until shortly before accession, since the post-accession data are not available now. Step two draws an analogy with the flow of FDI in some EU15 countries that were similar (i.e., less developed than other EU countries) to transition countries when they acceded some decades ago.

After the collapse of communism CEECs entered transition and started market reforms. Private investors reacted very positively to this change, especially where it was fast and profound. Since transition countries had not had enough accumulated capital they were required to import it. FDI is a fast way of transferring know-how, organisational and managerial practices and creating products for the world market, but above all it is a crucial indicator of a country's integration into the global division of labour. In order to attract private FDI, countries needed to develop a good business environment, and how good they were at doing that is to be seen from the table below. As expected, FDI was generally on the rise in the CEECs throughout the 1990s, but it started to decline in 2002-2003. FDI peaked in CEECs in 2000 or 2001, while Hungary had two peaks in 1993 and 2001.[7] The peak

CESifo, 2004, p. 96. Wagner & Hloushova (2002) expect that even poorer members of EU25 will catch up in three or four decades. Lajour & oth. (2001) predict 9% and 5.8% rise of GDP for Hungary and Poland after accession, while Maliszewska (2004, p. 42) predicts a rise of GDP for two countries of 7% and 3.4% respectively. CESifo (2004, p. 99) cites even higher growth figures after accession that were stated by the EU Commission and some other studies.

[6] One has to bear in mind that a small fraction of FDI may stem from foreign governments and non-market funds like the WB and EBRD, while the majority of FDI is a private investment.

[7] FDI in Hungary was negative in 2003, since the data do not include

for CEECs as a group was in 2002.

Table 1: FDI in 5 transition countries, 1989-2003, in million of dollars.

State	Czech R.	Estonia	Hungary	Poland	Slovakia	Total
1989	-	-	187	-	10	197
1990	-	-	311	0	24	335
1991	-	-	1459	117	82	1658
1992	983	80	1471	284	100	2918
1993	563	156	2328	580	107	3734
1994	749	212	1097	542	236	2836
1995	2526	199	4410	1134	194	8463
1996	1276	111	1987	2741	199	6314
1997	1275	130	1653	3041	84	6183
1998	1275	574	1453	4966	374	8642
1999	3591	222	1414	6348	701	12276
2000	4477	241	1650	9299	1500	17167
2001	5600	307	2730	6377	1763	16777
2002	9300	307	1281	4335	4620	19843
2003	3500	800	-85	3500	700	8415

Source: EBRD, Transition report, 2002; Global development finance 2004 (World Bank) for 2002 and 2003. Own calculation.

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reinvested profit. FDI does include inter-company loans.

By designing policies to attract FDI in the 1990s some countries used subsidies[8] that were not legal according to EU law.[9] Even before accession, accession-candidates started to change their legislation in order to adjust it to the EU regulations.[10] Some investors anticipated a loss of subsidies and decided to leave candidate countries or not to go there in the first place. For that reason Hungary, the Czech Republic, Poland and Slovakia had lower FDI in 2003, compared to 2002. Total FDI in five countries fell from $ 19.8bn in 2002 to $ 8.4bn in 2003. Only in Estonia was FDI on the rise in 2003 compared with 2002. By putting aside the question of opacity in defining and using subsidies in the EU, it needs to be added that the provision of subsidies to firms is also a transfer from some government or non-market funds to firms partially to cover differential costs. It has turned out to be a transfer largely to foreign owners. All subsidies, including those to attract FDI, support activities that invoke considerable losses, some of them deadweight. It was a positive step of CEECs to remove part of their subsidies, even if this happened because of enforcement of EU law rather than on their own initiative. However, the fact that it is good to remove subsidies for FDI does not justify the expectation that FDI is going to rise due to accession. All those that accepted such a view acted on all other considerations rather than factual ones. In 2004 and thereafter FDI in the eight new members will be significantly lower than the peak in 2002.

[8] A large majority of CEECs has used different subsidies (tax relief, financial assistance, property grants, provision of utilities, training, etc.) in order to attract more investment and especially FDI. For example, the Czech government approved in 1998 a package of incentives including corporate tax relief for 10 years (for newly established firms) or partial tax relief (for established companies), job creation grants, training grants, the provision of industrial property at low prices and infrastructure support.

[9] Beyond Common Agricultural Policy (CAP) and structural funds, the EU in general does not allow so called direct subsidies, but it tolerates so called horizontal subsidies, i.e. those that benefit many (all) firms, and not just those that otherwise get some subsidy. It also allows subsidies for extremely underdeveloped regions (like ex-German Democratic Republic) or for depopulated regions, like northern parts of Sweden or Finland.

[10] For example, special Slovak incentives for foreign investors or 10-year tax holidays were abolished in 2002.

The loss of subsidies was just one important factor for lower FDI in CEECs. Another may be the heavier regulation that was expected to be imposed on CEECs before and after accession. Some of the accession costs originating in regulation will be discussed later on. For now it suffices to say that the loss of subsidies and higher operation costs after accession were the main factors for more than halving FDI in CEECs in 2003 compared to 2002.

One may just partly accept my view and still say that FDI declined in the whole world after 2000, and that this trend explains the deterioration in FDI in newcomers more strongly than EU membership and the loss of subsidies do.

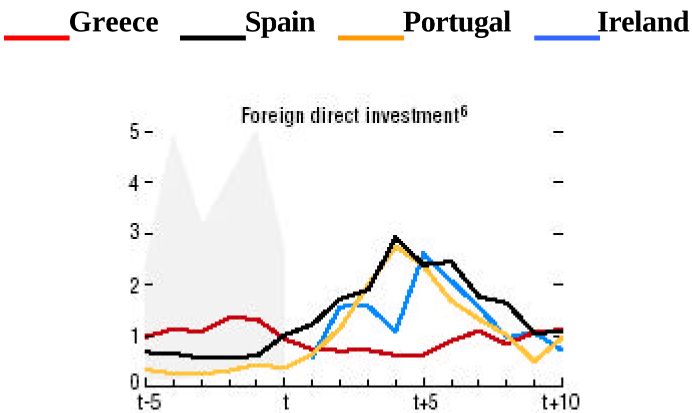
Table 2: FDI in the world, in billion of dollars

1990-94	1995	1996	1997	1998	1999	2000	2001	2002	2003
197.7	327.9	372.9	461.4	690.4	1076.6	1498.8	823	654	575

Source: IMF 2003, p. 10. For years 1990-94 an average is counted; for years 2001-03, see EIU 2004, p 9.

FDI was halved in 2001 compared to 2000, but the same move cannot be observed in the CEECs. On the contrary, FDI rose in four out of five observed CEECs in 2001 compared to 2000, and fell in just one. The total FDI in five CEECs was significantly higher in 2002 than in 2001 – again contrary to the world trend. FDI started to decline in accession countries in 2003 – with the exception of Estonia – and this was precisely due to their anticipation of EU-membership and the removal of non-allowed subsidies. It therefore seems obvious that accession rather than a worldwide decline in FDI caused a decline in FDI in transition newcomers, and this contradicts what was stated both in academic publications and the political "propaganda for happiness".

Let us now go to the second step. As earlier cases of less developed new entrants to the EU, like Greece, Ireland, Portugal and Spain, clearly show, FDI rose just temporarily due to the accession, and went back to the pre-accession level after some 8-10 years, so that accession did not matter in the long run. In Greece FDI even halved when the country became an EU-member in 1981. On the vertical axis in the next figure FDI is represented as a percentage of the GDP, while on the horizontal axis is represented the time of accession (t), with periods of 5 years prior (t-5) and 5 and 10 years after accession (t+5, t+10).



Source: **World economic outlook**, IMF 2001, ch.4, p. 150.

The above figure shows that FDI in Greece dropped, while that of Ireland, Portugal and Spain grew temporarily for some 8 years between t and t+10, and thereafter went down to pre-accession levels.[11] However, in Greece, Ireland, Portugal and Spain there was no deterioration in FDI prior to accession such as had happened in the transition newcomers mentioned earlier. Two factors explain this observation. The EU regulation was not as extensive (expensive) at the time when Ireland, Greece, Portugal and Spain acceded as it is now. Secondly, the EU policy toward the FDI-subsidies was not restrictive before, as it is now. Subsidies for

[11] Although a temporary rise cannot prove the case for higher FDI, it represents a gain for the specific economy for as long as it lasts.

FDI were used broadly two or three decades ago by the EU-members and in the 1990s they were outlawed due to the establishment of the common market.

The conclusion from both steps above is straightforward. Advance in economic freedom and the rule of law is the main factor for attracting FDI rather than accession to the EU. The reason for this is very simple. Private investors are interested in a good business environment rather than in accession that brings about more regulation, costly adjustments and more power of bureaucracy over the economy.[12]

Without larger changes in the design of economic institutions CEECs are unlikely to attract more FDI. A survey among international business people, conducted by ***The Economist Intelligence Unit***, cooled off high expectations related to FDI in CEECs. "The survey offers little support for the theory that EU enlargement will lead to a new surge of FDI inflows into the new entrants".[13] CEECs have already achieved the main benefits of integration for investment and "further positive changes to business environments associated with EU membership will be small".[14] Stagnation in the size of FDI on a world level, and increasingly tough competition from Asia in particular, are the main external factors.

[12] This is clear not just to pro-market economists but also to objective euro-optimists: "The preferential access to EU markets, coupled with the liberalization of Central and East European countries' domestic markets, has promoted changes of specialization patterns in these countries. However, national options in terms of economic policy have constrained the rhythm and intensity of those changes. Those who adopted more radical liberalizing reforms, and applied wider programs of privatization and macroeconomic stabilization have attracted higher amounts of FDI and have progressed more in economic terms." Caetano et alii, 2002, p. 5.

[13] EIU 2004, p. 14.

[14] EIU 2004, p. 13.

2. Bridging the GDP gap

Considerations relating to what is going to happen with the GDP gap of acceding countries from CEE are also divided in two steps. Firstly, I will present the evidence related to GDP-development in EU newcomers from CEE. Secondly, I will consider what happened with the GDP gap in Greece, Ireland, Portugal and Spain when these countries became the EU members.

GDP fell sharply in transition countries during 1991-3, due to costly market reforms, and 1994 was the first year of GDP growth in a majority of the eight acceding transition countries. Post-reform recession in the Baltic countries lasted until 1993-4, since they entered transition later on. Taking into account the period 1994-2003, the champions of growth are Latvia, Poland, Slovakia and Estonia, followed by Slovenia and Hungary, with Lithuania and the Czech Republic at the end.

Table 3: GDP growth in transition newcomers to the EU, in %.

Country	Czech R.	Estonia	Lithuania	Latvia	Poland	Hungary	Slovakia	Slovenia	Average
1991	-	-7.9	-5.7	-11.1	-7.0	-11.9	-	-	-8.72
1992	-	-21.6	-21.3	-35.2	2.6	-3.1	-	-	-16.24
1993	0.1	-8.2	-16.2	-14.9	4.3	-0.6	-3.7	2.8	-4.55
1994	2.2	-1.8	-9.8	0.6	5.2	2.9	4.9	5.3	1.19
1995	5.9	4.3	3.3	-0.8	6.8	1.5	6.5	4.9	4.05
1996	4.3	3.9	4.7	3.7	6.0	1.3	5.8	3.5	4.15
1997	-0.8	9.8	7.0	8.4	6.8	4.6	5.6	4.6	5.75
1998	-1.0	4.6	7.3	4.8	4.8	4.9	4.0	3.8	4.15
1999	0.5	-0.6	-1.8	2.8	4.1	4.2	1.3	5.2	1.96
2000	3.3	7.1	4.0	6.8	4.0	5.2	2.2	4.6	4.65
2001	3.1	5.0	6.5	7.9	1.0	3.8	3.3	2.9	4.19
2002	2.0	5.8	6.7	6.1	1.4	3.3	4.4	3.2	4.11
2003	1.7	5.0	5.8	5.5	2.9	3.0	4.0	2.2	3.76
1994-2003[1]	2.12	4.12	3.37	4.58	4.30	3.47	4.20	4.03	3.77

Source: **The World Bank files** (Internet) for years 1991-1994; **IMF World economic outlook 2003. Statistical appendix**, p. 183, for years 1995-2003. Note: 1 = average; estimates for 2003; Own calculations.

The picture of transition champions is very different if we consider the number of years for which some countries had an above average growth rate in eight CEECs after 1994. In that case, Estonia and Latvia are at the top with 7 such years each, followed by Lithuania (6), Poland (5), Slovakia (4), Hungary (3), Slovenia (2) and the Czech Republic (1). Poland had good years throughout 1995-1999, while all three Baltic countries grew faster than the CEE-8 group in 2001, 2002 and 2003. Slovakia is the only one of the remaining five countries, except for the Baltic states, that had grown above average in 2002 and 2003. This means that the Baltic states – as least those that are considered to be less developed among 8 CEE newcomers – bridged the gap faster than other transition countries and even the EU15.[15]

The growth rate of the eight EU newcomers has been significantly higher than the growth rate of EU15 or the Eurozone from 1995 onwards. With the exception of Ireland, no other EU15-country has grown faster than the eight CEE countries. This means that selected CEECs started to bridge the gap with the EU15 long before they became EU members. However, as can be seen from Table 3, growth rate in eight EU newcomers has been in decline from 2000 to the present – it was 4.65%, 4.19%, 4.11% and 3.76% in 2000, 2001, 2002 and 2003 respectively. The eight newcomers were obliged to accept costly EU-regulation progressively, well ahead of accession, and this had a deteriorating effect on economic freedom, economic activity and consequently on GDP growth. Some tentative estimates stated that these costs of adjustment might increase to up to 10-12% of a country's GDP. The topic, however, was never researched exhaustively and precisely, so that we will never find out what the real total cost of accession of the eight newcomers was. There are, however, some more or less complete estimates, and some of them are cited in this paper. Anyway, if transition newcomers continue to bridge the gap after accession, this is going to happen despite membership rather than because of membership.

In order to find out what is going to happen to the GDP gap in

[15] A country growing at 2% needs 35 years to double its GDP. Growth rate of 4% requires 17.5 years while growth rate of 7% requires 10.3 years to double GDP.

transition countries after accession, let us consider what happened with the GDP gap in less developed countries that joined the Union a long time ago – like Greece, Ireland, Portugal and Spain.[16]

Since its first enlargement in 1973, the EU bodies have stated that accession helps less developed countries to overcome backwardness, to narrow the gap and finally to catch up with more developed members. It seems that membership as such induces convergence in GDP and the standard of living. If this had happened before with less developed countries like Greece, Ireland, Portugal and Spain, this might be expected to happen to transition countries as well.[17] Table 4 summarizes evidence related to the GDP gap. Spain and Portugal narrowed the gap moderately; Ireland did the same explosively, while only Greece stagnated.

Table 4. Convergence in the EU15, selected countries and years,
(GDP *per capita*, EU15=100)

Country	1975	1985	1995	2001
Greece	62	64	66	65
Ireland	66	69	93	118
Portugal	56	57	70	69
Spain	82	74	78	84

Source: Barysch 2003, p. 5, according to the *OECD* and *Eurostat* data.

The level of the Greek GDP *per capita* compared to the EU average stagnated throughout the observed period, both before and after the country acceded to the Union. This happened despite the fact that Greece received significant subsidies from Brussels of between 2% and 5% of GDP *per annum*. When left-wing forces got rid of the dictatorship in the early 1970s, and when Greece became a democracy, the government designed policies to reward the main liberators' interest groups, which required very high state expenditures, and redistribution policies that deteriorated growth

[16] The investigation of the effects of trade creation and trade diversion is omitted, since it is related to the question whether actual EU-candidates were eventually close to the level of market protection or even above. See, Gross & Gonciarz 1996.

[17] Ireland has acceded in 1973, together with UK and Denmark, Greece joined in 1981, while Portugal and Spain joined in 1986.

and allowed only modest growth rates. By entering the EU Greece even worsened its economic policies – in exchange for costly adjustments in regulation Greece got subsidies from the EU. As a result, the country's distance in terms of GDP pc remained the same both before and after accession.[18]

Ireland has gone through two phases while being in the EU. First, it stagnated for more than a decade, again despite accession and a large volume of EU subsidies. Second, Ireland prospered after the mid-1980s and soon surpassed the EU average income. This happened due to a huge improvement in economic freedom rather than accession. As a result, after larger economic reforms were conducted in Ireland from the mid-1980s on, Ireland's GDP increased at an average rate of 5.14% from 1990 to 1995, and it increased at an average rate of 9.66% from 1996 to 2000. Empirical evidence clearly suggests that subsidies from Brussels have not been the major cause of Ireland's economic success.[19]

To sum up, all four considered cases show that membership in the EU *per se* does not mean solid growth rates and "catch up" policies. Growth rates result from liberalisation policies rather than from the EU membership. The regulation required by membership makes business transactions more costly and deteriorates growth. Without larger advances in economic freedom countries remain stagnant despite EU membership. Subsidies from Brussels cannot induce sustainable growth, if any. Governments benefit more from granting subsidies to their political supporters than by directing them to the most profitable projects. We are going to see later on that subsidies have a negative impact on a subsidised economy because they change the structure of incentives and retard growth. For now we may conclude that the expected large rise of GDP after accession was a myth in the past and that it is not likely to be very different with CEECs in the near future. Membership alone and subsidies from Brussels cannot help the eight transition countries in developing "catch-up" policies. If they have such an objective,

[18] Ironically, the fastest tempo of development Greece experienced after WW II was under the dictatorship of 1954-1974, with an average growth rate of 7%, when it conducted sound economic policies. Cf. Prokopijevic 2002, p. 17-18.

[19] Cf. Powell 2003, p. 431.

they need to introduce policies to improve economic freedom and the rule of law. EU membership is not an obstacle for such policies *per se*, as the cases of more liberal EU members show, like the UK, Ireland or Luxembourg. Provided governments are committed to reform and ready to pay for its cost, advances in economic freedom and the rule of law are possible. It is questionable, however, whether governments may resist rent-seeking policies strengthened by a flow of Brussels' subsidies that change the structure of incentives.

3. Subsidies to offset accession costs

In contrast to apparent disadvantages for transition newcomers resulting from the accession, which are kept far away from publicity, transfers from the EU to newcomers are highly publicised. They are the basic element of the "propaganda for happiness" that is systematically conducted from Brussels. Let us for now accept official EU propaganda that subsidies are useful. Transfers are limited to 4% of countries' GDP, and it is said that newcomers will profit more from the EU single market. However, newcomers profited from the common market long before they acceded, after they had contracted "Europe agreements" in the 1990s, which allowed free trade between them and EU15.

What is worrying about the subsidy of up to 4% of GDP, is that it is highly unlikely that the newcomers will get it, since the CEE countries by entering the EU will contribute 1.20% of their GDP to the EU budget, which reduces the net subsidy from 4% to 2.80% of their respective GDP. It is also questionable what proportion of the 2.80% subsidy the new entrants will get, especially in the first years after accession, since their "absorption capacity" is low, according to the EU bodies, due to poorly prepared institutions for that operation. But even if newcomers get subsidies of up to 2.80%, this is bad news for their economies due to a number of adverse effects.

By entering the EU, firms from the newcomers undergo quotas intended to reduce the production of some goods and services, which causes a net loss to the newcomers' economies. Quotas do restrain firms in some areas (agriculture, textile, steel, fishery) from entering the EU market, and these restrictions are negotiated before accession. For example, Poland and the Czech Republic are to reduce steel production for 1.2 m/t and 0.6 m/t respectively in the period 1996-2007.[20] Similar restrictions hold for other members. The EU Commission will monitor the implementation of reduction. Actually, wherever subsidies exist, overproduction is encouraged, and restraints like quotas are needed. During negotiations, Slovakia asked to produce 1.2bn litres of subsidised milk, but the EU set the limit at 950m litres per year. Slovakia wished to raise 400,000 sheep, but the EU set the limit at 218,000. According to the Hungarian political party Fidesz, Hungarian agriculture alone may lose up to $ 6bn over the next ten years due to trade restraints.[21] Accession related trade restrictions will have especially bad effects on the economically most liberal transition country. "Estonia will have to erect a vast wall of common external tariffs against non-EU countries, starting this year [2000], jumping from last year's baseline of zero to a total of 10,794 different tariffs. This will result in serious distortions, and will particularly increase the cost of food. […] [Also,] upon accession Estonia will have to introduce a panoply of EU non-tariff barriers (e.g., subsidies, quotas, and antidumping duties) that will divert imports from low cost locations outside the EU to high cost locations within it. In particular, imports of coal and steel will become more expensive."[22] Before starting accession adjustment, Estonia had a 0% customs rate and no non-tariff barriers. In addition, and contrary to other CEECs facing an annual financial burden of 2-3% for meeting environmental regulations, Estonia's environmental costs are estimated to be of the order of 4 to 5 percent of GDP.[23]

Probably the most damaging effect of accession consists in imposing very tight regulation on incoming economies, which is unnecessary and is merely intended to offset their comparative advantage, basically consisting of a cheaper labour force, less regulation, and lower taxes. The most costly are the regulations

[20] Cf. Perlitz 2003, p. 13, 14. Poland will have to reduce the number of employees in the steel sector from 23,000 to 16,000 from 1996 to 2007. Ibid, p. 13-14.

[21] Cf. Tupy 2003, p. 11.

[22] Razeen Sally, cited according Tupy 2003, p. 15.

[23] Cf. CESifo 2004, p. 103.

related to the labour market, environmental protection, consumer protection, and administrative and judicial standards. For example, environmental regulations will have imposed a cost of up to € 120bn on the eight CEECs by 2015. This means that CEECs will have to cover environmental expenditures of around € 10bn per year, which again is equal to the annual net transfers from the EU15 to the newcomers. The cost of confronting Poland with the EU environmental standards alone is estimated at **€** 40bn over the transitional period that ends in 2015.[24] It is an amount equal to the whole Polish budget. The EU Commission estimates[25] that costs of the environmental regulation alone will consume between 2% and 3% of the CEECs' annual GDP during the 7 year transition period.

Eventual application of the European regulations to the newcomers' labour markets will cause a larger jump in labour costs, which is going to affect adversely the demand for labour. Firms are going to be affected by costly regulations and in combination with higher labour and environmental costs this will raise both start-up and operational costs and impair the countries' competitiveness. Less demand for labour will lead to larger unemployment; higher start-up and labour costs will lead to fewer new firms than would otherwise have been the case; and lower business formation will inhibit the economy, slow down growth rates, and degenerate the business environment. Lower competitiveness will reduce market return and continue to have a negative dynamic impact on the economy.[26] This clearly contradicts bridge-the-gap-policies.

Bureaucrats from the EU15 worry about a flood of workers from the newcomers. The best way to keep workers at home is to

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[24] Cf. Walsh, 39.

[25] Environment, EU Commission, at the site: http://europa.eu.int/comm/enlargement/negotiations/chapters/chap22/index.html

[26] In addition, transition newcomers will be subject to economic policies over which they have no influence. For example, the CAP (Common Agricultural Policy) was defined for the period 2006-2013, before the new entrants had arrived. It is unlikely that the CAP is going to be essentially changed from what it is now, although it is well known for being ecologically harmful, economically inefficient and legally unjust, since it favours the largest farms.

allow them to get a good job in their home country. However, costly regulation that is going to be imposed on the newcomers will not just reduce the number of jobs available; by slowing down economic growth it will also keep workers from the newcomers relatively poor for longer than necessary, and thus increase worker flight to higher-wage countries. As it is well known, doors to higher-wage countries for workers from newcomers will be closed for 7 years, so that newcomers will have to bear the cost of higher unemployment.[27] Ex East Germany provides a very good example of what happens when a country gets high salaries and unnecessary but costly labour and other regulation. In 2004, despite a transfer of € 1.2 trillion from West Germany following reunification of the country, the unemployment rate in the Eastern part was more than twice as high as it was in the Western part. Something similar awaits the CEE newcomers if they accept business regulation at the French-German level.

In exchange for losing comparative advantages through regulation and quotas, the newcomers will get subsidies of up to 2.80% of GDP, which are unlikely to offset their losses, and which are going to change their economic environment over time, by providing incentives for more subsidies[28], regulation, rent seeking and arbitration over economy. This will result in lower competitiveness and productivity, and in a decline of risk-taking and innovation, the driving forces of modern economies. If a firm can earn more income from Brussels than from the market, it will invest less in becoming more efficient (competitive) and it will prefer to invest in lobbying and bribing bureaucrats controlling and distributing EU money.

[27] Unemployment rates in CEECs were on average during the period 2002-2004 between 5.8% in Slovenia and Hungary, and 16.5% and 20% in Slovakia and Poland respectively. Cf. CESifo 2004, p. 104. Unemployment figures are likely to rise in CEECs, not just because of more expensive regulation. The agricultural sector in CEECs employs 7-25% of the total working force. Since this sector will shrink to the 3-5% EU-level in the next years, surplus labour will join those who are already unemployed.

[28] Incentives undergo changes for all actors in a society – citizens, politicians, bureaucrats, firms, NGO, non-market funds, national and international organisations, interest groups, business associations, unions.

Both managers (owners) and bureaucrats will be engaged in non-productive activity. Subsidies from Brussels will decrease incentives of the government to conduct reforms. National and international bureaucrats will spend other peoples' money and both are well known for being ignorant as to where to invest.[29] Otherwise, they would be rich by being successful entrepreneurs and would not be bureaucrats at all.

The use of subsidies requires regulation (tariff, non-tariff barriers, export subsidy, protective price, etc.), which suspends market forces by implementing restrictions, prohibitions, non-necessary procedures, bureaucratic arbitration, government policies. This hinders whole sectors from developing and raises the cost of business operation.[30] It requires a larger increase of bureaucrats on all levels – from municipality to Brussels. An enlarged echelon of clerks will require further enlargement in monitoring, auditing, anti-fraud and similar agencies. Instead of doing something productive, all these people will live at the expense of taxpayers. Due to the "democratic deficit", the bureaucratic echelon will develop into an uncontrollable money extracting machine. But instead of being controlled, Eurocrats plan to hire 5,161 new bureaucrats in the CEE to monitor the newcomers' compliance with the *acquis*. Instead of being controlled more vigorously, bureaucrats will extend their own control over the economy and the electorate.

Predictably, corruption prospers in such an environment. The larger role of bureaucrats in economic life goes hand in hand with corruption opportunities. "A senior partner at *Ernst and Young* calculated that around five per cent of the Commission's budget – or almost £ 4 billion – goes missing every year, but even this may well underestimate the scale of the problem".[31] Having this in

[29] Cf. Stanchev et alii, 2004.

[30] Firms and whole sectors can misinvest in order to capture subsidies and this misallocation will be covered by taxpayers. The harm is doubled; first there is misallocation, and secondly, there is the prize (subsidy) for that. Employees will be engaged in lobbying, strikes, threat of strikes, cheating and bribes instead of in productive efforts leading to innovation, efficiency and growth.

[31] Cf. Blundell & Frost, 2004, p. 27.

mind, anti-corruption policies and measures should be well designed and tight. However, this is not the case. Cases of corruption involving EU bodies are unlikely to be investigated, publicised and prosecuted, since the investigation is impossible without the authorities in member states, and member states are short of incentives to conduct such an investigation. If they discover corruption and find offenders, they have to compensate damage to the EU funds and to punish the perpetrators. By doing so, member states will cause losses and trouble to themselves. First, by imposing fines over themselves, their budget will face a financial loss. Secondly, it is not easy to punish influential bureaucrats and at the same time avoid political clashes and unrest in the bureaucratic echelon. Thirdly, by fighting corruption, some interest groups will face losses and will not accept that without counteraction. Bearing all this in mind it is clear why Eurocracy keeps a low profile on corruption, and why some occurrences come to light only when things go too far, as happened in March 1999 with the resignation of Santer's Commission.[32]

As was already pointed out, subsidies are highly publicised, while the costs of subsidies and negotiations on imposing trade restrictions and regulations are not. The truth is that subsidies from Brussels are just a fraction of what the newcomers will lose due to regulation and quotas. Although total transfers from the EU15 to the ten newcomers exceed € 40bn for years 2004-2006, the net transfer per year over the same period is likely to be € 10-12bn.[33] As we have seen, environmental costs alone offset the amount of net transfers – not to mention other costs. But even if subsidies were larger, this would not offset the losses, since this money would flow from bureaucrats rather than from markets, making economies even more dependent on bureaucrats than on markets in the next round, and changing the structure of incentives in the economy. Bureaucrats spend money according to political objectives rather than according to economic efficiency, which again encourages corruption, stealing, unfair auctions and other forms of funds' misuse.

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[32] According to the official explanation, the Commission had lost control over EU funds. The investigation found more than € 3bn "misused" money.

[33] Cf. Walsh, 31.

All this playing with subsidies – unfriendly to market forces – might be tolerated provided there was some point in it. However, this is not the case. Greece has championed in subsidies from Brussels in *per capita* terms during the past two decades, but despite this it has remained the poorest EU15 country. Ireland, its poor companion some two decades ago, contrary to Greece, has relied on market reforms rather than on subsidies. As a result, Ireland is today the second richest country in the EU25, just behind Luxembourg. When the EU started disbursing aid through structural and cohesion funds, 44% of the EU population lived in regions that qualified for it. By 1997 that percentage increased to nearly 52%, which shows that the program not only failed to promote growth but spread stagnation and decline even beyond targeted regions.[34] Subsidies may be beneficial for politicians and users, but they are economically inefficient, damaging, or both. If so, CEECs are going to be punished twice for accession: first, by obtaining quotas and expensive regulation; secondly, by receiving subsidies which will worsen the situation.

4. Unintended consequences

The enlargement from 2004 onwards was designed similarly to previous ones, in a manner of social engineering: in order to provide a new market for the EU15 and to prevent costly changes in expensive EU15 regulation, new entrants will be allowed to join in exchange for accepting the existing rules of the game. This means that new members have to accept costly regulation, which reduces their competitiveness, and in exchange they will get subsidies to offset their adjustment costs. The amount of subsidies for the EU new members of 2004 was not generous compared to those made during previous enlargements when compensation moved around the level of 2-5% of the GDP of new members. New members were also promised that they would get larger FDI, speeded up growth rates, and would bridge the gap with the rest of the Union. Since this is unlikely to happen as we have seen in previous enlargements, it may be that for the economically most successful transition countries – those having well designed

[34] Cf. Tupy 2003, p. 17-18.

economic rules – it would be better to stay outside the Union.[35] Instead of entering the EU and a nightmare of bureaucratic supra-national regulation and arbitration over the economy, it would be better to stay outside and continue to improve economic freedom and the rule of law – i.e. all those things that contribute to individual freedom and welfare.

Conditions for this already existed, since Estonia [36] was already more free in an economic sense than nearly any of the EU15 countries, while Latvia, Lithuania and the Czech Republic were on average equally free as the EU15 average country (see Table 5). These countries have improved economic freedom more in 12 years than the average EU country had for decades. Even some rare authors, whose works are to be found on the EU-official web site, now recognize this. "In some cases, the accession states demonstrate a greater adherence to liberal economies than established EU members."[37] Had the CEECs opted out of the EU, the neighbourhood of reform-fatigued, over-regulated and passive giants, like the EU, would even have facilitated and speeded up the economic success of the economically open CEECs. This strategy might have induced Brussels' bureaucracy to reconsider its policy and to shift to diversity, liberalisation and competition. If the Wonderland had then changed in a positive way, Alice might have considered joining one day, if that was going to be profitable for her. The "first best" option – to stay outside the EU and improve economic freedom and the rule of law – has however been abandoned through accession for at least a period of time. The "second best" option – to fight for economic freedom and the rule of law inside the Union – is still available, but in no way guaranteed.

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[35] "… for the EU and for the new member states, enlargement is a poor deal". Walsh 2003, p. 7. Tupy (2003) agrees with this conclusion.

[36] Estonia is ranked just after Luxembourg and Ireland according to the Heritage foundation in 2004, and after UK, Ireland and Luxembourg according to the ranking by the Fraser institute in 2002. See Table 5 in the text.

[37] Walsh, 40.

Table 5: Economic freedom in the EU25 in 2001, 2002 and 2004

		HF Index[1]		**FI Index**[2]		**FI Index**		**(HF + FI)/2**	
Rank	**Country**	**2004**	**Rank**	**Country**	**2001**	**2002**	**Rank**[3]	**Country**	**Index**
4	Luxemb.	8.23	5	UK	8.2	8.2	1	UK	8.11
5	Ireland	8.14	8	Ireland	8.0	7.8	2	Luxemb.	8.01
6	Estonia	8.10	10	Holland	7.8	7.7	3	Ireland	7.98
7	UK	8.02	11	Finland	7.7	7.7	4	Denmark	7.80
8	Denmark	8.00	12	Luxemb.	7.7	7.8	5	Estonia	7.80
12	Sweden	7.75	13	Austria	7.6	7.5	6	Finland	7.66
14	Cyprus	7.62	14	Denmark	7.6	7.6	7	Holland	7.55
15	Finland	7.62	16	Estonia	7.5	7.7	8	Sweden	7.52
18	Germany	7.43	18	Belgium	7.4	7.4	9	Austria	7.40
19	Holland	7.40	21	Germany	7.3	7.3	10	Germany	7.36
20	Austria	7.30	25	Portugal	7.2	7.2	11	Belgium	7.21
22	Belgium	7.02	32	Sweden	7.1	7.3	12	Cyprus	7.11
23	Lithuania	7.02	35	Hungary	7.0	7.3	13	Italy	6.95
26	Italy	6.90	36	Italy	7.0	7.0	14	Lithuania	6.91
27	Spain	6.73	38	Spain	7.0	7.1	15	Spain	6.91
30	Latvia	6.60	39	Czech R.	6.9	6.9	16	Portugal	6.86
31	Portugal	6.52	44	France	6.7	6.8	17	Latvia	6.80
32	Czech R.	6.52	45	Greece	6.7	6.9	18	Czech R.	6.71
35	Slovak R.	6.39	54	Latvia	6.6	7.0	19	Hungary	6.65
37	Malta	6.22	61	Malta	6.4	6.8	20	Malta	6.51
42	Hungary	6.00	69	Cyprus	6.2	6.6	21	Slovak R.	6.46
45	France	5.93	70	Lithuania	6.2	6.8	22	France	6.36
52	Slovenia	5.62	76	Slovenia	6.1	6.2	23	Greece	6.20
54	Greece	5.50	79	Poland	6.0	6.4	24	Poland	5.91
57	Poland	5.47	80	Slovak rep.	6.0	6.6	25	Slovenia	5.91
	Average	**6.96**		**Average**	**7.04**	**7.18**		**Average**	**7.07**

Source: **The 2004 index of economic freedom**, ch. *Executive summary*, p. 9-10; Gwartney, J. (Ed) (2003), p. 13-15.

Note: 1= Index of the Heritage foundation for 2004 (HF), recounted on the scale 0-10; 2 = Index of the Fraser institute on the scale 0-10 (FI); in both ratings 0 means no economic freedom while 10 means maximum of economic freedom; 3 = Ranking of the EU25-countries is based on the arithmetic mean of HF and FI indexes.

What is going to happen to the economic freedom and GDP of the eight EU-newcomers from the CEE in forthcoming years basically depends on how they are going to behave after accession. Countries that will rely on heavy regulation, rent-seeking and the heavy hand of the state will become similar to the less liberal EU15 members,[38] and as a result, they will face stagnation both in investment and GDP rates. They will even miss the "second best" option.

Although accession was not the best choice for "success stories" among CEECs, it is not the end of the world now that they have mistakenly acceded. Their position now is weaker, but the adherents of individual freedom in these countries do not need to be altogether desperate. The EU25 is rather more a diverse than a homogeneous unit, and the EU15 will undergo a larger shock caused by the accession of the ten new countries.

The diversity of the EU is going to be greater after accession of the ten countries than before. There are situations where nearly all newcomers adhere to quite different rules compared to the EU15. For example, all eight CEECs have lower corporate tax rates than the EU – on average 10%, and lower top rates for income tax of 11%.[39] The total tax burden – taxes plus social contributions – in the EU25 is highest in Sweden (50.6% of GDP), Denmark (48.9%) and Belgium (46.6%) and the lowest in Ireland (28.6%), Latvia (28.8%) and Lithuania (31.3%). The former group has an average rate of 48.7%, the later one of 29.6% while the CEECs average is 35.2%.[40] Considering such larger differences, it is important to monitor what is going to happen after accession. Are high-tax EU nations going to suppress low-tax members, say, by enforcing tax harmonisation[41] at the higher tax rates? This has

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[38] The four economically most illiberal EU15-countries, according to the Heritage foundation index in 2004 are Greece (ranked 54th with index 5.50), France (45th, 5.93), Portugal (31st, 6.52) and Spain (27th, 6.73). The same four are the most illiberal according to the HF/FI average.

[39] Cf. European Commission 2004, p. 8. The VAT rates in the EU15 ran between 15% and 25%, while the CEECs' average is 19%.

[40] Cf. European Commission 2004, p. 239. Own calculation.

[41] A first attempt to harmonize direct taxes in EU25 failed in September 2004. It has been proposed by the ECOFIN and backed up by the EU

not happened in the EU15. For example, the tax burden in Sweden was larger by 22% than that in Ireland, and there have been no large indications of tax competition. But this may happen if high tax nations offer subsidies to low tax nations in exchange for their acceptance of higher tax rates. In order for this to happen, all EU15 members would have to accept this higher expenditure; although this is unlikely for now, it can not be excluded in principle. If high tax nations for any reason succeed in imposing high taxes over low tax nations, they themselves may postpone necessary changes in their over-regulated and expensive economic systems. In this case the EU25 will resemble an even more rigid, centrally harmonised "nirvana" that misses incentives for change, innovation and competition among jurisdictions.[42]

If high tax nations do not succeed in imposing heavy regulation on the newcomers, they will be forced to change their own tax systems with high rates and excessive regulation, which is politically extremely costly, and for that reason, the high-tax nations will do everything before falling back on this option.

It seems obvious that the EU after its "historical enlargement" is going to be much more diverse than ever before. This means, that this enlargement may have some unintended consequences. Instead of being a large homogenous and harmonised bloc, the EU may become divided into groups of comparatively diverse countries, which tend to move at two or more different speeds. Continued political integration and harmonization may appear to be impossible tasks in the light of greater diversity among country members. Instead of leading to a stronger and politically more integrated Union, the fifth enlargement may provoke a halt or even a set back to integration as conducted up to now. Enlarged diversity might lead to stalled political integration and a division of countries into several clubs rather than to a further push towards unification and closer political integration. But this is good news. By siding with more liberal "old members" of the Union, liberal newcomers may be a decisive factor in preventing a dangerous political integration and over-regulation and so inspire a comeback

Commission.

[42] Cf. Colombatto, 2000.

to the liberal economic dimension of the Union. It is surprising that a dirigiste, socialist design, due to unintended consequences, may lead to a liberal outcome, but this is not unlikely to happen. In behaving this way liberal newcomers will face some "aggravated circumstances". One would be their weaker internal position, due to a changed structure of incentives in their internal policies and economies. The other may be pressure from the EU institutions and some larger countries from the Union, who may share other plans and objectives. Nevertheless, Alice's battle is not lost either way.

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LOCKING IN HIGH TAX RATES

Richard Teather[*]

EU taxing powers – the claims

> *"The Government believes that the right of Member States to determine their own tax policies is a fundamental one. Tax matters are a key component of national sovereignty and vital to the social and economic wellbeing of the country."*
>
> ***UK Government, September 2003***[1]
>
> *"issues like tax, defence and foreign policy remain the province of the nation State"*
>
> ***Tony Blair, September 2003***[2]

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[1] "A Constitutional Treaty for the EU", para. 76, Foreign & Commonwealth Office White Paper, Cm5934, September 2003.

[2] Foreword to "A Constitutional Treaty for the EU", Foreign &

> *"The Government will continue to reject tax harmonisation and favour fair tax competition, recognising that in a global economy such harmonisation would impede economic growth, and not promote it."*
>
> ***UK Government, April 2004***[3]

The reality – EU-imposed taxes

Taxes are already harmonised and imposed at the EU level. The Commission's current tax harmonising activities are in general business taxation and the taxation of individuals' savings, but the process began many years ago with indirect taxes, particularly VAT where the tax system is controlled by the EU. It is compulsory for all EU Member States to adopt VAT, in the form and under the rules prescribed[4], and charge it on all sales except those that the EU permits to be exempt.

Two arguments are used to claim that this does not amount to an EU-imposed tax, or remove the national parliaments' power over tax. The first is that although the system of VAT is imposed by the EU, the rates are not, and so the decision to charge tax, and how much, is therefore still the prerogative of national parliaments. The second argument is that EU decisions on tax still require unanimity, and therefore an EU decision to tax is in fact a decision by each national government. Indeed the UK government, in its commentary on the constitutional treaty negotiations, cited this requirement for unanimity as proof that it has successfully resisted tax harmonisation:

Commonwealth Office White Paper, Cm5934, September 2003.

[3] "Prospects for the EU in 2004", para 36, Foreign & Commonwealth Office White Paper, Cm6174, April 2004.

[4] Currently the "6th Directive on the harmonisation of the laws of member states relating to turnover taxes", Dir 77/388.

"The Government committed itself in the September 2003 White Paper (paragraph 76) to ensure that tax matters would continue to be decided by unanimity, in line with its manifesto commitment. This commitment has been delivered upon. The Convention's proposals that certain aspects of indirect and company taxation could be adopted by qualified majority voting have been deleted."[5]

These arguments are not valid; the first is untrue, and the second is insufficient to ensure national democratic control.

Firstly, tax rates have been imposed at the EU level; the 6th Directive on VAT sets minimum VAT rates of 15% as a standard rate and 5% as a reduced rate[6] for favoured products.[7] It is therefore unlawful for an EU Member State to reduce its VAT levels below this point, and so tax would be imposed by the EU against the wishes of a national government.[8]

This is not just a theoretical provision; it has already inflicted tax on UK taxpayers. In 1997 the UK Parliament voted to charge VAT at the full rate on domestic fuel and power[9] (it had previously enjoyed a preferential 0% rate[10]). Later in the same year it desired

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[5] Foreign & Commonwealth Office, "White Paper on the Treaty establishing a Constitution for Europe", Cm6309, September 2004.

[6] 6th Directive on the harmonisation of the laws of member states relating to turnover taxes", Dir 77/388, paragraph 12(3).

[7] In addition, the products favoured by being taxed at reduced rates must come from approved categories listed in Annex H of the Directive.

[8] Admittedly these provisions are currently temporary, being imposed for 5 years at a time.

[9] Finance Act 1997.

[10] This 'zero-rating' is partly a mechanism by which the UK government avoided the EU prohibition on exempting any products and services from VAT other than those on an approved list; technically VAT is charged, but at the rate of 0%. It is also more beneficial than exemption, in that businesses making supplies of zero-rated products are able to reclaim VAT paid on their costs, so removing all VAT from the

to restore the 0% rate, but was unable to do so because although the EU Directive permits historic lower rates of VAT to remain as a 'transitional' measure, it forbids any new products to be added to the list or for products to return to a lower rate once their rate has (however temporarily) been increased. VAT is therefore charged on domestic fuel at 5% in the UK; the lowest rate permitted under the EU Directive.[11]

Taxes are therefore imposed by the EU. Of course this minimum tax initially had to be unanimously agreed by the governments of the Member States, which is the politicians' second defence against the claims of EU taxing rights. However this defence is only valid immediately, not temporally; the initial adoption of a tax rate needs to be unanimous, and so may not involve a transfer of taxing rights from national governments to the EU, but once that agreement has been reached national parliaments are unable to change their tax rates unilaterally. The citizens of a Member State are therefore unable to reduce their tax rates below the level prescribed by the EU, even if they elect a new government for that precise purpose.

Effectively this allows governments to bind in their successors to high tax rates, by agreeing to an EU minimum tax that cannot then be lowered without unanimous agreement across all Member States. This flouts the basic democratic principle that future governments cannot be bound (except by a constitutional provision, which usually requires a super-majority or referendum), and grants powers to present governments that should rightly belong to future electorates.[12]

The EU has therefore, at least in part, gained the ability to impose taxes; Member State citizens are unable to vote for a

supply chain.

[11] Finance (No. 2) Act 1997, s6.

[12] There is a further constitutional problem, namely that EU decisions are generally made by government ministers, whereas taxes generally have to be set by parliaments.

government that can reduce their VAT levels below the EU minimum. If they did so then legal action would be taken against that country's government through the European Court of Justice, either by the Commission itself or by businesses from other states who were made less competitive by the 'unlawful' tax reduction.

The Savings Tax Directive

The EU also has new powers to impose taxes on investments as well as spending, through the Savings Tax Directive. This is the widely reported process by which the EU governments are hoping to stop their citizens from sheltering their savings in low-tax countries, to enable future tax rises without causing capital flight.

Although defeated many times, the Directive was finally passed on 24th June 2005,[13] and came into force on 1st July 2005. Under this Directive all interest payments to EU residents will be subject to a minimum tax of 15% for the first 3 years of operation of the system, then 20% (the international norm for tax deductions from bank interest) for the next 3 years, rising to a clearly punitive 35% thereafter.[14]

Alternatively Member States can opt for a system of 'automatic reporting', where the bank has to notify the amount of interest paid to the recipient's national tax authority so that they can tax it themselves. This would make it easy for the investor's home authority to impose tax, but would run against the tradition in many countries of protecting investors through client confidentiality and banking secrecy.[15]

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[13] Council (ECOFIN) decision, document 10038/05 FISC 69.

[14] The proceeds of this tax will be split, with 75% going to the Member State where the investor is resident and the remaining 25% retained by the country where the interest is paid.

[15] Reporting also acts as tax harmonisation 'by the back door', as it

The European Commission has been pushing for such a scheme for15 years, but the process was held up primarily by two members of the EU that effectively act as on-shore tax havens.

The first, Luxembourg, has for its size a massive financial services sector, fuelled by its tax exemptions for interest payments and strong banking secrecy; it is therefore unwilling to agree to anything that would risk losing any of this business. Indeed it was the loss of tax revenue to the German government through its citizens putting their money into Luxembourg banks (a process made easier by the removal of border controls in the EU, and by the introduction of the Euro) that arguably started this whole process. Austria also has banking secrecy and is involved to a lesser extent in the same sort of financial business as Luxembourg.

However the other major EU tax haven is the UK, whose massive $3 trillion Eurobond market is tax-free. Multinational groups can issue bonds, traded on the London Stock Exchange, and pay interest without any requirement to deduct withholding tax. This allows companies (mainly but not exclusively US and Japanese) to borrow money more cheaply by paying interest to investors gross, and hence again promotes productive investment and so generates employment and wealth. The existence of this market in London brings much wealth to the UK, particularly highly paid financial sector jobs, associated legal and accountancy work and rents and taxes paid by banks and traders.

The Savings Directive and the wider world

For both of these countries therefore, the Savings Tax Directive would damage their national economies; both the Luxembourg bank deposits and the London Eurobond market are attractive primarily because they are tax-free. It is true that both

makes it impossible for many taxpayers to take advantage of lower tax rates on offer in other EU states.

countries also have reasonably efficient banking and dealing sectors, but no more than many other jurisdictions; if tax had to be imposed because of the EU then there would be no particular reason for this activity to stay in either country.

This relocation risk was one of the strongest arguments used by the UK and Luxembourg. Bank deposits are clearly mobile, and although the Eurobond market seems more permanent it has moved once already (from New York) because of tax and would presumably be ready to move again. The Savings Tax Directive would therefore do only harm, not good, since if all savings within the EU were taxed then investors would simply move their money outside. The EU would therefore lose valuable financial sector business and the related income (and employment), but without collecting significantly more tax.

Indeed there is evidence that capital flight has begun; the Hong Kong Securities & Futures Commission reported that investments in collective investment schemes had soared by 56% in 2003 after years of relatively stable growth. Although the source of these inflowing funds is unknown, there is speculation that it represents European capital moving out before the Directive is implemented.

This capital market mobility is not just a theory; the London Eurobond market was initially formed in 1964 when the USA started levying tax on bond interest, and corporate borrowing (and the associated trading) was swiftly relocated to London. Market mobility is if anything even greater than it was in the 1960s, so the loss of the Eurobond markets if a withholding tax were levied would be very rapid.

In the European Union tax measures can only be imposed by unanimous agreement of all Member State governments, which means that Luxembourg and the UK could, and did, veto any moves to introduce the savings directive. However after several years of strong pressure they extracted valuable concessions and finally gave way. One of the concessions was an exemption from the new rules for existing Eurobonds; this was essential as many of them included a clause for automatic redemption if withholding taxes were ever imposed, a factor that proves the importance of the tax exemptions to market location.

One of the strongest arguments used by the UK and Luxembourg was that the Savings Tax Directive would do only harm, not good; if all savings within the EU were taxed then investors would simply move their money outside. The EU would therefore lose valuable financial sector business and the related income, but without collecting any more tax. Bank deposits are clearly mobile, and although the Eurobond market seems more permanent it has moved once already (from New York) because of tax and would presumably be ready to move again.

The agreement between the EU member governments therefore made the Savings Tax Directive conditional on its rules also being accepted by various non-EU countries, to ensure that there was no-where for these markets to move to. Specifically it must cover:

The main non-EU European tax havens:

Switzerland, Liechtenstein, San Marino, Monaco and Andorra;

'Dependent or associated territories' of EU members:

the Channel Islands, Isle of Man, the Dutch Antilles and Aruba, and the UK's dependencies in the Caribbean.

The EU has no formal jurisdiction over these countries, but they were clearly chosen because the EU felt that it could pressure them into agreeing to its demands, either due to geographic proximity or political or economic ties. The dependent territories eventually all agreed to participate, after pressure from the UK Treasury that even the UK's Foreign & Commonwealth Office regarded as excessive.

Implementation of the Savings Directive

It was widely thought that the agreement to the Savings Tax Directive by the UK and Luxembourg, and its acceptance by the smaller low-tax jurisdictions, was an irrelevance because the process was conditional on Switzerland also agreeing. The Swiss government was thought to be unlikely to ever agree to anything that might damage its international banking sector.

However the Swiss were put under intolerable pressure, particularly by Germany (which was losing the most under the old system through its citizens investing in Luxembourg banks) introducing excessive customs checks and administrative inconveniences in an attempt to practically close the Swiss border (the Spanish have been using similar tactics against Gibraltar).

Finally in June 2004 the Swiss government, after extracting other concessions from the European Union, agreed to sign up to the Directive, and in June 2005 the European Union members (in the Council of Ministers) accepted the 15 bi-lateral agreements and gave the 'green light' for the Directive to come into force, just in time for its due date of 1st July.

Those new Member States from Eastern Europe, such as Estonia, who have celebrated their escape from communism by repositioning themselves as low-tax dynamic economies, may now find their renaissance damaged through having allowed the EU to reverse this policy by imposing Europe-wide taxes.

In its current form the Directive is full of holes and should be easily avoidable; indeed the Swiss have dubbed it the "fools' tax" because only those who do not take proper advice will be harmed by it. However this depends on how it is interpreted and implemented; since the primary duty of the European Court of Justice is to advance European integration (rather than to determine the meaning of new laws), there is a real danger that future disputes on the application of the Directive will see a widening of its scope, and a reduction in the opportunities for avoidance, by the Court.

Does tax harmonisation matter?

Of course one potential answer is that this does not matter; the EU has many powers, and imposing taxes is just one other.

Historically tax *does* matter; "no taxation without representation", the need for democratic consent to a tax, is a common theme of revolt against autocratic governments, and it was a sound practical understanding of power that put control over taxes at the heart of democratic sovereignty. Now that taxes can be imposed at the EU level, against the will of future democratically elected national governments,[16] then sovereignty has been transferred. This may be supported or opposed, but we should no longer pretend that it has not happened.

The imposition of minimum taxes at the EU level also raises wider issues. The minimum tax rates are part of a move towards tax harmonisation, the equalisation (or approximation) of tax rates across the EU. The motive for this is to reduce *tax competition*, the ability of national governments to improve their economies by reducing their tax rates and so attracting business activity and investment.

This tax competition has been a great benefit. The increase of the global market, especially the moves towards free capital markets following the ending of wartime exchange controls in the 1980s, enabled investors to take advantage of lower tax rates around the world, and the fear of capital flight forced governments to reduce their punitive tax rates. This benefit has been acknowledged by the OECD:

"The more open and competitive environment of the last decades has had many positive effects on tax systems, including the reduction of tax rates and broadening of tax bases which have characterized tax reforms over the last 15 years. In part these developments can be seen as a result of competitive forces that have encouraged countries to make their tax systems more attractive to investors. In addition to lowering overall tax rates, a competitive environment can promote greater efficiency in government expenditure programs."[17]

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[16] Albeit accepted by an *earlier* national government.

[17] "The OECD's Project on Harmful Tax Practices: The 2001 Progress Report", OECD, Paris (2001) paragraph 1.

Tax competition therefore acts as a restraint on individual governments' ability to raise taxes; politicians still face demands from their electorates for improved public services, but if these cannot be met through increased taxation they are forced to make the public sector more efficient and better directed. Tax competition therefore increases public welfare, by reducing waste and inefficiencies and allowing public goods to be provided at a lower cost. Indeed international tax competition is essential because, unlike other sectors of the economy, there are few other effective constraints on government inefficiencies.[18]

There are other knock-on benefits of tax competition; by acting as a restraint on governments' ability to raise taxes, and so keeping taxes lower than they would otherwise be, tax competition promotes capital investment and encourages business activity. The effect of taxes on economic growth is difficult to quantify, but long-term comparative studies have suggested that each 1% of GDP taken in tax reduces growth rates by between 0.2% and 0.4%.[19] This may not sound like much, but that is an annual loss; over 25 years the cumulative effect of a tax reduction of just 3% of GDP would be a national economy around 30% larger than it would otherwise have been, with a resultant increase in employment and wages.

Studies in tax harmonisation[20]

Numerous academic studies have been made into the harm or

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[18] See Teather, R., "Multinational Tax Competition – a legal and economic perspective", paper presented at the Tax Research Network conference, Cambridge University, September 2002.

[19] For a summary of recent studies, see "The negative impact of taxation on economic growth", Leach, Reform (London), September 2003.

[20] See Teather, R., "Harmful tax competition?", Economic Affairs, London, December 2002.

otherwise of tax competition, many of them focused on federal structures, real or imaginary, and so appropriate to the EU situation. However, although most of these studies concluded that tax competition is harmful, they are generally coloured by their underlying assumptions and are challenged by more recent work.

A few of the assumptions of these studies are so bizarre that, although often needed to simplify the mathematics enough to make the equations solvable, they risk invalidating the entire study. One for example assumes that the number of active entrepreneurs in the economy is a constant,[21] despite the wide debate on the effect of taxation policies on the number of business start-ups. Many make the similar, often unstated, assumption that the amount of investment capital available is similarly invariable, despite the evidence that the availability of lower tax rates increases savings and therefore capital and the fact that one of the purposes of tax havens is to increase the available capital by allowing it to be pooled from a variety of countries without imposing an additional layer of tax.[22] In the EU situation this assumption causes even more problems; although the EU may occasionally act as if there is no world outside its borders, it is in reality part of a global economy and therefore its tax policies can cause capital flight out to the rest of the world.

Largely the studies result in the conclusion that tax competition is inefficient,[23] distortionary, inequitable or generally welfare minimising,[24] as it leads to reduced revenues for

[21] Boadway, Cuff & Marceau, "Inter-Jurisdictional Competition for Firms: Jobs as vehicles for Redistribution", University of Quebec, 1999.

[22] For evidence on this point see the UK parliament's Treasury Select Committee's Examination of Witnesses, Hansard, 2nd May 1999.

[23] See for example "Corporate Income Tax Competition, Double Taxation Treaties and Foreign Direct Investment", Janeba, Journal of Public Economics, 1995.

[24] For a comprehensive over-view, see "Capital income taxation in Europe: trends and trade-offs", Gorter & Mooij, Netherlands Bureau for Economic Policy Analysis.

governments and therefore reduced welfare spending. However this is based on the questionable assumption that government revenues automatically result in public welfare. This means that these studies all share a fundamental (sometimes even unspoken) assumption of the efficiency of government spending. Their authors believe that "levels of taxation and public goods provision within jurisdictions are settled by majority voting",[25] and taxation is transformed into the provision of public goods without loss or waste.

Recently a few writers have challenged this assumption, concluding that the effect of tax competition on public welfare is "ambiguous"[26] because a proportion of the benefits of taxation are lost through "waste and inefficiencies in the public sector",[27] but their work is generally dismissed due to lack of quantifiablity.[28] In contrast Public Choice theory, the analysis of government action by subjecting it to the same processes as we would the actions of private persons, opposes the view of taxation as necessarily beneficial[29] and points out that governments are composed of and operated not by machines but by individuals, whose livelihoods and influence are generally dependent on the increase in government power and activity; governments are therefore run by people who have a vested interest in the increase of government.

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[25] "Tiebout with Politics: Capital Tax Competition and Constitutional Choices", Perroni (University of Warwick) & Scharf (Institute for Fiscal Studies), 1996.

[26] "Capital Tax Competition with Inefficient Government Spending", Eggert, Centre of Finance and Econometrics discussion paper, Konstanz University, 1999. Keen has also written in a similar vein.

[27] "Do We Need Tax Harmonisation in the EU?", Boss, Kiel Institute of World Economics working papers, 1999.

[28] See Gorter & Mooij (above), pg 58.

[29] Buchanan is the main exponent of Public Choice theory; it is therefore unsurprising that he was one of the signatories of a letter to President Bush opposing the OECD tax harmonisation initiative.

In fact there is no causal link between increased taxation and increased public welfare.[30] The inefficient conversion of government inputs (taxation) to outputs (valued public services) is caused not only by pure inefficiencies (such as over-manning and under-use of capital resources) but also by diversion (spending on outputs that are not sufficiently valued by the public).

Modern governments tend to have their own bureaucratic growth that politicians can rarely tackle in more than a few isolated areas,[31] and in a supranational system such as the EU this process is potentially even stronger, as the increased distance between the electorate and the government weakens the democratic controls and increases the opportunities for waste and self-enrichment.[32]

Tax competition is therefore beneficial in checking the trend of bureaucracies to open-ended growth, and forcing efficiency savings. However a process that is beneficial to citizens it is not necessarily one that is attractive to governments. European politicians are currently feeling trapped by electorates who are unwilling to pay any more tax[33] but want better public services for what they do pay, but faced with the choice of making their activities more efficient or increasing taxes, most governments would find it much easier to raise tax. Of course high taxes on savings income damages investment, reduces economic activity and jobs and ultimately makes the whole country poorer, but it is

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[30] Public welfare in this case must be defined as the value citizens receive from government activities, not the cost of such provision; a valuation of outputs rather than a summation of input costs.

[31] “It takes a very strong Secretary of State to resist recommendations from civil servants even though these are often quite narrowly founded”, Alan Clark (former UK government minister), quoted in his “Diaries”, Weidenfeld & Nicolson, London (1993) (see paperback edition, Phoenix (1994) p 74-75).

[32] See “The Theory of Public Choice: Federalism”, Tullock, 2000.

[33] In the UK for example, government advisers now believe that tax levels above 43% of GDP (only just above the current levels) will seriously damage their electoral prospects.

still a very tempting short-term target.

Conclusions

As a matter of law and constitutional principle, the EU has already taken tax raising powers, and can impose taxes against the will of a democratically elected national parliament through lasting minimum tax rates.

These powers are not just theoretical, but have been exercised; EU—imposed taxes have long been the norm for VAT, and (since 1st July 2005) they now also cover investment income.

This is not just a constitutional or political argument, but a practical and economic one. Imposing taxes in the EU can cause capital flight to non-EU countries,[34] reducing investment in Europe.

Furthermore competition between countries for investment has kept taxes lower than they would otherwise have been; harmonisation or minimum tax levels across the EU would stifle this competition and allow governments more freedom to raise tax levels. This would tend to lower investment and damage the economy, with consequent damage to jobs and wages.

Future generations, and the new EU entrants, could see themselves bound in to the higher tax rates needed to fund the welfare states and pension obligations of Old Europe; their prosperity would be better served by a more flexible approach.

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[34] Although the EU is hoping to minimise this effect by having forced other countries to sign up to its proposals, this is not an exhaustive process and there will still be many countries outside the scheme.

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THE CONSTITUTIONAL VALUE OF POLITICS. ESSAY IN HONOUR OF ANTHONY DE JASAY

Hardy Bouillon*

It is a real delight to celebrate one of the greatest social philosophers of our time in this journal. In fact, I do not hesitate to confess that to me he is not one but *the* greatest social philosopher of our time. On a personal note, I would add that not only is he a man of admirable good manners, which these days one hardly finds accumulated in a single person; Anthony de Jasay is also a noble and gentle man of the old school who lives what he preaches. He likes himself and others to keep an agreement, and he dislikes himself and others to breach it.

He is a most precise thinker, *and* a most precise reader. I remember one of his comments on a passage that contained a sloppy use of the word "naturally". In fact, in the sentence in which I wrote it, it was nothing but unnecessary verbiage, even worse, it was misleading. All this he revealed without compromising me by simply writing in the margin "why 'naturally'?"

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It is the way he puts it, which in itself calls for admiration. This applies to his own and most original system of ideas as well as to his manifold criticisms of competing intellectual frameworks. His criticism is always sharp, often amusing, but never invidious. Take, for instance, sentences like the following one. Alluding to constitutions, he wrote: “It should come as no surprise to students of human nature and the history of thought that some ideas are credited with a significance rather out of proportion with their intrinsic content.”[1] And with respect to politics, he states: “The intrinsically dangerous, naked-razor nature of politics arises, not from politicians being cynical and bureaucrats incompetent, though it surely does not help if they are.”[2] Finally, referring to Locke’s famous provisos of the original appropriation of land, namely ‘mix of labour’ with the land and leaving for late-comers ‘enough and as good’, he bluntly, but also elegantly, says: “The latter proviso can be dismissed as one that is impossible to fulfil except in fanciful conditions of abundance, where property rights are irrelevant in any case, so it does not matter how valid they are.”[3]

Even the titles of his papers are telling. Take ‘Justice as something else’, ‘The cart before the horse’, ‘The rule of forces, the force of rules’, ‘The twistable is not testable’. The list could be much longer, and behind these titles, the most valuable criticisms on contributions to political philosophy by Brian Barry, John Gray, James Buchanan, and Karl Popper are to be found.

His standing would not be the one it is, if in his writings the *pars destruens* were not matched by the *pars construens*. In other words, the criticism by Anthony de Jasay generates its strength from the ingenuity of his approach to social philosophy. His system of ideas is unique. He is a libertarian in a class of his own.

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[1] “The concept of rule-bound collective choice and the idea of constitutional safeguards”, in: *Do Ideas Matter? Essays in Honour of Gerard Radnitzky*, ed. by Hardy Bouillon, Brussels: CNE 2001, p. 55.

[2] See his *Choice, Contract, Consent: A Restatement of Liberalism*, London; IEA 1991. p. 114.

[3] See his *Choice, Contract, Consent: A Restatement of Liberalism*, London; IEA 1991. p. 72.

If it were not misleading, I would call his position *individualistic contractarianism*. I doubt that he would be happy with this branding. His criticism of contractarianism, especially that of Buchanan, added a flavour to the term which remains true even in another intellectual ambience. Therefore, I fear that perhaps he would disdain the term *individualistic contractarianism*. Whether the political philosophy (potentially) resting on this principle should be called individualistic contractarianism or not is anyway another matter.[4]

Rights stem from contracts

Out of the many insights we owe to Anthony de Jasay, I shall stress the following one, because it leads straight to the main question of this short essay, namely: What is the constitutional value of politics?[5]

Rights do not fall from the sky, they are not self-evident nor in any way logically deducible from natural or social facts of life. They may exist, but they provide no innate proof of the alleged unanimous consent of the parties involved. Jasay's rights theory avoids this calamity. His position could be described by the slogan: Contracts breed rights, not the other way round.

It is exactly this starting point that allows us to say what constitutes rights. To Jasay, "contract is their obvious, self-evident source, because only contracts provide proof that the correlative

[4] I do not know if Anthony de Jasay uses any token for his position. Though in his *Choice, Contract, Consent* he clearly speaks in favour of "strict liberalism", I wonder whether he would label his position this way. Strict liberalism may be a perfect name for the preferred outcome of an intellectual enterprise such as his, but it seems less appropriate to describe comprehensively the intellectual approach that gives birth to it.

[5] Of course, it would be tempting to dwell on more, for instance the insight that public goods do *not* derive from a prisoner's dilemma.

obligation has been *agreed to* by the obligor, hence its existence does not depend on controversial claims."[6]

Jasay does not exclude other potential sources of rights. "There is one clear case where the obligor can be placed under an unrequited obligation without unjustly harming his interests: when the obligation in question does not deprive him of any liberty, nor of any right, that *he would otherwise have had*. The obligation to respect the property of another acquired by 'finders keepers' would be of this kind; the wider obligation to respect the *status quo* can be derived along the same lines (…)"[7] Nevertheless, he does not conclude that to respect the property of another acquired by 'finders keepers' or any other unrequited obligation which does not unjustly harm a person's interests is an obligation to which a corresponding right exists that is of the nature of a contractual right.

Thus, we arrive at a generating dilemma. There are contractual rights and, *per impossibile*, non-contractual rights. Non-contractual rights consist of two classes, one which deprives the obligor of any liberty or any right, and one which does not. Hence, the latter is not a tertium quid amongst contractual and non-contractual rights, but a subsection of the latter. Even to representatives of this class Jasay's observance applies, that they "have a status that is, to put it as soberly as one can, not comparable to the status of contractual obligations."[8] It is exactly this difference to which I will return later when answering the question of which value is constitutional to politics.[9]

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[6] See his *Choice, Contract, Consent: A Restatement of Liberalism*, London; IEA 1991. p. 91.

[7] See his *Choice, Contract, Consent: A Restatement of Liberalism*, London; IEA 1991. p. 92.

[8] See his *Choice, Contract, Consent: A Restatement of Liberalism*, London; IEA 1991. p. 93.

[9] One remarkable aspect of Jasay's position is, however, that it includes a strong criticism of the widely spread natural rights approach in libertarianism. As I have tried to show elsewhere, it is the idea of natural rights that – besides apriorism, the argumentum e contrario and a logical

Freedom, rights, and liberties

It goes without saying that rights deriving from contracts are only worth the paper on which they are written if the contracts are voluntarily agreed upon by all parties included. Forced contracts are based on non-contractual obligations and thus establish no rights. Obviously, freedom is a necessary cornerstone in Jasay's thinking. If I am not mistaken, he does not explicitly define freedom[10], though he stresses, of course, that freedom includes the absence of coercion in a person's set of feasible acts. The point he is making about coercion is the following:

"Coercion is an intentional act by A, whether actual or threatened, whose effect is to change B's set of feasible alternatives as to make his chosen alternative different from what A presumed B's preferred alternative to be. Successful coercion must make B act otherwise than A thought that he had intended to act. It achieves this by intrusion into B's feasible set. Successful

circle in the definition of freedom – is hardest to accept in the libertarianism of Murray Rothbard and Hans-Hermann Hoppe et al; see my „Libertärer Anarchismus - eine kritische Würdigung", in: *Aufklärung und Kritik Sondernummer*, 1998, pp. 28-40. By the way, the natural rights approach in Rothbard seems to me to be purely a functional one, as so many formulations imply. For example: "Since each individual must think, learn, value, and choose his or her ends and means in order to survive and flourish, the right to self-ownership gives man the right to perform these activities without being hampered and restricted by coercive molestations." Murray Rothbard, *For a New Liberty, the Libertarian Manifesto*, New York 1973, p.9.

[10] I pondered on that question in a separate book, titled *Freiheit, Liberalismus und Wohlfahrtsstaat*, Baden-Baden: Nomos 1996, pp. 79-128. As a result of that long pondering process, I ended up with a definition whose gradual evolution cannot be appropriately reconstructed here. For a short version see my „Defining libertarian liberty", in: Hardy Bouillon (Hg.), *Libertarians and Liberalism. Essays in Honour of Gerard Radnitzky*, Avebury, pp. 95-103.

coercion alters the cost of alternatives so as to make B choose as A wishes, and not as A thought B wished."[11]

A point about this definition is that it does not lose its applicability if one replaces the term *coercion* either by *trade* or *seduction*. Be this as it may, I think the most important aspect of Jasay's analysis of freedom is that man's liberties are faculties "that we suppose to exist until proof is brought to the contrary."[12] If I understand his reasoning correctly, he basically makes an epistemological argument. Unless there is proof to the contrary, a person is free to do what is feasible for him/her. Liberties do not need to prove their existence, but their denial does, because it is epistemologically and practically impossible to exclude the existence of any possible legitimate objection to the liberty in question, whereas it is relatively easy to request from the person denying to provide one case that supports his position.[13]

I think this argument is a valid one.[14] However, saying that the burden of proof should be with the denier of a liberty does not prove the existence of freedom in any normative sense. Or to put it this way, saying that you do not have a right to intervene in my

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[11] See his *Before Resorting to Politics*, Cheltenham: Edgar Elgar 1996, p. 26.

[12] See his *Choice, Contract, Consent: A Restatement of Liberalism*, London; IEA 1991. p. 93.

[13] As Gerard Radnitzky has repeatedly pointed out, this is an analogous case to methodology. Scientific theories can never be proved to be true. Over a period of time they can only be corroborated by tests and corresponding test statements. The potential to be falsified one day remains. On the other hand, given that a falsifying test statement is less problematic than the theory it claims to falsify, then the theory in question is falsified. That is what (Popperian) methodology requests.

In addition to that, Jasay also stresses the analogy to jurisdiction. The culprit is innocent until proven guilty.

[14] Nevertheless, I doubt that in the debate with loose liberals this is as strong as the argument in favour of contractual rights; whatever this objection may be worth. After all, the validity of an argument remains untouched by its potential as a useful weapon in an intellectual debate.

freedom unless you prove your title, does not imply that I have a right to be free in the way I have a right to do things as the consequence of an existing contract. In other words, an action taken (only) in freedom has a different status than an action taken in accordance with an existing contractual right. Of course, an action can be taken in freedom as well as in accordance with an existing contractual right. Moving into the house one has just bought or doing the job for which one gets paid. All these actions are free and just.

In a way, freedom is similar to 'finders keepers'. The freedom of A as well as the 'finders keepers' principle place the obligor B under an unrequited obligation without unjustly harming his interest. Unfortunately both, the case of freedom and the 'finders keepers' principle, cannot be made stronger. Freedom imposes obligations on others, and the status of these obligations is not comparable to the status of contractual obligations. The corresponding rights are likewise incomparable. Though it might be difficult in practical terms, universal individual contracting would be a way to give actions taken in freedom another status.

Values, moral and political

Broadly speaking, a value represents a lifestyle category expressing a certain disposition or preference which reveals itself in certain situations via the choice taken among feasible options. Saying so already presupposes that individuals can act, i.e. choose among feasible options. Saying that an individual can act, in turn, presupposes that he/she is free with respect to the feasible options in question. In other words, freedom is a prerequisite to any action, moral or other, and any moral value revealed by a moral action.

Like all other values, a moral value reveals through the corresponding action(s) a certain outcome preference. Unlike most other values, a moral value expresses first and foremost a preference for the bettering or worsening of the status and/or the mores of the actor or any other person. That is to say, we do good primarily in order to better our lot or that of another person (or other people) and/or to better our or their doing, and also we do bad in order to worsen our lot or that of another person (or other people) and/or to worsen our or their doing. It goes without saying that both, virtues and vices, express moral preferences.

The actions expressing non-moral values, for example technical or aesthetical values, may also cause an improvement or deterioration in someone's life, but their performance was not undertaken *first and foremost* for the bettering or worsening of the status and/or the mores of the actor or any other person.

Traditionally, moral theory and political theory have always been linked, to say the least. Inspecting the history of political philosophy, one hardly finds any political theory of significance that does not seriously attempt to deliver an explicit or at least implicit theory of, and distinction between, moral and political values.[15] Politics without morals is commonly treated as unthinkable by any serious political theory and nihilism is claimed to be the logical consequence of trying to think the unthinkable.[16] Usually, the task of political theory is embedded the explanation of either the origin or the function of a political body, and both origin and function are explained, although differently, with references to moral values of various kinds. Along these lines, Plato, initially, ended up with the explanation of the function of the polis by first

[15] Although from time to time political values play significant roles in one or the other moral theory of a high number of authors, moral values play much more prominent roles in most political theories, especially modern ones. This fact, though not a very surprising one, is not self-evident, and possible ways of explaining it would result in another paper. However, this imbalance should not be left unnoticed here.

[16] Thinkers who oddly tried to think the unthinkable were often misinterpreted and/or discredited. By the way, to call Nietzsche a nihilist is completely beside the point and ignores that he was the first to sense the two morals Hayek described later. Friedrich Nietzsche clearly saw that the preservation of the great or anonymous society, as Hayek called it, asked for moral values beyond those embedded phylogenetically as well as ontogenetically in human kind. These values of the hordes, in Nietzsche's days more or less identical with Christian values, were to him insufficient to accommodate the new requirements of the great society.

of all looking for an answer to the question of what constitutes justice.[17] Likewise, Aristotle reflected on the best constitution(s) of a political body in the light of the moral values on which they might rest.

Nonetheless, temperance, fortitude, magnanimity, or their exaltations: none of them is constitutional to politics. Of course, like any other action, for instance shaking hands, political action can be moderate, brave or generous, but it may also be without any of these values. Hand shakers and actors of a political body can be licentious or unreasonable, they can rashly fight or cowardly surrender, and they can be wasteful or avaricious. But what they do does not *by necessity* rest on any of these adjectives and adverbs.[18]

Again, in an admirable manner, Jasay gets to the heart of the matter when he says what politics is about: "Politics at its most basic is the generation and execution of collective choices. As such it is an instrument of extraordinary power. It has evident potential both for great good and unpardonable bad, with a broad array of the middling-good and middling-bad in between."[19] Though politics has the potential to be carried out in a way that can be characterized by one of the above mentioned values, it does not need to make use of them.

[17] See the first book of Plato's *State*. Although it is still debated whether or not the dialogue of Thrasymachos historically makes up the first book of the *State*, it is fairly evident that to Plato a moral value (justice) has an enormous impact on politics.

[18] Also, as we look to political values, we see on the tablet a rich variety of goals, some competing, some complementary, to which the political process should lead us. They range from conservative values like traditionalism, nationalism, strong defence, authoritarianism, to more liberal ones like social justice, egalitarianism, redistribution, environmentalism, and so forth. Though all of these may justly fit into the group of political values, none of them self-evidently reveals what is constitutional to politics, that is, what is the specific difference by which we distinguish political values from all other values.

[19] See his *Choice, Contract, Consent: A Restatement of Liberalism*, London; IEA 1991. p. 104.

In generating and executing collective choices, political actors take decisions by, for and with other people, and by doing so they reveal, like it or not, their outcome preference. But looking at their preferences is on another level than answering the question of what constitutes a political value. Nevertheless, by looking at collective choices, their execution and generation, one has a splendid starting point for coming to a conclusion, for all these choices necessarily reflect agreements (or if not shared, of course, disagreements). Thus, with the exception of totalitarian dictatorship,[20] politics presupposes agreement and corresponding compliance. Hence, absurd as it may sound, politics cannot do without justice.[21] In other words, justice is a value that is constitutional to politics.

Conclusion

Politics in a voluntarily ordered society is by definition based on voluntarily shared contracts. These contracts are voluntarily shared if for the time being all parties involved keep the contracts, hence behave justly. In this sense, justice, i.e. contract-keeping, is a value that is constitutional to politics. All other values might occur in politics, but are not constitutional for a societal order. It is thinkable, though not likely, that a society shares nothing but justice. Nevertheless, it might be worth mentioning that history seems to teach us that such societies do not have the bond to hold together in the long run.

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[20] Even totalitarian dictatorship requires in practice a minimum of mutual agreement between the dictator and his entourage.

[21] It seems to be an irony of life that politics, experienced by so many as full of injustice (taxation, redistribution, regulation etc.), per se has to be just in one aspect in order to exist at all.

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