



## Brussels Bureaucrats and Whitehall Mandarins

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March 2017

# Quo Vadis? Identity, policy and the future of the European Union

Edited by Thorsten Beck and Geoffrey Underhill



**A VoxEU.org Book**

CEPR Press

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A VoxEU.org eBook

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# Foreword

With political and economic instability across the globe, it comes as little surprise that the European Union is in a crisis of its own. Events such as the Brexit vote, the refugee crisis, and the tide of populism have revealed problems with the identity of Europe that were previously hidden. The solidarity felt during the inception of the European project seems to have been lost to nationalist tendencies through this unfortunate culmination of events.

The aim of this eBook is to focus on the identity of the European Union in the post-crisis period, specifically in ‘socio-economic policy’. It emphasises not where the EU has come from, but where it should be going and the difficulties that policy may face along this path. The authors present a wide range of ideas and policy solutions to the dilemmas that have caused so much disruption. They focus on populism, globalisation, inequality, EU governance and structure, financial institutions and the role of economics in policymaking.

In a time of uncertainty for the European Union, this eBook is essential reading to understand how policy solutions can tackle the dilemmas we face. Widespread issues such as youth-unemployment and terror-threats are discussed by economists and political scientists to start a conversation on a sustainable future for Europe. The interdisciplinary character of the book shows the important role that social scientists have in the urgent attempt to revive the European project.

CEPR is grateful to Professors Thorsten Beck and Geoffrey Underhill for their joint editorship of this eBook. Our thanks also go to Simran Bola, Sophie Roughton and Anil Shamdasani for their excellent and swift handling of its production. CEPR, which takes no institutional positions on economic policy matters, is delighted to provide a platform for an exchange of views on this crucially important topic.

Tessa Ogden

Chief Executive Officer, CEPR

March 2017



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# Introduction: Europe – quo vadis?

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**Thorsten Beck and Geoffrey Underhill**

Cass Business School, City, University of London and CEPR; University of Amsterdam

Europe is clearly in a crisis – a political crisis with the impending departure of the UK and anti-integration sentiment on the rise across the member states; an economic crisis with the Eurozone only slowly (and after almost a decade) coming out of low or no growth and with many countries still enmired in recession; a social crisis, with a large share of the youth in many countries either unemployed or underemployed and the future of the aged likewise increasingly uncertain. These analytically distinguishable dimensions of crisis are interacting dangerously and quickly. The institutions and even the very idea of the European Union are under fire. Most importantly at the national level, large parts of populations feel disenfranchised, driving rising support for populist parties across Europe. At the same time, the EU faces external threats from the East (Putin) and the West (Trump), both eager to weaken, if not destroy, European unity, including the EU. It is no exaggeration to say that Europe as political entity is facing its greatest existential challenge of the past 70 years. The historical assumption that this particular crisis will, as in the past, lead to further European integration and last-minute solutions to this latest iteration of crisis should not be taken for granted. *Quo vadis* Europe and the EU?

This interdisciplinary eBook brings together 18 short essays by economists and political scientists. The focus is on analysis of this multidimensional crisis, and, above all, on the way out: the future of the European Union. The chapters cover a particularly wide range of policy issues and challenges, ranging from the dynamics of the EU's 'policy identity', to how to deal with populism, to an eventual rebalancing or even radical revision of the division of powers between Brussels and the member states.

The eBook also deals specifically with the challenge of reform facing some of the more crucial policy domains, such as fiscal policy and the efforts at banking and financial union. Alarmingly common to all the chapters is the message that muddling through will not be enough to save the EU as a political project. The contributors also explicitly aim to counter the charge from some quarters that the insights promoted by economists and scholars of the social sciences might be a central part of the problem. These 18 essays offer solutions, some of them bold. Our premise was that what is needed is fresh, out-of-the-box thinking!

The remainder of this introductory chapter offers a brief overview of the various chapters in the eBook. The volume is divided into five parts. It opens with a series of contributions on European identity issues that serve to frame the debate, and proceeds to link this in the second part to the rise of populism. Part three focuses on the structure of EU governance, and part four focuses on specific policy domains. The concluding part looks at the role of social scientists, and in particular economists, in the new world order.

## **European identity**

In the opening chapter, *Geoffrey Underhill* discusses the historical development of the policy identity of the EU, starting with the initial effort to permanently cement the post-1945 peace in Europe and ensure the restoration of European power and economic vitality. Over time, additional policy areas were added, including the customs union, agricultural policies, and the Single Market. Exchange rate cooperation and monetary union added another important macroeconomic aspect. To this expanding set of policy competences was added the ongoing dynamics of expanding membership, which increased from six to ultimately 28 countries, eventually integrating the former communist countries of Central and Eastern Europe. This process remains at least notionally incomplete, as more candidate countries prepare themselves for eventual membership. The policy identity of the EU thus evolved a long way from its early inception to the integrationist nadir of the 1990s and early 2000s and a new emphasis on solidarity, a budding social Europe, and a broadening of competencies. The initial and overwhelming popularity of the EU has unfortunately given way not only to integration fatigue, but to outright anti-Brussels political parties and movements.

Underhill concludes, however, that the responsibility for both policies and popularity (or the lack thereof) is clearly at the national level, and policy solutions must start from the national level and the behaviour of member states new and old.

Beyond the many policy-specific ‘technical crises’, the EU seems to be suffering from a more general crisis of identity. *Maurizio Ferrera* asks: what does it mean to be a European? Integration proceeded so as to favour the emergence of a pan-European elite identity, while the inherited weight and inertia of national cultural frameworks prevented the emergence of a deeper sense of common citizenship, or ‘neighbourhood community’, across the EU. The ‘econocracy’ and austerity politics of the recent crisis years has eroded what little sense of solidarity there might have been. In particular, the equality principle among nations in the EU has entirely broken down. Ferrera suggests two options for the way forward: (i) a both symbolic and institutional reaffirmation of political equality as a principle in EU governance; and (ii) a reaffirmation of the importance of national liberal-democratic welfare states as the solidaristic underpinning to the ‘European Social Model’.

*Theresa Kuhn* likewise argues that evidence of a genuinely European identity remains limited to a small avant-garde. Specifically, the individual experience of transnationalism and corresponding support for the EU is limited to a small segment of the population at the upper end of the socioeconomic ladder. This is consistent with the evidence presented by *Jonathan Story*: only 2% of EU citizens view themselves as ‘Europeans’ (i.e. favouring EU aspirations), with only 6% regarding a European identity as more important than their national identity. The push for EU policy and identity is driving a backlash against European integration among those Europeans who are not transnationally active themselves. So transnational experience needs to be locked in to what Europeans do, for example through the proposal from a member of the European Parliament to provide all young Europeans with a free Interrail Pass so they can experience Europe themselves.

Looking beyond the EU to the historical legacy that is Europe, *Story* reminds us of four striking characteristics of Europe: the shared cultural inheritance from Greece and Rome, the mosaic of interdependent peoples and states sharing an overall common inheritance, limited difference between intra-European politics and diplomacy, and the pursuit of peace as a founding principle. This last aspiration implies that the conflictual dynamics of national competition are to be replaced by a European-level

consensus. Story argues cogently that this can no longer be pursued through top-down supranational aspirations that have failed to elicit the consent of European citizens. Brexit, the threat of terrorism, ongoing Eurozone crisis, and also increasing claims for more local politics, all imply that reform solutions must start with an alliance of constitutional sovereign states – a bottom-up rather than a top-down approach.

## **Populist parties**

A defining characteristic of post-crisis EU politics has been the rise of populist parties, apparently sharing a largely common agenda on both the left and right. Well, yes and no, says *Brian Burgoon*. While left and right might share an anti-EU policy stance, radical parties on the left are consistently less anti-globalisation than those on the radical right. Indeed, the position of the populist left on globalisation issues is closer to the mainstream party average than to their radical-right counterparts. The historical origins of left versus right continue to matter, and mainstream parties in search of support thus need to make choices that reflect these different European traditions.

Alongside populist success, the Brexit vote is probably the clearest manifestation yet of popular protest against the elite political and bureaucratic establishment. *Sascha Becker, Thiemo Fetzer* and *Dennis Novy* match voting data with the socioeconomic characteristics of electoral constituencies and find that immigration from Central and Eastern Europe and austerity policies combine to explain the vote in favour of Brexit. *Diane Coyle* and *Rob Ford* argue that the powerlessness and alienation felt and expressed by Brexit voters was perfectly rational, but was focused on the wrong target. Echoing other contributions in this volume, they argue that the problems that have left these people politically marginalised are generated in Westminster, not Brussels. They see more political devolution in the UK as the only solution.

What might be done to counter the rise of populist parties? *Gijs Schumacher* suggests we should focus less on accommodating or opposing the host ideology of contrasting populisms, and more on developing mainstream proxies for their anti-establishment flourish.

The range of managerial and technocratic responses to the crisis may have promoted appropriate policies, but were much less successful at crafting and maintaining political identities. In particular, opposition politicians have been neglecting the psychology of voters and the extent to which all politics is emotional. This helps explain the dramatic failure of technocratic governments that took over in Italy and Greece at the height of the crisis.

## European governance structure

*Andrew Gamble* points out that serious governance reform in the EU requires treaty changes. This would inevitably trigger referenda in several member countries that pro-EU parties are unlikely to win against the populist parties. The EU is seen by its citizens – and is often portrayed as such by the governments that built it – as a remote supranational body which promotes globalisation, liberalisation, and cosmopolitanism, rather than as a state which protects its citizens. It is thus an easy scapegoat for the problems that afflict national economies – an obstacle which prevents national governments from tackling these challenges. Added to this, the EU has itself tried to masquerade as a sovereign power despite its high degree of dependence on the vicissitudes of member states and the highly limited fiscal means it possesses to address independently the problems faced by all. Too often, member states have dismissed the downside of national compromises as the work of ‘Brussels’. Echoing Story and others, Gamble concludes that the EU (or rather its member states) must choose: match its ambitions with the necessary means, or scale back!

*Kevin O’Rourke* likewise sees a clear binary choice for the EU: it should either serve as a port in the storm for anxious electorates, sheltering them from macroeconomic instability and the negative consequences of globalisation; or, failing that, it should stop preventing national governments from playing that necessary role. The EU as a whole must restore policy space at the national and/or European level, thus also restoring Europe’s political-economy shock absorbers. Similarly, *Erik Jones* points out that there is a vast asymmetry between the costs of national responsibility assumed by those states that suffered the greatest losses over the course of the Eurozone Crisis versus those less affected. This doctrine of national responsibility is far from conducive to the creation of a European identity through the solidarity principle. Instead, the trend is towards a loose confederation of nation states.

Europeans may identify with that arrangement, but they are unlikely to give it their allegiance. If we want to turn this negative dynamic around, mutual solidarity needs to be visible to citizens, regardless of national economic success.

*Erik Berglof* wraps up this part with a step back in history. He points to the important role model that the EU has played for Central and Eastern Europe during the transition process (above all by extending the prospect of membership). Unfortunately, the paralysis or potential collapse of the EU means that fragile states in the EU neighbourhood, to the East and in the Balkans, would lose this promise of eventual membership. EU breakdown implies the disappearance of this crucial external anchor for institutional and economic reform, thus jeopardising their future success.

## **Policy areas**

Several chapters touch upon those specific policy areas at the core of the Eurozone crisis: fragile government finance and bank fragility.

*Sergei Guriev* points to the lessons for today's EU from the post-communist transition process. First, the heterogeneity between the members of EU, and especially within the Eurozone, must be reduced. This requires reform at the national level from many countries: reform of labour markets, of fiscal and pension reform policies, of business regulation – the list goes on. Second, the Great Recession has demonstrated the need to complete the Union, by creating a Banking Union, joint unemployment insurance, a Capital Markets Union, and joint refugee integration policies. Here, EU members can learn from post-communist countries' reform experiences in the 1990s. We may interpret the rise of populist parties in several former transition economies at least partially as a backlash against the pain of the transition process itself. Guriev thus reinforces the message of a range of other contributors – the dynamics of reform implies necessary and effective compensation for the losers.

*Charles Wyplosz* invokes several principles that he concludes constitute a call for a fiscal federalism that cuts two ways. The pressures of externalities and the requirements of returns to scale imply more centralisation; while information asymmetries and the heterogeneity of preferences both imply *decentralisation*.



Applying these principles across the range of policy domains produces trade-offs and thus different solutions across policy areas. Some policies thus require more centralisation (e.g. banking union, see below) and others need greater decentralisation (e.g. regional policies).

The most important issue is that of excessive sovereign debt, above all in Greece and several Eurozone countries. The crisis exposed fault lines between creditor and debtor countries which, at the beginning of 2017, have yet to be overcome. While the ECB has somewhat reduced the pressure on bond yields for several periphery countries, the underlying problems have not been addressed. *Patrick Honohan* certainly regards the measures taken so far as insufficient, arguing that there is still no proper framework to deal with these critically high levels of sovereign debt. A politically viable EU will only flourish if solutions address both the current legacy issues and similar problems in the future. To this end, *Jeromin Zettelmeyer* proposes swapping a portion of national debts for Eurozone debt and (addressing future eventualities) introducing a sovereign debt restructuring mechanism.

*Zettelmeyer* also argues for the limited delegation of fiscal decision-making to the Eurozone level, combined with more market discipline and less micro-management of national fiscal policies. One of his suggestions includes a Eurozone-level fiscal agency of macroeconomic significance – that is, an entity that receives revenues, spends, and is allowed to borrow. Revenue could come from a pre-agreed, cyclical revenue source, such as a Eurozone corporate tax and/or VAT. Spending could take two forms: public investment (e.g. on cross-border infrastructure), and a nominally fixed ‘cheque’ for national governments referenced to proportional national GDP which governments could use as they choose. This structure would enhance existing automatic stabilisers.

Meanwhile, important progress has been made on developing a banking union. *Rachel Epstein* and *Martin Rhodes* identify this progress as a qualified success. Innovation in the domain of deposit insurance and insolvency/resolution is still required, and the division of responsibility between the EU and national authorities remains overly opaque at this stage.

## **And the role of social scientists?**

In recent years, economists have been ridiculed and denigrated either because their predictions were wrong, or because they do not seem to understand the anger of large parts of the population in advanced economies towards a globalised and liberalised world. In the final chapter of the eBook, *Thorsten Beck* argues for a significant, if humble, presence of economists in the public discourse on policy choices. Beyond their traditional concerns of efficiency and distribution, economists must focus even more strongly on the political economy of policy choice. It is here that there is an important overlap with the work of political scientists, as this volume illustrates. Finally, it is critical for economists to move beyond technocratic analysis and policy advice to provide robust support for the institutions that provide us with the data and statistics crucial to good policy, and for an open and informed media in defence of a civilised and fact-based discourse that often proves counter-intuitive to the citizens of Europe.

# Part I

## European Identity



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# 1 A past of plural identities: The EU as a coat of many policy colours

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**Geoffrey Underhill**

University of Amsterdam

There is much political science and socioeconomics literature on the European Union and identity issues: the EU as a normative power in the world (Manners 2002) and as a (neo-liberal) ‘market’ identity juxtaposed on elements of ‘social Europe’ (Fererra 2017), and the ‘experimental governance’ literature on EU policy processes (Sabel and Zeitlin 2008). This eBook does not aim to compete with, or contribute to, this literature. Instead, the aim is to focus on the post-crisis ‘socioeconomic policy’ identity of the EU in the post-crisis period. The emphasis is not on where the EU has come from but where it appears to be going, where it should be going, and what sorts of difficulties this might imply for the success of the Union and its various major policy domains.

This chapter presents two observations that shape its analysis. The first is that the EU policy identity has, of the moment, often reflected broader trends in policy at the national and global levels, and quite unsurprisingly so. Second, if the EU has a plural past in terms of policy identities, it need not be permanently rooted in the current and dysfunctional manifestation of the crisis period. Both leave at least some room for optimism that the current malaise may yet be overcome. Yet as a range of the chapters in this volume argue, the EU – and above all, its most powerful member state – need firstly to recognise just how acute the crisis has become. Populist reactions threaten to overwhelm both the political terrain on which economic openness is built as well as the cross-border problem solving without which openness cannot survive.

Secondly and logically, the change needs to be effected rapidly and determinedly, while the EU has a poor record of dealing with this sort of timescale where the issues go far beyond technocracy to involve deeply cross-cutting and distributional policy choices within and across member states.

The way the EU's policy identity has shifted over time is perhaps best understood by focusing on the Union's economic policy 'identity markers' prior to the crisis and what has emerged in the aftermath. We need to recognise that changes in the characteristics, and thus the policy identity, of the EU have been dynamic over time, as a function of both expanded competencies and expanded membership as well as changing times and fashions in public policy. Drawing attention to some of these changes over time will help us understand the changes wrought by the crisis, and thus the starting point of the volume.

The EU began as an effort to build peace in Europe, initially as a Franco-German project to which were added the Benelux Union and Italy. Economic reconstruction and development, in terms of catch-up with the US and a restoration of European power and economic vitality in the world, was very much part of this early phase that led to the establishment of the European Coal and Steel Community (ECSC) in 1952. The onset and hardening of the Cold War was the first of many important 'identity shifts' experienced by the initial six members – 'Europe' became very much 'Western Europe' under US leadership. The defeat in 1954 in the French parliament of the treaty establishing a European Defence Community (1952) made European security a NATO alliance affair. European integration would be driven by economic integration following the 'Monnet logic' which resulted in the European Economic Community (Treaty of Rome 1957) that both absorbed the ECSC and aimed at a customs union and a range of proposed common policies.

The completion of the Common Agricultural Policy (CAP) and the customs union and a common external tariff and trade-negotiating machinery established a clear focus on trade integration and agricultural subsidies as the central policies of the emerging EEC. Not all went smoothly, and member states showed themselves often determinedly resistant to the obligations to which they had signed up. The intervention of De Gaulle and the 'Luxembourg Compromise' of the 1960s firmly established this emerging economic zone as a 'Europe of states' with crucial and growing transatlantic trade and investment linkages.

The subsequent industrial difficulties of the 1970s resulted in occasional detours into initiatives such as the Commissions's Davignon steel capacity rationalisation plan that shared the adjustment burden among the member states. On the whole, trade and agriculture became legitimate domains of European supranationalism while most of the rest remained largely national, albeit with much talk of more. This was the time often referred to as 'Eurosclerosis'.

The long-run success of the customs union and the reanimation of the integration process through the implementation of the Single European Act of 1986 plus expansion to a membership of 15 more-or-less advanced economy member states established a much more liberal market identity of the EU under the leadership of Commission President Jacques Delors. Yet all along there were challenges to this primarily 'market-integration' element of the emerging Union. First, the economic backwardness of some regions, starting with the Italian *mezzogiorno*, always implied some redistributive as well as economic development 'identity'. The absorption of Greece, Portugal, and Spain, as well as industrial decline in the older member states, contributed to this element, as had the establishment of the CAP from the early 1960s. The result was an emerging 'social Europe' complemented by the establishment of more elaborate regional development policies that transformed Spain above all. These two elements combined somewhat uneasily, but were part of our understanding of how economic openness works in relation to redistribution at the national and cross-border level. By the early-to-mid 1990s, one might characterise the EU as a relatively radical integration and liberalisation experiment that confirmed the significance of the 'New Trade Theory' as a way of thinking about cross-border trade and investment – industrial clustering, scale economies/competitive advantage, and value chains (Krugman 2008, Gereffi *et al.* 2005) – in relation to our understanding of economic integration. The EU, including its new social and regional dimensions as well as forays into foreign and security policy cooperation, emerged as a flagship for the benefits of this identity of integration with redistribution, as a re-ignition of modernisation and growth accompanied the workings of the Single Market. Strong national welfare states and limited regional transfers underpinned this expansive liberal market vision, while the Commission and the more enthusiastic member states began to puzzle over the idea of translating this into a genuinely European identity.

Furthermore, attempts at monetary integration had involved an explicit burden-sharing bargain: the 1978 EMS involved the pooling of resources to support the exchange-rate and balance-of-payments difficulties of deficit economies within the EU, as capital mobility began to challenge, even more than trade integration, the largely national forms of policy framework developed after the Second World War. A clear signal that this was now part of the EU's economic policy 'identity mix' was the abandonment of exchange-rate devaluations as a solution to deficit-economy adjustment to the challenges of competitiveness in the Single Market and more generally. Complex patterns of intra-industry trade and extended value chains rendered the old way of thinking outdated. The abandonment of capital controls confirmed this 'open economy' identity.

The EU had developed, along with its 'new trade theory/market integration' personality, an identity that associated the extension and further integration of Community-level policy competences with assisting national governments in confronting the challenges of global market integration and the forces of the emerging global order in general. While capital mobility and the monetary coordination response were the most obvious 'face' of this trend, it extended to migration, security cooperation, policing, foreign policy, development assistance, and so on. Through into the 2000s, one easily associates the EU with the growth of 'Brussels' competences (the Parliament, the Commission) and the transfer of national policy jurisdictions to a wide range of new forms of coordination and governance (strengthening of the Parliament, co-decision procedure, 'open method of coordination', etc.).

This high-water mark of European integration went along with the onset of globalisation, which took off with the fall of the Berlin Wall and the development of enhanced European investment and regional funds in anticipation of the absorption of new members. Qualified majority voting in the Council was extended considerably. Yet the major integration step towards monetary union taken at Maastricht in 1992 also marked an important shift in this 'policy identity' – not to mention in terms of public opinion and popular legitimacy (Hakhverdian *et al.* 2013). The notion that weak (read 'deficit') economies would be assisted in their macroeconomic adjustment and competitiveness challenges by the surplus economies was abandoned without anyone apparently noticing. This shift came in favour of a more 'automatic', country-based adjustment model that was encapsulated in the 'no-bailout clause' of the Maastricht Treaty.



Social Europe advanced little, budget rows (viz. the UK) eclipsed Commission and Parliamentary ambitions, and regional funds were not enhanced. The apparently inexorable advance of EU competencies and initiatives that so angered the growing numbers of Brexiteers masked these new developments.

Absorbing new members while coping with the effects of German reunification meant finding ways to deal with this new complexity as well: the Union was charged with absorbing and supervising the integration of the new member states as they became 'transition economies' (and politics! a double transition to democracy and the market), while EU-level regional fund resources were far from augmented *pro rata*. German resources and attention were committed at home in this same absorption process, while UK and Danish 'opt-outism' became permanent features with deepening political roots, and this meant there was a general failure to increase resources when they were sorely needed. The CAP became less redistributive and smaller in general (no bad thing in itself), as did the social fund. The EBRD became more central to the 'member catch-up' aspect of the EU.

In short, the EU developed a new policy identity that was based on 'hard' national member-state adjustment at the macro level, conformity to the '*acquis communautaire*', far fewer resources at the EU level and less discretionary policy space as the expanded membership, driven by UK resistance and the costs of German reunification, sought a greater level of rules-based 'automaticity' in the way in which it faced the challenges of integration and the global order. The trend was set by the new member states and the current politics of these countries reflects the fallout: citizens seek comfort in national solutions that are likely to bear but sparse and bitter fruit in the face of global challenges. The Swedish electorate, among others, balked at joining the euro. Old and new member states alike developed a discourse of growing volume that signalled to their electorates that they regarded 'Brussels' as a constraint, not a solution.

The failure of the 2004 Constitutional Treaty signalled the cupidity of European electorates in a series of referendum surprises that frequently had as much to do with national politics as with the crucial EU issues on the ballot paper. The crash and crisis of 2007-8 greatly accentuated this trend and to it was added, perhaps as a logical consequence, the elements of austerity and 'bail-in'. The advent of Lisbon had meanwhile shifted responsibility for integration from the Commission to the member states,

which placed surplus-deficit country power differentials front and centre in the new EU identity and in debates about how to confront the economic catastrophe. The obvious ECB secondary market interventions that would have prevented the entire sovereign debt fiasco of the Eurozone crisis, without any implication of ‘transfer union’, were vetoed by the Dutch and Finnish governments and, above all, by the German government in a spectacular display of Article 130 Treaty violations by German Chancellor Merkel and her finance minister<sup>1</sup> that is ongoing and apparently unstoppable. A deliberate politicisation of electorates by national politicians in peripheral and core member states has taken place that roots the deficit country-surplus country standoff in populism, replicating the problem of the 1930s as the current economic stagnation becomes more enduring than that of the Great Depression, albeit at a much higher level of average GDP per capita. The only thing left for the EU in terms of solutions, under this identity model, is a reflexive reliance on automatic rules that is unsustainable if discretionary policy discussions cannot be re-established at both the EU and national levels simultaneously.

To this ‘union of national adjustment’ (aspects of which are analysed by a range of chapters in this volume), that much resembles – especially in the manifestation of lending and conditionality-based bail-out programmes – the world of developing-country IMF membership, has been added a radical decentralisation of the social and economic risks of integration towards depositors, pensioners, and (smaller) firms – in short, towards the very citizens upon whom the legitimacy of the EU and national politics ultimately relies. Citizen-taxpayers in both the south and north have bailed out the northern banks of Germany, France, the Netherlands, and the UK (directly and indirectly by bailing out peripheral governments) and continue to do so, bearing the burden of adjustment on a national competitiveness and labour-market competitiveness basis. Banking union – with its failure to address fully the resolution and deposit insurance questions, never mind the issue of ECB intervention in secondary sovereign bond markets – has only exacerbated the problem by reinforcing the self-insurance regime, wherein citizens understand that they are the ultimate backstop.

1 Article 130 of the Treaty on the Functioning of the European Union (version 26 October 2012) concerns the independence of the European Central Bank and national central bank members: “The Union institutions, bodies, offices or agencies and the governments of the Member States undertake ... not to seek to influence the members of the decision-making bodies of the European Central Bank or of the national central banks in the performance of their tasks.”

The young generation is facing barriers to entry into the labour market and thus not only to its economic prosperity, but also its ambitions and self-confidence.

The refugee crisis of 2015 brought additional social and, even more so, political distress to national politics and the coordination within the European Union, energising further nationalist-populist parties, both in countries that have absorbed large numbers of refugees (e.g. Germany and Sweden) and countries that have refused to take any refugees (most prominently, Hungary). Migration turns out to be the key issue that ignites popular resistance to global and EU integration (Burgoon 2012).

The policy identity of the EU has thus evolved a long way from its integrationist nadir and emphasis on solidarity, a budding social Europe, and a broadening of competencies of the 1990s and early 2000s. The Treaty of Maastricht also marked a watershed in terms of the popularity of the EU among citizens across the Union (Hakhverdian *et al.* 2013). Electorates and governments alike have long forgot the war-torn origins of the beast. Instead, members vote to leave. An identity based on self-insurance and low-growth stagnation, wherein the costs to citizens are distributed according to the rank-order of national competitiveness, to which are added decision-making inefficiency and introspection, would excite populism and extremism in any one country, and is doing so across the EU. The notion that politics and discretionary policy counts and can deliver (never mind redistribution) appears to have been abandoned in favour of automatic solutions that notionally absolve governments of responsibility. If the redistributive identity and machinery remains moribund and the decision-making machinery paralysed, Brexit may generate imitators in the wings and may be doing so now.

Where does this leave the EU? An easy response might be ‘minus a member and facing a threat of further referendums’. Yet the brief history rehearsed above tells us that a change of direction is more than possible, and is also *necessary*. Integration has not harmed national economies – on the contrary – but a failure (often at the national level) to attend to the distributional consequences and generate a virtuous circle understanding of the EU surely has. Brexit undoubtedly had more to do with 40 years of internecine UK politics and policy mix than with the EU itself. The national self-insurance identity turn begun at Maastricht was surely unintended and a product of its times. Things could be different.

So where does the EU go from here? The subsequent chapters in this eBook present a range of solutions, from a deliberate return to national governance to ways of squaring the tensions between national democracy and the benefits of integration and institution-building above the nation state. After all, historically there was nothing democratic about nation states in Europe; they were authoritarian monarchies from which citizens wrested liberty and built liberal democracy from the ground up. Voter support for populist alternatives, like it or not, challenges political elites as they take irresponsible refuge in 'wait and see'. Certainly, there is a broad concern, well-voiced, in this eBook that the current EU 'policy identity' is unsustainable and unsupportive either of further integration or of the successful reform of the governance of the single currency, inclusion of the Eurozone 'outsiders', or the governance of the enlarged and intricate Union as a whole. The centrifugal political and economic forces at work encourage these dynamics.

The analysis in this chapter indicates that above all, the problems are located at the level of the member states. National policy has generated the problems of inequality and the hollowing-out of middle-income voter support over time. If this were not so, we would not observe the considerable variation in national socioeconomic outcomes that we know are there. National policies have also fed the dynamics of the EU policy identity over time, including the latest turn. Far too often national political elites have indulged in Brussels-bashing, subtly or otherwise, while somehow evading responsibility for decisions and constraints on EU functioning for which they themselves are above all responsible. Why else is the EU budget so inadequate to the tasks member states have allocated to the Union? Among the most hypocritical is the German government's insistence on their unfailing support for European solutions, all the while claiming that further institutional and common policy development requires precisely the greater degrees of integration that their own position precludes.

If the EU really is an elite affair, national political elites have not served it well. They publicly claim to 'hear' their electorates, while taking care to respond to backroom corporate and other forms of special interest rent-seeking. Do they really think voters fail to notice? To fix things, political elites need to give voters the policy mix they seek in unstable times, and elites will have a harder time doing so if the EU is not rejuvenated at the same time. Above all, political elites need to pay far greater attention to the preamble of the treaty they claim to honour, and thus focus on the voters in *other* member states as EU *citizens* and not as aliens of differential and questionable worth relative to their own national community.

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## 2 Reforging EU commonality after the crisis

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### **Identity and Europe**

In ordinary language, identity means the ‘character’ or distinguishing features of an individual, a social group, a party, or a public policy. Political scientists employ the concept in a more technical way, to connote a set of beliefs and action orientations characterised by two elements: 1) they stem from membership of (belonging to) a community engaged in forms of self-determination; 2) they are ethically charged, i.e. underpinned by positive moral judgements that can motivate behaviour beyond self-interest. Understood in this way, identity provides the basis for dignity, self-respect, pride, honour, and recognition – at both the individual and collective level. In modern Europe the political identity of citizens is linked to the nation that stems from the long process of state formation. National identity filters through the whole range of political processes and plays a key role for the legitimisation of authority. Today’s European landscape remains a kaleidoscope of relatively crystallised national identities, more or less deeply entrenched throughout society.

Of course, national citizens also share *as Europeans* a deep cultural heritage and many collective memories and traditions. Integration has favoured the emergence of elements of a pan-European identity, especially among elites. But the weight and inertia of the national cultural framework means these traits are unlikely to become a proper EU identity any time soon. The elite identity nucleus has not automatically trickled down through national populations. Optimism prescribes a gradual and virtuous nesting scenario: integration opens national identities to each other, anchoring themselves to an overarching EU normative frame in which nationalities can recognise at least some part of themselves.

Defining and building this frame is very difficult for at least two reasons. First, there is an inevitable balancing act between preservation and transformation. Second, the range of substantive values that can be mobilised in this process is narrow and some of the candidate values have an inherently weak potential as 'identitarian' triggers.

Two normative clusters can be singled out as building blocks. Europeans are united by the culture and practice of citizenship, resting on values such as civility, equal dignity, respect and toleration, non-domination, a preference for compromise and accommodation vis-à-vis the hard facts of pluralism. There is no doubt that a culture of citizenship should feature centrally within an EU identity (and, in part, this is already the case). Its political traction is relatively weak, however, since its basic ethical postulate is, precisely, the protection and valorisation of *diversity*. Forging EU commonality out of national diversities is, of course, a highly desirable objective, but ordinary citizens are unlikely to fall in love with it. Especially in the current context, they may actually perceive this exercise as a threat to their own particular diversity. Within the citizenship cluster, the only potential effective trigger for the formation of an EU identity is the principle of *political equality* of citizens among the participating nation states. This principle resonates with an important and widely shared tradition of substantive ideologies and institutional practices, dating back to at least the French Revolution. It also has easily recognisable implications in terms of democratic procedures. If lifted up as a defining feature of EU identity, this principle has the advantage of shifting (or even generating) attention from intra-national political interactions (including claim-making) to cross-national and supra-national interactions and claim-making.

European politics is increasingly afflicted by a dangerous drift towards *souverainisme*. The 'liberation' of national communities from external intrusions and a return to full self-determination is a key idea of right-wing populism and to some radical left formations, partly linked to the perception that the EU has generated unfair political inequalities among its member states. Handled with care, a smart project aimed at reaffirming (symbolically and institutionally) the principle of political equality within the EU would offer an ideational alternative to *souverainisme*. And it could kill two birds with one stone: containing populist Euroscepticism in domestic arenas on the one hand, and establishing a supranational arena of ordered and more balanced political interactions among national governments on the other.



The second normative cluster is linked to the classical symbolic triad of *liberté, égalité et fraternité*, which has given rise to nation-based liberal-democratic welfare states and to the overarching image of ‘the European Social Model’. The culture of social protection, cohesion, inclusion, and participatory industrial relations is widely shared throughout Europe. The notion of social justice – a composite symbol which implies a virtuous combination of liberty, equality and solidarity – plays a fundamental role in the normative orders of virtually all functional spheres and territorial collectivities of the European system as a whole. Social justice ideals have played an important role in the formation of national political identities. Such ideals have inspired the creation of an extremely rich variety of ‘sharing’ arrangements which are still coveted by national citizens. Together with the principle of political equality, the principle of social justice (or, more simply, solidarity) has promise as a linchpin for defining the EU normative frame within which to nest national identities.

From Maastricht to Lisbon, political equality and social solidarity permeated the EU legal framework. Yet their identity-forming potential has been neglected and definitely underexploited. Many such provisions of the Lisbon Treaty remain a dead letter. Worse, crisis developments have challenged these provisions (and thus the underlying principles of equality and solidarity) by either ignoring or assaulting them. The result is a dissipation of what little ‘identitarian’ capital had formed over decades and which had created the necessary preconditions for the adoption of the novel normative framework of the Lisbon Treaty.

## **Technocratic crisis management and its political damage**

Crisis management generated a new mode of governance (which some define as an ‘*econocracy*’ in the making; see Earl *et al.* 2016) centred on strict economic surveillance, discipline, and sanctions aiming at ‘caging’ from above many of the standards and practices of member states. This system rests on deep-seated (and mostly implicit) descriptive and normative cultural predispositions. In essence, its supporters believe that budgetary probity and market efficiency are central, with a ‘right way’ of ensuring them (and more generally of solving all collective problems); that economic logic, supported by law, should prevail over politics, especially agonistic politics.

Instead of prompting a virtuous circle of upward convergence *cum* stability, fed by norms shared among the member states, policy divergence has been promoted alongside, and amplified by, moral economy which juxtaposes ‘good’ versus ‘bad’ pupils and encourages beggar-thy-neighbour policies. This dynamic nurtures the (internally contradictory) illusion that domestic political economies (and thus national identities) can be coerced into adopting a single template for growth and competitiveness. This approach has produced ineffective results while eroding the political conditions for its legitimacy. Obsessed with neutralising the ‘moral hazard’ incentives of governments, politicians, interest groups, or any other (national) actors, this particular ‘econocratic’ regime has unleashed the demons of anti-politics and populism that now attack the EU as such. European integration was historically guided by mixed logics. These reflected the heterogeneity of its constitutive components but ultimately aimed at achieving common goods. Crisis econocracy has disrupted this delicate mix and destabilised the precious normative fabric (albeit loose and implicit) which underpinned the interplay of logics. A key component was indeed safeguarding nation-based solidarity, and thus accepting a degree of reciprocity-based mutual assistance (including some redistributive transfers) among the member states.

The move to a “union of national adjustment” is a paradigm shift in both descriptive and prescriptive terms. Descriptively, the new paradigm assumes that the current EMU framework is indisputably ‘correct’ and that adjustment is essentially a matter of national responsibility, with no (or highly conditional and only temporary) pan-European solidarity. Eric Jones illustrates this point very effectively in his contribution to this volume. This approach, however, vastly underestimates the causal impact of economic and monetary integration on domestic political economies as well as the matrix of cross-national externalities and payoffs. The adjustment homework is not equitably distributed: some have more homework than others because their starting points were different and have been negatively affected by the EMU framework as such, combined with external asymmetric shocks. This diagnosis has obvious implications at the normative level. If adjustment is seen as a matter of homework and rule compliance, then solidarity is both unnecessary and harmful because it may encourage hazard. The derogatory characterisation of a *Transfer Union* in Brussels and in various Northern capitals testifies to this anti-solidaristic drift of the EU value framework, especially in the Eurozone.

Worse, the change of paradigm affects the very idea of what democracy is, or ought to be. Let us think of the *ordoliberal* notion of ‘market conforming democracy’ (explicitly and repeatedly advocated in public by Angela Merkel and Wolfgang Schäuble) which prioritises the market sphere without consideration for social and political externalities (Hien 2016) – or just assumes that externalities are positive and desirable enhancements to system competitiveness. This notion runs counter to that form of democracy that (with a host of compelling intellectual justifications) underpins Europe in the 21st century, wherein it is *democracy that tames the market* due to concerns about fair distribution, not the market which tames democracy through the imperative of competitiveness (Van Middelaar and Van Parijs 2015).

A second, crisis-based normative shift implicates political equality as the other key principle with identity-forming significance. In his masterful book *States, Debt, and Power*, Ken Dyson has shown that, inspired as it was by the creditor narrative and moral perspective, the management of the euro-crisis has given rise to a “politics of humiliation”, based on the paternalistic and hierarchical chastisement of the “bad pupils” instead of fraternal encouragement (Dyson 2014). This syndrome has been especially evident in the case of Greece. In his vibrant *j’accuse* against Merkel and the Eurocrats published in *Die Süddeutsche Zeitung* (Habermas 2015), Habermas noted that during the bailout negotiations Greek authorities (i.e. elected representatives of the Hellenic people) were often treated like “zombies”, in blunt violation of the principle of political equality of member states enshrined in the EU covenant. To quote his words: “this transformation into zombies [was] intended to give the protracted insolvency of a state the appearance of a non-political, civil court proceeding”. Scharpf (2016) has recently argued in turn that borrowers were not even considered as “deserving poor”. Humiliation has returned in the eyes of national elites and mass publics as crisis political exchanges blatantly violated the norms and practices of equal membership and attacked the bases of equal dignity and mutual respect among the member states. Neither Commissioners nor member state ministers (however large and powerful their states, thus in particular German officials) have legal or normative grounds on which to invoke unilateral demotions or forced withdrawal of group membership before the *elected* representatives of a participating state.

## **Economic stability, political equality and social solidarity: A strategy of normative reconciliation**

The post-crisis EU cannot survive without re-establishing a normative order more in line with the novel economic and social ‘ontology’ produced by EMU, and thus more respectful of the key principles of political equality and social solidarity and explicitly aimed at mending that thin ‘identitarian’ fabric so damaged by the crisis. Even if EU leaders agree on this goal, the scars produced will not be easily healed. Yet no political collectivity can survive and prosper without internal cohesion underpinned by solidaristic norms, institutions, and dispositions. Democratically organised solidarity is a fundamental political good, purposively facilitating social cooperation, managing conflicts, and sustaining generalised compliance. It is also essential for political legitimation, nurturing the experience of fairness among citizens across states. Like peace and physical security, organised solidarity is a necessary condition for the effective functioning of any spatially demarcated community. Either consolidating or maintaining EMU urgently requires a strategy of reconciliation capable of re-aligning the logics of economic stability/competitiveness with the logic of democratic equality between the member states, underpinned by symbolically clear and functionally effective principles of pan-European solidarity. A coherent normative/identitarian vision, articulated in a resounding narrative, must provide the ‘glue’ for the peoples and member states of Europe.

How can this vision be elaborated? Let me start by discussing equality. To understand the nature and implications of political equality within the EU normative order, a prior question is posed: what sorts of associational dynamics link the member states together? As I have argued elsewhere (Ferrera 2017), the EU is much more than a mere market association, but it is far from being a fully-fledged political community. It may be considered a ‘neighbourhood community’, i.e. a group of nations (and ‘state peoples’) characterised by durable spatial proximity and sharing a common project. Neighbours are not kin with spontaneous ties of ‘ethnicity’ and altruism, yet they have significant incentives to cooperate, especially in case of need and emergencies. The Weberian notion of ‘sober brotherhood’ may inform such cooperation: a brotherhood devoid of pathos, yet capable of fostering a cooperative disposition beyond the perimeter of immediate mutual advantage.

Physical proximity in turn implies mutual interdependence and shared exposure to certain risks that foster relational exchange and orientation incorporating reciprocity: the readiness to give something now (e.g. offering financial help during a debt crisis) conditional upon receiving or having received the loose equivalent. The definition of the risks, rules, and conditions of sober brotherhood must originate *politically*. Neighbours deliberate to argue their cases and search for compromise that serves two purposes: reaching contingency-sensitive redistributive arrangements (respectful of equal dignity and political recognition) and safeguarding the higher common interest of keeping the political collectivity together. This is the essence of a new practice that some authors aptly define as ‘*demoicracy*’ (Nikolaidis 2013). In practical terms, this implies for the EU a thorough reconsideration of the macroeconomic regulatory framework, and in particular its decision-making rules, now excessively skewed in favour of creditor countries and non-majoritarian institutions.

Let us now focus on solidarity. Here the hardest challenge is to define possible pan-European standards for social sharing among member states, particularly within the Eurozone. This exercise must go hand in hand with empirical evidence and sound reasoning about the causal impact of integration and about the matrix of cross-*demoi* externalities and payoffs. We need demoicratic ‘social theodicies’ – to put it, again, in Weberian terms: conceptions of distributive justice among increasingly integrated but still autonomous state peoples. Elaborating such conceptions involves balance between the minimalist, ‘sufficientarian’ views, typically tailored on the broader international system (solidarity as humanitarian aid), and more maximalist egalitarian views based on federal systems (solidarity involving cross-regional fiscal redistribution) (Vandenbroucke *et al.* forthcoming 2017).

Considering both historical experience and contemporary (nation-based) theories of justice, the obvious starting point for a ‘third way’ should be a risk analysis of the institutional *status quo*. Which member states are vulnerable to what, and why are they vulnerable? To answer this question, it may be useful to distinguish between similar and common risks. The first are the result of dynamics separate from either integration or externalities (e.g. demographic ageing). Here there is no need for joint action, let alone redistribution. The risks produced directly by integration and/or externalities are another matter: the asymmetric shocks that result from the constraints of EMU,

or the cross-national implications of trade deficits or surpluses, or the negative impact of sudden surges in worker mobility or foreign immigration. On both functional and normative grounds, the appropriate solution for these risks is joint action that includes reciprocity-based redistributions (e.g. risk pooling or re-insurance schemes).

An interesting debate has recently taken shape around the idea of a European Social Union (ESU): not a supranational welfare state, but a genuine union of national systems, an effective ‘hosting’ (and hospitable) institutional framework supporting the effective and smooth functioning of domestic welfare schemes (Vandenbroucke *et al.* 2017). The ESU would help the latter to better respond to similar (as well as country-specific) risks, while putting in place new instruments for the mutualisation of shared risks. Even more importantly, the project of European Social Union could turn into an effective political symbol with high identity-building potential.

## Conclusion

Re-forging and enhancing a common EU identity after the storm of the crisis will be a daunting task. European citizens will have to distinguish between domestic and interstate justice, between the solidarity in its various societies and the solidarity among its *demos* (Chalmers *et al.* 2016). Even if we were to come up with well-argued and articulated conceptions of *demos*ic equality and distributive justice, this may yet prove unable to defeat the constricting mentality of the current ‘econocratic’ policy mix – never mind in the post-Brexit context. Without an ambitious intellectual reframing, this political agenda cannot be imagined at all. The EU would then be fated to persist in the self-defeating exercise of undermining its own normative and political foundations.

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## 3 European identity through European experiences?

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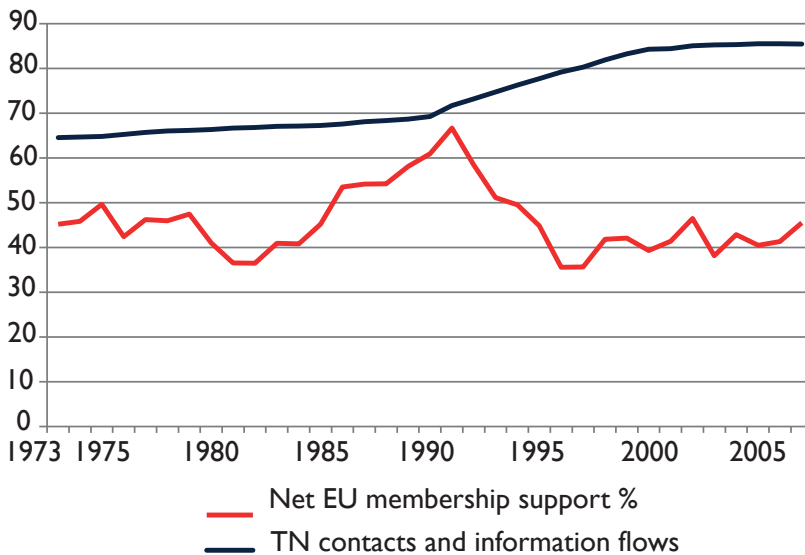
In October 2016, Manfred Weber, Vice-Chairman of the EPP Group in the European Parliament, suggested offering all young Europeans a free Interrail Pass for their 18<sup>th</sup> birthday. By travelling across the EU and getting to know other European member states and their citizens, he suggested, young Europeans might overcome their frustrations and scepticism concerning European integration. This idea gained momentum, and the European Commission is planning a pilot project in 2017.

This is not the first initiative aimed at promoting a collective European identity and support for European integration by giving citizens the possibility to interact across borders. The Erasmus student exchanges and town twinning projects are but two examples of existing policies that promote cross-border mobility and interactions among ordinary Europeans. This idea goes back to Karl W. Deutsch's transactionalist theory suggesting the creation of 'security communities' that set the framework for increased cross-border transactions among their publics. It has become part of the EU's standard 'policy identity' that proliferating transactions may be expected to induce learning processes, which in turn would lead individuals to lower their out-group boundaries, appreciate the newly established polity, and eventually adopt a collective identity.

Amid increased transnational interactions and networks in the EU today, one may thus expect that European citizens support European integration. However, while transnational networks and activities have indeed proliferated over recent decades, they have not been accompanied by an increase in political support for European integration. Quite the contrary – since the signing of the Treaty of the European Union in 1992, an increasingly Eurosceptic public has challenged Deutsch's optimistic assertions. This is documented in Figure 1 – whereas transnational contacts and information flows

(taken from the KOF index of globalisation) have increased tremendously over the past decades, net EU membership support has not. In short, despite Europeans leading increasingly transnational lives, they have not become more European-minded. This raises the question: to what extent are cross-border interactions among ordinary people really helpful in fostering a feeling of European identity and EU support? In a recent book, I aim to tackle precisely this issue (Kuhn 2015).

**Figure 1.** Net public support for EU membership versus cross-border transactions



Sources: Eurobarometer 1970-2007, Dreher *et al.* 2008

The central argument is that there is a significant relationship between individual transnationalism and EU support *at the individual level*, but that (1) transactions are socially stratified, (2) they can create a backlash against European integration among Europeans who are not transnationally active themselves, and (3) their effectiveness is dependent on their purpose and scope.

## **The social stratification of cross-border practices**

First, social structures filter who takes part in cross-border interactions. Analyses of Eurobarometer survey data in all member states in 2006 and 2007 show that only a highly skilled, wealthy, and young minority regularly interact across borders. For example, in 2006, two-thirds of the European population had no friends from outside their own country, and more than half of the European population did not socialise with other Europeans at all. Thus, the transactionalist hypothesis is relevant only with respect to a small, *avant-garde* section of the public, while most Europeans are not prompted by transnational interactions to develop support for European integration. Consequently, it is not sufficient to understand EU support as a function of the *aggregate* level of transnational interactions, since this conceals the unequal distribution of transactions across society. Rather, one ought to study the effect of transactions at the individual level.

## **Backlash against European integration**

It is therefore crucial to consider the effect of transactions on citizens who do not interact across borders themselves. These people are likely to feel overwhelmed by the influx of new ideas, people, and products into formerly rather homogenous national societies, and by the ensuing social and economic tensions. Moreover, they might feel excluded from the transnationalisation of their realm. Rather than observing more widespread and uniform EU support, we witness a divide between winners of transnationalisation, who favour further integration, and its losers, who opt for the closing of national borders. In fact, my analyses show that people who don't interact across borders but live in highly transnationalised societies, such as Austria or the Netherlands, are even more sceptical towards European integration than people with similar lifestyles in less transnational societies, such as Malta or Slovenia.

## **Which transactions strengthen European identity?**

The effectiveness of transactions in promoting European identity depends on a number of factors, such as their purpose and scope. These aspects influence how Europeans experience and frame their interactions, and consequently whether they link them to European identity. My analyses show that genuinely instrumental interactions, such as cross-border shopping, are less effective in triggering European identity and EU support than social interactions, such as socialising with other Europeans.

## **Implications for policymaking**

For policymakers who aim at fostering European identity, this has a couple of important implications. First, considering the social stratification of cross-border transactions, it is important to promote cross-border transactions across the overall population. Current policies, such as the Erasmus exchange programme, mainly target highly educated Europeans who already tend to travel and move across Europe, and to support European integration, to a very high degree. Rather than focusing on this Europeanised group of people, it is more effective to encourage transnational interactions among low-educated people. In this respect, giving a free Interrail Pass to all young Europeans, irrespective of their educational achievements and socioeconomic background, is clearly a step in the right direction. Second, given that purely instrumental interactions are less effective in promoting EU support than more social interactions, policymakers are well advised to promote the latter, or to emphasise the sociable aspects of instrumental interactions. As Jacques Delors once famously put it, “you don’t fall in love with a Common Market, you need something else”.

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## 4 A tale of two models

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**Jonathan Story**

INSEAD

A dominant note in the present discourse is of an EU menaced from within and without by resurgent populisms, by a fragmented leadership, and by an unsustainable institutional set up – part federal, part national – with a dysfunctional, poorly organised, unimaginative and risk averse bureaucracy, facing waning public support. Far from becoming a superstate and threatening national sovereignty, the EU, it is argued, is on a “slippery slope” to irrelevance (Merritt 2016). George Soros goes so far as to argue that the EU and Putin’s Russia are both in a race against time, with the question being which will collapse first (Soros 2016).

My argument is that it is time for some introspection as to why things have gone wrong. This would be the first step towards taking corrective action. The simple point is that government without the consent of the governed cannot be effective. As the great Anglo-Irish statesman, Edmund Burke, reminded us, in his life devoted to the repeal of the Test Act in Ireland, supporting the American revolutionaries, opposing the rapacity of the East India Company, and in his reflections on the Jacobin war-making machine that was the French Revolution, you govern by political consent.<sup>1</sup> This is, and will be, the key to creating a sustainable European polity. The present EU direction of travel is not only unsustainable, it is positively dangerous.

It is positively dangerous because the end state of the EU as it is currently conceived can only be a cross between a supranational entity, with highly centralised powers in specific institutions, and a federal EU, which promises a separation of powers, a single federal government, but plenty of decentralisation.

<sup>1</sup> See O’Brien (1992) and, more recently, Norman (2013).

To be polite, either of these is pie-in-the-sky politics. As recorded in the Spring 2015 edition of the Commission's own *Eurobarometer* publication, only 2% of EU citizens view themselves as "Europeans" (i.e. favouring EU aspirations), with only 6% regarding a European identity as more important than their national identity. Out of a population of about 550 million, that leaves, if one follows the prevalent apocalyptic view of the end of the liberal world order, around 500 million prey to 'populists'. If that were the case, and the ghost of Goebbels was back haunting us, we would indeed be in trouble.

All authors making the case for the EU recognise the continued centrality of national loyalties in the member states.<sup>2</sup> While praising what has been achieved, yet recognising failings, they inevitably become less confident of how a future EU will evolve. There is a seeming paradox here between the stated *ex post* success of a project with a teleological endpoint, and the difficulty of seeing into the project's future, where policy choices in the EU can assuredly be said to be shaped, in the future as in the past, by a myriad of political forces, most importantly located in each one of the 28 member states. Complexity in European affairs is a constant, making disintegration as much a possibility as further integration.

So, to the point – Europe and the EU are not the same thing. For the sake of argument, let us assert that 'Europe' holds four distinct, but related, features.

The first feature is the shared cultural inheritance from Greece and Rome, the now distant roots of a sense of Europe as Christendom (Dawson 1932, Holland 2008), the rediscovery of the ancient world in the Renaissance, and the shattering of European unity with the first 'Brexits' of Henry VIII in 1529, the religious wars, and the recomposition of a fragmented continent under the Treaty of Westphalia, the doctrine of "*cujus region, ejus religio*", and the competitive state system to which it gave rise. Those were the centuries that gave rise to the extraordinary flourishing of European literature and music, which is now shared around the world, but which, for instance, inspired the lives of such European leaders as Churchill, de Gaulle, Schmidt or Heath. As Ralph Dahrendorff wrote, when Europeans meet outside of Europe, they know instinctively they are from the same civilisation (Dahrendorff 1977).

2 See, for instance, Eichengreen (2007), Moravcsik (1999) and Middelmas (1995).



Second, Europe is a mosaic of interdependent peoples and states, sharing an overall common inheritance and, for the first time in centuries, common precepts of legitimacy (constitutional government, rule of law, freedom of expression, etc.), but, in practice, highly differentiated by language, religious sensitivities, and historical myths – better described as living realities – as well as tax systems, economic activities and national structures. The states are the pillars of this entity, but their existence tends to fragment the European market space, drive up costs through duplication, perpetuate intra-European rivalries in a variety of ways, ensure that the rule of law is politicised, and perpetuate, it is argued, Europe’s continued dwarfing on the world stage.

Third, diplomacy between the sovereign states is Europe’s politics. The substance of that diplomacy may be about trade and welfare, but that is not too different to diplomacy on the world stage. And because EU states are recognised sovereigns on the global scene, international diplomacy between its member states and their diverse external partners remains an integral part of intra-European politics. One of the major frustrations of those pushing ahead to a fully fledged federal European entity is that given the constant reality of global diplomacy, non-European powers are permanent participants in intra-European politics. That may well constitute one of the factors informing the EU’s ambitions to grasp for an ever-wider spectrum of competences, despite promises to ensure ‘subsidiarity’ (bringing decisions close to citizens) and despite ever scarcer means to implement an ever wider pallet of policies.<sup>3</sup>

Fourth, the prime motive for the reconstitution of a European diplomatic system after 1945 is to create a polity from which war is excluded. There are at least two components of this diplomatic system. The first was put in place by the Attlee government as junior partner to the US, and was predicated on the creation of multilateral organisations: the UN, the Council of Europe, GATT, the regeneration of the BIS, the OEEC, and the North Atlantic Treaty (followed by NATO in 1950). These institutions covered a variety of functional areas of significance to participating states – from human rights to trade, finance and security – but were all designed to better help states fulfil their multiple functions through international co-operation.

3 On overstretch through overambition via total optimism, see Majone (2015).

The second was put forward in 1950 when the French government proposed a very different concept of regional integration, with the proposal for a supranational coal and steel community (ECSC). The ECSC is the ancestor to the defunct EDC, Euratom, and the Rome Treaty, with its subsequent development through the Maastricht Treaty of 1992, and the Lisbon Treaty of 2009. The guiding idea here was that nationalism had caused the wars of the first part of the century, and hence nation states should be subsumed into a large entity with a federal/supranational endpoint, a United States of Europe. It is this model which is in crisis.

The foundational flaw in this design is that the vast majority of Europeans remain firmly national or (local) regional in their loyalties. Nationalism is a highly complex phenomenon, but for the sake of brevity, we may say that it is a coin with two sides: one shouts glory, dominance, race; the other provides the underpinning for modern constitutional states. Jean Monnet, the founding father of the EU, considered, in the light of his experience from two World Wars, that the crowds of democracy had to be kept at bay, tamed, and their enthusiasms channelled. That could best be done by élites from member states gathering in enclave to settle complex business in the European interest, yet able to explain or excuse their common decisions separately to their provincial audiences. The result over the years has been, as more and more legislative powers accrue to EU institutions, that the powers of member states have been seriously impaired, and with that the voter's right to sanction legislators. Member state powers have been hollowed out, without the EU gaining in legitimacy (Mair 2013).

As Peter Mair pointed out, the EU does not do opposition. Member states, however, do. Their constitutional democracies in effect institutionalise public debate, often involving fierce differences in opinion expressed in parliaments, in the media, and through the regular drumbeat of electoral battlegrounds where opponents gather their armies to capture office, if not power, in the hope that they can implement their particular programmes and sanction them in the name of the national interest.

It is this gap between the turbulent democratic politics of member states and the supranational/federal ambition to create a United States of Europe, in an apolitical space, that has opened wide in the years following the financial crash of 2008, followed by the Greek drama of 2010, the European depression, the drama of mass immigration and the vote for Brexit on 23 June 2016.

In every case, the old recipe which had enabled the EU to evade or side-track problems in the past – to locate an indefinite agenda of unsettled business in the future – no longer worked.

Two forces are at work here. first, the dynamic of globalisation, taking protean shape from multinationals, to global terror and social media, exerting constant but differentiating impact on European societies; second, the ever more urgent demands from member states that their citizens shape public policies. The revival of Europe can only happen by the European project downsizing, networking, and re-nationalising politics. The EU has to be recast as a European alliance of constitutional states, placing national democracy at its heart and building on nations at ease with themselves and their neighbours. In the words of Richard Bellamy, what is required is “the alternative of a republican association of sovereign states that allows sovereign states to mutually regulate their external sovereignty in non-dominating ways. It offers a more plausible and defensible means for sustaining the requisite fund of popular sovereignty in contemporary conditions, and a more appropriate vision of the EU” (Bellamy 2016).

I phrase very similar thoughts slightly differently: the EU’s re-foundation should be as a European alliance of constitutional sovereign states. There is little sign so far that this is on the agenda.

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## Part II

### The rise of populism





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## 5 When it comes to globalisation, not all radicalisms are created equal

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**Brian Burgoon**

University of Amsterdam

The deep crisis of political legitimacy faced by the EU, and indeed the crisis of Western liberal democracy, reflect and are manifested in the political successes of nationalist, populist parties. These parties are the vanguards of backlash, the political actors most prominently and effectively manning the barricades of Euroscepticism, anti-political-elitism, and re-nationalisation of the liberal international economic order. The most renowned are the populist parties of the radical right. These are not limited to long-standing pillars of the right like the French National Front (FN) and Danish People's Party (DF). Recent years have seen the growth and successes of newer radical-right parties in places hitherto thought to be inoculated against right-wing populism; parties such as *Alternative für Deutschland* (AfD) in Germany and Wilders' Party for Freedom (PVV) in the Netherlands. Yet the radical populist parties *of the left* are also becoming important to the political movements against the EU and general Western liberal internationalism. Parties like *Syriza* in Greece and *Podemos* in Spain are gaining ground electorally, and mobilising major coalitions of populist backlash that, in post-crisis politics, can be as vocal and effective threats to the post-crisis EU and liberal international order as their counterparts on the right.

These extremes of the political spectrum overlap in their appeals to populist backlash. Left and right extremes are clearly marked by differences in the histories from whence they emerged – the right being about conservative values, protection of traditional hierarchies of wealth and status, and the championing of the national weal; the left being about the ravages of markets and necessity of government market-taming egalitarianism.

But the radical left and right share a common populist critique of elites (as opposed to the people they claim to more truly represent); they demonise particular policies that favour such elites, in terms of both moneyed classes and educated arrogance (as opposed to the working man); and they often champion the halcyon days of an earlier order and stability.

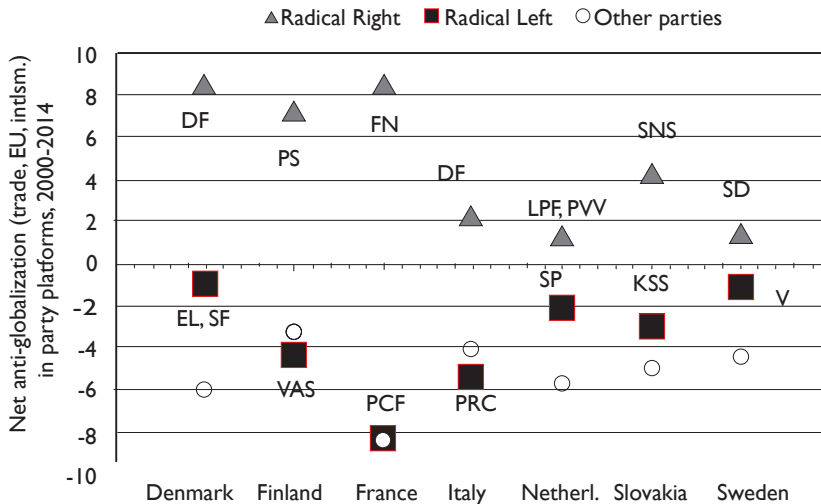
Most importantly, the radicalisms of the left and right also appear to share a core commitment to nationalist anti-globalisation – finding common cause in inward-looking backlash that is the crucial building-block of the barricade against anti-EU and anti-liberal-internationalist order. Indeed, a well-established finding in literature on European integration and globalisation has identified how the left-to-right political spectrum harbours a horseshoe-shaped pattern in Euroscepticism of party platforms (Hooghe *et al.* 2002). Recent studies of radical left and radical right supporters have also found this U-curve of Euroscepticism to unite the two electorates (Lubbers and Scheepers 2007, Visser *et al.* 2014). Although less studied, recent research has revealed that the party platforms of industrialised countries betray a similar, if less sharp, U-shaped pattern of anti-globalisation – including not just positioning against European pooling of sovereignty, but also against openness to international trade and support for global institutions and internationalism generally (Burgoon 2013, Burgoon *et al.* 2017).

Upon closer inspection, however, this apparent broad similarity in the anti-EU and anti-globalisation positioning by radical left and radical right populist parties underplays important differences between these radicalisms in their approach to an anti-globalisation backlash. Such differences have emerged particularly from studies of radical right versus radical left voters (Rooduijn *et al.* 2017, Visser *et al.* 2014, Lubbers and Scheepers 2007). But if we look more closely at the positions of the parties themselves, using the best and most systematic data available that measure party orientations, we also see important ‘radical distinctions’ in reactions to globalisation. Figure 1 captures the most important observed differences, focusing on those party systems that have both at least one radical left *and* one radical right party. The top panel does so using the codings in the Manifesto Project Database (Volkens *et al.* 2014), wherein we take the three crispest codings of positioning on globalisation matters and, following Burgoon (2013), code the platforms of the radical left

and radical right with respect to anti-free trade, anti-EU, and anti-internationalism statements, net of positive statements towards such issues. Here we see a tendency of both the radical left and radical right to be more anti-globalisation than their mainstream counterparts; but we also see a pattern wherein the radical left parties are consistently less anti-globalisation than the radical right parties. Indeed, the left parties tend to be closer in their positioning on globalisation issues to the mainstream party average than to the radical-right counterparts. The bottom panel (b) shows the Chapel Hill Expert Survey (CHES) coding of whether parties tend generally to be pro-immigration or anti-immigration (on a scale of 0-10, with 10 being the most anti-immigration) (Bakker *et al.* 2015). Here, we see an even stronger distinction between radicalisms, where the radical right parties are much more anti-immigration than their radical left or mainstream counterparts, and where radical left parties tend to be *less* anti-immigration than even the mainstream parties (see also Visser *et al.* 2014, Rooduijn *et al.* 2017).

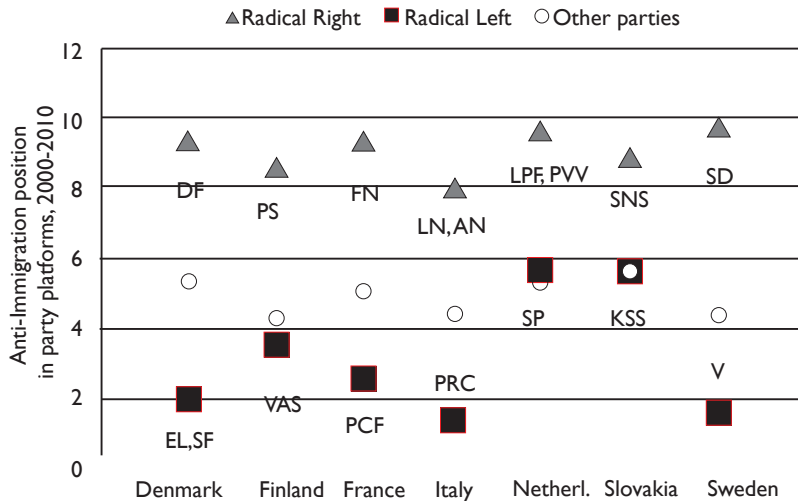
**Figure 1.** Anti-globalisation and anti-immigration in radical left<sup>c</sup>, radical right<sup>d</sup> and other parties

#### A. Anti-globalisation (EU, trade, int'l-ism)<sup>a</sup>



<sup>a</sup> Net anti-globalisation score, 2000-2014 = platform % anti-EU, anti-free trade and anti-internationalism, minus % pro-EU, pro-free trade, and pro-internationalism.

## B. Anti-immigration<sup>b</sup>



<sup>b</sup> Anti-immigration, 2000-2010 = expert coding of whether party strongly opposes (0) or strongly favours (10) tough policy towards curbing immigration

<sup>c</sup>Radical right parties: DF= Dansk Folkeparti (Danish Freedom party); PS= Perussuomalaiset (True Finns); FN=Front Nationale (National Front); LN=Lega Noord (Northern League); AN=Alleanza Nazionale (National Alliance); LPF=Lijst Pim Fortuijn; PVV=Partij van de Vrijheid (Party of Freedom); SNS= Slovenská Národná Strana (Slovak National Party); SD=Sverigedemokraterna (Sweden Democrats)

<sup>d</sup>Radical left parties: EL= Enhedslisten (Red-Green Alliance); SF= Socialistisk Folkeparti (Socialist People's Party); VAS= Vasemmistoliiito (Left Alliance); PRC= Rifondazione comunista (Party of Communist Refoundation); SP=Socialistische Partij (Socialist Party); KSS= Komunistická Strana Slovenska (Communist Party of Slovakia); V= Vänsterpartiet (Left Party).

Sources: Own calculations from Volkens et al. (2014); see Burgoon (2013); own calculations from Bakker et al. (2015)

These patterns likely reflect the very different traditions, in terms of ideological ends and means, from which the radical left and radical right have emerged as offshoots. The radical left grew out of commitments to economic and political egalitarianism or equality, critiques of the vagaries of unfettered markets, and broad commitments to other-regarding altruism. They also fostered commitment to economic activism by governments to pursue these ends. With such traditions, it come as little surprise that even the most populist and radical of the radical-left parties have opposed mainly the neo-liberal and negative-integration orientation of EU integration rather than more social democratic versions of the European project, replete of social clauses, upward-levelling, and redistribution. Similarly, radical left parties voice commitments

to 'fair trade' that protects labour and environmental standards for egalitarian ends, rather than simple nationalist protectionism. Broader commitments to cosmopolitan international institutions and liberal multilateralism, and certainly an actual embrace of protection for the rights and needs of immigrants, all align with the left's deep-rooted championing of equal treatment before the law with respect to individual, political, and social rights. Again, the radical left's anti-globalisation backlash is a rejection of neo-liberal Europe and economic openness that leaves plenty of room for alternative, more egalitarian governance of the European and global political economies.

In contrast, radical right populism grew out of various strains of nationalist and economically liberal right-wing conservatism. This includes more affinity with inequalities (particularly of outcomes if not of opportunities), with general nationalist line-drawing between insiders and outsiders, including acceptance of racial and gendered hierarchies, and an acceptance of market freedoms even where this rewards winners and punishes losers. The tradition also rejects government redistribution and general economic activism to pursue egalitarian goals, and has long been suspicious of any extra-national or even federal constraints on sovereignty. Little surprise, then, that radical-right populism has often been hostile towards the European project in all its manifestations, particularly more thorough-going political or social-Europe integration; has often been divided on how to deal with international trade, with some happy to protect national industries for their own sake; been hostile to global institutions that curb national sovereignty; and above all has been keen to keep racial and national 'others' from one's shores – equal treatment be damned.

To be sure, there are shared forces at work, underlying both the radicalisms of the left and right, and these common origins are important for thinking about the rescue of liberal economic and political order. Think of the general backlash against modernity (end of the male breadwinner model) or against the stagnation of middle-class incomes amidst out-of-control inequality. The deeper underpinnings are not just apolitical forces of technology and ineluctable globalisation. They are also deeply political (technology and globalisation have political origins, after all) linked to policy choices such as the partisan political deregulation and diminution of welfare state compensation, the gutting of unions and employer associations.

It remains crucial to understand the deep divergences between these party ideological responses to common threats that distinguish the radical left and right, each so central to our current post-crisis political distemper against European and global economic openness. These differences have important implications for coalition-building that feeds radical reform that one might fear or embrace. The paths of the radicals on the left and right are more important for their differences than their similarities: one is hostile to neo-liberal internationalism and Europe, not to Europe in general, the other is hostile to any and all of Europe and the world; one is interested in progressive recovery of national egalitarianism, and the other wants nationalist hierarchy. It should not be hard to choose your populist ‘poison’.

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## 6 Is the Brexit vote disconnected from the European Union?

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**Sascha O. Becker, Thiemo Fetzer and Dennis Novy**

University of Warwick and CEPR; University of Warwick / Visiting University of Chicago, Harris School; University of Warwick and CEPR<sup>1</sup>

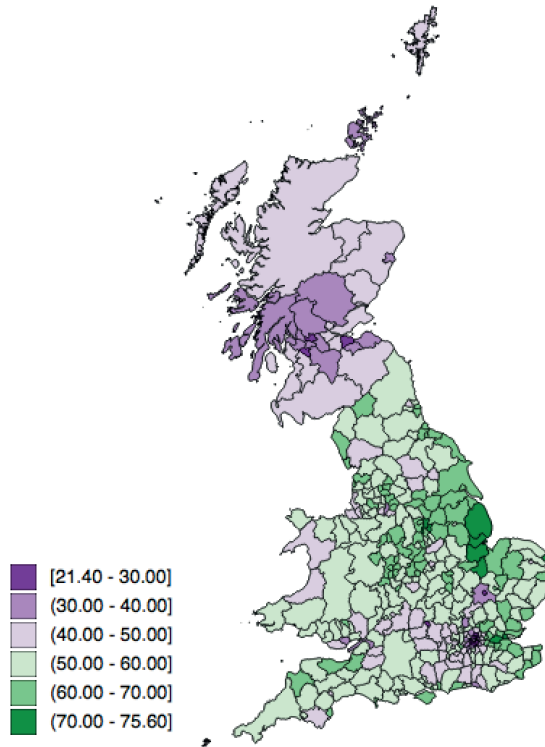
In the Brexit referendum on 23 June 2016, the British electorate voted to leave the European Union. The vote is widely seen as a watershed moment in British history and European integration. Why did some areas vote to leave the EU, while others voted to remain? What lessons can be drawn from the Brexit referendum regarding the rise of populism in the EU, and what might be done to address it?

The UK referendum on EU membership on 23 June 2016 is a key moment for European (dis)integration. Even though the outcome had been expected to be tight, in the days running up to the referendum bookmakers and pollsters predicted that the ‘Remain’ side would win. Many observers were left puzzled and keen to understand who voted for ‘Leave’. Various newspapers and blogs quickly reported plots relating the referendum vote to key characteristics such as the age profile of the population (Burn-Murdoch 2016). It was also pointed out that the Brexit vote related to class identification and social attitudes more generally (Kaufmann 2016a).

In a recent paper, we follow these early contributions and analyse the Brexit referendum vote in more detail (Becker *et al.* 2016b). We study the EU referendum result in England, Wales and Scotland in a disaggregated way across 380 local authorities, and also across 107 wards in four English cities. We relate the vote to fundamental socioeconomic features of these areas. Figure 1 plots the ‘Vote Leave’ shares across the local authority areas (excluding Northern Ireland and Gibraltar).

<sup>1</sup> Parts of this chapter were previously published at VoxEU.org <http://voxeu.org/article/fundamental-factors-behind-brexit-vote>

**Figure 1.** Map of the Leave share (in percent) across local authority areas in the 2016 EU referendum.

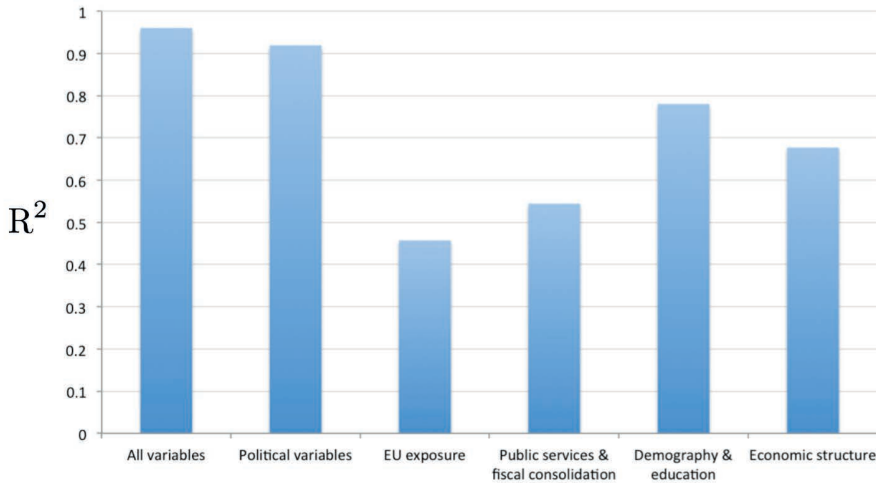


## Socioeconomic characteristics

We capture different subsets of socioeconomic variables that best ‘predict’ the actual referendum result. We cannot possibly give a causal explanation of the referendum result because the election outcome was obviously multi-causal and multi-faceted. In other words, our results reflect a broad range of correlation patterns.

Figure 2 reports the goodness of fit in regressions that use different sets of explanatory variables. This helps shed light on the relative explanatory power of different salient ‘issues’. For example, we find that demography and education (i.e. the age and qualification profile of the population across voting areas) explain just under 80% of the Vote Leave share. The economic structure explains just under 70%; variables in this group include the employment share of manufacturing, unemployment and wages.

**Figure 2.** Goodness of fit (measured as R-squared) in separate regressions explaining the Vote Leave share at the local authority area level using only regressors from the respective group of variables.



## EU exposure and immigration

Surprisingly, and contrary to much of the political debate in the run-up to the election, we find that relatively little variation (under 50%) in the Vote Leave share can be explained by measures of a local authority area's exposure to the EU. These measures include the local authority's trade exposure to the EU (albeit measured at a coarser spatial resolution), its receipts of EU structural funds and, importantly, the extent of immigration. We find evidence that the growth rate of immigrants from the 12 accession countries that joined the EU in 2004 and 2007 is linked to the Vote Leave share. This link mirrors findings of Becker and Fetzer (2016), who study the role of immigration from Eastern Europe in explaining the growth of UKIP. This stands in contrast to migrant growth from the EU15 countries or elsewhere in the world, and suggests that migration from predominantly Eastern European countries has had an effect on voters, albeit a quantitatively small effect. However, we cannot identify the precise mechanism, i.e. whether the effect on voters is mainly economic through competition in the labour and housing markets, or from changing social conditions.

## **Fiscal consolidation**

In the wake of the financial crisis, the UK coalition government brought in wide-ranging austerity measures to reduce government spending and the fiscal deficit. At the local authority level, spending per person fell on average by 23.4% in real terms between 2009/10 and 2014/15. But the extent of total fiscal cuts varied dramatically across local authorities, ranging from 46.3% to 6.2% (Innes and Tetlow 2015). It is important to note, though, that fiscal cuts were mainly implemented as *de facto* proportionate reductions in grants across all local authorities. This setup implies that reliance on central government grants is a proxy for deprivation, with the poorest local authorities being more likely to be hit by the cuts. This makes it impossible in the cross-section (and challenging in a panel) to distinguish the effects of poor fundamentals from the effects of fiscal cuts. With this caveat on the interpretation in mind, our results suggest that local authorities experiencing more fiscal cuts were more likely to vote in favour of leaving the EU. Given the nexus between fiscal cuts and local deprivation, we think that this pattern largely reflects pre-existing deprivation.

## **Which factors explain more of the variation in the Vote Leave share?**

Demography, education and economic structure – all fundamental, slow-moving factors – explain more of the variation in the Vote Leave share than measures of EU exposure, fiscal consolidation and public services. We therefore find a rather striking disconnect between the factors driving the Brexit vote shares across the UK and how these factors relate to the EU, with the partial exception perhaps of the immigration of low-skilled Eastern Europeans.

## **Did turnout by age matter?**

According to detailed polling conducted after the referendum, turnout among the bracket of youngest voters (aged 18-24) was 64%. This compares to an average turnout for the same age group of less than 50% in UK general elections since 2000, and to an average turnout in the referendum across all age groups of 72.2%.

At the other end of the age spectrum, voters aged 65 and above had a turnout of 90%. Support for Leave steadily increased with age, rising from just 27% among 18-24 year-olds to 60% among voters aged 65 and above.

Could the referendum have ended up with a victory for Remain if more young people had turned out? We calculate that turnout amongst younger people or, more generally, people who were supportive of Remain would have had to have been close to 100%. Clearly, this would not have been feasible. We therefore conclude that different turnout patterns would not have changed the referendum outcome. Nevertheless, we should keep in mind the potential for strong inter-generational conflict entailed by Brexit.

### **First past the post in the UK electoral system and lack of democratic representation**

Our results are consistent with the notion that the voting outcome of the referendum was largely driven by long-standing fundamental determinants, most importantly those that make it harder to deal with the challenges of economic and social change. These fundamentals include a population that is older, less educated and confronted with below-average public services. We therefore doubt that a different style of short-run campaigning would have made a meaningful difference to the vote shares. Instead, a more complex picture arises of the challenges of adapting to social and economic change.

It is clear that a majority of politicians and the media were caught off guard by the referendum result. This suggests that the needs of under-privileged areas of the country may be under-represented in the political decision process and the corresponding media attention. This is sometimes referred to as the ‘Westminster bubble’.

In fact, as a result of the first-past-the-post voting system, a mismatch arises. Despite strong electoral support in European Parliament elections, which follow a proportional voting system, UKIP (the right-wing party that has advocated Brexit since the 1990s) currently only has one Member of Parliament in the House of Commons out of a total of over 600 MPs. Voters went for an untested political entity. But given their by now fairly long history of electoral success in European Parliament elections, UKIP should not be an untested political entity.

The party should have been put in positions of responsibility over the years to demonstrate whether they are able to follow up on their slogans and promises with real political change that improves people's lives. It may therefore be appropriate to consider ways of introducing more proportional representation into British politics to allow more diverse views to be represented in Parliament and to subject them to public scrutiny in the parliamentary debate.

The political system also needs to better explain what the EU does and what it doesn't do. This is particularly important in the British context. For instance, the EU has essentially no influence on house-building and health care provision in the UK – two salient issues on voters' minds. Clearly, the role of the press is paramount in this context. Given the outlandish claims made in sections of the British yellow press and, increasingly, also in more established titles such as *The Daily Telegraph*, politicians will find it hard to stem the populist flow.

## **Rejection of the status quo with no clear alternative**

The conundrum of the Brexit vote is that it amounted to a rejection of the status quo without a clear alternative on the ballot paper. What exactly will Britain's new relationship with the EU be? Even six months after the vote we know precious little, and the government seems reluctant to put forward its preferred direction of travel. Most importantly, it is unclear whether Brexit will improve the lives of the very voters who were unhappy with the status quo.

The first cracks are already visible. On the one hand, Britain wishes to retain access to the Single Market in the broadest possible sense. But on the other hand, the EU will not grant broad access unless Britain maintains the free movement of labour. Indeed, the recent change of heart in Switzerland regarding their stance on immigration underlines how adamant the EU is on free movement.

## Lessons for the European Union?

The evidence overwhelmingly suggests that free movement of factors of production, in particular labour, can deliver large welfare gains. In the case of immigration, those welfare gains fall primarily on the immigrants themselves, but there are also wider spillovers to the host community, at least in the aggregate. Yet, the Brexit vote makes it clear that the political system needs to be more closely in touch with voters' concerns on immigration. In particular, it is up to national politics to decide how the benefits from immigration are shared with the wider electorate in the form of investment in public goods and infrastructure. A potential avenue for public debate could be a (fiscal) rule linking immigration to spending on public infrastructure to ensure that the electorate shares the gains from immigration in an appropriate way. This debate would mainly have to happen at the national level. But presumably the EU could also debate whether in cases of rapid immigration waves, sensible restrictions to slow down immigration would be acceptable to ease the adjustment, or whether immigration should be accompanied by corresponding investment in public infrastructure.

There is no doubt that populism has been on the rise across the EU for several years, to a large extent fuelled by nationalistic and anti-immigration sentiment. Italy's Cinque Stelle movement and Germany's Alternative für Deutschland are only the latest additions to the party spectrum. Of course, we do not claim that the patterns we uncovered for the UK automatically explain the voting patterns in other countries. Yet, the fact that the referendum was focused on Britain's EU membership makes it all the more surprising that factors relating to European integration played a far lesser role than one might have expected.

One may speculate that in other European countries as well, scepticism towards the European Union is not so much an independent factor but rather a reflection of discontent with economic and social circumstances. It is clear that voters are hardly willing to make economic sacrifices in order to restrict immigration (Kaufmann 2016b). In other words, economic motives seem to be at least as important as anti-immigration preferences. European governments should therefore focus their attention on supporting those who feel disenfranchised. Brexit could lead to further EU disintegration, or it could be a turning point towards a stronger union.

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## 7 Brussels bureaucrats and Whitehall mandarins: Taking regional identity seriously

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**Diane Coyle and Rob Ford**

University of Manchester

The UK's narrow referendum vote to leave the European Union in June 2016, part of a broader populist tide in the West, has the potential to damage both the British and other European economies – and perhaps worse, if it turns out to have created the conditions for a fundamental fracturing of the EU as a whole. Economists in Britain were near-united in favouring the Remain camp, with nine out of ten expecting a negative medium-term impact on growth.<sup>1</sup> Leave voters – who typically had fewer educational qualifications and were more concentrated in rural or deindustrialised areas – are the people most likely to be harmed by any downturn in the economy, which will hit the least qualified and most marginalised hardest.

If so, the obvious question is why did so many people vote against their economic self-interest? The obvious answer is that they did not think they had much to lose, because people in those categories have not gained economically since the financial crisis – and in many cases they had been stagnating or losing ground for many years even before the crisis. Average real incomes declined nearly 10% between 2009 and 2013; the latest (post-referendum) forecast from the Office for Budget Responsibility predicts they will still be lower in 2021 than in 2008.<sup>2</sup>

1 <https://www.ipsos-mori.com/researchpublications/researcharchive/3739/economists-Views-on-Brexit.aspx>

2 <http://budgetresponsibility.org.uk/cfo/economic-and-fiscal-outlook-november-2016/>

Unemployment and economic inactivity is lower in the UK than in other EU countries, but tends to be concentrated in the devolved nations, northern England, the northeast and the West Midlands (see Table 1). What's more, the obverse of the country's low unemployment rate is the growth in insecure, contingent work characterised by features such as zero hours contracts (although there are no reliable statistics on the extent of such conditions). Anger about the lack of work bringing dignity, security and a reasonable income has been building for a long time; this kind of work was lost in many Brexit areas in the 1970s and 1980s, and never returned. The bailout of banks in 2008-2009 and the swift return of bonuses and the swagger in finance further inflamed this slow-burning anger, and turned Brexit voters against a system they saw as corrupted and rigged against them.

**Table 1.** Employment indicators, UK regions, July-Sept 2016

	Employment rate <sup>1</sup> (%) aged 16 to 64	Unemployment rate <sup>2</sup> (%) aged 16 and over	Inactivity rate <sup>3</sup> (%) aged 16 to 64
North East	71.1	6.1	24.1
North West	72.2	5.3	23.6
Yorkshire and The Humber	73.0	5.6	22.6
East Midlands	75.1	4.5	21.2
West Midlands	73.4	5.2	22.4
East	77.1	4.3	19.3
London	73.6	5.6	22.0
South East	78.0	3.6	19.0
South West	77.0	3.9	19.8
England	74.8	4.8	21.3
Wales	73.1	4.4	23.4
Scotland	73.6	4.7	22.6
Great Britain	74.6	4.8	21.5
Northern Ireland	69.9	5.6	25.8
UK	74.5	4.8	21.7

Source: Office for National Statistics

1. Calculation of headline employment rate: Number of employed people aged from 16 to 64 divided by the population aged from 16 to 64. Population is the sum of employed plus unemployed plus inactive.

2. Calculation of headline unemployment rate: Number of unemployed people aged 16 and over divided by the sum of employed people aged 16 and over plus unemployed people aged 16 and over

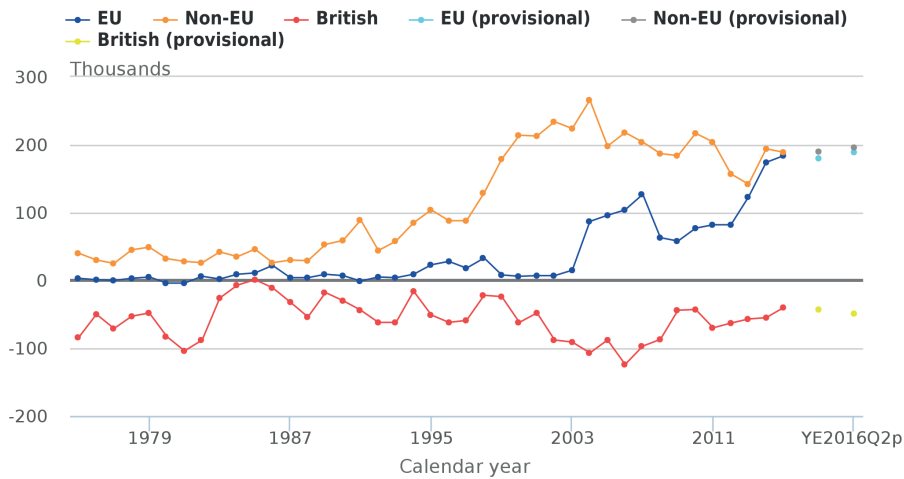
3. Calculation of headline economic inactivity rate: Number of economically inactive people aged from 16 to 64 divided by the population aged from 16 to 64. Population is the sum of employed plus unemployed plus inactive

The vote for Brexit was concentrated socially amongst voters with low education levels, in former industrial regions, among the most economically pessimistic, and among those who self-identify with the working class. This pattern of preferences was already clear in support for UKIP in the years prior to the Brexit referendum. UKIP rose to prominence by mobilising such voters with a combination of Euroscepticism, opposition to immigration, attacks on the political ‘establishment’ and assertive English nationalism.

UKIP’s emergence further complicated UK political debate on Europe and immigration, long the most divisive topics on the British political agenda. The combination of backbench Euroscepticism and electoral competition from UKIP made it impossible for any ambitious Conservative politician to engage constructively with Brussels, while public hostility to immigration left the Labour opposition unwilling to defend the EU free movement principle from increasingly strident media criticism. A semi-detached Britain found itself unable or unwilling to influence European policies, further increasing alienation and detachment in an adverse feedback loop.

However, the policy failures which produced the economic stagnation and political alienation of Brexit areas, disguised by pre-crisis growth, date back decades. The deindustrialisation of the UK’s manufacturing towns began long before the rise in immigration from the EU and rest of the world (see Figure 1). The North Sea oil-driven appreciation of the exchange rate and the policy-driven recession of the early 1980s ravaged the economic and social fabric of the industrial belts of the devolved nations and England outside the southeast. The policy response was minimal, leading to the embedding of worklessness, poor housing, ill health and dependency on benefits. To this economic depression was added steadily mounting political alienation, as voters in these ‘left behind’ areas found neither Conservative nor Labour administrations offered any effective solutions to their problems.

**Figure 1.** Net migration to the UK



Source: ONS

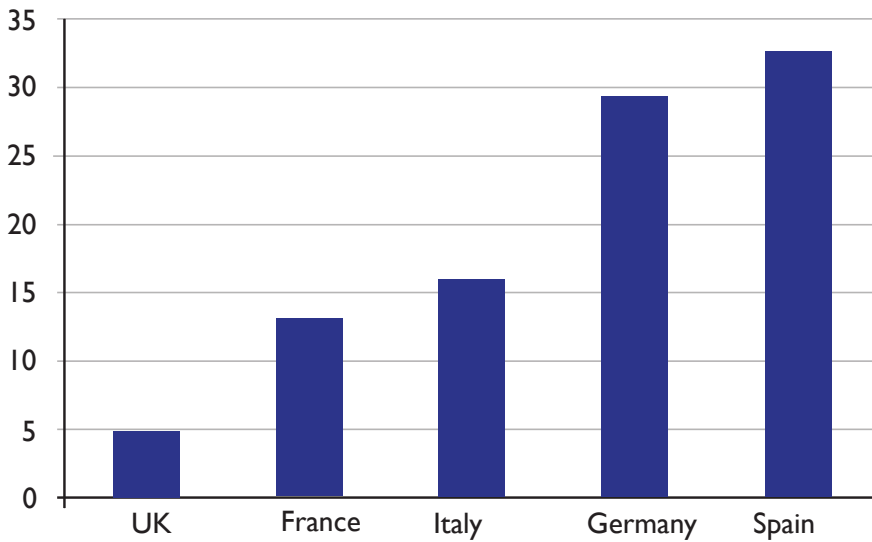
Part of the explanation for that policy catastrophe was centralisation in Whitehall. The UK is highly centralised both politically and economically.<sup>3</sup> Figure 3 shows a comparison of the UK's sub-central tax revenues with those of France, Italy, Germany and Spain. Even with the recent city devolution deals (starting with Manchester in November 2014), most officials, many Conservative politicians, and the think tankers, lobbyists and advisers rarely spend time in other parts of the country. 'Regional' visits mean a day trip to visit a factory and a school, and give a speech at dinner. There has been consistent under-investment in infrastructure, research and education outside the south and east.

The powerlessness and alienation felt and expressed by Brexit voters was perfectly rational – but was focused on the wrong target. The structural problems that have left them politically marginalised are in Westminster, not Brussels. Economists failed them in only looking at average growth rates, not at the distribution of growth, until the financial crisis brought home the salience of inequalities. Politicians failed them by focusing on swing seats and swing votes, leading to systematic under-representation of 'left behind' voters in safe constituencies. Civil servants failed them by seeing everything through the prism of London and Whitehall and refusing to let power flow elsewhere,

3 Evidence summarised in House of Commons (2014). <http://www.publications.parliament.uk/pa/cm201415/cmselect/cmcomloc/503/503.pdf>

leaving problems in struggling English districts well beyond the M25 motorway around Greater London to fester unnoticed and unaddressed.

**Figure 2.** Sub-central tax revenues (as a percentage of total)



Source: OECD fiscal decentralisation database (<http://www.oecd.org/ctp/federalism/oecd-fiscal-decentralisation-database.htm>).

There is an era of slower growth ahead for the continent, perhaps much worse for the UK depending on how the Brexit process unfolds; adverse demography, the debt overhang, and long under-investment in infrastructure and skills make this hard to avert. Slow growth prospects mean income distribution will matter for at least a generation. If there is to be hope for a reinvigorated European identity in this context, it will need to be a kaleidoscopic one, not a uniform and centralised one. After all, it is not only Britain that has large numbers of left-behind voters in left-behind places.

Is this message finally sinking home in Whitehall and Westminster? There have been some steps in the right direction: the devolution of power first to the Manchester ‘Northern Powerhouse’ and now planned for a number of other city regions; the emergence of genuine debates about industrial strategy and infrastructure investment; and positive noises from all the political parties about further devolution and efforts to address regional disparities.

Yet the agenda to date is nowhere near ambitious enough. There are signs (not least in the secret guarantees about trade conditions post-Brexit given to Nissan)<sup>4</sup> that the centre has finally recognised the importance to trade of industrial supply chains and industrial policy; but not yet that national policymakers have made the link between industrial success and the decision-making autonomy of the specific geographic areas where supply chains are located (Lamy 2013, Baldwin 2016).

The devolution reforms in the rest of the UK have delivered pluralism, political renewal and policy innovation in Scotland, Wales and Northern Ireland. Now we need a similarly ambitious agenda, with genuine devolution of fundraising and decision-making power, for the UK's largest constituent nation. This June, voters across the length and breadth of England expressed a striking desire to 'take back control'. The Westminster and Whitehall 'elite' should help them do so.

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## 8 A future EU: An inevitably emotional party animal

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**Gijs Schumacher**

University of Amsterdam

2016 gave us Brexit and Trump. What will 2017 have in store for us? *Madame Président* Le Pen? Prime Minister Wilders? A resurgence of the radical right in Germany? The media speak of ‘populist revolutions’ across the democratic world. Populism is probably the most abused concept of 2016. Often people label demagoguery, political opportunism, and immigrant bashing as ‘populist’. Supporters of these populists are often branded as misguided, or as protest voters. In particular, the popular ‘angry (poor) white men’ explanation of Brexit and Trump characterises populist supporters as overly emotional and unreasoned. I disagree with this view. Not because these voters *are* rational, but because emotion and reason are not two separate processes that we can turn on and off. We are in fact wired in such a way that emotions always precede and influence reason (Damasio 1995). By consequence, all politics is emotional. This chapter illustrates that psychological aspects such as emotion and personality play a pervasive, but underestimated role in politics – in particular regarding the role of populists in politics.

### **All politics is emotional**

Was it education, income, religion, racism, sexism, geography, authoritarianism, or something else? The weeks after Trump’s election saw a steady bombardment of plots demonstrating how one vital – overlooked – variable explained Trump’s victory. These analyses mostly left out the single most important predictor: partisanship. Most Americans identify with either the Democrat or the Republican Party. Party identification triggers immediate emotional responses that influence all our subsequent reasoning.

We search for and quickly agree with arguments in line with our world view, and reject those arguments against our world view (Taber and Lodge 2006). This explains how many Republicans supported Trump. Thinking that Republicans are good and Democrats are bad, Republican partisans ignored Trump's sexist and racist remarks, while quickly agreeing with negative characterisations of Hillary Clinton. The fact that Clinton had more policy ideas, and had better reasoning to support them, was electorally irrelevant as Republicans were not listening.

In Europe we tend to think of this as less of a problem, because fewer people identify with a party in Europe than in America. Recent research demonstrates this is not the case, and that also in Europe more than seven out of ten people identify with a party (Bankert *et al.* 2016). In sum, it is not only populist supporters that let emotions influence their political decision making; almost everybody does it. What is particularly important about populism is that it can make and break new partisan identities.

## **Populism breaks old identities**

Academics generally agree that populism is a 'thin ideology' that combines anti-establishment appeals with demands that the interests of the people should be (more) central in politics. These components are then always combined with some host ideology (Mudde 2004). Today that host ideology is mostly anti-European and anti-immigration. But there is also left-wing populism (Podemos in Spain) or populism without a clear host ideology (the Five Star Movement in Italy).

Populism works because people are very sensitive to anti-establishment appeals. Anthropological accounts of human behaviour in hunter-gatherer societies demonstrate that we are invested with strong anti-big man feelings (Boehm 2001). We share a general resentment towards leadership, especially if that leadership is evaluated as undeserving due to self-interested behaviour and self-importance (Smith *et al.* 2007). By framing the elite as harming the people's interests, populists set the elite apart as an 'outgroup' to be feared. It has been suggested that this is an effective strategy to craft new political identities (Brewer 2007). In a recent experiment that I conducted with Paul Marx, we found that people are willing to accept any policy proposal regarding tax and welfare, as long as it is not a career politician proposing it.

In fact, our results show that people would love to have construction workers as politicians.

Not everybody is open to anti-establishment appeals. Some recent experiments I conducted with Bert Bakker and Matthijs Rooduijn demonstrate that ‘low agreeable’ or discordant people – who are generally egoistic, distrustful and uncooperative – were particularly motivated by Trumps’s spitting on the establishment.<sup>1</sup> Elsewhere, we demonstrated that low agreeableness is a general feature of populist voters in Western Europe and the US (Bakker *et al.* 2016).

Agreeableness is a personality trait (Mondak 2010). These traits are generally stable. Language and policies can be crafted in such a way as to appeal to people with specific personality traits. As noted above, anti-establishment rhetoric appeals to ‘low-agreeable’ people. Politicians can achieve a ‘functional match’ between people’s personality traits and their language and policy ideas (Caprara and Zimbardo 2004, Jost *et al.* 2009). But there are many ways to do this. The experiment with Bakker and Rooduijn mentioned in the previous section also demonstrated that authoritarians, a personality trait indicating preference for social order and hierarchy, are particularly triggered by fears of immigrants. This is the second route to Trump and similar EU-populist support. Importantly, the authoritarians are different Trumpistas from the low-agreeable Trumpistas. The authoritarian aspect of Trump support is likely to be similar to the populist parties in Europe that have anti-immigration as their host ideology, but not to those populist parties (Podemos, Five Star Movement) who lack this host ideology.

## **Is populism dangerous?**

Populism is dangerous because it can sway people who do not naturally support the host ideology of the party. That is the anti-establishment route to populist support, particularly attractive to low agreeable people. Is it dangerous? If the host ideology is, then yes populism is dangerous.

<sup>1</sup> See <http://blogs.lse.ac.uk/usappblog/2016/09/02/donald-trumps-support-comes-from-two-distinct-groups-authoritarians-who-oppose-immigration-and-anti-establishment-voters/>

Also, the people-centric aspect of populism can be dangerous. Calls for the unmediated expression of the people quickly turn into the gradual demolition of liberal democracy, as is taking place in Hungary.

Bonnie Meguid (2005) demonstrates that accommodating populist parties (in contrast to ignoring or opposing them) is the best strategy to undercut their electoral support.<sup>2</sup> For example, Flemish Interest (formerly Flemish Bloc) was almost annihilated by the New Flemish Alliance's accommodation of their policies. The obvious downside is that while the populist challenger is destroyed, the mainstream has radicalised.

Can the mainstream be(come) populist? We typically equate populism with radicalism, but this need not be the case. Populism, in fact, should be seen as a scale rather than a category. Parties vary in the degree to which they are populist. Findings from text analysis or expert surveys demonstrate that, strictly speaking, 'populist' parties do not have a monopoly on populism (Jagers and Walgrave 2007, Polk *et al.* 2017, Rooduijn and Pauwels 2011); mainstream parties also use it. Think of Matteo Renzi, the former (and future?) prime minister of Italy, who called himself the political caste breaker. Also, parties vary in their level of populism over time, depending on their integration into the party system. In fact, many parties strike populist chords in their formative stages. They seem to lose this over time, which may in fact be one of the problems.

## **What to do about populism?**

My suggestion would be to accommodate not the policies – i.e. the host ideology – but the anti-establishment aspect of populism. Many populist claims are simply not all that absurd. Is it really controversial in South Europe to claim that the political elite is corrupt? No, even the European Commission would agree to that. Do politicians feel self-important? Yes, immensely. Is there a back-room deal-making political class? Of course. Many European opposition parties have missed an opportunity to propose a radical break with the existing political elite. They have themselves become too much part of it.

<sup>2</sup> Meguid analyses niche parties. By her definition most populist parties fall into this category. However, not all niche parties are populist.

Instead, many of them used the economic crisis to try and demonstrate their responsibility and their readiness to govern.

This managerial and technocratic response to the crisis was perhaps the proper policy, but it is – in my view - rather ineffective in crafting and maintaining political identities. It underestimates the psychology of voters. This chapter has illustrated this by summarising some of my recent findings regarding the link between personality and voting, and between emotions and politics.

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## Part III

# A new governance structure for Europe



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## 9 State capacity, populism and the EU budget

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**Andrew Gamble**

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The EU is in trouble and is facing challenges which could easily lead to its disintegration. Brexit is an irritant rather than the heart of the problem, because the UK has been semi-detached from the European project for most of its 43-year membership, and its leaving the EU will remove one of the major roadblocks to EU reform. More serious is the inability of the EU institutions to deal with the problems that have arisen since the 2008 Global Crisis, particularly around debt, deflation and migration. The first two of these flared up in the Eurozone crisis between 2010 and 2012. The Eurozone was held together by some exceptional measures initiated by the ECB, but the underlying problems of the currency union, particularly the mismatch between productivity and debt levels between its members, were not resolved and will return. The current flashpoint is Italy. The migration problem is different from the issue of free movement, but the nationalist populist parties have successfully linked the two in the public mind. The EU is blamed for failing to provide security for its citizens, and pressure is increasing to reinstate national control of borders.

The political and economic impasse in Europe is leading to a major realignment of European politics. Mainstream parties and governing elites everywhere are under attack from a range of populist movements and parties. Some of these are on the left, such as Podemos in Spain and Syriza in Greece, but most are on the nationalist populist right, such as the Front National in France and the Party for Freedom in the Netherlands. A few, such as the Five Star Movement in Italy, are hard to categorise. So far, the main loser from these insurgents has been the social democratic parties of the centre-left, which are in retreat everywhere, having been dominant in European politics at the turn of the century.

Some of these parties are no longer serious contenders for government, and the political contest is increasingly between mainstream parties of the centre-right and the parties of the nationalist populist right. The parties of the centre-left have lost touch with their traditional working class bases, partly because during the three decades of the neo-liberal era they came to be identified with support for globalisation, openness, and cosmopolitanism. In the new political climate since 2008, they have been punished severely for this. Centre-right parties have found it much easier to rally support through their command of the narratives of austerity and security, directing popular anger towards welfare recipients and immigrants and forcing centre-left parties on to the defensive. But the centre-right parties themselves have no solutions to the problems of secular stagnation, high debt, rising inequality or rising migration. The next phase of the political crisis is likely to see their dominance challenged, particularly as they remain committed to membership of the EU and the Eurozone. Most of the nationalist populist parties are hostile to the EU, and several want referendums on whether to exit the Eurozone. If one of the major states voted to leave the Eurozone, the euro would quickly unravel and the EU itself would struggle to survive. Nationalist parties would demand full control over their economies and their borders. Under these circumstances, the EU could break up very rapidly.

The situation appears bleak unless there is fundamental EU reform. There are many suggestions as to what those reforms should be, but little confidence that anything substantial can be implemented. Treaty changes would be involved, and no-one wants treaty changes because they would have to be agreed by all member states, and in many countries that would require referendums. The European governing class is not confident it can win any referendum against the nationalist populist right now, so is unlikely to support any reforms that might trigger them. Trying to maintain the status quo, however, is likely to lead to further erosion of support for the EU among national electorates, and to make an electoral breakthrough by one of the insurgent parties more likely. However politically difficult and unwelcome a treaty change currently appears, it is probably necessary if the EU is to save itself.

There are many things such a treaty change might, and should, encompass, but a priority is doing something about the size of the EU budget.

In the nationalist populist media, the EU is presented as a highly centralised state deploying a huge budget and intruding into the lives of all its citizens – the ‘EUSSR’, as oppressive and wasteful as its Soviet predecessor. The reality is very different. The EU budget comprises only 1% of total EU GDP. Attempts to raise it have always been blocked, with the UK one of the leading opponents of any increase. Member states have national budgets which are generally above 40% of GDP, and in the case of the Nordic countries are as high as 55%. Government spending as a percentage of GDP is a crude measure of what government does, but it tells us something. It is an indicator of the capacities and reach of a state. The small size of the EU budget reflects the very limited capacity and reach of its central institutions compared to the capacity and reach of the national governments.

Yet the EU persists in projecting itself as though its central institutions are much more powerful than they really are. The EU often presents itself as though it were a federal state, with its own flag and citizenship, and a single will and direction, but the reality is that it is still primarily a confederal arrangement or something even looser, with decisive power in the hands of the intergovernmental Council of Ministers rather than the supranational Commission. Because the EU has not developed much beyond the confederal stage, the European Parliament has remained weak and relatively ineffective. It can in certain circumstances hold the European Commission to account, but it cannot overrule the Council of Ministers. One of the key reasons why the EU is in trouble and losing legitimacy and support is because it is seen to be ineffective in addressing so many of the problems which citizens want to see addressed, and which the EU itself encourages its citizens to believe it has the power to address. Resources are not everything, but the EU is so starved of resources that it is severely hampered in what it can achieve. In federal states the percentage of GDP accruing to the centre varies, but in the United States it averages around 20%. If the EU had even 5% of EU GDP at its disposal, the effect would be transformative. The fundamental flaw in the design of the Eurozone was to create a monetary union but not a fiscal union. The latter was considered too difficult politically because all Eurozone members would have had to agree to harmonise their taxes and spending, and to make available much larger funds for transfers between states, as well as defining the sphere of competence of federal and national authorities.

The EU's problem is that it is seen as a remote supranational body which promotes globalisation, liberalisation and cosmopolitanism, rather than as a state which protects its citizens. In the era of expansion of the world market in the 1990s and early 2000s, that often worked to the EU's advantage and made it appear as a new form of networked governance, a new kind of state, a civilian power. But in the era of deflation and stagnation since the crisis, many European citizens have wanted a state to protect them, and the EU has neither the will nor capacity to do so. It has been easily scapegoated as a major source of the problems that afflict national economies, and as an obstacle which prevents national governments from tackling them. The EU often presents itself as a sovereign power, but has very few of the attributes of a sovereign power. If it cannot protect its citizens, why should its citizens feel any obligation to it? If at the time of the Maastricht Treaty the budget of the EU had been enlarged along with its ambitions, then it might have been possible to make social Europe a reality for all its citizens and to create a fiscal union which would have permitted the kind of internal transfers of resources which the Eurozone required when the crisis struck.

The EU faces a stark choice. To survive it must either find the political will to give its institutions the resources needed so that a real European state, which provides the guarantees and security its citizens require, can be built, or it needs to scale back its ambitions and some of its powers and cease pretending that it is more than the sum of its members. If it persists on its present course of not choosing between these two alternatives, it will be easy prey for the national populist right.

## About the author

**Andrew Gamble** is (Emeritus) Professorial Fellow at the Sheffield Political Economy Research Centre (SPERI). Prior to his return to Sheffield, he was Professor of Politics at the University of Cambridge and Fellow of Queens' College. The majority of his career was as a member of the Department of Politics at the University of Sheffield (1973-2007), from 1986 as a Professor. While at Sheffield University, he was a founder, member, and Director of the Political Economy Research Centre (PERC), Chairman of the Department of Politics (twice), and Pro-Vice Chancellor of the University. In 2005 he was awarded the Sir Isaiah Berlin Award for Lifetime Contribution to Political Studies by the Political Studies Association. His 2003 book, *Between Europe and America*,

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His publications include *Crisis Without End?: The Unravelling of Western Prosperity* (2014), *The Free Economy and the Strong State* (1988), and *Britain in Decline* (1981).





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# 10 Brexit, political shock absorbers, and the three Rs

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**Kevin H. O'Rourke**

All Souls College, Oxford University

Following the disaster of the interwar period, a political bargain was struck in Europe: workers accepted the market economy, in return for a variety of social insurance mechanisms, both microeconomic and macroeconomic. Policy makers followed the 'three Rs', learned from bitter experience during the 1930s. The first was a shock preventer: regulation, above all, of the financial sector. The second and third were shock absorbers: redistribution, to ensure that families and regions did not fall through the cracks; and reflationary macroeconomic policies, when needed, to correct deficiencies of aggregate demand. European integration was, as Alan Milward emphasised, an integral part of this essentially social democratic political economy mix. It was important to reap the benefits of trade, but this could not come at the expense of broader social and political objectives: "The problem genuinely was how to construct a commercial framework which would not endanger the levels of social welfare which had been reached ... The Treaties of Rome had to be also an external buttress to the welfare state" (Milward *et al.* 2000, p. 216). And so, the Treaty of Rome (1957) envisaged not just a customs union, but also *inter alia* a Common Agricultural Policy, the free movement of capital and labour, common competition rules, and the harmonisation of social policies. The supranational elements of the European project, which have always bothered the British, were a logical consequence.

The strategy was so successful that voters eventually took this security for granted, and the political post-war bargain came under strain from the late 1970s onwards. Insurance only matters when times are bad, and so for a long time this policy shift didn't seem to matter greatly, but eventually and inevitably bad times rolled around again. We are now suffering the political and economic consequences of not taking the three Rs seriously enough.

Financial deregulation was surely one of the ultimate causes of the financial crises of 2008. Those crises were bad enough, but to make matters worse this huge macroeconomic shock was superimposed upon a much longer drawn-out shift in comparative advantage, due to the opening up of China and other developing countries to the rest of the world (Irwin and O'Rourke 2014). We have known for a very long time that blue-collar workers in rich countries are hostile to this shift (Scheve and Slaughter 2001, O'Rourke et al. 2001, Mayda and Rodrik 2005), and this hostility had concrete political consequences as early as 2005, when French and Dutch voters rejected the so-called 'constitutional treaty' (O'Rourke 2008). But it is also true that there is nothing inevitable about stagnant living standards of poorer workers; domestic policies matter enormously. In many continental European countries, states have been far more protective of workers than in the UK and US, and this has mattered for outcomes. In France, for example, Piketty *et al.* (2016) estimate that the incomes of the poorest 50% of the population have increased by 32% since 1980, in sharp contrast with the situation in the US. It is in the Anglo-Saxon economies that the pendulum has swung the most towards markets, and away from the second R: redistributive states that can protect workers when things go wrong. It is no surprise that this is where the biggest political shocks of 2016 occurred.

But that should be of no great comfort in the Eurozone, since it is there that the third R – reflationary macroeconomic policy – has been most conspicuous by its absence. If it is in Britain and the US that long-run trends in income distribution have been particularly unfavourable to median households, it is in the Eurozone that the Great Recession has been worst. And so in countries like Greece and Italy, it is the poorly conceived and badly managed single European currency that is at the root of much of the popular discontent boosting populists' fortunes.

In this economic and political context, it seems clear what the priority for the EU should be. It should either serve itself as a port in the storm for anxious electorates, sheltering them from macroeconomic instability and the negative consequences of globalisation; or failing that, it should not prevent national governments from playing that role. It also seems clear that the EU, and especially its monetary union, is failing in this task.

Brexit offers the EU opportunities that it should seize. If one major political problem has been that the pendulum has swung too far towards the market and too far away from the protective state, then the exit of the UK should make it easier to tilt the balance back in the opposite direction. But Brexit is also an eminently teachable moment. It is understandable that for many voters in the Eurozone, the EU and Eurozone are seen as virtually synonymous. Britain's exit will serve as a useful reminder to everyone that there is a lot more to the EU than a flawed single currency, and that even if the latter collapses, as it may eventually do, we need to make sure that we preserve the former.

The key for the EU as a whole is to restore policy flexibility at the national and/or European level, so as to restore Europe's political economy shock absorbers. Democracy cannot simply be a matter of governments periodically agreeing to tie their hands behind their backs in the future; it requires not only that we be able to kick the bums out, but that we kick out their policies as well. The first principle should be to avoid doing further harm. Take the recent controversies over 'trade' agreements, for example. There is a reason why countries, when negotiating the Lisbon Treaty, decided to preserve their veto rights over certain policy matters. There is no reason why they should be pressurised into giving up those veto rights in the context of 'trade' agreements with third countries when they have not agreed to give them up in the context of their far more important relationships with European partners. The EU has imposed many constraints on national policymaking, without replacing this hollowed-out national sovereignty with an EU-level policymaking capacity. We don't need more binding constraints ruling out policy activism.

The second principle should be to exploit whatever existing policy flexibility exists in the treaties. To take just one example, consider state aid. Article 107 of the Treaty on the Functioning of the European Union (TFEU) sensibly states that:

*"The following may be considered to be compatible with the internal market: (a) aid to promote the economic development of areas where the standard of living is abnormally low or where there is serious underemployment, and of the regions referred to in Article 349, in view of their structural, economic and social situation; (b) aid to promote the execution of an important project of common European interest or to remedy a serious disturbance in the economy of a Member State;*

*(c) aid to facilitate the development of certain economic activities or of certain economic areas, where such aid does not adversely affect trading conditions to an extent contrary to the common interest; (d) aid to promote culture and heritage conservation where such aid does not affect trading conditions and competition in the Union to an extent that is contrary to the common interest; (e) such other categories of aid as may be specified by decision of the Council on a proposal from the Commission.”*

This flexibility should be exploited when member states judge it to be socially necessary, taking account of WTO rules. The European Commission might see this as giving up power, but people working there could usefully learn from the example of their British soon-to-be former colleagues. Losing some power is much less serious than losing your job.

The third principle should be to regard the EU's many social objectives, which are extensively spelled out in the treaties, as being central to the whole enterprise, rather than symbolic and peripheral.

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In the past he served as an Editor of the *European Review of Economic History*, as an editorial board member of the *Journal of Economic History and World Politics*, as Vice President of the Economic History Association, and as President of the European Historical Economics Society. Kevin's research lies at the intersection of economic history and international economics, particularly international trade. He has written extensively on the history of globalisation, and his *Globalization and History* (co-authored with Jeffrey G. Williamson) won the 1999 American Association of Publishers/ PSP Award for the best scholarly book in economics. *Power and Plenty: Trade, War and the World Economy in the Second Millennium*, co-authored with Ronald Findlay, was published by Princeton University Press in 2007; *The Cambridge Economic History of Modern Europe* (co-edited with Steve Broadberry) was published in 2010. *The Spread of Modern Industry to the Periphery since 1870* (co-edited with Jeffrey G. Williamson) is forthcoming with Oxford University Press.



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# 11 A Europe of national responsibility

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**Erik Jones**

John Hopkins University

If there is one theme that unites European responses to the financial crisis, it is national responsibility and not European solidarity. There have been moments of solidarity, to be sure. The creation of first temporary and then permanent bailout funds was the most obvious; the unconventional monetary policies of the ECB and President Mario Draghi's "whatever it takes" speech count as well. Nevertheless, with the exception of the European Stability Mechanism (ESM), these moments of solidarity have been exceptional, temporary and transitional. They bought time for governments to restructure their banks, consolidate their finances, reform their market institutions, and prepare for an uncertain future so that another round of crisis summits and rushed institution-building will no longer be required. Once this transition period is over, cross-border redistribution and burden-sharing can be kept to a minimum. That is the objective.

The pillars of this Europe of national responsibility are the fiscal compact, the macroeconomic imbalances procedure, the Banking Recovery and Resolution Directive, and the conditionality requirements attached to any support provided by the ECB and the ESM. The fiscal compact requires governments to write a doctrine of fiscal responsibility into binding domestic legislation. The overriding aim of the compact is to ensure governments maintain sound finances at the national level. The agreement provides little room for counter-cyclical demand stabilisation, and it makes no mention of cross-border externalities. It is not a 'European' fiscal policy in macroeconomic terms. It is a guideline for national performance.

The macroeconomic imbalances procedure has a national focus as well. The goal of the procedure is to encourage reform measures that will help governments maintain a current account position that is close to balance or in surplus. The procedure suggests there should be some check on surpluses that are excessive, but it is clear that the bias is against running deficits. Here again the focus is on the national balance of payments rather than on Europe as a whole. If every country in the EU runs a marginal surplus, then the policy would be considered a success – despite the fact that the cumulative surplus would create a significant macroeconomic imbalance at the global level.

What the macroeconomic imbalances procedure accomplishes for net balance of payments financing requirements, the Banking Recovery and Resolution Directive (BRRD) achieves for gross cross-border capital flows. The purpose of the BRRD is to protect taxpayers from carrying the burden of bank bailouts. Investors in equity and subordinated debt instruments should absorb the first losses; senior debt holders and large depositors offer a second line of defence. In a closed market situation, there is a certain financial logic to this rank-ordering of creditors ahead of taxpayers. In an open market situation, however, this bailout structure creates a disincentive for cross-border investments. This was an obvious problem for Ireland and Cyprus, though for different reasons. The rest of Europe did not want the Irish government to bail-in foreign investors for fear that this would create contagion that would spread across the Continent, whereas the Cypriot government worried that burden-sharing with foreign investors would bring an end to the country's specialisation in financial services. The solution to both problems is to reduce the volume of cross-border financial flows so that national responsibility could extend to banks as well as trade and public finances.

The emphasis on national responsibility does not preclude solidarity at the European level, but it does condition that solidarity in order to avoid creating 'moral hazard' – which is understood as the conditions within which national authorities will behave irresponsibly. The conditionality attached to ESM support illustrates this principle. Governments that hope to benefit from European support must demonstrate the capacity to reform their public sector and market institutions in accordance with European supervision. That qualification applies to ECB support in the form of open market transactions as well.



Governments that request ECB purchases to stabilise sovereign debt markets must agree to participate in an ESM programme or some type of more limited conditional credit arrangement. That way, any risk absorbed onto the balance sheet of the ECB is mitigated by a commitment to national responsibility.

There are a range of other, smaller areas where the emphasis on national responsibility is apparent. You can see it in the debate about common standards for deposit insurance and in the country-specific risk provisions built into the ECB's large-scale asset purchasing programme. It can be found in the discretion given to national financial regulators within the Single Supervisory Mechanism as well. The effect is to change the structure of financial market integration, with broad implications for the functioning of the internal market. In the 1980s and early 1990s, Europeans wanted to see the internal market completed; now they want to see it constrained.

The implications of this Europe of national responsibility are fundamental. If there was ever a dream of a federal Europe with an encompassing European identity, its influence on the function of the EU is greatly diminished. Europe may even be retreating from a looser, more confederal arrangement. In its place, we see emerging a more austere or limited Europe of nation states. The goal of this Europe is not a united continent, whole and free. It is a collection of countries willing to abide by particular rules or accept the consequences of failure. Europeans may identify with that arrangement, but they are unlikely to give it their allegiance. If we want to turn this negative dynamic around, then mutual solidarity needs to be visible to citizens, regardless of national economic success.

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# 12 Revitalising Europe's soft power

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**Erik Berglof**

London School of Economics and CEPR

The greatest losers following a failure of the European project would be the EU's immediate neighbours, but it is also in these countries and the less developed regions on the periphery within the Union that the greatest growth potential lies. Unleashing this potential will require both progress on the core European reform agenda and the substantial reinforcement of the EU policies aimed at supporting economic and political development in the neighbourhood.

Economic gravity, or the product of geographic proximity and market size, explains much of world trade and prosperity. For the EU's neighbours, economic growth (or lack thereof) in what is, at least until the departure of the UK, the largest market in the world matters greatly. In some countries the relationship is close to one-to-one, in other words, a drop (rise) of one percentage point of EU growth will bring increase (decrease) the growth rate of the neighbouring country by one percentage point.

But the real loss from the demise of the European project would be that of an outside anchor for institutional reform for the countries in the neighbourhood of the EU. We might despair about the reversals of reforms in Hungary and Poland, but the fact remains that the transformation in central and eastern Europe over the last 25 years represents the most successful episode of political and economic development in world history. We still see the impact of this anchor on institutional developments in southeast Europe and Ukraine, but the effects are much wider.

These achievements were largely the result of the widely held aspiration of a 'return to Europe' among the citizens of these countries. They shared a broader notion of wanting to be European, but they also largely admired what the European project represented.

Adopting the EU institutional package, as laid out in the 60,000 pages or so of the *acquis communautaire*, allowed these countries to shortcut many difficult institutional choices and fight off resistance from status quo interest groups.

While this transformation process was fundamentally driven by the accession countries, over time a coherent and largely supportive accession policy evolved on the side of the EU. It was the golden era of EU soft power, which had already shown its capacity in the political transformation in southern Europe during the period leading up to membership for Spain and Portugal, and later Greece. Arguably, the EU's transformational capacity was also on display in Finland and Sweden during their accession processes, but at no point was it more apparent, politically and economically, than in the eastern enlargement.

It is hard not to interpret at least some of the political backtracking on reforms in central and eastern Europe as a reaction to the stresses on the European project. Going to Warsaw used to be a way to regain confidence in Europe's potential, but the current government's narrative emphasises the patronising downsides of the accession process. Similar anti-EU sentiments have strong traction in Hungary, the Czech Republic and the Slovak Republic. The outcome of the Brexit referendum has reinforced scepticism towards the EU.

Regaining the soft power of the EU will require palpable progress on core items on the Eurozone reform agenda (such as fiscal coordination and completing the Banking Union) and the wider EU agenda (such as migration policy and deepening of the Single Market). But it is likely that a reinvigoration of the legitimacy of the entire European democracy project and a resurgence of trust in the EU institutions are also needed.

More immediately, a more effective projection of soft power will only come with a strengthening of the supporting instruments, particularly industrial and trade policy and development policy. Modern industrial and trade policy is essentially a growth policy. Long-term growth is mainly driven by innovation – in a broad sense, including imitation and adaptation of products, processes and organisational solutions that are new to the local market, but also genuine invention – all bringing a particular economy closer to the world technology frontier. For the emerging economies economic growth is about catching-up with the advanced economies.

Industrial and trade policy should aim to address specific skills and funding constraints in individual sectors, a process that must engage a broad range of participants in a particular sector. Such sector dialogues have proven to be very effective in identifying constraints and coming up with coordinated solutions. In this context, so-called 'smart specialisation' bringing together high-technology and traditional sectors – for example, agriculture and information technology, or textiles and biochemistry – has proven effective in many industries. These policies can be combined with measures to connect individual companies in these economies to global value chains.

At the same time as these economies move closer to the technology frontier, they must also prepare themselves for the rapid pace of technological change at the frontier and increasingly binding environmental and social constraints. EU industrial and development policies should aim to support neighbouring countries in achieving these objectives. Doing so will not only require direct support in individual sectors and for specific environmental and social purposes, but also strong assistance to these countries in developing state capacity to implement the agreed measures against entrenched interests.

All this has to be achieved in a context of a changing pattern of globalisation. As Richard Baldwin pointed out in his recent book, *The Great Convergence*, globalisation now increasingly involves massive amounts of advanced economy knowhow being shared through value chains increasingly tightly controlled by corporations (Baldwin 2016). In such a world of fragmented and easily mobile production, entry barriers come down – a country now only needs to become competitive in one part of the value chain, not the entire chain.

The key objective for governments in emerging economies should be to capture knowledge spillovers and convert them into productivity improvements in other parts of the economy. EU development policy should aim to facilitate this transfer of knowhow. A critical part of this support should be assistance for institutional reform and strengthened state capacity, but it must also involve incentives in terms of market opening to products from these countries and, if possible, visa relaxation.

The EU already has the key instruments for supporting economic development and institutional reform, and there has been a great deal of learning from the transformation of central and eastern Europe and, more recently, in southeast Europe. These lessons have been successfully applied in Ukraine where, after a slow start, European Commission resources are now being used to great effect. Integrating the experiences from the Ukrainian reform process, particularly those relating to transparency and state capacity, should reinvigorate EU development policy in its neighbourhood.

The EU also has the necessary development institutions to achieve these objectives through the European Investment Bank (an EU institution) and the EBRD (where the EU member states and the European Commission together control the majority of shares). Both these institutions have had their mandates expanded in recent years, but more resources are needed to harness their full potential. In particular, these institutions can be helpful in strengthening the private sectors of the neighbouring economies and promoting green, inclusive growth.

All of these elements, including industrial and migration policy measures, should be combined in packages that can help promote economic growth and help Europe to manage migration pressures. In order for such policy packages to be effective, they must first and foremost support the building of state capacity in these countries, thus strengthening the business environment and allowing the private sector to flourish.

In the longer term, these economies can become full-blown partners in building a future wider Europe, sometimes allowing solutions above the EU level where such collaboration is necessary (for example, in the management of regional value chains and migration flows). It is in the promotion of a wider European project that the EU has had its greatest successes to date, and it is here that the hope of an invigorated and more legitimate future Europe lies. Ultimately, this is where the EU can mobilise the energy and clout needed to make progress on other urgent reforms. And, in the end, it is from the success of these reforms that the EU will rebuild its ability to project soft power.

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## Part IV

### Policy areas



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## 13 Political economy of reforms: Lessons for the EU from post- communist transition

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**Sergei Guriev**

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Despite its recent troubles, the EU project has been a great success. This is the only major supranational entity in history for which countries democratically gave up significant parts of their sovereignty and which has delivered peace and prosperity to a continent that has been torn by wars for thousands of years. This is why many neighbours want to join the EU; and this is why migrants and refugees from many countries in the world want to relocate to the EU.

However, these days the EU is facing existential challenges. After the Great Recession, it has become clear that it needs reforms on two fronts. First, it needs to reduce heterogeneity between the members of EU, and especially within the Eurozone. For this, many countries will have to undertake reforms at the national level, including labour market reforms, fiscal reforms, pension reforms, reforms of business regulations and others. Second, the Great Recession has demonstrated the need for completing the Union – creating a banking union, joint unemployment insurance, a capital markets union, joint refugee integration policies, and so on.

While the need for these reforms has become quite obvious, they are slowed down by the legacies of the Great Recession. The previous waves of integration were carried out in an environment of reasonably fast, steady and generally inclusive growth. These days the situation is very different. Governments and households are burdened with debt.

Growth rates are slow. Some countries are stuck with high unemployment rates, and more importantly, in some countries long-term unemployment is high and persistent (Bentolila and Jansen, 2016). Given the limited fiscal space and slow growth, it is very hard to conduct reforms compensating the losers and maintaining social cohesion.

This is where EU members can learn from the reform experiences of post-communist countries in the 1990s. The initial conditions were somewhat similar. First and foremost, it was clear that the communist system was not efficient and that reform would eventually bring greater prosperity. Second, most of these countries were fiscally bankrupt and had limited borrowing space. Third, whole sectors of these economies were not competitive and would have to go through painful restructuring. Hence the importance of compensating the losers.

Overall, the post-communist reforms have been successful. In terms of GDP per capita, most transition countries substantially reduced the gap with Western Europe. Moreover, as we show in the EBRD's Transition Report 2016-17 (EBRD 2016), these countries have finally converged to the Western European countries in terms of subjective wellbeing. Until very recently, residents of transition countries were less satisfied with their lives than their non-transition peers, even when controlling for income. In 2016, this is no longer the case.<sup>1</sup>

However, in order to understand the political economy of reforms, we need to look beyond average income. In the Transition Report 2016-17, we study the evolution of incomes of different deciles of income distribution in 1989-2016. We find that while transition worked on average, it has not worked as well for the majority. It turns out that only 44% of residents of post-communist countries have experienced income convergence with the West – i.e. their incomes have grown faster than incomes in G7 countries.

1 The so called 'transition happiness gap' – lower life satisfaction among residents of transition countries – has been identified by Deaton (2007) and Sanfey and Teksoz (2007) using Gallup World Poll and World Values Survey (WVS) data, respectively. Later work by Guriev and Zhuravskaya (2009) and Djankov *et al.* (2016) has shown that the gap persisted in later rounds of the WVS, as well as in the Life in Transition Survey (2006 and 2010 rounds), the Pew Global Attitudes Survey, Eurobarometer and the European Values Survey. Only in 2014 wave of the WVS, 2015-16 round of the Life in Transition Survey and in the 2016 wave of the Gallup World Poll does the transition happiness gap finally disappear.

The majority have seen income growth that was slower than that of the West – i.e. they have lagged further behind the residents of the rich countries. The reforms were especially painful in the early years – in 1989-96, only the top 10% of populations saw positive income growth, while the incomes of the remaining 90% of households decreased.

In addition to studying incomes, we also looked at physical and subjective wellbeing. In development economics, it is well-known that socioeconomic hardship experienced in the first two years of a person's life can result in lower adult height. The children born right before and right after the transition have now grown up, so we can examine the impact of reforms on their height. It turns out that people born in the year when the reforms started or a year before are now on average about one centimetre shorter than their counterparts born right before or right after. This is a very large effect – comparable, for example, to the effect of being born in a country going through a violent conflict or civil war. This effect was especially strong in underprivileged households (with lower parents' education and employment), whereas in households where both parents had a tertiary education, the transition had no impact on height. We found similar results for subjective wellbeing – in underprivileged households, people born during the transition are less satisfied with their lives today than those born before or after.

The fact that the reforms have been painful and that their benefits have not been broadly shared explains why, in some transition countries, populist politicians came to power, reversed the reforms and built crony capitalist institutions (for a detailed discussion, see EBRD 2013). Some of the populists managed to remove democratic checks and balances and thus made it hard for the opposition to challenge their hold on power, even if they did not deliver on their promises of inclusive growth.

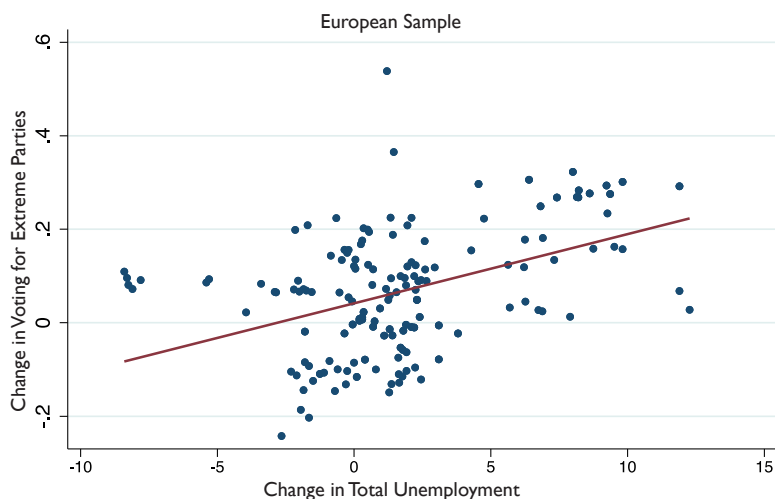
This experience offers important lessons for the EU reformers. The 'short-term pain, long-term gain' reform designs are very risky. If there are many losers from the reforms who are not compensated even in the short run, populists can take over and stall, or even reverse, the reforms. It is crucial to make the reforms inclusive from the very beginning and to think about compensating potential losers from the very start.

The other important question is what the compensation should be. First-year economics textbooks suggest a static view of the world where people who lose their jobs due to reforms should be paid a one-off compensation. In reality, unemployment is much more than reduced income. Staying out of work decreases relative human capital (as those employed continue learning on the job) and thus lowers the chances of getting a good job in the future. Unemployment – especially long-term unemployment – also undermines self-confidence, which may result in less healthy lifestyles. The unemployed understand these issues very well. Multiple studies of subjective well-being (Clark *et al.* 2016) show that unemployment reduces self-reported life satisfaction by much more than just the decline in income associated with the job loss.

This is why reformers should think not just about the passive, but also about the active labour market policies for those suffering the reforms. This is why labour market reforms and deregulation of job creation should be a priority in the national and union-wide reform agenda.

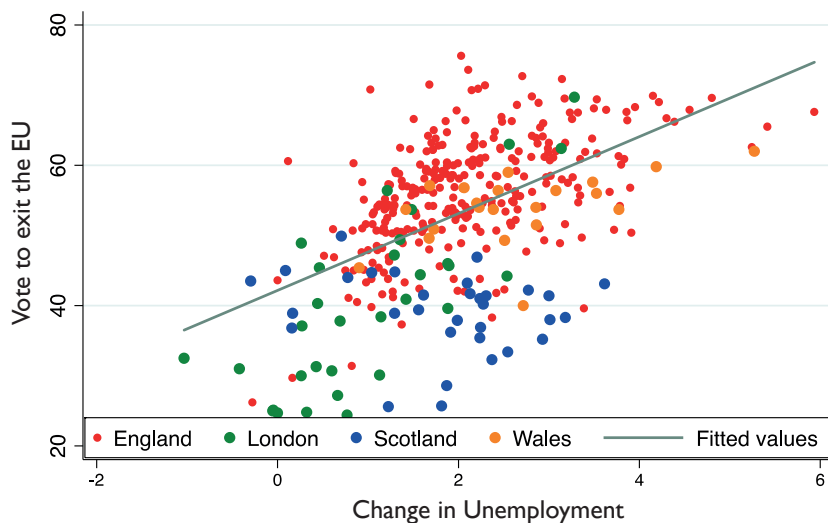
In recent years, the EU's track record on reducing unemployment has been mixed, especially in the South. This has already resulted in reduced trust in national and European politicians and in voting for extreme parties. In a recent paper, my co-authors Yann Algan, Elias Papaioannou, Evgenia Passari and I tracked the change in unemployment in the EU's subnational regions before and after the Great Recession. In order to identify the causal effect on attitudes and voting outcomes, we used the so-called Bartik instruments (Bartik 1991): the pre-crisis structure of the economy was a strong predictor of how badly each region was to be hit by the Great Recession. We found that the change in unemployment had limited or no effect on people's trust in one another, on their trust in the police or the church, or on their trust in global institutions. However, the increase in unemployment has resulted in substantially lower trust in national and European politicians – and in higher voting for extreme parties (Figure 1).

**Figure 1.** Change in voting for extreme parties and change in total unemployment



We also examined the correlation between unemployment and the vote for Brexit for 379 electoral districts in the UK (Figure 2). Although the UK has a flexible labour market and the *average* unemployment level is low, those municipalities where the Great Recession has resulted in one percentage point higher unemployment delivered five percentage points more votes for Brexit.

**Figure 2** Vote to exit the EU and change in unemployment



Europe does need reforms. But for these reforms to succeed, we need to make them inclusive from the very start. Furthermore, inclusion is not only about redistribution, it is also about active labour market policies and job creation. Even with unemployment benefits, those out of work report lower life satisfaction, which raises the likelihood of them voting for populist parties and for reversing the reforms.

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# 14 Patches won't do, fiscal federalism will

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**Charles Wyplosz**

The Graduate Institute and CEPR

## **The root of Europe's morass**

It need not have happened all at once, but here we are. The many imperfections of the EU architecture are bursting out into the open. Bewildered politicians keep on thinking within the box, as they believe that little changes here and there will put the EU back on track. They will not.

The Treaty of Rome will soon be 60 years old. It was thought of as the common denominator of a small number of countries traumatised by wars. Over the years, as ambitions grew and the world became more complex, new floors were built on top of each other, but without much regard to the overall structure. More countries joined in, bringing together a more diverse membership but with relatively unchanged governance rules. It is quite admirable how well it worked for so long.

Over all these years, the motto was 'muddling through', a.k.a. the Jean Monnet strategy. This worked when there were low-hanging fruits (from the Common Market to the Single Market) and few member countries with broadly shared world views. Reaching higher-hanging fruits (Schengen, the common currency) and enlargement has proven to be too much for the strategy. This is not a new observation. More than 20 years ago, Dewatripont *et al.* (1995) wrote: "Europe is now at a crossroads. Opportunities for further integration and enlargement are still there, but it is widely agreed that the present European Institutions are inadequate to meet the challenges that these opportunities present" (p.1). Since then, some changes have happened, but the main concerns remain.

We all know the symptoms: the democratic deficit, the use of ‘Brussels’ as a scapegoat because of the bewildering complexity of existing arrangements, sordid fights about a minimal and largely inefficient budget; a bureaucracy perceived as distant if not hostile; summits that last forever, only to frequently reach irrelevant or misguided conclusions; a hugely sized Parliament that reflects national prejudices and interests, while fighting for its turf; and so on. The common underlying cause is that the EU wants to be neither a federation nor a collection of nation states.

The question is what conclusions can be drawn. A first view is that this well-accepted ambiguity worked for a while, but it cannot work forever. Now is the time, so the argument goes, to take a number of steps to move along the ever-closer union path.<sup>1</sup> This is precisely what British voters rejected and what a growing number of voters dream of rejecting as well. For them – and this is the second view – Europe has gone too far. These views are seen as incompatible, but they need not be. We have a well-developed theory of fiscal federalism that addresses these questions and provides answers.<sup>2</sup> The answers can be applied to the EU if one does not see them as a set list of which tasks should be federal and which should be national. It is much more fruitful to see the fiscal federalism principles as a way to think about the allocation of tasks in a construction that is neither a federal state nor a collection of member states. Once we accept these principles, we can rethink the EU architecture.<sup>3</sup>

## **Fiscal federalism principles**

In a nutshell, fiscal federalism recognises that the decision to locate a particular task must confront four criteria:

- externalities across sub-central units, which calls for centralisation,
- returns to scale, which also calls for centralisation,
- information asymmetries across all units, which calls for decentralisation; and
- heterogeneity of preferences, which also calls for decentralisation.

1 This is one way of understanding the Five Presidents’ Report (Juncker 2015).

2 The seminal contribution is Oates (1972).

3 For an attempt, see Berglöf *et al.* (2003) and Wyplosz (2015).

These criteria are not black and white, they usually are a matter of degree. In most cases, the four criteria will lead to opposite conclusions. This makes it clear that any decision must be a matter of trading-off pros and cons. This may seem disheartening, possibly even useless, but that is not the case. It is extremely important to rely on a method and to realise that most allocation decisions, in either direction, are not obviously justified and therefore should not be carved in stone. An immediate implication is that the famed '*acquis communautaires*' can and should be challenged and, therefore, that they should not be off the negotiating table.

As an example, consider the four freedoms, officially presented as a non-negotiable package. The refusal to discuss the package arguably played a major role in the Brexit referendum. Fiscal federalism reasoning is likely to support freedom of trade and of establishment (very large externalities and returns to scale, limited information asymmetries and heterogeneity of preferences). Freedom of capital is a more complex issue (some externalities may be negative, information asymmetries can be large, and preferences differ between, say, Britain and the Netherlands on the one hand, and France and Germany on the other). Freedom of people is not unambiguously justified given deep heterogeneities of preferences, which also emerge within member states. At the very least, there is room for discussion. It is a fair bet that, sooner or later, it will be discussed.<sup>4</sup> Hopefully, we will not have to wait for another exit or two.

## Fears of unravelling

Ideally, all of the EU architecture could be passed through the prism of fiscal federalism principles with an open mind. Some new tasks would be allocated to the EU level, others given back to member states. Undoubtedly, the outcome would be a more functional and less controversial EU. That will not happen, of course. The fear is that, once we start questioning this or that, the whole architecture will unravel. On most issues, national views differ, and they also differ within each member country, so any proposed change is bound to trigger a process of give-and-take with unknown consequences.

4 Some contributors to Wyplosz (2016) support reopening this issue, others adamantly object.

Yet, it should be possible to focus on a limited range of issues – those that are the most controversial or the most dysfunctional. In addition to mobility freedom discussed earlier, a short list of economic issues could be the following:

- The Stability and Growth Pact, which has failed repeatedly. The likely conclusion would be to decentralise the task of enforcing fiscal discipline, simply because budgets are set by national parliaments, which will not give up their prerogative.<sup>5</sup>
- Bank resolution, an unfinished business of the Banking Union. The likely conclusion would be to fully centralise this task and to build a dedicated European fund.<sup>6</sup>
- The Cohesion Funds, a big part of the small EU budget. The likely conclusion would be to discontinue these collective expenditures and let individual countries decide whether the related subsidies are justified when financed by national taxpayers.<sup>7</sup>
- Research and development, widely seen as the source of future growth. Given large economies of scale and dysfunctional local preferences, the likely conclusion would be to make R&D funding a European competence.

## Conclusion

The EU is a spectacular achievement that has raised standards of living across its member states. The current backlash, which is gathering strength in most member countries, is largely driven by dissatisfaction with a limited number of issues. After all, it stands to reason that such a complex construction cannot be faultless. The key challenge for policymakers is to admit that mistakes have been made, to identify the important or pressing ones, and to rationally explore better arrangements.

For many reasons, the Commission should take the initiative since it is its responsibility to make proposals. For decades, it was at the forefront of successive integration steps. At a time when a clean-up is in order, it should also be shaping the agenda. That would require a change of mind, though. The Commission is mandated to be the guardian of existing treaties, but it has also seen itself as the agent of further integration.

5 The argument is developed in Wyplosz (2013).

6 This conclusion goes back to Goodhart and Shoenmaker (2009).

7 Berglöf *et al.* (2003) propose to replace the Cohesion and CAP funds with lump-sum payments.

Given the growing threats gathering speed across Europe, guarding the treaties cannot mean preserving the *acquis* that are economically inefficient and politically contentious, nor is it the time to push for further integration. An ever-closer union is one where public opinions feel ever-more comfortable.

Of course, reallocating tasks is not the only challenge that needs to be faced. Governance, in particular, has proven to be haphazard as it drifted from the community method to the intergovernmental method and to a *de facto* one-country leadership. This too is a federalism issue. None of this means that the EU should become a (con-)federation, only that there are theories and experiments from which Europeans have much to learn.

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# 15 Restoring trust in the arrangements for Eurozone intergovernmental debt

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**Patrick Honohan**

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## **Introduction**

The distrust and resentment over financial issues which the financial crisis has created between creditor and debtor members of the Eurozone strikes at the heart of cooperation and solidarity within the EU.

The crisis opened up a fault line in the political economy of Europe. For several years, almost all policy debates in Europe have divided along this creditor-debtor fault line, where previously, multiple shifting coalitions had allowed constructive and collaborative resolution of differences.

This is not just a legacy issue relating to existing indebtedness. Europe needs new arrangements that fully exploit its overall economic strength to deal with future asymmetric financial shocks. The dual nature of the challenge makes it more difficult to resolve – the legacy issues are poisoning discussion of future institutional and contract design.

## **Divergence in the crisis**

The emergence of the fault line coincided with the reversal of a trend towards financial and macroeconomic convergence among the members of the Eurozone (Estrada *et al.* 2013).

The dramatic widening of interest spreads after 2008, especially in countries where public debt was high or expanding, both reflected and contributed to national economic slowdown and a surge in unemployment rates. Far from being able to deploy fiscal policy in a fully effective manner to combat the downturn, the most affected countries found their access to international capital markets constrained.

Collective action at the level of the EU and its institutions has not been absent. In particular, the ECB, in support of its monetary policy mandate for price stability, has employed asset purchase schemes that have had the important side-effect of reducing interest rates generally and moderating risk premia on the liabilities of stressed countries.

And the member governments of the Eurozone created and deployed a large funding mechanism – the European Stability Mechanism (ESM) – which has, in partnership with the IMF, lent sizable sums to the most stressed countries.

While these measures have gone some considerable way towards reducing the worst divergences, allowing a resumption of growth in several stressed countries, they have not been effective in removing the fault line. Indeed, the scale of indebtedness amplifies both the fears of creditor countries and the sense of oppression of debtor countries, and seems likely to continue to erode the international spirit of solidarity within the EU, even as economic recovery is underway.

## **Polarised opinion: Creditor countries**

Opinion in creditor countries emphasises the clear statements in the Treaty that debt obligations of member states would not be mutualised (“no transfer union”). With actual and contemplated forms of mutualisation or international lending through various channels,<sup>1</sup> there is concern that, one way or another, hard-earned savings in creditor countries would be eroded through default or through financial arrangements that would prove disadvantageous to the lenders.

<sup>1</sup> The European Stability Mechanism, Eurosystem Target Balances, the Bank Resolution Fund, the mooted European Deposit Insurance Fund, and so on.

The most widespread view in creditor countries of the difficulties faced by the others is evocative of Aesop's fable of the ant and the grasshopper. If their affairs had been prudently managed in good times, the story goes, the over-indebtedness now observed would not have arisen. Such considerations, together with a sense that concessions will only encourage more insouciant behaviour by borrowers, weaken any sense of fraternal obligation.

While countries can move from net creditor to net debtor status over time, and although today's creditors have been debtors in previous historical episodes, seemingly deep-seated cultural and political factors that have made some European countries high savers seem likely to persist for some time to come.

### **Polarised opinion: Debtor countries**

Opinion in debtor countries resents the fiscal austerity measures that have had to be imposed in order to restore sustainability to the public finances. Creditor interests are blamed for at least part of this, and there are several specific examples.

The most debilitating issue arises from the 2010-2011 delay in restructuring unpayable Greek debt. It would have been better if more of the debt had been written down while it was still owed to private creditors. The result of the delay is that too much unpayable Greek debt is now owed to official creditors.

In addition, there has been a perceived asymmetry in resolution of the banking crisis, with bank creditors having been made whole, even if the banks they invested in had lost much more than their entire capital. This approach, rationalised in 2008-2010 as protecting overall economic performance from an even deeper recession, has undermined confidence in the even-handedness of the way in which contracts have been enforced. It has been gradually replaced by the bail-in rules finally codified in the Bank Restructuring and Resolution Directive of 2014.

## Keynesianism versus austerity

Reinforcing the debt fault line (because, although conceptually distinct, they are correlated) is the debate over the appropriate use of fiscal deficits to maintain high levels of economic activity. Influential economic policy advisers in creditor countries undervalue the potential of activist use of aggregate fiscal policy in the face of a recession, and overrate the merits of a mechanical approach to strict budgetary discipline. No wonder that governments persuaded by such views do not get into debt trouble.

In contrast, some other economic commentators brush aside macroeconomic constraints in the hope that a Keynesian multiplier will be large enough to ensure that their preferred budget deficit will prove self-financing. These alternative opinions receive a warm hearing from those experiencing the pain of fiscal austerity.

The analytical gap between such views widens the gulf between creditors and debtors (see Brunnermeier *et al.* 2016).

## Dealing with over-indebtedness.

At the microeconomic level, the inevitable divergence of opinion between borrower and lender on over-indebtedness is resolved through bankruptcy processes, or the threat thereof. Modern debt resolution practice is designed to remove the overhang of indebtedness in such a way as to incentivise the bankrupt's return to productive economic activity; while the individual creditor may lose out, it will be to the benefit of the economic system as a whole.

The tension is, of course, over assessing over-indebtedness – honest but unfortunate debtors are entitled to a fresh start, but debtors should repay their creditors if they can.

The rather large differences between countries in their approach to the bankruptcy of individuals, and the fact that the laws relating to bankruptcy have changed quite dramatically over the years in many countries, reflect a fundamental sense of unease which has always existed around debt distress.<sup>2</sup>

<sup>2</sup> For an account of the recent evolution of European law on insolvency, see Kilborn (2011); for the US, see Skeel (2001).  
For a wider discussion of changing attitudes to debt, see Graeber (2010).

This is not just a question of the welfare of the debtor. Indeed, when it comes to intergovernmental debt, allowing unresolved situations of over-indebtedness at the macroeconomic level to persist feeds back into underperforming economies, including the economies of the creditors. There can be little doubt that, for example, the post-crisis underperformance of even the German economy, relative to that of the US, owed something to the fact that emergent over-indebtedness of some Eurozone countries, especially Greece, has remained unresolved for so long.

## **A framework for the legacy and the future**

There are thus still two challenges facing policymakers if they are to remove the shadow of debt over the future prosperity of the Eurozone: (i) dealing with existing over-indebtedness; and (ii) putting the future financing of national governments on a lasting, incentive-compatible basis that is sure to avoid a recurrence of the sort of problem that has arisen. Both need to be done in a way that restores a sense of fairness, if the politics of the Eurozone are to be rebuilt.

Many scholars have discussed ways of using the collective financial might of the euro area in various ways that could dramatically reduce the financial instability associated with high indebtedness.<sup>3</sup> Their ideas fell on deaf political ears, but could now be revived and refined. And there are precedents for dealing with unpayable intergovernmental debt such as that of Greece, potentially including a role for GDP-linked bonds.

What has been lacking is a suitable political forum for arriving at an agreement on these two issues: legacy and future management of debt that will both work and be trusted as fair by creditors and debtors alike. Previous challenges of this type have been addressed by dedicated international financial conferences such as those at Bretton Woods in 1944 or London in 1953 (Galofré-Vilà *et al.* 2016). But the periodic, one-day meetings of economic and finance ministers, or one-day summits, on which reliance has been placed in recent years have been able to deliver only partial stop-gap solutions and have left a legacy of resentment and distrust.

3 See, for example, Allard *et al.* (2013), Bofinger *et al.* (2011), Brunnermeier *et al.* (2011), Pâris and Wyplosz (2014), Philippon and Hellwig (2011) and von Weizsäcker and Delpla (2010).

Comprehensive solutions have been deferred in deference to electoral timetables. A more structured and determined approach is now needed.

At a time of acute uncertainty about the future direction that economic and social policy will take worldwide, it would be a tragedy if Europe's collective political and economic capacity to ensure that its values are protected and advanced were to remain constrained by internal squabbling over what, in the grand scheme of things, are relatively small sums of money.

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# 16 A new fiscal governance for the Eurozone

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**Jeromin Zettelmeyer**

PIIE and CEPR

In the Eurozone, monetary policy is centralised while fiscal policy is determined by each member state, subject to fiscal rules overseen by the European Commission. One way of rationalising this regime is as follows. By giving up independent monetary policies, the members of a currency union give up an important instrument of country-level macroeconomic stabilisation. It is therefore essential that the remaining instrument – fiscal policy – works when needed. This requires fiscal space at the national level. However, while national fiscal responsibility contributes to the stability of the currency union, the costs of creating and maintaining fiscal space – fiscal adjustment, and resisting demands for overspending in good times – are borne at the national level. Given national costs and external benefits, members of the currency union would not be fiscally prudent enough, from a collective standpoint, when left to their own devices. This creates a rationale for rules that limit debts and deficits. At the same time, these rules must allow some flexibility – overly strict limits will defeat their purpose, which is to ensure that countries can use fiscal policy when they need it. Possible solutions include defining budgetary objectives in cyclically adjusted terms, and giving the European Commission some discretion in deciding what constitutes a violation.

Despite arguably being based on a sound logic – and despite several reform attempts in 2005 and 2011 aimed at improving the trade-off between discipline and flexibility – the Eurozone fiscal regime has not performed well. It has not been an effective stabilisation instrument in bad times, particularly between 2011 and 2013, when it likely contributed to procyclical fiscal policy (Barbiero and Darvas 2014, Bénassy-Quéré *et al.* 2016). Neither has it been a particularly effective instrument for instilling budgetary discipline in good times, as shown by the pre-2008 experience, when many Eurozone members violated the deficit rules despite strong cyclical positions.

And in both good and bad times, it has lacked a mechanism to ensure that fiscal policies in member countries add up to the Eurozone fiscal stance that would make most sense when constraints on monetary policy are taken into account. Given very low neutral interest rates since the financial crisis, fiscal policies in member states have in recent years been too contractionary for the Eurozone as a whole. This has left the ECB with little choice but to engage in highly expansionary, unconventional monetary policy, which has added to strains on European financial institutions and is contributing to bubbles in some member countries.

The Eurozone fiscal regime has also increasingly given rise to a political problem. It has fuelled discord across member states and between member states and the European Commission, contributing to a broad-based resentment against 'Brussels' and the European project. In the 'South', there is a frequent perception that fiscal adjustment imposed by Brussels involves micro-management of national policies and often inflicts social and economic harm. The European Commission's reaction has been to engage these countries and show greater flexibility. But this in turn has created resentment in the 'North', where the Commission is accused of abandoning its traditional role as the guardian of the treaties.

If the euro – and the EU, which is fast becoming the victim of generalised anti-Brussels sentiment caused in part by the poor functioning of the euro – is to survive, the Maastricht-based fiscal regime must be replaced by something that both works better in a stabilisation sense and that avoids constant frictions between member states and Brussels, while still aiming to correct the externalities associated with national fiscal policies. This can only mean moving towards a governance structure that relies less on rules and more on alternative mechanisms that ensure that fiscal decisions are in the collective interest, such as common institutions and market discipline. At the same time, building such a governance structure must be politically feasible at a time when most members countries are weary of reforms that further curtail national sovereignty, and the North – countries such as Germany, the Netherlands and Finland, but also the Slovak Republic – will not support plans that could give rise to large fiscal transfers.

The question is which options – if any at all – this leaves on the table. The answer could depend on the ability of Eurozone reformers to bundle several reform elements in a way that both addresses various weaknesses of the *status quo* and is collectively Pareto-improving. Each (or most) of the constituent elements might, on their own, be subject to veto. Collectively, however, they might stand a chance at consensus – provided that no individual element is seen as exposing any member to excessive risk.

The remainder of this chapter sketches four possible elements for such a package: (1) a minimalistic common budget devoted solely to Eurozone stabilisation policy; (2) a sovereign insolvency procedure to reduce cross-border externalities associated with fiscal crises and create incentives against over-borrowing; (3) GDP-indexed bonds to improve debt sustainability in the face of large or persistent growth shocks and/or create fiscal space for country-level stabilisation; and (4) a reform of the Stability and Growth Pact aimed both at reducing the pact's current procyclicality and creating stronger incentives for policies that strengthen fiscal solvency.

## **A fiscal stabilisation mechanism at the level of the Eurozone**

Attempts to 'coordinate' national fiscal policies in the Eurozone have not succeeded, essentially because they require countries to subordinate national interests to collective ones. In particular, successful coordination would mean that countries *meeting the fiscal rules* would have to undertake either more contractionary or more expansionary policies than they would like to. This is a non-starter.

Hence, closing the gap between the fiscal stance implied by national fiscal policies and the desirable Eurozone fiscal stance requires a Eurozone-level entity that can generate a macroeconomically significant fiscal impulse – that is, an entity that receives revenues, spends, and is allowed to borrow. This is usually dismissed as politically unrealistic. However, it may not be so unrealistic if this entity is (1) much smaller than national budgets, (2) largely stripped of allocative and distributional functions, and (3) bundled with other mechanisms that reduce risk and improve incentives (see below).

For example, consider a Eurozone budget comprising perhaps 2% of Eurozone GDP in expectation, financed by a pre-agreed, cyclical revenue source such as a Eurozone corporate tax and/or VAT (see Zettelmeyer 2016 for details). The spending side of this budget would be under the control of a Eurozone finance minister, subject to agreed limits or guidelines and an accountability structure. Spending could take two forms: public investment (e.g. on cross-border infrastructure); and a nominally fixed ‘cheque’ to national governments, set in proportion to national GDPs in a reference year, which governments could use any way they wanted. This structure would give rise to automatic stabilisation (revenues fall short of fixed nominal spending in Eurozone recessions and exceed them in booms). In addition, the Eurozone finance minister could be given the discretionary capacity to vary the ‘size of the cheque’ in the same proportion for all Eurozone countries. The maximum contractionary fiscal impulse would arise when no cash is sent back to capitals in a specific year. The maximum expansionary impulse would depend on the borrowing capacity of the budget (which would be limited by the need to repay debt over time out of the assigned revenue source, and could also be subject to deficit or debt rules specified *ex ante*).<sup>1</sup>

The impulse of the euro budget would be anticipated, and to some extent offset, by national budgets. However, this offset should be substantially less than full, for two reasons. First, some national budgets would continue to be constrained by fiscal rules (hopefully reformed, see below). Second, even when this is not the case, the size of the national deficit should have something to do with how this deficit is financed. For example, a country such as Germany might not be willing to spend an extra 1% of GDP in the name of Eurozone stabilisation if this requires accumulating an extra 1 point of national debt. But it might be persuaded if it is the Eurozone, rather than the German taxpayer, that foots the bill.

1 Assuming that no more than 25% of the Eurozone revenue flow (i.e. 0.5% of GDP) is dedicated to debt service, a long-term real interest rate of 2% and a long-term real growth rate of 1%, the standard stock-flow debt accumulation identity implies that the proposed revenue stream could sustain a maximum debt of just over 50% of Eurozone GDP. However, Eurozone debt should be far less in normal times – not more than around 25% – to give room for fiscal expansions in emergencies and maintain AAA status without requiring a joint and several guarantee. Although based on a different motivation, this makes the Eurozone budget proposal comparable with Angel Ubide’s (2015) proposal to create ‘European stability bonds’.

## **A sovereign debt restructuring regime for Eurozone countries**

A sovereign debt restructuring regime for the Eurozone would entail two elements: first, a legal device (for example, via a change in the ESM treaty) that would protect debtor governments from legal action by individual creditors if a debt restructuring meets certain conditions (in particular, approval by a supermajority of creditors); second, a commitment device that would make a debt restructuring a condition for ESM lending to insolvent sovereigns (Andritzky *et al.* 2016, Weder di Mauro and Zettelmeyer 2017). From the purposes of this chapter, such a regime is important both as a political *quid pro quo* for a Eurozone budget (as it would be seen as disproportionately benefiting the fiscally strong countries that bear most of the risk associated with Eurozone debt) and as a way of preventing over-borrowing without requiring fiscal rules.<sup>2</sup> One channel for the latter is standard market discipline – if debt restructuring (implying net present value losses for creditors) is part of the menu with which debt crises are resolved, countries engaging in excessive debt accumulation should face higher interest costs. But even if this fails – as it did before the 2008-09 crisis, when spreads were highly compressed although bailouts of insolvent countries were ostensibly prohibited altogether by Article 125 of the Lisbon Treaty – over-borrowing would be reduced in the presence of a sovereign debt restructuring regime simply by virtue of the fact that high-debt countries would lose market access sooner.

In order to work as intended, a sovereign debt restructuring regime would have to be designed and introduced very carefully. One problem is that sovereign debt restructuring may not be credible, even with ample legal protections, if it has large spillovers for the financial sector. Another problem is that introducing a sovereign debt restructuring regime in the Eurozone at the present time could be highly destabilising, as it might sharply increase the cost of sovereign borrowing in countries with high ‘legacy’ sovereign debts. For both reasons, the introduction of a sovereign debt restructuring regime must be preceded by (or be gradual and go hand in hand with) a process involving the gradual reduction of sovereign debt and – using regulatory incentives – of domestic bank exposure to sovereign debt.

2 A third argument, which is not emphasised here but which can be very important from a domestic welfare sense, is that sovereign debt restructuring can prevent redistribution at the expense of the domestic taxpayer, who bears most of the economic and social costs of austerity imposed to repay foreign creditors.

Importantly, the introduction of a Eurozone budget would facilitate this process, as it would offer banks a safe Eurozone-level alternative to holding mainly debts of their own sovereign. One way to accelerate the transition would be to swap a portion of national debts for Eurozone debt, as advocated by Corsetti *et al.* (2015, 2016); however, this would require a correspondingly higher assignment of revenue streams to the Eurozone level and might not be feasible politically. Another way would be to combine a portion of existing national debt into synthetic ‘European senior bonds’ (Brunnermeier *et al.* 2016) that banks would be asked to substitute for their current national sovereign debt holdings.

### **GDP-indexed bonds**

Eurozone members should be required to issue a minimum proportion of new debt (and possibly swap some of the outstanding debt) as GDP-indexed bonds. Indexing a substantial portion of debt to GDP (or growth) would reduce debt service in a downturn, creating fiscal space for macroeconomic stabilisation.

Even if this space is not used (i.e. stabilisation policies are unchanged), GDP-indexed bonds would improve the debt dynamics in the event of large growth shocks or protracted recessions. Using simulations based on shocks experienced by Spain between 1999 and 2014, Blanchard *et al.* (2016) show that GDP indexation of debt would improve debt sustainability, even factoring in the fact that issuing countries might need to pay higher interest rates to persuade investors to hold GDP risk. In turn, this would reduce the risk of debt crises induced by large recessions.

### **Reform of the Stability and Growth Pact**

It could well be that the combination of a Eurozone fiscal stabilisation device, a sovereign debt restructuring regime and GDP-indexed bonds make fiscal rules in the Eurozone superfluous. After all, the Eurozone budget would not only allow countercyclical fiscal policy at the Eurozone level, but also some automatic stabilisation (from the revenue side) at the country level. GDP-indexed bonds would create more fiscal space in downturns, and improve

debt sustainability. And the sovereign debt restructuring regime would prevent over-borrowing and could impart good incentives.

There is nonetheless a case for keeping a version of the Stability and Growth Pact. The sovereign debt restructuring regime may not be fully credible. And even if it is fully credible, it may not be a good disciplining device in good times. Both markets and sovereigns could exhibit a tendency to procrastinate, leading to low-cost debt accumulation, as has happened in the past, until there is a severe economic shock and/or markets wake up and cut the country off from further borrowing. Furthermore, since the sovereign debt restructuring regime could only become reality after an extended transition phase, fiscal rules may still be needed to encourage adjustment during that phase. Finally, a common Eurozone budget would have stronger stabilisation effects in the presence of fiscal rules than without these rules, since they make it harder for national fiscal policies to offset the intended effect of fiscal policy at the Eurozone level.

If the pact is maintained, however, it should be reformed with the aim of both giving countries more flexibility for managing fiscal policy in the short run and doing a better job in preserving solvency in the medium and long term. This requires two main changes.

- **First, the present mechanistic and error-prone methods to identify output gaps should be done away with.** They should be replaced by a procedure in which one or several independent expert bodies are asked to identify recessions using whatever methods they deem appropriate (Andrle *et al.* 2015, Bénassy-Quéré *et al.* 2016, Claeys *et al.* 2016). In such formally identified recessions, a modified set of fiscal rules should apply that would allow higher spending in specific categories – such as unemployment benefits, active labour market policies and/or public investment – even when they result in a higher deficit than the rules would allow in normal times.
- **Second, countries that violate debt or deficit limits should be given a broader set of policy options, if these contribute to improved fiscal sustainability.** These should include fiscal-structural reforms that reduce spending responsibilities or broaden the revenue base, and growth-enhancing reforms that allow GDP to grow faster than debt. Sufficiently strong reforms could justify a longer fiscal adjustment period and, in

some cases, a temporary *increase* in the deficit – something that is ruled out by the current Stability and Growth Pact. To ensure that countries do not renege on their reform plans, reforms would need to be broken down into steps which would need to be monitored. Failure to undertake agreed reforms would trigger a reversion to fiscal adjustment as the only way of complying with the pact.

A reform of this type would require a technically very strong and politically independent European Commission (or another institution to which Eurozone surveillance is delegated at arm's length). Rather than merely deciding whether a proposed budget complies with a rule that prescribes deficit reduction in the near term, it would need to make a judgement on the *quality* of public spending and on whether a broad reform package is convincing with respect to a medium-term objective. In exchange, countries would have more leeway in deciding how they would like to bolster solvency.

To conclude, making the Eurozone work will require a combination of some delegation of fiscal decision-making to the Eurozone level within clearly specified limits, more market discipline, and less micro-management of national policies. The details of the reforms proposed in this chapter are less important than this general principle – and the principle that Eurozone reform will not be successful unless it exploits both economic and political complementarities and seeks to minimise risk to individual member countries.

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# 17 European Banking Union – a qualified success

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**Rachel A. Epstein and Martin Rhodes**

University of Denver

Although the Eurozone crisis has most often been characterised as one of debt, the deeper source of Europe's problem was its banks. It was precisely the long-standing political ties between banks and governments, in the context of liberalisation in other realms, which shaped the severity and character of Europe's long crisis. It was those ties, including banking sector protectionism, state-based bank guarantees, and national regulatory and supervisory forbearance, in combination with other liberalising reforms, including international capital mobility, cross-border lending (and retreat) and the common currency, that created the dramatic costs and contradictions associated with the Eurozone crisis.

These can be summarised as follows:

- Bank-state doom loops. Bond traders reacted to bank-state political ties by fleeing fragile markets and raising the borrowing costs for crisis-hit governments. For investors, because banks were overlending to their sovereigns, they were becoming more vulnerable to state fiscal failure. State fiscal failure, in turn, was becoming more likely due to bank balance-sheet fragility and increasingly likely government-funded bailouts.
- Crisis contagion. Fears of Grexit raised borrowing costs for other peripheral European countries because observers perceived that they also risked expulsion. If a country exited, default and devaluation would result, at great expense to investors. EU bailout facilities were absent because states had clung to national bank oversight at the euro's founding.

- Nationally fragmented banking markets. The absence of widespread bank transnationalisation compounded downturns in crisis countries. Cross-border lending in the Eurozone before the crisis exacerbated downturns in particular countries, because that funding retreated behind national borders once the crisis was underway. Banks in crisis countries could not recover to lend, and countries could not recover if their banks were not lending.
- Obstacles to ECB monetary policy transmission. The ECB could not set the cost of credit across the Eurozone because banking sectors concentrated in particular national jurisdictions varied enormously in health and lending capacity, which were tied in turn to the fiscal strength of their governments.

But by 2017 the European Banking Union had significantly undermined the bank-state ties that lay behind all four problems. The two main innovations were the Single Supervisory Mechanism (SSM), under the ECB's authority and located in Frankfurt, and the Single Resolution Mechanism, a separate entity with a Single Resolution Board, located in Brussels. Of all the Banking Union reforms, the SSM, which came into full effect in November 2014, represented the clearest abdication of national sovereignty. The SSM had full licensing authority over all Eurozone banks and direct supervisory authority over the largest – in all, 127 banks comprising 82% of Eurozone banking assets by 2016. The ECB also had indirect supervisory authority over thousands of smaller banks. In 2013-14, the SSM undertook a comprehensive review of the balance sheets of 130 banks, and then subjected the largest banks to stress tests, in cooperation with the European Banking Authority.

By centralising supervisory authority, the SSM reduced the likelihood of bank-state doom loops because national authorities could no longer offer banks supervisory forbearance. By allowing the ECB to issue or revoke bank licenses, the banking sector protectionism that created nationally fragmented banking markets was now precluded. The SSM also alleviated the problem of compounded downturns and facilitated monetary policy transmission. By letting some banks fail, letting others expand, and allowing multinational banking groups untrammelled internal capital market flexibility, the ECB, through the SSM, could smooth out credit conditions across the Eurozone. Under ECB supervision, it also became politically less palatable for nationally based taxpayers to rescue banks that were no longer the charge of national authorities.

In 2013-15, the ECB and the SSM also narrowed the definitions of ‘capital’ that banks could use, cutting right to the heart of national discretion in bank governance. In addition to retained earnings and shareholder equity, banks had been counting other resources as buffers against potential losses, such as deferred tax assets or credits, which relied on states’ ability to pay in the event of bank collapse. The Basel Committee on Banking Supervision had serious reservations about the risk-weighting of mortgage lending and sovereign debt by EU banks and the quality of capital held by cooperative banks, as well as the treatment of banks’ holdings of capital instruments in insurance subsidiaries. But by 2014, the new Capital Requirements Regulation and the Fourth Capital Requirements Directive were rectifying most of these problems, and because the SSM and the ECB, not national authorities, were policing their implementation, rule enforcement across the EU was now more uniform.

The second major Banking Union innovation was the Single Resolution Mechanism (SRM), which included the Single Resolution Board and the Single Resolution Fund, in place from July 2014. In May of that year, all 28 EU member states approved the Bank Recovery and Resolution Directive (BRRD). Few of them had resolution regimes prior to 2008, and the BRRD harmonised and standardised the rules and procedures for bank resolution. Bailing-in bank creditors, shareholders, and uninsured depositors was the organising principle of the BRRD and would precede or replace taxpayer-funded bailouts. The BRRD encouraged stronger market actor surveillance of banks and their directors because investors could no longer be confident that governments would bail out banks, and by extension their creditors.

But compared to bank supervision, which was centralised at the ECB, resolution as of 2017 was still caught between national and supranational authorities. On the side of centralisation and harmonisation was the BRRD and the SRM, under which the Single Resolution Board operated with full resolution authority from January 2016, with access to the Single Resolution Fund to deal with a failing bank. But the SRF was only detailed in a separate, intergovernmental agreement and would not be fully funded until 2024, and then only at a level of €55 billion. Moreover, there was still some ambiguity with respect to who wielded ultimate authority over resolution: both the Single Resolution Board and Single Resolution Fund co-exist with national arrangements for decision-making and resolution funding.

Nevertheless, there is clear evidence that traditional political bank-state ties have also been undermined by innovations in resolution. First, by removing taxpayers from the front lines, the BRRD both lessens banks' dependence on public authorities for sustenance and simultaneously forces them to become more responsive to a series of market actors and price signals. Those actors in turn – including bank creditors, bondholders, shareholders and uninsured depositors – must be vigilant with respect to investment decisions, holding banks accountable for taking excessive risk. And much like the removal of national supervisory forbearance in the SSM, the removal of reliable public assistance through bank bailouts also acts to disincentivise bank-state doom loops.

Europe's new resolution rules could also reinforce the single supervisor's ability to prevent compounded downturns in crisis-hit countries and faulty monetary policy transmission. Again, the relevant power was in the Single Resolution Board's ability to counter national impulses to protect domestic markets from both internal and external competition for political reasons. In theory, the SRM could complement the SSM's authority to end banking market fragmentation along national lines and increase cross-national bank ownership.

Moreover, the European Stability Mechanism (ESM) introduced in 2012 and its 'direct recapitalisation instrument' (December 2014) is an additional limit on national authority, again undermining bank-state ties and tamping down the threat of crisis contagion across countries. The direct recapitalisation instrument can be deployed while the Single Resolution Fund is being built-up and mutualised, but also thereafter. The ESM has the power to inject capital into banks directly, rather than through Eurozone member states' budgets. With collectivised bailout mechanisms, both for banks and states as provided by the ESM, investors no longer had to worry that Greece's difficulties necessarily meant that Italian or French government debt was of dubious quality or that other euro-denominated assets were imperiled.

Critics would argue that although the ESM has a lending capacity of €500 billion, it is limited to €60 billion for direct recapitalisations. Also, the direct recapitalisation instrument could only be used once bail-ins of private actors had occurred under BRRD rules; when governments also contributed to bank recapitalisation; on the assumption that the ESM would take ownership stakes in banks receiving assistance; and once a bank restructuring plan was in place.



A complex network of decision-making bodies would also be in play, including the ESM Board of Governors, the ECB and its bank supervisors, the European Commission (monitoring compliance with state aid rules), as well as national authorities and bank managers. For all of these complexities, though, it was clear that if the direct recapitalisation instrument was used, Europe's supranational institutions would have the upper hand over bank restructuring or resolution, at the expense of national policymakers.

But there were three areas in which the severing of bank-state ties in the service of euro sustainability was incomplete:

- Lack of centralised and clear authority over bank resolution. Banking Union critics argue that resolution rules and resources are insufficient to protect the euro's credibility going forward. Ambiguities may be resolved in the heat of a given resolution process, but greater clarity of the hierarchy of responsibilities and liabilities is required.
- The absence of a pan-European and fully collectivised deposit insurance scheme, without which many argue that future European banking crises cannot be prevented. Germany's current opposition to the insurance scheme is due to the continued weight of national sovereign debt in many Eurozone bank portfolios. Germany fears that risk-sharing under the scheme, combined with 'home bias' in bank sovereign debt holdings, could create a 'moral hazard' problem, allowing governments to pressure banks to assume even more of their debt.
- The absence of a mechanism to end banks' disproportionate lending to their own sovereigns. Although SSM chief Danielle Nouy wanted to prevent 'home bias' in banks' behaviour towards governments by introducing both large exposure limits and risk weighting on sovereign debt holdings, no decision has yet been taken. Bank directors can still exercise some political discretion with respect to sovereign lending.

So, although major and politically quite extraordinary steps have been taken to ‘Europeanise’ banking supervision and resolution, indicating a significant transfer of sovereignty away from Eurozone members at least equal to that involved in creating a single currency, significant risks remain. European Banking Union is therefore a success, but a qualified one. Innovations in two key areas are needed to complete the project:

- A full mutualisation of deposit insurance across the Eurozone. Various steps have been suggested by experts to alleviate German opposition, including a limited capital charge on banks’ holdings of their sovereign’s debt above certain thresholds to diminish home bias in sovereign lending. Political action is needed to make this change happen soon.
- A full clarification of the line of authority and hierarchy of liabilities pertaining to bank insolvency and resolution. The ECB sought to illuminate this issue in a May 2016 Opinion in response to questions from the Slovenian Central Bank, which suggests that Eurozone national authorities should implement resolution but under supranational guidance and suasion. But – most likely for political reasons – this process remains much too murky to inspire confidence.

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## Part V

### The role of social scientists



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# 18 The role of economists in the new world order

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## **Thorsten Beck**

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In 50 years, 2016 might be regarded as the watershed moment, when socioeconomic and political integration started to reverse in Europe and across the globe, triggered by the Brexit vote and the election of Donald Trump as US president. Or it might be seen merely as a setback to the European integration process and a trigger for a different mode of global integration, rather than a reversal. As historians, political scientists and other social scientists are doing, economists are accompanying this process with both positive and normative analysis (what is happening and what should be happening?). But it does feel different from previous watershed moments, such as the end of the Bretton Woods system in 1973 and the start of the transition period in 1990.

Economists have been ridiculed and insulted over the past year, whether it be because their predictions have turned out wrong, or because they do not seem to understand the anger of large parts of the population in advanced economies against a globalised and liberalised world. At the same time, there is a clear threat to fact-based discourse. The analysis of trade-offs is being replaced with ‘having your cake and eating it’ approaches. Expert opinions are being replaced with populist slogans. And social media are not being used to connect the world even closer but to divide it by spreading fake information, if not outright lies. While politicians used to pick the statistic that served their purpose (such as Ted Cruz picking 1997 as the base year to claim that there was no evidence for climate change), such numbers and statistics are now simply being invented (such as the million and a half at Trump’s inauguration, or the £350 million sent by the UK government to the EU on a weekly basis ).

What is the role of economists in a period of populist anger, post-fact politics and strongman governments?

First, of all, it is easy to see what does not help. More predictions of impending doom are certainly not helpful! Economists have been notoriously bad at predicting growth beyond the next quarter, whether they work in the private or public sector. Most economists have been wrong with their predictions of a recession following the Brexit vote in June 2016. Why? One explanation is animal spirits, all but impossible to capture in econometric models. But predictions are also easily wrong because such predictions lead to policy reactions. Because it believed in negative economic repercussions of the Brexit vote, for example, the Bank of England lowered interest rates and loosened capital requirements. And the foreign exchange rate market internalised lower long-term growth, sending the pound 20% lower. All of this had short-term positive effects on the British economy.

But what about the long-term predictions of economic gloom for the UK after the Brexit? Will economists have the final, bitter laugh? It is important to understand that predictions for housing prices and growth trajectories are *ceteris paribus*, i.e. they assume that everything else holds constant. Obviously, this is an heroic assumption, as there are lots of *ceteris* and almost no *paribus*. If the EU falls apart, the UK might have made a smart move; if there is further integration and strengthening of the EU, less so. If the UK manages to put in place policies and institutions to improve productivity growth, it might ultimately gain (even if such policies could have been put in place while remaining an EU member). There might be a healthy academic debate on this question in the late 2020s and early 2030s, but it is of little practical use in the current policy debate.

So, what is the economists' role in this debate? On the one hand, it is important to continue modelling and quantifying the effect of different policy choices, while at the same time stressing the uncertainty of long-term predictions. On the other hand, we have to be humble in terms of how much we know about both the sign and the size of different economic forces, given the complexity of economic systems and the endogeneity of many other policy choices. In addition, technological changes and new economic trends will continue to disrupt not only economies and societies, but also economic models and paradigms. Take the example of the 'gig economy' and its repercussions for labour markets, price formation and product markets. Take also the example of the 'sharing economy' and its repercussions for durable consumption good investment.

Finally, take the example of blockchain technology, which allows for decentralised registration and enforcement, and its repercussions for payment and legal systems. Such trends force us economists to constantly update our models and concepts.

At the same time, it is important for economists to focus more on the distributional repercussions of policies and economic trends. While economists are well aware that certain policies produce both winners and losers, where the former can compensate the latter and still be better off, we have spent little if any thought on how such a compensation scheme would work. And beyond the focus on distributional repercussions, and thus individuals rather than the aggregate, we also have to learn not to ignore communities and nations. While it might seem more of a task for sociologists or anthropologists than for economists, cultural factors are critical in explaining policy choices and institutional set-ups, but also the feasibility of certain reforms.

The disruptive forces of technology and globalisation also call for a rethinking of social safety nets, both in benefits and funding. The concept of flexicurity (flexibility and security in the labour market at the same time, reconciling employers' need for a flexible workforce with workers' need for security) is often quoted in this context. More research is needed in this area.

## **From economics to political economy**

But beyond concerns over efficiency and distribution, economists have to focus even more strongly on the political economy of policy choices. I will touch again on the two watershed events of 2016. First, why is it that the vast majority of British MPs are against Brexit, while 52% of the population vote in favour? There are many explanations, but one lies in the first-pass-the-post system, where geographically spread parties such as UKIP cannot gain a political foothold and a referendum is then used as alternative channel for voters to voice their frustration (Becker *et al.* 2016). It is thus important to understand that the political structure has a clear feedback loop to the economic policymaking process. Second, there is an important geographic dimension to political economy, as Hillary Clinton and the Democrats found out the hard way in November 2016. Ultimately, the geographic concentration of 'globalisation losers' contributed to the electoral loss of Hillary Clinton, despite her winning the popular vote.

## **Beyond the ivory tower**

Fundamental research, not driven by current market needs or big donor money, is critical for the progress of science. But the current socio-political crisis also calls for a re-engagement of the economics profession with the broader population, with a necessary feedback to research. This does not so much imply changing research agendas with changing political or popular agendas, but rather questioning existing paradigms and also populist arguments. Economists in the 2010s have an enormous advantage over economists of 20 or 30 years ago, namely, the much better availability of data and higher computing power. However, they also have much better opportunities, and thus increased obligations, to engage with the broader public to foster an informed discourse on economic policy choices. Better research possibilities thus go hand in hand with stronger possibilities and obligations to engage with the public.

One of the striking characteristics of our profession is the global nature of our discussions. Academic economists rarely analyse economic problems from a national(istic) viewpoint. There has been a fascinating degree of cooperation by economists in the Eurozone, for example. A recent policy proposal to create safe assets in the Eurozone included authors from Germany, Italy, Belgium, Greece and Portugal – most of whom are not working in their country of origin (Brunnermeier *et al.* 2017). On the one hand, this is the successful result of an open and integrated Europe and world; on the other hand, such cooperation and analysis, free from national political capture, is critical for the survival of an open and integrated Europe.

## **From political economy to politics**

But it is also time for economists to move beyond technical analysis and a technocratic approach of supporting policymakers with our analysis. Academic freedom goes hand in hand with political freedom. Illiberal democracy does not encourage an open, fact-based discourse. So, independent of whether economists are Social democrats or Christian democrats, Socialist, Conservatives or Liberals, defending the institutions that provide us with data and statistics, defending the media, and defending a civilised and fact-based discourse is important.



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Thorsten Beck is Professor of Banking and Finance at Cass Business School in London. He is also (Co)-Managing Editor of *Economic Policy* and Co-editor of the Review of Finance. He was Professor of Economics and founding Chair of the European Banking Center at Tilburg University from 2008 to 2013. Previously he worked in the research department of the World Bank and has also worked as a Consultant for – among others - the ECB, EIB, IMF, the European Commission, ADB, and the German Development Corporation.

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The aim of this eBook is to focus on the post-crisis 'socio-economic policy' identity of the European Union in the post-crisis period. The emphasis is not on where the EU has come from but where it appears to be going, where it should be going and what sorts of difficulties this might imply for the success of the EU and its various major policy domains. This is perhaps best understood by focusing on the EU's economic policy 'identity markers' prior to the crisis and what has emerged in the aftermath.

The policy identity of the EU has evolved a long way from its 1990s emphasis on solidarity, a budding social Europe, and a broadening of competencies. Electorates and governments alike have long forgot the war-torn origins of the beast. Instead, members vote to leave. An identity based on self-insurance, stagnation, decision-making inefficiency and introspection would excite populism and extremism in any one country and is doing so across the EU. The notion that politics and discretionary policy counts and can deliver (never mind redistribution) appears to have been abandoned. If this redistributive identity and machinery remains moribund and the decision-making machinery paralysed, Brexit will generate imitators in the wings and may be doing so now.

So, where does the EU go from here? This volume is all about the re-launch and presents a wide range of, often clashing, ideas about and policy solutions to the dilemmas we face. What common-good dilemmas should the European Union address and how should it do so; including climate change, security against terrorist threats, youth unemployment? What should be the balance between subsidiarity and solidarity principles? This question has been complicated by the election of Donald Trump and the surge of populist-nationalist parties across Europe. Trends towards more nationalist and protectionist policy agendas might make any further integration in Europe difficult. By including columns from both economists and political scientists, we aim to provide as broad a perspective as possible and have as broad an impact as possible, as a start to conversation on a sustainable future for Europe.

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