What Future for the European Union?
An Economic Debate and Perspective

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Vorwort

Viele der aktuellen Diskussionen zur Osterweiterung, zum Schengen-Abkommen, zur Aufnahme weiterer Mitglieder in die jetzt 27 Länder umfassende Europäische Union, und vor allem zum Verfassungsvertrag, sind die Fragen der wirtschaftlichen Entwicklung in letzter Zeit eher in den Hintergrund getreten. Der Gemeinsame Markt, die Gemeinsame Währung, das sind inzwischen Selbstverständlichkeiten, die meist nur unter konjunkturellen Gesichtspunkten diskutiert werden. Dabei ist die wirtschaftliche Integration eine beachtliche Erfolgsgeschichte, die maßgeblich die politische Integration gefördert hat.

Bei jedem komplexen System ist es verführerisch, einzelne Komponenten zu analysieren und deren Interdependenz darüber zu vernachlässigen. Die Aufgabe der Europäischen Integration findet im sozialen und politischen, im mentalen und auch im individuellen Bereich statt und ist zudem von unterschiedlichen nationalen Kulturen und Perpektiven geprägt. Im wirtschaftlichen und sozialen Bereich steht die EU nach der Osterweiterung vor der Aufgabe, sehr unterschiedlichen Wirtschaftsräumen zu integrieren und gleichzeitig den wieteren Integrationsprozess fortzuführen. Nicht immer gelingt dies und eine gewisse Europamüdigkeit ist festellbar.

Wolfgang Quaisser und Manfred Wegner sind den komplexen Bezügen auf den Grund gegangen und versuchen in diesem Bändchen auf leicht verständliche Weise diffizile Zusammenhänge aufzuzeigen.

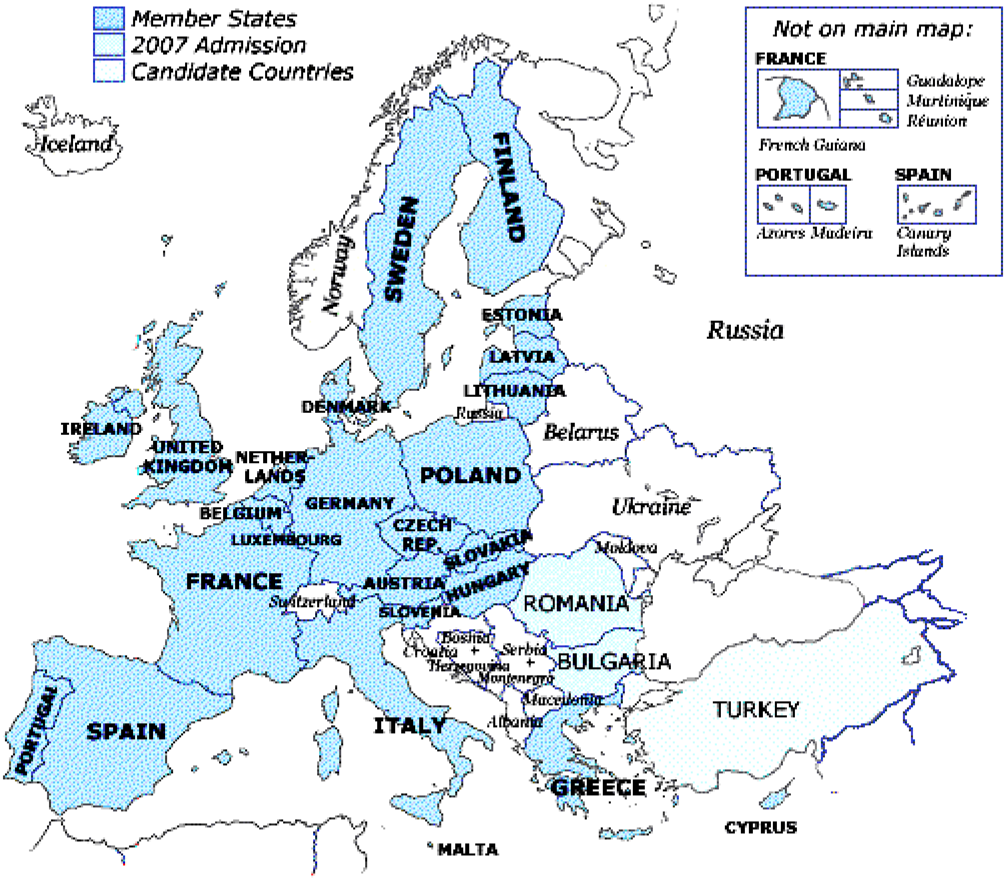
In Ergänzung zu den letzten forost-Heften, in denen der Begriff der "Europäisierung" beleuchtet, euroskeptische Überlegungen aufgezeigt wurden, und immer wieder die Problematik der Integration analysiert wurde, finden Sie im vorliegenden Band eine vergleichende Zusammenschau der Erfolgsstory Europa, der Gefahren und Krisen, die im Detail verborgen liegen und schließlich eine Aufforderung zum Handeln, um Erreichtes in dieser EU zu konsolidieren und die gegenwärtigen Aufgaben einer Lösung zuzuführen.

München, im Februar 2008
Helga Schubert

Inhalt:

The European Union

(Bulgaria and Romania acceded in 2007;
Western Balkan Countries and Turkey are Candidate Countries or Potential Candidate Countries)



1. Europe in Crisis

The integration of Europe is an unusual success story. It achieved the goal of securing peace and stability after a long succession of devastating wars; it overcame the disastrous schism between Eastern and Western Europe and made possible remarkable improvements in living standards. Still, since the surprising rejection of the Draft European Constitutional Treaty by the electorate in two of the EU's founding countries, France and the Netherlands, in the spring of 2005, a feeling of disorientation and despondency about the future of Europe has spread among Europeans. The enlargement of the EU by twelve new members has generated the fear that there will be no further progress towards an "ever closer Europe".

However, the most recent agreement at the European summit in June 2007 gives grounds for hope that the long crisis will soon be over and that some institutional reforms will be possible in the near future. The conference in Lisbon on October 18-19, 2007 approved the new Reform Treaty. Although this has been an unexpected success, especially for the German presidency, the sceptical views in some member states and of large parts of the public cannot be ignored. The new Reform Treaty has to be ratified by all 27 member states before the end of 2009, in time for the next elections of the European Parliament. An overall approval of the new EU treaty would be a small miracle. But a failure will throw the Union into a fundamental crisis.

To some, Europe seems exhausted, suffering from overcharge and overextension. There are Eurosceptics who see the EU on the brink of decline. At best, they believe, Europe as an entity may survive only as a kind of loose European Commonwealth (Timothy Garton Ash 2005). But there is some evidence that the process of European integration is actually suffering from its very success. The crux of the matter is that politicians have refused to draw the institutional conclusions from an integration that has come a remarkably long way since its beginnings. This policy failure can be identified in the fact that the deepening and geographical widening of the EU has weakened the capacity of decision-making, as well as delayed structural policy reforms.

Because "Brussels" and its bureaucracy often are used as a scapegoat for mistakes and failures committed by national governments, the idea of a unified Europe has suffered. To this day the European Union has failed to overcome its institutional weaknesses, its democratic deficits and its distance from its citizens. The heads of the EU states have not confronted the challenges of deepening and widening in time. Although the Reform Treaty might change the situation for the better, it remains an open question whether the treaty will be sufficient to solve the fundamental difficulties of the enlarged Union in a global world.

The paradox of the current deep discomfort is that the EU can look back on unusual achievements since the mid 1990s, starting with the implementation of the Single European Market (1993) and continuing with European Monetary Union (1999) and finally with eastern and southeastern enlargement (2004 and 2007). Apparently, the attraction of the EU has not been weakened, given the recent accession of Romania and Bulgaria and the new candidates (Croatia, Turkey and others) waiting at Brussels's door. In fact different integration zones emerged (see figure 1) and it is likely that the EU will differentiate further. With its 27 members, the EU today represents some 490 million people, contributes about 21 percent of the world's output and - with its more than 20-percent share - sees itself as the largest trading power in the world. The EU may appear to be an economic giant, but it plays only a secondary role in the fields of international politics and institutions.

The freezing of the process of integration at its current level is neither judicious nor is it wanted by the majority of EU citizens (see the Bertelsmann poll 2006). But the dangers of a gradual erosion of the current state of integration cannot be ignored. Only a united Europe can confront the challenges of globalization and economic modernization and achieve its role as a global player. What can be done both to protect the EU from falling apart and to usher in a new dynamic of integration? What kind of Europe do member states, and constituents of an enlarged union, want?

2. Single European Market: An Uncompleted Pillar

Since the Treaties of Rome (1958), the creation of a single European market without borders has been both the cornerstone and the driving force of integration. The initial goal - to create a common market for goods, services and production factors - was bogged down by the economic crises of the 1970s. With the expansion of the Treaties of Rome through the Single European Act (1987), it became possible to restart the internal-market project. The success of this sweeping liberalization effort was made possible by two innovations: the introduction of qualified majority decisions in the Council and the application of the basic principle of mutual recognition, based on minimum harmonization of rules, standards and norms.

With the internal-market initiative, the removal of all barriers to the free exchange of goods, services, capital and labour, the member states intended to reduce costs and strengthen European-wide competitiveness and productivity. Through strong gains in efficiency and welfare, Europe was to become an economic power that could measure itself against the USA and the new competitors in Asia. Since the mid-1980s, the internal-market initiative has launched an astonishing integration dynamic. Broad areas of previously insulated commodity markets have been exposed to competition; external trade has picked up and intra-industrial specialization intensified. The economic benefits of a large single market are enormous.[1]

However, the European single market is by no means complete. Instead of further strengthening this central pillar of the EU, numerous member states are actually attempting to undermine its functioning and to hinder transborder mergers and acquisitions (according to former EU Commission member Mario Monti, 2006). Another alarming sign is the increased number of treaty violations. Also unsatisfactory is the progress in the public procurement markets, where

[1] The EU Commission estimated the cumulative welfare 'gains' of the enlarged internal market over the period 1992-2006 at 223 billion euros. The single European market increased the gross domestic product of the 25 EU countries by a total of 2.2 percentage points and created about 2.75 million new jobs (Ilzkovitz and others, tables 3-7).

there exist numerous national restrictions and a lack of transparency. In addition, the removal of barriers in other areas has proceeded much more slowly than expected. The "network industries" - transportation, energy and communication - are still subject to restrictive regulations and barriers, while the guidelines for liberalization of the gas and electricity markets have not been fully implemented. State aids and guarantees continue to deform transnational competition.

The aid controls and competition policies of the European Commission increasingly run up against resistance. Both are among the EU's important areas of common responsibility, without which a single European market cannot function. Lately, so-called "national" interests dominate in many areas. However, an extensive purging (de-bureaucratization) of single-market regulations, which actually should have been carried out before the Eastern enlargement, still remains to be done.

Increased efforts are necessary in order to exploit the growth- and employment potentials of a true internal European market.[2] The greatest problems can be found in the realm of business services as well as in the dismantling of barriers to the mobility of workers and professionals. The Services Directive initially proposed by the Commission has been reworked and watered down because of objections by member countries and the European Parliament (fear of wage- and social dumping). The directive was intended to eliminate existing obstacles and regulations both to service providers' freedom of movement within the EU and to the free exchange of services among member countries. There is the risk that the numerous derogations will achieve only an insufficient opening of the services markets, thus limiting the potential trade in services.

The services sector in the EU makes up about 70 percent of the gross domestic product. But in most EU countries services are expensive, and possible production increases remain unrealized because of shielding from the outside market. Productivity increases and job creation within the euro region are noticeably lower than in the USA (and the United Kingdom and Sweden). A true liberalization of the European services market would induce appreciable improvements in efficiency and employment.[3] There is no doubt that the welfare gains of the single European market are considerable. But the increased competitive pressure of a large single market also requires painful adjustments, which - just like the gains - are unequally distributed among the member countries and regions. From the outset it was evident that the accelerated adjustment process would necessitate accompanying economic-policy measures, in particular swifter domestic reforms. A functioning single market and monetary union require greater flexibility in both labour markets and wage-setting systems. While smaller member states such as Finland, Sweden and Denmark have undertaken courageous reforms in their labour markets and welfare systems, the larger member countries have been reluctant to start these inevitable reforms.

The new member states made great efforts to adapt European policies and the shared body of legislation (*acquis communautaire*). They achieved astonishing, though varied, successes. However, in its 2005 progress report, the EBRD/Eastern Europe Bank (2005) noted a significant reduction in many

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[2] Ilzkovitz, Dierx, Kovacs, Sousa (2007), European Economy, European Paper No. 271, Brussels.

[3] For a survey of the debate and the welfare effects, see Vogt (2005).

southern European countries' readiness for reform. The backlogs in the adoption of the extensive EU regulations are still considerable. The lowest deficits are exhibited by Lithuania, Poland and Slovenia (European Economy, Convergence report 2004a). Necessary adjustment measures, which should have improved the long-term functioning of the market economy and the competitiveness of the business sector in these countries, were often postponed. Since accession, progress has been achieved to varying degrees, but the latest Transition Report (2007) also mentions deficits in some countries and a slow pace of reforms. The full compliance with the *acquis communautaire* has not been reached by many countries. This is reflected by several infringement proceedings launched by the EU Commission at the Court of Justice of the EC.[4] The increased competition within the large single market would presumably raise both the pressure for social adjustment and the unemployment in some accession states and as a result would also strengthen protectionist and defensive attitudes.

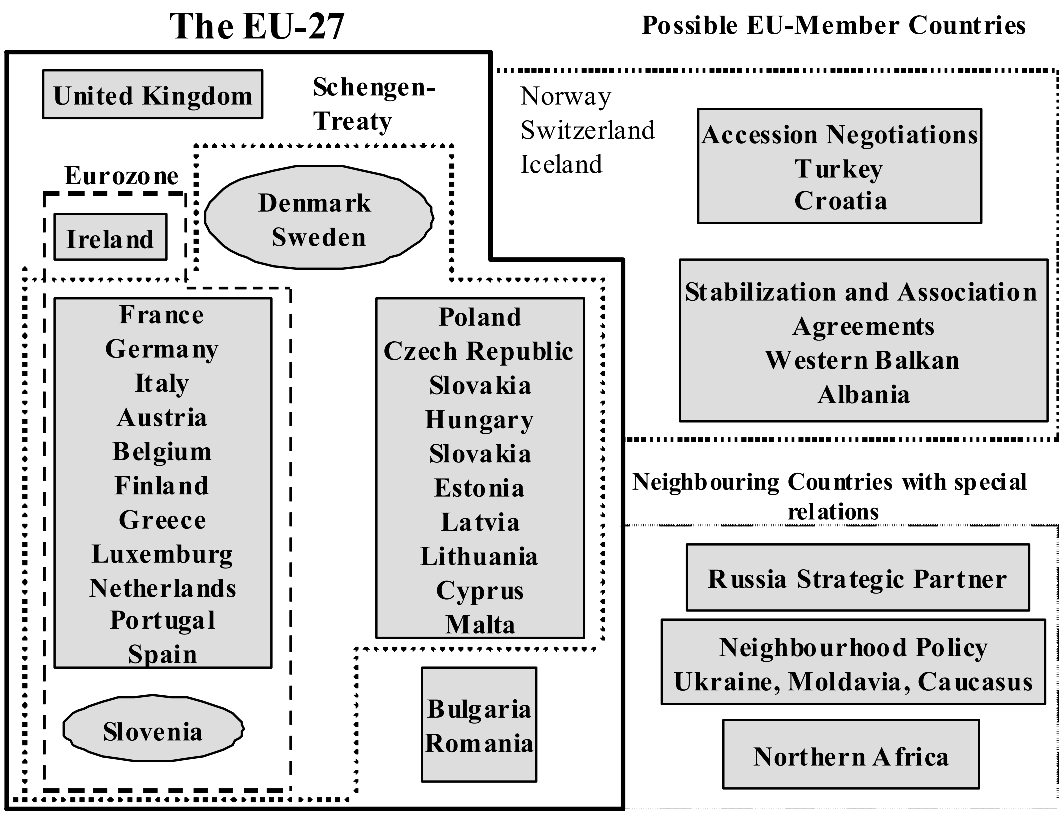


FIGURE 1 Different integration zones of the extended EU and its neighbouring countries

[4] Borissa, Lora (2007), Enforcement Actions under EU Law: The New Member States, European Institute for Public Administration, Working Paper 2007/W/01.

3. European Monetary Union: A Surprising Success

The creation of the European Monetary Union (1999) proved to be a huge step forward in the integration process, whose effects go far beyond the shifting of important national sovereign rights to the European level. The EMU's establishment was propelled both by propitious political circumstances and by the removal of barriers in the capital markets. The EMU embodies two innovations: On the one hand, there is the independence of the European Central Bank, which is responsible for the central monetary policies (though economic and fiscal policies - while also narrowed down by the stability pact and subject to a close coordination - will continue to be decided nationally). On the other hand, a differentiated integration approach is followed in the EMU, because only 13 members are currently taking part in the monetary union. The EMU is a unique experiment, which is expressed not least in the great challenge of establishing a monetary union without a political union. The hope that the monetary union would serve as a vehicle of political integration - a hope cherished above all in Germany - seems now to be buried.

The EMU has attempted to protect itself by two provisions. The first was to establish the price-stability goal (about two-percent inflation) as the main priority of the European Central Bank system. The second was to limit the dangers of diverging fiscal policies and excessive budget deficits with the Stability and Growth Pact (SGP). The latter sees to it that the national budget deficits do not exceed three percent of a country's GDP and that in the medium term the national budgets are 'close to balanced'. Deviations from the budgetary policy guidelines can be punished by financial sanctions. The SGP should prevent member countries from irresponsible debt-spending without facing the disadvantages of higher interest rates.

The institutional set-up of the European Central Bank, the exchange of national currencies for the euro as well as the first experiences of a single monetary policy have been effected astonishingly smoothly. In the previous seven years, the price-stability goal has been successfully achieved. The national rates of interest and price levels have converged rapidly, although recently the deviation of national inflation rates has again increased. Since 1999, the increase in price levels within the euro area has been a good two percent per year. However, budget discipline has suffered a loss in credibility, a development that could, among other things, threaten the long-term functioning of the EMU. After early successes in consolidating national budgets, especially during the pre-accession phases, the budget deficits of Germany, Italy, France, Greece and Portugal have sometimes risen far beyond the three-percent limit. However, the recent economic upswing in the euro zone has led to a significant reduction of the budget deficits of the above-mentioned countries between 2005 and 2007. Their deficits now lie below the three-percent line.

The fault for the overly high budget deficits lay in insufficient attempts to consolidate in advance, slow economic growth, delayed structural reforms (pension and health systems, labour markets, etc.) and finally the high costs of German reunification. It remains to be seen whether the recent reduction of budget deficits is sustainable. The stability pact has been softened noticeably, something that - given its political justification and the academic criticism of its lack of flexibility - ought not to come as a surprise.[5] Yet the reform of the stability pact has forced the EU members to concede to a stronger implementation of structural policies in pursuing monetary policy. The deficit bias of governments could better be dealt with by institutional constraints through constitutionally defined targets on a national level. The pact will remain a controversial issue, as will the question regarding the necessity, costs and efficiency of a coordinated fiscal policy within Europe.

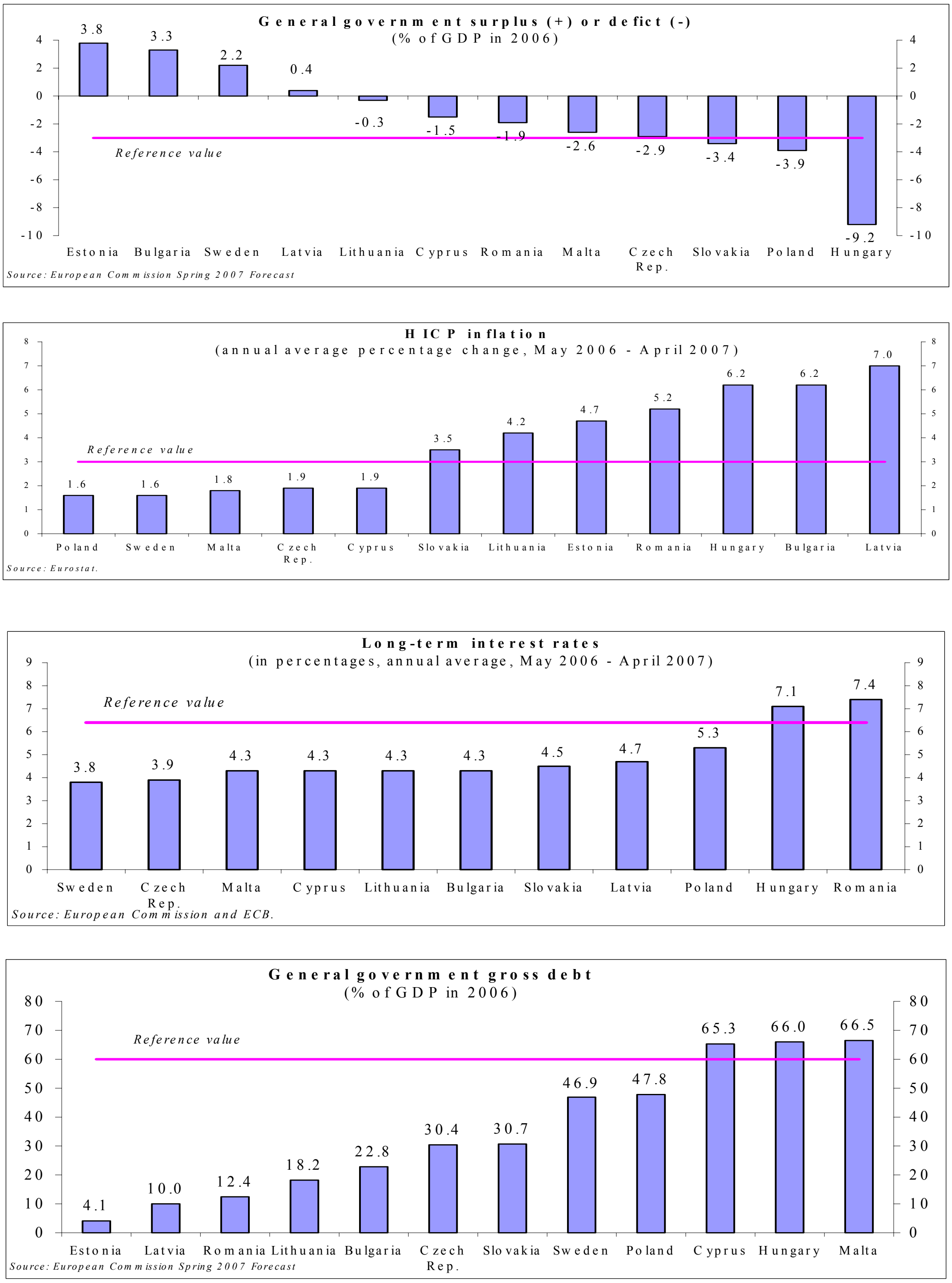
During its first seven years, European Monetary Union has proved to be a successful undertaking. The euro has become an astonishingly stable currency and has extended its role as an international currency. But the stable monetary course has not yet been able to improve Europe's growth performance. The monetary policy course was pragmatic, even if the European Central Bank resisted a less restrictive monetary policy, fearing a loss of credibility. The tight monetary policy of Europe is threatened by a comparatively loose coordination of other economic policies, because of the lack of enforcement incentives. Similarly, the alternative of discretionary actions, for example through strong binding fiscal rules (as provided for in the stability pact), has not proved to be crisis-free. The question of whether the EMU will continue to act as integration-policy glue in the long term depends on a series of circumstances and factors.

With the EMU, important monetary sovereignty was transferred from the national level to a supranational authority that executes a uniform "one-size-fits-all" monetary policy, which cannot take into account differing conditions and reactions in national economies. The member countries also lose an important economic-policy instrument: the possibility to offset different competitive conditions or shocks through exchange-rate corrections. The product and labour markets must now take over these tasks. Above all, a flexible and differentiated wage development will take on a greater role in regional and sectoral adjustments. The alternative would likely be higher and persistent unemployment and larger regional imbalances. Also here, up to now, the hope that the common monetary policy would encourage flexibility in the labour markets and lead to a convergence in important policy areas has proved deceptive. The economic-policy coordination practiced in the EU obviously has produced only marginal results. It remains an open question whether the new coordination cycle based on general broad economic-policy guidelines will have any effect on this.

Although the new accession countries have agreed to eventually introduce the euro (no "opting out"), most of them are facing considerable problems in meeting the Maastricht criteria, especially because of higher inflation rates and budget deficits. Hungary, in particular, is exposed to heavy imbalances, including rising foreign debt and budget deficits (see figure 2).

[5] Wyplosz, Charles (2006), European Monetary Union: The Dark Sides of a Major Success, in: European Policy, April 2006.

FIGURE 2: New EU Member Countries' Compliance with Maastricht Criteria



Source: European Central Bank, ECB 2007.

Nevertheless, Slovenia joined the euro network in 2007; most of the other accession countries have delayed the adoption of the euro. A premature linkage to the exchange rate and an overly restrictive budget policy would increase the internal adjustment pressure and limit the growth margins during a phase of major structural changes.

4. The Lisbon Strategy: Rhetoric or a New Policy Instrument?

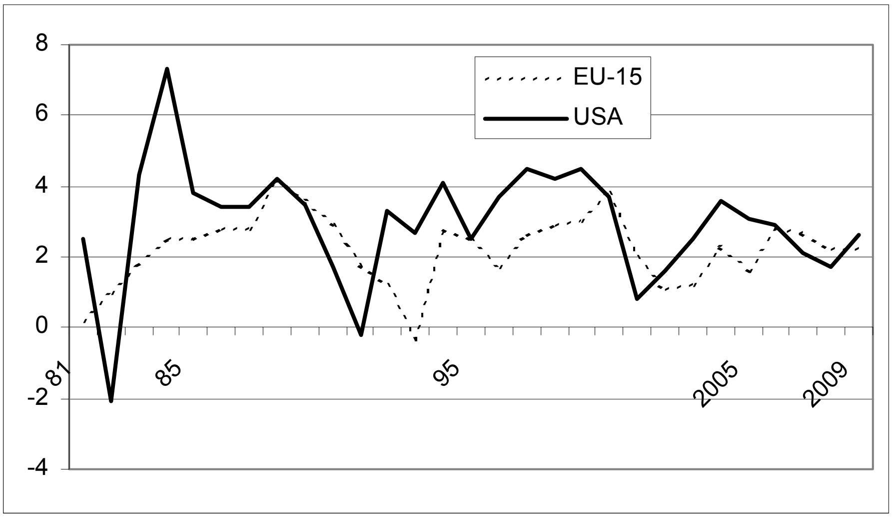
During the second half of the 1990s, Europe's growth rate fell below that of the US (see figure 3), but per capita GDP in purchasing power standards (measuring the GDP by correcting price differentials) remained rather constant. Although the new EU member countries reached significant higher growth rates during the second half of the 1990s, the real convergence process has been rather slow (figure 4). At the Lisbon Summit Meeting in 2000, the EU, responding to increased global competition and the weak growth performance compared to the USA, set the ambitious goal of transforming the EU into "the most dynamic, knowledge-based economy in the world by 2010", thus inducing higher growth, more and better jobs and greater cohesion. The Lisbon Agenda's[6] diverse goals are to be achieved with the help of a new kind of economic-policy instrument, the loose, minimally binding *method of open coordination*, which gives national governments a lot of leeway. This new instrument is based mainly on the establishment of common economic-policy guidelines, on national action plans for implementing those guidelines, on the formulation of national capacity indicators and "best-practice" comparisons, as well as on regular reports and monitoring by the Commission.

The results thus far have been disappointing (Pisany-Ferry 2005). The Kok Report of November 2004 determined two basic reasons for this: an overly broad agenda with contradictory priorities on the one hand, and insufficient implementation of reforms in the member states on the other. What is also evident, however, is that the strategy of "open coordination" offers insufficient incentives to achieve the best solutions in keeping with the "benchmarking approach". The EU thus is threatened with the likelihood of failing to achieve its stipulated goals, despite a stricter application of the Lisbon strategy. Moreover, the numerous signs of lagging behind in the old EU countries cannot be overlooked. Already as early as the mid 1990s, productivity growth in the EU remained well behind that of the USA. From 2001 to 2005, annual real GDP growth in Germany, France and Italy averaged one percent, well below the average of the other EU countries (2.3 percent) and the USA (2.6 percent). In all sectors the US performed better than the EU (Table 1), but a growth accounting analysis showed that the productivity differences could be explained mostly (to 75 percent) by the better performance of the private service sector in the US.[7]

[6] The completion of the single market and the integrated financial market, the creation of an information society and coordinated networks for R&D, the dismantling of burdensome regulations, social cohesion and sustainable development.

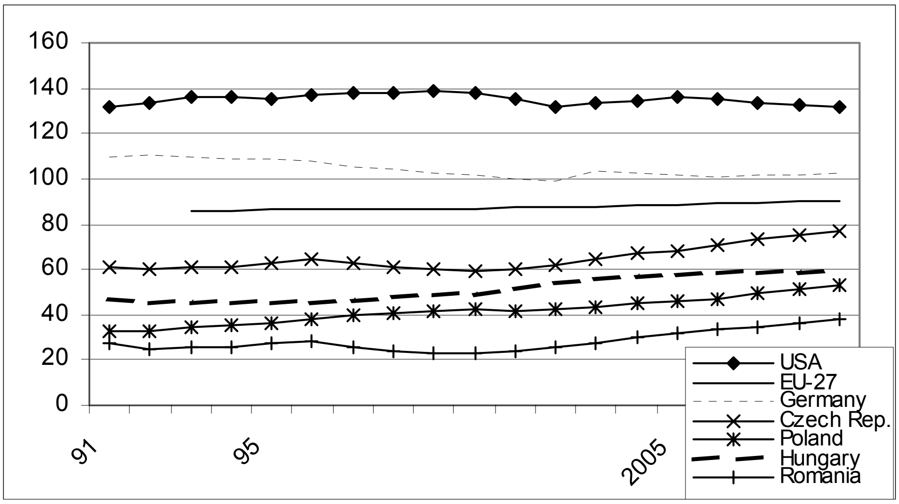
[7] European Commission (2007), DG Ecfin: The EU economy: 2007 review, Moving Europe's productivity frontier, Brussels, p. 48.

FIGURE 3: *GDP growth in the EU-15 and the US (constant prices 2000; annual percentage changes)*



Source: European Commission (2007a), DG Ecfin, European Economy, Statistical Annex, Autumn 2007, p. 49.

FIGURE 4: Per capita GDP at current market prices per head of the population in PPS: Purchasing Power Standards (EU=100)



Source: European Commission (2007a), DG Ecfin, European Economy, Statistical Annex, Autumn 2007, pp. 47-48.

Because of the failure to implement structural reforms and because of insufficient growth, among other things, unemployment in the EU-15 has risen to about eight percent. The recent cyclical recovery and employment improvements since 2006 are promising,[8] but a sustainable increase of the growth potential (currently estimated at two percent) is not yet guaranteed in face of the large financial burdens due to demographic and other problems in most EU countries.[9]

TABLE 1: GDP, labour input in hours and labour productivity per hour (annual average volume growth rates in percent) EU-10 (EU-15 minus Greece, Ireland, Luxembourg, Portugal and Sweden) and the United States

	GDP			Labour input in hours			Labour productivity in hours		
Total Industries									
	1981-95	96-2000	2001-04	1981-95	96-2000	2001-04	1981-95	96-2000	2001-04
EU10	2.0	2.6	1.4	-0.2	1.0	0,4	2.2	1.5	1.0
US	2.8	4.1	2.1	1.4	2.0	-0.4	1.3	2.1	2.6
Manufacturing									
EU10	1.5	2.0	0.3	-2.1	-0.3	-1.9	3.5	2.3	2.2
US	3.0	4.9	0.8	-0.3	0.4	-5.0	3.3	4.4	5.7
Private Services									
EU10	2.8	3.3	1.9	0.7	1.9	1.1	2.1	1.4	0.9
US	3.2	5.1	2.6	2.1	2.8	-0.4	1.2	2.2	3.0
Rest of the Economy									
EU10	1.0	1.5	1.3	-0.2	0.5	0.7	1.2	1.0	0.5
US	1.8	1.7	2.0	1.5	1.6	1.4	0.3	0.0	0.6

Source: European Commission, DG Ecfin: The EU economy, 2007 review, Moving Europe's productivity frontier, Brussels, 2007, p. 48.

Although the various indicators of competitiveness and the hard facts yield different results, they reveal that the average of EU economies performed worse than the US economy but also fell behind that of the other OECD countries. But there are considerable differences in performance among the individual EU member countries. At the top are Finland, Sweden and Denmark, while Italy and Greece remain at the bottom of the performance ranking. There are also tremendous differences among the Central European countries, which could

8 Real GDP growth of the EU-27 during 2006-2008 is expected to be around 2.9 percent per year. In addition, Germany has lost its role as growth laggard.

9 European Commission (2006), The impact of ageing on public expenditure, in: European Economy, Special Report No. 1/2006.

benefit from a successful Lisbon Strategy because an enhanced technological and educational policy would improve their growth and employment perspectives.[10]

There are many explanations for the weakness of European economies, most of them related to the failure to implement essential domestic structural reforms. The dynamics of reforms - or the absence of reforms - depends to a great extent on domestic political constellations and elections in individual countries. Competitive pressure both from within and outside the European Union has only moderate effects and increasingly tends to run up against protectionist tendencies. Up to now, it has scarcely been possible to implement an economic policy anchored to the European level or an efficient coordination of national economic policies, despite the fact that - at least within the euro zone - it is more urgent than ever.

5. Agricultural and Regional Policies: Major Needs for Reform

The central areas of European unity - the single market and monetary union - are flanked by common EU policies, especially the agricultural and structural policies, which receive the majority of the EU budget expenditure. The question as to whether the financial measures are used efficiently has always been a matter of controversy. Although a common agricultural market is among the central issues of common policy and is a part of the single market, the European agricultural policy (CAP) was aimed at supporting farmers' incomes. Yet the price supports created production incentives, which resulted in the notorious lakes of milk and mountains of cattle. In order to prevent a price explosion, one even resorted to planned-economy instruments (sugar and milk quotas), without substantially lowering the costs of agricultural policy. More than 40 percent of the EU budget still flows into the agricultural sector, although its share is declining over the financial period 2007-2013 (see Table 2).

Only very slowly is the existing system opening up. Beginning with the McSharry Reform (1992),[11] the EU gradually lowered agricultural prices. Step by step, it guided at least some of them (for example, grain prices) to world market level. Government leaders continued the trend with the Agenda 2000 (Berlin 1999). Yet the price reductions are compensated for through direct income assistance. A cost savings could therefore not be reached, especially since money was also pumped into agriculture via the "second pillar" (rural development). An important breakthrough was reached in 2003, because the income transfers were no longer strictly tied to the means of production (land and number of animals) but were paid as lump-sum operation premiums (based on an average of the previous years). In addition, the payment of premiums would be linked to the fulfilment of legally prescribed injunctions related to the protection of the environment, of animals and jobs, whereby simultaneously the entire agricultural budget would be frozen. The isolation and limiting of expenses make the agricultural policy more efficient. It is also hoped that these measures will control the costs of EU enlargement.

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[10] World Economic Forum (2007), The Global Competitiveness Report 2007-2008, Geneva.

[11] The agricultural reform started under the Irishman Ray MacSharry (EU agricultural commissioner from 1989 to 1992).

In November 2007 the European Commission presented new reform proposals anticipating the mid-term review of EU policies in 2008. The new CAP concept aims at limiting subsidies to larger farms, which are profiting the most under the existing system. Especially Germany is opposing the new proposals because it fears there will be fewer subsidies for the large eastern German farms. As compensation, the second pillar of the CAP (rural development) should be further extended.

TABLE 2: Financial framework of the EU 2007-2013 (share of expenditures related to different policy areas)

	2007	2013	2007-2013
Regional and Cohesion Policy	42.5	45.9	44.2
Agricultural and Rural Policy	45.6	40.2	43.0
Internal Affairs (Security and Justice)	1.0	1.6	1.2
External Affairs	5.1	6.3	5.7
Rest (i. e., Administration)	5.8	6.0	5.9

Source: European Commission, DG Budget, 2007.

The EU policy area's second pillar is its regional and cohesion policy. European unification may be based on the fundamental condition that it increases the prosperity of everybody and leads to economic convergence among and within the member countries. Nevertheless, empirical experiences qualify this assumption. At the national level, successful examples such as Ireland, Spain and Portugal contrast with disappointments such as Greece. Therefore, the EU supports the economic and social convergence with the help of the structural and cohesion policy. Yet the latter should not only reduce differences in income through transfer payments but should also obtain the prerequisites for a self-supporting development process in the regions. The economic argument is that certain deficits (infrastructure, education, etc.) have to be reduced or eliminated in order to allow the less-developed regions to profit from the more intense competition in the single market.

Criticism of the regional and cohesion policy has been around as long as the policy itself, and has been fed by its poor results**.** Although the EU Commission regularly points to successes[12] (European Commission 2004b), there is still less economic convergence among the EU regions than among the states. Scholarly investigations have called into question the effectiveness of regional policy.[13] Bureaucracy and centralism, incorrect allocation and political influence on

[12] European Commission, DG Regio (2004b), A New Partnership for Cohesion, Third Report on Economic and Social Cohesion, Brussels, February 2004.

[13] Boldrin, Michele and Fabio Canova (2001), Inequality and convergence in Europe's regions: reconsidering European regional policies, in: Economic Policy 32, April 2001.

methods of allotment, lack of transparency and overlapping of various programs, corruption and political bargaining: these are additional catchwords of the critical discussion. The critics' demands range from complete abandonment of the regional funds to partial changes (mainly objective-1 assistance).

The reform debate intensified with the Eastern enlargement in 2004, because the regional policy was formulated originally for countries with limited regional and income differences. With Eastern enlargement, however, the national and regional economic disparities increased dramatically. The only slightly modified regional and cohesion policy (three instead of five assistance objectives, streamlining of procedures, improved financial controls, etc.) will be insufficient to meet these new challenges.

By decreasing outlays/expenditures to the old EU member states (which, however, continue to receive considerable funds), the entire EU outlays for the next financial period (2007-2013) could be lowered by about one percent of GNP relative to their economic power, to a total of approximately 864 billion euros (in 2004 prices). They are modest compared to the national budgets, amounting to about 270 euros per person per year. The problem, however, lies more in the structure of the outlays than in their amount. Approximately 80 percent is used for the agricultural and regional policy - in other words, for policy areas whose effectiveness has been called into question (see table 2). In addition, it is questionable whether the European level should be responsible in this sphere. Other policy areas that could be more important for the continued development and the future growth potential of the Union (foreign and security policy, innovation policy, education) are also neglected in the new financial period. A wide-ranging reform of the EU budgetary system and EU policies is still on the agenda, especially if the EU wants to accept more members.

6. Rules versus Coordination and Systems Competition

In order to function properly, the EU requires institutions. In a complex, multi-level system, it must be determined which duties should be decided on a central (supranational) or a national level, as well as which rules (voting, for example) should be applied to form compromises and to define new scopes of action. Since the beginning of European unification, tensions between the "supranational" and the "intergovernmental" methods have accompanied the EU's integration path. At the centre of the integration strategy is the "Community method", based on the combined efforts of the commission's initiative monopoly (in other words, the exclusive right to initiate proposals), the decisions of the council and the monitoring function of the European Parliament. However, this innovative framework has been watered down and made less efficient by the large number of ill-defined tasks, overlapping competencies and increasing possibilities of minority blockades (in the majority decision making). With each enlargement round, the member states' blockade possibilities have increased. The ensuing advance of intergovernmental cooperation has eroded the community method, thus threatening one of the central achievements of European integration.

One main driving force of European market integration was the effort to remove all manner of economic barriers (non-discrimination). This began with trade liberalization and continued with the internal-market concept, which has been described as *one of the largest deregulation operations in history*. Originally, the harmonizing concept - the perfectionist approximation of laws - was in the forefront of attempts to bring about a convergence of basic economic conditions and policies. Very soon, however, this concept was caught in a thicket of national interests and protection requirements. The harmonizing idea finally was replaced by a new approach involving mutual recognition of norms, regulations and admission procedures, an approach that the European Court of Justice already had defined in 1979.[14] With it, the breakthrough was achieved for a competitive regulation system, encouraging a more long-term convergence of rules involved in single-market policies. Yet at the same time, the pressure of competition created by open markets and the removal of barriers (especially for capital movements) will give rise to a sharper *systems competition*.

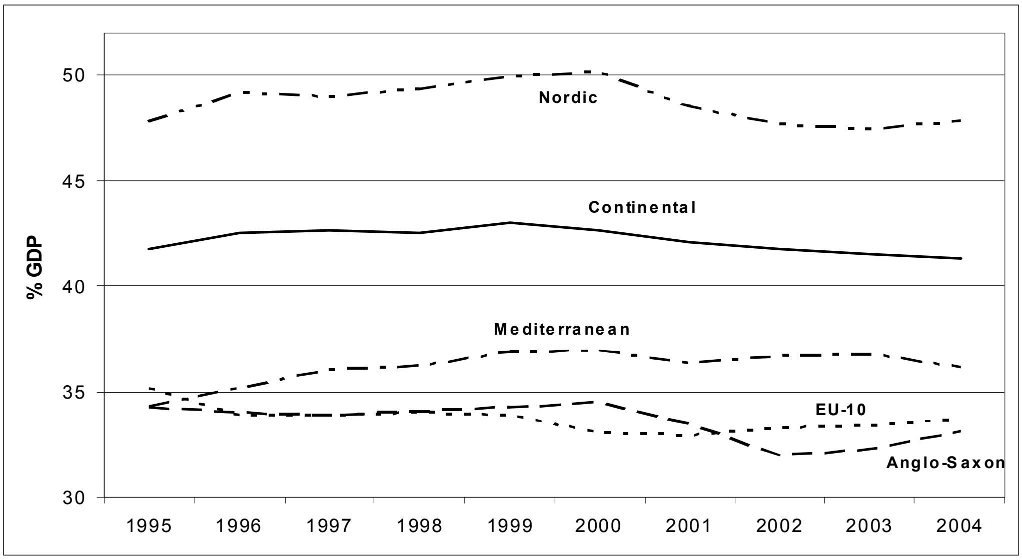
Can the systems competition, together with the principle of "subsidiarity,"[15] become a structural principle for Europe? It appears as if the system competition among the countries could replace centralizing decisions and central institutions, also eliminating some fears about the European superstate (and its regulatory addiction). Theoretical analyses[16] and early experiences in the new world of globalization indicate, however, that significant disadvantages emerge as well. It is to be feared that competitive pressures could also lead to an erosion of the social achievements, of environmental standards and of consumer protection in the welfare states. Another danger is an erosion of tax revenues, and thus of infrastructure facilities, because of the migration of capital away from high-tax countries.

14 "If a product is lawfully manufactured and marketed in one member state, it may be sold everywhere in the community" (Cassis-de-Dijon).

15 According to the subsidiarity principle (Maastricht Treaty 1993), in the areas that do not fall under its jurisdiction, the EU should only involve itself "as long as the goals of the measures under consideration cannot adequately be reached on the level of the member states ... and because of their scope or their effects can better be reached on the community level".

16 Sinn, Hans-Werner (2003), The New Systems Competition, Yrjö Jahnsson Lectures, Helsinki 1999, Basil Blackwell, Oxford.

FIGURE 5: Different levels of taxation (in percentage of the GDP) in various groups of EU member countries



Source: European Commission, DG Ecfin 2006.

Within the EU, the risks of a "race to the bottom" due to competitive pressures in areas of environmental and consumer protection have been met by minimum rules. In the social and tax area, both the European and national policies are challenged, while in the areas involving taxation of capital incomes and bank regulations, minimum harmonization and international voting procedures are becoming ever more urgent. Meanwhile, a broad-based tax harmonization, especially in the business sector, runs up against the opposition of many older and newer member states and - whether it is sensible or not - becomes almost impossible to carry through, at least in the medium term. For some countries (Ireland, Slovakia), low tax rates are an important instrument to improve the investment climate, especially for foreign companies. In the meantime, the old member countries, especially the net payers with high social standards, fear that the EU transfers would be used for a low company tax rate in the new accession countries and would thus favour the migration of jobs as well as the erosion of the old member countries' tax base. Here, too, clear conflicts of interests are evident, arising from a growing heterogeneity of the European economic sphere and standing in the way of a convergence on the European level (see figure 5 for different taxation levels).

These difficulties are even greater in the area of social policy, which (aside from minimum rules related to job and health security, etc.) has remained almost exclusively within the competence of the member states. Moreover, there is increasing pressure to reform the social models of rich European industrial nations because of internal developments (high unemployment rates, aging populations) as well as external challenges (globalization, Eastern enlargement). The new member countries face equally dramatic reforms, because of the need to replace the complete social protection in communism with systems financed by contributions or taxes. With increased migration, immigration countries could try to reduce the attractiveness of their welfare-state contributions by raising new barriers, which would not only run counter to the requirements of the single market but also would be counterproductive, because it rejects the advantages of labour migrations. The other possibility would be to admit immigrants from Eastern Europe only slowly and partially into the social system of individual member countries. The idea of swiftly bringing the social standards of accession countries to the level of the rich member countries is also counterproductive, because it would have serious negative effects on growth and employment in the accession countries (see, for example, the social union in the new German *Länder* after unification).

So far, the social-political regulations on the European level have had pacifying effects, although, time and again, the painful results of market fusion have encouraged demands for a European social model. It is evident that, in the long run, the majority of the European population can hardly support a Europe that is deeply split on the social level. But under the present circumstances neither the need for a centralized social and employment policy nor for policies involving massive redistributions can be justified on the EU level. The differences in the social systems and concepts of social order in the member states are still much too great, and there is no broad willingness among the rich member states to pay for extensive financial compensations. In addition, there are considerable dangers that a European-level social (and transfer) policy would have to accept responsibility for the mistakes and omissions of national economic and social policies and that the pace of convergence would be slowed. Conformity of social systems is only possible in the long run, and over the course of economic convergence. In the meantime, the learning process of the Lisbon Strategy and the adoption of "best practice" models must be in the forefront.

7. Institutional Reforms after the Rejection of the European Constitution

Little by little, in a dialectic process involving crises and piecemeal reforms, the European Union has continued to develop. However, in the 1990s European politicians missed their chance to turn the European house into a crisis-free structure and - in time for the EU's enlargement - to firmly establish the necessary decision-making procedures for an effective Union. There are many causes for the standstill in deepening the EU and for the existing public distrust. One is the lack of transparency and the growing complexity of European decisions. Another can be found in an increased heterogeneity resulting from successive enlargements. Great Britain and the Scandinavian countries joined the European Union for largely economic reasons. Fear of political pressures caused by a monetary union and of progressive losses in sovereignty prevented these countries (with the exception of Finland) from introducing the euro. Thus, suggestions for expanding majority decisions in the council or for transferring more sovereignty to common institutions regularly have met with stubborn opposition.

Hence it is not surprising that institutional and political integration have proceeded much more slowly than economic integration. Admittedly, the European Parliament gradually has taken on important competencies, but as a European institution it is still far from playing a central and visible role in

European politics. Although direct European elections have taken place since 1979, the dramatically diminishing voter participation in recent elections shows that the "Europe orientation" is poorly anchored in the media and population. In June 2004, the European Parliament was re-elected with a voter participation of only 44 percent (in Poland: 20 percent).

Attempts at institutional reforms over the last ten years had disappointing results. Neither the treaty of Amsterdam (1997) nor Nice (2001) improved the Union's capability to act effectively. The treaty of Nice actually in force must be seen as a step backwards, since it gave Spain and Poland voting weights in majority decisions of the council that stand in flagrant contrast to their share of the population. In the drafting of a European constitution, an attempt was made to overturn these imbalances using the "double majority" principle (a majority of the member states that make up at least three-fifths of the population), whereby the principles of a union of citizens and states are given equal weight.

After the debacle of the European Council at Nice, the constitutional convention took on a new and unconventional approach to make the EU more efficient, transparent and democratic. In the summer of 2003, the "Convention on the Future of Europe" presented a draft agreement on a European constitution. One certainly could disagree about the qualities of this draft agreement (a monster, with 465 articles, five protocols and three declarations). Yet numbers of important improvements are connected to it, including an enhanced ability to take actions, a simplification of the decision-making procedures, expanded powers of the EU Parliament, establishment of an EU foreign minister and inclusion of all treaties in one document. The draft agreement was formally signed by the state and government leaders of all 25 member states in 2004. Eighteen member states have ratified the draft treaty fully.

At the Brussels summit in June 2007, the guidelines of the new revised EU treaty - called the Reform Treaty (RT) - were accepted, which amounted to a great success for the German presidency. The RT, which preserves much of the substance of the draft constitution rejected by French and Dutch voters two years ago, was finally accepted at the Lisbon summit in October 2007. However, the delay in voting procedures (up to 2014/17) and the exceptions for some member states are signs of rising national egotism and of large rifts among member states. The new treaty will improve the EU's decision-making ability (double majority, expansion of majority decisions, etc.), but a wide and public debate about the transparency of policymaking and about the ultimate goals, instruments and limits of the EU has not yet taken place. At the same time, some risks still exist because the RT has to be ratified by all member countries in 2008 in order to be in force before the European Parliament elections in 2009. However, all member states intend to avoid a further referendum, which increases the chances of its success.

8. European Perspectives in a Consolidation Phase

The 27 EU states cannot be governed on the basis of rules and regulations originally conceived for six member states only. Thus the European unification project remains prone to crisis and its outcome uncertain. In the last 15 years, the EU governments shrank from realizing courageous reforms,[17] because they refused to recognize the dimensions of the problems and they feared domestic political consequences. Thus they put short-sighted "national" interests ahead of everything else. At the Copenhagen Summit (1993), there was still a consensus that Eastern enlargement should not be allowed to affect "the momentum of European integration". With the Eastern enlargement in 2004, the principle that enlargement must be accompanied by a deepening of the integration process was violated for the first time.

Nevertheless, one should recognize that the 50-year development of the European Economic Community to the European Union, from the customs union to the economic and monetary union, was successful, although stimulated by doubtful compromises and financial concessions. But the increase in competencies and the numerous enlargements led simultaneously to an increasing complexity and bewildering variety of overlapping decision-making and governmental levels, as well as to unclear competency assignments and procedures.[18]

Today the EU suffers from a growing ungovernability and lack of transparency, which can scarcely be overcome by the "open coordination" of economic, industrial, labour and social policies. Given a multi-level system (cooperation among regions, national states and supranational structures) with constantly changing coalitions, it remains uncertain if simple and transparent relationships can develop between member states and EU institutions. The governance of the EU, as well as the efficiency in coordinating economic decisions, thus might worsen in an enlarged union based on the Nice Treaty currently in force. In addition, in a union with 27 members, the complex tangle of council meetings, working groups, committees and national governments likely would become procedurally ever more problematic, and attempts to balance interests increasingly time-consuming.[19]

Ultimately, to avoid a dangerous erosion of the integration level already achieved, the solution to this deadlocked situation remains a model of differentiated developments, in which member states that are willing to advance do so, while the hesitant members follow along later. This solution, however, which would involve the "enhanced cooperation" of a centre of gravity, would at first only be realizable in a few areas. The previous integration motor - the team of France and Germany - has obviously become much weaker. Intergovernmental cooperation both within and without the Union could help a core (pilot) European group to promote flexible advances in, for example, foreign and security policies as well as in justice and home affairs.[20] However, any progressive solutions

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17 The various stations of this evasion are Berlin 1999, Agenda 2000, Nice 2002 and Brussels 2003.

18 Sapir, André et al. (2004), An Agenda for a Growing Europe, Oxford University Press. Wood, Steve and Wolfgang Quaisser (2008), The New European Union, Confronting the Challenges of Integration, Boulder Colorado, London.

19 The future 23 official languages (including Maltese) are likely not only to burden the functioning of the EU organs but also to develop into a financial scandal. Today the EU spends a billion euros for the language service and 500 million for translations.

20 Regular polls of the European public show an astonishingly positive and strong endorsement of a common security and defence policy (EU-25: 77 percent) as well as a

would be offset by the risks of a fragmentation of powers and the emergence of new frictions with the fringe group. Certainly, the political credibility and legitimacy of the European Union, as well as its foreign-policy effectiveness, would suffer. It would be fatal if the member states accepted the gradual spreading of intergovernmental cooperation forms and thus tolerated the EU's drifting into an imperfect internal European market with rudimentary forms of common policies.

During a consolidation phase, the first priorities would lie in the completion of the single market (especially the services and financial market) and in a gradual reorganization of the agricultural and structural policies. Common assistance policies should strengthen European cohesion and solidarity instead of opening new schisms with disputes about allocations. Through compulsory procedures and inducements, the coordination of economic policies and the dovetailing of monetary policy with fiscal policy in the euro area ought to improve, and the credibility of the stability pact be won back. The council should increase the transparency of its decision-making and expand the scope of majority decisions. Using its controlling and co-determination rights, the European Parliament ought to increase its visibility to the European citizens and thus help dismantle the democratic deficit.

The role of the European Commission as a trustworthy moderator and "Guardian of the Treaties" is indispensable, its authority and the efficiency of its agencies vital in order to advance the integration dynamics and avert undesirable developments. During a longer consolidation phase, one could clear up the question of common actions and policies and increase the efficiency of decision-making. It even should be possible to simplify the complex interconnections between EU organs and member countries, and to concentrate on core tasks of the EU (single European market, competition, external trade, monetary, security and defense policy) and bring secondary functions back to the national and decentralised level.

The member states should make it a priority to carry out domestic reforms and finally to pursue resolutely the consolidation of national finances. In this way, the swift completion of the single market could become the central element in a growth- and innovation-enhancing policy. Strong and sustainable growth would not only encourage the essential reforms in the member states and their tangible convergence but also would support the process of European integration.

A consolidation phase would also be helpful for the new accession countries. The tasks of getting used to the EU's complex rules, practicing procedures of finding compromises within European institutions, carrying out the single market rules and preparing to join the monetary union are difficult enough and will absorb all the countries' energies in the next few years. Only after this phase could the Union devote itself to new expansions, although this in no way rules out institutional rapprochements (Extended European Economic Area, in particular Extended Associate Membership, the right to speak out on political questions as well as financial and technical assistance for privileged partners).

The EU faces extraordinary internal and external challenges, which can no longer be met on a national level. These challenges derive not only from the difficult

common foreign policy (EU-25: 68 percent) (Eurobarometer, December 2005 and Bertelsmann poll 2006).

tasks of the current and future enlargement but also from the pressures of globalisation and the worldwide problems of combating poverty, epidemics, criminality and terrorism, and in the attempt to limit the smuggling of weapons and spread of weapons of mass destruction. To meet these challenges, Europe requires capable, stable and efficient institutions and decision-making procedures. In the context of political and economic-policy cooperation, only a united Europe can speak with one voice and act as important player in international affairs. National politicians should strengthen the credibility of European political actions instead of defending national positions or launching into European soapbox speeches. Only then will citizens take the big European project seriously again and be more willing to accept the necessary changes.

Europe cannot afford an extended standstill or - even worse - a failure of European integration. The political and economic costs of disintegration would be unimaginably high. If the European member states wish to secure their welfare as well as political and social stability, they must remember that only together can they accomplish their future in an ever-closer Europe.

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