CASE 25th Anniversary Conference, Warsaw, 17-18 November 2016

The Evolving Architecture of Europe: Functioning or dysfunctional for the 21st century?[1]

Professor Paul Hare, School of Social Sciences, Heriot-Watt University, Edinburgh EH14 4AS, UK; Email: p.g.hare@hw.ac.uk and paulhare10@gmail.com
and
Richard Stoneman, former mid-career Fellow at St Antony's College, Oxford, and International Consultant, UK; Email: richard.stoneman@me.com
Final, 30 October 2016

Outline contents

---

[1] We thank Conan Fischer and Richard Pomfret for helpful comments on an earlier draft. The authors accept full responsibility for remaining errors.

___

The Evolving Architecture of Europe: Functioning or dysfunctional for the 21st century?

Abstract

From modest beginnings in 1957 with the formation of a six-nation Common Market, the EU has since evolved both by deepening – adding new tasks and responsibilities to the Commission's remit; and by widening – adding new members in a series of accessions of varying scale and complexity, to arrive at the present 28 member states. A new complication, posing new challenges for the Union, was the UK's referendum in June 2016 that opted for Brexit. It gives rise to two questions: what sort of deal will the UK strike with the EU27; and how will Brexit change the EU itself?

The EU operates through an institutional structure made up of core organisations such as the European Parliament, the European Commission, and several others. The structure looks quite messy and complicated, but is probably no more so than it needs to be; some of the complexity is just a consequence of evolution. The EU introduced the euro and created the Eurozone, overseen by the European Central Bank. For a time this seemed to work well, but since the crisis its institutional shortcomings have been starkly revealed. Around the world the EU operates various trade deals, and it delivers aid to many countries. The EU 'model' appears to offer a poor guide to relations with Neighbourhood countries and some of the states in the accession pipeline. Issues of state building and politics are underestimated, and the EU has managed relations with Russia quite badly.

The EU has become seriously dysfunctional, especially since the financial crisis, and this is merely thrown into relief by the plans for Brexit. To move forward, the EU needs new, more flexible economic models, as well as new modes of engagement, both internally and with its various partners. In addition, the EU's political model needs reform, both to deal with the democratic deficit and to provide for more effective decision-making (if these two desiderata can be reconciled). All these issues need much new thinking.

PGH/RS/Oct.2016

The Evolving Architecture of Europe: Functioning or dysfunctional for the 21st century?

1. Introduction

Since proposing this paper to the organisers of this CASE Anniversary Conference, the UK has held a referendum on whether the country should remain a member state of the European Union. The vote was held on June 23rd 2016, and by early on June 24th it was clear that the UK was opting to leave the EU. After a short period of political turmoil and confusion, the UK formed a new government in mid-July 2016, committed to steering the country through the exit process. In the aftermath of the referendum vote it became embarrassingly clear that none of the UK's political leaders – on either side of the debate – had a clear understanding about exactly what the UK had signed up to as an EU member state (in other words, what does the 'membership package' look like); nor was it understood, therefore, what exactly would have to change to achieve exit from the EU.

Given these dramatic events in the UK, we did wonder whether to restructure this paper completely. In the end, we concluded that what we wanted to say remained valid, and relevant to the key issue facing the EU, namely the need to reform. The fact of Brexit adds to the sense of crisis already associated with the European 'model', and where relevant in what follows we do insert some remarks to indicate how we think Brexit either reinforces or modifies our main line of argument.

1.1 Growth and development

For countries that are already prosperous, economic growth remains a top priority. In the years since the 2007-9 crisis, unemployment in many advanced countries, and especially in Europe and among the young, has remained stubbornly high. A return to more rapid, job-creating economic growth in the advanced countries is most likely to be the result of long term trends in scientific development and innovation, though traditional Keynesian remedies to do with boosting aggregate demand still have an important part to play.

For low and middle income countries, however, the situation is even starker. They want and need to grow rapidly in order to raise living standards, eliminate the most severe poverty, and catch up to the income levels long taken for granted in the advanced countries[2]. And these countries can often achieve much growth by shifting workers from low productivity to higher productivity sectors of the economy. Much has been written about how countries can grow and develop, but it cannot be claimed that economists have achieved full consensus on the subject. However, there are some broad understandings that take us a little way forward (see CGD, 2008).

Thus we expect to see decent rates of productive investment; a good business environment; open trade; and basic institutions that protect property rights and business contracts. Political stability is also helpful, though this doesn't necessarily require parliamentary democracy as traditionally assumed and understood in western countries. Concerning investment, it is usually thought that a country investing less than 10% of its GDP in productive projects is going nowhere (presidential

[2] Nowadays, there is also much concern about how to achieve growth in a carbon-neutral or even carbon reducing manner, given increasing worries about global warming. However, this aspect of growth is outside the scope of the present paper.

palaces do not count as productive in this context), while investment of 25% or more is likely to be accompanied by moderate growth rates of 4-5% per annum or even more[3]. This assumes, of course, that most investment is well chosen, so the processes of investment selection, both for public sector and private sector investments are always important. As for the business environment, there is a good deal of excellent literature on how to measure different aspects, on the sorts of reforms likely to be helpful, and on policies to strengthen competitiveness (which can be understood as a consequence of a good business environment). See, for instance, World Bank (2015) and WEF (2015).

1.2 Convergence

Countries setting out to raise their living standards, especially if the process involves adopting a new economic model as has been the case for many of the countries joining the EU (especially the countries in transition, moving away from variants of Soviet-type central planning), typically hope the new model will enable them not only to grow their economies but to catch up with other countries – in the region or in the wider world. Such convergence can take various forms, and experience with it in Europe has been quite mixed. Sometimes political, institutional and cultural constraints on growth have been underestimated, sometimes it has proved harder than expected to open up trade effectively (due to weak financial institutions, inefficient trade agreements, etc.); or sufficiently to improve the business environment in general; or the investment environment in particular. Experience shows quite clearly that 'merely' adopting the EU economic model is not sufficient to guarantee either rapid economic growth or convergence to average EU income levels, a fact that has been a disappointment for some new member states. That said, at least until the 2007-9 global financial crisis and recession, the new member states of the EU were indeed growing faster than the old members, and convergence was occurring.

Contrasting economic performance, however, can be illustrated by the interesting cases of Ireland (joined the EU on 1 January 1973) and Greece (joined the EU on 1 January 1981). Thus around 1980, both countries had per capita income around 70% of the EU average; by 2007, shortly before the world financial crisis and recession, Ireland had advanced to around 125% of the EU average income, while Greece had only advanced a little beyond its initial position (Eurostat data). Over this period, therefore, Greece had grown only marginally above the EU average rate, while the Irish economy had grown far more rapidly. Both countries suffered badly in the wake of the financial crisis, with banking crises, debt restructuring and refinancing, and rescue programmes supported by the infamous troika of the IMF, the European Central Bank and the European Commission. But even here, it appears that by 2015-16 the Irish economy was well on the road to recovery, while Greece was still struggling badly.

1.3 Security and systems of alliances

For some countries, an important reason for adopting a new economic model – such as that embodied in the EU's *acquis* – has been the firm desire to leave one set of alliances (e.g. Comecon and the Warsaw Pact) and join another (the EU, OECD, NATO, etc.) in order to provide longer term security under more congenial conditions than existed before. For the countries of central and eastern Europe, this was a major element in their motivation to join the EU and the 'western system of alliances', even

[3] By way of examples, note that the UK in recent years has invested 16-18% of GDP, with average real GDP growth around 2% per annum; and China has invested over 30% of GDP with GDP growth of 10% for a long time, only recently slowing to 6-7% per annum.

at the cost of adopting an *acquis* that was already far too complicated and wide ranging to meet their real economic needs. While this argument was vital for central and eastern Europe, it makes no sense for the north African Neighbourhood countries, and only limited sense for other Neighbourhood countries that formerly belonged to the Soviet Union. These countries need new and different models.

1.4 The European 'model' – in crisis

Starting out as a free trade area with only six members, the EU had become a functioning customs union by 1968, and has now expanded to 28 member states each committed to following all the rules and regulations in the large and very wide ranging *acquis communautaire* (on which more below, section 3). At only a little over one percent of Community GDP, the EU's budget is surprisingly small, yet the Union seeks to manage an astonishingly wide range of areas of economic and political life across the member states. Hence quite a basic question to ask would be: is the Union trying to do too much with its modest resources, and hence almost inevitably ending up doing some things quite badly? A related question would be this. Has the EU, especially given its limited budget, taken on responsibilities and functions that might have been better left to the competence of the member states? We return to these questions later.

Some EU policies, such as the creation of the Eurozone (19 countries) and the Schengen area (26 states, including 4 that are not EU members), were arguably adopted too soon, before the needed political and institutional conditions were really in place. Before the euro came into being, many observers argued that the countries likely to form the new zone would not constitute an optimum currency area, and that the lack of a mechanism to make fiscal transfers across the zone would eventually prove seriously problematic. That aside, the Maastricht conditions were, to put it kindly, interpreted generously to allow certain countries to adopt the new currency; and the Stability and Growth Pact intended to ensure sound public finances and coordinated fiscal policies across the EU, partly in support of the euro once that currency was established (a process that began in 1999, and was completed by 2002), was not effectively enforced. Despite all this, the euro appeared to function remarkably well for almost its first decade. However, crisis conditions affecting several member states from 2008 onwards revealed very severe shortcomings of the Eurozone model.

As for Schengen, open borders and passport-free travel are wonderful ideas, widely supported across the EU; they make a large part of the EU more like the successful US model (no internal borders, common currency). For the policy to work, though, a hard and enforced external border is very important. In normal times, this appeared to work remarkably well, but the policy has crumbled in the last couple of years under pressure of large scale migration from conflict zones in the Middle East and elsewhere. The most immediately affected European countries have suddenly erected new border fences and put in place stronger controls over new arrivals, with EU-level policy responses still seeming too little, too late. But when member states seek their own solutions, the Schengen concept of open borders and free travel is significantly undermined. It is important to emphasise here that for the EU, the pressure for change has come from external migrants seeking to enter and then move freely across the EU; there has been far less concern over the free movement of existing EU citizens across the region. For the UK, though, never a member of Schengen in any case, the political concern has been over the total net flow of immigrants, both from EU member states and elsewhere, because the flows have been so high over the last decade, both relatively and absolutely, compared to other member states.

In addition to the continuing problems with the Eurozone and with Schengen/immigration, the EU has also faced difficult eastern neighbourhood issues in the past two-three years, notably involving political and economic instability in Ukraine, Russian intervention there (including the annexation of Crimea), and the imposition of economic sanctions against Russia. It is too early to say what the outcome of all this will be.

Last, there is Brexit. Quite aside from the many tricky issues to be resolved concerning the UK's continuing relationship with the EU27 (i.e. the EU without the UK), and the mechanics of extricating ourselves legally and politically from EU arrangements, perhaps a more interesting question concerns how Brexit might affect the rest of the EU? Might it stimulate other member states either to leave the EU themselves (presumably after holding their own referenda), or to demand reforms of the EU? Indeed perhaps the Commission itself could develop its own reform proposals to strengthen the Union. Or might Brexit instead lead to a closing of ranks across the EU, to preserve existing structures and policies? The UK's Brexit vote has certainly opened up a Pandora's Box of issues for the Union that will not be soon resolved.

2. Stages of EU enlargement

As we know, the EU was not simply formed in a single 'act of creation', as an amalgam of 28 member states. Instead, it began with six countries agreeing to form a Common Market (Treaty of Rome, 1957), and has evolved over time in two principal directions:

(a) Deepening

This means expanding and developing the institutional infrastructure of the EU, adding more responsibilities to the Commission's remit, and major policy innovations such as the formation of the Schengen area, the introduction of the euro. A side effect of deepening is that it makes life harder for subsequent entrants, by adding more elements to the *acquis* they then have to accept and adopt.

(b) Widening

Successive phases of enlargement, including that of 1973 which brought the UK, Ireland and Denmark into the EU, and that of 1981 which admitted Greece, have gradually led to the present Union with 28 member states. This process has often been referred to as widening.

Often the UK has appeared to favour widening over deepening, tending to see these two aspects of EU evolution as alternatives. Thus the UK has strongly favoured the customs union and single market features of the EU, and has been rather less interested in or supportive of other parts of the institutional machinery. Moreover, history has shown that widening and deepening have not really operated as alternative directions for the EU, although the tensions between the two have clearly increased since the financial crisis, suggesting the possibility of serious structural incompatibilities.

The basic conditions for EU accession are essentially the Copenhagen criteria of 1993, with some updating; they are (from the EU website):

1. stability of institutions guaranteeing democracy, the rule of law, human rights and respect for and protection of minorities;

2. a functioning market economy and the ability to cope with competitive pressure and market forces within the EU;
3. ability to take on the obligations of membership, including the capacity to effectively implement the rules, standards and policies that make up the body of EU law (the 'acquis'), and adherence to the aims of political, economic and monetary union.

For EU accession negotiations to be launched, a country must satisfy the first criterion. This is a much harder condition to fulfil than is usually assumed. Sometimes negotiations have commenced without the condition being properly fulfilled. Condition 3 is very demanding, and one can argue that if a country just wanted to improve its growth prospects, it would not wish – and nor would one advise it – to adopt the entire *acquis*. Yet for EU membership, an applicant has to do so. This point also comes up again later on.

2.1 Early enlargements and why they were 'easy'

Each enlargement is a different exercise, but some are significantly easier than others. An example of an especially 'easy' enlargement was that of 1995, when Finland, Sweden, and Austria joined the EU. In that round Norway took part in all the negotiations, but in a 1994 referendum the population voted not to accede. The three countries that did then join in 1995 were all small in population terms, very prosperous, and with small agriculture sectors. They were already well developed, market-type economies, and would be net contributors to the EU budget. Hence their accession proved to be fairly straightforward, since they already satisfied most conditions of the *acquis* and required only modest amounts of legislative amendment and upgrading to meet the membership conditions.

2.2 The enlargement of 1990

Already more difficult, and a unique case of its own, was the rapid absorption of the German Democratic Republic as five new Länder in an enlarged German Federal Republic, with economic and monetary union occurring in July 1990, full political union by October 1990[4]. Thus the former East Germany, by becoming part of the expanded Federal Republic, became part of the EU – but not as a new member state, instead by extending the scope of the German Basic Law to cover the territory of the former East Germany. For the new Germany, the result was many years of massive fiscal transfers to support the Eastern Länder both in terms of incomes, and in terms of rebuilding important infrastructure (see Burda and Hunt, 2001; European Economy, 2002; Sinn, 2000; Carlin, 2010 among many others). It was an expensive process, far more so than had been anticipated initially. The unique feature of this 'enlargement' is that it expanded the EU's territory and population without increasing the number of member states.

This 'model' of enlargement could not be applied anywhere else, as no other potential EU member state had a neighbouring member state ready to take on such burdens. So for other eastern countries, once they had allowed free elections and abandoned the communist system, accession to the EU was unavoidably a much more drawn out process.

[4] Germany's agreement to give up the deutsche Mark and support the Euro was also probably helpful in securing France's acceptance of early German reunification.

2.3 Enlargements of 2004, 2007 and 2013 and why they were 'harder'

Besides Malta and Cyprus (both part of the 2004 accession), these enlargements brought into the EU a total of eleven former communist countries, comprising three from the former Soviet Union (the Baltic States, joining in 2004); two from the former Yugoslavia (Slovenia in 2004, Croatia in 2013); and six from the rest of Eastern Europe (Poland, Czech Republic, Slovakia, Hungary in 2004; Bulgaria and Romania in 2007). These countries had been under communist rule for some decades, had little private property and very limited private markets when communism ended in the period 1989-91, had no recent experience of democratic politics or the rule of law, and needed substantial institutional development and economic reform to be able to meet the Copenhagen criteria. Also, some of the countries – notably Poland – had substantial agriculture sectors, most had average incomes considerably below the then EU average, and most would therefore be net recipients from the EU budget. There were also some concerns about migration – the free movement of labour – and most of the existing EU member states opted to impose restrictions on mobility for a transitional period after these countries became new member states; interestingly, at least for the 2004 enlargement, the UK allowed free movement immediately[5]. For all these reasons – and others – these accessions proved to be a more difficult series of challenges for the EU (see Hare, 2012; Csaba, 2005; Kołodko, 2000).

For all these new member states, implementing diverse new economic policies and incorporating the entire *acquis* into their respective domestic legislations were mammoth tasks, not least because of the need for careful translation into all the different national languages, with much adaptation to suit each country's culture and history. Often the most problematic sections of the *acquis* were those to do with political and legal matters, concerning the establishment of robust democratic systems ensuring respect for various minority groups and respecting national borders; ensuring an independent and well-functioning judiciary supported by lawyers and judges of competence and integrity; and assuring the rule of law.

The last of these, *the rule of law*, is especially difficult as it is often so poorly understood. Moreover, its scope extends well beyond the simpler matter of having a well-staffed and funded judiciary operating independently of the government. At a basic level, we tend to think of the rule of law as a means of ensuring that private property and business contracts are protected by the courts, so that one private agent cannot readily be cheated by another. This is certainly part of the story. But there are two other fundamentally important aspects (see Hare, 2013):

(i) Private agents also need protection against state predation. In other words, if a business is seen to be doing well, it should not suddenly be vulnerable to some form of state takeover or control, as is the case in many countries around the world.

(ii) Decisions taken by the state and its various ministries and agencies should be open to challenge in the courts by private individuals, firms and the like; and the government must respect the verdicts handed down. Again, there are many countries where this condition would not hold.

[5] Interestingly, the UK Home Office (i.e. our Interior Ministry) supported this on the basis of a very low projection of the likely number of migrants from the new EU Member States, just a few tens of thousands. In the event, closer to a million new EU citizens came to the UK in the ensuing two-three years.

An important lesson from this group of enlargements was the realisation that while the EU institutions could exert a great deal of pressure on an applicant state prior to accession, and hence force through changes and reforms which the state concerned might otherwise have been reluctant to accept[6], once accession has occurred the new member state can operate far more independently[7]. Of course, this was never intended to be so, and member states are expected to continue in compliance with the *acquis* at all times. But once inside the EU, states can more easily claim that parts of the *acquis* are open to interpretation, and in any case the EU monitoring and enforcement mechanisms, including possible sanctions, are quite weak and are only reluctantly and rarely applied.

2.4 How far has enlargement aided growth and convergence?

The picture here is quite mixed, but there was a good deal of progress by the group of countries that entered the EU in 2004 immediately after entry. However, economic crisis and the still unresolved problems of the Eurozone have made economic conditions more difficult for the new entrants in recent years as growth, and hence convergence, slowed significantly. To some extent, this calls into question the effectiveness of the EU 'model' as an engine of growth, especially for countries much less developed than the original EU6. Specifically, it is now probably clearer than it was before that for a country to take on board all the requirements of the *acquis* does not itself guarantee rapid economic growth. There are other aspects of the growth process to do with culture, institutions, investment and no doubt others, not fully covered by the *acquis* itself, where countries can and do still diverge a great deal.

3. The institutional framework of the EU – the EU 'model'

3.1 The evolving acquis communautaire

The core of the EU 'model' is the *acquis*, which now consists of 34 substantive chapters (Chapter 35, Other issues, is currently empty) to which all aspirant member states must adhere in full before accession; for reference, the chapters of the *acquis* are listed in Appendix 1. Yet if one were picking out key chapters from the point of view of creating good conditions for economic growth, probably no more than five or six chapters would be selected, along with implementation of the usual WTO conditions to facilitate foreign trade. Thus adopting the entire *acquis* represents an enormous burden, especially for small new states where democracy is not yet deeply embedded, and where public administration is likely to be weak. One must therefore think about the costs and benefits of the EU's 'membership package', both in economic terms and politically.

When people think about the *acquis*, we suspect they most often have in mind the EU's famous 'four freedoms', the free movement of goods, workers, services and capital across the EU; these basic principles are covered by chapters 1-4 of the *acquis*. They might also think of the customs union, chapter 29. Most of the rest are less well known, though procurement (chapter 5), competition policy (chapter 8) and energy (chapter 15) are among the topics that do arise from time to time in discussions

[6] As has been done over minority rights, independence of the judiciary, and many other issues involving various applicant states.

[7] Interestingly, however, in early September 2016, Luxembourg publicly called for Hungary's EU membership to be at least suspended, possibly even terminated, as a result of Hungary's policies regarding the migrant crisis. This raises a more fundamental question, namely whether the original EU members could or should take a tougher line over fulfilment of the core obligations of EU membership.

about the EU. In some areas of the *acquis*, such as fisheries (chapter 13) and agriculture (chapter 11), responsibility for policy development rests exclusively at the EU level, while in most areas there is a degree of shared responsibility between the EU and member state levels, reflecting the principle of subsidiarity.

3.2 The EU's basic institutions

The basic institutions of the EU, through which the *acquis* is specified, implemented as laws and directives, and monitored, are as follows.

(i) European Parliament;

With over 700 MEPs elected by the EU member states every five years, the Parliament is the EU's sole elected body, sharing responsibility for legislation and for discussing and approving the EU budget with the Council of the European Union (see below).

(ii) European Council;

Members of the Council are the heads of state or government[8] of the EU member states, supplemented by the European Commission President and the European Council President. The Council normally operates by consensus, setting policy directions and priorities for the EU; but occasionally votes are taken. The European Council normally meets quarterly. It is important to emphasise here that the European Council is not the same as the Council of Europe, whose membership and functions are very different[9]. The latter is not an EU institution, and it serves as Europe's leading organisation promoting human rights, democracy and the rule of law.

(iii) Council of the European Union

Often referred to informally as the EU Council or the Council of Ministers, this is the EU's main decision-making body (along with the Parliament). National ministers from the member states meet to discuss various topics needing review or decision; the ministers attending a given meeting depend on the theme of the meeting, e.g. agriculture, budget, etc.; in total the Council operates in 10 different configurations. Some of its meetings and deliberations are open to the public. Council meetings are chaired by the minister representing the country holding the six-month rotating Presidency. Depending on the topic and the nature of the decision to be adopted, voting at the Council is either by simple majority, qualified majority, or unanimity. Most voting is by qualified majority, but unanimity is required for certain topics considered sensitive by member states – e.g. the EU financial framework (the budget), EU enlargement, citizenship, and a few others.

(iv) European Commission

This is the executive body of the EU, essentially the EU's civil service, with a staff of around 23,000 personnel drawn from the member states. The Commission's main roles are to:

- propose legislation which is then adopted by the co-legislators, the European Parliament and the Council of Ministers (i.e. the Council of the EU);

[8] Thus in the case of the UK it is the Prime Minister (head of government) who attends these meetings, not the Queen (head of state); for France, François Hollande (President of the Republic and head of state) attends.

[9] For details, see the relevant websites.
Thus for the European Council, see: http://www.consilium.europa.eu/en/european-council/
For the Council of Europe, see: http://www.coe.int/en/

- enforce European law (where necessary with the help of the Court of Justice of the EU);
- set objectives and priorities for action, outlined yearly in the Commission Work Programme, and work towards delivering them;
- manage and implement EU policies and the budget;
- represent the Union outside Europe (negotiating trade agreements between the EU and other countries, for example.).

Further detail can be found on the Commission website, http://ec.europa.eu/about/index_en.htm. Mostly established in Brussels, some Commission services are located elsewhere, for instance the Statistical Service, Eurostat, based in Luxembourg.

(v) Court of Justice of the European Union (CJEU);
Based in Luxembourg, the Court serves to ensure that EU laws comply with the Treaties, and that member states administer them consistently. It also interprets European law when petitions are submitted by national courts and tribunals. Thus the CJEU is the principal judicial organ of the EU. Note that it is not the same as the International Court of Justice (a UN court, based in The Hague), nor the European Court of Human Rights (a court associated with the Council of Europe, based in Strasbourg)[10].

(vi) Court of Auditors
Also located in Luxembourg, the European Court of Auditors (ECA) has been the external auditor of the EU since it was founded in 1977, and has been a fully recognised EU institution since the Maastricht Treaty of 1993. The ECA can apply to the CJEU for a ruling if it considers that its independence is being infringed by any other EU institution. The ECA's aim is to improve the way in which the EU's funds are used and accounted for.

The above sketch of the EU's institutional structure, briefly introducing the key institutions, appears to be quite complex, and to some degree it is. However, to oversee the affairs of the 28 member states, it is probably no more complex than it needs to be. The structure itself has evolved over time, culminating in the institutional arrangements laid down in the Treaty on the Functioning of the European Union (TFEU, agreed in Lisbon, 2007; see TFEU, 2012).

The EU is commonly criticised for its alleged 'democratic deficit', which appears to mean that the EU's executive body, the Commission is not under direct parliamentary control in the way that would be expected for the governments of individual EU member states. Rather, each member state appoints a Commissioner, and the Commission President, appointed by the European Council, allocates portfolios to form a functioning executive. There is at most quite mild oversight by the European Parliament. That aside, if the Commission is answerable to anyone it is to the governments of member states, though its decisions and proposals can also be challenged in the CJEU, and the outcomes of EU policies are subject to audit – sometimes extremely critical – by the Court of Auditors. So there is some accountability, and there are even some checks and balances in the system, even if it appears less directly democratic than some observers would like.

---

[10] See the relevant websites. CJEU, http://curia.europa.eu/; ICJ, http://www.icj-cij.org/; ECHR, http://www.echr.coe.int/.

Part of the problem here is that the member states themselves, while accepting the idea that there should be a European Parliament, have been consistently reluctant to allow the Parliament to accrue much power. This is a contradiction at the heart of the current institutional arrangements.

3.3 The euro and the Eurozone

The decision to introduce the euro as a common EU currency, and to form the Eurozone, was confirmed in the Maastricht Treaty (agreed in 1992, ratified and coming into effect in 1993; see TEU, 2012). By many, it was seen as a natural step towards greater economic (and in due course political) integration in Europe. All member states except Denmark and the UK (which secured permanent exemptions from this important policy) are expected to adopt the euro in due course, once they have satisfied the Maastricht convergence conditions. At the time of writing, 19 of the 26 member states committed to join the Eurozone had done so. Some of the countries still outside the zone, such as Hungary, now seem to be in no great rush to join, even if they could satisfy the needed conditions, perhaps reflecting their response to the crisis conditions in the Eurozone in recent years.

The key institution required to manage monetary policy across the Eurozone, the European Central Bank, came into being in 1998 and is based in Frankfurt (see Scheller, 2004). The euro itself came into use in 1999 in the first countries judged to have complied with the Maastricht conditions, coins and banknotes following in 2002. Before this stage was reached, there was wide-ranging debate around the conditions for a workable monetary union, including discussion on the so called optimal currency area. At best, this analysis counselled great caution in regard to the 'euro project' of the EU; at worst, it advised against. Essentially, the argument was that monetary union, to work, required both easy labour mobility and the ability to make substantial fiscal transfers across the Zone, so that member states facing economic difficulty – but no longer able to devalue or set their own interest rates – could be helped by other members of the Zone (or EU member states more generally). Such flexibility is important across the United States, for instance, as well as within individual member states such as the UK (outside the Eurozone) or Germany (within the Zone), large enough for different areas to face differing economic conditions. Those favouring monetary union within the EU appeared to take the view that these important institutional arrangements facilitating flexibility and adjustment would evolve and develop as circumstances required.

In preparation for the euro, the Maastricht Treaty set out so called convergence conditions to be satisfied by countries joining the Eurozone. Broadly, the conditions made good sense, requiring inflation to be under control, the government deficit and debt levels to be well managed, the exchange rate only moving within a narrow band, and long term interest rates close to those in the three best performing member states. It would have been quite surprising and unwise, for the Eurozone to be established without conditions along these lines being applied. But actually measuring the relevant economic indicators for the countries set to join the Eurozone proved both difficult and controversial, due to ambiguities of definition, the variable quality of statistics in different member states, problems of treating and assessing public debt (especially what debt could be put on one side as 'off balance sheet').

However, the precise numbers chosen to define the Maastricht conditions in practice[11] could scarcely be justified except as an exercise in expediency, and the Stability and Growth Pact that was supposed to provide the framework of incentives to keep countries conforming to the Maastricht criteria was never allowed to work properly. Moreover, at times of crisis much economic analysis would urge countries to diverge from the Maastricht conditions to prevent unemployment from becoming unacceptably high. But the 'rules of the game' scarcely permitted such desirable flexibility. All this requires much fresh thinking.

While the Maastricht conditions for becoming part of the Eurozone were at best a political fudge, not grounded in solid economic analysis, they were in any event interpreted 'generously' to enable the first group of countries to join the euro – including Greece. As events eventually showed, the European Central Bank (ECB) initially had insufficient powers to handle crises well, and the lack of fiscal transfers across Europe led to shocking levels of unemployment in countries like Greece, facing severe and persistent imbalances, as well as unsustainable debt. Arguably, it was not just the 'insufficient' powers of the ECB that were the problem, but rather core features of the institutional design: thus the ECB was supposed to focus *only* on managing inflation (with no remit to consider unemployment, growth and the like); it was supposed to be an *independent* institution, which in practice seemed to mean that it operated with virtually no effective accountability, and that it paid much more attention to banker and financial market interests than to those of ordinary citizens; and for a long time it could only buy and sell *short-term government securities*. This was not a sound model for our ECB and hence for the Eurozone (see Stiglitz, 2016; Varoufakis, 2016; Elliott and Atkinson, 2016).

Gradually, the European monetary system has evolved to manage the financial crisis, but still not well, and only at enormous cost to the periphery countries of the EU. Poor, delayed and ineffective crisis response on the part of key EU institutions since 2008/9 has done great harm to the Union's economic and political credibility. Ironically, and quite unintentionally, the attempted move to a higher level of economic and monetary union in the EU has led to serious internal strife and discord within the Union, and has distracted attention from other current issues requiring urgent attention – such as the badly handled migration crisis of the past two-three years. Increasingly, adoption of the euro looks like a

[11] **The five convergence criteria**

What is measured:	**Price stability**	**Sound public finances**	**Sustainable public finances**	**Durability of convergence**	**Exchange rate stability**
How it is measured:	Consumer price inflation rate	Government deficit as % of GDP	Government debt as % of GDP	Long-term interest rate	Deviation from a central rate
Convergence criteria:	Not more than 1.5 percentage points above the rate of the three best performing Member States	Reference value: not more than 3%	Reference value: not more than 60%	Not more than 2 percentage points above the rate of the three best performing Member States in terms of price stability	Participation in ERM II for at least 2 years without severe tensions

bad mistake, both economically and politically, unless the institutional framework through which it operates can be reformed substantially[12]. Moreover, the possible structural incompatibilities between deepening and widening referred to earlier suggests that institutional reform alone may be insufficient: the euro area may simply be too large to function as an effective economic unit for the foreseeable future.

3.4 Trade and partnership agreements

With various groups of ACP countries (e.g. CARIFORUM), and certain individual countries (e.g. Canada, the United States), the EU either has already, or is at an advanced stage of negotiating trade and partnership agreements to facilitate diverse forms of economic relationship, starting with more liberal trade. These agreements are sometimes controversial and are always very complex. They form part of how the EU operates in the world economy, part of the architecture.

Evidence for net and significant benefits regarding the trade in good is quite modest, though normally positive, essentially because initial tariffs around the world are mostly low nowadays (including the EU's own Common External Tariff) – so cutting them offers benefits, but not large ones except in a few sectors. Also, liberalising services trade through these agreements turns out to be far harder than negotiators expected, since, for instance, international recognition of professional qualifications is a complex business; and securing conformity with regulations (e.g. to facilitate trade in financial services) is also more difficult than usually assumed. In other areas, such as trade in 'cultural services' (e.g. bands from Jamaica wishing to undertake a European tour), visa requirements are still often quite problematic and costly (e.g. a Schengen visa for a band also visiting the UK needs to be multiple entry, and a separate UK visa might also be needed).

These agreements are typically long and complex documents, the shortest one that we are aware of (the draft agreement with Canada, CETA[13]) is over 1500 pages, and others are well over 2000 pages (e.g. the still unratified DCFTA with Ukraine). Even for well-educated officials in tolerably well run and prosperous countries, such as the larger member states of the EU, it must be seriously challenging fully to understand one of these 'deals', and for the small and relatively poor countries around the world – often with small and weak public administration – managing such agreements at all well must be close to impossible. Part of the complexity has to do with rules of origin, part results from the complex tariff reduction schedules proposed by groups of countries with whom the EU establishes an Economic Partnership Agreement (e.g. in the Cariforum EPA, each Cariforum country had its own schedule of tariff cuts across the 6000 or so products at HS6). The EU itself, to be fair, does try to keep things simple and manageable by implementing its own tariff cuts in full more or less immediately, as

[12] Widening the discussion to encompass poor adjustment to stagnation in the global economy, but also focusing strongly on needed reforms in the Eurozone, see Sinn (2014). For some interesting thoughts about the need for 'creative destruction' in the Eurozone, see Sinn (2016).

[13] At the time of writing (late October 2016), it seemed that the EU would be unable to go forward to adopt CETA, the Comprehensive Economic and Trade Agreement, due to opposition from the parliament of the Walloon region of Belgium. Later, it seemed that a Belgian compromise could be reached adding some 'clarifications' to the draft agreement; these then had to be agreed by all other member states. CETA was finally signed in Brussels on 30 October 2016. It is an illustration of the dysfunctionality of the EU that a potentially important trade agreement, after years of negotiations, could apparently be blocked by a sub-national assembly in this way.

soon as an agreement is ready to be implemented (often provisional implementation, if ratification is not complete).

Underlying these agreements is the widely held view that liberalising trade – in both goods and services – is generally desirable and beneficial. Often this will be the case, as much experience in recent decades confirms, but there are exceptions, such as when a country considers – for employment and other reasons – that protecting some domestic sector would be justified. Even when an agreement is in place, it might sometimes be worthwhile for a country to trade on MFN terms, rather than comply with the agreement and have all the accompanying hassle of documenting the rules of origin conditions. Sometimes it is too easy for a small and poor country to be 'bullied' into accepting the terms of an agreement, because the country simply lacks the analytical capability to make a better judgement. Hence on the one hand it is a positive thing that the EU wishes to engage with various groups of countries to establish trade and partnership deals, but one should be a little cautious about automatically assuming that the results are a 'good thing'.

3.5 Politics and aid: How the EU engages with the world

Aside from steps towards EU accession for a few neighbouring states, now only progressing slowly and hesitantly if at all; and a wide range of trade and partnership agreements as just discussed; the EU has a third way of engaging with the world, namely through the provision of development assistance. The EU is a major donor, and most of the aid goes to ACP countries (and a little to Overseas Territories of the member states) under a wide range of programmes and projects. According to reports from the EU's Court of Auditors, a good deal of this aid spending is poorly directed and badly spent, with aid sometimes based on a poor understanding of the countries concerned.

This could be described as a scattergun approach to aid, with so many diverse projects in a given country that at least some of the spending is likely to be beneficial. Most likely a much sharper focus on issues and countries could improve both aid quality and its effectiveness. As a helpful side effect, such a restructuring of the aid effort could also enhance the EU's standing and reputation in the world.

3.6 Managing the UK's exit from the EU – will it change the 'model'?

An important new development for the EU is the UK's recent decision, taken via a referendum held in June 2016, to exit from the EU. While the exact timing and details of our exit process are still far from clear, and in any case this is not the place for a detailed analysis, the fact of our exit will call for some changes in the EU, possibly even including changes to the institutional architecture. For brevity, we confine ourselves here to listing a few key points.

(i) Might other member states, also unhappy with aspects of the EU's current functioning, opt to hold referenda of their own? In the worst case, this could lead to some degree of disintegration of the EU.

(ii) Aware of this possibility, might EU leaders re-think some aspects of how the EU currently functions to respond to quite widespread popular concerns about the Union? Much formal change might require a new treaty, but in practice this might be avoided if the EU were to issue some sort of informal protocol outlining how they wanted the EU to function in the new conditions. This is not an easy way forward, but it might work, especially if ways were found to overcome the perception of a large 'democratic deficit'.

(iii) Some member states might push for 'more Europe', insisting on full compliance with the *acquis* (raising interesting questions about who judges this), deeper integration, and adoption of the euro.

(iv) Post-Brexit, what sort of relationship between the UK and the EU27 could be workable and acceptable to both sides? This certainly includes a possible trade deal, but there is a huge number of other issues, minor and major, to be settled.

(v) In 2017 the EU will begin discussions on the next budget period from 2020. Without the UK, a large net contributor, the EU budget will most likely fall (unless the remaining 27 member states agree a new budget formula that compensates for the loss of revenue from the UK), and this will inevitably cut back net contributions to Hungary, Poland, and a few other member states. There will be some difficult adjustments ahead.

(v) Thinking more radically, the EU might even contemplate: (a) abandoning the euro and returning to national currencies, national central banks, giving up for the time being the current unsuccessful attempt to co-ordinate monetary policy; or (b) paring back the EU's scope and range of activities by closing, say, five or more directorates and returning the respective policy areas entirely to national-level parliaments and governments.

(vi) Last, seemingly the most contentious issue for Europe at present is how to handle the migration crisis, and how this interacts with the *acquis* chapter 2 on free movement of workers. This appears to have been a major factor in the UK's Brexit vote, and it clearly concerns many other member states. Hence more imaginative ways of handling this issue might be needed to restore some sense of European unity.

4. Does the EU 'model' suit countries outside the EU?

4.1 The EU values and core principles

According to the European Parliament website, 'The European Union's fundamental values are respect for human dignity and human rights, freedom, democracy, equality and the rule of law.' These are actually stringent conditions to fulfil, and even their precise interpretation is subject to a great deal of ambiguity and controversy. Very few countries around the world fulfil them completely, especially in regard to: (a) democracy; and (b) the rule of law. As regards the former, we have already remarked on the perceptions of a 'democratic deficit' within the EU itself; and the latter, the rule of law, is widely misunderstood and mostly operates very imperfectly. Indeed a major problem with the core ideas is that most people think they understand them and are happy to support them, but what exactly they 'understand' probably varies enormously.

Space does not permit an extended philosophical account of these fundamental values, and we effectively side-step the serious conceptual issues they raise by moving on to more concrete matters concerning the *acquis*.

4.2 Does the entire acquis make sense for candidate or potential candidate countries?

For accession, candidate countries are expected to adopt – and incorporate into their national legislation and administrative practice – the entire *acquis*, as noted above. This is very demanding, especially for smaller applicants with weak administrations and/or a tendency to govern via 'favours' to dominant firms and interest groups (much rent-seeking activity), e.g. some Balkan countries.

A further complication is that some of the countries concerned are still struggling with internal political/ethnic problems, e.g. Macedonia, Bosnia and Hercegovina. For several of these countries, the top priority is surely to manage their internal political problems; then they need to focus on restoring or achieving economic growth to raise incomes and bring down unemployment, and this needs investment and open trade, essentially. Only then should they pay much attention to the more arcane aspects of the *acquis*. Much of the *acquis* is at best a long way down any reasonable list of priorities, especially for small and quite poor countries. Parts, however, can and do help with state building.

It is sometimes asserted that EU 'entry standards' are being softened to facilitate accession by some of the Balkan applicants. This would be a serious error, in our view. Those parts of the *acquis* that correspond to the core values and principles of the Union cannot be compromised, surely? What we might argue instead, comes close to favouring more than a single category of member, ranging from full membership (satisfying the entire *acquis*) to various degrees of partial membership (fulfilling core principles plus selected other chapters of the *acquis)*.

4.3 How much of the acquis should Neighbourhood countries be encouraged to adopt?

The short answer is surely, 'very little'. These countries are not candidates for EU membership, they often have quite different cultures and traditions from long established EU member states, and often have severe internal problems that mean their priority needs to be with quite basic aspects of state building and economic stabilisation (e.g. Moldova, Ukraine, Tunisia, Egypt, etc.). The countries enjoy various forms of association with the EU, including DCFTAs (Deep and Comprehensive Free Trade Agreements). Yet since most EU MFN external tariffs are already low (i.e. the Common External Tariff of the EU), the direct economic benefits from moving towards freer trade between, say, Ukraine and the EU must be quite modest for most sectors, and the costs (in the case of Ukraine) include compliance with a seriously complex document that runs to 2135 pages[14] (English text, *Official Journal of the European Union*, 29 May 2014; provisionally in effect, but not ratified). This is surely not a reasonable and fair way to conduct economic and political relations with neighbouring states.

What might a better approach look like? Our suggested approach would not involve any form of grand, over-arching programme; instead, it would be far more modest, piecemeal and *ad hoc* in nature. For any given country such as Ukraine, it would be important to pick a small number of issues, perhaps only three or four; focus on these so they are properly resourced and implemented well; and leave most of the initiative over any other areas of useful cooperation with the Ukraine side. The EU should not be pushing its own agenda as it tends to at present. A few points to consider are now briefly listed:

1. Since 1991, Ukraine's economic performance has been dire, partly a result of the country's terrible politics, with very serious corruption and outright theft of state property. Right from the start, this

[14] Indeed one cannot help wondering just how good the translation into Ukrainian is, and how many Ukrainian officials and politicians really understand what they have signed up to. Signing up, for some, might even have been a symbolic act, rather than meaning a great deal substantively.

makes Ukraine a difficult country to deal with, and recent attempts by regions in the East to declare independence/autonomy (at least in part, we would judge, a consequence of persistent economic failure), Russian involvement in the East, and the annexation of Crimea are all unhelpful factors – to put it mildly. Repeatedly, the country has come under pressure to re-align itself with Russia or to opt for a more western/EU orientation. It finally chose the latter, but only at high political cost.

2. Yet Ukraine has a well-educated and hard working population, and good supplies of basic resources, so it has the potential to be a successful, wealthy country, enjoying rising living standards. At the start of transition, per capita income (in PPP terms) was quite close to that of Poland, and it is now well under one-third of the Polish level (World Bank data for the period 1990 to 2015). Relatively speaking, therefore, the country has slipped badly backwards, while a very small elite has become seriously rich.

3. So to make progress, Ukraine needs to grow. That will involve a decent level of well-directed investment, both public and private, support for innovation and new business, and openness to trade in all directions. More difficult, some of the leading oligarchs might well have to be taxed or jailed or both, their harmful links to the media and to politicians broken, and if necessary their physical assets re-possessed. Much less than this, and the government is really just playing games that will lead nowhere.

4. Ukraine is on the border between East and West, and under the best of conditions this would not be easy to manage either economically or politically. The EU can help by withdrawing the absurdly complex DCFTA, replacing it with a very basic FTA that cuts most tariffs and does little else. The EU can also encourage the European Investment Bank to work with Ukraine, as the EBRD already does. That aside, it should then be for Ukraine to determine when/whether it is ready to reform other areas, and how far it would welcome EU support and advice.

4.4 Issues of state-building and politics

State-building is difficult and complicated, and is poorly understood by the core institutions of the EU. Despite the evidence of even quite recent history, the EU tends to assume – in common with the UN and other international bodies – that state boundaries will remain just as they are, and that ethnic 'differences' will somehow be managed. Countries like Ukraine, Moldova, Georgia (and even, dare one say, member states like the UK[15] and Spain) become quite difficult to deal with. Likewise for countries with marked internal ethnic divisions, such as Bosnia and Macedonia. We simply don't know how best to relate to and support such 'difficult' countries, or even whether and how they can function as viable states in the longer term. What is already clear, however, is that existing EU 'models' fall well short of what is needed – and mostly by trying to do too much, and by failing to focus on key priorities.

Take the example of Macedonia[16], already accepted as a candidate for EU membership in 2005, with the Commission recommending that negotiations be formally opened in 2009. Since then, its slow and halting progress along that path has been regularly monitored by the DG for Neighbourhood and

---

[15] Here one could even argue that Scotland might be better placed to be the next EU member than, say, Macedonia. The real difficulty here might be securing Spain's support, as Spain might be reluctant to 'reward' secession. And of course, Scotland itself would have to hold another referendum and vote decisively for independence.

[16] Strictly, this should still be named FYROM – Former Yugoslav Republic of Macedonia.

Enlargement Negotiations (DG NEAR)[17], with the most recent assessment report being EC (2015). The structure of this report is very much in line with the Copenhagen criteria for accession, with a section on political criteria, one on economic conditions, then a long section going through the *acquis* chapter-by-chapter to assess Macedonia's current position, recent progress, and proposed new measures and reforms to be adopted 'soon'. As a report, we would have to judge this one as rather good. It does identify the issues facing Macedonia, including the most troubling ones of ethnic relations between the Albanian and Slavic parts of the population, the high rate of unemployment (around 29-30% of the workforce), and the slow rate of GDP growth (1 to 3 % per annum in recent years). However, anyone reading this report without some prior knowledge of Macedonia would not necessarily pick out these points, as the report is very wide ranging and offers policy advice on practically everything. In effect, therefore, the report unintentionally raises important issues of *reform priorities* and *sequencing*.

For a country like Macedonia, it makes no sense to advise it to reform too much at once, as the government and civil service simply lack the capacity (and perhaps the political will) to do that. Moreover, rebuilding inter-ethnic relations so that the opposition parties (predominantly supported by ethnic Albanians) will be willing to resume normal participation in the parliament surely has to be a top priority. Otherwise the country is scarcely functioning as such.

Beyond that, it is the economy that needs attention. Official statistics show investment in fixed capital regularly exceeding 20% of GDP, which is quite a respectable rate. However, it seems only to 'deliver' very slow growth, as noted above, accompanied by very low rates of job creation. This leaves unemployment apparently 'stuck' at a very high level, and especially high among the Albanian part of the population. It appears that much investment is not very productive, implying that the process of investment selection is not working well. To explore this issue further, it would be good to know more about the balance between public and private investment, and the ways in which project selection works in both sectors. With more productive investment, both GDP and employment growth could be stronger, and the latter, by getting more of the Albanian population back into work, could also help to ameliorate some of the ethnic tensions in the country: potentially, a virtuous circle.

Moreover, once the economy is growing at a decent rate, tax revenues will be rising and reforms in other parts of the economy and society can then be properly funded, step-by-step. For the most part, it would be better to proceed as and when Macedonia is ready to reform a given area of public policy and/or its political and institutional framework. In other words, surely the impetus for reform should normally come from the Macedonian side – and they may or may not seek EU help and advice. The country knows by now perfectly well what the *acquis* entails, so if they opt not to reform certain areas in the early years, they understand that accession might be significantly delayed. But why should anyone see this as a problem? Accession might take a couple of decades or even longer, but in the meantime the country can enjoy growth and improvements in living standards. This is far more important than adopting the *acquis* in a hurry.

4.5 The special case of Russia

Russia is unavoidably a difficult country for the EU to 'manage', and in recent years it has done so

[17] Formerly, DG Enlargement.

badly. Russia is the largest and most powerful successor state of the USSR, a major nuclear power, and a permanent member of the UN Security Council; it borders several EU member states or states in the EU Neighbourhood. The country also leads and promotes the Eurasian Economic Union (EEU), currently encompassing: Russia itself, Armenia, Belarus, Kazakhstan and Kyrgyzstan (with Tajikistan reportedly signing up soon). Russian annexation of the Crimea region of Ukraine, plus assistance to breakaway eastern regions within Ukraine, have led to economic sanctions against Russia[18]. The poor state of EU relations with Russia also adversely affects relations with several eastern neighbours, not least because there can be conflict between the alternative economic models offered by the EEU and the EU.

Economically, Russia performed very badly during the 1990s (though not as badly as Ukraine), and grew quite fast during the 2000s, largely on the back of high world energy prices, and booming exports of oil and gas. Efforts to diversify the economy have so far had limited success, and recent lower energy prices plus economic sanctions have put both the public finances and the economy as a whole under great strain. However, Russia remains a very important trading partner for the EU, even though there is no FTA in place; and the EU is also the major foreign investor in Russia. Trade takes place on standard MFN terms[19], and the EU generally runs a large trade deficit with Russia. The deficit is largely due to the EU's imports of oil and gas from Russia, and is only likely to come down if the EU finds alternative energy suppliers or, thinking of a global warming agenda, produces more of its energy from renewable and/or non-carbon-emitting sources (water, wind, solar, nuclear, etc.). A significant change in that direction would pose a major economic challenge for Russia. Meanwhile, despite their difficult and contentious political relations, the EU and Russia are actively engaged economically – whether they like it or not!

Russia under President Putin still appears to think that the territory of the former USSR constitutes the 'natural' sphere of influence for the Russian Federation, so (rightly or wrongly) claims to feel threatened when NATO and/or the EU appear to be advancing into that sphere. Thus the accession of the three Baltic States to the EU, countries with large Russian minorities, cannot have been easy to accept, not least because it left the Russian Kaliningrad oblast wholly surrounded by EU member states. Against that uncomfortable background, it was probably not entirely wise for the EU to push as hard as it did for Ukraine to agree to the proposed DCFTA (see section 4.3, above). Looser links with the EU could work much better for Ukraine, and would be seen as far less provocative.

Though Ukraine has not signed up to the EEU, what is going on to the east of the present EU can to some degree be viewed now as a competition between economic models: namely the EEU led by and promoted by Russia, and with its core institutions based in Moscow; and the EU, based in Brussels but with other important institutions in Luxembourg and Strasburg. The current incarnation of the EEU only came fully into effect at the start of 2015[20], and it operates at present with a very modest budget

[18] One could argue that the principal response to Russia's actions in Crimea and eastern Ukraine should have come from NATO, and to some extent it has. However, the response has appeared weak and hesitant. EU economic sanctions aim to signal the EU's strong disapproval of Russia's military actions in Ukraine.

[19] Russia has been a WTO member since 2012, an accession that was generally supported by the EU; reportedly, Russia continues to experience problems over complying with its agreed WTO obligations. In fact, though, both Russia and the EU have trade disputes with each other proceeding through the WTO dispute settlement process.

[20] See *Treaty on the Eurasian Economic Union* that came into force on 1/1/2015. The key institution to implement this Union is the Eurasian Economic Commission (EEC), located in Moscow. Interestingly, Article 63 of the TEEU

funded by contributions from the member states (mostly Russia). Nevertheless, the customs union is in place with an agreed common external tariff (referred to as the Single Customs Tariff, and listed in full on the EEU website[21]), and the EEU Treaty provides for the same four basic freedoms as does the EU. It also provides for a gradual process of regulatory harmonisation across the region. It is fair to say that the EEU is really only just getting going, with even the customs union still functioning imperfectly and little other harmonisation yet agreed and working. But the intentions, and direction of travel, are clear.

As for competition between models, the EEU offers free trade among a set of countries that are technologically lagging, with poor R&D and innovation systems. Hence the immediate economic benefits, though positive by encouraging more trade, would not be likely to stimulate more dynamic growth. On the other hand, EEU membership would not be very demanding either, since, as noted above, little harmonisation has yet occurred (except for the tariffs), and budget contributions would be small. In contrast, the EU offers trading access to a far more technologically sophisticated region, with good R&D and innovation systems. But it does so at the price of being far more intrusive, most likely insisting on a great deal of regulatory harmonisation by partner countries; and requiring the adoption of the entire *acquis* for new member states.

The EEU is already discussing free trade agreements with various countries, such as Vietnam, with an agreement coming into force later in 2016. Given the politics, it is doubtful whether the EEU would offer Ukraine an FTA, since it would probably insist on full membership or nothing. At some stage, though, when relations between Russia and the EU are less frosty, the EU and EEU could conceivably hold talks on better trade links between the two organisations. It is a hard to envisage anything more than limited agreements at first, confined to selected sectors. A natural question then is, where does this leave a country like Ukraine? Even if Ukraine still has some form of FTA with the EU, rules of origin in a trade deal between the EU and the EEU could easily be drawn up to exclude Ukraine from any benefits. Ukraine could be left in quite an uncomfortable position.

5. The EU 'Model' – Has it become dysfunctional?

5.1 Before the financial crisis

To some extent, albeit often rather slowly and creakily and with some glaring exceptions, the EU model did seem to work. EU budgets and a broad range of other programmes were agreed, directives were issued, and important progress could be seen in many policy domains. Even the linkages and the division of labour (subsidiarity) between the Union and the member states appeared to work tolerably well.

defines 'economic sustainability' in a similar manner to the Maastricht conditions for the euro, discussed above. However, there is no plan at present for a common currency.

[21] And based on essentially the same product nomenclature as that used by the EU, using the Harmonised System as defined by the World Customs Organization. However, parts of the document are quite confusing, with some tariffs in US$ (e.g. in chapter 17, sugar), some in euros (e.g. in chapter 9, coffee, tea, etc.). Most are, as normal, expressed in *ad valorem* terms, as a percentage.

5.2 Post-crisis, the need for reform

Since the crisis, much of the above has appeared to unravel, suggesting that the basic model is, at best, in need of serious modernisation and, at worst, in need of fundamental reform if the Union is to survive and prosper. Key problems for the Union include:

- The lack of democratic legitimacy, a point already noted. It is worth asking whether such legitimacy is even feasible in a body as disparate and diverse as the EU.
- Economic stagnation in recent years, with an apparently persistent high unemployment equilibrium.
- Insufficient innovation in the more advanced economies, sluggish catch up in others. This is despite all the policy pronouncements and targets that have emanated from the Lisbon process. Serious efforts by many member states have been directed at this area, with rather disappointing results.
- Though we noted above that widening and deepening the EU have proceeded in parallel, there is nevertheless a significant and growing conflict between them. Specifically, it seems that few outside the Brussels elite are ready for more deepening. There is little or no 'buy in' for a Greater Europe. Whereas independent polling suggests increasing opposition to Greater Europe across the EU, for a variety of reasons most of the newer member states share the UK's distaste for the founding fathers' concept of ever closer union. It perhaps has to be asked if this 20th century concept remains relevant to today's world.
- The Four Freedoms are commonly treated collectively as a 'sacred cow' of the EU, scarcely a permitted subject for discussion, let alone open to change. Despite this, the Four Freedoms are neither fully nor uniformly implemented across the EU, creating various distortions. Whilst this suggests insufficient consideration of sequencing and implementation issues, there is also increasing awareness that the Four Freedoms should not necessarily be fully implemented. This suggests scope for adjustment and compromise, rather than the EU elite's default response of ever closer and deeper union. This could also prove helpful in the forthcoming Brexit negotiations.
    - Regarding the free movement of capital, for instance, even the IMF nowadays no longer insists on it as dogmatically as it used to, and acknowledges that countries might indeed have good economic reasons for regulating and managing cross-border capital flows (see IMF, 2012 and 2013).
    - Goods and services are supposedly free to move as part of the single market. Goods do indeed move with very few impediments, while for services the practical situation falls a long way short of 'free movement'. This has to do with diverse issues, ranging from recognising qualifications through differing regulatory models across Europe to significant variations in business, social and cultural environments.
    - Even the free movement of people is full of ambiguity and diverse interpretation. Can EU citizens move to another member state just for a job, or to look for a job? How easy is it to register for a job, get a social security number or even to carry out essential practical tasks such as finding accommodation without paying unaffordable deposits or opening a bank account. Under what conditions and for how long can they access social security benefits in another member state? Answers to these questions are not uniform across the EU, so there is certainly no level playing field such as the principle would imply. Moreover, cultural and linguistic differences inhibit movement in certain directions (e.g. few Latvians

seek work in Bulgaria), while economic factors clearly stimulate movement in other directions. Noteworthy here is the large flows of EU citizens seeking to move to the UK in recent years, reflecting stronger economic growth, a much greater availability of jobs, a more open and flexible labour market and generally easier access to social and welfare services.

- While we summarised core values of the EU above (section 4.1), it increasingly appears that the EU's goals and decision-making arrangements are ill suited to coping with emerging 21st century problems such as the new international instabilities; persistent economic crisis; the emergence of populism; and the international migration crisis. The result has been a worrying degree of policy paralysis, with huge inflexibility and an alarmingly slow pace of decision-making – if a decision can be taken at all[22].

5.3 Analysis of EU divisions

It is often illuminating to think of the EU in terms of certain divisions, which might be geographical, or income based. Thus four natural divides are: North-South, East-West, Core-Periphery, High income-Catch up. These have natural interpretations, with East-West referring to the eastwards expansion of the EU when several former communist countries were admitted to membership (see section 2.3); Core-Periphery reflecting the Eurozone crisis, during which a few 'periphery' countries were rescued by the Troika when their banking and sovereign debt problems became too severe. Often it is not realistic to frame policy discussions either in terms of the EU as a single unit, or in terms of 28 separate member states, and various groupings, including those suggested, can make policy debate more manageable. At the same time, these divides also reveal some very real differences in interests and policy preference between different sub-groups of the EU, and can explain why in some areas it becomes next to impossible to make coherent decisions.

5.4 The emergence of populism

Populist politics has emerged in several EU member states in recent years, sometimes in response to economic crisis (e.g. Greece), sometimes in response to perceptions that significant population groups are being left behind by globalisation, also reflecting the limited democracy of the EU structures, and the apparent inability of the EU to manage either economic stagnation or the still serious and unsettled migration crisis (Hungary, Austria, the UK, France, Germany, and others). This mix of issues and problems does not sound very coherent, and it is not. But the mix has fostered populist movements in several member states as people become disenchanted with traditional politics, traditional political parties, and with the EU itself – the latter often for quite bad, and poorly informed reasons. The trouble is, neither member states nor the EU itself seem to know how to manage the recent upsurge in populism, though one imagines that effectively addressing some of the problems that have given rise to such developments would probably help.

5.5 The British problem

Even when the UK finally joined the EU in 1973, it was different from the rest. Politically, the UK has never aspired to be part of an EU that was evolving towards a federal state; indeed it is pretty clear, too, that most of the post-communist, new member states do not see this as the right way forward either. Economically, the UK's separate, successful path demonstrates the dysfunctionality and

[22] Though of course, the failure to take a decision is itself a sort of decision.

ineffectiveness of the EU's economic model, most especially in recent years. The UK has experienced higher investment, faster jobs growth and enormous inward migration (mostly, but not entirely, from EU member states). While the scale of this migration is increasingly seen as a problem in the UK, it has mostly been managed remarkably well, and the UK is probably the EU member state with the best integration of migrants, and with the least overt racism.

The EU needs to understand and appreciate the UK's relative economic success and to learn from its 'exceptionalism' in many important areas. Whilst this includes the obvious points about retaining its own currency and hence an independent monetary policy and flexible exchange rate, its more flexible labour market and its first-class business environment (in the World Bank's *Doing Business* rankings, the UK is scored ahead of all EU member states except Denmark), is something more *Schumpeterian* going on? Whilst less obvious, there is some evidence that the UK is better both at innovation and at incubating new businesses, not least in hi-tech and scientific areas, than other member states. This is probably related to the UK's highly effective university and research system, which lead all other EU members by a large margin.

Such an understanding and appreciation of the UK might suggest to the EU ways of extricating itself from continuing economic stagnation. This suggests, on the one hand, developing policies that favour creative destruction, rather than business and commercial ossification. On the other hand, it suggests that rather than adopting a mind-set of "punishing" the UK in the upcoming Brexit negotiations (with the object of reducing the UK to the level of remaining member states?), the EU could benefit from adopting a co-operative approach to turn the fact of Brexit into an opportunity to reform for the benefit of all its member states.

5.6 Ways forward for Europe

Putting these points together, it is all too easy to see why the EU is currently experiencing a major crisis, even though to a large extent the major EU institutions continue to operate with a 'business as usual' mind-set. An interesting recent example of this was the highly ambitious policy paper, Juncker *et al*. (2016), commonly known as the Five Presidents' Report. This contains some good ideas and its lines of argument are broadly coherent and logical, but in our view it is really an exercise in fantasy economics since it scarcely connects at all with the serious and urgent current problems of the EU, and it pays little attention to getting the member states on board.

Fundamentally, the EU needs to consider major structural reforms, not knee-jerk deepening which half of its Member States (and even more of its voters) will not support and which will do nothing to still the rise in populism.

6. Conclusions and remaining issues

6.1 Economic models and the political context

The economic model of the EU is based on the *acquis*; the euro and the Eurozone; partnership arrangements with many countries; and aid relationships with many less developed parts of the world. This model has worked quite well for early member states, somewhat less well for some of the newer member states. In its current form, nearly 60 years after the EU journey began, it seems most unsuitable as a model for Neighbourhood countries, probably unsuitable for some of the countries in the accession pipeline and perhaps increasingly unsuitable even for a significant minority of its existing member states. Hence an urgent need for the EU is to develop ***new economic models***, such as one incorporating a stripped down version of the *acquis* and which takes better account of economic and political realities as we approach the third decade of the 21st century. Overall, and with its very significant widening of recent years now a *fait accompli*, the EU needs to adapt to the fact that there are now much bigger economic, political and cultural disparities between member states than in earlier years. These disparities cannot be wished away: some disparities may be modified over many years by appropriate reform and architectural evolution; it is quite likely that others should be celebrated, if Europe is to develop a viable long-term model. Whilst the UK's departure is to be regretted, its distinctiveness is not! In today's world, 20th century concepts of integration and centralisation seem dated, whereas ideas of conformity and uniformity have long since been rejected.

For as we emphasised above, the priority for many countries – most of those on track for accession, most Neighbourhood states, etc. – is to sort out their domestic politics to ensure functioning states, and to create conditions for renewed economic growth. Only later should anyone be concerned about compliance with most of the detailed aspects of the *acquis*.

Politically, too, the EU functions rather poorly. The key institutions – European Parliament, European Commission, and the European Council – suffer from democratic deficits and ineffective working. In 'normal times' decision-making processes are sometimes slow and cumbersome, but they "appeared" to work and to operate tolerably well. At times of crisis and/or when decisions are needed that seriously cut across the diverse interests of the member states, then we see just how badly the EU functions. Whether it is decisions and policies emerging from all-night ministerial meetings or its palpably weak responses to so many of today's key issues, it is clear that the EU needs to develop more intelligent and reasonable ways of conducting important business.

6.2 Issues for further work

Several areas for future work/research are suggested by the strands of argument set out in this overview paper. Some of these need further thinking in the light of the UK's referendum on exiting the EU. These areas should include:

(a) Moving beyond the usual 'one-size-fits-all' approach of the EU to an acknowledgement that cultural diversity and varied economic needs call for ***a variety of economic models***, starting from basic elements of state building, and creating conditions for sustainable economic growth. Hence building these models and putting them into practice is an urgent task.

(b) Parts of the Neighbourhood (and even some candidate countries like Albania, and potential candidates like Bosnia-Hercegovina) could benefit from a relationship with the EU that is better focused on urgent needs, and that could be seen as less intrusive in cultural and political terms. Devising more suitable ***modes of engagement*** for these countries requires much new and creative thinking.

(c) New thinking is also called for in regard to the ***EU's political model***. This would include re-thinking what policy areas should be handled at EU-level and member-state level respectively. It would also include steps to overcome the widely perceived democratic deficit, and to devise more effective – and also more widely acceptable (if that is not a contradiction) – modes of functioning and decision making on the part of the top-level EU political institutions. This re-thinking should also include a review of how the top-level institutions relate back to the governments of EU member states. We clearly have not got this right!

(d) ***In the wider world, it seems to us that the EU needs to be both more selective and less ambitious in what it tries to do.*** It cannot go on trying to do a bit of everything nearly everywhere – this makes no sense economically and culturally (even accepting that, for the most part, the EU is well intentioned), and merely dilutes whatever 'message' the EU wishes to convey to the rest of the world.

(e) Last, a few closing thoughts about the possible/likely impact of ***Brexit***, building on the remarks of sections 3.6 and 5.5.

(i) First of all, the EU and its institutions could take the view that everything is just fine and that little or nothing needs to change. If voters in the UK opted to vote for Brexit, albeit not by an overwhelming majority, that is essentially their choice and they will need to live with the consequences as these unfold in the coming years. In our view, this would be an unwise stance on the part of the EU.

(ii) Given the internal divisions within the UK revealed by the Brexit vote, the EU could seek to be helpful (to Scotland) by facilitating a Scottish accession to the EU if Scotland holds another independence referendum and votes to leave the UK. At present this all seems highly unlikely, and in any event it would not be viewed as helpful in the slightest by the London government. But clearly, Scotland would find it easy to meet the usual EU accession conditions.

(iii) Assuming Brexit goes ahead on the basis of a still unified UK, politically delicate border issues arise, notably in Northern Ireland. It would be very damaging if the border between Northern Ireland (no longer part of the EU) and the Irish Republic (still an EU member state) were to become a 'hard border', with border posts, customs checks, and the like. A way needs to be found to reconcile Brexit with the UK/Ireland Common Travel Area that has operated successfully since the 1920s.

(iv) Aside from these awkward internal UK issues or UK/Ireland border issues, there is the wider question of what sort of deal we could strike with the EU concerning the terms of our separation and the nature of our continuing relationship with the EU27. The EU could attempt to take a hard line and even to be punitive. Apart from risking sending out the signal that the only reason to remain in the EU is to avoid the penalties that accompany exit, such as approach could backfire. On the other hand, a more generous and forward looking approach could pay off and lead to mutually beneficial co-operation in the future; the UK is, after all, leaving the EU, not Europe! This conveys a better, more positive message, namely that the EU has much to offer its member states, and that the UK may have been premature, if not misguided, to leave the Union.

(v) Taking point (iv) a little further, we worry a great deal that the EU may seek to punish the UK for the Brexit decision. Conceivably the EU could even perceive itself as benefitting by bringing down the present UK government, given the deep divisions that remain within it, on the grounds that the Brexit decision could then be reversed. Such a short-term tactic would likely turn out a serious misjudgement, as it would lead to huge resentment in the UK. No new government would tolerate such EU interference. Whilst the UK's position in the world may no longer be quite what it believes it to be, the country remains big enough and strong enough to cause serious retaliatory damage to the EU if the Brexit negotiations were to go badly. With the EU already in crisis, such a needless battle with the UK could even, in the worst case, catalyse the collapse of the EU.

(vi) With Brexit potentially as risky and dangerous for the EU as for the UK, it can be seen in classic game theory terms as a form of prisoners' dilemma problem. Both sides – the EU27 and the UK – can opt to take a hard line in the negotiations, or they can choose to go for a more flexible, co-operative and constructive negotiating stance, a softer approach. There is a serious need to avoid poor communication and a tendency for both sides to lay down rigid positions that become entrenched, the risk being that this could presage the probable worst outcome, (hard, hard). Rather, it is likely that the best outcome for everyone is the one that corresponds to (soft, soft).

(vii) Whilst Brexit at any time is perhaps regrettable, it is particularly badly timed with the EU in crisis and the world more unstable than at least any time since the collapse of communism. Nevertheless, "Brexit means Brexit" as we are all continually reminded. With the EU, including the UK, containing some of the most mature and responsible countries in the world, as well as some of the most sophisticated institutions, a display of such maturity and responsibility in the upcoming negotiations would be much the safest way to proceed. It could also allow some important reform lessons to be learnt and implemented. Whilst "Brexit may mean Brexit", it is the UK leaving the EU as currently constituted. It is certainly NOT the UK leaving Europe.

References

Burda, Michael C. and Hunt, Jennifer (2001), 'From Reunification to Economic Integration: Productivity and the Labor Market in Eastern Germany', *Brookings Papers on Economic Activity*, No.2, Washington, DC: The Brookings Institution

Carlin, Wendy (2010), 'Good Institutions are not enough: Ongoing Challenges of East German Development', *CESifo Working Paper No. 3204*, Munich

CGD (2008), *The Growth Report: Strategies for Sustained Growth and Inclusive Development*, Commission on Growth and Development, Washington, DC: The World Bank

Csaba, László (2005), *The New Political Economy of Emerging Europe*, Budapest: Akadémiai Kiadó

Doing Business 2016, Washington, DC: The World Bank

EC (2015), *The Former Yugoslav Republic of Macedonia: Report 2015*, SWD (2015) 212 final, Brussels: European Commission, November

Elliott, Larry and Atkinson, Dan (2016), *Europe Isn't Working*, New Haven, Conn.: Yale University Press

European Economy (2002), 'Germany's growth performance in the 1990's', *Economic Paper No.170*, European Commission: DG for Economic and Financial Affairs

Hare, Paul (2013), 'Institutions in Transition', chapter 2 in Paul Hare and Gerard Turley (eds), *Handbook of the Economics and Political Economy of Transition*, London: Routledge

Hare, Paul (2012), *Vodka and Pickled Cabbage*, CreateSpace (esp. ch.9)

IMF (2013), *Guidance Note for the Liberalization and Management of Capital Flows*, Washington, DC: International Monetary Fund

IMF (2012), *The Liberalization and Management of Capital Flows: An Institutional View*, Washington, DC: International Monetary Fund

Juncker, Jean-Claude, *et al*. (2016), *Completing Europe's Economic and Monetary Union*, Brussels: European Commission (often referred to as the 5 presidents' report)

Kołodko, Grzegorz (2000), *From Shock to Therapy: The Political Economy of Postsocialist Transformation*, UNU/WIDER Studies in Development Economics, Oxford: Oxford University Press

Scheller, Hanspeter K. (2004), *The European Central Bank: History, Role and Functions*, Frankfurt: ECB

Sinn, Hans-Werner (2016), 'The global economy is caught in a trap. The only way out is creative destruction', *The Guardian*, London; September 27th

Sinn, Hans-Werner (2014), *The Euro Trap: On Bursting Bubbles, Budgets, and Beliefs*, Oxford: OUP

Sinn, Hans-Werner (2000), 'Germany's Economic Unification: An Assessment after Ten Years', *NBER Working Paper 7586*, Cambridge, Mass.: NBER

Stiglitz, Joseph E. (2016), *The Euro and its Threat to the Future of Europe*, London: Allen Lane

TEEU (2014), *Treaty on the Eurasian Economic Union*, Moscow; came into force 1/1/2015

TFEU (2012), *Consolidated Version of the Treaty on the Functioning of the European Union*, OJEU (commonly referred to as the Lisbon Treaty, signed December 2007)

TEU (2012), *Consolidated Version of the Treaty on European Union*, OJEU (often referred to as the Maastricht Treaty, agreed in 1992, coming into force 1993)

Varoufakis, Yanis (2016), *And the Weak Suffer What They Must? Europe, Austerity and the Threat to Global Stability*, London: The Bodley Head

WEF (2015), *The Global Competitiveness Report 2015-2016*, Geneva: World Economic Forum

World Bank (2015), *Doing Business 2016: Measuring Regulatory Quality and Efficiency*, Washington, DC: The World Bank

Appendix 1. Chapters of the *Acquis Communautaire*

Chapters of the *acquis*
Chapter 1: Free movement of goods
Chapter 2: Freedom of movement for workers
Chapter 3: Right of establishment and freedom to provide services
Chapter 4: Free movement of capital
Chapter 5: Public procurement
Chapter 6: Company law
Chapter 7: Intellectual property law
Chapter 8: Competition policy
Chapter 9: Financial services
Chapter 10: Information society and media
Chapter 11: Agriculture and rural development
Chapter 12: Food safety, veterinary and phytosanitary policy
Chapter 13: Fisheries
Chapter 14: Transport policy
Chapter 15: Energy
Chapter 16: Taxation
Chapter 17: Economic and monetary policy
Chapter 18: Statistics
Chapter 19: Social policy and employment
Chapter 20: Enterprise and industrial policy
Chapter 21: Trans-European networks
Chapter 22: Regional policy and coordination of structural instruments
Chapter 23: Judiciary and fundamental rights
Chapter 24: Justice, freedom and security
Chapter 25: Science and research
Chapter 26: Education and culture
Chapter 27: Environment
Chapter 28: Consumer and health protection
Chapter 29: Customs union
Chapter 30: External relations
Chapter 31: Foreign, security and defence policy
Chapter 32: Financial control
Chapter 33: Financial and budgetary provisions
Chapter 34 - Institutions
Chapter 35 - Other issues

Source:
http://ec.europa.eu/enlargement/policy/conditions-membership/chapters-of-the-acquis/index_en.htm