The Right Way to Fix the EU

Put Politics Before Economics

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On January 30, 2020, representatives from the European Union's 28 member states gathered at the European Parliament, in Brussels, to approve the United Kingdom's official exit from the EU. After the vote was cast, the parliamentarians from the 27 remaining members waved their British counterparts goodbye while singing "Auld Lang Syne," the Scottish farewell song that celebrates lasting friendship and the passing from old times to new. Among the departing British, some wept tears of sorrow, others tears of joy.

On the continent, most consider the British decision to leave a tragic mistake. Even so, the Brexiteers' core contention—that the European Economic Community they joined in 1973 has grown far beyond an international union of sovereign states and into something far more ambitious and intrusive—is hard to deny. So is the claim that the EU's own missteps in handling the process of European integration played some part in driving the British out.

If the union wants to maintain its legitimacy and global influence after Brexit, it should use this moment as an opportunity to rectify those mistakes. Above all, the EU should stop putting economic logic ahead of political reality when it should be the other way around—as the original guiding principles of European integration held. The goal of integration, as the British historian Alan Milward wrote, was not to create a giant internal market or to eventually become a new global superpower but to rescue Europe's nation-states from the threat of collapse, annexation, and forced occupation—threats that many European

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states had failed to resist in World War II. Those states had failed in their primary task, to defend their national territory and protect their citizens. For the sake of their own survival, European states needed some degree of coordination to achieve the twin goals of political stability and economic prosperity. That would require some surrender of national sovereignty to a supranational entity, but the underlying objective would be to buttress the legitimacy of member states.

European leaders today should recommit to that vision and develop a new division of labor between Brussels and national capitals. That can happen only if the most powerful remaining member states—France, Germany, and Italy—reach a consensus over what went wrong and why. If those states manage to find common ground, Brexit could yet turn from a bruising debacle into a moment of promise and renewal.

ONE MARKET TO RULE THEM ALL

The roots of the EU's multiple crises during the past ten years—over the euro, migration, Brexit, and the rule of law—reach back to the 1980s and 1990s. For much of the postwar era, European integration had followed a simple logic. States would gradually liberalize their economies and foster trade and investment relations. Meanwhile, in the interest of domestic political stability, they would maintain national control over important policy levers—monetary and fiscal affairs, industrial policy, public procurement, labor-market policy, and so forth. But starting in 1985, the new European Commission president, Jacques Delors, turned that logic on its head.

Instead of policy discretion at the national level, Delors's vision for the bloc emphasized pan-European rules on matters of trade, regulations, and public procurement. Over the following decade, the EU rapidly created a genuine common market by abolishing all nontariff barriers to trade. Delors also laid the groundwork for a single currency, which transferred control over monetary policy and exchange rates to the eurozone level and severely limited member states' discretion over fiscal policy through a set of rules laid down in the Stability and Growth Pact. By the mid-1990s, the one-time grand bargain between sovereign states had given way to a radically new paradigm that put economic and financial connectedness first and political sovereignty second.

Yet the new model was deeply flawed. True federations rely on financial solidarity in times of crisis, but the EU failed to put in place the supranational institutions that would have made such solidarity possible, leaving the single market and the euro vulnerable to inevitable shocks. The single market enabled the free movement of capital but lacked the shared institutions to regulate those flows through mechanisms of joint financial supervision. The single currency meant a common monetary policy but had no provision for common control over fiscal matters to cushion the uneven effects of a potential crisis. At the same time, the EU's focus on strict economic and financial rules eclipsed its political priorities, in particular the need to enforce basic democratic principles and the rule of law, both of which were largely taken for granted, even as enlargement to the East became a reality in 2004.

The milestone treaties of the Delors era, the 1987 Single European Act and the 1992 Maastricht Treaty, radically altered European markets by enshrining specific economic policy choices in supranational agreements that could be changed only by a unanimous vote. To some extent, globalization was driving similar changes everywhere. But the EU's member states embraced the logic of international markets with much greater enthusiasm than anyone else in the advanced industrial world. And in the first decade of this century, when the EU expanded to take in ten formerly communist states of central and eastern Europe, its leaders mostly worried about how the new members would manage the transition from central planning to market principles. They did not concern themselves much with the possibility of democratic backsliding, which has since emerged as the main threat in newer EU members, such as Hungary and Poland, and has the potential to seriously erode the democratic integrity of the entire union.

THE RETURN OF POLITICS

If these oversights once seemed forgivable, the economic and political tumult of the 2010s revealed that they were anything but inconsequential. First came the eurozone crisis. The lack of an EU-wide financial and banking union was always going to lead to serious macroeconomic imbalances between creditor countries and debtor states. But what transmuted a relatively manageable Greek fiscal problem in 2010 into a full-blown, contagious sovereign debt crisis was the EU's obsession with rigid fiscal rules and competitiveness at the expense of national-level flexibility. When the Greek government struggled to pay its sovereign debt, the so-called troika—made up of the European Central Bank (ECB), the European Commission, and the International Monetary Fund—arranged a bailout. But in return, it insisted that Greece

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Was it something we said? At the G-7 summit in Biarritz, France, August 2019

build up a substantial budgetary surplus for the foreseeable future so it could pay back its debt. The troika imposed crippling fiscal austerity measures and sweeping structural reforms, mostly intended to deregulate the Greek economy. That intervention not only exacerbated the Greek sovereign debt problem by slashing growth; it also left the Greek government with very little say in its country's economy. As far as economic policy was concerned, the outcome of national elections—including the 2015 victory of the far-left party Syriza, which promised an end to austerity—was largely meaningless.

If national politics was powerless in the face of the European debt crisis, it came back with a vengeance during the migration crisis that followed in 2015. The EU's response to the wave of refugees reaching its southern shores was hampered by the so-called Dublin Regulation, which required asylum seekers to register as refugees wherever they first entered the EU, putting a disproportionate burden on the main entry states, especially Greece and Italy. German Chancellor Angela Merkel tried to redistribute the refugees more equally but failed. Several central European states, in particular, refused to accept more than a handful, arguing that Merkel's redistribution scheme infringed on their sovereignty. Before long, even the Schengen system of visa-free, open borders began to fray, with several EU states building fences or temporarily introducing passport checks. It was an ugly reminder that supranational solidarity in the EU had strict limits.

National politics continued its vengeful return in the 2016 Brexit referendum. In the months leading up to the referendum, British Prime Minister David Cameron toured European capitals to renegotiate the terms of his country's EU membership, hoping that the specter of Brexit would allow him to secure even better terms than those his country already enjoyed. But although London had in the past managed to negotiate opt-outs from the euro and the Schengen travel area, renegotiating any of the EU's four basic freedoms—the movement of goods, services, capital, and, above all, people—proved much harder. In the end, Cameron had to admit that under the new membership terms, London would still not be able to control the inflow of migrants from the rest of the EU. Quick to exploit latent fears of immigrants, the Brexit campaign, led by the conservative populists Boris Johnson and Nigel Farage, pounced—and promised, successfully, to "take back control" over British laws, money, and borders.

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In what is perhaps the bleakest reminder of the EU's failure on the political front, the bloc has impotently stood by as two of its member states have gradually slid into authoritarianism. Hungary and Poland still maintain formal democratic institutions, but both now tilt the playing field so far that neither meets the minimal standards for liberal democracy. Elections in Hungary and Poland are free but not fair, ruling parties have eliminated checks and balances on executive power, and after years of court stacking, the judiciary in both countries is no longer independent. In both cases, the EU has triggered a sanctions mechanism, the so-called Article 7 procedure, which can strip a member state of its voting rights in the European Council, among other sanctions. But the process requires unanimity among all EU member states (excluding the offending country), and Hungary and Poland have both promised to veto any sanctions against the other.

In past decades, European leaders might have agreed on enough to find a way out of these various imbroglios. Each of the big innovations that took shape in the 1980s and 1990s—the single market, the

euro, and eastward enlargement—found broad support among the main national players, with the exception of the British opt-out on the euro. The single market was an Anglo-French idea, the euro was a Franco-German one, and Berlin and London both championed enlargement, although each for its own reasons. Meanwhile, Italian elites across the political spectrum were happy to go along with all three of these projects, which they hoped would accelerate much-needed domestic reform and lower Italy's inflation and interest rates.

There is no trace of consensus today. The United Kingdom is out. French President Emmanuel Macron has outlined an ambitious vision for much more fiscal integration, in which member states would transfer to the EU not only control of monetary policy but also some of the power to tax and spend, so as to build a sizable eurozone budget. Germany, arguably the country that has benefited the most from the EU's current institutional framework, is quite comfortable with the institutional status quo and unwilling to make drastic changes. Many members of Italy's current political elite, meanwhile, dream of a return to a distant, pre-EU past, when the state could use the tools of currency devaluation and fiscal stimulus to spur national economic growth.

Overcoming the EU's current malaise will require European leaders to compromise on a broad set of political and economic principles. And since Germany's commitment to the current regime will be hard to sustain given growing opposition in eastern and southern member states, any such compromise would need to strike a balance between the Italian desire for greater domestic policy flexibility and the French dream of more intra-European solidarity.

A NEW CONSENSUS

What could such a new grand bargain look like in practice? On the economic front, it would mean giving member states far more political control over fiscal policy. National governments should be able to decide for themselves how to use their tax revenues and make budgetary tradeoffs. They should be free to temporarily subsidize ailing sectors, give preference to their own construction companies or law firms in their public procurement (a common practice at the state level in the United States), and bail out struggling banks and other systemically important companies, none of which they can easily do under current EU rules. That flexibility would once again give electorates a real say in economic policy, counteracting the so-called democratic deficit that has beset the union since the start of the eurozone crisis. Such a deal would require a fairly loose interpretation of the EU's current fiscal rules and some temporary deviations from a few sacred single-market principles, such as the prohibition against favoring national service providers. The outcome would be less economic efficiency at the European level but greater political stability: national governments could afford to be more responsive to the legitimate demands of their electorates, taking the wind out of the sails of right-wing populists such as Marine Le Pen in France and Matteo Salvini in Italy, who consistently argue that the EU does not benefit ordinary people.

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At the same time, the EU could follow France's lead in developing more supranational mechanisms for economic risk sharing, even if doing so would run counter to economic orthodoxy. The eurozone states took some steps in this direction in the years following the debt crisis, creating a banking union that allows the ECB to monitor and, if necessary, wind down ailing private banks (even though the rules governing this arrangement are, once again, needlessly strict and could have allowed for more national discretion). Europe should add to this banking union an additional pillar: a eurozone-wide deposit insurance scheme, which would ease the burden on any individual member state if one of its banks ran into trouble.

In the same vein, the EU should finally push its member states to pool some of their sovereign debt through so-called eurobonds, which would make a sudden return of high interest rates far less likely and give individual governments more budgetary breathing room, reducing the risk of capital flight or bank runs in a future crisis. Clearly, that step would carry some risk of moral hazard, since it would reduce individual governments' responsibility for the sovereign debt they accumulated. But even if pooling all present and future debt is not politically viable or financially desirable, a big chunk of the existing debt pile could be mutualized, as long as there are reasonable rules to prevent governments from taking advantage. (The system could have a debt ceiling, for instance, beyond which member states would need to raise their own funds on the market at higher interest rates.) Finally, EU leaders should revisit the ECB's narrow mandate. At present, the central bank's sole official responsibility is to ensure price stability—an outmoded function in a world where the battle against inflation has long been won. Instead, the ECB should be allowed to do as the U.S. Federal Reserve does and also focus on other goals, including full employment and overall economic prosperity.

On the political front, the EU must not compromise in its commitment to liberal democratic principles, the separation of powers, and the rule of law. The union's existing legal framework to protect fundamental democratic principles needs some extra bite—meaning much stricter rules for potential offenders. The EU disburses substantial amounts of funds to economically lagging member states, including Hungary and Poland, which are among the largest net recipients. It could make those funds conditional on good behavior. Additionally, the pan-European parties in the European Parliament, especially the influential European People's Party, which is home to parliamentarians from Hungary's ruling Fidesz party, should work out clear rules for expelling any representatives from national governments who undermine their country's democracy.

Finally, one need not call into question the free movement of people—one of the EU's fundamental principles—to recognize the political risks that come with high levels of migration among EU member states. Although EU immigrants make significant net financial contributions to their host countries at the national level, they can also put pressure on local public services, such as schools, housing, and hospitals, especially if the inflow is large and sudden. That fact offers ready fodder for populist exploitation.

What is more, the brain drain from eastern and southern European states weakens those countries' economies and can negatively affect their citizens' views of the benefits of European integration. As the political scientist R. Daniel Kelemen has shown in the case of Hungary, emigration can also have the perverse effect of strengthening nascent illiberal regimes. Liberal elites and educated young people leave the country in droves. Those who stay behind are either unwilling or unable to resist the slide into authoritarianism. Of course, counteracting that trend without imperiling free movement is difficult—all the more reason to fight democratic backsliding in Hungary and elsewhere head-on, through a more forceful Article 7 mechanism. As for immigration from outside the EU, the bloc could allocate more funds to border patrol and move away from the outdated Dublin Regulation to a more equitable distribution mechanism for asylum seekers.

THE PATH TO GLOBAL POWER

Putting its own house in order will also allow the EU to be a more effective global power in an increasingly hostile world. With a U.S. president who is loath to enter military conflicts and views the EU as a geopolitical rival, Europe can no longer rely solely on the United States to guarantee its security. Global trade and financial links have created dependencies that powerful actors can easily exploit, especially in an era of intensifying great-power competition. In this more multipolar and chaotic world, the EU is more relevant than ever for its relatively small member states, a lesson the United Kingdom is bound to learn the hard way in the not-too-distant future, as it attempts to steer its own course.

One area of potential European strength is international monetary relations. In the 1960s, the French finance minister—and future president—Valéry Giscard d'Estaing referred to the U.S. dollar as the United States' "exorbitant privilege." He was right—the United States gains both economic and geopolitical advantages from printing the world's reserve currency of choice. It can export some of its inflation and borrow from global markets in its own currency at much cheaper rates than other states. Through its control over the international payment service SWIFT and the influence of the U.S. Federal Reserve System, Washington has been able to pressure adversaries and impose financial sanctions with global reach. The euro has the potential to rival the power of the dollar, but for that to happen, the eurozone needs a much more liquid currency market. Adding a eurozone-wide deposit insurance system and eurobonds would go a long way toward that goal. A bigger international role for the euro would, in turn, allow the EU to give financial weight to its demands and squeeze rival powers such as Russia more effectively, just as the United States has done with Iran.

Trade is another source of European leverage. The trade wars initiated by U.S. President Donald Trump may have diminished his country's overall welfare, but they offer an important reminder: states can use market access as a geopolitical tool. When it comes to using protectionist policies, actors that run a large trade deficit, as the United States does, have a significant advantage over those that depend entirely on export-led growth. But there is no reason why the EU, despite its current trade surplus, could not use access to its formidable internal market as a bargaining chip to force other states to advance core European interests, such as reducing carbon emissions and protecting human rights. The

EU's market power makes trade one of the few domains in which the bloc can negotiate on equal terms with great powers such as the United States and China. The EU's commitment to multilateralism (through institutions such as the World Trade Organization) means it will also have many smaller states on its side in any new global trade disputes.

Finally, if the EU is to compete on equal terms with U.S. and Chinese industrial and digital services giants such as Apple, Google, Alibaba, and Huawei, it will need to create its own rival champions. Europe already has at least one such company: Airbus, the French-German-Spanish multinational aerospace conglomerate that dominates the world market for commercial aircraft in a duopoly with the American firm Boeing. But with only five EU companies among the global top 40 (by annual revenue), much work remains, and the EU's current strict antitrust rules are hopelessly out of date for this type of endeavor. Fortunately, some national leaders—especially France's economy and finance minister, Bruno Le Maire, and his German counterparts, Peter Altmaier and Olaf Scholz—understand the new realities of global competition and are pushing for changes, including an overhaul of the EU's merger rules.

WAITING FOR BERLIN

None of these steps will be easy. The biggest obstacle of all may be political resistance from Germany—the country that stands to lose the most in the short term from moving away from an institutional settlement that has served it well. But Merkel, who is in the twilight of her long tenure as chancellor, has admitted that Brexit should serve as a wake-up call to the EU. She should use her remaining political capital to make the case that more power at the bottom of the EU will mean more economic robustness at the top, just as more solidarity at the top will mean less political instability at the bottom.

The European Commission's new president, former German Defense Minister Ursula von der Leyen, is perhaps uniquely placed, alongside Merkel, to convince her fellow Germans of the need for fundamental reform. Von der Leyen has also promised that hers will be a "geopolitical" European Commission, in a sign that Brussels is at last beginning to take seriously the need for a globally assertive EU. Now national governments—especially in Paris, Berlin, and Rome, but also in Budapest and Warsaw—need to follow her lead. The guiding EU principle should once again be the primacy of politics rather than economics—not for old times' sake but for the future.