An EU 'Fit for Purpose' in the Global Age

An interdisciplinary, cross party investigation of policy options for the European Union post-2009 [1]

FIRST DRAFT OF SYNTHESIS REPORT
DO NOT QUOTE[2]

The global economic crisis marks the end of an era in economic, political and ideological terms. The globalisation model, which held sway for the last three decades relying on financial markets as the spearhead of global economic integration, is now in deep crisis; and so is the real economy in Europe and the world as a whole. The threat of protectionism, also directed against the European single market, is growing. The state is back in many different ways. If uncoordinated, rescue operations by the state in national economies in crisis could easily prove self-defeating while also helping to undo regional and global economic ties. The internal European package deal needs re-adjusting to the new economic and political environment. Can the EU deliver in these times of crisis? And can Europeans define and collectively defend common interests and values in an increasingly multi-polar world where size matters?

There are, inevitably, policy choices to be made at the national, regional and global level: trade-offs that are differently perceived through national or ideological lenses. The key challenge for the EU will be to redefine its own role in providing the regional framework for an effective management of close European interdependencies while also exerting a stronger collective influence in shaping the world outside. In short, to make the EU "fit for purpose" in the global age.

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[1] For more information about the 'EU fit for purpose' project, organised by Policy Network in partnership with the London School of Economics' European Institute and ELIAMEP, please see page 30.

[2] The final version of this synthesis report will be published in April 2009 at www.policy-network.net as well as on the LSE and ELIAMEP websites. For details on further forthcoming publications, please see pages 31-32.

The growing problem of legitimacy

There is something discomforting about the European Union in the year 2009. Despite its spectacular past successes, ranging from the single market and the euro to the consolidation of democracy and peace on the European continent, the EU is now faced with a growing problem of legitimacy that seems to constrain its ability to respond effectively to the challenges thrust upon it by the rapidly changing world around it.

But is the EU also in a crisis? During the last fifty years or so, the European Union has suffered a number of setbacks – only to emerge stronger and fitter afterwards. This is particularly true for those defeats inflicted by European citizens when consulted on important EU questions. With this in mind, many policy-makers and observers of the integration process have consequently not run scared in spite of the most recent negative referenda in France, the Netherlands and Ireland. They do not believe in a popular rejection of a project which is perceived as select and top-down in its approach.

Instead, they point to the constitutional and institutional complexities of the EU integration process, which require diligent and time-consuming explanations before European citizens are ready to give their blessing to major decisions reached at the EU level. The current positive prospects of a victory for "Brussels" in the forthcoming second Irish referendum may in the end prove them right once again.

At the same time, national support for membership of the European Union, as measured by the Eurobarometer, has stabilised at a level just over 50%, even though only a minority of EU citizens has now an overall positive image of the EU – this has been in decline since autumn 2007. True, those with a negative image of the EU are much fewer in most member countries, with a significant number of 'don't knows'. On the other hand, the level of participation in the forthcoming European elections risks heading to a new record low, having already seen a steady fall from over 60% in 1979 to just 45% in 2004. And this is despite hard-fought attempts by many politicians to equip the European Parliament with real power in EU policy-making, thus tackling the widely quoted "democratic deficit" of the Union. Taking all these insights together, do we really have to worry about the relative weakness of the popular mandate granted either directly or indirectly at various moments and occasions in the recent EU integration process? The honest answer seems to be yes.

Two important trends highlight why the issue of legitimacy should now be taken more seriously. First, more and more political parties in Europe, mostly populist but not exclusively so anymore, cultivate (and exploit) anti-EU feelings of those citizens that have been negatively affected by societal and economic changes in recent years. While the causes of anti-Europeanism are of course manifold, there is increased evidence that losers from change, in particular those with low-income and insecure jobs, are turning against the EU, perceived by them as an important vehicle of change. How to rebut the, often unfounded, accusations of a growing number of people, who blame the EU for prejudicial and unwanted developments, has become a major challenge for mainstream politicians.

Secondly, current reform processes and institutional arrangements are also increasingly coming under attack from parts of the European elite itself – both on the left and the right. Germany, the biggest member state of the EU, offers two revealing examples in this context. On the one hand, it has often been argued that recent decisions by the European Court of Justice constitute a violation of salient national interests, raising serious questions about the attribution of competences when it comes to defining and ensuring common EU rules. At the core of this criticism lies the concern that the non-political actors of EU policy-making have developed a degree of activism and autonomy, which tend to weaken the political legitimacy of member states, ultimately jeopardising the voluntary compliance of governments to implement EU norms and directives.

On the other hand, in an ongoing case against the ratification of the Lisbon Treaty, significant doubts have been raised by the German Constitutional Court about the Treaty's democratic consequences and new balance of political influence and power within the European Union. While the ultimate verdict depends of course on the compatibility with the German constitution itself, the fact it is being questioned by the court in Karlsruhe and senior counsels has already startled those EU federalists who tend to consider the German system as a potential role model for deeper integration. But can anyone imagine that Germany would be ready to bury the new institutional arrangement it has so vividly defended during the last years? At best, it seems that the court will issue a sombre warning against the Treaty.

All this should not, however, come as a surprise. There is now broad consensus among seasoned observers of the European scene that the EU does indeed have a problem of legitimacy, a problem that will not be resolved by the adoption of the Lisbon Treaty alone. Needless to say, major discrepancies are evident vis-à-vis the necessary next steps to resolve this problem. Several politicians, in turn, have singled out a more rigorous application of the concept of 'subsidiarity' as the king's road to tackle any related shortcomings. The disentanglement of competences would not only create a better understanding on the side of the EU citizens, it would also help streamline the EU policy-making process as a whole. According to this analysis, it is important to address where the EU may at present be attempting too much rather than too little. At first glance, such an approach appears compelling.

Yet, would it also sufficiently address the EU legitimacy gap? Major doubts persist, assuming of course that the level of member states' ambitions to use the EU as their primary vehicle to confront the big challenges of our times remains high. The stakes certainly are: global competition, combined with rapid change and uncertainty, the excesses of financial capitalism, international terrorism, growing inequalities , and a powerless and effectively disfranchised under-class have bred a hitherto unknown degree of alienation and cynicism that seems to rock the very foundations of our liberal democracies.

This might be the real challenge: can the EU provide the stable framework for the peaceful coexistence and continuous compatibility of capitalism and democracy in Europe under the conditions of the 21st century? Historians remind us that during the

Trente Glorieuses European integration was successfully married with a 'European Social Model' in its different national versions, which in turn managed to tame capitalism in the interest of justice and cohesion. But capitalism was by no means dispelled or even dissipated; on the contrary, it was strengthened and, most importantly, legitimised in the eyes of the vast majority of our society.

Nowadays, however, widespread feelings exist that our capitalist systems are beyond reasonable control, overwhelmed by the unprecedented level of global interdependence and capital flows around the world. As such, is it realistic to believe that the EU should act as a political project to re-tame capitalism without reversing globalisation and cutting back on the benefits of openness?

In many respects, we have now come full circle. Meeting this, or any other big external, challenge requires the EU to live up to the expectations of it alluded to above. This, in turn, seems to put a real strain on current EU governance, be it in relation to the institutional design or the manner in which EU politics is, or is not, conducted. Yet, democratically elected politicians *per definitionem* depend on some form of popular mandate and/or support in order to undertake major reforms, on the provision that the overarching interests in Europe remain aligned.

Taking this a step further, the quandary with the weakness of legitimacy finally comes down to the question of what could possibly be done to make the European Union take big and bold decisions again in the name and best interests of its citizens; decisions which are respected by a clear majority of our populations, including both the winners and the losers from any resulting change. This is where the focus of the European political debate might now have to be.

Four (unequal) roads ahead

It goes without saying that there is no silver bullet that answers this question. For instance, one crucial factor cannot be influenced at all: political leadership. Few will disagree that the major advances in European history have been initiated by outstanding personalities and visionary politicians, which some believe Europe lacks in this age. Additionally, the EU does not and will never resemble the United States of America, where the President accumulates a range of powers which not even the supporters of a 'United States of Europe' can dream of. Rather the opposite is the case in Europe, as institutional reform seems now to have reached its limit for some time to come, be it with or without the Lisbon Treaty.

Consequently, the task is to find ways in which the EU can gradually expand its basis of legitimacy that would allow EU policy-makers to act more decisively, coherently and consensually in the light of the big challenges in the global age. Four different roads, though very unequal and uneven in their potential implications and impact, come to mind.

First, any configuration of representative democracy, whether national or trans-national, must reflect a **shared sense of identity** to achieve legitimacy. Despite the EU being a *sui generis* political entity and the recognised constraints of direct representation in Europe, there are now strong indications that the Union's "identity deficit" has begun to undermine the integration process as a whole. In particular, the gulf between elite and popular perceptions of what the EU is actually all about and what is capable of achieving remains wide open. While some want to rectify this problem through better communication strategies, others judge that what may be needed is a stronger collective sense of "we" among European peoples.

Indeed, the weaker the shared identity, the less likely Europeans are to give their consent to developments in Europe, which they cannot always fully appreciate. At best, the problem of 'understanding' refers to the technical details of the issue at stake. Yet, it is equally possible that EU citizens actually do want to comprehend and control the broader context in which the EU is supposed to progress. Or, at the very least, how it relates to "others" in the equation. The emptiness of the EU identity might therefore be a real obstacle when seeking different forms of popular support for further integration.

Sure, sceptics argue that there is no such thing as a European identity: nothing, in any case, that we can build upon. However, identities are always plural and full of uncertainties and internal divisions. What matters here though is substance and familiarity. Many inveterate optimists therefore believe that renewing our efforts to build a "common European house" through the creation of truly European spaces of education, research and sport, or the establishment of more pan-European networks and institutions, with higher degrees of visibility, will ultimately pay off.

Second, some have understandably asked why we waste time, resources and energy in ensuring broad-based support for nearly every aspect of the EU project when important commonalities and common preferences already exist. In order to take a big decision, Europe primarily needs a big idea which, in turn, succeeds at the end of the day in overcoming the worrying mismatch between promises and results that have so far thwarted any attempt to increase EU legitimacy. According to this reading, the self-inflicted crisis of an inward-looking EU has to be cured by a renewed focus on '**output legitimacy**', in other words the kind of legitimacy founded on the ability of institutions to deliver the goods and hence meet the expectations of European citizens.

Correspondingly, the idea has to be in line with the concerns expressed by citizens, for instance, in public surveys over a solid period of time. Tackling climate change, energy security and a more effective common foreign policy appear to be the favourites in this context. In fact, they might even be the last available *cartes blanches*, which have essentially carried the EU forward in the previous decades. Brussels should, therefore, make the most out of them, if necessary by devising new *ad hoc* mechanisms that help to ensure successful delivery and implementation. It is not an uncommon belief that if the EU fails to act on these fronts, any question of legitimacy will sooner or later become obsolete.

Third, a Union of 27 that will continue to grow just cannot function in the same way as the EU-12 or EU-15 did. Despite the fact that voting records and the number of adopted rules and directives do not suggest a slow-down of EU policy-making processes after the latest big bang enlargement, the successive widening of diversities and interests has inevitably led to questions of how politics at the lowest common denominator can be avoided. For some, **flexible or differentiated integration** is therefore the answer.

Proponents of such an approach draw attention to the previously successful use of flexibility and differentiation, listing the euro, Schengen and the Treaty of Prüm as prime examples. Indeed, all major advances and important acts of integration since the Single European Act have been based upon some form of flexibility, allowing those, who opted out, to sidestep or postpone the tricky question of popular legitimacy. Several models are therefore being discussed: multi-speed, hard-core, *avant-garde*, or Europe *à la carte*. The core emphasis of the Lisbon Treaty on 'enhanced cooperation' seems somehow to be a compromise between all these slightly diverging options. Yet, should it also become a core norm of European integration?

The crux of the debate about flexible or differentiated integration is that its supporters have often little or nothing in common, ranging from those who look for practical ways of surmounting EU deadlock all the way to those who use it as leverage against stubborn partners, or simply those who yearn for "the good old days" when EU affairs were decided by a handful of like-minded Europeans over an expanded lunch break. High politics in the EU has so far been essentially a matter of intergovernmentalism, potentially leading to the accentuation of national prerogatives and unsatisfied demands. But the mission we are after seems a common one. Risks have to be weighted here too.

Fourth, there is the most obvious component for tackling the legitimacy deficit: **politicise the EU**! If you want to raise awareness and improve understanding of the EU, make the debates and ballots more interesting and worthwhile at the European level. If you want a strong mandate for reform and policy change, ask and involve the European people. Needless to say, democracy cannot simply be shifted from the nation state onto this singular EU design. And there are, of course, difficult questions around the use of referenda *per se.*

However, advocates of the politicisation agenda have diligently demonstrated how some form of democratic politics in the EU could work, even without further institutional change. A "winner-takes-more" model for the European Parliament, increased transparency in the EU legislation process, or a contest for the high places in the European Commission are only some out of many proposals.

While this road may appear the most obvious one – and there is growing approval at least for its rationale – it remains a highly controversial and contested one. Compelling arguments have been made for why a mediated emphasis on partisanship and the injection of 'majoritarianism' in the essentially consensual processes of the EU carry considerable risks. Thus, are those who recognise the limits of the functionalist method just more willing to run these risks than those equally committed Europeans who raise serious concerns with regard to greater politicisation? Difficult choices have to be made, while the prospects for re-opening the Pandora's box of further institutional restructuring in the EU are rather flimsy, at least for the foreseeable future.

There is very limited scope at the European level to try to follow Barack Obama's example of replacing polarisation with reconciliation and cohesion politics. For obvious reasons, the process of legitimisation in the European Union cannot be anywhere near like that. But exploring and pursuing ways of how greater legitimacy can assist better and bolder policy-making in the EU must now be an essential task.

Depending on an individual's political, societal or economic perceptions, each of the four roads briefly sketched out above imply in themselves a range of assets and potential drawbacks. Certainly, building a stronger 'shared sense of EU identity' and taking 'output legitimacy' seriously are less contentious and politically exposed. Yet even the latter can easily backfire as, for instance, the challenges of internal security and immigration demonstrate.

In both domains, EU policies and measures are so far of a "cooperative" rather than an "integrative" nature – unsurprisingly, one might say, given that providing security and residence or work permits for those coming from outside the EU belong to the litany of most sensitive political issues for member states. But since the EU, with its open borders and the facilitation of economic interpenetration, adds its own important dimension to a number of security and immigration challenges, how long will it manage to withhold the resultant tensions between calls and needs for joint responses and the highly resilient role of national systems? In other words, is there yet another expectation-reality gap in the making, which can directly affect the credibility and 'output legitimacy' of the EU?

For die-hard EU integrationists, some form of "convergence" should be part of the answer, even though the political, representational and institutional conditions do not seem to be met. Solidarity and cohesion are also the two crucial variables influencing the drive down the roads of flexible integration and greater politicisation. Both can be powerful ways forward in increasing the legitimacy of EU policy-making. However, they can also potentially destabilise the integration process as a whole, open old wounds and weaken the EU in its internal and external dealings. Those who do not believe or even care about EU solidarity and cohesion as core principles will not be afraid. Where do we strike the right balance?

Economic integration ahead of political integration

Until the dramatic escalation of the global financial crisis last autumn, the EU had enjoyed in recent years a relative upturn in its economic performance. However, much of what has been achieved in the social and economic realm now risks being rolled back in the wake of the global recession which has only just begun, requiring the European Union to face up to some tough choices on how it overcomes the challenges of any new capitalist settlement.

A central feature of this upturn was the remarkably smooth transition to the euro and the European Central Bank's management of monetary policy that had consolidated price stability across the eurozone – in sharp contrast to the preceding three decades. By the summer of 2008, unemployment had fallen rapidly to the lowest level seen in the EU as a whole since German unification, with jobs growing at a faster rate than in the United States. This reflected in part the success of piecemeal labour market reforms in member states and the embedding of a policy shift from work sharing, early retirement and limitations on working time (that had held sway in the 1980s and 90s) towards employment activation, 'flexicurity' and greater flexibility. The policy objectives, guidelines and peer review of the European Employment Strategy contributed to this shift.

Although the US record in R&D and innovation remained stronger than Europe's, and overall there was no real sign that the EU/US differential was narrowing in terms of output per head, detailed analysis showed that a large proportion of Europe's "productivity gap" with the United States could be accounted for by the retail sector and financial services. In manufacturing, the picture was more nuanced. While some sectors, such as apparel and footwear, were forced to restructure and downsize radically in face of new global competition, with a particularly severe impact on the southern tier of the EU, the success of Germany in re-establishing itself as the world's leading exporting nation demonstrated the pay off from difficult structural reforms at company level. There were, of course, winners and losers. Yet, globalisation demonstrated the scale of new commercial opportunities for European businesses that were able to reorganise their global supply chains, focus their European activities on high value added, and exploit new market niches.

Economic integration proceeded apace with an increased number of cross border mergers and some takeovers. In particular, cross border financial integration deepened as result of policy decisions concerning the creation of the euro and financial liberalisation. The City of London strengthened its dominance as Europe's major financial centre, despite the UK decision not to join the eurozone. Strong catch up growth, meanwhile, took off in the new member states, suggesting that the Central and Eastern enlargement would lead to rapid convergence, as it had done before in the case of Ireland and the three Southern European countries. The financial perspectives for 2007-13 significantly increased budgetary transfers to the new member states to support public investment in that catch-up. The free movement of labour within the enlarged EU facilitated above trend growth in old member states, such as Ireland, Spain and the UK, suggesting that when the current seven-year transition period comes to an end and all restrictions on free movement should be lifted, there would be overall benefit to the Union.

Of course, enlargement greatly increased social diversity within the EU, as well as geographical disparities between its regions. Average income per head ranged from a high of 290% of the EU average in London to a low of only 27% in North East Romania. The wage share in national income declined in most of the old member states, while measures of inequality and child poverty registered an upward trend, but Europe saw nothing like the increase in inequality that occurred in the United States. Increases in inequality in Europe appeared as member state specific and episodic rather than part of a general trend; or so they were perceived by most.

Alongside this improved economic performance, however, the momentum for further political integration at EU level stalled, as witnessed most notably by the demise of the Constitutional Treaty and the problematic ratification of its Lisbon replacement. With the admittedly important, albeit still uncertain, exception of energy policy and climate change, this loss of momentum was evident across the entire economic and social field.

This was particularly apparent in how modest progress was in strengthening eurozone governance. The rules of the stability pact underwent pragmatic revision and were made more flexible and intelligent, yet the feeling was that only the smaller and/or weaker countries really had to take notice. Also, the Eurogroup elected a permanent President, but still lacked single external representation.

The Lisbon economic reform agenda, meanwhile, though re-launched at the start of the Barroso Commission in 2004, failed to engage political attention or deliver high profile results. Lisbon's bolder ambitions were clearly beyond reach: the 2010 deadline had always been over-ambitious, especially given the big enlargement of 2004 and 2007. While the initial Lisbon goals had been inadequately specified or prioritised, the European Commission attempted to narrow the focus to "growth and jobs", though pressures within the Council and Parliament soon widened them again. The German refusal to contemplate the "naming and shaming" of member states meant that delivery depended on an opaque partnership between the EU and its member states that lacked real political purchase.

The services directive was, furthermore, watered down at the behest of the European Parliament, demonstrating a lack of political will to drive the extension of the single market beyond goods. There was sparse legislative achievement in harmonising internal rules and standards, with the important exceptions of the passage of the Reach directive and much of the financial services action plan. The dominant spirit of the times was anti-regulatory, with the Commission stressing its commitment to "better regulation" and the legislative simplification agenda.

The horse trade on the new financial perspectives reflected a lack of radical ambition for budget reform. Over 70% of the funds are still devoted to the common agricultural policy and the Structural Funds, despite the emergence of major new EU priorities such as climate change and the need to facilitate the transition to a low carbon economy; strengthening controls on migration at the common EU border; research and higher education in the light of Europe clearly falling behind the US; and a more active and effective EU neighbourhood and external policy. True, in agriculture subsidies have largely been decoupled from production and more funds switched to rural economic development. And Structural Funds are now supposed to be aligned with "Lisbon" policy objectives, although the Commission has little ability to direct spending towards its agreed policy priorities, and instead its accountability is centred on bureaucratic processes and financial procedures rather than better policy outcomes.

Finally, "Social Europe" remained largely a rhetorical construct. Debate was polarised between those who interpreted anything labelled "social" as a burden on business and those who advocated a traditional “social agenda” centred on labour market regulation. The Commission tried to focus attention on the “new social challenges” facing Europe – but was less clear about what new policies at EU level might flow from this. However, some political space for future European action was created by the establishment of a pale version of the Globalisation Adjustment Fund that had been proposed some years earlier, and the advancing debate on “flexicurity”.

The crisis as a catalyst for change

Yet this lack of integrationist momentum seemed unimportant given that the first decade of the twenty-first century was turning out to be a period of relative success for the European economy. Until the crisis broke out in the autumn of 2008, the prospects for radical policy innovation, outside the fields of energy and climate change, were poor. This reflected the prevailing orthodoxy that the single market in legislative terms was near complete; the euro had become quickly embedded in its early years, without a degree of turbulence that fundamentally called into question its governance; and social and budgetary questions were in the classically “all too difficult” redistributive category that many member states had no appetite to grapple with. Given the dominance of that view, it was generally assumed that the internal development of the EU would more or less proceed benignly as a result of market dynamics, the full exercise of the Commission’s powers of implementation and ECJ jurisprudence. Hence the focus of everyone’s attention could safely shift away from what seemed tired and stale internal questions and debates to the role of the EU as a global actor.

Perhaps the prevalence of this mood explains why Europe’s initial reaction to the global financial crisis was somewhat complacent and its impact seen as containable. The crisis was seen as a problem of Anglo Saxon financial capitalism, made in the US, with the implication that spillovers to the continental economy at least, would be limited. Obviously, some member states were exposed, such as the UK and Ireland, where financial services had grown (too) rapidly as a share of economic activity, and these member states, together with Spain, had seen an unsustainable boom in bank lending, house price rises and consumer spending growth in excess of GDP growth.

However, this complacency did not last long. The seizing up of the world financial system shook the banking system to its foundations in Europe as much as the United States. The spread of the crisis from Wall Street to Main Street triggered a sudden collapse in consumer confidence and world trade, to which Germany as the world's leading exporter, has been particularly exposed.

The crisis then found the European Union ill prepared – not surprisingly since few experts had predicted what would happen and even fewer seemed ready to do anything about it. Some had foreseen a looming problem in that financial market integration in Europe had proceeded apace without an adequate parallel development in the effectiveness of financial regulation at EU level. But even had better cross border supervision been in place, there is legitimate doubt how far it would have mitigated the scale of the crisis. The problem for supervision may have been a failure, possibly even a mental unwillingness, to understand the nature of systemic risk as much as a failing of regulatory processes. And when the problem became one of bank solvency, the absence of any European fiscal authority with the power to tax meant that member states had to take responsibility for bank rescues and recapitalisation.

For Europe, the banking crisis posed a classic problem of coordination similar in nature to the need for complementary structural reforms at EU and national level that the Lisbon strategy was intended to facilitate, but in this case, with a need for sudden urgency to find a resolution. The October 2008 European Council more or less managed to adopt a broadly pitched framework for national financial rescues that followed the UK model. This implied recognition that uncoordinated individual national responses could pose huge problems for other member states. At the same time, there was a recognition that the sudden demand shock created by the crisis could only be countered by government fiscal stimulus, but that would be far more effective if member states acted together. The Commission produced a fiscal stimulus plan – implementation of which has been imperfect and uneven – but nevertheless counts as a significant new move in economic policy coordination.

Other responses to the crisis, however, have largely been national, and the consequences of national actions for the EU have been treated as second order issues. Governments have sought legitimately and properly to protect their citizens against the impact of the crisis: the unprecedented risks of loss of savings due to potential bank collapse; more mortgage defaults and housing repossessions; and business bankruptcies. Emergency measures have been taken to mitigate the impact of the crisis on particularly vulnerable sectors, for example the motor industry, where orders have collapsed as new car purchases have been deferred.

But emergency actions taken at national level will inevitably lead to distortions in the single market. The scale of these remains uncertain until the crisis has worked its way fully through. We know already that, in banking and motor manufacturing, the provision of new state aids has been extensive. There is no certainty that these distortions will be easily unwound in the near future, unless there is a strong political call to do so in the Council, and a powerful Commission willing to take on recalcitrant companies and member states.

Regrettably, but in truth unsurprisingly, the crisis appears to be encouraging politicians to take nationalistic "my citizens first" positions. This poses large risks, not just to the single market, but also to the internal unity of the EU – particularly solidarity with the new member states. Calls for firms receiving public aid to repatriate investment, banks being under pressure to concentrate their lending on domestic customers, and increased resentment about foreigners (from other European countries) stealing "our jobs" are prime examples of tendencies that could easily get out of control, thus undermining the very foundations of the European edifice.

Gradual disintegration is surely one possible outcome of the economic crisis, but not the only one. Crises in the past have led to a stronger and more integrated EU; it can happen again. And there are already significant signs in that direction. European leaders have already committed themselves to a programme of reinforced financial regulation to buttress a "more responsible capitalism", and there is also growing consensus for a stronger coordinating role of EU institutions in trying to close the gap between objectives and delivery. Such a development would have profound consequences for Member States that often appeared to be reluctant to allow greater regulatory control over their financial markets.

Finally, there is also growing readiness to recognise the deepening economic crisis in Central and Eastern Europe, with a real risk of meltdown, as a European problem that will, in turn, require European, as well as international, action; and that would surely be costly. Will some governments nevertheless be prepared to take exceptional steps which can prevent any member country from defaulting on its national debt, thus undermining the stability of the European single currency?

<u>Options for a new political economy of integration</u>

The ongoing economic crisis may indeed lead to more integration, accompanied by a paradigm shift in the political economy of the EU. Ideological preferences will surely make a difference. At a first level, this difference will take the shape of a reversion to a familiar pro or anti European debate. On one side are those who feel that the EU offers a shield against the disruptive forces of global capitalism, potentially far wider and thicker than the diminished role that the nation state can now offer. Ranged against that view are those at the Right and Left ends of the political spectrum, those who see European integration as part of the problem, not the solution. They will want to see a stronger nation state as a consequence of the crisis, whether in protecting jobs at home, controlling migrant labour, or supporting national businesses in trouble.

The lessons of the crisis may be interpreted quite differently even among those who see an important role for the EU between the national and the global. One can identify four distinct camps. First, what we may call "**integrationist interventionists**": those who see the crisis as an opportunity and a justification for a wide range of public intervention in the economy, not just the need for tighter financial regulation. They originate from the traditional Left, but they also recognise that Keynesianism and industrial policy activism can only be effective at the European level given the degree of economic interdependence already reached.

In contrast, "**economic liberals**", who regard the single market as a central EU achievement, will only be "market-conditional integrationists". They will want to consider whether and how EU institutions need to be strengthened as an agency of liberalisation, both internally and in the wider world, in order to better defend, or indeed re-impose, what they regard as essential commitments to the four freedoms of the Rome Treaty and the centrality of the Union's espousal of the single market to its work.

There will also be some "**market redistributionists**" who would count themselves in the market liberal camp, although more prepared to embrace social and regional policy measures at EU level aimed at strengthening political support for open markets, as long as they cause no significant damage to competition, efficiency and dynamism.

Finally, there will be "**better market orderers**" who in the classic German social market tradition place heavy emphasis on closer social regulation of how financial markets operate and how business conducts its affairs and exercises its wider social responsibilities. This view gives priority to getting frameworks right and frowns on day to day public interventionism: it is fundamentally about shaping behaviours in the market place, not altering market outcomes. How will these different perspectives play out in their impact on future policy?

The fundamental concern that will unite (virtually) all strands of pro European thinking is the survival of the single currency. For "market orderers", the euro is what binds together the social market they seek to build. For "market liberals" and "redistributionists", it is the cornerstone of liberalisation without which the risk of fragmentation in the single market would grow as member states sought to protect their economies against the consequences of exchange rate instability. For “interventionist integrationists”, the existence of the euro holds out the hope of stronger European economic government.

Doubtless there will be political wrangling about, maybe even crisis in, the future of the euro and how to secure its stability. Yet, it is arguable that the financial crisis has already strengthened the bonds of informal cooperation within Ecofin and the Eurogroup. If the Lisbon Treaty is ratified, this is likely to result in greater formalisation of the role of the Eurogroup, though enhanced coordination will have resulted from shared experience of crisis, rather than simply from a set of treaty changes. Although the centralisation of fiscal authority in the eurozone may be a very long way ahead, more meaningful targets for each member state could be framed on the basis of a sustainable long term debt to GDP position.

Since the euro constitutes the most advanced form of flexible or differentiated integration, the link between the Eurogroup and Ecofin will continue to be delicate, to put it mildly. The role of Ecofin will surely not disappear: it is strongly in the interests of the eurozone that the necessary strengthening of financial regulation is agreed on an EU-wide basis. As the City of London is the “de facto” financial centre of the eurozone, despite being outside it, this still gives the UK significant, albeit conditional, leverage in designing the detailed shape of the new regulatory regime.

“Unfair tax competition” and “social dumping” are likely to feature prominently on the European agenda and they could also be linked indirectly to any future bailout operations for member states in trouble. And pressure to deal more effectively with tax havens is also likely to grow further as the old rhetoric of tax competition fades away. But there will be inevitable rows and tensions between the “market liberal” and “market ordering” views of how all this should be done, laced with vested national interest.

Financial services re-regulation will be at the heart of the reconstruction of the single market, once the worst of the crisis is over. Then, a great deal will depend on the vigour of the Commission in tackling the market distortions that the crisis has introduced, which will probably be a long haul slog over at least a decade. Some will argue that the crisis strengthens the case for an independent competition and state aids authority at EU level rather than the more politicised Commission, although most member states continue to see the Commission as already far too robust in its defence of the market liberal obligations of the Treaties.

Market liberals will probably have to give some ground to interventionists in this process of rebuilding the single market: for example the modernisation of the motor manufacturing sector, alongside wider policies to promote the transition to the low carbon economy, may be the early twenty first century equivalent of the structural policies for reshaping the coal and steel sectors in the first decades of the European integration.

Assuming the economic crisis is long lasting, it will lead to a serious social crisis. Much of Europe's impressive employment growth has been in the second tier labour market of insecure jobs with inadequate protections and employment rights. The privileged position of the labour market "inner core" is likely to seem even more indefensible. This should sharpen the debate in favour of more balanced "flexicurity", although it is impossible to foretell whether this will result in new EU labour market legislation or budget programmes.

One looming issue is how member states choose to manage domestic opposition to full internal labour mobility, which is supposed to come about in 2011. There will be pressure from the Left for a revision of the posted workers directive, for example, in order to limit the potential for wage undercutting and "social dumping": it would be, of course, a very divisive issue with those that have recently joined. This is one example of where the Left -Right balance in the European Council and Parliament can make a real policy difference.

A social crisis – combined with populist opposition to labour migration – may also lead to a new look at EU social policy. European funds could be used to realise some form of minimum income or anti- child poverty guarantee across the Union: a possible "sidepayment" for other liberal measures. The crisis also strengthens the case for wider EU budget reform; some rebalancing between instruments of economic and social cohesion could be part of it. If the crisis is prolonged, demand may grow for a Europe–wide recovery plan based on a modern version of Keynesian measures, including investment in low carbon transition, research and skills. This could be financed through the issue of Eurobonds.

The EU needs an overarching internal policy framework to replace Lisbon. This should embrace structural reforms to open up markets and strengthen competition; the sustainability and low carbon dimension; a new approach to regional policy and redistribution; and a modern social policy. This framework should also acknowledge the need for differentiated national approaches toward common goals given Europe's increased diversity. Several elements of the basic economic and social contract between Europe and its national constituents will need to be redefined as a result of the crisis.

European power in search of substance

European integration started as an inward-looking venture: the fathers of Europe (there were no mothers at the time) began to lay the foundations for peace and reconciliation in Europe after the end of the Second World War. Global order was taken as given and shaped by external actors. Greater prosperity, through the elimination of economic borders, was added to the list of key objectives; and so was democracy when new members with fragile institutions later joined in. Europeanisation thus acquired a much broader dimension.

The role of Europe as an external actor began with trade; it was part and parcel of the customs union. It gradually extended to other areas of policy, reaching all the way, albeit timidly, to traditional foreign policy and defence. The legal and institutional basis for EU external policy varies considerably from one area to the other, and coordination of different policies and instruments leaves much to be desired. True, there has been a great deal of the so-called spill over, but the experience of trade has proved difficult to transplant to other areas of policy. The EU is not a power in the traditional sense of the term, nor is it, of course, a typical international organisation. It continues to defy classification, which may be one of its many attractions.

Europe has developed a comparative advantage in different forms of soft power, through trade and aid, as well as its support for multilateralism and the defence of global public goods. Civilian power was the term coined for Europe many years back; normative power is another term used now to denote an emphasis on values and rules rather than interests narrowly defined.

There is, however, another less benign reading of Europe's collective role in the world as manifested through the EU. Adherents to the doctrine of *Realpolitik* would argue that Europeans are trying to make virtue out of necessity: soft power is often based on a low common denominator of (still) divergent national perceptions and/or interests, while Europe continues to depend on the security umbrella of the United States provided through NATO. There is so much that Venus can achieve in a world where martial arts remains a popular game – and we all know that Europe is weak militarily, with the exception of Britain and France.

The complexity of today's world offers enough examples to competing schools of thought in support of their preferred views of the world, and the policy implications that follow. Considerable progress has indeed been made over the years in bringing closer together the interests and policies of individual member countries, in some cases forging common policies out of them. Yet, there is little doubt that Europe's influence in international affairs is not commensurate with its collective size. To put it in simple words: the EU is less than the sum of its parts. Does it matter? And if so, what, if anything, can be done about it?

In a rapidly changing world where size matters, can Europeans define and collectively defend common interests and values? And perhaps more ambitiously, do they have a model they can export to the rest of the world?

Trying to do so, the Europeans will need to identify those policy areas where commonality of interests and values prevails over diversity – and then go on to invest in their unity in terms of money and institutions. Intergovernmental cooperation, when not backed by budgetary instruments and the appropriate institutional infrastructure, can only deliver so much: enough for those with modest expectations.

Europeans will need to address politically awkward (and often divisive) questions, including Europe's relations with the big powers and, most important of all, relations with Europe's most significant other, namely the United States. And they will also need to recognise that soft or normative power – dare we hope, even smart power – is not necessarily identical with talking power. As we all know, Europe does a great deal of talking, sometimes as a substitute for other things. There are political choices to be made with respect to common instruments and policies, as well as methods of reaching decisions internally and ways of being represented internationally. Choices involve trade-offs: they should be made as clear as possible. When it comes to the crunch, some countries may prove more ready than others to seek joint forms of external representation.

The Lisbon Treaty attempts to provide an institutional framework that is conducive to a more effective European presence on the international scene. It is far from perfect, and it can only provide a framework. This is what treaties are for. The contents of policies can only be decided later. At the time of writing, the future of the Treaty is still in doubt. Failure to ratify it would reduce the chances of Europe being able to exert a real influence on its external environment.

Neighbours and future partners

Foreign policy begins, of course, with the neighbours, and Europe's neighbourhood is mostly poor and unstable. Successive rounds of enlargement have been the most effective foreign policy of the EU. They have helped to export *Pax Europaea* to an increasing number of countries on the continent and they have also acted as a convergence machine for the economic periphery of Europe. This is a record to be proud of.

The big bang enlargement of 2004 and 2007, with the accession of twelve new members, has been the most daring, and also the most difficult. The appetite for further enlargement is now limited: arguably, a sign of indigestion, which will not be helped by the economic crisis. Many people believe that the criteria for accession have been applied loosely, at least in some cases. A strict application of those criteria in the future will mean that several candidates, including Turkey and most countries of the Western Balkans, not to mention possible future candidates such as Ukraine and Georgia, will have to exercise their patience in the waiting room for several years to come.

The process of further enlargement will be long – it also appears to be highly unpredictable. It will require strategic decisions, which the EU is not always best equipped to take. Hiding behind the technical aspects of the *acquis* is politically more convenient; it is also a much more natural reaction for bureaucrats. On the other hand, enlargement raises uncomfortable questions about internal cohesion, identity and borders, not to mention the budget and institutions. Whether we like it or not, enlargement has become politicised, and there is no way back.

We know that all previous attempts to offer substitutes for full membership have not convinced any of the candidates. It is unlikely to be any different in the future. Yet, if further enlargement proves to be a long drawn process at best, the EU will be forced to devise intermediate stages, and link them with concrete benefits, for countries in the waiting room. We need to do much more in this area. The emphasis on the adoption of EU regulations, as a pre-condition for improved access to the European internal market, inevitably carries with it an economic cost for countries with lower levels of development. This applies to other associated countries with no prospect of membership, only more so. Exporting rules and regulations to neighbours and others is not always cost-free.

Europe's neighbourhood is highly diverse: a common policy applying to all countries should recognise this diversity, and hence allow for much needed flexibility in relations with individual countries. The Union for the Mediterranean and the new Eastern Partnership are recent attempts to revitalise neighbourhood policies addressed to the South and to the East. Even though the EU would prefer a multilateral approach, geopolitical realities will impose their own logic and limitations.

European soft power in the neighbourhood has to tackle relations with Russia, as a pre-condition for a successful Eastern policy: easier said than done. Similarly, turning the Mediterranean into an area of peace and prosperity depends crucially on the resolution of the Israeli-Palestinian conflict, the EU having so often been reduced to the status of a frustrated observer while the carnage goes on in the Middle East. Such are the limitations of a timid (and often divided) civilian power.

Four policy areas for Europe as a global power

Trade policy, financial services, energy and climate are four areas in which the role of the EU will be crucial in the years to come. They combine the old and the new as Europe's fields of competence go on expanding, usually in response to a rapidly changing external environment.

The EU is already big and influential in trade matters; influence is indeed commensurate with its size, being the biggest trading bloc in the world. The Commission negotiates on behalf of the Union on the basis of mandates agreed by the Council through qualified majority voting. Material conditions differ widely inside the Union and so do political preferences on national or ideological grounds. Yet, the European legal and institutional system succeeds in delivering common positions in international trade negotiations, admittedly through intense bargaining and complex package deals, which are the trademark of the EU.

Liberal principles are not easy to reconcile with domestic interests and pressures, from agriculture all the way to shoes, cars and financial services. In times of economic crisis, with unemployment rising and national governments busy spending money to save financial institutions and other lesser mortals from bankruptcy, the task will become exceedingly difficult. It will not only affect European trade policy vis-à-vis the rest of the world: the survival of the single market will also be at stake.

Europe has been an advocate for multilateral management and rules for the international trading system, albeit not always in a consistent manner. For years, it tried to do a difficult balancing act between multilateralism and preferences. More recently, it has been tempted back to negotiating bilateral agreements. In order to be able to lead, if anything by example, in a world trading system in which power becomes more diffuse, the EU needs to be seen by others as complying with existing rules, including decisions that go against it in the dispute settlement procedures of the WTO, which itself has played a key role in setting up.

The EU has repeatedly tried to promote regional integration in other parts of the world, albeit with limited success. It should perhaps recognise the limitations of this approach, at least for the time being. On the other hand, Europe continues to suffer from the fragmentation of its trade policy, because EU competencies remain limited in the so-called new areas, including most notably services. Such fragmentation does not help Europe's negotiating stance in international fora.

The trade deficit with China is dangerously large in times of rising protectionism. However, Europeans will need to think hard whether it would be politically advisable to follow the recent US example of linking this trade deficit to currency manipulation by China. In any case, they should avoid speaking with 27 different voices, and thus risk not being heard at all in the vast land of this rapidly emerging Asian power.

The illusions held by so many people and for so long concerning the efficiency and self-regulating capacity of financial markets have come crashing down, causing a real disaster for the global economy in the process. The need for new standards, more effective financial supervision and global economic governance more generally are now almost universally recognised, although the devil will surely lie in the specifics. And we are only in the beginning. For a globally integrated market, nothing short of global solutions will make much sense. The credibility of the old hegemonic power has suffered a big blow; power will now be more diffuse, although of course not equally distributed among the key players. Free riding, through regulatory or tax havens, is less likely to be tolerated than before.

Europe will be a major player in the negotiation for a new global financial architecture, sometimes represented through the big countries, sometimes through the eurozone, and perhaps less so through the common institutions of EU-27. The form of external representation will in turn largely depend on what happens internally. Will attempts at strengthening global economic governance concentrate on existing financial institutions, albeit reformed, or will they instead be canalised through more loose intergovernmental structures along the lines of a revamped G-20? Whichever direction we go, the IMF seems to have been resurrected from the dead with an important mission in times of crisis. A real reform of the IMF, unlike what was achieved last time round, can only go hand in hand with a major redistribution of power in its governance structure.

Europe has been a keen supporter of strong international institutions and common rules, trying to project its own positive experience to the global level. Europe is also grossly over-represented at the IMF executive board, as it is also at the World Bank equivalent. Those calling for a single representation of EU countries, or perhaps more realistically the eurozone, coupled with a substantial reduction of the overall European weight of votes in those two financial institutions, have been growing in numbers. Such a move would have a strong symbolic value, while also providing a powerful lever for the reform of international financial institutions. Is Europe ready to turn rhetoric into action, or not yet?

Energy is not new on the European agenda, although the record of concrete achievements remains feeble. Coal went quickly into decline in the founding countries, while nuclear energy never took off as a collective European project. The completion of the internal market to include energy, security of supply and, increasingly, the link with climate change have become in recent years the main drivers for a European energy policy.

The EU is highly dependent on imported energy, especially oil and gas; this dependence will grow further in the future. On the other hand, import dependencies vary significantly from one member country to the other, and so does the energy mix, including the role of nuclear power, in each country. There is as yet no European market for energy; instead, a juxtaposition of national markets with different forms of state intervention and limited links between them.

The Commission has been pursuing a policy of 'unbundling' in electricity and gas, as a way of strengthening competition and creating a true European market for energy. This policy remains controversial. Do we need instead large companies in an inherently oligopolistic market, in which so much of the production is in the hands of large state controlled companies? And would the establishment of European grids in electricity and gas be a surer and more direct way of creating an integrated market?

European grids, strategic reserves, development of renewables and greater efficiency have been identified as the principal means of reducing Europe's dependence and vulnerability in terms of energy. The progress report so far is not very encouraging: delivery remains painfully slow.

The same is true with respect to the development of a common external energy policy. It certainly does not help that the main suppliers are to be found in Russia and the Middle East. Energy policy is inextricably linked with high politics: the European component is weak in both. National preferences often differ, and few seem prepared to entrust the Commission with representing their interests in this sensitive area of policy. Oil and gas pipelines have tended to divide European countries. Russia has been only too keen to exploit those divisions, while US pressures have not helped much either.

Energy is a prime example of how Europe could make a real difference combining the depth of a large internal market, solidarity among members and strong negotiating power vis-à-vis foreign suppliers. At the same time, it remains a prime example of the wide gap between ambition and delivery.

Energy is directly linked to climate change. Europe is turning 'green'; at least, it is aspiring to be. And it has also become a world leader in the fight against climate change, consistent with its ambition to act as a normative power defending global public goods. With the early adoption of post-Kyoto targets, Europe is trying to lead by example and also help set the international agenda. The arrival of President Obama means that Europe will now have an interlocutor it can discuss business with on the other side of the Atlantic.

There is, however, still a long road to travel. European targets need to be translated into realistic deliverables. There are big costs involved – and the politics of distributing those costs inside the EU is both difficult and painful. The negotiation on the Climate Energy Package provides clear illustration. Internal negotiations require consensus, which in turn raises the risk of agreements being reached on the basis of the lowest common denominator. The shift from coal to gas in some of the new members also raises awkward questions and trade-offs between security and clean energy. Will the EU be able to match its rhetoric with internal measures? And what if it fails to convince other key actors to commit to ambitious targets on the post-Kyoto climate regime? There is so much at stake on this issue, including, of course, Europe's credibility.

The global age has been forcing the European Union to turn outwards. In times of crisis, defending common interests and values, as well as drawing lessons from its own successful experience for global governance, could provide Europe with a new mission. There are difficult choices to be made and bargains to be struck; and there will always be a close link with internal policies. In a world in which power is becoming increasingly diffuse, but still very much unequally distributed, the risk of being marginalised will continue to provide the main driving force for the development of common European policies in relation to others.

ENDS

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The authors would like to thank Simon Latham, Policy Researcher at Policy Network, for his excellent assistance in producing this first draft. If you would like to comment on the synthesis report, please send an e-mail to: slatham@policy-network.net

<u>*Information on the project*</u>

The EU 'Fit for Purpose' project is organised by Policy Network, in partnership with the European Institute of the London School of Economics and ELIAMEP. Aside from the authors of this report, the project is also co-directed by **Maurice Fraser**, senior teaching fellow at the LSE's European Institute.

The central objective of this research initiative is to determine how the European Union can reform itself, both "internally" and "externally", to overcome and respond to the multifaceted challenges of the global age we now live in. The project's programme of study concentrates on areas where consensus is most difficult to establish, not where it is easiest to find. It was devised after a high-level brainstorming session in London in May 2008, which was based on a substantial critique by Loukas Tsoukalis of the challenges and choices facing the EU in an age of rapid globalisation.

Since then, the project has sought to engage with senior academics, policy-makers and government advisers from across Europe, with further symposia in Hydra Island and in Paris, on the key clusters of policy choices facing the EU post-2009. Notable contributors, among others, have included the former EU Commissioners Mario Monti and Anna Diamantopoulou.

On 9 March, 2009, Policy Network is convening its working group at the LSE for a seminar discussion of the first draft of this synthesis paper with other distinguished academics, government advisors and political thinkers. The discussions in this seminar will form the basis of revisions to the synthesis paper before final publication in April. A public lecture will also be held after this seminar at which the UK Foreign Secretary David Miliband and the Dutch and Irish Europe Ministers, Frans Timmermans and Dick Roche, will comment on the wider political implications of options outlined in this report.

Further details on the project can be found on the Policy Network website: www.policy-network.net

Papers and Publications

This synthesis report was informed by substantial policy papers submitted by the following authors:

Giuliano Amato, former prime minister of Italy
Alyson Bailes, University of Iceland
Stefano Bartolini, European University Institute
Iain Begg, London School of Economics and Political Science (LSE)
Nick Butler, University of Cambridge
Thierry Chopin, Robert Schuman Foundation
Fredrik Erixon, European Centre for International Political Economy (ECIPE)
Tony Fahey, University College Dublin
Kevin Featherstone, LSE
Maurice Fraser, LSE
Gabriel Glöckler, European Central Bank
Edgar Grande, University of Munich
Anke Hassel, Hertie School of Governance
Dieter Helm, University of Oxford
Dermot Hodson, Birkbeck College, University of London
Wade Jacoby, Brigham Young University and European University Institute
Charles Jenkins, The Economist
Nikos Koutsiaras, University of Athens and ELIAMEP
Alan Mayhew, University of Sussex
Patrick Messerlin, Sciences-Po, Paris
Sophie Meunier, Woodrow Wilson School at Princeton University
Simona Milio, LSE
Jörg Monar, University of Sussex
Xavier Prats Monné, European Commission
Carlos Mulas-Granados, Complutense University Madrid
Hans G. Nilsson, College of Europe

Pier Carlo Padoan, Organisation for Economic Co-operation and Development (OECD)
George Pagoulatos, Athens University of Economics and Business and ELIAMEP
Jean Pisani-Ferry, Bruegel
Lenka Rovna, Charles University, Czech Republic
Razeen Sally, European Centre for International Political Economy
Marco Simoni, LSE
Pawel Swieboda, demosEuropa
Anna Triandafyllidou, Democritus University of Thrace and ELIAMEP
Laurence Tubiana, Institute for Sustainable Development and International Relations
Nicolas Véron, Bruegel
Stephen Wall, former UK permanent representative to the European Union
Helen Wallace, LSE
Matthieu Wemaere, Institute for Sustainable Development and International Relations

These contributions will be published by Policy Network in three high-profile pamphlets this forthcoming autumn, launched at a major Brussels conference. Each pamphlet will deal with a central thematic dilemma that the EU now faces in a world of globalisation, multi-polarity, and economic uncertainty:

1. The challenge of solidarity, legitimacy and governance
2. A new socio-economic settlement after the financial crisis
3. EU leadership and security in the global age

More information about these pamphlets will be made available on the Policy Network website in due course.