HENRY FARRELL

A More Perfect Union

Over the years, European leaders forgot how to justify integration to their citizens. It's time they remember—and proceed with tough reforms.

Americans are writing Europe off—and apparently for good reason. The last several months have seen the European Union stagger from one crisis to another. After barely passing the Lisbon Treaty—which amended the EU's fundamental texts in order to streamline its institutional structures—the EU soon found itself in the throes of its current crisis over the economic governance of the euro, while simultaneously confronting the failure of its ten-year effort to modernize the European economy.

American pundits seem almost to take pleasure in Europe's problems. Richard Haass, the president of the Council on Foreign Relations, claims that the European project is "foundering" and that Europe's days as a world power are over. Officials in the Obama Administration are less consumed by schadenfreude, but are nonetheless irritated with Europe's navel gazing. They find the EU's

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decision-making structures confusing and indecisive—no one knows whether the president of the European Council, the high representative on foreign affairs, or the country holding the Council presidency is supposed to be in charge of foreign policy. While U.S. officials publicly claim that the relationship with Europe is "the cornerstone for U.S. engagement with the world," they privately do everything that they can to avoid entanglement with Europe's byzantine policy apparatus. When the United States wanted to make sure that some decision would emerge from the Copenhagen talks on climate change, it deliberately cut the Europeans out of the final stages of the negotiations in favor of one-on-one discussions with China. As European Commissioner for Energy Günther Oettinger acknowledges, "If the Copenhagen summit showed us one thing, it is that even the European Union isn't big enough for world authority when it comes to countries like China."

Europeans need to decide whether they are ready for real European politics, or whether they are content merely to senesce.

That the European Union is going through a rough patch is indisputable. The Greek debt crisis and the reluctant bailout by members of the union have underscored the unsustainability of Europe's economic arrangements. Even so, the United States cannot afford to lose patience with Europe. The U.S.-EU economic relationship is the largest and most important in the world. The EU and the United States together dominate international financial markets, accounting for 80 percent of the debt securities market and 65 percent of issued equity before the Great Recession. If, as Haass predicts, the EU falls into complete disarray, it will hurt the United States nearly as much as it hurts Europe. The collapse of the EU would cause massive turmoil in international financial markets, and very likely a new Great Recession, which would be far worse than anything recently experienced.

America has a strong interest in seeing the European Union come through the crisis. It also has a longer-term interest in the stability of Europe. Even when the United States wants to ignore Europe, it has much more in common with it than with most other parts of the world. Europe and North America are by far the most important examples of democratic stability in the modern world. The European Union has not only helped bring peace and stability, but has helped spread democracy in the wake of the fall of the Berlin Wall.

However, Europeans need to decide whether they are ready for real European politics, or whether they are content merely to senesce. The decisions that the EU takes about how to recreate its system of economic governance will have

long-term consequences. If Europe decides simply to muddle through, it will run a high risk of failure, with little real prospect of breaking out of the trap that it finds itself in. If it chooses instead to remake itself as an exemplar of harsh economic austerity, it will destroy what legitimacy it still retains. Europe needs instead to rebuild its economic framework so as to make it more flexible in accommodating national differences.

A Crisis of Legitimacy

The politics of the continent are a tangle of contradictions that would have led to the current predicament with or without an economic crisis. Europe is paralyzed by three major intersecting problems. The first is a general crisis in European integration—the EU lacks the political legitimacy to undertake major institutional changes. The second involves the more specific deficiencies of Europe's institutions for economic governance. These problems are inherent in the current system, but have been cruelly exposed by current harsh economic conditions. The third problem concerns the structural factors—an aging workforce, inefficient labor markets—that present long-term challenges to European economic growth. Raising European levels of productivity and innovation will be a struggle, as it has been for years.

The crisis of European integration is a byproduct of Europe's past success. The European Union began in France and Germany's desire to dissolve their historic enmities through economic cooperation. The EU's institutional ancestor, the European Coal and Steel Community, was founded in 1952 in order to create unity "through practical achievements which will first of all create real solidarity, and through the establishment of common bases for economic development."

Over almost 60 years, the EU has accumulated many such practical achievements. It now has 27 member states with about 500 million citizens. Its GDP adjusted for purchasing power parity—a measure that calculates consumers' actual buying power in different currencies—is $14.8 trillion, higher than that of the United States, and 21 percent of world GDP. In 2002, a new layer of economic governance was introduced to the EU with Economic and Monetary Union (EMU), which created the euro and sought to further break down economic barriers between member states. Today, 16 of the EU's 27 member states participate in EMU, and all other member states, except the UK and Denmark, are theoretically obliged to join it when they meet its membership conditions. EMU members share a single currency and delegate all their monetary decision making to the European Central Bank.

However, in building an integrated European economy, the EU has lost its original rationale. It gets no political credit for maintaining peace between

Europe's major states, because Europeans now take peace for granted. This means that the EU needs a different source of legitimacy. It cannot look to economic success. A recent report commissioned by the European Union's heads of government warns that Europe's current state of "relative" economic decline may become "absolute" if serious measures are not taken. Nor can it look to international stature for legitimacy. The EU's hope that its emphasis on peaceful diplomacy might increase its international clout looks increasingly forlorn. More militarily inclined powers such as the United States and China view it as a symptom of weakness rather than an alternative model of international relations.

To make matters worse, the old model of European integration has broken down. National politicians used to be able to negotiate changes to the treaties and expect that the public would accept them without necessarily understanding them. But over the last decade, European voters have stopped trusting their leaders. Voters have rejected treaty changes in France, Holland, and Ireland (twice) over the last several years. The EU's Constitutional Treaty—which was supposed to be the culmination of the European integration process—failed ignominiously. Last year's Lisbon Treaty limped into existence only after initial rejection by Irish voters, veto threats by the Polish government, and attempted sabotage by the Czech president (who is a noted Euroskeptic).

The situation poses a profound dilemma for EU leaders. For decades, Europe's politicians did not have to justify European integration to voters. Now, when they have to justify it, they do not know how. EU integration had its origins in the political imperative of preventing future war. It then became a series of ever-more technocratic bargains. Now, with major institutional changes needed, European leaders need to make the idea of a European Union politically attractive again.

Such institutional changes are necessary to make the EU's system of economic governance work. The place to start is EMU, which is still in the throes of a crisis that can be solved only through major changes to the EU's treaties. EMU's current rules are the worst of both worlds. They are sufficiently constraining to make it difficult to respond properly to crisis situations, while not constraining enough to prevent crises from happening in the first place.

When members first agreed to EMU in 1992, Germany insisted on an independent European Central Bank and a set of spending rules that were supposed to stop EMU members from running up big deficits. However, these rules were effectively abandoned in the mid-2000s when powerful member states (including Germany itself) found them politically inconvenient. The result was an EMU built on vague political expectations and informal commitments to back up member states that encountered difficulties. When Greece started to get into trouble earlier this year, these expectations and commitments got vaguer. Ger-

mans were especially unhappy at the prospect of a Greek bailout. Members of Germany's government coalition spoke of the possibility that Greece might have to temporarily leave EMU; one prominent German newsmagazine ran a cover showing the Venus de Milo giving German taxpayers the finger. The German response led to a protracted crisis of confidence that was resolved only when Germany and other major member states reluctantly agreed to lend Greece hundreds of billions of dollars if necessary.

While everyone agrees that major institutional reforms are needed to stop such a crisis from happening again, there is rather less agreement on what the reforms should be. Austerity hawks, led by Angela Merkel, want strict new rules to ban EMU members from amassing deficits in the future. These hawks want a revamped set of international spending rules, combined with rigid domestic constraints on fiscal policy. They are opposed by politicians in France and elsewhere, who want a very different kind of European economic government. These countries are worried about the European Central Bank's obsession with preventing inflation, and want to bring it to heel to promote employment and growth. Finally, Britain—which is not a member of EMU but still has substantial influence in internal debates—is opposed to any strong economic government but also fears having to bail out weaker member states that get into trouble.

These choices present Europe with some fundamental trade-offs. It could try to solve its economic problems through monetary rigor and harsh institutional controls on member-state spending. It could create a new economic governance system that would force the European Central Bank to be more relaxed about deficits and inflation. Or it could try to muddle through.

None of these options goes nearly far enough. Harsh controls on member-state fiscal policy will not avert future crises—problem states such as Ireland and Spain did not appear to be in fiscal difficulty before the crisis, since their troubles were concentrated in the private sector. While looser monetary policy might make it easier for Europe to respond to future crises, it would do little to address asymmetric shocks, where some member states need one monetary policy, and other member states need another. As Paul Krugman describes it, the EU now has a "one size fits one" policy, which suits Germany very nicely, but prevents Spain from easing its economic crisis by devaluing its currency. And muddling through is simply not a sustainable strategy. Without credible guarantees and funding mechanisms to back up these guarantees, the eurozone will collapse under a welter of speculative attacks by market actors shorting the government debt of weaker members.

No matter which path is taken, Europe faces long-term challenges to its productivity and economic growth. Economic growth has been consistently lower

than growth in the United States, let alone in the developing world. Europe's population is aging rapidly, creating increased strain on welfare states. And fewer working-age Europeans are employed than in other advanced industrialized countries. The so-called "Lisbon Agenda"—which was intended to make Europe the most dynamic economy in the world by 2010—was an inglorious failure. Its replacement, the "Europe 2020" program, is likely to fare just as badly. Like the Lisbon Agenda, it relies on soft measures of policy coordination and peer review among member states, rather than serious, targeted programs.

U.S.-based commentators such as Thomas Friedman often claim that these difficulties demonstrate the unsustainability of the mainland European model of big welfare states and labor market protections. This belies the fact that there is no European model. Some countries, such as Denmark and Holland, combine large welfare states with highly efficient markets to produce strong and sustainable economic growth. Others, such as Greece and Italy, have limited welfare states, but very inefficient labor markets (these countries have high pensions but low overall welfare spending compared to Northern European countries). It is enormously difficult to get the weaker European states to adopt the policy innovations that have worked in the stronger ones. Their existing arrangements are supported by powerful interest groups of state employees and other privileged insiders, who are distinctly unlikely to be persuaded by policy white papers and processes of peer review.

A Reform Agenda for Europe

Simply put, Europe needs a new institutional framework to deal with its problems. The new arrangement would seek to do three things: ensure that European states adhere to sustainable fiscal policies over the medium term; facilitate fiscal transfers to cushion asymmetric shocks; and promote domestic reforms within institutionally underdeveloped economies.

The fiscal element would begin from the premise of sensible Keynesianism. As IMF Chief Economist Olivier Blanchard and his colleagues have pointed out, fiscal Keynesianism is possible in hard times only if there is "fiscal space" to carry it out. Countries with high levels of accumulated debt or pro-cyclical fiscal policy pushed by booms in consumer spending will be in a poor position to enact stimulus policies when crisis hits. Hence, there *is* a strong economic case for policies aimed at gradually lowering the debt-to-GDP ratio in states where it is dangerously high, and for external monitoring to draw attention to risky scenarios, like the property-market booms that led to economic disaster in Ireland and Spain.

This would require a radical loosening of EMU rules that prevent states from running significant deficits. Short-term hikes in deficit spending are not a

problem for an economic and monetary union. Nor is moderate deficit spending to finance activities that have long-term benefits for growth, like spending on human capital or infrastructure. The fundamental problem is spending that is unsustainable over the long term, either because it creates debts so great that they will overwhelm economic growth, or because it is fueled by bubbles.

As both the European Commission and the European Central Bank suggest, EMU requires much more extensive monitoring of domestic economic policy. Such monitoring would be best carried out neither by the Commission (which lacks the capacity and political independence) nor the European Central Bank (which has a very different institutional focus), but by a new body—a College of National Budgetary Supervisors. This would build on efforts in member states such as the UK to build independent budgetary auditing offices, but provide such independence through shared European structures. It would also have a mandate that focused on the long-term economic *and* political stability of member-state fiscal policy, rather than rigid austerity.

A new body—a College of National Budgetary Supervisors—should be established to monitor countries' domestic policies.

Supervisors would be appointed by national governments, but with long and non-renewable terms of office to encourage independence. They would be based in national offices with expert staff, but would have a small independent secretariat (which would manage relations with other European institutions) and have monthly meetings in Brussels. National staff would be required to carry out regular tours of duty in other offices to create a common institutional identity and make it more difficult to conceal embarrassing national information. Where the College worried that a member state's policies were unsustainable, it could issue a public recommendation on the basis of a simple majority vote. This recommendation would then be placed on the agenda of the next meeting of the Eurogroup body of finance ministers of EMU countries, which could issue an authoritative recommendation for policy change, or impose fines on states that had refused to adjust their policies on the basis of a previous recommendation.

Such a system might have greatly mitigated domestic economic crises in countries like Ireland and Spain. The Irish government raised a substantial amount of its tax revenues from transactional taxes on property and had a strong interest in encouraging the boom to last as long as possible. When the Irish property market collapsed, so too did government revenue. An early-warning system could have identified this problem before it led to near economic collapse. The trends in

the Irish housing market were obvious to anyone willing to take even a cursory look at the data. A recommendation from a body such as the proposed College would have at the least forced the issue onto the national political agenda, and, if backed up by the threat of serious action, likely led to appropriate policy changes.

EMU cannot rely on domestic policy coordination and supervision alone. Hence the need for the second element: cross-national fiscal transfers in times of crisis. EMU's current emphasis on maintaining a single monetary policy means that member states have difficulty responding to asymmetric shocks. EMU currently seeks to impose federal requirements on member states' budgets without providing any federalized budgetary benefits. In the United States, federal spending helps cushion asymmetric shocks that hit one state harder than another. The EU has no equivalent, since its budget is far smaller than that of a true federal state. Hence, budgetary supervision must be supplemented by fiscal transfers across states to help those in asymmetric crises.

The more economically stable European states have begun to recognize the need for greater transfers in order to offset economic adjustment problems. In a recent interview, German Finance Minister Wolfgang Schäuble acknowledged the importance of increased solidarity among member states, arguing, "If you want to create a federal organization, you must be ready to have a certain amount of redistribution within it." Germany needs an economically stable European Union, and, sometimes, substantial fiscal transfers are needed to ensure economic stability.

The current system of panicky bailouts encourages procrastination and ad hoc solutions that are cobbled together at the last possible moment. A politically sustainable system would normalize transfers to countries undergoing asymmetric shocks before they reach a point of crisis. The Greek debacle suggests that early intervention will be far cheaper and more effective than political handwringing and last-minute interventions. This will mean that rich states will sometimes have to bail out poor ones—but it will cost far less money than a full-fledged economic crisis.

Fiscal transfers to deal with asymmetric shocks should go hand-in-hand with reform of labor-market institutions in Southern European countries. The divergence in economic performance between countries like Greece and Italy (which combine strong job protection with weak incentives for training and poor economic performance) and Denmark and the Netherlands (which have weak job protection, but strong welfare systems geared to provide continual training and maximize workforce participation) is remarkable. Denmark, for example, insulates workers against market risk by providing them with training while employed and unemployed. This means that they can more easily adjust to major economic changes. While it is highly unlikely that poorer European

countries can be transformed into new Denmarks, they can surely borrow from Danish policy lessons. For example, less than half of Greek women of working age participate in the labor force, compared to nearly three-quarters of Danish women. This is surely linked to the easy availability of excellent government-sponsored daycare in Denmark; more than 60 percent of Danish children under three are in daycare, as opposed to 7 percent of Greek children. An expanded welfare state—if it is work-friendly—can help to expand the workforce and improve its quality.

Unfortunately, peer review and discussion of best practice are an insufficient basis for change in these countries. Moving from a welfare system focused on pensions and unemployment benefits to one that emphasizes participation in the workforce will discomfit actors with extensive protections under the current system. Economic crisis may help spur reform—but is more likely to see the dismantling of existing welfare arrangements than the creation of new and better ones.

Here, the EU can help. Currently, the EU devotes 77 percent of its budget to agricultural subsidies and structural spending on physical infrastructure and the like. In contrast, the European Social Fund, which spends money on initiatives aimed at encouraging training, receives little funding. Moreover, the fund steers clear of political judgments on the relative efficiency or inefficiency of different national systems. Yet just such judgments are needed to spur useful change. The European Social Fund should be beefed up through cuts to agriculture spending, in particular, and should be targeted to specific goals and changes in government policy, most particularly continual training and the provision of services (such as affordable child care) that encourage workforce participation. Countries that are unwilling to adopt significant labor market reform should not be able to take advantage of these funds.

To be absolutely clear, these labor market reforms would *not* aim to create a lowest common denominator along American lines. Instead, they would seek to reform economic systems that now combine workplace insiderism with shoddy social benefits toward better protecting the majority of workers from market risks and limiting particularized benefits for privileged social groups such as state employees. Again, external monitoring and selective provision or denial of incentives could help member-state governments confront entrenched interest groups like public-sector workers who prefer the status quo.

Arguing About Europe

The institutional reforms proposed above would be neither easy nor uncontroversial. This is in large part because they reflect explicitly political choices about economic and monetary union. These reforms privilege a vision of Europe that

tries to combine relatively free markets with high social protection and extensive provision of training, child care, and other work-friendly incentives; they reject alternative visions that prize free markets with minimal protection or sticky markets that insulate privileged incumbents. How could they (or other ideas of similar ambition) succeed in winning over European publics?

What is remarkable is how few of the proposals that have been discussed forthrightly acknowledge that the European Union is an intensely political space. EU-level decisions about market rules, national welfare systems, and, increasingly, how national states raise and spend their money *are* political, not technocratic. They need to be justified in political terms and win the support of voters in electoral competition against other ideas of how society ought to function.

This points toward the need for proper electoral politics at the European level over the longer term. Key officials—most obviously the president of the Council—should be chosen through competitive cross-Europe elections in which different candidates propose policy platforms that they will seek to implement if elected, rather than being appointed through backroom deals among member states. Honest political contention is a far sounder basis for politics than either secretive inter-state negotiations or bloodless efforts to reach technocratic consensus. The work of political theorists like Nancy Rosenblum gives us some reason to believe that democratic legitimacy arises *from* contention—that without different parties adhering to philosophies, politics is likely to be feeble and deracinated.

Major political reforms will take time. In the shorter term, however, political elites can at least stop pretending that their choices about European market governance are purely technical measures. Honest and open discussion would go at least some way towards helping voters understand the issues at stake—and hence why they should care about European politics.

The U.S. Role

Understandably, American leaders are now tempted to wash their hands of Europe's mess. But they cannot afford to give in to that temptation. If Europe does not start solving its problems soon, the United States will likely find itself embroiled in a new economic crisis that will be *much* harder to resolve than the difficulties of 2008-2010. And if Europe tries to solve its problems through fiscal austerity alone, it will not only fail, but will seriously worsen global economic imbalances as well.

The first problem—staving off the collapse of EMU—is more pressing. If the EU does not come up with a credible set of economic governance arrangements very soon, EMU will self-immolate. It survived the last few months only

because Germany and other larger member states came up with a $141 billion credit line for Greece at the last possible moment. Although this stopped short-term speculation, it has failed to reassure observers that EMU has long-term prospects. If Europe fails to produce a more serious system to support weaker member states, it will suffer a series of rolling crises culminating in the collapse of EMU.

The major economies avoided a complete meltdown of the global financial system in 2008-2009 by guaranteeing troubled financial institutions, buying up bad debt, and spending enough money to keep the economy from collapsing. If EMU goes under, European states will no longer be in a position to make credible guarantees. Nor, quite possibly, will the United States—the same processes of contagion that led to a collapse of confidence in banks in 2008 may lead to a collapse of confidence in any U.S. promises to back up its economic partners during difficult times. In 2008-2009, states were the backstop. The next time there may be no backstop at all. The economic consequence would be a dramatic rollback of globalization and a correspondingly deep and long-lasting depression.

What the United States cannot afford to do is give up on Europe in a fit of exasperation. Schadenfreude makes a poor substitute for global stability.

The second problem—making sure that the cure is not as bad as the ailment—presents serious difficulties over the longer term. Austerity hawks and deficit doves are now battling over the shape of proposed reforms. At the moment, the austerity hawks are winning. Germany is pressing for more stringent penalties still for states with fiscal deficits, up to and including suspension of voting rights in the European Council, where member states make decisions over legislation. It also would like EMU members to introduce domestic laws that would bind them to obey these budget rules. The European Central Bank wants sanctions to be imposed quasi-automatically, so that a substantial majority of member states would have to act if they wanted to block sanctions.

But austerity measures will not lead to economic stability. They will never be applied to strong member states, and will fail to address the problems of weaker ones, which are more likely to face problems of overheating in the private sector than over-reliance on public borrowing. They are also extremely crude, and would provide little flexibility for states faced with asymmetric shocks. Most importantly, the emphasis of austerity hawks on fiscal rectitude and nothing but is not politically sustainable. They would reproduce the problems of the early twentieth-century "gold standard" system, in which economies responded to

crises with chopped wages and swingeing increases in unemployment. As Barry Eichengreen has emphasized, democracies cannot credibly maintain such a system over the long run. European citizens are suspicious of the EU because they do not understand it. If they come to see it as a set of shackles chaining them in economic squalor and misery, their suspicion will be transformed into positive detestation. EMU cannot survive widespread public loathing. Yet such loathing would be the ineluctable result of enforced austerity programs.

Austerity also would have international repercussions. If European economies are compelled to impose austerity, they cannot grow through increased domestic spending. Instead, they will have to look to increased exports, copying Germany's path to prosperity. Unfortunately, the world economy cannot accommodate 26 little Germanys. The current imbalance between the United States—as a net importer and borrower—and exporters such as China already poses a grave risk to international economic stability. If Europe dampens domestic demand and simultaneously looks to increase exports substantially, it will make this imbalance much worse. European deficit hawks assume that the United States will continue to act as importer of last resort. But the United States cannot go on borrowing money to finance domestic consumption forever. Unless it starts gradually to unwind its position, the United States—not to mention the global economy—faces a dramatic collapse.

While there is a lot at stake for the United States, it needs to recognize the limits of its ability to shape this debate. Direct public interventions would be no more welcome in Europe than EU insistence on filibuster reform would be in the United States.

But even if gross interventions would be unhelpful, the United States needs a roadmap to guide its more subtle and calibrated efforts. Such a map needs to show both the political fissures within European debates and the outcomes that the United States should favor. By spelling out the negative consequences of austerity hawks' proposed reforms, the United States can help make space for the proponents of more realistic change. Closer inspection shows that the European political debate is not as one-sided as it might appear. Germany—backed up by the Netherlands and a few other countries—is the strongest exponent of austerity. But it faces opposition, not only from France, but from other countries that are uncertain about whether they want their spending decisions to be subject to external oversight. Even within Germany, there are internal divisions and intellectual confusion, which are likely to lead to overt protest as Angela Merkel's domestic emphasis on slashing public spending begins to bite.

America has started to make diplomatic noises about Europe's obsession with fiscal austerity. Before the recent G-20 summit, President Obama sent a letter to

other leaders, pointedly observing that states should not stop their fiscal stimulus programs too soon. The G-20 concluded with a non-agreement that states should take account of their differing circumstances in deciding when to end their stimulus. Treasury Under Secretary for International Affairs Lael Brainard has sought to make clear that there must be "stronger domestic demand in European surplus countries" but has not publicly intervened in European debates over rebuilding EMU. These efforts have been helpful—but only in limited ways.

While some of the tensions in Europe point in different directions, they show that there is no consensus in favor of harsh and rigid new rules. The United States should not try to use these tensions to stymie institutional change. Instead, it should quietly encourage dissenters to the austerity faction to coordinate on new arrangements that address the need for more flexible fiscal coordination.

America's most important role may seem modest—making it emphatically clear to Europe, and in particular to Germany, that collapse of EMU or imposition of a fiscal straitjacket would have unacceptable international consequences, and quietly nudging Europeans onto a beneficial path of institutional change. But such intervention could have real consequences. European policy makers are bedeviled by uncertainty, and hence more likely to be moved by serious advice.

What the United States cannot afford to do is give up on Europe in a fit of exasperation. America's naysayers might find some emotional satisfaction from a collapse of EMU, but schadenfreude makes a poor substitute for global economic stability. D