CHALLENGE EUROPE

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State of the Union and key challenges for Europe's future[1]

Janis A. Emmanouilidis and Paul Ivan

In the last five years deep cracks have appeared in the European project. The 'euro-area crisis' triggered by a severe global financial and economic crisis has put European integration to a major test, more profound than ever before. The experience of recent years has revealed and exacerbated significant deficiencies in the European Union's (EU) economic and political construction. At time it has cast doubt on fundamentals of the European project and raised questions about whether Europe will be able to deal effectively not only with the immediate crisis, but also with the many other serious socio-economic, politico-institutional, societal and global challenges that Europe is and will be confronted with. At the start of a new institutional-political cycle (2014-2019) and while the crisis situation has for a number of reasons improved significantly since the summer of 2012, at least in systemic terms, the Union's new leadership and Member States will now have to take strategic decisions about the future of European integration.

'State of the Union' – improvements in systemic terms but no room for complacency

In 2010, at the beginning of the EU's last political cycle and two years after the collapse of Lehman Brothers, Europe became the centre of the biggest financial and economic crisis since the Great Depression. What began as a government debt crisis in one of the smallest economies on its periphery, representing only 2% of the EU's combined economic output, soon exposed the fundamental deficits of a monetary union without an equally strong economic and political dimension. As the Greek crisis escalated, many European leaders wanted to believe its problems were unique, but the markets followed their own logic and the crisis quickly spread to other EU countries. As the dominos began to fall, it became obvious that the E(M)U lacked the necessary institutional structures, procedures, rules, and instruments to prevent such a crisis from beginning, spreading and worsening. And then the unthinkable became a very thinkable reality: one or more countries could leave the euro; the euro zone could implode; or even that the EU could disintegrate.

To make matters worse, Europe faced not just one but a number of highly complex crises, which together produced a crisis of confidence, undermining the trust of markets, citizens and global partners in the future of the euro and the EU itself: Europe faced a *banking crisis* in a highly interwoven European financial system which included illiquid or even insolvent financial institutions burdened by high levels of public and private debt; a *public debt crisis* prohibiting or endangering the access of over-indebted countries to capital markets; a *private debt crisis* putting additional strains on the banking sector in many Member States; a *competitiveness crisis* illustrated by current account deficits in Europe's periphery at the outset of the crisis and by a limited ability to adapt individual European economies to the challenges of a more competitive global environment; a *growth and investment crisis* involving structurally low levels of GDP growth and a lack of public and private investment and the negative effects of a persistent credit crunch; an *institutional crisis* characterised by the rising significance of national governments in EU policy-making, while responsibilities

have been shifted to the Union without a parallel delegation of actual powers and resources to Brussels; a *social crisis* caused by deep, long-lasting recessions and very high levels of structural long-term unemployment in a number of Member States and by more fundamental and unresolved demographic challenges, with ageing societies and shrinking populations across the EU; and last but not least, a *political crisis* characterised by high levels of volatility and instability and the rise of populist, anti-establishment, anti-EU/euro, and anti-immigration parties and movements.

In this unprecedented situation, there was no textbook that European and national decision-makers could turn to for advice and guidance on how to react to these complex and interwoven crises. Responses have been often slow, insufficient and sometimes ill-advised, and the results sometimes meagre and disappointing.

At the same time, many things that seemed impossible some years earlier have happened since the outbreak of the crisis, including huge bailout programmes, two multi-hundred billion euro rescue mechanisms (EFSF; ESM), unprecedented fiscal consolidation efforts in deficit countries, a strengthening of EMU governance, the signing of an intergovernmental fiscal treaty, unprecedented action by the European Central Bank (ECB) to support sovereign debt markets and provide liquidity lifelines to banking systems; and the creation of a (limited) banking union with a Single Supervisory Mechanism (SSM) and a Single Resolution Mechanism.

But despite all these efforts, the EU and its members struggled for a long time to get ahead of the curve and persuade the markets and citizens that they were capable of meeting the multifaceted challenges posed by the crisis. At times, it seemed that the 'crisis snowball' might spiral out of control and trigger an avalanche with the potential to bury the euro or even the European project underneath it.

Today, the situation still remains volatile, but fears of the worst-case scenario becoming reality have receded for two main reasons: the ECB's promise to do 'whatever it takes' to guarantee the euro's stability and the significantly lower risk of country leaving the common currency. This has boosted confidence and significantly reduced the danger of a euro meltdown.

Although the situation has improved in systemic terms, this is not reflected in the day-to-day reality in many Member States. The crisis is by no means over and there is no room for complacency neither at European nor at national level, given the continuing fragility of the economic, fiscal, social, and political situation: economic growth remains elusive and (youth) unemployment (exceptionally) high; the European banking system and financial markets are still highly fragmented; in a number of countries government debt levels remain exceptionally high; the social and political situation in many Member States is tense and the rise of populist forces on both the left and right of the political spectrum has raised concerns about the state of democracy in Europe.

All this is happening while the world and the neighbourhood around us is in the midst of major transformations, and the EU and its members are under pressure to respond to fundamental changes 'out there'. History is very much in the making as proven by

developments such as the continuous rise of China but also more tragically, by the turmoil in the Middle East or the war in Ukraine and the stand-off with Russia.

It is impossible to predict what the future global order will look like. Despite different patterns of relative rise or decline, all major international players expose a considerable degree of domestic fragility. On balance we are witnessing a shift towards a less 'Western world'. The ability of the 'West' to influence international affairs is being put to test as its societies grow older and its share of world population and economic might is expected to further shrink. Under these conditions, Europeans have to face the challenges related to increasing global economic competition by individually and collectively preparing themselves for the transition of Europe's economy.

In the new global landscape, Europe is no longer a centre of gravity in international political and economic affairs, as global developments are increasingly shaped in other parts of the world while the 'old continent' is mainly preoccupied with itself. As a consequence, there are severe doubts as to whether the EU and its members will be able to manage the process of growing global interdependencies and connectivity. Globalisation is and will continue to be the most significant factor shaping international politics and Europeans find themselves once again at a crossroads while things could move in two very opposite directions: Europe could either face creeping decline, gradual marginalisation and in the worst case even global irrelevance or co-determine the future rules of global governance. While the distribution of power detracts from Europe's clout on the global stage, the EU remains a pivotal international actor whose combined economic, financial and political resources can make a positive difference to international cooperation, if mobilised for the pursuit of clearly defined goals. Whether Europe will be willing and able to act strategically to advance its values and interests in a changing world remains unclear and will very much depend on developments at home.

Three key challenges – fragmentation, stagnation, legitimacy

Given the current state of the Union and the changing external environment, it is still not clear whether the 'iron law' of European integration history will prove itself again; i.e. whether the EU will, once again, emerge stronger and more mature form the crisis, as it has in the past. But one thing seems rather certain: if Europeans want to exploit their combined potential, they have to collectively and individually address three interlinked key challenges: stagnation, fragmentation and legitimacy.

1. Stagnation

The first key challenge the EU and its members will face in the years to come is economic and institutional-political stagnation. Europe's feeble recovery seems to have ground to a halt and the EU is close to entering its third recession since the 'great crisis' started in 2008. Continuous economic stagnation would lead inevitably to growing pressures on the middle classes and to widespread perceptions of increasing social injustice both within and between Member States. After years of low growth or even recession, the main challenge facing European leaders in the coming five years will be to return the troubled European economies

to sustainable growth and to increase employment rates, productivity, competitiveness, and the overall level of prosperity in Europe.

However, the Union is not 'only' facing economic stagnation but also the danger of institutional-political stagnation. Collective efforts to overcome the Union's remaining structural shortfalls have lost momentum since late 2012, with the decreasing threat of a euro meltdown limiting governments' readiness to take bold(er) decisions. To be clear, the EU is still advancing, as shown by the recent agreement on the next leg of the banking union, the Single Resolution Mechanism. But there is a loss of ambition and growing complacency as reform fatigue has spread. 'Consolidation' has become the order of the day as immediate crisis threats and markets pressures have receded; 'doing less, but doing it better' at European level has become the predominant mantra in Brussels and in most national capitals. The question is whether this will suffice in the years to come.

2. Fragmentation

The second key challenge the EU and its members will face is that of fragmentation – in its different shapes: fragmentation between the EU and its citizens due to an increased uncertainty about the future added value of European integration and a growing feeling among citizens that they are directly affected by decisions taken in 'Brussels' which they cannot effectively influence; economic fragmentation between Member States due to a lack of competitiveness of certain EU economies and the lack of mechanisms between weaker and stronger countries to cushion economic and social shocks that hit some harder than others; political fragmentation characterised by a higher level of distrust between Member States and even national societies due a (re-)surfacing of national stereotypes, nationalism, chauvinism and resentments, and an ever-louder, over-simplistic and harmful blame game between Member States because of differing interpretations of the root causes, nature and complexity of the crisis, disagreements over the 'crisis recipe' as well as conflicting visions regarding the overall future of European integration; and, last but not least, social fragmentation within individual EU countries due to an increasing divide between the 'haves' and 'have-less' leading to widespread perceptions of social injustice resulting in indignation, despair, and anger.

The different sources and dimensions of fragmentation threaten to undermine the ability of the Union to develop, adopt and implement adequate policy solutions, which no country – irrespective of its size – can cope with alone. As a consequence, the EU and its members run the risk of struggling to meet citizen's expectations in terms of delivery, which in return undermines the Union's legitimacy.

3. Legitimacy

Finally, the EU is challenged by a loss of legitimacy of the European project in the eyes of citizens for a number of reasons. In more fundamental terms, the EU and its members are struggling with an increased loss of trust in traditional political elites and their ability to master the complex challenges of today's world. Although the resulting challenge to traditional

models of political representation is a wider phenomenon, it has particularly drastic consequences for the EU, which is still perceived as an elitist project and thus is brought into question more quickly and fundamentally than traditional political entities. This effect is fostered by the circumstance that national politicians often blame 'Brussels' for some of their own failings ('scapegoating') and are reluctant to give the Union credit for its successes.

The loss of trust in traditional parties also leads to a more dispersed political scene, with new movements and parties entering the political sphere, which has the potential to undermine the ability of the EU and its members to deliver adequate policy results ('output legitimacy'). The success of 'anti-forces' – anti-EU, anti-euro, anti-migration, anti-establishment – demonstrated most visibly in the 2014 European Parliament elections, is putting mainstream parties under severe pressure, which risks further complicating the search for compromises between Member States. At the same time, the success of 'anti-forces' on both the left and right side of the political spectrum increases the pressure on 'pro-EU forces' in the Member States and in the European Parliament to form coalitions and find adequate policy responses.

Finally, there is a widespread notion that the Union has in recent years become more inter-governmental and dominated by the views and interests of particular Member States, which undermines the legitimacy of EU decision-making. The Union's governance structures are not being perceived as being able to balance national interests so that all EU countries feel they profit from decisions taken in Brussels/Strasbourg. Since the Lisbon Treaty entered into force and over the course of the crisis, the powers and political weight of the heads of state and government have increased at the expense of the European Commission and European Parliament. This has boosted inter-governmentalism in the EU, at times undermining or even circumventing the traditional 'community method' through the introduction of a number of inter-governmental treaties/agreements outside the EU treaty framework. Today's Union is also characterised by what might be called 'unbalanced inter-governmentalism': a new balance of power between Member States, with Germany playing a much more dominant role than in the past.

Addressing internal and external challenges – a summary of contributions

So, what can and should the EU and its members do to effectively address the challenges of stagnation, fragmentation and legitimacy? What are the possible solutions that should be pursued to put the continent in the best possible position not only to confront the many risks and uncertainties it faces, but also to exploit and make the best use of all of Europe's potential? In the present volume a number of distinguished authors address key issues and challenges and identify recommendations on how to address them in the years to come.

In the first article of this volume, ***Herman Van Rompuy*** argues that in a time of sweeping worldwide changes, Europe risks losing the competition race. He argues that the EU needs to focus on innovation, to turn ideas into real business and to develop digital technologies by addressing the problems regarding intellectual property, copyrights, market fragmentation, consumer protection, investment in infrastructure, venture capital for start-ups, and digital skills. Europe also needs to focus not only on reducing production costs,

though that should be done for example regarding energy costs, but also on focusing on quality in all its shapes and guises: novelty, reliability, image, design, experience, durability.

Writing about the growth challenge for Europe and the EMU, ***George Pagoulatos*** contends that in the short term what is needed is a policy mix that first assists fiscal consolidation, economic adjustment and productivity-enhancing structural reforms in the economically weaker countries and that second, provides for an urgent countercyclical stimulus funded for example by the European Investment Bank (EIB) and assisted by the EU budget and the ECB. This would help to close the investment gap in the euro zone and to restore growth prospects. Pagoulatos argues that it would also be essential to install a fully-fledged banking union to enhance credit conditions. In the long term, he calls for the enactment of the recommendations outlined in the four Presidents report "Towards a Genuine Economic and Monetary Union" and the Commission's "Blueprint for a Deep and Genuine Economic and Monetary Union". He also calls for more steps being done toward a better growth strategy including the completion of the single market in services, the enhancement of energy efficiency and autonomy (via an energy union), the strengthening of EU industrial policy, and better public finances.

Writing about euro governance, ***Daniela Schwarzer*** affirms that the main challenge for the EU will be to return the troubled European economies to sustainable private sector-led growth and to fight unemployment. She also addresses the multiple lines of fragmentation the EU is faced with, between the euro area and non-euro area Member States, the one inside the monetary union between the North and the South, the fragmentation within societies, and also the fragmentation of financial markets. A final challenge identified concerns the reduced input and output legitimacy, with countries facing narrower policy options in times of crisis, which in turn has given rise to eurosceptics. Schwarzer argues that a robust economic recovery is necessary to help Europe tackle all these challenges and to help reduce the sovereign debt burden. Any promising path to economic recovery will have to combine measures that ensure accessible and cheap credit, structural reforms that release growth potential both in deficit and surplus countries, investment in education and mobility, and finally a better macroeconomic policy mix. In the long run, the author argues, it is unlikely that economic prosperity can be achieved without improving the decision-making mechanisms of the euro area.

László Andor maintains that restoring the capacity to achieve balanced growth and socio-economic convergence in Europe is a key condition for the EU to overcome the crisis and to regain output legitimacy. To achieve this, a predictable and rules-based mechanism of countercyclical fiscal transfers would be needed in the context of which EMU countries would share part of the costs of a short-term unemployment insurance (either via a basic European unemployment insurance scheme or through the reinsurance of national unemployment insurance schemes). Through such a scheme, it should be possible to create a European safety net for the welfare safety nets of individual Member States and to prevent short-term crises from unleashing longer-lasting divergence within the monetary union.

Pawel Swieboda argues that the post-crisis solidarity and cohesion agenda in the EU must focus on restarting the convergence process. The basic objective will be to restore the level-

playing field in the Union by completing the EMU with a robust fiscal pillar and elements of a "transfer union". On the one side, increasing investment to raise aggregate demand is the most pressing task. The other side of the bargain has to do with improving macroeconomic performance, increasing competitiveness and completing structural reforms in the vulnerable countries, for example through labour market reforms, improvements of the institutional and financial infrastructure or the sophistication of business models, altogether combining the objectives of fiscal consolidation with those of growth and equity.

In his article about the Single Market and Competitiveness, ***Malcolm Harbour*** calls on the new European Commission to pursue even more effective implementation and "better regulation" rather than new initiatives. He argues that President Juncker's team should tackle the continued problem of ineffective application and weak enforcement of key single market measures by Member States, introducing a "fast track" method for compliance monitoring. He also calls for improvements regarding the digital single market, the Services Directive, full implementation of the Consumer Rights Directive, a mutual evaluation and full appraisal of the Mutual Recognition Directive, and a consistent implementation of the Public Procurement rules agreed in 2014.

Jo Leinen argues in his article on the climate challenge that the EU needs to change the way it manages the energy resources it imports and reduce energy consumption. He calls for a rethink of business models and a move towards a circular economy where resources are reused and recycled. He proposes measures which could include a "product passport" which lists product materials and their origins, a mix of 'push and pull' measures to introduce legislative benchmark standards and to provide investment perspectives for the business sector, recyclable product designs, investment in technology and innovation, and better consumer information. He also argues that to mitigate climate change, renewable energies need to be expanded, energy efficiency and security needs to be ensured, and grid and storage capacities need to be enhanced.

Rosa Balfour, while mentioning that the European Union falls short of expectations to become a fully-fledged global actor, presents two options for EU foreign policy: a 'do less but better' option and a more ambitious one, of international engagement as a means for EU renewal. She holds that the next EU leadership will have to address energetically and with foresight relations with the EU's neighbours (including Russia and Turkey). This will require consolidating the EU's crisis management structures, dealing with energy matters (internally and externally), and will impose some long overdue thinking on European defence, both in terms of its industry and its existential purpose. Rosa Balfour argues that EU Member States cannot afford not to cooperate more closely on foreign policy, notwithstanding their lack of an appetite to do so. The choice is between levels of ambition. Feeding into that ambition a compelling narrative about a new form of international multilevel engagement, while also resting on the roots of peace-building, could become a source of renewal for Europe as a whole.

Cecilia Malmström calls for addressing migration with appropriate care, a key element of this being the respect for the rights of workers. While flexible labour migration policies which allow European economies to address real shortages are essential, they should not be used

to instigate unfair wage competition. A sustainable EU migration policy should also enable integration and labour market participation of all migrants. She argues that the EU needs to face the fact that people will not stop seeking refuge in Europe and should be adequately prepared. Measures include search and rescue at sea, enhanced cooperation with third countries, fight against migrant smuggling networks, and emergency support for the countries facing greater pressures. The EU should also consider the possible use of humanitarian visas and continue to engage with countries of origin and transit.

In his article on the freedom of movement of persons, ***Radoslaw Sikorski*** tackles some of the myths regarding the free movement of workers inside the EU, arguing that is has a limited scope (only 3% of EU citizens) and is an integral part of the single market that spurs economic growth and brings huge benefits to the EU economy. He argues that the possibility of finding employment is the main reason for why people move, not the misuse of social benefits. Sikorski calls for the elimination to abuses of the social welfare system but not by excluding migrants. The article defends the idea that the economic challenges which Europe faces can only be addressed by collective responses on the basis of the freedom of movement, which should actually be strengthened, not weakened. The freedom of movement is essential for the EU to be able to retain (or even strengthen) its global competitiveness.

Maria João Rodrigues deals with the issue of leadership at the EU level and argues that Europe is in need of new leadership to recreate a stronger European unity. She emphasises the gains in democratic legitimacy brought by the new procedure to elect the President of the European Commission and also stresses that candidates for the Commission should be evaluated in the national context in terms of their ability to address challenges at the EU level and their adaptive qualities regarding top Commission priorities. The process should also transcend the national level and involve more European selection input, including the Presidents of the Commission, the European Council and the Parliament. Member States should carefully consider their Commission candidates and assess their merits on the basis of proven competences and political outcomes.

Writing about populism in the EU, ***Heather Grabbe*** asserts that populist parties are thriving, partially due to deep concerns such as economic pain, disillusionment with politics, scepticism toward the representative value of European democracy and insecurities regarding national identities and the durability of European social contracts. She stresses that the increased political power of these parties could change the balance of power between EU institutions, lead to negative spill-over effects into national politics and endanger the EU infrastructure of rights and rule of law. Grabbe calls on European leaders to limit racism in the public debate; connect national and European politics to increase tolerance; and bring more voices into the debates and increase transparency at EU level. Furthermore, instead of forming a grand coalition to protect the *status quo*, mainstream parties should become more active and reform the EU by making progress on issues such as fundamental rights and services liberalisation, while fuelling public debates about the future of Europe and communicating better through social media.

In his article on differentiated Europe, ***Alexander Stubb*** stresses that differentiation is a tool for effectively enlarging and deepening the Union. He analyses the topic in terms of the three

meta-challenges identified. Stagnation is seen as a catalyst for differentiation as differentiated Europe can be a solution to political and economic stagnation. The author argues that the difference between differentiation and a second meta-challenge, fragmentation, is a thin line that is best guarded by strong common institutions. In terms of input legitimacy, Stubb sees the strengthened role of the Commission as providing a fair degree of accountability, whereas working outside the EU Treaties poses a challenge to legitimacy. In terms of output legitimacy, differentiated Europe tends to perform well because it typically is a solution to policy problems where joint progress is not an option. The fact that treaty change is not an option for the time being will mean that differentiated Europe can be a useful instrument in deepening integration. However, he argues, we also need to recognise that there are no-go areas for differentiation, namely those areas where the essence of European value added lies and where effects are much stronger when the whole Union participates.

Fabian Zuleeg maintains that in what concerns EU decision-making four key challenges need to be addressed: crisis management (which requires more flexibility and speedy but accountable decisions); cohesive and comprehensive responses to systemic challenges (rather than a 'silo approach'); as well as increasing politicisation and fragmentation of decision-making. Referring to the structure of the Commission, the author notes that the lack of a clear cluster structure in the new Juncker Commission will require a clear definition of responsibilities. Regarding the governance challenge posed by the politicisation of the Commission, the author proposes outsourcing some of the functions by establishing independent bodies. He also argues that the EU level needs to gain more executive powers, accompanied by accountability mechanisms. Referring to the challenge coming from the limitations of the EU rules-based system, he calls for instruments that can be employed quickly and to ensure Member State compliance. Another challenge is that of the impeded possibility of further pooling sovereignty, which could be tackled by giving more executive powers at EU level and increasing the politicisation of the system.

In a final article, ***Janis A. Emmanouilidis*** argues that the Union and its members are still facing the aftershocks and collateral damage of the 'euro crisis' and identifies one structural challenge the EU and its members will have to confront in the new political cycle: the danger of fragmentation – between the EU and its citizens, between Member States, between states and national societies, which takes various forms (economic, social, political, geopolitical etc.). These fragmentations have exposed severe cracks in the 'old bargain' between Member States and between the EU and its citizens, which makes it difficult to convey a convincing future-oriented 'narrative' about the future of Europe. Simply consolidating past achievements will not suffice. If EU institutions and Member States want to turn the tide, they will have to go beyond a lowest common denominator approach. Emmanouilidis stresses that a new 'win-win' situation needs to be created or, in other words, there is need for a 'New Pact for Europe' between Member States and between the EU and its citizens. Such a New Pact could be based on three main pillars: an 'Enabling Union' which should foster sustainable growth and job creation by stimulating investment and enhancing Europe's competitiveness; a 'Supportive Union' which should enhance the EU's 'caring dimension'; and a 'Participatory Union' which should strengthen the ties between the EU and its citizens. Furthermore, he proposes a new 'grand project' around an Energy Union,

to provide new momentum for European integration and calls for a reflection process regarding the concrete measures to be taken, with the aim of reforming the EU Treaties in the next decade.

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Endnote

1 This chapter draws from the first report of the *New Pact for Europe* project: *Strategic Options for Europe's Future,* Brussels, 2013, Available at www.newpactforeurope.eu/documents/1st_report_new_pact_for_europe.pdf