Introduction

Proponents of an ‘ever closer union’ of European states like to look towards the United States of America – perhaps dreaming of something like a ‘United States of Europe’. Canada, on the other hand, receives relatively little attention. This is unfortunate because the Canadian Confederation has much more in common with the EU than the US. While it is not always clear how well the idea of a ‘melting pot’ describes reality in the US, there are clearly no strong cultural and linguistic differences within the US that run along state borders and, in particular, English is the only official language of the nation. Canada, however, has a dominantly French-speaking province that is in many ways distinct from the rest of Canada. These differences go back to the time when Europeans settled Canada. So, Canada, just like Europe, has to cope with the integration of existing cultures. In the US, cultural diversity is based much more on immigration.\footnote{This poses much less of a problem because immigrants are usually more prepared to accept the existing language and culture. Thus, when exploring blueprints for economic, monetary and possibly political union, I believe Europeans should look towards Canada rather than the US.}

Judging from the Canadian experience, it is highly likely that differences in culture, language and politics are going to persist in Europe – even if the ‘ever closer union’ proceeds. Such differences can have many advantages – in fact, without them, the world would indeed be a dull place. However, differences can also give rise to conflict – in particular when binding decisions are taken at the central level. In order to avoid such conflicts, it is argued below that a high level of de-centralisation (‘subsidiarity’) should be retained. Furthermore, if differences lead to irresolvable conflicts a union should provide an option for orderly and peaceful secession. The Canadian example shows that secession is not just of theoretical relevance. It has been a possibility for the last twenty years. In spite of its rejection in the 1995 referendum, the Partis Quebecois is still pursuing secession and enjoys considerable support in the Quebec population.
Secession: dangerous games

The Canadian example shows that integration does not have to be a one-way street. Even if economic and monetary union is achieved, there is always the possibility that members will wish to leave. Although there has not (yet) been secession in Canada – in fact, there have not even been negotiations about secession – the mere possibility of secession has made clear that the Canadian constitution is incomplete; it lacks rules governing the proper handling of secession. There is no generally accepted framework that regulates secession. The lack of such a framework may lead to difficult negotiations full of conflict. A case in point is the question as to whether a simple majority in a referendum gives the government of Quebec the right to secede. The Quebec government thinks it does, the Federal government thinks it does not. Another significant point of disagreement is the role of the Supreme Court of Canada. According to the Federal government the Supreme Court should be the final arbiter in case of conflicts. The government of Quebec, however, is not willing to accept this opinion.

In the 1995 referendum, the population of Quebec rejected secession by a small margin. Strictly speaking, a majority in favour of secession would only have given the Quebec government a mandate to negotiate secession with the rest of Canada. However, the former prime minister of Quebec, Jacques Parizeau, stated that he would have declared independence right away. After the referendum of 1995, Parizeau also mentioned that the former French prime minister, Giscard d’Estaing, had advised him to do just that. Parizeau’s statement shows how close Canada had been to a break-up – possibly accompanied by turbulent and costly negotiations. In spite of the defeat in the referendum, the Partis Quebecois is still the strongest political party in Quebec and the issue of separation still has a lot of support.

Up until recently, the European Union had not reached a level of integration in which it would have been difficult to exit. After all, the EU was and still is an intergovernmental organisation rather than a federal state like Canada. However, the completion of monetary union is a great leap forward in the integration process so, with the advent of EMU on 1 January 1999, exit has become much more complicated. Therefore, the EU should urgently consider supplementing the EU Treaty with a secession clause. As the Canadian example shows, once a member wants to exit it is much more difficult to agree on the proper rules. Everyday life, as well, shows that unions require exit clauses: for instance, a large fraction of the law of marriage consists of laws governing divorce. In this respect, political marriages should not, I believe, be treated differently.

Secessions do not have to be disasters. After all, conflicts and prolonged negotiations would be costly for both sides. However, there are only a few examples of peaceful secessions in history, and even in these cases there was a lot of tension and unrest during negotiations (Young 1994b: 782). Such
tensions and rising nationalism may complicate negotiations and easily lead to conflict, even war. One does not have to take recourse to seemingly ‘irrational’ behaviour, however, in order to discount the argument that peaceful negotiations will prevail, because it is in both parties’ interest.

Secession games are complicated and potentially dangerous games. One reason is that the two parties involved can only separate politically, but not geographically and only to a limited extent economically (Young 1994a: 239–40). Thus, unlike in the case of divorce in marriage, they have to deal with each other after secession. Thus, in the case of EMU, if a member wanted to secede then the questions of the future exchange rate regime and continuing membership in the single market would arise as issues. Another issue would be the treatment of foreign lenders holding euro-denominated debt of the seceding member country. While short and co-operative negotiations seem to be in both parties’ interest, there may be strategic reasons for nonco-operation. A majority of EMU members may feel reluctant to be too ‘soft’ on the seceding country in order to prevent further secessions. After all, secession may have destabilising effects for the euro area as a whole and may weaken the euro. Therefore, these countries may chose to ‘defect’ rather than ‘co-operate’. At the same time, the seceding country may come under intense market pressure. Under these circumstances there may be little time for negotiations and the seceding country could chose to act unilaterally instead of co-operating in lengthy negotiations. So, in short, it is not clear that negotiations would be co-operative.

The bargaining situation of the two parties can be analysed in a game theoretic framework (Young 1994a). The pay-off matrix in Figure 8.1 depicts a situation with two players, the ‘secessionist’ and the ‘Rest of the EMU’. Both players have two strategies. They can try to compromise (‘co-operate’) or they can try to ‘play tough’ (‘defect’). Thus, there are four different bargaining outcomes. The likelihood of each of these outcomes depends on the preferences of the two players: that is, on the ranking of the four outcomes.

It is worthwhile to try to imagine what these four outcomes could look like. The four scenarios are described below:

Co-operation (Co-op): Rest of the EMU is willing to grant exit immediately, and the seceding country will remain a member of the EU with all rights. If demanded by the seceding country it will be allowed to peg its currency at a mildly lower exchange rate; the seceding country promises to find a suitable solution for its euro-denominated debt.

Tough exit (TE): the seceding country will not only leave EMU but also loses some of its rights as an EU member; it has to agree to peg its exchange rate for a certain period at the old central rate; existing foreign debt remains euro-denominated (alternatively, the country wishing to secede gives up its plans and remains within EMU).
Soft exit (SE): the seceding country is allowed to exit immediately and depreciate its currency considerably; it remains an EU member with all rights; all of its debt will be re-denominated in its new currency.

Impasse (I): both parties cannot agree on the conditions for secession; this might prompt a unilateral decision to secede and possible retaliation by the rest of the EMU.

One likely ranking is:

\[ TE > Co-op > SE > I \] for the Rest of EMU
\[ SE > Co-op > TE > I \] for the seceding country

Given these rankings, the two parties would play a game of chicken (Young 1994a). In this situation, both sides have an incentive to threaten defection. If, for instance, the seceding party believes that the rest of EMU will play tough in any case, then co-operation is the best strategy because \( TE \) is ranked higher than \( I \) (and \( SE \) and \( Co-op \) are not attainable). This raises the question whether the threat to defect is credible. After all, the ranking of the other party cannot be known with certainty. In general, it can be said that co-operation is the more likely the more both parties are convinced that the other party is, indeed, willing to defect. This implies that a nonco-operative
outcome \((I)\) may result from underestimation of the other side’s willingness to fight. Thus, although both parties rank \(SE\) and \(TE\) higher than \(I\), they may end up with \(I\). However, if both sides take the threat of the other side seriously a co-operative outcome is likely.

While it seems plausible to assume that Impasse is the least preferred alternative, this does not need to be the case. If the majority of member states think that it is in their best interest to prevent further secessions the ordering could be:

\[
TE > Co-op > I > SE \text{ for the Rest of the EMU}
\]

Similarly, if one country desperately wants to exit EMU the ranking would be:

\[
SE > Co-op > I > TE \text{ for the seceding country}
\]

In this case, the resulting game would be a prisoner’s dilemma. In a pure prisoner’s dilemma, both parties cannot communicate and \(I\) would be a stable equilibrium (Sugden 1986: 104–21). However, if negotiations are possible, both players may choose a strategy conditional on the strategy of the other player. Each may offer to co-operate if the other is co-operating and threaten to defect if the other is defecting (Young 1994a: 238). Again, the success of this strategy depends on its credibility.

While it seems plausible to assume that both sides have an incentive to co-operate in secession negotiations, a game theoretic analysis shows that things can go wrong. This is particularly the case when one side or both sides underestimate the willingness of the other side to defect. Therefore, it would be helpful to have a legal framework for secession.

**Fiscal policy: the case for subsidiarity**

A striking feature of Canadian politics is the move towards decentralisation. Ever since World War II, when the share of central government spending reached its peak, the provinces have been clawing back their own revenues (Courchene 1995: 5–7). Thus, in spite of growing transfers from the federal government in the 1960s, the provinces managed to gain more fiscal independence. However, more independence also involves more responsibility. When provincial deficits rose in the early 1990s, markets became concerned about the solvency of the provinces (in particular Saskatchewan) and interest rate payments became a heavy burden for provincial governments.4

In confronting this problem, the reaction was not to curb provincial independence in financial matters. Rather, each province reacted independently. Most provinces have enacted laws limiting deficit spending and have managed to reduce debt-to-GDP ratios significantly (see Millar 1997).
The EU has tackled the deficit problem in a different fashion. Instead of relying on member states to reduce their debts on their own, they agreed on an EU-wide rule. At the European summit in Dublin in 1996, the European heads of government decided on a ‘stability and growth pact’. Thus they opted for a centralised rather than a decentralised option, as in the Canadian case.

The stability pact is supposed to contain deficit spending within the future European Monetary Union. However, the practical relevance of this agreement is still far from clear. Some countries, notably Germany, whose finance minister Theo Waigel proposed the pact, want (or wanted) strict rules and automatic sanctions. Others, led by France, are strictly opposed to a rule that leaves no room for political decision-making. The compromise agreed upon in Dublin is neither an automatic mechanism to be applied without much fuss nor an agreement that will disappear in a dusty shelf in Brussels and be forgotten. Rather, the stability pact sets the stage for an endless drama, with some (more stable) countries sitting in court over other (less stable) members. Clearly, the stability pact is automatic enough to set into motion a process of evaluation whenever a country reaches the 3 per cent deficit limit. And, just as clearly, there are a large variety of cases where sanctions can be applied but do not have to be applied. A wide margin of interpretation remains. Now, by itself the need for interpretation is hardly a problem, as there are many rules or laws that cannot be mechanically applied but have to be interpreted. In such cases it is common practice to delegate interpretation to a third party that is not directly involved. This can be a judge, a referee or a panel of experts. However, instead of delegating the interpretation of the stability rules to a third party, say the European Court of Justice or the European Central Bank (ECB), the EU governments agreed in Dublin to interpret the rules themselves. Supposedly, this will ensure ‘democratic’ as opposed to ‘bureaucratic’ decision-making.\(^5\) Still, the whole construction rather looks like a set of rules which prescribes that it is best when the collective decides ‘democratically’ whether a situation is to be sanctioned or not, thus avoiding the ‘undemocratic’ interference of a referee.

The outcome of such a procedure seems clear: endless negotiations and severe and bitter conflicts between member states. On these occasions, one or more member countries will exhibit deficits that are somewhat ‘excessive’. But since the sanctions do not have to be applied in each and every case, there is room for negotiation. These negotiations would take place between politicians representing different countries. So what in fact takes place is that one country is the defendant – ‘accused’ by other countries (and maybe defended by some). Given that there often will be hard-liners on both sides who try to win votes by ‘playing tough’, these negotiations can easily produce strong national sentiments directed towards other countries. This is the problem of the ‘quasi automatism’ of the rules. If there is no strict rule saying that sanctions always have to be applied in case of excessive deficits, then it is hard for the citizens of a country to see why sanctions have to be
applied in its particular case. Also, it is a precedent where sanctions were not applied: the imposition of sanctions must appear arbitrary and will be interpreted as the bad-will of the other member states.

If the analysis above is correct, then the compromise reached in Dublin was not a ‘Victory for Europe’, as it has been claimed after the summit. The lack of automatic application of the rules will inevitably produce harsh conflicts. However, criticising the lack of ‘automatism’ does not imply that a binding and automatic stability pact would be ideal. While such a pact would clearly reduce the potential for conflict, it has to be remembered that there is no satisfactory definition of what constitutes an ‘excessive deficit’. Thus, a strict rule could, though it need not, produce a lot of damage. The example of the UK shows what is at stake. During the severe recession in the early 1990s, the budget surplus of 1989 (1.55 per cent) turned into a large deficit (6.56 per cent) in 1993. Thus within four years there was a swing of about 8 per cent in the balance of the UK budget. In such a situation, binding restraints on fiscal policy could have been very harmful.

What follows from this? First, it would be better to change the pact in order to have a third party interpret the rules. However, this seems currently impossible because some members consider such a procedure to be undemocratic. Second, if the pact cannot be changed it may be better to abandon the stability pact. This leads to the question whether there should be some other mechanism to replace it. In order to answer this question one has to analyse why a stability pact was deemed necessary in the first place. Why should a monetary union require safeguards against excessive deficit spending?

**A bankruptcy code for Europe**

One option for Europe would be to follow the Canadian example and let all member states enact budget rules on their own. However, debt-to-GDP ratios vary widely within Europe and those members who have relatively low debt-to-GDP ratios may find such a solution hard to accept. In principle, the no bailout clause of the Maastricht Treaty and the restriction on central bank financing of government deficits should prevent ‘spill-over’ of budget deficits on other member countries. However, these provisions are yet untested and it seems uncertain that they will be adhered to (DeGrauwe 1992: 172) and Watrin (1993: 182). Thus, it will be difficult to convince low debt/deficit countries to abandon the stability pact, and the EU may be stuck with an inflexible rule that is likely to lead to severe conflicts.

One possible way out of this dilemma is to replace the stability pact by a bankruptcy code for sovereign borrowers. Such a bankruptcy code would strengthen the credibility of the no bailout clause. This would enhance the effectiveness of capital markets as guardians of stability and lower the probability that countries with sound budgetary policies would have to bail out the others. Current policies are geared towards preventing the worst case of an outright bankruptcy, so such measures nourish the expectation that
politicians will do everything to prevent such a case – even if this means committing taxpayers’ money to bail out others. This undermines the credibility of the no bailout clause. On the other hand, if the possibility of sovereign default were openly acknowledged and if it were shown how state bankruptcy would be handled practically, investors would be warned that state bankruptcy may indeed be an option for governments. The possibility of sovereign default could no longer be ignored. The very existence of a bankruptcy code would change the rules of the game. Of course, governments could still try to persuade others to bail them out, but an outright default may be preferable in some cases. After all, a bailout would usually be in the form of soft loans from other governments, so there would be no reduction in the existing stock of debt. A default, on the other hand, could bring lasting relief.

Once sovereign default of member states has become a practical possibility, market participants will monitor the soundness of public borrowers much more closely. Increasingly, interest rates will reflect credit risk of individual member states. Countries with sound macroeconomic policies will be rewarded with low interest rates and will not be affected adversely by overspending of others. Furthermore, if excessive spending is ‘punished’ with high interest rates then there is an incentive to curb spending in order to reap the benefits of a better credit standing.

Why should governments be prepared to enact such a bankruptcy code? The answer is simple. When compared to the stability pact, a market solution backed by a bankruptcy code allows for much more flexibility. Any country can use deficit spending to stimulate the economy if need be. It just has to be prepared to pay higher interest rates. As long as deficit spending is used wisely such a rise in interest rates may not even be very large. Capital markets will probably not be disposed to punish a country that uses fiscal policy to get out of a deep recession. So there is no need to specify in advance how high a deficit may be in all kinds of conceivable situations. Each government can decide on its own without endless negotiations with the other governments. Given the wide differences of opinion between different EU countries, this is a major advantage of the market solution. By allowing different national approaches to fiscal policy, it could reduce a severe source of conflict.

A bankruptcy code could be agreed upon and enacted on the EU level, possibly giving a role to EU institutions in the negotiations between creditors and debtors. But it seems to be preferable that each country should decide on its own about a bankruptcy code and that there should be no involvement of EU institutions in the negotiations. If the EU is participating in the negotiations, there is a possibility that this will ultimately lead to the EU committing funds to help out. This scenario is well known after fifteen years of IMF experience in crisis management. ‘Crisis management’ only too often meant letting taxpayers pay for debts of other countries. Thus a bankruptcy code which is overseen by the EU could be interpreted as
more like a bailout rule in disguise. Under such a rule, markets would hardly believe in the credibility of the no bailout rule and interest rates would not reflect risks properly. In order to enhance the credibility of a no bailout commitment, it would therefore be preferable to have national bankruptcy codes and no EU involvement.

There is another reason why the EU should be kept out of the settlements of bankruptcies. If EU institutions are involved and if, contrary to expectations, they do not spend any money during bankruptcy negotiations, the position of the EU could be quite awkward. A bankruptcy of a country can be a traumatic experience for the population or part of the population. In such a situation the EU can easily become the scapegoat for financial problems which have been caused by national politicians. The result of this could be strong anti-Europe feelings and resurfing nationalism. For the sake of European integration, delicate matters like the handling of a state bankruptcy should be left to national politicians.

To sum up, a market solution is going to work if responsibility for the soundness of public finances rests ultimately with national governments. A bankruptcy code would signal to investors that there would be no supranational assistance when things go awry and a country defaults on its debt. Therefore, a code would allow for efficient pricing of government debt. Furthermore, a market solution has the great advantage of avoiding conflicts between member states, and it provides more flexibility than a strict rule, allowing national governments to follow different approaches to macroeconomic policy.

Conclusion

For an ardent believer in European integration it must be hard to accept inclusion of a secession clause in a document that establishes the ‘Union’ of Europe. It might also appear equally sinister to use a bankruptcy code for sovereign borrowers to safeguard monetary union. However, rules are most important when things go wrong – not when everything goes well. Rules help to prevent conflicts and provide codes of conduct when conflicts arise. A secession clause and a bankruptcy code would achieve just that.

Charles P. Kindleberger once asked his students for the difference between domestic and international trade. One student answered that domestic trade is among ‘us’ whereas international trade is between ‘us’ and ‘them’ (Kindleberger 1986: 1). Whether we like it or not, this distinction also applies to the relationship between EU member states. It is still ‘us’ and ‘them’. To be sure, the relationships are mostly friendly and there is little residual hostility. But it cannot be denied that ‘us’ hardly ever means ‘we the Europeans’. As the German Constitutional Court put it, there is no common European public opinion.

As long as the national aversion to European centralisation persists, supranational centralisation should not be pushed too far. The EU has
taken over the important and beneficial task of ensuring fair market competition within the community (and other less beneficial tasks). With the implementation of the EMU, monetary policy has now been centralised as well, so given the different philosophies in economic policy it would be folly to add fiscal (or even social) policy to this list. If economic conditions worsened in one country, there would be little agreement on what to do, so the EU would become the scapegoat. It would be the others who made mistakes — ‘them’, not ‘us’ — and friendly relationships between ‘them’ and ‘us’ could quickly deteriorate. This shows that centralisation does not necessarily foster further integration. The opposite can also be true. Centralisation and standardisation can easily produce disintegration and even hostility (Feldstein 1997). Canada with its strong separatist forces is a prime example.12 This does not mean that integration, in general, has to stop or to be reversed, but it does show how important it is not to centralise those tasks each country can perform independently, and perhaps more efficiently.

Notes

1 Being an immigration country, Canada also has to integrate immigrants. But this aspect of Canadian policy will not be considered here.
2 The recent attempts by the Federal government to establish a ‘Clarity Act’ which governs the rules by which a province can secede have been met with derision in Quebec.
3 This game is also known as ‘hawk–dove game’. See Sugden (1986: 58–62).
4 Rising debt-to-GDP ratios and falling credit ratings are reported in Kneebone (1994).
6 International Monetary Fund (1996) and own calculations.
7 This was first pointed out by Fuest (1993). See also Kratzmann (1982).
8 The enactment of a bankruptcy code for sovereign borrowing might also encourage developing countries to follow this example. This would make it easier to overcome financial crisis in emerging markets.
9 Under special circumstances, deficits may exceed the limits laid down in the stability pact. However, in most cases this is subject to the consent of the other member states.
10 It may be argued that the introduction of a bankruptcy code would reduce the credit standing of the countries involved, because markets would interpret this as an acknowledgement that bankruptcy is not only possible but also probable. However, such a view of market behaviour is ill conceived. The enactment of a bankruptcy code would show that governments live up to reality. After all, sovereign default has a long history. Indeed, at times it looked as if the history of public finance was a history of public bankruptcy (Manes 1922; Eichengreen 1991; Tammen 1990). However, most governments simply ignore this phenomenon — at least while they can. Any government that acknowledges the possibility of sovereign default and introduces sensible ways to deal with it can expect to be treated better than governments which simply pretend that the problem does not exist.
11 Eaton (1990) provides a critical account of the management of the debt crisis.
12 See Courchene (1991) and Young (1994a).
Bibliography