

**Global Vision Perspective**

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**Adam Smith and the European Union**  
***Is the EU compatible with free market principles?***

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For 50 years Europe was – at least on paper – committed to free trade. In 2007, President Sarkozy had the commitment to ‘free and undisturbed competition’ scrapped from the Reform Treaty. It was symbolic – largely to appease France’s mighty trade unions. But what would Adam Smith have said of the EU?

## 1 Summary

The EU's sluggish growth figures show that there is something seriously wrong with its economy. Both its method of regulation and the actions and regulations themselves are at fault. On balance, they distort the normal self-corrective mechanisms of the market.

The EU's favoured method of regulation – harmonisation – reduces competition between different regulatory systems. Instead of copying the best rules around, a 'middle-of-the-road' compromise is forced upon everyone in all the member states.

When we look at the direct cost of the EU, we notice that virtually its entire €106 billion budget is spent in a manner wholly or partly incompatible with normal market principles. It is mainly spent on subsidising agriculture, poor European regions and developing countries.

By subsidising poor regions, failure is subsidised and incentives to copy successful government are reduced. The Common Agricultural Policy distorts the market; subsidises one part of the population for reasons other than need; and is expensive and wasteful. Most important of all, the agricultural subsidies in combination with the EU's dumping practices and tariffs make it impossible for developing countries to compete. While foreign aid is given to developing countries, the EU closes off its markets to those same countries.

When we look at the indirect costs and benefits of specific regulations such as those emanating from the Financial Services Action Plan, we notice a propensity for heavy regulation administered by big government. Entrepreneurs vote with their feet. Overregulation does create jobs – outside the EU.

On balance, the market economy gets a raw deal. Adam Smith might have moved out of Europe.

## 2 Measuring costs and benefits

Is Europe a force for good – or not? The financial cost or benefit of the EU is almost impossible to measure. A wide range of groups provide us with widely differing estimates.

The EU never tires of telling us that the EU budget is only 1% of the joint GDP of the member states.<sup>1</sup> This does constitute the direct cost. But the real cost – including the cost of regulation – is much higher.

The same applies for the benefits. The EU claims credit for post-membership growth. It is not possible to know what the growth of a country would have been had it not joined or if it had only signed a free trade agreement instead.

One factor we can compare is economic growth between the EU and other countries such as China or the US. The EU is not doing particularly well. Both the methodology and the nature of EU actions and regulations are at fault.

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<sup>1</sup> In fact it is 1.2 %.

### 3 The EU's regulatory methodology

When Edward Heath ditched Britain's position of 20 years, and agreed for the UK to become subject to a supranational body,<sup>2</sup> he opened the floodgates for regulations emanating from that supranational body. The EU's preferred method of regulation is harmonisation. We are told that harmonising rules within Europe 'makes it easier to trade with each other' and bring the member states to 'a level playing field'. And, most of all, harmonisation is promoted through the collectivist mantra that 'Cooperation is good'.

Is it? Europe flourished when there was regulatory competition between its different states and within states.<sup>3</sup> Successful methods developed in one state would be copied in another; resulting in constant advance. Competition – not cooperation – was the fount of progress in all fields.

Today countries such as China have differing regulations at local and regional level. This brings acute competition and may be one of the factors explaining its high growth.

Harmonisation is hailed as the solution where companies would otherwise have had to comply with 27 different pieces of legislation to trade in all the member states. But the European Court of Justice<sup>4</sup> developed an alternative to harmonisation: in the Cassis de Dijon judgment, a system of mutual recognition was introduced. A product which satisfied the regulations in one member state could not lawfully be excluded from another country.

### 4 Nature of the EU's actions and regulations

Are the EU regulations themselves compatible with free market principles, and as such conducive to economic growth? Let us first look at what the EU budget is used for, and then consider two specific policies.

Out of the €106 billion EU budget,<sup>5</sup> most is spent on subsidising agriculture, poor European regions and development aid.

45% is spent on the Common Agricultural Policy. Agricultural subsidies distort the normal price mechanism and subsidises one class of people at the expense of others for no rational reasons (as explained below).

Around 30% is spent on regional aid ('Structural Funds'). Money is handed to regions which do less well than others. It is often used to build infrastructure – as if infrastructure alone will make commerce and industry flourish. It never seems to occur that it might be the local policies which make a region poorer than others. Handouts make complacency affordable. In fact, failure is rewarded and success punished – because it is the successful countries which pay for the handouts.

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<sup>2</sup> Instead of cooperation between sovereign states.

<sup>3</sup> Flanders, for example, did very well in the Middle Ages when several neighbouring city states dominated the region. If one local Lord imposed high tax or heavy regulation, the good burghers moved to another city. So taxes remained low and regulation was heavily influenced by what the neighbouring city states were offering to their burghers.

<sup>4</sup> One could almost say a lawmaker in competition with the lawmakers of the EU Council.

<sup>5</sup> The 2005 budget.

The best way to advance a region is competition. Without subsidies, failing regions will adopt the policies which make other regions a success. Those in favour of regional aid never tire of pointing to Ireland's economic boom to illustrate the success of regional aid. But among economists there is now a virtual consensus that Ireland's success stems from its extensive tax cuts. Indeed Ireland had been receiving Structural Funds for many years before its economic boom. The Republic was berated by the Commission in 2001 for daring to introduce 'inflationary tax cuts'. Greece receives more regional aid than Ireland, yet the economic miracle expected from this largesse remains strangely absent.

A relatively small chunk of the budget is spent on administration. This cost would have been substantially lower if the EU had not been a supranational organisation. And like all bureaucracies, the EU institutions' running costs always seem to increase and never to contract. Despite the Lisbon Treaty which, if ratified, would allegedly make the EU more efficient, the budget for the EU's bureaucracy is going up by 28% in real terms between 2007 and 2013.

About 7% is spent on foreign aid and foreign policy. The EU and its member states are jointly responsible for half of the world's aid programmes. The same principles apply as for regional aid: it is the rewarding of failure. The money often allows disastrous regimes to stay in power.<sup>6</sup> While giving aid to failing states, the EU dumps its agricultural products at below market price onto poor countries. This bankrupts local food producers.

In addition, the EU maintains its high tariffs for incoming agricultural and other products. The share of the ACP countries<sup>7</sup> in export to the EU has fallen from 6.7% in 1976 to 2.8% in 1999.

Let us now consider two specific policies: the Financial Services Action Plan and Agriculture linked with Free Trade Negotiations.

## **5 The Financial Services Action Plan (FSAP)**

Lisbon has not always been associated with centralisation. In 2000 the European Council finally noticed the EU's economic stagnation. The Lisbon Agenda aimed to make the EU "the most dynamic and competitive knowledge-based economy in the world (...) by 2010". Since then, comparatively, the EU has managed to fall further behind other Western nations.

To stimulate the economy, more regulation was introduced. The FSAP involved 42 initiatives to harmonise the law of banking, insurance, pensions and companies.

The new regulations were, at least according to their preambles, aimed at reducing regulation. But the impact depends upon the existing regulation in each country. EU regulations are always a compromise reached after negotiations between the member states. One ends up with something in between the two extremes. In other words: a

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<sup>6</sup> Often infrastructure is subsidised. The situation is slightly different from when infrastructure is subsidised within the EU: because of the legal instability, the market is often not inclined to build infrastructure in developing countries. As the governments of the developing countries often lack the funds, foreign subsidies may be the only way to have infrastructure built.

<sup>7</sup> A group of African, Caribbean and Pacific countries which were former colonies of the EU member states.

country with relatively low regulation (such as Britain) will rarely benefit, as the compromise will almost always entail more regulation than before. The other way around, a country with high regulation may end up with less regulation. This means that Britain rarely benefits from harmonised regulations – except when it can convince the others to copy its low regulation regime.<sup>8</sup>

Increased regulations drive enterprise out. This is especially the case in the financial world. There are many historical examples where new regulations resulted in financial flight. In the sixties Kennedy wanted to restore the US balance of payments and made it illegal for Americans to purchase bonds from foreigners in the US. But Americans were still allowed to purchase bonds abroad. A few clever London bankers got together and set up the Eurobond market. By 1985 this was worth \$2 trillion; and 80% was arranged in London. Another example is the introduction of heavy handed regulation of companies through the Sarbanes Oxley Act in 2001.<sup>9</sup>

The City of London is the engine of Britain, and its fuel is low regulation. The relative laissez-faire approach is the reason why the City overtook New York as the world's leading financial centre in 2006. If low regulation does not become the rule in Europe, tomorrow's top financial centre might well be Shanghai, Hong Kong or Dubai.

## **6 Free trade negotiations and agriculture**

Within two weeks of 9/11 the 'Doha Development Round' was set up by the World Trade Organisation. Free trade was to be the flip side of the War on Terror: an attempt to reduce world poverty by trying to "drain the swamp in which terrorism breeds".

The talks focused on agriculture and manufactured goods. The EU is one of the world's worst agricultural protectionists. On average Europe's taxes on food imports are five times higher than the US rate.

The EU, instigated by France, resists liberalising agriculture: it resists reducing the subsidies to its farmers and it resists bringing down import duties. Because of this, the Doha round failed.<sup>10</sup>

The EU is responsible for trade policy (and thus negotiations) with non-EU countries. In practice, this often means that the views of the most protectionist member states are imposed upon the other member states. Countries which want to liberalise trade more extensively, such as the UK, are prevented from doing so under EU law. There is an alternative. Trading blocs such as EFTA<sup>11</sup> allow their member states to negotiate bilateral agreements with third states as well as to negotiate as a group. It is sometimes argued that the combined power of 27 countries provides greater leverage in negotiating

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<sup>8</sup> British businesses benefit from regulation reduction (as a result of the European regulation) in previously over-regulated countries.

<sup>9</sup> Before Sarbanes Oxley, New York was responsible for nine out of ten of the world's IPOs. It now attracts one in ten.

<sup>10</sup> Peter Mandelson, the Trade Commissioner, firmly tried to shift the blame for the failure of the Doha round upon others. He said for example on the BBC that the EU had offered to cut agricultural tariffs in half. What he meant was that the previously agreed maximum ceilings for tariffs would be cut in half. But the EU's actual tariffs are only half of what they are allowed to be under previous agreements. So Mandelson was effectively promising nothing.

<sup>11</sup> The difference with the EU is that EFTA is a free trade area and the EU a customs union.

free trade with third countries. There is ample evidence to suggest that small countries manage just as well to negotiate with big countries.<sup>12</sup>

## **7 Conclusion**

On balance, Adam Smith would say that the European Union is not behaving in a manner compatible with free market principles. The situation is not black and white; some regulations have, for example, allowed UK companies to trade on continental European markets, as they would have been excluded from those markets if they had been perceived as having an unfair regulatory advantage. But the UK rarely benefits from compromises reached in a club where the majority is quite happy with big government interference.

The situation is likely to worsen. Under the proposed Lisbon Treaty, majority voting will become the rule in an additional 60 fields. The UK will no longer be able to block measures hostile to its traditional laissez-faire position. Sarkozy's crafty removal of the EU's 50 year commitment to free trade from the rejected constitution may only be the beginning.

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<sup>12</sup> Iceland successfully negotiated a free trade deal with China.

***Notes on the author:***

This article is based on a speech made by Cllr Jean-Paul Floru during Freedom Week in July 2007. Freedom Week is a one week seminar for UK students in Cambridge, which introduces students to the principles of a free society based on individual liberty and the free market.

[www.jpfloru.com](http://www.jpfloru.com)

Global Vision is a new campaign group backed by economists and business leaders that argues for a looser British relationship with the EU, based on free trade and mutually beneficial cooperation, whilst opting out of economic and political union. Global Vision believes that this is the right relationship for Britain in the 21<sup>st</sup> century's rapidly changing world. For more details on Global Vision please visit our website: [www.global-vision.net](http://www.global-vision.net).