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**SOCIAL AND ECONOMIC
RECONSTRUCTION OF THE EUROPEAN
UNION DIMENSIONS**

**Toward Bottom-Up and Top-Down
Institutional Reconstruction of the European
Union – more inclusive, more sustainable and
more pluralistic EU**

MATJAŽ NAHTIGAL



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Union – more inclusive, more sustainable and more pluralistic EU**

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INTRODUCTION

This monograph presents a collection of eight chapters that were written before, during and after the protracted financial, economic and social crisis in the European Union (EU). During this period, many different experts and policy-makers pointed out that the EU is facing the most severe existential crisis since its foundation. Even though the crisis has recently – and temporarily – subdued due to various measures, taken mainly by the European Central Bank, this does not mean that the EU has finally developed a resilient institutional architecture capable of effectively dealing with the potential emergence of new financial, economic, trade or social shocks. On the contrary, the emergence of various types of populism, the rise of nationalism in many different parts of the EU, and clearly visible broad popular discontent in other parts of Europe, should be viewed as a reminder that the EU has been unable to develop a working institutional formula to date that would embrace at the same time the European motto of “unity in diversity” and that would be capable of accommodating effective decision-making processes at the supra-national level and of enhancing the parliamentary democracy in the member states.

A pessimistic view is that, due to different levels of socio-economic development, such a workable institutional formula in the enlarged EU is impossible to achieve. According to this pessimistic view, the future of the European project should retreat to a minimalistic institutional formula that reduces the European project to a regional free trade area with a minimum of common institutions and policies and that pools resources. This view assumes that any additional tasks, competences and pooling of resources would inevitably lead to harmful centralization of the EU, thereby depriving member states of many traditionally held instruments, tools and policies at their disposal to provide economic and social security for their citizens. Such a view is most clearly expressed in the form of Brexit, which seems to represent an almost insurmountable challenge for the British polity and for the future path of the European integration.

On the other hand, a more optimistic and more ambitious view claims that the EU remains an unfinished project. The protracted financial crisis exposed inadequacies in the European institutional design. Therefore, steps must be taken toward completing the monetary, fiscal, banking and political union. The most obvious,

although not completely transferable model, is the model of gradual evolution of the United States (US) federalism in the European context. Especially the period of the New Deal with the adoption of new federal powers, new federal institutions, such as the Stock Exchange Commission, the National Labor Board, the Federal Deposit Insurance Corporation, and the Social Security Administration, should serve as a model to emulate in the European context. The difficulties with such an ambitious approach toward deepening European integration, however, are manifold. First, a substantial number of the member states are not ready to support such an ambitious approach. Especially large member states, most notably Germany, fear that such a path of integration may lead to a moral hazard and free riding by the economically weaker member states. This fear stems primarily from the experience with the unification process of East Germany, the costs of which substantially exceeded initial assessments. Even three decades after the fall of the Berlin Wall the process of unification is incomplete. Many economic, social, cultural and political cleavages still apparently exist between East and West German federal states. Sometimes these cleavages are explicitly recognized; at other instances, they are ignored at the country's own peril as witnessed by the rise of populist parties and movements in the East. Of course, the process of future EU integration does not need to resemble or replicate the unique process of German unification, but certain risks in such a pan-European endeavor cannot be overlooked.

Second, perhaps more importantly, but generally less understood, is the problem with the developments of the US federalist structure itself. The financial crisis, economic devastation of many traditional industrial centers of this big federal state, stagnation of wages, rise of inequality, social and political polarization show that the socio-economic developments of this advanced and rich country do not necessarily present the most optimal normative and conceptual framework. Without engaging in a discussion about the extent to which the dismantling of many of the achievements of the New Deal during the last few decades contributed to such an sub-optimal socio-economic and political development, for the purposes of our analysis it is important to point out that mere replication of certain historical normative and conceptual solutions may not present the most optimal approach to the future of European integration.

Third, even less visible is the issue of the establishment of a European institutional architecture under the supposedly neutral technocratic framework. Such a theoretical and practical assumption runs against the rich traditions of European social democracy, liberal democracy, and Christian democracy. A top-down, one-size-fits-all, approach toward the European common market framework runs against the development of historical types of market economy, representative democracy and organized civil society developed by the member states before

and after joining the European integration. Such a European technocratic top-down approach represents a European version of the “end of history”, according to which the existing institutional framework of market economy, representative democracy and organized civil society are universally valid. They cannot evolve, and they cannot advance. In this monograph, I argue that European acceptance of the institutional indivisibility of the market economy, parliamentary democracy at the national and supranational level and of organized civil society represents a departure from the post-war developments of socially cohesive, inclusive and balanced development of European model(s). By accepting that there is one single model of market economy, representative democracy and organized civil society, the European technocratic approach deprives European localities, regions and the member states of initiatives, creativity, engagement in institutional innovations and development strategies based on their tailor-made comparative advantages. At the same time, a top-down and one-size-fits all approach leads to centralization of economic, financial and political powers in a small number of most advanced European regions. No banking, transfer and political EU can adequately address the growing European inequalities.

The purpose of this monograph is to show that there is a path beyond the pessimistic, shallow, fragmentary EU on one hand and a path beyond centralized, technocratic one-size-fits all EU on the other hand. The theoretical assumption of this monograph is that there is no single, universally valid institutional form of market economy, representative democracy and organized civil society. This theoretical assumption represents an invitation, conceptual and practical, for institutional innovations, for institutional, economic and social reconstruction from the bottom-up and the top-down. It is an invitation for European citizens, various social groups and social alliances to engage and actively to shape, construct, innovate and reconstruct European markets and political and social institutions at all levels of European polity. It is an invitation to reimagine the European social-market economy in the context of knowledge economy for the many, in the context of rapidly evolving processes of globalization and in the context of persistent imbalances and inequalities. The best way to address many of the existing European cleavages, such as between the North and South, between the West and East, between the core and periphery, between the contributors and receivers of European finance, and between the socially cohesive and socially excluding members states and the regions is to empower excluded regions and citizens and to disseminate knowledge, skills, good practices and all other necessary resources. Such an approach beyond the pessimistic and optimistic European reformism can be called a European approach beyond centralization and fragmentation. Such an approach may at first glance resemble the discredited European third way, which was advocated and practiced in the last two decades. The European third way approach unsuccessfully and counter-productively combined the European continental model

of social security with the Anglo-Saxon version of market flexibility. It turned out that flexibilization in most parts across Europe was sought at the expense of economic and social security. The erosion of social welfare across the EU, with the exception of the few most advanced, most competitive and most cohesive member states and their regions, started to evolve even before the financial crisis. The financial crisis itself and the responses to the crisis only aggravated the socio-economic conditions in many parts of the EU.

The point of departure of this monograph is that it is neither possible nor necessary to replicate completely the social pillars developed in post-war Europe. Traditional industrial production required different types of supporting institutions than the present knowledge economy. To share opportunities and benefits from the knowledge economy widely, high quality education must be accessible to everyone, including life-long learning educational opportunities and incentives. A newly developed sphere of production and services, based on permanent innovations, requires constant efforts to gain new skills. New forms of ownership and the allocation and dispersion of property rights among a variety of stakeholders assumes a transformation of (neo)classical legal thinking and legal practices. New approaches to competition policy, including to dealing with high-tech digital companies, represents another realm of unexploited possibilities. New forms of modern industrial policies, in a decentralized and pluralistic version, should enable and support start-ups, small and medium size companies in many of the stagnant regions to tap the entrepreneurial potential of these places. Financial institutions should strengthen the links between savings and investments in ways not currently envisaged by the banking or capital market union. Fiscal policies in their decentralized forms should enjoy broad policy space to pursue long-term sustainable and inclusive development. Equally important, the trade policy should aim at more inclusive, more balanced and more sustainable developments for all trading partners. Rights and protections for international investors should be adequately balanced with their legal, social and environmental responsibilities.

A European approach beyond centralization and fragmentation looks for decentralized, but coordinated efforts in accommodating member states and their regions to the conditions and characteristics of a knowledge-based economy and society. It aims to open maneuvering room for member states to pursue largely autonomous economic policies while preventing any attempts at begging-thy-neighbor policies of participants. Simultaneously, by strengthening the European social dimension, the approach should become more inclusive and more sustainable than the current path of development in the EU. It should aim to find subtle dialectical relations between the common market and the social welfare of the member states that were pursued by Jacques Delors during his term as president of the European Commission.

Without more instruments, policy tools, and broader space for institutional innovations, the inherited European disparities may only deepen. This was the trend especially visible during the financial crisis, but it continues to date. The trend leads to hierarchical segmentation of the common market, in which a small number of advanced regions exists together with the large number of stagnating regions of mainly suppliers and relatively cheaper and less qualified labor. Accordingly, without substantial reversal of this trend and the dissemination of advanced practices, technologies, know-how and skills, the European cleavages may only deepen. No structural funds, no banking or fiscal union, no matter how comprehensive and well-intended, can reverse this trend without proper empowerment of the stagnating regions across Europe and without rethinking some key European policies, such as the competition policy, fiscal policies, technological policies and even trade policy. In place of the one-size-fits-all, top-down approach, a monograph in all of its chapters presents a call for a union that is more hospitable to a variety of institutional models across Europe. The argument is that a support and engagement with the bottom-up initiatives and diverse development strategies is equally or even more important than building a European banking, fiscal and political union. These two processes are not mutually exclusive, but they are mutually reinforcing, as the call for a different, more inclusive, more balanced and more sustainable union suggests.

Finally, reimagination of a European institutional framework assumes reimagination of the European trade and other external policies. Instead of remaining squeezed in a trade conflict between the US and China, the EU should develop a trade policy more consistent with the idea of an internally more inclusive socio-economic development. Similarly, the trade policy beyond one-dimensional liberalization should include adequate measures to ensure effective legal responsibilities for the multinational companies and measures to ensure adequate levels of labor and social protections, adequate health and environmental standards and the sufficient level of regulatory autonomy of the governments to intervene when legitimate and necessary. The goal of trade agreements, multilateral and bilateral, should not be to maximize trade but to secure the trade international framework conducive again to more inclusive, more balanced and more sustainable international economic, social and environmental development. Rethinking European trade policy along with other key European policies could again propel the EU closer to the ideal of the EU as a normative power in the international context.

The method of this research, based on the rich tradition of European social and legal thinking, is to apply the method of critical legal analysis in the context of a comparative legal and institutional perspective. More concretely, an outline of the monograph is the following one: in the first chapter titled *A Different Europe is Possible* a broad discussion on the institutional dimension of the financial,

economic and social crisis is laid out. The main argument, which is also a point of departure for all other chapters in the monograph, is that the current European institutional framework is too strong and too weak at the same time. It is too weak on universal social endowment but strong on macroeconomic and regulatory limits to national, regional and local innovation. Institutional asymmetry of the European project reinforces the existing inequalities and cleavages and should be reversed.

In the second chapter, a discussion is devoted to *The Economic, Legal and Social Aspect of the Role of Financial Institutions Before, During and After the Financial Crisis*. In this chapter a need for a more comprehensive theoretical and strategic debate about the actual role and importance of the financial sector for economy and society at large. The key problem according to the normative analysis of the financial sector is that the rise of the financial industry was not accompanied with the rise of productivity and the expansion of output. The link between finance and real economy is not automatic and guaranteed, it is tenuous and weak. Different institutional models and regulatory approaches can strengthen or weaken the relation between finance and economic activities. This observation has an important consequence especially for the stagnating regions with poor access to long-term finance for their companies, in particular for start-ups, small and medium size companies and for innovations.

The third chapter, *The EU Fiscal Compact: Constitutionalization of Austerity and Preemption of Democracy in Europe*, is devoted to the issue of fiscal policy within the context of the eurozone. It presents a comprehensive legal and socio-economic normative analysis of the European Fiscal Compact and it is argued that the EU Fiscal Compact is not designed in such a way to lead eurozone member states toward the necessary fiscal consolidation and toward the equally necessary fiscal expansion. As such, it may even present a future source of distrust and even conflict between the member states and the European Commission without improving macroeconomic conditions in several member states and without securing the necessary level of long-term public investments for sustainable and inclusive growth in these member states. A need to rethink European fiscal rules in more sustainable ways should be envisaged.

The fourth chapter, *The European Regional Disparities: The Crucial Source of European Un-sustainability*, is dealing with one of the crucial deficiencies in the European institutional design, which is the gap between the most developed European regions and those regions that are stagnating or even falling behind. The gap has worsened during the protracted financial crisis, because not sufficient attention to this structural problem has been devoted to by the European policy-makers. It is argued in this chapter that decentralized strategic coordination between the European institutions and the stagnating regions should be established

in such a way to support local and regional economic and social reconstruction based on broad participation of local civil society, entrepreneurs, policy-makers, experts and others to exploit the potential and comparative advantages of their localities and regions.

In the fifth chapter, *Rethinking European Industrial Policy: Beyond the Current EU Legal Framework*, the purpose of this chapter is to show that the current EU legal framework is unnecessarily restrictive toward economic and developmental initiatives in many stagnating regions across Europe. More innovative industrial policies, instruments and measures should be adopted in a highly decentralized manner across the EU. Between the 'laissez-faire' and 'dirigiste' approaches, there is significant room to maneuver for more pro-active industrial and development policies. New forms of industrial policies could be reinvented and implemented across the EU – not to harm or distort competition, but rather to further enhance it.

In the sixth chapter, *From Classical Toward Experimental Federalism: Different Pathways for More Inclusive and Balanced European Union*, discusses dilemmas and possible pathways for the future legal character of integration. From comparative constitutional perspective, there is no clearly optimal model that could be merely emulated by the European Union. This chapter discusses whether the model of classical federalism is the only way forward for European integration, or there are other possible trajectories for the future integration. It points out that there are limitations of classical federalism and examines possibilities of establishing cooperative or even experimental federalism as a new, innovative and distinctive model for European integration. The advantage of cooperative or experimental federalism would be preserving local, regional and national autonomies and maintaining their individual capacities to develop and implement comprehensive economic, social, cultural and political restructuring tailored to the needs, aspirations and potentials of citizens and various social groups. The role of the supranational institutions would be primarily to support and participate in implementing diverse development strategies across the EU, to prevent social dumping or other forms of mutually harmful behaviour of the member states and to support and strengthen the common European social pillars.

In the seventh chapter, *From Regressive Toward Progressive European Structural Reforms*, the purpose of this chapter is to analyze the concept of structural reforms, as defined by the European Commission. The article critically examines the content of structural reforms, which is not neutral and often leads – if not carefully designed out and implemented – to the deepening of economic and social inequalities. Especially structural reforms in the form of labor market flexibilization, reduction of social welfare support and weakening of the role of public

sector frequently deny large segments of society access to entrepreneurial activities, access to funding, know-how, to new technologies and all other necessary resources. Alternatively, public intervention on the supply side to open access of the excluded parts of population toward finance, new technologies, improved skills can present a growth enhancing measures necessary to achieve overall structural improvements of the stagnating parts of EU.

In the eighth chapter, *Modern Free-Trade Agreements – How to Redirect EU and Global Trade Policy*, I analyze the difference between the post-war development of international legal trade regimes and the context of the most recent free trade initiatives in the form of a new generation of free trade agreements. The focus of the discussion is on frequently ignored fact that the disparate effects of trade liberalization tend to also become more visible in the most advanced economies, not only in the developing countries. This trend offers an opportunity to rethink trade arrangements in such a way to equip all the trading partners with the adequate instruments, tools and policies when needed to restructure national economies. Careful calibration of such instruments, tools and policies should not distort, but rather strengthen international trade. It could provide an international legal framework conducive to long-term sustainable development and more resilient in different types of international financial crises that may appear in the future. Comprehensive efforts to disseminate the benefits as widely as possible should be applied at the local, national and international levels. In doing so, local communities should be encouraged to launch different development strategies suitable to their comparative advantages, their potential and their needs.

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1 A DIFFERENT EUROPEAN UNION IS POSSIBLE: TOWARD COMPREHENSIVE BOTTOM-UP RESTRUCTURING OF EU

INTRODUCTION

Current debates on the future of the European Union (EU) stem from the unfinished debate on the sustainable settlement for Europe, which started with the Laeken Declaration and the Convention on The Future of Europe in December 2001. They also stem from the ongoing economic, financial and social crises in many parts of Europe. The breadth and scope of these debates is perplexing. Proposals on diversity and mutual exclusivity, and very often internal contradictions in such proposals and ideas, originate from a broad spectrum of experts, politicians, national and supranational actors, citizens and various parts of European civil society. These debates are taking place in the most restrictive EU context of austerity and fiscal rules resembling the gold standard policy framework during the depression era in the 1930s. This context further complicates the purpose and sense of discussion.

The EU is struggling with its deepest economic, social and political crisis since its establishment. Despite the number of measures in the area of European fiscal rules and the European financial sector, the EU as a whole remains unable to overcome the crisis. After years of unsuccessful EU coping with the crisis, it is evident that the institutional and practical arrangement established by the Treaty of Lisbon from December 2009 is ill-prepared to successfully tackle the crisis. The problem is that the views and ideas of how to reform the established European settlement remain highly divergent. This makes the future of the European project in its current setting unsustainable.

The purpose of this contribution is to show that it is still possible to rescue the European project and to find the common ground between the European progressives and conservatives, between European North and South, and between the European center and periphery. In place of top-down imposition of ever more restrictive rules for all EU member states, their regions and local communities, it would require bottom-up institutional reimagination, involvement of citizens, entrepreneurs and local communities, and revival of European pragmatism in place of the current rigidity of European technocracy. The points of departure for the discussion are the following propositions:

- The current context of “austerity Europe”, enshrined in the Fiscal Compact of March 2012, is not sustainable and is going to hurt not only the EU periphery, but also most of the Europe core;
- While rejecting the Fiscal Compact as an unnecessary and harmful fiscal straitjacket for the member states and their regions, this is not a call for additional

creation of public debt and deficits, but a call for high quality, transparent, long term oriented and sustainable fiscal policies across the EU;

- Traditional social democrats should give up their hope to replicate the traditional welfare model on the EU level, which is neither feasible nor desirable. The traditional tax-and-transfer social policy should be replaced with the productive, developmental social welfare policies with an emancipatory goal for all European citizens;
- Modern types of industrial policy that are decentralized, pluralistic and experimental should be encouraged, not suppressed at all levels of European polity;
- The true EU goal is to become a more balanced, more inclusive and more diverse Europe. Such an EU should be hospitable to the co-existence of different economic, social and democratic models. It should resemble the EU from the first two decades of its establishment, albeit in the new context of a globalized and knowledge-based economy.

The crucial characteristics of the early golden age of European capitalism were a high level of autonomy of the member states in running their economies, strong public sectors supporting the development of private sector, a tame financial sector providing long term support for the real economy, full employment, and an active role of the government in promoting the market economy.

EUROPEAN UNION: FROM SUCCESSFUL INTEGRATION TO EXISTENTIAL CRISIS

The early model of the EU was much closer to the “varieties of capitalism” ideal. It created a space for comparative institutional advantages on the basis of local, regional and national innovations and experimentation. The EU was there to promote, not suppress institutional divergence that led to high levels of growth and close to full employment accompanied by the growth of worker salaries and expansion of social rights. The counterargument, namely that the golden age of the European post-war period was mainly due to recovering from the war devastation, is currently in place. On the other hand, the institutional context based on the broad autonomy of policy-makers and the availability of policy instruments secures much greater maneuvering room to run and develop economies and societies in the member states.

European integration through laws gradually created a European constitutional asymmetry, which appears to be insurmountable. It has narrowed the maneuvering room for social and economic development of member states and their regions. At the same time, the EU institutions were not able to acquire sufficient

resources, capabilities and instruments to adequately replace the functions, responsibilities and tasks of the member states. If it was the role and function of the member states to provide economic and social security for their citizens in the early stages of European integration, the gradual loss of instruments, resources and capabilities led to the gap between member states and EU institutions. This gap can be called European institutional asymmetry¹, resulting in a situation when no level of European polity can be held accountable for providing economic and social security for their citizens.

Subsequently, all hopes of the European political class are vested with the European single market. As witnessed from the beginning of the crisis, however, the most persistent dogma of the European single market cannot automatically lift the Eurozone and its members from the crisis. Coordinated, well thought-out responses at the European level and in the member states is needed to overcome the crisis. Most of the measures taken during the crisis are based on the premise that it will be possible to return the EU to the status-quo settlement developed before the crisis, albeit somewhat more centralized. This is in the author's opinion the biggest illusion of the European political, financial and economic elites. The efforts to adopt and implement the Fiscal Compact, to establish the Banking Union, and subsequently the modest version of the Transfer Union, all stem from this questionable premise of returning the EU to the status-quo settlement.

At the core of the European crisis is the gradual creation of the European institutional asymmetry, according to which the policy space and instruments for the member states have been increasingly narrowed. Among the most important instruments that were lost in the process of integration through law were: 1) a loss of ability to devise and implement the national (or regional) long term development strategies; 2) a gradual loss to adequately finance the social programs aimed at strengthening individual capabilities and supporting the life learning education process; 3) the ability to articulate and implement modern industrial policy; 4) the ability to keep in check domestic financial institutions and their channeling of financial resources to long term local, regional and national development; and 5) the underfunded education, particularly higher education in many of the EU member states. All of these things should be included in the debate on the future of Europe.

To overcome the existing institutional asymmetry, the most frequent proposal from the progressive voices is to continue with the fiscal consolidation in the member states, to implement as quickly as possible the Banking Union and to

1 F. Scharpf, *The Asymmetry of European Integration*, KFG Working paper no. 6, 2009.

start developing a modest Transfer Union. The conceptual idea behind these proposals is that the EU needs to create “greater structural homogeneity and institutional convergence (especially in labor markets) among its members... In the long run, EU countries need to look more like one another...”²

Most of the proposals from the moderately progressive side are questionable. It is possible and necessary to support the urgent need to improve labor market dualism across Europe. Most of other proposals with respect to the Fiscal, Banking and Transfer Unions, however, would inevitably lead to further centralization of the EU. They would open room for more one-size-fits-all policy measures and more top-down policies without sufficient transparency, without sufficient democratic accountability and without proper constitutional checks and balances. Moreover, highly divergent European localities, regions and member states would be effectively deprived of their initiatives, like how to search for new development opportunities, tailored to local, regional and national needs, capabilities and based on institutional innovations.

Therefore, a credible alternative to the top-down, one-size-fits-all approach, which is disinterested and inhospitable to the variety of needs, opportunities, capabilities, initiatives and innovations, is to open the future EU development to bottom-up institutional innovations and diversities. This is where the true energy, ideas and strength of the European project really lies, and not in the hands of European technocracy. “In fact, technocracy curiously mirrors populism: only one possible policy here, only one possible voice of the people there; nothing really to talk about.”³

Institutional innovations and imagination across Europe were the crucial elements of the golden era of European capitalisms. The ownership of development strategies belonged to the localities, regions, member states and their citizens. These are qualified versions of the varieties of European capitalism in the form of permanent institutional innovations and in the form of co-existence of different models for the market economy and social welfare across the EU. Such a decentralized union⁴, based on a variety of models and institutional innovations would resemble more the EU of the early “golden age” of the European integration, but adjusted to the context of twenty-first century globalization and knowledge-based society. Such an EU can again become an actor in reshaping the current context

2 D. Rodrik, *Europe's Way Out*. Project Syndicate, June 13, 2013.

3 J.-W. Mueller, *European elections: the false promises of populism*. The Guardian, May 4, 2012.

4 For the call on decentralizing EU as a step forward, see J. Delors et al., *Let's create a bottomup Europe*, Guardian, May 3, 2012. On the risk of European centralization see also Otmar Issing, *The Risk of European Centralization*, Project Syndicate, July 2, 2013.

of globalization that creates unsustainable economic, trade, financial, labor and environmental imbalances.

IMPOSSIBILITY AND UNDESIRABILITY OF THE TRANSFER UNION

There can be little doubt that the ongoing financial, economic, and social crisis is moving further away from the declared goals of the European social-market economy as stipulated in Article 2, para. 3 of the Treaty of Lisbon.

Contrary to the stipulated commitments and goals of the EU, however, the EU is facing historic levels of unemployment, especially among the young, and many of the EU countries and European regions offer no prospects or future for the majority of the population.⁵

The most frequent response to the dire European socio-economic situation is that “We need more Europe” to overcome the crisis. For far too long, this ill-defined and vague slogan has represented a poor substitute for a genuine and comprehensive discussion of the future of the EU. The debate regarding the future of the EU was organized in the form of the Convention on The Future of Europe before the adoption of the Treaty of Lisbon. The truth, however, is that the European political class and European civil society at large have been unable to find an appropriate model of balanced, sustainable, inclusive and pluralistic future development.

The real debate about the future of the EU should not be whether we need more or less Europe. Instead, the discussion needs to start with the observation made by Loukas Tsoukalis and start debating what kind of Europe we need, as well as what kind of Europe is possible, to finally start serving the needs of European citizens, communities, regions, and member states.⁶

When one asks what kind of Europe we need, the most frequent answer is that we need to proceed with the Fiscal and Banking Unions, improve coordination of fiscal and economic policies, and finally move to the Transfer Union – a Union most likely organized according to the German constitutional provisions of financial equalization.

5 “Without doubt, this is the most serious crisis the EU has faced since its inception...” P. Hall, *The Economics and Politics of the Euro crisis*, German Politics, 21 : 4, 355–371, 370 (2012).

6 L. Tsoukalis, *What Kind of Europe?*. Oxford University Press, 2005.

Let's start with the last and the most remote, although with some of the progressives and European citizens the most cherished and desired goal: the establishment of the Transfer Union. There are many possible objectives for such an outline of the future development of European integration. Some of these objectives are of a practical nature. Other objectives take a more subtle viewpoint. From a practical viewpoint, one should look at the current struggles within the German constitutional arrangement of financial equalization on the basis of Article 107 of the German constitution (*Grundgesetz*). At the moment, only four German federal states aid twelve other federal states through the fiscal equalization mechanism. This mechanism, although a successful postwar development now enshrined in the German federal constitution, is becoming an increasing source of conflict among the German federal states. It has already been announced by Bavaria that they are planning to legally challenge the transfer system of financial equalization before the federal constitutional court.⁷

If the constitutional mechanism of financial equalization creates such tensions within the German federal constitutional arrangement, one can only imagine the tensions that would result from any attempt to create a European Transfer Union based on a mechanism similar to the German approach. Especially in the period of self-imposed austerity measures and the introduction of the fiscal brake into the German constitution, applicable both for the federal budget and for the state budgets, it is likely that tensions regarding the transfer mechanism may further deepen in the future.

The EU currently consists of 271 regions on the Nomenclature of Territorial Units for Statistics (NUTS) level 2. During the protracting crisis, according to the most recent European regional yearbook, "out of the 271 NUTS level 2 regions in the EU for which data are available, the unemployment rate increased between 2007 and 2010 in 215 regions, remained unchanged in seven and fell in 49."⁸ It is theoretically and practically impossible to create a sufficiently meaningful Transfer Union that would address the needs and expectations of large parts of the excluded population in the majority of European regions and member states.

From a subtler and very rarely mentioned viewpoint, one should take a closer look at the nature and development of regional disparities across the EU. An overview of European regional disparities shows the level of uneven development across the EU. The main dividing line in the EU is primarily between the relatively few prosperous and advanced regions and the large majority of stagnating or even

7 Bavaria Mulls an End to Solidarity, Spiegel, July 18, 2012.

8 Eurostat Regional Yearbook 2012, European Union, Luxembourg, p. 78.

backward regions. This dividing line is even more important than the superficially presented narrative on the dividing line between the prosperous North Europe and the stagnating South Europe.

The majority of European citizens do not want their future prospects to lie in the hands and at the mercy of European paymasters. They want to shape their own future. For this, they need to be equipped and empowered to be able to emancipate themselves and become free and productive actors in the markets and their communities. Therefore, in place of the idea of the Transfer Union, is the idea of empowerment, sustainability and ability to mobilize local and regional potential across Europe. In place of (path) dependency via the Transfer Union, the alternative proposal should be to open up space for local, regional and national institutional innovations.

BEYOND THE HIERARCHICAL SEGMENTATION OF THE SINGLE MARKET, FISCAL COMPACT AND BANKING UNION

A single market is not a goal in itself. It is a means to an end. There is no one single, neutral version of the market. Markets are always created and they exist within the given institutional framework. Cecchini report⁹ before adoption of the Maastricht treaty in February 1992 calculated immense benefits for the European economy after the completion of the single market. Today it is clear that the outcome of the single market creation is far below the original anticipations and announcements. Strong distributional effects and creation of winners and losers excluded businesses and small firms without sufficient access to capital and all other necessary resources from successfully competing in the markets. The number of European regions and member states falling behind during the crisis is clearly on the rise. Therefore, to deepen access to the markets and spur entrepreneurship across the EU, local and regional support in the form of decentralized industrial policy with improved access to capital via local financial institutions needs to be (re)-established. Europe needs more markets in more ways for more people¹⁰ than the current version of the European single market model can provide. Without an active industrial policy at the local and regional levels, the European single market can amount to “kicking away the ladder” not only for the European periphery, but for the majority of European regions. Only in an increasingly small number of European regions

9 Cecchini Report, *The European Challenge: 1992*, summary of the report: <http://aei.pitt.edu/3813/> ¹⁰ “The task will be to use the power of the State not to suppress or to balance the market, but to create the conditions for the organization of more markets organized in more ways...” R. Unger, *What Should the Left Propose?*, Verso 2005, p. 26.

is the economic power, social wealth, advanced sectors of industry and services, knowledge, technologies and general know-how being concentrated.

The Fiscal Compact created new policing powers for the European institutions over the fiscal policy and budgets of the member states. It has further narrowed the maneuvering room for reforms and development strategies in the member states and it does not guarantee a quality fiscal policy even in good economic times. Simon Wren-Lewis, an Oxford macroeconomist, has put it directly and most succinctly: “The Fiscal Compact is exactly the opposite of what the Eurozone requires right now.”¹⁰ It may well be that in everyday practice, as it happens very often in the EU, the Fiscal Compact rules will be diluted or otherwise weakened. However, because it is a crucial symbol of wrong European policies tackling the crisis, it will have to be formally repealed to show new determination to launch comprehensive economic, social and political reconstruction of the EU and its member states.

The sooner the EU moves away from the unworkable European Fiscal Union, which “is macro-economically dangerous” and “imposes deficit rules on the countries that are based on arbitrary figures,” as warned by the European Macro Group of three European macroeconomic institutes (German IMK, French OFCE and Austrian WIFO) in their joint study, the greater are the chances that the EU as a whole returns to the sustainable and equitable pathway of growth.¹¹ Fiscal consolidation is important, but there is more than one way how it can be achieved. It should be left primarily to the member states to figure out how to return to the path of fiscal consolidation, based on socially inclusive growth.

The idea of the Banking Union is questionable for similar reasons. Two crucial developments before the crisis went almost unnoticed by a large portion of experts and politicians. Namely, due to rapid liberalization of finance, the size of European financial sector has tripled in the last three decades. Equally important, as noted by one of the most perceptive European experts on finance, Dirk Bezemer from University of Groningen:

“...Most of that debt growth has NOT been due to lending to the real sector – to nonfinancial firms, supporting growth in wages and profit. Almost all of it was due to mortgage lending and to credit to the nonbank financial sector credit, to inflate stocks and property prices and to create and trade options, futures, and other derivative instruments...”¹²

10 S. Wren-Lewis, *The Eurozone's Founding Mistake*, *Social Europe Journal*, July 22, 2013.

11 Macro Group (IMK, OFCE, WIFO), *Fiscal Compact Deepens Crisis*, March 201, p. 29.

12 D. Bezemer, *Finance and Economic Growth Delinked*. *Eurointelligence*, April 2012.

Neither of these two crucial issues – the oversized European financial sector and its turning away from mainly supporting the real economy toward European financial casino capitalism – are being adequately addressed by the idea of a Banking Union. Its goals to create common banking supervision, resolution procedures and possibly also deposit insurance may lead to further concentration, centralization and bureaucratization of the European banking and financial sector. This is without any guarantee that the quality, responsibility and support for the real economy, local producers and entrepreneurs would be improved.

From the legacy of successful European post-war development, different European members developed different financial models to support overall economic and social development. There was no one single best financial model and framework, universally valid for all local, regional and national economic and social conditions. Some of the financial models better supported local and regional development and productive potential than others. It should also be up to the local and regional communities to search, develop and innovate in the area of financial models. Instead of making efforts to break the supposedly pernicious ties between the sovereigns and banks, the true goal of European financial restructuring should be to re-establish the virtuous links between local and regional communities, businesses, entrepreneurs and financial institutions. The support for local producers and local consumers, strengthened links between local networks of banks and the real economy should be at the core of European economic, financial and social reconstructions. Immense resources, allocated for propping up the largest European financial institutions should be better used for revitalization of local communities and regions across Europe.

ALTERNATIVE PATHWAYS FOR EUROPEAN RECONSTRUCTION

The goal of European recovery should not be merely to overcome the ongoing economic, social, and financial crisis and then return to the previous status-quo position.

Similarly, the outcome of the crisis should not be a return to the EU's previous arrangement, albeit further centralized and bureaucratized within the framework of rigid one-size-fits-all fiscal and financial rules based on the economic orthodoxy. The better goal should be to create a socially inclusive, more decentralized, more innovative, and more diverse EU, wherein different regions and member states can develop their own development strategy. Such a decentralized EU should facilitate and foster different model of development, spur local initiatives from various social groups, and more successfully address the

needs, aspirations, and development potential of local communities, regions, and member states.

The European dimension to the decentralized, bottom-up economic, social, financial and political reconstruction could be complementary. On one hand, it could participate, learn from positive practices of successful regions and disseminate these practices to other regions across Europe. On the other hand, it can expand European employment policies with the aim of improving skills and enhance training opportunities for European workers. Investments in lifelong learning process, improved skills and retraining opportunities for European workers should become the most important common European policy together with carefully planned investments in the improved European infrastructure.

European viable growth strategy, which is still missing¹³, should be based on sustainable, inclusive, balanced and diverse European “green growth” potential. Such a redirection of European policies away from the unsustainable rigidities of the Fiscal Union, unworkable dogma of the single market, and unnecessary bureaucratization and centralization of the banking union could present a point of departure from the present unsustainable path of European integration. EU institutions should finally pay attention to the needs of local, regional and national communities across Europe.

The reconstruction of such an EU should be implemented bottom-up and it should be based on co-existence of diverse models of development. Instead of waiting or relying on comparatively small amounts of financial support from the EU, the European regions, local communities, and member states should rely primarily on their own resources. Of course, any additional support from the EU could be beneficial and complementary. The development strategies, initiatives, and decisions, however, should be made by the local authorities and other local stakeholders with the primary concerns of developing local producers, supporting local entrepreneurs, training local employers, and supporting local consumers.

There are examples of successful economic, social and institutional restructuring in European regions and member states. These should serve not as models for mechanical imitation, but rather as models for inspiration and encouragement. Other European regions and countries have other comparative advantages and different development potential. The crucial mistake the European technocracy is making in the crisis is to insist on imposing one-size-fits-all measures across the

13 P. Hall, *supra* 5, p. 365.

board. As a result, initiatives, ideas, and institutional innovations at the levels of European regions and their member states remain suppressed.

It is worth briefly considering the successful experience of Irish local public-private partnerships before the turn into speculative finance and creation of construction bubbles; the example of successful Finnish innovational, technological and educational policies; and the cooperative competition framework in the Emilia Romagna region of northern Italy. In these successful examples, the competitiveness of the regions or member states is based on the transparent partnership between the public and private sectors. These are practical examples of institutional innovations in the context of decentralized, participatory, and democratic models of development. They show that even in the era of globalization and Europeanization, it is possible to maintain high-quality enterprises with high wages and high levels of added value. Dense networks of local public-private partnerships should be supported, strengthened and developed. In place of stagnant and often decaying local communities and regions across the EU, dynamic, fast-developing and knowledge-based communities and societies should emerge. There are examples of successful, post-Fordist, highly dynamic, inclusive and competitive regions in Europe and countries around Europe. Their dominant characteristic is constant innovation of institutions and practices that are supportive of enhanced competitiveness and social inclusion.

Legal, economic, and social institutional innovations deviate from the standard model of economy and society, which has found itself in a period of protracted crisis and stagnation. Broad support for constant advancement and innovation from public institutions is an additional important element of success. The dense networks of civil society associations participate and provide initiatives for the local and regional governments where the future opportunities and challenges lie.¹⁴

Local government, local financial institutions, professional and commercial associations, trade unions, universities and research centers, and social networks all participate and have a stake in permanent improvements in their regions. They are examples of dynamic, competitive, innovative, and cohesive regions. They also show that it is not possible to overcome the gap between the advanced and backward parts of the economy and society without the deliberate action of public institutions.¹⁵

14 See M. Nahtigal, *European Regional Disparities – the Crucial Source of European Unsustainability*, *Lex localis*, July 2013, vol. 11, no. 3, pp. 601 – 614,

15 R. Unger, *Democracy Realized*, Verso 1998, London, p. 198.

In such a decentralized, bottom-up approach, based on the initiatives, institutional innovations, and development strategies that are suitable to the needs of local population, the role of the European institutions should be substantially redefined. Instead of clinging to the dogma of a European single market as a neutral mechanism, the European institutions should recognize that the markets always create distributional effects and consequences. In the words of Loukas Tsoukalis, the process of European integration has always created winners and losers, both real and imaginary: “Most of the national politicians (and others) were too late to realize it, not to mention trying to deal with it.”¹⁶ The distributional impact is not a result of the supposedly neutral, natural development of the European single market. Rather, it is a result of deliberate actions to create a single market, based on the dogmatic assumptions of the economic orthodoxy.

Therefore, to address the crisis and approach comprehensive economic, social and political reconstruction from the bottom up, the maneuvering room for the local, regional and national governments should be maximized. The current European context is, according to Roberto Unger, too strong and too weak at the same time – “weak on universal social endowments but strong on macroeconomic and regulatory limits to national, regional, and local innovation.”¹⁷ The current path of coping with the crisis is widening the gap between the privileged and backward European regions and countries. It is the gap between the relatively privileged segments of the society and large portions of the excluded population. This process should be substantially reversed to remain faithful to the original ideas of the European project and the declared goals of the Treaty of Lisbon.

The last European politician who understood the subtle dialectic between competitiveness and social cohesion, both on the level of the EU and on the level of the member states, was Jacques Delors. *A White Book on Growth, Competitiveness and Employment*, which was prepared under his presidency of the European Commission in 1993, explicitly put forward the need to establish economic and social cohesiveness as one of the pillars of the European reconstruction. The need to establish solidarity between the successful and unsuccessful European regions was also emphasized.¹⁸ Other important elements were also contemplated, such

16 L. Tsoukalis, *The Shattering of Illusions and What Next*, *Journal of Common Market Studies*, 2011, Annual Review, pp. 21–22.

17 R. Unger, *European Constitutionalism – proposal for an agenda of debate*, manuscript prepared for a meeting on the constitution of the European Union, Harvard University, March 2002.

18 European Commission, *Growth, Competitiveness, Employment – A White paper*, Luxembourg

as the research and technological policy, the need to invest in training and education to create high quality jobs for the European future, the possibility of issuing EU bonds to finance larger European infrastructure projects, and many other important ideas. In doing so, the balance between common projects and decentralized policies based on the principle of subsidiarity was carefully maintained. The single market was not perceived as a one-dimensional project without the social institutions and policies at the level of the member states and at the European level. In many ways, Delors' forward-looking vision for Europe remained poorly understood and ignored.

CONCLUSION: TOWARD GENUINE COMPREHENSIVE EU RECONSTRUCTION

The current EU context does not serve the real needs of large parts of the European population at the local, regional and national levels. The growing gap between the privileged segment of society, with its access to high-quality education, advanced parts of the economy, new technologies and capital, and large portions of the excluded population is a phenomenon that is occurring not only in the periphery of the EU, but also in the core EU countries and regions.¹⁹ Therefore, the most important task of authorities at all levels of the EU polity should be to develop anti-dualist policies to broaden and deepen access to advanced modes of production, high-quality education, skills and all other resources.

The state aid measures to financial institutions between 2008 and 2011 were of a historic proportion.²⁰ Unfortunately, however, the banks and other financial institutions do not sufficiently support the development and restructuring of the real economy, not to mention start-up firms and IPOs.

It would be better to take at least a small amount of the resources allocated for the support of mainly the large European financial institutions and channel it into all forms of life-long education for all European citizens and their communities

19 On the need to establish the new European social contract, see A. Skrzypek, *The Next Social Contract – A New Vision for European Society* in E. Stetter, K. Duffek and A. Skrzypek (eds), *For A New Social Deal*, FEPS 2013.

20 See High-level Expert Group on reforming the structure of the EU banking sector, chaired by E. Liikanen, Brussels, October 2, 2012.

across Europe. From there, the European citizens and their communities will be able to move on themselves.²¹

Many opportunities have been missed to approach comprehensive social and economic reconstruction of the European Union and its member states. The lost decade of austerity and Brexit call of institutional restructuring of the EU bottom-up, based on socially inclusive, sustainable growth agenda. The approach is consistent with the most recent green initiatives and with the needs of climate change adjustments.

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21 On the need to articulate European progressive vision beyond the 2014 European parliamentary elections, see A. Gusenbauer, Introduction to the Next Left – *For a New Social Deal*, FEPS 2013.

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2 THE ECONOMIC, LEGAL AND SOCIAL ASPECT OF THE ROLE OF FINANCIAL INSTITUTIONS BEFORE, DURING AND AFTER THE FINANCIAL CRISIS

INTRODUCTION

The purpose of this article is to reflect upon the importance and role of financial institutions before, during and after the financial crisis and to outline proposals for alternative approaches to the financial crisis. Financial institutions are commonly mentioned in academic and public debates, but their role remains inadequately understood. Financial institutions and their activities grew immensely over the last few decades. They became highly sophisticated, so much so, that many of their detailed operations and transactions are only understood by highly specialized experts. This is part of the reason why they attract a lot of attention, not only for the purpose of bailing them out, but rather to better understand their role, importance and relevance to the real economy and to the societies at large.

It is worth remembering that in the in the period between 1950 and 1980, financial institutions were primarily ‘uninteresting’, ‘boring’ institutions’ with the task of allocating financial resources from the savers to the productive activities of the society. In the period between 1980 and 2008, however, a fundamental shift in the world of finance occurred. Consequently, the world of finance and financial institutions has become one of the fastest growing sectors. The role, size and importance of finance have changed from the auxiliary role of supporting the development of other economic and social activities to a dominant role and position in modern (Western) societies. This fundamental shift has largely gone unnoticed.

At the explanatory level, the fundamental shift in the importance of finance can be explained as a necessary, natural development of mature capitalist societies. Only after the crisis, with its epicenter in the large financial institutions of the most advanced and developed countries worldwide, has it become clear that it will not be possible to return to the path of sustainable and equitable development without comprehensive structural changes in the role and activities of financial institutions.

The primary purposes of this article are threefold: (1) to analyze the underlying premises of the rise of financial institutions in the last three decades, (2) to illustrate how the financial system has become increasingly dysfunctional, and (3) to illustrate the possibilities of how to redirect and reorient financial institutions in the future to again become socially valuable and useful institutions.

THE RISE OF FINANCIAL INSTITUTIONS IN THE LAST THREE DECADES

Before analyzing the reasons for the rise of financial institutions in the last three decades, one observation should be made: although the best documented rise of financial institutions refers largely to the rise of financial institutions on Wall Street and London, this does not mean that a similar path of development did not take place in the European Union. On the contrary, the EU financial liberalization, establishment of the Eurozone and the idea that the EU needs large financial institutions in order to be able to compete with the US, led to the increased cross-border mergers. Subsequently, it also led to an increasingly weak supervision of banking activities. Some of the comparative analyses shows that “the larger European banks have become too big to be supervised effectively and the problem may be worse in Europe than in the United States”²² Moreover, as argued by Simon Johnson, the former IMF’s chief economist, professor of economics at MIT, and one of the leading experts in international finance, there is no distinction between the practices of US (United States) and EU financial institutions: “It’s one big trans-Atlantic money market out there, and these banks lend money to each other all the time... Deutsche Bank and UBS and Goldman Sachs and Citi are all intertwined”²³

Many things have changed since the beginning of the crisis on both sides of the Atlantic, including expensive bail-outs, stress-tests, the adoption of new regulations in the US in the form of Dodd-Frank legislation, and various other monetary and fiscal activities. However, the fundamental discussion on the role, practices, activities and accountability of the financial institutions remains inadequately addressed. The fear remains, that without such a debate, taxpayer money spent to rescue the financial institutions on both sides of the Atlantic is more likely to fuel future financial crises than to secure the success of financial institutions performing socially useful activities.

The empirical findings on the rise of size, profits, and the volume of trade of financial institutions on both sides of the Atlantic in the last three decades are truly extraordinary. One interesting account was by one of the leading Financial Times commentators Martin Wolf, who was largely supportive of globalization with all of its tenets, but became increasingly aware of the downsides and risks involved in the process:

22 M. Goldstein, and N. Véron, 2001. Too Big to Fail: The Transatlantic Debate, Working Paper Series WP 11–2, Peterson Institute for International Economics, Washington.

23 N. D. Schwartz, 2009. As it falters, Eastern Europe raises risks, New York Times, February 23.

“The US itself looks almost like a giant hedge fund. The profits of financial companies jumped from below 5 percent of total corporate profits, after tax, in 1982, to 41 percent in 2007, even though their share of corporate value added only rose from 8 to 16 percent. Banking profit margins have been strong, until recently. Now, at long last, earnings per share and valuations have collapsed... A financial sector that generates vast rewards for insiders and repeated crises for hundreds of millions of innocent bystanders is, I would argue, politically unacceptable in the long run. Those who want market-led globalization to prosper will recognize that this is its Achilles heel. Effective action must be taken now, before a still bigger global crisis arrives”²⁴

A more carefully elaborated and documented analysis of the rise of the financial institutions was provided by Simon Johnson and James Kwak. They clearly illustrated how the financial sector vastly outpaced growth in households and non-financial companies:

“Between 1978 and 2007, the financial sector grew from 3.5 percent to 5.9 percent of the economy (measured by the contribution to GDP). Its share of corporate profits climbed even faster. From the 1930s until around 1980, the financial sector grew at roughly the same rate as profits in the non-financial sector. But from 1980 until 2005, financial sector profits grew by 800 percent, adjusted for inflation, while non-financial sector profits grew by only 250 percent...; by the third quarter of 2009, financial sector profits were over six times their 1980 level, while non-financial sector profits were little more than double those of 1980”²⁵

Johnson and Kwak continue to illustrate how the financial sector simply got bigger and bigger:

“...in 1978, all of the commercial banks together held \$1.2 trillion of assets, equivalent to 53 percent of US GDP. By the end of 2007, the commercial banking sector had grown to \$11.8 trillion in assets or 84 percent of US GDP... Asset backed securities, such as collateralized debt obligations (CDOs), which hardly existed in 1978, accounted for \$4.5 trillion in assets in 2007, or 32 percent of GDP. All told, the debt held by the financial sector grew from \$2.9 trillion, or 125 percent of GDP, in 1978 to over \$36 trillion, or 259 percent of GDP, in 2007” (footnotes omitted).²⁶

24 M. Wolf, 2009. Why is it so hard to keep financial sector caged?, Financial Times, February 5.

25 S. Johnson, and J. Kwak, 13 Bankers: The Wall Street Takeover and the Next Financial Meltdown, First Vintage Books Edition, January 2011, Kindle edition, (Chapter 3, Wall Street Rising 1980-).

26 Ibidem.

The rise of the financial sector in the last three decades has had surprisingly little impact on the development of the real economy. Contrary to conventional wisdom, the rise of the financial sector, the comprehensive process of ‘financialization,’ characterized by the explosion of financial innovations, did not contribute to high levels of economic growth. On the contrary, despite the floods of cheap capital due to low interest rates and despite the rise of the financial sector, the growth rates in the 2000s were rather anemic. As explained by Simon Johnson and James Kwak:

“...the problem was that the cheap money was misallocated to the housing sector... that misallocation was due to the new mortgage products that made it so easy to borrow large amounts of money, the voracious appetite of Wall Street banks and investors for securities backed by those mortgages, and a decade of government policies that encouraged the flow of money into housing. And the more money that flowed into new subdivisions in the desert, the less flowed into new factories where Americans could go to work. Ultimately, the price of the housing bubble and the financial crisis is not just trillions of dollars on mortgages and mortgage-backed securities, but a decade of poor economic growth and declining real household incomes”²⁷

The rise of financial institutions and the financial sector did not substantially contribute to the development of productive activities, such as an increase in labor productivity and a strengthening and improvement in the process of innovations in various industries. Instead, the banking sector has demonstrated “a capacity to generate huge crises because of the incentives to take on under-appreciated risks”²⁸. On the other hand, it has only demonstrated a weak and tenuous capacity to support real economic growth in new, innovative ways in good economic times. Conversely, in the period of a crisis, the financial sector presents a drain on liquidity from the real economy and threatens to depress national economies and societies at large. To emphasize this claim about the massive government aid to banks primarily in the form of recapitalization, funding guarantees and other support measures: In the EU the state aid between the period of 2008 and 2011 was committed in total €4.5 trillion euros, which is 36.7 percent of EU GDP”²⁹. Despite this support for the banks, the real economy continues have difficulties to finance its development in many countries and regions of the EU and many EU governments have found themselves

27 Ibidem, Chapter 5.

28 M. Wolf, *supra* 24.

29 High-level Expert Group on reforming the structure of the EU banking sector, chaired by Erkki Liikanen, 2012, box 2.2. on p. 21, https://web.archive.org/web/20121003231405/http://ec.europa.eu/internal_market/bank/docs/high-level_expert_group/report_en.pdf
IMF Country Report, European Union: Publication of Financial Sector Assessment Program, No. 13/67, March 2013, Washington, p. 7.

in dire fiscal position due to the banking bail-outs. Meanwhile, the unemployment in the eurozone and in the entire EU continues to be at the highest levels in its history.

Therefore, before discussing the need for both a macro- and micro- prudential approach in order to improve the regulatory and supervisory framework of the financial institutions, a theoretical and strategic debate about the actual role, meaning and importance of financial institutions should be discussed. For the time being, there is precious little of such a strategic debate. It appears that policy-makers, bankers, academics, and professional commentators take the massive bail-outs of the financial sector, with the help of taxpayer money, for granted as the only possible and necessary way out from the present financial, economic and social crisis. The fear is that such a knee-jerk approach does not lead toward the improvement of quality of financial governance and toward enhancing possibilities for more balanced, more inclusive and diverse social and economic development. Instead, it may lead toward more instability and even bigger crises in the future, as warned by Martin Wolf:

“What is emerging is a slightly better capitalized sector, but one even more concentrated and benefiting from explicit state guarantees. This is not progress: it has to mean still more and bigger crises in the years ahead”³⁰

Why is such a strategic debate not taking place? Perhaps society is so overwhelmed by the immense complexity of the financial activities in the ability to create complex financial instruments, they forget to inquire about the actual purpose and broad social use of such instruments. We are assuming that the ‘masters of the universe’ are able to manage our finances in the best possible manner, because they are operating with the help of sophisticated mathematic models. However, when we look closer to the various financial practices, such as the form of leverages and the supposedly superior mathematical models, we realize that there is no such thing as a perfect, smooth, watertight system of finance, financial institutions and their activities. One such example is the collapse of the Long-Term Capital Management (LTCM) hedge fund, with two Nobel laureats, Myron Scholes and Robert Merton as members of the board of directors. In 1997 they won the Nobel Prize in economics for a new method to determine the value of derivatives. A year later LTCM hedge fund has incurred a multi-billion loss after the Russian financial crisis, which prompted intervention of the Federal Reserve.

30 M. Wolf, *supra* 24.

There is no normative framework that can guarantee a perfect, flawless and optimal financial intermediation. There are, however, financial frameworks that can help support overall economic and social growth in more sustainable and inclusive ways than others. There are also financial frameworks which are more prone to excessive risks and more capable of generating financial volatilities and crises to the detriment of the economy and society at large. This insight, that there is no neutral regulatory financial framework and that different regulatory financial frameworks can lead to substantially different outcomes of the allocations of resources, should precede the vague and superficial debate about the need to reregulate the financial market and tighten independent supervision. The kind of links between financial institutions and real economy that can be established varies from one regulatory framework to another. The key challenge is to establish a regulatory financial framework in which financial institutions and their activities begin again by serving and supporting the long-term development of productive activities, such as the enhancement of productivity and the expansion of output.

The key problem is that the rise of the financial industry, and of financial innovations, was not accompanied with the rise of productivity and the expansion of output. In good economic times, the rise of financial institutions presents little support and no threat to the real economy. In periods of financial crises, however, a bloated financial sector that is primarily turned to the conundrum of mutual trading, presents a drain on the real economy and society at large. Masters of the universe that tend to concentrate financial, economic and political power via revolving doors between financial and political circles, lobbying for benevolent legislation and loose regulatory supervision via media and mainstream academics who often appear as their consultants, contribute little to the broader public good in beneficial economic times. In good economic times, top bankers, employees and shareholders benefit immensely and pay themselves bonuses that are disproportionate to actual developments in the market. In periods of financial crises, however, they turn to governments and their implicit guarantees. Consequently, Simon Johnson and James Kwak have concluded that:

“Never before has so much taxpayer money been dedicated to save an industry from the consequences of its own mistakes. In the ultimate irony, it went to an industry that had insisted for decades that it had no use for the government and would be better off regulating itself – and it was overseen by a group of policymakers who agreed that government should play little role in the financial sector.”³¹

31 S Johnson and J. Kwak, *supra* 25 (Chapter 6).

The trouble is not only that the financial institutions turned to the government and taxpayers to bail them out, but the devastating social and economic consequences of the financial collapse due to the excessive risks, and many other dysfunctional activities, they pursued before the crisis. The crisis, and its subsequent measures, have negative consequences on the real economy, including homeowners, taxpayers, and the newly unemployed. It also has negative consequences on the undermined fiscal position of the government:

“...the collateral damage to the real economy was enormous. The collapse of the housing bubble tipped the economy into recession in December 2007, leading to the loss of 1.1 million jobs in the first eight months of 2008. The fall of Lehman Brothers in September 2008 and the ensuing panic triggered a severe economic contraction, leading to the loss of another 5.8 million jobs over the next twelve months as the economy shrank by 4 percent. The unemployment rate doubled from 4.9 percent at the beginning of the recession to 10.2 percent by October 2009... As the economy declined sharply, the sudden collapse in tax revenues left government finances in disarray. State and local governments resorted to severe cutbacks in services. The federal government dedicated USD 800 billion in new spending and tax cuts to stimulate the economy. However, stimulus spending and lower tax revenues pushed the 2009 federal deficit up to USD 1.6 trillion, or 11 percent of GDP, more than doubling the previous postwar record. The long-term effect of the financial crisis and recession is even greater.³²

The apparent huge asymmetry in information in the economic and political power of big financial institutions has become detrimental to practically everyone outside of the financial circles. Large financial institutions rose above any supervision and started serving themselves and their shareholders. Disproportionate returns on equity for banks, fee structures beneficial to the managers, and bonus payouts, are just some of the indices of unsustainable and harmful asymmetry on the markets and society. Simon Johnson has, for example, accused Josef Ackermann, former chief of Deutsche Bank, as one “of the most dangerous bankers in the world”, because even during the crisis, he was still pushing Deutsche Bank for a 25 percent annual return on equity, before taxes. Johnson has explained that such a goal encourages its bankers and traders to take more risks and employ lots of leverage, which can fuel profits on the way up, but amplify losses on the way down.³³

The only way to cool off the financial capitalism casino is to create a more balanced, more diverse and more inclusive environment, not only for the financial

32 Ibidem.

33 S. Johnson, cited in J. Ewing and L. Alderman L, Deutsche Bank's Chief Casts Long Shadow in Europe, New York Times, June 11, 2011.

institutions, but also for the economy and society at large. We need to re-connect financial institutions with long term productive activities of the real economy and society at large. Subprime lending was not about helping poor people solve their housing problems; instead, it was about creating new financial instruments for trading and betting between various financial institutions. The same applies to the European banks and their massive flows of cheap capital to the European periphery before the crisis. The financial flows were not directed to the productive investments of the peripheral countries in order to make them more competitive, instead, they were channeled to the property bubbles in the countries, such as Ireland and Spain. In other peripheral countries, such as Greece, financial flows went to private and public consumption. After the crisis, massive outflows of capital from the periphery left economic and social devastation of epic proportions in several countries, including Greece and Spain.

Several decades of prevailing doctrines that state that financial institutions perform most efficiently if they are left to themselves, alongside several decades of deregulation and financial liberalization, led to the highly asymmetric situation, without any proper mechanism of checks and balances. The efficiency hypothesis, where the market prices are always right, was at the heart of financial liberalization, deregulation and the explosion of financialization. It became almost impossible to discern between socially useful financial activities and those activities aimed at new profit-making opportunities to enrich financial institutions, top managers, and shareholders.

Accordingly, financial institutions on both sides of the Atlantic were able to concentrate on increasing profits. At the same time, they attracted most of their talent from society and became highly geographically concentrated in a few leading financial centers, including Wall Street, London, and Frankfurt. It will require the determination, creativity courage and vision of the next generation of leaders, to be able to redirect and reconnect financial institutions with the rest of the economy and society. In saying this, there is much to learn from past inspiring leaders, such as Theodore Roosevelt, who confronted the biggest trust of his time, Franklin Roosevelt, who restructured the entire US economy, Brandeis, who was very well aware of the fact that financial institutions are dealing with other people's money, and William Douglas with his awareness about the need to democratize financial sector and to keep it in check via regulatory and supervisory means. If nothing is accomplished in terms of financial reform, the economy and society at large may remain a hostage to the financial institutions and the financial and political oligarchy, who are capable of extracting extra rents for a very long time.

REAL ECONOMY, FINANCIAL INSTITUTIONS AND LONG-TERM DEVELOPMENT

Among the critics of the present financial environment, created in the last decades, is a significantly important and radical idea: breaking up several of the biggest financial institutions. The argument of Simon Johnson and several other important scholars is that the best way to tame large financial institutions and prevent future financial disasters at the expense of society is to break-up the largest financial institutions. The simplest explanation of the argument is that in making financial institutions smaller, a potential collapse of certain financial institutions would not bring international finance into turmoil. When large financial institutions operate in a highly leveraged form, with a great deal of debt and very little equity, huge and unfair costs may be imposed on the rest of the economy. While the implicit subsidies provided to too-big-to-fail companies allow executives and investors to increase compensation by hundreds of millions of dollars, the costs imposed on the rest of us are in the trillions of dollars. This led Johnson to the conclusion that this is a monstrously unfair and inefficient system. Many sensible public figures are increasingly pointing this out.³⁴

There are also other similar proposals for providing safer banking. One idea is legislating higher capital requirements. The purpose of this is to make sure banks and other large financial institutions depend more on equity and less on debt and to a binding 'leverage ratio' – a requirement according to which the banks should have at least ten percent in equity relative to their total assets.³⁵

Johnson admits that even smaller financial institutions, in comparison with today's megabanks, would not be sufficient to ensure financial stability. They would ensure, however, more efficient supervision and reduce systemic risks in cases of financial turmoil. The authors arguing in support of the limitation on the size and leverage of financial institutions also discuss, with lesser attention, the issue of the quality of these hypothetically restructured financial institutions. The open issue would remain as to whether these smaller financial institutions would be capable of providing stronger and better long-term support for the development of the real economy. Suppose that the first part of the issue can be described as a quantitative issue – the size, the cap on debt, on leverage and so on. As such, the second part of the issue can be described as qualitative. The qualitative issue can be described as the issue of the quality of financial support

34 S. Johnson, *Breaking Up Four Big Banks*, The New York Times, May 10, 2012.

35 Ibidem.

for innovations, for the enhancement of productivity and for the expansion of output.³⁶

The distinction should be made between all kinds of financial activities aiming at securing long term support for the development of a real economy and those financial activities aiming at creating benefits for the executives and investors. Needless to say, this distinction is, in reality, almost impossible to draw, but it nevertheless remains crucial. Dirk Bezemer, a finance professor from the Groningen University, is one of the few experts who pointed out this crucial, although rarely mentioned and analyzed, distinction. He has made a distinction between credit that supports economic growth and credit that fuels bubbles and subsequently hinders growth.

Bezemer's path breaking analysis starts with the recognition that current macroeconomic models do not distinguish between the credit flows that help and those that hinder the economy.³⁷ He is convinced that the neglect of credit and debt in economic theory left us unprepared for dealing with the financial crisis. Moreover, he has pointed out the paradox that the dominant macroeconomic models of 'general equilibrium' do not have "money, financial flows, credit or debt. The models that are widely used in policy institutes, academia and central banks, have no banks. These models assume the liabilities of all borrowers always exactly match the assets of all lenders.

The assumption is that, on the basis of accounting equality, the financial sector's assets are the real sector's liabilities. According to Bezemer, however, this accounting equality, on which macroeconomic models are based, is highly misleading and does not explain the true nature of modern finance. Namely:

“...most of that debt growth has NOT been due to lending to the real sector – to non-financial firms, supporting growth in wages and profit. Almost all of it was due to mortgage lending and to credit to the non-bank financial sector credit, to inflate stocks and property prices and to create and trade options, futures, and other derivative instruments. These credit flows, and the activities they fueled – share buybacks, leveraged buyouts, securitization – create no wage or profits for the many, but capital gains for the few, and a huge net debt burden on the economy.

Property and asset prices may be falling, but the debts that jacked them up are not. The threat to growth today is not a shrinking of the financial sector, but it enormous

36 Ibidem.

37 D. Bezemer 2012a, Finance and Growth: When Credit Helps and When it Hinders, conference paper, presented at the Berlin conference, organized by Institute for new Economic Thinking, p. 3.

size. The accumulated claims by the non-bank financial sector cause a daily drain of purchasing power on the economy in debt services. This is money that could be effective demand for goods and services and stimulate economic growth. Nowadays, finance is stifling, not stimulating growth³⁸.

These findings have far reaching consequences for the debate on the role and importance of financial institutions in the modern economy and society. They go beyond the discussion of the size and scope of large financial institutions. On the basis of these insights, Bezemer has illustrated the process of the gradual delinking of finances and the real economy over the last three decades. The financial institutions have turned away from supporting the real economy and from growing and developing in tandem with the real economy and society. These valuable insights by Dirk Bezemer, who has reminded us that James Tobin, when discussing the efficiency of the financial system, warned us that "...we are throwing more and more resources, including cream of our youth, into activities that generate high private rewards disproportionate to their social productivity" (reference cited from Bezemer³⁹).

The theoretical reason for the confusion in explaining the role and importance of large financial institutions in modern societies comes from accounting equality, according to which the financial sector's assets are the real sector's liabilities. There is, however, a trade-off between "the financing of production (out of retained earnings and fresh lending) on the one hand and credit flows returning into the financial sector on the other".⁴⁰ As noted by Bezemer, this trade-off is absent from the mainstream models, but is crucial to understanding the crisis.

On the basis of the flow-of-funds, credit has shifted away from the real economy to the financial assets market. This shift has created its own dynamics, according to which the credits into financial assets and financial instruments increased returns. This encouraged the next cycle of credit flows, debt growth and asset price rises. The unsustainable dynamic in the period of irrational exuberance was perhaps not viewed as deeply problematic, because the real economy developed and grew at the same time. In good economic times, the shift of credits from the real economy to the financial assets did not present a concern, due to the accounting identity assumption. This assumption created an illusion of common growth

38 D. Bezemer, 2012b. Finance and Economic Growth Delinked, Eurointelligence.

39 D. Bezemer, *supra* 37, p. 2.

40 D. Bezemer, 2009a. "No One Saw This Coming": Understanding Financial Crisis Through Accounting Models. Munich Personal RePEc Archive, MPRA Paper No. 15892, June 24, 2009, p. 13.

and prosperity. The longer the illusion lasted, the more destructive the social and economic consequences turned out to be.

If the above analysis is correct and the mainstream economic and legal experts and policy-makers failed to address the phenomenon, then the financial institutions turned away from supporting the real economy into extracting benefits from it. The crucial issue is how to re-connect the financial institutions and the real economy such that the financial institutions start supporting the real economy again. It is a challenge, not only in how to rebalance the power and influence the large financial institutions, but also in how to channel credit flows back into the real economy. This redirection would not necessarily make banking and finance 'boring' again, but it would make sure that the financial institutions grow and develop in a sustainable manner together with the real economy and the society at large. As a result, this redirection would probably decrease returns and bonuses to the large financial institutions and their executives. It would, however, spread economic, financial and other opportunities to the larger segment of businesses, new entrepreneurs, to start-up firms and to many other segments of society. The qualitative dimension of the financial reform should be added to the quantitative dimension of the financial reform.

For the time being, governments on both sides of the Atlantic pay little attention to such an alternative approach to the reform of the financial institutions. They continue to bail out the entire financial sector, regardless of the cost for the public finance, and ultimately, for the taxpayers. Their perspective seems to be that after bailing out the financial institutions, things would return back to prosperity, as we were witnessing in the years before the financial crisis. The problem with this approach is that the period of the so-called prosperity was based on many unsustainable and illusory premises. It was based on the supply of cheap money, on the toxic flows of excessive liquidity to increasingly inflated prices of financial assets, and on the so-called credit democracy for the citizens. Not one of the premises was sustainable and not one can be restored.

The attempt to restore the status-quo ante situation by merely making more regulations on large financial institutions would only mean that financial institutions are still not sources of support and that they may continue to present a "sustained drain of liquidity from the real sector to the FIRE (finance, insurance and real estate) sector".⁴¹ This problem with credit flows, which was little understood and rarely mentioned before the crisis, continues to be unresolved. The consequences of not recognizing what Bezemer has recognized – that the credits flowing to the

41 Ibidem, p. 16.

financial assets are distinct from the credits flowing to the real economy – go beyond the issue of the optimal size and scope of the financial institutions. Bezemer has offered another important argument to support this view:

“In the 1980–2007 era of cheap credit and deregulation, banks had every incentive to move from real-economy projects, yielding a profit, towards lending against rising asset prices, yielding a capital gain. In the 1990s and 2000s, loan volumes rose to unprecedented levels, supporting global assets booms in property, derivatives and the carry trade. The share of lending by US banks to the US financial sector – instead of to the real economy – went from 60 percent of the outstanding loan stock in 1980 (up from 50 percent in the 1950s) to more than 80 percent in 2007.”⁴²

Unfortunately, we do not have similar data for the EU, but it would probably be a fair assessment that in the last few decades, the EU, before and after the creation of the Eurozone, took a very similar path of development. This means that financial liberalization, cross-border mergers and the creation of large European banks led to a similar path of unsustainable development with negative economic and social consequences. As a result, the EU faces similar challenges in restructuring the banking sector to the US. The challenges of restructuring the banking sector and financial markets go substantially beyond regulatory measures and quantitative limitations on the size and leverage. The crucial debate remains how to recreate a socially beneficial financial sector. In this sense, Bezemer is right when he is reminding us that the financial sector continues to be bloated and dysfunctional. As long as modern societies cannot channel credits via financial institutions primarily in the enhancement of productivity, wages and the growth of the real economy, the efforts to bail out such a financial sector will present a drain, not a support, for the long term economic and social development of modern societies. Therefore, the key challenge for modern societies is to restructure and redirect financial institutions to again start performing socially useful functions.

Nothing less than the future of democracy is at stake. Concern about the future of democracy in relation to the role and importance of financial institutions was very well understood by the scholars, practitioners and politicians, such as Louis Brandeis, Douglas Williams and Franklin Roosevelt, decades ago. However, it is poorly understood by the present generation of leaders and mainstream scholars.

Another important aspect of the finance and financial institutions situation that was overlooked by most mainstream economists, lawyers, and policy-makers is that corporations, businesses and other parts of the real economy are increasingly

42 D. Bezemer, 2009b. Lending must support the real economy, *Financial Times*, November 4.

self-financed. This observation was almost completely ignored before the crisis in good economic times and remains to be largely overlooked today. Only a handful of scholars pointed to this issue of self-financing. The scholars who pointed out this phenomenon, including Roberto Unger, Zhiyuan Cui, and Colin Mayer, observed that relatively little real investment in the expansion of production and productivity is financed directly through stock markets:

“Corporations in all major Western countries fund almost all their capital expenditures – investment in plant, machinery, and inventories – internally, through retained earnings, in other words, through profits and depreciation. Since 1952, retained earnings have covered ninety-five percent of capital expenditures. Since the early 1980s, through mergers and acquisitions, buybacks, and dividend distributions, more stock has been retrieved from stock markets than has been issued. As a result, new equity as a net source of finance is negative!”⁴³

Why is it possible that such an important and revolutionary insight has been ignored for such a long time? Part of the theoretical and practical reasons lie in the nature of modern financial activities as explained previously. Another part of the reason lies with the neoclassical and Keynesian literature, according to which the accounting identity between savings and investment exists by definition. Whatever is saved is going to automatically be invested. This implies that saving cannot be wasted and money cannot be squandered in the financial casino. The reality of modern complex financial institutions illustrates a different picture. Huge volumes of financial transactions and trading between financial institutions do not necessarily and automatically guarantee that the financial flows will be channeled to enhance productivity and output. Empirical analyses illustrate that corporations have to rely on their own savings to finance their development. This observation, put forward by economic and legal scholars Bezemer, Unger, and Cui, has been suppressed by the neoclassical and Keynesian literature. The growing gap between the financial institutions and the real economy was less problematic in good economic times – when the underlying fragility and unsustainability of the financial arrangement was not taken seriously. It remains unaddressed today. Without addressing it, it is difficult to determine how it would be possible to overcome the ongoing crisis, except in the form of a temporary ‘kicking the can’ manner.

In addition to the theoretical reasons, practical reasons for ignoring the problem of the inefficient allocation of scarce resources lies ahead. Financial markets and financial institutions grew immensely in the last decades. Confronting them

43 Z. Cui Z. in R. M. Unger, *Democracy Realized*, Verso 1998, an appendix on saving and investment, p. 283.

directly would require courage and wisdom, as well as the theoretical knowledge and practical skills rarely seen of public figures, such as policy-makers and advisers. It remains more convenient to marginally improve the regulatory framework while bailing out many of the failing financial institutions with taxpayer money, rather than approach a comprehensive and strategic restructuring of the financial sector. Strategic restructuring would require a quantitative restructuring in terms of size and caps, as well as a qualitative restructuring of financial institutions in order to reconnect them with the real economy and the rest of the society.

These are the reasons why the approach toward banking bail-outs and toward the banking union in the European context is far from efficient from a broad social and economic perspective. The entire approach needs to be re-directed. The regulatory efforts should follow, not precede, such a reorientation. The best start in a new direction, such as this, is to focus on what worked best in the past. These were networks of small local banks which provided long term support for the development of small and medium sized local businesses. Local banks have traditionally been a backbone of local and regional development in many advanced economies, including the US decentralized banking sector and the German system of *Landesbanks*. They have a much better insight into the needs, possibilities and potential of local businesses and have a much bigger stake in the success of local and regional development. They represent one alternative possibility of how to secure a deepening of finance in place of the futile process of financial hypertrophy.⁴⁴

Other forms of financial institutions with much larger stakes in supporting the long-term competitiveness of the real economy, and with much greater interest in the more equal and inclusive access to credit, should evolve. The difference between financial hypertrophy and financial deepening was established by Roberto Unger and Tamara Lothian. They explain the contrast in the following way: “By the hypertrophy of finance, we understand increase in the size of the financial sector, of its share in profit, talent, and influence, regardless of the service that it renders to the real economy. By financial deepening, we mean the intimacy of the relation between finance and the real economy: not only consumption but also and above all production and innovation.”⁴⁵

44 T. Lothian and R. M. Unger in Lothian T., *Law and the Wealth of the Nations: Finance, Prosperity and Democracy*, Columbia University Press, 2017. Appendix Crisis, Slump, Superstition, and Recovery: Thinking and Acting Beyond Vulgar Keynesianism (with Roberto Mangabeira Unger), p. 356.

45 Ibidem.

Institutional innovations in the area of finance are something substantially different than the proliferation of financial instruments and financial innovations in the last decades. Financial innovations served the purpose of enhancing the volume of trade without the ultimate goal of supporting the development of the real economy. Wouldn't it be really exciting for banking to re-connect the financial institutions with the development of the real economy, so that the next generation of talented bankers would participate, support and help develop the real economy and society at large? It is true that the banking bonuses for the top executives and the returns on equity could (and should) be closer in line with the developments, returns and rewards in the real economy, but such a realignment would serve the real social needs and return prospects for the many excluded parts of the population.

We need to multiply and diversify financial institutions in order to reconnect the world of finance with the world of real economy. For example, the role of venture capital, which provides equity to start-up firms, the role of regional development funds, the role of pension funds and the role of other financial institutions can all contribute to the diversification of financial institutions. It also contributes to more innovative ways for how to provide long-term support for the real economy and its restructuring for start-up firms, industrial innovations and the productivity enhancement.⁴⁶

A reorientation of the financial institutions is not without risks. The key point is that decisions for when and how to provide finances for the real economy must be taken on the basis of a high level of expertise and an understanding of the real economy. It must also be independent on any political meddling at the local, regional and national level. Policy-makers should support the improved links between the financial sector and the real sector, but they cannot, and should not, interfere with the professional decisions of which investment opportunities deserve high quality financial support. The same principle applies, even in the case of public venture funds. However, these venture funds present a rare, but potentially promising, vehicle of the future socially inclusive economic development.

Financial deepening, as a qualitative and quantitative contrast to development, would lead to a more balanced, more diverse and subsequently more inclusive development of the financial sector, real economy and society at large. It would require strong leadership and a renewed opening of space for the economic, social

46 For the possibility to transform the US financial system toward more equitable and more efficient system, see G. Dymski, G. Epstein and R. Pollin (eds.), 1993. *Transforming the U.S. Financial System – Equity and Efficiency for the 21st Century*, M. E. Sharpe.

and financial initiatives bottom-up approach, as well as better chances to pursue a comprehensive economic and social reconstruction. It would present a task, as Tamara Lothian and Roberto suggest in their proposal, to return the financial institutions from the position of bad master again into a position of good servant to the economy and society.⁴⁷

Such a restructuring of the financial institutions would certainly require broader social and economic visions of modern economies and societies and would require broader social alliances. It would not be a magic wand, but it would certainly present a more transparent, more balanced and more inclusive approach to the economic and social recovery. Needless to say, it would also meet with strong opposition in the form of present financial and political oligarchies which continue to stymie any coherent and comprehensive approach to the recovery beyond hopeless but allegedly necessary bail-outs and banking unions in the trans-Atlantic world.

CONCLUSIONS

Since the beginning of the crisis, many valuable proposals for how to tame financial institutions were put forward. Among the most well-known is the Volcker rule, which is the prohibition of internal hedge funds, internal private equity funds, and proprietary trading in commercial banking institutions. They include a return to “narrow banking”, limitations of the size and leverage of financial institutions. Laurence Kotlikoff suggested a limited purpose banking, in which banks are not allowed to borrow short and lend long. In addition, all risky assets must be held in mutual funds.⁴⁸ In practice, new legislation and regulation, such as Dodd-Frank, was adopted. In a long and protracting legislative procedure – including heavy lobbying and opposition from the Wall Street – a comprehensive new legislation was adopted by the US.

According to Simon Johnson, the Dodd-Frank Act presents an important step forward in supervising and regulating large financial institutions and a missed opportunity. It is a complex legislation which leaves a dizzying number of details to regulatory discretion. Thus, it will depend largely on the integrity, quality, independence and professionalism of the regulatory bodies. More specifically, the

47 T. Lothian and R. Unger, *supra* 44, pp. 357–361.

48 Johnson, S. and Kwak, J., *supra* 25 (Chapter 7).

courts will have to supervise and regulate the financial institutions better than they have in the past.

Lawyers at Davis Polk counted 243 new rules and 67 new studies required by the Dodd-Frank Act. Despite the comprehensive legal framework, many important aspects are exempted from legislation, such as the new requirements for trading and clearing derivatives, which includes an exemption for “commercial end users” that use derivatives for hedging purposes. Johnson has pointed out that the size of that loophole turns out to be largely dependent on the wording of the rule defining exempt transactions.⁴⁹

It will be many years, before a judgment on the efficiency of such legislation could be made. It will also take many years before it will become clear as to whether the president’s announcement, when signing the Dodd-Frank Act, of the American people never again being asked to foot the bill for Wall Street’s mistakes and about the transparency and risk reduction of such a bill will be possible to verify.⁵⁰ It is already possible, however, to say that the Dodd-Frank Act does not present as substantial a reform of the financial institutions as the Glass-Steagall Act, in the New Deal era, despite the fact that the magnitude of the problems and issues related to the role of financial institutions is bigger today than at any other period of industrial, financial and social development.

Alternatively, more thoroughly thought out approaches toward financial sector restructuring are needed. The real tragedy is, however, that despite this massive support in state aid (and therefore leaving out other measures of support, such as the ECB measures) many EU member states economics and their regions economies continue to be in recession with high unemployment and with very weak financial institutions. The situation is not significantly better in the US, despite a more integrated federal financial system. The challenges ahead for the policy-makers today are even bigger than at the eruption of the crisis. Kicking the can down the road has its limitations too.

As a starting point for a more substantive reform of financial institutions, we again turn to Dirk Bezemer, who argues convincingly that there is no neutral regulatory framework. Only after we understand the nature, character and scope of modern financial institutions and only after we envisage a significantly reoriented role of the financial sector in the modern economy and society, can we turn to the adoption of a substantially different regulatory framework. Such a framework would

49 Ibidem.

50 Ibidem.

be more inclined to provide high quality financial support for the development of a real economy, for its active restructuring, for enhancement of productivity and for the benefit of more socially inclusive overall development. Namely:

“More specifically, the balance sheets of firms, households and governments, and the regulations in the economic system on what sorts of balance sheets are being allowed, co-determine what forms new credit flows can take, how much there can be of it to different sectors (e.g. to the FIRE sector versus the real economy), and consequently how the economy will evolve. These will not be the only factors shaping the economy, but neither can they be fully abstracted from, as is current practice in much of economic research. In sum, there seem to be important contributions that accounting researchers can make to economics – rather than just the other way around, as is sometimes suggested”.⁵¹

There is no doubt that financial institutions and financial instruments will develop in the future. Robert Shiller is correct about that and also about the many socially useful innovations that were developed in the past. The trouble is, however, that financial institutions in the last three decades contributed less to the public good than they did before the crisis. Many mainstream academics, policy-makers, monetary authorities, financial institutions’ representatives and corporate media defended the liberalized, deregulated financial institutions. The biggest challenge remains how to make the financial institutions serve broad social interests and make sure that they are doing their best in delivering better products and services. Unlike Robert Shiller, who believes that improved regulations would be sufficient enough for financial institutions to serve broad social interests in the best possible manner,⁵² many other scholars, described previously, argue convincingly that a mere regulatory reform will not be sufficient. Independent minded scholars from all over the world would make a historical mistake if they did not deeply understand the substantive nature of this disagreement. They should also not pay attention to the possible alternative ways to approach the financial, economic and social reconstruction of modern societies in different parts of the world.

The European Union initiatives to complete the Banking Union are well-intended and welcome. This initiative, however, should not overlook the need to tighten the links between the real economy and the banks. Especially the links between local banks and small and medium sized companies should be reinforced. Stiglitz has recently argued in favor of cooperative and local banks, because “cooperative

51 Bezemer, *supra* 41, p. 33.

52 Shiller R., *Finance and Good Society*, Princeton University Press 2012, Kindle edition, Introduction.

and local banks provide an antidote to the unproductive activities of the large commercial banks and the shadow banking system”.⁵³ Moreover, they possess a long-term horizon and present “an important source of stable funding for smaller enterprises.”⁵⁴

Therefore, a diversity of financial institutions, their linkages with the real economy, consumers and households need to be strengthened, especially at the local and regional levels, instead of potentially further stifling with the concentration of financial industry within the context of the European single market.

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53 Stiglitz J. (2019). *Rewriting the Rules of the European Economy*, Feps Brussels, p. 91.

54 Ibidem, p. 92.

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3 THE EU FISCAL COMPACT: CONSTITUTIONALIZATION OF AUSTERITY AND PREEMPTION OF DEMOCRACY IN EUROPE

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INTRODUCTION

Confronted with the deepest economic and political crisis of the EU since its inception, European political leaders signed the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (a.k.a. the Fiscal Compact) on March 2, 2012. The Fiscal Compact was signed by all the member states of the EU, except the UK and the Czech Republic. Lacking a unanimous support of all the member states, the Fiscal Compact could not be adopted as an amendment to the European Union treaty. Instead, it took the form of a separate inter-governmental Treaty requiring at least twelve euro area members to ratify the Fiscal Compact until January 1, 2013.⁵⁵

The Fiscal Compact is only the last in a series of constitutional and legislative measures adopted by EU political leaders with the intent to “solve” the euro-zone crisis.⁵⁶ As most of the other measures initiated by the German led Center-Right coalition of political forces in Europe, the Fiscal Compact subscribes to a now dominant economic “theory” of austerity which informs most of its rules. Namely, the main culprits for the euro crisis, according to this theory, are profligate governments and their public sectors. As a consequence, the only hope to discipline such “irresponsible” governments is to impose strict fiscal rules (balanced budgets) preventing further increase of budget deficits and public debt.

The Fiscal Compact requires ratifying member states to enact laws, preferably of a constitutional nature, requiring national budgets to be in balance or in surplus. The treaty defines a balanced budget as one which has a general budget deficit less than 3% of GDP and a structural deficit of less than either 0.5% or 1%, depending

55 The Fiscal Compact entered into force on January 1, 2013, after Finland, as a twelfth euro zone member state, ratified the Treaty in December 2012. The signatories now have one year time to incorporate the balanced budget rule and correction mechanism from Article 3 into national constitutional law.

56 In the last two years, the EU institutions adopted Strategy Europe 2020 (March 2010), European Semester (May 2010), European Financial Stability Facility (June 2010), Euro-Plus Pact (March 2011), Six-Pack (December 2011), European Stability Mechanism (February 2012) and Fiscal Compact (March 2012).

on a country's debt-to-GDP ratio. The aim of this "golden rule" of balanced budgets is to ensure budgetary discipline among the EU governments. Another element of the Fiscal Compact is the so-called "debt brake" ("schuldenbremse") modeled upon the German constitutional provision requiring the federal government to reduce its structural deficit to 0.35 % of GDP by 2016. No surprise then that one of the leading European legal journals, cynically referring to the statement of the CDU parliamentary leader Volker Kauder, entitled its editorial "The Fiscal Compact and the European Constitutions: "Europe Speaking German".⁵⁷ The treaty also places compliance with its budgetary and other requirements under the jurisdiction of the European Court of Justice which can fine countries up to 0.1 % of their BDP if they do not transpose correctly balanced budget rules.

With its rigid adherence to the ordoliberal principles of monetary stability and sound finance, the Fiscal Compact essentially outlaws one side of the debate how to deal with the euro zone crisis. While it elevates the austerity paradigm of the German Chancellor Angela Merkel to the status of "unbreakable law", it basically outlaws Keynesianism and its counter-cyclical economic policies. Furthermore, the Fiscal Compact deviates from traditional EU values of democracy, institutional balance and the equality of member states. As we argue in the legal analysis of the compact, it empowers European bureaucrats, judges and bankers at the expense of European citizens. As a result, the Fiscal Compact seriously preempts the most basic democratic principles and values of the EU. While it is true that the Fiscal Compact mostly reproduces already existing provisions of EU law, its importance should not be underestimated. First, its core provision, Article 3, requires a transposition of the golden rule of balanced budgets into member states' national constitutions. As a consequence, the economic theory of austerity will be, for the first time in the EU history, constitutionalised on both the EU and national level. In other words, Keynesianism is ruled out precisely when it is most needed. Article 3 (2) requires that provisions in national constitutions have "binding force and permanent character". Hence, the new Austerity Union will be almost impossible to change. Second, it restricts fiscal policy of member states more than the existing EU Treaty does. It strikes "at the heart of the institutions of parliamentary democracy by dislocating as a matter of constitutional principle the budgetary autonomy of the member states".⁵⁸ Third, access to financial assistance under ESM will be conditional, from 1 March 2013, on prior ratification of the Fiscal Compact. After the European Court of Justice ruling in Pringle case, where the Court basically constitutionalised the principle of strict conditionality from the

57 Editorial; The Fiscal Compact and the European Constitutions: "Europe Speaking German", *European Constitutional Review*, 8 (2012), p.1.

58 Ibid, p.5.

ESM Treaty, countries seeking financial assistance from ESM will be subjected to even more explicit forms of fiscal retrenchment imposed through the Memoranda of Understanding which struggling Member States have to “negotiate” with the troika made up of the EU Commission, the IMF and the ECB.

No surprise then that authors like Wolfgang Streeck, Fritz Scharpf and Perry Anderson describe this situation as sovereignty “on paper”, “occupation regime by the “Troika”, and troika diktat regime “reminiscent of Austria in 1922, when the Entente, under League of Nations colors, posted a high commissioner to Vienna to run the economy”.⁵⁹ It is obvious that in the new Austerity Union, countries like Greece, Portugal and Ireland will be treated differently from other states in the EU. For example, Ireland, the only country to have a referendum on the Fiscal Compact, voted for the Compact, but, with the EU gun to its head, as the Irish media sarcastically reported. Or, in Slovenia, another small EU country, the Constitutional Court justified its ban of two referendums on the government austerity package legislation with references to the Fiscal Compact even before it entered into force. What these cases show is that the profound transformation of the EU constitutional order is altering the “original” constitutional balance in the European Union. The new Austerity Constitution deepens the divide between the core and periphery in the Union.

While many prominent Nobel laureate economists like Paul Krugman, Joseph Stiglitz and Amartya Sen have been critical of the EU austerity policy in general and the Fiscal Compact in particular, political opposition to the EU imposed austerity has been surprisingly weak in Europe. Until the May 2012 elections in France, it seemed as if the Fiscal Compact enjoyed almost unanimous support among the European political leaders. When Merkel and Sarkozy agreed in October 2010 in Davuille to constitutionalize their economic policy of austerity, their decision soon became the virtually unchallenged new economic doctrine of the entire EU. One of Francois Hollande’s most important election promises was to renegotiate the Fiscal Compact. With the euro zone debt crisis deteriorating even further, other important institutions such as the IMF and the US Treasury also voiced a strong criticism of the austerity orthodoxy and urged for a new pro-growth approach. Ed Miliband, the leader of the British Labor party, after meeting Hollande, acknowledged that the tide was turning against austerity with Hollande in power. As a consequence, during the June 2012 Euro Area Summit the debate shifted from austerity to growth and several EU leaders urged for a new growth pact to complement the Fiscal Compact. However, while making certain minor concessions to the pro-growth

59 P. Anderson, EU elites haven’t really heard from the masses; Europe speaks German, *Le Monde Diplomatique*, December 2012.

advocates⁶⁰, the conclusions of the Summit fell short of producing a more ambitious alternative to Merkel's austerity policy. In the end, only the European Trade Union Confederation (ETUC) directly opposed the Fiscal Compact. As the leader of the ETUC Bernardette Segol remarked, her organization had never opposed a European treaty before. Paradoxically, ETUC opposition to the Fiscal Compact did not matter much, because the Compact sidelined all procedural guarantees of EU law and was adopted without participation of European citizens.

As we shall present in our analysis, the adopted Fiscal Compact cements the deeply flawed European direction. Failing to address the real causes of the euro zone crisis and to offer adequate economic solutions to the crisis, it could only plunge the EU into a deeper and prolonged economic depression. We argue that an alternative economic and political strategy is needed. Using legal and economic analysis, we demonstrate that the Fiscal Compact needs a substantial revision. Such a revision, we aim to show, would not inevitably lead to a fiscal union, as taxpayers from the core countries may fear, but rather to a more balanced, more inclusive and pluralistic EU. The attempt to impose top-down, one-size-fits-all, rigid and restrictive fiscal rules should be replaced by a much more decentralized approach toward fiscal, economic and political reconstruction of the EU. We conclude with a discussion of alternative proposals to the EU Fiscal Compact in particular and with proposals for alternative "possible Europes" in general.

THE ECONOMICS OF THE FISCAL COMPACT: TOO RIGID AND TOO RESTRICTIVE

The most concise and clearest explanation as to why the generalized European austerity cannot work and why it shall in effect further undermine the confidence of financial markets was provided by Paul de Grauwe, one of the preeminent scholars of European monetary integration:

When all eurozone countries are forced to accept austerity at the same time, deflationary forces are set in motion that lower output and government revenues throughout the eurozone. As a result, government budget deficits do not decline sufficiently to prevent debt-to-GDP ratios from increasing, as the denominator in these ratios (GDP) goes down faster than the numerator (the debt level). Thus, the effect of generalised austerity is recession and more unsustainable levels of

60 The Summit conclusions contain also an annex entitled "A Compact for Growth and Jobs", European Council 28/29 June 2012 Conclusions.

government debt. Generalised austerity undermines the confidence of financial markets, because it leads the eurozone straight into a recession.⁶¹

Contrary to its declared goals, the Fiscal Compact shows that it does not lead to good fiscal policy. It tries to secure the moderate and sustainable levels of public debt at the levels of the national government. Such a declared goal is reasonable and legitimate. However, the problem is that legally binding limits imposed by the Fiscal Compact are too rigid and too restrictive to allow such a reasonable fiscal policy. Karl Whelan from the University College Dublin analyzed the so-called golden rule. Despite the desirability of achieving moderate and sustainable levels of public debt and the need to return the country's debt to a 60 percent debt-to-GDP ratio, he concluded that the rule "[being] far from golden, is a poor one that does not correspond to either of the principles of good fiscal policy – it cannot guide an economy towards a moderate and sustainable level of public debt and it cannot keep public debt fluctuating around this moderate level in a countercyclical fashion."⁶²

Whelan puts forth the following argument: If the rule on long-run debt levels is followed, it will lead to debt ratios that fall well below those considered sustainable and moderate. An economy's debt-to-GDP ratio tends to converge toward the ratio of the average deficit percentage to the average growth rate of nominal GDP. As such, Whelan calculates that an economy with an average growth rate of a nominal GDP of 4 percent following a policy in which average deficits are a maximum of 1 percent will end up with a maximum debt-to-GDP ratio of 25 percent – far below what is required to operate a sensible and stabilizing fiscal policy.⁶³

In addition, Whelan's analysis of following the rules stipulated by the Fiscal Compact for stabilization purposes shows their overly restrictive nature: The 3 percent maximum deficit rule severely limits the ability to run countercyclical policies of this type that would still be consistent with moderate levels of debt.⁶⁴

61 Paul de Grauwe, 'Who cares about the survival of the eurozone', CEPS Commentaries, 16 November 2011, <<http://www.ceps.eu/book/who-cares-about-survival-eurozone>> (17. 3. 2012), p. 1.

62 Karl Whelan, Golden rule or golden straitjacket? A Critique of Europe's Fiscal Compact, 25. February 2012, <<http://www.voxeu.eu/index.php?q=node/7663>> (17. 3. 2012).

63 Ibid.

64 Ibid. His calculation is as follows: "For example, a deficit of 2.4 percent per year would, over time, stabilise the debt-GDP ratio at 60percent in an economy in which nominal GDP grew at an average 4 percent pace. Cyclical deviations of 2 or 3 percentage points around such an average deficit of 2.4 percent would also be possible without endangering fiscal stability. However, the 3percent maximum deficit rule severely limits the ability to run countercyclical policies of this type that would still be consistent with moderate levels of debt."

Using his analytics of the debt-to-GDP ratio, Whelan pointed out that the Fiscal Compact resembles the golden straitjacket – reminding us of the grave consequences of the rigidity of the gold standard in the 1930s – more than the truly productive and feasible golden rule for the EU member states. He is convinced that the Fiscal Compact was not carefully designed and was probably developed in haste, as often evident in the EU decision-making processes in the past; if not carefully revised, it may have long-term negative consequences for the European economies and societies. We are of the opinion that such serious claims and arguments cannot and should not be ignored by the European technocracy. To force EU countries to run one size fits all fiscal policies based on theoretically flawed prescriptions sounds like a true recipe for disaster.

The European Macro Group – three European macroeconomic institutes: IMK from Düsseldorf, WIFO from Vienna and OFCD from Paris – prepared a joint study on the impact of austerity measures, reinforced by the Fiscal Compact. Their findings are important and unambiguous. The current direction of the EU focused on austerity measures across the board and was reinforced with the newly adopted fiscal rules. The analysis and assessment of the Macro group is even more ominous: The combination of tough austerity measures across the EU, further strengthened by the fiscal rules, is likely to push large parts of the EU into a new recession in the near future. The outlook of most of the EU countries, including core countries, is not optimistic.

The European Macro Group provided further analysis of the adopted Fiscal Compact – namely, the requirement to balance the budgets or secure their surplus and ensure that the structural deficits will remain below 0.5 percent of gross domestic product, with the European Court of Justice empowered to verify whether this rule is obeyed, is deeply questionable. Countries exhibiting deficits will have to reduce them rapidly; countries whose debt ratio exceeds 60 percent will have to reduce the excess debt by 5 percent per year. In addition, budgetary plans and structural reforms will have to be approved by the European Commission and the Council.

The European Macro Group concluded that the Fiscal Compact is macroeconomically dangerous and imposes budgetary rules on the countries based on arbitrary figures. Automatic policy measures introduced by the Fiscal Compact mean that the countries will not only have to abstain from anti-cyclical policies, but will also have to adopt pro-cyclical measures. The mere control of numerical figures is not the same as true economic coordination. The Fiscal Compact is not consistent with sensible European economic policies and is heading in the wrong direction.

The European Macro Group's joint study reminds us of the arbitrariness of the target of a debt ratio of 60 percent. This figure was invented as part of the Maastricht

criteria and was justified under the assumption that a nominal GDP would grow by 5 percent per annum in the medium to long run.⁶⁵ The fundamental flaw of the debt criterion of the Fiscal Compact according to the European Macro Group's study is that no differentiation exists between government debt accumulated for cyclical reasons and government debt accumulated for other ("structural") reasons.

According to the European Macro Group, the only sensible way out of this macroeconomically dangerous Fiscal Compact, which may further dampen economic prospects in the Eurozone, is to move away from the (arbitrarily) determined numerical limits toward an improved quality of member states' fiscal policies. This can be obviously achieved in far less intrusive ways for the member states that are struggling with the biggest economic, financial and social crisis since the foundation of the EU. Not surprisingly, scholars from the EU country suffering from depression-like levels of unemployment concluded that the Fiscal Compact is "the most unbalanced and asymmetric treaty member states have ever signed, is the best illustration of the new Europe: while austerity is strictly enforced, growth is barely promised."⁶⁶

Thus far, we have presented economic contradictions of the Fiscal Compact. Equally worrisome are some of the theoretical assumptions of the Fiscal Compact. Paul de Grauwe, pointed out that the balanced budget rule is based on the cynical view of what governments do. The rule implies that the governments do best when they do preferably nothing and leave it to the markets to do the job:

There is no sound economic reason to back up such a rule. Governments invest in infrastructure, human capital, the environment, and the law and order. All these investments increase the productive capacity of a nation. There is no reason for governments to be prohibited from issuing debt to finance these investments. In

65 In this case, the government ratio converges toward 60 percent even if the budget deficit permanently reaches the Maastricht limit of 3 percent. In reality, the nominal GDP of 11 countries has increased by only 3.5 percent per year since 1992. This fact would require significant changes of the targets – a maximum target for the government debt ratio of about 86 percent. Moreover, if the overall deficit is to be limited to 0.5 percent, countries such as Italy would have to reduce their public debt by 5.3 percentage points of the GDP per year for 20 years. IMK (Düsseldorf), OFCE (Paris) and WIFO (Vienna): Fiscal Pact Deepens Euro Crisis – joint analysis of the Macro Group. <www.boeckler.de/pdf/p_imk_report_71e_2012.pdf> (March 2012), pp. 20–23.

66 José Ignacio Torreblanca, 'Time to say 'basta' to the nonsense of austerity', *Financial Times*, April 25, 2012. See also Mark Blythe, *Austerity: The History of a Dangerous Idea*, Oxford University Press.

much the same way as there is no reason to prohibit firms that invest productively to issue debt. In fact, economic theory tells us that governments that invest productively should issue debt to finance these investments. Productive investments profit present and future generations. It is therefore desirable to spread the cost of these investments over present and future generations.... What should be avoided is unsustainable debt, not debt per se.⁶⁷

The Fiscal Compact, in combination with synchronized austerity measures, will only reinforce the EU's recession and long-term stagnation and will not bring about improvements to the quality of fiscal policies across the EU. It is poorly designed, with many internal contradictions, and will inevitably become a source of new conflicts and divisions in the EU. As such, it is closer to the economic philosophy put forth by Andrew Mellon, Herbert Hoover's Secretary of the Treasury, and his idea of liquidating the "rottenness" from the markets.

However, this does not mean that many of the EU countries in the past decades⁶⁸ have not committed numerous mistakes in the public and private sector; rather, the ongoing EU response to the crisis, based on single-minded austerity and balanced budget, has further exacerbated the crisis. Many other crucial debates, such as how to reestablish links between local financial institutions and local business developments, how to address the EU's persistent current account balance and many other crucial strategic issues, are being ignored due to the EU's persistence in its austerity and balanced budget. It is a sign of a profound lack of ideas, initiatives and imagination, where the public discourse on how to move further in the EU is decisively missing. As Alain Supiot argues, reflections on the future of the EU must be reflections about alternative, possible Europes.⁶⁹

A WRONG DIAGNOSIS OF PUBLIC FINANCIAL DIFFICULTIES

After the critique of the economics behind the Fiscal Compact, we now explore the reasons why the European leaders decided in the midst of the most severe financial, economic and social crisis to start disciplining and penalizing governments for their supposed profligacy. The reason stems from the diagnosis that the public financial difficulties, public debts and deficits are the consequence of

67 Paul de Grauwe, 'Balanced budget fundamentalism', CEPS Commentaries, September 5, 2011, <<http://www.ceps.eu/book/balanced-budget-fundamentalism>>, pp. 1–2.

68 For a historical account of these past mistakes, see Ivan T. Berend, *Europe in Crisis: Bolt from the Blue?*, New York and London 2012, pp.60–90.

69 Alain Supiot, 'Possible Europes', *New Left Review* 57, May–June 2009, p.65.

the profligacy of governments prior to the financial crisis. There may have been elements of profligacy, to be sure. However, a more nuanced analysis of the last decades shows that most of the governments, with the exception of Greece, were disciplined with respect to public finances.

Based on various sources, Paul de Grauwe made the following observation: “While the government debt ratio in the Eurozone declined from 72 percent in 1999 to 67 percent in 2007) the household debt increased from 52 percent to 70 percent of GDP during the same period. Financial institutions increased their debt from less than 200 percent of GDP to more than 250 percent.”⁷⁰ Therefore, the Eurozone governments (with the exception of Greece) were more disciplined prior to the crisis than the private sector, and the explosion of the government debt after 2007 was the result of the need to save the private sector – particularly the financial sector.⁷¹

The wrong or at least partial or one-sided diagnosis of the root causes of the financial and economic crisis in the EU led to partial, one-sided measures being used to cope with the crisis across the EU. The EU insisted on a one-size-fits-all approach, being imposed from the top down to all member states and their regions. The approach to the crisis never carefully examined the role of large European financial institutions and how they escaped the necessary supervision of the European financial markets. If there were peripheral governments, excessively and irresponsibly borrowing, than there were large financial institutions on the other side that, in a similarly irresponsibly way, continued lending to over-indebted governments.

The debate and analysis about the large and small European financial institutions purchasing huge amounts of toxic assets on the other side of the Atlantic is an additional puzzle piece in the missing debate on the role, importance and supervision of the financial institutions. Was not the idea of the single market in the

70 Paul de Grauwe, Fighting the wrong enemy, 19. May 2010 <<http://www.voxeu.org/index.php?q=node/5062>>.

71 “Those who say that it is government profligacy that is the source of the debt crisis are mistaken. They also fail to see the inevitable connection between private and public debt. This connection is particularly strong in countries like Spain and Ireland that have been hit badly by the debt crisis. As can be seen from Figure 2, Spain and Ireland were spectacularly successful in reducing their government debt to GDP ratios prior to the financial crisis – namely, Spain from 60 percent to 40 percent and Ireland from 43 percent to 23 percent. These were the two countries that followed the rules of the Stability and Growth Pact better than any other country – certainly better than Germany, which allowed its government debt ratio to increase before 2007. Yet the two countries, which followed the fire code regulations most scrupulously, were hit by the fire because they failed to contain domestic private debt.”

financial sector to be an instrument to channel financial resources across Europe in the most efficient and rational manner? If so, why have such large quantities of European savings ended up via European financial institutions in the American toxic assets? What the EU citizens need is a more transparent, objective and comprehensive analysis of the role of European financial institutions if we are ever to move beyond the crisis toward more sustainable, transparent and balanced European economies and societies. However, the current approach of the EU elites to the Euro crisis falls short of providing such answers. What is clear is that more radical approach is needed. Robin Blackburn for example proposes a model of public utility finance system as a means to enhance a democratic control of the financial system.⁷² Needless to say, current proposals to create the EU “banking union” offer nothing of that sort.

Fallen revenues due to the recession, increased unemployment benefits and recapitalization of the financial institutions are among the main reasons for the deteriorating public financial position of the European governments. The fiscal trap of many European governments is a consequence – not a cause – of the financial crisis. It should be recognized and managed accordingly, not perceived as a main culprit and cause of the crisis.

Charles Wyplosz recommended a more decentralized approach to the fiscal consolidation.⁷³ Such a decentralized approach toward fiscal consolidation would be capable of taking into account the variety of macroeconomic situations in which different member states find themselves, thereby facilitating a much larger autonomy and larger maneuvering room for the member states and, subsequently, greater responsibility among the member states. Yet such an approach presupposes much stronger trust and credibility among the member states and potentially risks moral hazards. No one can deny that such a risk truly exists. Without the existing mutual trust and credibility among the member states and their governments, irrespective of their political structure, it is not possible to foresee a stable and sustainable union. To replace it with the previously discussed forced measures, reinforced by serious penalties, the union would most likely not be able to function successfully either. The founding fathers of the EU understood this paradox much better than the current generation of European leaders and technocrats.

In addition to the discussion on the right diagnosis of the root causes underlying European imbalances and weak democratic accountability at the supranational

72 Robin Blackburn, 'Crisis 2.0', *New Left Review* 72, Nov/Dec 2011, p.56–61.

73 C. Wyplosz, We need smart fiscal discipline – not saints and sinners, <<http://www.voxeu.org/index.php?q=node/7405>>.

– and often at the national – levels, an additional characteristic of the crisis and deep recession exists but has been overlooked. Such a phenomenon was widely analyzed and understood in previous crises (e.g., the Great Depression). Namely, all of the European economies are experiencing an ongoing complex process of deleveraging the public sector, households and companies. Irwing Fisher noted during the Great Depression that it is not possible to achieve a deleveraging of both the public and private sectors simultaneously. Attempts to deleverage both sectors simultaneously can damage the economy as a whole. The private sector can only reduce its debt if the government is willing to increase its own debt. Otherwise, negative dynamics are created that can pull the economy down into deflation. In the literature, this phenomenon is known as the Fisher paradox.⁷⁴

THE FALSE IDEA OF EXPANSIONARY AUSTERITY

The next argument in favor of adopting the Fiscal Compact stems from the conviction that the best solution to the public financial crisis and recovery is the implementation of austerity measures. Tough austerity measures would calm the financial markets and investors because new stability would be established, encouraging new investments due to the reduced risks in the markets.

Such an assumption about establishing the market and investors' confidence is based on tough austerity measures. Austerity measures are usually accompanied by other measures – most notably, structural reforms that include the labor market reform in the direction of further flexibility of the labor market, liberalization of the European market of products and services and other measures of market liberalization. Among member states that are still making efforts to preserve the remaining parts of the welfare protection for employees, structural reforms generally present the last measures in reducing the labor unit costs: the reduction of the remaining standards of social safety in the case of unemployment, medical, health, pension and other welfare protections.

The problem with the assumption about newly established confidence based on expansionary austerity is that it has very little support in empirical studies to date. The general effect of the measures across Europe is that the budget deficits do not decrease fast enough to prevent the deterioration of the debt-to-GDP ratio because the GDP is falling faster than the public debt. In this context, austerity

74 For more on the relation between the Fisher paradox and the poorly designed process of deleveraging across Europe, see Paul de Grauwe, 'Crisis in the eurozone and how do deal with it', CEPS Policy Brief, no. 204/February 2010: <www.ceps.eu/ceps/download/2928> p. 2.

measures do not establish the necessary confidence of the financial markets, but rather further undermine confidence. The answer of the European leaders in this context is that we need more austerity instead of measures and policies to stimulate jobs and growth. This economic philosophy again resembles Mellon's economic philosophy. Despite the empirical fact that the European policy is pushing more and more member states and their regions into a deep recession, resulting in high levels of unemployment, especially among the youth, European economic policies remain largely unchanged.

Empirical studies indicating that expansionary austerity has a very poor record remain ignored. A comprehensive study by the IMF, conducted on 173 case studies of austerity measures in 17 developed countries in the preceding 30 years aimed at financial consolidation with the help of tough austerity measures, clearly highlighted this misunderstanding. The findings are once again unambiguous: Countries that try to cut the expenditures too soon and too deeply increase unemployment – both short and long term – and reduce incomes, especially for the lowest income social groups.⁷⁵

Short-term effects of tough austerity measures are negative in contrast with the declared expectations of the European leaders. They negatively affect demand and economic growth. Based on these empirical facts and extensive research, IMF director Christine Lagarde, a former French finance minister, warned her former colleagues – namely, the European finance ministers – that slamming on the fiscal brakes too strongly might have negative impacts on the employment outlook and general economic recovery.⁷⁶ More important than implementing one-sided and unbalanced measures is the need to try to achieve fiscal consolidation in the medium run while simultaneously carrying out incentives to achieve economic growth and jobs.

Kenneth Rogoff and Carmen Reinhart demonstrated that growth in the time of debt has no simple causal links as often presented in the context of European decision-making processes. For example, they concluded that the relationship between government debt and real GDP growth is weak for debt/GDP ratios below

75 Jaime Guajardo, Daniel Leigh, and Andrea Pescatory, *Expansionary Austerity: New International Evidence*, IMF Working paper WP/11/158, July 2011. See also Laurence Ball, Daniel Leigh, and Praksh Loungani, *Painful Medicine*, Finance & Development, September 2011, Vol. 48, No. 3.

76 C. Lagarde, 'Don't Let Fiscal Brakes Stall Global Recovery', *Financial Times*.

a threshold of 90 percent of the GDP.⁷⁷ No one is trying to claim that debt burden (public, private, domestic, foreign) is unimportant. The argument is much more subtle: Debt thresholds are country specific; where the “debt intolerance” begins is a much more contextual matter. Therefore, approaching the fiscal consolidation on a more decentralized and medium-term basis, where other important macroeconomic aggregates and circumstances are taken into account, sounds like a more consistent approach to the crisis than the one-size-fits-all approach currently adopted in the EU.

The impression is that the European leaders encountered the financial and economic crisis unprepared. More often than not, they adopted the decisions in haste and under the huge pressure of the crisis unfolding before them. It may well be that the European institutional structure was unprepared for a crisis of such magnitude, but the decisions made by the European leaders as well as the decisions not made by them undoubtedly further exacerbated the crisis. In this sense, the Fiscal Compact presents only the tip of the iceberg. The EU economic policy and the economic policies of the member states need substantial redirection toward comprehensive institutional restructuring and economic and social reconstruction.

It is difficult to understand and explain why European leaders are unwilling to adhere to these more subtle recommendations. It is perhaps due to the superficial analysis of the nature and extent of the crisis or the misperception that the crisis is not only financial but also related to the real economy in the majority of the European regions. The weak and largely ill-conceived response to the crisis can also reflect the EU democratic deficit, which means that a large part of the European population remains excluded from the discussions, unable to articulate their ideas and initiatives or express their concerns and needs. This is the point where the weak development of the European constitutional democracy comes in with full importance.

POOR UNDERSTANDING OF THE ROLE AND IMPORTANCE OF PUBLIC DEBT

Advocates of fiscal realism, in the absence of strong normative, doctrinal and empirical arguments, prefer to use a very simplistic but seemingly convincing household logic: What holds for households also holds for national economies.

⁷⁷ Carmen Reinhart and Kenneth Rogoff, *Growth in a Time of Debt*, NBER Working Paper No. 15639, January 2010.

However, they tend to forget that the national economy consists of many households in different situations. Some households are saving while others are taking out loans for various purposes. The same is true for other actors in the national economies: Some companies invest and grow, start-up companies take on debts to develop, and others are saving their corporate profits. Thus, to take the household logic to the aggregate level is misleading.

Paul Krugman conducted a historic analysis of the British public debt, pointing out that British public debt exceeded 100 percent of the country's GDP in 81 of the last 170 years.⁷⁸ High levels of debts during various historic periods did not prevent Britain from developing and growing nor from repaying all of its commitments; they certainly did not prevent Britain from international financial markets. Of course, as the leading economic power at the end of the nineteenth century and one of the leading financial centers in the world, Britain has held a very privileged position. On the other hand, it shows that there is no simple metric for determining the threshold tolerance of debt for different countries. If the balanced budget rule would have been a panacea for all macroeconomic challenges, countries such as Great Britain or the United States – as prime examples of the free market economy – would have enshrined such a rule into their legislative and constitutional contexts, respectively.

Attempts have been made in the United States to incorporate the balanced budget rule into the federal constitution, but they have failed. The reason for such failures is partly the positive experience with the New Deal period of the active federal approach to the Great Depression in the form of industrial recovery programs as well as the creation of the social safety net and partly due to the pragmatic reasons for not limiting the government's maneuvering room during economic crises. Although many of the state constitutions in the United States have incorporated the balanced budget rule, this is not the case at the federal level. The federal budget, dedicated to key social programs such as Social Security, Medicare and Medicaid, together with defense and homeland security, represents 18 percent of the GNP. During a period of crisis, the United States even extended health insurance to a large part of the previously uninsured population. The EU budget, on the other hand, with little more than 1 percent of the EU's GDP, does not include any comprehensive social or other development programs. All these programs remain the responsibility of the individual member states. Sheri Berman nicely illustrates this difference: "Between 1990 and 2009, for example, richer, more productive American states (such as New York and Delaware) paid about 10 percent more of their state GDPs annually in federal taxes than they got back, while poorer, less

78 P. Krugman, 'Nobody Understands Debt', New York Times, 1. January 2012.

productive states (such as Mississippi and West Virginia) received annual subsidies worth more than 10 percent of their GDPs. Greece entire 2011 deficit, it bears noting, was 9.1 percent of its GDP.⁷⁹ To impose a balanced budget rule during an extensive economic, financial and social crisis would indeed amount to a fiscal straitjacket, making it not too difficult to foresee the social consequences. What is not clear to the EU leaders was perfectly clear to Paul Samuelson. In his classical textbook *Economics*, he argued;

“The debate over rules versus discretion is one of the oldest debates of political economy. There is no single best approach for all times and places. Indeed, the dilemma reflects the difficulty that democratic societies have in making tradeoffs between short-run policies intended to attract political support and long-run policies to enhance the general welfare. What is needed is not rigid adherence to rules but farsighted dedication to the public welfare.”⁸⁰

The issue of the public debt, public assets, deficits and public finances is in truth a much more complex issue than recognized by the Fiscal Compact. This is particularly evident in the historic example of the United States, which emerged from World War II with a high level of public debt. This high public debt did not present an additional burden for the taxpayers because of the high growth rates and subsequent high tax revenues. According to Krugman, the debt from the war was never repaid, it just became increasingly irrelevant as the American economy grew and, with it, the income subject to taxation. As long as the government can ensure that the tax base grows faster than debt, the debt remains in control. Of course this does not mean that the debt does not matter. It does. Yet Krugman reminds us that other things matter more. He is convinced that we need more, not less, spending for the United States to escape its unemployment trap. The ill-informed obsession with debt stands in the way of recovery not only in the United States, but also – or even more so – in the EU.⁸¹

Robert Heilbroner and Peter Bernstein have even shown that, “as long as growth continues and the debt remains in the same relation to GNP, there is no reason that a national debt cannot increase indefinitely.”⁸² In other words, public debt and deficits are not something bad in themselves; they do not present a burden for

79 Sheri Berman, *European Disintegration? : Warnings from History*, *Journal of Democracy*, vol.23/4, 2012, p.1–12.

80 Paul Samuelson, William Nordhaus, *Economics*, 16th Edition, 1998, p. 659.

81 *Ibid.*, See also P. Krugman, *End This Depression Now*, W. W. Norton & Company 2012, particularly chapters 10–13.

82 R. Heilbroner and P. Bernstein, *The Debt and the Deficit*, New York, 1989, p. 48.

future generations if they are well managed and sustainable over the long term. The qualified discussion in the leading economy has shown that public debts are an integral part of modern democratic societies. They represent one of the instruments for securing the long-term development of societies. As long as total output grows, the public debt can also grow steadily because it serves the purposes connected with growth. If issues such as the structure of production, development of international economy, the careful design of the tax and expenditure structures are dealt with carefully and deliberately, then the issue of debt burden can be also dealt with successfully. In such a case, public debts and deficits are not part of the problem; they are part of the solution.⁸³

Opting for public debt is sensible and justified because the public sphere, similar to the private sphere, contributes to economic growth. Public investments can even make a vital contribution to the economic development inasmuch they provide the necessary and adequate infrastructure, provide investments in education and training and support and participate in overall social development.⁸⁴ Economic growth and social development would suffer if modern societies were unable to provide resources for public investments.

The United States is a country with a long history of comprehensive data on the public and private sectors. A study by David Aschauer of the Chicago Federal Reserve from the 1980s – the period of Reaganomics – concluded that the productivity of public investments exceeded that of private investments. The costs, imposed on the private sector by an inadequate infrastructure, were so great that the study concluded that private profitability would have risen by two percentage points if non-defense public investment were to rise from its present low levels to the earlier levels.⁸⁵ Of course, such findings do not directly apply to many of the EU countries and regions, but they do suggest the need to pause for a second before cutting public investments on behalf of indiscriminatory austerity measures.

Two other important questions have emerged with respect to the issues of public debts and deficits and the often-mentioned arguments. These questions relate to the crowding out effect and the living beyond our means argument. The crowding out effect relates to the argument that the overly extensive amount of public spending and public investments suppresses private economic activity and private investments, thereby reducing the overall well-being of society. Similarly,

83 Ibid., pp. 53–54.

84 Ibid., p. 61.

85 Ibid., p. 61.

the living beyond our means argument states that the government should not be incurring public debts so as not to disproportionately burden future generations.

If the crowding out argument holds, we would expect the countries with the worst public performance to show the largest rise in interest rates while the countries with the best public debt performance would show the smallest rise. Yet an empirical study of seven industrial countries ranked by increases in public debt and real interest rates in government bonds indicated that no significant correlation existed between interest rate changes and growth in public debt. Other important factors that are not fixed affected the identified relationship, such as domestic saving rates, balance of trade and monetary policy. As this study demonstrated, relating public debt to interest is a much more complex and mutually dependent issue than the proponents of the crowding out effect claim.⁸⁶

The debate on the crowding out effect carries with it another important dimension – namely, the dilemma put forward by Heilbroner and Bernstein: Should private spending always have priority over public spending? Some public investments with small initial return provide very positive effects for the national economy while some investments with vast profits have no positive effects on the national economy. This debate is connected with the importance and role of the public sector and with a broader debate on the overall national strategies of development.⁸⁷ Of course, no one is claiming that there cannot be failed public and/or private investments as we can encounter them in both developed and developing parts of the world.

The argument of living beyond our means is similar to the crowding out effect. This argument applies to a country that does not generate enough savings to be able to support its own capital investment.⁸⁸ In the United States, which is well known for its “twin deficits” – budget deficit and trade deficit – the balancing of the budget would improve the shortage of savings only on the unlikely supposition that consumers and business firms made absolutely no changes in their decisions to spend, save and invest despite lower government revenues and higher taxes. In other situations, the economic growth would suffer even more than in the case of cutting back the private needs due to the failure to provide for public capital needs.⁸⁹ This is the reason why Heilbroner and Bernstein recommended an increase of public investments financed by borrowing: A deficit used for public

86 Ibid., pp. 102–106.

87 Ibid., pp. 106–107.

88 Ibid., p. 117.

89 Ibid., p. 120.

capital formation is the best way to raise household and business income and, as a result, their savings. Deficits used for investment do not “absorb” savings, but rather generate savings.⁹⁰

This discussion of the public debt and deficit in terms of public and private investments and savings in the American context illustrates the complex relation between the public and private sectors and between the government and the market. The discussion indicates that it is not possible to simply determine in advance certain numerical limits that define sustainable public debt and deficit as well as positive and negative consequences for the economy and society.

The risk of unsustainable public finance cannot be underestimated. For small, open economies sharing the fate of the common monetary area, such a caution is even more necessary. However, such awareness does not mean that we should indiscriminately, immediately and deeply cut public expenditures, especially growth-relating public expenditures. Quality of financial cuts matters more than quantity. This is often forgotten in the European context and further reinforced with the numerical limits determined by the Fiscal Compact and other fiscal rules. These rules are too intrusive; they go too far and are part of the problem, not part of the solution for high-quality and transparent fiscal policy. It would be economically and socially unacceptable to cut investments that support growth, employment and all other forms of more inclusive, more balanced future developments. Some of the most competitive European societies and regions also maintain the highest levels of social cohesiveness.⁹¹ Competitiveness and social cohesiveness go hand in hand. This is of equal importance in the context of achieving a high-quality and sustainable system of public finance.

What is less clear, however, is whether nationally elected governments today have the power to enact such investment policies when confronted with the increasing power of the international financial industry. As Wolfgang Streeck argues, we are witnessing an emergence of “a new, if temporary, settlement of social conflict in advanced capitalism, this time entirely in favour of the propertied classes now firmly entrenched in their politically unassailable stronghold, the international

90 Ibid., p. 127.

91 This is only one of the reasons why European scholars suggest the need to revise the Fiscal Compact in such a way to omit growth-enhancing investments in infrastructure projects, education, research and development from the balance sheets. See Vivien Schmidt, ‘Europe 2012: The devil is in the details’, BEPA Monthly Brief, January 2012, p. 3.

financial industry.”⁹² We return to this question in the last Section, where we discuss the alternatives to the Austerity Union.

LEGAL AND POLITICAL ISSUES OF THE FISCAL COMPACT

So far we have argued that the Fiscal Compact constitutionalizes a wrong economic policy. In this section we try to show that it is also deficient from a legal and political perspective.

The Fiscal compact substantially deviates from the established path of European decision-making processes and brings along with it many dangerous precedents. Instead of using an ordinary revision procedure for the amendment (Article 48 of TEU) or enhanced cooperation as provided for in Article 20 TEU and in Articles 326 to 334 of the TFEU, it was adopted outside the EU law, as a separate international treaty. As a consequence, it could bypass more democratic and transparent procedure as provided for in the EU law and with it the participation of the European Parliament and the national parliaments. Furthermore, it entered into force when it was ratified only by 12 out of 17 members of the euro zone, which clearly deviates from the established consensual principles among the member states. True, the consensual principle may be very cumbersome and sometimes an almost impossible barrier to overcome when trying to adopt certain crucial decisions. However, to adopt such a deeply problematic treaty outside the established European procedures might prove to be even more self-defeating. As Simon Hix, one of the leading experts on the EU political system, contends, any decision with significant redistributive consequences requires a strong sense of political legitimacy for the decision to be accepted by those to which it applies. Instead of submitting the Fiscal Compact to a broad public debate, the EU leaders basically imposed the treaty from the top down. Namely, the new fiscal rules which cut deeply into social and democratic rights are established, in a form of international treaty, outside of the EU constitution, which at least provides parliamentary control, independent judicial review, separation of powers, respect for fundamental rights and compliance with legal procedures.⁹³ Here, the members of the European Parliament were only “consulted” without having the right to decide on the Compact. Only Ireland put the Fiscal Compact on the referendum, but it

92 Wolfgang Streeck, *The Crisis of Democratic Capitalism*, *New Left Review*, 71 Sept/Oct, 2011, p. 29.

93 Lukas Oberndorfer, *The Fiscal Compact Bypasses Democracy and the Rule of Law*, at <http://www.tni.org/print/71093>

did so because of the requirements of the Irish constitution.⁹⁴ No surprise that Simon Hix concludes that the Compact lacks the political legitimacy. Agustin Jose Menendez, a prominent EU legal scholar, goes even further and argues that the Fiscal Compact is unconstitutional: “By taking fundamental decisions on the way European competences are organized and executed outside EU treaties, member states are opting out of Union law. They are therefore undermining the integrity of EU law.”⁹⁵

But even more problematic are substantive legal aspects of the Fiscal Compact. As mentioned in the Introduction, it basically entrenches a certain economic theory at the level of constitutional law. Thus, for the first time in the EU history, the EU constitution explicitly biases the content of decision-making in the neo-liberal direction. While the previous amendments to the original Rome Treaty, particularly the Single European Act and the Maastricht Treaty, had already introduced a neoliberal bias in the EU legal order, the new Austerity Union in the making does this in a more explicit and profound way leaving almost no room for a discretionary fiscal policy to member states. But the Fiscal Compact goes even further and requires the signatories of the pact to change their constitutions, preferably, with new provisions “of binding force and permanent character.”⁹⁶ In other words, the signatories of the compact are asked to introduce into their constitutions provisions which can’t be changed through regular amendment procedures. As a consequence, the austerity policy of Angela Merkel thus achieves binding and eternal legal validity. The Fiscal Compact instrumentalises national constitutional law for the benefit of the Union law “to a degree not seen before.”⁹⁷ As Menendez critically argues, national constitutions leave no room for the transfer of sovereignty to mere inter-governmental processes, “but that it has been achieved through stability and ESM treaties.” Hence, the very choice of such a form is, according to

94 Irish people voted for the compact, but, as many commentators suggested, with a gun to their heads. Namely, recital 25 of the Fiscal Compact makes access to financial assistance from the European Stability Mechanism, which Ireland needed at that time, conditional on the ratification of the Compact. As Andy Storey argues, in the Irish case the EU elites did almost everything, including deliberately rewording the original text of the Compact, to avoid the referendum in Ireland. See Andy Storey, *The Vampire Treaty and the Irish Referendum*, at <http://www.tni.org/print/71086>

95 Agustin Jose Menendez, *The EU’s unconstitutional treaties*, *European Voice*. 28. 6. 2012.

96 Article 3, paragraph 2 of the Fiscal Compact.

97 Editorial; *The Fiscal Compact and the European Constitutions: “Europe Speaking German”*, *European Constitutional Review*, 8 (2012), p.5.

Menendez, a breach of national constitutional law.⁹⁸ Hence, the Compact basically amends the “pouvoir constituant” of the member states.⁹⁹

Furthermore, the Fiscal Compact, through Article 7, introduces important change in the voting procedure which goes beyond the existing Treaty’s provisions. Namely, any decision on whether a Eurozone state has run an excessive deficit procedure and whether sanctions should be imposed will be now decided if the EU Commission and a minority of states are in agreement. For example, if Germany and France support the Commission, other countries cannot block the introduction of sanctions. With so-called “reversed qualified majority voting”, Article 7 strengthens the sanctioning power of the Commission and weakens the veto power of member states which could block the sanctions only with a qualified majority against the Commission proposal. Andreas Fischer-Lescano thus argues that the reverse voting procedure as introduced in Article 7 is in breach of EU Law.¹⁰⁰

Once thought to be a quintessential domain of the executive, economic policy now becomes a matter of constitutional law where major players with extensive power of control and sanction are not national parliaments or governments, but supranational technocracy and judges. The Fiscal Compact essentially empowers technocrats and judges to decide whether the member states fiscal policies are in compliance with internationally imposed rules of balanced budgets and other fiscal commitments contained in the Fiscal Compact. Once a country is found in breach of these fiscal obligations, both the Commission and the Court have extensive powers of control and sanction over a member state fiscal policy. For example, The Fiscal Compact allows “the correction mechanism” to be triggered automatically, without the need to be subject to parliamentary deliberation¹⁰¹, when countries deviate from the balanced budget rules from Article 3. How the Commission envisions such mechanisms is best understood from its Communication *Common principles on national fiscal correction mechanisms* from June 2012, where it presents the legal framework for future correction mechanism in national legal orders. The Commission strongly emphasizes the independence of functional autonomy of “national monitoring institutions”, which will, in the future, play a key

98 Agustin Jose Menendez, The EU’s unconstitutional treaties, *European Voice*, 28. 6. 2012.

99 L. Azoulai et al., Another Legal Monster? An EUI Debate on the Fiscal Compact Treaty, EUI Working Papers, LAW 2012/09, p. 12.

100 Andreas Fischer-Lesano, Legal Opinion. The European TSCH and EU Law, Centre of European Law and Politics, Faculty of Law, Bremen University, 7. 9. 2012.

101 Susan Watkins, Editorial: Another Turn of the Screws?, *New Left Review*, 75, May/June 2012, p. 7.

role in national fiscal policy. Whether these institutions will assume the form of fiscal councils or other institutions is less important. What matters is that member states will have to create yet another independent institution to be in charge of the quintessentially democratic power of making a fiscal policy. As argued by a prominent economist, “the profoundly undemocratic nature this approach is clear – the unelected European Commission can “request” that the elected national parliament and government change its budget.”¹⁰²

In addition, the European Court of Justice was given new powers to determine whether the member states comply with their duty to introduce balanced budget rules into their constitutional legal order. Such new power represents unprecedented constitutional intrusion, since the European Court of Justice never had the power to interpret national constitutions of the member states. This new power of the Court essentially means that the ECJ will have to decide whether the incorporation of the golden rule into a national constitution complies with the Fiscal Compact. The Court will be asked to decide on intricate issues of national constitutional law made by the people about their national constitutions. Highly critical of this new role of the ECJ, Damien Chalmers argues that “policing the constitutional retrenchment of public finances is an unusual role for a court” and that the Compact “means that changes that will ultimately transform the social contract between states and their citizens are to be railroaded through by the Commission officials and the Court of Justice judges ensuring that there is not the slightest expression of democratic deviation”.¹⁰³ Menendez argues that giving the ECJ such a role is against the principle of respect of the constitutional identity of member states and the primacy of decisions taken by the people: “If the people are not sovereign, there is no democracy to speak of”¹⁰⁴. Thus, the Fiscal Compact, by curtailing a core democratic power of a sovereign legislature to determine its own budget, essentially depoliticizes the democratic right to determine fiscal policy.¹⁰⁵

The Fiscal compact has brought not only a deep intrusion into the fiscal maneuvering room of the member states. It is also too rigid and too restrictive in terms of its budgetary and fiscal rules. Although many of its rules are ambiguous, that

102 Malcom Sawyer, *The EU Fiscal Compact*, December 12, 2011. At <http://triplecrisis.com/the-eu-fiscal-compact/print>

103 Damien Chalmers, *The ECJ has taken on huge new powers as enforcer of last week’s Treaty on Stability, Coordination and Governance. Yet its record as a judicial institution has been little scrutinized*. LSE European Blog.

104 Agustin Jose Menendez, *The EU’s unconstitutional treaties*, *European Voice*. 28. 6. 2012.

105 Jan-Werner Muller, *A Shared Fate: The Political Implications of the Eurozone Crisis*, *Boston Review*, Online December 21, 2011.

does not solve the problem of rigidity of its main “targets”: i.e. rules on allowed structural budget deficit and public debt. As the IMK study shows, few of the EU countries undergoing severe economic crisis would be able to implement these rules without seriously undermining its prospects for future economic growth. Likewise, one of the leading legal EU scholars, Damien Chalmers, argues that obligations from the Fiscal Compact have to be assessed in a particular socio-economic context. This leads him to an important observation about a differentiated impact of the Fiscal Compact on two different groups of countries: those few like Germany, Finland, Luxemburg and Estonia who already have a balanced budget will not be particularly affected, whereas the overwhelming majority of others will face very demanding requirements.¹⁰⁶ Needless to say, countries like Greece, Portugal and Spain may in fact in the end achieve required “targets” but the cost for that is already prohibitively high. Greece, for example, a country ranked 18th according to the UN Human Development Index in 2008, is today on the verge of a humanitarian crisis.¹⁰⁷

But that largely arbitrary rules on debt and deficit already have a detrimental effect can be clearly seen also from those countries which are used as role models for fiscal rules. Switzerland, which first introduced the debt brake in 2003, today has indeed very low debt-to-GDP ratio, but its levels of public investments are among the lowest in the developed world.¹⁰⁸ Germany, the main “exporter” of balanced budget rules and debt brakes also faces a critical lack of public investment in areas such as green energy and education.

From the perspective of comparative constitutional law the Fiscal compact opens another important constitutional issue: is constitution appropriate place to entrench a particular economic ideology or policy? As Justice Holmes argued in his famous *Lochner* dissent, people in democracy have different, often opposing views on economic policy. It would therefore be wrong to entrench one particular economic ideology/policy in the constitution. In Hollande’s opposition to transpose the Fiscal compact into the French constitution, we can clearly see the echo of Holmes’s argument. Hollande’s argument was that the constitution is a lasting document which should not be used for a short term policy objectives. As a result, France announced that it will transpose the golden rule of balanced budget into their organic law. Several other countries debate whether to include the golden

106 Damien Chalmers, *The European Redistributive State and a European law of Struggle*, *European Law Journal* vol.18/5, September 2012, p. 678.

107 Alex Politaki, *Greece is facing a humanitarian crisis*, *The Guardian*, 11. 2. 2013.

108 Adam Tooze, *Germany’s Unsustainable Growth*, *Foreign Affairs*, vol.91/5, September/October 2012, p. 29.

rule into their constitution or legislation. Such a decision is part of the constitutional and institutional tradition of each of the countries, and there can be no universal proscription as to what and when to include or exclude from the constitutions. To include certain economic doctrine at the constitutional level may shrink the space for constitutional pluralism and democratic deliberation processes. It may lead to the impoverishment of the public discourse on alternative possibilities and impoverish the level of constitutional democracy.

By introducing “a double bind”, first on the EU level in the Fiscal Compact, and second in national constitutions incorporating the golden rule into their provisions, EU law constitutionalizes austerity as a permanent character of the EU constitutional order. Moreover, by introducing such changes without a proper democratic procedure, it also preempts democracy as a guiding principle of the EU politics.

No surprise that even such pro-EU figures as Jacques Delors fiercely criticise the Fiscal Compact. In a speech in the European Parliament, Delors referred to the Fiscal Compact as a gas factory (“usine a gaz”). For lawyers, it is also very indicative that some of the leading European legal experts, such as Jean-Claude Piris, have expressed their doubts. Piris, the former director general of the EU Council’s legal service who helped pen the Maastricht, Amsterdam, Nice, Constitutional Treaty and Lisbon treaties, referred to the EU’s new Fiscal Compact as a “little piece of paper” and “a treaty outside a treaty” that could not stop the financial crisis. He has also mentioned that the austerity measures have a limited reach. He recommended that the national parliaments have a greater say in addressing the European financial and economic crises to ensure democratic legitimacy.¹⁰⁹

CONCLUSION: IMAGINING ALTERNATIVE “POSSIBLE EUROPE”

After presenting the economic and legal analysis of the Fiscal Compact, we turn to questions about possible alternatives to the Fiscal Compact and austerity policy in the EU. We argue that credible alternatives and other “possible Europes” do exist.

During the past three years, the EU and its member states have been dealing with the crisis in a way that can be summarized as follows: Austerity measures were adopted and imposed throughout the EU countries, irrespective of their fiscal,

109 EU Observer, EU legal expert casts doubt on new fiscal treaty, 11. January 2012, <<http://euobserver.com/9/114835>> and <<http://euobserver.com/1015/114833>>.

economic and financial position before the crisis; austerity measures were reinforced with the adoption of the Fiscal Compact, which presupposes one single model of fiscal consolidation across the EU, particularly in the Eurozone; bail-outs for certain peripheral countries, such as Greece, Ireland, and Portugal were adopted under strict conditions determined by the “troika”; and occasional interventions by the ECB took place, such as the lending scheme with very low interest rates in the amount of one trillion euros between December 2011 and February 2012.

Despite these measures, EU economies and societies have not been able to return to the path of economic, financial and social recovery. Indeed, the fiscal positions of many member states have actually deteriorated because their GDPs fell even more rapidly than they were able to reduce their public debt. The Eurozone and EU are experiencing the highest levels of unemployment in their histories, and the outlook for the labor market remains bleak. The harsh austerity measures have on the other hand proved to be primarily an attack on wages, social services and public ownership. This is most clearly seen in countries like Greece, Italy, Portugal and Spain.¹¹⁰

The EU could and should do better than that. First and foremost, the Fiscal Compact rules should be tailored less rigidly. The approach to fiscal consolidation should be implemented in a more decentralized way. It should be pursued as a medium-term goal and in close relation to economic recovery based on socially inclusive growth in each of the member states. The critics of the decentralized approach toward fiscal consolidation would undoubtedly reject such an approach based on member state governments’ lack of credibility in sticking to identified goals. Yet mutual trust and credibility are vital elements of any integration and any coordination of economic, social and political matters. We are of the opinion that the member states and their governments are in principal trustworthy partners. Moreover, in order to successfully pursue fiscal consolidation, the participation of social partners, local and regional governments, and independent civil society is crucial as all of them have stakes in the process of fiscal consolidation. As such, fiscal consolidation should be implemented using a more decentralized approach.

Instead of one single model of fiscal consolidation, pursued from the top down and on the basis of a one-size-fits-all approach, we should apply a more differentiated and nuanced approach. It may appear to be a more complicated model,

110 Klaus Busch, Christoph Hermann, Karl Hinrichs, Thorsten Schulten, Euro Crisis, Austerity Policy and the European Social Model: How Crisis Policies in Southern Europe Threaten the EU’s Social Dimension, Friedrich Ebert Stiftung, February 2013.

but it may be better suited for different fiscal, financial and other social characteristics of each of the member states. Establishing public trust and transparency when pursuing fiscal consolidation, is more important than creating and following clear-cut rules of fiscal consolidation. Sweden's successful fiscal consolidation provides an example of how fiscal consolidation can be achieved based on fiscal transparency and high-quality economic policy debate. According to the chair of the Swedish Fiscal Policy Council Lars Calmfors, this is more important for budget discipline than formally binding rules and automatic correction mechanisms as envisaged in the European Fiscal Compact.¹¹¹

If advocates of the Fiscal Compact want to ensure that the fiscal rules do not negatively impact economic growth, they should consider excluding growth-enhancing investments, such as investments in public infrastructure, education, research, training and development, from the rule on what counts toward the budget deficit.¹¹²

In addition to the substantially revised and improved rules on fiscal consolidation, the debate on the importance and role of financial institutions in the EU should follow. The inconvenient truth about Europe's financial sector in its present form is that it has become bloated and dysfunctional. In its current form, it does not represent support for the real economy, but a drain on it. The understanding of the role of financial institutions is a crucial point of the European crisis debate. Propping up the entire European financial sector without questioning to what extent it is capable of supporting and lending to the real sector is highly problematic.

When the last banking loan scheme – in the amount of one trillion euros to the European banks – was launched by the ECB between December 2011 and February 2012, these banks used the new cheap loans mainly to purchase government bonds, retire or repay existing more expensive borrowings while surplus funds were redeposited with the ECB. There is no evidence to indicate the extent of these funds being channeled into investments in the real economy. By propping up the financial sector, we are unfortunately not helping the real economy. The key lesson of the financial crisis – overlooked and ignored by the European and national policymakers – was succinctly put forward by Dirk Bezemer:

111 Lars Calmfors, 'What can Europe learn from Sweden? Four lessons for fiscal discipline', Voxeu, 12. March 2012 <<http://www.voxeu.org/index.php?q=node/7712>>.

112 Vivien A. Schmidt, 'Europe 2012: The devil is in the details', BEPA monthly brief, December 2011/January 2012, issue 52 <http://ec.europa.eu/bepa/pdf/publications_pdf/see_also/n52_-_december11_january_2012.pdf>p. 3.

...most of that debt growth has NOT been due to lending to the real sector – to nonfinancial firms, supporting growth in wages and profit. Almost all of it was due to mortgage lending and to credit to the nonbank financial sector credit, to inflate stocks and property prices and to create and trade options, futures, and other derivative instruments....¹¹³

The distinction between the socially useful financial activities and trading activities within the financial sector, both banking and non-banking, deserves more attention. Contrary to conventional wisdom, money used for the exchange of positions between financial institutions provides very little and only episodic links with the real economy. Short-term portfolio investments have dominated long-term investments in productive capacities.

Thus, the real challenge for policymakers is determining how to re-establish links between the financial institutions and the real economy. In its current form, financial institutions present very little importance for the real economy in good economic times; during periods of financial crisis, they represent a threat to the real economy and society at large. The challenge is to restructure financial institutions in such a way as to turn them from bad masters to good servants to provide the necessary support for economic and social activities. Small local and regional networks of banks are generally more supportive of local and regional economic development than large concentrations of finance. Any rescue of the financial sector should be carried out only to the extent that these financial intuitions can provide long-term capital for the productive investments. New financial institutions capable of tightening the links between savings and productive investments can be envisaged, including public venture capital funds.¹¹⁴

Revising the rules of the Fiscal Compact and restructuring the financial sector are only small parts of the genuine economic and social reconstruction of the EU project.. Future EU development should stimulate and support more initiatives stemming from the local, regional and national levels. The EU should support more diverse, balanced and inclusive development. Here we agree with Aglietta, who argues that

113 Dirk Bezemer, 'Finance and economic growth delinked', Eurointelligence, 27. April 2012 <<http://www.eurointelligence.com/eurointelligence-news/finance/singleview/article/finance-and-economic-growth-delinked.html?L=0&cHash=196658d57a2be4a98b5597a708158666>>.

114 Roberto Unger, 'Crisis, Slump, Superstition and Recovery: thinking and acting beyond vulgar Keynesianism', <http://www.law.harvard.edu/faculty/unger/english/pdfs/JOINT_PIECE.pdf>.

“Integration in the absence of a Europe-wide development strategy succeeded only in concentrating industrial activity in the regions where it was already strong, while the periphery lost ground. To counter this slide into long-term stagnation will require a development project capable of relaunching innovation across the whole range of economic activities, driven by investment largely anchored at regional and local level, with a strong environmental component”¹¹⁵

In this context, the debate on what should be decided at the common EU level, what should be the EU’s common policies and what should be left to the member states could be significantly reoriented. As argued by Roberto Unger, the EU should reorient its core mission, which has been thus far the centralization of economic regulation and decentralization of social policy, which has remained mostly local. The EU should expand the scope for economic experimentation on the ground, while giving the Union stronger prerogatives in social and educational policy.¹¹⁶ Hence, at the core of the EU’s common policy should be EU support for lifelong education to empower individuals and equip them with the necessary skills and capacities to participate actively in knowledge-based economies and societies. Maximum maneuvering room for more innovative economic and institutional policies should be retained for the member states. Parliamentary democracy can develop when the national parliaments can articulate and implement different strategies for socially inclusive growth. Moreover, Vivien Schmidt proposes more ambitious institutional changes ranging from common Eurobonds, workable “growth Protocol”, additional financial sources such as Tobin tax and Solidarity Tax, which all could be used for more ambitious developmental policies including new infrastructure projects, renewable energy, industrial revitalization zones, advanced technology development cooperation groups, unemployment and poverty reduction schemes, to name a few.

If countless billions were found for propping up large European financial institutions, it would be equally helpful to find a small fraction of this money for the support of education and research, as well to retrain and reskill European citizens.

The EU is not lacking financial resources, but rather ideas about how to create more inclusive, diverse and pluralistic European societies and economies. The future of the EU will be determined by the ability of the European political forces and civil society to articulate and push forward alternative scenarios for such “possible Europes”.

115 Michel Aglietta, *The European Vortex*, *New Left Review* 75, May/June 2012, p.36.

116 Roberto Mangabeira Unger, *What Should the Left Propose?*, Verso, 2005, p.93.

The most recent initiatives by the new European Commission to evaluate the rules of Fiscal compacts and to prepare possible reforms due to the complexity of the fiscal rules only confirm the need to search more balanced fiscal rules in the Eurozone that we have at present.¹¹⁷

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117 EU fiscal rules too complex, admits the Commission, EU Observer, February 5, 2020, <https://euobserver.com/tickers/147378>.

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4 EUROPEAN REGIONAL DISPARITIES: THE CRUCIAL SOURCE OF EUROPEAN UN-SUSTAINABILITY

INTRODUCTION

The ongoing European crisis has revealed many deficiencies in the existing European institutional architecture. One of the crucial deficiencies is the unsustainable European regional disparity between the most developed European regions and the regions that are falling behind. The gap between the advanced regions and the less prosperous regions is growing, and this pattern of development creates an unsustainable pattern for the future development of the EU.

The frequent response to the widening gap between European regions is that we need to create a transfer union, preferably according to the German constitutional arrangement. Leaving aside the feasibility of such a proposal, this article aims to show that such a recommendation is not necessarily the best possible approach toward alleviating the persisting European disparities. As the evidence from East Germany shows, the transfer union is not necessarily the most efficient way for allocating scarce resources across the EU. The reluctance of taxpayers in some core EU countries is an additional reason for being realistic about the transfer union idea.

Thus, the main purpose of this article is to explore alternative possibilities to address the widening gap between advanced and less developed regions in Europe. This issue is of crucial significance for the future of the EU project despite the fact that its importance has been underestimated in the last decade, marked by a care-free approach to cheap money and credit and liberalized financial flows from the core to the periphery – mainly to help create a property bubble, overinvestment in construction, and similar speculative financial activities. Yet if the transfer union is neither a realistic nor sufficient solution, if private credit flows from the EU core to EU periphery are no longer an option, and if we accept that austerity, with its perverse incentives for private and public investments, cannot secure the necessary economic and social reconstruction, what are the viable options and strategies for the European regions?

In its broadest sense we need to return sufficient instruments and policy goals to the European regions. We need to create a genuine policy space for European regions to be able to develop and implement their own development strategies. Different European regions with different comparative advantages should be allowed and stimulated to run different development strategies and, instead of imposing an ever-more shrinking policy space for European regions and European

countries, we must offer maneuvering room to address the crisis and address the development potential of various European regions. Instead of imposing a single economic and social model from the top down on all European regions and countries, no matter how diverse and how differently they are developed, the EU should in the future encourage much more diverse development strategies and a development model developed from bottom up. Bottom-up development should be able to take into account different needs, comparative advantages, and initiatives much more narrowly tailored to the needs, opportunities, and aspirations of European regions and their citizens.

At first glance, such a change would amount to the Copernican turn of a European project. However, a closer look at the development of the European integration suggests that the most successful period of European integration was the period in which the variety of social and economic models co-existed. It was the early period of European integration, which successfully balanced the role of national and supra-national economic, social, and political institutions. The European authorities did not try to exert one single model on all the member states and their regions in what was then a smaller as well as more cohesive EU.

If the enlarged EU with 27 member states and 271 regions on the NUTS 2 level is to once again become more prosperous as a whole, while avoiding massive transfers of wealth and avoiding massive immigration from poor European regions to the rich ones, the shift toward extensive decentralization is a crucial step. Only the regions and countries with sufficient instruments and broad policy space can start the necessary economic and social reconstruction. The fear that decentralization would damage the concept of a single market is not convincing. The single market concept is conceived in very abstract terms; it can be envisaged in other conceptual terms and therefore reshaped. No abstract, neutral, and unique presupposition exists as to how the genuine single market should appear. If the purpose of the single market concept is to secure the most efficient use of available resources, then we should not mix the instruments and goals. The single market is not a goal in itself. It is a means to an end, which is to create a dynamic, inclusive, and innovative economy and society. No ultimate presupposition exists in terms of how the single market should be organized to achieve this goal.

The processes in the EU before and during the crisis tend to go in the opposite direction: They lead to a small number of highly competitive and advanced regional economies and cohesive societies while a growing number of European regions are falling behind. The *European Regional Yearbook 2012* should be interpreted from this perspective of economic, financial, and competitive concentration in only a small proportion of European regions. The yearbook clearly shows that, with respect to unemployment, for example:

out of the 271 NUTS level 2 regions in the EU for which data are available, the unemployment rate increased between 2007 and 2010 in 215 regions, remained unchanged in seven and fell in 49.¹¹⁸

The increase of unemployment in more than two-thirds of European regions during the crisis is only one indication of the growing and unsustainable gap between the advanced and backward European regions. To be precise, even in some of the most advanced regions, substantial disparities exist between the relatively successful segments of economy and society and the excluded population. Thus, this analysis focuses attention on the magnitude of economic, social, and political challenges at all levels of European polity.

EUROPEAN SOCIAL COHESION BETWEEN RHETORIC AND REALITIES

The last European politician who was deeply aware of the need to create a more cohesive, more balanced, and more inclusive EU was Jacques Delors. He understood not only the need for a subtle dialectic between competitiveness and cohesiveness, but also the need to establish a European framework conducive to the faster development of less prosperous regions: “Solidarity, once again, between the more prosperous regions and the poor struggling regions. Hence the conformation of economic and social cohesion as an essential pillar of European construction.”¹¹⁹

Delors was aware of the need to maintain the balance between competitiveness and cohesiveness in all of the European regions before and after the enlargements. Unfortunately, many of his efforts have been forgotten or only half-heartedly and therefore insufficiently implemented. The enlargement itself was not very well prepared in the sense that new member states – with few exceptions – entered the EU with weak domestic institutions unprepared to face European competition at the sufficiently high level to be able to pursue autonomous and coherent domestic development policy. Instead, they followed the path of dependency, narrowly tailored for the most advanced European countries and regions.

118 European Union (2012) *Eurostat Regional Yearbook 2012* (Belgium: Publications Office of the European Union).

119 Commission of the European Communities (1993) *Growth, competitiveness, employment: The challenges and ways forward into the 21st century* [White Paper] (Brussels – Luxembourg).

The structural and cohesive funds, no matter how important and welcome, cannot make up for other important missing elements, instruments, and development policy measures. In addition, the increasing regional disparities before and after enlargement met decreasing means to offset them;¹²⁰ other important policies that presented a pillar of successful development of many leading European economies, such as the innovation and industrial policies, were inadequately developed at the EU level. At the same time, the restrictive macroeconomic framework,¹²¹ the demanding state aid rules, and the demanding competition rules present an insurmountable obstacle for most of the new member states and their regions.¹²² Such a narrow and limited European framework restricts the policy options and development instruments for the new member states and their regions. Moreover, it further narrows the possibilities to carry out a comprehensive economic and social turnaround at the regional and national levels. This is not to claim that even this narrowly defined framework completely forecloses possibilities for the necessary economic and social turnaround of the new member states; rather, within the restrictive framework, the probabilities are much smaller. It would take a highly able, competent, and sophisticated public and private sector to carry out such a comprehensive and demanding task. With the partial exception of Poland and perhaps few other countries, to a limited extent there are no sufficient skills, capabilities, and leadership in the new member states for such a demanding endeavor.

The increasingly demanding European legal and regulatory framework was not always in place. In the past decade, most of the advanced European countries and their regions enjoyed a much broader framework and policy space in which to successfully pursue their development strategies. However, in this debate, it is crucial to look beyond the superficial debate between new and old member states, between European North and European South. Such a debate readily overlooks the important difficulties facing many of the core European regions as well. We can observe difficulties in many French regions in terms of high unemployment, lack of investments, and manufacturing closures. A closer look could show that even the most advanced German regions are not without serious economic and social difficulties. For example, even the traditional industrial base of North Rhine Westphalia, the most populous state and one of the most advanced German federal states, shows that many German states and localities are not immune from the long-term economic and social decline. One of the contemporary scholars of German economic and social development has pointed to the often overlooked

120 J. Huffschnid, (2005) *Economic Policy for a Social Europe* (Houndmills, Basingstoke, UK: Palgrave Macmillan), pp. 158–9.

121 *Ibidem*, p. 38.

122 *Ibidem*, pp. 115–27.

socio-economic problems, which do not stem from the federal, but from the state and local levels:

The really pressing problem lies not at the federal level but at the level of the German states and local government. In recent weeks, comparisons have been drawn between the situation of Greece and heavily indebted California. But as a share of local GDP, the debts of German states such as Berlin, Bremen or Sachsen-Anhalt are four to six times worse than those of Arnold Schwarzenegger's state.

The situation at the level of the municipalities is truly dire. In North Rhine-Westphalia alone there are 19 cities fighting to avoid receivership. The problem afflicts not affluent Düsseldorf, but the likes of Bochum and Dortmund, Essen and Duisburg. Once synonymous with world-beating German heavy industry, they are now sinks of high unemployment, mounting social costs and plunging tax revenues. The most draconian provisions of the 2009 balanced budget amendment are intended to place a cap on the swelling problems of local finance. The states are the first port of call for desperate city governments. As of 2020, all new borrowing by these states will cease. It is against the backdrop of these stern measures of domestic consolidation that Berlin views disciplining the Greeks.¹²³

In relation to the challenge of European cohesion, the observation about the pressing problems at the local and regional level in Germany and other core European countries tries to put forward the substantive argument that the crucial dividing line in the EU is not between the prosperous North and declining South, but rather between the relatively few advanced regional entities and the majority of local and regional entities in stagnation. Even in the advanced regions, a dividing line exists between the advanced parts of economy with access to new technologies, know-how, capital, and all other necessary resources and the large segments of stagnating economic sectors and disadvantaged employees. The growing number of precarious jobs and other poorly protected atypical work is characteristic not only of the peripheral European regions, but also of the core European region. This phenomenon is one of the most poorly understood facts, by both experts and politicians, of the EU-wide modern economic and social conditions. The OECD has warned that even Germany, which has relatively successfully coped with the ongoing crisis, has experienced significant increases in inequality and poverty.¹²⁴

In the described circumstances, the idea of creating a transfer union as the complementary to the overly restrictive union is not realistic. We can take the German constitutional principle of fiscal equalization (*Länderfinanzausgleich*) according

123 A. Tooze, (2010) The message from Berlin that Europe failed to grasp, Financial Times, May 4.

124 OECD (2008) *Growing Unequal?: Income Distribution and Poverty* (Paris: OECD).

to Article 107 of the German constitution (*Grundgesetz*) and the principle from Article 106, which stipulates the “uniformity of standard living” across federal Germany, as an example. In real life, the differences in development between the German federal states and within the federal states, as well as the actual implementation of fiscal equalization, are a matter of great complexity. After adoption of the balanced budget rule in 2009, which required the federal and state budgets to maintain balanced budgets, the controversies between the German federal states might have even been exacerbated. The two most prosperous German federal states, Bavaria and Hessen, recently decided to challenge the system of fiscal equalization in front of the German federal constitutional court. The level of investments in Germany since the millennium as a percentage of GDP is lower than in any recorded history.¹²⁵ Public investments are lacking in higher education, the energy sector, environmental protection efforts, and elsewhere in many of the German federal states and municipalities.

When discussing German approach to the crisis, it has to be mentioned that its approach to the crisis was far more nuanced and sophisticated than the simple approach of non-discriminatory austerity. While the latter approach is prescribed as a key policy for EU peripheral countries, such as Greece, Spain or Portugal, Germany has during the crisis adopted two stimulus packages in 2008 and 2009, in which all of the key federal ministries, for finance, economics and employment were actively involved. Substantial support for the car industry was also carried out.¹²⁶ As pointed by international economic experts, Germany and other Nordic countries balance their budgets through high taxation, not low government spending, which enabled them to:

to ensure universal access to education, job training, and modern infrastructure. They insist on environmental standards, not environmental deregulation.¹²⁷

Despite the substantially different approach to the crisis by Germany and other Northern countries, even these attempts have important limitations. EU countries and regions have become too interconnected and too interdependent to be possible to successfully turnaround only a small number of core regions or countries, while large number of European regions and countries remain condemned to

125 A. Tooze, (2012) Germany's unsustainable growth, *Foreign Affairs*, 91(5), pp. 23–30.

126 W. Schelkle, Policymaking in Hard Times: French and German Responses to the Eurozone Crisis, in N. Bermeo and J. Pontusson (eds.), *Coping with Crisis: Government Reactions to the Great Recession*, Russel Sage Foundation, 2012, pp. 137.

127 J. Sachs, We must move beyond growth versus austerity, *Financial Times*, A-list comment, May 7.

stagnation or even worse. This short detour into the difficulties and to the limited success of some of the core European countries and regions did not aim to portray the EU picture in the bleakest possible terms, but to show that constraints – both real and artificial – do not only exist in the EU peripheral countries and their regions. If we accept this underlying assumption, the approach toward the comprehensive economic, social, and political reconstruction across the EU should substantially change. Instead of putting forward empty promises to provide more solidarity and social justice in the EU in some vague, remote, unrealistic, and most likely insufficient form of transfer union, which could create only further tensions among the EU member states, we should explore the possibilities of other credible alternatives. In the present European context where economic orthodoxy in the form of austerity has prevailed over any other alternative – with the notable exception of unreserved support for the large European financial institutions – the academic and expert debate should focus on alternative approaches.

FORGOTTEN SOURCES OF INSPIRATION

Once we move beyond the debate on the transfer union as a solution to the ongoing European economic and social crisis, the question arises: What other credible alternatives remain? One possible alternative is to revive the lessons of successful European regional restructuring in the decades before virtual, toxic financial flows created the property and asset bubbles and ultimately contributed to the period of great moderation.

The sources of inspiration are, for example, the successful Irish local public–private partnerships, the example of successful and coherent Finnish policies that created a truly knowledge-based society, and the cooperative competition arrangement in Emilia Romagna. These examples as well as other successful European development regions have dissimilarities, but they also have certain similarities: They are examples of institutional innovations at the local and regional levels and successful, transparent partnerships between the public and private sectors; they are also examples of decentralized, participatory, democratic, and pluralistic models of development. They represent successful examples, where competitiveness of the regions is combined with high levels of social cohesiveness. They show that, even in the era of globalization and Europeanization, it is possible to maintain high-quality enterprises with high wages and high levels of value added. These regions have successfully escaped from the traditional Fordist-type of mass production that requires low-skilled, low-paid workers producing large quantities of standardized products. In its place, the post-Fordist type of production gradually emerged. Its characteristic is flexible specialization with high value added,

with highly skilled teams of workers and experts producing in much more innovative ways than in traditional production schemes. Small and medium-sized enterprises can cooperate and compete at the same time, thereby successfully overcoming the difficulties of the traditional economy of scale. Public supportive institutions – educational, financial, and others – develop and progress together with the private sector.

Irish public–private decentralized partnerships

In 1991, 38 local public–private partnerships in urban and rural areas of Ireland were created to address the inadequate scope of the Irish central government in tackling the areas of unemployment and underemployment. These partnerships and their contribution to the broad-based and inclusive economic and social revitalization of urban and rural areas were analyzed by the OECD and some of the leading experts in this domain (the extensive and detailed report on the characteristic and contribution of the local public-partnerships was prepared by the group of experts, led by Professor Charles Sabel and assisted by the OECD Secretariat)¹²⁸. The idea was to establish a new legal vehicle to foster development and welfare through new forms of public and private local coordination. Independent legal entities, supported by the central Irish governments and the EU structural fund, were established in such a way that their boards consisted of broad representation of local community interests, including the unemployed as well as representatives responsible for training, economic development, and social welfare. In pursuing area-based economic development the experts emphasized that the traditional legal distinctions between public and private, national and local, and representative and participative democracy have blurred.¹²⁹

Urban and rural partnerships were very successful in developing innovative techniques for retraining and transferring marketable skills to vulnerable groups of people. In doing so, partnerships combined efforts in retraining with efforts to adjust social welfare programs in such a way as to broaden participation of various groups of people.¹³⁰

The legal framework for partnerships, adopted in 1991, led to the creation of area-based partnerships (ABPs) in order to address economic and social decline as well as the central government's inability to address such decline. ABPs presented an

128 C. Sabel, (1996) *Local Partnerships and Social Innovation*, [OECD report] (Dublin, Ireland).

129 *Ibidem*, Introduction.

130 *Ibidem*.

institutional innovation, capable of addressing local needs and unexploited local economic opportunities as well as establishing representative and accountable bodies. They were not meant to replace local governments, but to complement them for the purpose of launching successful training programs, welfare programs, and enterprise-creating programs.¹³¹ Because they were established in different urban and rural areas, their structure was somewhat different in order to suit the local needs of each of the areas in which they were established. As far as the formal structure is concerned, ABPs' board members consisted of representatives from statutory agencies, social partners, and the community sector. As observed by experts who have studied the role of these partnerships, according to the Companies Act, the representatives in these institutional innovations were primarily responsible to the partnership, not to the organizations that nominated them. As such, they not only blurred the traditional distinctions between public and private, but they also became an efficient institutional mechanism of the imaginative recombination of existing local and national government programs.¹³²

Different partnerships were engaged in different programs. Some of the programs were launched by the central government and supported by the EU's structural funds; other initiatives came from other sources. These programs included, for example, the Pilot Area Programme for Integrated Rural Development (and subsequently LEADER) as well as other programs in the areas of rural development, technological advancement, environment, and social welfare (Sabel 1995 and O'Keeffe, 2009).¹³³ At the heart of these programs was the key goal to reduce long-term unemployment at the local levels.

Through these programs, innovative techniques of decentralized production comparable to the most advanced countries in the world gradually emerged. In this decentralized, participatory, and experimentalist manner, partnership programs significantly improved the competitive capabilities of the country and broadened opportunities for vulnerable groups of people. Partnership programs adopted measures on the supply-side of policies, which positively influenced competitive advantage and social inclusion.¹³⁴ Innovative institutional arrangement not only focused on the adoption of successful supply-side measures to im-

131 Ibidem, Chapter 4.

132 Ibidem.

133 B. O'Keeffe, (2009) Regional and Local Devolution in Ireland – the Potential of LEADER Partnerships to Provide Municipal Government, *Lex Localis – Journal of Local Self-Government*, 7(3), pp. 257–282.

134 R. O'Donnell, (1998) Ireland's Economic Transformation [Working paper no. 2]. (Pittsburgh, PA: Center for West European Studies, Pittsburgh University).

prove the competitive advantage and social inclusion, but it also – an equally as important – offered an institutional innovation that encouraged the discovery and implementation of such measures.¹³⁵

Successful local public–private partnerships in Ireland were developed in the 1990s, but they seem to have been all but forgotten since the beginning of 2000, when Ireland turned to other, seemingly more profitable activities, such as speculative finance, real estate, and construction. Of course, the narrative of the rise and fall of the Celtic tiger is significantly more complex, but some of the institutional innovations, such as decentralized public–private partnerships for economic and social reconstruction at the local levels of the country, should be seriously exploited in the context of the badly needed recovery in the period of protracted recession and stagnation across Europe.

Another important dimension of the public–private partnerships in Ireland should be mentioned in the context of the emergence of the so-called public private partnerships (PPPs) that have emerged in the last decade in many of the Central and Eastern European countries, which are based on the British model. It is a substantially different model of public–private partnerships, both legally and practically. It is important to mention this distinction because many of the PPP projects in Central and Eastern Europe have been discredited due to poor management.

The example of Finland

Finland is another example of a peripheral country that has found its own way from the periphery to become one of the most innovative and competitive countries in the world. Finnish progress did not come overnight; it took decades of efforts, failures, and collective ability to learn from its own failures.

The core of strengths of the Finnish society and institutions are its world-class educational system, the transparency and high quality of its public institutions, the open and highly competent public debate about the strengths and weaknesses of the Finnish society, and the commitment to innovations and research in both the public and private sectors. The strong partnership between the public and private spheres is also crucial for understanding the ability of the country to develop and restructure itself.

135 Ibidem.

One of the most popular professions in Finland is teaching. It is also highly prestigious as only about 15 percent of teacher training applicants are accepted. Becoming a teacher at the primary school level requires a post-graduate degree, which takes about five years.¹³⁶ At the heart of the school system is trust: The society trusts teachers and teachers trust pupils more than in other countries.¹³⁷ The key success of the educational system is that less successful pupils still have higher skills than students in other OECD countries.¹³⁸ Thus, the Finnish school system demonstrates that, contrary to conventional wisdom, it is possible to both stimulate the most talented pupils in the classes and simultaneously improve and strengthen educational abilities of less successful children. This is why Finnish pupils outperform all other pupils across Europe in Pisa surveys. A closer analysis of Pisa surveys points to the remarkable achievements of Finnish pupils. The consistency of their performance is visible: “Results are remarkably consistent across the country ... and there is little variation between schools in urban and rural areas”.¹³⁹ The success of the Finnish educational system did not come overnight; it is the result of a patient, thoughtful approach with a long-term commitment to build a truly knowledge-based society. This commitment stems from the belief that, in order to remain internationally competitive and socially inclusive, entire generations must be able to achieve high abilities in linguistic, numerical, and scientific competences. Professor Jouni Valjarvi, director of the Finnish Institute for Educational Research at the University of Jyväskylä, offered crucial insights: “Emphasizing equality as well excellence of top pupils are not alternatives but rather objectives that support each other”.¹⁴⁰

The advancement of the Finnish educational system is only part of the broader context of educational and research opportunities in Finland. It is a part of a system that has become known as the Finnish national system of innovation. The national system of innovation has adjusted to different periods of Finnish development. In the post-1990 period, the system committed:

the state to supporting a national innovation system through a horizontal, public-private university collaboration and dialog at the national level. The Science and Technology Policy Council (STPC), which had been formed in 1987 to develop long term goals and systematic coordination of science, technology and innovation

136 K. Pankakoski & I. Kaminski, (2010) Why Finnish pupils are top of the European game, EU Observer, December 8.

137 Ibidem.

138 Ibidem.

139 Ibidem.

140 Ibidem.

policy for Finnish industry, was at the apex of the new national policy-making system. (Sabel and Saxenian 2008, 68)¹⁴¹

Equal to the gradual development of a world-class educational system, the success of the Finnish system of innovation was a result of the decades-long building of institutional capacities. As early as the 1970s and 1980s, the public sector was actively investing in building its domestic capabilities: The Ministry of Trade and Industry funded a variety of pre-competitive collaborative research initiatives, the PTO (a public telephone operator) stimulated demand through procurement of leading-edge telecom products, and the Department of Education expanded university-level education and research activities in electronics and information technology (Sabel and Saxenian 2008, 61). The authors of the Finnish system of innovation thus came to the conclusion that, perhaps most significant for the success of the system, was the fact that “the state contributed to the mobilization of a domestic network of skill and knowledge with expertise in the range of technical challenges”.¹⁴²

The broad network of public and private entities, as well as their collaboration and coordination, was at the heart of the Finnish system. Another important agency responsible for the continuous growth of R&D and for providing incentives for research collaboration between the private and public sectors was the Finnish Technology Agency Tekes, which was formed in 1983. It became the source of Finnish national technological policy.¹⁴³

The successful example of Finland presents a source of inspiration for other countries and regions. The successful transformation of society is not easy to achieve; it takes a lot of time, effort, failures, and the collective ability to learn. At the core of its success lies a highly competent, open, transparent, and strategic public discourse. Future strategies, opportunities, and constraints are constantly discussed in the Finnish parliament. This model cannot be easily emulated. The Finnish themselves also frequently remind any potential emulators that the success is never guaranteed in advance. It can also be easily turned into its opposite. Despite the fragility of the success, the key lesson is that only in the arrangement of high-quality public institutions can deliberative and sophisticated interactions between the public and private spheres and strong commitment to education and research create a more competitive and more inclusive society.

141 C. Sabel, & A. L. Saxenian, (2008) *A Fugitive Success – Finland's Economic Future*. (Helsinki: SITRA), p. 68

142 Ibidem, pp. 61.

143 Ibidem, pp. 64–65.

The example of the “Third Italy”

Another source of inspiration can be viewed in the so-called regions of the “Third Italy.” These Italian regions, especially Emilia Romagna, offer another example of decentralized, flexible cooperation and partnership between private and public spheres. They created a system that became known as the system of cooperation competition, in which dense networks of small and medium-sized enterprises in industrial districts cooperate and compete at the same time in the same segments of production. It is a system that is perhaps not entirely compatible with the European rules of competition, but in the past decades it helped these Italian regions develop one of the most advanced systems of production, innovation, cooperation, and competition in the world. The system is highly inclusive, and its level of social cohesion is among the highest.

Legal, economic, and social institutional innovations deviate from the standard model of economy and society, which has found itself in the period of protracted crisis and stagnation. The model of cooperative competition in the area of production successfully combines the traditional artisanal craft production with the skills, technology, and innovation of post-Fordist production.¹⁴⁴ Characteristic of this production is the production of small quantities of highly specialized goods with high value added that are tailored for customers. The production requires constant improvements and innovations, which requires highly skillful workers, experts, and managers who tend to work in small groups that promote a high level of collaboration among them. A competition among groups of workers occurs inside the firms as well as among the firms, promoting different methods to achieve best possible results. The experimentalist production, based on constant innovations, cooperation, and competition, is possible because of the strong institutional support from financial and technological spheres.¹⁴⁵

Broad support from public institutions, supportive of constant advancement and innovation, is one additional important element of success. The dense networks of civil society associations participate and provide initiatives for the local and regional governments, where future opportunities and challenges lie. Entrepreneurs, experts, salesmen, and others who follow and observe developments around the world by attending fairs around the world, travelling, and gathering information also present a valuable source of knowledge and understanding about the future developments as well as how to remain at the cutting edge of production and innovation.

144 M. Best, *The New Competition: Institutions of Industrial Restructuring*, Harvard University Press 1990, pp. 203–226.

145 R. M. Unger, *Democracy Realized*, Verso 1998, pp. 197–199.

Local government, local financial institutions, professional and commercial associations, trade unions, universities and research centers, and social networks all participate and have a stake in permanent improvements of their regions. They are an example of dynamic, competitive, innovative, and cohesive regions. They also show that it is not possible to overcome the gap between the advanced and backward parts of the economy and society without the deliberate action of public institutions.¹⁴⁶

CONCLUSION

The European “one size fits all” approach, with a distinctive economic, social, and political narrative, tends to ignore, marginalize, and narrow the policy options and initiatives from below. The attempt to reconstruct the EU from the top down according to a single economic, social, and political institutional model, based on the standard model of economic orthodoxy, is undermining the rich tradition of European innovation in the area of economics, social welfare, politics, and law. Many of the recently adopted restrictions, such as the European fiscal compact, present additional impediments to the initiatives and development in the growing number of European regions. Instead of reducing the gap between advanced and backward European regions or reducing the growing gap within the regions, the standard EU model does the opposite: It reinforces the inequalities and imbalances that are not sustainable. It has established a policy of economic and social dualism as rule to which only the few most advanced European regions have been able to escape.

The European regions that successfully escaped the economic and social dualism present the exception to the rule. Certainly, other successful regions exist beyond the examples of Ireland, Italy, and Finland discussed herein, including regions in southern Denmark, in some of the most advanced German states, and elsewhere. Yet these are not enough, and the *Eurostat Regional Yearbook 2012* confirms this socio-economic fact and fate of Europe.

In order to overcome the grave outcome of the European project, the EU should allow genuine economic, social, legal, and political reconstruction from below. It is a program of close partnership and cooperation at the local and regional level, which is closer to the real needs of people. It is a program which Roberto Unger calls “more-than-private and less-than-public,”¹⁴⁷ assuming the possibility of many new forms and many new institutional innovations in the public and private sphere.

146 Ibidem, p. 198.

147 Ibidem.

EU experts have internalized the idea of the end of history in the area of economics, social welfare, law, and politics. At the opposite end lie the most advanced European regions, which contradict this dogma. The sooner the EU experts, experts in the EU countries, and European civil society at large recognize the many alternative possibilities for more balanced, more diverse, and more inclusive development, the greater the chance for a more successful approach to the ongoing crisis and the closer we can study and understand the advanced European regions not as a source of mechanical emulation, but as a source of inspiration and encouragement for the excluded parts of society.

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5 RETHINKING MODERN EUROPEAN INDUSTRIAL POLICY: BEYOND THE CURRENT EU LEGAL FRAMEWORK

INTRODUCTION

The purpose of this article is to show that the current European Union (EU) legal framework is unnecessarily restrictive and that it unduly suppresses economic and developmental initiatives in many stagnating regions across Europe. In a growth-friendly context, various initiatives and development strategies based on local knowledge and local needs should stem from diverse European regions and member states.

If the EU genuinely intends to overcome the protracting economic, financial and social crisis and engage in economic reconstruction, modern types of industrial policy will have to be reinvented. This is true not only for the large parts of European regions and member states that suffer from protracting stagnation, lack of growth, high levels of unemployment and long-term loss of competitiveness but also for the advanced and successful European regions that want to remain competitive internationally.

Instead of remaining hostage to the dogma of free-market neutrality, the authorities at all levels of European polity should envisage the possibility of broadening and deepening access to markets for more people in more ways.¹⁴⁸ Spontaneous market initiatives can be combined with the deliberate actions of public authorities. Rodrik pointed out that markets and governments are complements, not substitutes. High-quality public institutions and good governance of the public sector are the necessary conditions for the successful development of the market economy (Rodrik, loc. 196–208, Kindle edition).¹⁴⁹

The term *industrial policy* is used in its broadest sense to refer to any form of deliberate public activity – at the local, regional, national or supra-national level – that contributes to productive capabilities and improved competitiveness. The distinction between the ‘old’ type of industrial policy – predominantly in the form of state intervention in the markets – and the ‘new’ type of industrial policy – in the form of stimulating the creation of firms and promoting innovation and

148 R. M. Unger, (2007) *Free trade reimagined – The world division of labor and the method of economics*. Princeton University Press, p. 144.

149 D. Rodrik, (2011). *The globalization paradox: Democracy and the future of the world economy* [Kindle edition]. W.W. Norton & Company.

competitiveness (for the distinction between these types, see Bianchi & Labory)¹⁵⁰ – will be taken into account in the discussion on the future of European industrial policy.

In the period when even British government officials like Vince Cable, the the Secretary of State for Business, Innovations and Skills, state that “pure laissez-faire does not work” (Wintour and Mullholland, 2011),¹⁵¹ the debate on the possibilities of enhancing the role and scope of modern industrial policy in Europe should finally overcome the traditional ideology. The debate on the future of modern industrial policy in Europe should become a debate on the productive potential of industrial policy and on the strategic partnership between the public and private sectors. The future model should resemble the first period of European integration, with much more room for the member states and their regions to maneuver while running and developing their economies. The difference with the traditional industrial policy, however, is that the modern ‘knowledge-based economy’ requires substantially different policies and instruments in order to stimulate high value added, as well as innovative and flexible business practices, in comparison with the ‘old’ style of government interventionism.

The first part of this article will analyze the EU legal framework for industrial policy. The second part will examine the dogma of neutrality of the European Single Market. The third part of the article will discuss the possibilities to open up space for a plurality of industrial and development policies, using examples of successful regional industrial policies in some of the most advanced European regions. These examples are often neglected in discussions on the future of European industrial policy.

The examples of successful European regions will serve as a source of inspiration and encouragement to disseminate their successful practices to the stagnating European regions. The intention of this discussion is not to propose mechanical imitation of these regions, but rather to offer examples of advance regions as a source of inspiration.

Finally, by analyzing the existing EU legal framework for industrial policy, this article aims to examine the most successful practices from advanced European regions in order to determine the ingredients and the risks associated with

150 P. Bianchi & S. Labory, (eds.). (2006). *International handbook on industrial policy*. Edgar Elgar Publishing, p. xv.

151 P. Wintour & H. Mulholland, (2011). Vince Cable: Pure laissez-faire does not work. *The Guardian*, September 11, 2011.

successful industrial policy, as well as how the European legal framework should be adjusted to the need for inclusive and balanced development from the perspective of stagnating European regions, member states and excluded parts of the European population. This adjustment should be made in such a way that opportunities will be opened up for all of the European citizens and businesses that are waiting in vain to experience the anticipated benefits of the laissez-faire version of a European Single Market.

CURRENT EU LEGAL FRAMEWORK FOR INDUSTRIAL POLICY

The current EU framework is primarily based on the concept of negative integration, which is characterized by the member states' gradual loss of many traditional economic powers and instruments. On the other hand, the process of positive integration in the form of harmonization at the European level took a gradual and different path. It has not replicated traditional instruments and powers at the supranational level but rather has focused on harmonization and the adoption of common standard. The debates regarding which areas, competences and instruments should be transferred to the European level have been a source of constant discussion and conflict, most notably during the Convention on the Future of Europe, which attempted to clarify divisions of competences and powers.

The idea behind the Single Market version of European integration and completion is that the liberalized Single Market should provide immense benefits for its participants and actors. Assessments and estimates about the benefits of the Single Market were presented in the well-known Cecchini report "Europe 1992 – The Overall Challenge." This report calculated an enormous reduction of costs due to the removal of remaining barriers, enormous improvements of efficiency due to improved competition and economy of scale and a substantial boost of employment.¹⁵²

In the context of the Maastricht treaty, these estimates and anticipated gains presented the basis for the completion of the Single Market, which was a key goal of European leaders and European institutions to which all other priorities, policies and instruments at the national and European levels should be adjusted. The less the governments would try to distort the Single Market, the faster the remaining barriers are being removed the greater would be benefits and efficiency gains emanating from the Single Market.

152 Cecchini Report. (1988). *Europe 1992: The overall challenges*, pp. 1–4.

Other goals, such as the reduction of inter-regional disparities within the EU, the preservation of the social welfare at the level of member states, and the adoption of any form of industrial policy – in the form of either ‘old’ or ‘new’ industrial policy – could be employed only to the extent that doing so would not interfere with the completion of a Single Market. The completion of a Single Market has become a goal in itself. The motto for uncritical supporters of a European Single Market as the regional version of the free market continues to be that the more complete the Single Market becomes, the better things will be for everyone.¹⁵³

In the context of the completion of a Single Market, industrial policy – which was already diluted because of the unclear division of competences and the general shift toward economic orthodoxy on the global and European level – has become constrained. More often than not, industrial policy has involved merely the lip service of European officials with little actual substance.

Article 157 EC (ex Article 130), which is dedicated to Industry, can be understood in the context of the Article 4 EC governing principle of ‘open market economy with free competition.’ As explained by Pelkmans, both EU and its member states have committed themselves to the governing principle of internal market governance, which narrowed the scope for industrial policy: “[S]ince member states have explicitly agreed with this set-up, one could interpret the framework as a quasi-institutional denial to fall back on interventionist industrial policy in the future” (p. 60).¹⁵⁴

Even this highly constrained reference to industrial policy in Article 157 EC was very difficult to adopt during the Maastricht negotiation. The Article itself has an explicit limitation preventing the adopting of any measures which could lead to a distortion of competition.

The limitations of the scope of industrial policy in the European legal framework can be explained by the historical background of their institutional development, national preferences according to the ‘varieties of capitalism’ concept, and negotiation strategies behind the adoption of the article on industrial policies. The historical background of this topic was analyzed by Fioretos, who pointed out that, before the Maastricht treaty, “the EC’s industrial policy had primarily been designed for market liberalization and the abolishment of discriminatory subsidies, and nowhere could one find a statement suggesting that the Community have an

153 J. Pelkmans, (2011). The case for ‘more single market.’ CEPS no. 234, Brussels, February 2011.

154 J. Pelkmans, (2006). European industrial policy. In P. Bianchi & S. Labory (Eds.), *International handbook on industrial policy*. Edgar Elgar Publishing, p. 60.

activist and interventionist industrial policy”.¹⁵⁵ All of the key actors had in mind their own preferences and interests. Britain, for example, opposed the adoption of industrial policy because of its (at that time) superior performance “by enhancing market mechanism...thus, the primary concern for the British was to extend the economic area regulated by the EC in a fashion that would enhance the market mechanism and provide British firms with an environment they were accustomed to and that would ensure their competitive edge.”¹⁵⁶

On the other hand, France advocated a more proactive industrial policy based on its *dirigiste* tradition of an interventionist industrial policy; together with Italy, France advocated for greater authority of the European Commission in the area of industrial policy to strengthen the competitiveness of European industry.¹⁵⁷ The attempt to ‘trump competition policy’ and the restrictions on state aid were also supported by the Belgian government.¹⁵⁸

Finally, Germany stood as another key actor between the maximalist French proposal and the minimalist British proposal. Germany was supportive of the insertion of an industrial policy clause committed to horizontal industrial policy and large-scale research projects. This was consistent with the German regulatory tradition in the area of industrial policy and with the German interests: “[T]he German position rests on regulatory principles of the coordinated market economy (CME), and the calculation that a limited EC industrial policy have beneficial effects for German producers in areas (especially high-tech) where the German market economy has been relatively weak”.¹⁵⁹

The background context of insertion of the article on industrial policy is particularly revealing for several reasons. First, it shows that the key actors in the EU acted on the basis of their preferences and the interests of the industries, as well as on the basis of the industrial policy tradition in the key member states. Second, the aim of the key member states was to secure or even improve the position of their industries on the internal market. Third, neither the balance between competition and proactive industrial policy nor the outcome of the crucial provisions of the

155 O. Fioretos, (2001). Sources of multilateral preferences. In P. Hall & D. Soskice (Eds.), *Varieties of capitalism – The institutional foundations of comparative advantage*. Oxford University Press, p. 227.

156 Ibidem, pp. 231–232.

157 Ibidem, pp. 227.

158 C. H. Church & d. Phinnemore (2002). *The Penguin guide to the European Treaties – From Rome to Maastricht, Amsterdam, Nice and beyond.*, Penguin Books, p. 345.

159 Supra 90, p. 238.

Maastricht treaty and all subsequent treaties is objective and neutral; rather, these are the result of bargaining powers, national preferences and beliefs regarding how the governing principles and rules should shape a European Single Market.

Despite various attempts to substantially redefine the relations among cohesion, research and development, proactive policies and the undistorted markets, the conclusion is that the principle of undistorted competition enjoys primacy.¹⁶⁰ In this highly constrained context, the EU and the member states did develop several instruments and policies in the areas of research, improved skills, innovations, and various schemes to support small and medium size enterprises (SMEs). On the other hand, sectoral and specific industrial policy almost entirely disappeared (Pelkmans, 2006, p. 73).¹⁶¹

The European legal framework with respect to the role and scope of industrial policy has not changed significantly over the last two decades. During the Convention on the Future of Europe, the working group on economic governance under the chair Klaus Hänsch was established to explore, among other topics, the changes in the area of economic coordination, but it did not present any particular new proposal of enhanced cooperation with respect to industrial policy.¹⁶²

In the last two decades, sporadic attempts have been made to more strongly articulate industrial policy at the European level and the level of the member states. One such attempt was the report of former Dutch Prime Minister Wim Kok and others in 2003, when the EU was confronted with low rates of growth, increased unemployment and the unsuccessful implementation of the Lisbon treaty. In the report, the governments and the EU were urged to take a more proactive stand in the areas of infrastructure and knowledge. In Kok's foreword to the report, he stated that the member states must take primary responsibility to act and the EU must support them.¹⁶³ The report also addressed the need to reskill workers in traditional industries in order to adapt to the needs of the 'knowledge-based economy' throughout the EU. As an example, the report mentioned the successful restructuring of Italian industrial districts with the help of small firm growth and the dissemination of knowledge and innovations among a network of firms.¹⁶⁴

160 Supra 93, p. 346.

161 J. Pelkmans, supra 89, p. 73.

162 European Convention (2002). *Final report of working group VI on economic governance*, Brussels 2002.

163 W. Kok et al. (2003). *Jobs, jobs, jobs – Creating more employment in Europe*. Report of the Employment Taskforce chaired by W. Kok, Brussels.

164 Ibidem, p. 25.

However, even the occasional calls for more aggressive industrial policy across Europe, such as those offered by Kok, were described as “too little too late” by Pelkmans.¹⁶⁵

PERSISTENCE OF THE DOGMA OF NEUTRALITY OF A EUROPEAN SINGLE MARKET

At the heart of the EU’s framework is the belief that the European Single Market version of the free market, free of any distortion, will work most efficiently. They claim that in order to overcome the current protracted economic, financial and social crisis – which is the largest crisis since the beginning of the EU – it is necessary to implement more of a Single Market.¹⁶⁶

However, proponents of the current version of the European Single Market as the best possible answer to all of the economic, financial and social difficulties in Europe tend to forget several things. First of all, they tend to ignore the fact that the existing European legal framework, which has been in place for the last two decades, is a result of bargaining powers, national interests and preferences rather than a result of the natural, neutral development of the European Single Market. There is no single best possible version of a market economy to which all countries should universally aspire in any given economic, social and legal context. Second, the benefits from the established European Single Market, as stated in the Cecchini Report, were grossly overestimated. At the same time, and perhaps even more remarkably, the costs of the established European Single Market were largely ignored. Any legal framework for the market economy creates distributional effects. As noted by Tsoukalis (2006), one of the leading experts on the European integration, a Single Market created ‘winners’ as well as ‘losers’: “Interestingly enough, the Cecchini report had virtually nothing concrete to say about the likely distribution of costs and benefits, apart from acknowledging the problem and expressing the hope that redistributive policies, supported by an active macroeconomic policy, would provide adequate compensation to losers or, even better, help weaker economies and regions to face the strong winds of completion unleashed by the elimination of barriers” Tsoukalis, 2006.¹⁶⁷

165 J. Pelkmans, *supra* 89, p. 66.

166 J. Pelkmans (2011). The case for ‘more single market.’ CEPS no. 234, Brussels, February 2011.

167 L. Tsoukalis (2006). *What Kind of Europe?* Oxford University Press, Kindle edition, Chapter 3.

Third, the last two decades, during which the current EU legal context of a Single European Market has been in place, do not represent the most successful period of European integration. In fact, the current context helped to create an increasing number of stagnating regions. The empirical evidence for this claim can be found in the latest edition of the Eurostat Regional Yearbook: “Out of the 271 NUTS level 2 regions in the EU for which data are available, the unemployment rate increased between 2007 and 2010 in 215 regions, remained unchanged in seven and fell in 49”.¹⁶⁸

This evidence on European regional disparities clearly shows the strong impact of the economic and financial crisis in the EU, which makes the current framework of the European Single Market grossly inadequate to cope with the magnitude of the crisis. Without a comprehensive and proactive EU-wide response to the crisis, the entire EU project is becoming increasingly unsustainable.

Fourth, in the period when the existing EU legal framework was put in place, a major shift in the organization of production, from Fordist mass production to post-Fordist flexible production, occurred in many developed and developing countries around the world. Whereas the goal of Fordist production is to produce large quantities of standardized goods with the lowest possible costs to pursue economy of scale, the goal of post-Fordist flexible production is to produce small quantities of high value-added products tailored to the needs of individual customers. This new type of production requires substantial changes in the organization of production, teams and firms, and also has important implications for supporting institutions, as it is based on constant innovations and improvements of products and technologies. Michael Piore and Charles Sabel, the pioneers in the area of flexible specialization, showed in their study that, contrary to conventional wisdom, Fordist mass production is not always the most efficient type of production. It can work efficiently in the context of stable demand; however, in the context of unstable, constantly changing demand, the flexible specialization can be a more efficient means of production and organization of production. The shift from Fordism to post-Fordism requires major organizational changes, changes in production and reskilling of workers, and it presupposes shifts in public policies and supporting institutions.¹⁶⁹ The shift from the ‘old’ to the ‘new’ type of industrial policy presents an important part of the shift from traditional Fordist mass production to the modern, post-Fordist type of production. It seems that, during the creation of the framework for a Single Market, the European deci-

168 Eurostat Regional Yearbook, 2012, p. 78

169 M. Piore and C. Sabel (1984). *The second industrial divide – Possibilities for prosperity*. Basic Books, pp. 28–30.

sion-makers overlooked these important historical shifts in the areas of production, organization of production, competition, and supportive public institutions. Only a small number of advanced European regions or member states can be described as post-Fordist – that is, highly innovative, flexible, dynamic, cohesive and knowledge-based.

Fifth, following the above discussion, the more appropriate debate during the protracted European economic, financial and social crisis should not be whether we need ‘more’ or ‘less’ of a Single Market, but rather what kind of a Single Market European member states and their regions, businesses, entrepreneurs, employees and citizens really need. We need a more dynamic, more supportive environment, as well as institutions at various levels of European polity that can translate business ideas and entrepreneurial initiatives into the practical market economy context.

We can conclude this chapter on the persistent dogma of neutrality of the Single Market by stating that the sooner we leave behind this dogma, the greater will be the chances for revitalization of a large part of the European regions and member states. In order to achieve institutional reconstruction, more diversity, more policy space, and more ideas and initiatives should grow from the bottom-up. Now that even the most free-market-oriented government in the EU, the UK government (or at least its State Secretary for Business, Innovations and Skills Vince Cable) is contemplating the need for new types of industrial policy, there is no reason for the EU legal framework to remain overly constrained and biased against the new types of industrial policy.

RETHINKING THE MODERN EUROPEAN INDUSTRIAL POLICY

In the process of integration through law, the EU and its member states have departed from the ‘old’ type of industrial policy to the highly constrained legal context of the weak type of industrial policy under the primacy of a Single Market. It has been widely accepted that the undistorted free market is the best guarantee for the efficiency and productivity of European economies. Two decades after the completion of a Single Market, the discussion should begin on how to revive modern, ‘new’ type of industrial policy all levels of European polity. Two decades after the adoption of the Maastricht treaty, it is becoming clear that the current particular version of a European Single Market may be beneficial for European retainable industries – that is, established industries effectively protected from new entrants due to high costs and lack of insufficient support for start-ups – but at the high cost of excluding almost everybody else.

The idea of the strong articulation of the ‘new’ type of industrial policy should begin to replace the dogma of neutrality of a European Single Market. There is evidence that many supportive institutions, instruments and policies to facilitate the restructuring are needed if increasingly large number of stagnating European regions and member states. The requirements to compete successfully in the period of the ‘knowledge-based economy’ are substantially more difficult than the requirements to compete successfully in the period of Fordist mass production. The former includes, for example, a high quality of education provided to all citizens; strong labor market institutions providing training for constant reskilling; financial institutions providing and supporting the long-term development of highly innovative firms, especially small and medium size firms and start-ups; and many other supportive institutions and proactive policies.

The distinctive need to rethink European industrial policy for the twenty-first century began to be addressed by former Dutch Prime Minister Kok but was abandoned due to the virtual period of growth based on cheap credit before the European bubbles finally burst. The peripheral regions are paying an extraordinary price, and increasingly many of the core regions are doing so as well.

Before Kok’s report, the importance of industrial policy was mentioned in the European Commission’s (1993) white paper on “Growth, Competitiveness, Employment,” which stated that “while industrial policy continues to be controversial no one is in any doubt as to the responsibility of governments and of the Community to create an environment as favourable as possible for company competitiveness”.¹⁷⁰ The subsequent development of European integration all but marginalized any development of industrial policies across Europe. However, today’s record levels of unemployment, bleak labor market perspectives, low growth rates and large number of stagnating regions and member states clearly remind us that the time is ripe to revive European industrial policy.

What would the ‘new’ European industrial policy look like? First of all, it would be important not to repeat the one-size-fits-all technocratic approach without taking into account the immense diversity in terms of economic development and social cohesiveness. More innovative industrial policies, instruments and measures should be adopted in a highly decentralized way. The role of European institutions should be to maximize the maneuver room for regional and national experimentation in production and the organization of production.¹⁷¹ Additionally,

170 W. Kok, *supra* 98, p. 14.

171 R. M. Unger (2001). *European constitutionalism – Proposals for an agenda of debate*. Harvard Law School, unpublished manuscript.

European institutions can learn from successful examples and disseminate them to other parts of the EU, not to mechanically imitate successful practices from one region to another, but rather to present successful examples as a source of inspiration and encouragement to other stagnating European regions.¹⁷²

The 'new' European type of industrial policy, therefore, should be decentralized and participatory by invoking ideas and initiatives from local producers, should be pluralistic in order to adjust to the different needs and different productive potentials of different European regions and should be experimentalist in order to permanently adjust, correct and improve the strategic partnership between the private and public sectors. The shift toward modern types of industrial policy began with the shift from Fordist mass production to post-Fordist flexible production. On the other hand, European industrial policy, instead of trying to transform its 'old' type of industrial policy to the 'new' type of industrial policy, has mainly tied the hands of European institutions, national governments and regional authorities. The reliance on the Single Market in the last two decades trumped or diluted all other attempts to develop a more pro-active approach toward steering and developing the economy.

What has been mainly overlooked, ignored and legally suppressed in the European context is the transformation toward 'new' industrial policy, which has been pursued by some of the most advanced, innovative, competitive and cohesive regions around the world. The characteristics of the 'new' type of industrial policy were summarized by Best in his analysis of the emergence of post-Fordist regions engaging in what he described as The New Competition: "The New Competition can be distinguished from the old in four dimensions: organization of the firm, types of coordination across phases in the production chain, organization of the sector, and patterns of industrial policy. The New Competition is about strategic actions within each dimension. The term 'strategic' refers to market-shaping activities in contrast with market-reacting responses".¹⁷³

The comparative analysis of the emergence of The New Competition as one possible and advanced type of 'new' industrial policy shows that successful regions around the world – including Japan, the US, China and advanced European regions – have developed various new forms of cooperation and competition in the same segments of production.

172 Ibidem.

173 M. Best (1990). *The New Competition – Institutions of industrial restructuring*. Harvard University Press, p. 11. On the productivity triad see also M. Best (2001). *The New Competitive Advantage: The Renewal of American Industry*, Oxford University Press, pp. 9–15.

The new form of industrial policy is both much broader, in terms of scope and instruments, and much less interventionist. Professors Roberto Unger and Tamara Lothian from Columbia University, one of the leading proponents of new, transparent, innovative and imaginative forms of collaboration between the public and private sector, is convinced that the new types of industrial policy should be agnostic about sectors. In a joint piece on the possibilities to overcome the ongoing economic, financial and social crisis, among other proposals, Lothian and Unger advocate the need to reinvent industrial policy means to establish “a form of strategic coordination between governments and firms that is pluralistic, participatory, and experimental. Its aim is to help make the conditions and instruments of advanced production available to larger parts of the economy and the society”.¹⁷⁴ The focus of such a policy should be on small and medium size enterprises as the key source of jobs and output. More specifically: “Its method should be the expansion of access to credit, to technology, to advanced knowledge and practice, to facilities for the organization of networks of cooperation that combine the benefits of flexibility of scale. Its characteristic concern should be to propagate successful organizational and technological innovations wherever they may arise”.¹⁷⁵ On this basis, Lothian and Unger have developed several components of modern industrial policy pursuing socially inclusive and broad-based economic development.

Perhaps the closest to the idea of decentralized cooperation as the new, reinvented form of industrial policy was achieved in some of the advanced European regions and member states. The examples of Emilia Romagna, Piedmont and other Italian regions should be mentioned, as should local public-partnerships in Ireland. Innovative policies and high-quality education in Finland as a basis for entrepreneurial and technological progress offer further examples of successful European industrial policies (for more detailed analysis of advanced European regions, see Nahtigal, 2013).

Italian cooperative regions serve as examples of decentralized, flexible cooperation and partnership between the private and public spheres. They created a system that became known as the system of cooperation competition, in which dense networks of small and medium-sized enterprises in industrial districts cooperate and compete at the same time in the same segments of production. While this system may not be entirely compatible with the European rules of competition,

174 T. Lothian and R. M. Unger in T. Lothian, *Law and the Wealth of the Nations: Finance, Prosperity and Democracy*, Columbia University Press, 2017. Appendix Crisis, Slump, Superstition, and Recovery: Thinking and Acting Beyond Vulgar Keynesianism (with Roberto Mangabeira Unger), p. 374.

175 *Ibidem*.

in recent decades it has helped these Italian regions to develop one of the most advanced systems of production, innovation, cooperation, and competition in the world. The system is highly inclusive, and its level of social cohesion is at the highest level (Nahtigal, 2013, p. 612).

The problem with these examples across the EU is that, despite their potential broader implications, they remain limited to a very small number of advanced European regions. The true goal of EU economic and social recovery, therefore, is to expand and further innovate instruments and policies. It is this goal that has led to the call for fewer legal constraints at the European level and for more room to maneuver at the regional and national levels across the EU to implement the 'new' modern types of industrial policy. It should be noted that a Single Market and modern types of industrial policy are not necessarily mutually exclusive; the possibility to redefine certain tenets of a European Single Market depends on our common understanding of its content and legal framework. European regions and member states should not be left to the mercy of the invisible hand. They should not primarily depend on the European transfers, which are not allocated – at least not in sufficient amounts. It is not even feasible to have a Transfer Union to sufficiently support the excluded and stagnating European regions and member states. Instead, these regions and member states should be empowered and equipped to restructure and revive their economies and societies on the basis of their potential, initiatives and aspirations.

CONCLUSION

Between the laissez-faire and dirigiste approaches, there is a large amount of room to maneuver to develop more pro-active industrial and development policies. New forms of industrial policies can and should be reinvented and implemented across the EU – not to harm or distort competition but rather to further enhance it. More than one form and framework exist for both a Single Market and the competition policies. On the European level, a legal framework and policies should be adopted that would be able to steer between foreclosing and opening the markets and between negative and positive aspects of competitive policies. A new balance must be achieved, both at the European level and at the level of European regions and member states, to allow for more maneuver room, more space for development and more instruments and policy tools for the European regions and member states.

Advocates of modern, advanced forms of industrial policies have increasingly put forth convincing arguments as to why industrial policy, especially in its modern form, should not be abandoned. In the last few decades, when industrial policy was mentioned or implemented, it was deemed as obsolete and outdated. During

the protracted crisis, however, even the most developed countries in many cases returned to the instruments of ‘old,’ traditional types and ‘new,’ modern types of industrial policy. Examples include the restructuring of GM with the abundant help of the US federal government, the large support for ‘green’ investments in the car industry around the world, the various measures taken by the German federal government in the case of Opel and many other examples. Massive support for the financial institutions in the US and EU should also be mentioned in this context.

Ha-Joon Chang, professor of development economics from Cambridge University, argues for the adoption of a more balanced and subtle approach toward the theory and practice of industrial policy. Industrial policy has been an important instrument throughout economic history, and almost all of the leading industrial nations in the world have implemented it in various ways throughout their economic progress.¹⁷⁶ As can be witnessed from the recent years of crisis, the most advanced countries in the world did not hesitate to return to various measures of industrial policy when they needed it. The existing legal constraints in the European and subsequently national contexts are increasingly difficult to defend theoretically and practically. The need to rebalance and redefine the constrained rules of a Single Market is becoming increasingly visible.

Of course, more space and more scope for modern industrial policy should not be viewed as a simple magic wand. It is only one additional instrument in an effort to revive ailing European industries and regions. A similar approach should be applied in the context of international trade rules.

On the other hand, industrial policy can be also ineffective. There are many examples of failed industrial policy efforts in both developed and developing countries. Modern types of industrial policy have additional safeguards, but there is no ultimate guarantee about its efficiency, which depends on many factors, including transparency and accountability of the policy-makers. For this reason, modern industrial policy has to steer between Scylla and Charibdis; as described by Unger, it has to avoid the “twin evil” by steering between bureaucratic dogmatism and favoritism.¹⁷⁷ There is a distinct risk of abuse of the instruments and tools of industrial policy. Modern industrial policy presupposes high-quality public

176 H.-J. Chang. (2009). *Industrial policy: Can we go beyond an unproductive confrontation?* Annual World Bank Conference on Development Economics, Seoul.

177 R. M. Unger (2007). *Free trade reimagined – The world division of labor and the method of economics*. Princeton University Press, pp. 144–145. See also Unger R. M. (2019). *Knowledge Economy*, Verso.

institutions with highly competent administration.¹⁷⁸ It requires autonomy and accountability of the public administration to counter the pressures of various interest groups. While there are dangers and risks involved in carrying out modern types of industrial policy, the alternative – doing nothing – almost certainly leads to continuous stagnation. In all likelihood, it may lead to a strong hierarchy on the Single Market – that is, a strong concentration of economic development in only a small number of advanced EU regions and member states. The proposal to revive and articulate modern types of industrial policies across the EU is a call for comprehensive economic and social restructuring. The task of modern industrial policy is to organize and strengthen capabilities of restructuring in the direction of high-productivity activities. Rodrik, one of the leading proponents of modern industrial policy for the twenty-first century, warns that restructuring is not an automatic process but rather requires a collective, deliberative approach: “[I]ndustrial policy is a *process* of strategic collaboration between the private and public sectors, where the objectives are to identify blockages and obstacles to new investments and to design appropriate policies in response.”¹⁷⁹

The proposal to broaden the scope and objectives of industrial policies in the existing European legal framework is only one of the first steps toward comprehensive European restructuring, the ultimate goal of which should be to create a more balanced, more inclusive and more pluralistic Europe than we witness within the increasingly restrictive European framework.

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178 Mazzucato M. (2013). *The Entrepreneurial State: Debunking Public vs. Private Sector Myths*, Anthem Press (Kindle edition)

179 D. Rodrik (2007). *One economics, many recipes: Globalization, institutions, and economic growth* [Kindle edition]. Princeton University Press, Introduction.

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6 FROM CLASSICAL TOWARD EXPERIMENTAL FEDERALISM: DIFFERENT PATHWAYS FOR MORE INCLUSIVE AND BALANCED EUROPEAN UNION

INTRODUCTION

The current context of the Lisbon treaty should be viewed as a pre-crisis institutional context. As such, the Lisbon treaty did not envisage the risk of such deep and protracted financial, economic and social crises and has not developed the necessary instruments and decision-making processes at the European level. An insufficient institutional context based on the Lisbon treaty was one of the important reasons why there were such weak common European responses to the financial and economic crises.

The experience with the financial crises in EU countries has stimulated new discussions and debates on how to make the European institutional structure more responsive to the possibility of financial, economic and social crises in the future. The debate is even more important because protracted social and economic crises are far from over in many member states and their regions across the EU. In many places across the EU, popular discontent is clearly visible. The referendum on independence for Scotland, movements for an independent Catalonia and social protest movements in many other parts of Europe should be on EU minds when contemplating the need for a new institutional architecture. The recent European parliamentary elections witnessed the rise of populists and demagogues in almost all parts of the EU, while the voter turnouts were historically low. This illustrates the rising level of disillusionment of European citizens. Historically low turnout illustrates that European citizens realize that their non-participation in the European general elections has little (if any) impact on the European decision-making processes. Even lower was the citizens' impact on the general direction of the European integration before the crises, during the crises and in the very slow and unequal process in the post-crises periods.

It is not surprising therefore to observe many new initiatives, proposals and recommendations, which are circulating around the EU, on how to improve and strengthen the European institutional arrangement to make it more responsive, efficient and resilient to the future crises. A common denominator of many different proposals is to consider the need to deepen and strengthen economic, fiscal, banking and political Union. One such proposal was prepared by the former president of the European Council, Mr. Van Rompuy with the title: "Toward A

Genuine Monetary And Fiscal Union”.¹⁸⁰ The premise of his document, prepared in close cooperation with other European institutions and leaders, was that the EU should move toward fiscal union with a certain degree of fiscal solidarity exercised over economic cycles. Gradual steps toward banking, fiscal and economic Union should ultimately improve the social cohesion in the EU and in the member states.

It is reasonable that efforts toward a deeper and better coordinated Union could lead to an improved one in comparison with the current socio-economic situation. However, the question is whether a call to move toward a genuine banking, fiscal and political Union is the best possible way for the future development of the EU. On the pathway toward a genuine monetary and fiscal union, there should be an objective assessment of risks, hidden costs and negative externalities for the member states, their regions and localities. Above all, the costs of reduced autonomy in steering local, regional and national economies and the erosion of democratic decision-making processes at the lower levels of European polity should be seriously taking into account. In addition, further growth of the centralized regulation and bureaucracy may lead toward concentration and centralization of economic, financial and political power. At the same time, it may also lead to further disempowerment of European localities, regions and member states. As a consequence, the future development of the EU may be less equal, inclusive and balanced. In its place, a strong hierarchy and segmentation of a common market may follow. The possibilities for backward European regions to climb the ladder of industrial development may become increasingly small.

There are scholars who argue that it may be worth considering the euro (the monetary union) even at the expense of democracy. According to this line of thinking, there are unavoidable conceptual and practical trade-offs when contemplating the future development of European integration. As suggested by Crum, for example, from the perspective of rescuing the European project and the Eurozone in particular, it would be possible or even desirable to emphasize the role of executive federalism and recognizing the value of national self-government. Because this emphasis could threaten to come at a democratic price, Crum suggested adopting flanking measures to mitigate the effect of a democratic loss.¹⁸¹

180 H. Van Rompuy (2012) *Towards A Genuine Economic And Monetary Union*. European Council, Brussels.

181 B. Crum (2013). Saving the Euro at the Cost of Democracy? Saving the Euro at the Cost of Democracy? *Journal of Common Market Studies*, 51(4).

It is the purpose of this article to explore alternative pathways for European integration in the future. The main goal of such exploration is to secure more balanced, inclusive and sustainable development in the future without succumbing to overly centralized, technocratic and “one size fits all” European integration. The general premise of current debates on the conceptual and institutional possibilities for European integration is that the EU either moves toward a more centralized framework or inevitably fragments further (or even disintegrates). The general premise of this article is that the single binary opposite – in popular language, the dilemma of whether we need more or less Europe – should be rejected. As this article shows, there are many different possibilities with different possible outcomes for all the participants engaged in the European project.

During the protracting financial, economic and social crises in large parts of the EU, it was widely expected that these crises also presented opportunities for the EU version of the historical New Deal era. One can understand this era in the 1930’s as a period of comprehensive institutional and policy responses of the U.S. federal government in the areas of industrial recovery, stronger regulatory and supervisory authorities over the financial sector and creation of labor and social institutions, such as introduction of collective bargaining and establishment of social security institutions. No similar policy measures took place in the EU in the recent post-crises periods and almost the exact opposite happened. General insistence on austerity measures across the EU and adoption of various strict fiscal rules amounted to a negative stimulus European approach to the country-level crises. The consequence of this approach to the crises had an impact that was not difficult to predict. As described in a recent European Commission report on Employment and Social Developments in Europe (ESDE), “the negative impact on employment and growth took place in the vast majority of EU regions between 2008 and 2012, bringing to a halt the tendency toward declining regional disparities that had previously been observed”.¹⁸²

The New Deal experience cannot be directly compared with the EU experience in the aftermath of the recent crises for many reasons. In the U.S. before the New Deal, the federal structure was largely in place, albeit in the process of evolution. Before the New Deal, the level of social welfare protection was not significantly developed. In the EU, the structure of European institutions, policies and instruments was comparatively less developed. However, the social welfare level was, in many European member states, highly advanced and based on the rich tradition of post-war social welfare institutions. The level of disparities within the EU after

182 Commission (2014) *Employment and Social Affairs in Europe in 2013* [online]. Brussels: European Union, p. 85.

the 2004 enlargement was very substantial. These are some of the reasons why there was such a weak response from the EU during the crises. Finally, the common European leadership capability for addressing the extent and scope of the crises in the EU as a whole was missing. National interests of some of the leading European nations took precedence over the common EU responses. As a consequence, the legitimacy of European institutions and policies suffered significantly.

EU AND THE CONTEXT OF CLASSICAL FEDERALISM

Different European and other scholars from different disciplines – legal, political, sociological, economic and historical – are trying to accommodate the nature and character of the European Union. Most of the time, students of European integration are taught that establishment and development of the supranational structures, policies and decision-making processes represents a *sui generis* construction. The reason for avoiding any reference toward the concept of federalism is mainly due to the historical origin of establishment of the EU. Namely, post-war European leaders tried to avoid the debate about the relation between the member states and the supranational institutions – both intergovernmental and community institutions – and explained their joint project rather as the evolution of the European *sui generis* structure. Such a depiction of gradual development of the EU made even more sense due to different arrangements and traditions of parliamentary democracy arrangements in various member states.

One literature example dedicated to the comparative constitutional studies in the last two decades showed that such an avoidance of conceptual discussion about the nature of the EU can be counter-productive. One of the scholars of comparative constitutional traditions, Daniel Elazar, explained that the reason for Europe's pragmatic withdrawal to "functionalism" in place of federation was because the step toward federation was simply too big for post-war Europe. In the place of federal concepts, terms like "supranational" and "political community" were applied (Elazar 2001, 32). Nevertheless, Elazar provided convincing arguments why the structure of the EU, after taking on functions one by one, resembles the theoretical model of a confederation with the goal of better handling the processes of globalization and ending the devastating inter-state conflicts from the past (Elazar 2001, 48–49).¹⁸³

183 D. Elazar (2001) The US and the EU as Models. In: Nicolaidis, K. and Howse, R. eds. *The Federal Vision: Legitimacy and Levels of Governance in the United States and the European Union*. New York: Oxford University Press, pp. 48–49.

More recent literature on comparative constitutional studies took one step further. Robert Schütze made a comprehensive comparative analysis in 2009 about the gradual developments from dual to cooperative federalism in the contexts of the U.S. federalism and the European integration. He pointed out to the conceptual confusion stemming from the false binary opposition between the state and international organizations. Specifically, he expanded the theory of federalism beyond the state, which made possible exploring the nature of the European integration in federal terms. In so doing, he helped unlock the European constitutional debate from a dead end, as he had pointed out. On the basis of development dynamics in the European integration, he made another important distinction between dual federalism and cooperative federalism:

“The first concept is based on the idea of dual sovereignty, where the federal government and the states are co-equals and operate independently in their separate spheres. Cooperative federalism, on the other hand, stands for a philosophy in which sovereignty is shared: ‘the national and state governments work together in the same areas, sharing functions and therefore power’. [T]he National Government and the States are mutual complementary parts... whose powers are intended to realize the current purposes of government according to their applicability to the problem at hand.”¹⁸⁴

Two different philosophies of federalism seem to offer new, more accurate and promising approaches to the discussion about the nature of European integration. On the basis of comparative analysis of the dynamics of European integration development, the gradual shift from dual to cooperative federalism can be observed. Such a gradual shift from dual to cooperative federalism can also be interpreted as a shift from classical traditional federalism to the new cooperative federalism.

Of course, the conceptual application of the federalism apparatus necessarily brings with it many aspects, dimensions and also new confusion. Examples of the new federalism in the context of the U.S. were used by Nixon and Reagan to move away from the New Deal legacy and the legacy of the post-war Great Society (Donahue and Pollack 2001, 89).¹⁸⁵ The term “cooperative federalism” in the context of U.S. constitutionalism may present a check by the states on

184 R. Schütze (2009). *From Dual to Cooperative Federalism: The Changing Structure of European Law*. Kindle edition ed. Oxford University Press, Introduction.

185 J. D. Donahue M. A. and Pollack (2001). *Centralization and Its Discontents: The Rhythms of Federalism in the United States and the European Union*. In: Nicolaïdis, K. and Howse, R. eds. *The Federal Vision: Legitimacy and Levels of Governance in the United States and the European Union*. New York: Oxford University Press, p. 89.

expansive federal powers (Bulman-Pozen 2012).¹⁸⁶ The Tenth Amendment to the U.S. Constitution provides an anti-commandeering principle, which stipulates that the federal government possesses only those powers delegated to it by the states or the people and may not compel the states to otherwise enact or enforce any federal policy or regulatory program, as emphasized in some of the recent cases as reported by Harvard Law Review.¹⁸⁷

There are many other dimensions and aspects of federalism including issues of the division of competences and responsibilities, preemption and exclusivity, principle of subsidiarity and fiscal federalism. Each of the federal models around the world developed different solutions to these issues. Another important substantive issue is that classical federalism was developed in the period of liberal capitalism in which the role of the government (central and local) was very limited. Only after the advancement of modern welfare, the demand for governments to intervene in the markets to launch anti-cyclical economic policies, and the need for governments to regulate the financial institutions, protect the environment and provide public services did the overall scope and nature of the debate about federalism change. This was not only a shift from dual to cooperative federalism, but it was also a shift from the neutral role of the government toward being an active shaper of how the modern market economy, public and private sectors are arranged.

In this sense, and with all the caveats against oversimplification, it would be possible to argue that the U.S. federal arrangement in the post-New Deal era is substantially closer to cooperative federalism, whereas the European constitutional context in the post-crises period is closer to the pre-New Deal era. That era can be represented as a period of dominance of a free market economy with a weak role for the government in steering, promoting and coordinating the market economy. It was the period marked by a predominant belief about the neutrality of the markets, where government intervention plays a very limited role. Economic and legal institutions, such as property rights, contracts and corporate rules were deemed neutral and inherently efficient. Only after the Great Depression in the 1930s did it become clear that the government could and should play an active role in implementing anti-cyclical economic policies, that the initial distribution of property rights and other legal entitlements matter and that the regulatory framework always has a distributional impact on the markets.

186 J. Bulman-Pozen (2012) Federalism as a Safeguard of the Separation of Powers. *Columbia Law Review*, 112(3).

187 Anon. (2014) Constitutional Law – Tenth Amendment – Third Circuit Holds that PASPA is an Appropriate Exercise of Congressional Power. *Harvard Law Review*, 127(7), p. 11.

These lessons in the New Deal era led to the many activities of the U.S. federal government when coping with the Great Depression. These activities included, among others, major infrastructure projects (especially in the southern states), implementation of industrial policies, comprehensive regulation of the financial markets and introduction of federal social welfare programs. From the legal point of view, major changes took place in the industrial relations collective bargaining and labor representation. The school of American Legal Realism between 1900 to 1940 criticized the traditional orthodox legal and economic ideal of a self-executing market economy.¹⁸⁸ The belief in the naturalness of the markets had to be overcome to address the Great Depression. From the comparative constitutional perspective, it should be highlighted that the entire shift in understanding of the role of the (mainly but not exclusively) federal government took place within the same U.S. constitutional framework. Nevertheless, the period of the New Deal can be seen from a comparative constitutional perspective as a conceptual shift from the classical federalism closer to the concept of cooperative federalism.

Contrary to the experience in the Great Depression and the subsequent New Deal period, the EU response to the global financial crisis after 2008 was much less proactive. Based on institutional fragility and lack of leadership, the EU “failed to take measures that might have prevented the crisis from growing worse...”¹⁸⁹ Moreover, in spite of calls for a comprehensive monetary and fiscal stimulus at the European level to counter the crisis, to alleviate negative economic and social consequences and to restore the economic growth, the EU took the opposite approach. It opted mostly for austerity measures as a key response to the crisis. Instead of a European fiscal stimulus, it opted for the restricted and rigid fiscal rules that further limited the already limited policy options at the supranational and national levels.

On the basis of the European approach to that financial crisis as well on the basis of several other conceptual and functional reasons, it is possible to argue that the European constitutional context is closer to the conceptual framework of classical federalism than to the concepts of cooperative federalism. There are other normative arguments supportive of this claim. For example, during the Convention on the Future of Europe (from December 2001 to July 2003), the goal was to clarify and to the extent possible enumerate the competences. In principle, this was a valid goal, especially in the light of the increasing pre-emption of competences

188 M. Horwitz (1992). *The Transformation of American Law 1870–1960*, Oxford University Press, pp. 192–193.

189 N. G. Bermeo and J. Pontusson, J. (2012). *Coping with crisis : government reactions to the great recession*. New York: Russell Sage Foundation, p. 2.

that contributed to the confusion of European citizens about who does what in the EU, at what level of decision-making processes and who is responsible for what. The main focus of the working group dedicated to complementary competences was directed to the issue of how to allocate various types of competences (exclusive, shared, supportive) with sufficient legal precision. All other working groups of the Convention, such as the working group on subsidiarity (economic governance), were dedicated to the goal of achieving sufficient legal precision.

The issues of institutional plurality developed by different member states and their regions, stemming from the rich tradition of institutional innovations, were insufficiently addressed during the Convention. The belief about the neutrality of the common EU framework, and especially the neutrality of the single market, prevailed in the mindsets of the European political class and technocracy and was only weakly addressed by the European civil society. The subsequent adoption of the Lisbon treaty, with the prevailing mindset about the neutral, natural and single universally valid market economy, pointed closer to classical federalism than to cooperative federalism. European institutions, including the important decisions by the European Court of Justice (ECJ), confirmed that point. Scholars of the ECJ jurisprudence pointed out that the recent decisions (such as the well-known and widely discussed cases of *Viking* and *Laval*) “fundamentally reconfigure the traditional balance between economic freedoms at the European levels and social rights at the national levels”.¹⁹⁰ They are also right to emphasize that any steps toward dismantling the social welfare of the western and northern European countries are not in the long-term interest of the new member states.¹⁹¹

The problems of European integration are of a conceptual, substantive and functional nature. Besides that European integration at the present stage resembles more the rigid form of classical federalism, the prevailing view about the neutrality of the European socio-economic model continues to exist. This belief is also that the regulation at the European level can be neutral and without distributional impact across the EU. It is often overlooked that the development of European integration at the same time narrows the policy options and instruments of the member states and creates a social deficit at the European level. These are the reasons why some of the leading scholars on European integration are referring to the problem of double asymmetry, which is simultaneously “undermining

190 C. Joerges and F. Rödl (2009). *Informal Politics, Formalised Law and the Social Deficit of European Integration: Reflections after the Judgments of the ECJ in Viking and Laval*. *European Law Review*, 15(1), p. 11.

191 *Ibidem*, p. 19.

political support for European integration and weakening democratic legitimacy at the national level¹⁹².

The path of European integration in the last three decades gradually narrowed policy options and instruments of the member states and their regions. On the other hand, the EU was never capable of developing instruments for protection of economic and social security of the European citizens at a similar level of quality and efficiency as previously provided by the member states. European integration is therefore at the crossroads of which path to take in the future. It is also in a deep conceptual, constitutional and existential crisis. What is certain is that the current conceptual framework, stemming from the Lisbon treaty and weak European response to the crises, is not sustainable and requires new institutional and conceptual thinking as well as practical reforms.

PATH TOWARD COOPERATIVE AND EXPERIMENTAL FEDERALISM: A POSSIBLE EU FUTURE

The previous section argued that from a comparative perspective, EU integration remains conceptually closer to the framework of classical rather than cooperative federalism. Robert Schütze, in his studies on the gradual development of European integration toward cooperative federalism, put forward many examples of cooperative federalism in the EU, such as in the areas of common agricultural policy and product harmonization. However, at the same time, he did not pay sufficient attention to the elements of classical federalism in terms of legal and policy preemption. Such counter-examples include the most recent requirement that the national governments send national budgets for review and approval to the European Commission before adoption in their national parliaments. Other examples include broad economic policy guidelines that stay as close as possible to the economic, legal and social orthodoxy of one single best socio-economic model for all the member states and European regions. These policy measures regularly come down to the requirements for privatization, further liberalization and structural adjustment as if these are the only policy options universally valid and available.

Finally, as described in the previous section, the discussions, dilemmas and recommendations during the Convention on the Future of Europe were closer to

192 F. W. Scharpf (2009). *The Double Asymmetry of European Integration – Or: Why the EU Cannot Be a Social Market Economy*. MPIfG Working Paper 09/12, p. 33.

the classical debates on allocations of competences between the member states and supranational institutions than on the need how to establish a cooperative European federalism. The debate on the allocation of competences was carried out as if it was a neutral technical decision, not a discussion on the substance of how European integration with the highly diverse member states and their regions should develop in the future.

Even before the 2008 financial crisis emerged, there was a discussion in the EU that the adopted framework of the Lisbon treaty is necessary but not sufficient to secure more balanced and inclusive development of European integration in the future. The crisis and the weak European response to it only proved such a viewpoint was correct. However, what remains less clear is in which direction European integration should move.

At a juncture for the future of European integration, many experts advocate the need to establish a fully developed banking union, an advanced form of fiscal union and ultimately achieve a political union based on common economic governance. It is possible to see several substantive and functional parallels between this line of thinking and the characteristics of the New Deal era in the development of the U.S. constitutionalism. Should it be practically feasible to develop European integration in a European New Deal of the twenty-first century, it would be possible to foresee that the overall outcome for European integration would be more beneficial in many social and economic aspects of life for excluded European citizens, European regions and the member states. It would also be more convincingly argued that the EU is moving closer to the concept of cooperative federalism.

The purpose of this article, however, is to argue that such a trajectory, albeit potentially more promising than the current unsustainable status quo, toward a European New Deal of the twenty first century is not the only possible pathway for the future development of European integration. From the comparative constitutional perspective for each federal arrangement, from the U.S. federal system to other federal developments around the world, each constitutional arrangement developed according to the needs, expectations and concepts of its own context. There was no universal blueprint for how the functional, democratic, dynamic and balanced federal arrangement should look. This observation also applies to the context of European integration.

Up to now, the discourse of the European integration focused too much on the need to further empower the supranational institutions while simultaneously constraining maneuvering room for the member states and their regions to confront their crises. The premise for such an approach was that this is the best possible way to preserve the unity of the common market and the unity of the European

socio-economic model. From a conceptual point of view, it was under-appreciated that there is no natural, neutral single best form of the market economy to which all the member states and their regions should aspire to. From a historical point of view, it was ignored that the most successful period of European integration was in the first two decades, characterized not only by full employment, growth of wages, developed systems of social welfare and relatively more stable financial systems, but also by the greater institutional varieties of European capitalism. Greater autonomy in policy choices, instruments and articulation of development strategies, tailored to the needs and potentials of diverse local communities across the EU, along with institutional innovations were the most important characteristics of this period. These characteristics enabled member states and regions to develop and grow in more sustainable and inclusive ways than in any other period of European integration.

The proposal for the future development of European integration is not trying to reverse the path of development or clinging to the idea that is possible to replicate the first two decades of European integration. The context of globalization and a knowledge-based society, with an enlarged and therefore even more diverse European Union, certainly requires different responses than the context of the early stage of European integration. The proposal for experimental federalism draws from the ideas of experimental governance in the EU context developed by Sabel and Zeitlin. Their proposal for a strengthened capacity of governance at all levels of European polity is characterized as:

“... a machine for learning from diversity. It is thus especially well-suited to heterogeneous but highly interdependent settings like the EU. There, local units face similar problems and can learn much from each another’s effort to solve them, even though the particular solutions will rarely be generalizable in any straightforward way. In this sense, experimentalism transforms diversity from an obstacle to integration into an asset to its advancement.”¹⁹³

Such an experimental approach toward the future of European integration could be potentially more productive and attractive pathway of development. Instead of building centralized European integration while narrowing policy options, and more reduced autonomy of member states and their regions, the experimental approach would open policy and development space for them. Such a step could unlock the productive potential of many stagnant localities, regions and member

193 C. Sabel and J. Zeitlin (2011) *Experimentalist Governance*. *Oxford Handbook of Governance*. Oxford University Press. See also A. Duff, (2018). *On Governing Europe: A Federal Experiment*, CreateSpace Independent Publishing Platform.

states. An experimental approach would stimulate the articulation and implementation of different development strategies and the creation of new public and private institutions as vehicles of local inclusive and sustainable development. Ownership of decentralized development strategies would belong to the localities, regions and their social groups, such as entrepreneurs, employees, trade unions, public-private partnerships and other groups of citizens. New institutions, such as decentralized public venture funds to support local and medium size firms, along with regional support centers to disseminate know-how, managerial skills, new technologies and other resources could be developed. Different regions would try to search for their niches according to their productive potential, sometimes stemming from their traditions and at other times looking for new niches and opportunities.

The supranational European institutions would not seat idle in the context of experimental federalism. One of the key policies could be to support all the measures to active labor markets, such as for lifelong learning education for acquiring skills, retraining of employees and supporting start-ups all across the EU. Supranational institutions could monitor and learn about the advanced productive, technological and organizational processes and participate in disseminating them to backward industries and firms. Another strategic task of the supranational institutions would be to prevent any decrease of labor and environmental standards via many overt and hidden practices of a “race to the bottom” on the EU level. The issues of strengthening labor and environmental standards should be brought by the EU institutions to the World Trade Organization as part of establishing global trade rules.

Such an experimental and dynamic approach to the future development of the EU is advocated by international scholars, such as Roberto Unger from Harvard Law School. He proposed the inverse approach to the European constitutionalism over a decade ago. Unger emphasized that the EU has become too strong on macro-economic and regulatory limits to national, regional and local innovations, while too weak on providing universal social endowments to the European citizens. The future of European integration should be exactly the reverse; strong on providing social endowments for the European citizens while providing “a maximum room for maneuver for national, regional and local governments to try out new forms of production, organization and association”.¹⁹⁴

There are several important examples of innovative, dynamic and socially cohesive regions across the EU. The real challenge for the future of European integration is

194 R. M. Unger (2002), *European Constitutionalism: proposals for an agenda of debate*, manuscript.

how to expand these successful examples to many other backward and stagnating regions across the EU. The existing imbalances, inequalities and the gap between the advanced and excluded parts of the EU are simply too large. Even any possible attempts of fiscal transfers or redistributions of wealth within the EU cannot realistically be large enough, even in the most optimistic scenarios, to sufficiently address the issue of inequality and development gaps within the EU.

What are the obstacles that such an experimental federalism model is not more widely discussed and debated across the EU? One possible explanation is that the risk of further fragmentation of the common European regulatory framework can lead to further disintegration of the EU as it is known today. However, comparative institutional analysis shows that such a fear is largely unsubstantiated. Despite a widespread assumption that the processes of globalization and Europeanization would inevitably lead to institutional convergence of different national socio-economic models, in practice the continuation of a variety of market economies can be traced. This study of comparative institutional development concluded that the member states use different strategies to retain, adjust or when it suits their comparative advantages, change institutional and domestic regulatory regimes when seeking compromises in the context of multilateral cooperation. In so doing, institutional convergence is not a prerequisite for the successful development of any kind of international integration.¹⁹⁵ Hence the emphasis that institutional diversity and coexistence within any kind of multilateral organization, in this case European integration, should not be hindered but rather supported when establishing the common framework.

This empirical and comparative institutional study teaches that the outcome of the multilateral institutional and regulatory framework is a compromise between the participants with diverse institutional traditions. Such a compromise cannot be interpreted as a neutral framework or be viewed as an optimal and static framework. If European integration wants to progress as a whole, it has to empower local, regional and national entities to reengage with the institutional innovations and experiments. Therefore, more space, instruments and capacity for institutional innovations should be returned to the member states, their regions and localities. Especially, the stagnant European entities should be stimulated and supported to engage in institutional experiments and innovations and to develop in the context of decentralized cooperation between the various public and private

195 O. Fioretos (2001). The Domestic Sources of Multilateral Preferences: Varieties of Capitalism in the European Community. In: Hall, P. and Soskice, D. eds. *Varieties of Capitalism: The Institutional Foundations of Comparative Advantage*. New York: Oxford University Press, pp. 242–243.

actors. Comparative studies showed great diversity of the models of fiscal decentralization within the EU member states, although the “hypothesis that more local self-government levels imply a higher share of local finance in the total finance cannot be entirely confirmed” (Finzgar and Oplotnik 2013, 670).¹⁹⁶ Nevertheless, the politics of decentralized cooperation¹⁹⁷ can help empower even the member states without a tradition of cooperation and coordination while making efforts to mobilize their potential and resources in more efficient ways. The real goal of cooperative or even experimental federalism is to establish a more balanced and inclusive Union with the institutionally diverse entities. Such a genuine “unity in diversity” could prove more resilient against the future financial shocks and crises and therefore be more sustainable.

CONCLUSION

The present article showed that the existing conceptual characteristics of European integration, looked at through the prism of federalist debate, are closer to the notion of classical federalism than to the concept of cooperative federalism. There are certainly many elements of cooperative federalism that were developed in the past few decades. The framework of the Lisbon treaty and the responses to the financial crises, however, can be viewed as a confirmation of the stated claim.

Many scholars and experts on European integration, as well as many policy-makers, recognized in recent years that the current institutional and conceptual framework is insufficient. Most of them advocate the future steps of European integration toward a fully developed banking union, an advanced form of fiscal union and ultimate achievement of a political union based on common economic governance.

This article concurs with the claim that the present framework is insufficient. At the same time, it questions the claim whether the proposed steps toward the banking, fiscal and economic Union are the only and optimal steps toward the future development of the EU. The issue of redistribution among the highly diverse member states and the risk of path dependency for the stagnant and backward European entities should be seriously addressed. Moreover, this proposal leaves

196 M. Finzgar and Ž. Oplotnik (2013). Comparison of Fiscal Decentralization Systems in EU-27 According to Selected Criteria. *Lex localis – Journal of Local Self-Government*, 11(3), p. 670.

197 P. Culpepper (2001) Employers, Public Policy, and the Politics of Decentralized Cooperation in Germany and France. In: Soskice, P. A. H. a. D. ed. *Varieties of Capitalism: The Institutional Foundations of Comparative Advantage*. New York: Oxford University Press.

the dogma of neutrality of the European institutional and regulatory framework outside its scope. In this way, the need for institutional innovations as a way forward to unlock the unrealized potential of the various European entities that are now stagnating, but without instruments, tools and tailored-made development strategies, that potential can be quickly lost.

On the other hand, reinvented capacities of the local, regional and national governments to articulate and implement development strategies can lead to the comprehensive economic, social and political restructuring of the Union from the bottom up. At the same time, active top down support for local and regional institutional innovations (such as public regional venture funds, regional support centers, new types of property rights and new types of competition such as cooperative competition), along with dissemination of know-how, technologies and other resources from the most developed and advanced European regions to the stagnating European regions, can lead to a more inclusive and balanced EU in the future. Such a cooperative and even experimental concept of federalism can be attractive to the parts of the EU fearing that the future EU development may become more expensive. It can also be more attractive for the excluded and stagnant parts of the EU because more policy space and instruments can finally start realizing the unused potential of these large excluded parts of the EU.

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7 FROM REGRESSIVE TOWARD PROGRESSIVE EUROPEAN STRUCTURAL REFORMS

INTRODUCTION

The era of deep international economic integration undoubtedly constrains the capacity of national governments to steer their national economies and to provide the traditional economic and social security to their citizens. The key question is therefore to what extent the traditional social-democratic compromise still holds for the economies and societies in the 21st century.

While recognizing that the processes of globalization, accompanied by liberalization of international finance and trade, constrain maneuvering room of the national governments, this recognition should not serve as a generic excuse for the governments to gradually dismantle the achievements of 20th century social democracy. Modern societies continue to provide social welfare not because social protections would continue to confirm the abstract commitment to social justice, but because the strong social welfare institutions secure more sustainable and socially inclusive development. Therefore, social welfare is not a luxury but a necessary element of modern knowledge-based societies.

This presentation puts forward three main claims: 1) there is no intrinsic trade-off between globalization, international competitiveness and the social welfare; 2) the traditional tax-and-transfer approach to social welfare is not a sufficient answer to the challenges and needs of modern economies and societies; 3) there needs to be a shift from the redistributive to the productivist paradigm of the social welfare. In so doing, the progressive supply side approach to overcome economic, social and institutional dualism needs to be elaborated.

First claim: there is no intrinsic trade-off between globalization, international competitiveness and social welfare

It is often mentioned that to maintain competitiveness at the international level, the countries need to reduce their levels of public social welfare spending. However, comparative empirical studies do not support this claim. Many of the most competitive countries in the world also belong to the countries with high levels of social welfare spending.

The explanation for such a claim is that competitiveness has many dimensions and price competitiveness is only one of them. Other dimensions of competitiveness include the innovative capabilities of the countries and firms and the qualities

of education and research, infrastructure and the public institutions. All these dimensions of competitiveness require a different approach and a different set of institutions and policies aiming at constant improvements in education, research, collaboration between science, public policies and industry.¹⁹⁸

Social spending on unemployment, disability, health care, pension, family services and housing tend to be higher in the developed and competitive countries. One of the reasons for a correlation between competitiveness and high social spending is that the advanced countries have also developed advanced social welfare institutions.

Despite fears that the processes of globalization would constrain, limit or even reverse the pillars of social welfare, empirical comparative studies have shown that these fears have not materialized, at least before the crisis and the most recent EU collective turn to austerity. Paul de Grauwe and Magdalena Polan concluded that “on average, countries that spend a lot on social needs score well in the competitiveness league”.¹⁹⁹ What is particularly important in their comparative analysis is the finding about the causality. Namely, it is possible to claim that the countries that are highly competitive and achieve higher growth rates can therefore afford to have higher social spending. Their study showed the opposite is true, namely that “high social spending goes together with strong competitiveness”.²⁰⁰ The explanation by the authors was that “a well-functioning social system creates a ‘risk-taking social capital’ that ultimately leads to an improvement of the productivity of a nation”.²⁰¹

Of course, the relationship between the social spending and globalization is much more complex than this. The claim that there is no intrinsic, natural and necessary trade-off between social spending and globalization is well founded theoretically and empirically.

On the other hand, this claim has not been broadly accepted in the EU and has been largely ignored during the period of European financial crisis. In the aftermath of this crisis, the response was overwhelmingly toward austerity, fiscal consolidation and tightening of the budget expenditures. By cutting expenditures for social welfare across the EU, the response to the crisis was therefore almost exactly opposite from the claim that there is no intrinsic trade-off between social

198 P. De Grauwe & M. Polan, *Globalization and Social Spending*, [in:] 10 Pacific Economic Review 2005, pp. 110–123.

199 Ibidem.

200 Ibidem.

201 Ibidem.

spending and globalization/Europeanization in a period of economic, financial and social crisis.

In the EU, one may not be fully aware of the implications of this approach. What is clearly visible is that the EU as a whole is not coping successfully with the protracted economic, financial and social crisis. The highest levels of unemployment in the EU and in the Eurozone, stagnation and loss of perspective for a large part of European member states and their regions show the inability of the EU to cope with the extent of the crisis. To make the debate within the EU even more complicated, there are also EU countries and regions that are not only capable of maintaining high levels of employment, but they are also strengthening their levels of competitiveness and social cohesion.

There are several different dimensions of the crisis that are taking place in the EU. Not only financial, economic and social, but also an existential crisis of the European project is taking place. Unable to launch a comprehensive process of economic, social and institutional reconstruction around Europe, the EU returned to the only remaining option: a program of austerity. By adopting rigid and excessively narrow rules of the fiscal compact, the EU as a whole appeared to opt for permanent austerity regardless the economic and social impact on future development. The consequences of such a defensive approach are becoming gradually visible.

The recent comparative study about the impact of austerity on the European social model presented by Daniel Vaughan-Whitehead concluded with especially concerning findings: "...that beyond the diversity and different magnitudes of the changes by country – the European Social Model being resilient in some while others have opted for its dismantling – these changes nevertheless have been considerable and have affected all the main pillars and elements of the European Social Model."²⁰² The experts are right to question the viability of the European social model, despite that the process of dismantling the key social pillars (education, health care, pensions, labor market and social cohesion in general) does not occur to the same extent across the EU. The countries that are hardest hit by the crisis experience much faster erosion of the key social pillars than the countries with less severe economic crises. As a result, the divisions within the EU are going to grow.

202 D. Vaughan-Whitehead, *Is Europe Losing Its Soul? The European Social Model in Times of Crisis*, ILO, 2015, http://www.ilo.org/wcmsp5/groups/public/---europe/---ro-geneva/---ilo-brussels/documents/publication/wcms_236717.pdf.

If the first claim in the debate tries to encourage the enhancement of the social welfare even in the period of economic crisis, the socioeconomic realities of the EU are moving in the opposite direction toward gradual dismantling of the key social pillars of European societies. The first claim should therefore be understood as a call for reversing these trends. Social welfare is not a luxury, but an institutional model that facilitates more inclusive, balanced and sustainable development.

Second claim: the traditional tax-and-transfer approach to social welfare is not a sufficient answer to the challenges and needs of modern economies and societies

It appears that the European financial crisis came at the worst possible moment for the European social democracy. It exposed weaknesses in the European institutional model and in the European general policy orientation.

The European “third way approach” can be viewed as an attempt to combine Anglo-Saxon economic flexibility with the Rhineland model of providing basic social and economic protections. As observed by Roberto Unger, this approach led to “abandonment of many of the historical features of social democracy in the name of the imperative of flexibility”.²⁰³ The attempts of “modernizing” reforms led to highly unequal outcomes and spread economic and social insecurity. In the name of “economic renewal, prudent management of public finance and, above all attenuation of barriers separating insiders and outsiders in the labor market... the result has not been flexibility to the benefit of all. It has been more often been the generalization of economic insecurity, and the concentration of resources and opportunities in the hands of an elite oriented to the world economy.”²⁰⁴

European social democracy was on defense even before the financial crisis emerged in the EU. It was without a convincing program during the European parliamentary elections in 2009 and again in 2014. Subsequently, the European austerity approach remains the only game in the EU; it has become a goal in itself regardless of the economic, social and political consequences.

The difficulties of the European social democracy that have been revealed during the European financial crisis can be traced back to the historic social democratic compromise. Adam Przeworski pointed out that social democracy “until 1930s

203 R. M. Unger, *European Constitutionalism: proposals for an agenda of debate*, manuscript 2002, <http://www.law.harvard.edu/faculty/unger/english/docs/europe1.pdf>.

204 Ibidem.

did not have any kind of an economic policy of their own”.²⁰⁵ Only with the emergence of the Great Depression, after the development of the anti-cyclical policy and the appearance of Keynes General Theory social democracy, developed “a distinct policy for administrating capitalist economies”. Nevertheless, social democracy had to make a historic compromise with private capital: “social democrats are subject to the structural dependence as any other party”.²⁰⁶

Inability of the social democracy to reinvent itself in the context of European integration led Wolfgang Streeck to the conclusion that historically speaking, social democracy was doing little more than buying time in the first decades of the European integration and has largely run out of distinctive, sustainable policies in the wake of the financial crisis. His main argument was that the situation today is significantly different from the situation during the Great Depression and that today’s levels of public and private debts accumulated in the periods of good economic times simply do not allow for the anti-cyclical policies.²⁰⁷

Streeck was right in arguing there is little maneuvering room today at the national and European levels to implement sufficient and effective anti-cyclical policies. The limited attempt at launching a Keynesian fiscal and/or monetary stimulus is not the sustainable answer to the existing challenges. Furthermore, it may fail and may lead to even a higher level of indebtedness.²⁰⁸

However and contrary to Streeck, European social democracy has not run out of options. European progressives should move beyond the choice between economic orthodoxy or shrunken Keynesianism. Both options remain within the context of a historic compromise: the normative framework of the market economy is neutral and therefore not subject to any change.

If European progressives accept that the market economy is a social artifact, as argued by Roberto Unger and other progressive scholars, the possibilities to institutionally innovate the modern market economy become much larger. The main goal of social democracy is not to merely regulate and redistribute but to open much larger opportunities to the individuals and social groups to emancipate themselves and to compete and cooperate at the same. Socially inclusive

205 A. Przeworski, *Capitalism and Social Democracy (Studies in Marxism and Social Theory)*, Cambridge University Press, 1986, p. 35.

206 Ibidem, p. 43.

207 Wolfgang Streeck, *Buying Time: The Delayed Crisis of Democratic Capitalism*, Verso, London 2014.

208 Ibidem.

development, based on initiatives and institutional innovations of individuals, local communities and social groups can lead to comprehensive economic, social and political reconstruction, even within the constraints of globalization and Europeanization.

Third claim: there needs to be a shift from redistributive to the productivist paradigm of the social welfare – beyond the narrow, technocratic version of structural reforms in Europe

Instead of resorting to the ever more limiting redistributive policies, the alternative is to democratize the market economy to broaden access for the excluded parts of population and to improve and broaden access to capital, new technologies, skills and know-how, high quality of education and all other necessary resources. (See more about the shift to the productivist paradigm in Roberto Unger, *Democracy Realized*, p. 78).

The phenomenon of modern economies and societies in both the most developed and developing parts of the world is one of economic and social dualism. This dualism, which exists both in poor and rich countries as articulated by Roberto Unger, means that the established industries and businesses are equipped with state-of-the-art technologies, knowhow, managerial skills and a skilled and educated labor force, with access to capital and all other necessary resources. Within this relatively privileged but increasingly insulated advanced sector, the circulation of knowledge, information and skills is taking place. The arrangement is also advanced in organizational terms and in terms of constant innovation and an experiment friendly environment.²⁰⁹

The gap between the relatively privileged sectors of established industries and businesses and the excluded ones is growing in the context of the EU and in many other parts of the world. Comprehensive development of start-ups and small and medium size businesses is something difficult to achieve in most of the core regions and countries in the EU, not just in its stagnating regions and countries.

Without deliberate public support to provide broad access to technologies, know-how, long-term finance and other resources, the entry costs for new companies and for the new entrepreneurs remain too high. In modern knowledge-based economies, it takes time to master technologies, production and their organization. As

209 R. M. Unger, *Democracy Realized: The Progressive Alternative*, Verso, London 1998, pp. 11–12, 32–35, 113 and 121.

a consequence, without deliberate and systemic public support for deepening access to all of the necessary resources for start-ups and for small and medium size enterprises, the established industries benefit from high entry costs. In the absence of decentralized, coordinated positive means and institutional innovations, the single market creates not only a strong distributional effect, but more importantly, amounts to the protection of established industries.

The effort to overcome economic and social dualism requires the establishment of various forms of strategic coordination between the public and private sectors. Such coordination should take place in decentralized, participatory and experimental forms, which would be specific to the local contents. The experimental form of reconstructive efforts throughout the European union presents a distinction with the recommendations to establish a banking, transfer and political Union to overcome the crisis. It presents a distinction from the insistence by the European institutions to the member states to pursue (regressive) structural reforms in order to strengthen their level of competitiveness.

FROM REGRESSIVE TOWARD PROGRESSIVELY DEFINED STRUCTURAL REFORMS

This is the crucial point at which the European progressive approach departs from the mainstream and conservative approaches to the European single market policies. The most frequently stated requirement for the EU member states is to pursue structural reforms. This requirement seemingly appears to be neutral and generally beneficial to the economies and societies of the European Union. Despite its importance and broad economic and social implications, the content of structural reforms is very abstract and is defined only in vague terms.

Even after careful examination, The Five Presidents' Report on completing the economic and monetary Union provides only a very superficial idea of the content of structural reforms. The Report states that, to achieve a sustainable convergence, member states must to pursue the "structural reforms geared at modernizing economies to achieve more growth and jobs. That means both more efficient labor and product markets and stronger public institutions."²¹⁰ According to the Report, the structural reforms take place in the context of addressing the macro-

210 J. C. Juncker, et al., *The Five Presidents Report – Completing Europe's Economic and Monetary Union*, European Commission, 2015, https://ec.europa.eu/priorities/publications/five-presidents-report-completing-europes-economic-and-monetary-union_en

economic imbalances of a given member state. The macroeconomic imbalance procedure should be used “not just to detect imbalances but also to encourage structural reforms through the European Semester. Its corrective arm should be used forcefully. It should be triggered as soon as excessive imbalances are identified and be used to monitor reform implementation”.²¹¹

We can understand from the Report that the structural reforms assume more efficient labor and product markets and stronger public institutions. Structural reforms also present a corrective arm for detecting and addressing imbalances. According to the Report, structural reforms should be used forcefully through the European semester to address the imbalances. Therefore, they should be used forcefully in cases of macroeconomic imbalances. In the context of macroeconomic imbalances it is far less clear, however, what is the causality between the structural reforms, envisaged by The Five Presidents’ Report, and the creation of jobs and growth. Especially in the context of fiscal consolidation across the Eurozone, the causality between the structural reforms and the creation of jobs and growth appears to be highly tenuous. What if the structural reforms, used forcefully, as recommended by the Report, lead to further loss of jobs, wage stagnation, further labor market fragmentation and ultimately to deepening of economic and social dualism in most of the member states?²¹²

Although the Five Presidents’ Report does not elaborate on the causal linkages between the structural reforms and jobs, a more elaborated explanation of the content of structural reforms was provided by the ECB president Mario Draghi. He emphasizes that “structural and cyclical policies – including monetary policy – are heavily interdependent”, whereas he sees structural reforms as “policies that permanently and positively alter the supply-side of the economy”.²¹³ Unlike The Five Presidents’ Report, the president of the ECB presents structural reforms in more substantive terms.

For example, in his recent speech on the policy alignment, he explores the ways to increase potential growth and productivity with the improved indicators on research

211 Ibidem.

212 Ibidem. In addition to tackling imbalances at the member state level by using structural reforms forcefully, the Report tackles the imbalances at the European level in a different way. Namely: “At the same time, the Macroeconomic Imbalance Procedure (MIP) should also foster adequate reforms in countries accumulating large and sustained current account surpluses if these are driven by, for example, insufficient domestic demand and/or low growth potential, as this is also relevant for ensuring effective rebalancing within the Monetary Union.” P. 8.

213 M. Draghi, *Structural reforms, inflation and monetary policy*, European Central Bank, 2015, <https://www.ecb.europa.eu/press/key/date/2015/html/sp150522.en.html>.

and development. He emphasizes the need to get more firms to the productivity frontier, to boost employment and wage equality, to organize a well-functioning financial market capable of channeling finance to dynamic firms, and to develop an efficient judicial system, including the bankruptcy laws to deal with unproductive firms. He also puts forward the need to provide an adequate social safety net. He especially emphasizes the need to invest in human capital as the key ingredient in making growth stronger and more inclusive. He is also aware that only a few member states are achieving a high productivity growth, but he is convinced that The Five Presidents' Report's support for a new convergence process would move all Eurozone countries toward the best practices on structural reforms.²¹⁴

This brief overview shows that many of the elements of the structural reform concept enjoys a broad public support. On the other hand, the approach toward structural reform requires a closer, more nuanced analysis, during which three serious problems should draw attention. First, determining how to approach structural reforms at the levels of Eurozone member states takes place within the very narrowly defined context of The Five Presidents' reform. Therefore, structural limitations imposed by the European economic guidelines and rules (for example, the limitations and constraints imposed by the Fiscal Compact) inevitably shape the scope of structural reforms in the member states. Second, very few and limited common European policy areas support the proclaimed new convergence process of the Eurozone countries (such as investment in human capital, lifelong learning schemes or building a common adequate social welfare network). Different member states are in different positions to implement structural reforms successfully. Their institutional capacities and their abilities to define and implement high quality structural reforms in a transparent and participatory manner differ markedly from one member state to another. In the European narrowly defined context of structural reforms and in the absence of more vigorous common policies, it is likely that the implemented reforms will lead to widening the gap between the most developed, most productive, socially cohesive member states and the stagnating member states and their regions. Third, many of the policy-orientations and the decisions of various authorities at various levels, including the decisions by the ECJ, such as *Laval* and *Viking*, lead to weakening not strengthening European labor standards and social welfare protections. In the context of the supposedly neutral common market rules, the gap between the advanced economic and social sector on one hand and the stagnating economic and social sector on the other hand is growing.

214 M. Draghi, *On the Importance of policy alignment to fulfil our economic potential*, European Central Bank, 2016, <https://www.ecb.europa.eu/press/key/date/2016/html/sp160609.en.html>.

On the surface, many elements of the structural reforms assumed by The Five Presidents' Report and elaborated more by the ECB president Draghi appear to be broadly acceptable. However, when these structural reforms are being implemented in the actual context of the Eurozone and the single market rules, these reforms frequently further undermine the existing levels of labor law and social welfare protections. The gains, however, are unevenly distributed across the firms and the labor market. More often than not they lead to the 'race to the bottom' with negative consequences for many European regions and the member states.

Some of the critics of the European approach toward the structural reforms recommend simply rejecting the whole notion and insisting on the structural reforms to return the EU, its member states and their regions to the path of socially inclusive economic growth and development. Others claim that structural reforms in practice focus on increasing market flexibility and reducing social welfare costs²¹⁵, which, in combination with fiscal consolidation (rapid deficit and debt reduction) lead member states, especially those unable to follow the agreed rules, toward slow growth, high unemployment, rising inequality, and, in case of the peripheral countries, even to a humanitarian crisis.²¹⁶ Some other critics put forward that structural reform is nothing less than a code word for smashing workers' rights²¹⁷, especially because of the often-stated critique that the European labor and product markets are 'too rigid'.

Structural reforms mean many different things to many different actors. Some elements of structural reforms may overlap between different proponents of structural reforms, while at other times there are fundamental disagreements about what kind of structural reforms are necessary and/or adequate. Sometimes, even the key actors significantly contribute to the confusion of the debate. Kent Whelan has enumerated fifteen uses of the phrase 'structural reforms' in Draghi's speech to the European Parliament's Economic and Monetary Committee. Although Whelan is not in principle against the structural reforms, he is convinced that "it is important for the ECB to take responsibility for its crucial role in the shorter-term

215 V. Schmidt, *Changing the policies, politics, and processes of Eurozone in Crisis: Will this time be Different?*, [in:] D. Natali & B. Vanhercke eds., *Social Policy in the European Union: State of the Play 2015*, p. 33, <http://www.etui.org/Events/Social-Policy-in-the-European-Union-State-of-Play-2015>.

216 Ibidem.

217 W. Mitchell, *Structural Reform – Code For Smash the Worker Resistance*, econblog, May 2015, <http://bilbo.economicoutlook.net/blog/?p=31018>.

macroeconomic management of the Euro area, and ECB officials continually placing structural reforms at the heart of discussions of this issue is unhelpful.”²¹⁸

The overall approach of the ECB toward the structural reforms, the approach presented in The Five Presidents’ Report, and the policy orientation of the European Commission – DG for Economic and Financial Affairs – are far from being neutral and unproblematic both in theory and practical implementation. According to the official European line, the main focus is on creating more adaptable and responsive labor markets, liberalizing service sectors, boosting competition in product and service markets, and improving the overall business environment. Not only is the approach toward the structural reforms taken out of the actual context of the single market (the context of fiscal orthodoxy and the context of largely pro-cyclical macroeconomic policy), this particular approach assumes that one single, universally valid market arrangement exists. It presents the extension of the neoclassical economic synthesis and a belief in the neutrality of the markets. It assumes that public institutions can do little to improve the competitiveness of the markets. This assumption has already been included in the fiscal rules as articulated by the Fiscal Compact. It is an approach that, according to ‘supply-side’ economics, assumes that there is automatic causality between structural reforms and convergence to the highest level of prosperity. In the actual socio-economic developments of the Eurozone and the member states, we can observe far more divergent trends. As pointed out by Reissl and Stockhammer, the official European approach toward structural reforms “is characterized by a strong belief in the efficiency of the market system, a distrust of state activity and an anti-labor bias.”²¹⁹

PROGRESSIVE STRUCTURAL REFORMS – PROGRESSIVE SUPPLY SIDE AND PROGRESSIVE DEMAND SIDE PUBLIC INTERVENTIONS

If it is more likely than not that the narrowly defined context for implementing structural reforms leads toward further divergence in the Eurozone, then the biggest challenge for scholars, policy-makers and practitioners becomes determining what more pro-development and more inclusive progressive structural reforms

218 K. Whelan, *Draghi on Structural Reform*, September 2014, K. Whelan's blog, <http://karlwhelan.com/blog/?p=1265>.

219 S. Reissl & E. Stockhammer, *The Five Presidents’ Report One Year One: More Of The Same*, in:] Social Europe Journal, July 5, 2016, <https://www.socialeurope.eu/2016/07/five-presidents-report-one-year/>.

will look like.²²⁰ In view of the analysis presented in this section, the distinction between the mainstream approach toward structural reforms and the progressive approach toward structural reforms is one of the most crucial distinctions regarding the future of the EU, the Eurozone and the single market. Beyond the discussion about the macroeconomic framework and the possibility of the transfer union, the discussion about the nature and scope of the structural reforms should become a crucial area of a debate about European alternative futures.

The focus of progressive structural reforms should not be merely on progressive intervention on the demand side. The focus should be broadened toward the progressive intervention on the supply side of structural reforms. The point of departure should be to articulate any elements of structural reforms with the broad participation of local communities, entrepreneurs, trade unions, civil society, and experts. Structural reforms are context specific and country or region specific. Different regions possess different potentials, skills, expertise and traditions. They can develop and implement different development strategies tailored-made to their niches, capabilities and comparative advantages. The role of supranational institutions is to become more hospitable and more supportive of bottom-up initiatives. They can help disseminate advanced practices, innovations, new technologies and newly acquired skills from the most successful European regions to the stagnating European regions.

According to the EU Innovations Scoreboard, “all the EU regional innovation leaders (27 regions) are located in only eight EU Member States: Denmark, Germany, Finland, France, Ireland, Netherlands, Sweden and United Kingdom. This indicated that innovation excellence is concentrated in relatively few areas in Europe.”²²¹ Despite certain improvements in the last two years, “the process of convergence in performance differences between Member States – as observed in previous reports since 2012 – appears to have come to a halt.”²²² There is plenty of room for opportunities for the European supranational institutions to become

220 On the troubling ambiguity of structural reforms, the conclusion by scholars examining the concept of structural reforms in the is “that the EU is trapped in a destructive – rather than constructive – ambiguity. Conflicting socio-economic strategies crystalize on which type of structural reforms should be implemented and when or, in other words, whether austerity and investment can be pursued at the same time. Amandine Crespy & Pierre Vanheuverzwijn, *What 'Brussels' means by structural reforms: constructive or destructive ambiguity?*, May 2016, <http://www.academia.edu/25827774/>.

221 European Union, *Regional Innovation Scoreboard 2014*, [in:] http://ec.europa.eu/enterprise/policies/innovation/files/ris/ris-2014_en.pdf.

222 European Union, *European Innovation Scoreboard*, 2016, [in:] http://ec.europa.eu/growth/industry/innovation/facts-figures/scoreboards_sl

more proactive in disseminating knowledge, research and technologies across the European single market.

In addition to including bottom-up initiatives from the European citizens in defining structural reforms and the broad dissemination of advanced practices, the next step in broadening the scope of structural reforms is to accept and support the national and regional institutional varieties of the European single market. In place of a one-size-fits-all, imposed top-down, economic and social model for all of the diverse European regions and member states, a variety of institutional, economic and social models should be encouraged. Institutional regional varieties across Europe should be accepted and supported to open more development space for European regions and to stimulate more initiatives from local communities and their citizens. Institutional divergence, based on regional comparative advantages, is a more plausible path toward common prosperity than a narrowly defined technocratic approach toward structural reforms.²²³

Another unexploited opportunity to achieve comprehensive structural reforms is to establish a strategic partnership between the public and the private sectors. Such a collaboration can be established in a decentralized, participatory and experimental manner. The goal is to help make the conditions and instruments of advanced production available to larger parts of the economy and the society. As proposed by Lothian and Unger, the focus of such a policy “should be on small and medium size enterprises as the key source of jobs and output. Its method should be the expansion of access to credit, technology, advanced knowledge and practice, and facilities for the organization of networks of cooperation that combine the benefits of flexibility of scale. Its characteristic concern should be to propagate successful organization and technological innovation wherever they may arise.”²²⁴

Perhaps the closest to the idea of decentralized cooperation as the new, reinvented form of industrial policy can be seen in some of the advanced European regions and member states, such as Emilia Romagna, Piedmont and other Italian regions and local public-private partnerships in Ireland. Innovate policies and high-quality education in Finland as a basis for entrepreneurial and technological progress offer

223 On the overlooked sources of institutional innovations in some of the most inclusive and cohesive European regions see M. Nahtigal, *European Regional Disparities: The Crucial Source of European un-sustainability*, [in:] *European Regional Disparities: The Crucial Source of European un-sustainability*, Lex Localis – Journal of Local Self-Government, vol. 11, no. 3, pp. 601–614.

224 T. Lothian, R. M. Unger, *Crisis, Slump, Superstition and Recovery: Thinking and Acting Beyond Vulgar Keynesianism*, [in:] Columbia Law and Economics Working Paper No. 394., 2011, p. 49, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1780454.

further examples of successful European decentralized development policies and structural reforms. The organization, tradition and supportive institutions of the German *Mittelstand* should also be included. To achieve the common prosperity standards on the European single market, we need to approach comprehensive institutional, economic and social restructuring well beyond the narrowly defined structural reform approach as currently proposed by the European institutions.

In parallel with a comprehensive institutional reconstruction of the market economy, a direction toward its democratization can be envisaged. There are several insufficiently exploited possibilities such as profit-sharing of employees in advanced sectors of the economy; collective representation to strengthen the power of organized labor at the middle range of wage hierarchy; and subsidies and training for the workers in low-wage and low-skill economic sectors.²²⁵ Comparative empirical studies in labor economics suggested that none of these measures is inherently inflationary. The next step in the direction of democratizing the market economy would be to spread, fragment and disseminate property rights to different property holders and stake holders to encourage cooperation and create long-term strategic alliances (on property-owned democracy see Zwicky.²²⁶

In the context of remaking the markets, there are many other unexploited possibilities. The role of pension funds in supporting long-term development of the firms is one such example. From the social welfare perspective, however, it should be emphasized that the social policy received a new role. It is a policy of empowerment of individuals, social groups and different stakeholders to emancipate themselves and to become the productive and creative participants in the modern knowledge-based societies. Hence there is a need for a shift from merely redistributive to the productivist character of the modern social welfare.

CONCLUSION

In the previous three claims, it was explained that modern social welfare is not a luxury nor a charity. It is a necessary and essential element of any modern, inclusive and dynamic knowledge-based society. The introduction of social investments by ensuring learning abilities during the life course offers a new dimension to the traditional social welfare approach.

225 Roberto Mangabeira Unger, *What Should the Left Propose?*, Verso, London, 2006, pp. 28–29.

226 Pascal Zwicky, *Economic Democracy as a Key Element of a Social Europe*, [in:] E. Stetter, K. Duffek & A. Skrzypek (eds.), *For a Connecting Progressive Agenda*, FEPS Next Left Book Series vol 9, FEPS Renner Institut, Brussels, pp. 358–394.

It was also explained that the EU and the European social democracy are at a crossroads. As argued by Gusenbauer and Skrzypek, a new social contract with the help of reenergized democratic politics is required.²²⁷ At the moment, the EU is going through the biggest existential crisis since the establishment of the European integration. Social democracy is also at a crossroads. On one hand, the important achievements of the twentieth century social democratic legacy are being gradually dismantled in many (but by no means all) of the European places. On the other hand, the process of reinventing social democracy for the twenty-first century is very slow. Progressive economic and social theory of the 21st century should move beyond the traditional tax-and-transfer policy and beyond the traditional Keynesianism of the 20th century. The valuable achievements of the twentieth century social democracy in the areas of economic security and social welfare present a source of encouragement to advance the causes of equal opportunities, social welfare and cohesion to the twenty-first century. Institutional innovations, tailored to the needs and potential of local communities and regions across Europe can open new prospects for the excluded parts of population. Progressive fiscal, tax, trade and other policies can directly address the persistent economic and social dualism in many stagnating European regions and member states.

Instead of accepting the definition of structural reforms as articulated by the European institutions, local communities, citizens, trade unions, entrepreneurs, NGOs, groups of experts, local financial institutions and policy-makers should articulate and implement structural reforms based on diverse local and regional development strategies. The role of the supra-national institutions in this context is to stimulate diverse strategies, support them and cross-fertilize good practices from prosperous to stagnant European regions and member states. Institutions and policies that would lead to more inclusive, more balanced, more sustainable and diverse European union can and should be articulated and implemented across Europe.

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227 A. Gusenbauer & A. Skrzypek, *The Next Social Contract – Progressive Politics after an Era of Plenty*, [in:] Olaf Cramme, et al. (eds) *Progressive Politics After the Crash: Governing from the Left*, I.B. Tauris, pp. 229–238.

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8 MODERN FREE-TRADE AGREEMENTS – HOW TO REDIRECT EU AND GLOBAL TRADE POLICY

INTRODUCTION

This research paper shows that variety in institutional models of capitalism does not necessarily stand in opposition to improved systems of cooperative economic governance and development of international trade. The goal of deeper integration at the regional level (for example, the European Union), at the transatlantic cooperation level (the most recent Transatlantic Trade and Investment Partnership, TTIP, and The Comprehensive Economic and Trade Agreement, CETA, as well as JEFTA), and at the global level (the incomplete Doha development round) should not be a simplified process of merely removing remaining trade and non-trade barriers.

Rather, the goal of modern trade agreements should be to secure more balanced, inclusive, and sustainable development at the regional level, in the context of transatlantic cooperation, and especially at the global level. In international trade talks, it is frequently underestimated that any kind of trade agreement – no matter how carefully crafted – creates strong distributional effects. In promoting trade agreements, the positive effects and benefits are generally highlighted, while the negative effects and losses are mostly overlooked. As witnessed in recent decades, trade agreements lack sufficient safeguards to compensate industries, employees, and local communities that lose their competitive edge. Equally important, they often lack safeguards for social welfare, public health, the environment, and consumer protection.

The basic principles, stemming from the European treaties, are often forgotten, when the EU approaches new trade agreements. Therefore, it should be mentioned The Lisbon Treaty, Article 3, Section 5, that expressly stipulates that the EU should uphold *free and fair* trade.

New rounds of trade talks in the last decade at the global, transatlantic, or regional levels start to lose their appeal in the eyes of large segments of workers, farmers, small entrepreneurs, consumers, environmental non-government organizations, and others. The one-sided effects of trade liberalization in recent decades have frequently led to a concentration of economic benefits and technological advancements in the hands of a relatively small number of the most competitive regional areas. Many other regions, localities, and large segments of society remain excluded from the benefits of deeper economic and legal integration.

The difference between the post-war development of international legal trade regimes and the context of the most recent free-trade initiatives is that the disparate effects of trade liberalization tend to become more visible in the most advanced economies in the world – the United States and the European Union. This trend requires the rethinking of trade arrangements to provide adequate instruments, tools, and policies when needed for restructuring. Careful calibration of such instruments, tools, and policies – not to distort, but to strengthen international trade – can be a “Bretton-Woods compromise” for the 21st century.

Such compromise could provide an international legal framework conducive to long-term sustainable development that is more resilient in various international financial crises that may occur. The most important challenge in the process of deepening and widening economic and legal integration is how to disseminate economic, technological, financial, and other benefits to excluded regions and populations. The prevailing notion that any deepening of economic integration may lead to a “race to the bottom” by undermining existing economic and social security should be addressed by policymakers. Comprehensive efforts to disseminate the benefits as widely as possible should be applied at the local, national, and international levels. In doing so, local communities should be encouraged to launch development strategies suitable to their comparative advantages, potential, and needs.

The question for academics, trade experts, and policy-makers from around the world should not be a one-dimensional dilemma between trade liberalization and protection. Instead, the debate should focus on how to secure international trade integration while maintaining room for domestic institutional innovations and local and regional development strategies.

The post-World War II liberalization of trade undoubtedly opened up immense opportunities for industries from both developed and developing countries to gain benefits.²²⁸ The classical conflict between protectionism (in the form of an import-substitution strategy mainly in Latin America) and liberalization (in the form of a free-trade strategy pursued by East Asian countries, while retaining domestic control of strategic companies and industries) turned into apparent success for the latter.

Subsequent rounds of trade negotiations led to an increasingly formalized international trade framework, to the expansion of membership in the World Trade

228 World Trade Organization, *The WTO at Twenty: Challenges and Achievements*, Geneva 2015, https://www.wto.org/english/res_e/publications_e/wto_at_twenty_e.htm

Organization (WTO), and to further reduction of tariff and non-tariff trade barriers. In recent years, many difficulties of a conceptual and practical nature have begun to emerge. One such difficulty stems from outside the relative success of Brazil, Russia, India, China, and South Africa (BRICS), whereas not many developing countries and regions were able to escape from their peripheral economic and social positions. This observation applies to many developing and middle-income countries around the world. The pathways from the periphery are always difficult in any given historical and normative context, but the current international trade regime is not sufficiently conducive to overall international economic development. The Ministerial Declaration, adopted in 2001, emphasized that the ‘World Trade Organization has contributed significantly to economic growth, development and employment throughout the past fifty years..., but at the same time has recognized ‘the need for all our peoples to benefit from the increased opportunities and welfare gains that the multilateral trading system generates.’²²⁹

As is now known, the Doha trade round (a pro-development round) failed to complete its mission after many rounds and high-level meetings. Subsequently, the international economic, political, and normative context has changed significantly for both the developing and the developed parts of the world. Therefore, even if any kind of new global, development-friendly agreement had been reached in the last decade, many of the original assumptions of the Doha round have changed to such an extent that a new agreement for the first half of the 21st century would have very likely been necessary.

The alternative to the incomplete Doha round was a decision to negotiate bilateral and regional trade agreements. The two leading trading blocs, the European Union and the United States, were especially active. In addition, the two trading blocs, along with the large Pacific Rim trading bloc (notably with the deliberate exclusion of China) opted for regional free-trade agreements with a comprehensive regulatory framework. The TPP was even declared as the gold standard for all other future free-trade agreements around the world. After years of trade negotiations without sufficient public scrutiny (a pattern that developed in the past), today the NGOs, the international civil society, and other social actors have grown more sensitive to the important details of any contemporary trade agreement. Not only are marginal social groups critical of many of the agreed clauses principles, and standards included in the trade agreements, but so have many mainstream representatives, experts, social actors, and policy-makers.

229 Doha Ministerial Declaration, November 20, 2001, https://www.wto.org/english/thewto_e/minist_e/min01_e/mindecl_e.htm

Traditional arguments in favor of free-trade agreements are being confronted by more critics and unresolved dilemmas than in the past, for three primary reasons. First, the gains from free-trade agreements frequently turn out to be smaller than anticipated at the adoption of agreements, whereas certain unanticipated costs may have greater impact on the firms, distribution of incomes, and the level of employment. Second, gains from free trade often accrue mainly to the privileged segments of an economy. Third, in an economic crisis, the entire economy and society can be exposed to the economic hardship. Fourth, the pressure on labor and social standards, health standards, and the environment is only mounting with each new round of free-trade agreements.

GOOD, BAD AND MEDIOCRE FREE TRADE EQUILIBRIUM

In modern trade theory, comprehensive modeling based on empirical data has led to the conclusion that there is more than one possible outcome of free trade agreements. William Baumol and Ralph Gomory came to the conclusion that multiple outcomes of free trade agreements with multiple equilibria (good, bad and mediocre) are possible. They emphasized that free “trade is not always and automatically benign”.²³⁰ To reach a good equilibrium (a situation of mutual gains for the trading partners), many elements need to be carefully calibrated. Among them is the need for an active role of governments in supporting the moves toward the good equilibrium. The gains of trade are not only a matter of individual firms and industries, as they affect entire national incomes in various ways.²³¹ Moreover, the trading partners should take into account the interests of other partners and not only their own.

The reason why in modern trade theory and practice there is more than one single outcome, but multiple outcomes with multiple possible equilibria, is that unlike in classical trade arrangements run by market forces and the invisible hand, the modern comparative advantages are based on knowledge-based economies and societies. These advantages are not inherited, but they are invented and constructed, often through the partnership between the public and private sectors.²³² In the words of Baumol and Gomory, high start-up costs and learning may lead to the establishment of the so-called retainable industry: “A retainable industry,

230 R. E. Gomory, and J. W. Baumol, *Global Trade and Conflicting National Interests*. Cambridge: The MIT Press, 2000, p. 17.

231 Ibidem, p. 20–22.

232 R. M. Unger, *Free Trade Reimagined: The World Division Of Labor and the Method Of Economics*. Princeton: Princeton University Press 2007, p. 36.

because of its high real start-up costs, offers the current established producers a substantial degree of protection from competitive entry, making it easier for them to retain their position... Market forces in retainable industries tend to perpetuate the status-quo.”²³³

The shift from classical to modern trade arrangements indicates the end of classical free trade agreements. The classical free trade agreements should be revised to establish whether they produce outcomes of mutual interest or lead to the zone of conflicts. As emphasized by Baumol and Gomory, in modern trade arrangements “there can be inherent conflicts as well as mutual gain for nations engaged in global trade.”²³⁴ (p. 40). In searching for a better equilibrium, one should move beyond the “mistaken impression that maximizing world output automatically maximizes national prosperity.”²³⁵

Perhaps in the past, the critical assessment of the underlying assumptions on which the free trade agreements were founded did not receive the necessary scrutiny because they did not significantly affect the advanced sectors of industry in the leading industrial countries. With the emergence of knowledge-based societies, with the increasingly important role of the large emerging countries from BRICS (especially China) and with the growing anxiety of the relatively privileged sectors of economy and society from the leading industrial countries, the opportunity emerges to carefully reassess the achievements and failures of the traditional free trade agreements. The next step should be to start carefully calibrating the future trade agreements with less focus on maximizing world output and with more focus on securing sustainable, balanced and inclusive development at the local, regional and national levels of both the developed and the developing parts of the world. Such an approach might be called a search for the new Bretton Woods compromise for the 21st century.

In the following sections, the missing elements of the failed Doha round to make it truly development friendly are discussed. In the next section, some of the most important implications of the rise of BRICS countries, especially China, are presented. In the subsequent section, the growing anxieties in the leading industrial countries are addressed. Finally, the opportunity to develop a compromise based on mutual interests and positive outcomes for the partners from developing and developed parts of the world are put forward.

233 R. Gomory and W. Baumol, *supra* 164, p. 73.

234 *Ibidem*, p. 73.

235 *Ibidem*, p. 40.

CONCEPTUAL DEFICIENCIES AND THE MISSING ELEMENTS OF MODERN FREE-TRADE AGREEMENTS

An assumption that free-trade agreements are always and automatically beneficial to all participating trading partners is theoretically and empirically flawed. Trade is about specialization in relative comparative advantages with the aim to contribute overall gains. It has distributional effects throughout the society; it creates winners and losers. In order to remain in the zone of mutual gains and prevent a slide into the zone of conflict, many safeguards must be put in place for all participating partners. These safeguards must be narrowly tailored according to the socio-economic, institutional conditions, and productive potential of each trading partner. In addition to a mutual understanding and an interest in the overall well-being for all participating partners, the capacity to compensate the excluded segments of workers and social groups (the so-called ‘losers’) must be retained in the hands of each trading partner. The goal of free-trade agreements is not to maximize trade, but to support comprehensive, inclusive, and sustainable development of all participating trading partners.

In so doing, each trading partner must address its own internal imbalances and look for new productive niches, while avoiding beggar-thy-neighbour policies. This model of mutual benefits and understanding was achieved during the GATT regime, with more policy space and more maneuvering room for the trading partners than allowed by the modern WTO rules or modern free-trade agreements.

When analyzing the missing elements of modern free-trade agreements, it is necessary to mention the NAFTA agreement, which represents the beginning of modern free-trade agreements. During the campaign to adopt the NAFTA agreement, many expectations about the benefits and new opportunities for shared growth and mutual progress were put forward. Two decades later, we can see the bilateral economic, investment, social, and political relations have evolved in substantially different directions for both trading partners than originally anticipated.

Simple rhetorical claims about common benefits and gains are no longer sufficient. For example, the North American Free Trade Agreement (NAFTA) was declared an important boost for the U.S. economy and a major boost for the Mexican economy. However, after 20 years in place, NAFTA can be called a rather mediocre equilibrium. Mexico’s exports to the U.S. increased substantially, as well as its foreign direct investments, but the Mexican economy did not experience an overall economic transformation. The Mexican economy grew slowly in comparison with other fast-growing developing countries. There was a net loss of employment for Mexico, and it had limited job creation in manufacturing but substantial job losses in agriculture due to imports of cheap corn and other agricultural

products. Despite the inclusion of ILO core labor standards in the NAFTA agreement and the stated goal of promoting an upward convergence of labor standards in North America, the wage gap of nearly six times between the US and Mexico has even widened. Almost half of Mexico's population cannot find formal employment. (Pardee, 2009, *The Future of North American Trade Policy: Lessons from NAFTA*).²³⁶

On the other hand, from the U.S. perspective, one of the often-stated goals was to address migration with Mexico by exporting goods and not people. The migration flows after NAFTA only grew until the adoption of all possible measures on the border between the U.S. and Mexico to limit the migration flows.²³⁷

One of the most important developments since the establishment of NAFTA was in job manufacturing. Since 2000, North America lost about one quarter of its jobs in manufacturing, which expresses a loss of competitiveness in the entire free-trade economy. North American now needs a new regional strategy to compete effectively with other manufacturing exporters, particularly China. Most significantly, the impact of NAFTA was that in place of convergence, it accentuated the economic and regulatory asymmetries that had existed among the three countries.²³⁸ The lessons and experience with NAFTA require deep rethinking about the free-trade agreement.

DEFICIENCIES AND CONCEPTUAL FLAWS OF THE MODERN GENERATION OF FREE-TRADE AGREEMENTS

After the stalled Doha trade talks – an attempt to launch a genuinely development-friendly round of world trade talks – the major trading blocks, most notably the EU and US, headed into a new round of bilateral trade agreements with other parts of the world. Both leading trading partners approached new rounds of trade talks without analyzing deficiencies of the previous trade agreements or questioning theoretical and conceptual assumptions. The main point of departure remained that reaching free-trade agreements is always positive and beneficial,

236 Pardee Center Report: *The Future of the North American Trade Policy: Lessons from NAFTA*, Boston University, 2009, <http://www.bu.edu/pardee/files/2009/11/Pardee-Report-NAFTA.pdf>. See also K. Gallagher and T. Wise, *NAFTA Unhappy Anniversary*, Guardian, January 1, 2009, <https://www.theguardian.com/commentisfree/cifamerica/2009/jan/01/nafta-anniversary-us-mexico-trade>.

237 Ibidem.

238 Ibidem.

whereas not being able to reach not free-trade agreements is a sign of lost opportunity and lost (anticipated) benefits. This assumption continues to be irrefutable, irrespective of the actual context or the socio-economic conditions of trading partners, as well as without paying any attention to the representation in the trade talks (such as representation of workers and trade unions, independent environmental and health experts, consumer organizations, and others). The secrecy of trade talks – presumably in favor of protecting national interests and national strategies – with the simultaneous involvement of lobbies, well organized interest groups, and multinationals reached new heights. Only occasional leaks to the public revealed deeply problematic legal clauses, often at the expense of public goods and public interests on all sides.

What is really new and different from past trade agreements is that the actual international trade framework is already so liberalized regarding low tariff levels that the focus of the new generation of trade agreements is on regulatory cooperation and harmonization. The goal of the new generation of free-trade agreements is to alleviate operations of multinational companies wherever they carry out their business activities. However, common regulatory standards, adopted by the newly created supranational technocratic bodies, reduce the scope of regulatory autonomy and democratic control in each of the trading partners. Furthermore, in absence of checks-and-balance mechanisms, regulatory harmonization at the supranational level could turn into an arm's-length service for the interests of well-organized multinationals. This regulatory tilt toward the interests of multinationals frequently runs against the interest other stakeholders, such as workers, consumers, local producers, civil society, and public goods. It narrows the scope and ability of the governments to regulate and provide public goods. Liberalization of trade, irreversible process of privatization on one hand, the supposedly neutral regulatory harmonization at the supranational level, on the other, are simultaneous processes. As a consequence, unequal and unbalanced free-trade agreements lead to corporate welfare and to the irreversible process of diminishment of public goods, erosion of high quality public services, and the erosion of economic and social security for a the large part of population. The unbalanced outcome of modern free-trade agreements creates more discontent in the greater segments of the population than the more well-known individual clauses, such as ISDS provision²³⁹ (in case of CETA agreement

239 A systemic overview of the growing importance of the ISDS provision in modern free trade agreements, H. Sweetland Edwards, *Shadow Courts: The Tribunals that Rule Global Trade*, Columbia Global Reports, 2016.

refurbished as ICS provision, different wording but not content),²⁴⁰ regulatory cooperation with the risk of reducing the achieved standards, the negative list of public services, according to which all the services are liberalized except those explicitly excluded. The foreign investors receive many new rights and protections, but these newly gained rights are not adequately balanced with their responsibilities toward domestic legal system and democratic regulatory decision-making procedures.²⁴¹ Consequently, the EU precautionary principle for “the protection of health, environment and consumers will be rendered more difficult by the CETA and (potentially) TTIP drafts”.²⁴² We have already seen in the example of NAFTA that trade liberalization does not automatically provide benefits for all participants. In the case of CETA, two international trade experts, Pierre Kohler and Servaas Storm, prepared an econometric study on socio-economic consequences of the CETA agreement.²⁴³ Contrary to the studies based on the computable general equilibrium (CGE) model with unrealistic assumptions, such as the permanent full employment in Canada and the EU, or that trade liberalization leads to an instantaneous and costless adjustment of trading partners,²⁴⁴ the two trade experts applied the United Nations Global Policy Model, allowing for changes in employment and income distribution. The findings of their alternative approach show a substantially different outcome from the officially announced benefits of the free-trade agreement.

Some of the main findings of their study show many negative externalities of the CETA agreement, such as a reduction of the labor income share, a raise of the share of national income accruing to capital, it will lead to wage compression. CETA will further lead to net losses of government revenue, shrinking policy space for supporting domestic investment, production and investment will reduce government revenue and expenditure. CETA will also lead to job losses. In sum, CETA will lead not just to economic losses but also to rising unemployment and

240 W. Koeth, *Can the Investment Court System (ICS) Save TTIP and CETA?* EIPA working paper, 2016/01, https://www.eipa.eu/wp-content/uploads/2017/11/20161019072755_Workingpaper2016_W_01.pdf.

241 G. Van Harten cited in Corporate Europe Observatory, *The Great CETA Swindle*, issue brief November 2016, p. 7, <https://corporateeurope.org/sites/default/files/attachments/great-ceta-swindle.pdf>.

242 T. Stoll, *ibidem*, p. 5.

243 P. Kohler and S. Storm, *CETA Without Blinders: How Cutting ‘Trade Costs and More’ Will Cause Unemployment, Inequality and Welfare Losses*, GDA Working Paper 16–03, Tufts University, 2016, http://www.ase.tufts.edu/gdae/policy_research/ceta_simulations.html.

244 *Ibidem*, p. 4.

inequality, with negative implications for social cohesion in an already complex and volatile political context.²⁴⁵

In this chapter we saw procedural and substantial deficiencies in the new generation of modern free-trade agreements. Secrecy of talks with only retrospective involvement of the parliament, under-representation behind the negotiating table are procedural issues that should be addressed. From the perspective of substance, the underlying premises of free trade as something automatically and universally beneficial to all of the participants, should be addressed. The role of governments, regulatory authorities, domestic legal system should be addressed, too. While there is a process of ongoing expansion of rights and protection of international investors, this process is not balanced with an expansion of responsibilities of these investors. As a consequence, public goods and values, enshrined in the EU treaties, are under growing pressure. The challenge ahead of us is to rethink the current direction of free-trade agreements and a current global trade regime so that it may become more conducive to decentralization, more inclusive, and see more sustainable development than we witness at present.

GOOD, BAD AND HIDDEN PROTECTIONISM

Protectionism is one of the most controversial and misleading points of discussion within the domain of trade theory. It is controversial, because a sharp cleavage exists between free traders and protectionists, whereby the proponents of free trade are portrayed as champions of economic literacy, historical understanding and advocates for overall prosperity, whereas protectionists are portrayed as economically ill-equipped, economic nationalists and potentially dangerous to the stable world economy. Such a dichotomy is unhelpful, because it does not lead to the productive and constructive discussion about the role of trade. Above all, it masks the much more complex history of trade development and the broad space between the two extremes.

Some of the leading experts in trade theory and economic development have pointed to the historical fact that all of today's leading world economies used a variety of protectionist measure in the early stages of their economic and social development.²⁴⁶

245 Ibidem, pp. 30–31.

246 H.-J. Chang, *Bad Samaritans: The Myth of Free Trade and The Secret History of Capitalism*, Bloomsbury Press, 2008.

The United States, for example, belonged to the group of the most protectionist countries in the late nineteenth and early twentieth centuries. As analyzed by Ha-Joon Chang, tariffs on manufactured imports were at 40 – 50 percent until the First World War and were the highest of any country in the world. In addition to the high level of tariffs, the United States developed and practiced infant industry protection to nurture a range of developing industries. The government supported an extensive range of agricultural research, promoted the development of infrastructure and invested in research and development. The disreputed Smoot-Hawley Tariff Act was enacted in 1930 at the peak of the Great Depression and widely regarded as one the crucial measures in triggering an international trade war and exacerbating the economic crisis. However, as observed by Ha Joon Chang, the Smoot-Hawley act “only marginally increased the degree of protectionism in the US economy... the average rate of tariff on manufactures in 1925 was 37 percent and rose to 48 percent in 1931” (Ha-Joon Chang, p. 29). Therefore, it was more about the timing of the enacted tariff than the actual tariff increase that provoked an international tariff war.²⁴⁷

A closer and more nuanced look at the development of other countries which today belong to the most developed countries in the world show that virtually all of the leading economies in the world practiced various forms of protectionism. “Thus, practically all of today’s rich countries used nationalistic policies (e.g. tariffs, subsidies, restrictions on foreign trade) to promote their infant industries, though the exact mix policies used, as well as their timing and duration differed across countries”²⁴⁸

Similar to the discussion about good, mediocre and poor trade equilibrium, which shows that trade agreements are not always and automatically beneficial to all of the participants of the trade agreement, the discussion about protectionism can show that the issue is far from satisfactorily resolved, at least to the scholars, experts and practitioners who are interested in the actual context of economic development and trade practice as opposed to the mythical retroactive interpretation of economic and trade development.

To avoid any misinterpretation or misunderstanding, this section should not be understood as a plea to return to the tariff wars, trade wars or other harmful policies of the past. The argument of this section is that, if the goal of trade agreements is to secure more balanced, inclusive and sustainable international development, a certain moderate and time limited level of domestic protectionism may be

247 Ibidem.

248 Ibidem, p. 44.

necessary at certain phases of socio-economic development. The purpose of such limited measures is not to harm other trading partners but to restructure domestic industries before re-entering international trade.

Such temporary and limited opt-outs were a frequent practice under a more flexible GATT regime, as noticed by Roberto Unger in his analysis of the international trade framework. He believes that temporary opt-outs should be further exploited to reconcile maximization of free trade with alternative national development strategies. According to this novel and innovative thinking, the explicit temporary opt-outs should be conducted through multilaterally agreed procedures, and they should come with a price – a temporary loss of access to other countries' markets.²⁴⁹

Once we accept that a certain temporary breathing space may be necessary even for the leading economies in the world to restructure the companies and retrain the workers, we may start thinking how to incorporate more explicit, transparent rules of opt-outs, as suggested by Roberto Unger, or temporary protectionist measures, as suggested by Ha-Joon Chang, into the international trade system. Such a move would allow even the leading economies in the world the use of adjustment protectionism during periods of major economic crisis, periods of unsustainable balance of payments, and periods of major industrial restructuring, such as the introduction of new, green technologies in various industrial sectors. Equally important, a recognition that even the leading economies in the world need breathing space will yield more breathing space and more instruments to the middle income and developing countries in their efforts to climb from the periphery and semi-periphery.

A good form of protectionism is a form of protectionism that is transparent and announced by the country that is applying certain protective measures during a period of restructuring and that is multilaterally agreed to by the participants of trade agreements. A good form of protectionism pursues the goal of reinventing domestic industries and markets. In contrast, protectionism is bad when the country implementing it is pursuing measures that hurt primarily other trading partners. All forms and measures of bad protectionism should be explicitly prohibited and penalized by international trade rules. There may be a thin line between good, legitimate forms of domestic protectionism and bad, harmful protectionism, but the international legal and economic professions together with developed international trade jurisprudence can draw a sufficiently clear line between acceptable, legally valid forms of protectionism and unacceptable, illegal forms of harmful protectionism.

249 R. Unger, *Free Trade Reimagined*, Princeton University Press, 2007, p. 181.

If such a transparent, limited and moderate protectionism is not permitted under the current international legal trade regime, then countries will occasionally be tempted to apply various hidden protectionist measures. According to the annual review of global trade practices, *Global Trade Alert*,²⁵⁰ during and after the global financial crisis, all of the G20 members resorted to various protectionist measures at the outset of the crisis despite pledging the opposite. The first peak of measures was in 2013 and the second in 2015. Even in 2017, however, in addition to the protectionist measures of the United States, other countries, such as India, Russia, Argentina, and Germany continue to resort to various protectionist measures. The *Global Trade Alert 2017* concluded that there is a diplomatic fiction in the G20 that protectionist measures have been tamed. Of all the distorting protectionist measures, the most widely used are tax-based incentives for exporters in various forms (for example, lower taxes on inputs and rebates for firms that export), other export incentives, public procurement localization, bailouts, local sources, tax or social insurance relief, and many others (pp. 25–26).²⁵¹

The *Global Trade Alert 2017* assessment of trade distortions is significantly broader than the evaluation of trade distortion by the WTO. It is not a purpose of this article, however, to discuss the differences between these two methodological approaches. The purpose of this article is to show that the debate about the scope and use of protectionist measures is far from completed. It is a goal of this section to show that the current international trade framework does not conceptually and practically solve all of the trade practices – beneficial or harmful – of the developed and developing countries.

The debate about various forms of protectionism is far more complex than conventionally deemed. There are historical and contemporary examples of when protectionism can serve legitimate economic and social purposes. The need to protect infant industries, to restructure industries in times of major economic turnaround, and to create the necessary breathing space in times of persistent economic imbalances are examples of legitimate protectionist measures. In addition, the developing and middle-income countries should be allowed more instruments and policy measures to reach the highest levels of competitiveness and socio-economic development.

On the other hand, measures that exploit the weaknesses or economic difficulties of other trading partners and “beggar-thy-neighbor” policies amount to bad

250 *Global Trade Alert, Will Awe Trump Rules?*, CEPR, London, 2017, <https://www.global-tradealert.org/reports/42>

251 *Ibidem*, pp. 25–26.

protectionism. Bad protectionism inevitably leads to conflicts between trading partners. The mechanisms of dispute resolution under the current WTO regime can keep trade disputes in check. Even though the WTO has managed the period after the international financial and economic crisis with relative success and has prevented the escalation of trade protectionism, the backlash against the recent decisions of the WTO dispute settlement panels is growing among some of the leading industrial countries. The United States, for example, is bringing the highest number of complaints to the WTO dispute settlement panels and wins far more cases than it loses. As calculated by Gregory Shaffer, the United States wins approximately 78% of its claims as a complainant in comparison with 69% for the rest of the membership.²⁵² Yet, there is a growing belief in the United States that the WTO is undermining the American trade position. The recent backlash of the United States against the WTO jurisprudence runs contrary to the conviction among many trade experts²⁵³ that the WTO dispute settlement regime is far from neutral and that its many substantive and procedural rules primarily favor the leading industrial countries.

To avoid an unproductive debate about the way in which the WTO rules and jurisprudence are allegedly biased, the more productive debate should aim at new proposals how to accommodate the needs of excluded workers in the developed, the middle-income and the developing countries.

The present international trade arrangement proved to be relatively stable during the period of prolonged crisis. At the same time, the crisis exposed many contradictions and inequities of the current international trade system. During the crisis, the leading industrial countries abundantly recapitalized their financial sectors. Europe and the United States subsidized the automobile industry. The international trade rules do not prohibit massive subsidies in agriculture, again abundantly applied by the United States and the European Union, and they tolerate research and development subsidies and subsidies that address regional inequalities. The reform of the international trade regime should move in the direction of opening more policy space, allowing more instruments and

252 Gregory Shaffer, Manfred Elsig and Mark Pollack, *The Slow Killing of the World Trade Organization*, Huffington Post, November 2017, https://www.huffingtonpost.com/entry/the-slow-killing-of-the-world-trade-organization_us_5a0ccd1de4b03fe7403f82df

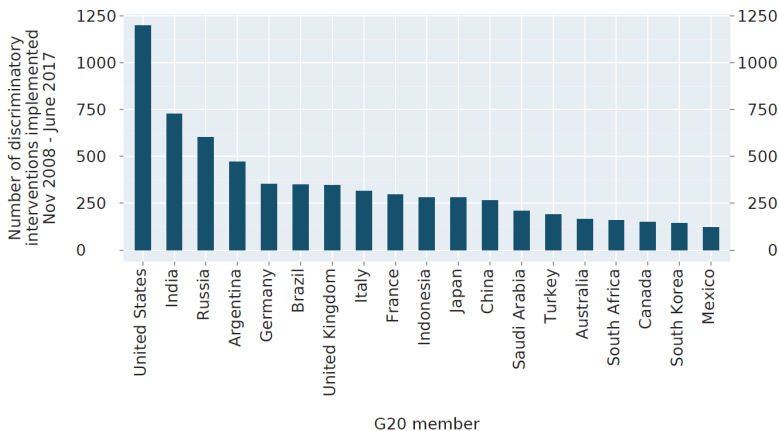
253 Gregory Shaffer, *How to Make the WTO Dispute Settlement System Work for Developing Countries*, working paper, March 2003: https://www.peacepalacelibrary.nl/ebooks/files/ICTSD_Shaffer_How-to-Make.pdf

measures when legitimate socio-economic needs of developed and developing countries must be addressed.²⁵⁴

Of all forms of protectionism described in this section, the most harmful is a form of hidden protectionism. The Global Trade Alert is right to warn that the hidden forms of protectionism, not identified by the current WTO system, may lead to future trade conflicts over subsidies and attempts to steal export market shares from foreign rivals (p. 6). If such a conflictual trend escalates, the management of future trade regimes might spiral out of control to the detriment of all participants. To avoid such a negative scenario, a rethinking of trade rules toward transparent, time limited and negotiated measures should be adopted by all trading partners. The less developed countries in greater economic stress should allow more measures and policy instruments; the most developed countries in recession or other significant socio-economic distress should recognize more limited measures and policy instruments.²⁵⁵

FIGURE 6.1

A ranking of G20 members according to the total number of protectionist measures implemented since the first G20 Leaders' Summit in November 2008



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254 M. Draghi in his speech about the need to maintain multilateral and open international trade system made an interesting distinction between the need for protectionist regulatory measures to ensure fairness, safety and equity and a risk of lapsing into protectionism over time: Sustaining Openness in Dynamic Global Economy, speech by M. Draghi, President of the ECB, at the Economy Policy Symposium of the Federal Reserve Bank of Kansas City, Jackson Hole, 25 August 2017: <https://www.socialeurope.eu/mega-regional-trade-agreements-what-agenda-for-social-democracy>.

255 Global Trade Alert 2017, p. 31., Figure 6.

TRADE RULES, MULTILATERAL TRADE INSTITUTIONS AND BILATERAL TRADE AGREEMENTS – MORE MANEUVERING ROOM TO SECURE SUSTAINABLE DEVELOPMENT FOR ALL TRADING PARTNERS

Every trade regime and every trade agreement has distributional effects. In any of the participating parties, there are industries, firms, employees and consumers that may benefit from the trade agreements, and there are industries, firms, employees and consumers that may be put under more stress. The new generation of free trade agreements did not develop mechanisms to compensate the sectors of economy and society that lose out from the trade liberalization. The first and most obvious step to alleviate the negative impact of trade agreements would be to tax the surpluses from the trade agreements and compensate for the losses.²⁵⁶

The mechanism for redistribution from the created new wealth cannot solve all of the problems posed by the new generation of free trade agreements. Among the most problematic points of the new generation of free trade agreements are the following: the expansion of corporate rights and safeguards without simultaneous expansion of their legal responsibilities; the loss of regulatory autonomy of the trading partners; irreversible process of liberalization and privatization of traditional public services; lack of sufficient tax obligations of the multi-national companies and others. The publicly most controversial ISDS clause (in case of CETA agreement ICS clause) is only the tip of an iceberg of problematic direction of the new generation of free trade agreements.

Popular backlash against free trade agreements is growing. It is not the first and most important social and economic challenge of the excluded parts of the population in the developed and developing parts of the world. Other policies, such as continuation of austerity, insistence on further privatization, structural adjustment, low levels of investments in infrastructure and low levels of social investments are all pointing in the same direction. They are widening a gap between a segment of the relatively privileged part of society and a majority of people without sufficient economic and social opportunities. This phenomenon of economic and social dualism is a pattern that can be observed not only in the developing countries, but also in the middle-income countries and the most developed countries in the world. The processes of globalization in its present context are going

256 D. Rodrik, *Straight Talk on Trade: Ideas for a Sane World Economy*, Princeton University Press 2018, kindle edition: he discusses why it is too late to focus merely on compensation for the losers of globalization, loc. 2982 and the following. He offers comprehensive alternative set of rules and institutions in Chapter 10, *New Rules for the Global Economy*.

in the direction opposite from inclusive and balanced development. They are not going in the direction of shared global prosperity toward sustainable and equitable development.

It is still not too late, however, to reverse these trends. In the area of multilateral and bilateral trade agreements, the developing countries should be granted special and differential treatment in its expanded, operational version, as envisaged by the Doha Ministerial Declaration. The developing countries, in their efforts to integrate with the world economy, should on their pathway retain the right to articulate and implement their own development strategies and exploit their own productive potential. Successful examples of some developing countries in escaping the poverty trap and dependency on international aid can serve as a source of encouragement for other developing countries and for the international community as a whole.

The middle-income countries, such as Mexico, should be encouraged and allowed to develop strategic partnerships between the public and private sectors, while integrating with the world economy. The goal of such a strategic partnership is to disseminate good practices, advanced technologies and know-how from advanced, integrated sectors of the economy to the excluded, informal sectors of the economy. The rise of productivity of all factors should be linked to the improvement of labor standards, and enhanced investments in education and the training of workers, young entrepreneurs, and farmers.

When the United States entered the NAFTA agreement, many large American companies benefited from this trade agreement. The benefits and social costs of the trade agreements were shared unevenly. Cullen Hendrix has pointed out that free trade was not accompanied by a rise of social protection and that the United States lags behind in government spending. Such an exposure to trade with minimal social protection for American workers led to the rise of protectionist sentiments in the United States. Without launching new government spending and compensatory programs to address technological and trade shocks, the rise of protectionism, even populism and perhaps future trade wars may become realistic possibilities.²⁵⁷

257 C. Hendrix, *Protectionism in the 2016 Election: Causes and Consequences, Truths and Fictions*, Policy Brief, Peterson Institute for International Economics, November 4, 2016, <https://piie.com/publications/policy-briefs/protectionism-2016-election-causes-and-consequences-truths-and-fictions>

See also the debates on the relation between globalization and populism in A. Grizold and M. Svetličič (eds.), *The Emerging New World Order: New Trends Calling for New Answers*, Teorija in praksa, posebna številka, št. 56, maj 2019. For the debates on the relation between

Compensating the excluded parts of society, employees and small businesses would be a step forward in correcting the negative impacts of trade agreements. Rearranging trade agreements and the work of international tribunals to include labor protection safeguards, social welfare provisions, environmental protection at the same level of enforceability as the corporate safeguards would be a step toward common prosperity. Taxing multinational corporations in the countries where they generate revenues would contribute to the leveling of the playing field between the multinational companies and the hosting governments. Clear rules on the taxation of multinational companies, while preventing any tax avoidance, and implementing sophisticated accounting practice with the proper control of taxing authorities, would also significantly improve the deficiencies of the free trade agreements. Protection of public goods and for this reason preservation of necessary regulatory autonomy by the governments is another step in balancing the new generation of trade agreements. The level of liberalization of public services, the extent of privatization, and the extent of public and mixed ownership is something to be primarily determined by the trading partners themselves, not by the trade agreements.

CONCLUSION

It is neither possible nor desirable to return to the regime that was developed after World War II. New global challenges, such as environmental issues and growing social disparities in the developed and developing parts of the world are some of the reasons why it is not possible to simply review the post-war trade, financial and monetary international arrangement. While it is not possible or desirable to return to the past, it is possible to apply and adjust some of the premises and principles that proved successful in the past. For example, more flexibility and broader maneuvering room for the members of the GATT regime was allowed in the early post-war period.

One of the measures of modern industrial policy, the rules on state subsidies in cases of restructuring and selective turnaround of industries, should again become less restrictive. These are the measures that were abundantly used by the developed countries in the past before they were reaching competitive edges in various industries. On the basis of establishing stronger cooperation between the public and private sectors of the national economy, Roberto Unger suggested there should be a “heavy presumption against outlawing subsidies.” Only in cases

EU law and populism see F. Bignami, *EU Law in Populist Times: Crisis and Prospects*, Cambridge University Press, 2019.

of direct interventions for changing the cost structure of export products could the negotiated compensatory measures be contemplated.²⁵⁸

The idea of flexibility received a qualified proposal in the form of temporary opt-outs from the international trade regime. The proposal was to allow countries to temporarily opt-out from the trade in the period of comprehensive restructuring of their economies. Such opt-outs should be negotiated multilaterally and with the following price: “a county will lose access to other countries’ markets to the extent it closes its own market.” Despite this price, Roberto Unger is convinced that explicit opt-outs are more transparent and more in favor of economic, political and social pluralism than the currently existing partial opt-outs in the areas of entrenched agricultural protection for the rich countries.²⁵⁹

To achieve the “possibility of coexistence among different development strategies, institutional systems, and forms of social life... the room for national and regional diversity, deviation [and] heresy” must be created. For Roberto Unger, a reconciliation between global openness and coexistence of variety of institutional models are more important goals than merely maximizing free trade.²⁶⁰ The idea of “one institutional size fits all” underlies the current international trade, economic and financial framework. The underlying assumptions of the Bretton-Woods compromise are tailor-made solutions, institutional innovations and decentralized development based on public–private cooperation.

The varieties of institutional models, suitable to the potential and comparative advantages of different regions and countries around the world, can offer more balanced, inclusive and sustainable development in the future. It can address the problem of persistent structural imbalances of the world economy. Global markets do not presuppose identical institutional and policy arrangements in all the diverse member states and their regions around the world. Different institutional arrangements stem from different traditions and decision-making processes. The world trade regime should not stall further development of various institutional arrangements. The international regulatory framework is not necessarily incompatible with the diverse institutional structures of the member states.

Comparative institutional analysis shows that despite a widespread assumption that the processes of globalization would inevitably lead to institutional convergence of different national socio-economic models, in practice the continuation of a variety

258 R. Unger, *supra* 183, p. 181.

259 *Ibidem*, 181.

260 *Ibidem*, 180.

of market economies can be traced. The study of comparative institutional development, at least in the process of Europeanization, concluded that the member states used different strategies to retain, adjust or when it suited their comparative advantages, changing institutional and domestic regulatory regimes when seeking compromises in the context of multilateral cooperation.²⁶¹ In so doing, institutional convergence was not a prerequisite for the successful development of any kind of international integration.²⁶² It is equally plausible to assume that institutional diversity and coexistence within any kind of multilateral organizations should not be hindered but rather supported when establishing the common framework.

Free trade is not a goal in itself. Maximizing the volume of trade and investments around the world does not automatically translate into higher growth and employment rates. It does not also automatically lead to more inclusive, balanced and diverse development.

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261 On the normative analysis with respect to many controversial elements of mega-regional trade agreements and also about the necessary improvements see M. Bartl, *Mega-Regional Trade Agreements: What Agenda For Social Democracy?*, Social Europe Journal, July 6, 2018, <https://www.socialeurope.eu/mega-regional-trade-agreements-what-agenda-for-social-democracy>.

262 O. Fioretos, *The Domestic Sources of Multilateral Preferences: Varieties of Capitalism in the European Community*, in:] P. Hall and D. Soskice (eds), *Varieties of Capitalism: The Institutional Foundations of Comparative Capitalism*, Oxford University Press, 2001.

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CONCLUDING REMARKS

The European Union is standing at a crossroads. Behind it is a turbulent decade of multiple crises, austerity, and uneven recovery. Brexit, which preoccupied the European Union over the last few years, is only the external expression of its conceptual, institutional, and policy weaknesses. Other external expressions can be seen in the slide toward authoritarian regimes in some parts of the European Union – usually labeled as the slide toward illiberal democracy – as well as the emergence of populism in other parts and the uncertain role of the European Union on the international stage.

The search for a coherent, sustainable institutional structure and governance started with the Convention on the Future of the European Union, followed by the greatest expansion of the European Union. This was a period full of enthusiasm and optimism related to the promising future of the European project.

The financial crisis has exposed the vulnerabilities of the EU at the policy level and in terms of institutional resilience, and it has revealed many dividing lines within the Union. Perhaps most importantly, the crisis has revealed conceptual deficiencies of the institutional design and many of the policies articulated by the common European bodies. The chapters written in this collection of essays has sought to engage, critically assess, and above all point to the not-yet-sufficiently-explored alternative pathways for the future development of the European Union. These chapters stem from the observation that the current discourse on the European project could and should be opened to more institutional possibilities than to the reduced and simplified binary opposition, such as more or less Europe, more centralization or less centralization, and more markets or more state. The chapters collected in this monograph tried to provide a conceptual framework and practical, encouraging examples of the many unexploited, but potentially workable pathways toward alternative pathways of the European Union.

The discussions in the present collection of chapters do not in any way pretend to cover the entire list of institutional alternatives and possibilities. On the contrary, these texts were written as encouragement to expand and enrich the current and future debates on the European project with the institutional opportunities and innovations fit for the purposes of the modern, knowledge-based economies and societies. If a meaningful and substantive debate on the democratic future of the European Union really takes place, it should be viewed as an opportunity to engage with as many stakeholders and other participants as possible.

The most important institutional innovations in the European context can emerge from the initiatives, collaboration, and engagement of European citizens, local communities, and regions as well as the independent civil society, groups of experts, trade unions, non-governmental organizations, and other stakeholders. If carefully designed, the European model can maintain and deepen democratic decision-making processes at the national and supranational levels, expanding the space for national autonomy and strategic development as well as strongly defined common standards of human rights, rule of law, labor protection, social welfare, and environmental protection.

As stipulated in the Lisbon treaty, the European Union is a highly competitive social market economy. It shall promote scientific and technological advances. It shall promote economic, social, and territorial cohesion in addition to solidarity among member states. Too many of these programmatic provisions were overlooked and forgotten during the decade of crisis. Too many policies adopted in the last decade went contrary to some of the basic principles and provisions of the Lisbon treaty. The chapters on regional inequalities, narrowed and rigid common fiscal rules, and weakly defined industrial and other development policies showed that the better design of these policies in the last decade – and much closer to the principles of the introductory clauses of the Lisbon treaty – could and should influence a substantially different outcome for not only the stagnating regions, economies, and people across the EU, but also many of the excluded people and social groups in the most developed countries in the EU. Several chapters of this monograph have tried to show that the transfer of the European Union – for which some experts argue convincingly while other experts have similarly convincing reservations – is neither the most optimal nor the most desirable outcome of its future development. There are other, more innovative and more creative alternative pathways to establish more cohesive, more inclusive and balanced socio-economic developments of the EU and all of its member states.

The rich tradition of European social and liberal democracy can present a source of inspiration for future developments of the European Union. Some of the most cohesive and competitive European regions offer a source of encouragement – not in the sense of mechanically copying the institutional framework and strategies of these regions, but rather searching for other institutional possibilities and regional comparative advantages of stagnating regions across the EU. Such a dynamic and constant search for improvements and innovations in diverse parts of the European Union was presented in the chapter contemplating the possibility to develop experimental federalism – as opposed to a technocratic, one-size-fits-all, and top-down imposed model of economic and social orthodoxy. The subtle coordination of policies and improvements on the national and supranational levels can open up space for new opportunities, new ideas, and new initiatives in the EU.

It can open space for participation, engagement, and creativity in place of orthodoxy and rigidity, which are ever more frequently driving away European citizens and voters from the European project.

Such a reinvented European social market economy can again become a model of inspiration and hope for other parts of the world. Current global, financial, trade, social, and environmental imbalances are not sustainable. The European Union can and should lead the way toward more sustainable, more inclusive, and more balanced globalization. A reinvented social market economy can give the European Union a voice and clout in the multilateral institutional context. The re-imagination of the European trade policy and trade agreements on the basis of an inclusive, sustainable social–market economy offers the opportunity to align its trade policy with the Lisbon provision of free and fair trade and to foster the sustainable economic, social, and environmental development of developing countries, as stipulated by the Lisbon treaty.

Finally, the monograph itself is an invitation to the readers, scholars, and experts to engage actively with the future development of the European project. Instead of leaving the project to the cunning of historical reason, it is on us to debate, shape, and reshape the European project according to the programmatic provisions and visions of a more inclusive and cohesive European project in the future. There are many more areas of discussion that go beyond the scope of this monograph, such as culture, education, research, and science, as well as many other important areas. By exchanging, disseminating, and articulating conceptual ideas and practical steps, we may at least try to reinvent the European project to fit the purposes and challenges of the modern era.

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