



Think Global – Act European

The Contribution of 16 European Think Tanks to the Polish, Danish and Cypriot Trio Presidency of the European Union

Directed by **Elvire Fabry**, Notre Europe





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PREFACE

At a time of intense debate over such symbolic achievements as the euro and Schengen, the difficult task of presiding over the Council falls to Poland, Denmark and Cyprus. These countries have a chance to help shape the future of European integration.

Europe's economic and financial crisis was of historic proportions and its negative social and political effects are still being measured. The twin challenges of the environment and energy remain at the top of European and international agendas. The "Arab spring" is an opportunity for the EU to lay the foundations of a new partnership with its neighbours. Across the world, powerful and emerging countries alike continue to assert themselves, on the basis of more or less cooperative relationships with Europe.

In these complex and stimulating circumstances, the Polish, Danish and Cypriot Trio Presidency will be able to make use of the newly implemented Lisbon Treaty to coordinate its action with that of the President of the European Council. The Trio will be able to focus on implementing the policies and projects that the European Union needs – and which this report aims to inspire.

A product of multinational, multicultural cooperation, with contributions by 16 eminent European think tanks, this third report lives up its title, "Think Global – Act European". Given the current trend of national introspection, such a credo is more necessary than ever. In an increasingly globalised world, the merits of the go-it-alone approach are unconvincing. EU countries have an interest in being "united in diversity".

To illustrate this motto, Notre Europe coordinated the report in conjunction with an editorial committee composed of three think tanks based in the countries of the Trio Presidency: demosEUROPA, the Danish Institute for International Studies, and the Cyprus Center for European and International Affairs. In the same spirit, some of the report's 54 contributions were co-authored. And to show that European aims can converge, the report highlights a short list of concrete recommendations for action.

As the new president of Notre Europe, I am proud to present the fruit of this deep cooperation between think tanks. I would like to thank them for their constructive efforts.

To the Trio Presidency, to the President of the European Council and to all decision-makers and interested observers, my wish is that the analyses and propositions in this third TGAE report serve as food for thought and action during the upcoming semesters.

Antonio Vitorino President, Notre Europe

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INTRODUCTION

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Stress tests for EU governance

These are the times that try Europe's soul. Over the past 18 months – under the auspices of the Spanish, Belgian and Hungarian Trio Presidency of the European Union (EU) – EU leaders have had to test their mettle. Not only did they have to boost Europe's economies and implement the Lisbon Treaty, but they were also obliged to salvage the euro and preserve the Schengen Area – two of the EU's greatest achievements. These stress tests – which have not yet subsided – have caused Europe as a whole to undergo unprecedented levels of division and duress, testing whether Europeans are determined to stay united.

Yet, overall, the Community decision-making system has demonstrated an extraordinary capacity for reaction. Not only has the number of initiatives been great – all taken in less than a year, between spring 2010 and 2011, but their importance has been too, notably in relation to economic governance. Regarding fiscal, macro-economic and financial surveillance, European leaders were forced to invent mechanisms for crisis management that did not exist prior to the sovereign debt crisis.

Nevertheless, the future might be just as testing. It is yet too soon to conduct an in-depth assessment of the EU's crisis management. Will the turn-of-the-decade crises trigger a federal leap within the EU or will the EU remain fragile and in danger of backtracking from the current *acquis*? From now until spring 2012, we will not know whether the EU's initiatives – such as the European Semester, the Euro-Plus Pact and the reform of the Stability and growth Pact – are effective tools for coordination. And it is still an open question whether the measures strengthened mutual confidence in Europe.

This said, by simply looking at the growing impact of international affairs, the safe prognostic is that Europeans will have to get used to this type of crisis management. More and more, unexpected events will require Member States to collaborate; the debate on the Schengen Area – triggered by North African migrants arriving on Europe's shores – is just the latest example of this.

What is left to the rotating presidency?

New power relationships resulting from the Lisbon-reforms and more co-decisions involving the European Parliament – in increasingly sensitive policy areas – may generate further complexity and political tension in the EU's political system.

The rotating presidency's political role was limited during the financial crisis and it has since then not addressed the most difficult dossiers. But its “administrative leadership”, which guarantees successful legislative negotiation, has proven to be crucial. The rotating presidency's responsibilities – such as chairing the Council, committees and working-group meetings (except for the Foreign Affairs Council and committees, chaired by the High Representative of the Union for Foreign Affairs and Security Policy) and organising, behind the scenes, legislative procedures – will continue to be vital to the proper functioning of the EU.

Although the Polish, Danish and Cypriot Trio Presidency (July 2011-December 2012) can co-shape some of the priorities on the EU's agenda, it will nevertheless continue to be only one of many agenda-setters. The crisis-context has, in and of itself, forced priorities into the Community agenda, thus leaving the rotating presidencies with less room for promoting priorities linked to their own interests. But it worth mentioning, that following the French Presidency's launch of the Union for the Mediterranean and the Swedish Presidency's inauguration of the Baltic Sea Strategy, the Hungarian presidency has successfully implemented its project for sustainable development and environmental protection in the Danube macro-region – i.e. the EU Danube Region Strategy. Until now, forming a Trio out of three rotating presidencies has not brought many benefits. Strengthening their cooperation could however enforce their agenda setting capacity and would foster consensus during Member States negotiations. This is why, in this report, the term “Trio Presidency” is given preference whenever appropriate.

The rotating presidency – formerly a key function within the EU's institutional landscape – is now greatly counter-balanced by the permanent Presidency of the European Council. If the rotating presidency wants to regain visibility and influence, it will have use the Lisbon Treaty to its advantage. The role of the General Affairs Council (GAC) should be reaffirmed, notably by politically channelling the work of the council formations or by sometimes upgrading issues from the Council level to the European Council level. Having the prime minister of the rotating presidency chair the GAC would allow for a stronger GAC – without having to amend the treaties.

The Trio Presidency should also waste no time in joining forces with influential Member States, who gain relative importance through their direct access to the European Council president.

Moreover, if it wants to define the EU's political priorities, the Commission will also have to become more assertive. On one hand, this would limit the Trio's agenda-setting scope even further, but on the other, if the Trio and the Commission agree to jointly push issues onto the political agenda, they could develop a productive alliance.

With regards to the European Parliament, the Trio Presidency's involvement should not only be sought in legislative, day-to-day work. Given its manifest interest in increasing its political role in economic governance, the Parliament can provide an important political forum for the Trio. The Parliament is, in any case, an influential player: as seen in four of the so-called Rehn-Package's legislative acts, but also in upcoming Single Market legislation. The European Parliament will likewise seek to extend its role informally when the new mechanisms for economic policy coordination are put into place. The Trio Presidency should thus serve as an honest broker not only between Council members, but also between the Council and the European Parliament. Without this strong role for the Trio Presidency, the institutional system risks further destabilisation – mostly due to the European Council exerting a dominant position.

Finally, a good working relationship between the rotating presidency, the European Commission and the European Parliament would make it possible to both supersede early inter-institutional compromises on co-decision matters, and, more broadly, to consider the political and legal implications, at the national level, of extending the use of the Community method to important policy issues – transfers of competence that constitutional courts may be inclined to scrutinise more intensively.

Economic governance and financial regulation

Over the next year-and-a-half, the EU's two main priorities will continue to be monetary stability and economic growth. Since the Trio Presidency chairs the Economic and Financial Affairs Council (Ecofin), it will be involved in the management of the sovereign debt crisis and the fragility of the banking system. In addition to activating financial solidarity mechanisms and ensuring Member States properly implement economic governance reform (i.e. the European Semester, the Euro-Plus Pact and the European Stability Mechanism), the Trio Presidency will have to focus on regulating undercapitalised banks.

Two factors here will restrict the Trio's role. First, in the case of another severe debt crisis, the European Council will very probably once again find itself in the driving seat. Second, most issues will have a strong eurozone-dimension and will thus be debated in the Eurogroup – chaired by the Eurogroup president – in which the Polish and the Danish are not present. However, if a crisis hits the banking sector, the Trio Presidency could be helpful regarding the cooperation that will be needed in the EU 27 as a whole. Furthermore, the EU could also face a political crisis if the government of one or more Member States in a critical state were to deviate from reform agendas – the 2011-2012 period will most likely be marked by an increased polarisation between core and periphery Member States.

Economic growth

EU leaders recently set-up several projects that will buttress European growth policies: namely, the Europe 2020 Strategy, designed to turn the EU into “a smart, sustainable and inclusive economy”; the Single Market Act, to improve the functioning of the Single Market – a crucial prop for other European policies; and a review of Cohesion Policy, designed as the leading development and investment policy for closing the Member States' competitiveness gap.

Implementing this plethora of European strategies will require a high degree of coordination. Such coherence between strategies would not only help avoid overlap, but would also increase citizens' understanding of “what the EU does”. And increasing the complementary nature of all policies can foster more trust in the EU. To achieve this, cohesion among Member States, and within Member States, should be fostered in conjunction with the current competitiveness criterion – the risk of seeing a two-speed Europe develop, with growing economic-performance gaps among the 27, is a *leitmotiv* in the 2011 edition of *Think Global – Act European*.

As a core community competence, the Single Market is one of the domains where the Trio Presidency has the most opportunity to prove its value. It is a crucial actor in the legislative negotiations between Member States within the Council, and increasingly between the Council and the European parliament. In order to improve the implementation of Single market legislation, both stronger political consensus regarding the adoption of the Single Market Act and a greater implication of regional and local actors are paramount. Concerning legislative negotiation, rather than adopting pick-and-choose tactics – which tend to paralyse ambitious projects – the Trio should thus go back to the “package deal technique” advocated by former Commissioner

Mario Monti. This technique involves bundling legislative measures into complete packages, which are then considered in their entirety – thereby facilitating across-the-board trade-offs.

Multiannual Financial Framework 2014-2020

To this picture, the institutional agenda adds the major issue of negotiating the forthcoming financial perspectives for 2014-2020, which is due to commence under the Polish Presidency. In light of the public-finance cuts being implemented at the national level, these negotiations look set to be particularly complex. The political authorities tasked with conducting the negotiations in the General Affairs Council should honestly explain to their fellow citizens that while a 1-percent-of-EU-GDP budget cannot be a panacea for re-launching economic growth, it can still have a significant effect on particular policy domains and territories.

One important responsibility for the Polish Presidency is to start the negotiations with a debate on Multiannual Financial Framework (MFF) priorities (improving policy targeting and programming of two major spending, namely Common Agriculture Policy and Cohesion Policy). Following this, the negotiations should focus on how the budget should be distributed. Determining from where the funding will come should only take place at the end of the negotiation. Placing discussion of concrete numbers at the end will help conduct a transition from concentrating on Member States' "net positions" towards a focus on European Value Added and European public goods. To convert the next MFF into an effective tool for re-launching the economic growth, the Trio should look for ways to increase the efficiency of EU spending, notably by improving coordination between national and EU spending (in diplomatic services, defence or research, for example) and by rendering EU spending more responsive to economic fluctuations. The overall coordinating function of the Trio should be to insist on aligning the next MFF with the promotion of low-carbon outcomes.

Area of Freedom, Security and Justice

In the area of Freedom, Security and Justice – which is run by the rotating presidency alone, the implementation of the Stockholm Programme, its attendant Action Plan, the Internal Security Strategy (ISS) and the Commission's Communication entitled "Internal Security Strategy in Action" will all be the object of greater public attention. Furthermore, the debate on the Schengen Area – relating to Bulgaria and Romania's future accession and, more recently, to media coverage of North-Africans migrants arriving

in Italy – calls for a new consolidation of EU immigration, border control and asylum policies. Asylum rules need to take into account Member State's lacking-resources; and concerning labour migration, this issue should not be regarded as a security threat, but more as a potential contribution to sustainable growth.

Foreign policy

As far as foreign and security policy challenges are concerned, the entry into force of the Lisbon Treaty has shifted responsibility to the Union's High Representative (HR) for Foreign Affairs and Security Policy. The HR, together with the newly established European External Action Service (EEAS), has stripped the rotating presidencies of a large part of their agenda. But the HR and the EEAS cannot go it alone. The Member States remain the key players in foreign and security matters. In order to facilitate the HR's work, the rotating presidencies must continue to be fully engaged and assist the HR and the EEAS in establishing effective coordination mechanisms with the European Council, the Commission and the European Parliament, which will enable the HR and her team to act as interlocutors between them.

In pursuit of interchangeability between national and European administrations, the Trio should furthermore serve as a role-model. It should facilitate the smooth exchange of national diplomats and experts with the EEAS. In third countries and international *fora*, the Trio should encourage cooperation between national embassies and EU delegations, thereby further strengthening the latter's coordination role – cooperation on the ground will be a litmus test for the EEAS. On the domestic front, the presiding government should also start a serious discussion about potential cuts in national diplomatic services, which in the long term could be implemented by the EEAS (consular services, and also reporting on political and economic developments in third countries, for example).

In addition, the development of the Single Market and benefits from market integration should be sought on the international level. The external dimension of internal EU policies – related to trade, energy, climate or the Single Market – is becoming more prominent. The Trio Presidency should thus use its chairs of the Permanent Representative Committee (COREPER), of GAC and of other Council groups and of their preparatory working groups to help uncover inconsistencies between the EU's various different external policies, including the external dimensions of internal policies such as terrorism, migration, asylum, climate change and energy. The Trio

Presidency should also push towards a trade policy that helps promote the Single Market interest and towards a conclusion of the Doha Round.

So far, the new HR and two Presidents – of the European Commission and the European Council – have not been steering the EU in the right direction. During the upcoming period, EU citizens will see whether the EU's new strategy process can overcome bilateral tendencies, China's shrewd negotiation-style – based on the “divide-and-rule” principle, and EU bureaucracy writ large. By working in the EU's engine room and by helping prioritise the Union's interests in each specific partnership, Poland, Denmark and Cyprus will help the EU become a stronger global actor.

Enlargement and Neighbourhood Policy

In light of the Arab uprisings, the auspicious review of the ENP is most welcome. While redesigning the ENP, the EU should compensate for its slow response to pro-democracy demands by getting involved in favour of the democratic transitions in North Africa and the Middle-East. The EU should also not neglect its commitment to the neighbourhood policy (ENP) in the East. A common interest in neighbourhood regionalisation policy, shared by the Hungarian and Polish Presidencies, should allow for a smooth transition between the two Trio Presidencies on this issue. Furthermore, the Trio should ensure that, during the next MFF negotiations, ENP funding is increased to support specific economic and social development projects.

Closer to home, the EU is losing influence *vis-à-vis* candidate countries. Since 2007, bouts of enlargement *fatigue*, in numerous Member States, have stifled prospective EU memberships. But disengagement is not an option. The EU should be as proactive as it once was – the fate of candidates should be seen as affecting the entire EU. Candidates need a clear road map, offering specific requirements for each policy area, thus ensuring that momentum for reform is not lost. At the same time the necessary benchmarks set by the EU for the candidate countries should not in any way be compromised.

The Trio Presidency should help to clarify the division of responsibilities between the European External Action Service (EEAS) and the Directorate-General for Enlargement – especially concerning states that are only potential candidates. In European Union terms, there is a distinction between countries that are negotiating and those that only benefit from the prospect of accession. Currently, enlargement is still the hands of the

Commission, while all enlargement issues are now dealt with by the General Affairs Council (GAC), which continues to be chaired by the rotating presidency and is subject to unanimous decisions on all enlargement issues.

The Council Working Group on Enlargement (COELA) is currently dealing with Turkey, Iceland and Croatia. This means that the rotating presidency's role is limited to the negotiations in the COELA, which mainly decides on the closing and opening of chapters. Thus two subjects of immediate concern to the Trio Presidency are mobility partnerships and visa liberalisation. Turkey's place in EU policies should also be better defined – especially with regard to the ENP and to the Common Security and Defence Policy.

Common Security and Defence Policy

In the area of Common Security and Defence Policy (CSDP), increasing (or at least stabilising) Member States' defence capabilities and strengthening collective European capabilities remain areas of concern. Fragmentation, duplication and cost-ineffective national armed forces are leading to a situation where the collective capability of European armed forces is much less than the sum of its national parts. Europeans need to tackle issues such as the level and manner of defence spending, EU-North Atlantic Treaty Organisation relations (NATO), and the building of a comprehensive approach to crisis management.

Increased pressure on already strained defence budgets and the creation of the EEAS could boost cooperation and integration in security and defence matters. Via its COREPER chair, the Trio could play a role by focusing attention on small, clearly defined initiatives by a few states – which would help the EU deliver success stories and increase Member States' good will. By establishing permanent structured cooperation, the Trio would play a limited, but yet important role as a mediator for small and medium-sized Member States. The Trio can also contribute to security and defence integration by encouraging the liberalisation of the EU defence market, notably by embracing new defence procurement rules and by helping the European Commission to dare to criticise non-compliant Member States.

Finally, to avoid having the EU acting like a coalition of the willing, in which the available means and participants define the CSDP mission, the coming Trio Presidency should – in conjunction with the HR – seek credibility and efficiency by introducing intervention criteria (affordability) and evaluation mechanisms (accountability), all open to public scrutiny at both EU and national-parliamentary levels.

The structure of this report

As in the two previous editions of *Think Global – Act European (TGAE)*, this report focuses on a medium-term scenario, covering the Polish, Danish and Cypriot Trio Presidency, running from July 2011 to December 2012.¹

Focusing on the Trio Presidency has allowed the authors to analyse the development of rotating presidencies' (direct and indirect) role in the context of the Lisbon Treaty, while highlighting, on a sector-by-sector basis, the way in which the role interacts with those of other EU institutions. This explains the attention devoted to external policy – over which rotating duty presidencies now only exercise an indirect influence, but which, according to the authors, might yet prove to be vital to the EU as a global actor.

Each part of the report is introduced by a summary that underlines possible consensus or divergence of views between the authors. In each chapter, the authors have three aims: to take stock of the initiatives adopted over the past eighteen months, to identify the challenges that have emerged during this time, and to formulate concrete short- to medium-term proposals targeting rapid progress for Community policies. Overall, the 18-month time frame to which each new edition of TGAE is devoted produces, from one report to the next, a comprehensive chronological picture of the EU's development.

This introduction reflects the analyses of the experts of the 16 think tanks, but it remains under the sole responsibility of its authors.

1. *Think Global – Act European. The Contribution of 13 European Think Tanks to the French, Czech and Swedish Trio Presidencies of the European Union*, dir. by Elvire Fabry and Gaëtane Ricard-Nihoul, Fondation pour l'innovation politique/Notre Europe, May 2008; *Think Global – Act European. The Contribution of 14 European Think Tanks to the Spanish, Belgium and Hungarian Trio Presidency of the European Union*, dir. by Elvire Fabry and Gaëtane Ricard-Nihoul, Notre Europe, March 2010.

12 SELECTED RECOMMENDATIONS TO THE PDC TRIO PRESIDENCY

Some of the proposals below lie beyond the Trio Presidency's responsibilities, as defined by the Lisbon Treaty; yet, via their coordinating role, the Polish, Danish and Cypriot governments should not hesitate to fully support these proposals.

COMPLETION OF THE INTERNAL MARKET

1 The EU should keep new Single Market legislation high on the agenda, notably by using the “package deal technique” – advocated by Mario Monti, albeit not taken up in the Single Market Act. This negotiating technique would facilitate trade-offs and would help avoid pick-and-choose tactics, which are capable of paralysing any ambitious project.

2 Specific attention should be given to making the new European financial supervision system reliable, in particular concerning banking regulation. Future stress tests must be more rigorous and provide for transparency, thus creating a solid foundation for the necessary recapitalisation and restructuring of banks in some Member States.

BEYOND ON-GOING EU ECONOMIC GOVERNANCE REFORM

3 For some Member States, particularly in the eurozone periphery, short term economic growth is likely to be anaemic. Given the tightness of fiscal policy at national level, the EU should consider practical ways to stimulate growth, through vital investment sectors, such as R&D, infrastructures and energy. Innovative financial instruments such as EU project bonds – mentioned in the Budget Review – should be given strong political support.

4 The European Stability Mechanism (ESM) will most probably not be able to provide for an “orderly default” for Member States that are insolvent and need debt restructuring. To make debt restructuring easier and more foreseeable in future cases, Member States should move beyond the current framework and set up the legal basis for a formal mechanism allowing the majority of creditors (private and other sovereigns) and the debtor to reach agreement in an orderly and swift manner.

5 Current and further EU economic governance reforms require strong public support. Thus, national actors should anticipate popular resentment and explain to their electorates that fiscal solidarity is in their long-term economic and political interest.

BUDGET REFORM

6 If the EU wants to deliver on challenges such as economic recovery / growth, the transition towards a low-carbon economy and EU cohesion – which all require substantial investments – it needs to align its means with its ambitions. In this respect, the Multiannual Financial Framework (MFF) should play a decisive role: – On the one hand, MFF negotiations should focus on efficiency gains, which could be obtained by improving coordination between national and EU spending (in diplomatic services, defence or research, for example) and by rendering EU spending more responsive to economic fluctuations. – On the other hand, new EU own resources, via a genuine EU VAT tax or an EU carbon/energy tax, would help increase the overall budget volume with independent sources of revenue. Such an initiative would be a first step towards diversifying EU funding, and should thus be taken seriously.

7 A way of avoiding a deadlock over CAP financing negotiations could be to simultaneously co-finance the first pillar of the CAP and deeply reform the policy, which would entail assessing, in conjunction with states and regions, an appropriate spending-level.

8 EU economic integration is at risk of running at a two speeds. To foster less developed Member States' competitiveness, EU Cohesion Policy should be turned into the leading EU development and investment policy, notably by equipping it with sufficient funds in the next MFF.

THE EU AS A GLOBAL PLAYER

9 The EU has a specific role to play in its neighbourhood's transition process. The EU should compensate for the slowness of its response to South Mediterranean countries' pro-democratic demands by now firmly involving itself in favour of democratic transitions. At the same time, the EU should not neglect its committed neighbourhood policy in the East and should therefore be determined to conclude far-reaching association agreements with Eastern Europe countries, making substantial commitments towards market-opening and regulatory alignment.

10 The EU needs to consolidate its immigration, border control and asylum policies. Schengen, one of the EU's main achievements, should not be weakened. At the same time asylum rules need to be looked at. The current "first safe country" principle could be replaced with a quota system where countries accept a set number of asylum seekers in proportion to their population size, available facilities and budget constraints. Those countries that do not reach their asylum quotas should accept some bone fide refugees from those that are over-burdened. Concerning labour migration, it should not be regarded as a security issue but rather as a way to meet sustainable growth objectives.

11 Coordinating external and internal EU policies would help avoid conflicting strategies. The EU has to produce integrated policy proposals by bridging traditional foreign policy with other issues, such as energy, migration, climate, security, development and trade concerns. As an illustration, to develop and strengthen the Union's external relations in the field of energy, a full set of EU foreign policy instruments should be used in a more coherent and multidisciplinary manner.

12 To develop strategic partnerships with major emerging powers and raise the EU's standing in international negotiations, the EU leaders should, for each specific partnership, prioritise the Union's interests and overcome the Member States' bilateral reflexes, which favour short-term national benefits over long-term European ones.

Filippa Chatzistavrou ELIAMEP, **Janis A. Emmanouilidis** EPC,
Elvire Fabry Notre Europe, **Piotr Maciej Kaczyński** CEPS,
Jacques Keller-Noëllet Egmont, **Thomas Klau** ECFR, **David Král** Europeum,
Ignacio Molina Real Instituto Elcano, **Clara Marina O'Donnell** CER,
Daniela Schwarzer SWP, **Paweł Świeboda** demosEUROPA,
Fabrizio Tassinari DIIS, **Andreas Theophanous** CCEIA, **András Vértés** GKI

As a policy, Bruegel does not take institutional policy positions.

The Contribution
 of 16 European
 Think Tanks
 to the Polish,
 Danish, and Cypriot
 Trio Presidency of
 the European Union

PROSPECTS FOR ECONOMIC GROWTH

INTERNAL MARKET

In October 2010, the Commission presented its draft “Single Market Act” (SMA). The plans were based on reports by former Commissioner Mario Monti and the European Parliament. The Commission’s 50 proposals were then followed by a four-month public consultation period. The European Parliament agreed to resolutions on the SMA in April 2011 and the Commission issued key initiatives the same month.

The strategic nature of the SMA is the first element discussed here. The first author believes the Commission’s draft SMA breaks with the tradition of lists, but that “the next Trio Presidency should make sure the relaunch is not diluted into a list of unrelated proposals”. Monti’s idea of an overarching political consensus – “great bargain” – should be maintained via the bundling of legislative measures in packages (Egmont). A second author argues that the SMA, as a milestone, is not sufficiently holistic. For this author, the SMA is in fact a list (SIEPS).

PART I ABSTRACT

The two papers do agree that Single Market legislation is already vast and seldom applied – notably due to Member States’ protectionist reactions during the recent economic and financial crises. Thus, attention should be given to already existing, but not fully-functioning areas. This is why both authors focus on the importance of communication as a means to properly applying Single Market legislation.

The first author underlines the Commission’s argument that in order for the SMA to be successful, political actors (at all levels) need to be involved in all stages of the project. Co-management of the Single Market could occur via the “increased use of mutual evaluation processes and the extension of the Internal Market Information System” (Egmont). In order to link the internal market to other political and economic projects, such as sustainability, social protection, innovation, cohesion, etc., it is also suggested “to create an overarching Single Market Group of Commissioners” and entrust the competitiveness council with a coordinating role in this treatment of Single Market priorities within the different council formations.

With reference to communication, the second paper develops Monti’s call for better legal implementation and enforcement. This would entail an improved

partnership between the Commission and the Member States, administrative cooperation between national authorities, mutual evaluation of national legislation, and better resolution mechanisms (SIEPS). The establishment of Single Market authorities could also help ensure that Single Market rules are correctly implemented. But this author warns against an excessive use of regulations – as opposed to Directives: the efficiency gains the Commission often perceives in the use of regulations (which do require national transposition legislation) must be weighed against the long-term efficiency losses (incurred due to incorrectly applied provisions and diverse national conditions).

SMART AND SUSTAINABLE GROWTH

Concerning growth, the European Union (EU) has, in principle, a clear strategy. The Commission presented a new version of this strategy – Europe 2020 – in March 2010. That same month, the European Parliament debated the Europe 2020 Strategy and gave its opinion on the topic. The European Council’s final approval of the Europe 2020 Strategy, and of its 5 EU-level targets, took place on 17 June 2010. More recently, the Commission released its “Annual Growth Survey” in January 2011. This April, Member States submitted their National Reform Programmes. And in June, the Commission is to release country-specific opinions.

The main objective of the Europe 2020 Strategy is for the “EU to become a smart, sustainable and inclusive economy” – notably via five “headline targets”: employment, innovation, education, social inclusion and climate/energy. The Commission also presented seven flagship initiatives: a digital agenda, the innovation union, youth mobility, resource efficiency, industrial policy, an agenda for new skills and jobs, and a platform against poverty. But the crucial question remains of how Member States and EU institutions are going to finance these initiatives in a period of economic turmoil and monetary instability. Recent austerity measures and the EU’s overall reduced economic potential are currently reducing the EU’s (and its Member States’) capacity to fund growth. Consequently, three measures are proposed here to facilitate the implementation of Europe 2020: public sector reform (not mentioned in the Europe 2020 strategy), EU-level investments (which should also reduce divergence in the EU), and the completion of the Single Market (as mentioned above), notably concerning digital markets (EPC) and energy markets (CEPS, Bruegel).

Although most of the papers below focus on specific policy fields – namely energy, innovation and demography, they nevertheless continue to keep the Single Market in sight: the creation of a single energy market is an example of

this. Two papers presented below argue that if the EU wants to complete the internal market, it needs to “start creating regulatory policies to enhance gas and electricity interconnections” (CEPS, Bruegel). The EU should also encourage the development of “super grids and smart grids”, which will allow renewables and energy efficiency to unfold their potential (CEPS).

Yet, combining “market completion” and “renewable support” is not unproblematic (Bruegel). In the last two decades, large amounts of political capital have been spent on creating a single, liberalised market for electricity. Even recently, during the “Energy Summit” on 4 February 2011, the European Council decided to create an internal energy market by 2014. But in the same time, national measures introduced to support renewable electricity generation are slowly creating 27 electricity markets and challenging the development of the liberalised market. The development of market based solutions that are compatible across the Union is then essential to achieve the long term target of decarbonising the power sector without putting the internal electricity market into peril, which means reaching both economic and environmental goals (Bruegel).

In relation to economic growth and EU-level investments, technological innovation, especially in the energy sector, is another subject of debate. Two papers below deem that the sluggish implementation of Carbon Capture and Storage (CCS) needs to be addressed quickly, lest American and Chinese competitors gain the upper-hand (CER). For this “bridge technology” to be implemented promptly, the authors argue, the EU would need to set the right incentives – notably through speeding up the timetable for grants awarded by the New Entrant Reserve 300 fund agreed in 2008 by EU Heads of State and Government (CEPS, CER). For the moment, many EU citizens do not want the resulting captured carbon in “their back yard” – mostly for environmental reasons. So in order for CCS technology to be successful, the EU needs to convince the public that the technology is safe.

Environmental risks and citizens “standing their ground” also relate to another energy source – namely shale gas. Novel technology and energy resources require environmental prudence, new legislation / regulation and a global political-economic outlook: all of which can be efficiently conducted at the EU-level (CEPS). As regards external energy policy, the Trio Presidency should continue to enhance cooperation with resource exporting countries, balancing security of supply with security of demand concerns in order to ensure an appropriate level of investments in production and transport facilities. It should also use its influence internationally to advocate measures to reduce the volatility of global oil markets (CEPS).

As it turns out, the EU’s innovation policies, per se, also affect the future of the internal market, notably in relation to the notion of specialisation. In the EU’s new Innovation Union, “an entrepreneurial learning process” is to take priority – over a top-down approach of choosing the most promising sectors – through the new European Innovation Partnerships (EIPs). A pilot EIP on “Active and Healthy Ageing” was launched in February 2011.

Lead Market Initiatives (LMIs) – which were launched in December 2007 – have already played a crucial role in promoting demand-side innovation policies within the EU. But as they focus on “promising sectors”, whereas the EU’s new philosophy focuses on “societal changes”, the final evaluation of LMIs – which should take place during the Polish Presidency – could lead to a replacement of them by the EIPs, whose ambition is “to enhance European competitiveness while tackling societal challenges” (demosEUROPA).

However if “smart specialisations” – i.e. innovation niches – serve as key criteria in the distribution of structural funds in the next Multiannual Financial Framework, this could lead to a further widening of the development gap between Member States; and the new EIPs might favour such divergence as well (demosEUROPA). Still the future of EIPs is just as uncertain as that of LMIs – dependent on the results of the pilot project that will be made public this autumn.

DEMOGRAPHIC CHALLENGES

Concerning European prospects for growth, completion of the internal market, energy issues and innovation writ large are not the only variables: the aging and decreasing population of the EU is also an important factor. Longevity and low birth rates are changing demographic structures and restraining both economic growth and budgets. Smaller and older populations mean a smaller workforce, and therefore fewer contributors to public social security systems (PSS). Under current policies, a growing and unsustainable PSS debt will make the financial system of almost all Member States insolvent.

Governments would usually try to repay their debt by either extending their revenues or cutting on other expenditures. A tentative calculation will immediately make clear that the required primary budget surpluses have to be double digit and thus are impossible to achieve for most Member States. Moreover, increasing the tax ratio may not be a solution for states where the ratio is already high. Other solutions to these current and future debt problems are found in three areas where Member States should move closer

together: increased (skilled) immigration, increased retirement ages and increased employment rates (SWP, CCEIA).

A first objective is to reduce the unemployment rate: the more people work, the more they contribute to national pension schemes. A reduction by two percentage points of the current unemployment rate by 2030 would reduce the sustainability gap by roughly 11% (SWP). But it is currently the most difficult goal to achieve. A second option concerns immigration (CCEIA, SWP). According to the Commission, net immigration is likely to decline in most Member States and EU citizens' show a strong unwillingness to accept (and integrate) a greater number of foreigners (CCEIA). However, keeping the net immigration ratio at 2008 levels (around 0.34% of total population) would decrease the sustainability gap around 8.7%, and would be especially useful for new Member States (SWP). The objective of attracting high-skilled migrants should also be developed at the EU level (CCEIA). Extending the retirement age represents a third option to reduce PPS debt. Raising the retirement age to 66.4 years by 2035 would reduce the sustainability gap at the EU level by 27% (SWP). If these three policies occurred simultaneously, the overall result might be even better.

No matter the policy chosen, the best response to the revenue-expenditure gap – the sustainability gap – is to act now (SWP). The longer the debt service is postponed, the higher the macroeconomic cost – the present value of the scheduled amortisation will decline, meaning that a larger amount of money (at present value) will be required. With the economic crisis coming to an end, long-term fiscal sustainability should then become a prime issue of concern to the next Trio Presidency. The newly established European Semester, a six-month period of macroeconomic policy coordination by the Member States, may be helpful. However, it would also mean broadening the focus of the Stability and Growth Pact (SGP) and the Broad Economic Guidelines to ensure that the Member States' sustainability gap is closed over time. Poland and Denmark's probable long-term finances should encourage them to initiate a monitoring and statistical report of each country's implicit fiscal position, on a par with the explicit one (SWP).



INTERNAL MARKET

The Single Market Act in Search of a Strategy

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Drowned out by the political drama surrounding the European Union's (EU) crisis management and economic governance debates, the EU has embarked on the urgently needed process of relaunching the Single Market. This contribution bases itself on the recently published "Single Market Act", as well as on the main preparatory documents, to reflect on the recommended course of action for the Trio Presidency.

A Single Market dream in urgent need of new momentum

Over the last two years, most of the EU's attention has been inevitably absorbed by efforts to weather the storms plaguing the monetary union. Hence, the focus has been on crisis management and "economic governance".

Yet, one piece of the puzzle vital to the EU's economic recovery as well as long term growth has, up to now, not received the interest it deserves, i.e. the effort to relaunch the Single Market. Indeed, given that a more integrated European market is an important catalyst for stimulating growth in the face of the economic and financial crisis, this component of the "E" in the "EMU" (Economic and Monetary Union) should urgently be given a more prominent role in the drive for economic recovery. One of the most striking examples of this untapped growth potential in the Single Market Project is undoubtedly the services sector, which, although it accounts for 70% of EU Gross Domestic Product (GDP), only makes up 24% of total EU trade.

The context in which today's Single Market operates is, however, different from that in 1992. For one, the financial crisis, rather than prompting increased market integration zeal, triggered a chain of protectionist reactions, thereby painfully revealing the remaining fragility of this cornerstone of European integration, so often taken for granted. However, even before the woes of the recent crises, the enthusiasm for further completing the Single Market had already faded considerably. Arguably, both the enlargement and the deepening of the

Union have contributed to this market integration fatigue. While enlargement has increased diversity within the Union, the gradual deepening of the integration process has meant that more nationally sensitive policy fields are being affected. This is especially noticeable in the area of free movement of workers as well as in the “people-intensive” services sector, and it explains much of the “socially”-inspired resistance. Hence, the polemic surrounding the adoption of the Services Directive seriously tarnished the whole market integration project, and left the Commission with a heavy political “internal market hangover”. Moreover, globalisation has intensified competitive pressure on the European economy, as well as interdependence with the rest of the world, and thus calls for a greater focus on the external dimension of Single Market Policy.

Given this increased urgency for a quantum leap in unlocking the Single Market’s growth potential, as well as the considerably altered context in which it operates anno 2011, a thorough rethink of this policy seems mandatory. It is clear that, rather than yet another gradual low-profile initiative, the Single Market needs a true “relaunch” addressing the many challenges. Convinced that such renewed momentum can only be created by means of a genuine “strategic” approach, this contribution seeks to establish how the Trio Presidency can contribute to this ambitious, yet indispensable, political project.

Towards a strategy for the Single Market?

During his second term, President of the European Commission José Manuel Barroso, sensed the necessity to make substantial progress in the domain of market integration and seized the opportunity of the upcoming 20th anniversary of the 1992 Single Market Programme to announce that the Commission would aim to “regain momentum in the internal market” by bringing forward “a major package for tomorrow’s Single Market”.¹ Aside from the Single Market Act itself, three preparatory documents laying the ground for this package are of particular relevance.

The Monti Report laying out a genuine strategy

In October 2009, Barroso asked former Commissioner Mario Monti to draw up a report setting out options and recommendations for the completion of the Single Market, which was to serve as a source of inspiration for the planned new Commission initiative. Monti sensed, however, that something more was needed than the “business as usual”-approach of drawing up a wish list of missing links, and thus set out to devise a genuine strategy to revive the Single Market.² After six months of consultations, he produced a 107-page long report on “A New

Strategy for the Single Market”, which *also* contains a list of problem areas and missing links, but devotes almost double the amount of pages to an analysis of the *forces de résistances* and strategic measures to address them.

At the core of Monti’s proposed strategy lies a unique attempt to seek an overarching political consensus or political “grand bargain” on the Single Market Project between the competing European economic models, and in particular between the Anglo-Saxon free market and continental social-market models. By way of specific measures addressing conflicts between market integration and social objectives, he hopes to persuade social-market economies to commit more truthfully to market integration and competition. In other words, the core of the compromise proposed by Monti is: a stricter enforcement of the Single Market rules to satisfy the Anglo-Saxon model adherents, in exchange for targeted policy measures addressing social concerns –including in particular a limited form of tax coordination– to conciliate the social-market economies with further market integration.

To maximize the chances of success for what would be a “quantum leap” in the Single Market Project, Monti holds on to the technique of a package deal. In other words, the proposals addressing gaps and bottlenecks are to be bundled together with the consensus-building measures and the initiatives to improve “delivery”, in an overall package deal containing “something for everyone”. This should allow Member States to compromise on certain issues and to strike a good deal on others.

Monti further emphasises the need for a comprehensive approach that integrates policies traditionally not regarded as policies for the Single Market “into a Single Market strategic objective”. To ensure a unitary vision of the Single Market across policy areas, European institutions should reorganise their operation to a certain extent. Within the Commission, an overarching Single Market Group of Commissioners could be created so as to ensure that an integrated approach is adopted towards Single Market policy formulation. Furthermore, the European Parliament and the Council should adopt a more integrated approach and treat Single Market measures beyond the confines of the Internal Market and Consumer Protection (IMCO) Committee and the Competitiveness Council formation. The European Council, for its part, should make the Single Market a key priority and assist the Council in adopting an integrated approach.

A committed European Parliament

Almost in parallel, the European Parliament produced a Resolution on delivering a Single Market to consumers and citizens based on an own-initiative report by Louis Grech.³ At the core of this report lies the call for a new paradigm of political thinking, which places

1. José Manuel Barroso, “Political guidelines to the next Commission”, 3 September 2009, available at: http://ec.europa.eu/commission_2010-2014/president/pdf/press_20090903_en.pdf, pp. 28-29

2. Mario Monti, “A New Strategy for the Single Market: At the Service of Europe’s Economy and Society” (hereafter “Monti Report”), 9 May 2010, available at: http://ec.europa.eu/bepa/pdf/monti_report_final_10_05_2010_en.pdf

3. European Parliament, Resolution, “Delivering a Single Market to Consumers and Citizens”, P7_TA(2010)0186, 20 May 2010

the European citizen at the heart of EU policymaking, thereby hoping to increase public support for the Single Market. This is thought to depend on the adoption of a holistic and common approach to the Single Market in which economic, consumer protection, social, environmental and health policy objectives are fully incorporated. The report also devotes considerable attention to the “governance” of the Single Market, emphasizing the need for stricter enforcement, political leadership by the Commission and political ownership by Member States.

The European Parliament has shown itself to be truly committed to making the Single Market relaunch a success and it is in the course of adopted⁴ three reports following up on the Commission’s Draft Single Market Act.

The Single Market Act

On 27 October 2010, the Commission finally published its long-awaited Communication “Towards a Single Market Act”⁵, with the ambitious objective of relaunching the Single Market. Yet, rather surprisingly given the urgency of the matter and the preparatory fieldwork done by Monti, the Commission did not come forward with a definitive Single Market Act but rather with a “proposal” as the basis for a four-month public consultation, following which a final Single Market Act was ultimately published on April 13, 2011.⁶

Whereas the Draft SMA contains 50 proposals, the Commission decided to limit its final SMA to a total of 12 key priority actions. Truthful to the successful methodology of the 1992 Single Market Programme, the objective is to have a key action adopted for each of these “twelve levers”, aimed at boosting growth and strengthening confidence by the end of 2012. Based on an evaluation of the results in terms of growth creation and confidence-building, the Commission will then propose a second phase with new proposals addressing other sources of growth and trust. Since the more elaborate Draft SMA is important for the Commission’s “narrative” regarding the Single Market relaunch, both the Draft and the final version will be analysed together.

The Draft SMA and final SMA should clearly be credited for breaking with the tradition of lists of disparate technical proposals and for attempting to devise a more coherent and engaging political project to relaunch the Single Market. A novelty in the Commission’s approach is undoubtedly its attempt, in line with Monti’s suggestion, to squarely address the causes of citizen’ dissatisfaction with the Single Market. For that purpose, great emphasis

is laid the social aspects of the Single Market Project and, more generally, the strategic objective of placing the European citizen at the heart of the integrated market. Hence, the final SMA contains potentially far-reaching proposals concerning social cohesion (such as the announcement of legislation clarifying the exercise of freedom of establishment and freedom to provide services alongside fundamental social rights, like the right to take collective action) as well as social entrepreneurship.

The Commission has also – to a certain degree – followed up on the European Parliament and Monti’s call for a more “holistic or comprehensive approach” to the Single Market, wherein the interconnection and interdependence between Single Market policies and other EU policies is recognised. Aside from policy measures intended to appease citizens’ – mainly social – concerns, the Commission also integrated other EU policy objectives, such as sustainability, innovation, etc. Unfortunately, this intention to create a “global” strategic package for relaunching the Single Market has not been matched by the concrete political action of placing other policies at the service of an overarching Single Market Project. On the contrary, almost simultaneously with the release of the Draft SMA, the Commission published a multitude of overlapping communications and reports in the domains of industrial policy, citizens’ rights, digital agenda, etc.

In respect of governance of the Single Market, the Commission relies heavily upon the paradigm of “partnership”. The public and stakeholders are to be fully involved by means of more dialogue, as exemplified by the four-month consultation process on the Draft SMA and, on a more permanent basis, a “new framework for dialogue”. Member States and local governments are called upon to co-manage the Single Market by way of, for example, the increased use of the mutual evaluation process, the extension of the Internal Market Information System, etc. Moreover, by involving all actors as closely as possible at all stages – i.e. preparation, implementation, evaluation or monitoring, enforcement the Commission hopes to trigger a “collective commitment” towards the Single Market.

Recommendations

A general recommendation to the Trio Presidency would be to guard over the strategic character of this much needed Single Market relaunch and ensure that it is not watered down to a mere technical exercise resulting in a list of disparate proposals. If genuine political momentum is to be created, a “strategic” approach seems indispensable.

Being one of the core community competences, the Single Market is probably one of the domains where the rotating presidency has the most opportunity to “prove its value”. As a crucial actor in the legislative negotiations, both between the different Member States within the Council, and, increasingly, between the Council and the European Parliament, the rotating presidency can exercise considerable influence.

4. European Parliament, Resolutions, *Governance and Partnership in the Single Market*, P7_TA(2011)0144; *Single Market for Enterprises and Growth*, P7_TA(2011)0146; *Single Market for Europeans*, P7_TA(2011)0145, 6 April 2011.

5. European Commission, Corrected Communication, “Towards a Single Market Act”, COM(2010) 608 final/2 replacing COM(2010) 608 final, 27 October 2010, available at: <http://register.consilium.europa.eu/pdf/en/10/st13/st13977-re01.en10.pdf>

6. European Commission, Communication, *Single Market Act*, COM(2011)206 final, 13 April 2011, available at: http://ec.europa.eu/internal_market/smact/docs/20110413-communication_en.pdf#page=2

Therefore, within the Council, the Presidency should:

- ensure that the legislative proposals implementing the 12 key priorities are put high on the agenda and their adoption is fast-tracked.
- attempt to use the “package deal technique”, as also advocated by Monti and which, at the time of the 1992 Single Market Project, aided the British and Belgian Presidencies in unblocking the adoption of the necessary legislative measures in the Council. In essence, this involves the bundling of legislative measures in packages, which are then to be, in principle, considered as a whole, thereby making across the board trade-offs possible and avoiding pick-and-choose exercises capable of paralyzing any ambitious project.
- seek to obtain a more general political consensus between Member States on an ambitious relaunch of the Single Market Project as whole. Indeed, although the intention to take into account the citizens’ concerns and to place the citizen at the heart of the Single Market is essential, it should not distract from the fact that what is really needed to make headway in completing the Single Market is political agreement between Member States. Even though the draft SMA and SMA did, regrettably, not take up the “grand bargain”-idea carefully constructed by Monti, the rotating presidency should strive to convince the different positions about their mutual interest in a stronger Single Market corrected with, or complemented by, specific social measures.
- ensure an integrated approach by treating Single Market measures beyond the confines of the Competitiveness Council formation; while entrusting the Competitiveness Council a coordinating role in this treatment of Single Market priorities within the different Council formations.

Lastly, the Trio Presidency should also strive to strengthen political commitment to this project at the highest level, assisting and encouraging President Barroso and the President of the European Council, Herman Van Rompuy, in their efforts to create the necessary political momentum.

INTERNAL MARKET

The Single Market Act: Is it Really What the Market Needs?

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The Single Market is, as is noted in the Commission Communication¹, not an end in itself, but it is instead a tool used to support policies in other areas. This observation may seem self-evident, but it is an often forgotten very important point. This is why it has always been wrong to speak about the Single Market as a final goal in the shape of a particular date. This applied in 1992 and still applies for 2012. The Single Market remains the most important tool to achieve the targets of the European Union (EU). It is, however, important not to disregard the dynamics and changeability of the process. If the Single Market is regarded as a completed project, progress will stagnate and there is a risk that the European integration process may slow down profoundly. In this light, the fact that the Single Market has been put into focus again in recent years is naturally welcome.

The aim of the SMA is to be a milestone in the development of the Single Market, in a similar way to the Delors White Paper of 1985. From this perspective however, the SMA (Single Market Act) is a disappointment. It is difficult to discern a coherent and overarching vision. The paper gives the impression more of a smorgasbord, where efforts have been made to scrape together 50 concrete proposed measures.

Bearing in mind the broad scope of the proposed Act, this paper will recommend a prioritisation of the measures that would appear to be the most urgent ones for the Single Market to function.

“First things first”

In its Communication, the Commission includes 50 proposed measures; some of which are old issues that remain important, for instance the EU patent, while others are newer, like the “Ecological Footprint of Products”. There is no reason to criticise the innovativeness of the

1. European Commission, Communication, “Towards a Single Market Act – For a highly competitive social market economy, 50 proposals for improving our work, business and exchanges with one another”, COM(2010) 608 final, 27 October 2010, p.4

Act, but measures should primarily focus on current areas that do not function properly. As former Commissioner Mario Monti points out in the report that forms the basis of the SMA, the problem is hardly a lack of rules. Monti claims:

- In many areas, the Single Market exists in the books, but, in practice, multiple barriers and regulatory obstacles fragment intra-EU trade and hamper economic initiative and innovation.
- In others, the potential for greater economic gains is frustrated by lack of physical and legal infrastructure or by absence of dialogue between administrative systems.²

Thus the situation is diametrically different to the year 1985 when the Delors White Paper was presented. At that time there was a great need for rules. Today, the Single Market's bulk of legislation is instead generally considered as too heavy. According to Monti, there are currently 1521 Directives and 976 regulations in the area.³ In other words, what is required is not a new wave of legislative initiatives to realise the Single Market. Focus should instead be placed on trimming and improving the current legislation.

Improved partnership between the Commission and Member States

One aspect, which is very important in developing the Single Market and has been observed by the Commission, is that much can be gained by achieving improvements in the partnership between the Commission and the Member States. The Single Market legislation – and thus the prerequisites and conditions for its growth potential – are handled by a myriad of national authorities in the now 27 Member States or to be more correct in the current 30 European Economic Area (EEA) states. In this complex multicultural landscape, there is significant uncertainty about how central Single Market principles, for example the principle of mutual recognition and proportionality, are to be applied in practice. As long as this is the case, the advantages of the Single Market will not be realised or as Monti expresses it, the Single Market exists only in books.⁴ The realisation of the Single Market should therefore not only take place at the European level, but autonomous national measures, which aim to improve domestic conditions, are just as important. An improved partnership and dialog is vital in this respect and is required to achieve an effective and similar implementation of the Single Market rules in all Member States.

One issue that is not raised in the SMA is that it is important that Member States ensure and strengthen a Single Market coordination function, to promote efficient coordination within and between authorities responsible for Single Market issues at national, regional and local level. This was pointed out in the Commission Recommendation of 29 June 2009 on

2. Mario Monti, "A New Strategy for the Single Market: At the services of Europe's Economy and Society", 9 May 2010, p. 37. Available at: http://ec.europa.eu/bepa/pdf/monti_report_final_10_05_2010_en.pdf

3. *Ibid.*, p.93.

4. *Ibid.*, p. 37.

measures to improve the functioning of the Single Market.⁵ Member States should actually go further and establish Single Market authorities, which could help to ensure that the Single Market rules – in particular the horizontal provisions – are implemented correctly and lead to the anticipated impact in each Member State. These authorities should also be responsible for information *vis-à-vis* other authorities, companies and people affected. The establishment of Single Market authorities would facilitate cooperation between the Commission and Member States (the partnership), and would contribute to a better implementation and application of Single Market rules.

In this context, a warning flag needs to be raised against the increased use of regulations at the cost of Directives. The SMA does not raise this issue specifically, but Monti does and an increased use of regulations is also mentioned as a proposal in the Europe 2020 Strategy. Such an important development should not take place without a great deal of reflection. Regulations do not provide Member States with as much room for manoeuvre to ensure that the rules really are applied in an effective way as a Directive. The provisions in a regulation are worded in such a way that they can work in 27 different legal environments. Applying the provisions in a national context makes huge demands of the applying party. There is a distinct risk concerning uncertainty on the correct implementation of the rules. The efficiency gains, which the Commission often perceives in the use of regulations, which come into force in all Member States rapidly and do not need any national transposition legislation, must thus be weighed against more long-term efficiency losses that are due to the provisions being poorly adapted to the national conditions and not being applied correctly by Member States.

Administrative cooperation and surveillance

Several EU legal instruments are aimed at facilitating administrative cooperation between Member States and their competent authorities. Several specific networks of collaborating bodies have been created to that aim. The aim is that the networks will help to increase faith in the market and thus facilitate cross-border activities. The vital thing is to compensate for the problems that may arise when Member States are not allowed to impose the same requirements on businesses as was permissible in the past, for example appointing a competent representative or fulfilling requirements of registration in the host country. However, what all such requirements have in common is that they aim to ensure some kind of control in the interest of the state, for example as regards taxation or to protect consumers and workers.

As the Single Market has developed, these requirements have increasingly become impermissible. The basic principle is that service providers shall only be controlled by the state in which they are established. This means that national authorities are only able to fully

5. European Commission, Recommendation, "Measures to improve the functioning of the Single Market", 2009/524/EC, OJ L 176, s. 17, 29 June 2009, available at: <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:176:0017:0026:en:PDF>

control the operations of a company when the company has decided to establish itself in the country in question. As regards companies that are already established in other EU countries, it should instead be possible for host country authorities to retrieve information and receive other assistance from the home country's authorities when the need arises. What is of particular importance in this context is the Service Directive's⁶ system of points of contact. This is the most ambitious form of administrative cooperation in the EU today.

The development of mutual trust would appear to be one of the most important issues at the moment. It is only through close cross border cooperation between the competent authorities of the Member States that an increase in trust can be achieved. This was specifically noted in the above-mentioned Commission Recommendation of 29 June 2009, on measures to improve the functioning of the Single Market.⁷ According to this Recommendation, Member States should take the suitable and necessary measures to ensure the management of existing cross border networks or electronic information systems.

It is evident that administrative cooperation can only be efficient if it is used. Here, Member States can seize the opportunity to regain some control, if that is needed to fulfil legitimate aims. Administrative networks should therefore be further developed and analysed and this should be prioritised. One weakness with the current system is that it can be difficult to identify foreign traders who operate in a country. The Commission takes a very negative attitude towards an obligation to register or any similar system, making it possible to identify these traders since this entails obligations on companies. However, this negative attitude must be balanced against the interest of obtaining better functioning administrative cooperation. It is only in this case that enhanced mutual trust can be created between national authorities in the market, which is a precondition for a better functioning Single Market.

A final point is that in a system that is based on cooperation between authorities in 27 states (or 30 if one takes into account the whole of the EEA), the effectiveness of the system is dependent on its weakest link, in other words the authorities with the least resources or the areas with the least surveillance activities. It is reasonable to claim that a precondition for this mutual trust is that the whole chain of surveillance authorities functions properly. In this light, it is not unreasonable that the EU makes demands on surveillance, which has in fact been the case as regards market surveillance relating to the marketing of products,⁸ even if this has traditionally been a national matter. Nor is it at the end of the day unreasonable that the EU co-finances the establishment of an efficient market surveillance system in order

6. European Parliament and Council, Directive, "Services in the internal market", 2006/123/EC, OJ L 376, 12 December 2006, p. 36. Available at: <http://www.deti.ie/trade/marketaccess/singlemarket/07serv005.pdf>

7. Op. Cit., European Commission, 2009/524/EC, p. 17

8. See European Parliament and Council, Regulation, "Setting out the requirements for accreditation and market surveillance relating to the marketing of products and repealing Regulation", (EEC) No. 339/93", (EC) No 765/2008, 9 July 2008, p. 30. Available at: <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2008:218:0030:0047:en:PDF>

to guarantee a safer market for consumers. No market can function and lead to the desired growth without the faith of consumers.

Mutual evaluation

The Service Directive has not entailed any extensive changes to the basic rules that used to apply to the free movement of services, but it entails two fundamental changes. Firstly, the legal situation has been specified and fine-tuned, which has rendered the conditions on the market more predictable. Secondly, unusually far-reaching demands were made with regard to adaptation during the transposition period of the Directive. Compared to a sectoral Directive, the implementation of the Services Directive has therefore led to an unprecedented removal of impermissible provisions in national legislation. National requirements, which were found to be incompatible with EU rules on the freedom of establishment and the free movement of services, were eliminated even before the Directive entered into force, and Member States were obliged to notify the Commission and other States of the requirements that remained.

These remaining requirements are thereafter subject to mutual evaluation. Only requirements that are legitimate from the EU legal standpoint may be kept, and the Commission may bring infringement cases on Member States that continue to uphold unjustified requirements in their legislation. The system of mutual evaluation is therefore a very efficient method of getting the Single Market to function better in a short period of time. It also leads to increased dialogue between the Commission and Member States, and generates new knowledge in the ministries and authorities concerned. The proposal to extend this method to areas outside the Services Directive is therefore very welcome.

However, more publicity with regard to the system of mutual evaluation should be considered. It is reasonable that those affected by obstacles to free movement (in particular the European businesses) also have the possibility of identifying them and adapting their operations in that regard. If mutual evaluation is used correctly, the method may in the end reduce the need for harmonisation measures in certain areas, since the degree of predictability required by the market can be achieved in another way.

Dispute resolution mechanisms

Already established systems for alternative dispute resolution (SOLVIT, for example) can have a far greater reach than trying to solve each individual case at hand. These disputes may generate information about areas that do not function well and can hopefully lead to important changes. Expanding dispute resolution mechanisms and making these better known is therefore an important measure for the Single Market. The outcome of the dispute resolution should also be given greater publicity, both at the national and the European level.

Conclusion

The Single Market obviously needs to be improved and the SMA is a step in that direction. However, there is a risk that the SMA's very broad scope and lack of coherent strategy turn it into a failure. It is therefore highly recommended that the Trio Presidency works out an agenda based on the SMA that specifies the most imperative measures to be taken. The Single Market is a never-ending story where the importance of quality outweighs quantity in the long run. It is submitted that much more emphasis should be added to already existing, but not fully functioning areas. In this article, it has been argued that such areas include an improved partnership between the Commission and the Member States, administrative cooperation between national authorities, mutual evaluation of national legislation and the need for dispute resolution mechanisms. Of paramount importance is the building of stronger mutual confidence in the market. No market can function and lead to desired growth without the faith of consumers.

SMART AND SUSTAINABLE GROWTH

Implementation of Europe 2020: Time to Act

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The agreement on the Europe 2020 Strategy in 2010 came amidst a period of economic upheaval. Europe has been facing a deep recession, suffering a setback in fulfilling its long-term ambition of achieving “the sustainable development of Europe based on balanced economic growth and price stability, a highly competitive social market economy, aiming at full employment and social progress, and a high level of protection and improvement of the quality of the environment”.¹

The economic crisis has made the achievement of the central goal of Europe 2020 – smart, sustainable and inclusive growth – even more important, but at the same time has limited the resources available to pursue the Europe 2020 objectives. This article sets out what critical actions are necessary to drive forward the implementation of Europe 2020 to avoid the Lisbon Agenda's fate of having the right ambitions, but insufficient implementation.

The long term impact of the crisis²

While most of Europe is now on the tentative road to recovery, the economic crisis has not only had a profound impact in the short term, but it looks increasingly likely that the crisis will also result in long-term impacts, which will influence Europe's ability to deliver on its development priorities.

The more difficult economic position of the European Union (EU) is not due to the crisis alone: the crisis has aggravated pre-crisis challenges. Growth rates in Europe were already relatively low, for example with average growth from 2002-2006 at around 2%. In part, this is due to

1. Treaty on European Union

2. Economic data in this section is taken from the Autumn 2010 forecast, European Commission

the long-term challenges Europe faces, including a significant ageing of its population, global competition, increasing resource prices and the need to finance climate-change adaptation and mitigation. But, policy also played a significant role: while some of Europe's economies are among the global top performers in terms of competitiveness (with the Nordic EU Member States consistently among the top 10 in the World Economic Forum's Global Competitiveness Index)³, others have fallen behind, not least due to lack of sustained economic reform.

Falling GDP

The most direct impact of the crisis has been a sharp reduction in Gross Domestic Product (GDP) – the EU lost on average 4.2% in 2009, with the growth rate for 2010-2012 at 2% or below, implying that pre-crisis GDP levels will only be recovered in the course of 2012. This masks significant variation within the EU, with a double-digit contraction in 2009 in the Baltic States (Estonia -13.9%, Lithuania -14.7% and Latvia -18.0%) and contractions of around 8% in Finland, Ireland and Slovenia. In 2010, Bulgaria, Latvia, Ireland and Spain continued to contract (albeit at a marginal rate of between -0.1% and -0.4%), whereas Romania's economy shrank by -1.9% and Greece's by -4.2%.

Reduced economic potential

What is even more worrisome is the reduction in economic potential, which is likely to take place unless new momentum for growth can be mobilised. Some important sectors that were drivers of economic growth in many countries, such as construction or the financial sector, are unlikely to recover to pre-crisis level. In addition, the crisis has accelerated the structural change that has been driven by global competition, with the emerging economies drawing in a bigger share of global economic activity.

The crisis has also served to emphasise that it is not merely growth that is needed, but sustainable growth in every sense of the term – economic, financial, environmental and social. Consumption and profit fuelled by debt and high risk financial transactions can no longer be the foundation of economic success. However, this does not mean that a new sustainable growth model that promises high growth and employment rates is readily available.

A mountain of debt

The future inability to fuel future economic growth through debt-financed spending extends to the public sector. The crisis – and the policy response to it – have resulted in large deficits and consequently mounting public debt burdens. By 2012, average gross public debt will be over 80% of GDP in the EU, up from around 60% before the crisis. Belgium will

have a debt to GDP ratio of 102%, Ireland 114%, Italy 120% and Greece a staggering 156%. Portugal, France and the United Kingdom will be somewhere around the 90% mark. On average, debt financing costs will be around 3% of GDP in the EU but Greece is in a precarious situation at 7.4% of GDP.

These levels of debt will necessitate fiscal consolidation. While in the short term there is a need to avoid a potentially difficult spiral of lower public spending resulting in lower growth and thus lower revenues, necessitating further fiscal consolidation, in the medium term fiscal consolidation will be inevitable. Given the scale of the debt mountain, this will require more than a simple cutback in expenditure and a slight increase in taxation – there is a need to reorganise public services fundamentally. In addition, it is unlikely that the public sector will be able to provide significant public investments which are needed to increase further growth potential.

Divergence

There is not only a growth crisis across the EU when compared to the rest of the world, but also increasing divergence within the EU, which is a major driver behind the current eurozone crisis. While divergence pre-dates the economic crisis, most notably in balance-of-payments performance, it looks increasingly likely that some of the weakest economies will be left even further behind. While countries such as Germany are rebounding strongly, economies such as Portugal and Greece record low growth and investment rates. The fundamental question is whether this is a temporary phenomenon or whether it represents a trend towards further divergence. It is true that there is a need to rebalance economic policies in the weaker economies and this will have a short-term impact. But it also seems unlikely that in those economies with a fundamental structural problem the current wage moderation in itself will be enough to restore competitiveness.

A growth strategy for Europe

The developments charted above make it essential that a significant focus of EU policy must be on encouraging economic growth, with a particular focus on growth in Europe's weakest economies. As a starting point, the EU has agreed on the Europe 2020 Strategy, which aims to stimulate "smart, sustainable and inclusive" growth.

Strengths and weaknesses of Europe 2020

The Europe 2020 Strategy does represent in many ways an improvement on its predecessor, the Lisbon Strategy. For a start, it has a clearer focus with only five headline objectives – on innovation, labour market participation, education, combating poverty and climate change mitigation. It also specifies seven flagship initiatives with – more or less concrete – areas

3. With Sweden on rank 2, Finland on 7 and Denmark on 9 in the 2010-2011 index. Germany is on 5 and the Netherlands on 8; (World Economic Forum, Centre for Global Competitiveness and Performance, *Global Competitiveness Index 2010-11*, 2010, available at: http://www3.weforum.org/docs/WEF_GlobalCompetitivenessReport_2010-11.pdf

of action for the EU. Importantly, Europe 2020 recognises that the main problem with the Lisbon Strategy was not its ambition, but the implementation, which varied greatly across Europe. The architects of Europe 2020 have tried to overcome this by creating more buy-in at the highest level, giving the European Council a much greater role in implementation.

But nagging doubts remain – is the implementation mechanism strong enough to overcome significant resistance in many Member States, especially in the context of a very difficult economic environment? There is also a noticeable contrast to the current discussions on economic governance where ambitious plans are being put forward for more integrated economic governance. The political emphasis is currently on better governance for fiscal policy with a real question remaining over how strongly structural reform is going to be promoted.

But despite its shortcomings, the Europe 2020 Strategy is an important element of European policy development, which can potentially help to overcome the crisis. This article now focuses on three areas for action that can potentially be crucial components in the implementation of the strategy by generating investments in future growth: reform of the public sector, European-level investments and the creation of the right framework for investment through the further development of the Single Market.

The missing link

One significant absence from Europe 2020 is any detail on public-sector reform, and even less on an implementation mechanism. The importance of public-sector reform is noted: “Fiscal consolidation and long-term financial sustainability will need to go hand in hand with important structural reforms, in particular of pension, health care, social protection and education systems. Public administration should use the situation as an opportunity to enhance efficiency and the quality of service.”⁴ But beyond the general monitoring of reforms, Europe 2020 does not give much concrete information on what to do, and how to ensure these structural reforms take place.

Arguably, this is not a problem. In traditional economic growth theories, the public sector does not feature. However, this ignores both its importance for the long-term development of a country and its role in tying up crucial resources. This is especially true in Europe, where the public sector has a proportionally larger role than in the rest of the world. In Europe, the public sector can provide a crucial role in creating the framework conditions for growth in three ways: by focusing on growth enhancing spending it can boost overall long term economic performance, for example focusing on the formation of human capital; by helping to develop new areas of competitive advantage for European firms, for example pio-

neering the use of “green” goods and services; and, by minimising the level of inefficient or ineffective spending, freeing up resources to be used elsewhere in the economy.

The achievement of such public-sector reform could be supported more effectively at the European level. As a crucial first step, much more emphasis should be given to public sector and social innovation. In monitoring the implementation of Europe 2020 and of fiscal policies, more emphasis should be given to identifying and promoting structural reform that can simultaneously help to reduce public-sector deficits and encourage growth, for example removing provisions in public pension systems that encourage early labour-market exit. In short, public sector reform should be a fundamental and integral component of Europe 2020 implementation.

The investment challenge

To achieve the objectives of Europe 2020 will require significant investment, which is a particular challenge in times of public-sector austerity. Funding is, for example, required to realise invest-to-save schemes, aimed at achieving the transformation to the smart economy. At the same time, there are still significant infrastructure needs across the EU, both in forms of traditional infrastructure such as roads and rail, but also in terms of new infrastructure in relation to smart grids and next-generation broadband. In addition, there is a need to accelerate investment in education and skills formation to help Europeans realise their full potential and to increase the value-added of European goods and services, enabling Europe to continue competing with the emerging economies, which are investing tremendous efforts in this area.

The challenge to generate such investment is particularly large in the economically weaker European economies, both in Mediterranean and new Member States. Here, such investment can fulfil a dual purpose: in addition to boosting competitiveness and productivity, it can help new Member States catch up faster with the rest of Europe. This would be difficult in the absence of private foreign direct investment, which suffered in the crisis. It could also help to counteract the austerity measures in the Mediterranean countries, helping to make public-finance reform less painful and more socially acceptable.

The benefits from such investment are significant – both for the countries concerned and the economically stronger countries in the EU from where the investment must come or at least be underwritten. It would improve cohesion in the eurozone as well as delivering, productively, European solidarity. At the same time, helping to develop these countries in the direction of smart, sustainable and inclusive growth will encourage European companies and individuals to provide additional investment.

At European level, much can be done to help this process. The resources of the EU budget, such as cohesion funding for example, could help leverage investment in these areas, but it would require reform, including for example much closer public-private partnerships

4. European Commission, “Europe 2020: A European strategy for smart, sustainable and inclusive growth”, p. 24 available at: http://ec.europa.eu/europe2020/index_en.htm

and more investment in the development of human capital. In addition, the activities of the European Investment Bank could be greatly expanded to provide more low-cost investments. The idea of EU project bonds, as noted in the Budget Review should also be implemented, to provide crucial investment in pan-European infrastructure projects.⁵

Size matters

Probably the most important function the EU can fulfil is to develop the Single Market further. European companies have the ability to generate tremendous amounts of investment, but they require an integrated market that makes it worthwhile. The Single Market, as it stands, is the most significant result of European economic integration, but it is far from complete. Not only is more work required in realising the original four freedoms, but the Single Market also needs to be made ready for the future knowledge economy.

Many of the problems encountered by firms and consumers within today's Single Market are not due to the overall framework of rules, but to its incomplete or indecisive implementation. More needs to be done at EU level to ensure that the rules are applied uniformly and consistently across the EU, with a particular focus on ensuring that legislation is evaluated ex post to ensure that it has delivered the desired market integration.

This is particularly important for the services Directive. While much has been achieved in the free movement of goods, the services Directive has only been in force for just over a year and it still has many shortcomings. The free movement of capital has also taken a blow through the economic crisis, especially from a consumer perspective, where cross-border access to capital remains elusive. The free movement of people remains one of Europe's proudest achievements but it, too, needs to be updated to reap the full benefits: Europe needs a Single European Labour Market with measures that encourage mobility and open European labour markets to the rest of the world.

To generate additional growth and enable the transformation to the knowledge economy, creation of the Digital Single Market is critical, which is recognised in Europe 2020: "The aim is to deliver sustainable economic and social benefits from a Digital Single Market."⁶ This requires making progress on a number of thorny issues including, for example, harmonisation of consumer and data protection, common standards for e-invoicing and e-signatures, a pan European patent, IPR and licensing framework and significant investment in hard (broadband) and soft (skills) infrastructure.⁷

5. European Commission, Communication, "The EU Budget Review, SEC(2010) 7000 final", 19 October 2010, available at: http://ec.europa.eu/budget/reform/library/communication/com_2010_700_en.pdf

6. European Commission, "Europe 2020: A European strategy for smart, sustainable and inclusive growth", *op. cit.*, p. 12

7. For details please see European Policy Centre, *Establishing the Digital Single Market*, available at: http://www.epc.eu/dsm/6/Policy_recommendations.pdf

But the potential benefits for the EU economy are large: it could add at least 4% to EU GDP, help create European digital companies of scale, as well as helping to integrate EU labour markets, combating climate change and countering the effects of population ageing.⁸ It would bring many benefits to consumers, not least to a new ICT-savvy generation that expects a free online market where they can, for example, download music anywhere in Europe.

At EU level, there has been much progress: the Digital Agenda,⁹ the Citizenship Report¹⁰ and the consultation on the Single Market Act.¹¹ The latter two followed on directly from the Monti Report¹², which provided a comprehensive blueprint for the development of the Single Market. However, it remains to be seen exactly how ambitious, integrated and visionary the concrete proposals will be and what, in the end, will be translated from ambition to reality, given the difficult economic and political environment as well as protracted European decision-making mechanisms.

A more competitive, sustainable knowledge economy

If the coming presidencies put their weight behind reform in these three crucial areas – inclusion of the public sector in economic governance and Europe 2020 considerations, reform of the EU budget and associated loan-based instruments with a particular view towards generating the investment needed to underpin Europe 2020, and pushing forward the further development of the Single Market, in particular the Digital Single Market – much could be achieved in turning Europe 2020 ambitions into reality. Conversely, without decisive action in these areas, Europe 2020 might well remain a laudable ambition that will go undelivered. In the current economic situation, Europe does not have many opportunities to generate future growth: it is critical to turn Europe's public sectors, European funding and the European Single Market into assets that will deliver smart, sustainable and inclusive growth.

8. For further details please see European Policy Centre, *Europe Needs a Digital Single Market Now*, April 2010, available at: <http://www.epc.eu/dsm/>

9. European Commission, Communication, "A Digital Agenda for Europe", COM(2010) 245 final/2, 26 August 2010, available at: <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2010:0245:FIN:EN:PDF>

10. European Commission, "Report, EU Citizenship Report 2010: Dismantling the obstacles to EU citizens' rights", COM(2010) 603 final, available at: http://ec.europa.eu/justice/policies/citizenship/docs/com_2010_603_en.pdf

11. European Commission, Communication, "Towards a Single Market Act. For a highly competitive social market economy – 50 proposals for improving our work, business and exchanges with one another", COM(2010) 608 final/2, available at: http://ec.europa.eu/internal_market/smact/docs/single-market-act_en.pdf

12. Mario Monti, Report to the President of the European Commission, "A New Strategy for the Single Market at the Service of Europe's Economy and Society", 9 May 2010, available at: http://ec.europa.eu/bepa/pdf/monti_report_final_10_05_2010_en.pdf

SMART AND SUSTAINABLE GROWTH

A New Innovation Spirit and the Future of Lead Markets

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Judging by the scant attention devoted to innovation during the extraordinary European Union (EU) summit in February 2011, the European Council has not started yet to treat this question seriously. In spite of this, over the span of one year the European Commission has managed to launch a silent innovative revolution in the EU. One could reasonably ask about the meaning of this new innovative spirit for the future of the Lead Market Initiative, whose final evaluation has been planned for autumn 2011.

A silent revolution

A discussion on innovation had initially been planned for the EU Summit in October 2010, but it had to be postponed until December and then, once more, until early 2011. Finally, European leaders looked into it during the last moments of the February Summit. Some may conclude that this has clearly demonstrated that innovation does not belong to the most pressing European priorities. Yet, such an estimation would be misleading and superficial. Contrary to appearances, the EU Innovation Commissioner, Maire Geoghegan-Quinn, has already managed to introduce innovation into the hard core of the EU agenda. What is more, unlike in the case of the Lisbon Strategy, many of the measures that the Commission has proposed give its innovation plan a fair promise of being implemented.

Institutional changes, introduced within the EU over the span of the last two years, have turned out to be unexpectedly favourable for innovation.

Firstly, innovation gained a determined and well-positioned spokesperson, and a Commissioner-level one. The personality of Geoghegan-Quinn has played an important role: since the very beginning she has been actively promoting her agenda, whereas for this semester she has already announced a further offensive.

Secondly, the Lisbon Treaty has reinforced the role of European Council, thus urging the Commission to take new steps in order to re-establish its position. It seems that the Commission has used the discussion over a successor to the Lisbon Strategy as an opportunity to present itself as an ambitious and forward-looking, yet effective and practical institution.

In any case, we should not be surprised by the fact that innovation does not arouse just as strong feelings among national leaders, as do fiscal coordination in the eurozone or social upheavals in the Arab world. The latter issues are happening “here and now”, whereas in the case of innovation one usually presumes that they will always find their time. Still, part of the problem is that many governments find innovation unattractive, as it seems difficult to be ‘sold’ to their voters. In a way, they are “maximizing their marginal benefit”, focusing on the most pressing issues that have a direct influence on wallets (like the New Financial Perspective and corresponding Common Agricultural Policy and Cohesion Policy questions). Most of the more long-term and strategic problems are left over to the Commission – which actually seems to be very well suited for tackling them.

It was thanks to the Commission’s initiative that the conclusions of the February Summit included a number of solutions that are key to innovation in the EU. For instance, the Commission has been obliged to draft, by the end of the year, a proposition on a pan-European venture capital market, as well as a proposition on a Small Business Innovation Research Programme (which would correspond to a very successful American programme of supporting demand for innovative solutions produced by small and medium-sized businesses). The Council has also agreed to launch a pilot European Innovation Partnership (EIPs) in the area of healthy aging.

At the same time, the Commission has managed to introduce into the European agenda two relatively novel ideas (“smart specialisation” and “conditionality clauses”), which should make Europe2020 much more effective than its predecessor.

Smart specialisation is supposed to become one of key criteria in the distribution of the Structural Funds within the Next Financial Perspective. In a country like Poland, it may therefore be easier to obtain financing for the development of clean coal technologies, than for a basic research in nanotechnologies. According to this new philosophy, the Commission would support different sectors of expertise and on different stages of development (basic research versus application), depending on the potential of particular countries. The concept of “smart specialisation” is still very fresh and it provokes strong controversies. Some experts argue that it may lead to a further widening of the development gap between EU countries. Others, to the contrary, say that it should induce Member States to reflect on their “innovation niches”, thus contributing to greater European integration and economic cohesion, and to a greater competitiveness of the EU as whole. Given the uncertainty about its real impact, it might seem very risky to include it in the EU strategies at this stage.

As regards the conditionality clauses, they are not such a new concept, but the Commission would like to try to make it effective at last. According to this idea, the support from Structural Funds in the Next Financial Perspective may be granted depending on whether a country has succeeded in fulfilling its objectives included in a yearly Programme of Reform, an obligatory document showing the progress in the implementation of Europe 2020. The supporters of this idea underline that it should be perceived as a system of incentives rather than of penalties. However, it is clear that it should also provide for some penalisation, if it is to be effective at all.

The Europe 2020 is often denigrated as an otherworldly document, detached from the current socio-economic context. But as far as the long-term perspective is concerned, it is much more concrete than the Lisbon Strategy. It is no longer based on a wishful thinking of “let’s catch up with the US and Japan”. Instead, it draws attention on specific objectives that the EU should pursue; matches them with indexes; and forces the Member States to fit into this scheme. Thanks to the conditionality clauses, as well as to the European Semester (inaugurated this year as a way to better coordinate economic policy between Member States), the new European strategy has a fair chance of being carried out not only in words, but also in deeds.

The story of the LMI

Both the new EU philosophy and the launching of European Innovation Partnerships (EIPs) are of crucial importance for the future of the Lead Market Initiative (LMI), whose final evaluation is to take place during the Polish Presidency.

According to an official definition, “lead market is the market of a product or service in a given geographical area, where the diffusion process of an internationally successful innovation (technological or non-technological) first took off and is sustained and expanded through a wide range of different services”.¹ The 2006 Aho Report “Creating Innovative Europe” identified five markets that fulfilled these criteria: e-health, pharmaceuticals, transport and logistics, environment, and digital content industry. Based on this report, the Lead Market Initiative was launched in December 2007. The report “identified a first set of markets with the potential to become lead markets and called for urgent and coordinated action through ambitious action plans for these markets, in order to rapidly bring visible advantage for Europe’s economy and consumers”.² After consultations with stakeholders, six markets were eventually chosen: e-Health, protective textiles, sustainable construction, recycling, bio-based products and renewable energies. What is most important, all of them were equipped with demand-side policy instruments dealing with regulation, public procurement, and standardisation.

1. European Commission, Communication, COM (2005) 474 final, 5 October 2005

2. European Commission, Communication, “A Lead Market Initiative for Europe”, COM (2007) 860, 21 December 2007

The implementation of lead markets demonstrated, however, that the initiative suffered from a range of weaknesses. A crucial one resided in its structure, which passed over national governments, focusing solely on strengthening links between the stakeholders on the ground. What this often provoked was a strange situation whereby the ministries responsible for innovation policy in a particular country disposed of only fragmentary information on lead market initiatives involving their national partners. This may, to some extent, explain another problem about LMI, which is that they have quickly lost the momentum, failing to maintain the support on the top political level. This explains why they have not fulfilled the ambition of becoming a central European project aimed at boosting the EU’s innovativeness. It quickly became clear that lead markets involved only a small number of stakeholders, in sectors that were still starting to emerge, and only in particular countries. It is no accident that the LMI mid-term progress report, published in September 2009, was based on information from only 16 countries. The so-called “new Member States”, who entered the EU in 2004 and 2007, have never been too enthusiastic about it: first of all, because they did not participate in the initial stages when the LMI was designed, and therefore could not identify with the sectors chosen; and secondly, because just after accession, they had a whole lot of other problems to tackle and usually did not care too much about innovation policy.

The LMI final report, which is currently prepared by an independent consulting agency from the United Kingdom, should be unveiled in the first days of July 2011, while the decision on the future of the initiative should be taken in November or December 2011. Not long ago it seemed that the future direction for the LMI would consist in adding other market sectors (space industry, for example); adding new instruments; better connecting LMI to Research, Development and Innovation (R&D&I) funding; or even using LMI as a tool for addressing societal challenges. However, the political context has changed since then and it is no longer certain that the LMI will survive at all. There are three major reasons behind this:

Firstly, the EU has adopted a new innovation strategy, which not only absorbs a whole range of existing instruments, but also puts a very strong emphasis on the demand-side innovation policies – like public procurement, standardisation, regulation, or the promotion of user-driven innovation and design-innovation. These became popular largely thanks to the LMI. But once they are employed in all other sectors, the LMI loses its uniqueness.

Secondly, we may imagine that LMI would somehow become “absorbed” by EIPs. Of course, the future of the latter is also unclear. The first Partnership, on healthy aging, has only been launched in February, as a pilot project. If it produced positive results, then following ones should be selected in December. However, there is a serious risk that there would be too little time for a proper evaluation, whereas many countries may be reluctant to agree on further partnerships, if the preliminary results are unknown. Of course, we should remember that EIPs cannot wholly replace lead markets. While the latter focused on promising sectors, the former are rather directed to societal challenges. What they have in common is a comprehensive perspective (involving many instruments) and the aim of engaging a wide array of

stakeholders. However, in this respect the EIPs should be much more complex and thorough, encompassing both supply and demand-side innovation policies plus the existing and prospective financial instruments. EIPs have already gained a hype that lead markets have never known, and this may suggest that ‘symbolically’ they have already managed to absorb them. Nevertheless, the final decision on whether LMI would be absorbed formally by EIPs, should be taken in October or December 2011, after the results of the healthy aging pilot project are unveiled and discussed.

One last argument would be that LMI does no longer fit very well in a new European philosophy of innovation, whereby the concept of “smart specialisation” is quickly gaining ground. According to this new idea, European countries should avoid concentrating their efforts on the same sectors, looking rather for innovation niches instead. What is more, an entrepreneurial learning process should take priority over a top-down approach of choosing the most promising sectors. This rests in a clear contrast with the approach underlying LMI, which altogether puts a question mark over the compatibility of LMI with the new innovative spirit in the EU.

Conclusion

The Trio Presidency, and Poland in particular, should carefully observe the ongoing debate on EIPs, LMI and “smart specialisation”. It will be the responsibility of the Trio Presidency to guide discussion in the right direction and work out a consensus on the future of LMI. The final decision should be based on a balanced evaluation of effects of LMI hitherto, its potential for future progress, and its capability of being replaced by EIPs.

The Trio Presidencies should also take account of the fact that the future of lead markets remains, as yet, unclear. Much would depend on the results of the evaluation, which should be ready in July, as well as on the effects of the EIP pilot project on healthy aging, which should be known in autumn. Lead markets have already played a crucial role in promoting demand-side innovation policies within the EU. But for the time being, it seems that the continuation of LMI may not be needed anymore. With the “Innovation Union” and the European Innovation Partnerships, their uniqueness is irretrievably gone. Besides, they do not seem to be consistent with the new innovation philosophy, which is expected to reign in the EU at least for the next decade. Therefore, it is quite probable that in October or December 2011 the European Council decides that LMI should retire.

The good news is that this would happen not because innovation has lost, but – just the opposite – because, at last, it is starting to win itself a proper place among the EU’s top priorities.

SMART AND SUSTAINABLE GROWTH

Reconciling the Single Market Objective with the Renewable Energy Objective

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During the last two decades, large amounts of political capital have been spent on creating a single liberalised market for electricity. At the same time, administrative measures have been introduced to support renewable electricity generation. The success of these administrative measures (in terms of increasing shares of renewable) is challenging the development of the liberalised market. Consequently, institutional settings that reconcile the two policy targets are needed. The development of market based solutions that are compatible across the Union is essential to achieve the long term target of decarbonising the power sector without putting the internal electricity market into peril.

Renewables targets on a good track

Renewable energy is high on the European political agenda. By 2020, Europe wants to use 20% of its energy from renewable sources, such as water, wind, biomass and the sun.¹ The corresponding targets of the Energy and Climate Package from 2009 have been reiterated in the Europe 2020 Strategy. And it appears that these goals are among the few measurable targets in this strategy document for the next decade that can actually be reached. National support schemes incentivise the deployment of significant amounts of solar cells and wind turbines. Member States transpose their national renewable energy targets into action plans that seem actually capable of reaching the goals set in Brussels. This is an impressive achievement that many observers did not deem possible.

The success of the renewable energy policy is starting to affect other dimensions of European energy policy. Among the headline targets of the European energy policy is the creation of a single energy market. By combining the strength of 27 energy systems, such an internal market should lead to more competition, more efficient use of resources and installations,

1. We want to focus on renewable electricity sources, as this is supposed to bring the largest contribution to the overall renewable energy targets (that also includes biofuels for transport and heating).

as well as lower greenhouse gas emissions. However, the national approaches to deploy and integrate RES-E (electricity generated from renewable sources) in the existing electricity systems are often not based on market solutions and incompatible between Member States. Thus, continuing national policies towards RES-E deployment and integration might put the internal electricity market into peril.

During the next Trio Presidency, significant decisions to integrate the European energy market need to be taken in order to avoid a complete disintegration of the internal market. The good sign is that the “Energy Summit” on 4 February 2011, concludes that an internal energy market is to be reached in 2014. As the third energy market package is to be transposed into national legislation in 2011, the European Council should support the European Commission in ensuring that Member States do not only follow the letter, but also the spirit of the Directive.

Renewables success challenges the Single Market

The European renewable energy policy is in conflict with the internal market on at least four issues. *First*, electricity generated from renewable sources is not traded in a European market. This leads to an artificial divergence of the price for renewable energy in Europe. This is inefficient. *Second*, renewable deployment is one source for congestion in cross-border transmission lines and thus reduces the potential for intra-EU trade of electricity. *Third*, RES-E installations intentionally replace conventional power plants most of the time. Thus, conventional power plants are much less often called upon and median wholesale prices decrease. As conventional power plants are still needed as back-up, Member States are contemplating mechanisms to remunerate the provision of capacity. Those mechanisms risk being non-market based and incompatible across the Union. And *fourth*, every Member State develops its own system for dealing with the intermittency of RES-E. The value of the corresponding services (reserves, frequency control, etc.) is increasing with the deployment of RES-E. Thus, a growing share of the electricity value chain risks to be operated outside the Single Market.

To achieve their national renewable energy target, each Member State has developed a different policy mix. Policy tools include “green certificates”, “feed-in tariffs”, obligations, direct subsidies, preferential grid access regulations, tax breaks, etc. Due to the use of different fiscal, parafiscal and non-fiscal instruments the actual size of the state support for RES-E is very difficult to assess. Data on state aid for environmental protection, collected in the Directorate-General Competition state aid scoreboard –by many means an imperfect indicator for RES-E support, hints to large divergences inside the EU. In 2009, it amounted to 1.1% of the Gross Domestic Product (GDP) in EU27, while it was 2.4% of the GDP in Germany, but only 0.12% of the GDP in Italy.² Consequently, the national systems for RES-E support in

Europe seem to differ, both in structure and in size. This is economically inefficient as it leads to different prices for the same good (electricity produced from renewable sources) within the Union. One striking illustration for the inefficiency of the fragmented support schemes is that there are currently higher incentives for installing solar cells in northern Germany than in southern Italy. This is one of the reasons why the European Commission has been pushing for a transferability of RES-E achievements. Such transferability – for example through the obligation of any Member States support scheme to accept foreign “green” electricity – should quickly lead to harmonisation. But the European Commission did not succeed in 2008-2009, as the present fragmentation is based on a political choice by the Member States at this time. The rationale for this choice lies in national security concerns about supply, but also in national “green” industrial policy considerations. From an economic point of view, an institutional competition argument might have partly justified differentiated approaches. But it is quite clear that the fragmented system based on national state aid and barriers to trade is not only at conflict with the Single Market idea, but also precludes reaching the renewable targets at least cost.

A second impact of RES-E deployment on the internal electricity market is linked to the electricity network. RES-E are characterised by limited predictability and generation far from centres of electricity consumption. Thus, the existing electricity networks will have to accommodate higher security margins and new flow patterns. In the current design of congestion management, both effects decrease the capacity for commercially available transmission capacity. Consequently, intra-EU electricity trade – a cornerstone of the internal market – will decline, if no measures are taken.

A third threat to the internal market is the sheer success of the RES-E support instruments in certain Member States. Since 2005, Germany has deployed about nine gigawatt hour (GW) of wind turbines and 14 GW of solar panels. This is about 18% of the total installed electricity generation capacity in Germany. Spain deployed 10 GW of wind and four GW of solar, which represents 15% of its total installed capacity. Through the zero-variable cost of wind and solar power, those installations typically run irrespective of the electricity price³. Thus, conventional power plants are much less often called upon and median wholesale prices decrease. But, some conventional plants might be essential to meet consumption when a cloudy, low-wind hour coincides with high-demand. However, in the current system those plants will only stay in the market if they can recover their fixed cost by charging very high prices in the few hours they are called upon. To date there is no consensus whether such a system of highly volatile prices (very low prices when RES-E plants are sufficient to meet demand and very high prices if they are not) is politically sustainable and sufficient to incentivise the provision of back-up capacity needed to run the system securely. Consequently, Member States are contemplating alternative mechanisms to remunerate the provision of

2. In comparison to electricity consumption, the distribution is equally wide. While the member states of the EU27 spend a total of €13 billion on environmental aid and consume about 3000 terawatt hour (TWh). For Germany this ratio is 2.5 times higher and for Italy 16 times lower.

3. In countries that have fixed feed-in tariffs, the variable cost of RES-E generators is actually negative, as commercial operators would only accept curtailing production when the operator obtains more money for not supplying than he would obtain from supplying at the feed-in tariff.

capacity. Member States discussions show that those mechanisms risk being non-market based and incompatible across the Union.

And finally, the fourth impact is that the growing share of RES-E increases the need for so called ancillary services. In simplified terms, ancillary services consist of the provision of electricity (or load) to the network at a certain network point at short notice. That is, if the wind does not blow as expected in a certain region, the system operator has to balance the difference between demand and supply by either (i) bringing in electricity from another region, (ii) increasing conventional generation in this region or (iii) reducing demand in this region. Electricity markets in Europe essentially evolved out of nationally optimised systems of power plants and networks built in the pre-liberalisation period. Networks are remunerated from regulated tariffs. Thus in most European countries, liberalisation mainly consisted of implementing one Single Market-based price signal – a wholesale electricity price. The idea was that the price signal could coordinate the optimal scheduling of power plants (switch on only the cheapest plants to meet the demand), the cross-border electricity trade (export as long as you are cheaper than your neighbour), as well as power plant investments (build a power plant that can create profit given the expected distribution of prices). Since electricity traded at the wholesale-level represented the largest part of the non-regulated value in the electricity sector, this idea was deemed sufficient. Other services, essential to maintain electric-system reliability, only represented a negligible share in the variable electricity cost of the final consumer. Consequently, many Member States allowed system operators to procure these services and bill them to the customers as a part of their regulated tariffs. Due to the limited predictability and intermittency of RES-E system, operators will have to provide significantly higher volumes of these services than in the past. Consequently, the procurement of ancillary services will feature an increasing share in the value of electricity. Contrary to the standardised trade of electricity at forward and spot markets, ancillary services are typically not traded across border – because market arrangements in Member States are incompatible. Thus, a growing share of the electricity value chain risks to be operated outside the Single Market.

In the following section, a couple of recommendations are presented to solve the outlined issues and to accommodate both the renewable and the internal market targets.

Compatibility of national market design choices is essential

Reconciling the renewable energy target with the internal market target is feasible and beneficial. Only in a functioning single electricity market can the feed-in of an increasing amount of renewable electricity be managed at reasonable cost. Wide geographic averaging of intermittent generation and consumption reduces the need for expensive back-up capacities. Trade of ancillary services decreases market power in this segment. And optimal management of transmission lines reduces losses. Accommodating the renewable and the internal market targets requires, first, an acknowledgment of the need to reform the design of electricity markets in

order to prepare national electricity systems for increased deployment of RES-E, and second, the EU must also make sure that the national market designs are compatible.

The electricity sector is a complex system with many actors. The corresponding market designs are quite heterogeneous. At the high voltage level alone, the spectrum ranges from countries with state-owned monopolies with regulated prices to countries that separate prices according to time, location, response time, capacity made available, quality of the power delivered etc. In Europe, the most widespread system is a national wholesale market with hourly prices combined with a national solution for renewable support, capacity provision and ancillary services. Thereby, only the electricity at the wholesale market can be traded across borders. As lined out in the last section, the increasing share of RES-E is challenging the ability of this market designs to efficiently manage the system.

Thereby, the challenge of defining functioning markets for the different dimensions of electricity has been accepted by Member States to different degrees. While Poland seems to accept that prices for electricity at different locations of the network cannot have the same price in the presence of internal congestion and network losses, Germany is still fighting this insight. And while Nordic countries allow integration of demand-side measures to increase reliability, the United Kingdom does not do so. So, the big challenge is to get development of new market designs going without ending in incompatible national systems. Member States should not strive to find the optimal solution for deploying and accommodating RES-E in their respective markets. For in such a national approach, the political economy around the differing legacies of power-plant-parks would favour the development of up to 27 almost equivalent though incompatible systems. Thus, the general rule should be that all dimensions of the commodity electricity should be freely tradable inside the Union.

Consequently, the next Trio Presidency should make sure that the converging prices between Member States in (the declining) wholesale segment are not mistaken for the fulfilment of the internal market. It should in fact monitor much closer developments in the other – still nationally dominated – segments. Beyond pure monitoring, a bold step towards the development of compatible market designs that, at the same time, allow reaching both the renewable energy and the internal market targets is needed. For this purpose the Agency for the Cooperation of Energy Regulators (ACER), set up in the third liberalisation package, should be upgraded from its role of coordinator, for certain narrowly defined processes, towards an institution that possesses own powers to enforce compatibility. Only then, the hundreds of main stakeholders (27 governments, 27 national regulation authorities, 33 TSO's, a dozen power exchanges, hundreds of electricity trader, producer, large consumer, etc.) could be incentivised to cooperate. Above this, the possibility to make the RES-E feed-in tradable across Member States should be revised.

The big advantage of linking electricity systems is that a joint system can be much more than the sum of its parts. But to make this happen the parts have to fit.

SMART AND SUSTAINABLE GROWTH

Carbon Capture and Storage: EU Advancing, but not Fast Enough

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Carbon capture and storage (CCS) is an essential low-carbon bridge technology, to be used in the several decades it will take before Europe can be totally reliant on renewable energy. The EU's energy commissioner Günther Oettinger recognises this¹, and the EU has a programme to subsidise large-scale demonstrations by 2015. The money will come from auctioning permits under the Emissions Trading Scheme (ETS). CCS is not only essential to meet the EU's climate objectives; it is also a major business opportunity. So, it is welcome that the Commission is serious about promoting this technology.

However, the timetable for selecting projects and awarding grants makes the 2015 deadline look unlikely to be met. The amount of money available, being based on the ETS price per tonne of carbon, is uncertain. The portfolio of technology types and industrial sectors to be covered is not yet clear.

Beyond demonstration, rapid deployment will be necessary. This could best be achieved through regulation: limiting the amount of carbon emissions permitted per unit of production. Yet, the EU has made no progress on this. The Commission has at least recognized the need to think beyond demonstration and highlighted the need for carbon dioxide transport as a key part of the EU's future energy infrastructure².

The greatest threat to CCS success in Europe appears to be strong public opposition to underground storage in several Member States, notably in the Netherlands and Germany.

1. For example: "Carbon capture and storage (CCS) stands out as one of the most important technological solutions if Europe is to achieve its goals for energy and climate change". Available at: http://www.powergenworldwide.com/index/display/articledisplay/2121886504/articles/powergenworldwide/coal-generation/coal-generation-equipment/2011/01/ec-commissioner_backs.html

2. European Commission, Communication, "Energy infrastructure priorities for 2020 and beyond – A Blueprint for an integrated European energy network", COM(2010) 677 final, 17 November 2010, available at: http://ec.europa.eu/energy/infrastructure/strategy/2020_en.htm

New Entrant Reserve 300

The "New Entrant Reserve 300" (NER 300) fund was agreed in 2008 by EU heads of state to support CCS and innovative renewables technology. This is the revenue from the auctioning of 300 million ETS permits. At the time of agreement, the Commission spoke of this money being used to subsidise 12 large scale (more than 250 megawatt) demonstration plants, to be operational by 2015. But in November 2010, when it launched the competition for the grants, this was only for eight projects, using the revenue from 200 million permits. A second round of grants, for the other four projects, is promised for 2012, making it very unlikely that they will be operational by 2015.

The timetable for the first round could be speeded up. Potential projects had to apply to Member State governments by 9 February 2011. The governments had to assess them by early May 2011, and then pass on applications to the European Investment Bank (EIB). The EIB is expected to take around nine months before making recommendations to the Commission. Then comes the inevitable consultation / negotiation between the Commission and Member States. So, no actual awards are expected before the second half of 2012.

The amount of money available depends on the amount for which the permits are auctioned. At a price of 20€ per tonne of carbon, the revenue would be about €6 billion. But the current ETS price is significantly below this, reducing the revenue. The division between CCS and renewables has not been defined. And any EU money must be co-financed by the Member State government, and most governments are not flush with money at present. So, the CCS financial picture is very uncertain.

Portfolio of technologies

The Commission has identified four eligible categories of CCS technology: pre-combustion, post-combustion, oxyfuel, and industrial applications other than the power sector. But it has yet to say how many of the demonstration projects will be in each category, arguing that all applications should be assessed without any pre-set portfolio for the awards. This is an understandable line to take in administrative and political terms (though there are legitimate questions being asked about the assessment criteria – discussed below). Still, there should be projects from each of the categories. Pre-combustion CCS covers the whole capacity, so it is good in emissions reduction terms. Yet, it cannot be retrofitted. Post-combustion can be retrofitted, but it does not necessarily cover the full capacity. It is necessary, as many existing power stations globally will have to be retrofitted to reduce carbon emissions far enough and fast enough. But, there is no justification for using public money to demonstrate post-combustion on new power stations. Oxyfuel technology covers the full capacity and

can also be retrofitted, but is a less developed technology than pre- or post-combustion, so it would be unwise to put all EU eggs in this basket.

Some money should go to demonstrate CCS on gas power stations. The Commission's grant awards to CCS projects under the European Economic Recovery Plan did contain one award to a gas power station in France, so it has a good track record on this. Nevertheless, the Commission should make it clear that the NER portfolio will also cover gas.

The portfolio must also include cement and steel. A recent report by the Öko-Institut, sponsored by the Greens / European Free Alliance, argues that around 7% of the emissions reductions needed to meet climate objectives by 2050 should be made through CCS the steel and cement sectors, plus biofuel processing.³

Assessment criteria

The main criterion that the EIB and Commission are proposing to use is cost per tonne of carbon abated. Clearly cost-effectiveness is an important consideration, though the justification for publicly-supported demonstration projects is that CCS has yet to be demonstrated at large scale or integrated throughout the process, which means that costs are very uncertain estimates. Beyond this general point, a criterion of cost per tonne of carbon abated will inevitably favour coal power stations because coal is much more carbon-intensive than is gas. A better criterion, which would lead to a more balanced portfolio, would be cost per unit of low-carbon electricity produced. Scottish and Southern Energy (SSE), which wants to demonstrate CCS at a gas power station, is arguing for this:

Linking performance payments and / or assessment criteria to “£/tonne CO₂” creates a perverse advantage for higher carbon power stations i.e. coal or inefficient power stations. This is a result of the higher concentration of CO₂ produced, the cheaper it is to collect on a £/tonne basis. A more appropriate measure would be ‘£/MWh of ultra-low CO₂ electricity’.⁴

Which Member States are interested in CCS?

Major coal users Germany, Poland, the Netherlands, the United Kingdom (UK), and Spain, all have CCS projects awarded €180 million under the European Economic Recovery Plan (EERP), and are aiming to submit projects for the NER 300 grants. A number of countries that

3. Öko-Institut, “The Vision Scenario for the European Union, 2011 Update for the EU-27”, January 2011, available at: http://www.greens-efa.eu/cms/topics/dokbin/368/368667.the_vision_scenario_for_the_european_uni@en.pdf

4. SSE response to UK Department of Energy and Climate Change consultation, “CCS Demonstration Competition Market Sounding Document”, 2010

did not get Economic Recovery grants are also aiming to get NER 300 grants, including the Czech Republic and Hungary. The notable absentee is Greece, which is very coal dependent (in 2008 52% of its electricity was generated from coal). The Greek government has strong opposition to CCS, on cost grounds.

Deployment

Large scale demonstration projects are needed because CCS has only so far been shown to work at small scale and at various stages of the process, not at large scale or integrated throughout the process. But CCS will only contribute significantly to climate objectives if demonstration is followed – assuming it works as planned – by rapid and widespread deployment. So, how should deployment be achieved? There is the usual debate between supporters of market mechanisms and those favouring a regulatory approach.

The EU does not have a carbon tax, and is unlikely to get one any time soon, despite the Commission suggesting one as an “own resource” in the next Multiannual Financial Framework (2014-2020). Several Member States, including Germany and the UK, remain opposed to any EU taxes, on subsidiarity grounds. Jacques Delors spent much of his period as President of the European Commission arguing for an EU carbon / energy tax. But he failed to get the Member States to agree. Taxation measures require unanimity in the Council of Ministers, so any country can prevent adoption. In fact, many Member States, including the UK, opposed the Delors proposal on subsidiarity grounds – the argument that taxes are for national governments, not the EU. Other countries less opposed to EU integration, such as Germany, opposed the Delors proposals because they would have damaged their coal industries. After Delors’ failure on energy taxation, the EU moved to a ‘cap-and-trade’ system, the ETS. This is stronger than it was: the Commission has the lead role in deciding the total number of permits, and permits will be auctioned rather than given free to key sectors, including electricity generation. But the price of permits remains much too low. The ETS would only help significantly with CCS deployment if there was greater price stability and an expectation of prices rising substantially. Both could be achieved through a rising floor price.

The European Parliament tried to insert a regulatory limit on the amount of greenhouse gases emitted into the Industrial Emissions Directive in 2009. The Parliament was unsuccessful, but the Directive did at least acknowledge the right of Member States to set their own Emissions Performance Standard to limit the amount of carbon dioxide per unit of electricity (based on the Californian approach).

The UK government is taking a lead on these issues, currently consulting on setting a de facto ETS floor price by converting the Climate Change Levy (which, despite its name, is an energy tax rather than a carbon tax) into a carbon tax and making the power sector pay it (it

is excluded at present) and on setting an Emissions Performance Standard. The level of the standard has not yet been decided, but the options in the consultation paper would prevent any new coal power stations without CCS being constructed.

Local opposition

A major worry for CCS supporters is strong and apparently increasing opposition from those who live near proposed storage sites and from some environmental Non-Governmental Organisations (NGOs). In November 2010, the Dutch government dropped Shell's proposal to store carbon dioxide from its oil refinery near Rotterdam in a depleted gas field under the nearby town of Barendrecht. This was despite the active support of the Rotterdam council and the Rotterdam Climate Initiative, headed by former Dutch Prime Minister Ruud Lubbers.

Many Barendrecht residents said they opposed the proposal because it could endanger the town. Some also said they feared a fall in house prices. Shell did try quite hard to win over local opinion, but critics say they only began trying this after protests had begun.

Vattenfall aims to capture carbon dioxide from its Schwarze Pumpe coal station in Brandenburg, Germany and store it under the town of Beeskow. But this project has also provoked considerable local opposition, with Beeskow residents erecting large yellow crosses along the route on which the carbon dioxide would be transported. They argue that the full impact of storing carbon dioxide below their town is not known and that they do not want to be used as "guinea pigs". Beeskow council vetoed Vattenfall's plans to conduct geological research and criticised the German federal government for allowing Vattenfall to proceed with its plans before introducing a federal law on CCS. Germany is required, under the EU carbon dioxide storage Directive, to have such a law by June 2011 but there have been repeated postponements – most recently in November 2010. The parties in the federal government, the Christian Democratic Union / Christian Social Union of Bavaria (CDU / CSU) and the Free Democratic Party (FDP), appear to be split on the issue. The two ministers with direct responsibility are Economy Minister Rainer Brüderle (FDP) and Environment Minister Norbert Röttgen (CDU) and so far they have been unable to agree.

There is strong opposition from some key Land governments, including Niedersachsen and Schleswig-Holstein, in which there are extensive potential storage areas. These governments aim to block any storage of carbon dioxide on their territory. They probably do not have the constitutional powers to do this but the federal government is said to be considering offering them the right to set a maximum limit, which might well be too low to allow any commercially viable projects.⁵

5. Frank Albrecht, "Nord-Allianz gegen Kohlendioxid-Lager", Schleswig-Holsteinischen Zeitungsverlags, 27 September 2010, available at: <http://www.shz.de/nachrichten/top-thema/article//nord-allianz-gegen-kohlendioxid-lager.html>

German environmental NGO BUND has claimed that there are "enormous risks" associated with CCS. There is little scientific evidence presented to back up this claim⁶ and BUND is part of Friends of the Earth International, which supports CCS as a better bridge technology than nuclear. Nevertheless, a prominent and large environmental group speaking out against CCS has great potential for damage and delay.

A business opportunity for Europe

As well as its contribution to climate control, CCS has the potential to be an excellent growth sector for the European economy. However, Europe is in danger of missing the bus. The Obama administration has given significant grants to several large CCS projects. China is constructing large demonstrations, largely with US financial support. Australia is doing likewise (though without US money).

As well as public opposition and the time it is taking to get awards made, another challenge for CCS in Europe is the predicted flat level of electricity demand for the next few years, following the recession. Many existing power stations will need to be closed in the next decade, partly for age reasons and partly to meet the Large Combustion Plants Directive. So there will need to be many new power stations, even if overall demand for electricity is flat. Nevertheless, major utilities, like E.ON, say that they are looking increasingly at expansion outside Europe.⁷

In order to take advantage of the business opportunity and make a major contribution to global climate protection, the EU must ramp up its efforts on CCS. Demonstration will require subsidy. Deployment may require continuing subsidy and will definitely require a combination of regulation and market mechanisms. The EU should therefore:

- speed up the timetable for the NER 300 grants with the aim of making awards by the end of 2011;
- set a floor price for the ETS, and pre-announce that the level will increase steadily;
- commit to no new coal power stations without CCS.

The next two Presidencies of the European Council of Ministers, Poland and Denmark, have significant interest in CCS. Poland gets around 90% of its electricity and heat from coal, and received a grant from the European economic recovery plan for a CCS demonstration plant. Denmark gets around half its electricity and a quarter of its heat from coal and when she was Danish Climate and Energy minister – before becoming Europe's Climate Action Commissioner

6. Jonas Helseth, "German CCS debate is misguided, Bellona says", The Bellona Foundation, 29 November 2010, available at: http://www.bellona.org/news/news_2011/CCS_debate_in_Germany

7. "Flat market prompts E.ON to look outside Europe, Power-Gen Worldwide", 25 January 2011, available at: http://www.powergenworldwide.com/index/display/articledisplay/589265575/articles/powergenworldwide/Business/Policy/2011/01/flat-market_prompts.html

– Connie Hedegaard said she was determined to ensure that one of the EU’s CCS demonstration plants should be in Denmark.

After Denmark comes Cyprus, which has no clear interest in CCS (its electricity comes from oil. CCS could and should be used at oil refineries and oil power stations, but the Cypriot government sees other issues as being more important). So in the second half of 2012, progress on CCS will be largely down to the Commission and Council President Herman van Rompuy.

Money for CCS will be hard to protect, given the economic circumstances and the high-level political arguments about the EU budget. The most sensible way to get more money available for CCS would be to stop giving public money to dirty coal. Member States should transfer all remaining subsidies to the coal sector to CCS programmes and the loan that the EIB has given Slovenia to build a new coal power station, without CCS, should be cancelled.

SMART AND SUSTAINABLE GROWTH

Policy Options to Improve the Security of European Energy Supplies: Results from the SECURE Project¹

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The SECURE context

The SECURE project (Security of Energy Considering its Uncertainty, Risk and Economic implications)² analysed the risks associated with the supply of various energy sources in the European Union (EU) in order to come up with concrete policy proposals for their mitigation. It was funded by the European Commission under the Seventh Framework Programme. A key conclusion of the project was that security of supply and climate change cannot be considered separately and that there are clear synergies between strong climate action and energy security policies.

Oil

The functioning of markets is a key determinant of energy security. While geopolitical and other threats to physical supply may cause price shocks, they are – based on historical experience – unlikely to cause any significant physical shortage. Price volatility is in many ways more important and more devastating than potential threats to physical supplies because related costs are much higher than the potential costs of supply disruptions. The root cause of price volatility is the rigidity of demand and supply in the short-term. Unfortunately,

1. This paper presents research results from all members of the SECURE consortium, including Observatoire Méditerranéen de l’Energie (OME), Fondazione Eni Enrico Mattei (FEEM), Romboll Oil & Gas, Lithuanian Energy Institute (LEI), Fraunhofer Institute for System and Innovation Research, Joint Research Centre (JRC), Technische Universität Dresden (TUD), Paul Scherrer Institut (PSI), Ricerca sul Sistema Energetico (RSE), Energy Research Institute of Russian Academy of Sciences (ERI RAS), University of Bath, Gulf Research Centre Foundation (GRCF), Centre for European Policy Studies (CEPS), Vienna University of Technology (TU-Wien), and Centre National de la Recherche Scientifique (LEPII).

2. See also: www.secure-ec.eu

however, this phenomenon cannot be easily addressed. The SECURE project has reviewed several approaches:

- Freer trade of major crude oil streams, notably those from the Gulf.
- Accumulation of larger (industry) stocks, by establishing a public agency to invest in larger storage facilities (to be used by oil producers at low cost), for example.
- Improved price finding mechanisms (forward pricing rather than spot, flexible and adjustable price band, increased trading in real oil barrels rather than future paper contracts, etc.).
- Increased demand security through take-or-pay contracts.
- Vertical integration with direct access of producing companies to the final customer.

None of these approaches is sufficient to stabilise prices, but collectively they may succeed in reducing the extreme volatility observed since 2004.

Another key SECURE recommendation is related to climate policies. Ambitious targets aimed at decarbonisation and energy efficiency may lead oil (and gas) producing countries to reduce investments in expanding or maintaining capacity for fears of demand destruction. This can pose a risk to long-term EU supplies in case climate and energy targets are not met. Hence, it is recommended not to pursue policy objectives that cannot realistically be reached, but to emphasise cooperation with exporters and pragmatism.

In addition, the EU should aim at mitigating the danger of closure of critical sea lanes, first and foremost of the Strait of Hormuz. Although such a closure is not easily accomplished, the recommendation (mainly for producing countries) is to maintain readiness to reorient oil flows as required. At the same time, the EU should aim at mitigating the danger of closure of other critical sea lanes, which might be caused by navigation accidents through congested passages, the most critical situation being that of the Turkish Straits. An option would be to seek a revision of the Montreux Convention of 1936, to allow for the imposition of size limitations and passage charges on tankers, to discourage free riding and create conditions for the commercial development of pipeline by-passes. The EU should aim to facilitate investment in infrastructure adapted to reduce the danger of accidents and vulnerability, by offering financial incentives and promoting even more stringent regulations for oil and chemical tankers.

Natural gas

Security of demand and security of supply are complementary issues in ensuring an overall balance in the security of natural gas supply in the EU. Security of demand requires the EU to provide clearer signals regarding future gas demand to avoid underinvestment in exporting countries. Therefore, the EU should develop gas demand forecasts based on the amalgamation of energy policies and individual national plans.

National and regional differences imply that overall EU security of supply policy will need to allow for adjustments of measures and policies to specific regional circumstances. The Baltic Energy Market Interconnection Plan (BEMIP) could serve as a role model for such a regional focus.

The importance of a functioning internal market cannot be overstressed in terms of security of supply. However, markets alone will not solve the current issues of low security of supply in some countries, especially where markets are poorly developed (in Baltic countries, for example). Thus increasing security of gas supplies in these regions is likely to be dependent on government intervention and / or EU regulation. Further regional diversification can be ensured by reverse flow and interconnections, as well as new supply routes, both pipelines and Liquefied Natural Gas (LNG). Demand flexibility should be studied further regarding its ability to mitigate security of supply issues in the EU. The development and strengthening of early warning and crisis prevention mechanisms at the EU level, as well as the implementation of regional emergency plans, should be encouraged.

Regarding transit risks, the possibility of an independent transmissions operator in the Ukraine composed of Ukrainian, EU and Russian operators should be evaluated. Such cooperation would reduce the chances of bilateral disputes affecting gas supply and ensure the much needed investments in Ukrainian transmission infrastructure.

As regards unconventional gas, an accurate survey of recoverable resources in Europe should be produced in order to evaluate its potential impact on supply security. In addition, legislation should be streamlined and reviewed in order to close legislative gaps and to accompany any potential future development in this area.

With the relevance of traditional suppliers, such as Norway and Algeria, about to decline in the medium term, Europe needs to commit to robust policies with those export partners that are expected to play a more important role in European gas supply after 2030 (i.e. Russia, the Caspian region and the Middle East), focusing on pragmatism, partnership and commitment.

Coal

Due to the fact that virtually all major exporters of coal can be considered reliable in the long-term, the real issue for European steam coal supply security is the absence of an economically and politically sustainable use of coal due to obstacles in the implementation of Carbon Capture, Transport and Storage (CCTS) technologies. The SECURE project concluded that there is a risk that coal will no longer be an essential element of European energy supply in the future because there is justified concern that CCTS roll-out will be delayed or never carried out. In Europe, the economic use of coal in the power sector and in industry could be

threatened and its substitution may pose considerable challenges, especially in industrial processes. In the light of recent developments, SECURE came up with the following policy recommendations:

- The potential contribution of CCTS to decarbonising the European electricity sector should be reconsidered given new data on CCTS costs, a better understanding of the complexity of the process chain and the lowered CO₂ storage potential.
- The EU should keep technology options open and avoid premature intellectual property appropriation. EU co-funded projects should make new knowledge widely available and promote competition between projects in order to facilitate technical progress.
- The huge and readily available funds for CCTS should be rapidly deployed. Where industry does not respond, the legal and regulatory framework should be readjusted and the level of incentives should be raised [for example, through a credible carbon dioxide (CO₂) price path].
- The strong focus on implementing CCTS in the power sector should be extended to industry, which can be highly vulnerable to an abandonment of coal.
- Early planning of transport routes (along existing networks, for example) is essential, should large-scale CCTS deployment ever become reality.
- Future regulation should specify the allocation and financing principles, as well as access for third parties. Sufficient incentives for the private sector to manage the network development are unlikely, given the political, regulatory, technical, and economic uncertainties.
- If Europe fails to become a CCTS pioneer, new strategies for the global roll-out of CCTS are needed (for example, via the inclusion of CCTS in the Clean Development Mechanism).

Nuclear

The sensitive issues for nuclear energy include risk aversion towards very low probability accidents with very severe consequences, the necessity to assure safe storage of relatively small volumes of radioactive waste over an extremely long period of time and the possibility of nuclear proliferation. These aspects strongly influence the public opinion and consequently also the social acceptability of nuclear power.

In the EU, the often announced nuclear renaissance is having a difficult birth. According to International Energy Agency (IEA) and European Commission energy scenarios, EU nuclear share may halve between now and 2030. Because nuclear is presently providing almost two thirds of all low-carbon electricity in the EU, this will make the achievement of EU climate objectives more difficult.

Nuclear energy is a divisive issue in the EU, but those countries that wish to proceed with it will need to address the following points:

- Promote public debates on nuclear safety, energy security of supply and climate change issues thus providing a balanced perspective on nuclear and other energy supply options.
- Assure that legal, regulatory conditions for nuclear energy are clear and stable.
- Promote human capital building.
- Implement the planned waste repositories to demonstrate practically their feasibility.
- Explore regional centres for high-level waste disposal.
- Create a level playing field for low-carbon technologies via an effective EU-wide emission trading system and/or carbon tax.

The highest safety standards must be strictly applied to nuclear reactors and all other elements of the associated infrastructure: conversion, enrichment, fuel fabrication, spent fuel storage and reprocessing. The EU should use all its geopolitical weight to make sure that these rules are respected everywhere and to promote non-proliferation. In fact, as proven by recent incidents in Japan, a major nuclear accident anywhere in the world can have dramatic consequences on nuclear development in Europe.

Renewable energy sources

A high share of Renewable Energy Sources (RES) in the mid- to long-term cannot be reached without strong increases in all three sectors: renewable electricity (RES-E), heat (RES-H) and biofuels. While an extensive set of supporting mechanisms for RES-E, and to some extent for biofuels, exists, the currently limited and dispersed support for RES-H needs to be addressed in the future. Concerning biofuels, efforts should be directed to develop second generation biofuels, which have a better GHG emissions performance and reduce competition with food supplies and biodiversity.

The general approach should be to keep a level playing field among different technologies, so that most efficient solutions can emerge from market forces rather than being selected by policy makers. Present technological uncertainties suggests the need to maintain some public support to a wide range of technologies, at least until the relative merits of different solutions emerge on the basis of experience. Consequently, any future policy framework should consider providing technology-specific support to the various RES options. However, this policy should entail periodic reviews of the incentive schemes, in the light of a possible future phasing out.

The uneven distribution of RES potentials and costs emphasises the need for intensified cooperation between Member States. Suitable accompanying flexibility mechanisms can assist the achievement of national RES targets in an efficient and effective manner.

RES policies should be supported by strong energy efficiency policies to reduce energy demand and hence the amount of RES required, as well as associated costs to achieve the 20% RES target by 2020.

To face the challenges resulting from an increased share of variable wind electricity, several potential remedies may be applied:

- Improvement of the tools to forecast the variations of wind power outputs.
- Trading at the intra-day market platform would correct all imbalances (contrary to imbalance payments, which only apply for the net system imbalances).
- Although not all storage systems are yet economically competitive, they can facilitate the integration of fluctuating generation (for example: pumped-storage hydropower plants, hydro reservoirs, compressed air storage, flywheels, or batteries).
- By enabling intelligent monitoring and an improved control of supply and demand, smart grids can improve system reliability and the security of supply.
- Finally, the reinforcement and extension of the electricity grid represents a key option to integrate large amounts of fluctuating electricity into the electricity system.

Looking at the longer term, a beneficial political and regulatory framework promoting solar energy imports from North Africa should be created, including options for granting these projects priority status under EU infrastructure projects, as well as promoting the development and operation of European and trans-Mediterranean super-grids. Such super-grids would need a high level of redundancy or resilience, otherwise they may be easy targets for terrorist attacks.

Electricity

Regulatory certainty is key to ensuring (capital intensive) investments in the electricity sector. It is thus fundamental to guarantee investors some basic conditions under which they will have to operate, in order to let them correctly assess their risks.

In terms of electricity *generation*, meeting and monitoring an adequate level of capacity is essential. To this end, Transmission System Operators (TSOs) should determine how much cost-effective new generation capacity of the different types (base load, mid-merit, peak, for example) may be needed to meet the security standards, and also when and where it is needed. In case public authorities were to identify significant security problems, they could set up incentive / obligation schemes (through instruments such as tendering procedures, capacity payments, capacity markets, etc.) to induce investors to pursue the “optimal” development of the generation set outlined by TSOs. This process should best be coordinated and harmonised at the EU level (by the European Network of Transmission System Operators for Electricity – ENTSO-E and the Agency for Cooperation of Energy Regulators – ACER) to increase its effectiveness and to avoid market distortions.

As regards *transmission* of electricity, a significant increase of cross-border transmission capacity is highly desirable. To this aim (but also for developing national transmission lines), it is necessary:

- To pursue a more stable and harmonised regulatory framework at the European level under the control of ACER.
- To pursue more harmonised, efficient, clear and time-limited authorisation procedures at all administrative levels requiring the compliance with general framework guidelines.
- To gain social acceptance by clearly stating and quantifying the public benefits of the projects, especially from security of supply, sustainability and economic points of view.

In order to achieve more efficient system operation in the short-term and more optimised siting of new generators and loads in the long-term, regulation should also be designed to provide “locational signals”, i.e. providing spatial (zonal / nodal) differentiation of electricity prices (related to maximum transfer capability constraints and losses along the lines) and of transmission charges (calculated on the basis of how much each agent uses the network).

As to the progressive transformation of *distribution* networks from “passive” to “active” and “intelligent” networks, cooperation among international, European and national standardisation bodies, regulatory authorities, grid operators, and manufacturers should be encouraged to further improve open communication protocols and standards for information management and data exchange, to achieve interoperability of smart grid devices and systems, and to get rid of technical barriers to their deployment. From a regulatory point of view, a key issue is how to support investments of distribution network companies in such innovative technologies in order to ensure that their deployment provides a cost-effective solution to the needs of network users. From this perspective, both incentive and minimum requirements regulation should be based on the quantification of the effects and benefits of such investments through appropriate indicators.

The demand dimension of energy security

In general, the promotion of greater end-use energy efficiency should be the priority of any energy policy. Since most actions in this field incur “negative” costs, they are more efficient than actions to support RES development and to reduce CO₂ emissions (such as CCTS). Demand response programmes should be encouraged, with a rapid and extensive deployment of enabling technologies, such as smart metering. Moreover, they should provide strong economic signals while being simple and userfriendly.

Although significant improvements in energy efficiency have been achieved in Western Europe, more fine-tuning and coordination among Member States is required in order to reap the potential benefits also in terms of energy security. This suggests that EU measures should have a binding character wherever effective. In this process, differences in the responsiveness of energy consuming sectors to efficiency policies should be taken into account: SECURE’s analysis has highlighted, for instance, that mandatory standards for electrical

appliances seem to work better for the residential sector, whereas measures supporting information, education and training are more effective in the industrial sector.

Cross cutting measures, in particular those related to market-based instruments, have the strongest influence both on energy security and energy efficiency. From this perspective, it is recommended to consider the development of white certificate market models at the EU-level.

The role of a public intervention aimed at curbing structural inefficiencies should be evaluated, not only in terms of financial support, but also in terms of creating a market with a clear and stable regulatory framework, in which Europe-wide standardisation will reduce the costs of adaptation to national markets.

Conclusions

The importance of energy security for Europe will need to be reflected in the upcoming Trio Presidency’s agenda. This paper has given an overview of key strategies to increase the security of European energy systems. On the European level, the Trio Presidency should work closely with the European Commission to speed up progress on key issues. Those measures that remain in the hands of Member States can still be influenced by the Trio Presidency by means of discussing, coordinating and streamlining them.

Key issues to be addressed include the completion of the internal market, which – inter alia – requires regulatory policies to enhance interconnections in gas and electricity in order to foster competition. With regard to renewables, the Trio should facilitate the Europeanisation of technology neutral support schemes, while aiming for policies that can increase the share of RES in heating. Renewables and energy efficiency can only unfold their potential with the development of super grids and smart grids. Policies to support the modernisation of European electricity grids should thus be designed soon. As regards external energy policy, the Trio should continue to enhance cooperation with resource exporting countries, balancing security of supply with security of demand concerns in order to ensure an appropriate level of investments in production and transport facilities. It should also use its influence internationally to advocate measures to reduce the volatility of global oil markets. Finally, the slow implementation of CCTS needs to be addressed by setting the right incentives, including a credible CO₂ price path.

DEMOGRAPHIC CHALLENGES

Demographic Shock and Implicit Public Debt: Closing the Sustainability Gap

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The implicit public debt: General context and specific challenges

Implicit public debt (or liabilities, IPL) refers to uncovered future government expenditures grounded in promises to pay pensions, offer medical treatment to the insured, and to provide long-term care to the elderly. What if a nation’s current and future spending on health, pensions and care for the elderly is not covered by the revenues of the health care, pension and long-term care insurance? There will be a revenue-expenditure gap, a sustainability gap. Adding up all gaps to infinity yields the total IPL. A consequence of this phenomenon is that the longer the debt service is postponed the higher the macroeconomic cost – the present value of the scheduled amortisation will decline, meaning that a larger amount of money (at present value) will be required. IPL also implies an intergenerational overlapping, which calls for intergenerational justice: a timid response to the IPL causes the burden to shift to the disadvantage of future generations.

Table 1 | Implicit public liabilities (IPL) as a percentage of 2009 GDP

Country	IPL	Country	IPL	Country	IPL
Luxembourg	860	Finland	300	France	120
Greece	575	Slovakia	290	Sweden	107
Slovenia	553	Spain	285	Italy	100
Cyprus	490	United Kingdom	240	Denmark	93
Romania	380	Germany	220	Latvia	50
Malta	370	Austria	207	Estonia	-10
Czech Republic	335	Lithuania	160	Poland	-120
Ireland	285	Bulgaria	150	EU-27	211
Netherlands	333	Hungary	150	€-Area	232
Belgium	320	Portugal	127		

Own calculations. Source: EU Commission; DG Research

Current status and fiscal room for manoeuvre

Usually, a government would try to repay its debt by either extending its revenues or cutting other expenditures to free money for the debt service. The countries in the upper part of Table 1 would have great difficulty trying to achieve large primary budget surpluses. Better would be to raise the nation's tax ratio – the share of taxes and social security contributions in Gross Domestic Product (GDP). The required tax ratio is IPL divided by the present value of all future taxes and contributions. A new, larger tax ratio, especially in the heavily indebted countries, will be needed.

A raised tax ratio expands the government's room for fiscal manoeuvre without putting a strain on other spending. The disadvantage is that if the tax ratio is already large, a further increase will be hard to achieve. Table 3 demonstrates this. Other things being equal, Greece, a deeply indebted country, will remain relatively well-off. Athens will have to achieve a new tax ratio (48.5% of GDP) that is still less than the current figure in many Member States (mostly in Northern Europe) and that will remain less than the figure in some Western European Member States or in Slovenia (Table 2).

Table 2 | 2009 tax ratios, required tax ratios to repay the implicit public liabilities, and growth rate of tax ratios (% of GDP)

Country	2009 tax ratio	New tax ratio	Required permanent adjustment of the tax ratio, %	Country	2009 tax ratio	New tax ratio	Required permanent adjustment of the tax ratio, %
Luxembourg	39.4	52.3	32.7	Germany	42.9	46.2	7.7
Greece	37.0	48.5	31.1	Austria	47.1	50.2	6.6
Ireland	33.8	40.5	19.8	Portugal	43.3	45.2	4.4
Cyprus	42.1	50.4	19.7	Bulgaria	38.4	39.9	3.9
Slovenia	42.9	51.2	19.3	France	47.1	48.9	3.8
Spain	36.0	41.7	15.8	Hungary	45.1	46.6	3.3
Romania	32.0	36.9	15.3	Italy	45.4	46.9	3.3
Malta	42.0	47.7	13.6	Sweden	52.0	53.6	3.1
Netherlands	45.1	50.1	11.1	Latvia	32.9	33.9	3.0
Belgium	48.2	53.0	10.0	Denmark	53.0	54.4	2.6
Slovakia	31.4	34.3	9.2	Estonia	42.4	42.3	-0.2
United Kingdom	39.4	43.0	9.1	Poland	38.3	37.1	-3.1
Czech Republic	40.9	44.6	9.0	EU 27	43.2	46.4	7.4
Finland	50.6	55.1	8.9	€-Area	43.8	47.3	8.0
Lithuania	36.3	39.5	8.8				

Own calculations. Source: EU Commission

Intergenerational justice

What might the overall cost of tardiness be? Postponing decisions to restore balance will be more costly than an immediate policy change. The numbers in Table 2 consider the necessary increase in taxes borne by both current and future generations to keep public finances sustainable. If current generations were exempted from the debt service, only the not-yet-born would deal with the debt. The longer the debt repayment is postponed, the heavier the economic (fiscal) load on future generations.

Table 3 provides an scenario based on the assumption that Europe's governments have decided to wait ten years, until 2020, before beginning to service the IPL. For instance, Luxembourg and Greece would have to raise their 2009 tax ratio even more: not 32.7 and 31.1%, respectively, but 38 and 37.9%.

Table 3 | Required increase in tax ratios (%) if the implicit debt service is postponed by ten years

Country	Change, %	Country	Change, %	Country	Change, %
Luxembourg	38.0	Lithuania	10.7	Italy	3.8
Greece	37.9	United Kingdom	10.6	Latvia	3.7
Ireland	24.2	Finland	10.3	Hungary	3.7
Cyprus	22.9	Slovakia	10.2	Sweden	3.6
Slovenia	22.5	Czech Republic	10.0	Denmark	3.1
Spain	19.3	Germany	8.9	Estonia	-0.3
Romania	16.9	Austria	7.6	Poland	-3.5
Malta	15.8	Portugal	5.1	EU-27	8.5
Netherlands	12.9	France	4.4	€-Area	9.2
Belgium	11.6	Bulgaria	4.3		

Own calculation. Source: EU Commission

As far as burden-sharing between present and future generations is desired, a deferral of the start of debt service will cause a higher cost to the not-yet-born and benefit the currently living generations. The cost can be expressed as a percentage of GDP (Table 4): future taxpayers in Luxembourg and Greece would feel the greatest pressure because the additional cost of delayed reforms is 15% and 14% of their present GDP, respectively. Others would face additional fiscal pressure, as well. Unless these countries implemented debt reduction mechanisms soon, the financial burden would increase.

But, for Estonia and Poland, Eurostat projects a growing net wealth in their public social security system (PSS). If the baseline assumptions held, the Estonian and Polish PSS will accumulate assets (unlike the rest of the countries struggling with growing liabilities). Enjoying assets is advantageous as they allow for the absorption of unforeseen shocks – economic crises, technological shifts, trade wars, etc.

Table 4 | Cost borne by future generations if debt reduction is delayed by 10 years (% of present GDP)

Country	Macroeconomic cost	Country	Macroeconomic cost	Country	Macroeconomic cost
Luxembourg	14.7	Finland	5.1	Italy	1.7
Greece	13.7	United Kingdom	4.1	Bulgaria	1.6
Slovenia	9.5	Czech Republic	4.0	Hungary	1.6
Cyprus	9.5	Lithuania	3.8	Denmark	1.6
Ireland	8.0	Germany	3.8	Latvia	1.2
Spain	6.8	Austria	3.5	Estonia	-0.1
Malta	6.5	Slovakia	3.2	Poland	-1.3
Netherlands	5.7	Portugal	2.2	EU-27	3.6
Belgium	5.5	France	2.1	€-Area	4.0
Romania	5.4	Sweden	1.8		

Own calculations. Source: EU Commission

Recommendations – what should the Trio Presidency do?

The Spain-Belgium-Hungary Trio did not pay attention to the implicit debt question. But with the economic crisis coming to an end, long-term fiscal sustainability should become a prime issue of concern to the next Presidency Trio. Because Poland and Denmark feature sound long-term finances, they should initiate a monitoring and statistical report of each country’s implicit fiscal position, on a par with the explicit one. Here, the newly established European Semester, a six-month period of macroeconomic policy coordination of the Member States, may be helpful. However, it would mean broadening the focus of the Stability and Growth Pact (SGP) and the Broad Economic Guidelines to ensure that the Member States’ sustainability gap is closed over time. This sort of fiscal responsibility must be encouraged by defining requirements for national age-related fiscal frameworks and by monitoring and correcting deviations from the established sustainability path. To implement these measures the Trio should approach all major stakeholders, starting with the Commission and the Van Rompuy Task Force on Economic Governance. The Council, Commission and the European Parliament have agreed that the reinforced provisions of the SGP should be “fast-tracked” and adopted by summer 2011. They will be part of the new governance cycle which coincides with the Polish Presidency. The Trio member at the helm of the Council is hence supposed to insist on a long-term fiscal sustainability programme. It should become part of the regular Commission reports that summarize the recommended economic policy actions to be undertaken by the Member States. Fortunately the reports pay major attention to employment and fiscal soundness.

But reducing IPL relying on fiscal measures alone would not deliver. Rather, a variety of policies must be drawn up to close the sustainability gap. The Presidency is expected to

encourage policies other than fiscal austerity to deal with the implicit debt, as explained below. The endeavour may be facilitated by the newly adopted Euro-Pus Pact, provisions of which complement those of other instruments already in place, foremost the European Economic Semester, Europe 2020, the Stability and Growth Pact and the National Reform Programme.

With regard to IPL, the new Pact suggests measures to be taken in order to make public finances sustainable in the medium-run, working on the basis of the same sustainability gap indicators used in this study.

In the first place, countries should work faster in bringing pension and health care systems in accordance with national demographic trends. The Trio Presidency should support all moves that align the effective retirement age with life expectancy, especially by limiting early retirement schemes. But also, steps to reduce unemployment and rise employment rates, such as increasing participation shares and using tailored incentives to employ older workers (in the age group above 55), should be pursued by the Trio Presidency.

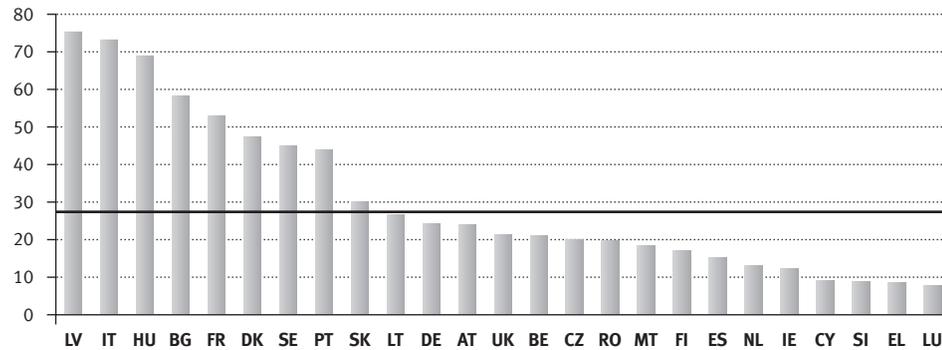
Also, the Trio Presidency should vigorously pursue the important goal of narrowing the competitiveness gap and reducing trade imbalances, as quoted in the Pact. This would translate into higher saving rates and less financial constrain in a number of deficit economies. The Presidency is called upon to back the Commission in playing a more important role in the handling of excessive imbalances and deficits *vis-à-vis* the Council in order to avoid a watering down of decisions. Overcoming imbalances is the best way to cut the implicit debt. In a practical sense, the Trio Presidency should insist on a few urgent steps in the same order as those outlined below.

Extension of retirement age

Given increasing life expectancy, longer working lives are a chance to get implicit debt under control. When retirement age is pushed up, the old-age and economic old-age ratios would improve, as a longer working life translates into a larger active population.

As a first step, retirement would take place at the age of 64, up from the age of 60 at present. After this, another extension by 5% – alongside increasing longevity – is assumed to take place. That would bring the average retirement age to 66.2 years. Further steps are not considered. This is consistent with recent trends: in a number of Member States’ legislation for retirement at age 67 has passed. It is likely that, by around 2035, the average working life would be 46.2 years, with as a result that the sustainability gap at the EU level will be reduced by some 27%. But for individual Member States, the outcome would be significantly better: in Latvia, Italy, Hungary or Bulgaria this measure would be sufficient to almost close the sustainability gap (Graph 1).

Graph 1 | Raising retirement age to 66.2 years by 2035: contribution to closing the sustainability gap (in %)



Own calculations. Source: EU Commission

The proposal to raise the retirement age is often criticized on the grounds that older people working longer would make it harder for the young to find appropriate jobs. This critique is known as the *lump of labour fallacy*. In reality, workers are not perfect substitutes, so younger employees usually would replace the old only at high cost. Early retirement as a job machine is an idea that has never been supported by serious statistics. Rather, experiments in this domain – especially in France in the 1990s, but also in Germany and other countries – failed to deliver and these countries soon returned to higher retirement ages. Germany has even taken the lead by introducing the so called “Pension at 67”.

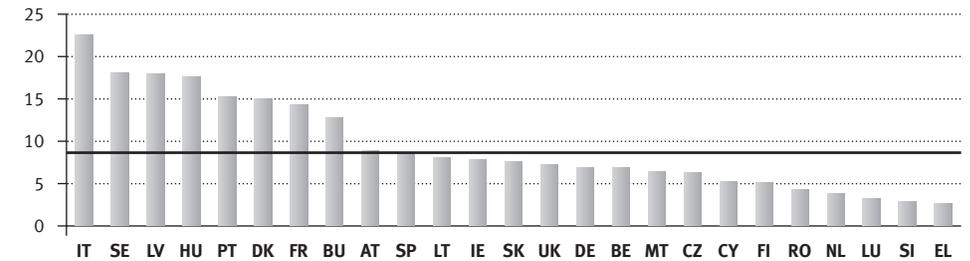
Immigration from the rest of the world: modelling assuming constant net migration ratios

Immigration tends to counterbalance the disadvantages of the demographic shock, as it causes labour supply to increase.¹ The total dependency ratio (the number of young and old people as a percentage of population aged 15-64) would fall.² While the Commission projects declining net immigration in the EU as a whole and by most Member States, the following considerations are based upon the idea that migration would stay constant over time (meaning that it would contribute more to lowering the sustainability gap). If the EU pursued a policy of keeping the net immigration ratio in the coming decades at the 2008 level of 0.34% of total population, the effect would be a sustainability gap that is 8.7% smaller (Graph 2). This is two percentage points better than the result based on the Commission’s projection of declining net immigration (a 6.9% cut of the sustainability gap). In practically all new Member States the implicit

1. To keep the analysis realistic, calculations assume that only half of all immigrants enter the labour market – a quite conservative assessment
 2. Of course, immigration does not come for free, but rather at a given social cost. But, it is widely accepted that its economic effect is positive

debt would decline. The reverse applies to the Club Med countries (save Greece) plus Ireland, though: they would be losers since their current net immigration ratios are higher than 0.34%.

Graph 2 | Constant net immigration around 0.34% of total population: contribution to closing the sustainability gap (in %)



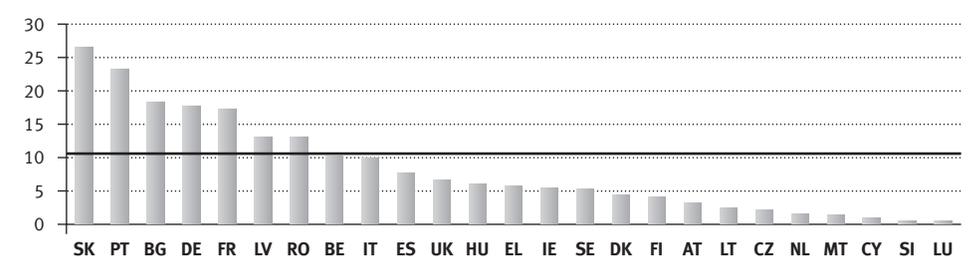
Own calculations. Source: EU Commission

Reducing unemployment/raising employment rate

Unemployment is not just a social issue; it also affects the handling of the IPL. Fewer unemployed and more people working translate into better revenue for the PSS. Because the social security contributions as a share of the gross wage are assumed to be the same, revenue would catch up with expenditure. A reduction by two percentage points of the current unemployment rate would reduce the sustainability gap by roughly 11%. There are more effects though: the old-age dependency ratio would fall in the long run.

Calculations by Member States show that Slovakia, Portugal, Bulgaria and Germany might enjoy the largest gains. In particular, all countries with an already narrow sustainability gap would clearly benefit. But in countries with a very large sustainability gap even a much better labour-market situation would be less helpful – in Greece and Romania, for example. A reduced unemployment rate does not play a role in Luxembourg at all, as that country’s gap is very large and more cuts in its already minimal unemployment rate are not likely (Graph 3).

Graph 3 | Reduced unemployment rate from 8.5% to 6.5% till 2030: contribution to closing the sustainability gap (in %)



Own calculations. Source: EU Commission

To sum up, three factors are more or less sufficient to close the sustainability gap in most countries: retirement age extension, reduction in unemployment and more generous immigration. In this paper, the factor analysis was conducted by changing one indicator while keeping all other indicators constant. In reality this is of course not the case: the overall result might be even better if the respective policies happened simultaneously. Politicians might hope for a trick to escape the debt service of the implicit debt. Yet this is impossible: implicit debt puts the same burden on the economy as the explicit one, because the two concepts are economically equivalent.

DEMOGRAPHIC CHALLENGES

Europe's Demographic Challenge and Immigration

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Immigration in Europe remains an unsettled issue, caught between worries about growing numbers of migrant populations, and the need for them, all in a context of demographic decline. The reality is that Europe today faces a demographic crisis of considerable proportions, which, left on to its own dynamics will have dire consequences, economically, socially and politically. In order to keep the labour force at current levels, and to avoid shrinkage of population, Europe will have to take in an increasing number of immigrants. Europe thus needs to become more open and more receptive of immigration. Yet, Europe finds it difficult to assimilate migrant populations because of own historic and cultural reasons. But what are the options and the implications? In this paper we examine immigration in the context of demographic decline. We examine the reasons for the lack of integration of immigrant populations and consider immigration policies generally in the context of demographic decline.

The demographic problem revisited

The European Union (EU) is faced with a difficult demographic situation. This is exemplified in falling fertility, rising life expectancy and the resulting ageing of the population. The fertility rate in the 27 countries of the EU was 1.6 children per woman in 2009, which is considerably below the replacement rate of 2.1 children per woman. At the same time, the life expectancy of people is rising everywhere. Between 2000 and 2009, life expectancy at birth rose from 74.5 to 76.4 years for males and from 80.9 to 82.4 years for females (Table 1). In many countries, life expectancy at birth had risen considerably more than the EU average. It is expected that by 2050, the average expectancy of males will reach 83 years in some places and correspondingly the female life expectancy will reach up to 88 years.¹ As a result of these trends, population in Europe is decreasing at a considerable pace and the corresponding age profile is fast ageing with far reaching implications.

1. Population Division of the Department of Economics and Social Affairs of the United Nations Secretariat, "World population Prospects: The 2008 Revision", available at: http://un.org/esa/population/publications/wpp2008/wpp2008_text_tables.pdf

Table 1 | Demographic statistics in the European Union

	Life expectancy at birth				Fertility rate (number of children per woman)	
	Males		Females			
	2000	2009	2000	2009	2000	2009
EU 27	74.5	76.4	80.9	82.4	1.5	1.6
Belgium	74.6	77.3	81.0	82.8	1.7	1.8
Bulgaria	68.4	70.1	75.0	77.4	1.3	1.6
Czech Republic	71.7	74.3	78.5	80.5	1.1	1.5
Denmark	74.5	76.9	79.2	81.1	1.8	1.8
Germany	75.1	77.8	81.2	82.8	1.4	1.4
Estonia	65.2	69.8	76.2	80.2	1.4	1.6
Ireland	74.0	77.4	79.2	82.5	1.9	2.1
Greece	75.5	77.8	80.6	82.7	1.3	1.5
Spain	75.8	78.7	82.9	84.9	1.2	1.4
France	75.3	78.0	83.0	85.0	1.9	2.0
Italy	76.9	79.1	82.8	84.5	1.3	1.4
Cyprus	75.4	78.6	80.1	83.6	1.6	1.5
Latvia	64.7	68.1	76.0	78.1	1.2	1.3
Lithuania	66.8	67.5	77.0	78.7	1.4	1.6
Luxembourg	74.6	78.1	81.3	83.3	1.8	1.6
Hungary	67.6	70.3	76.2	78.4	1.3	1.3
Malta	76.2	77.8	80.3	82.7	1.7	1.4
Netherlands	75.6	78.7	80.7	82.9	1.7	1.8
Austria	75.2	77.6	81.2	83.2	1.4	1.4
Poland	69.6	71.5	78.0	80.1	1.4	1.4
Portugal	73.2	76.5	80.2	82.6	1.6	1.3
Romania	67.7	69.8	74.8	77.4	1.3	1.4
Slovenia	72.2	75.9	79.9	82.7	1.3	1.5
Slovakia	69.2	71.4	77.5	79.1	1.3	1.4
Finland	74.2	76.6	81.2	83.5	1.7	1.9
Sweden	77.4	79.4	82.0	83.5	1.5	1.9
United Kingdom	75.5	77.8	80.3	81.9	1.6	2.0

Source: Eurostat

According to the United Nations, European populations will shrink considerably between 2010 and 2050.² Under constant fertility assumptions, the population of the whole of Europe will shrink from 732 million in 2010 to 657 million in 2050 (Table 2). Under low fertility assumptions, the population of Europe will shrink to 609 million in 2050 for a total decline of

2. Population Division, *op. cit.*

124 million people. Population declines will be even more pronounced in Eastern Europe and in some individual countries, most notably Russia, but also Germany³. Even if birth rates are increased in the next ten years for instance, the impact of low fertility rates for a long period in the past will still be felt.

Table 2 | Population projections to 2050⁴

	Actual		Projected populations to 2050			Population change 2010-2050		
	2000	2010	Medium	Constant	Low	Medium	Constant	Low
Europe	726,6	732,8	691,0	656,8	608,8	-41,7	-76,0	-123,9
Eastern Europe	304,1	291,5	240,0	219,1	208,4	-51,5	-72,3	-83,1
Northern Europe	94,4	98,9	112,5	111,8	99,4	13,6	12,9	0,5
Southern Europe	145,1	153,8	153,7	145,1	136,8	-0,1	-8,7	-17,0
Western Europe	183,0	188,6	184,9	180,8	164,2	-3,7	-7,8	-24,4

Source: Eurostat, Population Division.⁵

Excluding normal migration flows the decline in population will be even more dramatic. Net migration flows per year as projected by the United Nations are summarised in Table 3 below. On the basis of these projections, we can easily calculate the total net migration between 2010 and 2050. Specifically, total net migration is projected at 38,5 million in the whole of Europe in the period.⁶ In order to restore populations to 2010 levels, however, the net flow of migration will have to be considerable larger, depending on fertility assumptions. Under a low fertility scenario, as discussed above, to keep current population levels, net migration will have to be well over a 100 million people. Added to current population levels, the ratio of migrants to native populations will rise steeply. It is conceivable to arrive at a result that for every five native persons there will be two immigrants. This underlines the importance of assimilating immigrant populations.

3. The population of Russia is projected to shrink from 140 million to 105 million in 2050 under constant fertility assumptions. Respectively, the population of Germany is projected to shrink from 82 million to 67 million. *Ibid.*, Population Division

4. The alternative scenarios –low, medium and constant fertility– are defined on the basis of differing assumptions regarding the evolution of the fertility rate between 2010 and 2050

5. The country groupings are as defined by the United Nations. Europe includes Russia and other ex soviet Republics

6. This total breaks down as follows: 1,9 million in Eastern Europe; 9,8 million in Northern Europe; 15,1 million in Southern Europe; and 11,8 million in Western Europe

Table 3 | Net migration per year in thousands

	Europe	East Europe	North Europe	South Europe	West Europe
2000-2005	1,669	26	296	859	488
2005-2010	1,341	-10	286	739	326
2010-2015	1,100	-2	258	550	294
2015-2020	993	42	238	419	294
2020-2025	932	57	239	341	294
2025-2030	929	57	243	334	294
2030-2035	931	57	246	334	294
2035-2040	943	57	247	345	294
2040-2045	943	57	248	344	294
2045-2050	944	57	248	344	294

Source: Eurostat, Population Division.⁷

Rising old age dependency ratios

The combination of a low fertility rate and an ever increasing life expectancy means that the proportion of the older people in the demographic profile increases. That is, as the fertility rate stays constant below the replacement rate, and as the death rate drops, the old age dependency ratio, the percentage of people aged 65 years and above as a percentage of the working age population of 15 to 64 years, increases sharply.

In the EU 27, the old dependency ratio is projected to rise from 25.9% in 2010 to 50.4% in 2050 (Table 4). That is, the dependency ratio is expected to double in the next four decades, when there will be one old age person who must be supported by social security for every two of working age. A similar dire prospect awaits the majority of countries in the EU. The old age dependency ratio is projected to rise to 59.2% in Italy, 58.7% in Spain, 57% in Greece, and 56.4% in Germany.

This changing demographic profile in Europe has serious economic, social and political implications. The increase in the old age dependency ratio will make it more difficult to maintain the current social welfare systems. Also, smaller populations reduce productive capacity and tighten conditions in labour markets. Labour shortages in turn will tend to put upward pressure on wages. The tax burden will have to increase, something that is likely to lead to intergenerational conflict.

A sustained influx of young immigrant workers would relieve labour market pressures, support low inflation economic growth, allow for steady population growth, and keep pension commitments under control.

7. The country groupings are as defined by the United Nations. Europe includes Russia and other ex soviet Republics

Table 4 | Old age dependency ratio actual and projected (in %)

	Actual dependency ratio				Projected dependency ratio		
	1990	2000	2010	2020	2030	2040	2050
EU 27	20.6	23.2	25.9	31.1	38.0	45.4	50.4
Belgium	22.1	25.5	26.0	30.6	37.6	42.3	43.9
Bulgaria	19.5	23.8	25.4	31.1	36.3	43.6	55.4
Czech Republic	19.0	19.8	21.6	31.1	35.7	42.7	54.8
Denmark	23.2	22.2	24.9	31.9	37.9	42.7	41.3
Germany	22.0	23.9	31.4	35.3	46.2	54.7	56.4
Estonia	17.5	22.4	25.2	29.2	34.4	39.0	47.2
Ireland	18.6	16.8	16.8	20.2	24.6	30.6	40.4
Greece	20.4	24.2	28.4	32.8	38.5	48.3	57.0
Spain	20.2	24.5	24.7	27.4	34.3	46.4	58.7
France	21.2	24.3	25.7	32.8	39.0	44.0	44.7
Italy	21.5	26.8	30.8	35.5	42.5	54.1	59.2
Cyprus	17.2	17.0	18.6	22.3	27.4	30.8	37.7
Latvia	17.7	22.1	25.2	28.1	34.6	40.7	51.2
Lithuania	16.2	20.8	23.3	26.0	34.7	42.8	51.1
Luxembourg	19.3	21.4	20.4	24.2	30.8	36.3	37.8
Hungary	20.0	22.0	24.2	30.3	34.1	40.1	50.8
Malta	15.7	17.9	21.3	31.3	39.1	41.7	49.8
Netherlands	18.6	20.0	22.8	30.7	40.0	46.8	45.6
Austria	22.1	22.9	26.1	29.2	38.1	46.0	48.3
Poland	15.4	17.6	19.0	27.2	36.0	41.3	55.7
Portugal	20.0	23.7	26.7	30.7	36.6	44.6	53.0
Romania	15.6	19.3	21.4	25.7	30.3	40.8	54.0
Slovenia	15.5	19.8	23.8	31.2	40.8	49.4	59.4
Slovakia	16.0	16.6	16.9	23.9	32.3	40.0	55.5
Finland	19.8	22.2	25.6	36.8	43.9	45.1	46.6
Sweden	27.7	26.9	27.7	33.7	37.4	40.8	41.9
United Kingdom	24.1	24.3	24.7	28.6	33.2	36.9	38.0

Source: Eurostat

The challenge for Europe

The challenge for Europe is to maintain the working age population necessary to support the retired population, whilst at the same time avoiding social tensions. The problem will become even more acute as the baby boomers retire and start to leave the labour force. Policies to raise the fertility rate are important and should be part of an overall solution to the

demographic problem, but they will take years to have an effect. Consequently, sustaining Europe's labour force in the next forty years or so will require additional immigration flows.

It is not difficult to project immigration needs long into the future. A large number of immigrants will have to be taken in every year simply for the purpose of maintaining the size of the labour force steady in 2050. A considerably larger number of immigrants will be needed to maintain the population of working age needed to support Europe's retirees in the future.⁸ Professor Klaus Zimmerman, president of the Berlin-based DIW economic institute says Germany needs an annual inflow of at least 500 000 immigrants in the medium term.⁹

Increasing the labour force participation rate, or raising the retirement age, will be arresting somewhat the decline of the workforce. But the fundamental problem cannot be solved without increasing immigration. However, Europe is not capable of integrating large numbers of immigrants. European societies are less tolerant to cultural and ethnic disruption. This is evidenced in rising xenophobia and emerging extreme right wing politics in Europe today.

Immigration and integration in Europe

Europe remains an exclusive society and issues of identity are always prominent. Acquiring citizenship is not the same as being accepted culturally. This was exemplified, for instance, in the French riots of 2005 and 2007. The rioters were immigrants or the children of immigrants from former colonies. They were French citizens for the most protesting at being excluded.¹⁰ Citizenship and nationality is not the same thing in Europe. This is the result of the nature of the nation-state in Europe.

Europe as we know it today came out of the dissolution of dynastic multinational empires. The nation state and democratic rule were submerged inside the multinational empires. As the empires were collapsing nations were reasserting their identities. The concept of nation-state in Europe includes, besides the geographical base, a common culture, language, history, religion and set of values. This comes in contrast with immigrant countries, like the United States, where citizenship denotes nationality. The problem is that failure to accept immigrants leads to their ghettoisation.¹¹

The French riots of 2005 and 2007 therefore, are indicative of a problem that is common across the whole of Europe and makes assimilation, not impossible but extremely difficult. Europeans feel increasingly threatened by immigrant flows largely from Muslim countries from the Middle East and North Africa. The international crisis of 2008-2009 brought about anti-immigrant sentiment

8. For this, roughly the ratio of working age to retired populations will have to be three to one

9. Quentin Peel, "Merkel's answer: make immigration work", *The Financial Times*, 18 October 2010

10. This point is further elaborated in: George Friedman, "A Question of Integration", *Stratfor*, November 8, 2005

11. *Ibid.*, Friedman

in Europe and rising xenophobia. Throughout Europe, far-right parties are making inroads into national politics on the basis of such themes as immigration, Islam and national identity.¹²

Angela Merkel's recent remarks that the vision of a multicultural Germany had "failed, absolutely failed," focused on the need to work harder at integrating migrant populations. At the same time however, Merkel's remarks stoked the debate over the lack of integration of Muslim immigrants.¹³ Concerns about integration and immigration need to be taken seriously. Integration is a two-way process involving the host country and the immigrants themselves. The host country must support immigrants. In their part, immigrants have to accept the core values of the host country and learn its language.

Concluding remarks and recommendations

Europe is facing a demographic crisis of considerable proportions. The demographic crisis in turn poses a tremendous economic problem. To sustain economic growth, it is necessary to have growing (and not declining) populations. This underlies the need for an increasing influx of young immigrants to fill labour shortages and keep pension commitments manageable. The problem is that Europe finds it difficult to assimilate immigrant populations for historic, cultural and other reasons. Japan faces the same problem; this is, perhaps, one of the reasons for the sustained deflationary decline for almost two decades now. The consequences of demographic decline will be serious and pervasive. It leads to economic decline and with it to shrinking geopolitical significance.

It is clear that Europe will need to address this issue effectively. It will have to encourage its own population growth as well as take in increasing numbers of immigrants in the next thirty to forty years. This stresses the need for well structured and targeted immigration and integration policies. The task is multifaceted and policies should aim in a number of directions at both the national and EU levels, including:

- For long term effects at sustaining population levels, more generous policies to raise fertility rates should be considered at both the national and EU levels.
- Policies should also be pursued for a more efficient use of domestic labour potential. Such policies can focus on increasing labour participation rates and training for better skills matching, thus facilitating re-entry of unemployed workers
- Immigration policies should be subject to skill requirements and ease the integration of the resultant populations. High skilled migrants are particularly attractive in this regard, but this is an area where Europe lags global competition badly. Although the Blue Card is a step in the right direction, it may not go far enough because it is not a truly EU common policy. Its results should be monitored closely and adjustments made accordingly.

12. Tony Barber, "Immigration: tensions unveiled", *The Financial Times*, 15 November 2010

13. Peel, *op. cit.*

- Education systems should adjust to accommodate larger numbers of foreign students, many of whom will choose to stay after their studies.
- Integration programmes should be pervasive, permeating various aspects of life, from education to health care and social security.

Indeed, immigration should be addressed in the context of demographic decline and the need for socioeconomic integration. Policies and approaches should be multifaceted both at the national and EU levels.

The Contribution
of 16 European
Think Tanks
to the Polish,
Danish, and Cypriot
Trio Presidency of
the European Union



ECONOMIC GOVERNANCE AND FINANCIAL REGULATION

ECONOMIC GOVERNANCE

The euro's first years of existence, from inception to the onslaught of the 2008 global economic crisis, was characterised by growth and convergence, but also by widening imbalances and rising debt burdens. The adoption of the euro ushered in a period of unprecedented credit expansion, which underpinned the creation of bubbles. Faced with lower interest rates and almost zero spreads, the countries of Southern Europe embarked on an unprecedented credit expansion. Growth was debt financed and accompanied by growing fiscal and payment imbalances – hence the recent debt crisis in Europe (CCEIA).

The current management of this debt crisis consists of a number of measures and reforms which have as aim to strengthen the eurozone: namely, the creation of a permanent stabilisation fund (the European Stability Mechanism), the strengthening of economic governance, and the inclusion of the private sector in bailout funding (CCEIA).

PART II ABSTRACT

The European Stability Mechanism (ESM), which will replace the European Financial Stability Facility (EFSF) in 2013, will be a supranational institution. Access to the ESM will be on the basis of strict conditionality, while the need to have a serious debate on sovereign debt restructuring is likely to grow. With a formal default policy in place the interest rate spreads in the eurozone would diverge further. Hence, the new mechanism would have the inherent problem that the private sector would be less willing to hold sovereign debt (CCEIA).

The European Council had also agreed on the Euro-Plus Pact, which commits eurozone Member States, and the non-euro countries that opted in, to reforms aiming at long-term fiscal consolidation and competitiveness.

During the next Trio Presidency, economic governance issues are thus bound to remain a focus point: not only are current reforms still incomplete, but future financial and economic crises are bound to occur.

The economic outlook for the EU in 2011 and 2012 remains mixed. The greatest risk to economic recovery in the EU lies in the financial sector. Yet, increasing

fiscal austerity could also cause demand to break down. External demand and external developments related to appreciation of the euro will also influence the EU's economic performance. Overall, average Gross Domestic Product (GDP) growth is expected to be modest, with indebted countries experiencing extremely low growth and competitiveness. As a result, intra-EU economic divergences – which are already occurring – may increase (SWP).

The combination of a modest economic outlook and a fragile banking system means that crisis management will be required in 2011 and 2012. Since the Trio Presidency chairs the Economic and Financial Affairs Council (Ecofin), it will be involved in such management. But as a result of two factors, its role will be limited. First, in the case of a severe debt crisis, the European Council will play the leading role. Second, since most relevant issues involve the eurozone, these issues will be debated in the Eurogroup – where Poland and Denmark are absent. However, if the crisis hits the banking sector, cooperation will be needed in the entire EU-27. Furthermore, the EU could also face a political crisis if the government of one or more Member States in crisis deviates from its reform agenda. This underlines the fact that the 2011-2012 period will most likely be marked by an increased polarisation between EU core and EU periphery Member States (SWP).

In relation to this theme, one author below argues that intergovernmentalism, as opposed to the Community method, is on the rise in the EU. This is demonstrated by such developments as 1) the elaboration of proposals for economic governance reform by the Van Rompuy Task-Force, and 2) the willingness of some Member States to work in small groups. Still, the Trio Presidency remains important in terms of chairing some Council, Committee and working group meetings and negotiating legislative procedures behind the scenes. The author suggests three priority areas for the upcoming Trio Presidency: crisis management; strengthening the new framework for economic governance; enhancing growth perspectives (SWP).

When the Trio Presidency takes over, broad economic governance reform should be accomplished. However, three weaknesses will remain. First, failure to introduce a European logic in national policy making may initiate a debate on sovereignty. Second, failure to put the eurozone on a convergence path will lead to a dilemma for the EU: to decide either to increase transfers or surrender its convergence and cohesion objectives. One author, for example, argues that what is needed to safeguard the stability of the eurozone is a form of fiscal union that at the same time would allow for a degree of flexibility at the national level (CCEIA). In relation to the ESM, eurozone leaders have not yet come to a consensus regarding the mechanism's role. Germany wants it to play a more proactive role, notably by using liquidity aid to prevent a self-fulfilling financial

crisis. At the same time, transferring funds from one Member State to another remains controversial (SWP).

As mentioned, a main difficulty to a rapid resolution of the eurozone debt crisis is the difficulty tackling the spill over effects. Consequently, the implementation of more rigorous and credible stress tests in the eurozone are a precondition to addressing sovereign insolvency. Given the inadequacies of the previous round of stress tests, it will be preferable to involve the International Monetary Fund (IMF) and the Bank for International Settlements. Following the stress tests, two authors below argue that the eurozone should proceed with debt restructuring as necessary (Bruegel).

Concerning the sovereign debt crisis in the eurozone, some authors make a particular reference to the case of Greece. They argue in favour of a mechanism for orderly debt restructuring and propose a European Crisis Resolution Mechanism, consisting of three separate and distinct bodies: legal, economic and financial (Bruegel). Greece may share common characteristics with other debtor countries like Ireland, Spain and Portugal, but it stands out because the country is practically insolvent. The sizes of primary surpluses needed to return the country to sustainable levels of public debt are very large and lowering the interest rate charged on official EU loans or extending respective maturities will not be sufficient to restore solvency. Hence a significant reduction of Greek debt is needed and the sooner the better (Bruegel).

Enhancing growth perspectives will require a mix of old methods and new. Raising productivity through investment and supporting innovation will not suffice. New sources of growth will be required: developing the internet, communication technologies, environmental protection and alternative energy technologies. European integration itself could be made an additional source of growth and employment through the further development of the Single Market, a review of the Europe 2020 Strategy, and the new financial framework (SWP).

Regarding the Single Market, the Monti Report sets out a broad strategy which now requires implementation. In relation to the Europe 2020 Strategy, failure of some countries to fulfil their targets impacts on cohesion and convergence and raises the question how the necessary infrastructure for growth can be provided in these Member States. Concerning the debate on the 2014-2020 Multiannual Financial Framework (MFF), the Trio Presidency could focus the debate on political priorities rather than on the size of the budget or net contributions (SWP).

In the long run, the success of the euro also depends on a sustained rate of growth, necessary for convergence and political stability. The greatest

challenge for the EU and the eurozone is to encourage structural reform for real convergence (CCEIA).

By and large, indebted countries will have to cope with high unemployment and ongoing pressure on public finances, and will thus have to face high political and social costs – hence the need to consider instruments and mechanisms that can help increase convergence in the eurozone (SWP). The debate on economic governance led, via the Van Rompuy Task-Force and legislative proposals from the Commission, to the strengthening of the Stability and Growth Pact, the creation of a new excessive imbalances procedure (based on the monitoring of a set of indicators for detecting the potential for dangerous imbalances), and the introduction of the Euro-Plus Pact (to strengthen the competitiveness of participating countries).

But not all believe these measures are fitting. According to two authors below, the current system of economic governance is, essentially, a dictatorship of the large, creditor countries, with its modus operandi creating a two-tiered EU. They say an emphasis on competitiveness risks making the policy agenda lopsided. In their paper, the authors argue that the effort to create a grand competitiveness design, aiming for reducing divergences between countries, will neither help solve the eurozone crisis, nor enhance economic governance. According to them, the measures proposed to measure competitiveness are flawed: focusing on divergence and competitiveness shifts attention to the symptoms instead of the causes. For them, the debate on governance has failed to address the debt issue and thus has been unable to resolve the crisis (CEPS).

According to these authors, because the policy agenda risks being lopsided, the next Trio Presidency should try to restore balance. Specifically, the Trio Presidency should deal with undercapitalised banks and refocus attention on financial stability – mentioned below. Competitiveness divergences during the last decade were driven mainly by capital flows. Since these flows are now reversing themselves, so will the imbalances. But for this to happen, financial markets must be stable. According to the authors, an obsession with competitiveness will not solve the problem (CEPS).

Another author also looks at the eurozone's macroeconomic imbalances. After discussing the prevailing situation in terms of current account imbalances, she considers possible adjustment paths, while also highlighting gaps in the economic governance reform package (Bruegel).

According to this author, in the context of the current crisis, current account imbalances are important for two reasons. First, current account imbalances are

intertwined with the way in which the debt crisis has evolved. Countries with perceived debt problems had relatively high current account deficits, which were mostly accumulated in the private sector. Second, excessive current account imbalances are unsustainable in the long term and signal the need to intervene mostly through fiscal consolidation and structural reform (Bruegel).

Current account imbalances in the eurozone deteriorated sharply after 2003, driven mainly by capital flows. As just mentioned, Europe is now divided between debtor and creditor countries – that is to say, countries with large current account deficits (Greece, Spain, Portugal, Ireland) and countries with large current account surpluses (Germany, Austria, Netherlands). Current account imbalances had different causes in different countries. In Greece, the main cause was fiscal imbalances. In Ireland, Spain and Portugal, debt accumulated in the private sector, giving rise to significant current account imbalances (Bruegel).

The design of the economic governance reform was based on the idea that current account imbalances in the countries of southern Europe accumulated as a result of poor competitiveness. However, this author agrees with those mentioned prior that the relationship between the current account and competitiveness indicators is weak. According to her, the relationship is stronger for those indicators that reflect the strength of demand conditions. She argues that the data also shows a strong correlation between private debt and current account deficits. In the monetary union, with nominal interest rates fixed by the European Central Bank (ECB), southern countries benefited from below average real interest rates. Low real interest rates in turn led to high investments, which underpinned higher growth and higher prices – as mentioned in the introduction (Bruegel).

This said, improvements in competitiveness would allow indebted countries to grow out of the crisis nonetheless. Some of the adjustment in deficit countries will come about in an automatic fashion. For instance, as demand picks up in the recovery process, particularly in the surplus countries, debtor countries with a good export base will be able to benefit from the upswings in other eurozone countries (Bruegel).

In addition to automatic adjustments, contractionary measures that limit consumption in the debtor countries or structural reforms that would enhance productivity in the tradable sector would generate part of the required correction. Productivity enhancing structural reforms is the least painful adjustment path and one that guarantees long term results. This is recognised in the Euro-Plus Pact. However, the problem is that changes in competitive positions take time. Enhancing investment in research and development is one way to proceed with

countries such as Greece, Spain and Portugal where the corresponding expenditure as a percentage of GDP is considerable below the European average. The key, however, is to translate increased spending in research and development into comparative advantages. Structural reform can also relate to the labour markets. The Euro-Plus Pact explicitly refers to the need for wages to reflect productivity trends (Bruegel).

According to one author, orderly restructuring of sovereign debt requires a procedure for negotiations with the creditors. For the eurozone such a framework would have to have four main elements: a formal way to initiate a debt-resolution procedure; a mechanism to prevent a minority of bondholders from blocking the restructuring in the hope of extracting concessions from the bigger bondholders; a mechanism to conduct the negotiations; a rule for the provision of fresh credit from the EU to the debtor country (Bruegel).

There are two approaches to the design of sovereign debt restructuring procedures: the contractual approach and the statutory approach. The contractual approach incorporates collective action clauses in the sovereign bond contract, which is an advantage, but it is unsuited for the eurozone where a default has implications for financial stability. Here, the author advocates for the statutory approach, which allows aggregation over all creditor claims (Bruegel).

This author also proposes the creation of a European Crisis Resolution Mechanism (ECRM) involving three bodies: a legal body in charge of adjudication and conflict settlement; an economic body to provide necessary expertise and judgement; and a financial body to deal with necessary financial assistance to the debtor country to enable it to undertake the necessary economic adjustment toward fiscal sustainability. The roles should be distinguished to avoid conflicts of interest. The author suggests that the legal role be assigned to the Court of Justice of the EU; the economic role to an independent and capable institution such as the European Commission or jointly with the ECB; and the financial role to the European Financial Stability Facility (ERFSF) which would thus need to be made permanent and be given preferred creditor status as envisaged for the European Stability Mechanism (Bruegel).

As already mentioned above, overall, the existing economic governance reform packages fail to pay adequate attention to financial reform and regulation. Yet, it was abundant credit that allowed consumers and investors in the southern peripheral countries to borrow from the northern countries in order to consume and invest. The next Trio Presidency should devote attention to financial and banking regulation. Strong coordination in financial reform and regulation should be one of the reform conditions in any future economic governance package (Bruegel).

FINANCIAL REGULATION

The two authors below present contrasting views on the quality of recent financial regulation reforms. One of the authors below argues that the new financial supervisory framework is not very different from the previous one, and its adequacy is thus brought to question. The main characteristic of the pre-crisis supervisory framework was home country control. This framework proved inadequate primarily because continuous financial integration and the emergence of large multinational financial institutions rendered national supervisors more and more obsolete. Whilst many financial institutions had outgrown their national borders, their supervision did not. At the same time, the three Lamfalussy Level 3 Committees – grouping national supervisors separately for banking, insurance and securities – lacked binding powers and their supervisory tasks were limited. EU-level supervision was limited to exercising basic monitoring tasks (Egmont).

The reforms initiated in 2009 by the Report of the High Level Group of Financial Supervision, chaired by Jacques de Larosiere, resulted in three major changes: the creation of the European Supervisory Risk Board (ESRB); the introduction of three European Supervisory Committees (ESAs) replacing the Lamfalussy Committees; and the making of the supervisory colleges mandatory for all large financial institutions (Egmont).

These changes, according to the author, lead to an increased role for European supervisors, but the heart of financial supervision remains at the national level. The ESRB, which is tasked to supervise the financial system, lacks coercive powers and has a bulky decision-making body. The ESAs have substantial competences, but are subject to several constraints and their actual supervisory role is limited to a small set of actors, such as credit rating agencies. The supervisory colleges rely on voluntary cooperation, which leaves the home country supervisor in control. Hence, post-crisis reform does not fundamentally alter the financial supervision framework. Asymmetry between the integration of the financial sector and financial supervision persists. Thus, argues the author, the possibility that post-crisis reforms might end up being insufficient must be considered (Egmont).

In this case, the author presents three policy options: a patch-up limiting the discretion of national supervisors without altering the basic supervisory set up; a European solution, implying EU-level financial supervision at both the macro and micro levels; and if a European solution is not possible, the only option remaining would be to re-introduce host-country supervision. Of the three

policy options, the most feasible, but also the least likely to succeed, is the limited patch-up option. The European solution would lead to a loss of national autonomy and would require considerable political will. Re-introducing host-country supervision would reduce the Single Market, which is not an attractive prospect for policy makers (Egmont).

The other author, however, notes that, under the new regulatory framework, the ESAs have in fact become executive agencies, with full fledged regulatory and to some extent supervisory powers – provided these powers derive from those attributed to the European Union. Contrastingly, according to this author, the authorities should be considered embryonic federal supervisory authorities, which would assist competent national authorities in the interpretation and application of EU rules, whilst at the same time contributing to financial stability. Their supervisory powers rest on the need for greater regulatory harmonisation through the achievement of a single rulebook to be composed of regulations and implementing technical standards (CEPS).

At the same time, the author notes that more progress has been achieved in relation to the G20 commitments than in relation to single financial market improvements – concerning Single Market measures, there is little consensus among Member States. The author concludes that the new institutional structure and new rules should cause European financial integration to progress again (CEPS).



ECONOMIC GOVERNANCE

Governing the EU out of the Economic Crisis

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During the next Trio Presidency, economic and economic governance issues are likely to remain high on the European Union's (EU) agenda for at least three reasons. First, the EU will still have to cope with crisis management, in particular in the field of sovereign debt and in the banking sector. Second, in 2011 and 2012, parts of the current economic governance reform may still need to be concluded – and given its apparent weaknesses, further steps may need to be taken. Third, economic recovery cannot be taken for granted in all Member States, so improving growth performance and economic convergence remain political priorities.

The economic context

The EU's economic outlook for 2011 and 2012 is mixed. Since 2010, economic activity has increased, but average Gross Domestic Product (GDP) growth in the EU remains modest (1.7% forecast for 2011, 2% for 2012). In the eurozone, economic divergence may increase further. France and Italy continue to struggle with competitiveness problems, which limit the scope for export growth, while planned fiscal consolidation is likely to weaken domestic demand. The situation is worse in countries in debt crises: Portugal, Ireland and Greece are stuck in a negative spiral of tight budgetary austerity, causing deficits, low growth and low competitiveness.

The Central and Eastern European Countries (CEEC) are likewise divided into two groups: Countries such as Bulgaria or Latvia struggle to recover after unsustainable booms – Hungary, Latvia and Romania even had to request balance-of-payment loans from the EU and the International Monetary Fund (IMF). Others are converging economically and politically with the eurozone's north: Poland and the Czech Republic created a competitive export-base in the pre-crisis period.¹ On the EU's future economic map, the East-West divide may be replaced by a centre-periphery-line that runs right through the eurozone.

1. Of course, despite these positive prospects, the Central and Eastern European Member States remain vulnerable to the growth performance of the EU, as domestic demand is not yet robust

In the EU, one of the most important risks to economic recovery is that the financial sector gets under further stress, possibly causing a credit crunch. Demand could break down, also as a consequence of fiscal austerity, which weighs heavily on domestic consumption in some Member States. An overarching challenge is to regain trust in financial markets.

External developments, such as demand in the main export markets and the euro's exchange rate, will also influence the EU's economic performance. A crash of the United States' (US) economy or ongoing uncooperative exchange rate policies of emerging countries would lead to an appreciation of the euro. This would weigh heavily on the eurozone's economic recovery and would increase divergence.

The Trio Presidency in the new Lisbon context

The combination of reforms of the Lisbon Treaty and the EU's persistent crisis-management mode has increased the role of the European Council. Intergovernmental working methods are on the rise, and not only because the European Council has never met so frequently for European and eurozone summits as it did since the start of 2010. Another example is the elaboration of proposals for economic governance reform by the Van Rompuy Task Force. The European Commission was present during the meetings, but had to struggle for its role as an initiator of legislation. It tabled six legislative acts just a few weeks before the Task Force submitted its report to the European Council. The European Parliament, which acted as a co-legislator on four of the six legislative acts, was likewise more or less politically sidelined by the Task-Force. A further indicator for the rise of intergovernmentalism is the demonstrated willingness of some Member States to work in couples (for example, the United Kingdom (UK) and France on defence, France and Germany on economic governance reform) or small groups (the rather spontaneous joining of forces of the UK, France and Germany at the EU summit in October 2010, the letter of the net payers, etc.). Germany's Chancellor, Angela Merkel, has openly defended the intergovernmental "Union Method" against critics who argue that the "Community Method" is being undermined, in particular by larger Member States.² The most obvious example was probably the "Competitiveness Pact" (later dubbed the "Pact for the Euro" and then the "Euro-Plus Pact") as proposed by Germany and France in order to establish an agenda for closer social and economic policy coordination among the 17 heads of state and government of the eurozone.

The rotating Presidency's task to chair the Council, committee and working group meetings, and to organise and moderate behind the scenes in legislative procedures will remain important

2. Angela Merkel, "Rede von Bundeskanzlerin Merkel anlässlich der Eröffnung des 61. akademischen Jahres des Europakollegs Brügge", [Speech by Federal Chancellor Angela Merkel at the opening ceremony of the 61st academic year of the College of Europe in Bruges], 2 November 2010, available in German at: <http://www.bundesregierung.de/Content/DE/Rede/2010/11/2010-11-02-merkel-bruegge.html> – in English and French at: <http://www.coleurop.be/events/2186>

– and may become more complex compared to pre-Lisbon-times. The reasons for more complexity and possibly more political tensions are the new power relationships resulting from the Lisbon-reforms and more codecisions involving the European Parliament in more and more sensitive policy areas.

If it wants to gain visibility as an agenda setter, the rotating Presidency will have to engage strongly in the EU with Lisbon. This former key function of the rotating Presidency is now strongly limited by the permanent President of the European Council. The Commission may also have to become more assertive if it wants to define political priorities for the EU. On the one hand, this limits the agenda setting scope of the rotating Presidency even further. On the other hand, the rotating Presidency and the Commission may be natural allies if they agree to jointly push issues onto the political agenda.

The Trio Presidency should also join forces early with influential Member States, who gain relative importance through their direct access to the permanent President of the European Council. Strong involvement of the rotating Presidency with the European Parliament should not only be sought in legislative day-to-day-work. The Parliament can provide an important political forum for the Trio Presidency, given its manifest interest to increase its political role in economic governance. It is in any case influential in four legislative acts of the so-called Rehn Package or in upcoming Single Market legislation. It will likewise seek to extend its role informally when the new mechanisms for economic policy coordination will be put into place.

Priority 1: Ongoing crisis management

Given the economic outlook, the foreseeable evolution of the sovereign debt crisis and the fragility of the banking system, crisis management may be required in 2011 and 2012. The Trio Presidency chairs the Economic and Financial Affairs Council (Ecofin) meetings and will hence naturally be involved, but there are two limiting factors for the Trio Presidency's role. First, in the case of a truly severe crisis, the European Council will very probably be, once again, in the driving seat. Second, most issues will have a strong eurozone-dimension and will thus be debated in the Eurogroup, chaired by Eurogroup President Jean-Claude Juncker – where the Polish and the Danish rotating Presidencies are not even present. However, if the crisis seriously hits the banking sector, the CEEC will likewise be affected and cooperation in the EU-27 will be required.

The EU could also face a political crisis, for instance in Ireland or Greece, if either government turns away from their very ambitious reform agendas. This would trigger a negative evaluation by the EU and IMF, which would then probably refuse to pay the next credit tranche to the highly indebted country in question. Portugal is also facing a period of political instability, as may be true for Belgium and Spain. The 2011-2012 period could witness increasing polarisation between peripheral Member States struck by the financial crisis and Germany, which is likely to be, once again, blamed for the economic problems, the financial market reactions

and for an imposition of its preferred set of governance reforms. In these countries that are subject to EU / IMF conditionality, public opinion may also turn on the EU for imposing too much austerity, which harms growth, and too far-reaching structural reforms.

Even after 2013, when the new European Stability Mechanism (ESM) will be in place, an “orderly default” is not to be expected, as the ESM and its rules for creditor involvement will most probably be based on so-called collective action clauses, which will only apply to newly emitted debt. Hence, the negative consequences of a legally and institutionally unframed default would have to be borne. The task of the EU and its Member States would not only be the political stabilisation of the Member State and those groups that would support a return to a reform and consolidation track. Most importantly, the financial sector would require stabilisation, as the effects would be widely felt beyond the borders of the Member State and could provoke domino effects.

Priority 2: Strengthening the new framework for economic governance

Four years into the crisis, the EU is about to accomplish a broad economic governance reform driven particularly by the sovereign debt crisis. When the 2011-2012 Trio Presidency takes over, the reform of the Stability and Growth Pact will be either completed or about to be decided. The basic elements of the ESM have been agreed at the European summit on 24-25 March 2011, while details will probably still need to be settled throughout 2011. The so-called « Euro-Plus Pact » will celebrate its first anniversary in March 2012, right in the middle of the upcoming Trio Presidency. First conclusions will be possible whether this is an accepted and efficient tool for policy coordination and how it relates to the new macro-surveillance procedure that is to be launched in 2011.

At least three weaknesses remain that are likely to require further reforms. First, as there is no transfer of competencies to the EU-level and no automatism in implementing the surveillance mechanism, there is a danger that national policies will not be disciplined sufficiently. Even if market discipline backs the rules-based approach, coordination may not succeed to introduce a European logic into national policy-making. If national policy makers perceive that their scope of action is reduced, this can have two consequences: Either, European interference will be more or less ignored; Or « Brussels » will be blamed for illegitimate interference. A debate on limits to sovereignty and the technocratisation of politics is likely to emerge.

Second, it is by far not guaranteed that the reforms put the eurozone on a convergence track. Some of the highly indebted countries are likely to have difficulties improving growth and competitiveness through structural reforms and consolidation. Furthermore, it is unlikely that the Europe 2020 Strategy will decisively contribute to their catch-up-process. If the periphery decouples even further, the EU will have to decide whether to support the catch-up process by higher transfers – or to surrender its own convergence and cohesion objectives. The countries concerned would have to cope with high unemployment and ongoing pressure

on public finances, which restricts investment in education, research and innovation, with no possibility to devalue the currency or to inflate. Political and social costs would be high and populism could rise. There is hence a need to pursue reflection: which instruments and mechanisms can legitimately help increase convergence in the eurozone?

The new permanent crisis resolution mechanism has taken further shape at the March 2011 summit. But the tedious negotiations reveal that several fundamental problems remain to be solved. First of all, there is not yet a general consensus what purpose the ESM should actually fulfill. While the German position is to have the ESM only to prevent the worst (i.e. a crisis that could endanger the euro), there are good arguments for a more pro-active use of liquidity aid to help prevent self-fulfilling financial crises. Also, the EU is probably not politically ready to accept that providing credit may actually entail the risk of losing it. In other words, the idea that there could be a need for transfers from some Member States to others is not accepted. This case should be consciously prepared in order to prevent a severe decline in public support for the euro in the donor countries. Finally, the ESM, as it looks today, will most probably not be able to provide for an “orderly default” for those Member States who are in a liquidity crisis and need debt restructuring. To make this an option, Member States would have to move beyond the current framework and set up a formal legal procedure that would also allow agreements with other governments who are lenders.

Indeed, even if the ESM is agreed in detail in the course of 2011, the EU will be far from having solved its sovereign debt crisis. One political taboo remains: how to deal with banking sector problems. European banks would be seriously affected if the sovereign debt crisis develops further and if debt restructuring has to be undertaken – and this fact considerably limits the political options on how to deal with insolvent Member States. The Ecofin should in a first step revisit the question of stress tests. The EU has already conducted two rounds of tests that essentially helped to hide the real problems. Effective tests would provide for transparency – and hence the fundament upon which the necessary recapitalization and restructuring of banks could then be undertaken in some Member States.

If a reform process is triggered, this may be once again driven by larger eurozone Member States together with the President of the European Council and the Commission. The Trio Presidency risks being marginalised as none of the Trio-members is a medium-sized or large eurozone country. Nevertheless, with mostly an outsider’s view, the Trio Presidency may be able to point to the sensitive points that the Council has not yet solved.

Priority 3: Enhancing growth perspectives

In order to strengthen the economic recovery process, what the EU needs is a vitalisation of old and new sources of growth. Part of this strategy would be to raise productivity based on increasing skills of a larger workforce, higher investment in productive capital based on free enterprise, and supporting innovation in a liberalising world trade environment. But new

sources of growth would likewise need to be mobilized by developing the internet, communication technologies, environmental protection and alternative energy technologies. The annual work programme of the Commission includes several initiatives in these areas which can be built upon.

Furthermore, European integration itself should be made an additional source of growth and employment. Key elements of such a strategy could include, first, a further development of the Single Market. The “Monti report” sets out a broad strategy, which now requires implementation.³ Legislative initiatives by the Commission form the core of this work and involve the Trio Presidency. Benefits from market integration should also be sought on the international level, which is a key argument for the Trio Presidency to push towards a conclusion of the Doha round and to promote a new trade policy.

Second, the Europe 2020 Strategy should be reviewed by the end of 2012. Given the evolving divergence in the EU, an interesting question is how a failure of some countries to fulfill the targets will impact cohesion and convergence perspectives. This raises the question of how to provide the necessary infrastructure for growth in these Member States. One of the key priorities of the growth strategy, research and development (R&D) spending, should be critically scrutinised. In some Member States, public finances are tight, infrastructure is lacking and private-sector R&D investment track records are weak. Under these conditions, Member States with weak competitiveness may fail to fulfill the targets. If the highly competitive Member States comply with the targets, this will contribute to widening the competitiveness gap.

Third, an intense political debate on the 2014-2020 financial framework will develop, in particular once the Commission has submitted its Communication. While most Member States will prefer to take positions on the size of the budget and net contributions, a value-added of the Trio Presidencies could be to focus the debate on political priorities.

Conclusions

The next Trio Presidency has some scope to co-shape some of the priorities on the EU’s and the eurozone’s broad economic and economic governance agenda. Yet, in this complex political setting, it will only be one of many voices.

In public opinion, under the effect of the economic crisis, two tendencies combine: On the one hand, there is less support for integration (as in almost every economic crisis situation in a Member State since the 1950s) and falling trust in the EU and national institutions. On the other hand, citizens formulate clear expectations towards the EU, increasingly including

3. Mario Monti, “A new strategy for the Single Market – At the Service of Europe’s Economy and Society”, Report to the President of the European Commission, 9 May 2010, available at: http://ec.europa.eu/bepa/pdf/monti_report_final_10_05_2010_en.pdf

economic wellbeing and social security. It is therefore key to explain why the currency union may need further steps of integration and how prospects for growth and employment can be improved. The instruments, such as further market integration or more political integration, will require justification and explanation. The relative economic and demographic decline of the EU is probably one of the strongest arguments underlining the need for EU Member States to move closer together. In 2011 and 2012, political energy may be, once again, mostly directed towards crisis management and the implementation of economic governance reforms, which are currently being completed. But as these are insufficient, the next reform objectives need to be defined. The next Trio Presidency – mostly from the outside of the eurozone – should attempt to drive this debate.

ECONOMIC GOVERNANCE

Sense and Nonsense of the Euro-Plus Pact

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The sovereign debt crisis in the eurozone has generated a large debate on how to ensure better economic governance. In late 2010, this debate led to the report of the Van Rompuy Task Force and the legislative proposals of the Commission.¹ The report and proposals, which are almost identical in their content, are supposed to achieve greater policy coordination among Member States and improve the functioning of the Economic and Monetary Union (EMU) using existing institutions in a better way. The legislative proposals, are now under consideration by the European Parliament and are likely to be adopted soon. In essence, they foresee a strengthening of the Stability and Growth Pact, by introducing the “European Semester” for national budgets, and the creation of a new excessive-imbalances procedure, which will be based on the monitoring of a set of indicators (competitiveness above all) supposedly able to detect potentially dangerous imbalances.

On top of these changes being prepared for the economic governance of the eurozone via the normal Community process, at its March meeting the European Council added a new, intergovernmental mechanism, namely the “Euro-Plus Pact”. The purpose of this pact is to strengthen the “competitiveness” of the participating countries (at first it had been called the “competitiveness pact”). Although this new pact was intended to represent a particular commitment by eurozone member countries, many non-euro Member States have also signed up.

While the policy process at the European Union (EU) level is in full swing to create new coordination mechanisms, what one observes in reality is not coordination, but the combined pressure of markets and large creditor Member States. In practice, the current system of economic governance resembles a creditors’ dictatorship: on the part of the creditors, it is a benevolent dictatorship as its main aim is to restore the creditworthiness of the

1. European Commission, “A new EU economic governance – a comprehensive Commission package of proposals”, DG ECFIN, September 2010, available at: http://ec.europa.eu/economy_finance/articles/eu_economic_situation/2010-09-eu_economic_governance_proposals_en.htm

debtors, but it works with different rules than the official ones. While official procedures foresee a complex set of reports by the Commission to be discussed in the Economic and Financial Affairs Council (ECOFIN) meetings, which then decides normally by qualified majority, the reality is different. Markets deliver verdicts on the creditworthiness of the debtors every day and their judgement is influenced by the political signals given by the creditors about the conditions under which support will be provided. The case of Portugal provides another illustration of this. The various fiscal programmes presented by the government of Portugal had been accepted by ECOFIN until the markets decided that it had become too risky to buy Portuguese government bonds. At this point the EU's institutions suddenly discovered that the country needed profound structural reforms to restore its competitiveness.

As long as the crisis continues, there might be no alternative to this system, but its *modus operandi* raises some fundamental questions concerning political legitimacy. First, as mentioned, the system resembles a creditors' dictatorship, where creditors protect their interest by restoring the debtors' creditworthiness. Second, it creates a "two tier" Member State system comprised of: the debtor countries, which have to accept prescriptions on fiscal policy, structural reforms, etc., and the creditor countries, which are free to conduct their economic policy without any meaningful interference. The most recent evidence of this approach is the aforementioned Euro-Plus Pact, a sort of "more European" version of the Franco-German proposal of a "pact for competitiveness".

Our contribution will concentrate on the economic aspects of the debate on governance and focus on competitiveness as this is a key theme in the current discussion. We shall argue that the current effort of grand design for competitiveness aiming at reducing divergences among countries by means of procedures and rules will help neither to solve the eurozone crisis nor enhance European economic governance. First, as will be shown below, the various elements which have been proposed to measure competitiveness tend to be flawed and of limited use. This might appear to be a technical point, but it is crucial because if the elaboration of new mechanisms is of little use for preventing future crises (or to resolve the current one), then this will only increase the sense that the EU cannot cope with its own problems. Second, focusing exclusively on how to reduce divergences measured by competitiveness indicators may risk monopolizing all attention on the symptoms, i.e. competitiveness divergence itself, rather than on the real disease, i.e. why this happened.² Last but not least, the current crisis is a sovereign and bank debt crisis, but the ongoing debate about governance has failed to address the debt issue and, consequently, has been unable to resolve the crisis.

2. See Cinzia Alcidi and Daniel Gros, "Fiscal policy coordination and competitiveness surveillance: What solutions to what problems?", CEPS Policy Brief 213, 7 September 2010, available at: <http://www.ceps.eu/book/fiscal-policy-coordination-and-competitiveness-surveillance-what-solutions-what-problems>

Sense and non-sense in competitiveness indicators

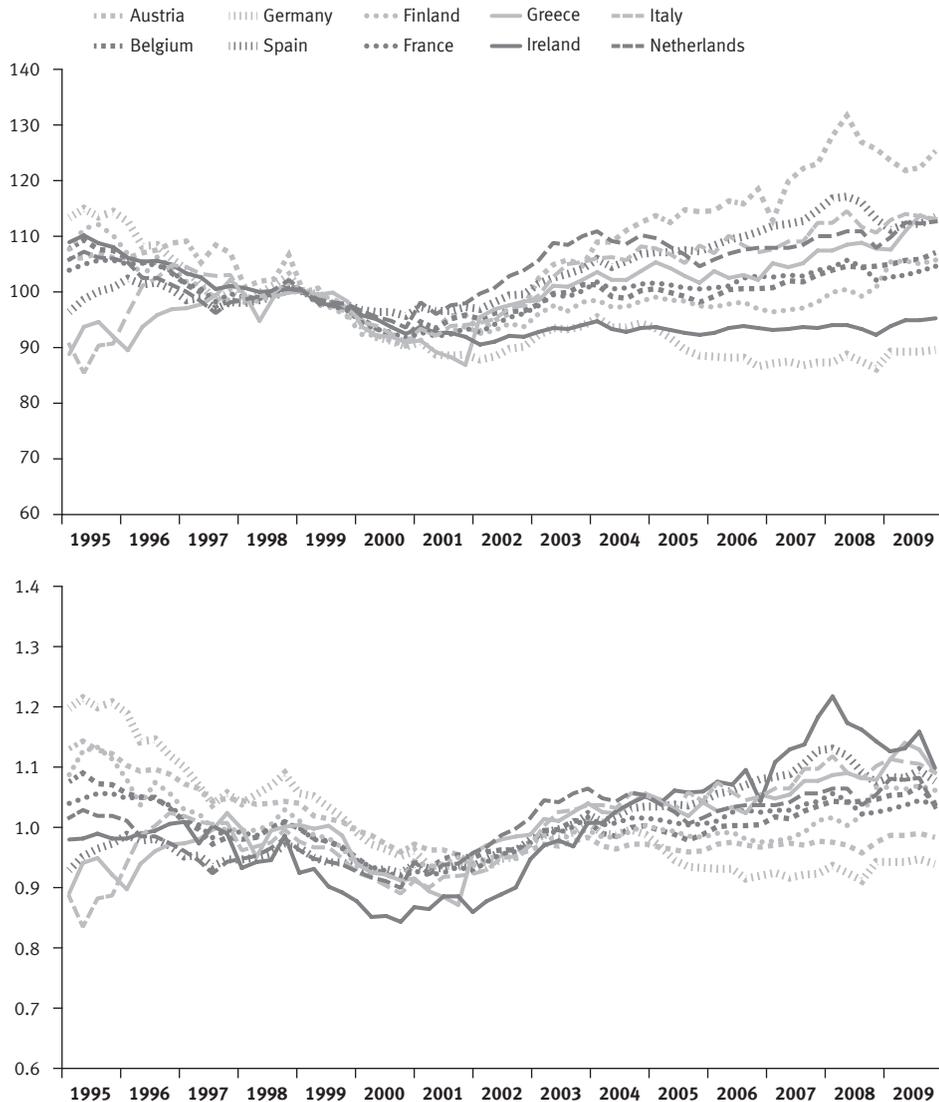
Divergences in competitiveness within the eurozone have been central to the policy debate for some years. The common element of a number of existing proposals has been to develop competitiveness indicators and then force member countries to take "remedial action" should large divergences in the indicators emerge. We argue below that this approach risks leading in the wrong direction and we start by conveying some technical arguments.

A first point is that competitiveness usually measured as relative unit labour cost (ULC) is a relative concept. The gain of one country is the loss of another. Hence if one wants to restore the competitiveness of a member country (for example Greece) others (Germany in the first instance) must accept deterioration in theirs: the adjustment might come about either through wage increases in the lower labour cost countries or cuts in those with a too high cost. There is some consensus that no country should be forced to increase wages and everybody gains if structural reforms increase productivity, but this does not change the fundamental fact that if German wages increase, intra-eurozone divergence is reduced by definition.

A second point is that it is always difficult to determine the proper base year for the competitiveness index. It is often implicitly assumed that the start of EMU represents an equilibrium and hence the best base, but there is no actual economic ground for this. The chart on the left hand side of Figure 1 shows the evolution of the ULC in the eurozone countries, assuming that 1999 is the base year, while the chart on the right hand side shows the same index re-scaled dividing it by its average over the period 1995-2010 to remove the bias induced by the choice of the base year. The comparison suggests that 1999 might not have been equilibrium itself. When the long-term average is taken as equilibrium concept, 2003 appears to be the year with the smallest cross-country differences. It also emerges that prior to 2003, Germany was one of the countries with lowest competitiveness, while after 2003, countries that have experienced a significant loss in competitiveness are those where bubbles had developed, Ireland and Spain for example.³ Importantly, the consequence of a bias in the base year is a bias in the measurement of the divergence. The analyses based on 1999 as equilibrium year conclude that countries now in difficulties have lost about 25-30% in terms of ULC relative to Germany, while using the long term average as equilibrium concept suggests a loss of about 15%, a substantially smaller estimate of the divergence. The purpose of these simple considerations is not to show that unambiguously 2003 should be taken as proper base year, but how difficult it is in practice to measure divergences in competitiveness.

3. See Daniel Gros, "Adjustment Difficulties in the GIPSY club", CEPS Working Document No. 326, 5 March 2010, available at: <http://www.ceps.eu/book/adjustment-difficulties-gipsy-club>

Figure 1 | Real harmonized competitiveness indicator Unit Labour Cost (ULC) in total economy deflated (LHS: ULC base year 1999, RHS: re-scaled ULC)



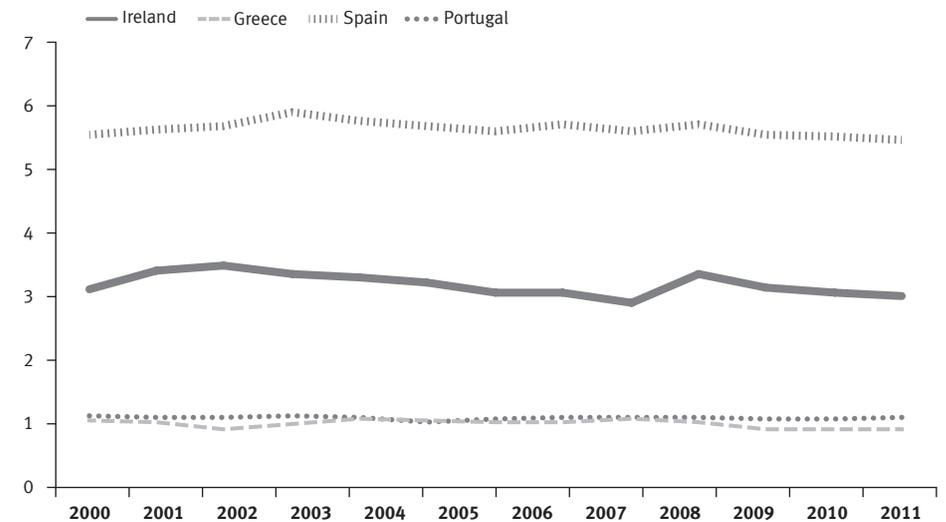
Source: ECB Statistical Warehouse and own computation
Note: ECB EER-21 group of currencies and eurozone 16 country currencies.

Besides measurement issues, even assuming that an agreement can be found on how to assign desired future losses and gains in competitiveness to each country, one has to keep in mind that member countries are not centrally planned economies. There is little a government can do in a market economy to force lower wages in the private sector. Governments can

of course enforce wage cuts in the public sector. This is being done on a large scale in Greece and Spain, for example, but there is little empirical evidence that public sector wage trends have a significant impact on wage growth in the private sector.⁴

Finally, a more fundamental reason to be sceptical about the usefulness of the standard competitiveness indicators is that their power to predict imbalances is rather low. In principle, a loss of competitiveness should lead to lower exports, or at least lower market shares. It is widely repeated that labour costs in the four euro countries, i.e. Portugal, Ireland, Greece and Spain, which face difficulties in financial markets, have increased too much in relation to those of Germany and this is the main reason for their large external imbalances. Yet, data on export market shares do not seem to support this hypothesis. Figure 2 shows these four countries' share of goods and services exports within overall EU-27 exports: all lines are essentially flat and not downward-sloping as one would expect.

Figure 2 | Exports of goods and services (% of EU27 exports)

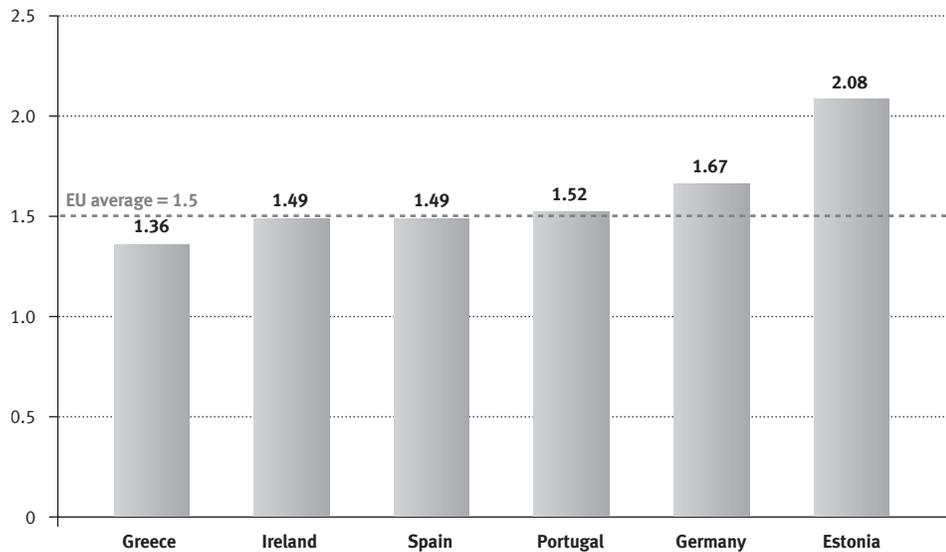


Source: European Commission services (Ameco database)

Moreover, as suggested by Figure 3, which displays the ratio of exports of goods and services of the year 2010 relative to 2000, exports have grown significantly both in countries with low and high competitiveness. In fact, within the EU, countries with the worst performance are the UK, France and Italy, and not those under high market pressure.

4. See the work of Ana Lamo, Ludger Schuknecht and Javier J. Pérez "Public and private sector wages: co-movement causality", *ECB Working Paper Series 963*, 2008 – for empirical studies, which find econometrically significant effects, but the orders of magnitude remain so small that any politically feasible autonomous change in public wages would have only a negligible impact on private sector wages. Available at: <http://www.ecb.int/pub/pdf/scpwps/ecbwp963.pdf>

Figure 3 | Export ratios 2010 / 2000



Source: European Commission services (Ameco database)
 Note: If one takes 2008 rather than 2010 as numerator, the picture does not change significantly; there is just some reshuffling in the order of Greece, Ireland, Portugal and Spain (GIPS).

There are possible alternative explanations as to why losses in competitiveness are not necessarily reflected in export growth and why competitiveness indicators do not necessarily reflect economic performance. Some of them follow below.

The first explanation is export supply growth: this is largely the case of Estonia whose exports have increased dramatically, doubling in a decade, but whose “competitiveness” indicators have worsened considerably – about 20-30 percentage points more than those of Greece or Spain. This argument, which to a lesser extent also applies to peripheral eurozone countries, is based on the fact that export increases can be driven by a larger supply of new products and new firms.⁵

The second is increased openness: both imports and exports have increased considerably in all countries, and most notably in Germany. In this respect, it is often overlooked that German imports (especially of intermediate products), and not only exports, have increased more than those of its trading partners or other eurozone countries.

The third explanation relates to the distinction between tradable and not-tradable goods and the fact that in some countries, like Spain, competitiveness in the tradable sector did not

5. See Paul Krugman, “Scale Economies, Product Differentiation, and the Pattern of Trade,” *American Economic Review*, No. 70, pp. 950-959, 1980. Available at: <http://www.aeaweb.org/aer/top20/70.5.950-959.pdf>

deteriorate over time, which explains why exports have been growing, but in the non-tradable sector labour cost, driven by the bubble in the construction sector, have augmented significantly.

Notwithstanding the explanations above, large export growth in Greece, Spain and Ireland over the last decade seems difficult to reconcile with these countries’ large current account deficits. A closer look at the data shows that for Spain and Greece, the balance on goods and services has been approximately the same in 2000 and 2010, suggesting that in a country starting with a large imbalance, in order for the trade balance to improve, exports need to grow not only significantly, but also much more than imports. In the specific case of Greece, the large deterioration of the current account is explained by a huge accumulation of foreign debt, which it has to service. Similarly in Ireland, current account deficits were driven mainly by the income balance. The real challenge for countries with large foreign debt is that when financing conditions deteriorate, they have to devote a much larger part of income to debt service – whatever the situation in terms of usual competitiveness indicators.

Conclusion

While the current EU political debate is engaged in enhancing economic governance and preventing divergences in economic performance through correction in competitiveness differences, the evidence presented above suggests that the emphasis on competitiveness indicators risks being of very limited use. The newly created Euro-Plus Pact has reinforced this tendency by repeating the fallacy that because peripheral countries have lost competitiveness over the last year, this is the only problem that needs to be resolved. This approach is made possible by the fact that, at present, creditor countries control the official agenda and are free to put emphasis on those issues that do not require much adjustment on their side. It is thus not surprising that Euro-Plus Pact concentrates on issues that do not represent a problem for Germany (for example, national debt brake, increasing retirement age, etc.). Other areas, where reforms would be needed in Germany as well, such as liberalising the services sector and dealing with doubtful assets on the balance of “government sponsored” banks, have been left out.

It should not be forgotten that until recently Ireland, and to some extent Spain, were held up as shining examples of competitive economies that created a record number of jobs. Their current troubles are the result of bubbles and it is doubtful that tighter economic policy coordination or the pact for competitiveness will reduce the consequences of the bursts or prevent new bubbles from emerging.

The policy agenda thus risks becoming lopsided, with important issues not being treated because they are not on creditor countries’ domestic agendas. The coming Trio Presidency should use its influence to restore balance in the policy agenda and assign priority to those

issues that are vital to the existence of both the eurozone and the future of the EU. Among those, dealing with undercapitalised banks, which is both a creditor and debtor country problem, should be a main concern. Of course, improvement in productivity and competitiveness, driven by (structural) reforms, is always welcome – this is a *raison d'être* of the Europe 2020 (and before it the Lisbon) Strategy. However, competitiveness divergences during the last decade were mainly driven by capital flows – now the flows are reversing and so will the imbalances. But for this mechanism to work, financial markets must be stable. This implies that the coming Trio Presidency should re-focus attention on stabilising financial markets, an objective clearly not achieved by the previous European response to the crisis. This does not mean that financial markets should set or are setting the policy agenda; it simply means that the EU needs to put aside its competitiveness obsession and face the problems at hand. Over time, the combination of the asymmetry between creditors and debtors and the likely ineffectiveness of the new mechanisms risks delegitimizing the EU process even more, with dangerous consequences for the Union.

ECONOMIC GOVERNANCE

Current Account Imbalances: the Role of Competitiveness and of Financial Sector Dynamics

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The sovereign debt crisis and the long-term challenge of current account imbalances

The last Trio Presidency of Spain-Belgium-Hungary was faced with extraordinary circumstances. The joint programme laid down in November 2009 referred to the need to progressively withdraw from the stimulus packages implemented in response to the financial and economic crisis and strengthen the European economy thereafter. But, the commitment to a gradual exit strategy and to productivity-enhancing structural reforms had to give way to urgent measures in response to the sovereign debt crisis that hit the south of Europe in the first months of 2010. The Greek fiscal problem became mostly evident at the beginning of 2010, under the Spanish Presidency. Financial markets were prompt to react and started betting in favour of the country's default. The risk of contagion to indebted Ireland, Portugal and Spain became evident as of April 2010, and marginally touched Belgium and Italy towards the end of the year.

The risk of contagion prompted European Union (EU) action. On 9 May, 2010, the European Council, under the Presidency of Van Rompuy, approved a set of measures to support financial stability in Europe. The extraordinary package included three main elements: i) the extension of the Medium-Term Financial Assistance Facility (MTFA) to eurozone countries; ii) the creation of the European Financial Stabilisation Facility (EFSF); and iii) the approval of a special EU / IMF loan to Greece for a value of €110 billion. These new lending facilities were meant to provide short-term liquidity to countries in need, but they did not address the question of solvency.¹

In parallel, the European Commission put together a set of reform proposals to address flaws in the EU's economic governance structure. The Council viewed and approved most of the

1. See in this volume: Jean Pisani-Ferry and André Sapir, "Sovereign Debt Crisis Resolution in the Euro Area", *Think Global – Act European*, Paris, 2011

suggested measures, welcoming the new attention devoted to non-fiscal macroeconomic imbalances. In fact, the reform package provides a series of guidelines for the monitoring and possible sanctioning of excessive external imbalances.

There are at least two reasons why current account imbalances deserve special attention in the present context. First, they are tightly intertwined with the way in which the debt crisis has evolved. All the countries that financial markets have been targeting after Greece had relatively high current account deficits (i.e. Ireland, Spain and Portugal), a good part of which was accumulated in the private rather than in the public sector. The risk, as perceived by financial markets, was that private debts would turn into a public liability, as happened in Ireland through the government rescue of the banking sector. Second, independently of the reactions and pressures from financial markets, excessive external imbalances signal the need to intervene, mostly through fiscal consolidation and structural reform, lest the external debt trajectory appear unsustainable.

This brief note looks at macroeconomic imbalances in the eurozone through the lenses of the debt crisis. Part II provides a description of the current situation, analyses the possible determinants of current account imbalances and the extent to which they can be attributed to cross-country differences in price competitiveness, as implicit in the recent economic governance reform packages. Part III describes possible automatic and discretionary adjustment paths and highlights gaps in the current economic governance reform package.

The current situation

Current account imbalances are not new to Europe or the global economy, but they have increased remarkably since the early 1990s and more so in the eurozone than in other Organisation for Economic Co-operation and Development (OECD) countries.² The suggestive evidence is that capital flows have been the main driver of the rapid surge in current account imbalances, especially after 2003 when, with the elimination of exchange rate and country risks, financial investors have just been looking for the highest relative returns. Another interesting feature of current account imbalances in the eurozone is that they have developed in a symmetrical fashion. Europe is now divided between debtor and creditor countries, that is countries with large current account deficits on the one hand (i.e. Greece, Spain, Portugal and Ireland) and countries with relatively large surpluses on the other hand (i.e. Germany, Austria and the Netherlands).

Current account imbalances have been having slightly different causes in individual countries. Greece's large current account deficit is mainly the result of a lax fiscal policy. Public finance

figures for Greece show that the country's fiscal problems preceded the financial and economic crisis. The country suffered from the incapacity to control public expenditure growth, but also from weak fiscal planning capacity, as manifest from the fact that actual deficits almost always overshoot planned budgetary outcomes³. The consequences on financial markets are well-known. Greek bonds' yield spreads over Germany rose sharply in the spring of 2010 and Irish, Portuguese and Spanish bonds followed suit, although at a distance from Greek ones. These other countries have been much more fiscally virtuous in the preceding years than Greece. Debts accumulated instead in the private sector, giving rise to significant current account deficits. The negative reaction from financial markets internalised the belief that private liabilities could easily turn into public ones.⁴

Implicit to the design of the recent economic governance reform is the idea that southern European countries have accumulated large current account deficits because poor price competitiveness impeded them to export abroad. Thus, the indication is that the problem of macroeconomic imbalances originated on the export side. There is no doubt that deficit countries have seen their prices growing more rapidly than surplus countries. From 1994 to 2007, Greek, Spanish and Portuguese prices have been growing respectively by 18%, 17% and 14% above those in the rest of the eurozone, whilst in Germany they declined by 15%.⁵ However, the relationship between current account positions and price indicators is weak for those indicators that truly capture competitiveness developments (i.e. real effective exchange rates based on wage costs in the manufacturing sector or export prices), whilst much stronger for those indicators that reflect the strength in demand conditions and the evolution of prices in the service and government sector relative to the manufacturing sector (i.e. real effective exchange rates based on Gross Domestic Product (GDP) deflators and unit labour costs for the total economy).

At the same time, the data show a strong correlation between private debt and current account deficits. Households' debt accumulated for consumption purposes had a strong effect on external positions in Greece and Ireland, whilst Spain has mainly borrowed from abroad to finance investment in the real estate sector.

Even if relative price developments may have not been at the root of current account imbalances, they have nevertheless contributed to those real demand conditions that incentivised borrowing in the south of Europe. Financial market integration allowed the free movement of capital, and monetary unification eliminated the exchange rate risk. With EMU, capital could move freely and financial investors had no reason to discriminate amongst countries on the basis of expectations regarding exchange rate movements. Against this background, financial investors had an especially strong reason for investing in countries in which economic growth

2. Olivier Blanchard and Francesco Giavazzi, "Current Account Deficits in the Euro Area: The End of the Feldstein Horioka Puzzle?", *Brookings Papers on Economic Activity, Economic Studies Program*, the Brookings Institution, vol. 33/2, pp. 147-210, 2002

3. See Marzinotto, Pisani-Ferry and Sapir, "Two Crises, Two Responses", *Bruegel Policy Brief*, March 2010

4. It is a standard argument in the literature that trade account imbalances trigger debt crises, see for example: Paolo Manasse and Nouriel Roubini, "The Rule of Thumb for Sovereign Debt Crises", *IMF Working Paper*, N°42, 2005

5. In Ireland, average prices rose by a more modest 5% relatively to the rest of the eurozone

was buoyant such as Ireland, Spain and Portugal. Strong cyclical conditions came in fact with higher prices than in the rest of the eurozone and, because the nominal interest rate is set by the European Central Bank (ECB) for the whole area, the end-result was that growing economies in the south of Europe benefited from below-average real interest rates that functioned as an incentive to invest and hence to borrow in order to invest.⁶

Even if relative price competitiveness is not at the root of current account imbalances, improvements in competitiveness would allow indebted countries to grow out of their own debt and represent the least painful way out of the crisis. Some of the adjustment is expected to come about in an automatic fashion, and the crisis has already partly contributed to it.⁷ Further automatic forces should be at play.

First, the recovery is distributed asymmetrically. Deficit countries are suffering from poor growth, whilst some surplus countries enjoy an unexpectedly strong recovery. The reversal in growth trends relatively to the pre-crisis period will allow indebted countries to grow out of their own exports towards booming economies.

Second, risk aversion has increased in the crisis. Where demand will pick up will be mostly in the form of consumption rather than investment. This should come with a relative advantage for deficit countries that have some specialisation in the production and export of consumption goods. Revealed comparative advantages may offer a better picture of competitiveness trends in the eurozone than just relative prices. Spain and, to a minor extent, Ireland have a comparative advantage in the production and export of consumption goods and have thus good chances of being supported by the upswing in other euro area countries.

Third, financial markets have been treating the monetary union as a single entity since the inception of Economic and Monetary Union (EMU). With the crisis, however, the country risk has re-emerged. The medium-term effect is that financial investors will limit capital outflows towards problematic countries, but the short-term perverse effect is that recent cross-border transactions have been short-term also in countries where they had been traditionally long-term,⁸ with the consequence that problematic countries will have to repay part of their debt sooner rather than later.

Together with the automatic component of adjustment, parallel discretionary measures are deemed necessary to set external debts on a sustainable path. The immediate and most painful adjustment path consists of a contraction in consumption, which the crisis has partially induced automatically, but could be further strengthened by means of fiscal consolidation. For example, fiscal adjustment that targets public wages in countries in which there is a large public sector will inevitably be associated with a fall in consumption, thereby

6. This mechanism has been described in depth and is known as Walters' critique

7. European Commission, "Surveillance of Intra-Euro-Area Competitiveness and Imbalances", EU Economy 1, 2010

8. *Ibid.*, European Commission

generating at least part of the required correction. The least painful adjustment path is to implement structural reforms that would enhance productivity in the tradable sector, so that future net exports match today's liabilities. The goal can be achieved through structural reform on product and labour markets.

The so-called Euro-Plus Pact adopted during the 24-25 March European Council indeed addresses these issues and includes references to the need to monitor relative wage developments, guarantee fiscal discipline by also strengthening national fiscal frameworks, make pension and other social security systems sustainable and provide a clear-cut procedure for dealing with domestic banks in difficulty. The merit of the pact is having recognised that competitiveness improvements are the least painful way out of the current crisis, and the only one that guarantees long-term results. The downside is that changes in competitive positions require time.

Structural reform and finance

Current account imbalances were not generated on the export side, but stemmed from strong demand in countries with high growth prospects. Nevertheless, competitiveness improvements represent the least painful way out of the crisis and are useful to support the sustainability of external debts. From a governance perspective, all the discretionary measures that can be put in place to correct existing macroeconomic imbalances have a chance to succeed only if national governments assume ownership of reform, a goal that would require less, rather than more, centralisation in economic policy coordination.

Structural reform is what allows productivity gains in the tradable sector. Enhancing investment in research and development (R&D) is one way to proceed in countries like Greece, Portugal and Spain, where the share of high technology products over total exports is well below the EU average. Yet, it is not only about fostering R&D expenditures. The greatest challenge is to find ways of translating higher spending into strong comparative advantages, which would depend on the organisation of production, for example. In Ireland, exports of high technology as a share of total exports are above average, but total R&D expenditure is only 1.28% of GDP, against an average in the old Member States of close to 2% of GDP. Micro-management issues, such as the organisation of national and international production, and management practices are likely to play an important role.

Structural reforms can also tackle the functioning of labour markets. Deficit countries should better align productivity and wage growth. The Euro-Plus Pact does explicitly refer to the need to make sure that wages reflect productivity trends. The pact offers a good roadmap for crisis resolution, but it will only succeed if national governments recognise and assume ownership of reform. The whole debate about relative wage developments is a case in point. The initial idea of eliminating wage indexation had the sole purpose of avoiding inflationary

wage settlements, which occurs by definition when wages grow faster than productivity. But the scrapping of the automatic adjustment of wages to inflation is neither necessary nor sufficient to make sure that wage developments align with productivity developments. The question is one of wage bargaining modes. It is much easier to align wages with productivity when it is handy for an employer to monitor a worker's productivity, which is something you can do when bargaining takes place at the firm-level. Wage bargaining systems cannot be reformed by imposition from above. National governments need to recognise the desirability of reform, and involve the social partners in the process.

Secondly, the existing economic governance reform packages fail in one other important respect, namely they pay modest attention to the issue of financial reform and regulation, showing therewith little appreciation of complementarities between macroeconomic and regulatory issues. Key to the accumulation of external imbalances over the last decade was in fact the intermediation of the financial sector and the channelling of savings accumulated in the North to consumers and firms in the South. It is abundant credit supply that allowed consumers and investors in the South to borrow from the North so that they could consume and invest "above their means". The upcoming Trio Presidency should devote attention to financial and banking regulation, addressing cross-border issues, in this case through more centralised economic policy coordination. Stronger coordination in financial reform and regulation should be one of the reform conditions in any future economic governance package.

ECONOMIC GOVERNANCE

European Monetary and Fiscal Policy Revisited

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The European Economic and Monetary Union (EMU) constitutes a case of monetary union with a single currency and a common monetary authority, but without a political union. The EMU had run ahead of fiscal and financial integration and happened at a time of diverse economic records in Europe. However, multiple benefits have accrued to its Member States over time. The EMU has forged the necessary nominal policy anchor for macroeconomic stability, increased transparency, enhanced competition and integrated capital markets. It also induced structural change and productivity growth. Nevertheless, in times of crises or asymmetric shocks, the EMU may not be able to reduce potential costs. As the eurozone and the European Union (EU) face a sustained debt crisis, the question of whether a monetary union can be viable without a fiscal union is resurfacing. This paper addresses this question and other relevant issues in the context of efforts to manage the debt crisis in Europe.

The Euro in perspective and the case for a fiscal union

During the short period of its existence, the euro contributed to growth for all eurozone members. The EMU led to integrated capital markets, has supported a more stable economic environment by anchoring inflationary expectations, lowered borrowing costs across the board, and thus underpinned considerable economic growth. This ultimately helped to advance real convergence (although more remains to be done), thus reducing marked disparities in per capita income levels. The elimination of transactions costs and increased price transparency further enhanced trade and benefited consumers.

However, the international financial crisis of 2008 and the European debt crisis that ensued ushered in a new period of introspection and intra-European rivalry. The first period of the euro was also marked by widening imbalances amongst Member States and rising debt burdens. This was the result of weak fiscal structures and tax enforcement mechanisms that failed to maintain the necessary fiscal discipline across Member States. It was also the result

of a bubble mentality that prevailed in the 1990s as an outcome of several factors, including an inadequate regulatory financial framework. Subsequently, the financial and economic crisis in the United States (US) also critically affected developments in the EU.

Problems in European banking originated with the general global credit expansion that began in the early 2000s. The adoption of the euro in 1999 effectively allowed traditionally higher inflation countries – like Spain, Portugal and, after 2002, Greece – access to credit at much lower rates. Corresponding spreads with German bonds narrowed sharply and dropped almost to zero in some instances. This situation led to unprecedented credit expansion, creating a number of housing bubbles across Europe.

The EU is a relatively diverse region in terms of geography, political systems, national endowments and economic fundamentals. Northern European countries are capital rich, and technologically and administratively advanced in comparison with peripheral countries in the south. Countries in the north would favour a strong currency, while countries in the south would favour a weaker currency in order to be more competitive abroad. This diversity of the EU renders efforts for a political and fiscal union highly complicated.

With the creation of the eurozone, interest rates in the countries of southern Europe dropped to near German levels and spreads almost dropped to nil in the period prior to the eruption of the global financial crisis. An environment of significantly lower interest rates in these countries led to an unprecedented credit expansion by corporations, consumers and governments alike. Growth in the peripheral countries was debt financed and was accompanied by growing fiscal and payment imbalances. A decade of remarkable growth came to a sudden end on a pile of private and public debt.

For the export oriented, highly productive and technologically advanced German economy, the single currency has been especially advantageous. About 40% of Germany's exports go to less productive and less capital-intensive eurozone partners. With the exchange rate locked in the currency union, these eurozone countries cannot devalue in order to gain a competitive advantage and to correct their payments imbalances. The result is amassing trade and current account imbalances, which are also reflected in fiscal imbalances and rising debt burdens.

Highly competitive economies like Germany are able to amass huge trade and current account surpluses against eurozone trading partners. In the context of the current crisis, Germany acquires considerable leverage to force upon eurozone member countries its economic and fiscal reforms.

Obviously the pre-crisis fiscal framework in the eurozone requires major overhaul. If weak fiscal structures sit at the centre of the eurozone's current problems, then what is needed to safeguard the stability of the eurozone is a form of a fiscal union. The real issue is what combination of power sharing between the eurozone and the nation-states would make the EMU

stable and viable. The challenge is to arrive at a fiscal union that would allow nation-states to have a high degree of flexibility with their economic policy.

Managing Europe's debt problems

Europeans expect to manage their debt problems by a series of measures and reforms that strengthen European integration. These measures include:

- Expanding the size and powers of the European Financial Stabilisation Facility (EFSF) that was created in the wake of the Greek debt crisis in May 2010;
- Establishing a permanent stabilisation fund to replace the EFSF when it expires in 2013;
- Including the private sector in funding the bailouts;
- Strengthening economic governance in the eurozone.

Agreement had been reached in “principle” at the European Council meeting of 24-25 March, 2011, to increase the lending capacity of the EFSF from €250 billion to €440 billion. However, a decision about how to raise the fund's lending capacity was delayed until the next European Council meeting in June.

This delay in the decision is apparently linked to growing reaction amongst populations in some countries and pending elections. Far-right movements in some cases, which stand against bail-outs and eurozone reforms, are gaining support. As the electoral successes of such non-traditional and nationalistic parties increase, resistance to eurozone reforms, bail-out mechanisms and austerity measures will be increasing. This stresses the need for a better understanding and better communication of the significance and benefits of the eurozone for the future of Europe at large and its position in the global system.

Increasing the lending capacity of the EFSF is absolutely necessary to allay market fears regarding the stability of the eurozone. It is certain that a solution will be found in June to accommodate reactions and thus increase the fund's lending capacity. But going forward, the anti-reform sentiment is an area that European elites should watch very carefully.

The European Council also agreed to establish a permanent stability mechanism: The European Stability Mechanism (ESM). The ESM, which will be a supranational institution, will assume the role of the EFSF in providing financial assistance to eurozone Member States after June 2013. The ESM will have a total subscribed capital of €700 billion, of which €80 billion will be in the form of paid-in capital and the remaining €620 billion will be in the form of callable capital and of guarantees from eurozone Member States.

Access to ESM financial assistance will be on the basis of strict conditionality. There is also an implicit agreement on sovereign debt restructuring. Part of the conditionality for ESM financial assistance is that “[...] the beneficiary Member State will be required to put in place

an appropriate form of private-sector involvement, according to the specific circumstances, and in a manner fully consistent with IMF practices”.¹

Against this possibility, private investors will be requiring higher yields to compensate for the higher likelihood of default, which will be pushing nations’ debt financing costs higher. In case of budget distress, financial assistance is made available only on the basis of well-structured adjustment programmes in the form of strict austerity measures, which are very unpopular. Whilst interest rate spreads in the eurozone remained very narrow for most of the euro’s life, they have started to diverge with the appearance of debt problems. With a formal default policy in place, those spreads are going to diverge further. There is a tendency therefore to return to interest rates that prevailed before the introduction of the euro. Knowing that partial defaults will be part of the solution to the eurozone’s debt problems, there will be upward pressure on corresponding yields on all new debt issues and on old issues that come up for refinance. This will make it more difficult for states to fund their deficits, particularly if they depend more heavily on foreign investors. Higher financing costs, in turn, make a default or the need of a bailout more likely.

The new mechanism has this inherent problem whereby the private sector will be less willing to hold sovereign debt; this may ultimately jeopardise the effectiveness of any permanent bailout mechanism. The financial crisis therefore might just get worse before it can get better. If the new permanent bailout mechanism comes into existence in 2013, when the temporary mechanism expires, many countries will be facing bigger debt burdens and higher financing costs. Germany might be in control of the bailout mechanism, but the mechanism as such does not constitute a political union.

The European Council also agreed on the Euro-Plus Pact, which commits eurozone Member States and six (Bulgaria, Denmark, Latvia, Lithuania, Poland and Romania) non-eurozone Member States – that opted in – to reforms aiming at long-term fiscal consolidation and competitiveness. The Euro-Plus Pact replaces the Competitiveness Pact agreed upon earlier by France and Germany.

Germany at present has considerable leverage inside the eurozone because it provides the bulk of the support needed for the bailouts. Opposition to Berlin’s designs therefore is expected to come mostly from non-eurozone Member States. The United Kingdom (UK) has already expressed disagreement to further eurozone reforms that strengthen coordination between eurozone members at the expense of the entire EU.² Countries such as Poland and Sweden, which are not members of the eurozone, but contribute to the EFSF, will object

1. European Council, Conclusions, “Conclusions of the European Council”, EUCO 10/11, 25 March 2011, p.21, available at: http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/120296.pdf

2. Furthermore, it is expected that some countries, including Ireland and Cyprus, will object to the (possible) provision for a common assessment basis for the corporate income tax

to a system dominated by Germany and France. These reforms give Germany considerable leverage in the eurozone, whilst at the same time underpinning a two-tiered EU.

Lessons from the economic crisis and the future of the Euro

When the EMU was created, there was criticism in relation to its economic rationale. One of the issues raised was that countries could face asymmetric recessions and shocks, and as members of a monetary union, they would not be able to exercise discretionary monetary policy. Furthermore, as currency depreciation is not an option under such conditions, participation in a monetary union may be procyclical. On the other hand, it had been supported that the creation of the monetary union and the euro were inevitable. In an economic area of free capital mobility, the alternative would have been regular monetary and currency crises, including speculative attacks. Consequently, although the shortcomings of a monetary union are recognized, the alternative would have entailed higher costs.

Given historical experiences with financial and currency crises, fiscal strains and low economic growth constitute major risk-considerations for the single currency and the EMU. On the other hand, such circumstances tend to enhance the need for solidarity and coordination. Whilst the welfare state can be the basis of much social stability and economic resilience in Europe, the classic trade-off between social welfare and economic efficiency sets limits on the reach of the welfare state.

Government finances are coming under severe strain as a result of two interconnected developments. On the revenue side, there is increasing pressure in a globalised world to reduce corporate tax rates. On the spending side, a number of interrelated factors – the ageing of the population, rising medical costs and rising demand for public services in general – are straining public finances. Lack of coordination of national fiscal policies may create a serious threat to the single currency.

The long run success of the euro also critically depends on a sustained rate of real growth. Low growth or markedly variable growth rates across different regions and countries would generate political strains against the euro. That means that in addition to fiscal discipline, there must also be provisions for flexibility encouraging growth. For example, the rules of the Stability and Growth Pact in relation to the fiscal deficit should be revisited. It may be wiser to expect the 3% fiscal deficit to be an average over time instead of an annual target.

The recent international economic crisis was the most serious since the Great Depression. One of the lessons is that international coordination and cooperation on various issues, including regulation of financial institutions, is of utmost importance. For the eurozone, the crisis also had additional dimensions. Countries with serious structural fiscal problems found themselves in an extremely difficult situation and had to cope without having the

option of currency depreciation. The EU was successful to offer a particular level of solidarity to countries requiring support. Nevertheless, it is questionable whether this, on its own, will be enough to effectively address similar crises in the future.

The greatest challenge for the EU and the eurozone is to further encourage structural reform for real economic convergence. At the same time, the EU should seriously consider the adoption of a form of fiscal union. This may imply that the budget of the EU should be higher than what it is today. After all, a major characteristic of any fiscal union is the capacity to spend and subsequently influence economic outcomes. Given that, in the case of the eurozone, the business cycles are not uniform, such a move will be a major step in the right direction. It is essential to note that the budget of the EU today is about 1% of Gross Domestic Product (GDP) – in the US, the federal budget revolves around 37% of GDP.

Following the marked devaluation of the US dollar, beginning in 2005, the euro has come into focus as an alternative international currency. Consequently, the strength and governance of the new currency constitute areas of increasing interest in global finance. But the single currency in the framework of divided and / or shared sovereignty raises a number of issues and potential threats.

The fundamental question and challenge is whether, in the long run, the euro can be successfully sustained without further political integration. A key problem is conflict among national agendas for growth and full employment. This is related to the incidence and severity of potential asymmetric shocks. Further integration and the creation of cooperative fiscal arrangements will be vital for the durability of the EMU.

It may also be interesting to assess the impact of the common currency on the identity of eurozone members. Future generations that will not have gone through the experience of national currencies, but will be using and sharing the euro, may have a higher propensity to put more emphasis on European identity.

The euro has *de facto* evolved as the second reserve currency of the world. However, the euro stands in contrast to the dollar in a number of respects. Unlike the dollar, the euro is not the currency of a superpower. The euro is held for political reasons and for diversification purposes. More importantly, it is not dependent on continued capital inflows like the dollar.

During the deep international financial and economic crisis of 2008-2010, the euro proved to have reduced negative impact in eurozone countries. The multidimensional utility of the euro is well understood and complaints about loss of national monetary and economic independence are gradually fading. The sustainability of the euro as well as the achievement of other economic objectives are core issues. These dynamics raise *de facto* the issue of further economic deepening and political integration. Even if not all Member States of the EU and of the eurozone may be interested in discussing further economic and political integration,

this will be undertaken by some countries. This may lead to a multi-speed EU, with the core moving toward a form of federation.

Recommendations

Besides any suggestions for fiscal discipline and harmonisation, the EU must also revisit its philosophy in relation to spending. First, while the rule of the Stability and Growth Pact for an annual fiscal deficit no higher than 3% is essential, given the reality of business cycles, it may be wiser to expect the 3% deficit to be an average over time, instead of an annual target. Second, the EU must gradually increase its own budget. Currently, it only represents 1% of EU GDP; this is very low for an economic and monetary union. Such an approach would certainly encourage further integration as well as economic stability.

ECONOMIC GOVERNANCE

Sovereign Debt Crisis Resolution in the Eurozone¹

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Searching for a comprehensive solution to the eurozone debt crisis

In the past two years, the countries most affected by sovereign debt crises – Greece, Ireland, Spain and Portugal – have announced and started implementing consolidation plans and economic reforms. These countries share common characteristics and problems (mainly high private and / or public debt and low competitiveness), but Greece stands apart among them because of the seriousness and the nature of its woes. With a debt-to-Gross Domestic Product (GDP) ratio scheduled to exceed 150%, the country is on the verge of insolvency. Also, the public debt predicament has arisen mainly as a consequence of public finance mismanagement, while banking problems have played a secondary role (in the case of Ireland and Spain, the situation is reversed).

This assessment is confirmed by the forward-looking evaluation undertaken in Darvas et al. (2011). This analysis shows that even under the most optimistic hypotheses, the adjustments to public finance that would be needed to stabilise debt at its 2015 level or to meet the Maastricht criteria of 60% in 2034 are of a frightening magnitude both in the case of Greece and Ireland. Even more worrying for Greece is the size of the primary surplus that would need to be maintained over a period of years to achieve a return to safe levels of public debt: more than 8% of GDP in an optimistic scenario and more than 14% in a cautious one. Over the last 50 years, no Organisation for Economic Co-operation and Development (OECD) country (except oil-rich Norway) has sustained a primary surplus above 6% of GDP for a meaningful period of time. Our conclusion, therefore, is that Greece has become insolvent. The same

1. This paper draws on François Gianvitti, Anne Krueger, Jean Pisani-Ferry, André Sapir and Jürgen von Hagen, "A European Mechanism for Sovereign Debt Crisis Resolution: A Proposal", *Bruegel Blueprint Series N°10*, 9 November 2010, available at: http://www.europolitique.info/pdf/gratuit_fr/282201-fr.pdf – and on Zsolt Darvas, Jean Pisani-Ferry and André Sapir, "A Comprehensive Approach to the Euro-Area Debt Crisis", *Bruegel Policy Brief N°2011-02*, 8 February 2011, available at: <http://www.bruegel.org/publications/publication-detail/publication/496-a-comprehensive-approach-to-the-euro-area-debt-crisis> – We are grateful to Christophe Gouardo for his help in preparing it

does not hold for Ireland, where the necessary primary surplus remains within the range of what has been achieved historically, or for Spain and Portugal where the required adjustment is lower.

There does exist a form of middle-way between adjustment and restructuring: a lowering of the interest rate charged on all official EU loans, an extension of the maturity on official EU loans (and possibly on the International Monetary Fund (IMF) portion of the Greek rescue package), and the repurchase of all government bonds currently held by the European Central Bank (ECB), with the retrocession of the haircut to the issuing country. In March, the European leaders agreed on the former, but did not contemplate the latter. However, even assuming all three measures are implemented and a positive market reaction, this would still be grossly insufficient to restore solvency in Greece. Estimates suggest that a further 30% haircut would be required to ensure long-term sustainability.

This is the kind of estimate economists can come up with. We do not claim, however, that our numbers are definitive. What we do claim is that the presumption of insolvency is sufficient to necessitate a comprehensive sustainability assessment. For such an assessment to be accurate, however, the situation of the banking sector has to be clarified.

On the basis of the above evidence, it appears that a significant reduction of Greek debt is needed. As the share of official creditors will rise with time (and that imposing losses upon them appears politically unpalatable), the size of the haircut required to restore sustainability will rise as well. Moreover, delaying is likely to weigh on growth and create the risk of a negative feedback loop with respect to public finances. For these reasons, restructuring should happen sooner rather than later.

One of the main obstacles to a rapid resolution of the eurozone crisis is, however, the difficulty policymakers have in tackling spillover effects, both between banking and sovereign difficulties and across countries. Our estimates indicate that the spillover from a sustainability-restoring haircut on Greece (aggregate losses in the range of €35 billion) would be manageable. Some banks would need recapitalisation and the impact on the public finances of other eurozone countries would remain limited – certainly they would be limited in comparison to total aggregate losses from the subprime crisis, which the IMF puts at €500 billion for the whole of the eurozone.

The dire financial situation of sovereigns is, however, only one of the facets of the eurozone crisis. In the case of Ireland and Spain, it is uncertainty over unrealised losses in the banking sector that is cause for concern. This was supposed to have been addressed by the European stress tests in July 2010, but the subsequent developments in Irish banks have discredited the exercise. The implementation of new and this time rigorous and credible stress tests is therefore an absolute priority for the euro-area and a precondition to addressing sovereign solvency.

Because EU supervisors squandered credibility in the previous round of stress tests, it would be highly desirable to involve the IMF and possibly the Banks for International Settlements (BIS) in the next round. Once these tests have been carried out, eurozone countries should immediately proceed with restructuring where necessary, which should imply the recapitalisation of viable institutions and the closure of non-viable ones. As well as helping to stem contagion to other countries, this strengthening of the banking sector would help to limit the downside risks for the financial system that would arise from a restructuring of Greek debt.

The absence of contingency plans

One of the reasons for the high volatility during the crisis was the absence of contingency plans to deal with sovereign debt problems. The crisis revealed a gap in a policy framework that focused exclusively on prevention and included no provision for crisis management and resolution. Whatever the outcome for the current difficulties, it is clear that no set of fiscal rules, however well enforced and however well designed, will eliminate the possibility of future debt crises. Additionally, the crisis has shown that sovereign debt crises are not the sole preserve of developing and emerging countries.

As we have seen in the case of Greece, there can be situations where the debt burden is such that the required retrenchment would be economically unrealistic, not to mention politically unfeasible in democratic states. Outright bailouts are naturally out of the question, as the treaty makes clear that each Member State is only responsible for its own liabilities, leaving restructuring as the only exit from an unsustainable level of debt.

Two arguments are traditionally put forward against allowing for sovereign debt restructuring within the eurozone. The first is that, as eurozone government bonds are mostly held by eurozone residents (and particularly banks), the losses from a restructuring could jeopardise financial stability. This is an important concern, though a transitional one. Banks exposed themselves to Greek debt under the assumption that it was risk-free. Once banks have become familiar with the new regime and price risk accordingly, they will adjust their exposures to sovereign risk. Moreover, consistency of regulatory policies would imply that banks be required to hold capital against public debt.

The second argument is that the mere creation of a sovereign-debt resolution mechanism could have negative effects on the borrowing costs of other Member States because it would signal, for the first time since World War II, that advanced countries' government debt securities are not safe assets. It is true that the reputational spillover effects of a default within the euro area cannot be taken lightly. But the existence of a procedure would in fact only open the possibility of reasonably orderly defaults, instead of only 'bad and ugly' ones.

In the event of a future debt crisis, a debt restructuring mechanism would go a long way towards avoiding market turmoil – this is because the mechanism would guide market expectations about the steps that would be taken and their likely outcomes. In establishing clear rules for involving creditors, it would also create stronger incentives to care about the creditworthiness of sovereign debtors ex ante and thereby strengthen market discipline.

Designing the European stability mechanism

Sovereign defaults are different from private defaults in a number of ways. The first is that, in contrast to a private company, the sovereign entity cannot be dissolved, a forced liquidation of its assets is impossible, and its creditors cannot assume ownership. This implies that a debt restructuring procedure, if it exists, must be invoked when the sovereign debtor declares itself unable to pay its debt service.

Second, while a private bankruptcy procedure primarily aims at maximising the value the creditors can extract from the defaulting institution, a defaulting sovereign must be left with the financial means to perform at least minimal functions of government. The only sensible goal of the procedure should be to restore the sustainability of the sovereign's public finances.

Third, under democratic government or a community of democratic states, it is inconceivable that a government be put under receivership, because this would contradict the nature of democracy.

Fourth, evaluating solvency requires a judgement on the possibility for the sovereign to levy taxes and repay its debt. This generally involves an economic, but also a political assessment of the size of the primary surplus that can be attained and maintained in a given context.

These differences imply that the instruments to deal with sovereign-debt crises in an orderly way are more limited than in the case of private debt. A procedure must be found to restructure the debt in an orderly fashion through negotiations with the creditors. For the eurozone, such a framework would have to have four main elements:

- First, a formal way to initiate the debt-resolution procedure. The initiative to start the procedure can only come from the debtor government. With the opening of the procedure, the country would immediately stop servicing its debt to national and international creditors and there would be a stay on all litigation by individual creditors seeking repayment.
- Second, a mechanism to prevent a minority of bondholders from exploiting the majority by refusing to agree to a restructuring of the debt in the hope that the majority would buy them out. This requires that a super-majority of bondholders can outvote the minority in the decision to enter into negotiations and to conclude agreement with the debtor country regarding a restructuring of its debt.

- Third, a mechanism to conduct negotiations. In civil bankruptcy procedures, this is the role of the court-appointed trustee. In the context of sovereign default, the sheer size of the task implies that it would have to be assumed by a neutral, politically independent body.
- Fourth, a rule for the provision of fresh credit from the EU or other euro-area Member States to the government in financial distress. In the past, sovereign defaults have often been accompanied by periods during which the defaulting government no longer had access to credit markets.

There are two approaches to the design of sovereign-debt restructuring procedures that are potentially consistent with the four elements just outlined. One is the ‘contractual’ approach that would encourage the inclusion of collective-action clauses (CACs) in sovereign-bond contracts. The other is the ‘statutory’ approach.

The contractual approach has obvious advantages. It does not involve supranational decisions and leaves negotiation on the terms of the agreement to the parties involved. It only requires, as a way to overcome the collective-action problem, a joint commitment to include CACs in bond issues, presumably at no visible cost. And it does not involve any detailed legislative work. This is why it has been preferred by the EU.

Our view is, however, that the contractual approach has severe limitations and is perhaps even unsuited to the European case. The reason is that it is intended to facilitate the negotiation of a settlement between a country and its private creditors, whereas the default of a eurozone country might raise concerns over financial stability in the eurozone as a whole. This would necessarily lead the governments of the affected countries to step in, thereby transforming the negotiation between a country and its private creditors into a *de facto* international negotiation involving states.

Therefore we have been advocating the statutory approach², which allows aggregation across all creditors’ claims, and have proposed the creation of a European Crisis Resolution Mechanism (ECRM). We have suggested that the ECRM should involve three separate bodies: a legal one in charge of adjudication and conflict settlement, an economic one to provide the necessary economic expertise and judgement, and a financial one dealing with financial assistance.

The legal body would have the authority to open a debt-restructuring procedure upon the request of a eurozone sovereign borrower and upon approval by the economic body that the debtor’s debt is actually unsustainable. It would be a common judicial organ capable of sorting out and assessing claims by the parties, of ruling on disputes between creditors or between a creditor and the debtor, and of enforcing the decisions taken by the parties within the framework of the mechanism.

2. Gianvitti *et al.*, *op. cit.*, 2010

After the formal opening of the procedure, **the economic body** would have the task of calling for meetings of the borrower and the lenders and of guiding the negotiations with a view to finding a solution acceptable to both sides. To fulfil this task, it would have i) to be able to review the economic and financial accuracy of a borrower’s representation of its economic and financial situation and perspectives; ii) to evaluate the implications of any restructuring proposal for the borrower’s outstanding debt (i.e. the extent of the haircut) and its sustainable level of debt going forward (i.e. the projected future path of primary budgetary surpluses). These functions require that all parties trust that the judgment of this body be not only neutral but also ‘fair’.

The economic body would have the responsibility of assessing when a country is truly unable to meet its future financial obligations and by how much its debt needs to be reduced to solve that problem. There can be no simple test or rule for doing this, because a government can legally use its taxing powers to reduce citizens’ income and make room for servicing the debt. Reliance on judgment will therefore be inevitable. But what is crucial is that such judgments are coherent across time and countries and that they are based on sound principles.

The financial body would have the tasks of providing shorter medium-term financing to the debtor country on behalf of the EU to enable it to undertake the necessary economic adjustment towards fiscal sustainability. Lending conditions should include a risk premium, but not a penalty, in other words lending should be at rates charged by financial markets for governments with debt levels similar to those of the country in question after its restructuring.

Various institutional arrangements can be conceived as regards the assignment of the legal, economic and financing functions of crisis resolution, but whatever the arrangement, these three roles should be fulfilled and distinguished in order to avoid creating conflicts of interest. Our suggestion is that the legal role would be assigned to the Court of Justice of the EU, to a specialised chamber within the court or, if preferred, to an entirely new institution. The economic role should be given to an independent institution capable of providing the required assessment and of keeping a stance throughout the negotiations between creditors and debtor, if the extent of the assistance becomes an argument in negotiations. This role should in our view accrue to the European Commission or to the European Commission jointly with the ECB. Finally, the natural choice for financial assistance would be the European Financial Stability Facility (EFSF), which would thus need to be made permanent and be given preferred creditor status, as envisaged for the European Stability Mechanism (ESM).

The statutory solution is more ambitious than the contractual one and it is for this reason that the latter has been chosen for the ESM. It should nevertheless be regarded as a reference, the principles and procedures of which should, as much as possible, be mimicked in a less ambitious system. Especially, the three roles – legal, economic and financial – should be distinguished and assigned to existing or newly created bodies.

FINANCIAL REGULATION

The Financial Crisis Response: a Mid-term Review

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By early 2011, the European Union (EU) was well advanced in its response to the financial crisis. The “de Larosière” institutions were established, and in relation to the G-20 commitment to regulate all markets, products and institutions and to further streamline the Single Market, proposals were either adopted or were progressing in the discussion process.

The rapid adoption of most proposals, all of them in a single reading so far, indicates that the sense of urgency was great on both sides, i.e. the European Parliament and the Council. Both institutions, together with the European Commission, have done an enormous job in delivering upon the commitments taken.

The question that remains is: will it work by 2013, when most measures should be in place. The amount of regulation has increased enormously, and more is to come, in both primary and secondary legislation. In addition, the new European Supervisory Authorities (ESAs) have been mandated to implement a single rulebook, which is facilitated by the new Lisbon Treaty provisions on comitology. This article will first discuss the role of the ESAs, followed by a brief review of the measures adopted or under discussion.

The “de Larosiere” institutions

The new regulations creating the European System of Financial Supervisors (ESFS) were adopted by the EU in time for the new bodies to start functioning in 2011. The final compromise did not fundamentally alter the decision reached by the Council on the new bodies in December 2009, but added additional tasks for the authorities, such as the possibility to prohibit or restrict certain financial products or activities (Art. 9), or clarified and strengthened their role, in emergency situations, for example (Art. 18). For the European Systemic Risk Board (ESRB), the most important change was the addition of an “independent” element, with the creation of a Scientific Committee, and the requirement to have a delegate of this Committee on the Steering Committee of the ESRB.

A fundamental change as compared to the “Lamfalussy” Committees is that the authorities have become executive agencies under the control of the Commission. Before, the committees (CEBS, CESR and CEIOPS) functioned fairly independently from the European Commission, but also only had advisory powers. Now, the authorities will have fully-fledged regulatory and, to some extent, supervisory powers, but they can only have these powers to the extent that they derive from the powers attributed, under the EU Treaty, to the EU and the Commission. In other words, the authorities’ powers are limited to what the Commission can do under the EU Treaty to contribute to the good functioning of the internal market. “The purpose and tasks of the Authority – assisting competent national supervisory authorities in the consistent interpretation and application of Union rules and contributing to financial stability necessary for financial integration – are closely linked to the objectives of the Union *acquis* concerning the internal market for financial services”.¹ The Meroni doctrine, dating back to an EU Court judgement of more than 50 years ago, continues to be with us.

The profound change that the authorities generate for a more integrated financial market cannot be sufficiently emphasized. Without exaggerating, they can be considered as embryonic federal supervisory authorities, but all will depend on the management of the authorities and the cooperation with national supervisors. Given what the Lamfalussy Committees achieved with limited personnel and budget, there are no reasons for scepticism. It can be argued that the first appointments for the authorities are too low key, not in line with the depth of their tasks or the sea change they should bring about, but we should give them the benefit of the doubt.

The tasks of the authorities can be subdivided into three sorts of powers: regulatory, supervisory and institutional (see box below). The regulatory powers are based upon the need to achieve a much greater degree of regulatory harmonisation in the EU through the achievement of a single rulebook. In practice, the single rulebook will be composed of regulatory and implementing technical standards. Both standards can only be adopted by the ESAs to the extent that they are part of delegated powers, based upon Art. 290, respectively Art. 291 of the Treaty on the Functioning of the EU (TFEU). Both shall be “technical, shall not imply strategic decisions or policy choices and their content shall be delimited by the legislative acts on which they are based”.² Formally, both standards are adopted by the Commission, following a procedure as described in the regulations, and are limited in time, but the powers may be revoked at any time by the European Parliament or the Council. In practice, the process of regulatory and implementing technical standards will be entirely in the hands of the authorities, with limited control by the European Parliament, and the Commission rubber-stamping the proposals. The ESAs can also adopt guidelines and recommendations, which have no force of law.

1. European Parliament and Council, Recital 17, Regulation, “Establishing a European Supervisory Authority”, PE-CONS 40/10, No 1095/2010, 9 November 2010, available at: <http://register.consilium.europa.eu/pdf/en/10/pe00/pe00040.en10.pdf>

2. *Ibid.*, Art. 10 resp., Art 15

Box 1: Powers of the European Supervisory Authorities (ESAs)

- formal rule making powers
 - Regulatory technical standards (Art. 10)
 - Implementing technical standards (Art. 15)
 - Guidelines and recommendations (Art. 16)
- mediation, binding delegation btw supervisors (Art. 21, 28, 31)
- individual decisions in emergency situations (Art. 18)
- participation in College of Supervisors (operational standards)
- supervision of national supervisors (Art. 30)
- control of financial activities and products (Art. 9)
- sanctioning powers (Art. 30)
- constitution of supervisory data bases (Art. 8)
- specific supervisory tasks: The European Securities and Market Authority (ESMA) to licence credit rating agencies (CRA), trade repositories, and Automated Publications Arrangements (APAs), participate in supervision of Central Counterparties (CCPs) and Centralized Securities Depositories (CSDs), decide upon eligible over-the-counter (OTC) derivatives and third country hedge funds and managers (under the Alternative Investment Fund Managers Directive – AIFMD)

The supervisory powers of the new authorities can be subdivided into categories: direct and indirect. Indirect supervisory powers relate to those that contribute to improve the financial supervision from an EU perspective. They are composed of mediation between national authorities, and eventual delegation of powers amongst them, the participation in colleges of supervisors, and the supervision of supervisors. The latter is probably the most important element, as it allows for effective comparison of the performance of national supervisors (Art. 30), and the possibility to adopt recommendations. The ambition is to arrive at a common European supervisory culture (Art. 31).

Direct supervision is composed of decisions on individual cases in emergency situations, and specific supervisory tasks, which are most developed for the ESMA for the time being. Individual decisions by the ESAs can only happen in situations where there is a manifest breach of EU law by national authorities, following the procedure described in Art. 18. However, such decisions may not impinge upon the fiscal responsibilities of the Member States (Art. 38), an issue that provoked heated discussions in the Council.

The momentum the authorities already have is clear from the specific supervisory tasks, which are rapidly emerging, specifically for the ESMA. The ESMA is the sole authority to license credit rating agencies (CRAs) in the EU, and – under draft legislation – in the licensing of trade repositories for over-the-counter (OTC) financial instruments (draft European market infrastructure regulation – EMIR – legislation) and automated publication arrangements (APA's) or data vendors (under the Markets in Financial Instruments Directive – MiFID – review consultation). The ESMA will also participate in the supervision of Central Counterparties (CCPs)

in the draft EMIR legislation and soon also of Centralised Securities Depositories (CSDs). The ESMA will, with the Commission, decide upon those OTC derivatives that will be eligible for central clearing in CCPs and give advice on access of third-country hedge funds and managers under the Alternative Investment Fund Managers Directive (AIFMD). The ESMA is thus certainly an embryonic federal securities authority.

A problem that remains is the division of tasks in between the three ESAs and with the ESRB. The division of roles amongst the three ESAs is functional, but some issues may fall through the cracks, as they do not clearly belong to a certain authority. This relates to horizontal financial services issues, such as consumer finance, retail investment products or the supervision of bank-insurance companies. As regards the interaction with the ESRB (and indirectly the European Central Bank – ECB), for some issues, the regulation or financial services Directives require coordination, for others, it does not. It is at this stage too early to say how important the role of the ESRB will be – it all depends upon the authority the entity will acquire, and how its mandate will be occupied. However, given the macroeconomic implications of ratings, the ESRB is not given any role in the supervision of CRA's, the clearest exclusive ESA competence for the time being. The assessment of the methodologies used by CRA's is something where the ESRB know-how could have been used. On the other hand, the close participation of the ECB in the stress test in July 2010, and in the other tests to come, demonstrates that in practice there will have to be close cooperation with the most reputed European financial institution (but also that the ESRB will need to position itself carefully when cooperating with the ESAs).

Notwithstanding the creation of the ESAs as a form of Commission-based executive agencies, it will be extremely important that, in the start-up phase, the Commission respect their independence “in practice”, to allow them to emerge, over time, as federal supervisory authorities. The former “level 3” committees were always insisting on their independence, which was, in the case of the Committee of European Securities Regulators (CESR), part of its statutes. The independence as stated in the ESA regulations, however, is limited to the chair, the supervisory and management board (Art. 42 and 46), and does not apply to the ESAs as an institution. Respect for the committees' independence will be even more important for the new authorities' supervisory tasks, as the Commission has limited expertise in this domain.

The G-20 follow-up and single financial market completion

As regards regulatory matters, the consensus among the EU Member States was greater on the G-20 commitments than on single financial market improvements. The progress achieved on the former seemed more clear-cut than on the latter, which has led some commentators to argue that “Europe” had disappeared as an objective for rulemaking. But it also indicates that the Commission should have acted as the G-20 did at a global

level: garner support at the head of state or prime minister level for a new “Financial Markets Action Plan”, which was insufficiently done. Urgent single financial market reform matters were given only very limited attention in the Europe 2020 agenda, unlike the attention given to the financial services action plan in the Lisbon Agenda. It was not interwoven or consistently argued within the Europe 2020 objectives of smart, sustainable and inclusive growth.

By early 2011, new rules on issues related to many elements of the G-20 commitments had been enacted or proposed, with discussions being well advanced (see table in annex). The only element remaining was the implementation of the new Basel III rules, which were published by the Basel Committee on December 15, 2010. In this sense, the EU and the United States (US), which adopted the Dodd-Frank Bill in June 2010, containing its response to the crisis and the G-20 commitments, seem to be more or less advancing in parallel.

On core Single Market issues, several proposals have been made, but the consensus among the Member States was less clear, and the discussions less advanced. This was exemplified in the discussions on the reform of deposit protection or the harmonisation of bank resolution schemes, both matters that demand a fundamental change if the EU wants to move to a truly Single Market. Both elements will be briefly discussed below.

The most important G-20 related measures concern the regulation of hedge and private equity funds in the AIFMD, the introduction of a mandatory licence for rating agents in the rating agencies (CRAs) regulation, and the centralised clearing of derivative financial instruments in the draft EMIR. A key characteristic of the former two pieces of regulation is that protectionism has increased importantly. In the AIFMD, third-country alternative fund managers’ access to the EU market is subject to a long five-year transition period, and may still be refused at the end of this period.³ In the CRAs regulation, for banks and investors to use ratings produced outside the EU, these ratings must be locally endorsed by a licensed rating agent.⁴ The key problem with the draft EMIR regulation is the need to find a balance with the US concerning the requirement of eligibility of derivatives for central clearing, and the governance and risk-control procedures of clearing houses.

Regarding Single Market related measures, there is little consensus amongst Member States. Two examples will suffice. For the reform of deposit protection schemes, although the Commission did not propose a single EU-wide fund, as the European Parliament had proposed in its reading of the ESAs, even the proposal of mutual borrowing between funds – a step towards joint liability and a single fund – went too far, according to several large

3. See Mirzha J. de Manuel Aramendía, “Third Country Rules for Alternative Investments: Passport flexibility comes at a price”, ECMI/CEPS, 16 December 2010, available at: <http://www.ceps.eu/book/third-country-rules-alternative-investments-passport-flexibility-comes-price>

4. See Karel Lannoo, “What reforms for the credit rating industry? A European perspective”, ECMI/CEPS, 13 October 2010, available at: <http://www.ceps.eu/book/what-reforms-credit-rating-industry-european-perspective>

Member States, including Germany and France. The related discussion on bank resolution was still at the level of consultation at the time of writing, but it promises to be as sensitive of an issue, if not more. As long as there is not a unified approach to problem-banks, there will be no level playing, and no Single Market. Hence, banks headquartered in Member States with bigger treasuries will have an advantage over those from smaller states.

A symbolically important measure is the EU-wide regulation of mortgage credits, on which a proposal was made by the Commission on 31 March 2011. Real estate bubbles are seen as one of the causes of the financial crisis, and the non-existence of EU-wide rules contributed to the disintegration of the single financial market. Problems in some markets no longer remained confined to national boundaries, but rather had EU-wide ramifications, either affecting banks in other jurisdictions, or deteriorating the country’s fiscal position as a result of bank bail-outs. A harmonising effort is part of the measures to improve and further align banking supervision in the EU, and to avoid spill-overs of lax regulation in certain jurisdictions, affecting the reputation of the sector as a whole.

A remarkable development from a Single Market perspective is the increased use of regulations rather than Directives. Although before the financial crisis the issue was often presented as a means to achieving greater harmonisation, it took a financial crisis to get it changed, and already five of the adopted measures are regulations, with more coming. In addition, all the financial crisis related measures adopted so far passed in a single reading of the European Parliament and the Council, demonstrating the consensus amongst these institutions in the urgency to respond.

While the use of regulations eases the job for the Commission and the new authorities, as they will be directly applicable, the amount of rules covering the financial sector has grown enormously, and more are to come. Generally speaking, we are only at level 1, and the amount of rules will further grow in regulatory and implementing technical standards. This raises the question of whether it will work by 2013, when all the measures should be in place, and whether investors’ confidence will be restored.

Conclusion

The combined effect of a new institutional structure and new and more direct rules brings sea change for financial markets. It should bring the single financial market project back on track, and cause European financial integration to progress again. But much work remains in making it function on a day-to-day basis, on which it is too early to pass judgement. The response to the financial crisis was a remarkable example of global regulatory cooperation in the G-20, which seems to not have lost too much of its steam, yet. However, the same commitment is not so convincingly present with regard to remedying Single Market imperfections, as revealed by the crisis.

Annex. Financial crisis related regulation at EU level

Measure	Purpose	Status	Context
Credit rating agencies regulation	<ul style="list-style-type: none"> Introduce single licence Adapt to existence of ESMA 	<ul style="list-style-type: none"> Adopted April 2009 Amendments June 2010 	G-20
Capital requirements Directive (CRD) amendments: <ul style="list-style-type: none"> Securitisation, large exposures executive remuneration, trading book and complex products leverage ratio, capital buffers, liquidity regulation 	<ul style="list-style-type: none"> min. 5 % retention extra charge for high pay packages higher capital charge for trading book, more and better capital, minimum liquidity 	<ul style="list-style-type: none"> Commission Directives (adopted April & June 2009) Directive (CRD III, July 2010) Consultation (April 2010), draft Directive July 2011? 	G-20
Alternative investment fund managers Directive (AIFMD)	Regulate non-regulated segment of fund industry (hedge funds and private equity)	adopted November 2010	G-20
Depositaries of funds	Segregate fund managers from depositaries	Consultation (May 2009)	Single market
Regulation on OTC derivatives, central counterparties and trade repositories (European Market Infrastructure Regulation, EMIR)	Transparency, mandate central clearing for eligible OTC derivatives, licence for trade repository	Draft September 2010	G-20
Short selling regulation	Prohibition of naked short selling of all types of financial instruments, including credit default swaps on government debt securities	Draft September 2010	Single Market
European Systemic Risk Board regulation	Identify macro-financial risks	adopted November 2010	G-20
European Banking Authority regulation	Coordinate banking regulation and supervision	adopted November 2010	Single Market
European Insurance Authority regulation	Coordinate insurance regulation and supervision	adopted November 2010	Single Market
European Securities Markets Authority regulation	Coordinate securities markets regulation and supervision	adopted November 2010	Single Market
Omnibus Directive	Adapt existing rules to ESFS	adopted November 2010	Single Market
Deposit guarantee schemes Directive	<ul style="list-style-type: none"> Increase minimum level to €50,000 Further harmonisation 	<ul style="list-style-type: none"> adopted October 2008 draft 12 July 2010 	Single Market
Investor compensation schemes Directive	<ul style="list-style-type: none"> Further harmonisation 	<ul style="list-style-type: none"> draft 12 July 2010 	Single Market
Market in financial instruments Directive review (MiFID II)	Extend price transparency to non-equity products, further regulation of trading platforms	Consultation December 2010	Single Market
Crisis resolution procedures	Coordinate national winding-up rules for banks	Consultation (October 2009, May 2010, January 2011)	Single Market
Bank tax	Coordinate national rules		(G-20)
Mortgage lending	EU-wide harmonisation	Draft Directive (March 2011)	Single Market

FINANCIAL REGULATION

What if the New Financial Supervision Framework Proves Insufficient?

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The financial crisis has underscored the need for effective financial supervision. The crisis demonstrated that supervision serves not only to verify whether financial institutions apply the rules, but that it also preserves the stability of our financial system and the economy at large.

Despite its crucial role, pre-crisis financial supervision proved inadequate. Therefore, the European Union (EU) committed itself to a reform of its financial supervision framework. The resulting legislative changes fully entered into effect in 2011.

This contribution will start with a sketch of pre-crisis financial supervision, followed by an overview of its inadequacies. Subsequently, the post-crisis reform will be discussed. As we will argue, the resulting supervisory framework is not all that different from the previous one. As a consequence, the adequacy of the framework is all but certain. If it were to fail again, the remaining policy options might prove to be most uncomfortable. This should lead the Trio Presidency to do its utmost to get the supervisory framework off to a good start and to carefully follow up its functioning. If needed, the EU should not shy away from early reforms.

Pre-crisis financial supervision

The EU financial framework has been characterised by two interrelated principles: minimum harmonisation and mutual recognition. Both are well established in EU law. For the financial sector, it implies that minimum EU rules allow a financial institution duly licensed in a Member State to provide its services in the rest of the Union without being subject to supplementary requirements.

The legal framework resulted in home country supervisory control. Such supervisory control implies that a financial institution is supervised by the Member State where it is licensed. This includes the supervision of cross-border and branch operations. For example,

the French supervisor supervises a French bank's branch in Austria, as well as its cross-border operations in Belgium. Things are different when a financial institution sets up a separate legal entity in another Member State, referred to as a subsidiary. As a subsidiary is conceived and licensed as a separate financial institution, it is supervised by the country in which it is established. Nonetheless, the European harmonisation process has facilitated the setting up of subsidiaries.

Home country control significantly reduces the supervisory role of the host country, i.e. the Member State where the financial institution provides its services. The supervisory powers of the latter do not stretch far beyond the supervision of a branch's basic liquidity provisions and the collection of information for statistical purposes. While Member States may not have liked giving up on supervision of foreign branches, this was inevitable if a Single Market in financial services was to be created *without* the transfer of financial supervision to the EU level.

Nonetheless, policymakers realised that mere home country supervision was inadequate. The continuous integration of the European financial sector and the subsequent emergence of large, multinational financial institutions have rendered national supervision more and more obsolete. Financial supervisors are increasingly required to take into account operations which stretch beyond their national borders. To facilitate a cross-border vision, consolidated supervision has been introduced for multinational financial institutions. Such consolidated supervision takes into account a financial institution's overall operations.

In addition, supplementary arrangements allowing for cooperation between national supervisors have been adopted in the form of both EU legislation and multiple Memoranda of Understanding. Despite these arrangements, cross-border supervisory cooperation remained of a non-binding nature.

At the EU level, a Banking Supervision Committee was created inside the European Central Bank (ECB). The Committee (still) serves as a forum for information exchange between national banking supervisors. Furthermore, it is tasked with analysing and ensuring the stability of the financial system. Apart from the ECB's Banking Supervision Committee, three so-called Lamfalussy level 3 Committees played a role in pre-crisis financial supervision. The three Committees grouped the national supervisors and covered respectively the banking sector, insurance and occupational pensions firms, and the securities sector¹. Their tasks expanded over the years, but like the ECB Committee, they lacked binding powers. Furthermore, their supervisory tasks were, at most, limited. As a result, the role of EU-level supervisors was largely limited to exercising basic monitoring tasks and to providing a forum for noncommittal cooperation.

1. These three Lamfalussy level 3 Committees were: the Committee of European Banking Supervisors (CEBS), the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS) and The Committee of European Securities Regulators (CESR)

The inadequacies of pre-crisis financial supervision

In retrospect, it has become clear that supervisors were unable to effectively detect, signal or mitigate the financial crisis. The pre-crisis supervisory system thus failed to perform its core tasks. A multitude of problems lies at the basis of this failure. On the one hand, supervisors carry part of the blame, as they neglected overall financial stability and overlooked potential risks. On the other hand, policymakers were insufficiently prudent and tended to neglect supervisory warnings.

More generally, the supervisory setup proved ill adapted to the integration of the financial sector. This is an international phenomenon, but was more pronounced in the EU, due to its Single Market and monetary union. While many EU financial institutions had outgrown their national borders, financial supervision had not. The provisions in place simply did not result in sufficient cooperation between national supervisors.

The limited supervisory reform

The recent reform of the supervisory framework was initiated in 2009 by the Report of the High-level Group on Financial Supervision chaired by Jacques de Larosière. In September 2010, the European Parliament and the Council reached an agreement on the legislative package. It entered into force in January 2011 and was widely welcomed as one of the main achievements of post-crisis regulatory reform. In essence, the crisis resulted in three major changes to the European financial supervision framework.

First, a macro-prudential supervisory body was created, named the European Supervisory Risk Board (ESRB). The ESRB's core task is to supervise the financial system, in order to prevent or if needed mitigate harmful financial system disruptions. Despite its important role, the ESRB's functioning is hampered by several constraints. The ESRB notably lacks coercive powers, has a bulky decision making body and depends heavily on the central banks. For the most part, the ESRB will have to rely on its reputation to influence the actions of policymakers and supervisors, which is far from evident given its challenging task.

As a second major change, three European Supervisory Authorities (ESAs) have replaced the aforementioned Lamfalussy Committees². In contrast to the previous Committees, the ESAs have been endowed with substantial competences. They notably have a role to play in emergency situations and can counteract breaches of EU law, settle disagreements between national supervisors and adopt draft technical standards. In some cases, ESAs

2. These three ESAs are: the European Banking Authority (EBA), the European Insurance and Occupational Pensions Authority (EIOPA) and the European Securities and Markets Authority (ESMA)

can even impose actions on national supervisors and individual financial institutions. These competences are however subject to several constraints, lengthy procedures and / or the go-ahead by an EU institution. This is likely to limit their application (draft technical standards being the exception). Furthermore, the actual supervisory role of the ESAs is limited to a small set of specific financial actors, such as credit rating agencies.

A final important change is the increased role of cross-border supervisory colleges. These bring together the different supervisors of the markets in which a given financial institution operates and are to strive towards a consensus on supervisory decisions. Some supervisory colleges had already been put in place before the crisis, but they proved too immature to play a substantial role when problems arose. As part of the post-crisis reform, supervisory colleges have become mandatory for all large financial institutions³. However, their weakness lies in the voluntary nature of cooperation. In the end, the home country supervisor remains in control. So merely making supervisory colleges mandatory will not necessarily render them effective.

In sum, the supervisory reform represents a significant evolution, but in no way a revolution. While it has led to an increased role for European supervisors, the heart of financial supervision remains unmistakably at the national level. The supervision of individual financial institutions is still a Member State competence and the principle of home country supervision is maintained. Consequently, only national supervisors combine both substantive supervisory tasks and binding powers. Moreover, the cross-border and EU-level supervisory bodies consist, for the major part, of national supervisors. These bodies are in no way supranational entities.

What if the reform proves insufficient?

While the post-crisis reform was substantial, it does not fundamentally alter the financial supervision framework. Consequently, financial supervision in the EU remains out of line with the integration of the sector it supervises. This is not necessarily incompatible with effective supervision, but it does require smooth and intense collaboration between national supervisors. Yet, this was not the case before the crisis.

As the asymmetry between financial sector integration and supervision persists, it is unclear whether the reform will remedy the previous supervisory framework's failings. Keeping this in mind, we need to consider the possibility that the post-crisis reform could end up being insufficient. If this were the case, the EU has in essence three policy options.

3. This reform was the consequence of a 2009 revision of the Capital Requirements Directive. See: European Parliament and Council, Directive, 2009/111/EC, JO L 302, 17 November 2009 (16 September 2009), available at: <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:302:0097:0119:EN:PDF>

The first policy option implies a limited patch-up. This entails minor changes that limit the discretion of national supervisors, but without changing the basic supervisory set-up. The aforementioned asymmetry would hence remain. As the recent reform would have been unsuccessful, a subsequent similar reform would most likely lead to similar supervisory failings.

A second option can be referred to as the European solution and it implies a genuine EU financial supervision, both at the macro- and the micro-level. In terms of regulatory requirements, the change would not be tremendous, as most of financial regulations stem from the EU level. It would, however, result in a loss of national autonomy. To make matters worse, two major obstacles prevent a shift to EU-level financial supervision. First, current EU supervision is already on the edge of what is legally admissible. More EU supervisory powers could require a change in the EU's legal structure. Second, supervision is undeniably linked to financial sector crisis management. Yet, owing to its fiscal implications, financial sector crisis management is a Member State responsibility. It would be unacceptable for Member States to separate the two. As long as there is no EU crisis management or at least an effective European burden sharing mechanism, supervision will and should remain dominated by Member States. Opting for EU financial supervision would therefore require considerable political will, which seems currently absent.

Host country supervision constitutes the final policy option for the EU. Instead of aligning supervision with financial sector integration, policymakers could do the reverse. If the current supervisory system proves to contain essential flaws and if policymakers cannot agree on creating European supervision, the only option remaining is to reintroduce host country supervision. It would imply cutting back the Single Market and would thus lead to a less integrated financial sector. This does not seem an attractive prospect for policymakers.

While a patch-up is the most feasible policy option, it is equally the least likely to be successful. The two other policy options have a greater chance of success, but they are much harder to achieve. In addition, they would bring about consequences that Member States desperately seek to avoid.

Recommendations to the Trio Presidency

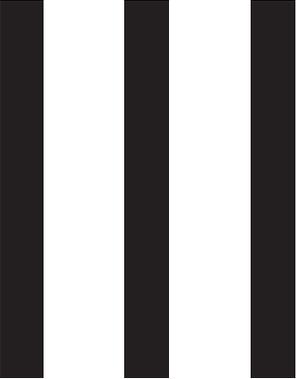
While imperfect and suffering from several of the pre-crisis framework's weaknesses, the renewed supervisory framework does have potential. Nonetheless, political will and effort will be required to exploit this. Here, the Trio Presidency can play an important role. It should do its utmost to get the supervisory framework off to a good start

The Trio Presidency should also closely monitor the functioning of the renewed supervisory framework. It should assist the Commission in preparing the future review. However, even with

the support of the relevant actors, the supervisory framework can fail. If the Trio Presidency finds that the supervisory system remains subject to the same vital failures as before, it should speed-up the review process. If needed, it should even steer towards early reforms.

Although it is likely and understandable that, in case of renewed supervisory failings, minor changes will be considered first, they might prove insufficient to tackle the framework's essential flaws. Therefore, the Commission and the Trio Presidency should not only reflect on which reforms are feasible, but also –and more importantly– on what reforms are needed. Opting for significant reforms is far from evident and would imply controversial changes. Even so, the Trio Presidency should not shy away from such reforms. The importance of our financial sector and its stability should provide ample incentives to stay clear of pre-crisis business as usual. Only in that way can Europe obtain the effective supervisory framework it requires.

The Contribution
of 16 European
Think Tanks
to the Polish,
Danish, and Cypriot
Trio Presidency of
the European Union



**MULTIANNUAL
FINANCIAL
FRAMEWORK
2014-2020
NEGOTIATION**

The next Multiannual Financial Framework 2014-2020 (MFF) represents a cross-cutting issue for the Poland-Denmark-Cyprus Trio Presidency. With the Commission's proposals for the next Multiannual Financial Framework due in June, negotiations are set to begin at the start of the Polish Presidency. Due to traditional emotions related to these questions, these negotiations are bound to be quite a touchy topic for the coming Trio Presidency. Moreover, the circumstances surrounding the negotiations will be of no relief. Many countries will seek to implement austerity programmes at the European Union (EU) level, replicating recent ones conducted at the national level. On the other hand, to be successful, any new policies or instruments will require sufficient funding. This is why the Trio needs to fundamentally "re-think" the EU multiannual budget in this new austerity, low-growth context (Notre Europe).

PART III ABSTRACT

Three crucial issues may be distinguished here. First of all, the EU will once again have to reconsider basic assumptions for the next multiannual budget: what should be its priorities, how should the money be distributed and where exactly should it come from? Second, the Common Agricultural Policy (CAP) budget – corresponding to 40% of the total EU budget could be seen as a potential source of funding for other common policies. But transferring CAP funds would raise strong controversies

– Agriculture Policy is predominantly financed at the EU level and represents one of the smallest public expenses in Europe (0.4 % of EU Gross Domestic Product) (Notre Europe). Third, Cohesion Policy will face a difficult moment, as diverging positions among Member States add to an already difficult context where a contrast is emerging between cohesion and competitiveness objectives.

Nonetheless, discussion over EU-budget reform has lasted for years, and hence it seems clear that the prospects for a major reform of the EU budget look bleak (SIEPS). The authors of this chapter recognise these difficulties, but they nevertheless try to find ways to make budget structures and policies more efficient. Changing underlying priorities, fine-tuning and improving policy targeting and programming are some of the approaches applicable to the policy-sectors in question, namely Common Agricultural Policy, Cohesion Policy, own resources and general budget priorities.

FROM EU PRIORITIES TO OWN RESOURCES

As far as basic assumptions for the next MFF are concerned, most of the authors agree that instead of succumbing to the lure of a single, extreme objective, such as cutting spending or re-launching the EU's economy, the EU should aim for a mid-point position. Nevertheless, when discussing specific types of budgetary reform, the authors bring forward very diverse ideas.

For example, one author argues that when leading MFF negotiations, the Trio Presidency needs to accept rules such as *juste retour* and unanimity (SIEPS). Since this consensus is needed for deciding on both revenues and expenditures, a stable equilibrium will emerge – where the net receivers and net payers counterbalance each other with their power to veto. In order to break this stalemate, reforms intended to change Member State incentives could be implemented. These include introducing the multistage procedure (agreeing on the level of redistribution first, then assessing the exact transfers and finally making necessary corrections); a limited correction mechanism (for unacceptable redistributive effects); or a reform of the co-funding of the direct payments of the CAP (SIEPS) (the latter is also proposed by CER and Notre Europe).

In another line of thinking, one author writes that "we cannot expect major savings from applying austerity at the EU level". Therefore, this author focuses on efficiency gains that may be derived from improved coordination between national and EU spending, in diplomatic services, defence or research, for example (Notre Europe).

Some of the authors below put emphasis on the need for low-carbon objectives to be reflected in the budget, for example when it comes to CAP or research and development (R&D) spending. They argue that it is difficult to imagine that the EU will be on track to a low-carbon economy in 2020 if the next EU budget is not clearly aligned with the promotion of low-carbon outcomes (demosEUROPA).

Finally, in the long run, a transition has to be conducted from concentration on Member States' net positions towards a focus on European Value Added and European public goods. It would then be easier to reduce contributions based on Gross National Income (GNI) and increase own European budgetary resources, namely by means of a European tax (GKI, Notre Europe).

REFORMING THE COMMON AGRICULTURAL POLICY

Budget reform cannot be done without including two main expenditure items – specifically, the CAP and Cohesion Policy. Among other criticisms, the former is often perceived as discriminating between “old” and “new” EU Member States. Budget reform has to unify the differing payment models, but, what is more, reform has to be based on the notion of equal opportunities, and not equal funding – which means that farmers in the richer countries are justified to receive higher payments due to higher production costs. Also, limits would have to be imposed on additional national funding, which distort the level playing field in Europe (Europeum).

Regarding the CAP, all of the authors try to balance the arguments for and against its continuation. They also reflect on possible reforms for the policy, which cannot be maintained in its current shape. For example, one of the authors below argues that while there is no longer a food security problem in Europe, two potent challenges have emerged: growing global food demand and climate change? Agricultural policy should be re-shaped to tackle both of these. Among other things, the author puts forward two particularly interesting ideas: for the CAP to encourage biodiversity and to become a more powerful tool of rural development only in the new Member States, where agrarian reform has been especially limited (CER).

European growth goals – as established in the Europe 2020 Strategy – should also be incorporated into CAP reform. Indeed, the first priority of the CAP should be to encourage agricultural competitiveness. Innovation, development and research in agriculture can all work to the benefit for EU citizens, farmers and rural areas (CER, Europeum, Notre Europe). Moreover, at a time when the EU is trying to meet Europe 2020’s green growth targets, a deep reform of the CAP would provide a means of acting directly on more than 21 million economic actors with a direct link to the environment (Notre Europe).

COHESION POLICY AND THE EUROPE 2020 STRATEGY

The experts below also draw attention to the need to enhance Cohesion Policy’s position among post-crisis Europe’s driving policies. The debate over Cohesion Policy is widely regarded as a field where developed Member States compete with poorer neighbours for development funds. Despite a necessity to increase the budget to at least 1.5% of Gross National Product

(GKI), tensions are likely to persist. To overcome this issue, our contributors propose better coordinating the goals and means of Cohesion Policy with those of Europe 2020 (GKI, Notre Europe). This can be done in a number of ways. First, more emphasis can be placed on the differentiation between the developed and catching-up countries – the former benefit more from the Europe 2020 approach, with investment in R&D as the main source of sustainable growth. For the latter, the main driver for growth is investment and capital accumulation via infrastructure modernisation. An acknowledgement of this distinction and an appropriate division of funds – supported by newly created cohesion indicators – could alleviate the two groups’ different interests (GKI).

On the other hand, one author proposes “a closer alignment” of Cohesion and Europe 2020 policies. Here, this author argues, the best way to advocate adequate funding for Cohesion Policy is to present it as a “leading European development and investment policy” (Notre Europe).

Regarding specific proposals for the Trio Presidency, the authors below mention that discussion on concrete numbers should be postponed as long as possible or even be placed at the end of the negotiations process. First, Cohesion Policy governance, as well as Cohesion Policy’s strategic dimension and linkages with Europe 2020, should be discussed – with questions concerning the allocation of funds being left until the end of the negotiations (Notre Europe). Similarly, one author recommends a bottom-up approach, where first policy goals are decided and only then are financial resources adjusted to these goals – and not the other way round, as was practiced in the past (GKI).



EU BUDGET PRIORITIES, EXPENDITURES AND RESOURCES

Options for EU Budget Reform

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The prospects for a major reform of the European Union (EU) budget look bleak. The positions of several “net contributing” Member States indicate that the room for manoeuvre might be the smallest since long-term budgeting –today known as Multiannual Financial Frameworks (MFF)– was introduced in 1988. In a joint letter to the President of the European Commission, José Manuel Barroso, in December 2010 five Member States¹ asked for the EU budget to be frozen in real terms at 2013 levels over the next MFF. The letter was motivated by the strain on Member States’ public purses after the recent financial and economic crisis² and is, as intended, likely to set the tone for the negotiation process. Furthermore, the lateness of the Commission’s budget review communication³ implies a missed opportunity to discuss reform without disturbances from the negotiations on the next MFF.

It is generally agreed that the challenges, which require measures and funding at the EU level are growing in both number and necessity and that a much higher degree of flexibility is needed to make the EU better equipped at “expecting the unexpected”. It is also generally understood, not least among economists, that the EU is misallocating its resources and that a budget reform could potentially increase the welfare of EU citizens and do more to aid the EU in achieving its policies.

However, if there is to be any hope of coming to terms with the current status quo of the EU budget, the reform process will have to take into account the political-economic constraints that are blocking reform. A number of proposals have surfaced in the literature in recent years with the common factor of attempting to alter Member State incentives with respect to funding for certain EU policies.

1. Finland, France, Germany, the Netherlands, and the United Kingdom
 2. The austerity argument was also present in the run-up to the 2005 MFF negotiations, only then it was mainly related to France and Germany’s problems with respect to the Stability and Growth Pact
 3. European Commission, “The EU Budget Review”, COM(2010) 700 final, Brussels, 19 October 2010

Understanding the EU budget deadlock

The literature offers several models for analysing the evolution of the EU budget⁴ but, in the short space available, three factors deserve a specific mention. First, as Member States view their contributions to the common purse as rivalling with national expenditure, they tend to seek to minimise their contributions while promoting policies that maximise their receipts from the budget, rather than supporting policies that would be motivated by their own merits (see below). The tendency of making sure that budget receipts are proportional to budget contributions is commonly referred to as *juste retour*.

A second factor, related to the first, is the relationship between the Common Agricultural Policy (CAP) on the one hand and the UK rebate on the other. Their perpetuation –due to path dependencies, vested interests and the diffusion of corrections to other Member States– has maintained a strong link between the revenue and expenditure sides of the budget. Therefore, it is not conceivable that a revenue reform would be likely without also simultaneously reforming EU expenditure (and *vice versa*).

A third factor is the budget reform of 1988, which amongst other things introduced Interinstitutional Agreements (IIA) between the Commission, the European Parliament and the Council – consisting of long-term budgeting and ensuring budgetary discipline – and a new Gross National Income (GNI)-based resource.⁵ The reform was successful in so far as it brought down the level of conflict between the Council and the European Parliament during annual budget negotiations. Furthermore, it also ensured that financing of the budget would be both stable and sufficient.

At the same time, the reform also implied that there would be little room for change during the frameworks’ duration. However, the most important aspect in terms of affecting current prospects for reform is the fact that the MFFs are decided on the basis of the unanimity rule. Hence, a consensus is required for both revenue *and* expenditure. This has effectively cemented the status quo between net payers and the net receivers. Dana Puia has offered the following description:⁶

Net receivers object to any reallocation of resources away from their individual interests, whereas net payers, anticipating net receivers’ power to attract additional resources, veto any increase in their financial burden. However, net payers cannot enforce a decrease of their burden, as this would be objected by net receivers. This leads to a status quo that is a stable equilibrium.

4. For a recent overview, see Dana Puia “The Dynamics of Institutional Change and the Case of the Budgetary Negotiations”, PhD dissertation submitted in November 2009, University of Pittsburgh, 2010
 5. The Delors packages I and II were also instrumental in securing agreement on Maastricht and Economic and Monetary Union (EMU) in particular, as the then new European Community (EC) Member States showed reluctance due to fear of losing out from the deepening of market integration. As a consequence, funding for regional policy increased substantially. The EU enlargements of 1995, 2004 and 2007 further accentuated the division between net receivers and net payers
 6. Puia, *op. cit.*, p. 55

This insight also points to the conclusion that net payers would block a decision-making reform that aims to soften the veto power on either side of the EU budget, as they would otherwise lose their control over expenditure increases. In sum, the scope for EU budget reform is severely limited.

Revenue and expenditure reform in the EU budget review

As part of the EU budget review, two research teams were commissioned to examine EU revenue and expenditure, respectively. The Ecorys, CPB and IFO team of researchers who examined EU expenditure employed a subsidiarity test, in which economies of scale and cross-border externalities were weighed against heterogeneity of preferences and political economy considerations (such as the disciplining role of competition or the relative power of lobbies at national and European levels).⁷ Based on the results obtained, the authors recommended a shift towards three “policy packages”: climate change and energy resources; knowledge and innovation; and common security and foreign affairs. They also concluded that aspects of Cohesion Policy (especially in the richer Member States), the CAP’s income and price support, and a large share of rural development funds were not compatible with the test. In the latter cases, the authors recommended that funds be either reduced or reverted to Member States; or in the case of CAP market interventions that funds be abolished altogether.

The researchers who were commissioned to study options for revenue reform presented two “straightforward” and two “more controversial” proposals for the 2013+ and 2020+ periods. In the “straightforward” proposal for 2013+, the Value Added Tax (VAT) resource would be incorporated into the GNI-based resource, along with the introduction of some form of generalised correction mechanism. For the “straightforward” 2020+ scenario, the group proposed to introduce progressivity into the GNI-based resource and to phase out the correction mechanism. In the “more controversial” proposal for 2013+, they proposed to have at least 25% of the budget funded by true Community-owned resources (e.g. flight charges or revenues from the Emissions Trading System) and to introduce some form of progressivity into the GNI-based resource. In the “more controversial” 2020+ scenario, the European Parliament would be given responsibility over EU revenue, the European Central Banks (ECB)’s seigniorage would replace the GNI-based resource, and a fiscal equalisation mechanism would be introduced.⁸

It is perhaps not surprising that the European Commission chose an approach that is politically more sensitive than the one proposed by the Ecorys team. Although many of the latter’s

recommendations are mirrored in the budget review due to the strong emphasis on Europe 2020, the approach with respect to, for example, the CAP is one of continuing down the reform pathway into which the EU has already entered, rather than one of significant spending cuts. However, the cautious approach does not extend to the revenue section of the communication, where the Commission argues rather strongly in favour of tax-based own resources. Taxes are not only seen as a cure to the Member States’ addiction to *juste retour* (and as a long-term solution to remove the many corrections that are currently in place), but also as a means to increase budgetary autonomy, efficiency and transparency.

Aside from the difficulties described in the preceding section, one problem with the Commission’s approach is that discussion on revenue reform is inextricably linked to the distribution of expenditure and is at the very least dependent on an expenditure reform that is lacking in the communication. Furthermore, while the proposed taxes may possess many advantages, any pro- or counter-arguments pale in comparison with the fact that several EU Member States have very clearly spoken out against them. In view of the unanimity criterion, the implication is that a proposal to introduce new tax-based own resources is unlikely to succeed *regardless* of how the expenditure side of the budget may change.

Reform options designed to alter incentives

In contrast to the content-driven reforms described in the preceding section, the reforms that will be described below attempt to alter Member State incentives so that they refrain from giving preference to policies that maximise their receipts from the EU budget.⁹ However, the implicit assumption in these models is that the EU budget would be refocused along the lines of those proposed by the Ecorys team.

A first option for reform is to introduce a multi-stage procedure in the decision-making process.¹⁰ The first stage of the procedure would have the Member States agree on the level and mechanisms required to finance EU expenditure; and the desired level of redistribution. Based on this agreement, indicative net balances that are inversely correlated to income levels would be calculated for each Member State. Next, decisions would be taken on expenditure *without* taking national net balances into account. Finally, some form of correction would come into play, ensuring that the agreed level of redistribution is fulfilled. Since the final allocation is fixed, Member States would be more inclined to focus on policies, as opposed to net balances.

7. Ecorys, Netherlands Bureau for Economic Policy Analysis (CPB) and Institute for Economic Research (IFO), “A Study on EU Spending: Final report”, commissioned by the European Commission, Directorate General for Budget, June 2008. Available at: http://ec.europa.eu/budget/reform/library/issue_paper/study_EUspending_en.pdf

8. Iain Begg, Henrik Enderlein, Jacques Le Cacheux, and Mojmir Mrak, “Financing of the European Union Budget. Study for the European Commission, Directorate General for Budget, Final Report”, April 2008

9. For a more extensive survey that also includes other reform options, see Friedrich Heinemann, Philipp Mohl, and Steffen Osterloh, “Reforming the EU Budget: Reconciling Needs with Political-Economic Constraints”, *European Integration*, 32(1), pp. 59-76, 2010

10. Angel de la Fuente and Rafael Domenech, “The Redistributive Effects of the EU Budget: An Analysis and Proposal for Reform”, *Journal of Common Market Studies*, Vol. 39, No. 2, pp. 307-330, 2001

A second option is the generalised but limited correction mechanism (GLCM).¹¹ Building on the generalised correction mechanism (GCM) proposed by the Commission in its 2004 own resources report,¹² the correction mechanism would only come into effect for expenditure that was characterised by unacceptable distributive effects. Hence, the correction mechanism would not apply for expenditure where redistribution was deemed desirable (economic convergence) or where the benefits were non-allocated (EU-wide public goods). It is argued that, whereas a large share of CAP expenditure is highly controversial, the convergence objective in Cohesion Policy is less controversial, as it can be motivated by the fact that some Member States gain more than others from market integration.

A third reform option is the proposal to co-finance the first pillar of the CAP; more specifically, to co-finance the direct payments. Co-financing would not only imply additional room for spending on other policies, but it would also affect incentives for the Member States whose CAP receipts currently outweigh their contributions, in so far as they would be less interested in pursuing the policy.

These reforms are not immune from criticism. Even if the richer CAP benefactors start to question the policy in the face of rising costs and deteriorating net positions, the Central and East European (CEE) Member States are expecting to get their share of the funds in the coming years. This would be a strong counterargument against the GLCM proposal: it identifies the CAP as one of the main culprits, which essentially is tantamount to explicitly saying that funding will be reduced. On the other hand, it has been pointed out that a shifting of money from the CAP to the cohesion funds might appeal to the CEE Member States, as they would be better off from such a move.¹³ Moreover, the GLCM can be calibrated so that the distributive pattern of the budget is reproduced.¹⁴

The focus on the CAP would also seem to speak against the co-financing proposal. It could be argued that some Member States would find it difficult to finance the policy, and in view of how the CAP has been financed up until now, it may also seem rather unfair to begin a transition towards less beneficial funding requirements at this point in time. On the other hand, co-financing could be modified in various ways so as to mitigate this problem. For example, Núñez Ferrer proposed co-financing direct payments in relation to the average gross value added (GVA) per farmer.¹⁵ Since the productivity of farmers is generally lower in poorer Member States, CAP support would end up where the needs are greater and at the same time impose a heavier burden on the richer Member States, thus creating the right incentives. While there is no guarantee that co-financing of the direct payments would affect incentives

in terms of reducing the focus of Member States on juste retour, it would at least imply that money could be shifted towards, for example, Europe 2020 priorities.

The proposals described here are by no means mutually exclusive. For instance, the Slovenian EU budget review taskforce proposed combining the GLCM with the multi-stage procedure.¹⁶ This would imply the same separation of expenditure as in the GLCM proposal. However, while there would be a simplified and single-phased procedure for expenditure with non-allocated benefits, adoption of the remaining expenditure would be carried out according to a variation of the multi-stage procedure. With the addition of co-financing the direct payments according to GVA per farmer, so as to come to terms with the uneven distribution of funds and to free up additional resources for other expenditure, this proposal may offer a way out of the net balances trap and over time allow for a more thorough reform of the EU budget.

11. Heinemann *et al.*, *op. cit.*

12. European Commission, "Financing the European Union. Commission Report on the Operation of the Own Resources System", COM/2004/0505 final, 2004

13. See Valentin Zahrt, "A Guide to CAP Reform Politics: Issues, Positions and Dynamics", *ECIPE Working Paper*, No. 3, 2011. However, it should be noted that Cohesion Policy in the richer Member States will probably have to be retained to some degree in order to make it a European policy, rather than a policy that is exclusively for the CEE Member States

14. Heinemann *et al.*, *op. cit.*

15. Jorge Núñez Ferrer, "Can Reforming Own Resources Foster Policy Quality?", *SIEPS Report*, 2008:3

16. Begg *et al.*, *op. cit.*, p. 205. A summary of the taskforce report is available at: http://ec.europa.eu/budget/reform/library/contributions/o/20071218_O_1_FR_en.pdf. See also Angel de la Fuente, Rafael Doménech, and Vasja Rant, "Addressing the Net Balances Problem as a Prerequisite for EU Budget Reform: A Proposal", *CESifo Economic Studies*, 56 (2), pp. 221-250, 2008

EU BUDGET PRIORITIES, EXPENDITURES AND RESOURCES

Rethinking EU Finances in Light of the Crisis: Balancing Growth and Austerity Needs

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As we approach the start of the next Multiannual Financial Framework (MFF) negotiations, any independent observer following the European Union (EU) budget issue over the last years cannot stop from having a strong sense of *déjà vu*. As in 2004, the European Commission's proposal has been preceded by an "open letter" from a group of "net contributors" setting a limit on the size of the budget. As in 2004, while researchers and experts engage in an intellectually appealing discussion on how to re-align EU spending in accordance to "added value" considerations or on the general benefits of moving towards a real own-resource based financing system, an army of bureaucrats in the Ministries of Finance are already defining their positions in the coming negotiations by calculating the impact of different scenarios of reform on net budgetary balances.

And yet, the political and economic context in which the next MFF negotiations will take place is radically different from the context in which the latest MFF negotiations developed. In 2005, when the European Council reached a compromise on the 2007-13 financial perspectives, the European economy was growing at a rate of around 2%. As is the case today, national public finances were in bad shape, but middle-term economic forecasts were optimistic. Indeed, the main issue of concern was how to render the EU economy more dynamic, as this 2% rate of growth was considered highly dissatisfactory and a proof of "quasi sclerosis" in a world growing at annual rates of around 5% and with the United States' economy strongly rebounding at rates of 4%. Concerning the political context, the EU had just come through the most challenging enlargement of its history, with the entry of 10 new countries having an average income level equivalent to less than 50% of the EU-15 average. Against this backdrop, there was a general consensus among both EU officials and independent observers on the need to "re-direct EU funding to the goals of creating a dynamic knowledge-based economy and on helping new Member States to catch up with the rest as rapidly as possible".¹

Today, the economic and political climate is quite different. EU leaders are still worried about the EU's potential for long long-term growth, but also, and more urgently, about the EU's capacity to fully recover from the crisis. Indeed, the EU economy as a whole is growing at 1.8%, but the outlook remains highly uncertain due to the (still unresolved) eurozone debt crisis and the fragility of the financial system. Besides, the aggregate picture hides important differences between Member States. In particular, a new divide is emerging between core eurozone countries, some of them growing at rates of above 2% (i.e. Germany), and so-called "peripheral euro countries" (Greece, Ireland, Spain and Portugal), with very low or negative growth rates. Finally, public finances are in very bad shape. Despite the consolidation effort undertaken in 2010, the aggregate deficit in Europe is forecasted at 4.1% of Gross Domestic Product (GDP) for 2011 (and 6.1% of GDP in the eurozone). The situation is particularly worrisome in peripheral euro countries, with deficits of around 7-10% of GDP. Indeed, these countries find themselves in a negative spiral of low or negative growth rates, tightened budgetary policies and high deficits. It is not clear how they are going to break this vicious circle and regain growth.

Thus, the question is how to re-think the EU multiannual budget in this new austerity / low growth context. Some believe that, at the moment when many Member States are making efforts to curb their level of public spending, the EU budget should be equally submitted to a "cure" of austerity. Others, on the contrary, think we need, more than ever, an ambitious growth-enhanced EU budget in order to "compensate" for spending cuts at the national level. Which of these two sides is right? There are reasons to reject the first approach. Calls for the EU to "set a good example" by applying austerity are more fuelled by ideological convictions than economic rationales. The EU budget is by law on balance, and therefore not pressed by financial markets to reduce any deficit. Having said so, it is true that, as things stand, revenues for the EU budget accrue from national budgets; thus, it is not totally absurd to make a conceptual link between austerity at the national level and the EU budget. On the other hand, the second approach also poses some problems. Claiming to re-launch the EU economy with a 1-percent-of-EU-GDP budget is quite unrealistic. However, this objection needs to be qualified as well: while EU-level spending is irrelevant as a percentage of the EU's GDP, it can have a significant effect on particular policy domains and territories. Thus, for instance, in 2008, funding from European Regional Development Fund and the Cohesion Fund accounted for 28% of total investments on transports, communications and energy, and for 50% of total expenditure on the environment in the so-called "cohesion countries".²

So what is the right vision for the next MFF? Probably the most intelligent solution is to adopt a mid-point position; that is, to think on ways to convert the next MFF into an effective tool to re-launch the EU economy while at the same time looking for ways to increase the efficiency of EU spending. What are the practical implications of this in terms of size and composition of

1. André Sapir *et al.*, "An Agenda for a Growing Europe- Making the EU Economic System Deliver", ("The Sapir Report"), July 2003, p. 128, available at: <http://www.euractiv.com/ndbtext/innovation/sapirreport.pdf>

2. European Commission, Report, "Fifth Report on Economic, Social and Territorial Cohesion", Directorate-General for Regional Policy, November 2010, p. 153, available at: http://ec.europa.eu/regional_policy/sources/docoffic/official/reports/cohesion5/pdf/5scr_en.pdf

the MFF is difficult to say, but we can formulate some general reflections on how to adapt EU finances to the double challenge of low growth and budgetary austerity.

The EU budget and growth: Do not neglect short-term needs

A first important issue concerns our ideas on how the next MFF can stimulate growth. Calls for a more “growth-oriented” EU budget are not new; indeed, this has been the main ‘motto’ of reform over the last decade or so. Up until now, however, when pleading for a “growth oriented EU budget” we usually referred to increasing EU funding on long-term investments – a vision popularised by the influential 2003 Sapir Report, which called for a major increase of EU spending on research and innovation, higher education and trans-national infrastructures.

Investing on the long-term is indeed necessary, particularly now that the crisis has forced many countries to cut back on public investment. There are many ideas under discussion on how to ensure the financing of long-term, strategic investments, including the Commission’s proposal of “project bonds”. And we should welcome these initiatives. Having said so, it would be erroneous to focus the next MFF exclusively on the long-term. In current circumstances, we should not under-estimate the short-term economic impact of EU spending. In particular, two things should be kept in mind when negotiating the new MFF.

First, as Europe’s post-crisis recovery remains tentative, any changes in the MFF should be mindful of its effect on demand in the short run. Hence, for instance, it is more important than ever to ensure a well-designed phase-out programme for countries and regions losing eligibility to Cohesion Policy funding in the post-2013 period, so as to prevent that the loss of funding hamper their recovery. Concerning the Common Agricultural Policy (CAP), despite all justified criticisms on the effectiveness and appropriateness of current CAP Pillar 1 spending, we should not neglect the fact that this is the only EU direct income support programme. Thus, any reform on CAP direct payments for the post-2013 period should pay adequate attention to its short-term redistributive impact.

Second, EU leaders should do their utmost to prevent eurozone peripheral economies from plummeting into a long recession. This leads us to the broader question of how these economies can regain growth in the short to medium term, and what the EU budget can do in this respect. The dominant thinking in EU and international *fora* is that these countries need to reform their labour and product markets to become competitive again. This might be true, but one should be mindful of the political difficulties inherent to passing such reforms (which entail long-term benefits, but negative short-term effects in terms of job losses or greater job insecurity). Adding to the negative impact of budgetary austerity plans, if left on their own, it is hard to believe that these countries will be able to pass these reforms and regain growth in the near future.

Against this backdrop, it seems necessary to use part of EU spending in the coming MFF to stimulate growth and facilitate reforms in these countries. A solution in this respect could be

the creation of an *ad hoc* reserve fund in the next MFF for countries receiving assistance from the European Stability Mechanism (ESM) or at risk of being bailed out by the ESM. Contrary to the current ESFS or the future ESM (whose aim is to provide financial assistance to governments to help them honour their debt payments), this *ad hoc* fund would be geared to stimulate growth. It would be used to finance or co-finance programmes having strong counter-cyclical properties (i.e. training programmes and mobility grants for workers and financial aid for Small and Medium-Sized Enterprises). The “moral hazard” would be diminished by conditioning the disbursement to reform implementation, hence using EU spending as an incentive tool to pass politically-costly reforms.

Another option is to create a permanent EU-wide stabilisation fund geared to provide temporary assistance to any EU country suffering from exceptionally negative economic circumstances. While today the idea of setting up an EU stabilisation mechanism seems politically unrealistic or too radical, one should note that it was seriously discussed in the early 1990s, at the moment of creating the Economic and Monetary Union (EMU). Indeed, it was such a mainstream idea that in 1993 an independent group of economists entrusted by the Commission to examine the role of public finances on the EMU concluded the following:

*The group shares the view of much of the literature on EMU that there is a strong case for a Community role in assisting Member States to absorb severe specific shocks. This is in order to compensate for the loss of the exchange rate as an adjustment instrument and for the loss of an independent monetary policy, and should help to prevent longer-lasting economic deterioration which could increase the pressure for greater redistribution. It should also make it easier for Member States to respect fiscal discipline.*³

The same report notes that such an EU stabilisation fund would not require a lot of spending (i.e. around 0.2% of EU GDP). If well designed, it would work as a sort of insurance: it would be activated automatically on the basis of a reliable indicator monitoring changes in real activity – that is, countries would be eligible only if and when the indicator would report a major fall in real economic activity relative to the EU average – and its use would be halted as soon as no further changes occur, irrespective of the level at which the national economy would become stable again.

The EU’s budget and austerity: Exploring the efficiency gained from a better coordination of national and EU-level spending

The other big challenge for the next decades is austerity. As said before, as long as the EU’s budget is financed by national budgets, austerity at the national level will require an effort to

3. Henrich Matthes *et al.*, “Stable Money – Sound Finances. Community public finances in the perspective of EMU”, *European Economy*, n° 53, 1993, p.6, available at: http://ec.europa.eu/economy_finance/publications/publication7524_en.pdf

implement EU spending programmes in a more efficient way. Already, we see some positive moves in this respect, such as current debates within EU cohesion communities on the need to reinforce the Commission's control on the use of EU funding or to introduce a more performance-based approach in the allocation of funding and in evaluation. However, this is a partial approach to the challenge of austerity, which does not take into account the potential efficiency gains that can derive from reorganising spending tasks and from a better coordination of public spending at the national and EU-level.

In effect – as pointed out by a recent report from three prominent Members of the European Parliament (Jutta Haug, Alain Lamassoure and Guy Verhofstad) – in various policy areas there are duplicities between EU and national-level spending. In these areas, better coordination and some pooling of resources at the EU-level could translate into efficiency gains.⁴ Thus, for instance, it would be nonsense if the creation of the new EU external action service is not accompanied by a restructuring of national diplomatic services, so that the new EU external action service does not entail extra-cost for taxpayers, but on the contrary, net savings. In the domain of research, we have a European Research Council, but also multiple National Research Councils that finance research activities according to national priorities, unaware of the actions financed by their neighbours. Better coordination in this area would avoid duplicities and fruitless competition, ensuring a more efficient use of public resources on research in Europe. Finally, there are many potential savings from coordinating national spending on defence, as shown by Fabio Liberti.⁵ European governments' concern to develop and protect its own national defence industry has led to absurd situations, such as the development of 16 armoured fighting vehicles or 11 different frigates in the 27 Member States. And the effectiveness of national-level spending in defence is questionable. One fact is particularly appalling: the EU has 27 national defence army forces that combined make a total of 2 million soldiers, but only 2% of these soldiers are capable of carrying out “high intensity action” (that is to say fighting).

To sum up, while the EU budget should not be isolated from austerity concerns, due to its limited size, we cannot expect major savings from applying austerity at the EU-level. A more efficient response to the austerity challenge is to look at ways to make savings by better coordinating EU and national-level spending. In some areas, it might be intelligent to pool services or financial resources to benefit from economies of scale. In others, more “ex ante” coordination of national budgetary processes might be the right answer. Such ex ante coordination could be conducted within the context of the so-called “European Semester”, providing the latter pays adequate attention to the quality of public finances and not only to deficits and debts levels.

4. Jutta Haug, Alain Lamassoure and Guy Verhofstad, “Europe for Growth : For a Radical change in Financing the EU”, CEPS/ Notre Europe, 6 April 2011, available at: http://www.notre-europe.eu/uploads/tx_publication/Europe_for_Growth__For_a_Radical_Change_in_Financing_the_EU.pdf

5. Liberti, Fabio, *Defence Spending in Europe: Can we do better without spending more?* Notre Europe, forthcoming.

Final remark: How to finance the EU budget?

We have already noted that, as things stand, revenues for the EU budget accrue from national budgets. Thus, to a certain point, it is understandable that austerity at the national level translates into calls for freezing the EU budget. However, this state of affairs is not inevitable. There is a very simple way to avoid calling on national budgets, and that is by creating new “EU own resources” to finance the EU budget.

The idea of creating a new “tax” in a period of crisis is seen by some as a non-sense. Yet, what is really non-sense to have the Greek or the Irish government contributing to the common budget with a direct payment from their respective national budgets while at the same time receiving a “bail out” from the rest of eurozone governments to cover their debt obligations”: as pointed out by the previously mentioned report⁶, fully funding the EU with independent sources of revenue is possible; it is only a matter of political will. The report proposes two reform scenarios. In the short-medium-term, they propose to fund the EU budget with a genuine EU VAT tax (at a rate of one percent) and a EU carbon tax on carbon dioxide (CO₂) emissions not covered by the Emissions Trading Scheme (ETS). The EU carbon tax would consist of an imports tax and of a tax on the production of fossil fuels (carbon, oil and gas), at a rate of 20€ per ton of CO₂ emissions. For the long-term, they propose a partial offsetting of the carbon tax by an EU financial transaction tax (a tax of 0.05% on exchange-traded equity and bonds), thus anticipating the possible “success” of the EU carbon tax in mitigating emissions.

6. Haug *et al.*, *op. cit.*, 6 April 2011.

EU BUDGET PRIORITIES, EXPENDITURES AND RESOURCES

Own Resources and European Added Value

András Vértés Chairman, GKI

There is a long-lasting debate on the usefulness of own budgetary resources in the European Union (EU). In the near future, unavoidable fiscal policy austerity in many EU Member States will limit direct contributions from national budgets. The current Multiannual Financial Framework (MFF) basically depends on that type of contribution. The Commission's communication on Budget Review includes as possibilities a financial sector tax, revenues from auctioning greenhouse gas Emissions Trading Scheme (ETS), a charge on air transport, Value Added Tax (VAT), energy taxation and corporate income tax. The Commission proposed "the simplification of Member States contributions, the introduction of one or several new own resources and the progressive phasing-out of all correction mechanisms".

On the other hand, in Member States there is little appetite for a new funding on the European level. Furthermore some Member States announced their goal to shrink the EU budget below 1% of Gross National Income (GNI). This approach does not take into account the fact that EU-budget is very small, in every sense (compared with national budgets, budgets of other integrations or international institutions). To the contrary, it is fundamentally based on the view that the spending structure relies much more on historic priorities than on the new Europe 2020 goals (criticism that is in some part true).

So, the next EU budget procedure is in each part approaching a no-policy-change situation. This would be very unfavourable.

The EU budget issue from a wider economic governance perspective

When analysing the role and significance of the EU budget from a wider perspective, we can see that the European Union is already employing a whole range of economic policy instruments: regulation, policy co-ordination, common policies, budget, direct investments, etc.

In many cases, political union is lagging behind as regards its ability to shape and influence the EU's economic policy. But there is no question that the crisis led Member States to the

conclusion that economic and political union needs to be strengthened. Maybe the willingness has not increased, but when instability of one country threatened the whole eurozone, this unavoidably pushed countries towards much stronger commitments and closer coordination. The crisis forced EU leaders, institutions and Member States to start to build a new, comprehensive economic governance structure. There are some positive changes, but to strengthen economic union, several tools are available, and these should be considered together:

- Strengthening EU prerogatives to regulate,
- Giving tools (teeth) to the EU to co-ordinate and / or supervise Member State's economic policies,
- Restructuring and modernising the MFF, including key principals, policy goals and common policies, revenue and expenditure side, the extent of the budget and the delivery as well.

At the political level, European regulation and policy coordination are changing deeply. This process is necessary and beneficial for strengthening the European Union. There are two main aspects to it:

Enforcing stability

With introduction of European Semester, enlarging the Stability and Growth Pact and – in a broader sense – adding to it and adopting new rules and tools (EFSF and ESM), the EU on the one hand strengthens macroeconomic policy coordination and regulation (in fiscal and monetary policies) and on the other hand consolidates regulation (especially with European financial supervisory institutions and the Basle III rules). The main rationale behind this is that, in such a turbulent world, we cannot develop without stronger common rules, which need to be strictly monitored for compliance and followed with penalties for any infringements.

Foster growth and competitiveness

In reality, the EU has, sensibly, supplemented the Stability and Growth Pact. So far, this has in fact just been a stability pact that has nothing to do with growth. The EU had taken the topic of competitiveness on board in the Lisbon Agenda, and most recently in the Europe 2020 Strategy. However, both were a separate national policy on growth, competitiveness and sustainability with weak tools to deliver. The planned parallel evaluation of Stability (Convergence) Programs with National Reform Programs will improve coherence; the Euro-Plus Pact creates more possibilities (with stricter rules and indicators mostly based on structural reforms) for coordinated and effective action.

As we can see, in such an unprecedented and challenging economic situation, the European Union and Member States are much more open to create mechanisms for coordination and regulation rather than build a fundamentally new MFF. Considering all these elements, the structure and nature of the next budget will – willingly, or by default – also represent a step towards or backwards from economic union, as a whole. Why is the budget kept, but also kept out of the

reforming process? Because of contradictions between very different national interests and unanimity rules.

How to refocus spending on European added value or European public goods?

Both stability and growth (competitiveness) oriented policies need much larger and better-targeted resources. As the Commission announced “the EU budget should be used to finance EU public goods, actions that Member States and regions cannot finance themselves, or where it can secure better results”.

Certainly, there is a wide range of criticism about the introduction of an EU tax. From a political point of view, one of the decisive elements is the restructuring of the expenditure part of the budget. If EU-spending was more in line with professional and public expectations, introducing own EU-resources would be much easier. This is one reason to strongly base the EU-budget’s expenditure structure on the concept of European public goods or added value.

European added value is one of the theoretical (but not very practical) economic bases of the EU. The basic idea is clear: a euro spent at the EU level should bring more benefits than if it were spent at the national or regional level – easy to say, but difficult to fulfil.

Why? European added value is hardly possible to clarify (needs some faith as quite often in economics). Different experts, Member States have different ideas on what is and what is not European added value. Spending is mostly related to projects and investments whose effects are medium and long-term, so they are difficult to measure. On the micro-level, you rarely have a relevant comparison, and on the macro-level, too many noises change elements in the model. So, European added value is good in theory, difficult to use in practice.

Sometimes European added value and European public goods are used as synonyms terms. As Zuleeg argued, public goods are connected with market failures and very strictly defined in economic literature: these are non-rival (non competing), non-divisible and non-excludable goods and services. In this very strict reading, hardly only a few activities (for example the police) produce public goods. In the modern world, so called public utilities are no longer considered public goods (because gas supply may compete with electricity). We can use a less strict rule, assessing something as a European public good or service, in a broader sense, when one of the three criteria have been met. Using this wider approach, we can make detailed analyses to see which parts of EU activities belong to that box. May be all European public goods produce European added value, but on the other hand there can be many other (social or environmental) rationales for policies ending up with added value or a bigger cake.

Let me list an experimental typology of added value producing or European public good activities:

- fiscal, monetary and financial stability enhancing policies on the EU level,
- projects with large multiplier or economies of scale effects, transnational or cross border effects (common investments in international competitiveness, cohesion, energy-security, climate-change, transport),
- policies with strong –and sometimes long– forward or backward linkages (food security, protecting environment, natural resources and surrounding),
- synergies for the internal market (competition on the Single Market),
- spill-over or catalytic effects (on the quality and mobility of the labour force, on the structure of the labour market, on education, excellence in research),
- external savings or surpluses (EU as a global player, migration policy, European Neighbourhood Policy).

Conclusion

When a European policy or project creates European public goods or added value, it can be financed from European or national resources as well. Not all European public goods need European budgetary financing (for example fiscal stability oriented EU-policies). But reversely: the European budget in the medium term should be mostly used on developing European added value, European public goods. The whole process needs a thorough revision of policies, evidence based monitoring and evaluation, and effective and efficient implementation and delivery.

It is a real danger that the incoming political debate on the next MFF will be very sharp and will strongly concentrate on “net positions”. Most Member States have substantial difficulties in improving macroeconomic stability and fostering employment and growth. They are questioning how to build the next EU MFF on European policy goals. An approach based on detailed analyses of European public goods or added values is workable, but not enough: there is a need for political will.

Policy recommendations

1. Reforming and modernising the MFF procedure, in each part, is equally important as improving stability and fostering growth and competitiveness.
2. In the short term – because of Member States’ very low appetite for changing the EU budget – even minor improvements of the expenditure structure (decrease of CAP, wider room for new policies) or in introducing a new own resource (probably a very low tax on financial transactions or on auctioning ETS) are welcomed.
3. Now is a good time to start a comprehensive research project analysing in great detail which EU activities produce EU public goods or European added value.
4. Is it an extraordinary revolutionary idea to suggest for the countries to be involved in Euro-Plus Pact to start thinking on their separate, small, but efficient Euro Plus Budget?

EU BUDGET PRIORITIES, EXPENDITURES AND RESOURCES

EU Budget Reform and the New Low-carbon Economy

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If Member States are to address the collective challenges threatening their security and prosperity, an effective European Union (EU) budget is imperative. In June 2011, the European Commission will publish its proposals for the next Multiannual Financial Framework (MFF). Given that the size of the EU budget is unlikely to increase, the quality of spending becomes ever more important, with pressure building for a more active prioritisation in line with the current and future strategic EU goals identified in the Europe 2020 Strategy. This chapter argues that low-carbon investment must lie at the heart of the next EU budget.

A new narrative for EU climate policy

We are witnessing a shift in perceptions about how the EU should address the challenge of climate change. While the ultimate end goal of securing a stable climate remains the same, a more hard-headed calculation of European self-interest is driving thinking on the benefits of moving to a new low-carbon economy. Gone are the days when an appeal to “international leadership” could form the central motivating theme for EU climate policy.

The European Commission’s February 2011 Communication on a “Roadmap for moving to a competitive low-carbon economy in 2050” indicates that the economic recession has resulted in a reduction in the costs of policy action, together with a range of positive co-benefits to the European economy, such as those linked to reductions in fossil fuel imports. Independent analyses further point to the improved distribution of costs and benefits to the European economy resulting from early efforts to reduce emissions, rather than delaying action into future decades, which risks locking-in high carbon patterns of investment.¹ Similarly, the

1. See for example Emmanuel Guerin, “Is there a case for the EU moving beyond 20% GHG emissions reduction target by 2020?”, *Climate Strategies*, 2011, available at: <http://www.climatestrategies.org/research/our-reports/category/57/312.html>

recent study “A new growth path for Europe: generating prosperity and jobs in the low-carbon economy” highlights that, if learning dynamics and investor perceptions are incorporated into modelling assumptions, a 30% emissions reduction target for 2020 could result in increased economic growth and reduced unemployment.²

The challenge facing EU decision makers is therefore to create a set of interlocking policy drivers that increase investments in the technologies and infrastructures that will make the shift to a low-carbon economy possible. These policies must have a “robust credibility” if they are to succeed. The European Commission estimates that per annum, an additional €270 billion of public and private investment is needed between 2010 and 2050 compared to business as usual scenarios, with the increase in the period 2014-2020 being less pronounced, reflecting the time-lag between investment plans and actual spending.³ This figure represents added investments of about 1.5% of total annual EU Gross Domestic Product (GDP) and amounts to more than twice the size of the current annual EU budget (approximately €120 billion).⁴ It is within this context that we can view the potential added value of the EU budget, not as the sole delivery vehicle for investment on this scale, but as a catalyst to orientate many other spending decisions.

Why the EU budget matters

As a political signal of the EU’s collective will to move towards a low-carbon economy, the EU budget is unparalleled, in that it will provide the most visible demonstration of the EU’s policy priorities for the remainder of the decade. As a policy instrument, it can leverage investment and incentivise policy delivery in ways that complement the impact of carbon pricing and regulatory approaches. It is the tangibility of EU budget decisions that accounts for its influence, for citizens, private sector investors, and Member States alike:

For citizens, public spending is understandable on a personal level due to its parallels with their own lived experience, something that cannot be said of more esoteric challenges such as “saving the euro”. In an age of austerity within national politics, and increasing scepticism of the value of EU cooperation, it is an imperative for the EU budget to demonstrate that it is not being wasted, but instead is being visibly invested to fuel future low-carbon growth.

For private sector investors, the multiannual nature of the EU budget can help provide the policy credibility and durability required to unlock investment. There is an international component to this too, in that a concerted effort to catalyse national and regional low-carbon

2. Carlo C. Jaeger et al., “A New Growth Path for Europe: Generating Prosperity and Jobs in the Low-Carbon Economy. Synthesis Report”, *European Climate Forum*, 2011, available at: http://www.european-climate-forum.net/fileadmin/ecf-documents/Press/A_New_Growth_Path_for_Europe__Synthesis_Report.pdf

3. European Commission, Communication, “A Roadmap for moving to a competitive low carbon economy in 2050”, COM(2011) 112, 8 March 2011, available at: http://ec.europa.eu/clima/documentation/roadmap/docs/com_2011_112_en.pdf

4. *Ibid.*

development strategies via the EU budget will provide an improved level of assuredness for international capital providers, while simultaneously boosting the EU's collective position *vis-à-vis* the rapidly increasing low-carbon investments underway in China and other emerging economies.⁵

For Member States, the EU budget can play a catalytic role in fostering improved political receptiveness towards investment in the new low-carbon economy. Despite the emerging framing for EU climate policy discussed above, the question remains as to how to make this new low-carbon economic model an attractive proposition for all Member States. Proponents of a “low-carbon transition” for Europe must bear in mind that Central and Eastern European (CEE) Member States have already been through an enforced “low-carbon transition” of their own, and that, for many of their citizens, it was a miserable experience. EU climate policy has already sought to address this through decisions on effort sharing and flexibilities within the emissions trading system, yet more will need to be done to address CEE Member States’ understandable hesitance.

For all three of these audiences, the EU budget can play a pathfinder role by fostering an explicitly pro-investment, pro-growth approach to stimulating a new low-carbon economy. The central success criteria for the leaders of the European institutions must therefore be that they secure an EU budget that clearly invests in meeting Europe’s current and future challenges, not continuing to spend money reflecting past political compromises.

The 2008 consultation on the budget review identified climate, energy and competitiveness as the top three priorities for the next EU budget, and that prioritisation still holds true today, notwithstanding the immediate short-term pressures of the economic crisis. Given that previous MFF periods have been communicated under the narratives of “Single Market”, “enlargement” and “Lisbon Agenda”, we would therefore propose that this next MFF should be presented as one of “investing in the future” via catalytic spending on low-carbon infrastructure and innovation. Clear conditionality mechanisms will be required to ensure that low-carbon outcomes result as headline MFF decisions flow down into programming frameworks and Member State prioritisations.

Making up for a missed opportunity

The reality check for supporters of reform is that the history of the EU budget provides a potent demonstration of the EU’s struggle to align political will and economic resources behind the pursuit of its policy priorities. Member State negotiating strategies are driven primarily by *juste retour* calculations of net benefit or loss rather than a consideration of policy outcomes, while negotiations additionally suffer from conflicting policy aims within

5. Pew Environment Group, “Who’s winning the clean energy race? 2010 Edition”, 29 March 2011, available at: <http://www.pewenvironment.org/uploadedFiles/PEG/Publications/Report/G-20Report-LOWRes-FINAL.pdf>

and between Member States. These dynamics are likely to be further reinforced in 2011-12 by the impact on public finances of the current economic downturn.

Additionally, we must include in this inauspicious mix the missed opportunity of the Budget Review process agreed at the time of the last negotiations in 2005, but not delivered by the Commission as intended during 2008-09. The Commission’s forthcoming MFF proposals are subsequently expected to start from a position much closer to the status quo, rather than incorporating novel ideas such as the “climate and energy axis” included in the leaked draft Budget Review paper of October 2009.⁶ Notwithstanding the reduced scope for a radical revision of budget structures, the Commission will still need to communicate a clear political narrative and include strong policy instruments to deliver low-carbon outcomes. With a mainstreaming approach expected, the pressure is now on to identify how the next MFF will deliver a prioritisation of resources.

Given the expectation that cohesion funds will continue to be accessible to all regions of the EU, a strong case can be made for climate and energy actions to form the leading priorities for investment, requiring both a prioritisation of low-carbon outcomes, and an effective “climate proofing” approach that reduces lock-in to higher-carbon spending and identifies win-win opportunities to catalyse next generation infrastructures.⁷ There is therefore an implicit deal that will need to be reached during the MFF negotiations, whereby CEE Member States secure the resources they desire for Cohesion policy in return for a clear commitment that a significant portion of these funds will be dedicated to investments that support the development of the low-carbon economy.

Similarly, spending on the Common Agricultural Policy should match the overarching “investment” narrative by being oriented towards ecosystem and biodiversity protection and rural development. Likewise, funding for research and development (R&D) and critical infrastructures will need to prioritise the broad set of investments that can help stimulate a low-carbon economy, including broadband internet, digital services, energy infrastructures and transportation technologies. Proposals for a new system of EU project bonds and the further development of innovative financial instruments could both play useful roles in catalysing spending, provided that they too are subject to the same low-carbon objectives.

Such measures taken within the current budget framework would result in a surge in spending on climate, energy, environment, and a broader suite of technologies and infrastructure compatible with the low-carbon economy, up from the current level of direct spending on the environment, which today equates to just 5-8% of the total multiannual EU budget. Recent analysis

6. European Commission, leaked draft communication, “A Reform Agenda for a Global Europe [Reforming the Budget, Changing Europe]”, October 2009, available at: <http://lowcarbonbudget.eu/timeline/european-commission/the-leaked-draft-budget-review-communication/>

7. Keti Medarova-Bergstrom et al., “Strategies and instruments for climate proofing the EU budget”, Institute for European Environmental Policy, 2011, available at: http://www.ieep.eu/assets/782/Climate_proofing_EU_budget.pdf

by the World Wildlife Fund suggests that 43% of the total EU budget could play such a positive role.⁸ Assuming a stable multiannual budget in relative terms (1.13% of EU Gross National Income) for the next MFF, this would translate to €492 billion over the 2014-2020 period. A prioritisation of low-carbon outcomes from a third or more of the EU budget would provide a clear demonstration of political intent, particularly if coupled with some specific low-carbon wins such as investment in the Strategic Energy Technologies (SET) Plan.

Conclusions: Member State champions required

It is difficult to imagine that the EU will be on track to a low-carbon economy in 2020 if the next EU budget is not clearly aligned with the promotion of low-carbon outcomes as a driver for private sector investment. Similarly, there is a need for a popular mobilising focus that can engage different stakeholder interests and Member State coalitions in a collective effort to secure a future-oriented budget. Such a mobilising focus must encompass a range of national and sectoral interests, while being sufficiently clear that it can redirect spending patterns within the EU budget in reality and not just on paper. We believe that the pursuit of a low-carbon agenda can provide this motivating force.⁹

Ultimately, low-carbon outcomes will only be secured from the next MFF if Member States make these a priority in the negotiations. Such outcomes are however already at risk in that ministries of environment or energy are not the lead departments in the sectoral negotiations. To mitigate this, there need to be joint positions within governments and high-level support to ensure low-carbon outcomes are not side-lined. One example of how this can be pursued is the United Kingdom's (UK) position detailed in its March 2011 Carbon Plan, which gave the UK Treasury the task to: "Complete negotiations on next EU budget spending period – including agreement to increase the share of EU budget allocations for low-carbon investments within a reprioritised budget."¹⁰

There of course remains the risk that this aim will be overtaken by the UK's traditional priorities of a small budget and maintenance of its rebate, but the public statement of this position gives leverage to external stakeholders to hold the UK government to account for the final budget deal reached. The best chance of success will come via the development of coalitions of Member States who share an interest in low-carbon outcomes, and who can agree that they provide a means of improving the quality of spending of the EU budget. Usefully,

8. Sebastien Godinot, "Unlocking the potential of the EU budget – Volume 2: Intelligent Investments", World Wildlife Fund – European Policy Office, March 2011, available at: <http://www.wwf.dk/dk/Service/Bibliotek/Handel/Rapporter+mv./Unlocking+the+Potential+of+the+EU+Budget+vol+2>

9. See for example the contributions from private sector, NGOs, social groups and think tanks in Green Alliance's 2010 publication: Chris Littlecott (Ed.), "Unlocking a low-carbon Europe: perspectives on EU budget reform", 2010, available at: http://www.green-alliance.org.uk/uploadedFiles/Publications/reports/unlocking_a_low-carbon_Europe.pdf

10. David Cameron, Nick Clegg and Chris Huhne, "Carbon Plan", Department of Energy and Climate Change (DECC), HM Government (UK), 2011, p. 61, available at: <http://www.decc.gov.uk/assets/decc/What%20we%20do/A%20low%20carbon%20UK/1358-the-carbon-plan.pdf>

this interest already cuts across the traditional categories of net-contributor / net-recipient, with Member States such as Greece, Portugal and Spain all championing the push for a 30% emissions reduction target for 2020.

Recommendations

European Commission. One of the central criteria against which Commission President José Manuel Barroso's time in office will be judged will be his ability to deliver a future-focused budget that reflects his "no taboos" rhetoric. The Commission must set the tone for the MFF negotiations via proposals that present the EU budget as an investment in Europe's future, accompanying this with clear conditionality mechanisms. The headline narrative must be further demonstrated with some iconic wins such as funding for the Strategic Energy Technologies (SET) plan. An approach that relies on mainstreaming alone will not be sufficient.

Council Presidencies. The majority of the negotiations are envisaged for the Polish and Danish Presidencies. Despite their different positions on either side of the net-recipient / net-contributor divide, they do share a concern for a broader approach to European economic recovery beyond eurozone governance, and were both signatories to the letter from nine heads of state and government to Presidents Herman Van Rompuy and Barroso in March 2011 that included a call for "an EU budget which addresses the challenges of tomorrow". They will need to maximise the scope for prioritisation of low-carbon policy outcomes, not allowing them to be squeezed out of sectoral formations or dropped from the political negotiations when the going gets tough.

Member States. Member States themselves will need to develop their own internal strategies that join-up across ministries, identifying opportunities for low-carbon spending and modalities for policy delivery. Ministries of environment, climate and energy will need to provide consistent internal pressure to ensure measures such as "climate proofing" are maintained. As the negotiations proceed, coalitions of Member States will be required to ensure that low-carbon outcomes are secured and clearly communicated. Just as previously the "friends of Cohesion Policy" coalition did much to shape the final outcome, this time around there will need to be a "friends of low-carbon investment" group.

External stakeholders. Decisions on the next MFF will ultimately be taken by heads of state and government at the European Council. Domestic political pressure from civil society and private sector in favour of investment in the low-carbon economy will therefore be of value, particularly if framed as the key success criteria against which the final deal will be judged. There is therefore a need for a smart mobilisation of influence in support of budget reform proposals, as a counterbalance to the pressure from existing vested interests. The EU budget negotiation offers the best opportunity in the next two years for sustained political influence. We should seize it.

CAP

Strengthening the EU by Audaciously Reforming the CAP and its Financing

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Out of every €100 of public expenditure, Europeans spend €41.40 on social protection and labour-market policies, €14.20 on health, and €11.30 on education and training. Far behind this trio come energy and transport (€2.20), research and development (€1.50) and agriculture (€1.10). Yet, it is mainly over the agricultural budget that Member States have argued, since it represents 40% of the European Union (EU) budget – the most important policy in spending terms. The Common Agricultural Policy’s (CAP) real problem is not so much its cost in relation to other public policies as its status as the only one for which competence has been transferred to the EU level. Along with national policies, which represent more than 98% of EU public spending, the CAP is therefore the focus of all attention.

With the European Council refusing outright to increase the common budget, the EU finds its back against the wall. As a first paradox, in order to finance other necessary policies (research, external action, energy, etc.), it is obliged to erode the budget of one of the least tax-hungry policies so as to support areas mainly financed at the national level. As a second paradox, at a time when the EU is trying to meet Europe 2020’s green growth targets, the CAP provides a means of acting directly on more than 21 million economic actors with a direct link to the environment (mostly farmers).

In a context of debt crisis and pressure on public spending, the negotiations over the 2014-2020 Multiannual Financial Framework (MFF) will likely be fraught. The Union has little chance of negotiating its budget in accordance with its long-term priorities, in particular concerning the environment and climate change. Even prior to the opening of these negotiations (in June 2011), Member State representatives are staking out radical positions. In December 2010, the Prime Minister of the United Kingdom, David Cameron, declared that he will firmly defend the British rebate. And the Prime Minister of Poland, Donald Tusk, asserted that Poland will resist any budget cuts, citing the importance of European funds for economic crisis measures in several countries. Member States seem to be heading for a showdown over *juste retour*, “net transfers” and the defence of correction mechanisms.

The EU needs audacious reform, as much in its budget as in agricultural policy. A scenario of high tension in the Council over the budget risks an outcome of deep conservatism on choices crucial to the future: a situation that allows everyone to settle on a minimal agreement with no real shared ambition. During these negotiations, how can the Polish, Danish and Cypriot Trio Presidency promote the European public interest? How can the EU’s effectiveness be improved? Concerning the CAP in particular, how can this policy push the EU towards a society that better conserves resources, better protects biodiversity and works more effectively against climate change? How can the debate be oriented towards solutions that allow the CAP to make a better contribution towards employment, regional cohesion, competitiveness and growth?

Translating policy objectives into budgetary terms: a major challenge for the Trio Presidency

A debate on CAP reform successfully launched by the previous Trio in an inauspicious context

Debate on CAP reform is well under way within the agricultural Council of Ministers. Since 2008, the rotating presidencies have anticipated reform by leading discussions on the future of agricultural policy and by tackling major underlying issues (for instance, climate change under the Swedish Presidency). In 2010, efforts by the Spanish Presidency to pursue these discussions were particularly noticed. Whereas the CAP was practically absent from the Europe 2020 Strategy adopted by the European Council of June 2010, Spain pushed the agricultural Council of Ministers to focus on the CAP’s contribution to the objective of smart, sustainable and inclusive growth. These discussions became heated when the British Secretary of State for Environment, Food and Rural Affairs, Caroline Spelman, asserted a desire to radically reform the CAP and reduce agricultural spending at a time of economic difficulty. Despite the differences, the Council of Ministers was able to agree on the imperative of a strong CAP. The Belgian Presidency subsequently launched a debate – proposed in a Commission communication on 18 November 2010 – on the main objectives of “The CAP in 2020”. In March 2011, the Hungarian Presidency brought this debate to a close, to allow the Council of Ministers’ ideas to complement a formal proposal by the Commission to be published under the Polish Presidency. This practice of thoroughgoing discussion by the decision-makers of agricultural policy has allowed a debate to take shape outside the period of formal negotiation and in parallel to the efforts of Directorate-General Agriculture and Rural Development to encourage a public discussion.

The coming Trio Presidency and budget negotiations. Will the new institutional context allow confrontation in the Council to be bypassed?

The pertinence of a complete rethinking of the CAP is clear, but a confrontation between Member States over the budget must be avoided. The first feature of an unpredictable reform is that the CAP’s significant share of the EU budget is no longer guaranteed: the “compulsory spending”

status will disappear, as will the accord between Jacques Chirac and Gerhard Schroeder to freeze agricultural spending. A second aspect is the end of the network of alliances, which in the past worked in agriculture's favour. There is total uncertainty over the future position of the European Council, where the number of Member States has increased from 15 to 27. Thirdly, negotiations over the multiannual budget will take place within an EU that has been hit hard by both recession and a public debt crisis. In this climate conducive to the rhetoric of national solutions, the European Council has so far been opposed to any increase in own resources – which would work against the *juste retour* calculations of Member States. This situation could change in the coming months, given the extra resources that will be necessary to finance treaty obligations – particularly new competences arising from both the Lisbon Treaty (for instance, the external action service) and from new challenges such as energy. A fourth feature of this reform is that the debate will take place in a post-Lisbon institutional context, where for the first time codecision will be applied to agricultural policy. It is difficult to predict the European Parliament's position in these negotiations. However, the Parliament's mode of representation means that it should, in theory, counterbalance the approach of Member States, based on horse-trading over figures.

Two hazards to avoid during the CAP and its budget

The Commission will present formal proposals on the multiannual 2014-2020 budget framework and CAP reform in June and September 2011. The rotating presidencies will need to direct the Council's discussions so as to find a policy agreement in 2012. This way the new rules can be finalised in 2013 and the Member States can define their national strategic priorities for an entry into force in 2014. Given the differences that might emerge during budgetary negotiations, Member States could opt for conservative choices rather than audacious reforms. In particular, this is the case of the CAP, which would suffer as much from the budgetary status quo as from cuts with no preliminary assessment of the policy's objectives.

Hazard 1: A budget cut that takes no account of the history of reforms, nor the services provided to the taxpayer by the CAP. The CAP is an attractive target for cuts in order to finance other policies. Yet, since the 1990s, agricultural spending has been subjected to financial discipline and upheavals unknown in most other sectors. Today, it represents less than 0.4% of the EU's GDP.¹ Its share "is decreasing and at a much faster rate than EU public spending".² In addition, it has changed: 20% of CAP spending targets competitiveness, the environment and rural development. Lastly, the agricultural budget has not increased with the enlargement from 15 to 27 states, with as result that the average support per farm and per hectare has fallen.³ Arguments in favour of a major cut in the CAP budget rest therefore (generally because of a lack of information) on a stereotyped 1980s

image of the policy, when funding was still coupled to production. Despite reforms, the reduction of European agricultural spending seems inexorable as long as the CAP remains one of the largest EU spending items⁴. This vision even finds expression in the communication on budgetary reassessment: the Commission advocates a continued reduction in CAP spending, without justifying its position with political or economic arguments. The approach takes account of neither the services provided by the policy nor the potential losses from a continued reduction in credits. It throws doubt on the gains for the European taxpayer of a reallocation of credits to other sectors.

Hazard 2: Conceding to the conservatism of older Member States on the reform of direct payments. The debate over the size of the agricultural budget is not the only one that the Trio Presidency will need to face. There is also the critical question of the future of direct payments. These represent 33% of spending, equivalent to €39 billion in 2009, and they ensure support for farming incomes. Their distribution between Member States has been a source of discord since the British complaint of 1974, because in practice the payments favour large agricultural countries at the expense of rich countries with less agriculture. Moreover, under the regime of differentiated payments for the EU 12 until 2013, the single payments currently benefit mainly the EU 15. Within Member States, there is also significant inequality in the level of payments from region to region, depending on the type of agriculture. Given these inequities, most Member States since 2008 have been in favour of a rebalancing of the distribution system. But as negotiations approach, Member States that benefit from the system (including France, Italy and Spain) could give into the temptation to make *juste retour* calculations rather than defend equity. An example was found in Ilse Aigner – the German Federal Minister of Food, Agriculture and Consumer Protection – who in January 2011 declared her intention to oppose any reallocation of funds between Member States that would result from a policy more favourable to smallholder farmers.

Recommendations to the Polish-Danish-Cypriot Trio Presidency

Advocating shared policy objectives as an alternative to the narrow national focus on figures

As is shown by the Europe 2020 Strategy document adopted in June 2010, agriculture and the CAP are practically absent from the thinking of European decision-makers (except those responsible for agriculture) when they consider ways of boosting Europe's economies. At best, the CAP is seen as a policy with benefits (relating to food supply, health, climate change, etc.), but which is still too costly (demonstrated by the budgetary revision). At worst, it is seen as a dead weight in the EU budget. These ideas are often based on a lack of information about the costs and benefits of agricultural policy for European economies and societies. In a context of economic difficulty and pressure on public spending, the EU does not need to make choices that will be inappropriate

1. David Harvey and Attila Jambor, "On the Future of Direct Payments: CAP Bond Revisited", 2010, available at: <http://www.staff.ncl.ac.uk/david.harvey/ACE2006/Policy/Harvey&Jambor2010CAP.pdf>

2. European Commission, DG Agriculture and Rural Development, "How much the CAP costs", *The Common Agriculture Policy Explained*, accessed 18 April 2011, available at: http://ec.europa.eu/agriculture/capexplained/cost/index_en.htm

3. Harvey and Jambor, *op. cit.*

4. European Commission, Communication, "The EU Budget Review", COM (2010) 700 final, 19 October 2010, available at: http://ec.europa.eu/budget/reform/library/com_2010_700_en.pdf

and costly in the long term. To counter these budget-focused visions of the debate would imply making the CAP a part of a post-crisis European economic strategy, including an assessment of strengths and weaknesses – sectoral, regional and environmental. In this way, the EU would rediscover the role agriculture and the rural economy play in creating balanced economic and social development – in terms of jobs, growth, external trade, tourism, environmental management and protection of biodiversity, action on climate change, and culture. Such an analysis could serve as a starting point for the negotiations over the next MFF. New financing methods should be measured against the financial and political needs of the EU's policies, in particular those of the CAP.

Direct agricultural spending towards the European public interest

The principle of financial solidarity as practised today within the CAP operates against the European public interest. The system works in favour of national calculations by encouraging beneficiaries to demand more first-pillar CAP funding (mainly direct payments), which is financed entirely by the common budget, while contributors always demand less. Co-financing direct payments (the main spending item) at differentiated rates would help correct these flaws by involving states and regions in assessing the spending level needed to achieve the objectives.

The CAP currently works against the principle of cohesion as featured in the Lisbon Treaty. The CAP's second pillar, which includes support for zones of natural handicap, contributes to cohesion. But the credits are insufficient to counter the imbalances caused by the method of calculating single payments, which encourages farm concentration and helps major agricultural regions. Such disparities undermine cohesion and represent an important flaw in current agricultural policy. They should receive special attention from the presidencies since they are a ready-made argument for those who question the legitimacy of agricultural spending.

A CAP to finance European public goods and services and to stimulate competitiveness

The European public goods delivered by the CAP should be assessed before any reallocation of credits to other policies. Among them are commonly cited the quality of the European environment (carbon storage, biodiversity management), country landscapes, security of food supply, and food safety. Other benefits include the Single Market and its advantages – such as economies of scale and the large-scale sharing of risks. “However, other quality improvements in rural regions, or water quality, are essentially public goods of a local nature”.⁵ To continue to benefit from these, the policy must compensate for market failures that hinder the provision of these public goods, and also establish safety nets to help farmers deal with a collapse in prices and incomes in times of crisis. Lastly, the policy should encourage competitiveness in European agriculture, while remaining compatible with the rules of the World Trade Organisation.

5. Jean-Christophe Bureau and Louis-Pascal Mahé, “CAP Reform beyond 2013: an idea for a longer view”, Notre Europe, 27 May 2008, available at: http://www.notre-europe.eu/?id=38&tx_publication_pi1%5BshowUid%5D=1802&L=2

CAP

A Chance for Further CAP Reform

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The Common Agricultural Policy (CAP) accounts for around 40% of current European Union (EU) budget spending, so it is central to the debate about the future EU budget. The CAP, in its current shape, expires in 2013. British critics argue that the CAP is a costly historic relic, whilst the French claim that it remains a cornerstone of the EU's Single Market.

When it was established in 1958, the CAP reflected France's position. Driven by the experience of chronic wartime and post-war food shortages, European governments were happy to provide generous subsidies to their farmers in order to raise food production. Furthermore, relatively free trade between the six original states in agricultural products was the first, symbolic step towards creating a wider common market.

French farmers were concerned about their ability to compete against German farmers. In fact, they coped pretty well. And the original case for the CAP has been overtaken by events. During its first 25 years, it increasingly got out of control as farmers produced far more food than the market could absorb. The cost of storing or, worse still, dumping these surpluses on the world's market soared. Eventually the situation was stabilised by the introduction of production caps. But the subsidies continued, as did tariffs on food imports.

Global context and new challenges

The EU is broadly self-sufficient in food, with imports of tropical fruit and out-of-season vegetables being offset by surpluses in some indigenous food sectors, notably cereals. Farmers' fortunes vary considerably: large, well invested cereal farms with fertile soil and favourable weather can prosper globally, especially when prices are high, but small livestock farmers cannot compete with New Zealand, Brazil and the United States. Farmers within the eurozone have been damaged by the strength of the currency, whereas farmers in Britain have benefited from the weakness of the pound against the euro.

There is no food security problem in the EU, and nor would there be if subsidies were phased out. Furthermore, if support for farmers was run down in an orderly way and in conjunction with the United States, the industry's income might not be seriously damaged. Indeed, European agriculture might even benefit. Without the cushion of subsidies and protectionist barriers, farmers would have an incentive to tackle the extensive inefficiencies of their industry. The most inefficient farmers would probably go out of business (and should receive one-off compensation, if need be). But the better farmers could further expand with all the benefits of scale. Good small farmers would also survive by continuing to diversify and develop alternative sources of income.

The accession of Central and Eastern European countries has had a major impact on discussions about the future of the CAP. Farmers in new Member States will not receive full CAP payments until 2013, and the Commission is now suggesting that there could be further transitional arrangements even after 2013. Cereal farmers in the newer Member States in Central and Eastern Europe should do relatively well as they modernise their structures and apply existing science and technology. But it is difficult to see a viable future, with or without subsidies, for small, full-time farmers who have been unable or unwilling to diversify and modify their methods.

Two new factors – growing demand and climate change – will have a profound impact on global food production. It is possible that farmers will struggle to meet the rising demand for food from a growing and more affluent global population. Over the next 40 years, the world's population is set to grow by about 40%, to 9 billion. More affluent people eat more food – in particular more meat – which puts even more pressure on resources because animals are very inefficient at converting cereals into meat. It may be necessary to double global food production to meet this demand.

Yet, yield increases per hectare, which as a result of the “green” scientific revolution rose dramatically in the years following the Second World War, and which produced global food surpluses, appear to have peaked in the last 20 years. Yield per hectare has stopped increasing partly because regulations have been introduced (especially within the EU) to stop the environmental and health damage arising from the irresponsible misapplication of some of this science. The use of dangerous chemicals has been suppressed and the excessive use of oil-based fertiliser has been restricted. Another reason why yield per hectare has stopped increasing is that support for agricultural research has been reduced. Pressure groups have successfully persuaded governments to discourage critical research work, notably on the development of genetically modified foods.

The second factor that is likely to have a significant impact on global food production is climate change. Global warming is already beginning to turn fertile regions, such as southern Spain, into desert. But as temperatures rise, farmers in more northern, colder areas, such as Britain, will be able to grow a wider range of crops. Nonetheless, low-level

fertile deltas in Bangladesh, Egypt and China are in danger of being overwhelmed by the sea. Unless governments respond appropriately, this could put a severe strain on the capacity of the world to produce enough food.

Farming is a significant contributor to greenhouse gas emissions – about 9% of the EU total. Crops become more productive through the application of oil based fertilisers and are protected from disease and predators by the extensive application of chemicals. Organic farmers campaign for the abandonment of these practices, but the crop yield from even the best organic farms is about a third lower than from chemically-treated fields. Responsible scientific and technological research, including research and development of genetically modified pest-resistant, drought-resistant and salt-resistant crops, is key to addressing these problems. And farmers must expect further regulation to curb any possible excesses.

Current status

The reforms of the CAP introduced by Commissioner Franz Fischler in 1999 and 2003 effectively ended a system based on high farm-gate prices achieved through import tariffs and direct market intervention by the Commission. Subsidies were decoupled from production and farmers were instead given income support, according to the size of their farms, in the form of a “single farm payment”, just for being a farmer. Farmers in some Member States get considerably higher payments per hectare than farmers in others. The EU average is €200 per hectare, but a Greek farmer gets €500 and a Latvian farmer only €100. (Some direct interventions still apply when there is a crisis, but on a much reduced scale than was the case before). Fischler's reforms also diverted funds away from farmers' incomes and towards the promotion of good environmental practices and rural development. By 2013, about 20% of the agricultural budget will be allocated to these schemes.

So the CAP is much better than it was, less protectionist and aspiring to promote environmental sustainability. It also comprises a smaller share of the EU's budget – still over 40% of the total, but in 1990 it was over 60%. The fact that it is the main budget line for EU expenditure makes the CAP central to discussions about the next Multiannual Financial Framework (MFF), due to run from 2014 to 2020.

The CAP continues to attract criticism from taxpayers because of its cost, from farmers because they do not believe it gives them sufficient protection from global competitors, and from environmentalists who do not think it does enough to protect wildlife and landscapes or to reduce greenhouse gas emissions. In Britain, the consumers and the taxpayers make the most noise – the British government is lining up other Member States to demand that there be no significant increase in EU expenditure. In France (and Ireland), the farmers still rule the roost. The Germans remain rather quiescent, but the German government is also saying that there should be no significant increase.

Many of the criticisms made of the CAP are valid:

- It seeks to maintain a status quo both in farm structures and rural society, holding back much needed reform rather than stimulating change.
- The system designed to administer the single farm payment is complicated, costly and open to fraud.
- The single farm payment encourages farmers to keep inappropriate land in production.
- The system enables inefficient farmers to survive – though not to prosper.
- It seeks to meet the multitudinous needs of millions of farmers across the EU.
- Much of the subsidy ends up with middlemen rather than bone fide farmers.
- It puts too much money into the hands of very large farmers.
- It is designed around full-time farmers, whereas an increasing and substantial proportion of farmers are now part-time, supplementing their incomes from other work.
- It inflates land values and makes it difficult for new farmers to enter the market.

Because of their deep and long established ideological differences about trade and the role of the state in the economy, Britain and France have been the main protagonists in this debate. In addition, Britain receives relatively little benefit from the CAP, while France is a significant beneficiary. The fact that the United Kingdom (UK) was not a major beneficiary of the CAP was central to Margaret Thatcher's successful argument that there should be an annual UK rebate.

The main economic justification for a CAP is that, consistent with the rules of the Single Market, it offers all EU citizens secure and adequate supplies of affordable food. So, putting the case the other way round, would supplies of food be at risk if farmers did not receive financial support from the taxpayer?

If such action was taken precipitously and unilaterally (i.e. without comparable action by other large food producing countries, especially in North America) some areas of European agriculture would contract in the short term, especially dairy and beef farming. But imports would fill any gap in the market without much difficulty. If there were a problem of supply, prices would rise and this would entice European farmers back into production. Interestingly, pig farmers receive no support from the CAP, yet they survive.

Recommendations

Because of the strong vested interests in France and elsewhere, it is politically unrealistic to propose that the CAP should be scrapped altogether. But most EU members accept that agricultural policies need to be adjusted to today's changing circumstances. Further reform of the CAP should be built around the radical changes introduced by Fischler, with a continued, gradual phasing out of direct subsidies. A reformed CAP also needs to provide incentives and regulations to reduce the impact of agriculture on climate change.

In order to complete the Fischler reforms, there should be further reductions to market support:

- All tariffs on food imports into the EU should be phased out by 2023.
- The Commission should still have the power to buy and store certain products such as butter, milk powder and beef – when market prices collapse because of freakish events, such as a food scare. However, the intention would be to dispose of stocks as soon as markets recover, and not to dump them on markets as happened in the past.
- No farm should be entitled to subsidy for more than 1,000 hectares of land. This would cap the subsidies claimed by very large landowners such as the UK Royal Family.
- All restrictions on production (the main one being milk quotas) should be phased out.
- Subsidies should only be paid directly to farmers. At present, payments are frequently made to manufacturers – sugar, butter and milk powder processors. This results in a large amount of subsidy remaining in the hands of such middlemen, some of it fraudulently.

The aim should be to phase out the single farm payment by 2023. This is by far the largest component of the CAP – somewhere around three-quarters of the €43 billion total. If global food prices remain high, as many forecasters believe, then the single farm payment becomes an irrelevant extravagance.

Farmers will ask how such a loss of income can be recouped. In part it cannot be, because the existing system condones and sustains inefficient farming practice. It is up to farmers themselves to address these problems, and other reforms should help them to do so, especially the abandonment of quota restraints. Subsidised dumping of products on world markets depresses prices, so if these practices were stopped, prices would rise.

Structural reform of European agriculture should be encouraged rather than opposed. The trend towards fewer and larger farms has been continuous ever since the CAP was set up, and the refusal to recognise this reality has disadvantaged small farmers, whom the policy was intended to benefit. The CAP should address this problem head on by encouraging small farmers to expand and diversify, whilst providing support for those existing farmers who want to retire, but cannot afford to do so.

The differential between subsidies to farmers in old and newer Member States should now be eliminated. This would be possible even while the overall CAP budget was being reduced, so long as it was coupled with the phasing out of single farm payments.

Three aspects of current CAP spending should be reviewed:

- Payments encouraging farmers to enhance biodiversity in the way they manage their land. The aspiration is laudable, but there is no strong evidence that these subsidies are effective in meeting their objectives.

- Subsidies for biofuels. These may not be contributing to the reduction of greenhouse gas emissions, and when world food prices are soaring and supplies are tight, it seems inappropriate to convert land from food production to energy crops.
- Policies on rural economy diversification. Different rural communities have very different circumstances. If they are within easy reach of thriving conurbations, they should be able to benefit from such proximity. But if they are remote from alternative economic activity, there is a good case for taxpayer support. However, most of this should be provided by national governments rather than the EU. The CAP budget should concentrate on rural development in the newer Member States, where agrarian reform has been especially limited.

The EU should substantially raise its investment in agricultural research, to improve yields, to develop plants which can cope with the extremes of flood and drought, and to enable its farmers to grow more food. If this happens, Europe could well become a major source of food for other parts of the world struggling to cope with a combination of population growth and climate change.

When Poland takes on the Council Presidency, it should focus on the need to pay farmers in newer Member States their full CAP payments, rather than delaying this even beyond 2013 (as the Commission has proposed). To make this affordable in current economic circumstances, reductions in payments to western European farmers will be unavoidable. After Poland comes Denmark, which supports sensible CAP reform, and whose pig farmers show that efficient farmers can survive without CAP support. Then comes Cyprus, whose focus is likely to be on rural development. That is sensible: as argued above, rural development should remain an important part of CAP objectives. But the Cypriots should also focus on the need to make all farming more efficient – as should the Presidencies before and after them.

CAP

How to Prepare a Fair and Efficient CAP Reform?

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The common agricultural policy (CAP) is one of the oldest common European Union (EU) policies. It has had a Community character from the very beginning: responsibility for agricultural policy has been transferred from the Member States to EU institutions. Many EU citizens think of the CAP as the most costly policy of the EU, but perhaps this perceived costliness is simply due to the fact that the policy is largely managed at the EU-level? What other reasons can explain the high costs associated with agricultural policy? These questions and others will be answered in this policy paper. When planning a new financial perspective there is always much talk about the CAP. The new financial plan is due to be discussed later this year and approved next year, and the future form of the CAP is already being discussed. Talks on new CAP rules and a form of direct payments have been under way for a few months now. The CAP now seems faced by several crucial issues concerning its very future.

Will all the rules be decided during the Hungarian Presidency, or will the Poles have their say? What is the attitude of the Trio Presidency – Poland, Denmark and Cyprus – towards the CAP? What are the opinions of those countries regarding the European Commission proposal on the future of the CAP? And finally, can the ongoing debate about the future and reform of the CAP influence the preparation of the new financial perspective? Will the CAP continue to be one of the most important spending items in the EU budget or will other areas receive more attention following the economic crisis? This policy paper will focus on the above issues – the content of the planned reform of the CAP, the ongoing discussion on the future of the CAP in the context of planning for the new financial perspectives, and the attitudes of the Trio Presidency towards the CAP and its financial performance. In conclusion, a few recommendations and visions for the future of the CAP will be outlined.

The future form of the CAP: what does the European Commission propose?

On November 18, 2010, the Commission presented a Communication on the future form of the CAP after 2013. The proposal followed several months of public debate started by the

Commission in April last year. Four key issues were identified and comments were solicited from all interested European citizens: the general public, interest groups, entrepreneurs, farmers themselves, various experts, research institutes, etc. During the two months that were allowed for this discussion, the Commission received about 5,600 contributions. Its summary served as the basis for the Communication.

What was contained in the Communication? The key theme of the communication, however, is direct payments. Production volumes from the reference period 2000-02, which are used to calculate direct payments, are somewhat irrelevant now: the formula for calculating them must be updated or a new one created. In addition, we still use a different system of direct payments for the “old” and “new” Member States. The aim of this reform is to unify everything into one model identical for all Member States. The new model should also be more transparent and equitable, and the farmers will continue to follow environmental requirements. There will also be a ceiling set for direct payments. What can be viewed as a step in the right direction is that subsidies will support only active farmers. Subsidising football pitches and golf courses or other non-agricultural areas will finally come to an end.

One question that remains to be resolved is the relationship between financial support and the size of companies. This is some kind of roofing of direct payment of large farms, so-called *capping*. In this regard, there is strong disagreement between Member States, mainly due to historical context. For example, in the Czech Republic and other former Eastern Bloc countries, large farms may risk a reduction of payments. It is expected that this will be a very complicated agenda item. The less favoured area (LFA) payments will most likely be maintained, since it is necessary to promote specific farm locations in order to conserve biodiversity, landscapes, and the daily life of remote rural areas. An unresolved question is whether the LFA payments will be included in the first or second pillar of the CAP.

Aside from direct payments, another important issue raised by the Commission is the fight against climate change and the issue of environmental protection. The Commission proposes several solutions. One is to sow immediately after harvest to ensure permanent vegetative cover. Another is to follow crop rotation practices that alternate crops according to certain rules and thus do not exhaust the land unilaterally (allowing the earth to regenerate better). Equally important is to maintain a certain percentage of pastures, for example for carbon dioxide (CO₂) storage. The Commission also proposes to restore set-aside fields. Such fields left fallow can provide shelter to various animals and plants.

The Communication’s conclusion also deals with the future outlook. For example, the Commission notes that the United Nation’s Food and Agriculture Organisation expects world food demand to increase by 70% by 2050. This highlights the importance of food production. The Commission also correctly draws attention to the sustainable management of natural resources and the development of rural areas, where income is currently only 40% of the European average.

Some experts criticised the Communication for its excessive generality. However, in defence of the Commission, it must be pointed out that its document was intended merely to outline the main issues that need to be addressed. Now that the issues have been outlined, it is up to the Council and Parliament to discuss their opinions and make conclusions. The Commission’s Communication could be criticised for its diplomatic language, which is intended not to offend any Member States. Although that was expected, it is clear that in the end it will be impossible to meet the requirements of all the Member States. The future shape of the CAP will once again be a practical compromise. From the debate surrounding the future of the CAP after 2013, it is clear that the crucial issue is funding, which will be the subject of the next part of the paper.

Why does the CAP receive so much from the EU budget?

CAP has always been one of the main expenditure items of the EU budget. In part, this was due to the fact that the policy was from the beginning managed centrally at the European level, so it also needed to be funded centrally – if only so that all Member States have the same conditions for competition. At first, the CAP was also financially supported with the intention to ensure food self-sufficiency and the competitiveness of European farmers in relation to American producers. Of course, the cost of the CAP has also increased proportionally with the enlargements of the EU. The administrative burden has also increased, as has the need to improve conditions for farmers in backward regions of some of the new Member States.

It is clear that the issue of financing of the CAP will also be relevant to the matter of creating a new financial framework, because the net-payer Member States no longer want to contribute as much. Another source of money will have to be found, such as an EU tax, which is also a subject of discussion. However, the matter of financing of the CAP is now overshadowed by the negotiation of an overall policy framework. The agreed formula for direct payments will be crucial, especially for the distribution of financial aid. According to the formula, each country can clearly calculate what CAP budget they would need to ensure sustainable farming. Discussing spending amounts in the EU budget will be the next step on the road to a new and perhaps better organised CAP.

Politicians and the public have become increasingly demanding in the area of environmental protection and welfare. The Commission’s Communication therefore puts a major emphasis on the so called “greening of the CAP”. But if the CAP budget is not higher, it may not be possible to tighten the criteria, to follow them and be competitive not only within the developed world, but also against outside countries. If the budget remains the same, it will probably be necessary to make the CAP cheaper and simpler in other areas, so that resources are saved for more important things (such as environmental protection).

The Member States, especially the new ones, will under no circumstances accept a transitional period for direct payments, which was also mentioned as a possibility in the Communication.

This does not mean that the amount of funding that goes to each Member State will be the same – this should be explained to the public. A Czech farmer will not and cannot receive the same payment as his French colleague, because in France the price of land and labour are more expensive. If the Czech farmer received the same support, it would be a huge advantage for him and the French farmer would not be competitive. So this is not a question of equalising funding, but rather of equalising conditions so that all farmers in the EU have the same opportunities.

Another important issue is co-financing from national budgets. Since each state can afford to pay its farmers a different amount, a maximum limit of additional national funding must be established. So, this is another area where establishing certain rules is necessary, because it is already evident that some countries financially support their farmers more than others, leading back to the problem of unequal conditions.

There is one further question to consider. Is the CAP really so expensive when calculated per person? Let us assume that CAP spending is about €40 billion per year and that there are 500 million EU citizens. That equates to about €80 per year or approximately €6.5 per person per month. This does not seem such a high price to pay to obtain a sufficient supply of high-quality food, while protecting the environment, caring for the countryside and performing many other functions of today's agriculture. It should be noted that CAP funds do not only go to agriculture, but also to rural development, the environment, forestry and other areas related to the preservation of natural resources.

Opinions of the coming Trio Presidency on the issue of CAP

Poland believes that it will not be possible to ensure sufficient European farmers' competitiveness if the CAP budget is limited. The same problem, according to Poland, can be seen in meeting the CAP objectives in these circumstances. It is therefore expected that Poland will fight for a higher CAP budget. Concerning the direct payments scheme proposed by the Commission, Poland is unhappy that the Commission has proposed ideas without providing any analysis of the problem. Poland does not understand why the Commission sees so negatively the EU-level flat rate. It would like to know what analysis the Commission used to support the idea that guaranteeing a minimum payment level for farmers is economically and politically sustainable, and why the Commission proposes to introduce only economic and environmental criteria and omit social ones.

Poland also proposes two basic criteria for the distribution of direct payments. The first is *agricultural area*, because it ensures both food security and environmental security, and the second is the *number of employed people in agriculture*, measured in annual work units. Poland believes that this would resolve the ongoing dispute between the Member States about the size of businesses.

The “greening” component constitutes another cause of criticism from Poland. It is not that Poland has a negative attitude towards environmental protection, but rather that it believes that, in the first pillar, it could be sufficient simply to follow cross compliance principles. Even when following these principles, there have been significant differences among Member States. So, is it reasonable to reward farmers with the same amount for equal work carried out with differing thoroughness? And does the Commission dispose of analyses that show the environment effects of meeting cross-compliance? Poland suggests first to coordinate and harmonize the meeting of cross-compliance principles. Additional greening measures could then be carried out in pillar II within long-term projects, but perhaps it might be advisable to make some of the additional requirements of greening obligatory. This may occur only under pillar I, since in the second pillar all projects and requirements are on a voluntary basis.

One important observation from Poland about the “greening” component concerns competitiveness. Can European farmers be competitive if they have to fulfil many ecological demands with a limited budget while other new players are admitted into the European market under the new trade agreements, especially if those players are not obliged to follow similar rules?

Poland also sees a problem in the issue of LFA. If the new biophysical criteria defined in the Communication came into force, most current medium LFA in Poland would lose their status. Poland would also like to know the outcome of previous discussions and analysis relating to the establishment of new criteria for LFA. Poland will surely ask under which pillar it is better to place the payment for LFA. It would also like to push for better a coordination of the CAP's Pillar II with Cohesion Policy. According to Poland, it is necessary to determine the functions that should be added by the common strategic framework for these two areas.

Denmark, the country that follows Poland in the Presidency, also has specific ideas on which direction the future CAP should take. It should continue with a market-based orientation, focusing on new challenges and providing public goods, and it should continue to contribute to sustainable development. In order to support research, development and innovation in the agricultural sector, the goals of the “Europe 2020 Strategy” should be partially incorporated into the future CAP. Denmark believes that the future of the agricultural sector lies in its ability to be innovative and to make use actively of its professionalism, rather than simply relying on traditional support mechanisms. This seems a step in the right direction.

Denmark proposed sensible comments on the Commission's Communication. It asked the Commission to take into account the need to simplify the CAP, for both farmers and the authorities who distribute payments. And it asked that more detailed information be provided on important points in the Communication as soon as possible.

Pillar I's direct payments can be divided into three layers: a basic component, a green component and specific natural constraints. According to Denmark the question is what kind

of model to use for financing the various layers of the new system. At what rate should direct support be distributed among these three components? The basic component is a direct payment providing a uniform level of support to all farmers. But what will be the method of calculating this payment? What does the Commission understand by “uniform level”? It is necessary to clearly define these terms, which so far have been lacking substance.

The second layer, the so-called green component, is also somewhat vague. What exactly will be included? How should it be handled in particular Member States? Each country according to its conditions and character should fulfil different specific requirements in the framework of the green component. How will the elements of the green component be managed and controlled? What is the legal framework attached to this measure? For example, what are the implications if some requirements are not met? Denmark also asks, if the two layers are obligatory, why they are separated? Why can they not be administered together?

The third layer of direct payments, the so-called specific natural constraints, is also a complicated issue. It is necessary to clearly specify the criteria that define these areas. And, what if granted funds are not used for intended operations, in layer 3 for instance? How will the matter of unused funds be resolved? Finally, will it be possible to transfer funds between different layers? Will unspent funds be returned to Member States or to the EU budget?

Another issue in the Communication which the Danes find debatable is the problem of small farms. The Commission proposes a special scheme for small farmers. But what is the purpose of this proposal? Simplifying single payment for these farmers or increasing financial support for small farms? It is necessary also to clearly specify the definition of “small farmers”. Another highly controversial issue is “capping”. Will the Commission propose an upper limit for payments that go to large farms or will there be progressive reductions in support of these businesses? How should the funds obtained in this way be used? To provide a general increase in the value claimed by all Member States or for the second pillar, i.e. rural development?

Denmark also believes that it is not necessary to modify the existing definition of active farmers, because the CAP has long supported other areas besides agriculture. It aims, rather, to support beneficial land use. In the case of redefinition, how does the Commission intend to take the different structure of agriculture between Member States into account? Overall, there are growing doubts about the additional administrative burden that the new system could cause.

Concerning the CAP and the Commission’s Communication, the position of the third country in the next Trio Presidency, namely Cyprus, is not well known. Cyprus does not appear to have written an official opinion on the Communication. Its position will thus not be known until June 2011, when the future Trio Presidency officially presents its common position on important issues.

Conclusion and recommendations for the future CAP

What should the CAP look like after 2013? What specific recommendations can be made? Can we expect a further increase of the CAP budget for the CAP, or the opposite?

Regarding the budget issue, it is clear that due to the current economic crisis the CAP budget is not likely to grow. The European Union has other priority areas that it would like to support more, such as Cohesion Policy, energetic and research. Agricultural policy is therefore likely to be put aside. Agricultural powers such as France will make efforts to ensure the CAP budget is not reduced.

It is a commonplace that the economic crisis (which affected not only the EU) means that there are other fields more important than agriculture. But this need not be the entire programming period. It is important to note that the funds we set now will be valid throughout the entire financial perspective, and economic stability is likely to return. As already mentioned, it is necessary to equalise the conditions for all Member States, to make direct payments fair, to provide some limits for additional funding from national budgets and to not let these financial contributions affect the competitiveness of farmers in the EU.

Furthermore, it is important to define properly the concepts “active farmer” and “LFA”. If the LFA are moved to pillar I, this might mean co-financing by the state, the merits of which can be debated.

The capping of payments for large farms is another matter for discussion. It is true that large farms can benefit from economies of scale, but then if the EU cuts their money, this will work against the development of innovations that only large companies can handle. However, it does seem necessary to encourage small and medium enterprises, which in some areas are the key factor in rural development.

The Commission is right to declare that the future CAP should be fair, simple, market-oriented, sustainable and transparent. If the new CAP builds upon these words, it would be a genuinely stronger and more functional policy.

Other recommendations follow:

To specify clearly the requirements of the “greening” component so it will not be just another administrative burden of the CAP.

To better identify and clarify the relationship between the CAP, rural development and Cohesion Policy, and avoid duplication of functions. Money should be targeted so that the boundaries of these policies do not overlap unnecessarily.

To deal better with the issue of ageing population in the rural areas, by making the countryside and agriculture more attractive for young people. About half of the farm owners in the EU are over 55 years old. In contrast, young farmers report higher profits, are not afraid to introduce new technologies and promote environmental issues. The problem for them is the initial long-term debt and also the fact that they often do not have satisfactory qualifications to receive EU subsidies. Better conditions for young farmers need to be encouraged.

To find a reasonable balance between imports from third countries and European products, which must meet high quality standards. Third countries have fewer such restrictions, but limiting imports into the EU market could threaten their existence. It is therefore necessary to find a compromise solution.

To bind the new direct payment system to the provision of public goods. By “public goods” we mean things such as agricultural landscapes, biodiversity in soil, water quality, water availability, air quality, carbon storage and climate stability. Farmers provide these services or goods to the public.

To create a new optimal formula for direct payments. Apart from the land area criteria, regional criteria should also be used – e.g. where the farm is located, and the level of modernisation of the company. Member States’ cost of production inputs, including land prices and rent, should also be taken into account. It would be possible to divide direct payments among Member States according to agricultural land, and in this case, the aforementioned criteria could be used for more detailed analysis. However, this would mean greater power in the hands of national governments.

COHESION POLICY

The Challenges for Future Cohesion Policy

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According to a now well-established tradition for Cohesion Policy, negotiations on the future multi-annual financial framework and the new regional policy were preceded by the publication of the 5th Report on Cohesion¹ on 9 November 2010.

In accordance with the Lisbon Treaty (Article 175), this triennial report presented “the progress made towards achieving economic, social and territorial cohesion and on the manner in which the various means provided for have contributed to it”. The Commission rounded it off with conclusions² setting out the broad outlines of the future Cohesion Policy. These proposals were submitted for public consultation over a three-month period that culminated in the 5th Cohesion Forum on 31 January and 1 February 2011. The Commission had five months to prepare all the draft regulations governing Cohesion Policy and the related funds. These are due to be published after the Commission’s proposals for the future multi-annual financial framework, by the end of June. Negotiations can then begin in parallel in the various specialised groups within the Council.

The Polish government has already scheduled fortnightly meetings for the “Structural actions working group” from the beginning of July. Its successors in the Trio Presidency will probably take up the reins in the first and second halves of 2012. Indeed, the future Polish Presidency would like to wrap up the technical negotiations and the broad political outlines as quickly as possible, but these will need to be constantly adjusted to reflect the progress made in negotiations on the budget or any hold-ups they may encounter.

Although the recent debates and the contents of the 5th Cohesion Report had successfully prepared the ground for the new framework, the proposals put forward by the Commission and initial political exchanges have exposed a marked tendency towards inertia and several gaps, which the Trio Presidency will have to try to make good quickly, if an agreement is to be reached in time.

1. European Commission, *Investing in Europe's future, 5th Cohesion Report*, 2010

2. European Commission, *Conclusions: the future of Cohesion Policy – 2020*, 9 November 2010

Convergence at work in the EU-27 and a new conceptual format

As the 5th report is based on figures from 2007, it cannot reflect the impact of the crisis or the recovery measures undertaken by the European Union (EU) and Member States since 2009. Nevertheless, the comparison with the differing levels of wealth noted prior to enlargement shows how much the new Member States have caught up. For example, between 2000 and 2007 Latvia, Lithuania and Estonia chalked up Gross Domestic Product per capita / Purchasing Power Standards (GDP / PPS) annual growth rates of 9.6%, 8.6% and 8.2% respectively. The regions covered by the “convergence” and “transition” objectives as a whole have grown twice as much as the other EU regions.

Differences between the regions are evening out more slowly, particularly as the most dynamic regions, such as capital city regions, have benefitted more from innovative investments and increases in productivity. The increase in the per capita GDP index in the mainly rural areas of the EU-12 between 2000 and 2007 was 6.9%, compared with 20.4% for urban areas.

The more strategic emphasis placed on Cohesion Policy, which has translated into an earmarking of programmes addressing the Lisbon strategy priorities of innovation, research and development, the environment and developing human resources seems to have borne fruit overall. The initial thresholds of 60% in the “convergence” regions and 75% in the “regional competitiveness and jobs” regions were surpassed, showing figures of 65% and 82% respectively. More than €80 billion will be channelled into support for businesses and innovation over the 2007-2013 period, which is a 100% increase over the previous period.

Ex-post assessments of the 2000-2006 period confirm the vital role played by Cohesion Policy. According to the Commission, more than 1 million jobs were created, 230 000 businesses received funding, a third of the jobless benefitted from programmes co-financed by the European Social Fund (ESF) every year, and more than 23 million people were connected to systems for collecting and treating waste water.

Besides the 5th Cohesion report, three major debates (on the goals of the policy, how it will operate and its future structure) have fed into the discussions over the past two years:

- The report by Fabrizio Barca³, which yielded an in-depth analysis and proposals condensed in the concept of a territorialised social agenda that can be summed up as follows⁴:
 - the need for the future Cohesion Policy to give equal priority to economic competitiveness and social inclusion because each goal has its own relevance without anticipating the knock-on effect of one on the other;

3. Fabrizio Barca, *An agenda for a reformed Cohesion Policy, a place-based approach to meeting European Union challenges and expectations*, Independent report for DG REGIO, 2009
 4. Marjorie Jouen, *The Barca report: a spring clean for Europe's Cohesion Policy*, Notre Europe, 2009

- the relevance of a territorialised approach, as opposed to the neo-liberal type of approach that advocates policies targeting individuals, but taking no account of where they live and work. At the same time, the report underlines the meagre results of exclusively regulatory and / or national approaches, as the open coordination method has revealed in certain areas;
- the potential advantage of combining a more strategic and political approach to Cohesion Policy, mainly undertaken by the Commission, with strong ex ante and ex post conditionality to guarantee the policy's effectiveness and proper use of funds in the form of contracts with the Member States and their regions.

- Including the goal of territorial cohesion in the framework of the Lisbon Treaty. The question of implementing this new goal is still up in the air, despite its foreshadowing with the Green Paper⁵ and the consultation carried out under the French Presidency during the second half of 2008.

Indeed, the Commission did not publish the White Paper requested by the European Parliament and the Committee of the Regions. It deemed that no agreed definition of territorial cohesion had emerged from the discussions. Nevertheless, it was not difficult to imagine how it might be implemented⁶. Firstly, the sectoral policies needed to be coherent with this new goal and the programmes for substantially reducing regional disparities needed rationalising, essentially through systematic territorial impact assessments. Secondly, the future Cohesion Policy needed to be re-arranged around three priorities: more systematic confirmation of positive discrimination for the least well-off regions; establishing a priority action line in the form of a “territorial cohesion objective” with the emphasis on geographic handicaps and socio-economic disadvantages (restructuring, low population density, rural areas); and allowing areas to take part in specific thematic territorial cooperation programmes to help them overcome their shared territorial problems by working together and as a network.

At the same time, the momentum behind the German initiative in 2007 with the territorial Agenda and the Leipzig declaration seems to have run out of steam. The limitations of an exercise based on the goodwill of peers and the heavy burden of interdepartmental coordination gradually became clear. It is by no means certain that the Hungarian Presidency, which has put this item on its agenda for the first half of 2011, will be able to generate fresh impetus.

- The March 2010⁷ strategic report on implementing the 2007-2013 programmes. In this report, the Commission underlined the very disparate levels of progress between countries. Amongst the shortcomings it pinpointed the “unclear distribution of tasks nationally, insufficient experience, lack of administrative capacity at

5. European Commission, *Green Paper on Territorial Cohesion Turning territorial diversity into strength*, COM(2008) 616, 6 October 2008

6. Marjorie Jouen, *Territorial cohesion: from theory to practice*, Notre Europe, 2009

7. European Commission, *Strategic report 2010 on the implementation of the programmes 2007-2013*, 31 March 2010

both managing authorities and beneficiaries and internal reorganisation processes of public administrations”.

Whilst the new procedures for strategic programming and the monitoring rules introduced in 2007 considerably slowed down the launch of the new programmes, the Member States were not stinting in their criticisms of the red tape generated by the new assessment system and the complexity created by the monitoring and follow-up rules. The Commission therefore undertook to take account of the desire for more stability in the regulatory and procedural framework, and make much greater efforts for simplification to facilitate access to the funds for all categories of beneficiaries.

A debate with much at stake that has barely begun

The first ministerial-level discussions on the 5th cohesion report opened in autumn 2010, under the Belgian Presidency. The public consultation generated more than 450 contributions. The European Parliament, the Committee of the Regions and the European Economic and Social Committee delivered their opinions. The adoption of the conclusions of the General Affairs Council (GAC) on 21 February was the first notable step on the path towards institutionalising regional policy at the Council, nudged along by the Hungarian Presidency.

The current general state of play can be summed up as follows:

- The relatively conservative option put forward seems to have been well received. It should be noted that the Commission has thus completely abandoned the provisional internal document that was leaked in October 2009 and had several countries and all the regions up in arms. The affirmation that Cohesion Policy is the Union’s leading investment policy seems obvious in the aftermath of the crisis. Nevertheless it leads to a *status quo* proposal for the regions’ eligibility criteria, which once more rejects more qualitative criteria or those resulting from the work of the Stiglitz-Fen-Fitoussi committee, and retains that of per capita GDP. This produces an identical structure with targets based on the types of regions that are eligible and their level of co-financing.
- The economic crisis, which was amplified by the monetary crisis in 2010, has pushed the Commission and the Council towards accepting tougher economic governance. This shift has had two consequences for Cohesion Policy: firstly, the inclusion of the Structural Funds in the repressive general arrangements intended for Member States that failed to observe the Stability and Growth Pact and their public deficit obligations, and secondly, the alignment of regional development programmes even more closely, if not completely, with the priorities of the Europe 2020 Strategy. And yet it is difficult to see how the regional development programmes could be split into the three priorities of smart, sustainable and inclusive growth. It is impossible to rule out the possibility of some aspects either overlapping or being excluded. Stakeholders are extremely divided on these proposals.

- A very strong emphasis has been placed on contractualisation accompanied by preconditions. In an attempt to make European expenditure more effective, the Commission announced in its communication on the EU budget review⁸ that it intended to make Cohesion Policy part of a common strategic framework that would also include rural development policy and the common fisheries policy. At the operational level, it is proposing signing partnership contracts for development and investment with each Member State. This has echoes of the Barca report and probably suggests a desire to extend the current Cohesion Policy governance – essentially characterised by co-financing, partnership, multi-annual programming, and additionality – to other policies, whilst making it more binding on all the Member States and regions in terms of results and implementation. This proposal has been rather well received by regional and local authorities, who see it as the outline for a common management of the funds for territorial development (i.e. the EAGGF, the ESF, the Cohesion Fund, the EAFRD and the EFF). It has failed to secure the unanimous support of governments, as it is one of the few items left in suspense by the GAC conclusions. Indeed, there are frequently appeals from them for flexibility and adapting the rules to local or national characteristics.
- Taking the territorial dimension into account has generated doubts and a measure of disappointment. The conclusions of the 5th Cohesion Report highlight the territorial problems – or more precisely, the territorial levels – that Cohesion Policy has difficulty in addressing: problem urban neighbourhoods; relationships between cities and the countryside; large conurbations; and trans-national macro-regions. The Commission has added to this the concept of “functional area” and rather loosely set out the most appropriate methods that might encourage public intervention: stronger territorial cooperation, partnership and integrated local development. As for cooperation between internal border areas and cooperation between EU regions and those outside the EU, the Commission plans to promote European Groupings of Territorial Cooperation (EGTC), a new kind of legal instrument set up in 2007⁹. As regards macro-regions, it points to the pilot strategies for the Baltic Sea and the Danube area and the possibility of launching others.
- The proposal to create a new intermediate category of regions, which will include the current two transitional ones (phasing-in and phasing-out regions) has caused some controversy. Essentially, because the specific priorities for this category have no sound policy justification (i.e. specific socio-economic needs), the question comes down to deciding whether or not to grant additional funding to moderately prosperous regions. Needless to say, Member States and regions grasped the opportunity to start their own calculations. The proposal also failed to meet with agreement in the GAC and

8. European Commission, *The EU budget review*, COM(2010)7000, 19 October 2010

9. European Parliament and Council, Regulation, *On a European grouping of territorial cooperation (EGTC)*, No. 1082/2006, 5 July 2006

could be the first budgetary cloud on the horizon of the Cohesion Policy debate, which had hitherto remained political in nature.

Recommendations: Avoiding the trap of discussing the budget

Historically, the negotiations in the Council had followed different approaches, either beginning with subjects on which there was agreement and ending with the thornier issues, or by advancing block-by-block. Because of the changes wrought by the Lisbon Treaty, the European Parliament will have a greater role to play this time than in the past. Furthermore, negotiations on the Common Agricultural Policy and the second pillar in particular, will take place in parallel instead of being addressed separately as they were before. The Trio Presidency will therefore probably be forced to think up a new method.

There is nothing to stop successive Presidencies from using their “jokers” (e.g. the disposal of a European reserve, the list of priorities in the compulsory menu) that the Commission is bound to give them to secure a more innovative and flexible policy than the current programming offers. Indeed, whilst there is currently agreement in favour of greater consistency between the funds and a harmonisation of the rules, which may be reflected in a common strategic framework, the regions that benefitted from the 1994-1999 programming period will all be sad to lose the Europe-wide programmes (namely the Community Initiatives) for encouraging innovation and experimentation or for responding to unforeseen new needs. One by one, the Presidencies will have at their disposal an unrivalled weapon for setting out the policy to the public, providing information and consulting with them, and they would be well advised to use it.

In any event, the Trio Presidency should try to put off for as long as possible the time when the numbers come to muddy the waters of the debate on the political content. That means that they might do well to concentrate first of all on the governance of the future Cohesion Policy using the common strategic framework and partnership contracts, its linkage with the Europe 2020 priorities and greater consideration for the territorial cohesion objective, not least in order to comply with the Barca proposal for a Territorialised Social Agenda¹⁰. They could subsequently deal with the more technical aspects of management, monitoring, follow-up and assessment, the amount to be allocated for subsidies and other types of funding, finishing up with eligibility criteria.

Basically, it is always going to be easier to advocate adequate funding for Cohesion Policy, if it is perceived as the leading European development and investment policy; in other words, if Cohesion Policy governance guarantees effective and transparent spending that is accessible to as many beneficiaries as possible.

10. Marjorie Jouen, “A territorialised Social Agenda to guide Europe 2020 and the future EU Cohesion Policy”, *Europe 2020, towards a more social EU?*, Eric Marlier and David Natali Eds., Peter Lang Editor, Brussels, 2010

COHESION POLICY

Where Does Europe 2020 Leave Cohesion Policy?

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In the Europe 2020 Strategy, the major focus is on competitiveness, which is identified mainly in terms of research, development, innovation and similar indicators. This is at the expense of cohesion, defined inter alia in terms of providing funds to beneficiary Member States and regions for catching up to the European Union (EU) average in per capita Gross Domestic Product (GDP), and other related purposes. Competitiveness – the promotion of which better serves the interests of more developed Member States – may conflict with the bolstering of economic growth and catch-up, from which less developed countries benefit. As a consequence of this bias towards competitiveness, new and less developed EU Member States may be handicapped by the Europe 2020 Strategy, since they are not able to benefit fully from measures associated with, and funds allocated for, the improvement of competitiveness. In the present state of affairs, Cohesion Policy cannot compensate for this deficiency fully. In order to reconcile various interests, a more differentiated approach is needed in both the Europe 2020 Strategy and Cohesion Policy (which is currently under revision).

Reconciling diverging interests

The objectives of the Europe 2020 Strategy are in line with the factors of potential output and potential economic development. On one hand, the strategy identifies competitiveness mainly with research and development – as well as with the technology-intensive economic development path associated with research and development (R&D), such as education and training. On the other hand, it reflects an economic approach that corresponds to the needs of developed market economies – which are characterised by relatively slow GDP growth, significant R&D capacities and a rather low investment rate (that has been sufficient for the implementation of the necessary structural changes). In developed countries, the role of R&D and innovation in economic growth is undoubtedly significant. In contrast to competitiveness, as interpreted in terms of R&D and innovation, less importance is attached to cohesion. The Europe 2020 Strategy mentions cohesion, but the catching-up of the new Member States does not receive proper attention and weight.

In less developed Member States, economic catching-up requires infrastructural and other sorts of investments, including in industry and / or machinery. In these countries, the major driving force of economic growth will be investment rather than research and development, for the foreseeable future. This conclusion is supported by the findings of the Fifth Cohesion Report of the European Commission. In addition, with the last enlargement, regional differences widened in the EU, and a new category of very “backward” regions appeared in some of the new Member States, with per-capita GDP amounting only to some 30% of the EU average. The economic catching-up of these regions requires strategies, approaches and methods that are quite different from mainstream ones and that have few features in common with the Europe 2020 Strategy.

Based on these considerations, a more differentiated approach is necessary. It would include, firstly, investments or capital accumulation in a broader sense among the sources of sustainable economic development amended by total factor productivity. Second, the new approach should reflect the interest of the new Member States in economic catching-up. This may take the form of a broadly defined Cohesion Policy. Even present Cohesion Policy treats regions differently, taking into account their specific features and needs and avoiding “one-size-fits-all” approaches. In this context, more funds should be allocated to cohesion, and the funds should be spent more efficiently. The elaboration of a cohesion index that reflects efficiency requirements would also be an asset. All of this, together with competitiveness, appears in the Lisbon Treaty on the Functioning of the European Union. It should be noted, furthermore, that cohesion is related to the enlargement of the Economic and Monetary Union. If no appropriate response is given to the problems outlined, the European Union may move towards two-speed integration.

Implications for EU financing

In order to finance the Europe 2020 Strategy and to improve efficiency in the allocation of EU sources, a modification of the profile of EU funds and of the European Investment Bank is necessary, with the overhaul of the existing funds and the setting up of new ones. Financial sources allocated for the development of widely defined infrastructure (transport, the energy sector including security of supply, environmental protection together with climate change), which is not financed exclusively according to market principles and which serves economic growth in the long-term, should be channelled into an Infrastructure and Regional Development Fund or Economic Catching-Up Fund, comprising the existing Cohesion Fund and Regional Development Fund. The exclusive task of the European Investment Bank would be the provision of repayable financial sources to the business sector in order to finance projects related to economic development (research and development, innovation and competitiveness).

The Europe 2020 Fund, based on the European Social Fund, should finance the accomplishment of the objectives of the Europe 2020 Strategy (with the exception of economic

development) by providing beneficiaries non-repayable resources (with appropriate contributions from those countries) in order to promote employment and the development of human capital. Finally, in the long run, a stability and crisis-management fund should be set up and institutionalised in order to help EU and Economic and Monetary Union (EMU) Member States cope with liquidity and solvency problems. This is likely to be the European Financial Stability Mechanism to be set up in the eurozone as of mid-2013, the successor to the European Financial Stability Facility.

Funding from the three EU financing sources should be based on the separation of “competitiveness policies” (particularly R&D) and “catching-up policies” and their combination, since the catching-up policy for competitiveness must facilitate the implementation of the Europe 2020 Strategy in less developed EU Member States. Obviously, the EU itself should allocate more resources for “competitiveness policies” in the next decade, but it is also necessary to elaborate qualitative “catching-up policies” for those still lagging behind, yet willing to accept the conditionality for their catching-up process. These policies can give real opportunities to less developed Member States and regions to accelerate not only their quantitative development in terms of GDP per capita, but their qualitative development as well. This was the case of Ireland, Spain and other states.

Implications for the EU budget

At present, the elaboration of the new EU budget (Multiannual Financial Framework – MFF) as well as the reform of the EU budget are on the agenda for the period 2014-20. On one hand, the major bottleneck of financing the Europe 2020 Strategy is the present budgetary period that is going to expire in 2013, in which there is a grey zone from 2010 to 2013. In this grey zone, the present financial commitments are in effect, and no funds are allocated for the financing of the initial phase of the Europe 2020 Strategy. Consequently, in 2011 and in the subsequent two years, no funds will be available for funding the Europe 2020 Strategy in the EU budget. (The funding of Cohesion Policy is ensured in the current budgetary period.) This is counterbalanced partially by the increased space for manoeuvring in the budget, and more specifically by the fact that the Treaty of Lisbon cancelled the distinction between compulsory and non-compulsory expenditures. Furthermore, the objectives approved in the Europe 2020 Strategy determine the expenditure side of the EU budget to a large extent. Based on these considerations, the objectives of the Europe 2020 Strategy should be connected with the priorities of the next financial perspectives of the EU.

The Europe 2020 Strategy and the Cohesion Policy, as interpreted in this paper, both presuppose the reform of the EU budget. This reform makes necessary the reconsideration the EU’s vision of the future, as well as an overhaul of the EU’s general political and economic strategy. As a result of this, EU resources should be subordinated to existing and future EU policies rather than the opposite, as has been the case until recently.

Although the reform of the EU budget is on the agenda, discussion of the Europe 2020 Strategy and Cohesion Policy had to be separated from the debate over the new financial perspectives of the EU. At the same time, the approval of the Europe 2020 Strategy may determine strongly the size and the structure of the new EU budget, to be launched in 2014.

In order to avoid tensions that have stifled progress in the past (in budgets and in integration in general), and to achieve a reform of the EU budget in line with the requirements of the Europe 2020 Strategy and Cohesion Policy, a bottom-to-top approach to individual policies is proposed. This approach is based on the identification of common objectives and existing and future policies, to which the budget is subsequently subordinated. It is the size and the structure of the budget that should be determined according to the requirements of the policies and not the other way round, where policies are derived from the resources available. This practice is the most substantial barrier to the reform of the EU budget. The identification of objectives and policies makes sense only if public goods of sufficient quantity and quality are available at the level of the EU that represent added value created by European integration.

In the formulation of the bottom-to-top approach, the funding side of the EU budget must also be considered in order to avoid the imposition of excessive taxes on economic actors. The procedure of achieving the final objective and stressing the primacy of policies over funds should be based on scenarios designed to reach an acceptable balance between projected budgetary expenditures and revenues. Restructuring and streamlining expenditures, such that they are in line with the requirements of internal and external challenges to serve EU policies, implies the radical reduction of redistribution policies (like the common agricultural policy) and the diversion of freed resources to existing policies and new ones (for example, enlargement, climate change, European neighbourhood policy, energy supply and ageing).

The bottom-to-top approach based on the supremacy of policies over the size of the budget makes an overhaul of the funding side of the EU budget necessary as well. The introduction of supranational or EU taxes would alleviate the horse-trading by Member States over net positions, but it would not eliminate political struggles, as EU taxes affect Member States differently and with uneven redistribution effects. Nevertheless, correction mechanisms could mitigate the negative side effects. The introduction of a supranational fuel tax would both replace taxes on the use of roads and motorways (whose collection needs enormous investments) and raise funds for financing EU budget spending.

In order to achieve the objectives of the Europe 2020 Strategy, the EU budget must increase in size. As a minimum requirement, the size of the budget should be raised to at least 1.5% of the combined Gross National Income of the Member States from the current 1%. Nevertheless, stable financing would require a 5-6% proportion. A more substantial increase would most likely be opposed by the Member States.

The conclusion can be drawn from the Europe 2020 Strategy (among other initiatives) that the more developed, older Member States attach primary importance to the funding of future-oriented industries and activities (such as research and development, innovation, competitiveness, education and training). These activities lay the foundations of sustainable economic development, in contrast to Cohesion Policy and the common agricultural policy. However, the newer, less developed central and eastern European Member States are interested in approaching the EU average in terms of per capita GDP and rural development. As was pointed out above, the major driving forces of GDP growth include investments in countries with a medium level of economic development, whereas research and development, as well as innovation assume the role of nurturing economic growth only at a higher level of economic development. In this context, the new central and eastern European Member States are not interested in the reallocation of financial resources to areas that serve the interests of more developed Member States, because they may benefit from such a structure of EU spending only modestly. Although they should endorse the reform of the spending structure of the EU budget, they are actually interested in maintaining or even increasing the size of cohesion funds in order to promote economic catching-up. As a minimum objective, they should try to reach a balance in the financing sources of cohesion and future-oriented areas. In the latter field, they should make efforts to gain access to a certain share of EU resources.

New Member States preferring economic catching-up, where investments and exports are the major driving force of economic growth, are interested in maintaining or increasing the size of resources serving cohesion targets. In addition, they should make efforts to gain guaranteed access to a pre-determined share of EU resources of future-oriented fields (research and development, innovation, competitiveness, etc.) where they have competitive disadvantages *vis-à-vis* the old Member States. The preparation of the launch of the new strategy needs more time. Considering the time requirements, the proposed comprehensive strategy could start in 2014 at the earliest, following a transitional period of three years.

Policy recommendations to the Trio Presidency:

1. The Europe 2020 Strategy should be harmonised with Cohesion Policy, reducing the contradiction between competitiveness and economic growth and attaching more emphasis to the economic catching-up of less developed Member States.
2. The allocation of funds should be reformed by giving more room to market principles at the expense of bureaucratic coordination. This means that repayable loans with preferential conditions, loan guarantees, and interest subsidies, higher own resources, etc., serve the set objectives, rather than non-repayable grants awarded to those who fulfil certain detailed administrative preconditions devised by either by EU institutions or national governments. The stronger involvement of market principles includes the consideration of returns as well as higher risks for beneficiaries. Nevertheless, the risk should be lower than that taken in the market, but higher than that occurring in the case of bureaucratic

coordination. The modification of the profile of the EU funds and the European Investment Bank is necessary, with the overhaul of the existing funds and the setting up of new ones. Funding from EU financing sources should be based on the separation of “competitiveness policies” (particularly R&D) and “catching-up policies”.

3. New and / or less developed Member States should be guaranteed fair access to funds aiming at the improvement of competitiveness.
4. The funding implications of the Europe 2020 Strategy and Cohesion Policy include an increase in the size of the EU budget, the application of the bottom-to-top approach in designing expenditures (the policy objectives determining the size and the structure of expenditures rather than the other way round) and the introduction of supranational or EU taxes in order to raise the necessary funds. A balance in the financing sources of cohesion and future-oriented areas has to be reached in expenditures.

The Contribution
of 16 European
Think Tanks
to the Polish,
Danish, and Cypriot
Trio Presidency of
the European Union

IV

FREEDOM, SECURITY AND JUSTICE

On December 2009, the Lisbon Treaty and the Charter of Fundamental Rights gained binding legal effect. Since then, Europe's leaders have adopted a number of legal documents intended to enhance the Union's "Area of Justice, Freedom and Security" (AFJS) – derived from Title V of the Treaty on the Functioning of the European Union and, since July 2010, governed by two Directorates-General (DG Home Affairs and DG Justice).

In December 2009, the European Council also adopted the five-year Stockholm Programme, replacing the expiring Hague Programme. In April 2010, the Commission proposed an ensuing Action Plan.

PART IV ABSTRACT

Hoping to add a strategic ethos to the five-year programme (that many considered both inward-looking and politically weak), the European Council of December 2009 also called for an Internal Security Strategy (ISS). The Council adopted such a security strategy in February 2010, with the European Council endorsing it the following month. The Spanish Presidency later called on the Commission to devise a number of methods to properly implement this ISS, thus hoping to increase security within the European Union (EU).

The Commission did just that and on 22 November 2010, it produced a Communication entitled "Internal Security Strategy in Action". In this document, the Commission listed five "strategic objectives", covering a total of "41 actions targeting the most urgent security threats facing Europe". Most recently (February 2011), Justice and Home Affairs Ministers adopted "Conclusions on the Commission's Communication". At the end of their conclusions, the ministers asked the "Commission to submit to the European Parliament and the Council by the end of 2011 its first annual report on actions taken within the framework of the Internal Security Strategy".

The Lisbon Treaty introduced a number of AFSJ innovations: own legal status; separation of AFSJ's raison d'être from internal-market rationales; introduction of the ordinary legislative procedure for issues such as asylum, migration, etc.; an ability for the European Commission to initiate proceedings against Member States for non-compliance; and the possible establishment by Member States of enhanced cooperation regarding police and judicial matters. But according to the authors below, the European Union has not yet

witnessed the full potential of these innovations. The EU has yet to go beyond "institutional tweaking"...

Before the AFSJ can function at full capacity, EU civil servants need to carefully reconsider their studies of this domain (internal security, justice and migration asylum affairs). The Stockholm Programme, its attendant Action Plan, the ISS and the Commission's Communication – all meant to serve as such studies – fail in this regard. According to some authors below, these programmes, plans and communications do not take into account major divisions within the EU: different opinions, different needs, different interests, different Member State capabilities, etc. To the contrary, the political projects and legal documents tend to omit diversity in the EU. They have a propensity to treat the EU's Area of Freedom, Security and Justice as, more or less, a homogenous bloc.

One author uses internal security as an example. According to this author, the ISS ignores the fact that different Member States face different threats (CEPS). The Commission's five ISS objectives (organised crime, terrorism, cybercrime, external borders and natural disasters) are definitely not priorities for all 27 Member States – except concerning natural disasters. This puts in doubt the need for a common policy in this domain. Based on this reasoning, some authors below deem a common rule of law and liberty model preferable to a common internal security model. Lest EU citizens be unequal in the face of EU law – the argument goes – Member States must agree on fundamental EU rights and civil liberties. Attending to this, the new post of Commissioner for Justice was created, with as objective to eventually reduce the EU's apparent bias for security.

But by and large the security bias endures. Despite some recent measures indicating the reverse (concerning interpretation and translation in criminal proceedings, EU contract law, international divorces, inheritance, etc.), the overall impression is that the ISS and the Commission Communication continue to favour security (CEPS). For example, an interpretation of these documents could lead one to think that the intergovernmental approach (from the former third pillar) is spreading to areas (formerly in the former first pillar) such as external border controls and migration/asylum policies. Moreover, exceptions and flexibility relating to Member State cooperation in internal security matters could lead to different degrees of civil liberties within the EU, varying in function of geographical location. The degree to which Member States should have similar legal systems is a question that is likely to cause debate in the months to come.

The topic of differing human rights within the EU is closely related to this juridical harmonisation debate. Having the EU join the European Court of Human Rights (ECHR) and subjecting the EU (as an entity) directly to Strasbourg's jurisdiction

is bound to cause tension not only between Member States, but also between the EU and its citizens. Not properly explaining these types of legal renovations to the public risks damaging (even more) the EU's (currently weak) legitimacy. When fully implemented, the planned human rights structure will be exceptionally complex – it will be difficult for citizens to directly access the ECHR, especially if their Member State has made reservations concerning individual ECHR clauses or if it has opted-out of from the EU Charter of Fundamental Rights. This is why the EU should publicly clarify the fact that accession to the ECHR shall not be a panacea for human rights protection (Europeum).

Divisions within the EU relates to a third, rather topical AIFS domain: immigration and asylum policy. Not only does the EU's migration and asylum policy seem to favour internal security over justice for immigrants (ELIAMEP), but more generally migration and asylum policy fails to acknowledge a number of divisions within the EU. What is more, the Lisbon Treaty has only provided superficial remedies for these policy deficiencies (DIIS / SWP). Concerning migration and asylum policy-making, EU divisions currently ignored by European leaders are visible in four areas: incompatible DG capabilities, post-negotiation disagreements, differing economic needs and disparate state resources.

As mentioned in relation to internal security, common migration policies tend to ignore substantial legal, economic and cultural differences between Member States. To avoid EU-wide projects that are bound to fail (such as the EU Blue Card approach), Member States should form common policies (based on a variable geometry approach) only between states that actually share common languages, comparable legal traits and similar economic interests.

This lesson – that coherence needs to be applied at the appropriate scale – also applies to EU governance. The capabilities and competencies of various EU policy communities (home affairs, foreign policy and development policy, for example) still vary tremendously. Because of this, the Holy Grail that is coherence is still not within reach – for now. According to one author below, if policy coherence is sought before EU civil servants enjoy similar capabilities, then all that is likely to happen is that one policy will gain primacy over the others. Until policy communities develop their respective capabilities, the search for synergy will remain vain (DIIS / SWP).

EU migration and asylum legislation is not only deficient in terms of coherence – it is also in terms of implementation. The transposition and implementation of migration-related legislation often fails because Member States ignore differences of opinion between themselves and differences of opinion between the EU and those key to transposition (third countries, businesses, citizens, etc.).

Member States seldom pro-actively tackle political differences before they pass EU-wide legislation. More importantly, those key to transposition (governments to the east of the EU, for example) are certainly not invited to participate in intergovernmental negotiations, and thus their (possibly) differing opinions and suggestions are rarely heard. Instead of co-opting other actors into policy implementation, the Trio Presidency could usefully build new policies in a spirit of partnership, starting with a revamp of the EU's mobility partnerships with third countries (DIIS / SWP).

Finally, migration-related legislation often fails because Member States' (administrative and technical) capabilities differ. This causes conflict over border-states' legal standards and other states' (lack of) solidarity. With regards to state capabilities, one cause of contention is the "first safe country principle", which allows Member States to send asylum seekers back to the first EU country they entered (ELIAMEP). To avoid what is called "asylum venue shopping", the Dublin Convention and the Dublin II Regulation sought to stop asylum applicants from lodging applications in the country of their choice. By avoiding taking into account the wishes of the applicants, states that already hosted a great number of immigrants sought to have border-states share the "burden". Thus far, this strategy has not been successful because most border-states, such as Greece, do not enjoy great administrative capabilities. This is why EU leaders need to agree on how to measure migration "burden" – via quotas, for example. Once this is done, they also need to raise the capabilities and the legal standards of states currently sitting on the borders of the EU (DIIS / SWP). The amendment of asylum Directives, the establishment of the European Support Office, and the mitigation of asylum pressure (via regional protection programmes, protected entry procedures, and resettlement) make some progress in this regards.

Once the AFSJ becomes fully-fledged, new AFSJ laws will directly affect EU citizens. This will either provide the EU with a new found glory or, to the contrary, will stultify the EU's legitimacy by making it appear either too powerful or not powerful enough (depending on one's political inclinations) (Europeum). Simply put, once the EU starts passing more AFSJ-related legislation, this domain will receive more public attention. As already mentioned, in order to prevent excessive fears and expectations, EU institutions should clearly describe to the general public their respective internal security responsibilities. In the coming months, the Trio Presidency will be in charge of shaping freedom, security and justice in the EU. This will require a balancing of these three goals. The lesson to take away from these reports is that when harmonisation as a means is confused as an ends, the diversity of the Union will always resurface.



FREEDOM, SECURITY AND JUSTICE

The Rocky Road from Empty Prescriptions to Meaningful Policy: Four Imperatives for a Better Immigration and Asylum Policy

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It is a myth, of course, that European Union (EU) officials spend their time lazing around, watching daytime television.¹ If anything, they are just a little too busy. And yet, they do seem to take inspiration from one staple of daytime easy-viewing: makeover shows. The Union is forever pouncing upon some neglected and unlovely policy field, tweaking one or two institutional elements, and creating a “common”, “coherent” or “effective” policy.

Justice and home affairs policy is one of the EU's most regular makeover victims. Every time it emerges from the Union's frequent constitutional convulsions, it finds itself replete with new constitutional lip-gloss and perm. Migration policy, for example, came out of the Lisbon treaty reform as a common policy, based on principles such as burden-sharing between Member States, thorough transposition and coherence with the EU's foreign policy.

The trouble is, of course, that institutional makeovers are only meaningful if they reflect, alter or harness political realities in an intentional way. And the home affairs and migration policymaking that emerged from Lisbon does not seem to have been greatly improved.

It is odd, for example, that the EU's strategic prescriptions for an effective internal security policy currently have a shelf-life of around six months, whilst its tactical behaviour in international negotiations may take two or three years to work out. Recent developments in Greece

1. The recommendations in this text draw on the more in-depth analyses by the authors. For an elaboration of their ideas on coherence, see: Birgitte Mossin Brønden (forthcoming DIIS Brief 2011) “Migration and Development in the EU tool box: for whom and for what purpose?”, and Birgitte Mossin “Migration and Development – a mantra losing its impact?” in Den Ny Verden 2009, and Roderick Parkes, “When Home Affairs Becomes Foreign Policy”, *SWP Comment*, 2010; on burden-sharing see: Steffen Angenendt and Roderick Parkes, “A New Impulse for EU Asylum Policy? The Potential of the European Asylum Support Office”, *SWP Comment*, 2010; on implementation: Roderick Parkes, “Costing Free Movement: Fear and Non-transposition in the Schengen Area”, *SWP Comment*, 2010, and Roderick Parkes and Moritz Schneider, “Partnership: A New EU Approach to Fighting Irregular Immigration”, *SWP Comment*, 2010; and on common policies: Steffen Angenendt and Roderick Parkes, “The Blue Card Impasse”, *SWP Comment*, 2010

and Bulgaria meanwhile throw up questions around the Lisbon Treaty's prescriptions on burden-sharing and implementation. And, even after Lisbon, moves towards a common legal immigration and asylum policy continue to lurch from one political limbo to the next.

The outgoing Trio Presidency groused about being landed with the – in reality rather jolly – task of implementing the Lisbon Treaty's institutional prescriptions. This new Trio Presidency, by contrast, has the altogether thornier task of actually realising the Treaty's intentions. This area of policymaking is cracking under its own deep political divisions, and the treaty makeover does nothing more than disguise a few wrinkles. The goals of a common policy based on solidarity, coherence and proper implementation can only be achieved by the Trio Presidency if the EU recognises the true nature of these political tensions. These run not only between member governments, but also between the Union's various policy communities, the EU and third countries, and the EU and civil society and immigrants.

In moving from the cosmetic world of daytime television and into real politics, the Trio Presidency should bear four principles in mind for a coherent, common policy based on burden-sharing and reliable transposition:

There can only be coherence with foreign policy when the EU has a foreign policy

The Lisbon prescriptions on coherence between foreign and migration policy are just the latest step in a long process. Since 2005, the EU has redoubled its efforts to ensure the complementarity of the two. Back then, the EU realised that regulating international migration in a certain way could be beneficial to its foreign-policy goals. Increased freedom of movement throughout the EU and its neighbouring regions could, for example, promote cultural and economic exchange as well as encourage political transformations in other countries. Migrants in the EU-27 might also play a key role in furthering the Union's development-policy goals in countries of origin (remittances, contribution to development made by diasporas in the EU) – and if the EU was not careful, also in disrupting them (if “circular” migration is not encouraged, brain drain can occur). At the same time, interior ministries realised that many of the migration and security challenges they face have roots outside the EU. They are keen for EU foreign policies to take the “root causes” of irregular migration and terrorism into account.

Yet, the EU is not seeking to achieve coherence between fully-fledged home affairs, development or foreign policies. And the fact that the EU's competencies in the relevant policy fields have developed at different speeds remains a considerable source of tension between its policy communities. It is fair to say that those political actors who are keenest on “coherence” tend to be those whose EU competencies and capabilities are fewest. They have enviously eyed up the EU's resources in other policy areas, using

the imperative of coherence as a means of pilfering other's goodies rather than building up their own approach and measures.

In the 1990s, for example, interior ministries enjoyed few tools to deal with migration flows before they reached the Union, and they enviously eyed the EU's ample capabilities in development policy. It was not just that they wanted to use development policy as a carrot to obtain readmission agreements. Stressing the need for coherence, they advocated a "root causes" approach, which would see a measure of development aid diverted to those third countries that produced the most illegal immigrants. "Coherence" in this regard implied the primacy of one policy over another, and the predictable result of this bid to reduce the economic and political "push factors" behind immigration to the EU was a disruption of development goals as some of the EU's development support was channelled away from countries most in need of it. Moreover, insofar as it had any effect on the "root causes" of migration, it may also have been counterproductive, tending to lead to a "migration hump": the resulting economic development led to an initial increase in mobility. So, it is surprising that interior ministries look set to repeat these mistakes in taking a "root-causes approach" to international terrorism.

The EU's foreign policy actors are just as guilty of this magpie version of "coherence". Visa policy is, for example, a core tool of home affairs. If it has become a core element in the EU's foreign relations with the western Balkans and eastern partners, it is in large part to make up for the EU's lack of broader foreign policy capabilities. The result of these efforts to exploit free movement and reform-conditionality for reasons of foreign policy has been unfortunate: due to international pressures, third states have been offered visa-free travel before they were ready; interior ministries have reacted by threatening to reintroduce controls, leaving the EU trying to leverage permanent reforms in third countries through incentives that look entirely wobbly; and the EU's existing efforts to improve and liberalise its visa practices (the new Visa Code) have been disrupted by their use as a *quid pro quo*.

If the Trio Presidency wishes to ensure fruitful coherence between its policy communities, it should acknowledge the cause of the political tensions that have disrupted past efforts: home affairs policy cannot substitute for foreign and development policy, just as foreign and development policy cannot substitute for home affairs policy. In some cases, coherence can actually best be ensured by building the EU's capabilities in a particular policy field, rather than trying immediately to exploit synergies. This should inform the Union's approach to countering terrorism outside its borders. Where its policy competencies are relatively mature, by contrast, the Trio Presidency should redouble its efforts to explore synergies – for example between migration policy and development. But even here, the Trio Presidency should keep an eye open as to whether migration policies have unintended consequences for development and vice versa: notice how the strict migration laws, the deportations and return programmes together with the deterritorialisation and

externalisation of boarder controls have negative impacts on the EU's foreign and development policy aspirations.

The best place for policy implementation is the negotiating table

The Lisbon Treaty increases the Commission and Court's powers when it comes to policing the implementation of EU home affairs rules. It is hoped that this greater capacity to punish naughty Member States will improve the previously shaky transposition in policy fields such as police cooperation and criminal law. Yet, doubts remain. In the area of EU immigration and asylum policy, where the Commission and Court's coercive powers to oversee implementation are already quite robust, serious problems persist. European asylum statistics and the current problems in Greece, for example, show that there are enormous disparities in the way that the Member States interpret their obligations under EU law.

For academics who know their way around implementation theories, the continued problems in asylum and immigration policy will come as no surprise. They know that if serious political disagreements are papered over during the formulation of a policy, there will be a tendency towards a "politics of implementation", in which aggrieved parties use the transposition stage as an opportunity to make their dissatisfaction known. The trend, reinforced at Lisbon, to pursue implementation through reactive, coercive means suggests a disinclination to tackle pro-actively the underlying political causes of non-transposition.

To overcome persistent problems of non-implementation, the Trio Presidency could usefully acknowledge the way that tensions between governments at the negotiating table can disrupt later implementation: firstly, proper transposition relies upon the clarity of the obligation. If political differences between governments are not resolved during negotiations, they will be tempted into loose formulations and lowest-common-denominator rules. The resulting confusion will throw implementation into turmoil. Secondly, governments' willingness to implement policy depends in large part upon having the administrative capacity to do so. States which do not have the capacity to implement an obligation may nevertheless sign up to it on the basis that nobody will notice. The EU needs to better exploit administrative cooperation between its members as a means for better-off Member States to show solidarity to other members and to cajole them into improving their standards.

But, the most important lesson is that those *excluded* altogether from intergovernmental negotiations are most usually key to transposition. After all, good implementation and the policing of implementation occur largely out of sight of national governments and the European Commission. They instead rely upon "sheriff's deputies" who either implement policy or report transgressions: policies where these deputies – third countries, immigrants, citizens, businesses – gain positive rights are those that tend to be best implemented and policed. Quite simply, they are the policies which have the most stakeholders. The more

restrictive policies, by contrast, often tend to alienate those charged with implementation and give few bystanders an incentive to report non-implementation. Instead of co-opting other actors into policy implementation at pain of sanctions (employers' sanctions, carrier sanctions, international sanctions) and thereby creating paper tigers, the Trio Presidency could usefully build new policies in a spirit of partnership, starting with a revamp of the EU's mobility partnerships with third countries.

Common policies should be based on diversity

Most people would agree that the point of the EU is to achieve common policies and approaches. And yet, in migration policy, this goal routinely founders on Member State resistance and the notion of a common approach on asylum or legal immigration seems as distant as ever. Why? Common European policies tend to create shared standards relying upon a degree of homogenisation and centralisation. Only so, it is thought, can the EU create policies of scale which guarantee goals like fairness, clarity and global influence. This would explain why, in policy areas such as legal immigration, the Union has sought to compete with large states like the United States, creating a greater degree of coherence and commonality in its labour market policies towards migrants than even these states can achieve. The almost unanimous criticism of this policy tool suggests that there is something wrong with the EU's thinking.

The Blue Card approach of course made perfect sense on paper. It was based on a desire to pool the EU's labour markets, offering certain forms of particularly desirable migrant access to all Member States. Yet, if its one selling point was the very thing that simply cannot be realised, to pursue it as an idea was clearly an act of folly. And this was very much the case in the Blue Card approach. Not only were the Member States unwilling to pool their visa and labour market policies to the necessary degree, but certain immutable differences of language, geography and history, undermined the idea of a homogenous policy of scale. Instead of trying to blend out differences in the Blue Card approach, the EU might have turned them to its advantage. A common policy tool in which small groups of Member States made use of shared traits – unusual labour market regulations for example or a shared language – in order to attract immigrants and to offer them preferential access to their labour markets would have worked better than homogenisation.

The same principle of creating common policies out of inter-national difference and diversity could usefully be applied to the EU's other policy goals. Homogenous rules do not, for example, necessarily guarantee fairness between EU members, but may rather cement structural inequalities. True fairness would take account of the differences between individual states, such as their geographical proximity to the EU border or their administrative capacities. If the Trio Presidency wishes to help the EU achieve common policies of scale, it should concentrate its efforts on a central question: how to reconcile the need for clarity and coherence with the realities of difference and diversity?

Burden-sharing is not yet a value but a calculation

It is all very well for the Lisbon Treaty to underline values of solidarity and burden-sharing between Member States in the areas of asylum and illegal immigration, but if such values owe more to romanticism than reality, it will put the lives of migrants at risk. The EU may well be a community of grown-up values such as solidarity, but it is also an international organisation run by hard-headed governments carefully watched over by increasingly irritable national electorates. They are not convinced by the arguments for solidarity, and this plagues the work of the EU in areas such as border control and asylum.

The trouble is that different Member States tend to measure the burden they bear by different yardsticks, and all with some justification. Is, for example, the burden borne in asylum policy measured by the number of asylum-seekers a country accommodates (and in which case should it be measured in absolute terms or relative to the population)? Does it derive from having high asylum standards, and thus the possibility of encountering “pull factors” relative to those members with lower standards? Does it come from having a poor administrative capacity and being quickly strained? Does it come from having to deal with the new responsibilities of EU membership and cooperation?

Rather than stressing burden-sharing as an established value, the Trio Presidency needs to build it, creating it out of a series of hard-headed political calculations from member governments. The Trio Presidency could usefully start by identifying a means of overcoming the most obvious political division: the Member States on the Eastern and Southern borders of the EU demand solidarity in the form of practical, administrative support in dealing with their new responsibilities under the EU acquis. Member States in the North and West of the EU believe that solidarity lies in these peripheral countries raising their standards for border control and the treatment of asylum-seekers. The creation of the Asylum Support Office gives a credible framework for a mutually beneficial compromise in which administrative cooperation is conducive to, and contingent upon, a rise in standards. Member States in the North and West would share their administrative resources with those in the South and East, in return for the latter countries raising their standards.

FREEDOM, SECURITY AND JUSTICE

Managing Asylum Seeking in Europe: How to Revise the Dublin II Convention

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“Today’s ruling by the European Court of Human Rights (ECtHR) clearly shows the EU’s need to urgently establish a Common European Asylum System and to support Member States in meeting their obligations to provide adequate international protection.” Statement of Cecilia Malmström, European Commissioner for Home Affairs, 21 January 2011.

Seeking asylum in Europe and the Dublin regulation

Long standing Member State concerns that asylum seekers from other continents were abusing their asylum systems, engaging into what has been called “asylum venue shopping”, have led, as early as 1990, to the creation of the Dublin Convention. The Dublin Convention (named after Dublin, Ireland, the city in which it was signed on 15 June 1990) first came into force on 1 September 1990, among the first 12 signatory states: Belgium, Denmark, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Spain and the United Kingdom). Later on 1 October 1997, Austria and Sweden joined, and on 1 January 1998, Finland did the same.

The idea behind the Dublin Convention was to limit the movement of asylum seekers transiting in Europe and avoid that they would lodge their application in the country that they preferred (because, for instance, they already had family or friends there, or because they spoke the language, or indeed because they heard that this country had a higher approval rate than another). The underlying idea was that although the right to asylum is indeed very important, people in need should purely seek international protection and not express a preference as to where they would like to receive this protection. In addition, of course, the underlying policy and political priority was that countries with the largest immigrant and refugee communities – such as the United Kingdom (UK), Germany, the Netherlands or France – should face less pressure, and that those countries in the periphery of Europe – the “natural” geographical stepping stones of asylum seekers – should receive at least part of these applications.

In 2003, the Dublin Convention was replaced by the Dublin Regulation (Regulation 2003/343/CE, in common parlance referred to as Dublin II). The Dublin Regulation is complemented by the EURODAC Regulation, which establishes a Europe-wide fingerprints’ database for unauthorized entrants to the European Union (EU). This database, combined with the provisions of the regulation, allows Member States to rapidly and relatively easily establish which Member State is responsible for dealing with an asylum claim and hence to transfer the asylum seeker to that Member State. Recently, Norway and Iceland joined and in December 2008 Switzerland, too. On 3 December 2008, the European Commission proposed amendments to the Dublin Regulation, creating an opportunity to reform the Dublin System.

Failures of the European asylum system and the challenges ahead

Ironically, it may be argued that the Dublin II Regulation has been successful if we assume that its main aim has been to shift some (or indeed most) of the asylum seeking examination burden to the peripheral countries of the EU. If however the aim of the Dublin Convention and the Dublin II regulation has been the streamlining of the asylum system in Europe, then it has actually been an immense failure. Indeed, the side-effects have been important: southern European countries, which are the first safe countries asylum seekers from Asia and Africa encounter on their way – more often than not travelling on foot, by car, truck, with the help of human smugglers – face disproportionate pressures with which they are unable to deal.

Greece is perhaps the champion in this failure to adequately respond to Dublin II. Asylum seekers arriving in Greece hardly have the opportunity to seek asylum. Irregular migrants and potential asylum seekers arriving at Greek land and sea borders with Turkey are routinely detained in overcrowded reception centres and indeed in inhuman and degrading conditions. They do not receive information, regarding their right to claim asylum, in a language that they understand. It is their co-ethnics and smuggling networks who usually are the ones to inform them about the proper procedures for seeking asylum, notably the need to lodge applications at a special office located in Athens. Thus, the irregular migrants and potential asylum seekers usually arrive in Athens with an expulsion decision in hand, written in Greek, which invites them to leave the country within 30 days. Here, they often receive assistance from the Greek Council for Refugees, the only specialized Greek NGO dealing with asylum issues. Nonetheless, the procedure for lodging an application and the understaffing of the relevant police office in Athens makes submitting the application almost impossible.

Until recently, every week, on the night between Friday and Saturday, people used to queue outside police offices at Petrou Ralli, in downtown Athens. Early on Saturday mornings, the office would release about 300 numbers to the first 300 people standing in the queue. These numbers corresponded to 300 appointments for filing an application. Routinely, first

instance applications were rejected, mainly upon consideration of the country of origin of the applicant. The interview to which first instance applicants were subjected was rudimentary. The questions addressed to them were formulated in such a way so as to conclude that the applicant had come to Greece as an economic migrant.

This system was reformed in July 2009, abolishing the possibility to appeal to a first instance decision. This amendment led to the United Nations Refugee Agency's (UNHCR) withdrawal from assisting the Greek state in dealing with the applications. Eventually, the whole system came to a standstill in autumn 2009, leading to the additional piling-up of thousands of applications, creating an important backlog. In January 2011, law 3907/26.1.2011 was voted. This new law puts in place an adequate asylum system for Greece, but of course it will be several months before it is effectively implemented.

Asian and African irregular migrants and asylum claimants often travel through Turkey and then Greece, making Greece one of the main geographical points of entry to the EU. In three years time, apprehensions of irregular migrants (including potential asylum seekers) at Greek-Turkish land and sea borders have nearly doubled (from 32,000 in 2007 to 53,000 in 2010).

Clearly Greece has, until recently, lacked the political will to implement an appropriate asylum system. But due to its geographical position as well as to Turkey's unwillingness to cooperate in taming these flows, the country has also been subject to disproportionately high irregular migration pressures. While given the geographical position of the country such pressures may not be avoided, actually it may be avoided that all asylum seekers who arrive at the Greek-Turkish border have to have their applications lodged and examined by Greek authorities.

Recognising Greece's failure to implement the Dublin II Regulation, the European Commission started infringement proceedings against Greece on 31 January 2009, bringing the country in front of the European Court of Justice. The infringement concerned mainly the fact that Greece lacked the legal guarantees necessary for a substantial examination of all asylum claimants' applications. Not only were asylum applicants routinely placed in detention and, when released, given no housing or subsistence assistance, but also, and most importantly, the applicants' applications were routinely rejected without a proper examination or interview.

In a report published in March 2008, under the title: "Sharing Responsibility for Refugee Protection in Europe: Dublin Reconsidered", the European Council for Refugees and Exiles (ECRE) showed the limitations and injustices of the current system. In particular, it noted that 10 years after its full operation, responsibility for examining asylum claims was assigned, but not carried out by the Member States concerned – multiple claims and secondary movement persisted. The report argued that by requiring those fleeing persecution to claim asylum in the first safe country they reach, the system assumed there was a level playing field of protection

across the EU. But this was not the case. For instance, the report concluded that the recognition rate of Iraqi asylum seekers in 2007 varied from over 80% in some Member States to practically null in others.

Along with this report were related decisions by specific Member States, acknowledging the failure of the system, in particular concerning the role of Greece as a safe country: Soon after Norway stopped sending asylum seekers to Greece, in March 2008 a Swedish court stopped the extradition of an Iraqi asylum seeker to Greece, but it was only in November 2010 that Sweden revoked the application of the Dublin regulation as regards Greece. Finland stopped returning asylum seekers to Greece on 18 April 2008. The UK stopped returning asylum seekers to Greece in September 2010, while in late January 2011 Germany did the same.

In May 2009, the European Parliament (EP) voted an asylum package that aimed to better safeguard the rights of asylum seekers seeking protection in the EU. In particular, the EP argued that solidarity among Member States could not work (as experience had proven) by voluntary measures alone and that compulsory instruments were necessary to assist Member States receiving large numbers of asylum applications. Members of the European Parliament (MEPs) deplored the reluctance of the Council of Ministers to introduce in fact binding mechanisms in the Dublin asylum system. In May 2010, the EP introduced financial incentives for countries that would volunteer to host resettled refugees. Indeed, the UNHCR documented that nearly 800,000 people are in need of resettlement, and that, in terms of resettlement programmes, Canada and the United States are doing much more than the EU. On that occasion, the EP also decided to create a European Asylum Support Office in Malta.

Most recently on 21 January 2011, the European Court of Human Rights (ECHR) found that Greece's broken asylum system and its appalling detention conditions meant that Belgium's transfer, in 2009, of an Afghan asylum seeker to Greece, under the Dublin II Regulation, had breached the prohibition on ill-treatment and denied the asylum seeker an effective remedy.

In the MEP session of 15 February 2011, the MEPs concluded that the European asylum system was not only a problem for Spain, Italy, Malta or Greece, and that it should be treated as a genuinely European problem. They acknowledged that the ECHR decision of 21 January indeed marked a turning point, showing that the European asylum system is in dire need of reform. The measures that need to be taken include not only financial and operational assistance to the countries receiving most asylum seekers, but also better cooperation with neighbouring countries through which asylum seekers transit, Turkey in particular.

Current developments in North Africa put the situation under new light and indeed call for immediate action on the part of European institutions. The current dramatic situation in Libya will produce a high number of people in need of temporary international protection at Europe's southern shores. The Italian Minister of Foreign Affairs, Franco Frattini, estimated

that the Libyan crisis would produce between 200,000 and 300,000 arrivals in the EU.¹ On 2 March 2011, José Manuel Barroso noted, among other things, that FRONTEX and Italy are continuing their joint operation, called HERMES, patrolling the central Mediterranean Sea, where most transits are expected to take place. Arrivals (mainly of Tunisians, and to a lesser extent of sub-Saharan Africans escaping Libya) at the small island of Lampedusa, south of Sicily, stand at 18,000 for the period January to March 2011 (compared to 27 only, for the same period in 2010), creating a true emergency for Italy. The Italian government (which had managed during the previous three years to reduce the number of arrivals from North Africa to one tenth of what it used to be, essentially with the cooperation of the Gheddafi government and its dubious migration control methods) emphasises that the issue is a European and not a specifically Italian one. But other EU countries stay silent while France reinforces land border patrols at the southeast, close to the Ventimiglia border crossing where several hundreds of young Tunisian men (who had escaped from the reception centres in southern Italy) have been gathering during the last weeks, with the aim of crossing to France.

In the meantime, more than 200,000 people have crossed from Libya to Egypt and Tunisia, two countries that are themselves in a phase of political transition and turmoil. On 3 March 2011, the European Commission raised the sum allocated for humanitarian relief in the region to €30 million, while about €16 million are available through the European Refugee Fund, which could be allocated by Home Affairs Commissioner Cecilia Malmström to address the effects of the crisis in Libya.

During this crisis it becomes clear how much asylum, temporary international protection and irregular migration are entrenched as realities and as concerns for European governments and for EU institutions. The question arises with pressing urgency: how to deal with irregular migration while allowing potential refugees to lodge an application? And how to deal with humanitarian or political crises that take place near the EU's external borders and which unavoidably produce large numbers of people in need of temporary protection?

How to reform the European asylum system?

The above picture clearly shows that the Dublin II Regulation is in need of urgent reform. However, the reform is not in the direction taken so far by the European Parliament or the European Commission. More guarantees for asylum seekers rights or the expansion of the resettlement programmes in the EU will not effectively change the main flaws of the Dublin II asylum system. What needs to be reformed is the “first safe country” principle. Since geography cannot be changed and since asylum seekers usually travel by the cheapest means of transport available, and not by plane, people fleeing persecution and ethnic conflict in Asia and Africa will continue

1. Alessandra Arachi, “Un’ ondata di 300 mila arrivi Il dopo-Gheddafi è un’ incognita”, *Corriere della Sera*, 23 February 2011. Available at : http://archiviostorico.corriere.it/2011/febbraio/23/ondata_300_mila_arrivi_dopo_co_8_110223006.shtml

travelling for instance through Iran, Iraq, and Turkey, or through the Sahara to North Africa, and hence will always land first in Europe's southern shores. The vast majority will always reach Greece, Italy, Spain or Malta first, rather than Sweden, the Netherlands, Britain or Germany.

The creation of a Common European Asylum System as proclaimed in the Stockholm Programme requires – contrary to what is suggested in the Programme – the thorough revision of Dublin II. In particular we recommend that:

- Asylum applicants should be allowed to lodge their applications to the country where they wish or where they are able to do so, regardless of their first safe country of entry. Upon examination and acceptance of their claim, they should normally stay in the country where their claim has been accepted.
- There should also be, however, a system of annual asylum quotas. Each country should have a certain number of permits available each year for recognized refugees and for people under temporary international protection. This number should be a percentage of population – for example, France has 62 million inhabitants, the related quota could be 0.10%, i.e. 62,000 permits. When, within a year, a country has achieved its annual quota, the remaining asylum seekers accepted in this country should be immediately resettled to one of the countries that still have available slots in their own quota. The existence of an annual quota of refugees for each country and the possibility of resettlement when a country exceeds its quota ensures that all countries share equally in the European asylum system. It also takes away the incentive of rejecting all applicants with a view of (a) spreading the rumour that X country is not a good place to apply for asylum, (b) expelling the asylum seekers and thus “solving” the “problem” of having too many asylum seekers in the country.
- The selection of the country where refugees should be resettled will take into account the wish of the applicants and effective proof of where they have family, or where they know the language or prefer to live.
- In cases of (imminent or actual) mass influxes of displaced persons, from third countries, who are temporarily unable to return to their country of origin and hence in need of temporary international protection, a double course of action is needed. On one hand, affected EU countries should receive immediate financial and operational aid from the European Refugee Fund and if necessary through exceptional humanitarian relief funds. On the other hand, the people concerned should be exempted from the Dublin II regulation and hence be able to seek temporary protection in any EU country.

In addition to the above, it will be necessary that the European Refugee Fund continues to support capacity building in countries whose borders are external EU borders and which naturally face the largest incoming irregular migration and asylum seeking flows. Here, the challenge is not only to tame irregular migration, but truly to do so without compromising the possibility that people in need of international protection can apply for asylum. For this reason, Greece, but also Spain, Italy and Malta should step up their efforts for putting an efficient and fair asylum system in place, honouring thus their international obligations.

FREEDOM, SECURITY AND JUSTICE

The EU's Internal Security Strategy and the Stockholm Programme: A Challenge to Rule of Law and Liberty in Europe?

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The EU Internal Security Strategy (ISS) was adopted by the Council in February 2010 under the auspices of the Spanish Presidency with a view to setting out a common European Security Model.² This initial document followed the entry into force of the Lisbon Treaty and the adoption of the Stockholm Programme, which sets out the new five-year plan for the development of the European Union's (EU) Area of Freedom Security and Justice (AFSJ) in December 2009. The Lisbon Treaty formally abolished the old pillar structure in Justice and Home Affairs (JHA) policies and brought the different AFSJ policies into one fairly homogeneous legal and institutional framework. The implementation of the Stockholm Programme under this new Treaty framework and the development of an ISS have constituted central priorities for the JHA Trio Presidency Programme (January 2010 – June 2011).³ The Commission published in November 2010 a Communication titled “The EU Internal Security Strategy in Action: Five steps towards a more secure Europe” which identifies “the most urgent challenges” to EU security in the years to come and proposes a shared agenda of common strategic objectives and specific actions for the implementation of the ISS between 2011 and 2014.

The Stockholm Programme⁴ stressed that it “is of paramount importance that law enforcement measures, on the one hand, and measures to safeguard individual rights, the rule of

law and international protection rules, on the other, go hand in hand in the same direction and are mutually reinforced.”⁵ Do the ISS and the Commission Communication “putting it into action” fulfil this political priority? This paper argues to the contrary. It starts by providing an overview of the objectives, principles and guidelines for action outlined in the ISS. The Commission Communication putting the ISS into action, and its five key strategic objectives is examined in Section two. Section three concludes by addressing the question of the extent to which the ISS will make the EU more secure or insecure, and it recommends to the Commission to develop a solid rule of law and liberty strategy.

The Internal Security Strategy: The old Third Pillar through the back door?

The objective of the EU's ISS is to establish a shared agenda on internal security that enjoys the support of all Member States, EU institutions, civil society and local authorities, and interestingly enough, the EU security industry. The ISS identified a number of principles and guidelines for action in pursuit of a “European security model”.⁶ The principles included:

- a. Justice, freedom and security policies that are mutually reinforcing whilst respecting fundamental rights, international protection, the rule of law and privacy;
- b. Protection of all citizens, especially the most vulnerable;
- c. Transparency and accountability in security policies;
- d. Dialogue as the means of resolving differences in accordance with the principles of tolerance, respect and freedom of expression;
- e. Integration, social inclusion and the fight against discrimination;
- f. Solidarity between EU Member States; and
- g. Mutual trust.

On the basis of these principles, the ISS provided a number of guidelines for action “to guarantee the EU's internal security”, which included a proactive (intelligence-led) approach driven by prevention and anticipation, the reinvigoration of information exchange between law enforcement authorities through the use of EU databases as well as an improved operation cooperation between EU security agencies (Europol, Eurojust, Ceuol, Sitcen and Frontex) and ensuring stringent coordination between them by the Standing Committee on Operation Cooperation on Internal Security (COSI). Apart from that, the ISS did not specify the actual ways in which the specific guidelines were going to constitute an implementation of the above-mentioned general principles.

The Treaty of Lisbon and the Stockholm Programme have provided the legal and political impetus for the ISS to be developed and implemented. The Commission Communication thus comes indeed at a moment when there is much clearer responsibility within the EU

1. This contribution constitutes a revised version of written evidence submitted by the Justice and Home Affairs Section of CEPS to the inquiry currently carried out by the Select Committee on the EU of the UK House of Lords into the Internal Security Strategy

2. Council of the European Union, “Draft Internal Security Strategy for the European Union: Towards a European Security Model”, 5842/2/10, 23 February 2010, available at: <http://register.consilium.europa.eu/pdf/en/10/st05/st05842-re02.en10.pdf>

3. Council of the European Union and Spanish, Belgian and Hungarian Presidencies, “JHA Trio Presidency Programme (January 2010 – June 2011)”, 5008/10, 4 January 2010, available at: <http://www.statewatch.org/news/2010/jan/eu-council-jha-trio-5008-10.pdf>

4. European Commission, Communication, “The EU Internal Security Strategy in Action: Five steps towards a more secure Europe”, COM (2010) 673 final, 22 November 2010, available at: http://ec.europa.eu/commission_2010-2014/malmstrom/archive/internal_security_strategy_in_action_en.pdf

5. Council of the European Union, “The Stockholm Programme: An Open and Secure Europe serving and protecting Citizens”, 5731/10, 3 March 2010, p. 9. Available at: <http://register.consilium.europa.eu/pdf/en/10/st05/st05731.en10.pdf>

6. Council, *op. cit.*, “Draft Internal Security Strategy for the European Union: Towards a European Security Model”

institutions on competence for internal security generally; the framework of Member State / EU institution activity is more precisely delineated and the balance of powers among the EU institutions following the augmentation of the European Parliament's competences by the Lisbon Treaty is beginning to become apparent. That notwithstanding, the new institutional and legislative framework provided by the Treaty of Lisbon has not meant a formal end to the third pillar "way of working and thinking" on issues of security at EU level.

When reading the ISS and the Communication aiming at putting it into action, it appears as if the old third pillar spirit is not only very much present but it is also now contaminating other first pillar areas, such as for instance those of external border controls and migration / asylum policies as well as Frontex. The "depillarization" emerging from the Lisbon Treaty is allowing for the extension of the police and insecurity-led (intergovernmental) approach to spread over the entire EU's AFSJ. This raises concerns over the greater effectiveness, democratic accountability and judicial control as well as rule of law / fundamental rights consequences that the end of the pillar divide in JHA policies was expected to bring.

The former "third pillar" policies are amongst those in the new Title V of the Treaty on the Functioning of the European Union (TFEU) where more exceptions to the general rules have been allowed in European cooperation. This will further enhance the intergovernmental and "police-led" motif of future EU security measures. Not only the maintenance of law and order and the safeguarding of internal security remain exclusively a matter of national competence under the Treaties, but there are a number of derogations from the expansion of the Community method. "Cooperation between police, customs and other specialized law enforcement services in relation to the prevention, detection and investigation of criminal offences" remains under unanimity and consultation with the European Parliament. This goes along with the possibility offered to EU Member States to use "emergency brakes" and / or enhanced cooperation, with the limited jurisdiction of the Court of Justice to review the validity and proportionality of operations carried out by the police and other law-enforcement authorities, and with Protocol 36 on Transitional Provisions.

The Communication putting the ISS into Action

The Commission's position on an EU ISS presented in the Commission Communication "The EU Internal Security Strategy in Action: Five steps towards a more secure Europe" of 22 November 2010, commences with a series of arguments that move in one direction only: first, there is a need for "more security", and secondly the EU27 Member States share a common framework based on convergence of "security threats", which provides the objective framework for a common ISS. These assumptions need to be examined on the basis of the available evidence. One shortcoming of the Communication is a tendency to include assertions about factual matters, which lack any indication of the evidential basis

on which they repose. It is critically important that the EU develops policy on the basis of the best research, analysis and evidence available.

The Commission identifies five key themes which form the pillars of the ISS: 1. disrupt organised crime; 2. prevent terrorism; 3. raise levels of security in cyberspace; 4. strengthen external borders management; and 5. increase EU's resilience to natural disasters. The first question that needs to be addressed is the extent to which these five issues, all of which are concerns for at least some Member States, are concerns for all EU Member States and the extent to which the issues share common aspects in the 27 Member States at all.

Organised Crime

It is apparent that there are very wide differences regarding organised crime across the Member States. The 2009 EU Organised Crime Threat Assessment (OCTA) states that there are five criminal hubs with a wide influence on criminal market dynamics in the EU. These are the North West criminal hub, which acts as a distribution centre for heroin, cocaine and synthetic drugs, but influences the United Kingdom (UK), Ireland, France, Spain, Germany and the Baltic and Scandinavian countries. The South West hub is formed around the Iberian Peninsula and the issues for this hub are cocaine, cannabis, trafficking in human beings and illegal immigration. The North East hub, which borders the Russian Federation and Belarus, engages in human trafficking (women for sex), irregular immigrants, cigarettes, counterfeit goods, synthetic drugs and heroin. The Southern criminal hub is based in Italy, where in addition to drugs and irregular migration, it is involved in genuine and counterfeit cigarettes and the production and distribution of counterfeit euros. The South East criminal hub, centred in Bulgaria and Romania, is involved in drugs, heroin, counterfeit euros and payment card fraud.⁷ What is interesting from this summary, for the purposes of the ISS around organised crime, are the wide differences across the EU, which are evident even in a report designed to highlight synergies and homogeneity in the Union. There is clearly much competition in the field of organised crime and different parts of the EU face very different challenges. Any one-size-fits-all approach to policy is therefore likely to be highly counterproductive.

Terrorism

Turning then to terrorism, there do not appear to be many Member States touched by terrorist acts, and those that are affected appear to be primarily concerned with local terrorism. According to TE-SAT 2010, the EU's Terrorism Situation and Trend Report,⁸ in 2009, six Member States⁹ reported a total of 294 failed, foiled or successfully perpetrated terrorist attacks, and

7. Europol, "Organised Crime Threat Assessment (OCTA)", 2009, pp. 13-15, available at: [http://www.europol.europa.eu/publications/European_Organised_Crime_Threat_Assessment_\(OCTA\)/OCTA2007.pdf](http://www.europol.europa.eu/publications/European_Organised_Crime_Threat_Assessment_(OCTA)/OCTA2007.pdf)

8. Europol, "Terrorism Situation and Trend Report (TE-SAT)", 2010, pp. 6-8, available at: http://www.europol.europa.eu/publications/EU_Terrorism_Situation_and_Trend_Report_TE-SAT/Tesat2010.pdf

9. Austria, France, Greece, Hungary, Italy and Spain

the UK reported 124 attacks in Northern Ireland. Only one “Islamist” attack was reported (in Italy), while France reported 89 Separatist attacks and Spain 148. The next largest category of attacks was under the heading “Left Wing”, with 15 in Greece and 23 in Spain. Clearly, the vast majority of terrorist acts reported in the Member States relate to various separatist groups active primarily in particular parts of the affected Member States. The issues are so intricately related to specific local or national political issues, which are only fully accessible to the national and local authorities, that to call terrorism in the EU a common issue is problematic. Certainly, there is political violence in the EU, but a single common approach is unlikely to capture the specificities of the national and local situations. Further, it is an issue that affects less than a third of the Member States, which raises questions about the appropriateness of EU budgetary expenditure on the subject.

Cybercrime

Data regarding cybercrime are fairly limited. The Commission produced a Communication towards a general policy on the fight against cybercrime in 2007,¹⁰ in which it most helpfully sought to clarify what it is. Most importantly, it covers traditional forms of crime (such as forgery and fraud) carried out over electronic communications networks, the publication of illegal content and crimes to electronic networks such as attacks on information systems, denial of service and hacking. The Commission, rightly, identified the problem as one for the criminal justice systems of the Member States as the issues that hamper coercive action against cybercrime relate to the jurisdictional limitations of criminal justice systems. The Communication also recognizes that by its very nature, cybercrime is not limited to Member States, but may commence on the other side of the world. It can only be classified as crime if the places where it takes place have in their criminal code offences that encompass the activities that some EU Member States consider crimes. The current situation regarding the 2010 WikiLeaks revelations, which are subject to very different legal regimes depending on which country is host to the WikiLeaks activities, highlights the problem.

The EU’s External Borders

According to the Council, there were an estimated 355 million entries by persons into the Schengen area in 2009.¹¹ Of these people entering, about 105 million were third country nationals (approximately 61 million non-visa nationals and the rest visa nationals). According to Frontex, over the first three months of 2010, 14,200 detections of irregular external border crossings were reported.¹² A yearly figure on that basis is 56,800 irregular external border crossings. Further, irregular border crossings in the first three months of 2010 dropped by

36% in comparison with the final quarter of 2009. The disproportionate nature of the two figures – the 61 million third country nationals who enter the Schengen area annually, against the approximately 56,000 people who are treated as entering irregularly most graphically indicates that border crossing by individuals is not a security issue in the EU. It is a matter of trade and tourism, industry and family relations. To the extent that there is a security dimension at all, this is in relation to travel infrastructure. The external border of the EU most properly facilitates the entry and exit of people who seek to enter the EU, whether they are citizens of the Union or third country nationals. The number of people who are treated as inadmissible and thus seeking to enter irregularly is statistically insignificant. In an EU of over 500 million people, there is a real need for a sense of proportion regarding the policy area of irregular migration.

Natural Disasters

Natural disasters are a subject where there is perhaps greater scope for common approaches. The eruption of a volcano in Iceland certainly showed many EU citizens, wherever they were in the world, the need for more consistent and coherent consular protection and assistance in the face of such disasters. The fact that many EU citizens were stranded in far-off countries, were provided highly misleading information by government departments of some Member States, felt abandoned by their authorities, and were unable to access assistance from other Member States’ authorities, leads to the conclusion that we could do much better in this regard.

Conclusions: Towards a European Liberty Strategy

A European ISS must be built on the basis of evidence and analysis of the security interests of the people of Europe as well as the added value and effects of new security policies. It must not be promoted on the basis of a lack of information or a wilful misrepresentation of the available data. Moreover, it may be easy for some parts of the media (and sadly also some EU leaders and politicians) to fan fears about irregular migrations, terrorist threats and organised crime among the people of Europe, but such irresponsible behaviour helps neither EU citizens to understand their world, nor policy-makers to promote sound and measured policy responses.

All five strategic objectives that the Commission Communication proposes as core pillars reveal substantial variations across the Member States whether it regards relevance to some Member States at all, fundamental heterogeneity or insignificance. This challenges assertions referring to a common EU model on internal security. Another issue of concern is that the strategy proposed by the Council and followed up by the Commission is to bring back the old “third pillar” logic of cooperation on JHA and spread it throughout the Freedom, Security and Justice domains, including policies and EU agencies dealing with migration, asylum and borders.

10. European Commission, Communication, “Towards a general policy on the fight against cyber crime”, COM(2007) 267, 22 May 2007, available at: <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2007:0267:FIN:EN:PDF>

11. Council of the European Union, “Note from the Presidency to the Working Party on Frontiers/Mixed Committee”, 13267/09, 22 September 2009

12. FRONTEX, “Irregular immigration hits new low in first quarter of 2010, facilitator detections up 13%”, 7 July 2010, available at: http://www.frontex.europa.eu/newsroom/news_releases/art68.html

The ISS offers little in terms of new ideas or policies towards meeting the challenges that the Union will increasingly face in delivering liberty, justice and security to individuals across the EU. The field of an ISS which touches all Member States and touches a central concern of the people of Europe is the one least developed in the specific actions – promoting the Rule of Law and fundamental rights as the central planks of an EU ISS. By not addressing these elements, the strategy will lead to more insecurity for the individuals subject to these public policy responses.

The next JHA Trio Presidency Programme should give priority to build the EU's ISS around the objective of delivering to everyone living in the EU the twin rights of Rule of Law and protection of Fundamental Rights. The Trio Presidency should call for a solid rule of law and liberty strategy (model) to be jointly devised by the Directorate General of Justice, Citizenship and Fundamental Rights of the Commission, along with the one put forward by Home Affairs. Such a strategy should be not only focus on the development of better (fundamental rights) monitoring and – ex ante and ex post – evaluation of EU policies and their national implementation.¹³ It should also ensure a more integrated cooperation and coordination between EU (freedom) agencies, such as the European Agency for Fundamental Rights (FRA), the European Data Protection Supervisor (EDPS), the European Ombudsman, etc. The FRA should make use of its current (post-Treaty of Lisbon) powers to assess the ISS and it should also see its competences expanded as regards evaluation of EU policies covering police cooperation and criminal justice. All this should go hand-in-hand with the strengthening of the coordination role played by the COSI, and of democratic accountability in activities and cooperation conducted by EU security agencies.

13. See European Commission, Communication, “Strategy for the effective implementation of the Charter of Fundamental Rights by the European Union”, COM(2010) 573 final, 19 October 2010, available at: <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2010:0573:FIN:EN:PDF>

FREEDOM, SECURITY AND JUSTICE

EU's Area of Freedom, Security and Justice: From Post-Lisbon Tactics to EU Citizen-Oriented Strategy

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At the beginning of the year 2010, the European Union (EU) experienced two fundamental changes in its domain of “freedom, security and justice”. Firstly, the Lisbon Treaty has been (finally) ratified and structural changes of the EU regulatory powers in the AFSJ, as defined in the Lisbon Treaty, have started to have effect. Secondly, the five-year Stockholm Programme, establishing the EU's work programme in the AFSJ for 2011-2014, was agreed on, indicating key issues for the EU's medium-term activity.

The two changes mentioned created an institutional environment in the EU that could enable the AFSJ to be the most dynamic area of European integration in the second decade of the 21st century. However, the AFSJ visibility and its profile in the political debate seemed to decrease significantly in 2010; also, the AFSJ agenda received only relative modest attention in the Presidency programmes of 2011-2012.

Several explanations for this (temporary) implosion of the EU's AFSJ agenda can be offered. The most frequent explanation is that key EU decision makers' attention and political energy was consumed by other agendas than AFSJ in 2010 – primarily by the EU institutional debates in the foreign policy domain (for example, the debate on the role of the High Representative, negotiations linked with the establishment of the European External Action Service, discussion about role of the European Parliament in EU foreign policy) and by the response of the EU to the fiscal crisis in several Member States.

Another explanation for the lack of high visibility of the EU's activity in the AFSJ policy in 2010 is the character of the changes brought into the AFSJ by the Lisbon Treaty. The decision making process in the AFSJ has changed since 1 December 2009, both in theory and in practice, albeit without a significant public attention. In particular, the expansion of qualified majority voting to the pre-Lisbon “third pillar” area enabled Member States to overcome the veto power of individual “dissenters”. The European Parliament used its new competences in

the internal security policy domain, including activating its veto power over several international treaties (SWIFT agreement between the EU and the United States) with implications for internal security policy. Moreover, for the first time, the (post-Lisbon) mechanism of flexible cooperation was triggered within the EU and its first application concerned the AFSJ (i.e. EU rules on choice of law applicable to divorces with trans-border element).

At the same time, the EU had to finish the leftovers of the Lisbon Treaty concerning ASFJ. The Lisbon leftovers in this domain are not as vast as in other European integration areas, in particular in the EU's Common Foreign and Security Policy and its Common Security and Defence Policy (CFSP / CSDP), but they still require a significant amount of energy and political bargaining at the EU level. For instance, the European Commission's internal structure had to be adjusted to reflect the division / separation of the AFSJ portfolio between two commissioners – Vivian Reding with responsibility for area of “justice, fundamental rights and citizenship” and Cecilia Malmström in charge with “home affairs” agenda. The Lisbon Treaty also required the European Union to open negotiations on its accession to the European Convention for the Protection of Human Rights and Fundamental Freedoms (ECHR) which might result in an even more complex system of human rights protection in the EU (debated in more detail later).

And finally, with the rejection of Schengen space enlargement to Romania and Bulgaria, even the AFSJ has not escaped the EU's post-Lisbon fatigue – a step properly documented and supported by shortcomings in Schengen rules compliance in both countries, but also a political decision demonstrating a more sceptical and less enthusiastic mood within the core of the EU.

Therefore, concerning the AFSJ, the EU primarily spent its energy on negotiating and settling new inter-institutional rules and norms, a project whose practical implications will be visible only in the long-term perspective¹. The risks of giving excessive attention to inter-institutional tuning can clearly be demonstrated by studying the adoption process of the first post-Lisbon Directive in the area of criminal law: the Directive on the rights to interpretation and translation in criminal proceeding.² The original proposal of the framework decision on the right to interpretation and to translation was presented by the European Commission in July 2009, but the final version of the document had not been agreed on before 1 December 2009, when the Lisbon Treaty (with its new rules on EU legislative procedure) entered into force. Therefore, the Swedish Presidency called for Member States' proposals on a Directive on the right to translation and interpretation, which was submitted by 13 Member States in December 2009. Regardless of the fact that the new proposal was substantively identical to the older framework decision proposal, and in spite of Member States' objections, the Commission submitted its own proposal, slightly different and more ambitious than the Member States'

proposal, in February 2010. The European Parliament was then confronted with two similar proposals of a legislative document with the same objective. The European Parliament opted for using the Member States' proposal as the key document for further legislative bargaining and the Directive has been finally adopted in October 2010 (as the first legislative instrument in the criminal law domain to be adopted according to Lisbon Treaty rules). The Directive itself is generally interpreted as a success and as an improvement of procedural guarantees in the EU, but it was also described as an unnecessary exercise of inter-institutional muscle-stretching and of “marking of the territory” by the EU's actors in the field of criminal law.³

As the post-Lisbon leftovers and inter-institutional tuning are gradually being settled, one can, with a relative high level of confidence, predict that both the legislative and non-legislative activities of the EU will expand in the following years. In addition to this, the new post-Lisbon systemic features regarding the EU's activity in the AFSJ – such as the shift towards qualified majority voting in the Council when individual Member States lose their veto power, direct application of certain categories of EU legal norms, the EU Court's new powers concerning review, interpretation and enforcement of the AFSJ's legal norms, and the simplified conclusion and ratification of international agreements by the EU, all have the capacity to increase the direct impact of AFSJ rules on the lives of EU citizens, and thus increase their awareness of the EU's new source of regulation in the internal security domain.

Hence, the “consolidation” and “enhancement” of post-Lisbon AFSJ activity also creates new challenges for the EU.

The EU's AFSJ actions have a high potential to both increase the positive perception of the EU as well as to simply endanger the legitimacy of the EU's actions – an example from the pre-Lisbon EU was the excessive interpretation of the EU-based *ne bis in idem* principle, which was interpreted, from perspectives of Member States with slower and / or more punitive system of criminal justice, as a “European Union” measure preventing them from efficiently and legitimately punishing offenders who have already been sentenced or acquitted for the same delict by another EU state⁴.

Therefore, the post-Lisbon EU must give increased attention to “explaining” its activities within the AFSJ to its citizens – with the objective to both prevent fears that the European Union hijacks Member States' legitimate interests in the AFSJ and to avoid excessive expectations from the EU's action. The human rights agenda provides an illustrative demonstration of this task.

1. It also should be mentioned that the EU's key post-Lisbon instrument for criminal law harmonisation is the Directive, whose implementation period shall expire only several years after adoption at the EU level

2. European Commission, Decision, “On the adequacy of the competent authorities of certain third countries”, 2010/64/EU, 5 February 2010, available at: <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2010:035:0015:0017:EN:PDF>

3. Steven Cras and Luca de Matteis, “The Directive on the Right to Interpretation and Translation in Criminal Proceedings – Genesis and Description”, EUCRIM – *The European Criminal Law Associations' Forum*, March 2010, p. 161, available at: http://ec.europa.eu/anti_fraud/publications/agon/eucriim_2010-4.pdf

4. For broader debate on the *ne bis in idem* principle in the EU law, see Eleanor Sharpston and José María Fernández-Martín, “Some Reflections on Schengen Free Movement Rights and the Principle of *Ne Bis In Idem*”, Catherine Barnard (ed.), *The Cambridge Yearbook of European Legal Studies*, 2007-2008, Volume 10, Oxford: Hart Publishing, 2008

The Lisbon Treaty provides a very complicated system of human rights guarantees in the European Union. Firstly, the Charter of Fundamental Rights of the European Union (EU Charter) has become an integral part of the EU's legal system. Secondly, the EU's Court continues to use human rights based argumentation in its jurisprudence. Moreover, the EU plans to adjoin the system of the ECHR and to directly⁵ subject itself to the jurisdiction of the European Court of Human Rights in Strasbourg. When fully implemented, the planned human rights structure will be extremely complex, less predictable and very difficult to navigate.

The EU's accession to the ECHR is a complicated technical exercise both in the phase of negotiating the conditions of the EU's accession – representation of the EU in the European Court of Human Rights, the mechanism of the EU's representation in proceedings before the ECHR, definition of the exhaustion of other judicial remedies before the start of the procedure at the European level, relevance of reservations of Member States to individual clauses of the ECHR and to opt-outs from the EU Charter of Fundamental rights, issue of concurrent complaints against the EU and the respective Member State – and in the phase of ratification of the new treaty in all states of the Council of Europe. However, the technicalities of the accession process should not over-shadow the importance of the message this process sends to EU citizens, and the risk of deformation thereof. The outcome of the EU's accession to the ECHR will inevitably result in an extremely complicated system without a direct and straightforward judicial pathway towards the European Court for Human Rights. The “openness” of the final system will be influenced, among others, by the (un)willingness of the Court of Justice of the European Union to hear cases filed by the unprivileged applicants and by the (un)readiness of the European Court of Human Rights to prefer complaints against Member States, instead of complaints against the European Union, in cases where the EU general rules were implemented and applied in concrete cases by the Member States. Even such a scenario can be imagined where major beneficiaries of the EU's accession to the ECHR will be companies and individuals in competition cases and disputes about access to EU documents.

This (potential) ambivalence of the EU's accession to the ECHR should be explained to the public. The message from the EU should clarify that the EU's accession to the ECHR shall not be a panacea for human rights violations within the EU, but only one piece within broader system.

Concluding, the major tasks for the forthcoming Trio Presidency in the Area of freedom, security and justice is not only to tackle the subtleties of the Lisbon institutional leftovers and to start a process of adopting an impressive catalogue of legal norms in the internal security area, but also to intensely and systematically communicate EU actions to EU citizens and to explain that EU actions are often only a segment of a more complex and multilateral international regime.

5. The EU Court is already “indirectly” subject to the jurisdiction of the European Court for Human Rights via the Strasbourg's Court jurisdiction over actions of Member States implementing EU rules. The European Court for Human Rights already ruled on the compatibility with the ECHR in cases when EU states applied the EU's rules on the elections to the European parliament (Matthews v. UK), sanctions against Yugoslavia (Bosphorus v. Ireland) and the union rules on asylum (M.S.S v. Belgium and Greece)

The Contribution
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Trio Presidency of
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ENLARGEMENT AND NEIGHBOURHOOD

The European Union (EU) needs to be an effective global actor, if only because the well being, security and quality of life of Europeans depends on external developments. In order for the EU to become an influential actor, the next Trio Presidency should make sure that external policies are given sufficient funds in the next Multiannual Financial Framework (MFF). But funds are just the means to the EU's ends. What is even more crucial to the EU's ability to shape world events is a good strategy – and in the domain of Trio competencies, this means working with Russia on energy security, while intensifying the EU's Neighbourhood Policy (ENP) writ large (GKI).

PART V ABSTRACT

Favourable medium-term growth-prospects should allow for an enhanced EU role in global governance. Hoping that this occurs, the Trio Presidency can take preparatory steps: it can seek to give Member States, small and large, a stronger voice during G20 preparations; it can also plan to couple future economic recovery with mega-regional development and environmental protection projects, such as the Danube Region Strategy and Baltic Sea Strategy (GKI).

In the short-term, however, the European Union's soft power is ebbing. In order to reaffirm its influence, the EU needs to reevaluate not only what it hopes to get from its neighbours, but also what it can offer them. Regarding the ENP, this sort of appraisal is currently underway – but the same needs to be done in relation to (prospective) candidate countries.

For example, two authors below believe the EU losing leverage in Turkey, where the accession process is dormant. The reasons for this lull are varied and complex: contentious issues include the role of Turkey's military, questions surrounding Turkish Kurds and poor relations with Cyprus (CCEIA). So far, the Cyprus issue remains the most serious obstacle to Turkey's membership. Turkey does not recognise the Republic of Cyprus and continues to occupy a substantial part of the island's territory. Likewise, Turkey is reluctant to implement obligations undertaken in relation to the Additional Protocol to the Ankara Agreement. Some authors below argue that Turkey's policies indicate an ambiguous commitment to adopt the EU's value system (CCEIA).

In addition to those that feel Turkey's accession would threaten the identity of the EU and negate the potential for political integration, others in the EU believe

Turkey's accession would reduce tensions between the East and the West and would help integrate Muslim communities. Furthermore, it is also argued that Turkey's Europeanisation is important in itself.

Going beyond these intra-EU concerns, one author below argues that the EU should take Turkey's geopolitical power into consideration (ECFR). Turkey's foreign policy is changing from an insular approach, which dates back to the 1920s, to a leadership approach, which is mainly fostered via political engagement in its neighbourhood. Turkey currently pursues an activist foreign policy that is based on three pillars: mediating in regional hotspots, acting as a catalyst for economic integration, and projecting a model for political and socioeconomic development. According to the author, Turkey's record in the former pillar is relatively poor, but is more positive in the latter two. Specifically, the paper argues that Turkey has gained considerable credibility as a model for political and socioeconomic development in the Islamic world (ECFR). Given the importance of Turkey and its rising role in the Middle East, the EU should engage with Turkey more meaningfully and propose a parallel track for strategic dialogue on regional issues of common concern (ECFR).

The EU's influence in Eastern Europe and the Southern Caucasus – considered as the EU's Eastern Neighbourhood – is also waning. The entire region is not making the top of the EU's foreign policy agenda. As said above, this is mostly the consequence of a lack of consensus in the EU on two crucial issues: relations with Russia and the question of membership (demosEUROPA / EPC). Tougher Member-State attitudes regarding enlargement are putting the credibility the European Union's (EU) policies at risk – consequently, (potential) candidates are not delivering on their pledges. Furthermore, the EU's post-Lisbon institutional set-up raises coherence issues. Yet, the Eastern Neighbourhood is not only extremely important as a bridge with the Middle East and Central Asia, but it is also a crucial transit route for energy supplies. In view of the EU's waning leverage, authors below argue that conditionality should be at the forefront of all policies (Europeum / DIIS).

The EU started to engage with Eastern Europe in the second half of the 2000s, as reflected in programmes and initiatives such as the ENP and the Eastern Partnership (EaP). Overall, there are four areas of action in the area: effective financial commitments, developing relations with civil society, linking mobility and visa liberalisation with reform, and confidence building measures in dealing with security issues and frozen conflicts. Democratisation and stability in some countries are tightly linked to the EU's policy toward them. In Ukraine, Georgia and Moldova stabilisation is linked to democratisation, which has little chance of success without support from the EU. The impact of EU policies in terms of Europeanisation in the region has been modest. The EU is reluctant to

digest the Eastern neighbourhood and at the same time fears their exclusion and destabilisation (demosEUROPA / EPC).

More importantly, as mentioned above, the EU has yet to fine tune its institutional approach, notably because of Lisbon Treaty changes. When the EU's numerous institutional actors bargain with differing wagers, neighbouring countries find themselves faced with conflicting quid-pro-quo. Stagnating reforms in Kosovo and Bosnia and Herzegovina (BiH) are the best examples of this. The problem in Kosovo is a lack of EU unity over the country's recognition, whilst in BiH, lack of progress is mainly the result of the ethno-territorial organisation of the state, where constituent nations have the right of veto in case of vital national interest. This blocks EU reforms. The most urgent issue is constitutional reform and the next Trio Presidency should focus on discussing such constitutional change. BiH is divided not only politically, but also legally. According to authors below, the Trio Presidency should push for a Supreme Court, which would contribute to the creation of a single legal framework. They also feel the EU should take more decisive steps in the fight against corruption, namely by supporting the capacity of state-level agencies to carry out their tasks (Europeum / DIIS).

The Southern Mediterranean rim has also been characterised by a lack of political and economic progress, but recent events change the status quo. The transition under way in many Arab countries, from authoritarian regimes to more participative systems, is filled with uncertainties and generates fears across Europe on the potential threats and risks that might arise. The fall of Zine El Abidine Ben Ali in Tunisia and Hosni Sayyid Mubarak in Egypt – not to mention current event in Libya – will all require a major change in Euro-Mediterranean relations (Real Instituto Elcano). According to authors below, in the past, Euro-Mediterranean cooperation has been subject to the ups and downs of regional conflicts, particularly the Israeli-Palestinian conflict. No substantial progress was made in bilateral terms. Currently, the EU faces the challenge of redefining its Mediterranean policy and a review process has been initiated in this regard by High Representative Catherine Ashton (Real Instituto Elcano). When it takes charge, the Trio Presidency will find a complex landscape in the Union's Southern neighbourhood. In this context, the authors below argue that the EU should refocus on the objectives of the Barcelona spirit of 1995. According to the authors, the EU should abandon its previous policy of securitisation, commit more resources, apply conditionality more effectively, launch agricultural liberalisation, engage civil societies, and facilitate the movement of people where adequate progress in democratic transition has occurred (Real Instituto Elcano).



ENLARGEMENT AND NEIGHBOURHOOD

The EU Enlargement to the Western Balkans: Time to Put Conditionality First Again

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Enlargement after the Lisbon Treaty: a risk of incoherence

The coming into force of the Lisbon Treaty brought some changes in the enlargement area. As a policy, it remains under the Commission's competence, while all the enlargement issues are now dealt with the General Affairs Council (GAC). This is still chaired by the rotating presidency and subject to unanimity decisions on all enlargement issues. However, in European Union (EU) terms, there is a distinction between countries that are already negotiating and those which only enjoy accession perspectives. The Council working group on enlargement (COELA) currently deals with Turkey, Iceland and Croatia. The remaining countries with accession perspectives are dealt with by the working group on the Western Balkans (COWEB).¹ The Stabilisation and Associations process (SAP) and the status of Kosovo, etc., are considered a part of EU external relations and foreign policy and thus handled by the Foreign Affairs Council, which is chaired by Vice-President of the European Commission / High Representative of the Union for Foreign Affairs and Security Policy Catherine Ashton. This means that the role of the rotating presidency is limited to the negotiations in the COELA, which mainly decides on the closing and opening of chapters.

The actual effects of the new institutional set-up remain to be seen. However, due to the different chairmanships of the two Council working-groups, and due to the parallel presence

1. Bosnia and Herzegovina, Serbia, Montenegro, Kosovo, Macedonia and Albania

of geographical desks at the European External Action Service (EEAS) and the responsible offices in the Directorate-General (DG) for Enlargement at the Commission, the situation does raise coherence issues. The initial intention of the Lisbon Treaty, to simplify the EU's relations with the rest of the world in general and the Western Balkans specifically, has been obscured.

Credibility of the enlargement process: a triple challenge

The credibility of future enlargement is more at risk than ever. This lack of credibility concerns all three major actors: EU members, the European Commission and candidate or potential candidate countries.

The somewhat flawed accession process of Bulgaria and Romania has led to tougher positions among Member States in the Council. This is reflected, *inter alia*, in a higher number of negotiating chapters or in a stricter negotiating framework allowing for suspension of negotiations. Although bilateral disputes have always featured in the accession negotiations, never before were they used to block the accession negotiations as much as we have witnessed recently. The internal problems in many of the Member States, coupled with the outcomes of the serious debt crisis in several EU members has also led to a generally lukewarm attitude towards enlargement. Nowadays, there is not a single EU leader strongly in favour of continued expansion. Thus the political impetus of the policy is largely lost. Although granting Montenegro candidate status in December 2010 as well as substantial progress in negotiations with Croatia can be judged positively, this illustrates that Member States can move forward on non-controversial issues while more sensitive ones (Kosovo, Turkey) are intentionally left off the agenda.

The Commission has consistently reiterated emphasis on conditionality, most recently in its 2010 Enlargement Strategy. This worked quite well in the case of visa liberalisation for the Western Balkans. The Commission reflected on this positive experience in order to produce a set of more tangible criteria in order for Montenegro and Albania to be able to open accession negotiations. However, the Commission's insistence on conditionality is still largely dependent on the room for manoeuvre left to it by the Member States. This can be illustrated with the example of Macedonia, where the start of accession negotiations was blocked despite the Commission's positive opinion, or with Kosovo, where the Commission is held back by non-recognising Member States.

Morover, the candidate countries also bear part of responsibility for the diminished credibility of the enlargement process. They often send negative signals towards the EU – for example, concerning elections in Albania or Kosovo, or by not delivering on pledges to the EU (especially in case of Bosnia, or the inability to apprehend General Ratko Mladić in case of Serbia). Although the population of all the countries in the region is highly supportive of

European integration, the political elites often prefer particular interests, at the expense of putting this ambition at the top of their agenda.

Diminished credibility I: Kosovo

The EU perspective for Kosovo has seen perhaps the most disappointing change in the region. Despite persistent reassurances from Brussels, the gap between the country and the rest of the region is widening. The main problem is lack of unity over the country's recognition, which prevents the EU from placing contractual relations with Kosovo on a new footing and enabling it to participate fully in the Stabilisation and Association Process (SAP). Having to balance various restrictions on which Member States insist, the Commission cannot move forward on any technical agendas. The EU did not use the momentum produced by the International Court of Justice's (ICJ) advisory opinion on the declaration of Kosovo's independence. This would have allowed the EU to engage with non-recognising Member States and thus search for viable ways to respond to this new reality. Despite the EU's readiness to facilitate dialogue between Pristina and Belgrade (reflected in a joint EU-Serbia declaration, which was also adopted by the United Nations General Assembly), there is little excitement in Pristina about the dialogue. Firstly, recent political developments mean that Pristina could remain paralysed with a weak or caretaker government, and the possibility of early elections ensures that dialogue with Serbia does not top Kosovo's political agenda. Secondly, if the feeling prevails that the dialogue is solely an EU-Serbia endeavour where Kosovo authorities are not invited to shape its agenda, priorities and expected results, then the likelihood that Pristina will be ready to engage fully in such dialogue diminishes substantially. At the moment, the EU's political agenda with regard to Kosovo has become limited to the prospect of launching the dialogue that could become a way of overcoming its own stalemate regarding status. However, it is somewhat naïve to believe that Serbia and Kosovo will be able to solve the conflicting issues in the framework of the dialogue, while the EU has not been able to address them, despite its strong involvement on the ground (for example, through the EU Special Representative (EUSR), the EU Rule of Law Mission (EULEX) or the European Commission Liaison Office).

After Albania and Bosnia and Herzegovina were granted a visa-free regime with the EU in December 2010, Kosovo is now in isolation in the region. In Kosovo's case, not only has the EU failed to propose a roadmap setting forth technical conditions to be fulfilled, but the Member States' consular practices regarding issuing visas to passport-holders remain strikingly different, with some Member States not issuing Schengen visas at all. The first step for which the next Trio Presidency should aim is to unify the Schengen-visa procedure for passport-holders from Kosovo. After this, the next logical step is to set the list of technical conditions necessary for a visa liberalisation dialogue, and once these are met, to set a clear timeframe for such a dialogue. The example given by other countries of the region has shown that if there is a timeframe and a clear list of technical requirements, conditionality can work. The EU needs to take these steps *vis-à-vis* Kosovo as well.

Diminished credibility II: Bosnia and Herzegovina

Bosnia and Herzegovina (BiH) can serve as another prime example of the EU's reduced conditionality in the enlargement process. The EU has in the past clearly chosen the country's stability over support for democratisation and EU-inspired reforms, succumbing to threats by various Bosnian political representatives to destabilise the country (particularly those from Republika Srpska). Yet, the visa liberalisation process has proved that when the Road Map conditions are clearly tabled as non-negotiable, conditionality can work.

This, unfortunately, does not apply to other areas of EU-Bosnia relations. The 2010 Progress Report is considered to be the worst ever, with little or no progress at all in almost all the areas (except for the aforementioned visa liberalisation), meaning that the country has fallen behind its neighbours in progress towards the EU. The lack of progress can be explained, *inter alia*, by the complicated ethno-territorial organisation of the state and the abuse of the constituent nations' right of veto in cases of "vital national interest". This not only blocks the EU-conditioned reforms, but also generates a nationalist and exclusivist political environment and a blockage of decision-making. Constitutional reform is thus the most urgent issue, particularly with regard to the need to reduce the predominance of collective rights (vested in constituent nations) over individual rights. The Bosnian Constitution is in breach of the European Convention on Human Rights as well as previous rulings of the Constitutional Court of BiH.² The incoming Trio Presidency should thus focus on discussing constitutional changes, and not simply concerning political representation. There is also a need to lead a wide public debate, involving experts and non-governmental organisations, and taking inspiration from the Venice Commission reports on the BiH Constitution and from European Parliament resolutions.

Likewise, the Trio Presidency should push for the establishment of a Supreme Court of BiH, which would contribute to the creation of a single legal framework. Bosnia is divided not only politically, but also legally, with different incompatible laws and regulations among the administrative units and the state. Among other things, this hampers the emergence of a single economic market.

Similarly, the EU must take decisive steps to press for a more efficient fight against corruption in BiH, which is a serious problem undermining the functioning of the state. Compared to lower-level agencies, which are often politically controlled and the independence of which is questionable, the state-level law enforcement agencies (such as BiH State Prosecution or BiH's State Investigation and Protection Agency) have a fairly good track record in prosecuting and investigating organised crime and corruption. Thus, the EU must support the

capacity of state-level BiH agencies to carry out its tasks, with political support, technical and logistical assistance and training. It must reject firmly some Bosnian politicians' calls for the abolishment of such agencies or any attempts to weaken them – unlike in 2009, when EU representatives agreed with the termination of international judges' and prosecutors' mandates at the Court of BiH, all of whom were involved in investigating corruption.

Also, the EU should be more cautious in judging progress in regional cooperation. It praised the recent rapprochement between President Ivo Josipović of Croatia and President Boris Tadić of Serbia in the case of their regional cooperation initiative. But, it did not take note of the marginal involvement of the Presidency of BiH in this endeavour, nor the leaders' interventions in the internal affairs of BiH – such as Tadić' unconditional support for President Milorad Dodik of Republika Srpska or Josipović' recent interference with coalition-building talks in Sarajevo.

Conclusion

Conditionality is a central part of EU's enlargement policies and its long-term credibility is key to the EU's success in transforming countries in the EU's neighbourhood. When the objective opinion of the Commission is overruled by bilateral disputes or security-related concerns in the Council, the credibility of conditionality as an instrument decreases dramatically. The same holds true in the opposite case – when an accession country is being rewarded without actual compliance, this has a negative impact on the reforms needed to join the EU. In the coming period, the Trio Presidency should make it a priority to put conditionality first again.

Top recommendations to the EU:

1. To avoid sending mixed signals and to ensure coherence in the enlargement process, clarify the division of responsibilities between EEAS and DG Enlargement in relation to potential candidate countries (not yet in the process of accession negotiations).
2. Create a framework for the settlement of bilateral disputes so that they cannot be used to block the entire negotiation process (including unrelated chapters), for instance by creating a special negotiating chapter dealing with neighbourly relations.
3. To renew the credibility of the accession process, introduce clear and tangible criteria that must be met in order to proceed to the next stage of the accession process – such as the criteria for the opening of accession negotiations with Montenegro and Albania set forth in the Commission's opinion in 2010.
4. The EU should stand firm on its previous conditions such as full cooperation with the International Criminal Tribunal for the former Yugoslavia (ICTY) and continue to support the promotion of human rights and the process of reconciliation.

2. Case U 5/98 III, Issue of the "Constituent Peoples", Constitutional Court of Bosnia and Herzegovina, *Official Gazette of BiH*, No. 23/00, 1 July 2000, available at: http://www.ccbh.ba/public/down/Bulletin%202005_english.pdf

5. In relation to Kosovo, the EU should provide a clear list of technical conditions that must be met in order for the visa liberalisation dialogue to begin. Once these criteria are met, the EU needs to set a clear timeframe for such dialogue. In the meantime, the EU should harmonise the Schengen visa procedures for passport-holders from Kosovo.
6. The dialogue between Kosovo and Serbia should be placed in a clear timeframe with a specific agenda, which should be compiled by active contribution of both parties to the dialogue. New issues that might arise between Belgrade and Pristina should not be added on an *ad hoc* basis to this agenda, but dealt with separately, should they arise. Also, possible lack of progress in the Kosovo-Serbia dialogue should not be used as a pretext for impeding Kosovo's progress on other issues, such as SAP or visa liberalisation.
7. The EU must insist on swift constitutional reform in BiH in order to bring it into compliance with the ECHR and pave the way to more democratic and efficient decision-making, based on civic rather than national or ethnic principles.
8. The EU should support the creation of a Supreme Court of BiH, which would contribute to the creation of a single legal framework across Bosnia and thus strengthen state-level governance and law enforcement.
9. The EU should support the efforts of state-level agencies in BiH dealing with the fight against organised crime and corruption by providing them with political support, technical and logistical assistance and training.

ENLARGEMENT AND NEIGHBOURHOOD

EU Integration and the Prospect of further Enlargement: The Case of Turkey

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Despite the fact that it has been over five years since the European Union (EU) and Turkey started accession negotiations, this remains a major issue of intense debate and controversy across Europe. With the bulk of the negotiations chapters blocked by the EU, the prospect of Turkey's accession is uncertain. Turkey considers accession to the EU as a strategic objective. Yet, it does not appear that Ankara fully appreciates what is required in order to become a member of the EU. Turkey seems to be pursuing an *à la carte* policy in relation to the multi-dimensional challenges that it has to address (such as respect for basic freedoms, the Cyprus problem, the Kurdish issue and the role of the army, among many others). This paper briefly assesses the prospects for a potential EU enlargement involving Turkey.

Within this framework, a number of issues are addressed: (a) the philosophical approaches in relation to Turkey's potential accession, (b) the wider debate concerning the kind of Europe that existing members would like to see, as well as (c) the practical problems faced in relation to Turkey's accession process. In this context, key questions are raised as to the extent to which the problems encountered, as well as the intense debate on the issue of Turkey, threaten to derail this country's accession course. The broader philosophical debate in relation to the future of Europe and Turkey's commitments are also assessed.

Historical background

For over half a century, the EU (and its predecessor, the European Economic Community) has been pursuing, in a broad spectrum of policy areas, ever-deeper integration through closer cooperation among its members. At the same time, this integration process has come to involve more Member States through successive enlargements. The two processes (deepening and widening) have often moved in parallel, without cancelling each other out.

Instead, with the aim of advancing peace and economic prosperity, as well as consolidating democracy and the rule of law, the EU has hoped that the two processes would foster one another by creating an ever-growing and continuously deepening cooperation among neighbouring countries that share the same principles and values. At the same time, it was expected that these countries would also foster solidarity and enhance tolerance.

Since the 2004 enlargement, the EU has turned its attention to South Eastern Europe. More specifically, the states most likely to be involved in future enlargement waves are: Albania, Bosnia and Herzegovina, Croatia, Kosovo under United Nations (UN) Security Council Resolution 1244, the Former Yugoslav Republic of Macedonia, Montenegro, Serbia, and Turkey. The European Commission believes that if and when these countries meet all the requirements of EU membership (Copenhagen Criteria and other obligations) this will benefit all parties involved.

The challenge of enlargement and the case of Turkey

EU enlargement and Turkey: understanding the key issues and debates

In relation to Turkey, the situation is complicated by a number of issues: these include the size of its population, its socioeconomic structure, the Kurdish problem, the Cyprus question, media freedom, religious rights, the military's role, etc. So far, the process has moved at a very slow pace, often reaching points of stagnation. Despite the fact that Turkey has been a candidate country for EU membership since 1999 (Helsinki European Council), accession negotiations were not launched until October 2005, following the screening process. At the same time, Turkey's failure to implement the Additional Protocol to the Ankara Agreement with respect to the Republic of Cyprus, led to the Council to decide in December 2006 that eight relevant chapters of the *acquis* (Free Movement of Goods, Right of Establishment and Freedom to Provide Services, Financial Services, Agriculture and Rural Development, Fisheries, Transport Policy, Customs Union and External Relations) would not be opened, while no chapter would be provisionally closed until Turkey fulfils its commitment and opens its ports and airports to ships and planes from the Republic of Cyprus. One of the most important chapters, that of Energy, which could carry significant benefits for both Turkey and the EU, has been all but frozen, as Turkey (also) questions the sovereign right of the Republic of Cyprus to exploit its recently discovered natural gas reserves. Overall, since October 2005, the EU has provisionally closed only one chapter of the *acquis* and opened negotiations on another 12 chapters.

Philosophical approaches to Turkey's potential EU accession

There are arguably three philosophical approaches in relation to the potential accession of Turkey to the EU. These can be summarised as follows:

- Turkey's accession to the EU would contribute to a better understanding between the West and the Islamic world. This would also facilitate the integration of Muslim communities and immigrants into European societies. Furthermore, it would ease tensions between the East and the West and contribute to the economic and demographic rejuvenation of the EU. Besides, it is argued, there have been promises and commitments to Turkey that cannot be revoked.
- Turkey does not really belong to Europe, either politically or culturally. If Turkey accedes to the EU, it could seriously challenge the identity of the Union and may compromise its ambitions, as well as its political culture and the prospects for its political integration. The EU cannot absorb Turkey. If the latter becomes a member of the Union, then the potential for political integration, even in the long run, is likely to be frustrated.
- It is more important to keep Turkey on the track of further modernisation and Europeanisation. The challenging question of whether Turkey should become a member of the EU does not have to be addressed at this instant. The possibility of the Turkish accession should be kept open. If Turkey fulfils the necessary criteria, it would be unfair to keep this country out. If it does not, then it would be unwise to adopt a shorter yardstick in order to make Turkey a member. Under these conditions, a special relationship could be discussed.

Unquestionably, these challenges involving the future of Europe and Turkey preoccupy politicians, academics and policy analysts, as well as the mass media and public opinion at large. It will take some time before a clear and definite path is charted. Clearly, the EU finds itself in a very difficult situation: on the one hand, there are principles and norms that cannot be violated, and on the other, there are serious issues *vis-à-vis* Turkey that must be addressed.

Which Europe? Three possible scenarios for future integration

Different perspectives among Member States over the shape and direction of Europe are commonplace, as the Union faces today both historical as well as political dilemmas in relation to its future. There are three possible scenarios that different countries within the EU as well as various national political groups are currently contemplating:

1. The first school of thought believes in an ever-deepening integration process that would further strengthen the structure and institutions of the Union. This camp would like to see a more efficient, effective and democratic organisation, which would be in a position to bridge its deficits. Furthermore, it is stressed that the EU should have an enhanced international role. This scenario promotes a more integrated system of governance within a Union that would be able to determine its own common foreign security and defence policy. This prospect may very well lead to a federal union that would foster greater solidarity among its citizens. The possibility of gaining a voice in the UN Security Council could further elevate the Union's international position.

2. The second school of thought mostly reflects the British perspective. This emphasises an even more enlarged EU, which would include both Turkey and the Balkan countries, as well as former Soviet states, such as Ukraine and Georgia. This Atlanticist vision centres on the idea of an enlarged economic union with loose political relations among Member States. The latter would thus be in a position to opt in or out of policy areas. As far as foreign, security and defence policies are concerned, this group pays particular attention to the role of Washington and the North Atlantic Treaty Organisation (NATO).
3. The third school of thought concerns the scenario of a multi-speed Europe. At the core of this new Europe would be the countries wishing to form a politically united Europe, while the rest would engage in various forms of cooperation. The idea of countries integrating at different levels could be a plausible scenario, as variable geometry could allow countries like Turkey to join the EU's ranks. It should be noted that although this model was not seriously considered until now, today's reality is that the EU does not move in a uniform manner.

It is important for the EU to be able to specify its current vision and pursue it successfully, while overcoming important controversies among its members regarding the course and shape of future integration.

The challenges for Turkey today

The Cyprus question remains a serious obstacle on Turkey's accession path. Turkey does not recognise the Republic of Cyprus and continues to occupy (since the summer of 1974) almost 40% of its territory. Even though (with the reserved consent of Cyprus), the EU started accession negotiations with Turkey in October 2005, Ankara still seems to be reluctant to implement even the minimal obligations undertaken in relation to Cyprus (and by extension the EU), which derive specifically from the Ankara Protocol and from European political culture in general. This behaviour may be indicative of attitudes in Turkey – attitudes which seem to address these obligations in an *à la carte* manner. Perhaps the strong support that Turkey has been receiving from various countries has encouraged this policy pattern. Nevertheless, as already mentioned, in December 2006 the European Council froze eight chapters for Turkey.

Apart from Cyprus, however, Turkey has yet to address several other challenges. These include additional reforms for a modern legal framework, economic transformation, the Kurdish issue, claims in the Aegean, religious rights, the Armenian genocide, the alleged “re-islamisation” of the state under the Erdogan government, the (supreme) role of the army, women's rights, media freedoms and respect for basic freedoms more generally. Several EU countries – such as France, Austria, The Netherlands, Germany, Greece and Cyprus – have particular sensitivities to all these issues. The question of the EU's vision for the future is also key in this regards.

Furthermore, one of Turkey's major characteristics is its high degree of statism, which also assumes a supreme role for the army; this contradicts the European value system. It should also be noted that the Turkish establishment internally promotes the consolidation of one identity and pursues an assimilationist approach – which makes several ethnic and religious minorities feel suffocated. Yet, Ankara tends to encourage Turkish-speaking people residing outside Turkey to maintain their Turkishness even at the expense of not integrating into the society of the country in which they live. This has been causing serious problems across several societies. Thus, Cyprus is not the only country where Turkish demands – if implemented – would lead to a deeply segregated society. This attitude and practice recently prompted Chancellor Angela Merkel to claim that the multicultural model had not worked in Germany.

Euro-Turkish relations constitute a major issue in both European and international affairs. No doubt the further democratisation and modernisation of Turkey would contribute to the enhancement of stability, security and cooperation in the broader region. Yet, Turkey has not seemed to be willing to fully comply with the prerequisites of becoming a full member of the EU, and its policies do not demonstrate an unambiguous commitment to adopting the value system of the EU. Similarly, it is doubtful whether the EU can eventually absorb Turkey without changing direction, purpose and philosophy. This is the major reason underlying advocacy by Germany and France for a special relationship between the EU and Turkey.

Even though the Commission's 2010 Progress Report on Turkey refers to positive steps taken in the country – such as the improvement of fundamental rights, the continuation of judicial reform and the lifting of restrictions on broadcasting in languages other than Turkish, it also raises concerns about Turkey's difficulties in guaranteeing basic freedoms. Clearly, Turkey must introduce further reforms in order to protect freedom of the press, speech and religion. It must also protect women's and minority rights, conscientious objectors from imprisonment and reduce the role of the army, amongst other things. At the same time, it must implement the EU-Turkey Association Agreement's Additional Protocol in full (thus including the Republic of Cyprus). Moreover, it must withdraw its occupation troops from the northern part of Cyprus and respect the independence and territorial integrity of the island-state. This would also facilitate the solution of the Cyprus question. Indeed, if we take into consideration the recent demonstrations of Turkish Cypriots against Turkey, there is no doubt that if Ankara ends its occupation, the Cyprus question would be soon resolved.

Concluding remarks

Euro-Turkish relations constitute a vital challenge as well as an issue of international concern. The strengthening of the EU and its further integration are major aspirations. At the same time, however, the further modernisation and democratisation of Turkey also remain fundamental objectives. An important aim would be to accommodate all these objectives.

Turkey's European path necessitates the fulfilment of serious obligations. Major internal reforms need to be made. Adopting, and above all implementing, new legislation is essential. The country should also seek to address its relations with other states in a conclusive manner. Turkey has so far expected other countries to adjust to its own demands without itself displaying the political will to move forward. If Turkey is indeed serious about its democratisation and European orientation, it must eventually choose to leave behind its maximalist designs on Cyprus and see it as an equal partner in the EU.

Perhaps one of the major issues that needs to be studied further is the likely outcome of a decision for a special relationship between the EU and Turkey on Cyprus. Such a decision may be reached either by the EU, or by Turkey, or by both. In view of the fact that, to a great extent in the last few years, the strategy in relation to promoting a resolution to the Cyprus question depended (particularly in recent years) on the assumption that Turkey will eventually join the EU, this matter should be revisited.

Nonetheless, it is widely acknowledged that the further democratisation and modernisation of Turkey will serve multiple objectives. Turkey must have a fair chance for accession to the EU. But, Turkey's Europeanisation process involves obligations that cannot be compromised. Turkey should take note of this and act accordingly. If, however, Ankara believes that eventually its interests would be better served by a special relationship than that is a possibility that would need to be examined and acted upon accordingly.

ENLARGEMENT AND NEIGHBOURHOOD

Turkey and the EU: Time to Break the Stalemate

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On 1 February 2011, as mass protests swept through Cairo, Alexandria and Egypt's other large cities, Turkey's Prime Minister Recep Tayyip Erdoğan broadcasted a speech on the waves of the NTV channel. Unlike his homologues in Western Europe or indeed within the Obama administration, the Turkish leader had few qualms in taking the side of the anti-Mubarak demonstrators. He delivered a robust message, steeped in religious and moralist overtones, to the Egyptian dynast: "You must be the first to take a step for Egypt's peace, security, and stability [...] Take steps that will satisfy the people". For Erdoğan, the upheaval was much more than Egypt's internal affair:

Turkey is playing roles that can upturn all the stones in the region and that can change the course of history. My dear brothers, we are pursuing a foreign policy with character. Turkey is saying no to the oppressors. It is challenging what was blindly accepted until now. It is calling the murderers murderers. It is destroying taboos. Turkey is saying wait a minute to those who condemn others to poverty and to blockades. Turkey is shouting the truth and the just at every opportunity. Turkey is positing a strong will to help peace, stability, tranquillity, democracy, universal law, rights and freedoms to prevail in its region. We represent a mentality that seeks for its brothers whatever it wants for itself.¹

Mubarak left, swept by the wave of popular discontent. Erdoğan soon found himself delivering a similar message to Libyan leader Muammar Gaddafi, while urging Western powers to show restraint in enforcing a no-fly zone over Libya. Next in line was Syria's President Bashar al-Assad, who in March 2011 was asked by Turkey to lift the state of emergency dating back to 1963, embark on political reform, and defuse tensions sparked by pro-democracy demonstrations in Deraa and Latakia. The punch line: ride the wave of democratisation or be swept by it.

Those following Turkey will see a U-turn in its foreign policy. Just a few years ago, Turks left, right and centre reacted with opprobrium to suggestions of their country being a model for

1. A translation of the speech is available at : <http://mideastwire.wordpress.com/2011/02/02/erdogans-cairo-speech-birthpangs-of-a-new-middle-east-as-obamas-cairo-moment-fades/>

the Arab-speaking Middle East, dear to the neo-cons around former President of the United States (US) George W. Bush. Since the 1920s, the Turkish Republic – meaning primarily the bureaucratic and military establishment – saw itself as a Western outpost, fundamentally different from the lands further south. Despite talk of commercial expansion embraced as early as the 1980s, during the years of Prime Minister (later President) Turgut Özal, in Istanbul and Ankara the image of the Middle East was not very different from the stereotypes prevalent in the West. To the median citizen, Iran and the Arab world evoked associations with religious extremism, authoritarian habits, cultural backwardness, stagnant economies and myriads of threats to Turkey’s cherished national security.

But after nearly a decade under the rule of the Justice and Development Party (Adalet ve Kalkınma Partisi, AKP), Turkey is no longer an outsider or a passive observer of events beyond its frontiers. It is now actively pursuing a leadership role, leveraging its economic weight and newly-discovered soft power through political engagement in regional hotspots such as Iran, Gaza, Lebanon, Iraq – and now Egypt, Libya and, most significantly, Syria. Back in May and June 2010, Turkey’s new neighbourhood policy put it on a collision course with erstwhile ally Israel and later, when Ankara opposed sanctions against Iran in the United Nations Security Council, with the US and the European Union (EU).

Of course, after the NTV speech, domestic critics of the AKP did not miss the opportunity to lambast Erdoğan’s double standards. Back in 2009, the prime minister was quick to congratulate Mahmoud Ahmedinejad over his “victory” in the Iranian presidential elections, ignoring mass demonstrations staged by the pro-reform Green Movement on the streets of Tehran. As with any foreign policy, that of new Turkey has to strike a tenuous balance between high principles and hard facts and interests. The country’s foreign policy reflects in equal measure a strategic calculus and the ideological commitments of the AKP.

Yet, Turkey’s involvement in the revolutionary upheavals of Egypt (and also Tunisia, where the country’s founding father Habib Bourguiba once held Kemal Atatürk as a role model) points to a new reality. As ECFR’s recent report, “The Spectre of Multipolar Europe”, argued, Turkey has now transformed from a periphery of the West to a centre of its own world, which includes the Middle East, the Balkans, the Caucasus and the Black Sea. It is imperative that the EU wakes up to this reality and, pun aside, re-anchor Ankara’s neighbourhood policy with a renewed strategic partnership.

EU-Turkey: momentum lost

Turkey’s rising political clout is partly due to Turkey’s advanced relationship with the EU – the Customs Union completed in 1996 and the accession negotiations that kicked off back in 2005. At the same time, neighbourhood activism dramatically recasts Turkey from being a *demandeur*, a role played in earnest since the 1999 Helsinki Summit granted the country

candidate status, to being an independent power pole with which the EU and the US must now reckon. This about-face has to do with both a sense of betrayed promises shared by the AKP government and a majority of Turkish citizens, and, at a deeper level, the “Turkey’s-only-friend-is-another-Turk” mentality deeply ingrained in Turkey’s national political culture.

It is crystal clear that the EU and Turkey are now facing a critical point in their relationship. For some time, the Union has been pretending to be negotiating on membership with Ankara while Ankara has been pretending to be taking Brussels seriously. This façade is beginning to crumble and 2010 showed more than one crack. In contrast to years past, in November 2011 few bothered to read the regular monitoring report issued by the European Commission.

Turkey remains a profoundly divisive issue for the EU. The EU collectively blocks eight chapters over Ankara’s refusal to implement the 2004 Additional Protocol to its Association Agreement with the European Community (EC) and over its refusal to open ports and airports to Greek Cypriot ships and aircraft. Germany and France have been openly opposing accession, arguing instead for a form of “privileged partnership”. (Although, in all fairness, due to a concession made to the junior coalition partner, the Free Democrats, Germany is still formally in favour of Turkish membership). President Nicolas Sarkozy declared that “Turkey is a great civilisation, but not a European one”. Tacitly encouraged by Berlin and Paris, Cyprus continues to block negotiations on six further chapters. Former blocker-en-chief Greece is also changing its position, from a supporter to a bystander, due to the persistence of hard-security issues in the Aegean, but more importantly because of the painful economic crisis it has been enduring, which drastically narrows Athens’ scope for foreign policy entrepreneurship at the EU level. The pro-accession camp includes the United Kingdom, Spain, Finland, Sweden, Italy and most Member States in Central and Eastern Europe, including neighbouring Bulgaria and Romania.

The end result is a stalemate in membership negotiations. In the first half of 2010, the Spanish Presidency declared its ambition to start talks on three new chapters in the first half of the year, but on 29 June only the Food Safety, Veterinary and Phytosanitary Policy (Chapter 12) was opened. There are only three further chapters that remain not “frozen”. Unless the EU starts trading directly with North Cyprus, Turkey refuses to implement the 2004 additional protocol to the Ankara Agreement and open its ports and airspace to Greek Cypriot ships and aircraft. The regulation proposed by the European Commission to that effect has been blocked in the European Parliament, which in turn gives Ankara few incentives to reconsider its position and put pressure on Cyprus to lift the vetoes. After the election of Derviş Eroğlu, a hardliner, as president of unrecognised North Cyprus in April 2010, there is a widely shared sense that a window of opportunity for the ongoing unification talks has been closed.

Compared to the 2002-2006 period, the golden era of the EU’s “transformative power” in Turkey, the Union has all but lost its leverage. Diplomats in Ankara may talk the EU talk, but Brussels was not a reference point in the ill-fated “Kurdish Opening”, embarked upon by the AKP in

late 2009, nor in the constitutional referendum of 12 September, 2010, which rocked Turkey's domestic scene. Even without formal negotiations on the relevant chapters, the Turkish government is insisting that it is nevertheless implementing the *acquis*, but there is little evidence to support this. Time is running out. The EU is heading into a crisis at a time when the Middle East and North Africa are undergoing tectonic shifts unseen for two generations or so.

The regional dimension

In the wake of the flotilla incident and the Iran vote, pundits on both sides of the Atlantic, but mainly in Washington, were anxiously asking “who lost Turkey”. Former US Secretary of Defence Robert Gates observed that the country was “pushed by some in Europe refusing to give Turkey the kind of organic link to the West that Turkey sought”. Of course, reality is more complex. The EU remains a pole of attraction, yet Ankara is diversifying its economic and political relations. Back in October 2010, *The Economist* captured this sense of shifting positions in its special report entitled “Anchors Aweigh” (paradoxically, a heading evocative of America's military ascendancy). In a way, Turkey is behaving rationally, keeping all its options open. Turkey is not an issue, as the EU believes, but a full-fledged actor. The three principal pillars of Turkey's activist foreign policy are (1) mediating in regional hotspots, from Lebanon to Bosnia; (2) acting as a catalyst for economic integration, and (3) as the reaction to the recent events Egypt demonstrate, projecting a model for political and socio-economic development.

While the three elements are interlinked, Turkey's success as a peacemaker and mediator has been at best qualified. On the one hand, Turkey has managed to dramatically improve its relations with neighbours, in line with the “zero-problems” doctrine enunciated by Foreign Minister Ahmet Davutoğlu in the days he was a university professor. The most clear-cut example of this can be found in Turkey's relations with neighbouring Syria, which was at the verge of war with Turkey in 1998. Now the two governments enjoy an excellent relationship with good contacts at all levels and a number of joint economic projects. Most recently, this includes a high-speed rail service between Aleppo and Gaziantep in Turkey. Encouragingly, Ankara has cultivated strong commercial and political ties with the Kurdistan Region in Northern Iraq, opening a consulate in Erbil in March 2010. AKP has also strengthened its links with Tehran, thanks to diplomatic support on the nuclear dossier as well as a number of joint energy projects dating back to the 1990s.

Yet, things look different with regard to Turkish ambitions to act as an intermediary. Before the 2008-2009 Gaza conflict, Ankara sought to exploit its advantageous position *vis-à-vis* both Israel and Syria and act as a go-between in bilateral negotiations. This is no longer in the cards as Turkey has effectively taken a side and chosen to openly confront Israel. In Iraq, Nuri al-Maliki managed to put together a coalition even though Ankara backed the rival Ayad Allawi bloc. Despite success in mediating between Serbia and Bosnia and Herzegovina (primarily the Bosniak parties), Turkey has limited leverage over Republika

Srpska, one of the two entities in the common state, while its preferred candidate for the tripartite Bosnian Presidency, Haris Silajđić, lost to Bakir Izetbegović in the general elections held in October 2010. As no Bosniak politician can afford not to have Turkey's backing, Izetbegović is now friends with Ankara. Because of Azerbaijani opposition and lack of progress in Nagorno-Karabakh, agreements concluded with Armenia cannot be ratified in Ankara and Yerevan.

Turkey has fared much better as an agent of “economic integration”. In 2010, it pushed for facilitation of free movement of people and trade liberalisation with Arab neighbours. On 3 August, a quadripartite free trade agreement (FTA) was concluded with Syria, Lebanon and Jordan, followed by a bilateral FTA with Lebanon on 25 November. In January, Turkey and Lebanon agreed to abolish visas, following similar deals with Syria and Jordan. Yemen was next in line with a bilateral agreement concluded in early 2011. The initiatives replicate the EU's functional integration model, while Turkey's appeal is closely related to its advanced integration in the EU market. Experts now quip about the advent of Sham-gen (referring to Sham, the Arabic name of the Levant) to replace Schengen. However, softening borders with the Middle East comes at a price. In January, Turkey and the EU agreed on the wording of a readmission agreement. But Ankara refused to sign as the Union declined to grant it a visa liberalisation roadmap on the model that had been implemented in the Western Balkans. Meanwhile, the near-crisis on the Greek-Turkish land border in Thrace in 2010 has fueled fears that Turkey is a gateway for illegal migrants sweeping into Western Europe from Africa and Asia.

Nowhere has the power of the trading state been as visible as in relations with Russia, with bilateral exchanges worth €25.6 billion in 2008, prior to the economic downturn. In 2010, there was a strong recovery. Every year, more than 3 million Russians travel to Turkey for business or tourism, with the number projected to grow even further thanks to a visa-free deal. Energy is a key bilateral issue as imports from the north are essential for meeting demand from the ever expanding Turkish economy. During a visit on 8 June, Prime Minister Vladimir Putin unveiled, together with Erdoğan, a joint plan to build a nuclear power plant near the city of Mersin. Furthermore, Russia is a significant market for Turkey's globalised construction sector.

Finally, but perhaps most significantly, Turkey has gained credibility as “a source of inspiration”, if not a model, for its neighbours, immediate and more distant. Ankara's soft power boils down to a demonstration effect in Muslim-majority countries to the south and to the east. The core message aired by the AKP brand is that one can embrace modern lifestyles, democracy and the capitalist marketplace while remaining true to pious principles. A very potent channel for conveying this message is Turkish popular culture, which commands a large following in the Arab world, Iran and the Balkans. Parallels with other actors espousing political Islam elsewhere in the region may be deceiving, yet present-day Turkey offers an alternative to both sclerotic authoritarian regimes and the radical, anti-Western Islam preached by the global jihadis.

The way forward?

EU policymakers should strive to engage meaningfully with the new Turkey, which is both more democratic and less prone to follow the West. Ankara is a potential partner not only in Egypt and Tunisia, but also in the Western Balkans, Iraq, the Southern Caucasus, and hopefully in Palestine and Lebanon. Yet, the EU has failed to integrate Turkey in frameworks such as its Common Security and Defence Policy (CSDP) and the European Neighbourhood Policy (ENP). The negotiation chapter on CSDP is still unopened and is very likely to be vetoed by Cyprus. Turkey keeps itself at an arm's length from the ENP, which it sees as an alternative track to accession – even though Turkey is the physical link between the policy's eastern (post-Soviet) and southern (Middle East and North Africa) branches. Turkey is a key ally in the effort to diversify energy supplies to the EU, especially given strategic projects such as the Nabucco gas pipeline. Yet the negotiation chapter on energy is still to be opened and Turkey has not started full-blown alignment with the *acquis* in this field.

What the EU needs is a parallel track for strategic dialogue with Turkey on regional issues of common concern. The dramatic events in Egypt present a perfect opportunity for coordinated action or, at the very least, close collaboration and structured exchange of views and ideas. Amongst other benefits, such a dialogue will give credibility to the nascent European External Action Service (EEAS) headed by Vice-President of the European Commission / High Representative for the Union for Foreign Affairs and Security Policy Catherine Ashton. Turkey's clout in the Middle East is in no small part related to its privileged ties to the club of rich and democratic countries that is the EU. Conversely, the EU would benefit in its dealings in the region if it acts together with a country whose stocks are hitting a high, especially in the eyes of societies. Such cooperation could be replicated in other settings, such as in Bosnia or in Nagorno-Karabakh.

Such strategic dialogue will complement rather than cancel the ongoing accession talks that have fallen prey to the Cyprus conflict and the current phase of EU introspection. Foreign policy cooperation on issues that pose a common challenge is the pragmatic way out of the deadlock and a means to inject more trust in the deteriorating bilateral relationship. Contrary to popular belief, Turkey still needs the EU as an ally as much as the EU needs Turkey. We have yet to see whether leaders on both sides will seize the opportunity.

ENLARGEMENT AND NEIGHBOURHOOD

The EU and its Eastern Neighbourhood: Challenges of Engagement

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Since their independence 20 years ago, Eastern Europe and the Southern Caucasus have lived in the paradoxical situation of representing a crucial geographic, security and energy crossroads for the European Union (EU) while failing to reach the top of its foreign policy agenda. Since 2004, six countries have become the EU's direct Eastern neighbours, while at the same time remaining Russia's Western neighbourhood, a traditional area of Turkish economic and security interests in the Black Sea region, and an increasingly attractive terrain for China's power projection, especially in the economic dimension. From a broader perspective, the EU's Eastern neighbourhood represents a strategic bridge connecting Europe with the Middle East (Iran) and, through the Caspian Sea, with Central Asia. The EU's Eastern neighbourhood also represents a transport corridor between the EU and China. And, last but not least, it is of geostrategic importance as a transit route for European energy supplies. Currently, around 20% of the EU's gas supplies transit through Eastern Europe.

While offering these sets of opportunities, the region remains volatile. Internal political tensions (post-electoral unrest and riots), gas wars between Russia and the Eastern European countries, ecological risks, illegal immigration, smuggling, organised crime, and the frozen conflicts in Moldova and the Southern Caucasus have all contributed to undermining stability and reform processes. Political instability in the region is strongly linked to economic and social weaknesses, where economic and social conditions are precarious. The global economic crisis hit almost all Eastern European countries exceptionally hard, bringing a period of fast growth to a halt and putting the region's financial system under duress. The most serious hard security challenges are frozen conflicts and Russia's assertiveness in maintaining its leverage on the region, as the 2008 "August War" in Georgia dramatically demonstrated.

Despite these opportunities and challenges sitting on the EU's doorstep, the region has not appeared on Brussels' foreign-policy radar screen. The coherence and effectiveness of EU engagement in Eastern Europe has suffered from a lack of consensus on two crucial

issues. Relations with Russia remain one of the most divisive issues when trying to develop EU common foreign policies. Some Member States are keen to avoid developing policies that Moscow could interpret as interfering with what it sees as its “sphere of privileged interests”. To various degrees, maintaining good bilateral relations with Russia remains a priority for some important EU states (France, Germany and Italy). Notwithstanding the length to which EU officials have gone to explain that the various policies developed towards Eastern Europe are not intended to antagonise Russia, the notion that Eastern Europe is a space for competition between the EU and Russia has been unavoidable. In an EU with very diverse historical relations with Russia, this has meant belated engagement with the region and a search for compromises based on lowest common denominators. This approach has fallen short of expectations held by democratising countries in the East – Ukraine, Moldova and Georgia.

The second red line hindering further EU engagement in the region concerns the question of membership. The EU has consistently avoided addressing the demands of countries such as Ukraine, Moldova and Georgia for prospects of accession, to which they enjoy – on the basis of Art. 49 of the Treaty – the right as European countries. This idea is supported by some EU Member States (the Czech Republic, Poland, Romania, Sweden and the United Kingdom), but for others it is currently unacceptable (France and Germany).

Nonetheless, taking a broader historical perspective, the contrast between the 1990s and the second half of the 2000s is noticeable. Pushed by demands from some countries in the region and those EU Member States that see the Union’s Eastern neighbourhood as strategically important – such as the Central European Member States, the United Kingdom and Sweden, the EU has started to engage with Eastern Europe, even at the risk of antagonising one of its most important partners further east. For Russia, a country digesting Central Europe’s accession to the EU and to the North Atlantic Treaty Organisation (NATO), the attraction of the Union in parts of Eastern Europe has had strong reverberations in its relations with the West and in its policies towards its Western neighbourhood, with the Ukrainian Orange Revolution standing out as a defining moment leading to a re-evaluation of Moscow’s regional and international role.

The EU’s engagement in the East is characterised by the multiplication of EU programmes and initiatives, starting with the European Neighbourhood Policy (ENP), developed between 2003 and 2004, which was later accompanied by the Eastern Partnership (EaP), launched in 2009 on the basis of a Polish-Swedish proposal. The EaP’s set-up reflects a perceived twofold need: to provide a path of integration and association for those countries aspiring to achieve a prospect of accession (Ukraine, Moldova and Georgia) without making any concessions on eventual EU membership, and to try to engage those countries most impermeable to EU influence (Belarus, Azerbaijan and Armenia). Especially with regard to Belarus, the EU’s policy of isolation pursued through targeted sanctions since the freezing of the Partnership and Cooperation Agreement negotiations in 1997, on human rights grounds, did not produce

any results. This is why the EU had been searching for new ways forward that did not compromise its principled position.

The EaP also represents the highest possible level of consensus within the EU over how, and to what extent, the EU should engage with Eastern Europe. As an enlargement-neutral policy, it is interpreted by those EU Member States against promising accession as an alternative strategy; conversely, for the Member States pushing for closer association, the EaP is seen as a possible preparation for future accession, recognising that currently the debate on membership has reached a political *cul-de-sac*.

The EU’s engagement in its Eastern neighbourhood is influenced by several of the region’s features. Despite significant similarities, the region also has a high level of political, cultural and economic heterogeneity. This makes the creation of a coherent and holistic approach difficult. From the EU’s point of view, the most fundamental differences among the EaP countries concern attitudes towards EU membership and the character of political systems (democratic vs. authoritarian).

In the case of the more democratic Eastern partners, democratisation and stability are tightly bound to the EU’s policy towards them, particularly the European perspective. In Ukraine, Georgia and Moldova, the EU faces defective democracy. It is a source of instability in these countries, and also of their fragility, but at the same time it almost completely excludes their stabilisation, even if in 20 years of independence these countries have avoided an authoritarian slide. In effect, their stabilisation is closely linked to the completion of democratisation and the building of rule of law, which, without EU support, has little chance of success. The most efficient incentive and driving force for reforms would be, beyond any doubt, a long-term European perspective.

Indeed, the impact of EU policies, in terms of Europeanisation in the region, has been modest so far. The almost annual attempts to improve the ENP’s offer for the East indicate that EU engagement is still under construction. It also confirms that Brussels is dissatisfied with the performance of the programmes designed for the Eastern Neighbours. EU engagement in the East is a history of searching for the optimal model that would rely on enlargement policy tools (integration and conditionality) without offering a prospect of accession for the Eastern neighbours. This model of “integration without membership”, aiming at preventing the emergence of new dividing lines in Europe, is driven by efforts to solve the fundamental “inclusion / exclusion” dilemma which the EU faces with regard to the Eastern neighbours. In effect, some basic similarities are common to all the EU initiatives and programmes directed towards the East since the fall of the Soviet Union, as far as their agenda is concerned (convergence with the EU model, conditionality). However, they all continue to replicate the inclusion / exclusion dilemma. The EU’s policy towards the East is characterised by permanent perplexity stemming from both a reluctance to “digest” the Eastern neighbours and, paradoxically, fear of their exclusion and destabilisation.

Priorities for the coming presidencies

In this context, the challenges for the next EU rotating presidencies revolve around two main pillars: a political-strategic one, and one that relates more closely to the implementation of policies and the priorities to be pursued in the 18 months to come.

In the second half of 2011, the Eastern Partnership summit will be held under the Polish Presidency, co-organised with the Hungarian Presidency of the first half of the year. In the absence of clear “sponsors” for Eastern Europe, as during 2011, the challenge for Warsaw will be to ensure continuity of engagement in 2012. Alongside agreeing with the Danish and Cypriot Presidencies on the priority accorded to the region, this will mean ensuring that the European External Action Service (EEAS), the special unit in charge of the EaP, and other EU Member States are aware of the importance of the dossiers in question.

This will be particularly important in the context of the negotiations for the new Multiannual Financial Framework for 2014-2020. During 2007-2013, the budget for the entire neighbourhood was in excess of €12 billion, with some €700 million added for the Eastern Partnership since 2009. As things currently stand, it is extremely unlikely that the budget for external relations and / or for the neighbourhood will be increased in any significant way. In the context of the revolutions in the Arab world and the calls by many EU leaders for increasing international generosity towards the South Mediterranean (while falling short of making any financial commitments), the distribution of the ENP budget between the Eastern and Southern neighbourhoods may become an issue of political dispute. Since the early 1990s, the ENP budget has always been subject to compromises between the two EU vocations. A new understanding (which might entail confirming the unwritten rule of thumb of two-thirds to the South and one-third to the East) will have to be reached.

Managing this discussion politically will not be easy: the EU already suffers from deep internal divisions that have ultimately undermined the effectiveness of external policies. Secondly, the patterns of international relations have shown that geographical distance does not make countries immune from the consequences of instability: both neighbourhoods are important to the all of the EU.

In a context of economic austerity, improving the quality and impact of aid towards the neighbourhood will acquire renewed salience. In order to make European financial commitments more effective, it would be opportune to increase coordination with other donors, especially within the EU. An exercise of information-gathering concerning national governments’ and agencies’ aid programmes, and concerning multilateral institutions engaged in the region would be a first step in the search for improved coordination and new synergies between programmes that seek to increase aid spending effectiveness.

A number of policy areas could also be prioritised. The ENP review, published by the Commission in April 2011, reflects a discussion process that started in July 2010. Themes covered include: the exercise of conditionality; the question of the long-term prospects and the unavailability, for the foreseeable future, of accession as an incentive; the principle of differentiation that was introduced with the ENP; the budget; and engagement with civil society.

Out of these discussions and proposals – a matter of debate in the Council during the Hungarian Presidency – it is important to single out some issues. Engagement with civil society has constituted one of the innovative aspects of the EaP, given that, in the past, there were few mechanisms for developing sub-state and non-governmental networks. The full potential of the Civil Society Forum of the EaP, however, has not been fulfilled. In the context of unstable and weak democracies in Ukraine, Moldova and Georgia, and given the undemocratic nature of Belarus and Azerbaijan, and the only partially democratic nature of Armenia, developing relations with civil society is a way to nourish struggling democracies from within and, in the case of non-democratic regimes, to develop relations with countries without offering too much to their governments. It also provides policy-makers useful feedback on how to implement projects and on which priorities to pursue in multi-lateral and bilateral relations.

Mobility and visa liberalisation is another incentive that features high on the agenda. From visa dialogue to visa facilitation to visa liberation, experience with the Balkans shows that the process can be highly successful. It gears political parties and government administrations to carry out the necessary reforms and it delivers a good that is highly considered by citizens. Here, the rotating presidencies and their role in chairing Council meetings (except the European and Foreign Affairs Councils) can be crucial. Visa liberalisation requires the involvement of national Ministries of the Interior, which often have different priorities than Foreign Ministers who decide on offering visa liberalisation to third countries. If Brussels is to deliver one of its most prized incentives, coordination in this matter – and the maintenance of political commitment within the EU – is fundamental.

Dealing with regional security and frozen conflicts in the region is one of the most controversial issues, especially where Russia is involved. Yet, the persistence of these situations is one of the main obstacles to EU efforts to improve the political and economic environment. While political negotiations continue without offering much by way of solutions, the EU should continue to be engaged in confidence-building efforts. It will be important to keep the visibility of these efforts high, especially during the transition phase during which the mandates of Special Representatives to the conflict zones end (February 2011) and the new EU Delegations and the EEAS take over their specific tasks.

Finally, given the nature of the tensions in the region, it would be wise to invest in a project that could bring benefits to all parties involved, including Russia, such as pan-regional energy efficiency project.

ENLARGEMENT AND NEIGHBOURHOOD

Towards a Paradigm Shift in Euro-Mediterranean Relations

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Arab societies have chosen 2011 as the year of the fall of the “wall of fear” from kleptocratic and brutal regimes. North African and Middle Eastern countries are undergoing rapid transformations after decades of apparent immobility and misleading stability. Under different circumstances, but driven by the same fundamental feeling, millions of Arabs have put their physical integrity at risk to call for dignity, opportunities and good governance. The entire world witnessed how Tunisian and Egyptian protesters, assisted by new information technologies, were the first to force their corrupt presidents to leave in a peaceful and non-ideological manner. The results of social uprisings vary from one country to another, but transitions towards a new relationship between state and society and new forms of governance are already underway across the Southern and Eastern Mediterranean.

Uprisings in the European Union’s (EU) Southern neighbourhood caught many both within and beyond the region by surprise, including European governments and institutions. The rapid spread of the social protests that sparked off in Tunisia at the beginning of 2011 to virtually all Arab countries has challenged the ability of European institutions and national governments to predict, analyse and react to the unfolding events. This has led to hesitant, late and uncoordinated reactions – if not unfortunate statements by European politicians – to the democratic demands expressed by Arab societies. The close ties between Western governments and the toppled Tunisian and Egyptian regimes, as well as other authoritarian Arab regimes that still cling to power, have significantly conditioned European positions and contributed to damaging their image.

Euro-Mediterranean relations in a changing region

Euro-Mediterranean relations call for a “mental revolution” on the European side in order to truly understand and react to the wave of changes that are extending throughout Arab countries and transforming the political culture of their societies. The reasons are manifold.

The sociopolitical changes that are brewing in those societies have to be considered in combination with the ineffectiveness of some of the European initiatives conceived in recent years. The Union for the Mediterranean (UfM), pompously launched by President Nicolas Sarkozy in 2008, has been trapped in a stalemate virtually since its earliest stages. The aim of this initiative was to bridge the results, visibility and co-ownership deficits of previous European policies. However, its implementation has resulted in an obstacle- and boycott-ridden political dialogue, poorly functional institutional structures and generalised confusion regarding its objectives and the means to achieve them.

Although the EU’s image in the Mediterranean is not in its best shape and Euro-Mediterranean cooperation has not generated excessive enthusiasm among European governments for years, it is impossible to turn a blind eye and ignore what is happening in the EU’s southern neighbourhood. The Euro-Mediterranean region has been and will always be a central area in the Union’s external and proximity relations. Successive initiatives have been rolled out in the region, orchestrated to a lesser or greater extent by European institutions. Among them are: the Euro-Mediterranean Partnership, also known as the Barcelona Process, launched in 1995; the integration of Mediterranean countries in the European Neighbourhood Policy (ENP) as of 2004; and the unsuccessful attempts to turn the UfM into an instrument for regional transformation. Despite the different tools and approaches involved, all these initiatives share the goal of promoting political, economic and social convergence to prevent the Mediterranean from becoming the “iron curtain” of the 21st century.

To these genuinely Euro-Mediterranean initiatives must be added the repeated and more or less discrete attempts to keep the Euro-Arab dialogue alive, as well as the implementation of a sub-regional dialogue in the Western Mediterranean known as the 5+5 and, in parallel, the robust bilateral policies of some EU Member States with third countries in the Mediterranean. In this respect, the Mediterranean can be seen as one of the regions where the EU has made more significant efforts and where high doses of creativity and imagination have been invested to re-think cooperation frameworks. However, it is also a region that has generated high levels of frustration. Current changes and uncertainties in the region should prompt a profound reflection on what has brought us here and lead to a joint effort to escape the apparent deadlock in which the region seems to be stuck, grasping the opportunities that might arise in this new phase.

The need to put an end to stagnation

Those in charge of managing Euro-Mediterranean relations in European institutions or national capitals during recent years have not had an easy task. The feelings of fatigue and, at times, frustration have not favoured effort mobilisation. These feelings also permeated the countries that held the EU’s rotating presidency before the new phase started with the triumph of the Tunisian revolution in January 2011.

Of all the most recent Presidencies, Spain was the country that devoted the most efforts to strengthen the UfM and produce a qualitative jump in bilateral relations with some Mediterranean partners. In fact, Spain had already used previous Presidencies (1989, 1995 and 2002) to promote the EU's Mediterranean agenda. However, the specific nature of the 2010 institutional setting (the coming into force of the Lisbon Treaty and the lack of definition of the UfM's "communitarisation"), the economic environment (global economic and financial crises) and the regional context (growing tensions in the Middle East and lack of progress in the regional integration of the southern countries) did not enable initial aspirations to materialise in the form of tangible results.

The efforts did not bear the expected results. Under the Spanish Presidency, some progress was made in launching the UfM Secretariat, based in Barcelona, but the overall results were relatively disappointing. The impossibility of holding a summit of Heads of State and Government with the 43 members of the UfM (postponed twice, first under the Spanish and then under the Belgian Presidency) and the ongoing negative impact of regional tensions, even on technical and sectoral activities, have spread the feeling that Euro-Mediterranean cooperation, at least in its multilateral dimension, has been subject to the ups and downs of regional conflicts, particularly the Israeli-Palestinian conflict.

Similarly, no substantial progress has been made in bilateral terms. Even though the first EU-Morocco Summit was held in March 2010 in Granada – the first with an Arab country and with a third country after the coming into force of the Lisbon Treaty, the "advanced status" granted to Morocco has not yet translated into effective commitments and continues to prioritise the symbolic dimension over tangible results. With regard to remaining bilateral relations, the possibility of granting Tunisia and Egypt an "advanced status" (months before the revolts), based on formulas similar to that of Morocco, met strong resistance, especially by human rights organisations, who claimed that these regimes did not deserve such an acknowledgement. As for Syria, the Partnership Agreement could not be signed, while the negotiation of the Framework Agreement with Libya was negatively affected by a crisis between the latter and Switzerland. In the case of Israel, political circumstances prevented any form of progress in bilateral relations and, as a result, the Association Council was suspended. Finally, the government of Algeria expressed its dissatisfaction with the implementation of some of the clauses of its Partnership Agreement and said it would request a revision.

The Belgian Presidency inherited this troubled scenario in the Mediterranean. However, it ended up taking a back seat, leaving the leading role in the hands of the European institutions, on the one hand, and France (that holds the northern co-presidency of the UfM) and Spain (as host of the summit that was never held) on the other. Hungary, in turn, assumed the rotating presidency at the beginning of 2011, in identical circumstances and with an even smaller degree of attention given to the Mediterranean agenda. Nonetheless, the ENP strategic review process continued under this presidency and, more importantly, the sensitive and complex negotiation

process for the Financial Perspectives of 2014-2020 started, which is key to the shaping of the UE's Mediterranean policy.

The financial dimension adds to the need to unblock the regional dimension of Euro-Mediterranean relations and to react to the new political and social realities after Ben Ali's fall in Tunisia and Hosni Mubarak's in Egypt, as well as the growing climate of discontent that exists in Mediterranean Arab countries. In a context in which economic recovery is yet to be consolidated and temptations to "renationalise" certain European policies are still alive in some capital cities, the EU faces, collectively, the challenge of giving new meaning to a contested and questionable Mediterranean policy.

This review process started with a letter sent, on 10 February, by Vice-President of the European Commission / High Representative of the Union for Foreign Affairs and Security Policy Catherine Ashton requesting her European counterparts to submit contributions regarding the future of the EU's policy towards Southern Mediterranean countries. Several countries submitted "non-papers", and on 8 March a Joint Communication was issued by the High Representative and Commissioner for Enlargement and Neighbourhood Policy Štefan Füle, giving some hints concerning the policy's review and the creation of a "Partnership for Democracy and Shared Prosperity with the Southern Mediterranean".¹ On 11 March, in a climate of emergency, due to the situation in Libya, the Heads of State and Government agreed a *de minimis* statement welcoming the review process, which was to be followed by concrete proposals on the much-needed ENP reform.

A changing Mediterranean brings new opportunities

Poland, Denmark and Cyprus, the three countries that will hold, successively, the rotating presidency of the EU Council during the second half of 2011 and in 2012, will find a complex landscape in the Union's southern neighbourhood. They are unlikely to have the same influence or the same ability to take action as the countries that held this position before the full enforcement of the Lisbon Treaty. However, nothing prevents them from putting items on the agenda and acting constructively through Europe's institutions to find solutions for some of the major problems in Euro-Mediterranean relations. In fact, in view of the current stagnation, some voices are being raised calling for a greater involvement of countries other than the "Med Trio" (France, Spain and Italy), whose approaches to the countries to their south have shown limitations or reveal high doses of voluntarism that do not yield the tangible results needed to bridge the emotional and economic gap that separates societies across the Euro-Mediterranean space.

1. European Council, European Parliament, Council, European Economic and Social Committee, and Committee of Regions, Joint Communication, "A Partnership for Democracy and Shared Prosperity with the Southern Mediterranean", COM(2011) 200 final, 8 March 2011, available at: http://www.eeas.europa.eu/euromed/docs/com2011_200_en.pdf

The policies promoted by the EU towards the Mediterranean have been criticised for decades for lacking both the political will and the means required to pursue the declared objectives, among them the creation of an area of peace, stability and prosperity across the Mediterranean, as stated in the Barcelona Declaration of 1995. Nonetheless, the tacit agreement under which the EU granted a quasi-acritical support to regimes detested by their own people in exchange for stability and access to resources is no longer valid in the new context. In this respect, the implicit acknowledgement of the reality contained in the Joint Communication of the Commission and High Representative cannot be ignored, as the text states that “the EU has to take the clear and strategic option of supporting the quest for the principles and values that it cherishes”.²

The transitions now underway in some Arab countries and those that may occur from now until 2013 will certainly attract the attention of the Trio Presidency comprising Poland, Denmark and Cyprus. The uncertainties and difficulties inherent to transitions from authoritarian regimes to participative systems will significantly shape the Euro-Mediterranean agenda in the coming years. These uncertainties are generating fears across Europe on the potential threats and risks that might arise as a result of the transformation of the southern police states. Many have voiced concerns regarding the potential inflows of refugees or new migration flows from the Maghreb, the possibility of having radical parties find their way to power in democratic elections, and the risk of dissemination of terrorist and criminal activities. However, aware as the EU might be of these potential – though not inevitable – risks, it would be a major mistake for the EU, indecisive and absorbed by its internal problems as it may be, to be largely guided by these fears.

Over a period that might last for years, it will be difficult for the EU to apply a common approach to its southern neighbourhood, since the changes that are currently taking place can lead to highly diverse scenarios. For the time being, three basic scenarios can be envisaged for Arab countries: (1) a general trend towards democratic transitions; (2) highly diverse situations from one country to another, combining democratisation with repression; and (3) counter-revolutionary processes from “old guard” forces or radical sectors, thus endangering the trend initiated in 2011. How these events will unfold remains to be seen, but the scenario that will prevail will depend, to a large extent, on whether the EU will contribute to the creation of a “democratic, stable, prosperous and peaceful Southern Mediterranean”, which is precisely what these populations demand.

Towards a paradigm shift in Euro-Mediterranean relations?

There is no doubt that the fall of Ben Ali and Mubarak represents a turning point in the political and social evolution of the Arab countries. This requires much more than a mere change in

2. *Ibid.*

approach or minor changes in Euro-Mediterranean relations. In fact, it is highly likely that we are witnessing a “paradigm shift” as suggested by the President of the United States Barack Obama on 11 February, shortly after the forced resignation of Mubarak, when he said that “Egyptian people changed their country, and in doing so changed the world”.³

The EU should compensate for its slow response to pro-democratic demands by involving itself in a decided and generous manner (in terms of funds, but principally of political will) in favour of democratic transitions. To do so, it should abandon an approach that is focused, on the one hand, on the “securitisation” of Euro-Mediterranean relations and, on the other, on the belief that commercial and economic liberalisation will solve all problems and bring about democracy and good governance. Stability and prosperity in the Mediterranean can be best achieved with the support of “strong states” instead of “fierce states”, as has been the case until now. Actively fostering good governance in Arab countries will necessarily translate into new opportunities for societies and economies on both shores of the Mediterranean. To do this, it is all the more necessary to resume the objectives and the “Barcelona spirit” of 1995, since its diagnosis was accurate, although there was a lack of political will, the context was adverse and the means were not tailored to meet the ends.

The EU and its southern neighbourhood have to put an end to the climate of stagnation in which they have lived over the past years. It is essential to find solutions and to examine the best way to achieve them: through bilateralisation, another form of multilateralism or “recommunitarisation”, using and readjusting what has proved useful until now. At the current stage, the ENP must be strengthened with a powerful multilateral dimension in the South, which goes hand in hand with the Eastern Partnership, driven by the Commission in close contact with the neighbouring countries’ governments and societies. Further resources are needed and, more importantly, should be better used so as to support specific economic and social development projects that make a visible difference in peoples’ lives. Results will be all the better if the administrative procedures for the projects’ management are simplified and the formalities and fund-transfer deadlines streamlined.

Conditionality, if efficiently applied, can strengthen the incentives / disincentives systems required to promote good governance and balanced development within the southern Mediterranean states. It is also necessary to impose a healthy and reformist competition process between them. In addition, in those countries that show satisfactory progress in their political transition (criteria must be defined first to determine what this means), a more ambitious partnership framework should be proposed, with a new generation of partnership agreements that go beyond the vague proposals contained in the “advanced status”. Furthermore, a serious and realistic reflection on agricultural liberalisation should be launched. Although liberalisation, in itself, is no solution to the existing imbalances – and

3. Barack Obama, *Remarks by the President over Egypt*, The White House, 11 February 2011, available at: <http://www.whitehouse.gov/the-press-office/2011/02/11/remarks-president-egypt>

could even prove detrimental for some farmers in the South, it is essential to reinforce the weight of agriculture in Euro-Mediterranean relations and, in order to encompass rural development and territorial cohesion, go beyond a merely commercial liberalisation. In addition, democratic progress in specific countries should be accompanied by measures aimed at facilitating the movement of people within the EU through the signing of Mobility Partnerships, as proposed in the 8 March Communication.

Moreover, it is important to grasp the wave of mutual sympathy that the Arab uprisings have raised among citizens on both shores of the Mediterranean. Civil societies need to be a fundamental vector to materialise the paradigm shift. Relations should move beyond the current P2P approach (“palace to palace” or “president to president”) and move towards a “people to people” approach. This is also the responsibility of civil society organisations on both shores. Furthermore, the EU needs to be prepared to respond both rapidly and resolutely in the event that a country decides to opt for repression or for regression in the democratisation process, which is contrary to the will of the people. The EU must not choose silence; a more courageous declaratory policy is called for as well as more objective criteria to assess the reformist drive and a sole voice to denounce abuses against the freedoms of individuals in neighbouring countries.

It is possible that the UfM could become, in the future, the framework for Euro-Mediterranean political dialogue and regional integration. However, at a time as critical, vulnerable and highly changing as the one in which we are currently living, it would be wrong to believe that this is the most useful framework to channel European reactions *vis-à-vis* the new political situation and the development and cooperation needs of our partners. Nonetheless, nothing prevents the UfM Secretariat from seeking partners to launch efficient and feasible technical cooperation projects. If it is successful in its attempt, it should be adequately backed by Member States and European institutions.

All paradigm shifts in international relations entail a profound revision of policies, objectives and means to achieve them. The EU should decide as soon as possible whether we are facing a paradigm shift in North Africa and the Middle East or whether only a change in approach is required, with a partial review of the policies deployed to date. Regardless of what its choice is – and we consider it should choose the first option – it should act accordingly, investing both means and political will during the coming years. Europe’s credibility as a global player, as well as its own future security and wellbeing will depend, to a large extent, on the EU’s capacity to accompany democratic transitions in its southern neighbourhood and to foster progress in these societies.

ENLARGEMENT AND NEIGHBOURHOOD

Regionalising the EU’s Neighbourhood: Planning the Global Role for the Trio Presidency

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The prolonged global crisis has confirmed the main outline of the European Union’s (EU) external policy for the Polish-Danish-Cypriot Trio Presidency as globalisation cum regionalisation. First, concerning the emerging new powers, efforts for enhancing global governance were formulated as “strategic partnerships”. Second, promoting accession in the Western Balkans and widening through the Eastern Partnership have implied an intensive regionalisation of the EU’s neighbourhood.

The European challenge: reforming the global role of the EU

2010 was a particularly turbulent year. The euro crisis and subsequent steps taken in economic governance created tensions among Member States. This year has markedly reinforced both parts of globalisation cum regionalisation, by strengthening the new global role of the European Union (EU) and intensifying the regionalisation of neighbourhood on the other. This dual task had been clearly outlined in advance:

Externally, it must ensure that Europe is a coherent rather than fragmented actor both globally and in its own backyard. [...] At regional level, the challenges for a largely reunified Europe were to carry through enlargement and redefine its relationship with neighbours. At global level, it was to behave as the soft but effective power it claimed to be.¹

2010 was a year in which the EU looked to the future in both ways, internationally by strengthening itself as a global actor and internally by elaborating a form of European economic governance. In this regard, for the 60th anniversary of the Schuman Declaration on 9 May, the

1. André Sapir (Ed.), “Europe’s economic priorities 2010-2015: Memos to the new Commission”, Bruegel, 2009, p. 10, available at: <http://www.bruegel.org/publications/publication-detail/publication/319-memos-to-the-new-commission-europes-economic-priorities-2010-2015/>

European Policy Centre issued “A Schuman Declaration for the 21st Century”, offering some thoughts on what Schuman might say today on the new European challenge:

*In global terms the EU and all its members are in relative decline – politically and economically. The world is becoming ever less euro-centric: global affairs are increasingly shaped in other parts of the world. Without change, the old continent is doomed to gradual marginalisation and irrelevance.*²

The document also demanded an enhancement of Europe’s global role and suggested a programme to reform the representation of the EU in international governance structures in order to promote European values.

The 16 September, 2010, European Council Conclusions focused on relations with strategic partners. This document identified the challenge for the EU in a changing world:

*The recent economic and financial crisis has dramatically shown the extent to which the well-being, security and quality of life of Europeans depend on external developments. The emergence of new players with their own world views and interests is also an important new feature in the international environment. The European Union must be an effective global actor, ready to share in the responsibility for global security and to take the lead in the definition of joint responses to common challenges.*³

It has also emphasised that the EU should act more strategically and establish a system of strategic partnerships:

*The European Union’s strategic partnerships with key players in the world provide a useful instrument for pursuing European objectives and interests. This will only work if they are two-way streets based on mutual interests and benefits and on the recognition that all actors have rights as well as duties.*⁴

The dual task of globalisation-cum-regionalisation was apparent, given that the EU “also plays a major stabilizing role in its neighbourhood. The Union has secured stability in the Western Balkans particularly through the European perspective given to that region”.⁵

The September 2010 document was clearly written in the spirit of integrative balancing – that is, partnership with balancing mechanisms between and among policy fields through negotiations and with reciprocity. In global policy, the emphasis is on the asymmetrical reciprocity of global cooperation, since the profiles of the global powers are different, while in regional policy it means empowering the weaker regional partners in order to facilitate their development. In both cases, it is about creating synergies by combining strengths and capacities, since the

system of strategic partnerships presupposes the wherewithal “to ensure the coherence of the European Union’s external action as a whole”.⁶ The document also indicates an emphasis on integrative balancing in neighbourhood policy: “The smooth implementation of projects launched within the Eastern Partnership constitutes an outreach of EU values and promotes the legal, economic and social approximation of the concerned countries to the EU”.⁷

President of the European Council Herman Van Rompuy emphasised that the September 2010 European Council meeting had been a turning point in the EU’s global policy:

*Pour moi, c’est le plus important résultat du Conseil européen de la semaine dernière. Pour la première fois, les Chefs d’Etat et de Gouvernement ont consacré une réunion à la place de l’Europe dans le monde nouveau. Nous nous sommes concentrés sur nos relations avec les partenaires stratégiques de l’Union, tels les Etats-Unis, la Russie ou la Chine.*⁸

Van Rompuy also underscored that the principle of strategic partnership with reciprocity means a win-win situation – i.e. the mutual advantages referred to here as integrative balancing. Undoubtedly, the Polish-Danish-Cypriot Trio Presidency will support both directions. However, establishing strategic partnerships for better global governance is a task better suited to the European Council and its permanent president. The Trio Presidency would be better able to deal with the problems of regionalising the EU neighbourhood.

The new approach to widening: functional macro-regions

Functional macro-regions have been designed as bridges between global and regional governance. The specific feature of the Swedish-Belgian-Hungarian and the Polish-Danish-Cypriot (PDC) Trio Presidencies is the continuity between two Central European states, Hungary and Poland, which facilitates the synergy between the Baltic Sea and the Danube Strategies. The Baltic Sea Strategy emerged earlier, with the active participation of all Member States concerned, including Poland. The Action Plan of the Danube Strategy is to run until June 2011, during the Hungarian Presidency. It involves the intensification of the pre-accession process, by means of the Danube Strategy for the Western Balkan states in general, and via the Croatian accession in particular. Another Hungarian Presidency priority was “Enlarging responsibly and engaging globally” – i.e. the promotion of globalisation cum regionalisation in both ways:

Reviewing the European Union’s neighbourhood policy is a special priority. [...] The Union is a strong global player. The Lisbon Treaty has provided a new institutional structure and new possibilities. These will enable the EU to develop its relations with

2. European Policy Centre, “A Schuman Declaration for the 21st Century”, 6 May 2010, available at: http://www.epc.eu/documents/uploads/1091_schuman_declaration.pdf

3. European Council, Conclusions, EUCO 21/1/10, 12 October 2010, available at: http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/116547.pdf

4. *Ibid.*

5. *Ibid.*

6. *Ibid.*

7. *Ibid.*

8. Herman Van Rompuy, « Non pas renationalisation de la politique européenne mais européanisation de la politique nationale », *Discours à l’invitation de Notre Europe*, Sciences-Po, Paris, 20 September 2010, available at: http://www.notre-europe.eu/fileadmin/IMG/pdf/REVUE_DE_PRESE__d_bat_Van_Rompuy.pdf

third countries – especially with strategic partners – as well as with the EU's neighbours to strengthen its global position.⁹

Thus, in the neighbourhood regionalisation policy, there is a strong continuity between the Hungarian and Polish Presidencies. The Eastern Partnership (EaP) was a Polish-Swedish initiative, hence the expectations that the PDC Trio Presidency will support it. As the Polish programme pledges:

Poland will promote the subject matter of the Eastern policy. In relations with Member States of the Eastern Partnership it will strive for conclusion of association agreements, mandate for negotiation of the free trade area with the European Union and conclusion of such negotiations with Ukraine.¹⁰

Similarly, the Danish draft programme also offers a model of globalisation-cum-regionalisation:

Focusing on further development of the EU's (strategic) partnerships with third countries and regions, not least neighbouring regions, and developing regional frameworks and strategies will be important in order to ensure the EU's continued role in solving regional and global challenges, while promoting European growth, prosperity and security. Therefore, in line with its role as a global player, the EU should continue to ensure positive development in the Neighbourhood areas.¹¹

The alternative futures for the EU during the PDC Trio Presidency

Concerning global developments, the 2011-2012 period will be decisive for the EU, and therefore future scenarios should be outlined for the upcoming Trio Presidency. Alternative future scenarios range from the narrow status quo to new visions in the spirit of the Europe 2020 Strategy. Four scenarios for Europe 2013 can be posited: (1) Head Start scenario (best case scenario – strengths); (2) Continental scenario (partial success scenario – opportunities); (3) Fragmented EU scenario (partial disintegration – weaknesses); and (4) Domsday scenario (worst case scenario – threats). These four scenarios cover the main possible future outcomes for the EU27, in a SWOT analysis with positive or negative synergies.

In fact, the best case and worst case scenarios are positive and negative ideal types, which only outline the framework within which the future itinerary of the EU can be designed. The Head Start scenario has a relatively quick convergence and homogenisation in the EU27, based on the “V model” of a quick global recovery after the recession. In this eventuality,

the EU would be a superpower, serving as a trendsetter in the global governance of the post-crisis world. Conversely, the Domsday scenario is based on the “zero-growth model” of a long stagnation in the European economy, which slowly leads to the quasi-disintegration of the EU. In this case, the EU as a global actor must face declining influence in the global arena. Both extremities are nowadays unlikely, although excessively high expectations of the EU's global role have occasionally been apparent. In deep crisis periods (for instance in the spring 2010 euro crisis), the Domsday scenario has even been set in motion, for example in the form of the Anglo-American press' notion that “the European Union is dying”.

The softer Continental and Fragmented EU scenarios show the main opposite characteristics. The future EU will likely be some combination of these possibilities, depending on the strength of the various external factors (since the global environment will play a decisive role in the future of the EU). The Continental scenario, of partial success, presupposes basic convergence and increasing coherence in the EU, as a result of the relative successful crisis management and based on the “W model” of the global recovery (in which after the failure of the first recovery effort, the second one is successful). According to the Continental scenario, the EU as global actor can, in this way, withstand tough competition in a multipolar world. The Fragmented EU scenario indicates partial disintegration due to failures and hesitations in crisis management, and is based on the “L model” in the European economy (a partial and slow recovery). This somewhat negative scenario predicts continued convergence and increasing coherence in some fields, but marked divergence and deep disintegration in others. In general, the EU's internal cohesion could be damaged if the Europe 2020 Strategy fails to generate policy reforms for regaining global competitiveness, and the EU as a global actor could be paralysed with conflicts in its close neighbourhood or by a disturbance of its energy supplies.

These more realistic scenarios, with opportunities and weaknesses, outline the itinerary for the PDC Trio Presidency. The 1.8% economic growth of the European economy in 2010 offers some cautious optimism for the multispeed global recovery.¹² The EU is set to grow by around 2% in 2011 and 2012, which would allow for a return to normality in the EU after the “exit strategy” – as the February 2011 Presidency Conclusions have noted: “Beyond the immediate action required to tackle the most pressing challenges posed by the economic and financial crisis, it is important to continue laying solid foundations for a sustainable and job-creating growth”.¹³ There can be no return to the pre-crisis world, so the main task of the Trio Presidency is to contribute to “laying foundations” in the EU for the post-crisis world, including for a new global EU role. In the spring of 2011, the opportunities seem clearer than the weaknesses. The Franco-German “engine” has begun to put together the

9. Hungarian Presidency, “Strong Europe with a Human Touch”, The Programme of the Hungarian Presidency of the Council of the European Union, 17 December 2010, available at: http://www.eu2011.hu/files/bveu/documents/HU_PRES_STRONG_EUROPE_EN.pdf

10. Document of the Council of Ministers, “The six-month programme of the Polish Presidency of the EU Council in the second half of 2011”, 15 March 2011, available at: <http://www.prezycja.gov.pl/en/areas-of-preparations/program>

11. Danish Government, “Danish contribution to the strategic part of the 18-months programme of the Polish, Danish and Cypriot Presidencies”, Draft Document

12. European Commission, “European Economic Forecast – Autumn 2010”, *Economic and Financial Affairs*, accessed 28 April 2011, available at: http://ec.europa.eu/economy_finance/eu/forecasts/2010_autumn_forecast_en.htm

13. European Council, Conclusions, EUCO 2/1/11, 8 March 2011, available at: http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/119175.pdf

basic mechanism of economic governance that strengthens not only the euro, but also the economic strength of the EU, allowing an enhanced role in global governance.

The clear outlier in economic performance is Poland, with the highest European growth rate in 2010 (3.5%) and with high growth expectations in the next two years (3.9% in 2011 and 4.3% in 2012).¹⁴ In the same way, Denmark has been one of the best performers in terms of the Lisbon Strategy. Given this dynamism, the PDC Trio Presidency has optimal internal pre-conditions for economic take off and for an enhanced global role for the EU. Concrete steps that should be taken by the PDC Trio Presidency to boost this enhanced EU role in global governance include: (1) contributing to the preparations of the next financial perspectives in a way that supports both the new global role of the EU and its Cohesion Policy, (2) reaching a “historical compromise” with Russia on energy security, and (3) continuing the intensification of the neighbourhood policy, mainly along the lines of the functional macro-regions.

Policy recommendations:

1. A larger say for all Member States in the preparations for G20 meetings by creating a common platform (single voice) by means of discussions at EU forums before the European Council meetings concerned.
2. More specific treatment of the Eastern and the Southern dimensions of the neighbourhood policy in order to overcome the “carrot crisis” of weakening conditionalities in these mega-regions by means of more original forms of development.
3. Coupling the general economic recovery of the EU with a widening strategy through mega-regional development projects like the Danube Strategy and the Baltic Sea Strategy, which could be a source of dynamism for both the EU and its partner states.

14. European Commission, “Interim Forecast 2011”, *Economic and Financial Affairs*, accessed 28 April 2011, available at: http://ec.europa.eu/economy_finance/articles/eu_economic_situation/2011-03-01-interim_forecast_en.htm; for alternative estimates concerning Poland, see: International Monetary Fund, “World Economic Outlook. Tensions from the Two-Speed Recovery: Unemployment, Commodities, and Capital flows”, April 2011, available at: <http://www.imf.org/external/pubs/ft/weo/2011/01/index.htm>

The Contribution
of 16 European
Think Tanks
to the Polish,
Danish, and Cypriot
Trio Presidency of
the European Union



FOREIGN POLICY

The implementation of the Lisbon Treaty brought about major changes to the set-up of the European Union's (EU) foreign policy, notably affecting the role that the rotating presidency is to play. The creation of a High Representative of the Union for Foreign Affairs and Security Policy, who will now chair the Foreign Affairs Council – instead of the rotating presidency's foreign minister, is one of the major changes that will minimise the Trio Presidency's role in foreign affairs.

The Belgium Presidency played an important role in assuring a smooth transition of foreign policy powers from the Member States to Vice-President of the Commission / High Representative Catherine Ashton and the newly established European External Action Service (EEAS). In contrast, up until now, the new foreign policy structures have not been followed by a policy offensive. This has pushed Member States to a higher degree of individual or group activism, which is undermining the Lisbon Treaty's function as a means of streamlining EU foreign policy.

PART VI ABSTRACT

The authors below argue that the EU's new institutional structures do leave room for the Trio Presidency in other aspects of the EU's external relations. First of all, the Trio Presidency can assist the High Representative in creating coherence in both international policy and forum representation (SWP). Another important issue is to link the internal and the external policy agendas. The coming Trio Presidency could introduce the external dimensions of inter-

national policies as a regular item on the agendas of the sectoral councils and of the General Affairs Council (GAC), with regular reviews carried out by the Commission (demosEUROPA/EPC). The Trio Presidency's work within the GAC would also enable it to help Ashton look for better coherence across policy fields (SWP) and avoid the creation of "independent silos", which hinder the objective of following an integrated and comprehensive policy approach (demosEUROPA/EPC).

Thus, according to one author below, the Trio Presidency should, in close cooperation with Ashton, push for more integrated and innovative policy proposals in cross-cutting policy fields, such as energy, migration and climate issues. The Trio Presidency should also use its continued influence in these areas to tackle issues that go beyond traditional foreign policy (SWP).

Many authors below believe the Trio Presidency has a great part to play with respect to energy issues. Increasing competition for fossil-fuels might foster

intra-European rivalries and undermine solidarity, a keystone of European cooperation. In order to prevent such a situation, some authors argue that the EU should adopt a common external energy strategy – an issue that the Trio Presidency could bring forward. Furthermore, all Member States' external action relating to the energy sector should be closely coordinated with the EEAS (Notre Europe / demosEUROPA, SWP, demosEUROPA / EPC).

Many authors below underline the fact that the Trio Presidency also has a role to play in international climate negotiations. Rather than using the all-or-nothing approach – which proved inefficient at the 2009 United Nations (UN) Climate Change Conference in Copenhagen – the EU went to the 2010 Cancun Conference with a stepwise strategy, which garnered better results. However, if the Trio wants to help reduce the effects of climate change, it still has a lot of work to do. In terms of internal policies, the Trio Presidency needs to work towards: helping raise emissions reduction targets, decarbonising the power sector by 2050, creating more bilateral partnerships, and increasing long-term and short-term financing. These policy initiatives will encourage "green" economic growth in the EU. Moreover, on the international scene, the focus should be put on building bilateral climate partnerships with strategic partners such as China, India and South Africa. These partnerships should be implemented on the basis of a carrot and stick approach (Egmont).

Strategic partnerships do not only play an important role in climate negotiations. This is a concept that Ashton emphasised during the September 2010 European Council. With its rise on the global scene, China has become an important partner for the EU. Once again, notwithstanding Ashton's leading role in the debate, the Trio Presidency has a part to play in this domain. Trade policy is an important aspect of EU's general policy towards China, and this trade is still run by the Trio. For the EU's China strategy to be effective, Member States need to think about EU interests – and not national interests. This will require a good team player and coordinator behind the scenes, helping Member States find a common stance towards China. The Trio Presidency can help by defining priorities and by creating policy coherence and coordination in this matter (ECFR).

The financial and economic crisis is still creating challenges for Europe.¹ In order to ensure global harmonisation, proper and thorough financial sector reform is needed on all (national, EU and global) levels. A failure to effectively coordinate global financial reform will unavoidably lead to a fragmented and

1. For more information about the EU's role in global economic governance and financial regulation, see Chapter II – notably the article by Karel Lannoo

uneven international regulatory landscape. The Trio Presidency must therefore make sure that the EU assumes, at the different levels, a leading role in the coordination of financial regulatory reforms. International agreements, negotiated at international summits should be implemented in a consistent way and with a minimum degree of variation between Member States. And as already mentioned above, the next Trio Presidency should try to forge a unified position among European representatives in international forums, consistent with the view of the EU (ELIAMEP).

In matters of global economic governance, legitimacy and effectiveness go hand in hand. In order to ensure effective global economic governance, one author below argues that the Trio Presidency should work to move away from the G20 model. According to this author, the G20 effectively undermines the existing system of multilateral cooperation in institutions such as the International Monetary Foundation (IMF), the World Bank and the UN. Moreover, the author argues that the G20 model does not reflect the geopolitical structure of the 21st century, and that it is therefore an illegitimate forum that cannot be an effective solution to global economic governance. Instead, the Bretton Woods institutions must be revised so as to allow them to operate effectively as key pillars in a multilateral system of global economic governance. The Trio Presidency and France, which holds the 2011 Presidency of the G20, should work on creating a Heads-of-State forum, a Global Economic Council and reforming the voting power systems of the Bretton Woods Institutions (DIIS).

In spite of the Lisbon Treaty changes, the Trio Presidency still has much to achieve in the area of foreign policy. This work will require close cooperation with the High Representative and the EEAS. If the EU is to speak with a single voice in global affairs, close coordination and cooperation is the only way forward.



FOREIGN POLICY

Facilitating Ashton's Work: a Role for the Rotating Presidency

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From inward to outward-looking: Europe in an interdependent multipolar world

2010 was a year of re-orientation for the European Union (EU) in foreign policy terms, in three regards:

First, with the coming into force of the Lisbon Treaty, the EU High Representative of the Union for Foreign Affairs and Security Policy, Catherine Ashton, had mainly to deal with defining her new triple-hatted role and setting up her foreign policy machinery, the European External Action Service (EEAS), which led to bitter institutional turf wars in Brussels and national capitals.

Second, the EU had to recognise the changing international system in which emerging powers, especially in Asia and Latin America, want their say, which therefore re-started the debate on the EU's relations with strategic partners.

Third, the Euro-crisis demanded great efforts from the EU, which made it appear inward-looking; many commentators were of the opinion that if the eurozone falls apart, the EU will not have any foreign policy at all.

In that difficult context, the new post-Lisbon foreign policy apparatus took shape and all actors had to define their new or adapted roles. The European Council, which also gives strategic foreign policy guidelines, gained a permanent President, Herman Van Rompuy; the main decision-body for foreign policy, the Foreign Affairs Council, is now permanently chaired by the High Representative, Catherine Ashton; the European Parliament demonstrated that it is more willing than ever to use its clout also in foreign affairs, mainly via its budgetary powers and the right of assent to international agreements; and the European Commission successfully fought to maintain part of the power of the purse by still administering the money for most foreign policy instruments.

At first sight, the principal victim of the institutional struggle in foreign affairs seems to be the rotating presidency, which has lost most of its previous tasks in foreign affairs. But Belgium, the second of the national presidencies in 2010, successfully demonstrated the foreign policy role the rotating presidency can still play, facilitating Ashton and her team's work, especially in those formats where it is still legally competent. Belgium set an important precedent for the following presidencies in transferring all classical foreign policy powers to Ashton and her EEAS. This willingness to stand behind the EU institutions performing European foreign policy may not be as strong among other countries. However, if one looks at the foreign policy challenges for 2011-2012, an approach that clarifies at least part of the EU's leadership structures in foreign policy-making is very important: externally, natural disasters and global crises will continue to occur, and global and more and more interconnected challenges such as climate change, terrorism, cyber-crime, poverty and migration will persist. Internally, the EEAS will need to develop in practice; discussions about economic and financial governance issues will continue; the debate about the next multiannual financial framework, which includes the budget for external relations, will begin.

A diminished, but still important role for the rotating presidency in foreign affairs

Thus, in contrast to the superficial observation that the rotating Presidency has lost its relevance in foreign affairs, the present analysis of the concrete distribution of competences and practical working arrangements installed under the Lisbon system brings a more nuanced interpretation.

Indeed, since Ashton chairs the Foreign Affairs Council (FAC) and takes part in the European Council meetings (which is no longer the case for the foreign ministers), she defines the foreign policy agenda and drafts foreign policy texts for the European Council. Having EEAS representatives in most FAC working groups (all geographic ones, most horizontal ones and those of the Common Security and Defence Policy), Ashton and the EEAS define and control the very important preparatory work of the principal foreign policy decisions.

Still, the rotating presidency continues to chair the Permanent Representatives Committee (COREPER) in both its configurations (including the foreign policy-related one), the General Affairs Council (GAC), the FAC when it meets in trade or development configuration and some horizontal working groups¹, the working groups for trade and development and the COREPER

preparatory groups Antici, Mertens and Friends of the Presidency.² It thereby defines part of the foreign policy agenda and potentially has an overarching view, which links foreign affairs to other EU policies. Legally, if the European Council President is unable to perform his duties of office, the rotating presidency stands in for him. Finally, the rotating presidency presents and evaluates its priorities in front of the European Parliament and is thus an important interlocutor with the directly elected democratic body of the EU.

Some open questions are not yet clarified. These relate to the representation of the EU in international *fora*, especially in the areas of shared competences (for example, environment, agriculture, fisheries, etc.). The EU makes a poor impression if it does not decide who the lead-negotiator is and who speaks on behalf of the EU in international organisations or at Conventions – as has already happened in some cases, most problematically still in Geneva. Similarly, the question of who represents or deputises for Ashton at the European Parliament (EP) is not properly settled; Members of the EP demand political representatives instead of EEAS officials, whom they see as not accountable by the EP.

To sum up, the rotating presidency has a diminished and altered, but nevertheless important role in external relations. It is no longer responsible for traditional foreign affairs. Here, Ashton and her team set the agenda and can bring more continuity and consistency via their chairing of the FAC and the main preparatory working groups. However, the rotating presidency's role in the GAC is becoming more relevant. As Belgium demonstrated, the GAC can function as a body that ensures better preparation of and follow-up to the European Council (EC) meetings, thus putting the focus on the implementation of EC decisions. Furthermore, its work in the GAC enables it to help Ashton look for better cohesion across EU policy fields. Thus, Belgium was able to launch and close chapters in accession negotiations and sign trade deals with South Korea and Pakistan. As regards the EU's external representation at international conferences and Conventions (for example, in Nagoya on biodiversity and on climate in Cancun), Belgium found practical solutions in the form of team-representation by the Presidency and the Commission, with joint negotiation arrangements and joint seating behind the EU flag. In addition, there is sometimes an *ad hoc* role for the Presidency's Head of State or Government or its Foreign Minister. Thus, the Belgian Prime Minister Yves Leterme was the main negotiator with the EP in the budget deliberations and also the Belgian Foreign Minister, Steven Vanackere, briefed the EP on issues discussed in the FAC.

Overall, the role of the rotating presidency, but also of Ashton and the EEAS, in foreign affairs depends much on the ability to co-ordinate and find compromises with two other foreign policy actors: First, the other Member States, since most of the decisions in foreign affairs

1. Working Party of Foreign Relations Counsellors (RELEX), Working Party on Terrorism (International Aspects) (COTER), Working Party on the application of specific measures to combat terrorism (COCOP), Working Party on Consular Affairs (COCON), Working Party on Public International Law (COJUR), and Working Party on the Law of the Sea (COMAR)

2. The Antici Group is the preparatory Group for Coreper II, the Mertens Group is the preparatory Group for Coreper I, and the Friends of the Presidency Group is an *ad hoc* body which the Presidency can activate to deal with a specific, often complicated issue, for example by studying its multidisciplinary aspects

are adopted by unanimity; and second, the European Commission – whose Vice-President is Ashton – due to its powerful role in non-CFSP / CSDP related issues.

Recommendations

In its limited but important role, the rotating presidency should support Ashton in making the EEAS operational so that it brings added-value to the EU's external relations. More concretely, it should, in close cooperation with Ashton, push for more integrated and innovative policy proposals, going beyond traditional foreign policy by also tackling cross-cutting energy, migration and climate issues and bridging security, development and trade concerns: it's all about teamwork!

The Presidency should support Ashton and the EEAS in their role to:

Think strategically and discover inconsistencies in EU external policy. The Presidency should use its Chairs of COREPER, other Council formations and their preparatory working groups to help discover inconsistencies between the different EU external policies, including the external dimensions of internal policies such as terrorism, migration, asylum, climate change and energy. A special role for the Presidency will lie in the (preparation of the) *negotiations on the next multiannual financial framework (2014-2020)*, which will define the importance of external action also with regard to other EU policies. An important discussion here will concern the interpretation of “budget neutrality” with regard to the EEAS. More strategically, the discussion about the EU's long-term financial orientations should go hand in hand with a definition of the EU's strategic priorities (for example, a conceptual change from development aid to strategic partnerships also with developing countries, priorities in the neighbourhood and the BRICS, proofing of development aid against climate change, etc.) resulting also in a re-definition of the EU's financial instruments.

Provide a bridge between the national and the European level. In pursuit of the goal of *interchangeability* between national and European administrations, the Presidency should facilitate the smooth exchange of its national diplomats and experts with the EEAS. In third countries and international *fora*, it should encourage good co-operation between its embassies and the EU delegation, thereby further strengthening the latter's coordination role. Cooperation on the ground will be a litmus test for the EEAS. Domestically, the presiding government should also hold a serious domestic discussion about possible cuts in national diplomatic services, which in the long term could be implemented by the EEAS (consular services and also reporting on political and economic developments in third countries, for example). It should encourage cooperation between national and European diplomatic services, which bring added-value compared to the status quo. The Presidency country should thereby contribute to building trust also with regard to informa-

tion-sharing and better coordination between the Foreign Ministry and the Head of State or Government.

Coordinate and facilitate the smooth running of the other institutions. The output of the post-Lisbon foreign policy system will, even more than before, depend on the cooperation of the different European institutions. In that regard, the Presidency should assist Ashton and the EEAS to establish effective coordination mechanisms with the European Council, the Commission and the European Parliament, which enables Ashton and her team to act as interlocutors between them. Teamwork requires a leader.

Find practical solutions to open questions. The rotating presidency should actively help to *clarify* the issue of the EU's external representation in international *fora* and Conventions. It should encourage an inter-institutional arrangement about shared competences and offer practical solutions that guarantee at least a strong and common message. In the end, it should convince the Member States to let the EEAS work in their name and to stop acting as additional players themselves.

To sum up, the rotating presidency (also through its Prime Minister / President and Foreign Minister) could demonstrate ownership and offer its services to Ashton and the EEAS in a number of ways: *strategically* (for example, by providing expertise on certain policy or regional issues; encouraging innovative European foreign policy proposals, which show the added-value of the service and joint staff training; monitoring the implementation of the EEAS, with its first review expected in 2012); *operationally* (for example, by proposing to deputise for Ashton in the European Parliament – although not as a rule and depending on the policy issue, which might be better presented by another foreign minister on behalf of the EEAS – or at international conferences, as the then French Foreign Minister Bernard Kouchner did at the Haiti conference in 2010); *and with the necessary resources* (for example, by sending skilled diplomats to the EEAS, deploying national experts in European crisis management missions and offering national military equipment, as well as expertise and networks).

If the Presidency has the political will to perform this important supporting role both at European and national level, it can make a difference in the making of a genuinely European foreign policy.

FOREIGN POLICY

Making the EU's Voice Heard Globally

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A foreign policy treaty?

The Treaty of Lisbon introduced a number of significant innovations and fuelled high expectations in the area of European Union (EU) external relations. The reforms are primarily institutional. The most incisive reform relates to the enhanced role of the High Representative of the Union for Foreign Affairs and Security Policy (HR), who is now “multi-hatted” as High Representative, Commission Vice-President in charge of external relations, and chair of the Foreign Affairs Council.

An entirely new *sui generis* body, the European External Action Service (EEAS) was created to support the work of the High Representative. The EEAS, designed as “a functionally autonomous body” separate from both the Commission and the Council is unprecedented in its objective to develop a European foreign policy by integrating both diplomats from national capitals and officials from EU institutions (Commission, Council Secretariat). In addition, the Union gains a more coherent representation with eventually more than 130 EU delegations replacing those of the Commission.

In the new foreign policy structure, the rotating presidency has seen many of its previous functions taken over by the High Representative and her team. The foreign minister of the country holding the Presidency no longer chairs the sessions of the Foreign Affairs Council. The Political and Security Committee (PSC) and most of the working groups are now chaired by a “representative” of the HR.

The role of the rotating presidency is also weakened on the top political level. The Head of State or government of the country holding the Presidency no longer presides European summits, which are now chaired by the semi-permanent President of the European Council. In EU foreign policy, the latter has been attributed a treaty-based role as he shall represent the Union on “his level” on issues concerning the EU's common foreign and security policy. In his first year in office, President Herman Van Rompuy has already shown that he wants the European Council to be a strategic agenda-setter (also) in the realm of EU foreign and security policy.

Irrespective of the rotating presidency organising some key events with external partners such as the EU-Latin America Summit or the Eastern Partnership Summit, its role has changed to that of providing support to the new foreign policy apparatus introduced by the Treaty of Lisbon. At the same time, the external dimension of internal EU policies – related to trade, energy, climate or the Single Market – is becoming more prominent with the rotating presidency often driving the process as it still chairs all sectoral Councils (with the exception of the Foreign Affairs Council), the General Affairs Council, and COREPER, which is responsible for preparing the work of the Council.

The aforementioned changes have created a new, complex hybrid structure, which still needs to pass the test of time. But what are the experiences after the entry into force of the Lisbon Treaty on 1 December 2009?

New set-up in action – high expectations and early deficiencies

The creation of the EEAS and other innovations aiming to enhance EU foreign policy were communicated to the outside world as a flagship project. Many analysts went even so far as to describe the Treaty of Lisbon as primarily a foreign policy treaty. Key capitals, especially Washington, were told that once the treaty-making process was completed, the EU would emerge as a strong and capable actor on the world scene.

All this created high expectations, to which the EU has not (yet) lived up. On the contrary, while the EEAS was being set-up in 2010, partners witnessed major difficulties and turf wars between national capitals, and among Member States and the Commission as well as the European Parliament. In the end, all actors involved were able to strike a compromise. However, there will be a need for a lot of reassurance among the EU's partners once the current birth pains of the EEAS subside.

Creating a separate service and working out its relationship with established institutions and especially the Commission were always bound to be tricky. This process was burdened by the fact that the EU lost time in preparing for the EEAS. The initial decision to set up the service was already taken in 2003-2004, in the framework of the Constitutional Treaty. But following the “non” and “neen” in the French and Dutch referenda in May and June 2005, nothing much happened until the Lisbon Treaty entered into force at the end of 2009. And the actual work on the structure and internal organisation of the EEAS only began in earnest in 2010 and once the approval of the European Parliament for the terms of its establishment became clear.

Following the formal launch of the EEAS in December 2010 and the official start of operations in January 2011, there are still a number of major uncertainties and challenges surrounding the new EU foreign policy machinery.

First, the EEAS relies largely on a geographic division of labour, with some functional and horizontal functions attached. The geographical emphasis in the structure of the service has meant that political issues have been the dominant focus, rather than the whole spectrum of tools – diplomatic, military, civilian, political, legal and cultural – which Hilary Clinton has famously named “smart power”. In the case of the EU, such a comprehensive strategy would cover a similarly broad range of issues, from climate change to non-proliferation and trade. A horizontal, thematic focus is currently in embryonic form, which partly has to do with the intention to avoid friction and rivalry between the EEAS and Commission services. Strategic planning has not been given a prominent place – at least for the time being. Overall, the mix between geographic and horizontal departments runs the risk of once again creating “independent silos”, which counter the objective of an integrated and comprehensive policy approach connecting the dots between different policy areas and different foreign policy instruments.

Second, the roles of the top management and the division of labour between top officials in the EEAS have not been clearly defined and the respective chain of command still needs to be fine-tuned. Third, the selection of staff has aroused enormous sensitivities with strong national rivalries and the ensuing scramble for positions, which in many ways lacked transparency. Fourth, some training programmes have begun, but no systemic decision has been taken on the optimal institutional set-up, involving, for example, the creation of a Diplomatic Academy.

Finally, it remains to be seen how effective the EU’s new hybrid arrangement can function on the highest level. The multi-hatted position of the High Representative represents a daunting challenge for any person holding the post. In her first year in office, Catherine Ashton has been absent from up to 40% of Commission meetings due to other obligations and she has been unfairly criticised for not being at different places at the same time. The initial arrangements prevented her from being deputised or participating in the meetings through video-conference. This experience has made it all too clear that the High Representative must be able to delegate tasks to different deputies, who can represent her in and outside the EU.

Having said all this, it was always clear that creating such a novel and innovative, but also complex institutional set-up, for which there was no precedent, would take time and effort. The EU had already lived through similar experiences in the past. The introduction of a High Representative in the second half of 1990s or the creation of EU Agencies, such as FRONTEX, were also a struggle at the outset, but with clear leadership and determination, they have grown and matured to fulfil their functions well.

The future of the EEAS will be at least partly decided by the budgetary means put at its disposal. It is understandable that in times of austerity, EU governments insist on the principle of “cost-efficiency” being applied in the course of setting up the new service. At the same time, the EEAS cannot grow properly without a sufficient level of investment. One option is to save resources within national diplomatic services and transfer them together with some of the functions, including the consular ones, to the EEAS.

Substance in the shadow of the process

The launch of the new foreign policy structures has been an absorbing process, often at the expense of policy content. In the absence of substance, Member States have taken a fairly distanced attitude to the new arrangements. This development is highly alarming as the overall success of the reforms brought about by the Lisbon Treaty will ultimately require that national capitals feel a sense of ownership towards and buy into the new EU foreign policy structures.

Initially, there was an attempt to identify an area in the new system where individual foreign ministers could be more active. The idea of sending foreign ministers as plenipotentiaries or representatives to trouble spots or conflict areas was discussed. One option, which could have been undertaken, is that of carrying out policy reviews of the most important dossiers. A number of foreign ministers could have been in charge of coordinating that type of exercise on the basis of their particular expertise.

The early days of the new foreign policy structures have not been followed by a policy offensive. The High Representative has rather taken a cautious stance on most sensitive issues. The High Representative’s Timid reaction to some critical international events in 2010-2011 pushed Member States to a higher degree of individual or group activism. This could be witnessed in the case of Poland’s unilateral actions on Belarus after the presidential elections there at the end of 2010 or by statements by groups of Member States, especially the largest ones, on developments in North Africa in early 2011. When asked about their expectations concerning the EEAS, officials in EU capitals often say they had hoped to be bombarded with strategic papers and policy initiatives. The sense of frustration is strongest when it comes to the weak and unconvincing crisis response. Comparison is often made between the way the United States (US) and the EU reacted to the Haitian earthquake, with the former immediately sending an aircraft carrier with 19 helicopters, hospital ships, assault ships, troops and hundreds of medical personnel, and the former strenuously collecting contributions from Member States – such as search and rescue teams, tents and water purification units.

However, one should not be overcritical. There have been some important success stories in the first year, as well. The fact that Ashton and her team were able to strike a compromise on the EEAS – more or less on time – has been a major accomplishment. The High Representative and her team are also credited for having enhanced the concept of strategic partners, which was discussed at the September 2010 European Council meeting. Based on answers to questionnaires sent to EU capitals, three discussion papers were produced during the year on relations with China, Russia and the US. In policy terms, the new understanding between Serbia and Kosovo is also rightly credited to the High Representative.

In institutional terms, delegations in third countries have largely seen a positive transformation. Placing high officials from national capitals in charge of EU embassies, such as the

one in Beijing, has been welcomed as a sign of enhanced bilateral relations between the Union and key strategic partners. Naturally, there is still ample ground to better coordinate positions on the ground. One example of the disjointed approach is provided by different reactions of national embassies to the announcement of the Chinese carbon efficiency objectives. Some immediately expressed satisfaction, others stressed that the objectives were nothing new since China would have implemented them anyway as part of its policy of managing an increasing demand for energy.

Despite all the aforementioned uncertainties, deficiencies and remaining challenges, one can expect that the innovations laid down in the Lisbon Treaty will, over time, contribute to achieving the overall objective, which the godfathers of the Constitutional Treaty had on their mind when they constructed the EU's new structures, i.e. the enhancement of a more unified common European foreign policy culture.

But the EEAS and the new hybrid structure still need to be tested and adjustments will have to be made over time. It is thus wise that the Decision on the EEAS already foresees a first Report on the implementation of the EEAS in 2011 and a substantial review by the end of 2013 – which coincides with the end of the current and the beginning of the next Multiannual Financial Framework.

However, making the EU's voice heard globally will obviously be no easy task as global affairs are in a major state of flux. Those who predicted the “end of history” were proven wrong. On the contrary: History is very much in the making – even if we, as spectators from the inside at times, do not seem to grasp the complexity and speed of developments as well as the gravity of change. The world is in the midst of a major transformative moment and the EU and its members are under pressure to respond to the fundamental changes and challenges “out there”.

One cannot predict what the global order will look like in the end. It is uncertain which powers will prevail and whether the new system will be characterized by “confrontational rivalry” or “cooperative interdependence” between old and new global players. However, one can obviously witness a shift towards a less transatlantic and a less Eurocentric world. Europe is no longer in the centre of gravity and history, as global developments are increasingly shaped in other parts of the world. This geopolitical shift increases the pressure on the “old continent” to fill the gaps and to rise to the new challenges of regional and global affairs. If Europe fails to formulate a comprehensive and effective response, it runs the risk of gradual marginalisation and global irrelevance.

The role of the rotating presidency

The intensifying global competition and growing turbulence in many regions of the world mean that the EU cannot afford not to have a functioning foreign policy structure. In this

set-up, there is scope for a proactive approach regarding the rotating presidency's role. There are four areas in which the Presidency could and should make its voice heard.

The first of them has to do with linking the internal and external policy agenda. Given the leading role of the Presidency in sectoral Councils as well as in the General Affairs Council, the Presidency should, in cooperation with the High Representative, examine ways of maximising EU impact through policies on agriculture, energy and climate, internal market and others. The Presidency could introduce the issue of the external dimension of internal policies as a regular item on the agenda of the sectoral councils and the General Affairs Council, with regular reviews carried out by the Commission.

Secondly, the Presidency should facilitate the EU-27 work on global governance and the G20 agenda. Even though the Presidency is only a participant of the G20 meetings, if it is held by one of the EU G20 members, there is a reason for its “special interest” in helping work out a common EU position. Most issues addressed by the G20 cut across a range of policy fields, especially internal ones. They are discussed by the General Affairs Council in preparation of the European Council, which approves EU positions for G20 meetings. There would be a merit in awarding the Presidency a more prominent role in the process.

Thirdly, the Presidency should play a particularly important role in the closest EU neighbourhood. The summits of the Eastern Partnership and future meetings with southern European neighbours at top political levels should be closely coordinated with or even hosted by the Presidency, especially if the EU country holding the Presidency has a strong expertise and commitment to the region concerned. Foreign ministers of the countries holding the Presidency should be involved in the policy formulation process as well as visits of the High Representative in the neighbouring regions.

Fourthly, the Presidency should be involved in designing and framing certain discussions of the European Council devoted to EU external relations. The themes should be selected in such a way so as to combine the current relevance with a particular interest and knowledge of the country holding the Presidency. In addition, the Presidency should plan and host “Gymnich” type meetings for foreign ministers.

A proactive approach to the role of the Presidency should be understood as strengthening the EU's capacity to act in external relations, while also enhancing the new foreign policy structure created by the Treaty of Lisbon with the key role of the High Representative. Given the pressures of increasingly unpredictable and turbulent international relations, the EU must engage all its resources and capabilities to play an active global role. The Presidency ought to be part of that effort.

FOREIGN POLICY

An External Energy Strategy for the EU

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A comprehensive European energy policy has to be viewed in a global context. In the energy field, the European Union faces both internal challenges and external constraints. Internally, the EU is committed, in the short term, to the completion of single internal energy markets for gas and electricity, and in the medium to long term to the transition towards a low-carbon economy supported by “near-zero carbon” energy systems. However, despite a spectacular increase in regulatory activity aimed at creating a unified energy market, barely half of the work needed to create a single energy market has been done. Deregulation has been achieved, but there is a long way to go before the various national markets become parts of a homogeneous block.

On the external front, the EU is facing an international energy landscape marked by an unprecedented level of uncertainty. Whereas the international energy competition has become increasingly political, the European Union has remained impotent, with very limited powers in external energy policy. Until now, the external strategic dimension of energy policy remains mainly the prerogative of EU Member States. As a consequence, the European Union struggles to develop a common strategy regarding the selection of different energy sources and geographic origins.

Global energy context and new specific challenges: Unprecedented uncertainty

The future international and European energy context up until 2030 is defined as an “unprecedented era of uncertainty”¹. The factors of uncertainty that constrain the evolution of the international and European energy context mostly include:

- the global economic downturn because of the strong correlations between economic activity, energy supply and demand, and energy investments in key areas;

- the outcome of current international negotiations regarding climate change, which might have a direct impact on energy systems, i.e. the choice of primary energy sources, on new energy infrastructures and technologies required, etc.;
- the potential impact that “breakthrough” technologies (such as Carbon Capture and Storage or exploration of shale gas) might have on both energy supply and demand.

The external constraints facing the EU remain to be extremely important for the development of a comprehensive European energy policy. To start with, fossil fuel energy will continue to dominate the energy mix across Europe (78%), with oil (36%) and natural gas (24%), followed by coal (18%), nuclear energy (13%) and renewable energies (8%)². In the meantime, fossil fuel resources are becoming increasingly rare, and particularly in the European Union where the production of primary energy has fallen considerably in the last 10 years.

International competition for these fossil fuel resources has become a major issue for the years to come. Increased consumption of increasingly rare fossil energy has stoked major international rivalries. The great economic powers, emerging or otherwise (United States, China, India, EU, etc.), have committed themselves to unprecedented strategies of energy-source diversification. This competition has a particular impact on the European Union with its increasing dependence on external sources for its energy supply. Whereas the Union already imported 53% of its energy needs in 2007 with a relative 83% of its needs in oil and 60% in natural gas, its imports should reach 59% in 2030 with 93% for its oil and 83% for its natural gas needs.

Moreover, Europe’s strong feeling of insecurity has drastically increased due to the successive gas disputes between Ukraine and Russia directly affecting the EU. Such increasing vulnerability and dependence of EU Member States are causing intra-European rivalries. Various competing and controversial projects for oil and gas pipelines along diversified supply routes have emerged, such as Nabucco versus South Stream.

In this unstable energy landscape of the twenty-first century, the pressing question for the European Union is how it can deal with the numerous and wide energy issues it faces today and in the future on an unprecedented scale. Indeed, the future of energy policy has become a major long-term geopolitical, economic, environmental and social concern for Europe as a whole.

Current status and achievements during the last Trio Presidency

While major progress has been achieved since 2005 in developing a common internal energy policy, it has been much more complicated to develop a common approach to the external

1. International Energy Agency, *World Energy Outlook (WEO)* 2010, November 2010

2. For all data, see European Commission, “EU Energy and Transport in figures”, June 2010; and *World Energy Outlook, op. cit.*, 2010

dimension. The Union remains incapable of speaking with a single voice on the international energy scene. This prevents it from exerting its full economic, commercial and political weight in its relations with producer and transit countries. Hence, the basic principle – strongly defended in the Council – is that the energy policy should fully respect Member States’ choice of energy mix and sovereignty over primary energy sources (Art. 194 TFUE).

Initiatives taken at the EU level regarding the external dimension of energy policy remain, so far, mainly in the form of soft law, i.e. communications, statements of objectives and declaratory resolutions adopted by the EU Institutions, but without binding commitments. The only area in which the EU undertook legislative action is related to security of supply and the issue of crisis management, with the new regulation on the security of gas supply adopted in autumn 2010 (Regulation No 994/2010) in order to create a genuine EU mechanism for rapid and coordinated management of external energy crises.

Last but not least, the Lisbon Treaty explicitly recognises energy as a European policy, and stipulates that the policy’s objectives must be met in a spirit of solidarity between Member States. Yet, this solidarity has not been defined in concrete terms at the European level. While the European Council of 4 February 2011, recently created political momentum concerning the EU’s energy policy, it only resulted in the repetition of vague formulas and rhetoric, without taking any decisions regarding answers to provide or changes to occur. Concretely, the Commission has been tasked to provide a Communication on the external energy policy dimension by June 2011. Meanwhile, The Polish Presidency has made this issue one of its numerous priorities for its EU Presidency.

The need for both internal and external strategies to mitigate the external constraints

A key dimension of a European Energy Policy is to guarantee a high level of diversification of supplies both in term of sources and resources. It is therefore important to diversify energy supplies by supporting and developing a wide variety of energy sources.

Diversification of resources

It is projected that between 2010 and 2020 natural gas consumption in Europe will rise by 90 billion cubic meters (from 540 billion cubic meters in 2009 to 630 billion cubic meters in 2020). Over the same time, the amount of gas produced in Europe is supposed to fall by 102 billion cubic meters – nearly 40% (from 265 billion cubic meters in 2009 to 163 billion cubic meters in 2020). This means that Europe will be in 74% dependent on gas imports. What is more, just after crude oil, natural gas is the main fuel used by the EU countries – the share of natural gas in the primary energy consumption in the EU is approximately 25% and its importance will rise.

At the same time, initial geological analyses have identified numerous areas with potential deposits of shale gas in Europe. In 2009, the EU launched a major international project (GASH), which is to examine potential locations of shale gas in the following Member States: Sweden, the Netherlands, Germany, Austria, France and Poland. If the exploration of reserves for unconventional gas proved successful, the price of gas could significantly fall. Additionally, the continuing electrification of transportation and the use of natural gas to produce electricity could gradually supplant oil and petroleum in these sectors. These factors could also contribute to the reduction of Greenhouse Gas (GHG) emissions. Last but not least, it is argued that shale gas might have the potential to decrease European Union’s dependency on natural gas imports, at least partially. Having said that, at the moment the European Commission approaches with caution the potential of shale gas. Investments in fossil fuels are not perceived to be in line with the current policies.

The conclusions by the last EU Council on Energy (4 February 2011) underlined that “in order to further enhance its security of supply, Europe’s potential for sustainable extraction and use of conventional and unconventional (shale gas and oil shale) fossil fuel resources should be assessed”. The Polish Presidency should then undertake the first step and start the preliminary assessment of shale gas potential in Europe by the end of 2011.

In the nearest future, Europe will not be able to stop burning coal (even if it wanted). This source of energy remains an important component of many EU Member States’ energy mix (to name a few: Poland, Germany, Italy). At the same time, due to its climate change policy and commitment to GHG emissions reduction, Europe will have to implement technologies that will enable it to rapidly decrease emissions from burning fossil fuels. One of the key technologies here is Carbon Capture and Storage (CCS). CCS has to be implemented and commercialised if Europe is serious about the transition to a low-carbon economy.

For some EU countries (heavily dependent on coal) clean coal technologies can become the only tool that would enable them not to increase their dependence on external energy supplies. Take Poland as an example. If the carbon dioxide (CO₂) allowances price goes up (as it is projected), the cost of electricity production from coal will be much higher. There are two solutions to this situation: (1) development, deployment and commercialization of clean coal technologies that would make coal (and gas) fired power plants more environmentally-friendly or (2) increase of gas and other energy imports (at least in the short- and medium-term perspective) due to the fact that development of alternative fuels in Poland will take time. The second solution means more dependency on energy supplies from third countries. CCS can therefore bring benefits to the entire European Union (both within its climate and its energy policy), but a number of barriers need to be overcome for this technology to emerge.

CCS is for the time being very costly. However, certain trends on the global energy market show that many decisions will be more political than economic in nature. These include decisions

that bring about widespread use of CCS. In light of the not insignificant role of coal in the production of electricity in the foreseeable future, it is also an important element of the process connected with shaping the global climate and energy policy. Consequently, it cannot be based on a purely economic calculation. Like every political decision, costs are an element that cannot be ignored, but should not be the main factor determining the measures that are taken.

This philosophy applies to both global and European policy objectives. International organisations – such as the European Union, the United Nations, International Energy Agency, the Zero Emission Platform for Fossil Fuel Power Plants, Carbon Sequestration Leadership Forum, or the Global CCS Institute, as well as governments of selected countries around the world whose energy sectors are largely dependent upon fossil fuels, such as the United Kingdom, Germany, Australia, the United States, Canada and China – decided to support the research and development (R&D) phase of CCS.

The EU has already committed some funds to European CCS R&D projects (including the European Energy Programme for Recovery (EEPR) and NER300). There is still a financial gap to be filled, although not financing of the projects, but public acceptance for storage of CO₂ is the biggest barrier for CCS implementation for the time being. It is therefore crucial to ensure the safety of storage (by introducing necessary legislation) – every EU Member State is obliged to do so due to the EU CCS Directive – and to increase public awareness on the role of CCS in ensuring Europe's energy security in the years to come. It is again in the very interest of the Trio Presidency, starting with Poland, to engage in a Europe-wide CCS information campaign in the second half of 2011.

Diversification of sources

The second branch of the diversification policy is to launch various projects ensuring diversity of country of origin, and transit of supply for the European Union. The EU is indeed trying to develop partnerships with its neighbours, including Russia, as well as with other main energy producers, transit and / or consumer nations of the world. However, the unilateral approach of the Member States to secure their energy supply remains the rule, and bilateral deals between separate EU states and external energy suppliers continue to prevail over a specific EU approach, as often illustrated for instance in the energy relationship with Russia.

If it wants to succeed, the EU needs above all to remain committed to pursuing this process of diversification and to conclude separate binding international agreements and energy partnerships with producer and transit countries, and other international actors dealing with energy. Whereas the EU has engaged in opening its Southern Corridor to energy imports from the Caspian reserves and Central Asia, mainly through the building of the Nabucco gas pipeline, it needs now to conclude the necessary agreements and align its economic, technical and political means in order to finalise this project in due time.

Liquefied Natural Gas (LNG) terminals will also play a very important role in terms of diversification. Potential directions of supply of LNG are countries from North Africa and the Scandinavian Peninsula. This kind of approach is worth following and can help Europe fight with potential shortages of gas from one or the other supplier.

The European Union also needs to project the reach of the internal market beyond its borders, especially in its neighbourhood. The possibility of earning a reasonable return on investment in a stable and prosperous environment will continue to attract private investment – both European and foreign investors as well as energy suppliers. Foreign investment, export of new technologies and trade relations create a mutual interdependence that makes Europe less vulnerable to erratic external decision making.

A coherent external energy policy

Beyond the simple inclusion of energy objectives in foreign relations, the EU further needs to achieve a more systematic, structured and coherent use of the full set of foreign policy instruments that could contribute to the development and strengthening of the Union's external relations in the field of energy (i.e. CFSP, trade agreements, development policy association treaties, the energy community with south-eastern European countries, enlargement process, European Neighbourhood policy, strategic partnerships, etc.). In this respect, the new diplomatic service – the European External Action Service (EEAS) – should play an active role in better coordinating the EU's external action in that field.

Finally, Europe and its Member States will only make themselves heard if they present a united front. Secure access to fossil energy resources mostly situated outside the Union implies, if need be, a pooling of energy supply capacity. When internal market regulation is at stake, the European Union should be in a position to question commercial deals at the national level which may be beneficial to the parties to the deal, but not for Europe's security-of-supply as a whole.

Conclusion

Issues described in this paper have a long-term character. This means they cannot be solved in next 18 months, but they can be substantially brought forward by the Poland-Denmark-Cyprus Trio Presidency of the EU, inter alia with the use of the following instruments:

- Impact assessment of Europe's potential for sustainable extraction and use of conventional and unconventional fossil fuel resources;
- Europe wide information campaign on Carbon Capture and Storage technology;
- To achieve a more systematic, structured and coherent use of the full set of EU foreign policy instruments that could contribute to the development and strengthening of the Union's external relations in the field of energy;

- Supporting a more active role of the European External Action Service in better coordinating the EU energy external action;
- To project the reach of the European internal market beyond its borders;
- The decision of all EU Member States to allow the European institutions to question national commercial energy deals that might influence Europe's energy security in a negative way.

FOREIGN POLICY

Engaging China: EU on the Path towards Reciprocity with a Global Power

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What will be the price of rare earths? The next outcome of future sanctions on Iran? And the possibility of progress in the Doha-round or on climate change negotiations? When China reduces cars licences, it dents German car exports, a driver of growth in the European Union (EU). In all of these, China is a significant factor. China is a ubiquitous presence in international relations. It should play a similar role in the EU's policy formulation.

The EU should seek to engage China as the global and realist power it has become. The strategy should also be one of reciprocal engagement, giving something when China gives something in return. Such a reorientation demands that the EU sits down and lists its priorities for what it wants to get from China. Should it be increased market access, better protection for technology transfer, human rights improvements, cooperation on Iran or joint development aid cooperation in Africa? A long Christmas list with dispersed wishes has gotten the EU nowhere for years. A short, focused and prioritised list could provide inroads in negotiations with China. That would also provide the basis for possible trade-offs with China. The responsibility rests with the Member States to agree on such priorities. The next step is for the EU's leaders to negotiate these so China is met by a coherent negotiation partner.

Realism and trade-offs are not a substitute for a continued value-based approach by the EU. When it comes to defending democracy and human rights, the popular uprisings in Tunisia and Egypt demonstrate that Europe has to move on the right side of history. This is also a lesson for Europe in its dealings with China, where the human rights dialogue has almost grinded to a standstill and few Member States raise their voices any longer.

What do the EU's dealings with China look like? The EU does not yield as much concentrated power in the relation as it could. China uses a divide-and-rule policy when it needs to, using differences between Member States within the EU. China knows that southern European countries will dilute EU human rights policy. It knows that free-traders in the north, spearheaded by the United Kingdom (UK), Netherlands, Denmark and Sweden, will work to block strong retaliatory moves on trade that smack of protectionism. And some

Member States will even be more Chinese than China. One example is last year's decision to lift visa requirements for Taiwanese passport holders entering the EU. The EU's move was first put on hold by some of China's loyal allies inside the EU not even realising that the Middle Kingdom had moved on to a more forthcoming approach to Taiwan since 2008. Bottom line: the EU's policy continuously ends in a lowest common denominator comfortable for China.

Furthermore, the current Trio Presidency has been occupied with the euro-crisis and with the institutional rearrangement following the Lisbon-treaty (with the new President of the European Council, as well the High Representative for Foreign Affairs and the on-going establishment of the External Action Service). This is an understandable prioritisation. Yet, it leads to the perception abroad, also in China, that EU has continued a phase of navel-gazing that was supposed to be over with Lisbon. As an Asian commentator put it, it corresponds to rearranging the deck chairs on the Titanic.

The Trio Presidency seems to be off the hook concerning China-policy since the strategic partnership is now run by meetings chaired by the President of the European Council, Herman Van Rompuy and the High Representative for Foreign Affairs, Catherine Ashton, and by the Commission when it comes to the High-Level Economic Dialogue and the Executive-to-Executive meeting. Yet, concerning China, the Trio Presidency still has work to do (see recommendations below).

In principle, the removal of the rotating presidencies from international Summits should entail better coherence and less six-month thinking. Still, the EU-China summit in 2010 – chaired by the Van Rompuy and the President of the European Commission, José Manuel Barroso – was low-calorie on both content and results. So far, the confusion and coordination between a new EU Foreign minister and two Presidents is not pushing the EU in the right direction.

Talking tough with your Chinese banker

Keeping in line with Europe's inwardness, the big events of the last Trio Presidency have been defined by China.

The first was China's bond diplomacy. With the onset of the euro-crisis, China started on successive high-level tours around Europe, coming to the rescue of debt-ridden countries like Spain, Greece and Portugal. That was the story that China wished to tell. Western media happily helped diffuse it.

The reality is a much more interdependent relation between Europe and China. Europe is China's largest trading partner and it needs a stable European market. A break-down of the euro or a prolonged euro-crisis makes the currency go down and China's exports less

attractive. On top of that, China makes a virtue out of necessity because it needs to – slowly – diversify from its main reliance of dollar holdings.

China's astute bond diplomacy in Europe was also enhanced by opacity on both sides. Europe makes it easy to give it a bilateral tweak as saviour of Spain, Greece and Portugal. For example, there was no official Chinese announcement on investment in the eurobonds issued by the new EU emergency fund to sustain Ireland. The auctioning of those bonds coincided with China's bilateral declarations in Spain in January 2011. China knows that dealing bilaterally with the political dwarfs of Europe, as labelled by Wikileaks, leads to larger pay-offs than bolstering multilateral European initiatives. Japan, on the other hand, made a public announcement of purchases of the mutual European Fund.

The European reality is that, although there is a common currency there is no communal bond market, so each country meets with its creditors, like China, on a stand-alone basis. China does not reveal the composition of its purchases in bonds, only the total amount of foreign currency reserves. European countries have no harmonisation in this area. The European Central Bank only gives figures for non-domestic buyers of sovereign debt, which includes intra-European purchases. My own estimate, based primarily on news sources, was that the actual purchase in the three countries amounted to around €20 billion. This sum is quite small when compared to China's overall addition of more than \$500 billion from June 2009 to September 2010 even in a year of international economic crisis.

Europe should welcome larger purchases by China, but mitigate any political effects by increasing transparency. The inspiration should be the United States (US) Treasury's monthly publication disclosing foreign purchasers of bonds. Europe should also develop joint messages for bilateral Chinese visits, so that bond purchases and feelings of vulnerability do not impact a coordinated European message. Europe must learn from the US to talk tough with its banker.

China's dream of empty chairs in Oslo

The second China skirmish was on awarding the Nobel Peace Prize to Liu Xiaobo. The initial European reaction to the award was piece-meal and hesitant. Some countries published strong bilateral statements and others stayed silent. France was notably absent at the top-level, busy preparing for the state visit of the Chinese President Hu Jintao. In the statement by Barroso, there was not even a demand for the release of Liu, which is a constant element when the EU raises his case with the Chinese authorities. China could have left the EU in that disarray, but it decided to push further, which back-fired.

Vice Foreign Minister Cui Tiankai threatened that there would be repercussions for European countries attending the award ceremony, and similar messages were relayed through China's

diplomatic network in Europe. This new version of non-interference – telling the Europeans which meetings to attend inside Europe – galvanised the Europeans to decide on securing attendance at the level of ambassadors. Sources say that some countries like Romania had been ready to down-grade their presence to accommodate China. The EU even extended the value fight and got Serbia, a country with EU aspirations, to show up. The first report was that Serbia was going to defer to China in its quest for empty chairs.

Yet, in a relationship where the balance of power has tilted, this was a short hour of glory for Europe. This Europe – which in the 1990s, after the crack-down on Tiananmen Square, put sanctions on China and orchestrated human rights resolutions in the United Nations (UN) – is now facing “soft sanctions” by China to discourage high-level meetings with the Dalai Lama and a China-led block in the UN that dilutes European influence and pressure concerning human rights.

Can Europe change from paper-diplomacy to genuine strategy?

Simultaneously, and outside of the limelight of the euro-crisis, Europe has actually been working quietly on improving strategy and coherence when facing China. The right moves have been taking place – on paper.

The EU has reassessed its strategic partnership with China. The foreign ministers debated China in September 2010 – a novelty – last conducted back in 2004-2005 in the divisive years of discussing the arms embargo. Ashton held in September her first strategic dialogue with Dai Bingguo, the Chinese state councillor dedicated to foreign policy.

In December 2010, the European Council adopted a new approach based on reciprocity, trade-offs and interests. As Van Rompuy has explained, reciprocity is no longer a “bad word”. The aim is to define Europe’s principal interests and negotiate these with China. This specifies an urgent need for the EU to define clear priorities and stick to them in negotiations, in order to match China’s consistent demands and so-called “core interests”.

That is easier to write in a strategy paper than enact in practice. Dealings with China by individual Member States show that short-term benefits for national capitals are often preferred to joint European priorities. China will work actively to continue that state of play. And on top of the 27 Member States, China can now also exploit the potential creaks between two Presidents and the High Representative. Not to forget the European Parliament, also with a role to play in foreign policy post-Lisbon. China has already foreseen that development and sent its eloquent Vice-Minister of Foreign affairs to address and lobby the Parliament in October 2010.

This more hard-nosed approach is mostly evident in EU’s trade relations with China. It also has origins going back to the 2006 Communication on China from the Directorate-General (DG)

for Trade, realised during Commissioner Peter Mandelson’s reign, which sharpened the pen and tone of the EU’s trade relationship with China. And now the financial crisis has increased European impatience, waiting for better market access in China while the economic boom of the world’s self-proclaimed developing country continues unhindered. Asymmetries in the relationship are no longer tolerated to the same degree. When a Chinese company got the public tender for rebuilding a high-way in Poland, it highlighted the openness of the European system. There is a stark contrast to the lack of access for European companies in China, particularly in public procurement. In the new draft trade policy issued in November, DG Trade suggested the possibility of a new instrument that will encourage reciprocal opening and, if not, will also envisage the possibility closing Europe’s public procurement market.

Likewise, the EU did push back on China’s desire to make its coming innovation policy purely home-grown. China softened its stance on this at the High-Level Economic Dialogue in late December 2010. Later in January 2011, with much larger publicity, it gave the same concession to Obama at the meeting with Hu.

Yet, events – like Chinese bond diplomacy, the flow and ebb of bilateral visits and the short-term desire for new contracts to be inked – seem still to overtake any new European strategy. Ashton and the European External Action Service (EEAS) cannot be expected to salvage this. She can give consistency to a joint approach. Yet to be solidly grounded, the new approach still has to overcome Member States’ bilateral reflexes, which favour short-term benefits to joint European messages.

This demands a genuine reality check as to what serves the national interest. The big players in Europe have been bypassed economically in the last decade by China. They still have traction individually, but much less than their national egos would like to think – this is true even for Germany, which is currently accelerating its large-scale exports to China. Bilateral state visits must be employed to amplify European priorities. Germany could find a new role here as a natural leader and the *primus inter pares* among the big three European players, amplified by its own burgeoning trade relationship with China that gives it traction in Beijing. The stake here is for Europeans to streamline and rationalise their demands and amplify European messages at the bilateral level in order to obtain what they want.

Europe has to work hard to be taken seriously as a global player – or just as an equal negotiation partner – by Beijing and not just as a large market with opportunities for investment and high-tech acquisitions, similar to how Africa is needed for China’s search for commodity access.

The coming period during the Trio Presidency of 2011-2012 will show if the new strategy process can overcome bilateral tendencies, China’s shrewd negotiation-style of “divide and rule”, and EU-bureaucracy. Poland, Denmark and Cyprus can play a role in this. Neither of the presidencies will be in the front seat in Summits with China. Instead but equally important for the success or failure of EU’s approach to China there will be tasks in the machine room of

the EU. A coherent China strategy has to combine elements from trade, climate change and foreign policy in order to be successful and create the possibilities for linkages and interest-based trade-offs.

Recommendations

What does Europe want from China? Define European priorities in the strategic partnership to match the Chinese “core interests” and consistent demands on the arms embargo, Market Economy status and the One-China policy. This debate has to be led by Ashton. Yet, the Trio Presidency can play a role in nudging the debate on among Member States as well as linking it particularly to the trade policy still run by the rotating presidencies. It requires a good team player and coordinator behind the scenes. Belgium played this role well during its Presidency.

Connect the dots in the China-strategy. Internal EU policy changes have impact on over-all China strategy. For example, agreeing to an instrument on public procurement targeting third countries that close off their markets to Europe will have broader positive ramifications for negotiating with China. Likewise, on climate change and energy. The coming presidencies have a stake here and in seeing in the broader light of EU-China relations.

Greet Chinese bond diplomacy with transparency and common messages. Europe’s debt woes will not go away. China, with extra reserves, should be a welcome part of the solution. Yet, Europe must learn to talk toughly with its banker as well. Standards should be introduced in Europe – like those of the US Treasury on publishing foreign countries’ purchases of sovereign debt – so that opacity cannot be employed to enhance political influence. This could be promoted by the Trio Presidency. Joint European messages should be delivered at bilateral visits to ensure that purchases do not affect policy.

FOREIGN POLICY

State of Play of the International Climate Negotiations: How to Bridge the Remaining Gaps?

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The stakes were high after the fifteenth session of the United Nations’s (UN) Conference of the Parties (COP) in Copenhagen last December 2009. The UN process was in bad shape and trust among the parties was lacking. Expectations for the next UN COP in Cancun last December 2010 were therefore at rock bottom. Rather than the all-or-nothing approach that proved inefficient in Copenhagen, the European Union (EU) envisaged the Cancun summit with a stepwise approach. The aim was to reach a balanced package capturing progress made thus far and allowing for concrete action. These expectations were broadly met as the agreement reached in Cancun – approved by all parties but Bolivia – laid the groundwork for concrete action against climate change at the international level.

Although we are back on track, the Cancun agreement falls far from a comprehensive and legally-binding agreement that includes all major emitters. Important stumbling blocks remain, making the conclusion of such an agreement at the next COP in Durban at the end of 2011 unlikely. What is likely though is that international efforts will be increasingly driven by a bottom-up approach from the private sector, concerned citizens and committed governments.

Before laying out a number of recommendations for the Trio Presidency, the positive outcomes of the Cancun UN summit and the remaining important gaps to the conclusion of a comprehensive global climate agreement will be examined.

The positive outcomes of the Cancun UN summit

Given the low expectations, the agreement reached in Cancun was hailed by many as a success. Although the achievements are relatively modest, they appear to have revived faith in the multilateral UN process, while formally recognising the political guidance of the Copenhagen Accord.

A shared vision for long-term cooperative action has been adopted, writing a new chapter in history of international climate action. Besides the formal recognition of the objective to maintain the rise in global temperature below 2°C above pre-industrial levels, parties have also recognised that the current national emission reduction pledges need to be significantly scaled-up to achieve this goal. While mitigation is paramount, adaptation to the impact of climate change was identified as equally important. The impact of global warming has already occurred in a number of countries and will continue in the years ahead, even under the most optimistic scenario. Climate change has also been recognised as one of the greatest challenges of our time. This challenge will require a paradigm shift towards a low-carbon society, offering substantial opportunities.

The Cancun agreement also elaborated on most of the key issues of climate negotiations, including:

- The development of two slightly different systems for the measurement, reporting and verification (MRV) of emissions reduction for developed and developing countries. MRV is very important; not only does it serve the international community to track countries' compliance with their pledges, but also it allows national decision makers to track progress, prioritise correctly and verify the return on their investments.
- The establishment of a Green Climate Fund (GCF) to help developing countries finance the fight against climate change in the long-run.
- A strategy to Reduce Emissions from Deforestation and Forest Degradation (REDD).
- An Adaptation Framework.
- A technology transfer mechanism between developed and developing countries.
- Capacity-building in developing-countries.

These achievements lay the groundwork for further action. In preparation of the next UN summit in Durban, a number of technical issues will have to be resolved, especially on the climate governance system. Besides, the decisions reached have so far failed to resolve key issues, addressed here-under, that could yet prove to be stumbling blocks to the achievement of a global climate agreement.

What commitments can we expect?

The question of the national emission reduction commitments is intimately linked to the legally-binding nature of the agreement. So far, the commitments are not binding under international law, leaving the most contentious issue of legal form unanswered.

The existing legally binding agreement, namely the Kyoto Protocol, expires in 2012 and the question of whether it should be prolonged for a second commitment period has divided the international community. Developing countries, including emerging economies like China and India, insist on a second round of the Kyoto Protocol under which they do not have

binding emissions reduction commitments that could hamper their economic development. The EU, Japan, Australia, Russia, and Canada support the establishment of a new legally-binding agreement, taking into account the positive elements of the Protocol. However, the United States (US), which never ratified the Protocol, is not ready to approve any legally-binding agreement unless major economies, such as China and India, are also included.

Although the EU favours the conclusion of a new legally-binding agreement, it has also shown willingness to commit for a second round of the Kyoto Protocol since October 2010. It argues that if we do not have a replacement, we should take care to not throw out what we have. In Cancun, Japan, Russia and Canada made it clear that they would not sign up for this as long as the two biggest emitters – namely the US and China – are not willing to commit to the Protocol. The EU's support of the Protocol is therefore of very little value. This key issue was left up in the air in Cancun, but it seems clear that there will be no successor to the Kyoto Protocol by the end of 2012.

So far, no agreement has been reached on an ambitious global target of emission reduction. The International Panel on Climate Change (IPCC) recommends reducing global emissions by 50-80% by 2050 compared to 1990 levels, with developed countries needing to reduce emissions by 80-95% by 2050. Since the Copenhagen UN summit, many countries – among which the biggest developed and developing economies – have agreed to reduce their emissions by 2020. However, it is estimated that current pledges put the world on a path for a global warming of 3.5°C by 2100. Yet, significant risks are now associated with a global temperature rise of 2°C, hence the important call from more than 100 countries to consider holding the raise in global temperature to 1.5°C.

As the top-down approach of legally-binding reduction targets is breaking down, a new bottom-up approach is emerging. Efforts are increasingly driven by the private sector, concerned citizens and committed governments. A green gold rush to seize the enormous opportunities offered by the necessity of building a sustainable low-carbon economy has started. This challenge is no longer simply perceived as environmental, it also represents a huge potential for competitiveness, job creation and economic growth. All large economies like China, Japan, the US and the EU are embracing the race to compete in the research, development and deployment of new green technologies. In order to do so, the EU has adopted a Strategic Energy Technology Plan (SET-Plan). However, China has recently overtaken the EU in green technology investment. National and local policy change will therefore increasingly lead rather than follow international efforts. Over time, a well-designed international agreement remains nevertheless central to provide certainty in order to encourage and accelerate domestic action. Without certainty at the international level, investors will continue to be cautious about investments in green technologies.

Although the EU has one of the world's most ambitious emissions reduction target, it is increasingly obvious that the 20% emissions reduction target by 2020 is insufficient in several

respects. Not only is it inconsistent with the 2°C target, but also with the need to capture the opportunity that the transition towards a low-carbon society represents. Moreover, the Emissions Trading Scheme (ETS), the cornerstone of the EU's climate policy, suffers from a lack of ambition demonstrated by the 20% target, which prevents the emergence of a consistent carbon price.

How to finance climate action?

Ensuring the necessary financing to address climate change is another difficult and highly political issue for climate negotiations. Given their economic capabilities and their historical responsibility for global warming, developed countries are expected to bear the majority of costs associated with global climate action. As such, an agreement on climate financing is crucial for building trust between developed and developing countries.

In Cancun, developed countries confirmed their commitments made one year earlier in Copenhagen to provide funding to support mitigation and adaptation activities in developing countries. They committed to jointly mobilise \$100 billion annually by 2020 from both public and private sources (long-term financing). In addition, they have pledged new and additional resources amounting to \$30 billion for the 2010-2012 period (fast-start financing), balanced between adaptation and mitigation, and prioritised for the most vulnerable developing countries. Developed countries are invited to submit to the UN Framework Convention on Climate Change (UNFCCC) secretariat an annual report on resources provided and on access to fast-start financing from mid-2011. The EU's report on fast-start financing in 2010 already shows its commitment to transparency.¹

The Cancun agreement also set the framework of climate financing governance by establishing a Green Climate Fund as well as an assisting committee, called Standing Committee, under the UN's COP. A significant share of funding for mitigation and adaptation should flow through the fund. Currently, only about 10% of climate financing has flowed towards adaptation. Since the Cancun agreement requires a balanced allocation between adaptation and mitigation, a percentage much closer to 50% would be appropriate. The Green Climate Fund should therefore address this adaptation gap. The fund will be governed by a board of 24 members comprising an equal number of members from developed and developing countries. It will have the World Bank as interim trustee. A Transitional Committee will be in charge of recommending a proposal to the next COP in Durban for the design of the Fund. With regard to the Standing Committee, it will assist the COP in terms of improving coherence and coordination in the delivery, rationalisation, mobilisation of resources and MRV of support provided. These functions need to be further defined though.

So far, it is unclear how scaled-up, new and additional funding will be raised to mobilise \$100 billion per year. The agreement stipulates that the money will come from various sources, public and private, multilateral and bilateral, including alternative sources. The report of the High Level Advisory Group on Climate Change Financing, mandated by the UN Secretary-General to study the contribution of potential sources of revenue towards meeting this goal, provides an important input.² The practical proposals set out in this report include interesting innovative sources to be considered, such as taxes on international aviation and shipping or a Financial Transaction Tax.

The bulk of climate finance will come from the private sector, particularly through market-based mechanisms. To date, the Clean Development Mechanism (CDM) has been the main source of mitigation finance for developing countries. This mechanism, by which developed countries can compensate their domestic emissions by investing in cost-effective emission reduction projects in developing countries, must be part of the post-Kyoto architecture, albeit in an improved form. Several design and operational shortcomings regarding environmental integrity, economic efficiency, geographical balance and procedural complexity need to be addressed. Nevertheless, as a technology transfer mechanism towards developing countries, the CDM has achieved progress as it was agreed to include carbon capture and storage technologies into the mechanism.

Another open issue for the next summit in Durban is the development of new sectoral carbon market crediting mechanisms. After 2012, these sectoral carbon markets should be phased in for more economically advanced developing countries. They should allow these countries to scale up private investments in accordance with their climate priorities. These voluntary carbon markets could become important in key sectors such as forestry where emissions can be reduced at reasonable costs. Before REDD can be linked to carbon markets, some important issues must be addressed though.

International public funding will be of particular importance for adaptation and capacity building. However, given the tightening of government budgets coming out of the economic recession, scaling up public finance will be difficult. In the EU, the revenue of the auctioned allowances from the ETS was envisaged as one of the major sources to mobilise climate finance. However, given that the carbon-price is likely to remain low in the next years with the current 20% emission reduction target and that Member States are likely to allocate only a small percentage of auctioning proceeds to finance climate action, it is clear that scaling up public finance in the EU will not be easy. Besides, developing countries fear that public funding results in recycled funds. Being classified as Official Development Assistance, climate finance may divert funds normally dedicated to development aid programmes. Yet, the Cancun

1. Council of The European Union, Report, "EU Fast start finance Report for Cancun", ECOFIN 686, 15889/10, 9 November 2010, available at: <http://register.consilium.europa.eu/pdf/en/10/st15/st15889.en10.pdf>

2. United Nations, "Secretary-General's High-level Advisory Group on Climate Change Financing", Report, 5 November 2010, available at: http://www.un.org/wcm/webdav/site/climatechange/shared/Documents/AGF_reports/AGF_Final_Report.pdf

agreement states that the funds shall be new and additional. However, the definition of “new and additional” funds constitutes a big political discussion with no clear way out.

Recommendations for the Trio Presidency

The state of climate negotiations has clearly improved since Copenhagen. However, in light of the significant remaining gaps, it will be difficult to pave the way towards a legally-binding framework. In order to be successful, the EU will have to show continued leadership by endorsing the following recommendations:

Provide a clear signal domestically

- Create an ambitious roadmap towards the reduction of EU emissions by 80-95% by 2050 in order to seize the *substantial opportunities* offered by the necessary *shift towards a low-carbon society* to tackle climate change required by the Cancun agreement. In order to do so, the EU should move quickly from a 20% to a 30% emissions reduction target by 2020. It is clear that the 20% target is not consistent with the 2°C global target, the need of a consistent carbon-price in the EU ETS and the EU international finance obligations. Besides, intermediate targets in 2030 and 2040 should also be determined.
- Commit to the full decarbonisation of the power sector by 2050.
- Improve the efficiency and effectiveness of the SET-Plan in order to accelerate the research, development and deployment of cost-effective low-carbon technologies. This will require an increased contribution for the SET-Plan in the next EU Multiannual Financial Framework, involving a political commitment from the EU.

Maintain a stepwise approach internationally

- Continue its stepwise approach consisting in capturing progress made thus far and working concretely through issues one by one.
- Focus more on building bilateral climate partnerships with strategic partners (for example, China, India and South Africa) on the basis of a carrots and sticks approach.
- Reflect on sources for long-term finance and ensure the best use of EU fast-start finance, while maintaining efforts of transparency.

FOREIGN POLICY

EU and the Financial Sector Reform: Ensuring Global Harmonisation

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Reforming global finance: The challenge of harmonisation

Since the outbreak of the global financial crisis, political and regulatory authorities around the world have been engaged in a difficult and ambitious effort to reform financial markets. Given the seriousness of the crisis, the financial reform process attained unprecedented political prominence, sealed with a display of international solidarity and commitment for fundamental reform in the financial sector in the first G20 Summit in Washington in November 2008. The European Union (EU) was fast to act in this area, with the European Commission bringing proposals for reform already in the autumn of 2008, at the height of the crisis. Since then, the Commission has drafted a programme of comprehensive reform, including more than 30 legislative initiatives covering all aspects of financial regulation. Many of the proposed changes have already been agreed and implemented, including a new European institutional supervisory structure, comprising new supervisory authorities for banking, insurance and securities, and a European Systemic Risk Board (ESRB). Other proposals are under discussion and still others are to be presented in the coming months, with a view to adopting all new legislation by the end of 2011, and completing its implementation into national law by the end of 2012. At the same time, the United States (US) has embarked on its own national deliberations for reform, achieving a major milestone with the passage of the Dodd-Frank Act in July 2010. The Act has brought significant changes in all areas of financial regulation, comparable in scope with the European initiatives. Finally, at the international level a host of international and transnational organisations, active in the drafting of financial regulation, are also engaged in a wide array of regulatory initiatives. Significant progress has been made in a number of areas, most importantly with the establishment of the Financial Stability Board (FSB), tasked to ensure the stability of the global financial system, and the agreement on new capital requirements for banks (which is accompanied by new liquidity and leverage ratios) at the Basel Committee on Banking Supervision (BCBS), endorsed by the Seoul G20 Summit in November 2010.

Despite the significant progress that has been achieved, the parallel national, regional and international reform initiatives, do not always proceed at the same pace, and do not always

result in similar or even consistent regulatory solutions. The resulting differences stand in the way of a globally harmonised regulatory regime, desperately needed for the effective supervision of a financial system whose global reach has not been affected by the crisis. This problem becomes all the more important as many issues remain unresolved, while the details of many headline agreements are still to be worked out. Failure to coordinate effectively the global financial reform will unavoidably lead to a fragmented and uneven international regulatory landscape, offering opportunities for regulatory arbitrage, with potentially dire consequences for the future stability of the global financial system. Given the interdependence of the European and international financial markets, and the former's impact on the European economy (both features illustrated vividly by the recent financial crisis and its on-going reverberations in Europe), the EU has every incentive to be at the forefront of the international reform effort, and to work for the harmonisation of the global financial regulatory regime.

International financial reform initiatives: current problems and pressures for divergence

The current situation presents three problems that need to be overcome in order to meet the challenge of international harmonisation. The first two have to do with regulation that has already been agreed, and refers to differences that have emerged in the new rules adopted since the crisis in a number of issue-areas, and to pressures already apparent in both the EU and the US to deviate from particular aspects of recently completed international agreements. The last problem refers to the fragmentation of EU's representation in the G20 and other international regulatory *forums*. This last problem is particularly important for the regulatory negotiations that follow, since, despite the problems, the current situation also presents a unique window of opportunity, given that many issues, especially those that concern international aspects of the financial system, remain open.

Differences in regulatory approaches

As mentioned above, while recording significant successes, the international financial reform process has not always been consistent. There are a number of issue-areas where new regulation has moved in different or even opposite directions, providing opportunities for regulatory arbitrage. For example, one of the most significant and high profile issues that has been directly related to the crisis, and which has received different treatment in the two sides of the Atlantic, is the issue of executive compensation in financial institutions. The third revision of the Capital Requirements Directive (DRD III), has introduced significant changes in remuneration issues, in force since January 2011. The new legislation stipulates that banks have to defer 40 to 60% of bonuses for 3 to 5 years, and 50% of any immediate bonus must be paid in shares or in other securities linked to the bank's performance. As a result, bankers will only be able to receive between 20 and 30% of any bonus in upfront cash, while deferred bonuses

can be clawed back later if performance in the latter years deteriorates. In contrast, the most important change in this area in the Dodd-Frank Act, introduces only the right of the shareholders to a non-binding vote on executive pay and golden parachutes. It is evident, and European officials have repeatedly pointed this out, that this difference in the treatment of executive pay puts European financial institutions at a competitive disadvantage. A move in early 2011 by US regulators to propose a deferral requirement for three years and the possibility of claw-back clauses reduces the gap between the rules (although it does not completely eliminate it), provided of course that the proposal survives what is certain to be a long and intense deliberation process.

Another significant issue-area where differences have emerged is the harmonisation of accounting standards. The G20 has asked the International Accounting Standards Board (IASB), whose standards the EU has adopted since 2005 for the consolidated accounts of all listed companies, and the US Financial Accounting Standards Board (FASB) to redouble their efforts to produce a single set of global accounting standards and complete their convergence project (on-going since 2002) by June 2011. The G20 also asked the accounting standard setting bodies to improve and harmonise their standards for various aspects of financial instruments and loan-loss provisions. Despite significant overall progress with their convergence project, the IASB and the FASB have issued different proposals for dealing with fair value for financial instruments, with the FASB opting for an all-out fair value approach, while the IASB proposed a mixed approach that combines fair value and amortized cost. Given the controversial role of fair value accounting for financial instruments during the crisis, and the fact that to some degree these differences reflect a deeper rift between the American and European accounting approaches to fair value, achieving the goal set by the G20 is far from guaranteed. Indeed, in June 2010 the two bodies announced that they would not be able to reconcile their differences by the June 2011 deadline set by the G20, and postponed the completion of a number of projects for the end of 2011. Although a December 2010 decision by the FASB to revise its previous approach for the use of fair value for the classification and measurement of financial instruments is a significant step towards convergence, new IASB proposals on hedge accounting are moving in a direction that increases the differences between IASB and the FASB in this issue-area, raising new problems for the timely completion of the convergence project.

National / Regional implementation of international agreements

Differences are not only found in regulations and standards developed by different regulatory bodies, but also in the national and / or regional implementation of internationally agreed rules. There is evidence that the consistent implementation of some of the international agreements that have been reached these past two years is already undermined by conflicting national regulations and industry pressure. The most worrisome developments in this context relate to the adoption of the new Basel III agreement, regarding the capital requirements for banks, which arguably is the single most important piece of international financial

regulation. Already a potentially significant conflict between Basel III and the Dodd-Frank Act has been identified, as the latter bans the use of credit rating agencies' assessments for regulatory purposes in financial regulation, while the former continues to rely on them for measuring risks and determining the capital requirements. As US regulators have not been able to come up with a credible alternative to credit ratings these past few months, there are fears that the implementation of Basel III will be delayed (and will probably be inconsistent with international practice, as it will rely on different ratings) in the US, which it should be noted, has not yet fully implemented Basel II. This has caused concern in Europe, which however faces pressures of its own to provide a "European version" of Basel III. A number of European banks, backed in some cases by national politicians, have been making public their disagreement with many of the Basel III requirements, particularly the introduction of the leverage and liquidity ratios. Indeed, they are already engaged in significant lobbying efforts to introduce deviations from the original Basel rules in the context of the deliberations on the draft of the fourth update of the Capital Requirements Directive (CRD IV) that will transpose Basel III into European law.

European fragmentation in international *fora*

This is an issue already identified by previous TGAE contributions, and one that remains relevant and significant in the current situation. The fragmentation of European representation in international *fora*, such as the G20, undermines the regulatory position of Europe at the international scene, while also weakening the prospects of effective international cooperation by increasing the diversity of national voices in international negotiations. This situation is troubling, since there are still a lot of important regulatory issues that remain open, particularly those with significant international implications, such as the regulation and supervision of systemically important financial institutions (SIFIs) and the management of cross-border financial crises. These issue-areas require close cooperation between regulatory authorities at the international level and the adoption of consistent regulations at the national and / or regional level.

Enhancing EU's contribution to global harmonisation: Some recommendations

Ensuring the coordination of the regulatory initiatives taking place at the national, regional and international levels is absolutely necessary, if they are going to be effective in preventing a future global financial crisis. Protectionism and national vested interests should not derail the international effort, because in the end, the interpenetration and interdependence of international financial markets will ensure the spread of a future crisis to all countries, irrespective of the particularities of their regulatory regime. Given the weight of the European financial markets, and its wider economic significance, the EU has a special interest and responsibility in safeguarding the stability of the global financial system. In this respect, the Polish, Danish

and Cypriot Trio Presidency has a particularly important role to play, as it will preside over the last stage of the European financial reform process, due to be completed by the end of 2012, and more generally over a period when all remaining significant issues in international negotiations are going to be decided and implemented. In this context, the following recommendations aim to help the next EU rotating Presidency address the problems described above, and advance EU's contribution to the harmonisation of global financial regulation:

- The Polish, Danish and Cypriot Trio Presidency should ensure that EU assumes a leading role in the coordination of financial regulatory reform at the national, regional and international levels.
- There should be efforts, in cooperation with other jurisdictions and/or international organizations, to discuss and coordinate possible revisions and/or amendments of current regulations that lead to significant national differences and offer opportunities for regulatory arbitrage.
- The EU should resist unjustified deviations from internationally agreed regulations, in their transposition into European law.
- Other jurisdictions (most importantly the US) should be persuaded to desist from similar deviations from international agreements, requiring at the very least the adoption of regulations with equivalent results.
- When developing its own rules in the context of the European financial reform process, the EU should make every effort to ensure their conformity with existing internationally agreed principles and regulations.
- The next Trio Presidency should try to forge a unified position among European representatives in international *fora*, consistent with the view of the EU. This is particularly important for issues that have not yet been addressed in the European financial reform process. A unified position would allow Europe to exert more influence in the construction of the new international financial regulatory regime, but also, by reducing the diversity of national voices in the context of international negotiations, enhance the prospects of greater international cooperation.

FOREIGN POLICY

The Future of Global Economic Governance:
From the G20 to a Global Economic Council

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To many, the Seoul summit was thus the real test of the G20: the outcome would show whether the G20 continued to have viability and relevance. The result was disappointing. In the words of the *Financial Times*, the G20 had shown “how not to run the world”.¹ In the view of many, the self-declared steering committee for the global economy had failed.

Often, issues of legitimacy and effectiveness are thought of in terms of a trade-off: more legitimacy, less effectiveness – and vice versa. This paper is based on the reverse assumption: that in matters of global economic governance, legitimacy and effectiveness go hand in hand. The paper therefore sets out to identify the main legitimacy problems of the G20, and uses this analysis as the basis for proposing a mode of global economic governance that it considers more likely to be effective. The proposal should be pursued jointly by France, which holds the Presidency of the G20 in 2011 and the Trio Presidency (Poland, Denmark and Cyprus) of the European Union (EU).

The paper advocates a fundamental reform of the existing Bretton Woods system, reshaping its governance structures to reflect the geopolitical realities of the 21st century. Being firmly embedded in the Bretton Woods system, the creation of a Global Economic Council would establish a legitimate steering committee of the global economy, serving as the pinnacle of a new model for global economic governance.²

The origin of the G20

The G20 first emerged in the wake of the financial crisis in Asia in 1999, as an informal finance ministers and central bank governors’ forum. On 25 September 1999, the G7 finance

1. “G20 show how not to rule the world”, *Financial Times*, 12 November 2010
 2. This essay draws upon a recently published report: Jakob Vestergaard, “Beyond the G20. Towards effective global economic governance”, DIIS report 2011:4, Danish Institute of International Studies (DIIS), 2011, available at: http://www.diis.dk/graphics/Publications/Reports2011/RP2011-04-G20-and-beyond_web.pdf

ministers and central bank governors announced their decision to “broaden the dialogue on key economic and financial policy issues”.³ The G7 countries hence invited their “counterparts from a number of systemically important countries from regions around the world” for the first G20 meeting held a few months later in Berlin. The Berlin *communiqué* reiterated the intention stated by the G7 in its September meeting:

The G20 was established to provide a new mechanism for informal dialogue in the framework of the Bretton Woods institutional system, to broaden the discussions on key economic and financial policy issues among systemically significant economies and promote co-operation to achieve stable and sustainable world economic growth that benefits all⁴.

It is striking that the G20 was conceived as a forum for informal dialogue within the framework of the Bretton Woods system. A decade later, many would see the relationship between the G20 summits and the Bretton Woods system as, at best, antagonistic and ambiguous. No less remarkable is the reference to “systemically significant economies” and the absence of a reference to the G20 as a “representative” forum. The question of legitimacy, in terms of “representing” a large share of the global economy, was not really an issue in 1999. It was a club of the “systemically significant”.⁵

For the first decade, from 1999 to 2008, the G20 forum of finance ministers and central bank governors attracted little public attention. With the advent of the global financial crisis this changed completely. Now leaders of the largest powers of the world economy decided to use the G20 construction as the basis for creating a Heads of State forum in which to discuss and coordinate responses to the global financial crisis. In a short period of time, the G20 moved from relative obscurity to centre stage, in face of a financial crisis that threatened to cause a meltdown of the global economy.

The illegitimacy of the G20

The G20 claims that its “economic weight and broad membership gives it a high degree of legitimacy”.⁶ However, in a setting where the great majority of countries have no voice and influence, any claim to “representational” legitimacy is less than convincing. The permanent exclusion of 173 countries violates the principle of universality, a fundamental principle of liberal internationalism and indeed of international cooperation since the Second World

3. G20 Research Group, “The Group of Twenty: A History”, November 2008, p. 8, available at: www.g20.utoronto.ca/docs/g20history.pdf

4. *Ibid.*, p. 63

5. The countries invited for the first G20 meeting in Berlin in December 1999 were Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, the Republic of Korea, Mexico, the Russian Federation, Saudi Arabia, South Africa, Turkey, the UK, and the USA. In addition to these 19 nation states, the twentieth member of the G20 was the EU, “represented by the rotating Council presidency and the European Central Bank” (G20 2010a). The G20 is really a “G19+1” then

6. French G20 Presidency/HM Treasury, United Kingdom, “What is the G20?”, 2010, accessed on 22 April 2011, available at: http://www.g20.org/about_what_is_g20.aspx

War. There are several further reasons why the G20's claim to representational legitimacy is unconvincing:

- There is only one African member country (South Africa)
- No low-income countries are included
- Not one single "small, open economy" is present in the membership

This reflects, of course, that when the countries were originally selected, the intention was to create a forum for "systemically significant" economies. Today, however, after having been elevated to a Heads of State forum, which alludes to being the premier forum of global economic governance, under-representation of Africa and the absence of low-income countries have become highly problematic. The same applies for the absence of small, open economies. This type of economy is perhaps the most common in the world economy, but there is nevertheless no small economy included in the G20 to voice the perspectives and concerns of such economies.

As a leader's forum for responding to the global financial crisis, the G20 was outdated from the beginning. Had twenty countries been selected in 2008, on the basis of the then prevailing geopolitical world order, there is no doubt that a different set of countries would have been chosen. The problem was not only that member countries had been selected a decade earlier, however, but also that the process by which countries had been selected was of questionable legitimacy, a "reflex of the G7 world":

They were selected by Timothy Geithner at the US Treasury in a transatlantic telephone call with his counterpart at the German Finance Ministry, Caio Koch-Weser. Geithner and Koch-Weser went down the list of countries saying, Canada in, Spain out, South Africa in, Nigeria and Egypt out, and so on; they sent their list to the other G7 finance ministries; and the invitations to the first meeting went out.⁷

The inclusion of countries such as Argentina, Australia and Saudi Arabia reflected not so much that these were considered more "systemically significant" than other countries, but that an effort was made to include in the forum good allies of the United States (US). This means that, contrary to received wisdom, the G20 cannot claim to be legitimate, not even in the limited sense of being the world's largest economies.⁸

Going forward, the absence of objective criteria for membership is a serious shortcoming of the G20. How is membership to be adjusted to the rapidly changing realities of the global economy in the coming years? One may say that the main strength of the G20, that it was already there, ready-made and "flexible", has turned out to also be its main weakness: its membership is outdated – and this problem will only increase in coming years.

7. Robert Wade, "From global imbalances to global reorganizations", *Cambridge Journal of Economics*, 33, 4, 2009, p. 553

8. If one was to reshape the G20 so as to be comprised of the world's twenty largest economies, Argentina, South Africa and South Korea would need to be replaced by the Netherlands, Poland and Spain (see Annex 1 for details)

Annex 1 | The world's largest countries, by GDP (billion USD) and population (millions)⁹

Ranking	GDP (nominal)	GDP (PPP)	GDP* (60/40)	By population
1	US (14256)	US (14256)	US (14256)	China (1331)
2	Japan (5068)	China (9104)	China (6633)	India (1155)
3	China (4985)	Japan (4138)	Japan (4696)	US (307)
4	Germany (3347)	India (3784)	Germany (3202)	Indonesia (230)
5	France (2649)	Germany (2984)	France (2458)	Brazil (194)
6	UK (2175)	Russia (2687)	India (2300)	Pakistan (170)
7	Italy (2113)	UK (2257)	UK (2207)	Bangladesh (162)
8	Brazil (1572)	France (2172)	Italy (2036)	Nigeria (155)
9	Spain (1460)	Brazil (2020)	Russia (1813)	Russia (142)
10	Canada (1336)	Italy (1922)	Brazil (1751)	Japan (128)
11	India (1310)	Mexico (1540)	Spain (1474)	Mexico (107)
12	Russia (1231)	Spain (1496)	Canada (1314)	Philippines (92)
13	Australia (925)	Korea, Rep. (1324)	Mexico (1141)	Vietnam (87)
14	Mexico (875)	Canada (1280)	Korea, Rep. (1029)	Egypt (83)
15	Korea, Rep. (833)	Turkey (1040)	Australia (898)	Ethiopia (83)
16	Netherlands (792)	Indonesia (967)	Turkey (786)	Germany (82)
17	Turkey (617)	Australia (858)	Netherlands (745)	Turkey (75)
18	Indonesia (540)	Iran (844)	Indonesia (711)	Iran (73)
19	Belgium (469)	Poland (727)	Poland (549)	Thailand (68)
20	Poland (430)	Netherlands (673)	Iran (536)	Congo, DRC (66)

Source: World Development Indicators (WDI). All data are for 2009 (latest available).

A key line of defence for the G20 is that because it is so obviously an improvement *vis-à-vis* the G7, it cannot sensibly be criticised. It is a positive development that the G7 countries now feel inclined to consult in a systematic manner with dynamic emerging market economies. Indeed, some form of multipolar deliberation and dialogue has become a *sine qua non* for global economic governance, given the geopolitical realities of the world economy. There are several reasons, however, why the G20 was the *wrong* form of multipolar deliberation:

- First, the G20 continues and reinforces a troubling trend towards "plurilateralism-of-the-big", by which the vast majority of nations lose voice and influence on matters that affect them crucially.

9. There is no agreement among governments about which Gross Domestic Product (GDP) indicator to use. Generally, most developed countries are proponents of using GDP at market values (nominal), while many emerging market economies prefer GDP at purchasing power parity (PPP). In the recent voting power realignment in the IMF and the World Bank, the compromise reached was to use a composite GDP indicator, given 60% weight to GDP at market values and 40% weight to GDP at purchasing power parity

- Second, the G20 effectively undermines the existing system of multilateral cooperation in institutions such as the International Monetary Fund (IMF), the World Bank and the United Nations, causing resentment towards the G20 in those institutions in general and among non-G20 countries in particular.
- Thirdly, what is needed to address today's key problems – such as global imbalances, climate change and rising poverty – is not an informal leaders' forum, but binding deliberations in a truly multilateral framework.

Institutional Framework for a Bretton Woods II

From the perspective of effective global economic governance for the 21st century, the two main deficiencies of the Bretton Woods system that need to be addressed are the following:

- There is no Heads-of-State forum, and hence Bretton Woods suffers from a lack of “political weight”
- Its systems of voting power do not adequately recognise the increased economic and political weight of dynamic emerging market economies

The way forward is to reform the Bretton Woods institutions so as to allow them to operate effectively as key pillars in a multilateral system of global economic governance, under the stewardship of a Global Economic Council. Three key reforms should be undertaken: (i) creation of a Heads-of-State forum, the Global Economic Council; (ii) reform of the voting power systems of the Bretton Woods institutions; and (iii) reconfiguration of their systems of country constituencies.

Establishing a Global Economic Council

The cornerstone of a revised Bretton Woods system should be a Global Economic Council. Its key task would be to act as steering committee of the global economy.¹⁰ The Council should consist of 25 country constituencies, in an arrangement similar to that of the Boards of the IMF and the World Bank, with procedures for consultation and rotation to ensure that all member countries have a voice in the process in proportion to their Gross Domestic Product (GDP). A Global Economic Council based on country constituencies – with the relevant 25 Heads of State meeting twice a year on the basis of prior consultation with their country constituencies – would have the benefits of multilateral legitimacy and the advantages of being embedded in the existing institutional framework of the IMF and the World Bank.

10. The Council should deliberate on key issues with regard to the further reform of the governance arrangements of the existing Bretton Woods institutions. But it would be natural for the Council to have also informal discussions on global economic governance issues beyond the two Bretton Woods institution such as, for instance, the matter of how new momentum may be brought to the WTO's Doha Round

Reforming the existing voting power systems

The current systems of voting power of the Bretton Woods institutions do not adequately reflect the geopolitical realities of the world economy. The oft-cited principle that voting power in the Bretton Woods institutions should reflect countries economic weight in the global economy is theory more than practice. In both the Bank and the Fund, a range of other criteria than weight in the global economy – such as degree of “openness” and “economic variability” and amount of international reserves in the case of the IMF – has been used in calculating the voting power of member countries. As a result, relative voting power no longer has a strong, consistent link with economic weight in the global economy.¹¹ It is of paramount importance to the legitimacy of the Bretton Woods institutions that their voting power systems are revised in a manner that restores a fundamental balance between voting power and GDP. The proposal here is to simply allocate to countries a share of voting power equal to their share of world GDP. This is the best way to ensure that relative voting power continuously reflect the realities of the global economy.

Revision of system of country constituencies

Since the existing configuration of country constituencies in the World Bank and the IMF is in need of serious repair, fundamental revision of country constituencies must be undertaken. New principles are needed both for the allocation of chairs among regions and for the allocation of chairs within regions.

The first principle of allocation of chairs among regions should be to achieve reasonable representation of all the world's main regions. This paper proposes basing future global economic governance arrangements on four main regions: Africa, Asia, Americas and Australasia, and Europe.¹² In the council, 16 seats should be distributed evenly among each of these four main regions; 4 seats for each region.

The second principle should be that 9 additional seats are assigned to the four regions in proportion to their weight in the world economy. At current, this would mean that all four regions except Africa would get 3 additional seats. Together, the application of these two principles would give Africa 4 seats and the three other regions 7 seats each:

11. Voting power to GDP ratios – which should ideally vary within a 0.85 to 1.15 bank – in fact varies from less than 0.5 to almost 4. This means, in brief, that the value of one dollar of GDP – in terms of voting power – varies dramatically from country to country, which it shouldn't

12. This categorisation of countries is based on UN statistics, which divides the world in five regions: Africa, Asia, the America, Europe and Oceania. The latter of these regions, Oceania, is integrated in two of the other regions, namely the Americas and Asia. Oceania consists of Australia, New Zealand, Norfolk Islands and three groups of island states: Melanesia, Polynesia, and Micronesia. Taken together, Australia, New Zealand, Norfolk Island and the Melanesian islands are known as Australasia. This part of Oceania is combined with the Americas, whereas Polynesia and Micronesia is considered part of the Asian region

Table 1 | GDP* and the allocation of seats in revised Bretton Woods system

	GDP* (% of total)	GDP seat indicator	Allocation of GDP seats	Regional seats	Total number of seats
Africa	3.23	0.30	0	4	4
Americas & Australasia	34.55	3.11	3	4	7
Asia	33.69	3.03	3	4	7
Europe	28.53	2.57	3	4	7
Total	—	9	3	16	25

The allocation of chairs *within* the four different regions should be based on two main principles. First, country constituencies should be *elected* chairs, with a minimum size of three countries per constituency. This would break with the current “mixed-system” of five appointed chairs and nineteen elected chairs. Second, all chairs should involve a mechanism of rotation to ensure consultation and dialogue within constituencies. Each constituency could have one Director and two Alternates, and decide internally whether there should be rotation on both levels or only at the level of Alternates. This flexibility in rotation modalities would allow large economic powers – such as the US and China – to maintain Directorship of a chair, while ensuring consultation with countries in their constituency through the system of Alternates.

Concluding remarks

The way forward in global economic governance is to revise the existing Bretton Woods system in a manner that addresses its weaknesses and makes it responsive to the geopolitical realities of a rapidly changing global economy. It is of paramount importance that the Trio Presidency of the EU (Poland, Denmark and Cyprus) joins forces with France, which holds the Presidency of the G20 in 2011, to gather global support and momentum for reforms towards this end.

Three reforms are essential. First, a Heads-of-State forum needs to be created, which is predicated upon the voting power and country constituency systems of the Bretton Woods institutions. Second, so that voting power better represents the economic weight of its member countries, the voting power systems of the Bretton Woods institutions must be revised. Third, to ensure a more balanced representation of the world’s main regions, the country constituencies of the Bretton Woods institutions must also be revised.

The three major advantages of such a reconfiguration of global economic governance would be that:

- It would embed a leaders’ forum within the institutional framework of the existing Bretton Woods institutions while at the same time bringing the latter up to date.

- It would reconfigure the current country constituencies so that all chairs represents at least 3 and no more than 16 member countries.
- It would give long-term durability to global economic governance by being responsive to the rise and fall of nations – in and through a transparent, automatically updated system of weighted voting (based on GDP) – while at the same time ensuring inter-regional legitimacy by means of the proposed balanced allocation of chairs to the world’s main regions.

A Bretton Woods system revised along these lines would allow for a better balance between established and rising powers, and provide a more durable way of adjusting the governing balance as the economic balance changes. Last but not least, a Global Economic Council firmly embedded in a revised Bretton Woods system would likely be significantly more effective in addressing the key challenges of global economic governance than the G20 leaders’ forum could ever hope to.

The Contribution
of 16 European
Think Tanks
to the Polish,
Danish, and Cypriot
Trio Presidency of
the European Union

VII

COMMON SECURITY AND DEFENCE POLICY

The focus on budget deficits and on the future of the euro did not allow EU leaders to keep the Common Security and Defence Policy (CSDP) high in the agenda, as the Belgium Presidency would have wished – with the launch of permanent structured cooperation initially planned as one of its key priorities. Yet, both increasing (or at least stabilising) EU Member States' defence capabilities and strengthening collective European capabilities remain priorities – this seems especially true in light of the recent democratic revolutions in the North Africa and the Middle-East. Hitherto, the EU has successfully launched 24 missions in its neighbourhood, reaching as far as Central Africa and Afghanistan. But fragmentation, duplication and cost-ineffective national armed forces are leading to a situation where the collective capability of European armed forces is less than the sum of its national parts.

PART VII ABSTRACT

Authors below argue that increased pressure on already strained defence budgets and the creation of the European External Action Service (EEAS) are two realities that could actually boost increased cooperation and integration in security and defence matters. Concerning adapting EU security-cooperation to the post-crisis era and turning the European public's preoccupation with the economy (saving money and increasing efficiency) into an asset, these authors present different options.

One way to increase security and defence integration via economic efficiency is by completing the Single Market. This is currently sought by means of two defence industry Directives – one relating to intra-EU arm transfers and the other concerning procurement. According to one of the authors below, whether these Directives realise their full potential depends on the degree to which Member States desire this outcome (CER). If security and defence integration is a priority, then the Trio Presidency should help the European Commission encourage the liberalisation of the EU defence market, notably by embracing the new defence procurement rules and daring to criticise non compliant Member States.

It is argued below that a number of small success stories is a necessary precondition to Member States being willing to move towards high-end cooperation. Under this logic, what the EU needs is to quit the large, all-encompassing projects coordinated from Brussels and shift attention to smaller initiatives by a few states on clearly defined issues (Europeum). Leaving the combat troops and jet fighters aside and focusing on common training, common education

or possibly common air defence, this approach would encourage low-end defence cooperation between several Member States.

To obtain these success stories, to improve the EU's comprehensive crisis management approach and to make the most out of the establishment of the EEAS, the Trio Presidency should – in cooperation with the High Representative – propose elevating EU special representatives to a “coordinator status”, wherein they would manage the EU's presence in crisis areas by communicating with the heads of civilian missions, commanders of military operations and heads of EU delegations supporting them (Europeum).

Yet to avoid having the EU acting like a coalition of the willing, in which the available means and participants define the CSDP mission, the coming Trio Presidency should also seek credibility and efficiency by introducing intervention criteria (affordability) and evaluation mechanisms (accountability), all open to public scrutiny at both EU- and national-parliamentary levels (Real Instituto Elcano).

In the same vein, it is also argued below that bilateral cooperation initiatives, such as the recent Franco-British one, do not necessarily have an agenda for Europeanisation, and that flexible military cooperation should be brought into the EU framework (SWP). The Trio Presidency could, for example, play a limited, but yet important role as a mediator for the small and medium-sized Member States, thus giving a political impulse to the Ghent initiative by establishing permanent structured cooperation.

In order to avoid any additional delay in the implementation of the Lisbon Treaty's solidarity clause, implementation should be done via general provisions (and not case-by-case ones), based on broad criteria of geographical scope and magnitude of the event, all the while respecting principles of sovereignty and subsidiarity. Such provisions would then be built on what already exists in this field at the Union level (through better coordination and coherence between actors and instruments) and bring a specific added value both at the political and operational level, while respecting the division of competences between the institutions as well as between the EU and the Member States (Egmont).

Finally, new patterns of cooperation on military capabilities are needed between the EU and NATO. Specific attention is given here to the Cyprus issue, currently blocking dialogue at the highest levels between NATO and the EU (DIIS). Solutions to this issue are scarce, but the author here pleads for a reciprocal mobilisation of the EU on the principle of new members' acceptance

of prior agreements (especially in relation to Turkish membership of the European Defence Agency), and of NATO (and especially the United States) to put pressure on Turkey to agree to a Partnership for Peace status for Cyprus, and to sign security agreements.



COMMON SECURITY AND DEFENCE POLICY

The Double Challenge of the EU Security and Defence Policy

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The European Union (EU) recently decided on a new military operation in support of humanitarian assistance efforts in Libya. The European states played a leading role in the international community's intervention against Colonel Muammar Quaddafi's troops. Yet, the related rise of attention to military matters should not lead to the conclusion that security policy is of a particular concern in European politics.

On the contrary, security and defence policy – which for the past decade was a key issue for European policy-makers – has made way to more pressing issues of the day, namely the financial and economic crisis and the post-crisis recovery. The attention of the world media and world politicians is chiefly focused on possible new Bretton Woods-like systems, the rise of new economic powers and the old giants' struggle with budget deficits. In Europe, the future of the euro is the issue of the day. Quite understandably, policy-makers have little time for other topics.

Moreover, the entry into force of the Lisbon Treaty shifted the responsibility for the European Union's (EU) foreign and security policy towards the High Representative of the Union for Foreign Affairs and Security Policy. The High Representative, together with the newly established European External Action Service (EEAS), has stripped the rotating presidencies of a large part of their agenda. It might be tempting for the Trio Presidency to focus on economic governance, the Single Market or justice and home affairs, where they run the show alone and don't need to communicate with the High Representative.

This would be a mistake. Foreign and security policy challenges have not lost their significance and they should remain on the top of the EU agenda. Common security and defence policy might be up and running, but too many issues remain unresolved and need to be tackled, such as the level and manner of defence spending or a comprehensive approach to crisis management. Similarly, the High Representative and the EEAS cannot go it alone. The Member States remain the key players in foreign and security matters and the rotating presidency must continue to be fully engaged, while respecting the High Representative's

responsibility. It should be welcomed that all three presidencies included the EU's role in the world in their priorities.

Considering it was established only little over 10 years ago, the EU Common Security and Defence Policy (CSDP) has been doing remarkably well. The EU has launched well over 20 operations. It has been able to deploy soldiers, police units, judges and civil servants not only in its closest neighbourhood, but as far away as Central Africa and Afghanistan. With the establishment of the Crisis Management and Planning Directorate (CMPD) in 2010, it made great progress on a comprehensive approach. And with the Lisbon Treaty, the EU has become (even if just potentially) a common defence organisation. The Lisbon Treaty has also provided (again potentially so far) a mechanism of structured cooperation among states that want to move faster on defence.

However, the CSDP is still in the making and concerning security issues the European Union still punches below its weight. To turn the EU into a full-fledged power, a concentrated effort by the High Representative, the rotating presidencies and the Member States will be needed. With the High Representative presumably concentrating on other areas, such as general foreign policy and the creation of the EEAS, the rotating presidencies will need to pay more attention to security and defence cooperation.

Today, the CSDP faces a double challenge.¹ First, it needs to turn the European public's pre-occupation with the economy into an asset and adjust security cooperation to the post-crisis era. Second, it must make the best out of the establishment of the EEAS and further improve the EU's comprehensive approach to crisis management.

Post-crisis CSDP: Doing more with less

Capabilities have always been the fulcrum of European cooperation on defence. Since the very beginning, Europeans aimed at improving their armaments and equipment and at deploying more people more readily. In terms of manpower, the Helsinki Headline Goal set the military objective very high, but dragged behind in quick response. With the battlegroup concept, the Headline Goal 2010 raised the readiness level, but this never really delivered. The battlegroups are ready, but political concerns have prevented their deployment.

The European Defence Agency (EDA) was established in order to help Member States cooperate more closely and effectively in defence procurement and research. In the same

1. The improvement of EU-NATO cooperation would surely be of much help. But, unless the Cypriot problem is resolved, EU-NATO relations will never improve on a strategic level. Unfortunately, it would be naïve to expect any EU presidency to be able to significantly contribute to the matter, and this is especially true concerning the coming Trio Presidency, which will include Cyprus. Thus, the EU will have to continue to make the best out of an *ad hoc* cooperation on an operational and tactical level and to rely on the Member States' self-interest to keep their actions in the EU and NATO coherent

area, the permanent structured cooperation of the Lisbon Treaty should boost Member States' defence spending and streamline their procurements. None of this has helped so far. The EDA has not changed Member States' procurement habits. Nor was the Belgian Presidency able to launch the permanent structured cooperation, which was one of its key priorities.

Spending more on troops and armaments will not get any easier in times of austerity. Yet, Europeans need not spend more; they just need to spend better. They will not achieve this through yet another Headline Goal or a new voluntary code of conduct. Cooperation on the high end will always be difficult, the more so in defence. The EU needs to quit the big all-encompassing projects coordinated from Brussels and shift its attention to smaller initiatives by a few states on clearly defined issues.

Defence cooperation requires trust. The closer we get to the core of state security, to the matters of the life and death, the more trust we need. This trust does not emerge out of nothing. It does not even emerge from the simple fact that the partners are all members of the EU. Here is the reason none of the big projects with many participants truly succeeded.

The EU should move in a different direction. It should encourage low-end defence cooperation between several Member States, which does not require so much trust. It should leave the combat troops and jet fighters aside and focus on common training, common education, or possibly common air defence. It should provide a forum for best-practice exchange. It may support the cooperation administratively. Only with a few success stories might Member States be willing to move forward to high-end cooperation. Only with positive experience will trust arise.

The debate on defence spending should be refocused. European publics are not ready to give up their peace dividend. The Member States, led by the Presidency and the High Representative, should move step-by-step in the name of savings. The latest Council support for pooling and sharing is a step in the right direction, but it should start with smaller, less exposed projects. Small projects will save small money, but they will deliver sooner and pave the way for the bigger things.

Comprehensive approach revisited: The role of EEAS

A comprehensive approach to crisis management has been the European Union's trademark. The EU has been in a unique position among other international actors, with soldiers and police officers at its disposal, together with experts on rule of law, administration and development. Since the very beginning of the CSDP, the EU has focused on civil-military and civil-civil cooperation. Starting with security and defence structures dominated by the military, the EU has developed a strong civilian crisis-management branch. It has established a Civilian Planning and Conduct Capability. And it has ended up with many more civilian than military

operations. However, the military and the civilians have remained in two separate worlds, with too little in common.

The new CMPD has the potential to bridge the two worlds. It employs military, police and civilian personnel alike and will help the Political and Security Committee (COPS) make strategic decisions on EU engagement. Other initiatives may follow soon, such as a single intelligence-sharing and early-warning body for military, civilian and humanitarian crises. Such improvements are useful and should be encouraged.

There are limits to comprehensiveness, however. The military and civilians are not the same and they need to remain distinct. They are trained for different tasks and they should be used for what they learned to do. The two worlds should be bridged, but they must not be merged. The strategic level has to consider all options in a complex manner, but the planning and conduct of operations should run the military and the rest separately.

The separation of military and civilian operations requires strong coordination. The CMPD or the COPS in Brussels are too far apart and cannot harmonise actions on ground. There is no structural mechanism for the head of mission and the operation commander to cooperate. Too much remains informal, depending on whether the two like and need each other. Other EU actors, such as EU delegations or EU special representatives, not to mention the Member States, are often present in the area. All in all, the European Union sends mixed signals to the locals as well as to other international actors.

The EEAS offers an opportunity that should not be missed. Incorporating the crisis-management structures as well as EU delegations abroad and contributing to neighbourhood, enlargement and development policies, the EEAS will have all instruments necessary to maintain a unified EU presence in crisis areas. The EU's support to the African Union's mission in Sudan may provide a blueprint for the future. The EU special representative should be the key person representing the EU, reporting to COPS and the High Representative. The head of the civilian mission, the commander of military operations and the head of the EU delegation should support the special representative in their respective capacities and he or she should coordinate them. Thus the EU would achieve a unified presence on the ground while retaining the special character of its existing tools.

Conclusions and recommendations

Today, the EU security and defence policy faces two great challenges, but both of them may and should turn into opportunities. Economic austerity is yet another argument for more cooperation in defence spending, which should be achieved through incremental steps and small projects. The initiative should come from the bottom, not from the top, but it

should be encouraged at the European level and favourable conditions should be created. The new EEAS should be used to achieve more coordination between civilian and military crisis-management while retaining their special character.

The Trio Presidency should, in cooperation with the High Representative:

- initiate a debate on low-end cooperation projects in defence; create a forum for the exchange of best practices, using the existing platform of the European Defence Agency; and consider possible forms of European support to such projects.
- propose the elevation of the EU special representatives to coordinators of EU presence in crisis areas with the heads of civilian missions, commanders of military operations, and heads of EU delegations supporting them.

COMMON SECURITY AND DEFENCE POLICY

NATO and EU: Towards a Constructive Relationship?

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The security challenges of the 21st century are likely to be both multifaceted, highly complex and of an increasingly interdependent and global nature. The international community is therefore faced with problems that cannot easily fit into traditional boxes and which require a so-called comprehensive approach, with emphasis on cooperation between different international actors and between different agencies across the traditional divides that separate civilian and military approaches. New ways of thinking are therefore needed and new patterns of cooperation between the main international organisations, such as the European Union (EU), the North Atlantic Treaty Organisation (NATO), the United Nations (UN) and the African Union (AU), are urgently required. Under these conditions, it seems obvious that two international organisations that are both based in Brussels and that share a considerable overlap in membership should be at the forefront of such cooperation – even more so since the organisations share similar concerns and are both engaged in locations such as the Balkans, Afghanistan and the Gulf of Aden. Yet, despite the clear need, and despite pledges from political leaders and high-ranking officials to support a more constructive relationship, relations between NATO and the EU remain hamstrung by the unresolved issues regarding the status of Cyprus.

The separateness of NATO and the EU has effectively always been a reality, but it has only been an issue in recent years with the growing realisation that the new challenges facing the international community can no longer be managed by the organisations individually. NATO recently placed a commitment to a better and more constructive relationship with the EU in its new strategic concept. And during a summit dinner in November 2010, conversations reportedly focused on how to overcome the political obstacles to a more constructive relationship. At this dinner, President of the European Council Herman Van Rompuy said, “the ability of our two organisations to shape our future security environment would be enormous if they worked together”.¹ In other words, the unconstructive nature of the relationship persists despite clear political commitments on both sides to change it for the better, and despite a number of positive experiences of cooperation

between the two organisations on the ground. The question that has to be asked, therefore, is if it is really the case that the establishment of a constructive relationship between NATO and the EU is in effect being held hostage to the long-standing disagreements about Cyprus.

Two planets in the same city

The relationship between NATO and the EU has never been a close one as the two organisations have historically tended to focus on different agendas and different policy areas, roughly divided between a focus on economic and development issues and a focus on military and security issues. However, after a rather unconstructive and competitive relationship during most of the 1990s, the first decade of the 21st century has witnessed convergence between the two organisations. Through the successful establishment of the European Security and Defence Policy (ESDP) in 1999, the EU has taken on a much greater role as a security actor, whereas NATO’s experience in the Balkans and Afghanistan has clearly revealed that military solutions alone cannot bring peace and prosperity to post-conflict societies.

Convergence between the two organisations in policy areas has been accompanied by geographic convergence, as they are both deeply engaged in the Balkans, Afghanistan, Darfur, Pakistan and the Gulf of Aden. Indeed, it has become obvious that, in some situations, the EU may simply be more relevant than NATO and vice versa, and that the actions of one organisation may positively contribute to the policies and programmes of the other. This was the case in Georgia, for example, where, in the wake of the Russia-Georgia conflict in August 2008, the arrival of EU monitors not only facilitated positive action, which would have been politically difficult for NATO, but was also instrumental in consolidating a ceasefire and promoting a greater degree of transparency. Even though, as suggested by NATO Director of Policy Planning Jamie Shea², such strategic benefits may well have resulted more from a happy coincidence than from an actual concerted effort, the example shows the potential benefits that could be achieved from a closer relationship between the two organisations. Moreover, it seems clear that they will both be involved in the on-going revolutionary situation in North Africa, and that, politically, the EU would be in a more favourable position here than American-led NATO.

Since the ESDP was declared operational in 2003, the EU has undertaken 25 military and civilian ESDP operations. NATO’s engagement in Afghanistan has grown from a relatively limited involvement focused on Kabul to one focused on the entire country, with nearly 50,000 troops under the NATO-led International Security Assistance Force (ISAF) command. In the process, the two organisations have been faced with the operational necessity to cooperate in places where both are present on the ground, and it has become increasingly clear that no one sole organisation can manage the conflict and post-conflict situations of the 21st century alone. However, whilst the

1. Judy Dempsey, “Between the European Union and NATO, Many Walls”, *The New York Times*, 24 November 2010, available at: <http://www.nytimes.com/2010/11/25/world/europe/25iht-letter.html>

2. Jamie Shea, “Ten Years of the ESDP: A NATO Perspective”, Special Issue of the *ESDP Newsletter*, Council of the European Union, October 2009, pp. 44-46, available at: <http://www.consilium.europa.eu/uedocs/cmsUpload/ESDP%20newsletter%20-%20Special%20issue%20ESDP@10.pdf>

convergence in policy areas and geographic scope suggest an urgent need, and the possibility for, increased cooperation and coordination between the two, most efforts have, so far, been severely hampered by the as-yet unresolved issues between NATO member Turkey and EU member Cyprus, which has prevented any real, enduring and politically sanctioned cooperation between the two organisations. The problem is that without a so called “comprehensive approach”, including constructive cooperation between NATO and EU, the challenges faced – especially in the Balkans and Afghanistan – cannot be overcome. This is a problem that is recognised at the highest political level and by most of the two organisations’ Member States. Yet, the problems that have proved the most stubborn have deep roots and involve countries that feel poorly treated by the institution of which they are not members. As a result, these states have chosen to leverage their position in their institution where they are members, in order to make their point in other. So far, the current political impasse to improving the NATO-EU relationship therefore seems stuck in a seemingly endless cycle of diplomatic retaliations that are damaging to both NATO and the EU.

The Bermuda Triangle between Turkey, Cyprus and Greece

The current political obstacle finds its roots in the EU’s and Turkey’s complex relationship and in the status of the divided island of Cyprus, whose northern part was invaded by Turkey in 1974 and has been occupied ever since. The northern part of Cyprus is only recognised by Turkey, and Turkey does not recognise the southern (Greek) part, which became a member of the EU in 2004. Once each side of the unresolved Cyprus question was represented in each of Europe’s security organisations (Turkey as a full member of NATO, Cyprus as a full member of the EU and Greece as a full member of both organisations) a political stalemate ensued.

The standard explanation for the impasse is that Greek Cyprus (representing the whole island and a full member of the EU since 2004) blocks Turkish participation in the European defence institutions, such as the European Defence Agency (EDA), and that Turkey responds by obstructing the use of NATO facilities by Cyprus, its participation in Partnership for Peace (PfP) and the signing of security agreements to release classified material to Cyprus. The result is that high-level meetings between NATO and the EU cannot take place because Cyprus cannot participate (as it does not have the necessary security clearance from NATO) and it insists that the meetings cannot take place unless all 27 EU members participate. The result is that the EU and NATO are prevented from discussing urgent problems related to their involvement in, for example, Afghanistan, Kosovo or the Gulf of Aden, and that no security agreements exist concerning, for example, NATO rescuing EU personnel in Afghanistan in the event of a critical situation.

The overlooked responsibility of the EU

The current situation is clearly frustrating for all concerned. However, it is often overlooked that the EU itself bears some of the responsibility for the impasse. Firstly, when the Cologne

European Council in 1999 decided to transfer the responsibilities of the WEU to the newly agreed European Security and Defence Policy (ESDP), the EU failed to make adequate provisions for associate members of the Western European Union (WEU). Secondly, the EU reneged its own principle that the status of the island of Cyprus had to be resolved before membership of the EU could be realised. And thirdly, there is a lack of clarity about what was actually agreed with Turkey at the 2002 Copenhagen Summit – Turkey subsequently claimed the EU had abandoned agreements made during the summit. The issue is problematic because the precise agreement is contained in a letter from EU High Representative Javier Solana, which is referred to in the official documents, but which has not been made public. The Turkish claim is that the letter contains clear commitments to non-EU NATO members such as Turkey.

The problem is that the *de facto* closure of the WEU effectively robbed Turkey of important privileges, which had only been achieved when Turkey gained associate membership of the organisation in 1998, including membership of the Western European Armaments Group (WEAG) – the organisation responsible for cooperation in the field of armaments within the framework of the WEU. With the absorption of the WEU, the responsibilities of the WEAG were transferred to the European Defence Agency (EDA). But Turkey has not been able to negotiate an agreement that would allow it to participate in the activities of this agency. This has been a major source of contention ever since.

Turkey’s difficult position *vis-à-vis* the EU following the signing of the Nice Treaty in 2001 was recognised by, amongst others, the United States (US) and the United Kingdom (UK). And on Turkey’s insistence, a process of negotiations to clarify Turkey’s position as a NATO member but not a EU member was set in motion. The process led to the acceptance of the so called Ankara Agreement, which was later renamed the “Nice Implementation Document”. The gist of the agreement is that the EU would recognise that it had some liabilities to fulfil *vis-à-vis* non-EU NATO members. The negotiations enabled agreement to occur at the December 2002 Copenhagen Summit in the form of a NATO-EU Joint Declaration, which allows the EU to have access to NATO assets under the so called Berlin-Plus arrangements. The “Berlin-Plus” agreement between NATO and the EU allows the EU to use NATO’s collective assets and capabilities for EU-led crisis management operations when NATO as an institution is not involved. The crucial point is that a complex negotiation process paved the way for Turkey to agree to the deal. And it is during these negotiations that the EU agreed to a number of provisions *vis-à-vis* Turkey.

The provisions agreed to at the Copenhagen Summit include that Berlin-Plus arrangements would only apply to EU members that also belonged to NATO or Partnership for Peace (PfP). Secondly, that the EU would engage in peacetime consultations with Turkey regarding security issues near Turkey. However, although Turkey has twice requested such consultations (in connection with the war in Iraq and the war in Georgia) none have taken place. Thirdly, there was a commitment to Turkish membership of the EDA, and lastly an agreement for exchange of classified information between Turkey and the EU to pave the way for Turkish participation in the ESDP.

Turkey insists that the agreements of the 2002 Copenhagen Summit are the foundation for Turkey's relationship with the EU through NATO, and that since this agreement was entered into before Cyprus gained membership, Cyprus should be bound by its contents. In doing so, Turkey effectively puts the blame for the unconstructive EU-NATO relationship at the doorstep of the EU, arguing that the EU failed to make sure that the accession of Cyprus to the EU would not interfere with previously reached agreements. The situation is murky to say the least: the letter itself is perhaps not part of the *acquis* – although it might be, as it is mentioned in documents that are part of the *acquis*. If the Turkish position is right and the letter does constitute a legal agreement, then, in saying that accession countries are required to abide by previously agreed decisions, it would appear that they have a point. Therefore, although it is technically true to say that the problem started with the accession of Cyprus to the EU in 2004, the root of the problem is really to be found well before then and in areas where the EU probably ought to have been more careful in the accession negotiations with Cyprus.

An end in sight?

The question, of course, is: where do we go from here? Can the negative dynamic be broken so that the EU and NATO can fulfil their stated ambitions of moving towards a more constructive relationship? The “easy answer” is that the situation can certainly be changed by “simply” solving the Cyprus problem and granting Turkey membership to the EU – but this is, of course, easier said than done. Following the failure of negotiations between the Greek and Turkish parts of Cyprus, which were conducted under the leadership of the UN until April 2003, the conclusion was that an end to the Cyprus problem was due to a lack of political will rather than absence of favourable circumstances. Similarly, although making Turkey a member of the EU would most likely constitute a security gain for Europe and improve relations with the Muslim world, politically there is currently little chance of Turkey becoming a Member State of the EU. In other words, we are left with small steps and partial solutions to remedy an unsustainable situation. It would be unrealistic to assume that solutions to the two main issues at the core of the EU-NATO relationship will be found in the near future. However, there may still be room for small steps and for negotiation on some of the issues at hand. Nevertheless, in recognition that the international environment is substantially changed since April 2003, the Cypriot government may be willing to invite the Turkish Cypriots to revisit the UN plan and solve the Cyprus issue – without reopening substantive parts of the plan. However, the above analysis points in the direction of seeking more positive action from the EU concerning the principle of new members' acceptance of prior agreements (especially in relation to Turkish membership of EDA). Meanwhile, NATO and especially the United States may be able to put pressure on Turkey to agree to Partnership for Peace status for Cyprus, and to sign security agreements. Until such a time, however, NATO and the EU will almost certainly have to find innovative new ways of “working around” the political situation, through the so called transatlantic dinners and on-the-ground practical cooperation.

COMMON SECURITY AND DEFENCE POLICY

Trio Leadership: The Need to Liberalise the European Defence Market

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Global context and new specific challenges

Over the last year, renewed defence spending cuts in many European Union (EU) Member States have increased the need for closer EU defence cooperation. European governments have long acknowledged that significant savings could be gained through more common procurement in defence, joint logistics and common ownership of the most expensive military capabilities. In response to the new defence spending cuts, the EU has introduced a series of initiatives in recent months – including a German-Swedish sponsored plan – to help Member States explore more “pooling and sharing” of their military equipment.

As they respond to the economic crisis, another way European governments must rationalise their defence spending is through strengthening their efforts to integrate their defence markets. Even before the latest budget cuts, EU Member States had acknowledged that maintaining their largely fragmented defence markets was unsustainable. Not only was duplication wasting taxpayers' money, but it was also undermining the European defence industry's competitiveness (on which European military capabilities rely) and hampering the ability of European militaries to deploy side by side.

During the next Trio Presidency – composed of Poland, Denmark and Cyprus, EU Member States will need to start applying two EU Directives that should help the defence industry become more competitive and deliver equipment more cheaply.¹ But the impact of the Directives will largely depend on how much Member States are willing to use the new tools at their disposal. The Trio Presidency should encourage their fellow Member States to fully

1. The European Parliament and the Council, Directive, “Simplifying terms and conditions of transfers of defence-related products within the Community”, 2009/43/EC, 6 May 2009, available at: <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:146:0001:0036:EN:PDF> and The European Parliament and the Council, Directive, “On the coordination of procedures for the award of certain works contracts, supply contracts and service contracts by contracting authorities or entities in the fields of defence and security”, 2009/81/EC, 13 July 2009, available at: <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:216:0076:0136:EN:PDF>

exploit the new rules, and it should support the European Defence Agency (EDA) and the European Commission in exploring additional ways to liberalise the EU defence market.

Current status

For decades, Europeans have fought side by side within the North Atlantic Treaty Organisation (NATO), the United Nations (UN) and more recently under the aegis of the EU. Yet European governments have maintained a broadly national approach when purchasing their military equipment, relying largely on their domestic suppliers. As a result, European defence markets remain fragmented. This fragmentation has not only proved unnecessarily expensive, it has also hampered the ability of European militaries to work together on international missions.

Until the EU's package of Directives in defence was agreed at the end of 2008 and early 2009, each EU Member State had its own complex regulations governing procurement and exports of defence goods, and most defence procurement was not open to foreign or domestic competition. As a result, defence firms were not able to benefit from the economies of scale that larger markets would provide. The fragmentation of the market also led to wasteful duplication. In 2009, it was estimated that EU countries had a total of nearly 90 different weapons programmes, while the United States (US), whose defence budget was more than twice the size of the EU's defence budgets combined, had only 27.

Europe's defence companies – which operate increasingly across borders – were forced to struggle with complicated and diverging national requirements for exports. For example, many Member States required individual authorisations for each defence-related export, even when the same item (such as a spare part) was sent to the same firm within the EU. So, every time a multinational company wanted to ship components from one of its plants to another one in a different Member State, it had to ask for a new licence. Although such requests were hardly ever rejected, they could take several weeks to process. Worse still, company staff based in different EU countries often needed individual authorisations to talk over the phone. The European Commission estimated that the total cost of these barriers amounted to over €400 million a year.

Most Member States also required individual export authorisations for every sale of military equipment to another Member State's defence ministry. This entailed unnecessary and perverse delays. For example, France and Italy had been using French-built armoured vehicles in their contributions to the UN's mission in Lebanon. When a vehicle owned by French troops broke down, the French could get a new part from the manufacturer in France within days. But if Italian troops needed a spare part, the French manufacturer had to ask for an export authorisation. As a result, Italian troops had to wait several weeks for the export licence to be processed.

Conscious of the unnecessary costs and obstacles to military cooperation resulting from such fragmentation, in recent years EU Member States introduced a series of measures to liberalise their defence markets. The two aforementioned Directives, agreed in late 2008 and early 2009, have been the most ambitious steps so far.

The first Directive – known as the intra-EU arms transfers Directive – is designed to simplify procedures for moving military goods amongst Member States. It requires all Member States to offer general and global licences in addition to individual export licences – until now, many Member States had only provided individual authorisations.² The Directive aims to reduce the use of individual export licences. In particular, it encourages Member States to grant general licences when they authorise weaponry or spare parts to be sent to armed forces in another EU country, or when goods are sent as components to trustworthy defence companies in the EU.

The second Directive aims to increase the amount of defence procurement that is open to competition across the EU. For 50 years, defence-related goods had remained largely exempt from the EU's internal market rules. EU countries agreed in 1958 that European rules on competition and the free movement of goods should not apply to military and security when “essential security interests” were at stake (a provision known as Article 346 under the Treaty of Lisbon).

In principle, Member States were only supposed to use the exemption on an exceptional basis, and justify why competitive procurement would pose a security threat. But Article 346 carries no definition of the scope of an essential security interest. Consequently, many governments regarded Article 346 as an automatic exemption. Over the years, they routinely excluded competition from the procurement of even the most non-sensitive defence goods – including helmets, uniforms and military catering. “National security” was often a cloak for protectionism. In theory, the European Commission could have challenged such abuse of Article 346 and brought member governments before the European Court of Justice. But the Commission was wary of pushing too hard in an area that many governments see as central to national sovereignty.

Already in 2005, EU Member States committed themselves to increasing the amount of cross-EU competition in defence goods through a voluntary code of conduct within the EDA. The defence procurement Directive goes further – it is legally binding and offers procurement procedures tailored specifically to defence and security needs so that governments can safely open more of their defence procurement to competition. Under the new rules, ministries of defence benefit from substantial flexibility and security guarantees – bidding companies must protect classified information and be able to ensure delivery is always on time, even in times of crisis.

2. Broadly speaking, goods that benefit from a general licence can move across EU borders without exporters having to ask for specific licences to do so. Global licences are granted to defence companies and allow them to transfer several goods to various recipients

Over the last 18 months, EU Member States have been transposing both Directives into national legislation, and from August 2011 the new defence procurement rules will apply across the EU. The rules governing intra-EU transfers will apply from June 2012, after the European Commission has assessed Member States' implementation efforts during the course of the year.

Potentially, the two Directives could bring significant improvements. More competition in procurement would promote a more efficient industry and better-value defence goods, to the benefit of defence ministries and European taxpayers. Easier transfers of defence goods within the EU would help large defence companies with plants and subcontractors in several Member States. Small and medium-sized enterprises (SMEs) would find it easier to break into markets in other Member States. And national militaries would have shorter delays when importing new equipment, as in the case of the Italian troops in Lebanon.

However, the reforms will only make a significant difference if Member States choose to use them to their full potential, something from which governments might shy away. When resorting to the new intra-EU transfer rules, governments will be able to choose which military goods are safe for general and global transfer licences, and there is a risk that they will issue general and global licences for only a limited range of goods – or perhaps none at all. EU governments remain wary of trusting their neighbours to ensure that their defence goods are not re-exported to undesirable destinations. (While some Member States, such as Germany and the United Kingdom, are known to have very reliable export controls, other countries have suffered from lower standards, in particular some of the new Member States, such as Romania and Bulgaria.) When EU Member States agreed to the new transfer rules, they committed themselves to improving the quality of their export controls and introducing a series of confidence-building measures (including the need for defence companies that want to import goods benefiting from a general licence to be certified by their governments). But if Member States do not consider export controls to be thorough across the EU, there is a significant risk they will only resort to more efficient export licences for their least sensitive military goods.

Governments might also shy away from exploiting the defence procurement Directive, particularly as the current economic crisis could strengthen the temptation to protect national industries and domestic jobs. The scope of what constitutes an “essential security interest” has still not been clearly defined in Article 346, so governments could continue resorting to the exemption. Even when resorting to the new procurement procedures, governments could attempt to manipulate the criteria within their contracts to favour national competitors.

Recommendations

Poland has identified EU defence cooperation as one of the key priorities for its Presidency, although the Polish government has so far expressed an interest in focusing on aspects of EU defence other than the defence market. But Warsaw should widen its efforts into this

important field and, with its Trio Presidency partners, encourage fellow Member States to make full use of the new Directives.

The Trio Presidency will not be the main actor in encouraging full implementation across the EU – this will largely be the responsibility of the European Commission, which will have the authority to take reluctant Member States to the European Court of Justice if they abuse the new procurement rules. The Commission will also be making an assessment of how well Member States have implemented the various confidence-building measures relating to the intra-EU transfers Directive.

The Trio Presidency can nonetheless help in the following ways:

- Leading by example: Poland, Denmark and Cyprus should embrace the new defence procurement rules, even though they might, at times, have a detrimental short-term impact on jobs in their national defence industries. The three countries should also ensure their export controls are of the highest standard.
- Increasing the visibility of the new Directives and their potential benefits by organising public events.
- Providing support to the European Commission as it assesses the implementation of the intra-EU transfers Directive across the EU. The Trio Presidency should also encourage the Commission to dare to criticise Member States that fall short. And if required, it should assist in setting up frameworks for EU Member States to share best practices in export controls and certification procedures, so that shortcomings in any European capitals can be addressed before the intra-EU transfer rules start being applied in June 2012.
- Finally, the Trio Presidency should support the EDA and the Commission in exploring additional initiatives to dismantle many of the remaining barriers to trade amongst EU Member States' defence markets, including the different rules governing foreign investment in European defence companies.

COMMON SECURITY AND DEFENCE POLICY

The Need for an Open System to Evaluate European Union CSDP Missions

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The European Union (EU) has launched 24 Common Security and Defence Policy (CSDP) missions since 2003, but very little is known about them. The information available from open sources is limited to the information provided by the Council through its website, and only in the last few years have external evaluations begun to appear. Compared to the uncritical and complacent descriptions of official reports, independent evaluations coincide in pinpointing common deficiencies in the missions. Among other factors, they point to a lack of strategy in the mandates, limited results in terms of solving the underlying problems, a democratic deficit in management, difficulty in coordinating interventions, differences in strategic cultures among Member States and a lack of military planning capacity.

Now that the Lisbon Treaty is in force, European presidencies no longer need to continue promoting CSDP missions as they did in the past, but they do need to articulate new measures that will consolidate them in the future. As well as improving the operating and doctrinal aspects of the missions, future presidencies will have to turn their attention to two structural conditioning factors linked to their affordability and accountability. While the missions have served as a laboratory for the gradual development of the EU's procedures and civilian and military crisis management bodies, they have not been subject to critical assessment and monitoring processes as stringent as have been established in some countries. This paper contends that CSDP missions will not be able to rely on such a tolerant framework in the future and that they will be subject to more criticism and more thorough evaluation. Consequently, the forthcoming Trio Presidency must start implementing mechanisms to strengthen the legitimacy and transparency of the CSDP missions and prevent European citizens and their representatives in the European Parliament from becoming distanced from them.

Reasons for concern about the missions' affordability

The number of, and international demand for, CSDP missions has not stopped growing, due to the proliferation of crises and the European aim of contributing to international

governance, exerting its responsibility to protect and provide humanitarian aid as a global security player. However, the resources available to the EU do not live up to these expectations. New needs are constantly arising and priorities must be set in crises. As the 2008 report on the implementation of the European Security Strategy of 2003 highlighted, the EU must "prioritise [its] commitments, in line with resources".¹ The concept of affordability refers to undertaking only those missions that can actually be conducted and that, furthermore, produce the expected results in acceptable cost and efficiency terms. Affordability means earmarking expenses in accordance with the global priorities and resources of the CSDP and Common Foreign and Security Policy (CFSP).

Experience reveals that political support for CSDP missions is out of step with contributions to launch them, since the Member States that approve the missions are not obliged to provide the necessary resources to implement them. Several of the missions approved in Brussels have seen their roll-out delayed because they did not have the necessary resources (C.f.: Concordia, EUFOR Chad/Car, EULEX Kosovo and EUPOL Afghanistan), while others were deployed quickly due to the sponsorship of some states (Cf.: Artemis Congo, EU NAVFOR Atalanta and EUMM Georgia). The practical consequence is that despite appearing to be acting collectively, the EU actually acts like a coalition of the willing, in which the available means and participants define the mission.

Because the EU wields a range of civilian and military instruments that other players do not have, most official evaluations highlight the EU's capacity to implement missions requiring comprehensive management. However, some evaluations question this comparative advantage because many missions have experienced difficulty in assembling military, civilian and financial resources. The European Defence Agency (EDA) data shows that the difference in military capabilities among Member States continues to increase and, unless future presidencies make real efforts to introduce convergence criteria, there will be increasingly few countries able to operate jointly. The Trio Presidency could also sustain efforts to meet civilian and military headline goals. These goals were not achieved by the 2003 and 2010 deadlines – while resources have been launched, such as the EU battlegroups, so far they have not been used in CSDP missions.

The EU has shown a capacity to generate civilian capabilities in technical, development and humanitarian aid missions, but not in missions like those of Kosovo or Afghanistan, which required sizeable police contingents, or in missions to reform the security sector in complex scenarios, such as in Guinea Bissau or Somalia (perhaps this explains why missions like EUJUST LEX Iraq, EUSEC DR Congo and EUTM Somalia do not even feature on the Council's website). Similarly, experience shows that, in order to achieve results, peace-building and

1. Council of the European Union, Executive Summary, "Report on the Implementation of the European Security Strategy", S407/08, 11 December 2008, available at: http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/reports/104630.pdf

nation-building missions require more resources, strategic patience and management capacity than the EU can provide.

The funding of these missions is another source of uncertainty. Civilian missions can be funded using CFSP funds (€327 million for 2011), but this is barely 3 to 4% of the total EU external affairs budget. In military operations, states involved assume most of the expenses (costs lie where they fall), except some common costs covered by the Athena mechanism and others to launch the operations, which only cover approximately 10% of the real expense. Despite the financing mechanisms and the budget increase applicable to CSDP missions, the funds are insufficient and their management by the Council, the Commission and the European External Action Services needs to be made more coherent.

Reliance on national military, civilian and financial contributions gives major European countries extraordinary power to reject those missions or mechanisms that oblige them to make significant contributions (Germany and Sweden in EUFOR Chad, for example) or to demand – in exchange for their contributions – a control of the decision-making process, a more prominent role and greater visibility in the missions (France contributed 53% of EUFOR Chad/CAR troops, for example).

So that missions are not approved unless their necessary resources are guaranteed, the Trio Presidency must aim for synchronisation between the political decision-making processes, operation planning and the generation of forces. When this synchronisation worked in the past, it has been possible to conduct missions as demanding as the Concordia mission in the Balkans or Atalanta in the Horn of Africa. But when common decision-making has underestimated the availability of resources, either it has not been possible to deploy the missions (in Darfur, for example), or they have been delayed (it took 6 months to assemble 16 helicopters and 10 transport aircraft for EUFOR Chad/CAR, for example), or they have been deficient, as was the case of Kosovo and Afghanistan. The Trio Presidency must also continue to support initiatives, such as permanent structural cooperation, the division of tasks, functional specialisation, the pooling of resources or outsourcing, which could increase the collective resources and reduce dependence on individual countries.

In a Europe where citizens' welfare is being scaled down and where many are questioning their governments' decisions to intervene in international missions, presidencies must turn their attention to streamlining EU intervention criteria. An international player's influence is not gauged by the number of missions it conducts, but by its missions' results. Presidencies must help change the mentality of those in charge, to shift the focus on the missions' quality and not their quantity. The EU must take advantage of the emergence of new global and regional players and share with them the responsibilities of international security, within the complementary framework implied by a comprehensive approach.

Reasons to demand accountability in respect of the missions

European governments are finding it increasingly difficult to justify involvement in international security missions to their citizens – this is especially true regarding missions where costs do not translate into results. Because of the need to secure and maintain political and societal support for these missions, many countries established democratic supervision mechanisms to authorise involvement in international initiatives. These mechanisms apply mainly to military missions, but they have increased the influence of parliamentary debates and opinion polls in the approval of, and continued involvement in, missions. The general tendency of governments asking for prior approval before sending troops abroad forces them to justify the reasons for their involvement in such missions, the goals thereof, results to be obtained, and human, material and financial resources necessary to realise them.

It is true that not all 27 EU Member States have accountability mechanisms, that these mechanisms vary from one country to another and that they are all in the test phase. But it is also true that they have become widespread and that the governments that were previously opposed to being scrutinised are now benefiting from the support and legitimacy it affords them. At the EU level, there are not yet similar mechanisms in place, due to the democratic shortfall of the CSDP in general, and missions are not subject to public scrutiny. However, it will not be long before societies and parliaments that are used to demanding accountability from their governments with regard to missions start insisting on the same from Brussels. It would therefore be a good idea if the coming Trio Presidency began preparing the institutions and changing the procedures so as to improve accountability.

A first step would be to increase the information available regarding the status, results and lessons learned from the missions. Official civilian and military evaluations do not transcend to civil society and the constraints on open information are compounded by the lack of methodological instruments for assessing CFSP missions, which has hampered self-criticism and learning. Accordingly, it would be advisable for the coming Trio Presidency to present initiatives to boost information flow and to develop more transparent evaluation mechanisms and indicators. This would enable increased interaction between national parliaments and the European Parliament, Europeanising the defence commissions, in order to foster greater societal involvement, as suggested by the EU Institute for Security Studies (EUISS).

Until now, most CSDP missions have lacked a strategy that clearly marks out the EU's vital interests and priorities at play, its strategic objectives, the resources needed and how these resources will be used. European public opinion and Members of the European Parliament (MEPs) do not have this information because the available public documents are too general and because crisis-management concepts and operation plans (OPLANS) are confidential. Without this information, it is very difficult to know why missions are approved and what strategic effects they have. Nor are there efficient reporting mechanisms for MEPs to receive

this information confidentially, since governments avoid being accountable to the European Parliament by arguing that they are accountable to their own national parliaments, and they avoid being accountable to the latter by arguing that the decisions are made in Brussels. As a result, missions are as likely to be as out of step with societies at the EU level as they already are at the national level. The way to prevent this is for those responsible for the missions to provide transparent and systematic accounts of their results.

Entry into force of the Lisbon Treaty and the launch of the European External Action Service represent an opportunity to introduce reporting and assessment mechanisms that would render CSDP missions more democratically legitimate and accountable than at present. The European Parliament now has more capacity to supervise and interact with the High Representative and the European External Action Service, to have them provide more information on missions financed with European funds, and respond to requests from the president of the Parliament or the External Affairs Committee concerning the CFSP. The European Parliament also receives periodical reports and can draft non-binding recommendations with the information received during visits, hearings and open sources. However, European institutions have little capacity to demand accountability from those responsible for CSDP missions whose financing and resources come from governments.

Consequently, although it hardly seems logical to ask the Trio Presidency to promote the transparency and supervision of the intergovernmental system, it must do exactly that. Establishing a European open evaluation system would help European citizens better identify with CSDP missions and would nurture the European strategic culture. In a strategic context such as that of the next few years, in which the available resources will shrink, there will be no shortage of people questioning the wisdom of the EU continuing to expand the number and complexity of CSDP missions without those responsible for managing them being asked to explain their goals and results. As well as official assessment mechanisms, a more open and transparent evaluation system must be implemented to enable governments and institutions to share the lessons learned with MEPs and civil society. Furthermore, the implementation of such a mechanism would help advance towards monitoring procedures based on the best national practices and strengthen democratic supervision by national parliaments, which would be able to verify the information they receive from their governments against the information received from Brussels.

Since this is a long-term process, the immediate step for the Trio Presidency is to create evaluation, supervision and communication instruments for those CSDP missions that do not have a significant military component. The Trio Presidency must try to put an end to the current dilution of responsibilities throughout the institutional universe and the various decision-making levels, and start defining and personalising responsibilities. In the long term, in order to do the same with military missions, the presidencies must foster cooperation between the European Parliament and national parliaments, in order to consolidate accountability and accessibility principles, regulate open or classified information systems, harmonise

evaluation procedures and methodologies, and promote strategic communication between European leaders with regard to CSDP missions. Now that the Trio Presidency has lost much of its prominence in CSDP missions, its work must be aimed at consolidating the missions by fostering the EU's credibility and efficacy as a leading player in global security.

Key recommendations:

- Recast the Trio Presidency's role in CSDP missions towards monitoring and supervision.
- Introduce intervention criteria to synchronise political decision-making, operations planning and generation of resources (affordability).
- Introduce transparency, evaluation and supervision mechanisms for the missions (accountability).

COMMON SECURITY AND DEFENCE POLICY

Bilateral vs. Structured Cooperation? Flexible Cooperation In and Outside the EU Framework as a Tool for Advancing European Capabilities

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With its Common Security and Defence Policy (CSDP) and over twenty operations in the Balkans, Africa and at the shores of Somalia, the European Union (EU) asserts the claim of having become an international security actor in its own right. Despite the fact that, in comparison to the CSDP's level of ambition, most of these operations have been small and symbolic in nature, each of them has nevertheless confronted the EU and its Member States with recurring problems concerning the collection of necessary capabilities among them. Even when Member States have politically agreed on the necessity of acting together, tortuous wrangling and hard bargaining in the run-up to CSDP action remain the norm. More than ten years after the creation of CSDP, the Union still lacks many of the capabilities identified as shortfalls in 1999.

In light of these persistent shortfalls, in 2008 the Council concluded that “strengthening available capabilities in Europe will therefore be the principal challenge faced in the years ahead. In a tough budgetary environment, such a goal can only be achieved through a joint, sustained and shared effort which meets operational needs”.¹ But, in order to address the recognised capability shortfalls, how can the EU provide added value as an organisational framework for military cooperation between Member States?

So far, the debate on enhancing military cooperation has primarily been shaped by the large EU Member States. Although the Lisbon Treaty significantly reduced the role of the rotating presidency in foreign, security and defence affairs, it is exactly the large Member States' strong role – regarding questions of military-capability cooperation – that creates a need for the upcoming presidencies to function as mediator for small and medium-sized Member States.

1. See: Permanent Representatives Committee, Note, “Draft Declaration on Strengthening Capabilities”, 16840/08, COSDP 1140, 5 December 2008, available at: <http://register.consilium.europa.eu/pdf/en/08/st16/st16840.en08.pdf>

The capability gap revisited

In principle, CSDP's capability gap is due to three factors – first, it is a matter of (lacking) political will and distribution of resources according to political priorities. The European Defence Agency (EDA) estimates that out of the total number of European forces in 2008, roughly 464,500 were deployable, and of these about 125,000 were sustainable in external operations. Nevertheless, due to political priorities, EU Member States' deployments have focused on North Atlantic Treaty Organisation (NATO) operations, in particular the International Security Assistance Force (ISAF) in Afghanistan, while the initial dynamic of CSDP operations has stalled since 2008.

On a second, more fundamental level, in the last decade defence spending has been significantly reduced across EU Member States. As both the EU's and NATO's strategic outlooks regard the security situation in Europe as relatively benign, it is hardly surprising that European publics do not see defence expenditure as a priority. Overall, between 1999 and 2009, the average EU Member State defence budget shrunk from 1.8 to 1.4% of Gross Domestic Product (GDP). In the wake of the financial crisis, most EU Member States are enacting further cuts. In consequence, the core capability shortfalls identified by the EU in 1999 remain – i.e. strategic and tactical lift, intelligence and reconnaissance, and force projection.

Finally, even those capabilities that EU Member States bring to the table can often not be used jointly so long as they are not sufficiently interoperable. Due to the different equipment, ammunition and spare materials used in CSDP operations, Member States often have to maintain individual logistical chains in the area of operations. This dilemma is set to increase in the future: as European states further scale down the size of their militaries, they have yet to abandon the ambition of each upholding all standard elements of armed forces. The resulting national armed forces fragmentation, duplication and cost-ineffective structures all lead to a situation where the collective capability of European armed forces is less than the sum of its national parts.

In sum, if CSDP is not to stall or even slowly erode, a new impetus is more than overdue. If the EU Member States want to increase or at least stabilise their defence capabilities, they will have to work closer together. The real question is therefore how to organise this closer cooperation. After previous initiatives, like the Headline Goal or the European Capability Action Plan (ECAP), achieved little progress, the more willing Member States are increasingly looking towards flexible cooperation in smaller groups, both inside and outside EU structures, to organise defence cooperation.

The bilateral approach: Franco-British Defence Cooperation

France and the United Kingdom (UK), the two reluctant drivers of CSDP, are particularly disappointed with the lack of progress in European capability development. They have

hence decided to hedge their bets with bilateral cooperation outside the EU framework. In November 2010, British Prime Minister David Cameron and French President Nicolas Sarkozy signed an extensive Treaty on Defence and Security Cooperation. This treaty not only takes their defence cooperation to an unprecedented level, it also has far-reaching and difficult implications for European defence. Three aspects of this agreement are of particular importance for the future of CSDP.

First, it brings together the two countries that have had a decisive, yet also very ambivalent influence on the creation and shape of CSDP. At the origins of CSDP was the Franco-British Saint-Malo Declaration. Following the experience of the Balkan Wars, in 1998 the two countries partially overcame their longstanding differences on the role of the United States (US) and NATO in European defence and jointly called for the development of an autonomous EU capacity for military action. Although for different reasons, both countries put their weight behind the creation of CSDP with the aim of increasing the military capabilities of European states. Their joint call had a particular importance, as they stand out among EU Member States in security and defence – both nuclear powers and permanent members of the United Nations (UN) Security Council, Britain and France together account for almost half of all European defence spending, and over 60% of expenditure in defence research and development. However, over the course of the development of CSDP, their diverging preferences in regards to NATO and the US also continued to be an obstacle to several major initiatives, such as the proposals to set up EU military headquarters.

Secondly, the agreement represents for the two countries a radical step towards a new level of cooperation in security and defence policy. Taking a broad approach to defence cooperation, the treaty aims to provide “an overarching framework” for joint initiatives in almost all possible areas. The only two major, though crucial, exemptions are that France and the UK retain their full sovereignty over the decision to deploy their forces and that the agreement is not to affect their rights and obligations under other defence and security agreements. Bar these exemptions, the agreement covers cooperation in military doctrine, sharing and pooling of materials, equipment and services, the pooling of forces and capabilities for military operations, including the option to deploy a 10,000-strong joint Franco-British Brigade, as well as industrial and armament cooperation and exchange of classified information. If followed through, the agreement could therefore lay the basis for an unprecedented interdependence and progressive convergence of the two countries’ military operations, capabilities, doctrine and armament industries.

Thirdly, the new Treaty on Defence and Security Cooperation is not Saint-Malo 2.0. Although a bilateral declaration, the foremost aim of the 1998 Saint-Malo declaration was to provide an impetus for the development of a security and defence policy within the EU. However, large parts of the British Conservative party, including Defence Secretary Liam Fox, have publicly voiced their scepticism towards military cooperation within EU structures and emphasised the pragmatic nature of the bilateral cooperation. Fuelled by French disillusionment, due to

a lack of tangible progress within CSDP, the agreement has no agenda for a Europeanisation of the bilateral initiatives. The only possible way for the new bilateral treaty to act as a “new engine” for European Defence would be to force other Member States to step up their engagement in military capabilities in order not to be left behind by France and the UK.

The structured approach: Organising flexibility within the EU framework

This approach of bilateral cooperation outside the EU framework has proven controversial with other EU Member States. Officially, during an informal meeting in December 2010, EU Defence Ministers endorsed the agreement, seeing it as something that could contribute to improving European defence capabilities. Behind closed doors, however, several governments voiced apprehension that the bilateral initiative may lead to disentanglement from CSDP and argued for organising flexible cooperation within the institutional structures of the EU. As a first step, in late 2010 EU Defence Ministers followed an initiative by Germany and Sweden to analyse Member States’ options for military-capability cooperation.

The core idea of the so called “Ghent initiative” is to revitalise capability development in CSDP via a bottom-up approach. The first step consists of a systematic analysis of the ongoing and possible areas of Member State cooperation in military capabilities. To this end, all Member States agreed to consider cooperation in three areas: “measures to increase interoperability for capabilities to be maintained on a national level; exploring which capabilities offer potential for pooling; intensifying cooperation regarding capabilities, support structures and tasks which could be addressed on the basis of ‘role- and task-sharing’” (emphasis added).² This bottom-up information is to form the basis for an assessment of the possible scope for cooperation in defence capabilities between the Member States.

This assessment can only be successful if the willing Member States make use of this defined scope for military cooperation. As these initiatives are unlikely to encompass all Member States, they will have to use flexible cooperation. Exactly for this scenario, the Lisbon Treaty introduces the instrument of Permanent Structured Cooperation (PESCO). Although yet to be used, this instrument allows groups of Member States that are willing to jointly enhance their efforts in defence to do so within the Union framework. These Member States then have to fulfil higher criteria in their capabilities and make yet-to-be-specified commitments on the further development of their capabilities. In order to provide reliability and incentives for real progress, PESCO allows for the combination of these qualitative criteria with a mechanism for regular scrutiny, peer pressure and even sanctions. Additionally, those Member States not participating in PESCO can take part in its decision-making process, though without a formal vote.

2. Council of the European Union, Press Release, “Council conclusions on Military Capability Development”, 9 December 2010, available at: http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/EN/foraff/118347.pdf

Unlike previous capability-development processes in the EU – such as the Headline Goal or the European Capability Action Plan – PESCO includes the possibility for a top-down element. In order to screen Member States' compliance with the criteria and their commitments, it foresees a regular assessment to be carried out at least once a year by the European Defence Agency (EDA), which then gives a progress report to the Council. For the participating Member States, PESCO could therefore be used to introduce yearly capability planning at the EU level. If a Member State no longer fulfils the set PESCO criteria or is no longer able to meet its commitments, the other states participating in PESCO can decide to suspend its participation. Although this constitutes a rather crude sanction mechanism that will only be used as an ultimo ratio, it does at least allow for the Member States to exert political pressure on one another.

The instrument of Permanent Structured Cooperation could therefore form the basis for organising flexible cooperation in the full spectrum of military capabilities within the EU. The largest question mark surrounding its realisation concerns the qualitative criteria and commitments Member States would have to fulfil in order to take part in PESCO. While the treaty provisions are relatively vague in this regard, so far Member States have not been able to agree on a compromise that allows for broad participation while at the same time providing a real incentive for increased engagement in military capabilities. As an added benefit, due to their formal participation in decision-making, non-participating Member States would be kept in the loop. The largest benefit of PESCO, therefore, is that it would keep flexible military cooperation within the EU framework, and thus be directly aimed at stimulating CSDP.

Looking ahead – coordinating flexible military cooperation

After an initial phase of rapid development and a quick succession of small operations, the EU's Common Security and Defence Policy finds itself at a crossroads. The development of the civilian and military capabilities of EU Member States has not kept pace with the EU's ambition of becoming a global player in security affairs. Looking ahead to an "age of austerity" looming in the aftermath of the financial crisis, the pressure on finding further pockets in already strained national defence budgets is set to increase. Faced with this challenge, the UK and France have opted for a decisively bilateral approach in defence cooperation, aiming to use flexible and pragmatic initiatives outside the EU framework to boost their national capabilities. With the Ghent initiative, on the other hand, EU defence ministers have adopted an approach that aims to lay the foundation for flexible cooperation within the EU structures.

Set for a first progress report in mid 2011, this initiative will only be successful if followed by a real political push for more military cooperation aimed at delivering concrete results. It is here that the upcoming rotating presidencies can play a limited yet important role. Although their role has changed under the Lisbon Treaty, defence matters and in particular military capabilities remain a realm of the Member States, where coordination and mediation by the

Presidency continues to be of high importance. If the upcoming presidencies want to support capability cooperation within the EU structures, two aspects are crucial.

First, the Presidencies should organise initiatives for flexible military cooperation – such as the use of the instrument of Permanent Structured Cooperation – in close contact with the structures of CSDP, in particular the High Representative, the departments in the European External Action Service and the EDA.

Second and more importantly, coordination by the rotating presidencies will be crucial for bridging the gap between the large and smaller Member States. Poland, with its growing interest in advancing CSDP and its position as a medium-sized East European state, is particularly suited for this coordination. If this coordination is successful, the EU could indeed become a viable framework for flexible military cooperation, and CSDP could be revitalised.

COMMON SECURITY AND DEFENCE POLICY

The Solidarity Clause of the Lisbon Treaty's

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The Solidarity Clause, enshrined in Article 222 of the Treaty on the Functioning of the European Union (TFEU), enforces the legal obligation for “the Union and its Member States to act jointly in a spirit of solidarity if a Member State is the object of a terrorist attack or the victim of a manmade or natural disaster”. They will assist such a Member State “at the request of its political authorities”. The clause further provides that “the Union shall mobilise all the instruments at its disposal including the military resources made available by the Member States” for prevention, protection and assistance in case of terrorist threats or terrorists attacks. This clause was introduced by the Convention; while another “solidarity clause” – more comprehensive – dealing with “mutual defence” was not going to be acceptable due to a curious alliance of Atlanticists, led by the United Kingdom (UK), and neutrals. In the Intergovernmental Council (IGC) which followed the Convention, the principle of a mutual defence guarantee in accordance with article 51 of the United Nations (UN) Charter was however accepted on the understanding that this should not prejudice the specific situation of the neutrals nor commitments under NATO, which for those states belonging to it remains the foundation of their collective defence and the forum for its implementation.

Implementation

As far as the formal *procedure* is concerned, the situation is pretty clear: the arrangements for the implementation by the Union of the solidarity clause shall be defined by a decision of the Council acting on a joint proposal by the European Commission and the High Representative of the Union for Foreign Affairs and Security Policy... The Council shall act unanimously where this decision has defence implications and the Parliament shall be informed.

As far as the “will” to give a quick follow up to this provision of the treaty, the situation is more complicated for many reasons, political as well as practical. Seven years after its conception during the Convention on the Future of Europe in the aftermath of 9/11, the Solidarity Clause no longer appears to be such a high political priority for either the Members States or

the Institutions. The new general context created by the Lisbon treaty characterized – to a certain extent – by a return of “intergovernmentalism” and a central role given to “subsidiarity”, does not favour the establishment of a potentially “intrusive” mechanism, which could risk undermining the principle of sovereignty of Member States or, at least, interfere significantly in their internal organisation, including democratic control, citizen’s rights, national security, constitutional and judicial traditions, etc. These fears are all the stronger given that the solidarity clause, as it stands in the treaty, entails, in a single rather vague provision, recourse to “all the instruments” at the Union’s disposal (see Article 222 paragraph 1), such as police and judicial cooperation, civil protection interventions and even military resources made available by Member States.

The drafting of Article 222 – which is both rather ambitious and somewhat vague – is precisely the second obstacle to its implementation. Indeed the provision included in the Lisbon Treaty does not contain any details of any kind on the application of the clause, details which would have been an extremely useful guide for the legislator in its task and would therefore have facilitated the rapid adoption of the implementing measures. The third paragraph simply mentions the procedure according which the Council is asked to adopt a decision defining the necessary arrangement for its implementation. The absence of any outlines – either institutional nor operational – inevitably opens the door to different interpretations as regards, *inter alia*, its scope, the possible measures to be decided, what could trigger them, the respective responsibilities of the Union and the Member State concerned, and the role of the High Representative as well as that of the Political and Security Committee (PSC) and the Standing Committee on Internal Security (COSI), etc. If the avoidance of such detail on these very sensitive matters certainly made the task of the Convention and the subsequent IGC easier at the time, it now constitutes a challenge for the Institutions... and especially those that have to put a proposal on the table, i.e. the Commission and the High Representative.

A final reason why the implementation of the solidarity clause has been delayed is probably due to a decline in its practical interest due to the reduction of its potential scope. Since its original conception, some of the objectives of the Solidarity Clause have been overtaken by various concrete initiatives and decisions, in particular in the area of terrorism prevention. Improvement of existing mechanisms, creation of new legislative and operational instruments in the field of police and judicial cooperation, as well as systematic reinforcement of information gathering capacities have resulted in significant progress over the last seven years in the areas covered by the clause, thus reducing the sense of urgency in its implementation.

All these reasons, combined with urgent problems needing to be resolved in other spheres of Union’s activity (EEAS, economic crisis and economic governance), as well as some natural reluctance by Member States to activate binding procedures, could explain why work on the solidarity clause has been delayed. Such a cautious approach was revealed by the fact that

the solidarity commitment made in the Declaration on Combating Terrorism following the attacks in Madrid was not reiterated in the wake of the bombings in London one year later. The reasons for this preference for a national response could be: the long tradition of the UK intelligence services, the fear of disclosing sensitive intelligence sources, as well as subsidiarity-related considerations. On the other hand, the recent experience of the H1N1 pandemic, the volcanic ash crisis, forest fires in Portugal and other countries have demonstrated that cross-border crises are becoming increasingly frequent and make it impossible for any single European government to manage.

The best way to overcome these political doubts and to resolve the potential difficulties raised by the effective implementation of the clause is probably to try to analyse the legal nature and the purposes of the basic provisions as laid down in the treaty, to identify the different issues at stake, and to imagine concrete options for politically reasonable, practical and effective solutions.

The general level of ambition

The Solidarity Clause is now a treaty provision under the jurisdiction of the European Court of Justice. Even if the involvement of the court seems quite theoretical at this stage, for many reasons, there is no doubt that there is already today a “legal obligation” to help, although Member States are free to decide how, having coordinated within the Council. There is therefore a need to reflect on a pragmatic line to take in case a Member State invokes the clause before the adoption of the necessary arrangements – these reflections serving at the same time as a basis for the preparation of the formal implementing proposal to be put on the table of the Council.

The solidarity clause has to be seen in conjunction with other specific provisions of the Lisbon Treaty that pursue different, but interlinked objectives, such as TFEU Article 196 on civil protection, TFEU Articles 75, 83 and 88 on terrorism, Article 168 on public health, and Article 214 on humanitarian aid. It has also to be read in the broader context of Treaty on European Union (TEU) title V1 (general provisions on the EU’s external action, including provisions on consular cooperation) as well as TEU title V2 (Common Security and Defence Policy – CSDP).

The large number of provisions already enshrined in the treaty, having – directly or indirectly – solidarity as one of their *raison d’être*, could give the impression that the solidarity clause of Article 222 should be seen as a mainly “procedural facility”, aimed at maximising the effectiveness of the other existing instruments. However, this minimalistic approach does not correspond to the spirit and the letter of the treaty, which gives the EU the responsibility for mobilising all the instruments at its disposal as well as ensuring the adequate coordination of Member States in the Council. In doing so, it should of course build on what already exists...

Practical aspects of application: Nature and magnitude of the event or threat

To avoid unnecessary or disproportionate intervention by the EU, it will be necessary to identify - and to agree on - broad criteria to qualify which kinds of crises and / or disasters will fall under the solidarity clause. Two main types of criteria may be taken into consideration. The first one is based on the magnitude of the event in order to define what could be called a “subsidiarity threshold”. This criterion would avoid a situation whereby any type of attack could fall within the loose scope of the Solidarity Clause – which would imply a risk for both the subsidiarity principle as well for countries’ national capacities, where an over-reliance on the solidarity of others could create dangerous capacity gaps. Since a purely quantitative approach is inappropriate, the only way to circumscribe the material scope of the clause is to try to define qualitative criteria characterising crises and disasters to be taken into consideration; those criteria could be *inter alia* a) their cross-border nature, meaning for example that they have an impact in one or more other European countries, b) their “multisectorial” impact, c) their magnitude being such that they overwhelm the response capacity of a single Member State.

In other words, the two main reasons that could justify action at the EU level are on one hand the “global” nature of the threat / event (echoing new paradigms that have been given a variety of labels such as “global security”, “human security” or “societal security”) and on the other hand its “level” measured against the capacities of the Member State concerned as well as the effectiveness of any response (subsidiarity principle). In concrete terms, this mixed approach could be reflected in a text which could include:

- General qualitative criteria on the global nature of the threat/attack/disaster as well as, where possible, indicative thresholds linked to implementation of the subsidiarity principle;
- A (non exclusive) typology of the main threats/crises to be taken into consideration: what is a man-made disaster: maritime spills? pandemics? immigration flows? etc;
- A triggering procedure allowing a reasonable interpretation of these principles on a case by case basis.

Finally, it should be noted that even if clarifications on all these points would be welcomed in implementation arrangements, the principle has to remain that the assistance clause can be triggered only at the request of the political authorities of the Member State concerned.

Geographical scope

The text of Article 222 always refers to the territory of the Member States,¹ which seems to imply that in principle the applicability of the clause is limited to the territory of the Member

1. See paragraph 1 (a) first and third indent, and (b)

State *stricto sensu*. However, this principle has to be qualified in three ways. First, it is clear that the clause applies irrespective of whether the crisis originates inside or outside the Union; secondly, it will apply in the event of an attack on a Member States' embassy / European Delegation or to ships and planes of a Member State; finally, the question of the applicability of the clause in relation to consular cooperation (for example, a Mumbai-like incident) – even if not obvious – is worth considering because it appears as being more a question of opportunity – or ambition – than one of a purely legal nature. The same problem applies to the interpretation of “natural or made disasters” in cases of trans-boundary threats, such as terrorism, migration, oil spills, etc.

Role of the institutions

The Council shall adopt the arrangements for the implementation by the Union of the solidarity clause on the basis of a joint proposal by the Commission and the High Representative. Those arrangements could be seen as one single framework act covering any relevant situation or as individual ad hoc acts for every single crisis requiring the activation of the solidarity clause. The former option seems more appropriate for many reasons inter alia because adopting a specific act during a crisis could be lengthy and thus not compatible with the urgency characterising this kind of situation. Afterwards, the role of the Council needs to be focused on giving political guidance and orientations and not on the operational level. The clause foresees a role for the Political and Security Committee (COPS) and the Standing Committee on Internal Security (COSI), which should be consulted in order to ensure – when necessary – operational cooperation in areas covered by Common Foreign and Security Policy (CFSP) and Internal security. The role of the Counter Terrorism Coordinator will also have to be clarified. As far as the European Council is concerned, its main task – and prerogative – shall be to regularly assess the threats facing the Union and give political guidelines to enable the Union and its Member States to define priorities and take effective action in response to those threats, including prevention efforts. This threat analysis should be carried out with the help of all the EU and national competent authorities (EEAS, i.e. the Joint Situation Centre – SitCen; various Commission services; Agencies; national experts; etc), whose coordination should be improved.

The Commission has the responsibility, jointly with the High Representative / Vice President, to present a proposal on the necessary arrangements for the implementation of the solidarity clause. As recalled above, the Commission will also be on the frontline at the operational level because most of the instruments / policies to be mobilised in response to the threats are directly or indirectly under the Commission's responsibility, even if, for historical reasons, the clause comes under TFEU Part five (external action). The High Representative will normally be involved in the event of a terrorist attack or a manmade disaster whose origin is external to the EU, thus implying a possible diplomatic dimension; following the same reasoning, one could imagine that the High

Representative will also intervene when military means are mobilised, in order to coordinate the resources made available by Member States. It may, however, be worth differentiating between the use of military resources for relief / civil protection purposes and military resources used for security purposes. In both cases, the High Representative's services should work in close collaboration with the services of Commission and the competent authorities of the Council.

Conclusions

At a time where various types of cross-border threats and crises are becoming ever more frequent, the solidarity clause could bring a significant contribution to the global response of the EU alongside the efforts made at national level. This should encourage the coming Trio Presidency to adopt quickly the necessary arrangements for the effective implementation of the clause. They should pay particular attention to end with general – and not case by case – implementing provisions, which must (i) build on what already exists in this field at the Union level (through better coordination and coherence between actors and instruments) and (ii) bring a specific added-value at both the political and operational level, while respecting the division of competences between the Institutions as well as between the EU and the Member States.

The Contribution
of 16 European
Think Tanks
to the Polish,
Danish, and Cypriot
Trio Presidency of
the European Union

VIII

INSTITUTIONAL INNOVATIONS

In the preceding sectoral analyses, the authors have, amongst other things, evaluated the implementation of the new Lisbon Treaty rules and instruments over the past 18 months. In this concluding chapter, the authors specifically focus on the details of the Lisbon Treaty. Namely, they raise questions concerning both the participation of citizens in EU politics and the Treaty-based distribution of competences – between key institutional actors, but also between the national and EU levels.

The Lisbon Treaty is still in a transitional period and more time will be needed to clearly delimitate the roles of the Trio Presidency, of the permanent President of the European Council and of the High Representative of the Union for Foreign Affairs and Security Policy. Yet, it is already clear that, under the new Treaty, the Trio Presidency's political dimension is diminished. During the recent financial crisis, for example, the Trio Presidency's role was limited. This said, the Trio Presidency's "administrative leadership" has proven to be crucial. Even if during the recent eurozone crisis the Trio Presidency did not deal with the most difficult dossiers, its role in assuring successful legislation negotiation was decisive (CEPS).

PART VIII ABSTRACT

The precedent created by the Spanish-Belgian-Hungarian Trio Presidency favours good cooperation with the High representative and the President of the European Council. In order to shorten the legislative process, the key role for the coming Polish-Danish-Cypriot Trio Presidency should be to serve as an honest broker not only between Council members, but also between the Council and the European Parliament. Without this strong role for the Trio Presidency,

the institutional system risks further destabilisation – mostly due to the European Council exerting a dominant position (CEPS).

Unfortunately, during the previous Trio Presidency (January 2010-June 2011), the General Affairs Council (GAC) was widely unused. Thus, two authors below argue that the GAC's role needs to be clarified and politically reinforced, albeit without amending the Treaties. One way to do this would be for the prime minister holding rotating presidency to chair the GAC (CEPS, Real Instituto Elcano). The GAC should also serve as a hub, channelling the Council formations' work or uploading issues from the Council to the European Council. Moreover, the GAC could accomplish many other tasks: such as coordinating all sectoral Councils,

dealing with inter-institutional matters and public relations more clearly, better connecting prime-ministerial and governmental offices, and negotiating conflicts regarding external action, all the while eluding temptation to reappropriate foreign policy dossiers (Real Instituto Elcano). With weak rotating presidencies, too many decisions are taken up to the European Council level, rendering the rotating presidencies unable to control the political process.

Strengthening the GAC, however, would not silence current debates about furthering, halting or reducing European integration. The current return to intergovernmentalism, notably through the European Council, seems to underline the political significance – notably in relation the future of the EU – of such institutional tension. Even if the GAC were strengthened, national parliaments and Constitutional Courts are bound to scrutinise all new competence-transfers. Since the European Council seems to be exerting a dominant position, and since the Lisbon Treaty transfers much (potential) law-making power to the EU level, a balance might need to be restored vis-à-vis the national level. EU institutions should thus ready themselves for such an eventuality. The Trio Presidency should substantially invest in a good working relationship with the European Commission and the European Parliament, in order to both supersede early inter-institutional compromises on co-decision matters and more broadly to consider the political and legal implications at the national level of extending the use of the community method on important policy issues (ELIAMEP).

In relation to the national governments' discretion to decide what constitutes a transfer of powers, the Trio Presidency should pay attention to the increasingly active role of national Constitution Courts (CCs) (ELIAMEP). Activation of the "passerelle" clauses, which allow a switch from unanimity to majority voting, may lead national Constitutional Courts to raise more matters of constitutional transgression than before. Using the enhanced cooperation mechanism in some sensitive policy areas could also provoke such reactions. CCs could react to the use of the communitarised procedure to authorise enhanced cooperation itself, as well as to Member States' decision, once the cooperation is launched, to transform unanimity into Qualified Majority Voting and to introduce the ordinary legislative procedure in cases where special legislative procedures are foreseen. Given that the issue of compatibility of EU law with national constitutions is not just a technocratic judicial matter, but a political matter of great importance for the process of European integration, the Trio Presidency should then prevent blocking situations by establishing a preventive mechanism where the Council Legal Service could be involved actively. In addition, the Trio should consider granting the GAC a special competence on EU power extensions.

Concerning institutional checks and balances, one author below argues that the Trio Presidency, in collaboration with the national parliaments (via the Conference of Community and European Affairs Committees of Parliaments of the European Union – COSAC), should ensure that the subsidiarity check becomes the tool it has the potential to be. In other words, subsidiarity should not serve as an empty slogan, but rather as an efficient legal check on how EU institutions use their powers. Moreover, in order to make the dialogue between national parliaments and the Commission much more accurate from a constitutional perspective, national parliaments should consider new EU legislation in the light of not only the principle of subsidiarity, but also the principle of proportionality (SIEPS). The Protocol on the application of the principles of subsidiarity and proportionality does not explicitly provide for such a dialogue today, but it does not prevent it. In the long term, the protocol should be revised to explicitly permit this kind of input from the national parliaments.

Another way to render the EU's institutional system more balanced and democratic might be to modify the way the Members of the European Parliament are elected. The increase of the Parliament's powers with the Lisbon Treaty and the ever-more prominent quest for a "cure" of the EU's "democratic deficit" have given a fresh impetus to the idea of amending the electoral procedures by 2014. The authors support here the European Parliament's (EP) proposals to introduce a transnational list to personalise and Europeanise EP elections, invigorate the "strategic partnership" between the Parliament and Commission, and strengthen the autonomy of European political parties. So that European and national parties can prepare for the implementation of the various innovations, the coming Trio Presidency should put electoral reform on the agenda as early as possible (EPC). The Polish, Danish and Cypriot Trio presidency has an important role to play in the framework of the ordinary revision procedure. To initiate the procedure, the Council has to submit the EP's proposed amendments to the European Council, which can decide to examine the revisions put forward. Ultimately, any Treaty amendments have to be settled in the framework of an Intergovernmental Conference (IGC) – independent of whether a Convention has been convened or not. Here again, the Trio Presidency can be pivotal, as the IGC has to be convened by the President of the Council. The rotating presidency will have to consult with the EP in order to obtain the parliament's consent not to convene a Convention

A final way to make the EU more democratic and balanced would be to increase citizen participation. One of the past Trio Presidency's specific institutional successes was the agreement reached in December 2010 on the European Citizen's Initiative (ECI). Most loose ends are now closed, allowing the implementation of the most ambitious initiative to date when it comes

to participatory democracy at the EU level. The Commission has, however, no obligation to follow the ECI's. Thus how the Commission responds to the first wave of ECI's in 2012 will determine whether the ECI becomes just another piece of symbolpolitik, or whether it will evolve into a useful and influential tool for the European people. The Trio Presidency should then inform EU citizens about the new Citizen's Directive, but also about what the EU "does" – otherwise, the new tool is likely to alienate citizens and only serve pre-established interest groups (DIIS).



INSTITUTIONAL INNOVATIONS

What is Left for the Rotating Council Presidency under the Lisbon Rules?

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The Lisbon Treaty has completely changed the rotating presidency's role. Before Lisbon, each rotating presidency held political responsibility for (almost) the entire European project. National diplomats brokered all the main decisions. Under the new system, the rotating presidencies' "political" dimension has been seriously limited, if not eradicated. In the new institutional system of the European Union (EU), the rotating presidencies' main task is to take care (within the Council and with the European Parliament) of ongoing legislation. The most difficult dossiers, usually negotiated politically at the highest level of the European Council, have now been taken away from the rotating presidencies' responsibilities. Still, even if the role of the rotating presidency is less relevant in the most difficult dossiers, its active engagement in negotiating legislation is absolutely crucial for the system to successfully continue its functioning. The importance of the legislative responsibility is even greater in the specific context of economic instability and the eurozone crisis.

In this new legal and politically changed reality, the new Trio Presidency takes office when none of its partners fully participates in all EU structures (Poland and Denmark are outside of the eurozone and have other opt-outs; while Cyprus is not member of the Schengen Area, it is also a neutral state).

Domestic affairs

In this context and under the rulebook of the Treaty of Lisbon, for a rotating presidency to be successful, one needs two domestic elements: first, dedication on the part of the country's political elites, and second, commitment on the part of the public administration, who is to play the role of an honest broker in the Council. The civil servants, and their capacities, are the Presidency's strongest assets in fulfilling its task. Civil servants work constantly, permanently building their personal reputation and – their state's reputation – in the eyes of their partners. In parallel, they are engaged in hundreds of working-group meetings and thousands of official and unofficial consultations. They all work for the cause of having the job done well; the one

element they need most is the most fragile element: credibility. In the corridors of Brussels, credibility is probably the most wanted virtue. One (person, institution, state) works on it for many years; ruining it takes sometimes five seconds or one politician's statement.

This is why the political elites' dedication is crucial to the rotating presidency's success. Politicians can ruin instantly the credibility their civil servants have been working on for years. At the same time, their commitment became much more complex. One expects the wolves (politicians) to dance the waltz (be an honest broker) in a situation when there is no reward for complying (no visibility). Interestingly, the first "Lisbon"-presidencies (Spanish, Belgian and the most recent one of Hungary) show a different lesson in this respect. The Belgians had a major political crisis during the entire process. After early elections in June 2010, they were unable to form a majority government and the Presidency was executed by the outgoing, caretaker government. However, the political elites remained committed to European affairs despite problems "at home" and the Belgian Presidency has been widely accounted for being a successful one. Six months beforehand, the Spanish Presidency of the Council, in the first semester of 2010, was run by a stable government with most of the ministers committed to the cause of running the Council's presidency smoothly. At the same time, the new system offered the Prime Minister virtually no "perks" for staying engaged; after the first few weeks, the image José Luis Rodríguez Zapatero gave was one of detachment. This did not help the Spaniards concerning the coordination of the Presidency between various Council formations. In the end, a few crucial mistakes appeared and one of them (cancellation of the EU-US summit) – which was widely attributed to the rotating presidency – had a major effect on the perception of the Spanish Presidency. It became widely accepted that the Presidency became largely irrelevant towards the end of the Spanish term, despite the efforts of many Spanish officials brilliantly performing their duties.

The Hungarian example is of a different nature still and most relevant for Poland and Cyprus. Like them, the Hungarians were running their first Council presidency. Although in Budapest the Hungarians had a very strong government in office, with a constitutional majority (not the Belgian case), they nevertheless had to face a major visibility challenge in the early days of their term; the attempt to change Hungarian media law lowered expectations from Hungarian leaders, and to some extent undermined the credibility of Hungarian officials.

The good news for the upcoming rotating presidencies is that in the Lisbon reality, whatever the developments back home may be, as long as the Presidency stays on course and political leadership is dedicated and able to coordinate the various elements of the system – the success of the Presidency can be unattached. The link between developments at home and the performance of the Presidency are made only in January (or July, for the presidencies of the second semester); later into the Presidency, visibility is significantly diminished (in January / July the College of Commissioners comes to the national capital and the Prime Minister of the country holding the rotating presidency addresses the European Parliament) and the Presidency becomes much more low-profiled.

Pending institutional questions

There is one role the Trio Presidency can play in the rearranged institutional system of the European Union: It has to be a credible and honest broker. Without assuming such a role, no success can be possible – nor, with this role, is success guaranteed.

One has to recognize that the post-Lisbon institutional system has not been fully settled-in. Among many institutional treaty innovations is the new (lack of) role of the prime minister of the country holding the rotating presidency of the Council. Until now, the rotating presidencies did not work out any lasting model of cooperation between the head of the rotating Council presidency and other institutions, most notably with the President of the European Council. The Spanish were the first Presidency under the new system and everything was fresh and new, including the permanent chief of the European Council. On top of things, most of the time the Spanish Prime Minister remained rather disengaged. During the Belgian semester, a functional model was worked-out, but it was a very specific model based on two elements not applicable elsewhere. First, the Belgians had only a caretaker government; the acting Prime Minister had no power to even try to challenge the leadership of the President of the European Council, Herman Van Rompuy. At the same time, as a caretaker government the Belgians had to focus only on the competences they had: to administer. Secondly, Van Rompuy is a Belgian and a former Prime Minister. Most of the sitting (acting) ministers were his ministers in his government. As a result, we saw the naturally close relationship between the sectoral Council formations and the permanent President. Such a close relationship would probably be most welcomed in the future, but it is equally unlikely as it is necessary.

The Hungarian experience has not been conclusive. On one side, the rotating presidency has tried to reclaim some of the territory previously extensively covered by the Permanent European Council President. The trend of reclaiming the Council's autonomy from the European Council should be expected to continue until the upcoming Polish and Danish rotating terms. Yet, at the same time, Hungarians were largely unsuccessful and among some Hungarian officials there was a degree of dissatisfaction and (a subjective) perception of marginalization of the Council by a “Brussels belt” consisting of the European Council President and the Council's General Secretariat.

Hence the challenge: how to separate the Siam twins (Council and the European Council) so that they become two separate institutions, but with mutual respect towards one another? How to avoid tensions along the way? If the Poles, Danes and Cypriots succeed in working out a functional model of rotating presidencies, the input of rotating presidencies into European politics can be of great added value.

Certainly the rotating presidency, as the helm of the Council and as a provider of blood to the legislative functioning of the Union, needs to be further strengthened. Without a stronger role for the rotating presidency, the system risks further destabilisation and a lack of balance, with a dominant position of the European Council over the entire system. A “stronger” Council

means a rotating presidency that would be more centralised than it has been until now (post Lisbon). The role of the General Affairs Council (GAC), for example, needs to be re-affirmed. Together with the Foreign Affairs Council, it is the only treaty-based Council formation. Still, the previous Trio Presidency's experience (January 2010-June 2011) shows that the GAC has been widely unused by the rotating presidency to politically channel the works of the Council formations or to upload issues from the Council to the European Council level.

Also, the role of the prime minister of the country holding the rotating presidency needs to be re-established. He or she should play a “Vice President” role in the European Council, with a special role unlike other national leaders. He or she should be the only person in the European Council with detailed knowledge about the proceedings of all Council formations. At the European Council, he or she should not only report on Council work; he or she should also be able to confirm what is and what is not feasible on the Council level. Until now, the special situation belongs only to the President of the European Commission and his first deputy, the High Representative for the EU's foreign policy.

To achieve a higher degree of political centralisation – that is in the interest of any rotating presidency – the prime minister of the country holding the responsibility should be the one to chair GAC meetings. In some situations, it would be up to him or her to decide if a given issue needs to be dealt with at the highest political level at the European Council, or can still be returned to the Council formations; he or she may also attempt to strike a compromise at the GAC level. This way the GAC, in the hands of the rotating presidency, would become a central filter for all legislative and political processes. Only the most important ones would be delegated to the higher level. Which ones are the most important would remain at the discretion of the rotating presidency's head. This is how he or she could also influence the European Councils' agenda. So far it has not been the case.

Recommendations

The primary function of the rotating presidency is to be an honest broker within the Council. The Polish, Danish and the Cypriot rotating presidencies should try to play the role of honest brokers not only within the Council, but in the entire legislative process (i.e. involving the European Parliament). This way they should be able to shorten the legislative process.

The prime minister/president of the country holding the rotating presidency should chair the General Affairs Council. The GAC should be the central coordinating place of all sectoral Councils. With weak rotating presidencies too many decisions are taken up to the European Council level and the rotating presidencies are unable to control the political process. Regaining the posture of the rotating presidency by stronger centralisation of the work of the Council will also improve the position of the national leader holding the rotating presidency. Effectively, a strong rotating presidency's head becomes a Vice President of the European Council.

INSTITUTIONAL INNOVATIONS

The Role of the General Affairs Council Revisited in the Light of the 18-month Experience with the Lisbon Treaty

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The first 18 months of the Lisbon Treaty – corresponding to the Spanish, Belgian and Hungarian Trio Presidency of the European Union (EU) – has left a rather bittersweet taste over the supposed positive effects of the new decision-making framework, which proved so difficult to agree on and then ratify. Over the past years, the treaty in and of itself did not allow Europe to resolve the big integration-process challenges: financial turbulences and recessions during 2008 and 2009, subsequent sovereign debt crises, or, more generally, Europe’s declining international position in a context of major geopolitical shifts and changing global economic competitiveness. However, the new Lisbon Treaty mechanisms did help the EU better address those issues where there was at least a minimum of political will. To give two examples: (i) the institutionalisation of the European Council was an advantage, rather than an added difficulty, in moving towards reinforced economic governance or the so-called Euro-Plus Pact; and (ii) the strengthening of the European Parliament has been a source of support, rather than hindrance, in the design and launching of the European External Action Service (EEAS).

Although it is premature to assess changes in the institutional balance as a whole, it is possible to say that the new tools improved the EU’s political performance with regard to policy-making continuity, visibility of decisions and accountability. This said, the treaty also makes for greater complexity in decision-making and this requires more political coordination among institutions. It is worth noting that in the previous edition of “Think Global, Act European”, four of the final recommendations dealt with the need for better coordination. In particular, the first recommendation made an appeal to “ensure that the new General Affairs Council – chaired by the Trio Presidency – fulfilled the role of a strategic coordinator of policy-making in the EU”.¹ Given that, nearly a year-and-a-half later, the need to develop

this function is more acute, the recommendation is even more compelling than before. The General Affairs Council (GAC) has not asserted itself politically and other possible coordinators, who are well established and permanently based in Brussels – such as the President of the European Council, the Committee of Permanent Representatives (COREPER) or even the Secretariat General of the Council, are not the ideal actors to carry out this function, which requires Member States to be politically involved at the ministerial level.

In late 2009, the GAC was created as a new configuration of the Council, splitting it from the former “General Affairs and External Relations Council”. The other part became the new Foreign Affairs Council. The idea was to clearly distinguish between the definition of the EU’s international action on the one hand, and the transversal coordination of all issues that the Council dealt with on the other. Thus, in the first case, the foreign ministers – and sometimes those responsible for defence, development or trade – acted, under the stable presidency of the High Representative, as representatives of the Member States on foreign and security matters. In the latter, the ministers of Foreign or European affairs – under the six-month rotating presidency – would have to carry out three functions. Firstly, because the Council still had nine vertical configurations, the first function involved the need to give consistency to sectoral work. Secondly, to the extent that some transversal issues were difficult to assign to the vertical councils – such as enlargement, for instance, it made sense for there to be a horizontal body in charge of these issues. The third function, in light of the separation between the European Council and the Council as different institutions, stemmed from the need to connect the former’s role as provider of political drive to the latter’s role, which is fundamentally legislative.

None of this was achieved during the first three presidencies conducted under the Lisbon rules. The GAC probably achieved the basic goal of guaranteeing a minimum of consistency in the work of the nine other Council configurations and it formally prepared and followed-up on the meetings of the European Council. However, it failed to become a powerful and distinctive actor with a strategic approach. Given that after the treaty came into force the rotating presidency’s clearly lost of functions and visibility, it is odd that neither Spain, nor Belgium, nor Hungary harnessed and strengthened the GAC, which, under the Lisbon Treaty, is the remaining instrument the Trio Presidency can use to maintain influence in EU policy-making. Some factors inherent to those presidencies help explain this weakness: that is to say, Spain’s relative state of confusion over the new treaty, during a semester that was considered transitional; Belgium’s management by an interim government; and the fact that holding the EU Presidency was a novelty for Hungary. Besides this, the difficult economic situation forced the Trio to hand over most politicised intergovernmental decisions to the European Council. In any case, it is not at all certain that during the next Trio Presidency – held by Poland, Denmark and Cyprus – the GAC will gain political strength or clarify of its functions.

Other, more structural factors also explain why, so far, the GAC is not living up to the expectations created by the Treaty of Lisbon, which in principle assigned it an important position

1. Elvire Fabry and Gaëtane Ricard-Nihoul (eds.), Think Global, Act European, Notre Europe, March 2010, p. 276, available at: http://www.notre-europe.eu/uploads/tx_publication/TGAE2010--EN.pdf

within the EU. These factors include the discontinuity inherent to semi-annual Presidencies, the departmentalisation intrinsic to the Council's functioning as an institution, and the foreign ministers' relative lack of interest – for it is the foreign ministers who, for the most part, make up the GAC.

Why it is important to strengthen the GAC? And how to advance towards this goal over the next 18 months? Boosting this body is a good idea both in terms of institutional efficiency and democratic legitimacy. The GAC is potentially well-placed to help provide the European policy-making process with more coordination (efficiency) and more visibility (legitimacy). The idea would be to offset the myriad fragmented sources of power that now characterise the Council itself (specifically, the Trio Presidency, the High Representative, the Eurogroup and other specialised configurations under the rotating presidency) and the European Union as a whole (that is to say, the European Council, the European Commission, the European Parliament and national parliaments). Effective coordination and democratic transparency in the decision-making process must be accepted by Member States and as well as by EU institutions. It would seem that the GAC – inasmuch as it is a European institution and at the same time boasts an intrinsically intergovernmental nature – could be the ideal body for this purpose. The COREPER or the General Secretariat of the Council can certainly help the decision-making process be more consistent, but their technical nature prevents them from doing it with a strategic vision – and in any case, the General Secretariat of the Council operates in an opaque fashion, without any orientation toward public discourse or accountability. Of course, the European Council can, for its part, help achieve major political consensuses on integration, however it is unable to get directly involved in the drafting or implementation of legislation, and therefore its relations with the European Parliament and the Commission are limited.

Recommendations: How can the General Affairs Council be strengthened?

The GAC has room for political strengthening in each of the three major functions assigned to it by the Treaty and by Council's Rules of Procedure:

- Regarding coordination of all the configurations of the Council.
- Regarding transversal issues.
- Regarding preparation for, and follow-up of, the European Council.

Regarding coordination of all the configurations of the Council

During the Constitutional Convention of 2002-2003, it was proposed that the new GAC concentrate on all of the Council's legislative activity, on the basis of prior deliberations carried out by its various specialised configurations. Because of the profound implications this would have for how the institution worked, this proposal, intended to guarantee coherence, was rejected at the intergovernmental conference of 2004. Since the outset of the integration process, it has been understood that the Council has been formally convened and enjoys all of

its attributions and prerogatives, regardless of whether it is made up of ministers for specific sectors or for foreign affairs. However, adopting a rather political than legal approach with regard to the goal of coherence, the GAC should have, nevertheless, efficient mechanisms for undertaking one of its main missions: guaranteeing consistency in the work of the Council. The success of its ties with the European Council also depends on this.

To this end, and in strict application of the principle of *primus inter pares* (first among equals), the GAC could thoroughly examine the nine other councils' activities and be able to express observations, suggestions or even – although obviously with caution – warnings, all based on the programme and priorities of the semester and / or of Trio Presidency. By the same token, in cases of doubt, the specialised configurations of the Council could encourage a political appeal to the GAC for it to set the position of the institution. It is not so much an issue of changing the rules governing the Council as having the members of the GAC embrace a certain degree of political authority over the rest of the other configurations, which, in any case, would continue to be, technically, equals. Otherwise, if the work of the GAC is limited to a routine review of what has been done by the other configurations, it will not be contributing any added value to the goal of consistency. In any case, the GAC would be contributing much less than that contributed by the ambassadors of the COREPER, which would not seem logical. What is more, looking to the specific rotating presidency function and considering that some governments do not have high-quality domestic coordination mechanisms, such a role for the GAC would be most welcome. Finally, if the rotating presidencies of the Trio decided to divvy up, by sector, the work of the different Council formations during the 18-month period, this role could become essential.

This said, it is no secret that this function would have a particularly delicate dimension in terms of the Foreign Affairs Council, assuming that in that case the High Representative assumes the permanent Presidency. However, precisely because the rotating presidency does not act here as leader of the meetings, the task of providing consistency to the work of the Council is even more necessary. Of course, the GAC would have to act here with special care and avoid any temptation to re-appropriate the Common Foreign and Security Policy (CFSP) dossiers. But it is also true that almost all the specialised councils have an external dimension: for instance, "Justice and Home Affairs" in issues of international terrorism, "Economic and Financial Affairs" (ECOFIN) in matters of global economic governance, "Environment" in issues of climate change, or the GAC itself, which is in charge of enlargement policy. This can trigger occasional inconsistencies or even conflicts that only the GAC – with the rotating presidency acting more than ever as an "honest broker" – can resolve.

Regarding transversal issues

A second line of strengthening is closely linked to the goal of achieving consistency in the Council's work. Along with the need to coordinate sectoral issues is the need to take the lead in issues that are transversal by definition and affect several Council formations, without

clearly being the responsibility of any specific one of them. These dossiers intrinsically involve European integration politics, such as reform of the Treaties, enlargement policy, negotiation of financial perspectives, or the structural reform agenda, now known as the Europe 2020 Strategy. All of these issues affect the rest of the formations: depending on the cases, especially the ECOFIN, the Competitiveness Council and the Foreign Affairs Council. However, due to its horizontal nature, only the GAC can manage consistently and with strategic vision the agenda-setting process and the final decision-making. Otherwise, many dimensions of these transversal dossiers – germane to European integration – could slip into limbo. In all of these cases, however, the final word rests with the European Council. Thus, from a functional standpoint, it is necessary to channel in an orderly fashion the upward conduit – in other words the decision-making process, the descending one – in the application of what the Heads of State and Government decided, and those decisions which go from one institution to another.

For this same reason, the Council's institutional relationship with the Commission, the European Parliament, the Court of Justice and national legislatures should be channelled through the GAC. The rest of the Council's formations would of course continue to deal with the Commission or the European Parliament in legislative work or in specialised political matters. But the actual management of the policy of inter-institutional balance, of political dialogue and the job of acting as spokesman of the Council – except in foreign affairs – must belong to the GAC. Furthermore, this will give the institution projection in the media and thus among the citizenry of Europe. Here, it is not a matter of adding more complications to the image of the EU as a whole, which in principle should be concentrated in the president of the European Council, the President of the Commission and the High Representative. Rather, the idea is to add consistency and visibility to the Council's now-fragmented voice. This would entail presenting the priorities and conclusions of the semester before the European Parliament and other circumstances that require the Council as such to speak. For the Member State holding the rotating presidency, this relative personification of the Council could also be useful from a domestic point of view.

Regarding preparation for and follow-up of the European Council

As we have stated, the Council's ties to the European Council – now that the Treaty of Lisbon has separated the two institutions – are maintained at the administrative level by the General Secretariat, which is common to both, and at the political level by the GAC, at least in theory. In practice, keeping in mind what has been said so far, this function has only been carried out formally during the first months after the Treaty came into force. For this reason, if it managed to improve the GAC's ability to coordinate vertical issues and lead the horizontal ones, it would, along the way, achieve a third element, namely the political strengthening of the Council. In other words, the establishment of a strategic position for the Council and the production of consistent legislative work will facilitate the GAC's political preparation of European Council meetings, will substantially fuel its conclusions and will ensure effective

continuity in the legislative implementation of the politically-driven decisions made by Heads of State and Government.

Besides what has been discussed so far, in order to achieve this result, it would be necessary to boost the GAC's ties with the European Council via two channels: on one hand with the permanent President, and on the other with the Heads of State and Government. Concerning the former, the idea is to strengthen internal relations and do so both for formal meetings of the European Council and for increasingly frequent informal meetings. So far, President Herman Van Rompuy has acted in a loyal fashion and organised efficient contacts and prior meetings – usually in the format of dinners. Perhaps it would be a good idea to go a step further. For example, now that it seems clear that the prime ministers of the countries holding the rotating presidency have discarded the possibility of chairing GAC meetings, it may be interesting to invite to the European Council – along with the prime minister who it is to speak first to his / her colleagues – the national government member who has effectively presided over the GAC.

As for boosting ties between the GAC and the Heads of State and Government, the way to go is not within European institutions, but rather through national capitals. For this reason, achieving this goal depends on progress that can only be completed through an indirect and probably slow process of changing the current GAC. Here, it is a matter of connecting GAC members, in a more or less formal, way with Member States' prime-ministerial or governmental offices. In an implicit way, this connection should mean that the makeup of the GAC would no longer be one of foreign ministers, who should concentrate on the Foreign Affairs Council, but one of European affairs ministers. This does not necessarily mean that European policy would no longer be linked to the 27 Member States' foreign ministries, but it would in fact mean that the European minister – even in cases in which they are junior figures – would also have domestic authority, which only comes if they, apart from being still connected to the foreign ministries, are very close to the prime minister.

It is unclear if this network of top national officials' tasked exclusively with European affairs will be created. Nevertheless, the post-Lisbon EU seems to require that key Member States political representatives, who are domestically close to the 27 Heads of State and Government, may lead the ever more complex national formation of European policy and, therefore, may monopolise their countries' participation in the GAC. This is already the case for some Member States, such as Sweden or Slovenia, but it remains to be seen whether the GAC is gradually consolidated or not as a true European network of politicians whose strategic role – of coordinating and serving as a liaison between the EU and the Member States – is key to the future of European integration. The next Trio Presidency will run the GAC over the next 18 months and can contribute in a critical way to reaching this goal.

INSTITUTIONAL INNOVATIONS

Does Subsidiarity Ask the Right Question?

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Subsidiarity was formally introduced in the European Union (EU) with the Maastricht Treaty, which entered into force on 1 November 1993. By introducing this principle, Member States wanted to impose a check on how EU institutions used their powers. The principle of subsidiarity implies a preference for decisions to be taken as close as possible to the people affected, but if more efficient outcomes can be reached at the central level, then decisions should be taken there.

Article 5.3 in the Treaty of the European Union (TEU) provides that:

Under the principle of subsidiarity, in areas which do not fall within its exclusive competence, the Union shall act only if and in so far as the objectives of the proposed action cannot be sufficiently achieved by the Member States, either at central level or at regional and local level, but can rather, by reason of the scale or effects of the proposed action, be better achieved at Union level.

The institutions of the Union shall apply the principle of subsidiarity as laid down in the Protocol on the application of the principles of subsidiarity and proportionality. National Parliaments ensure compliance with the principle of subsidiarity in accordance with the procedure set out in that Protocol.

Hence, the principle of subsidiarity concerns all cooperation in the Union “which do not fall within its exclusive competence”. The areas in which EU has exclusive competence are enumerated in Article 3 in the Treaty of the Functioning of the European Union (TFEU) which reads as follows:

1. *The Union shall have exclusive competence in the following areas:*
 - (a) *customs union;*
 - (b) *the establishing of the competition rules necessary for the functioning of the internal market;*
 - (c) *monetary policy for the Member States whose currency is the euro;*
 - (d) *the conservation of marine biological resources under the common fisheries policy;*
 - (e) *common commercial policy.*

2. The Union shall also have exclusive competence for the conclusion of an international agreement when its conclusion is provided for in a legislative act of the Union or is necessary to enable the Union to exercise its internal competence, or in so far as its conclusion may affect common rules or alter their scope.

But subsidiarity is not the only principle in the EU Treaty that relates to the distribution of powers between the EU and Member States. Article 5 TEU contains in fact three fundamental principles, which each impose limitations on the institutions of the Union: the principles of conferral, subsidiarity and proportionality.

The meaning of these principles can be summarised as follows. The principle of conferral controls when the EU is able to act, the principle of subsidiarity when the EU should act and the principle of proportionality how the EU should act. In contrast to the principle of conferral, the principles of subsidiarity and proportionality are therefore not concerned with the issue if the EU has the power to do something or not, but rather impose certain conditions on how these powers should be used. While the principle of subsidiarity regulates whether and to what extent the powers are to be exercised, the principle of proportionality shall ensure that they do not give rise to actions that are more extensive than is necessary to achieve the objectives of the Union.

The role of the national parliaments

The assessment of subsidiarity has, until the entry into force of the Lisbon Treaty, been handled exclusively by EU institutions. A political *ex ante* control has been made by the Commission, the European Parliament and the Council and a legal *ex post* review has been possible before the European Court of Justice (ECJ). The Lisbon Treaty alters this situation and national parliaments have now been assigned the task of monitoring draft EU legislation to see if it complies with the principle of subsidiarity. This means that for the first time national parliaments have a (although limited) Treaty-based opportunity to exercise influence over the legislative process in the Union.¹ Subsidiarity has thus shifted from being primarily a judicial *ex post* control to essentially be a political *ex ante* control. It is of utmost importance that it is no longer the EU’s own institutions, but rather the national parliaments who are now primarily responsible for this control. National parliaments have a particular interest to verify that the transferred powers are not abused, because it is they who initially gave away these powers to be shared within the EU. However, the legal ex-post control before the ECJ remains as a complement to the political ex ante control.

The new procedure is constructed as follows. National parliaments receive a draft legislative act. Thereafter, they have the possibility, within eight weeks, to lodge a reasoned opinion

1. See Jörgen Hettne, “Subsidiaritetsprincipen: Politisk granskning eller juridisk kontroll?”, *Sieps*, 2003:4, p. 39 Available at: <http://www.sieps.se/sites/default/files/6-20034.pdf>

stating why they consider that the draft in question does not comply with the principle of subsidiarity. If such opinions represent at least one third of all the votes allocated to the national parliaments,² the draft must be reviewed. This threshold shall be a quarter in the case of a draft legislative act submitted on the basis of Art. 76 TFEU on the area of freedom, security and justice. After such review, the Commission – or another institution depending on the case – may decide to maintain, amend or withdraw the proposal. If it chooses to maintain the proposal, the Commission or the other institution will have to justify, in a reasoned opinion, why it considers that the proposal complies with the principle of subsidiarity. As regards legislative acts under the ordinary legislative procedure, an alternative procedure is available.³

The limited scope of the subsidiarity check

It is noticeable that the scrutiny of national parliaments under the Protocol on the application of the principles of subsidiarity and proportionality is limited in several respects. Firstly, it is only a draft legislative act they are able to scrutinize not non-legislative acts, i.e. acts under TFEU that are not derived from a legislative process, such as delegated acts and implementing acts adopted by the Commission. It is thus important to verify which pieces of legislation constitute “legislative acts”. It follows, for example, of the TFEU that a request to amend the Statute of the court is a “draft legislative act”.⁴

Second, a national parliament can only comment on why it considers that a draft is inconsistent with the principle of subsidiarity. National parliaments are not invited to comment on whether a proposal appears to be incompatible with the principle of conferral or the principle of proportionality. Still, these two principles are obviously part of the same context (the distribution of powers between the EU and the Member States) as illustrated by Art. 5 of the EU Treaty, where these three principles are grouped together. Furthermore, there is no explicit provision for national parliaments to object if they believe that national identity has been violated within the meaning of Art. 4.2 of the EU Treaty.

From a practical perspective, it is understandable that national parliaments are not given more extensive powers than at present under the Protocol. The task of monitoring the subsidiarity principle is new and certainly already demanding in itself. However, there is a risk

that subsidiarity is proving to be a very blunt instrument of control if the principle is isolated from other related principles.

Consider the following example. If the Commission proposes that English should be the language of the EU, some national parliaments would probably object and claim that this is not in accordance with the principle of subsidiarity. However, in such a case subsidiarity misses completely the point. The judgment to be made under the principle of subsidiarity is not about the objective pursued but whether the pursuit of that objective requires Community action.⁵ Thus, that principle does not (on its own) provide a method to balance between the interest of the Member States and the Union. It rather asks who should implement the already agreed objectives. Looking at the issue of English as the language of the EU, it is obvious that one of the biggest obstacles to mobility within the EU is lack of language skills. It is therefore possible to argue that the TFEU provides a basis for harmonization of this. Moreover, it is completely impossible for Member States to solve this problem on their own. Accordingly, subsidiarity provides no reason not to legislate.⁶

As can be seen from this reasoning, the problem is that added value to the Union is not balanced against the damage done to national interests. To add this national aspect it is necessary to consider the proposal in the light of the principle of proportionality. It would probably be a convincing argument that one single language for the EU is disproportionate to the aims, if the costs to Member States’ interests are considered.

It could be argued that an element of proportionality is part of the principle of subsidiarity. Renaud Dehousse has for instance claimed that “the proportionality test [...] is a logical component of any subsidiarity assessment”.⁷ Some support for this can also be found in Article 5 TFEU, which provides that “the Union shall act only if **and in so far as the objectives of the proposed action cannot be sufficiently achieved**”. In the case at hand it would therefore be possible to argue that language teaching could reduce linguistic obstacles to movement. However, the crucial question is if this permits the conclusion that free movement is sufficiently achieved by such teaching?⁸

The case is obviously extreme, but similar questions have also appeared in cases before the ECJ. In fact, it has proved virtually impossible to challenge a harmonization measure in the light of the subsidiarity principle. In these cases, the Court has pointed out that when the objective pursued by the measure is that of harmonization, which is necessary in order to prevent differences between national laws causing obstacles to movement or distortions of

2. Each national Parliament shall have two votes, distributed on the basis of the national Parliamentary system. In the case of a bicameral Parliamentary system, each of the two chambers shall have one vote (see Article 7 in the Protocol on the application of the principles of subsidiarity and proportionality)

3. When reasoned opinions (on the non-compliance with the principle of subsidiarity of a proposal for a legislative act) represent at least a simple majority of the votes allocated to the national parliaments and the Commission chooses to maintain the proposal, the issue of subsidiarity will also be considered by the Union legislator (Council/European Parliament). If, by a majority of 55% of the members of the Council or a majority of the votes cast in the European Parliament, the legislator is of the opinion that the proposal is not compatible with the principle of subsidiarity, the legislative proposal shall not be given further consideration

4. According to Article 3 of the Protocol: “For the purposes of this Protocol, ‘draft legislative acts’ shall mean proposals from the Commission, initiatives from a group of Member States, initiatives from the European Parliament, requests from the Court of Justice, recommendations from the European Central Bank and requests from the European Investment Bank, for the adoption of a legislative act”

5. See opinion of Advocate General Maduro in Case C-58/08, Vodafone Ltd and Others v Secretary of State for Business, Enterprise and Regulatory Reform, not yet reported, paragraphe 30

6. See Gareth Davies, “Subsidiarity: The Wrong Idea, in the Wrong Place, at the Wrong Time”, *CMLrev* 43, 2006, pp. 63, 69

7. See Renaud Dehousse, “Centralization and Decentralization in the European Community: Are we Asking the Right Questions?”, in *The Future of Europe – Centralized and Decentralized Approaches*, ERA 1994, p. 36. See also “betänkande 2010/11:KU18 Uppföljning av riksdagens tillämpning av subsidiaritetsprincipen”

8. See Davies, *op. cit.*, p. 72

competition, it is manifestly the case that Member States alone cannot act.⁹ Accordingly, subsidiarity in itself has no relevance to those measures whose aim is to create the uniformity necessary for the Single Market. Still, this is the area where the principle has been claimed to have its biggest impact (shared competences). Where uniformity is necessary, only the Union will be able to act.¹⁰

To make the subsidiarity check the instrument that it originally was intended to be – a counterweight to the increased competences of the EU – it must be complemented with a full-fledged application of the principle of proportionality. Then, the correct question to ask is whether the importance of a Union measure is sufficient to justify its net effect on Member States.

It may be noted that so far the ECJ has avoided making such a full-scale review of proportionality, given that in assessing the proportionality of decisions made by the legislature, the Court is required to accord a margin of discretion to the legislature. Accordingly, in principle and in these domains, “judicial review of the exercise of [the legislature’s] powers must be limited to examining whether it has been vitiated by a manifest error of assessment or a misuse of powers or whether the legislature has manifestly exceeded the limits of its discretion.”¹¹ However, having regard to the different nature of national parliamentary control, there is obviously no reason for national parliaments to observe the same level of precaution towards Commission proposals. In their case, it is about an *ex ante* political control and not an *ex post* legal control.

Finally, it should be stressed that even though subsidiarity and proportionality control of national parliaments is not – and should not – be legal in nature, it nevertheless concerns the application of constitutional principles. Therefore, to avoid asymmetry, incoherence and fragmentation, it would be desirable if Member States’ national parliaments could agree on what these principles do entail and on common procedures for how the control should be undertaken in practice.

Conclusions

One reason why national parliaments were allocated responsibility for monitoring the subsidiarity principle was that legal control exercised by the ECJ hitherto had been perceived as a disappointment. It has been showed in this article that one explanation to this is that subsidiarity does not ask the right question in all cases. The principle of subsidiarity does not, on

its own, provide a method to balance between the most important interests at stake, i.e. to balance the added value to the Union with the possible harm to national interests. To make this possible, it is necessary to consider new EU legislation in the light of not only the principle of subsidiarity, but also the principle of proportionality. This would avoid the truncated control currently formalised in the Treaty and it would make dialogue between national parliaments and the Commission much more accurate. The Protocol on the application of the principles of subsidiarity and proportionality does not provide an explicit basis for national parliaments to object on reasons of violations of proportionality. However, this should not prevent national parliaments from discussing a proposal in the light of these principles and from making their views known to the Commission in the form of a reasoned opinion. This is also obviously true for the principle of conferral or control of the legal base. It is an important task for the forthcoming Trio Presidency to ensure, in collaboration with the national parliaments (in the COSAC – Conference of Parliamentary Committees for Union Affairs), that the subsidiarity check becomes the tool it has the potential to be, i.e. an efficient check on how the EU institutions use their powers, and not a pointless ritual. Cynicism regarding subsidiarity control is the easy option – taking it seriously is the correct one. In the longer term, the protocol should be revised to explicitly accord, when it comes to national parliamentary control, the principle of proportionality the same standing as the principle of subsidiarity.

9. See for example Case C-491/01, *The Queen v Secretary of State for Health, ex parte British American Tobacco (Investments) Ltd and Imperial Tobacco Ltd*, ECR 2002 I-11453, paragraph 182

10. The review of the Court of Justice has further been influenced by the fact that “the Court is not substituting its judgment for that of the Community legislator but simply compelling it to take subsidiarity seriously”. See opinion of Advocate General Maduro in Case C-58/08, *Vodafone Ltd and Others v Secretary of State for Business, Enterprise and Regulatory Reform*, not yet reported, paragraph 30

11. See for example Case C-127/95 *Norbrook Laboratories* [1998] ECR 1531, paragraphs 89-90

INSTITUTIONAL INNOVATIONS

EU Policy and Constitutional Sovereignty: a Road Map

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The challenge of the EU crisis: How to boost European integration by way of different national needs?

The last Trio, with the current Hungarian Presidency, was the first to experiment with the application of the Lisbon Treaty (LT) in a very insecure economic context. During this 18-month period, attention has been drawn to the practical operation of the new institutional architecture and mainly to the need to reinforce the Council Presidency's stability within it.

Even though the Trio had to pursue the common programme – based on issues and legislation that were already on the table, the eurozone crisis affected the official agenda considerably by putting forward new issues of high politics, thus progressively transforming policy discourse and action. By way of illustration, Hungary was obliged to set aside two original priorities – water management and cultural diversity – because of more pressing issues on the economic front, namely the need to secure treaty change in order to accommodate the euro's bailout mechanism and dealing with the first EU semester of economic governance.

Undoubtedly, we enter a phase where there will be an intense debate on policy action in the context of European integration. The transfer of some law-making power to the EU-level, under the Lisbon Treaty, offers new possibilities for EU legislative activism. But, at the same time, the Lisbon Treaty already provokes national constitutional issues. Some Member States may decide to set limits on the penetration of EU law into the domestic constitutional order. Three cases of Constitutional Court dissensus are to be identified.

Firstly, the Lisbon Treaty extends Community competence to new policy areas. Some new competences have been transferred and some existing have become subject to qualified majority voting in Council. But the legal base remains small. In case of activation of the *passerelle* clauses, which allow the switch from unanimity to majority voting, much room for interpretation will be left to EU and national actors – and national Constitutional Courts (CCs) – who implement the Treaty.

Secondly, any treaty change under the simplified procedure for revision (Article 48, Section 6 of the Lisbon Treaty) can bring significant changes in a particular policy domain, provoking strong reactions from the CCs. The European Council of December 2010 agreed on a limited amendment to Article 136 of the Lisbon Treaty – the European Commission issued a favourable opinion last February – so that the permanent European Stability Mechanism (ESM), which is largely intergovernmental in nature, will be put in place, coming into effect in 2013.

Thirdly, using the enhanced cooperation mechanism in some sensitive policy areas may result in an increase in such reactions. CCs can react to the use of the communitarised procedure to authorise enhanced cooperation itself, as well as to Member States' decision, once the cooperation is launched, to transform unanimity into Qualified Majority Voting (QMV) and to introduce the ordinary legislative procedure in cases where special legislative procedures are foreseen. Furthermore, even in the case of policy areas that function only on the basis of institutionalized intergovernmental cooperation, the involvement of EU institutions in the adoption of policy instruments could provoke more reactions from the Constitutional Courts than ever before¹.

In all the above cases, emphasis is placed on transferring to the EU powers or extending competences at European level towards European institutions and (new) established agencies. In such cases, CCs can defer the time for the constitution to be amended (less extensive changes in one or more of its provisions), require a revision of the constitution (substantial changes to the entire Constitution), involve national parliaments more directly in all above procedures. New EU powers, which are normally inherent to the exercise of national sovereignty, can also trigger a referendum in some Member States (binding or facultative, depending on national constitutional traditions). By opening up the possibility of national constitutional constraints to EU law, political decisions concerning the extension of EU powers can be delayed or even blocked and, consequently, the spill-over mechanism would cease to operate or at least slow down seriously.

The eurozone crisis brought a new issue to the surface, an issue of political ethics. How to reconcile two parallel, but opposing tendencies: a functional necessity for extending integration in certain policy areas and a national distrust against EU acting as a proxy for conducting common policies. The next Trio Presidency (Poland, Denmark and Cyprus) starting in July 2011 will have to complete a number of proposals already launched, as well as develop a number of initiatives currently under discussion. During this next Trio period, legislative issues brought forward by the agenda-setting actors, the European Commission and the President of the European Council will probably provoke reactions from the CCs of some Member States. How

1. Before the communitarisation of the justice and home affairs (JHA) domain, the EU institutions have been active and have adopted instruments provoking reactions from the CCs or other highest courts in the Member States (see also note 3). As a matter of fact, the Lisbon Treaty's depillarisation of JHA cooperation is not problem-free, either. The construction of a European area of freedom, security and justice comes up against national reticence because it infringes on aspects of sovereignty, particularly internal security issues. Actually, the special competences of the EU in the coordination of economic and employment policies (Art.5 TFEU of the Lisbon Treaty) can spark the same kind of concerns

should the governments of Member States composing the next Trio Presidency deal with this increasingly important issue? What position should they adopt in this two-level game, where they must respect the institutional autonomy of Member States, as well as preserve their own mission as representatives of all EU Member States?

The tension between the acceleration of Europeanisation of domestic policies and the preservation of national constitutional democracies

Nowadays, more than ever, Member States are asked to show mutual trust in their relationship with the European Union, while at the same time national Constitutional Courts are committed to preserving the constitutional integrity of their country. Since the LT entered into force, an increasing tension has been observed between the process of Europeanisation of domestic policies and the distrust stance of some national CCs. This tension could be explained by Member States' fear of losing control of their constitutional agendas.

In this context, CCs assume a more active role in defining the boundaries between national constitutional order and European legal order. Lately we have witnessed some Member States that raised a national constitutional matter showing resistance against any top-down pressure². With increased EU powers under the LT, since police and criminal justice cooperation are subject to the community method, the strengthening of the JHA domain is intended to work in favour of the good functioning of the common market. Several CCs – Spanish, German, Czech, Latvian, French, etc.³ – have dealt with the transfer of competences related to the JHA in the context of the Lisbon Treaty, trying to set limits to this transfer of powers. Some of the new EU members remain strict and hold particularly reserved positions due to sensitivities towards sovereignty. Polish and Lithuanian courts serve as examples.⁴ Furthermore, the United Kingdom's (UK) intensely discussed EU Bill, enforceable by the British Courts, is indicative of the same tendency. It contains a sovereignty clause aiming to reaffirm the supremacy of the British Parliament and a referendum lock seeking to identify and control any extension of EU powers over any area of policy or any treaty change that hands over powers to the EU.⁵ Besides, the issue of UK's 2014 opt out on EU police and justice laws and the plan to give the British Parliament a vote on opting into new EU justice and immigration laws illustrate a quite new practice seeking to increase (direct) national democratic control.

2. Much attention has been paid to developments in constitutional courts in Member States when they concern EU law, such as for instance replies by constitutional courts to questions concerning the compatibility of the Lisbon Treaty with the national constitution in the course of the ratification process of the Treaty (for example, cases in the German CC or the Czech CC) or questions to the national CCs on the compatibility with the national constitution of some transposition measures of EU Directives into national law (for instance cases in the German constitutional court on the transposition in German law of the European arrest warrant or of the Directive on data retention in the telecommunications sector)

3. Czech Constitutional Court, Judgment PLUS 29/09 of 3 November 2009; Latvian Constitutional Court, Judgment no. 2008-35-01, 7 April 2009; French Constitutional Court, decision no.2007-560 DC, 20 December 2007

4. Poland's Membership in the European Union, Polish Constitutional Court Judgment of 11 May 2005, K 18/04; Lithuanian Constitutional Court, Case No. 17/02-24/02-06/03-22/04 of 14 March 2006

5. Since, the UK's EU Bill creates strict safeguards against the simplified procedure for revision and the *passerelle* clauses, these two legal instruments run the risk of becoming obsolete

More cases of national resistance can be expected given the fact that the Lisbon Treaty (Treaty on the Functioning of the European Union – TFEU) has brought significant changes in a number of policy fields. Actually, the running of the Council Presidency by the next Trio will focus on issues, such as better coordination of macro-economic and employment policies, broader and enhanced surveillance of fiscal policies at EU level, and strengthening the Stability and Growth Pact and its implementation. Such issues of major significance are also addressed in the Commission's annual programme of 2011. Given the mere fact that in the current eurozone debt crisis EU governing structures are definitively summoned to materialize new possibilities for the development of policy instruments, enforcement mechanisms and legislative frameworks, seeking new forms of cooperation on economic, fiscal and social policy emerges as a high-stakes issue for the next Trio Presidency. Some examples, such as the harmonisation of national budget-making⁶, salary indexation, tax, social security and pension schemes (following the Green Paper of July 2010 on pensions), are already under discussion. In that respect, the use of the mechanism of enhanced cooperation could be envisaged, allowing a group of Member States to move further.

Nevertheless, several Member States confront the dilemma of broadening the scope of cooperation on new policy areas. Some of them show reluctance to embrace new regulatory policies expressing concern about the impact on the hard core of their national sovereignty. For instance, fiscal sovereignty, as monetary at other times, is considered to be a traditional element of statehood. The UK expressed vehement opposition to the proposed Directive on national budgetary frameworks, thus seeking a guarantee from the Commission so as to opt-out. Sweden, among other countries, took a stand against the harmonisation of salary indexation, tax, social security and pension systems, insisting these are matters of national sovereignty. Even when the option of institutionalised intergovernmental cooperation is put forward, which means that governments will have to consult national parliaments, there is no guarantee regarding the nature of subsequent reactions in Member States. For instance, the Franco-German plan for a Competitiveness pact (renamed the "Euro-Plus Pact"⁷) proposed at the last EU summit on 4 February 2011 – addressed to the 17 eurozone countries, but to others outside the eurozone as well – could include calls for putting debt limits in national constitutions, raising retirement ages, and getting rid of salary increases tied to inflation.

In this emerging policy environment, key actors within the EU should raise awareness regarding the increasingly involved role of national CCs. Since CCs have the exclusive competence to review EU law for compatibility with the national constitution, they develop an expertise on the constitutionality of EU law. As a matter of fact, this trend is accentuated by the inclusion of the national constitutional identity clause in the Treaty (article 4.2 LT). The clause contains a mention about the formal recognition of the role and importance of national

6. The proposed Directive on national budgetary frameworks includes new rules on public accounting systems, statistics, forecasting practices and many other stages in the budgetary process

7. European Council, Conclusions, EUCO 10/11, 24-25 March 2011, available at: http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/120296.pdf

constitutions. To the extent that the Lisbon Treaty focuses on state structures, there is a shift in emphasis from national identity as such to constitutional identity. Some CCs read it as an implicit limit to the primacy of European law whenever that law would affect national constitutions. Actually, the fact that primacy of EU law is consigned to Declaration 17 attached to the Lisbon Treaty should not be neglected⁸.

National parliaments' decreased control of governmental activity could explain why the CCs are more inclined to affirm their role as guardians of national sovereignty and, consequently, preserve the policy autonomy of Member States⁹. The further development of the competences of the European Parliament, as well as the new role of national Parliaments under the LT, can reduce but not eliminate the structural democratic deficit of the EU, i.e. the gap between the substantial and steady extension of EU competences and action, and the internal EU decision-making and appointment procedures analogous to international law. More than ever, national CCs are able to cope with the legal and political demands of European integration.

Roadmap proposals

Member States do not have a unified vision of the EU, which can seriously weaken their willingness to undertake joint responsibility for its further development. The next Trio Presidency should not disregard the fact that the increasingly involving role of national CCs will certainly exacerbate the tension between the pursuit of national agendas by Member States and the need for directional leadership at the EU level. In this sense, the issue of compatibility of EU law with the national constitutions is not just a technocratic judicial matter, but it becomes a political matter of great importance for the process of European integration. How can situations where progressing integration impelling Member States to establish significant constitutional constraints be prevented? How can the unwillingness to change or even slightly amend the constitutions, by state legislatures or referenda, be avoided?

Especially within a system of dispersed power, multiple actors and polycentric opportunity structures, more advanced methods should be identified in order to tackle this issue:

- Establishing a preventive mechanism where the Council Legal Service will be actively involved. The main functions of such mechanism will include monitoring and evaluating the stances of Member States towards important and sensitive EU policy issues in relation to their constitutional framework. The Council Legal Service could play a key advisory role in providing legal opinions to the Committee of Permanent Representatives (Coreper) and the General Affairs Council (GAC) on national constitutional issues relating to the EU, which may be raised in the course of the Council's work.

- Granting to the GAC a special competence on extension of EU powers. Given its focus on the general coordination of the EU's sector policies and institutional concerns, the GAC could contribute significantly towards a better management of the Kompetenz-Kompetenz problem – this problem concerns the question of which court decides the boundaries of the EU's legislative competence.
- Urging a relationship of cooperation between national CCs and the European Court of Justice (ECJ), the first to determine the constitutional identity, the latter to determine the meaning of the relevant European law.
- Broadening the role of the so-called dialogues – the informal inter-institutional negotiations between the Council of Ministers, represented by the rotating president, the European Commission and the European Parliament. The Trio Presidency could substantially invest in a good working relationship with the European Commission and the European Parliament, in order not only to supersede early inter-institutional compromises on co-decision matters, but also to consider more broadly the political and legal implications at national level of the extension of the use of the community method on important policy issues.
- Encouraging the European role of national Parliaments in order not only to participate in the mechanism for monitoring respect for the principle of subsidiarity by EU institutions, but also generally to shift their attention to the scrutiny of the content of European policies, raising or not a subsidiarity issue.

8. The primacy of EC law would have become a treaty provision if the Treaty establishing a Constitution for Europe had been ratified (Art. I-6 Constitutional Treaty)

9. The German Constitutional Court in Karlsruhe published a radical verdict on the relations between the national parliaments and European integration (Lisbon Case, BVerfG, 2 BvE 2/08, from 30 June 2009)

INSTITUTIONAL INNOVATIONS

The Citizens' Initiative: A Participatory Cure for Europe?

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The European citizens' initiative: Why and how?

Ever since the Danish “no” to the Maastricht Treaty in 1992, the democratic deficit of the European Union has been extensively debated. The past decades, many aspects of the democratic deficit have been discussed, from the lack of transparency in the European Council to the lack of power of the European Parliament. Still, the passivity of the European people in EU politics has probably been the most widely discussed phenomenon.

It is a well-established fact that most Europeans are uninterested in European politics. The European Parliament elections have been widely neglected since their launching in 1979, with the worst ever turn-out in the 2009 election, where only 43% of all eligible voters cast a ballot. In addition, general knowledge about the EU and its policies has remained extremely low. One of the manifested goals in the Lisbon Treaty was to overcome popular indifference, and make the Union more democratic through enhanced institutional transparency and broader channels for popular participation. Many institutional changes were made; with some limitations, the Council's meetings are now opened for the public, and the co-decision procedure (re-named “the ordinary legislative procedure”) has been expanded to more policy areas, increasing the power of the European Parliament.

The most prominent of the new institutional innovations is the European citizens' initiative (ECI). And the ECI is also one of the most ambitious initiatives to date when it comes to participatory democracy at the EU-level. Launched as the first attempt to challenge the Commission's monopoly on legislative proposals, high hopes followed the ECI when it was introduced in the Lisbon Treaty. Still, the ECI had many open ends. Art. 11, paragraph 4, of the Lisbon Treaty states:

Not less than one million citizens who are nationals of a significant number of Member States may take the initiative of inviting the Commission, within the framework of its powers, to submit any appropriate proposal on matters where citizens consider that a legal act of the Union is required for the purpose of implementing the Treaties.

The article left many practical questions essentially unanswered: how many countries are “a significant number of Member States”? Which means should be used for collecting the signatures? How to verify these signatures? Should there be a time limit for the Commission's response? What would be the Commission's obligations when receiving an ECI? These questions were only a few among many in need of clarification.

Under the last Trio Presidency, the procedures and conditions for the ECI were adopted. In November 2009, the Commission launched a Green Paper, which was followed by hearings and consultations of stakeholders.¹ On this basis, the Commission sent out its “proposal for a regulation of the European Parliament and of the Council on the citizens' initiative” in March 2010.² And by mid-December 2010, the Council and the Parliament reached an agreement on the ECI. Most loose ends are now closed. The agreement stipulated that a minimum of one quarter of the Member States had to participate in an ECI. The minimum number of signatures from each of these countries is determined by multiplying the country's number of seats in the European Parliament with 750. The minimum age for signatories is the minimum age at which people are entitled to vote in European Parliament elections.

Also, we now have a stronger idea about how the ECI will work in practice. Initiatives will be registered online in software provided by the Commission. If the proposed initiative goes against EU's fundamental values or lies outside the competences of the Commission, the Commission can reject it. The ECI has to be initiated by a so-called “citizens' committee”, consisting of at least seven citizens resident in a minimum of seven different Member States. After the registration, the committee has up to one year to collect the necessary signatures. After the signatures have been handed in, the Commission has three months to examine the proposal. Meanwhile, members of the citizens' committee attend hearings at the Commission as well as present their initiative to the European Parliament. The Commission's conclusions will be available in a public statement, which includes the action, if any, the Commission intends to take. The first ECI is expected to be registered in early 2012, one year after the new procedures are announced in the Official Journal of the European Union.

New challenges for the citizens' initiative

Now the main question is how to secure a successful launch of the ECI in 2012. Here, the Commission and the European people are key actors. The Commission will, for the first time, be somewhat challenged on its monopoly on legislative proposals. The “somewhat” should, however, be emphasized as the Commission is not obliged to follow an ECI. Still, the expected

1. European Commission, Green Paper, “Green Paper on a European Citizens' Initiative”, COM(2009)622 FINAL, 11 November 2009. Available at: <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2009:0622:FIN:EN:PDF>
2. European Commission, Proposal, “Outcome of the Public Consultation on the Green Paper on the European citizens' initiative”, 8399/10 ADD1, 9 April 2010, available at: <http://register.consilium.europa.eu/pdf/en/10/st08/st08399-ad01.en10.pdf>

challenger, being the European people, might well prove to be uninterested in accepting the challenge. The Europeans have numerous times before proven reluctant to engage in European politics. And previous attempts to enhance the level of interests and activity in European politics have largely failed.

As mentioned, the Commission has no obligation to follow the ECI's. Thus, how the Commission responds to the first wave of ECI's in 2012 will determine whether the ECI becomes just another piece of *symbolpolitik*, or whether the ECI will evolve into a useful and influential tool for the European people. Overall, it is crucial that rejections of an ECI happen on legitimate ground. The Commission can refuse an ECI even before signatures are collected for two reasons: if the ECI goes against the fundamental values of the EU or if the initiative is outside the competences of the Commission.³ Both potential grounds have weaknesses. The first refers to a not very clearly defined set of values, and the latter requires more knowledge about the European enterprise than what an average citizen is likely to possess. I elaborate on these aspects below.

The Commission can reject an ECI if it conflicts with the Union's fundamental values. Although this rejection is made to avoid extremist and fundamentalist misuse of the ECI, the fundamental values of the Union are still a grey-zone. What we learned from the prolonged discussions surrounding the now-buried Constitutional Treaty was the fact that a firm set of shared European values is not present in the EU. To highlight a few controversies, Member States have very different views on essential questions like abortion, euthanasia, drugs and separation of religion and state. Most of these issues are based on very different fundamental values; values that are not all shared across the continent. While many of these areas are not yet under the jurisdiction of the Commission, they might soon become so. And then what? How will the Commission take a stand on these sensitive topics? And, if indeed the Commission rejects an ECI with references to the Union's fundamental values, how can it possibly avoid alienating from the EU the citizens behind the proposal?

The other basis for rejection of an ECI is if it strikes a policy area outside the power of the Commission. Indeed, this situation is very likely to occur. The EU consists of a confusing web of intergovernmental and supranational cooperation divided between policy areas. Although information about the Commission's competences will be available on the Commission's webpage, it is still too ambitious to believe that citizens are able to determine which policy areas are within the competences of the Commission. Sadly, many ECI's could then end up as the famous petition against the two-seat location of the European Parliament. Here a petition with over a million signatures was sent to the European Parliament, only to be rejected as the issue was outside the community's competences.⁴ If similar rejections happen to an ECI,

the new initiative, as well as the EU in more general terms, runs the risk of being perceived as intransparent by the European people.

What about the European people? Are they equipped to embrace the ECI in their daily lives? Certainly, if the aim is the creation of a European public sphere, challenges still lie ahead. Until now, the Europeans have shown little interest in European politics. They show little interest in the direct elections to the European Parliament just like they are uninformed about European affairs. Like it or not, this indifference has been the choice of the European people so far. And throughout the years, this behavioral pattern has been persistent. Will the ECI be able to act as a catalyst for change? Probably not – mainly because the ECI makes too many demands on European citizens.

One of these demands is an extensive international network. Recall that an ECI has to be initiated by a citizens' committee, consisting of at least seven citizens who are residents of at least seven different EU Member States. It is highly questionable that regular European citizens possess such a broad international network. In contrast to for example the US, the Europeans remain largely immobile. A majority tend to stay where they were born. They do not move to foreign countries, and they do not interact with other European nationalities on a daily basis. Thus, establishing such a citizens' committee with seven different EU nationalities is most likely not feasible for many Europeans. Arguably, since Internet access is becoming widespread, the formation of a citizens' committee could take place in the virtual space. Still, however, many Europeans do not have internet access. In Slovakia, for example, only 4.1 million out of a population of 5.5 million actually had internet access in 2010.⁵ While the Internet enables some to participate cross-nationally, others are left behind. Sadly, those left behind are in particular those who are in demand for a successful creation of a European public sphere, embracing all social layers of the European community.

Another requirement for a successful ECI is extensive knowledge about the EU. As mentioned above, the Commission can reject an ECI that falls outside the Commission's competences. Yet, the average European citizen has shown a profound ignorance of even the most basic knowledge about European institutions, making it highly unlikely that they would be able to make a proper assessment of whether any particular proposal fits into those competences. What is required, however, is not only knowledge about the powers of the Commission, but also knowledge about the national role at the EU-level. Far from all Member States participate in all EU policy areas to the same extent. Much integration happens in a so-called multi-speed EU, where some countries, for one reason or another, have opt-outs from EU cooperation. Often these opt-outs are tricky and their consequences in a national context are difficult to determine. The settlement on the ECI ignores the multi-speed aspect of the EU, providing us with an odd democratic situation where citizens can sign an ECI and suggest legislation at the EU-level, which might not even be applicable to their own country.

3. European Commission, "Commission welcomes agreement on European Citizens' Initiative", IP/10/1720, 15 December 2010, available at: <http://europa.eu/rapid/pressReleasesAction.do?reference=IP/10/1720&format=HTML&aged=1&language=EN&guiLanguage=en>

4. Petitions Committee: "Listening to the EU's citizen", Press release, Brussels, 23 September 2008. For more see: www.oneseat.eu

5. For more numbers see: <http://www.internetworldstats.com/stats4.htm#europe>

Although explicitly stated in connection to the ECI that established organisations cannot organise an initiative, it is hard to envisage regular citizens take on the task without the promotion and support by an organisation.⁶ The capacity to form an ECI will most likely be found in already established entities, resembling interest and lobby organisations. These organisations have proven well adaptable to the European framework and managed to influence, in particular the Commission, for decades. Still, it was exactly these sorts of organisations, being criticised for their undemocratic influence on the Commission at the expense of the regular citizen, the ECI was set up to supplement. But the huge demand for personal political capital from the individual citizens in the ECI makes it likely that already established entities, possessing the necessary political insights as well as international network, take over this new democratic tool as soon as a citizens' committee has launched an initiative. And then the initial goal of the ECI is lost. The ECI will then not expand participation of the European citizens nor will it create the much-wanted European public sphere. It will then be politics as usual, mobilising an already-mobilised group.

Recommendations to the Trio Presidency

The Member States are only allocated with an administrative role in the ECI. They are provided with the capacity to secure the validity of the signatures in that particular country. Yet, nothing stands in the way for the Trio Presidency also to assume an informative and agenda-setting role. The advantage of the EU Presidency is that it brings the EU geographically closer to people that might otherwise feel distanced from the institutions in Brussels. Presiding means time in the media spotlight, and here the Trio Presidency should make an effort to push the ECI on the agenda. Through media coverage, the Trio Presidency is able to inform citizens about the existence of the ECI (they most likely do not know) as well as stimulate their political curiosity about this new democratic tool. The Trio Presidency should furthermore pay extra attention to provide information about the Commission's competences, and thus where an ECI could make a difference. Without information about the initiative to citizens as well as helpful procedural guidance about the ECI, the new democratic tool will most likely, in some form, end up in the hands of already existing cross-national networks or entities.

6. Press Release, "European Citizens Initiative (ECI)", MEMO/10/683, 15 December 2010, available at: <http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/10/683&format=HTML&aged=0&language=EN&guiLanguage=en>

INSTITUTIONAL INNOVATIONS

The EP Electoral Reform: Another "Brick" in the Union's Democratic Construction?

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Many politicians and scholars have long considered that changing the rules of the electoral game would enable the European Parliament (EP) to deal with some of its most pressing problems, including the steady fall in turnout at European elections, limited popular recognition of the Parliament's democratic functions, weak transnational parties, electoral campaigns dominated by national rather than European issues, and scant media coverage of EP activities.¹

The increase of the Parliament's powers through the Lisbon Treaty and the ever-more prominent quest for a "cure" of the EU's "democratic deficit" have given a fresh impetus to the idea of amending the electoral procedures. Moreover, the start of the countdown to the next EP elections means that any attempt to revise the system by 2014 has to begin without much delay.

To that end, the European Parliament has in the first half of 2011 adopted a proposal to modify European electoral rules in due course for the 2014 elections. The report prepared by Member of the European Parliament (MEP) Andrew Duff aims to increase "the legitimacy and efficacy of the Parliament by strengthening its European democratic dimension".² What are the key elements of the proposal? And is it likely to meet its ambitious objectives?

1. See Andrew Duff, "Post-national democracy and the reform of the European Parliament", Policy Paper 42, Notre Europe, 2010; and Simon Hix and Sara Hagemann, "Could changing the electoral rules fix European Parliament elections?", Working Paper, London School of Economics and Political Science, 2008

2. Draft report on a proposal for a modification of the Act concerning the election of the members of the European Parliament by direct universal suffrage of 20 September 1976, Committee on Constitutional Affairs, rapporteur Andrew Duff, PE440.210v03-00, p. 6

Four reform pillars

The electoral reform proposed by MEP Andrew Duff rests on four main pillars:

- The election of 25 additional MEPs by a single constituency from the whole territory of the EU. The candidates are to be drawn by European parties from at least one third of Member States, and must compete on gender-balanced, transnational lists. Each citizen will be able to cast one vote for the EU-wide list and another for the national or regional list. Voting for the European constituency must be in accordance with the preferential semi-open list system, whereby the elector can choose to vote for the party list en bloc or an individual candidate.
- A shift in the timing of European elections from June to May.
- The amendment of the 1965 Protocol on Privileges and Immunities with a view to establishing a uniform supranational regime for MEPs.
- A distribution of the existing 751 seats on the basis of a mathematical formula to reflect demographic changes in the resident populations of the Member States and to respect the principle of “degressive proportionality” enshrined in the Lisbon Treaty (Article 14 Treaty on European Union (TEU)).

The adoption of the three latter reform items would – according to the draft proposal – require an amendment of the “Protocol (No 7) on the Privileges and Immunities of the European Union” and of the 1976 Elections Act. With regard to the 25 additional MEPs, the report calls for an amendment of Article 2 TEU. This would entail the application of the ordinary treaty revision procedure, which foresees an Intergovernmental Conference (IGC) and possibly a Convention composed of European and national parliamentarians, as well as representatives of EU governments and the Commission. However, the European Council may decide by a simple majority, after obtaining the consent of the European Parliament, that a Convention is unjustified by the extent of the proposed amendments. Either way, any amendment(s) would have to be ratified by all Member States before it can enter into force in time for the 2014 EP elections.

The proposal to bring forward the timing of European elections from June to May has two major advantages. First, it could increase turnout in a number of Northern Member States where EP elections in June collide with the start of summer holidays. Second, it could allow the newly elected Parliament to kick-off its activity before the summer break, which would enable it to organise itself more efficiently ahead of the election of the new Commission President in the fall. Then, the long-standing call to revamp the 1965 Protocol on Privileges and Immunities finds justification in the need to overcome previously thorny discrepancies between Member States in the legal position of their MEPs, and to allow the Parliament to use its powers in situations where national and EU law are in conflict on this matter. As for the suggestion to adopt a mathematical formula for the redistribution of EP seats, it could provide a more objective and less politically contested way to determine the total of MEPs per Member State. Ongoing demographic changes in Europe as well as the accession of new countries to the EU could

render this proposal increasingly imperative, albeit not necessarily easy to swallow by states that might have to cut back on their number of MEPs.

While none of the above-mentioned reforms falls short of controversy, the proposal to put 25 additional seats up for grabs by MEP candidates competing on an EU-wide list stands out as the major bone of contention. But what are its envisioned benefits and potential limitations? And how likely is its adoption?

An EU-wide list – potential benefits...

With respect to potential benefits, the introduction of a transnational list could personalise and Europeanise EP elections, invigorate the “strategic partnership” between the Parliament and Commission, and strengthen the autonomy of European political parties.

Personalisation and Europeanisation of EP elections

The prospect of a pan-EU constituency vote on semi-open lists could offer candidates incentives and opportunities to raise their specific profiles with electors in order to secure visibility and popular support across Member States. The personalisation of EP elections could produce more “colourful” and recognisable European political figures in a post-national political space. Moreover, the introduction of a transnational list could effectively fuel competition among the contenders and encourage them and their parties to campaign on issues of relevance to the whole European electorate. A meaningful EU-wide electoral contest fought on European rather than domestic concerns could render the “second-order” label previously coined for EP elections less appropriate.

Additionally, the personalisation and Europeanisation of EP elections could help to boost the interest of media and citizens in European political affairs. More relevant and competitive European elections might also persuade citizens to exercise their voting right, with obvious positive implications for the deplorable turnout witnessed so far in EP elections. Finally, the transnational list – likely to breed candidates for the top jobs in the EU – could attract political heavyweights to campaign for the European Parliament, and thus increase the quality of “political personnel” and strategic thinking at the highest political level in the EP.

“Strategic partnership” between EP and Commission

The political significance of European elections could be further enhanced if the group of 25 MEPs supplied the runner(s) for the position of President of the European Commission. The opportunity to replace the “secretive horse-trading” between EU heads of state or government with an indirect popular say over the choice of the next Commission President would not

only make the nomination process more transparent, it would also enhance the legitimacy and standing of the successful incumbent(s), while simultaneously strengthening the role of the Commission and the Parliament in the Union's institutional architecture.

Linking the (s)election of the Commission President to the vote on the transnational list and the outcome of EP elections more generally could reinforce the political ties between the Commission and the Parliament. Following the entry into force of the Lisbon Treaty one can already sense a rapprochement between the Barroso II Commission and a strengthened, more self-confident EP. The introduction of an EU-wide list including top candidates for the post of Commission President could fortify this “strategic partnership” and also work to the advantage of the “Brussels executive” by consolidating the political power base and popular legitimacy of the Commission, which has lost much of its strategic clout since the late 1990s.

More autonomous and interactive European political parties

Finally, “forcing” European parties to agree on candidates for the 25 extra seats and to coordinate support for them in different national settings could offer ample scope for inter- and intra-party interaction. Joint efforts to support candidates on the EU-wide list would require the elaboration of a genuine transnational campaign strategy and an agreement on a party manifesto going beyond the lowest common denominator. All this could substantially advance the autonomy of European political parties, which are still loose conglomerates of national parties dominated by party headquarters in national capitals. Finally, competition between European parties for the top-executive job(s) in Brussels could contribute towards the emergence of a transnational party system in the Parliament.³

...and some points of caution

Notwithstanding all the latent benefits of electing 25 additional MEPs in a single EU constituency, there are several aspects that could raise objections to the proposal or hinder its effectiveness.

European “beauty contests”

An increased personalisation of EP elections could encourage European parties to select candidates who “qualify” for the job primarily because they are well known to the European electorate. In that case, experience, competence, and political substance run the risk of becoming secondary issues. Instead, parties and voters would focus attention on the candidates’

3. See e.g. 2010 EUDO Report (PE 425.623) for the EP Committee on Constitutional Affairs: “How to create a transnational party system” by Luciano Bardi, Edoardo Bressanelli, Enrico Calossi, Wojciech Gagattek, Peter Mair, and Eugenio Pizzimenti

popularity and campaigning style rather than on concrete policy issues, and evaluate top candidates on the basis of non-political personality traits instead of professional skills and performance. Despite the superficial and short-term appeal of such “beauty contests”, if EP elections failed to convey the meaningful programmatic choice voters face, the quality of European democracy could be at a loss.

Inflated and false expectations

Moreover, there is a risk that EU-wide election campaigns could become dominated by issues which attract the interest of the wider European public but are not in effect co-decided by the European Parliament. Election campaigns fought on “European issues” that fall outside the Parliament’s Treaty prerogatives would be as irrelevant for EU outputs as contending EP elections on national topics.⁴ Creating false impressions with respect to the EP’s actual influence could eventually backfire if the European Parliament proves incapable of fulfilling the expectations raised during election campaigns. Thus, voters’ awareness of the Parliament’s role in the highly complex system of EU policy-making could benefit more if candidates and parties tailored their campaign message first and foremost around European issues that clearly fall within the scope of the EP’s formal powers.

Perils of executive control

Furthermore, the added-value of potentially connecting the outcome of the transnational vote to the (s)election of the President of the Commission can be challenged on various grounds. First, increased political ties between the Parliament and the “Brussels executive” could weaken the EP’s scrutinising role *vis-à-vis* the Commission, if parliamentarians feel inclined to support and protect “their Commission President”. Second, the potential reinvigoration of the “strategic partnership” between the EP and Commission could jeopardise the independence of the latter and hamper its role as an honest broker and guardian of the Treaties – a role which is becoming ever more important in times of increased national focus and growing tensions between Member States. Finally, unless the President of the Commission is directly elected by European voters, it is not automatically the case that a President nominated by elected European parliamentarians would enjoy more trust and support than one chosen by the heads of states or governments in the European Council.

Ultimately, as all electoral reforms, the proposal in question involves trade-offs between envisioned and less desirable outcomes. However, the possibility of fostering transnationalisation in the EU and increasing the popular appeal and political significance of EP elections are benefits that clearly warrant taking the potential risks associated with the adoption of this initiative.

4. E.g. Peter Mair and Jacques Thomassen (eds.), “Political Representation and European Union Governance”, London and New York, Routledge, 2011

Opposition from governments and national political elites

Yet, despite strong arguments in favour of this reform, one cannot assume that national political elites will support the adoption of a semi-open, transnational list. Member States have already rejected similar proposals in the past and they could do so again for a number of reasons.

First, EU governments might fear that the election of 25 additional MEPs by a single EU constituency could further shift the balance of power from national capitals to Brussels and Strasbourg. It seems particularly improbable that the heads of state or government will be ready to renounce their remaining privileges concerning the (s)election of the President of the European Commission. Likewise, national politicians will not be eager to accept reforms that could strengthen the overall position of and structural ties between the EP and the Commission in the institutional power game. On the contrary, Member States have been pushing in recent times for a more “intergovernmental Europe” through an increased role of the European Council.

Second, national parties might resist plans for a semi-open preferential voting system given that this would effectively subtract the control they have enjoyed so far over the designation of MEP candidates, in order to grant European parties a more autonomous say in the process. Moreover, domestic parties could block any attempt to organise a coordinated, let alone a single pan-EU election campaign by refusing a more direct influence of the European level in the selection of campaign issues and tools.

Third, national political elites opposed to a single EU-constituency vote will probably build their counter-argument around the fact that such an innovation will require an EU Treaty amendment, especially if the application of the ordinary treaty revision procedure would entail not only an Intergovernmental Conference but also a Convention. They will most likely claim that this formula would open the Pandora’s Box to yet another lengthy and complex treaty reform exercise, which most governments and national parliaments are (still) very keen to avoid.

Hence, in order to increase the chances of translating the idea of an EU-wide list into practice, the Parliament should indicate early on that it would be ready not to ask for a Convention, if Member States’ governments would in return be willing to revise the EU Treaty in time for the next EP elections in 2014. This trade-off would be worth it, because changing the rules of the electoral game could mark a qualitative leap towards increasing the popular appeal of the Parliament, the European character of EP elections, and the role of political parties at the EU level, thereby adding another important “brick” to the democratic construction of the Union.

The role of the Trio Presidency

After the EP has brought forward its proposals, the ball is in the court of the Member States. Thus, the Trio Presidency including Poland, Denmark, and Cyprus has an important role to play

in the framework of the ordinary revision procedure. To initiate the procedure, the Council has to submit the EP’s proposed amendments to the European Council, which can decide to examine the revisions put forward. Ultimately, any Treaty amendments have to be settled in the framework of an IGC – independent of whether a Convention has been convened or not. Here again, the rotating presidency can be pivotal, as the IGC has to be convened by the President of the Council. The rotating presidency will also have to consult with the EP in order to obtain the parliament’s consent not to convene a Convention.

In other words, the Trio Presidencies has a special responsibility, if this reform proposal is to come into force in time for the next EP elections. The Treaty amendment will have to be initiated and decided during the Trio Presidency 2011-2012, so that the new provisions can be ratified and enter into force before 2014. Moreover, the Trio Presidency should put electoral reform on the agenda as early as possible, so that European and national parties can prepare for the implementation of the various innovations. In particular, an early start could buy national party elites some time to agree on the potential candidates for the transnational list and reflect on a division of labour between the national and European levels when drafting their strategies and preparing their campaigns. Finally, the Trio Presidency should help raise the salience of the EP electoral reform issue and awareness about its likely domestic and European implications by advocating to all EU governments its adoption. This could facilitate agreement on the proposals and possibly ease the implementation process.

The Contribution
of 16 European
Think Tanks
to the Polish,
Danish, and Cypriot
Trio Presidency of
the European Union

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*We would like to thank the authors of the think tanks
who contributed to this report and
the team of Notre Europe, who coordinated the project;
in particular, we are very grateful to Olivier Lewis
for his invaluable help.*

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Notre Europe (www.notre-europe.eu) is a European independent think tank dedicated to promoting closer European unity. Under the guidance of Jacques Delors, the association's aim since 1996 is to "think a united Europe". This involves participating in current debates from a vantage point of informed positions based upon thorough policy analysis and relevant policy proposals that are designed to help Europeans achieve closer unity. It also entails fostering the active involvement of citizens and civil society in the process of European integration and in the emergence of a European public space. Its analyses and policy proposals focus upon four themes: Visions of Europe; European democracy; Competition, cooperation and solidarity; Europe and world governance. *Notre Europe* aims for complete freedom of thought and works in the spirit of the public good. The association was headed by Jacques Delors (1996-2004), Pascal Lamy (2004-2005), Tommaso Padoa-Schioppa (November 2005-2011), and is currently presided by Antonio Vitorino (since June 2011).

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The Centre for European Reform (www.cer.org.uk) is a think tank devoted to improving the quality of the debate on the European Union. It is a forum for people with ideas from Britain and across the continent to discuss the many political, economic and social challenges facing Europe. It seeks to work with similar bodies in other European countries, North America and elsewhere in the world. The CER is pro-European but not uncritical. It regards European integration as largely beneficial but recognises that in many respects the Union does not work well. The CER therefore aims to promote new ideas for reforming the European Union. The CER makes a point of bringing together people from the worlds of politics and business. The conclusions of our research and seminars are reflected in our publications, as well as in the private papers and briefings that senior officials, ministers and commissioners ask us to provide. The CER's work is funded by donations from the private sector. It has never received core funding from governments or EU institutions. The director of CER is Charles Grant.

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The European Policy Centre (www.epc.eu) is an independent, not-for-profit think tank, committed to making European integration work. The EPC works at the "cutting edge" of European and global policy-making providing its members and the wider public with rapid, high-quality information and analysis on the EU and global policy agenda. In line with its multi-constituency approach, members of the EPC comprise companies, professional and business federations, trade unions, diplomatic missions, regional and local bodies, as well as NGOs representing a broad range of civil society interests, foundations, international and religious organisations.

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The Swedish Institute for European Policy Studies (www.sieps.se) conducts and promotes research on European policy and policy-making. The research is conducted under three broad themes: power and democracy; the external dimensions of the European Union; consequences of EU policies. SIEPS considers that it is important to broaden and intensify research into matters that are significant for the future development of the European Union and, towards that end, actively seeks to develop close cooperation with institutes and research centres in Europe and globally. SIEPS strives to act as a link between the academic world and policy-makers at various levels. By publishing reports and arranging seminars and conferences, SIEPS aims to further stimulate research on the future of Europe. The director of SIEPS is Anna Stellingner.

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**Notre Europe receives
the financial support of major partners:**

The European Commission: support to active entities at European level in the field of active European citizenship,



Education and Culture DG

'Europe for Citizens' Programme

the French Government,
the Compagnia di San Paolo,
the Macif,
the Grand Duchy of Luxembourg.

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Printed by E3 Expansion,
Boulogne-Billancourt (France)

Phil2fer Graphic Design

Dépôt legal

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As in the two previous editions of *Think Global – Act European (TGAE)*, coordinated by *Notre Europe*, this report focuses on the medium-term, covering the Polish, Danish and Cypriot Trio Presidency, which will run from July 2011 to December 2012.

Such a focus allows for an in-depth analysis of the Trio's role, both front-stage and back-stage, as it develops in the context of the Lisbon Treaty's implementation. Consequently, the authors of this report, coming from 16 European think tanks, take stock of the initiatives adopted during the past Trio Presidency, identify emerging challenges and formulate concrete short- to medium-term proposals aiming for rapid policy-progress; while each chapter highlights, policy-by-policy, the way in which the Trio interacts with other EU institutions.

Overall, the 18-month time frame to which each new edition of *TGAE* is devoted produces, from one report to the next, a comprehensive chronological picture of the EU's development.

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