A EUROPE OF INCENTIVES: HOW TO REGAIN THE TRUST OF CITIZENS AND MARKETS

Mark Leonard and Jan Zielonka

EUROPEAN COUNCIL ON FOREIGN RELATIONS
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Background: the Reinvention of Europe project

In the summer of 2011, against the background of the deepening euro crisis, ECFR launched the Reinvention of Europe initiative to inject a new dynamic into the discourse around the crisis and questions concerning Europe's future at both national and European levels. The project aimed to focus attention beyond the current crisis to the choices and challenges facing Europe in the future and to reconcile the necessity of deeper integration to save the euro and Europe's role in the world with impossibility of persuading markets, parliaments, courts and citizens to support it.

The project has three strands:

A debate on the future of Europe

In November 2011 ECFR published a policy brief by Mark Leonard, Four scenarios for the reinvention of Europe, which argued that the rise of anti-EU populism across Europe had prevented the continent's politicians from grasping political challenges and instead sought technocratic solutions that had in turn provoked more populism. The brief set out four possible scenarios for solving the euro crisis without exacerbating the chronic crisis of declining European power: asymmetric integration involves finding incremental solutions without treaty changes; a smaller eurozone; political union through treaty change; and deeper integration in the eurozone outside the scope of existing EU treaties and institutions.

Following publication of the brief, we invited responses from politicians and thinkers around Europe and beyond, which were published on our website (www.ecfr.eu/reinvention/home). The quotes in this report are from these responses. ECFR also published a series of other papers on key aspects of the debate, including "Explaining the Fiscal Pact" and "Making the case for a federation lite".

ECFR's blog included the "€ View" series by Sebastian Dullien on the economics of the crisis (which was highly commended in the Reuters Reporting Europe prize). We have also held a series of high-level events across Europe.

Views from the capitals

We published a series of papers on the debates in individual EU member states. We have already published papers on the Czech Republic, Italy and Poland and papers on Bulgaria, the Netherlands and Portugal are due to be published in the near future. We have also published papers looking at specific debates in Germany and France, including The long shadow of ordoliberalism: Germany's approach to the euro crisis. In addition we used ECFR's blog to examine how the crisis is being viewed across Europe, from Berlin to London to Madrid.

Europe in the world

In March we co-hosted a conference in Prague, together with the Czech Institute for International Relations, the Czech Diplomatic Academy, and the Adenauer Foundation, at which prominent scholars from Turkey, Brazil, India, China, Japan and Russia presented their analysis on how the EU appeared to other global powers. The debate continued on ECFR's blog and in our series of audio podcasts. In the future we will also begin to "map the Europe that others want" and also examine how Europe's foreign policy will change in the era of global political awakening.

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Special thanks also go to colleagues responding to Mark Leonard's first major effort to outline four scenarios for the reinvention of Europe: Harold James (Princeton), Richard Rosecrance (Harvard), Brigid Laffan (Dublin), Charles S. Maier (Harvard), Georg Sørensen (Aarhus), Chris J. Bickerton (Paris), Carlos Gaspar (Lisbon), Dimitri Sotiropoulos (Athens), Pawel Świeboda (Warsaw), Claus Offe (Berlin), Mario Teló (Brussels), Josep M. Colomer (Barcelona), Marco de Andreis (Rome), Miguel Maduro (Florence), Narcís Serra (Barcelona), Brendan Simms (Cambridge), Christine Ockrent (Paris).

We have also learned from colleagues contributing *a series of blog posts on particular aspects of the crisis*: Tibor Dessewffy (Demos Hungary) on populism in Hungary, Jean Pisani-Ferry (Bruegel) on the economics of the crisis, Hans Eichel (former German finance minister) on Franco-German leadership and Ivan Krastev (Centre for Liberal Strategies) on the lessons from Soviet breakup.

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Finally, on a personal note, we would like to dedicate this report to Mabel van Oranje, a friend and inspiration whose bravery and strength shine through even in the toughest of times.

A Europe of incentives

Executive Summary

European leaders are facing up to the fact that the current EU can neither survive this crisis nor prevent the next one. There is a growing realisation that – in order to survive – the eurozone will need to face up to its two structural flaws: the creation of a single currency without a common treasury and a common policymaking space without a common politics. These flaws, coupled with the choices of the last few years, have pushed the EU into a three fundamental traps.

The attempt to minimise the costs of bailing out crisis countries has put them under deflationary pressure while sending costs spiralling. The attempt to enforce rules and punish offenders regardless of the effect on the real economy has led to a revolt in deficit countries. The attempt to impose decisive action by Germany alone or by a closed Franco-German directorate has created paralysis by stimulating populism. Individually, these three approaches have been flawed but collectively they have made the European project seem stingy, rigid and oppressive.

The unintended consequences of the decisions European leaders have taken in the last two and half years are to drive Europe apart. The result of this approach to the crisis has been to exacerbate the flaws of an integration process that has narrowed the space for political decisions at the national level without increasing it at the European level. Europe now needs a different model of integration based on politics rather than technocracy and rewards for reform rather than only the threat of sanctions. Only a Europe that is generous, flexible and empowering – a "Europe of incentives" – will be able to inspire citizens across the continent, satisfy global economic markets and boost the confidence of Europe's diplomatic partners.

First, in the place of the "low-cost" Europe that motivates the current agenda, we argue that the EU needs to decrease the cost of borrowing and lengthen the time debtor countries have to repay their debts in order to escape the debt-deflation trap. In order to do this, the EU will need to develop the equivalent of a treasury backed by some kind of Eurobonds and the ability to raise resources. In the longer term, it should find ways of incentivising countries to introduce structural reforms rather than spreading the use of sanctions and threats to the area of structural reforms.

> "Populism is politics without policies; technocracy is policy without politics."
> Chris J. Bickerton, Sciences Po

Second, while Europe needs rules and institutions, it must get out of the trap in which countries are punished for undertaking painful reforms because the effect of rapid austerity measures is an even greater fall in domestic demand. In the place of a rigid "law and order" approach, the EU should adopt a flexible approach: it should be firm about its objectives but elastic enough about their implementation to ensure they are not counter-productive or overtaken by events. We suggest focusing on the actions of countries and rewarding those that do the right thing rather than the current approach that often rewards reforms with more cuts.

Third, in the place of a "two-class" Europe in which decisions are taken behind closed doors by a self-imposed directoire and offered to others on a take-it-or-leave it basis, we call for a political and participative Europe. At the level of member states, there must be a system of governance that relies more closely on the community method and is open to all that want to participate. At the level of citizens, we need to find new ways of restoring political competition to the EU level and ensuring that the voice of citizens can be heard, by making national governments more accountable and responsive in part by introducing a committee of deputy prime ministers based in Brussels that meets weekly to take decisions, overseen by a second chamber of national parliamentarians. This could be brought to life by improving the coverage of European affairs in the national media in order to create the possibility of pan-European deliberation.

Unless Europe's leaders embrace this vision of a "Europe of incentives", there is a real danger of disintegration. Historically, the incentives for states and citizens to take part in the European project were abundantly clear. But today, as the EU is mainly associated with threats and injunctions, it is hard even for the most enthusiastic supporters of the cause to make the case for Europe. To survive the crisis, European leaders should embrace pluralism, participation and solidarity rather than the technocratic centralism of rules and sanctions. If Europe's leaders rise to the challenge, they may yet re-establish trust which could be the basis for reintegrating our continent rather than disintegrating by default.

Introduction

The European Union is one of the most inspiring political projects in history but today its existence is hanging by a thread. At an ECFR meeting in Berlin at the end of May, George Soros gave member states a three-month window to save the euro, Emma Bonino argued that there was no alternative but a leap forward to political union and Joschka Fischer spoke in apocalyptic terms about a possible break-up: “Germany destroyed itself – and the European order – twice in the twentieth century. It would be both tragic and ironic if a restored Germany, by peaceful means and with the best of intentions, brought about the ruin of the European order a third time.”

It is increasingly apparent that if Greece is allowed or forced to leave the euro, the common currency may collapse, and this could subsequently lead to the disintegration of the EU with devastating geopolitical as well as economic consequences. At the same time, there is a real danger that in trying to solve the acute euro crisis, decisions are taken that could lead to the unravelling of the EU 27. This would hamper Europe’s ability to have a voice in the world and to face up to its chronic crisis of declining competitiveness and power in a multipolar world.

As the cost of borrowing increases to unmanageable levels and threatens to turn Spain – the eurozone’s fourth-largest economy – into Greece, the choice that the eurozone’s leaders have been avoiding for two and a half years has now become inescapable: economic and political integration or dissolution. The EU’s leaders have now tasked European Council President Herman Van Rompuy, European Commission President José Manuel Barroso, Eurogroup President Jean-Claude Juncker and European Central Bank President Mario Draghi to work on four sets of “building blocks” for further European integration: banking union, fiscal union, economic union and the vaguely defined political union.

The euro's problems have not been caused by a few indebted countries lying or cheating or by creditor countries mismanaging the crisis – although these have all played a role – but by the structural flaws of a single currency that is not backed by a common treasury and by a common policymaking system that is not animated by a common politics. As EU leaders develop economic plans to save the eurozone, they must also abandon the approach they have taken in the last two and a half years which has exacerbated the structural flaws. In other words, it is not just a question of *what* needs to be done but also of *how* it is to be agreed and implemented.

> "The more Europe suffers, the more its people will see that a reform agenda that is just an exercise in incrementalism is also nothing more than an exercise in futility."
> Harold James, Princeton University

The reform agenda of the past years has pushed Europe into a series of three traps. The attempt to minimise the costs of bailing out crisis countries such as Greece has put them under deflationary pressure while sending costs spiralling. The attempt to enforce rules and punish offenders regardless of the effect on the real economy has led to a revolt in deficit countries such as Greece. The attempt to impose decisive action by Germany alone or by a closed Franco-German directorate has created paralysis by stimulating populism. Individually, these approaches have been flawed but collectively they have made the European project seem stingy, rigid and oppressive.

The result of this approach to the crisis has been to exacerbate the flaws of an integration process that has narrowed the space for political decisions at the national level without increasing it at the European level. On the one hand, Europe demands austerity, prohibits central bank interventions, prevents parliaments from taking sovereign decisions and ejects democratically elected politicians. On the other hand, it does not protect them against unregulated markets, socialise debt or allow citizens to shape EU-level decisions. Thus, as well as economic growth, Europe needs a more political and empowering way of governing and a narrative that can inspire citizens across the continent, satisfy global economic markets and boost the confidence of Europe's diplomatic partners.

This brief, based on interviews with officials and experts in 12 countries around the EU as well as on seminars and working papers from leading analysts in national capitals, argues that what is needed is a new reform agenda. The principles of this political Europe should be to be seen as generous, flexible and empowering – a "Europe of incentives". Deeper political and economic integration is certainly needed to solve the current crisis. But while the 17 members of the eurozone need to move towards fiscal union, they must also give a new impulse to the integration of 27 (plus) states, and not just to 17 (minus) ones. Europe needs a different model of integration based on politics rather than technocracy and rewards for reform rather than only the threat of sanctions.

A European nightmare

After a year of slow responses and half-hearted commitment following the Greek sovereign debt crisis in 2010, Europe's big member states finally grasped hold of the reform agenda in the summer of 2011. In a short period, they developed a set of institutional responses (the so-called six-pack and fiscal compact) and political responses (a stronger Franco-German relationship and the effective forcing out of office of the Greek and Italian prime ministers) which cleared the way for the European Central Bank (ECB) to play a more ambitious role in restoring liquidity to the European economy. This was also a period when what German policymakers call the new "policy mix" was developed.[1]

Chancellor Angela Merkel and the German government realised that a break-up of the euro would have disastrous strategic consequences, especially for Germany, and made a decision last summer that they would do all they could to prevent the euro from collapsing. In September, Merkel declared that a collapse of the euro would also mean the collapse of Europe.[2] Polish Finance Minister Jacek Rostowski even suggested that such a scenario could result in war.[3] Shortly afterwards, the governments of Mario Monti in Italy and Mariano Rajoy in Spain embarked on ambitious austerity and structural reform programmes and a new consensus has slowly developed about the need for a growth package.

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1 Speech by Dr Wolfgang Schäuble at the award ceremony for the 2012 Charlemagne Prize, Aachen, 17 May 2012, available at http://www.bundesfinanzministerium.de/nn_103466/EN/Topics/Europe/Articles/20120517-Charlemagne-Prize.html?__nnn=true.
2 "Video zur Eurokrise: Merkel warnt vor Kontrollverlust der Politik", Sueddeutsche.de, 13 September 2011, available at http://www.sueddeutsche.de/politik/merkel-o-merkel-warnt-vor-kontrollverlust-der-politik-1.1142713.
3 Cited by Tomasz Bielecki, "Wojna Idzie," *Gazeta Wyborcza*, 15 September 2011, available at http://wyborcza.pl/1,76842,10290674,Wojna_idzie_.html.

As the markets calmed, a new optimism emerged in Berlin about the pragmatic policy mix of new rules, low-cost liquidity and political leadership. This mix is based on a view that what was going wrong with Europe was spiralling costs for creditor nations, widespread disregard of European rules and a paralysis of the decision-making in an enlarged EU. The measures taken in response – the fiscal compact agreed in January, the national austerity measures undertaken by Greece, Ireland, Italy, Portugal and Spain, the creation of the ESM, the long-term refinancing operations (LTRO) undertaken by the ECB, and the "Merkozy" model of leadership – added up to a new model for the EU based on the ideas of minimising the costs of integration, forcing wayward nations to obey the rules and developing a decision-making structure that better represents the real balance of power within the EU.

> "As the Union intrudes more and more into domestic budgetary and public finance choices, can party politics in Europe adapt to a very different governance regime?"
> Brigid Laffan, University College Dublin

However, what is becoming clear is that the apparently rational, coherent policies that European leaders have carefully crafted in recent months to overcome the crisis seem to be driving the continent in the opposite direction than originally intended. By trying to minimise short-term costs, creditor nations are actually driving up longer-term costs. By imposing rigid rules and threatening sanctions, member states are actually increasing the chances of cheating and blackmail from debtor countries. And by excluding some countries from European decision-making, the big member states, and above all Germany, are actually finding themselves gridlocked by popular opposition and weakened on the global stage. In the medium term, there is a growing danger that efforts to save the euro may by default lead to the weakening of the EU by antagonising non-eurozone countries to the point that their membership becomes unsustainable.

This is the tragedy of the current EU reform agenda. European leaders have moved beyond the stage of denial and are genuinely doing their best to grapple with Europe's problems. But the unintended consequences of their decisions are to drive Europe apart. Thus the policies Europe has adopted are in danger of being self-defeating as they make it more difficult to generate the political support needed for necessary measures. Although there was never a European equivalent of the American dream, there was a hope that joining the EU would bring freedom, peace and wealth to countries whose histories had been blighted by their opposites and that integration would increase member states' capacity to face the new global environment. However, what is now emerging is a European nightmare.

Three traps

Behind the approach to the euro crisis that European leaders have taken over the last two years is a toxic combination of three different impulses. The first is to engage in European projects only if they have reasonable chances of success and do not cost much in either financial or political terms – what we call the “low cost” approach. The second is to invest much more in economic and political terms in making the EU institutions work but also to try to impose strict conditionality on European partners – what we call the “law and order” approach. The third is to try to reinvent Europe through ad hoc coalitions of the willing with other member states and to use the EU institutions only when they are useful to achieve collective aims – what we call the “two class” approach.

These three impulses do not stand for national perspectives, but rather for visions that each compete for hearts and minds within member states. For example, Germany – the most powerful country in the eurozone – has supported decisions that embody each of the three approaches. Its opposition to Eurobonds has been motivated in part by a desire to keep costs down (although many people would also say that it was to maintain pressure for reform in debtor countries). Its support for the fiscal compact embodies the desire for rules and institutions. And its willingness to take decisions through a Franco-German directorate and to create informal intergovernmental institutions such as the European Stability Mechanism (ESM) stems from the “two class” (and not just two-speed) version of Europe.

Because of the complexity of the current EU – which is divided between debtors and creditors, euro-ins, euro-outs and maybes, federalists and intergovernmentalists – it was never likely that any of these three approaches to the future of Europe could be implemented in full. Instead we have seen an eclectic reform agenda emerging piece by piece and through compromises between and within member states. Thus the policy mix that has emerged is a complicated mixture of elements of the three approaches. Each of them is individually deeply problematic and in particular runs the risk of achieving the reverse of what it aims to do. Taken together, however, they are disastrous.

A "low cost" Europe: the debt-deflation trap

The "permissive consensus" for European integration has disappeared: citizens are no longer willing to make sacrifices to support a European project that is perceived to benefit elites, big business and banks rather than ordinary people. For example, citizens of affluent member states such as the Netherlands and less affluent member states such as Slovakia are reluctant to "bail out" their European cousins who are seen as responsible for the mess they are in. Eurosceptics who used to fear a federal superstate now argue that they are "tethered to a corpse": a eurozone that is doomed to low growth, a single market that is binding Europe's economies in red tape, and a customs union that is hampering free trade by allowing protectionist lobbies in Europe to block negotiations with emerging markets for access.

European leaders under pressure from these views seem to have drawn the conclusion that, rather than looking for European solutions to national problems, they should do the minimum necessary to stop the EU collapsing while increasingly trying to solve problems on their own or in a non-European framework. Even if European leaders do not openly abandon the European project, they want to invest a minimum of capital in it and use it chiefly for symbolic purposes to improve public relations. In other words, they are taking a "low cost" approach to Europe.

In economic terms, they avoid a mutualisation of European debt, for example through Eurobonds, and instead take opaque measures such as the ECB's LTRO programme – even though it exacerbates the divergence between surplus and deficit countries. In political terms, they avoid making the difficult case for European solidarity and for bold measures to solve the crisis and instead use national parliaments and the European Council for legitimacy rather than the European Commission and the European Parliament. In foreign-policy terms, they allow the EU to deal with difficult issues such as Iran but hedge against it by developing unilateral policies for really important relations and form coalitions of the willing to deal with crises such as Libya.
The leaders of each member state define the minimum in different ways based

on their own history, political culture and national interest. For Angela Merkel, the minimum is treaty change to avoid a challenge by the Constitutional Court, bailouts for Greece, Portugal and Ireland to stop them defaulting or leaving the euro, and saving German and French banks. For British Prime Minister David Cameron, on the other hand, the minimum is to not get in the way of a eurozone that he recognises must integrate in order to survive while at the same time keeping his own Eurosceptic backbenchers at bay. He will therefore refuse to sign up to any new treaty and seek to minimise the British contribution to any bailout facilities.

> "The British can imagine that their banks will suffice, the Germans their autos, but such comparative advantage can dissipate quickly. I'd as soon wager on Greek beaches."
> Charles S. Maier, Harvard University

The problem with the "low cost" approach is that it precludes solutions to the serious structural problems that Europe faces. Rather than reassuring the markets with "big bazookas", member states only begrudgingly and incrementally increase the money allocated to the European Financial Stability Facility (EFSF) and the ESM. Rather than gaining public support for bold measures, they do things covertly – for example, the ECB's LTRO programme. The net result of this approach is that it becomes more difficult to win public support for each step forward – however cheap – and ultimately makes solutions more complex and controversial than they would have been with decisive action at the beginning of the process.

It is also more expensive in the long term. Because surplus countries such as Germany are not solving the causes of the crisis and in particular the economic imbalances between them and deficit countries, they are forced to keep paying for ever larger bailouts. Meanwhile, instead of reducing their level of sovereign debt, deficit countries such as Greece end up paying ever-higher interest rates that actually increase their deficits. Because the single currency means they devalue their currency, they are left with no alternative except to deflate. Thus the "low cost" approach actually sets up a debt-deflationary trap.

A “law and order” Europe: the rule-revolt trap

Some in Europe, particularly in creditor countries such as Germany, believe that the crisis was caused by the lack of sufficiently robust rules that would prevent free riding and cheating. They therefore see tougher rules, a more intrusive monitoring system and heavy penalties as the best instruments for enhancing the European centre of governance. This may in time lead to a fully-fledged economic or even political union, but for now the priority is to prevent fiscal imprudence and other forms of “irresponsible” behaviour by some of the “peripheral” member states. The starting point is the so-called six-pack and the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (EMU), which was signed by all but two EU member states (including several that are not members of the eurozone) in March.

The new fiscal rules for the euro area are built on the Stability and Growth Pact (SGP), which committed countries to a balanced budget, a debt-to-GDP ratio below 60 percent and a budget deficit below 3 percent of GDP. But many member states felt that the SGP was unenforceable, both because it could only be initiated once the deficit criteria were violated – in effect closing the stable door after the horse had bolted – and because it had a decision-making structure based on qualified majority voting that allowed large and politically powerful countries such as France and Germany to break the rules with impunity.

> “A substantial part of the present euro crisis has less to do with European cooperation and more to do with member states that are fragile, ineffective, have serious corruption problems.”
> Georg Sørensen, Aarhus University

The six-pack and the new treaty strengthen the rules by introducing a “European Semester” in which member states would share their budget plans with the EU institutions, a requirement for member states to introduce national “debt brakes”, and a 1/20 rule that opens countries to sanctions if they do not reduce their excessive debt by 5 percent a year. But they also allow member states to bring another member state before the European Court of Justice. The next wave of debate will be about how to make the so-called Lisbon Agenda on competitiveness, which relied on voluntary measures, more binding. The German chancellery is exploring the idea of a “Lisbon with teeth” that would threaten non-reforming countries with sanctions and fines.

One of the most important features of the EU is that it is a community motivated by the rule of law rather than power – and to establish the trust that will be needed to exact solidarity between nations, there must be a belief that countries will abide by the rules. However, even if countries are responsible for getting into their fiscal difficulties in the first place, they will never escape from them if the conditions are set at unachievable levels. There are, in fact, many reasons to imagine that an excessively rigid adherence to rules and sanctions without the ability to revise them and reward good performers could actually have the opposite effect to the one intended.

First, a single blueprint is unlikely to work for all member states: an economy with thousands of small and medium-sized enterprises exporting capital goods to emerging markets such as Germany might need different policies than a service-based economy with a strong financial sector, such as Britain, or an economy in which a handful of powerful, big companies are of central importance, such as France. Moreover, it is very plausible that different economic models perform differently in different times. Germany's manufacturing-based economy was not doing well after the dotcom crash of 2000 when companies worldwide cut back on capital spending. In contrast, Britain was thriving at that time thanks to growing demand for financial services. Now, after the crisis, fortunes have reversed. Imposing a single blueprint on all of Europe would mean putting all of its eggs in one basket and foregoing the benefits of both diversification and variety.

Second, regardless of how much they are monitored or threatened with sanctions, member states are unlikely to abide by rules that they see as either unsuitable or illegitimate. The history of European integration shows that giving the European Commission more powers does not necessarily prevent cheating and that policing the ever-growing number of diverse member states is a daunting and ungrateful task.

Third, European laws and regulations cannot be implemented in the same way in diverse settings. The same capital requirements for banks might have a very different impact whether you have a small number of large, internationally operating banks or a large number of small, mostly regional banks providing finance for companies.

Fourth, rigid laws are ill-suited to ever-changing economic and political circumstances. Historically, all attempts to bind economic policy by simple rules – be it the rigid money-supply rule tried by the US Federal Reserve under Paul Volcker in the early 1990s or the Argentine currency board in the early 2000s – have failed.

Even more worrying, this approach based on strict rules and discipline has dramatically narrowed the political space in member states as important decisions are taken in Brussels or Frankfurt. Telling a politician such as new French President François Hollande – who has received a mandate to renegotiate the fiscal compact – that "there is no alternative" sends a terrible message to European publics: they can change governments but not policies. Thus the "law and order" approach is creating a gaping democratic deficit that is actually making it harder for countries such as Greece to undertake reforms amid widespread public anger, ideological conflicts and political confusion.

> "We still live in an era in which the nationalist project is more seductive than any project of integration among nations."
> Dimitri Sotiropoulos, University of Athens

In fact, this approach is now creating a full-blown rebellion in countries such as Greece, where it has become impossible to form a government to implement the new rules. Even in countries such as Portugal, where mainstream parties were able to form a workable alliance committed to macroeconomic reforms, there is little hope that discipline by itself can get the country out of the crisis. There is also increasing opposition against the technocratic governments in Italy, and former prime minister Silvio Berlusconi and his former allies from the Northern League are talking openly about a suspended democracy in their country. The situation in Hungary – which has gone through a financial crisis, followed by a technocratic government and is now being run by a populist leader who is consolidating power and threatening the checks and balances of liberal democracy – could actually be a sign of things to come.

A "two class" Europe: the technocracy-populism trap

As the crisis developed, the necessity of deeper integration to solve the crisis ran into the impossibility of getting 27 member states – each hemmed in by citizens, courts and markets – to agree to measures in a timely way. As a result, the governance of the continent began to be defined less by the rule of law and transparent politics and more by different classes of actors defined by their wealth and power. The most visible embodiment of this power-based "two class" Europe was the emergence of "Merkozy" – an exclusive directorate that made many decisions and then presented them to the rest of the EU on a take-it-or-leave-it basis (even though it only lasted a few months). Such a select decision-making system has been seen as illegitimate across the continent even though there is a growing realisation that in a Europe of 27 states it is difficult to accommodate the demands of all its members.

If the eurozone's core economic problem boils down to the creation of a common currency without a common treasury, its political dilemma lies in the development of common policymaking without a common politics. The EU was created at a time when citizens were deferential and national leaders had the space to pursue visionary foreign policies without fear of popular opposition. As a result, the EU was driven from the beginning by a "technocratic imperative" and the Monnet method of integration was based on deliberately reducing controversial decisions to incremental, technical steps that could be taken away from the glare of publicity and the excitement of partisan politics. Since then, this "permissive consensus" has eroded, but rather than giving way to a continental politics, it has created a new situation where the technocracy of the elites has provoked a populist backlash. The populist critique maintains that the EU now has two classes of states (creditors and debtors; big and small) and two classes of citizens (with the EU serving the interests of big business, banks and minorities against the embattled majority). As a result, instead of normal patterns of ideological competition, European integration has been defined by the contradictory but mutually reinforcing forces of technocracy and populism.[4]

Since the crisis, the EU has responded with a technocratic drive for "more Europe" that has resulted in some significant transfers of sovereignty from a national to an EU level. But the six-pack, the ESM and LTRO were created in response to market pressure and ratified by national governments at the last minute. Rather than proposals coming forth from the EU institutions and being ratified by governments, they have been developed in a Franco-German *directoire*, the Frankfurt Group or other non-treaty-based bodies.

The "two class" Europe is not only about a Franco-German directorate, but also about a small group of countries, presumably rich, going forward and leaving others behind. This model of integration is not just attractive for the

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4 See Mark Leonard, "Four Scenarios For the Reinvention of Europe", European Council on Foreign Relations, November 2011, available at http://www.ecfr.eu/page/-/ECFR43_REINVENTION_OF_EUROPE_ESSAY_AW1.pdf.

most powerful member states which think that they should have a voice to match their economic contribution to the EU. In fact, smaller member states may also be tempted by the idea of a "two-class Europe" if they think they might be granted preferential status by local hegemons. Even a country such as Greece might think it would be easier to negotiate a special deal with Germany and France than to wait for an overall solution that would also take into consideration diverse economic problems faced by Italy or Spain.

"Europe is not just needed as a defensive mechanism to prevent the weak being overpowered by the strong, who first administer an austerity cure without then providing the requisite support for recovery."
Claus Offe, Hertie School of Governance, Berlin

However, as tempting as the "two class" approach is as a short-term solution, a Europe of 27 states cannot be governed for long by a self-appointed, self-serving and non-accountable directorate of only a few states in this way. In the past, many other member states supported the idea of "more Europe" because it diluted the power of big member states such as Germany or France and gave them a chance to have more say over their future.

The hardening of this technocratic core has also led to the hardening of the backlash against it – with a populist critique of the EU as a project that has been run by the elites against the interests of ordinary people. In many European countries – from Austria and Finland to the Netherlands and Slovakia – the so-called "mainstream" pro-European parties now represent a minority of the electorate. The most dramatic example of this is in Greece, where Syriza, or the Coalition of the Radical Left, quadrupled its share of the vote in the May 2012 legislative election and became the second-biggest party in Greece behind New Democracy. The fact that Greece was denied a chance to have a referendum on its willingness to stay in the euro, and that all the mainstream parties were bullied into signing up to the reform package, has created a powerful sense of despair and a rejection of mainstream parties that are not able to take responsibility for the future direction of their country. The whole of Europe has found itself in thrall to a small, radical coalition and its 37-year-old leader Alexis Tsipras.

The situation could very well now spiral out of control, with incredible collateral damage to the rest of the eurozone. A Greek exit carries the danger of unleashing huge destructive capital flows from countries such as Spain, Italy and even France and the Netherlands into Germany, which ultimately might trigger a domino effect of countries leaving the euro and a paralysis of the common market. Thus the “two class” apolitical approach to Europe is ultimately counter-productive: far from ending Europe’s paralysis, it has actually exacerbated it. At his first EU summit, François Hollande staged a symbolic joint arrival by train with the Spanish leader Mariano Rajoy in order to create the perception that he is breaking with this approach. But it is still too early to see if this will work or if, after the French parliamentary elections, the “Merkozy” format of the past transmogrifies into a “Frangela” format for the future.

The alternative: a Europe of incentives

The EU has now reached a new point at which everyone from David Cameron to Mario Monti agrees on two things: the eurozone needs to take a big step into deeper integration, and it needs to stimulate growth as well as austerity. There is talk about a banking union, fiscal union and austerity union. But just as important as adjustments in economic policy is the pressing need for the return of politics. A "big bazooka" may temporarily calm markets, but restoring public confidence is a different matter altogether. The latter requires a vision that can restore public confidence and create the basis for member states, with the support of their citizens, to work together towards greater integration in the long term.[5] This is the essence of political leadership, and it is most likely to emerge from a clash of ideas in public forums.

Although there is loose talk about "political union", there is not yet any consensus on what this might mean in practice. In some countries, it seems to be a way of taking economic policymaking out of the political sphere by "constitutionalising" the rules. In other countries, the goal seems to be about winning back the space for politics at a European level that has been lost at a national one. In our view, the EU will not be able to escape the three traps of the last few years if it does not embrace more ambitious visions of political union.

Yet, once again, it is not just a question of what but of *how*. The final vision of political union is important, but the process of arriving at it is equally crucial. A political blueprint imposed by a few of the most powerful states with little public consultation across the entire continent is not likely to work. The quest

5 For a visionary long-term plan for Europe, see Emma Bonino and Marco de Andreis, "Making the case for a 'federation lite'", European Council on Foreign Relations, 3 May 2012, available at http://ecfr.eu/content/entry/commentary_making_the_case_for_a_federation_lite.

to give citizens and states a sense of control over the future will be key to the survival of the euro, as the current EU has become dangerously unbalanced in economic, institutional and political terms.

We call the new approach a "Europe of incentives", to distinguish it from the punitive account of Europe that has taken hold since the crisis began. The goal must be to develop a Europe that is seen as generous, flexible and empowering. Instead of threatening bad performers with sanctions, the EU should give member states positive incentives to do the right thing so that real reform becomes more attractive than breaking the rules. Instead of imposing rigid rules that may be overtaken by events in the real world and closed hierarchical structures that exclude member states from integration projects that they could enhance, it should be as responsive as possible. And instead of a Europe driven by diktat – whether from Brussels, Paris, Frankfurt or Berlin – it should be a participatory one.

"For democracy to survive in Europe, the responsiveness and accountability of rulers should be moving from the state level to the EU level, where so many crucial decisions are already being made."

Josep M. Colomer, Institute for Economic Analysis, Barcelona

If the biggest challenge facing Europe is the wholesale reform of our economic and political model, European leaders need to develop a series of incentives for governments to change their policies and to embrace Europe. By "incentives", we do not just mean subsidies or the prospect of growth – Greece has certainly benefited from its fair share of those features over the last few decades – but rather targeted support to take on difficult reforms, access to decision-making at an EU level, and the sense of being part of a European project that offers opportunities. Only such a "Europe of incentives" will be able to generate support among its citizens and elites. The text that follows is not an attempt to solve all of Europe's problems, but rather a sketch of the principles that could drive an alternative European agenda as well as policy ideas that illustrate an alternative approach.

A generous Europe: how to escape the debt-deficit trap

Although there are moves afoot to create a banking union and the economic debate is now beginning to move from austerity to growth, none of the steps that have been taken seem to deal with the underlying causes of the crisis: the great divergence of eurozone members and the existence of a common currency without a common treasury. An alternative approach should be based on the goal of reducing imbalances in wealth rather than simply imposing monetary discipline, and the idea that the most powerful way to do that would be through incentives rather than sanctions. True, some of the countries would have to reach into their pockets to provide valuable incentives. But, as we tried to show earlier, "cheap" options are likely to cost much more in the long term. Most voters would understand this if given a sound alternative to the current unworkable project.

In the short term, governments will need to develop an appropriate "growth compact" that could help debtor countries escape from the debt-deflationary spiral. In a recent ECFR paper, Sebastian Dullien set out some concrete ideas on how this could be done.[6] The first step would be to allow countries with large deficits (such as Spain) more time to get back to the deficit threshold of 3 percent of GDP in order to help break the downward spiral of contracting GDP, rising unemployment and rising deficits. Second, in order to make sure that public investment is not reduced so quickly that it sucks demand out of the economy, the financing of public investment could be taken out of the national budgets (and hence the measured deficit). One possibility would be to give the European Investment Bank (EIB) a central role in public investment financing. To avoid cheating, what qualifies as investment could be subject to approval by a European authority.

However, the most important proposal – in the short term – is to relieve crisis countries from excessive interest-rate burdens that will make growth impossible. A move towards Eurobonds or the introduction of a European debt redemption fund (as recommended by the German Council of Economic Advisors) would significantly lower these interest rates, and so help the countries back towards the path of economic growth. George Soros has

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6 Sebastian Dullien, "Reinventing Europe: Explaining the Fiscal Compact", European Council on Foreign Relations, 1 May 2012, available at http://ecfr.eu/content/entry/commentary_reinventing_europe_explaining_the_fiscal_compact.

proposed that a special-purpose vehicle owning the seigniorage rights of member states could use the ECB to finance the cost of acquiring the bonds without violating Article 123 of the Lisbon Treaty. A core principle of the idea of a "Europe of incentives" is that reform should be rewarded, for example by making the inclusion of national debt into Eurobonds or a debt redemption fund conditional on the achievement on certain reforms, or by making EIB infrastructure finance available based on reform achievements.

The longer-term challenge will be to deal with the gulf in competitiveness that has opened up between Europe's best and worst performers. Many of the reforms needed were identified by the architects of the Lisbon Agenda in 2000. The fact that this ambitious project – which also pioneered a new form of more flexible integration – has become a bad joke among European observers is one of the saddest tales of European integration. In institutional terms, policymakers should also realise that targets are more likely to be met if the EU is seen as a partner for delivering positive change rather than as an enforcer of bad or unpopular policies. Many of the economic reforms that are necessary for long-term prosperity are likely to involve short-term pain. That is one of the reasons why EU governments have been reluctant to reform the system.

"The creation of European politics must go hand in hand with a change in the character of politics. For that, changes in policies may be even more important than changes in institutions."
Miguel Maduro, European University Institute, Florence

The solution to this conundrum should not be to develop a "Lisbon with teeth" – but rather to explore how member states can be incentivised and helped to undertake reforms which will be painful in the short run but vital to sustainability in the medium term: "Lisbon with carrots". Lessons could be learned from the United States, where the federal government gives generous grants but imposes specific conditions – for example, to increase the quality of schools run by states and municipalities. Similarly, the EU could give grants to member states to train young people or to increase labour market flexibility. Alternatively, European co-financing for publicly financed research and development could be a way to give incentives to national governments to prioritise research and development in times of tight public budgets. Funds for the renovation of public university buildings might be linked to the achievement of certain enrolment or graduation rates in a country.

In the longer term, there is enormous potential to create wealth by removing barriers to trade in areas such as services, energy and the digital economy in line with the blueprint suggested by Mario Monti in his report on re-launching the single market.[7] Again, rather than simply calling for more reforms, it will be important to find ways of compensating losers from liberalisation to make sure that these vested interests do not prevent the completion of the single market from becoming a reality, or at least use some of the funds to convince the people in the countries to challenge these vested interests. An important point here would be to try to lower the fear of unemployment due to proposed changes in the economy. Measures that try to strengthen the social-security net without creating incentives not to work might help here.

In order to move from a punitive Europe to a generous one, European leaders will need to agree an explicit new deal between surplus and deficit countries and between northern and southern, and eastern and western member states. As well as reconciling the eurozone with the non-eurozone countries, this deal will need to strike a balance between austerity and budget transfers, liberalisation and social protection, and ways of transferring money from the rest of the world to the eastern *and* southern neighbourhoods. Such a deal will require many national leaders to recognise that it is in their own national interest to reach consensus about how the eurozone and the EU should work in the future. They must agree on a vision that is perceived as fair by all member states rather than seeming to penalise any of them.

A flexible Europe: how to escape the rule-revolt trap

One of the causes for the current crisis is a breakdown of trust between member states and EU institutions. This is leading to a desire for rules to be enforced and for greater clarity within the system so that countries are not allowed to fudge their way out of commitments. Creditor nations are being asked to support debtors that they do not trust to reform their economies or stick to their commitments. At the same time, deficit countries do not trust the intentions of creditors, and note that it was France and Germany that first undermined the Stability and Growth Pact. This is leading to the natural desire to develop more intrusive monitoring and early-warning systems to spot if countries are likely to default.

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7 "Mario Monti's Report on the re-launch of the Single Market", available at http://ec.europa.eu/internal_market/smn/smn58/docs/monti_en.pdf.

In the economic sphere, the solution will be to remain firm on the goals of policy but to be more flexible on the means used to attain them. Importantly, the process of reform and consolidation should be action-based rather than outcome-based. At the moment, stability programmes are outcome-based: the Spanish government has committed to a certain headline deficit in 2012; if the recession deepens, they just have to make additional cuts. This is economic nonsense. If a government takes the right actions but does not achieve the desired outcome, it should not be punished but helped to remain on the right track. Moreover, circumstances of individual countries may recommend diversified routes for arriving at the agreed destination point. Member states should have some flexibility in meeting common objectives both in terms of specific policies and time schedule. Effective governance must be able to recognise diversity of individual circumstances and envisage mutual learning between policymakers and policytakers. Effective governance must also be able to regularly review and adjust the agreed rules and policy objectives because markets are moving very fast.

Clearly, there are many different variables that make institutions work and break. One of the key lessons of nature and organisational history is that in a time of crisis, the organisations most likely to survive are those that are flexible and resilient – while those that are rigid are more likely to fail.

An empowering Europe: how to escape the technocracy-populist trap

In order to create the incentives for states and citizens to embrace rather than reject Europe, they need to feel that European policymaking is a process over which they can have some control – rather than something which is being done to them. In the past, many European governments saw integration as a way of reclaiming sovereignty in an interdependent world where many decisions are taken by markets or super-powers and imposed without consultation of national governments. One of the drivers of the creation of the euro was a desire by other member states to water down the hegemony of the Bundesbank. More Europe was meant to mean less Germany. The paradox is that it has produced exactly the opposite result.

Today, many member states feel that more Europe means more rather than less Germany even though the Germans do not seem to have any hegemonial ambitions. And the EU is seen as a transmission mechanism for global diktats rather than a source of emancipation from global markets even though its trade and agricultural policies are very much about protectionism. Some such as George Soros now even see the danger of "a German empire with the periphery as the hinterland" in which "the divergence between the creditor and debtor countries would continue to widen and the periphery would turn into permanently depressed areas in need of constant transfer of payments."[8]

The quest to create an empowering Europe of incentives from the oppressive Europe of today must have two elements. The starting point will be to give democratic states more ownership of the political process so that their citizens' faith in politics can be restored. Second – and much more challenging – is the need to make citizens feel that the process of constructing Europe is not simply a technocratic exercise designed to advance the interests of elites.

> "In all the countries where people struggle with the economic crisis and fear for their children's future, Europe has, more than ever, become the scapegoat."
>
> Christine Ockrent, journalist

The first goal will be furthered by moving comprehensively away from the "Merkozy" model of integration, but not simply to another form of a directorate. The core principle of a new Europe should be broad participation of all member states in European decision-making. In practical terms, all integration projects should have membership criteria that are open so that other countries can join at any time if and when they are willing and able. (Many Eastern Europeans are keen to make sure they are able to join the euro when they meet the convergence criteria and they therefore want to have a voice in shaping the arrangements they will join.) Secondly, steps should be taken to preserve the integrity of the EU 27 and its governance arrangements. It will also be important to leave a gateway open for the absorption of new institutions developed by different cores into the larger union at a later stage.[9]

One way of creating more of a sense of common leadership would be to explore more closely how Herman van Rompuy, José Manuel Barroso and

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8 George Soros, Remarks at the Festival of Economics, Trento, 2 June 2012, available at http://www.georgesoros.com/interviews-speeches/entry/remarks_at_the_festival_of_economics_trento_italy/.

9 See Sebastian Kurpas, Julia De Clerck-Sachsse, José I. Torreblanca and Gaëtane Ricard-Nihoul, "From Threat to Opportunity: Making Flexible Integration Work", EPIN, Working Paper No. 15, September 2006, available at http://www.ceps.eu/files/book/1380.pdf.

EU High Representative for Foreign Affairs Catherine Ashton could work more closely with the member states to create strong collective (rotating) presidencies (building on the experience of troikas). One could also explore how to give the European Commission instruments and a budget to offer incentives for communitarian endeavours pursued by a minority of member states. Most importantly, Germany must rebuild its model of leadership for a more diverse Europe. Rather than pursuing all projects through a Franco-German directorate, it could launch a variety of different projects in different formats – working with Italy, Poland and a collection of member states on different topics.

Appealing to European citizens is more complicated – as the debate over the democratic deficit over the last three decades has shown. People initially tried to do this through the European Parliament, but this institution is more a reflection of the absence of politics on the European stage. Its mainstream parties are products of the Brussels bubble, espousing a technocratic agenda that is a long way from European citizens. And their main opposition comes in the form of the symbolic politics of populist groupings that campaign against the EU such as UKIP and Geert Wilders' Freedom Party. Elections for the European Parliament might be made more relevant if they are linked to the selection of the next European Commission President, but this will not solve Europe's political deficit because most of the power and the entire infrastructure of political debate remains at a national level.

> "Merkande must avoid making Merkozy's mistake of publicly presenting the other European partners with *faits accomplis*."
> Hans Eichel, former German finance minister

The biggest challenge is therefore how to ensure that real debates about policy choices take place at a European level. In particular, the challenge is how to get the politicians that have the most legitimacy and visibility – that is, national heads of state and government – to behave in a more political way; to thrash out their differences in public; and to take more responsibility for what they have done. In practical terms, the goal should be to get the European Council to break with its practice of voting for measures behind closed doors in Brussels and then blaming the EU for them in the national media. During the European Convention there was an idea of setting up a council of deputy prime ministers based in Brussels to act as a sort of super-COREPER in order to make decision-making more political and accountable and less bureaucratic. It would mean that there was a visible person in each member state who could attend Cabinet meetings and be held directly accountable to national parliaments and in the national media. In order to increase the domestic scrutiny of their deliberations, a second dimension should be to increase the role of national parliaments rather than relying only on the European Parliament to scrutinise European legislation. One idea that has been mooted is to create a second chamber of national parliamentarians that could sit alongside the European Parliament and play a role in signing off national budgets.

This could be further strengthened by investing in the Europeanisation of the media. The EU should not aim to create EU media outlets operating from Brussels such as the poor quality Euronews, but it could try to enhance the exchange of information among media outlets operating in individual member states by sponsoring websites offering translations of leading articles, subsidising the exchange of radio and TV documentaries or backing a journalistic equivalent of the Erasmus programme. By making the best national television programmes or newspaper articles available to audiences of other countries it will be possible to have more pan-European deliberation, and the scope for national politicians to say one thing in Brussels and another to their domestic audiences will be reduced. Mobility of journalists within Europe should also be assisted, especially as national media outlets are drastically cutting their foreign correspondents. The Erasmus programme has brought Europe closer to generations of young academics, and giving the same opportunity to journalists will benefit not only them but also their audiences.

The best hope of regaining credibility – and to stem the tide of disintegration – may, however, be to develop political rather than institutional responses to the arguments of the populists. The EU should therefore actively embrace a policy agenda that visibly serves the interests of ordinary people. European leaders cannot just talk the language of institutions and money; they should also talk the language of the people, if not primarily. Embracing a growth union rather than an austerity union is a step in the right direction, but more specific projects ought to follow focusing on such important issues as youth unemployment, urban planning, medical care, biotechnology research, energy conservation, transport and aging.

As well as taking measures to increase competitiveness, it is advisable to change the rules of the Euro-Plus Pact on public finances to allow for social investment, reform the EU budget to help with adjustments, and make receiving money conditional on reforms. The EU also needs to address managed migration, including more common measures on the protection of external borders and burden-sharing arrangements.

Conclusion: the dangers of disintegration

Historically, the incentives for states and citizens to take part in the European project were abundantly clear. Much has been written about the success of the EU as a peacemaker, the creation of the biggest single market, and the democratic transformation of countries across Europe. But even more important than that is the revolution that the EU represents in our ideas about security and politics. The EU model allows countries to have the benefits of small states that are close to the people and control all the things they care about while getting access to the economies of scale that they need to thrive and survive in a cutthroat world, and solutions to collective action problems.

But today, the EU is mainly associated with threats and injunctions – rules that must be obeyed, sanctions, cuts and austerity. As a result, it is hard even for the most enthusiastic supporters of the cause to make the case for Europe, and all of the historical achievements are under threat. There are many books on European integration, but hardly any on disintegration. However, the key lesson we learned from the collapse of other political entities, from the Soviet Union and Yugoslavia to the various imperial projects of the past, is that disintegration is usually an unintended consequence of other policies rather than the result of a conscious decision to end a union or dismantle an empire.[10] Too often the rigidity of political systems has stopped its champions from taking the steps they would need to take in order to save them from destruction.

In Europe too, most of the political and economic elites desperately want the EU and its currency to survive. But the danger is that their attempts to

10 See Ivan Krastev, "European dis-Union: lessons of the Soviet collapse", *Open Democracy*, 15 May 2012, available at http://www.opendemocracy.net/ivan-krastev/european-dis-union-lessons-of-soviet-collapse.

save the EU could have the opposite effect and make the EU too rigid and oppressive to navigate the complex politics of the crisis. One is reminded of Vaclav Havel's words in *Power of the Powerless* about the "yawning abyss" between the system and the reality of modern life: "While life, in its essence, moves toward plurality, diversity, independent self-constitution and self-organisation, in short, towards the fulfilment of its own freedom, the post-totalitarian system demands conformity, uniformity, and discipline." Current practice – from the drafting of the fiscal compact to the reactions to the Greek elections – also seem to be driving a wedge between the facts of life and the designs of EU technocracy.

Four sets of issues will determine whether the EU is able to rise again from this crisis. First, the mechanics of the economic response: if the eurozone needs to develop into a real economic government, how can this be done in practice and what political oversight will be necessary to make it legitimate? Second, the politics of the crisis: as the populist backlash strengthens across the EU and the "mainstream" pro-European parties become marginalised, how will the European project be legitimated at a national level in an era where the "permissive consensus" has disappeared? Third, the chronic crisis of European competitiveness: how can European leaders redress imbalances within the eurozone and make the European model sustainable in a globalised world? Fourth, the geopolitical implications of the crisis: how will European leaders stop the cycle of disintegration from adding to the insecurity of the continent and how can they ensure that the EU of 27 member states is united enough to become a common force in an increasingly multipolar world?

Historians will look back at this period as a time when key decisions for the future of Europe were taken. However, there is very little debate in European capitals about the long-term implications of these choices and many decisions are being taken by default. There are numerous alternatives that need to be debated. To survive the crisis, European leaders should embrace pluralism, participation and solidarity rather than the technocratic centralism of rules and sanctions. If Europe's leaders rise to the challenge, they may yet re-establish trust which could be the basis for reintegrating our continent rather than disintegrating by default.

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