



ISSN 2443-8022 (online)

Externalities, Institutions and Public Perception: The Political Economy of European Integration Revisited

Hans Peter Grüner

FELLOWSHIP INITIATIVE
“Challenges to Integrated Markets”

DISCUSSION PAPER 057 | JULY 2017

EUROPEAN ECONOMY



Economic and
Financial Affairs

2017 Fellowship Initiative Papers are written by external experts commissioned to write research papers, retaining complete academic independence, contributing to the discussion on economic policy and stimulating debate.

The views expressed in this document are therefore solely those of the author(s) and do not necessarily represent the official views of the European Commission.

Authorised for publication by Mary Veronica Tovšak Pleterski, Director for Investment, Growth and Structural Reforms.

DG ECFIN's Fellowship Initiative 2016-2017 "Challenges to integrated markets" culminates and comes to a successful conclusion with the publication of the fellows' contributed papers in our Discussion paper series. Against the background of increasing strains to economic integration at both the global and the European level, the Initiative has brought together a group of outstanding scholars to re-examine integration challenges at the current juncture and to explore the policy options to address these challenges in a discursive interaction process between the group of fellows and Commission services. The research themes of the fellows have spanned a broad area including topics in the political economy of globalisation and integration, issues of macroeconomic policy making at the zero lower interest rate bound, and market integration challenges not least in view of deepening EMU.

LEGAL NOTICE

Neither the European Commission nor any person acting on its behalf may be held responsible for the use which may be made of the information contained in this publication, or for any errors which, despite careful preparation and checking, may appear.

This paper exists in English only and can be downloaded from https://ec.europa.eu/info/publications/economic-and-financial-affairs-publications_en.

***Europe Direct is a service to help you find answers
to your questions about the European Union.***

**Freephone number (*):
00 800 6 7 8 9 10 11**

(* The information given is free, as are most calls (though some operators, phone boxes or hotels may charge you).

More information on the European Union is available on <http://europa.eu>.

Luxembourg: Publications Office of the European Union, 2017

KC-BD-17-057-EN-N (online)

ISBN 978-92-79-64905-9 (online)

doi:10.2765/91202 (online)

KC-BD-17-057-EN-C (print)

ISBN 978-92-79-64906-6 (print)

doi:10.2765/83378 (print)

© European Union, 2017

Reproduction is authorised provided the source is acknowledged. For any use or reproduction of photos or other material that is not under the EU copyright, permission must be sought directly from the copyright holders.

Externalities, Institutions and Public Perception

The Political Economy of European Integration Revisited

Hans Peter Grüner

Abstract

This paper develops a politico-economic model of the joint dynamics of economic interaction and political integration. Based on the theoretical model, we derive several hypotheses on how to explain the recently observable decline in popular support for European integration. These hypotheses are matched with data from various sources in order to scrutinize their empirical validity. The paper proposes a five pillar approach to prevent a counterproductive process of disintegration. Accordingly, (i) common policies must better fit voter preferences, reduce inequality and unemployment, (ii) policy processes must become more efficient, (iii) institutions must enable voters to properly attribute policy outcomes to political actors, (iv) policies should foster cross border political debates, and (v) any further deepening or enlargement of the Union should be based on European wide popular support. We discuss a series of specific policy measures that help to achieve these goals.

JEL Classification: D62, D7, F02, F15.

Keywords: European integration, externalities, political economy of reforms.

Acknowledgements: I thank seminar participants at the European Commission and the University of Mannheim for their useful comments. I am grateful to Patrick Bernau (FAZ), Reinhard Felke (DG ECFIN) and Eckhard Janeba, Harald Fadinger and Thomas König (Universität Mannheim) for helpful discussions on topics related to this paper. I also thank Paul Schäfer who helped me to prepare some of the tables and figures. The paper was written while I was a research fellow of the Directorate General Economics and Finance of the European Commission under the programme "Moving closer rather than drifting apart: Challenges to economic integration at the global and European level", Ref. 2016 ECFIN 013/B. The views expressed in this paper are those of the author and not necessarily those of the European Commission.

Contact: Hans Peter Grüner, University of Mannheim and CEPR, London, gruener@uni-mannheim.de.

CONTENTS

- 1. Introduction.....5
- 2. The paradox of public sentiment 6
- 3. An agnostic theory of economic and political integration7
- 4. Sources of a lack of public support 9
 - 4.1. Economic Policies..... 10
 - 4.1.1. Austerity and public opinion..... 11
 - 4.1.2. Stagnation, inequality and political gambling..... 12
 - 4.1.3. Refugee crisis 13
 - 4.2. Institutional factors..... 14
 - 4.2.1. Dysfunctional procedures 14
 - 4.2.2. Disrespect and disagreement 16
 - 4.2.3. The paradox of bureaucracy 16
 - 4.3. Signal extraction problems 17
 - 4.4. Lack of common ground 18
 - 4.4.1. Europeans are divided about the role of markets 18
 - 4.4.2. Europeans lack identification and mutual trust 18
 - 4.4.3. Segmented political debate and advisory markets 19
 - 4.5. Overshooting and political unravelling 19
- 5. Policy measures: Five pillars.....20
 - 5.1. Pillar I: Tailor common policies to voter preferences.....20
 - 5.1.1. Compensate insider workers through capital taxation20
 - 5.1.2. European risk sharing.....20
 - 5.1.3. Cross country compensation for reforms22
 - 5.2. Pillar II: Policy processes must become more efficient22
 - 5.2.1. Improve information flows and decision processes22
 - 5.2.2. Improve respect for common rules22
 - 5.3. Pillar III: Improve signal extraction.....23
 - 5.4. Pillar IV: Strengthen coherence and resilience23
 - 5.5. Pillar V: Base deepening and enlargement on eu-wide referenda.....24
- 6. How to save the *acquis communautaire*25

REFERENCES

ANNEX I: A MICROFOUNDATION OF THE E-I MODEL

ANNEX II: TABLES AND FIGURES

1. INTRODUCTION

International economic and political integration has become increasingly unpopular in many countries. A series of recent policy events indicate that a long process of political and economic integration has entered into an era of crisis. Rising protectionist tendencies in the U.S. are matched by considerable resistance to new free trade agreements in some European countries (Bertelsmann Foundation 2016). In several countries of the European Union, there is a lack of support for monetary integration¹ and also widespread discontent with the outcomes of Europe's "common" migration policy. In the aftermath of the financial crisis, confidence in the main European institutions has declined dramatically, a trend that could only recently be reversed to some extent.² The share of Eurobarometer respondents who "tend to trust the European Union" fell from 51 percent in spring 2007 (i.e. right before the financial crisis) to 31 percent in spring 2014. Trust rose to 40 percent in spring 2015. However, it again fell to a low value of 33 percent in Autumn 2016.³ Britain's voters have narrowly decided in favor of leaving the European Union altogether while many Europeans in other member countries believe that they would be better off if their country was to leave the Union⁴. The entire project of a deeper European integration lost political support across most of the union. These developments go hand in hand with a rise of nationalist political movements on both sides of the Atlantic.

The emerging opposition and vanishing support for political and economic integration is particularly puzzling as policy externalities have actually become stronger in many important areas. Externalities can only be dealt with efficiently if the actors involved somehow coordinate their activities. While policy coordination can take many forms with different degrees of formal institutionalization (ranging from informal talks, over the reliance on implicit sanctions, formal treaties to fully integrated decision making systems), an uncoordinated approach has well known disadvantages. Better information and communication technologies, a reduction of transportation costs, increasing returns to scale in key information technologies, climate change, political crises in Europe's neighbouring regions and terrorist threats should actually call for more political coordination if not for a deeper institutionalization of policy cooperation. Economic interdependency and emerging externalities should both make political integration more valuable.

The coexistence of rising externalities and a decline in public support for integration is a paradox that this paper tries to explain. In a first step, we provide a theoretical framework that permits to analyse - sometimes counterintuitive - trends in economic and political integration. The core of the model consists of two relationships: (i) the institutional response to cross-border externalities, a relationship that will be called $I(E)$, and (ii) externalities arising from more integration, $E(I)$. The model permits to identify factors that influence the politico-economic equilibria and it permits to study ways to reverse unproductive developments of both key magnitudes.

¹ According to Eurobarometer 86.2, QA17.1, only 55 percent of the EU respondents are in favor of "a European economic and monetary union with one single currency, the euro".

² Source: Eurobarometer 2015, QA16, 1+2+3.

³ Source: Eurobarometer 2015, QA8a.

⁴ According to Eurobarometer 2015, QA21a5, only 50% or less of the respondents from Austria, Italy, Poland, Cyprus, Slovakia and the UK do not agree that their country faces a better future outside the EU.

Based on the theoretical model, we derive several hypotheses for the recently observable decline in popular support for political and economic integration. These hypotheses are matched with data from various sources in order to scrutinize their empirical validity. One key purpose of the present research is to empirically disentangle hard (economic) factors from soft (behavioral) factors that explain the recent decline in popular support for integration.

Based on these theoretical results, we argue that political integration benefits from a functioning common political system that provides distributionally balanced outcomes and permits voters to properly attribute policy outcomes to national and supranational actors. We find that even minor events can lead to major trends in political integration when the identification with the common political system is too weak. This holds in particular when there is a popular misperception according to which a joint institutional approach causes international policy externalities whereas it is actually one way to deal with them. This view may lead voters to wrong policy conclusions: Abolishing common institutions would not eliminate the policy externalities but it would lead to a less structured and non-cooperative way of dealing with them. As a consequence, a very unproductive unravelling of international integration may obtain.

In a third step, the paper proposes and analyzes different institutional solutions and political measures that help to prevent a counterproductive process of international economic and political disintegration. The paper proposes a five pillar approach that addresses both soft and hard factors: First, common policies must better address voters' needs. Ideally, they should be designed in a way that they can attract the support of a majority of voters in all member countries. Second, policy processes must become more efficient. It is not just important to pick the right policies, it is also important to implement them in a timely manner and through widely accepted, standardized and transparent procedures. Third, institutions must enable voters to properly attribute policy outcomes to political actors. Fourth, policies should foster cross border political debate on all levels. Fifth, any major step towards further deepening or enlarging the Union should be based on a sufficiently broad European wide popular support. We discuss a series of specific policy measures that help to achieve these goals.

2. THE PARADOX OF PUBLIC SENTIMENT

The years after the beginning of the global financial crisis in 2007 exhibit a rise in cross-border externalities in many policy fields and, at the same time a significant decline in public trust in key European political and economic institutions. Beginning with 2007 the trust in the European Parliament, the European Commission and the European Central Bank declined from over 50 to less than 40 percent (Figure 1). This trend could only be briefly reversed in the second half of 2014, but in 2016 trust values returned to levels that are far below the pre-crisis ones. One should note that average trust in national governments still much lower than trust in European institutions (Figure 2). However, in absolute terms (and also slightly in relative terms) trust in the EU institutions fell more than trust in national governments (see Eurobarometer 2015, QA21a5).

It is important to note that a decline in trust in European institutions need not be associated with a decline in the support for European integration. Citizens can well be in favor of a more integrated Europe and at the same time not be satisfied by the currently existing institutions. Exactly this seems to be the case for many respondents of the Eurobarometer survey. Survey data about the preference for more integration shows that in Spring 2015, 53 percent of the respondents were in favor of more European integration. Counting those who "do not know" as satisfied with the status quo, the group that definitively wants to reduce integration has a size of about one third of the population. If there

was a collective vote on the extend of European integration, the median voter of the union (assuming that preferences on integration are single peaked) would definitively not be in favor of unwinding the Union.

In Spring 2015, a common policy approach was still widely favored in very different policy areas (Figure 3). However, after a five year long struggle about who should pay to clean up Europe's fiscal situation, the support for the common currency was particularly weak. Interestingly, the support for a common policy on migration has suffered very little from the somewhat chaotic decision process during the summer 2015. In Autumn 2016, 67 percent of the Eurobarometer respondents supported a common European policy on migration. This indicates that Europeans do not always blame poor policy outcomes on integration.

An on average slightly positive view of the EU is also reflected in Eurobarometer (Fall 2016, QA9) data on the image of the Union with an EU wide 30 percent stating that the image is fairly positive (4 percent very positive) and 20 percent stating that the image is fairly negative (7 percent very negative). The European median has a neutral view. However, it is not the European median voter who decides on the fate of the union. The coherence of the union lies in the hands of national governments that often tailor their choices to their national constituency. This means that the union can be at risk even if a majority of Europeans has a neutral or positive stance.

Centrifugal tendencies have emerged in many countries. Importantly, in the largest country, Germany, the support and the opposition towards the EU is (Eurobarometer, Spring 2016) are roughly balanced with 29 percent of respondents having a positive image of the EU and 29 percent having a negative one (see table 1). Only six other countries have a ratio of positive to negative image results that is worse. It is also important to note that out of these seven countries with relatively poor support, Austria, Cyprus, Greece, and Germany use the Euro (the list also includes the UK that just decided narrowly to drop out).

To summarize, the support for Europe's political institutions and their policies have suffered more during the crisis years than support for a deepening of the union. But even voters favoring integration per se are likely to withdraw their support for the integration project if they believe that institutions regularly do not deliver what they want. The unpopularity of recent policies and existing institutions can ultimately harm the entire project of European integration. The paradoxical situation has arisen that the Union is at risk in a situation in which the emergence of new and important policy externalities seems to call for a more integrated approach. This paradox of public sentiment calls for an explanation.

3. AN AGNOSTIC THEORY OF ECONOMIC AND POLITICAL INTEGRATION

Before we empirically scrutinize various explanations for a decline in the support for political and economic integration, it is useful to develop a theoretical framework that helps to organize thoughts about the issue. This section briefly outlines a theory of the joint development of international externalities and international political integration that serves this purpose. The exposition in the main part of the text is an abstract "macroeconomic" one. In the technical appendix to this paper, we provide a detailed microeconomic foundation of the model with positive externalities and we also study the case of negative externalities in more detail.

Our model deals with two key magnitudes I - standing for the extent of political or regulatory "integration" - and E - standing for cross border "externalities" or "economic exchange". The model

studies the interrelationship between these two magnitudes. Our model exhibits multiple equilibria with different levels of integration and externalities. The model permits different interpretations of these externalities. One interpretation is that the externalities are negative ones and the high integration equilibrium is associated with a suboptimally low social welfare. According to a second, alternative interpretation, the externalities are positive ones (think of externalities associated with economic exchange) and the low integration equilibrium is associated with a suboptimally low welfare level.

The first effect that we consider, $I(E)$, is that stronger externalities and more economic exchange make a deeper political integration desirable. Environmental spillovers, common security problems, or financial contagion on an integrated capital market are important examples of cross border externalities that make it desirable for countries to better co-ordinate their activities. All three examples have in common that national inactivity leads to adverse externalities abroad. In such a context, the purpose of policy coordination is to raise collective investments that reduce the size of adverse externalities. Another important channel is that economies which are more open to the trade of goods and services benefit more from integrated regulation. Obviously, when more goods are exchanged, common standards can be more valuable both for exporters and for consumers. Consequently, both positive and negative cross border externalities should - *ceteris paribus* - lead to a more integrated political or regulatory system. In our model we assume that international integration reacts optimally - but myopically - to the extent of externalities or exchange, i.e. policy choices maximize social welfare in response to observed externalities, not taking into account that these choices may trigger further adjustments of externalities⁵.

The second main effect of our model, $E(I)$, is that international political integration leads to more cross-border externalities and exchange. There are many examples for such a relationship. The establishment of an integrated financial market that is subject to a common regulation facilitates the purchase of foreign financial assets and so leads to more cross-border exposure to financial risks. An integrated regulation of goods and service markets facilitates entry into foreign markets and further fosters economic exchange. This in turn leads to stronger business cycle spillovers. Through an integrated labor market, education policies in one country affect labor supply in another country. The introduction of the European common currency also created significant realized or expected fiscal externalities (through bailout and security programmes or through Target II imbalances that would materialize as cross border debt in case of a breakup) as one could witness over the last years.

The key to understand the limits to integration is that complete political integration is not a likely response to any given level of externalities. Even very strong externalities will not lead to perfect integration of political systems. One reason is that transaction costs make it undesirable to integrate all political activities in one large "country". Another important reason is that regulatory tastes and traditions differ across countries. This is why a system consisting of several regions or countries will not converge to a state of full integration. Figure 4 illustrates why full integration need not obtain. The upward sloping curve $I(E)$ describes how economic interaction responds to the existing institutional setup and another upward sloping curve $E(I)$ represents the effect of integration on externalities. Even when there is no integration, some externalities naturally arise, i.e. $E(0) > 0$. The two curves in Figure 4 intersect at one single point, which one could interpret as a long run equilibrium of the political system. The system starting to the left of point A will exhibit a deepening of the union for some time (Figure 5), whereas a system starting to the right of this point will exhibit a decline in integration.

⁵ Bolstad (2015) argues that in the European Union this process of integration as a response to emerging externalities does not always follow a top-down procedure in which governments politically or technocratically decide on integration (the banking union is such an example). Rather, European integration often responds to developments in the public opinion.

Such a decline would be triggered by a lack of popular support for integration - a process that is also called a "constraining dissensus" (Hooghe and Marks, 2009).⁶

Our simple dynamic model permits to study the response of the politico-economic system to exogenous changes of the environment. Figure 6 provides one example of such an analysis. Outside factors (such as the civil war in Syria and the migration that it triggers) create additional externalities. This would correspond to a shift of the blue $E(I)$ curve to the right. Ultimately, such a development will result both in more integration and more externalities. Both externalities and integration determine economic outcomes which in turn shape the population's attitude towards integration.

It is important to note that our model may exhibit multiple stable equilibria (Figure 7). The process that we study in the present paper is one of step by step adjustments, i.e. the political decision on the extent to integration reacts to the observable externalities and externalities react to the existing institutional environment. This is why initial conditions may be key. They ultimately determine towards which long run equilibrium the system converges.⁷ Moreover, very small changes of the relationships $E(I)$ and $I(E)$ may lead to major changes of the joint path of integration and externalities. Figure 8 provides such an example. Here, the high integration equilibrium disappears due to a small change of the $E(I)$ curve.

In this context, our model permits to study the effects of the perceived quality of the common political system on the dynamics of integration and externalities. A less efficient integrated policy leads to a smaller level of integration for all levels of E . When individuals cannot perfectly evaluate the quality of integrated policy, poor policy outcomes may be partly attributed to political integration. Poor national policy outcomes may accordingly also lead to a flatter $I(E)$ curve. This effect makes it possible to explain a seemingly paradox coevolution of externalities and integration. To see why, consider the case where a rise in externalities is associated with poor national policy outcomes that are partly attributed to integration. This leads both to a relocation of the $E(I)$ curve and, at the same time, to a relocation of the $I(E)$ curve. Figure 9 makes clear that both effects may actually lead to a new equilibrium in which one observes more externalities but less international integration.

4. SOURCES OF A LACK OF PUBLIC SUPPORT

The previous theoretical analysis leads to several hypotheses about how a trend towards disintegration can be explained. While our theoretical arguments are not specifically about Europe, we concentrate on the case of the European Union in what follows.

1. Europe's common policies do not address many citizens' needs. The first hypothesis is that common policies fail to address many citizens' needs. Disappointment with the direction of common policies is likely to make integration less attractive. In the context of our model, this shifts the $I(E)$ curve to the left. Trivially, any political system is likely to disappoint some voters because citizens do not unanimously agree on what is desirable. In what follows we argue that, still, a lot can be done to gain more widespread support for the Union's policies.

⁶ Note that this type of disintegration does not necessarily require that existing common rules are abolished. It is sufficient that the rules are not followed anymore. In this sense, there can be a process of disintegration even though a system of rules seems to be intact from a de jure perspective.

⁷ Another interpretation of our framework is that a strong political leadership can select the desired equilibrium by committing to a level of integration, or it may even pick any other point on the $E(I)$ curve if it prefers to do so.

2. Europe's political system needs to be improved. From the citizens' perspective, both procedural inefficiencies and a lack of respect for institutions may be seen as an intrinsic feature of political integration. When this is the case, support for integration is likely to be affected. Therefore, a second important class of problems concerns cases in which the "direction" of policies fits voter preferences but where inefficiency losses arise due to suboptimal rules and procedures. A related potential source of distrust in the political system of the Union and in the Union's institutions is a lack of respect for common European policymaking rules on the side of the member state governments.

3. A signal extraction problem makes citizens attribute policy failure to integration. Events that are beyond the control of the European Union's institutions shape economic outcomes. Our third hypothesis is that such events are often misinterpreted as a consequence of integrated policies or structures. In a multi-layer governance system, voters face a signal extraction problem when they deal with policy outcomes. The consequences of technological developments or national policy choices may in part be wrongfully attributed to the Union or to "centralization". This effect should be particularly important when national policymakers have an incentive to blame the European Union for homemade problems.

4. Exogenous changes of preferences for national policymaking. The fourth hypothesis is that citizen's attitudes towards integration are subject to changes of taste that are due to non-economic factors including in particular cultural, historical and demographic developments.⁸ ⁹ Moreover, educational policies may affect the location of the $I(E)$ curve and the long run equilibrium.

5. Overshooting of political integration. Political choices that disregard voter preferences may lead to overshooting in the E-I system. According to our model, integration steps that are not backed by popular support will be followed by a subsequent correction (See Figure 10). A corresponding interpretation of the support for European disintegration is that the introduction of the common currency went beyond the stable equilibrium point, and that it is consequently followed by a process of institutional unravelling.

It is important to note that, according to our theoretical model, unravelling may be welfare improving when it leads the system towards the proper equilibrium or when it corrects political overshooting. In this sense, our theoretical model is agnostic about the interpretation of unravelling.

Also note that the above five explanations for an unravelling of a political and economic union are not mutually exclusive. Therefore, ideally, an empirical analysis of the recent political and economic trends in Europe would try to identify the relative importance of the factors that lead to the observable decline in the support for integration. However, with only one time series at hand, such an analysis is unlikely to succeed which is why, in what follows, we will empirically scrutinize all five explanations for a decline in the support for political integration individually.

4.1. ECONOMIC POLICIES

We first address the hypothesis is that citizens are not content with the economic policy outcomes and attribute these outcomes to political integration. There are several reasons why the European political

⁸ It is often argued that the number of citizens who experienced world-war II affects attitudes towards European integration.

⁹ In the language of the model from the previous section, a common policy that better fits voters' preferences is associated with a lower resistance parameter a . The same holds for policies that emerge from a consistent and transparent process. All policies that make citizens understand positions of other countries better will stabilize the location of the $I(E)$ curve.

system may fail to tailor policy outcomes to citizens' preferences. Joint policies may sometimes not be well designed in the sense that they are unnecessarily different from what most citizens want. A good example might be the EU's lack of effort in closing tax havens before the turn of the century.

There is substantial evidence that efficiency and fairness concerns can play a role in the formation of individual behavior (Engelmann and Strobel, 2004, Fehr and Schmidt, 1999, Bolton and Ockenfels 2000) and political attitudes (Corneo and Grüner 2000, 2002, Alesina and Angelotos, 2005, Benabou and Tirole, 2006). This is why a broad political support for political integration benefits from collective policy outcomes being perceived as fair by a substantial part of society. It is difficult to achieve such a broad consensus in a polarized or divided society. Similar difficulties arise in the European Union, since it is composed of member states with different histories, cultures and interests. With a heterogeneous group of citizens it is particularly difficult to match the intentions of many citizens across nations by one single policy outcome. In this context, it is important to notice that there exist considerable differences regarding essential elements of the union, specifically the fact that the union relies on free markets. The differences in attitudes towards markets are certainly a problem when one wants to tailor EU political outcomes to citizens' needs. Still some policies emerging in the EU are country specific. In such cases it is possible to avoid unnecessary mistakes.

4.1.1. Austerity and public opinion

It is difficult to identify a crisis-related pattern in the development of the support for EU institutions or EU deepening. Considering the support for (or opposition against) a further deepening of the EU on a country by country basis shows that between 2008 and 2014 the support measure did increase on average in two of the crisis countries, Portugal and Spain. Moreover, support increased in Germany, a country in which many citizens believe that they are exposed to a fiscal risk arising from the establishment and use of the ESM or the banking union. Instead, the decline in the support for integration is strongest in small wealthy countries (Denmark and the Netherlands) and two eastern European countries¹⁰ (see figures 11, 12, and 13).

Another hypothesis is that disagreement about the direction of member states' fiscal policies erodes the support for integration. This could be reflected in a U-shaped relationship between the debt to GDP ratio and public support. Figure 14 links member countries' debt/GDP ratios to the support for EU deepening. Again, there is little support for a relationship between the two, indicating that the Eurozone debt crisis was not the key reason for the decline in the support for the project of European integration¹¹ and that unpopular austerity policies could not be successfully "blamed" on the European Union¹². By contrast, Braun and Tausendpfund (2014) provide some evidence for an impact of the financial crisis on the support for the EU based on data about the individual perception of the crisis. In their regressions, a variable that captures the individual perception whether the worst part of the crisis is over is significant in explaining individual support for the EU.

One trivial conclusion that supporters of integration can draw from this is that economic crises should be avoided - a recommendation that no one would object anyway. Perhaps more importantly, one should cautiously design the EU's country specific policy measures and recommendations in a way that they do the least political harm. The European Commission's country specific recommendations

¹⁰ Data for Hungary is not included in the 2014 ESS survey.

¹¹ See also Jeffrey Frieden http://www.debatingeurope.eu/2016/04/13/how-has-eu-become-so-unpopular/#.V_T1ZMnDESsw.

¹² Note that, at the time of the writing of this paper, the 2016 ESS data is not yet available. Also note that, due to a lack of 2014 ESS data, some countries are not part of the sample.

(CSRs) play an important role in the process of deciding and implementing austerity measures¹³. They are a key product of the European semester.¹⁴ For those countries that were protected by the ESM the Commission's country specific recommendations are of particular importance because they serve as a standard against which one can evaluate the performance of programme countries.

The European Commission's mandate is a very indirect one. The members of the Commission are proposed by governments that are in many cases elected by a parliament which in turn is elected by voters. The Commission needs to be confirmed by the European Parliament - an institution about which many Europeans seem to know very little. Taking this indirect legitimacy into account, the Commission should always place efficiency concerns over distributional considerations, i.e. it should seek to enlarge the size of the pie in the member states and leave distributional choices to national governments. This does not mean that the Commission can ignore distributional aspects of its proposals. On the contrary. It is exactly because the Commission has no distributional mandate that it should spell out the distributional consequences of its policy proposals as clearly as possible.

Policies that emerge from the European Commission and do not take into account adverse distributional effects risk to undermine support for the Commission and ultimately for European integration itself. Therefore, in a first step the Commission should thoroughly analyze the distributional consequences of the policy proposals.¹⁵ The Commission should spell out likely distributional consequences of its reform proposals explicitly. It should thoroughly discuss ways to compensate losers from efficiency enhancing reforms. Moreover, it should make clear that policy recommendations are a menu of choice for national governments. Wherever possible, the Commission should offer a variety of policy measures with different distributional effects which can be combined to balance the distributional consequences of reforms. Finally, the Commission should involve national governments from the beginning in the development of country specific reform proposals.

4.1.2. Stagnation, inequality and political gambling

A puzzling feature of the rise of nationalist political movements is that their electoral success would imply considerable policy uncertainty. Nationalist parties often have little or no governance experience. Their supporters are often a heterogeneous group that grows quickly. This makes it

¹³ Austerity measures have two dimensions: the size of the fiscal adjustment and the direction (where does a country save). This paper does not add anything to the debate about the appropriate size of the adjustment. The corresponding "southern" narrative is a Keynesian one: If we were given more flexibility, then this would permit more growth. A large adjustment is counterproductive. The "northern" narrative is one of small fiscal multipliers and necessary structural reforms. According to this view, there is no hope to grow out of fiscal difficulties through purely national deficit spending. Instead, growth enhancing policies and fiscal austerity jointly produce sustainable public finances in the medium run. We cannot verify whether these views were truly held by the respective policymakers and we do not want to take a position on whether they are right or wrong (this is an old macroeconomic problem on which this paper has nothing new to offer). For what follows it is sufficient to notice that - based on policymakers' stated preferences - there were gains from a political trade of medium term fiscal support in exchange for austerity and structural reforms. Not surprisingly, the political outcome was a compromise consisting of limited fiscal guarantees (but no full risk sharing), some austerity measures and reforms. What is important is that such a policy mix can be made more or less politically efficient - where a more efficient policy mix receives broader popular support on both sides.

¹⁴ In the context of this procedure, Eurozone governments present to the Commission their national reform program, a stability program, and a three-year budget plan. Having assessed the EU governments' plans, the Commission presents each country with the CSRs. The recommendations focus on the next 2-18 months.

¹⁵ Grüner (2013) discusses this point in broad detail. We here only summarize the main point that have been made in that paper.

difficult to predict political outcomes. Brückner and Grüner (2010) argue that this unpredictability makes extreme political parties relatively more attractive in times of economic crises. Accordingly, anti-establishment parties gain support in times of crisis because they offer a new political gamble to disappointed voters. Their drastic policy measures promise (at best) short run returns and, at the same time, considerable long run risks. Whereas economic growth makes these risks more important, a low growth rate makes the extreme proposals more attractive.

According to a related empirical analysis in Brückner and Grüner (2010), a one percentage point decline in the growth rate leads to at most a one percentage point increase in the support for nationalist parties. Considering this number, the recent trend in the support for such parties in countries such as France or Germany can hardly be explained by the decline in the trend growth rate alone. Other - in particular distributional - factors need to be taken into account. In this respect, it is helpful to extend the logic of the theoretical argument in Brückner and Grüner (2010). According to their argument, individuals are willing to accept an extreme political gamble when there is little prospect for (general) income growth. For the same reason, extremism should benefit in societies in which the economy grows but where this growth is unlikely to benefit a large subgroup of the population. In this case many citizens do not expect that the (politically moderate) status quo is associated with personal income gains.

It is therefore important to also look into recent distributional developments in Europe. These trends are mixed (Figures 15 and 16). Some countries with elevated deficits (Cyprus, Greece, Italy, and Ireland) experienced higher inequality (2008-2014), others (Belgium, France, Portugal) not. According to Figure 17 there is no clear relationship between rising inequality and a declining support for EU deepening for this short period. While inequality increased in most countries between 2008 and 2014, some countries that were very strongly affected (Spain and Germany) display increasing support for a deepening of the union.¹⁶ By contrast, Kuhn (2016), finds some support for the hypothesis that national inequality has an impact on individual euroscepticism. Her data set covers a much longer period, ranging from 1975 until 2009. According to some of her regressions, an increase of the Gini coefficient of 0.1 increases the probability of individual euroscepticism by about 5 percent (accordingly, the population of eurosceptics would increase by five percentage points). The effect is stronger for the less educated. She also finds that lower education and individual unemployment contribute to euroscepticism.

Friedrichsen and Zahn (2012) show that unemployment (a specific form of inequality) plays an important role in shaping political attitudes towards the entire political system. They relate answers to the survey question "Are you satisfied with the way which democracy works in your country?" to individual specific and macroeconomic data. The study includes the years since 2001 and therefore also data on the financial crises. Both economic growth and the unemployment rate have an effect on the support for democracy - even if one controls for the individual economic situation. The effect of growth and unemployment is relatively stable across subgroups of society. Individual unemployment also plays an important role and it turns out that unemployment is much more important on average than inflation. Accordingly, governments would risk to reduce the support for democracy if they rely mostly on austerity measures that go along with extended periods of elevated unemployment.

4.1.3. Refugee crisis

According to Eurobarometer survey data, there was still widespread support for the European integration project in Spring 2015. A majority of 53 percent of respondents answered in favor of more decisions being taken at the EU level. Specifically, 73 percent of respondents were in favor of a common migration policy. This strong support for a common policy indicates that the more recent distrust in European institutions may in part have arisen because (i) many Europeans did not get the

¹⁶ Figures 18 and 19 also indicate that there is no obvious explanation for the change of the support for redistribution between 2008 and 2014.

common policy that they expect or (ii) because citizens believe that the common institutions and procedures do not work as efficiently as they should.

A good example for both may be the EU's "common" migration policy of the years 2013-2015. Both before 2015 and in the critical summer of 2015 policy was strikingly uncoordinated. Both the early Italian and the 2015 German efforts to achieve some burden sharing have remained broadly unsuccessful.

A recent empirical analysis by Dinas, Hangartner, Matakos and Xefteris (2016) shows that mass migration can raise the support for extreme political parties in those areas that are strongly affected. The authors study the development of party preferences in 2015 when some Greek islands close to the Turkish border have received far more refugees than other islands nearby. The fact that otherwise these islands are quite similar with regards to their institutional and socio-economic features permits to study the effects of the exposure to migration on political attitudes. On islands with a large inflow of refugees the vote shares for the nationalist Golden Dawn increased by almost 50% in only a few months. Although it was the noncooperative approach of some political leaders that lead to a sometimes chaotic situation in Greece and in other countries - the outcome may ultimately be less political support for integration. The recent absolute and relative success of right wing parties in Eastern Germany where the population share of residents with foreign origin is relatively low indicates that competition for scarce social security support might be a second motive to support nationalist parties.¹⁷

4.2. INSTITUTIONAL FACTORS

4.2.1. Dysfunctional procedures

Another possible source of a lack of support for coordinated or collective political choices is that the policy finding process is (wrongly or rightly) perceived as inefficient. Obviously, an inefficient exchange of information can result in a substantial delay in finding solutions to pressing problems¹⁸. Moreover, and on a less technical level, the disrespect of national governments for collective rules and procedures may undermine the authority of collective institutions. Both factors are likely to affect the support for European integration because voters do not just care about policy outcomes, but also about the quality of procedures. This is why it is important that the European political system makes a coherent impression and that it is perceived as fair.

Debate and political struggle are essential parts of democratic decision making. However, some ways in which policies emerge are generally perceived to be inefficient and counterproductive. This holds in particular when policymaking is frequently driven by deadlines. This was the case on several occasions during the global financial crisis, the European debt crises and the refugee crises. In all three cases the European Union did not react to unfolding events in a forward looking or coordinated manner. A sign for serious procedural deficits is the growing number of emergency meetings of the European Council. Table 2 lists the number of European Council meetings and Euro summits held in the years since 1975. The number of meetings has increased sharply with the 2008 financial crisis and it has risen further with the European debt crisis. Many of the Euro summits have been held over

¹⁷ According to Gary and Tilley (2009), "living in a relatively wealthy member state, with its associated attractiveness for economic migrants, increases the salience of economic xenophobia as a driver of sceptical attitudes."

¹⁸ Radner (1993) studies this problem formally.

weekends. In some cases, a viable solution had to be found before markets opened in Asia on the next Monday morning. A system that makes frequent use of emergency meetings does not make the impression that collective policy is sufficiently forward looking.

European Council meetings and Euro summits are not the only platforms for exchange between the European heads of state. Another important way to exchange information and to conclude agreements are bilateral or multilateral consultations (both in person or via telephone). There is considerable scope for improvement in this area. An example for chaotic communication practices is the intergovernmental communication during the days of the Budapest refugee crisis in August and September 2015. At that time a large number of migrants took the "Balkan route" with the intention to reach Germany or other relatively prosperous European countries. On September 4, several hundreds of refugees started to march from the Budapest train station towards Vienna. A plan how to deal with these refugees once they reach the Austrian border was urgently needed. At the same time there was a dissensus about the appropriate way in which refugees should be treated in Hungary. The communication flow between three heads of state and their foreign ministers during two critical days has been documented in FAZ (2016) and it is summarized in Table 3. It is striking that the coordination between the heads of state has been so difficult. More importantly, it is surprising that the EU mass migration directive (Council Directive 2001/55/EC of 20 July 2001) was not invoked in exactly the type of situation for which it has been constructed.

Another period of intense exchange between heads of state was September 2016. During that month, a joint meeting by all heads of state took place in Bratislava at which the refugee crisis and the allocation of refugees were discussed. The German Chancellor was very active before and after the meeting, trying to get support from others for the allocation of refugees that was already decided but contested by the Hungarian government. The personal interaction between heads of state in September 2016 is (partly) summarized in Table 4 and visualized in Figure 20. The key player in the network that emerges from Figure 20 is the German Chancellor, Angela Merkel. The overall meeting structure does not fully reflect information flows because it excludes letters, e-mails and telephone calls. Still, the meeting activity looks strikingly uncoordinated.

Motivated by this example, we collected additional data on personal interactions between European heads of state and also the President of the European Commission during the entire year of 2016.¹⁹ The appendix (Tables 5-10) summarizes some of the 2016 meeting activity of the President of the European Commission, Jean Claude Juncker, the High Representative for Foreign Policy, Federica Mogherini, the Lithuanian Prime Minister Algirdas Butkevičius, the French President Francois Hollande, and the German Chancellor Angela Merkel. Even taking into account the limits of an admittedly narrow analysis of personal meetings, the central position of the German Chancellor during this year becomes obvious. She had about 50 contacts with other government leaders, about three times as many as the President of the Commission. In September 2016, the French president had seven meetings with other European leaders, four of which also included the German chancellor. The Italian Prime Minister Matteo Renzi has, during the first half of 2016, met government leaders nine times - including four meetings with Angela Merkel. These Figures indicate that there political deals are ultimately brokered by the German government (or not brokered at all).

It is intriguing that the High Representative for Foreign Policy has very little contact to leading European political figures. In 2016 she did not meet one single head of government. Her contacts to foreign secretaries were almost completely limited to the regular meetings. In the second half of 2016 she had one meeting with the president of the Commission and one with the Czech prime minister.

¹⁹ Obviously, personal meetings are not the only option to exchange information. Heads of state can talk over the phone, write or send ambassadors or ministers. Still, since some exchanges benefit from a personal contact, we believe that the meeting schedule provides some insights about the intensity of interaction.

The leaders of small countries such as Prime Minister Algirdas Butkevicius seem to be completely cut off from the general communication flows (Table 9). According to his agenda, a major part of his foreign interaction seems to consist of congratulating colleagues on the occasion of their respective national independence days (Table 10).

Procedural fairness is a major determinant of the support for any decision making system. The fact that Germany seems to organize a large part of the search for a European consensus is likely to undermine the perceived legitimacy of the European political system - at least from the perspective of the majority of non-German EU citizens.

4.2.2. Disrespect and disagreement

The previous section makes clear that communication flows can be chaotic even when political actors behave in line with the agreed upon rules. However, in many instances, national European policymakers break the common rules. It would be too much demanded that citizens support the common institutions if their national political leaders do not do the same. Some examples of an obvious breach of community law by member countries are Hungary's referendum of the acceptance of a refugee quota, Greece's failure to provide accurate statistics about its debt level before 2009, and member countries' refusal to enact EU legislation in time.

Besides such formal breaches of common rules, there are several instances in which informal action makes formally established institutions obsolete. The European Union has installed a high representative for its foreign and security policy. However, the peace talks between "Europe", the Ukraine and the Russian Federation were held between the Heads of state of Germany, France, Ukraine and Russia. The EU's high representative for foreign policy was not present during these talks. Another recent example is the EU directive on mass migration that has not been made use of even though it has been designed specifically for cases such as the one of the 2015 refugee inflow.

In some cases, rules may be subject to different interpretations. If there exists no broad enough consensus about the "true" meaning of common rules, then conflict is unavoidable. Again, these conflicts risk to ultimately undermine the popularity of the union in at least some member countries. Perhaps the most important example are the very different interpretations of the stability and growth pact that coexist within the EU. The same deficit figures trigger very different sentiments and interpretations in different countries and the interpretation of common rules often emerges in nationally segmented debates.

To summarize, popular support for the union and its institutions is likely to benefit from (i) more common ground regarding the interpretation of rules (ii) a higher level of enforcement of rules and (iii) respect for the representatives and institutions of the union.

4.2.3. The paradox of bureaucracy

The European administrative system is widely believed to be bureaucratic which is also widely interpreted as an undesired property. It is important to distinguish two interpretations of the term "bureaucratic". The first concerns the complexity of administrative procedures (red tape). Unnecessarily complex procedures are a phenomenon that the European Commission tries to deal with through the establishment of the High Level Group on Administrative Burdens. The second interpretation concerns the range of issues that is decided by a bureaucracy (as opposed to decisions that are left either to citizens or to their elected national representatives). Obviously, if more areas are dealt with by a bureaucracy, there is a risk that there is little democratic control. It seems to be a natural approach to address this concern by granting more decision rights either to citizens themselves or to their elected representatives, i.e. the European parliament or the European Council. However, two recent contributions argue that the empowerment of the European parliament may actually have the effect of leading to more rather than less decisions that are subject to bureaucratic action and

discretion. The reason for this paradox result is that there are actually three institutions involved in EU legislation: the Commission the Parliament and the Council. The empowerment of the European parliament makes it more likely that Parliament and Council block each other. As long as there is no agreement, there is scope for bureaucratic intervention. According to Junge, König, and Luig (2013) "a high risk of gridlock may not necessarily decrease overall productivity, but shift decision making to the bureaucracy." According to König (2016) the same effect also enlarges the scope of decision making for the European Court of Justice. Accordingly, an attempt to reduce the scope of bureaucratic action would require to reduce the risk of political deadlock through appropriate measures. The best way to achieve this is to reduce the political power of one of the two potentially conflicting institutions, the Parliament or the Council.

4.3. SIGNAL EXTRACTION PROBLEMS

The European Social Survey (ESS) asks respondents whether or not they would prefer a deepening of the European Union. One might expect that those respondents who are particularly satisfied with their national government should be the least interested in a deepening of the union since this reduces the own governments sovereignty. Instead, the response to the question about deepening is significantly (at the one percent level) positively correlated with the satisfaction with the national government (ESS, 2014 data). One possible explanation is that discontent citizens attribute the blame for their situation to all potentially relevant political actors - be it on the national or on the supranational level. Such a broad attribution of responsibility can actually be rational when citizens are not perfectly informed about the exact reasons for their own economic situation. This is why, under unfavorable economic conditions of purely national origin, the popularity of EU institutions can still suffer (see also table 11).

Indeed, recent survey data makes clear that Europeans do not know very much about their common policy institutions. In Spring 2015 only about half of the Eurobarometer survey respondents say that they understand how the EU works. In some member countries the lack of knowledge is particularly impressive. A lack of knowledge is also visible in the responses to questions about the functioning of EU institutions. Only 45% of the French respondents (QA17.2) say that members of the European parliament are elected directly by the citizens of the member states. Nothing is reported about what the other 55 percent believe. Europeans are also generally uninformed about the common market and its rules and benefits to society. According to Question QD5 45% of respondents feel fairly uninformed about their rights within the single market. This is particularly problematic because the single market should be one of the most attractive building blocks of the union.

The severe lack of economic and institutional knowledge of Europeans extends to the causes of policy failure. In 2013, 45 percent of Eurobarometer respondents felt not very well or not at all informed about the origins of the crisis (Special Eurobarometer 398, QA21). This lack of knowledge facilitates that national policymakers attribute poor policy outcomes to European institutions. As it stands, one cannot expect that the reasons for policy failure will be properly allocated to the national or supranational level.

4.4. LACK OF COMMON GROUND

4.4.1. Europeans are divided about the role of markets

A cornerstone of the European integration project is the reliance on open and competitive markets²⁰. The integration project in its current legal form can only be politically successful if Europeans in all countries perceive markets as a useful and – at least to some extent - fair allocation mechanism. Instead, a whole range of survey data impressively demonstrates that the Union's member states - and in particular the two largest countries France and Germany - are deeply divided about the role that markets play in the economy. While Germans and Italians on average hold fairly positive views of markets, the view in France is a deeply critical one (see also table 12). This is also reflected in ESS data from 2014 reported in figure 21.²¹ Similarly, there are major differences regarding the redistributive role of the state. In a cross country study of preferences for redistribution, Isaksson and Lindskog (2009) find large country dummies for France and Spain (controlling for a wide range of other factors) relative to West-Germany.²²

According to Janeba, Boyer and Heinemann (2016), the serious lack of common ground between citizens of France and Germany is also reflected in the views of the countries' policymakers. They found that French and German MPs differ in their support for granting more competencies to the EU in different fields. Specifically, French MPs are more inclined to transfer competencies in the fields of taxation, wages, and labour market regulation. French and German MPs strongly disagree on Eurobonds. Germans lend less support to a common Eurozone unemployment insurance system and also to the ECB's asset purchase programmes. Even members of parties with the same political orientation differ in their views on these important issues.

4.4.2. Europeans lack identification and mutual trust

An early study by Hooghe and Marks (2004) points out that EU citizens who state to have an "exclusive national identity" are more likely not to support European integration. By contrast, national attachment alone plays a much weaker role. Thus, it seems to be of key importance whether individuals have a European identity - no matter whether it is an exclusive one or not. Based on data that has been collected before the outbreak of the European debt crisis, Roose (2010) paints a fairly pessimistic picture of the EU's ability to create such a continental identification. According to her analysis of ISSP and Eurobarometer data the extent of continental identification in Europe is not higher than in other continents. Moreover, there has been no increase in European identification over time. According to Fligstein (2008) the share of individuals who feel National and European is remarkably stable at around 50 % from 1992-2004 (i.e. Euro introduction). 40 percent of Europeans just have a national identity.

We have already pointed out that Europeans are strikingly uninformed about their common political system. This does not only imply that there is a serious signal extraction problem when it comes to understand reasons for undesired policy outcomes. It also means that there is little hope that Europeans identify with their political system.

²⁰ According to Article 119 TFEU, "(...) the activities of the Member States and the Union shall include, as provided in the Treaties, the adoption of an economic policy which is based on the close coordination of Member States' economic policies, on the internal market and on the definition of common objectives, and conducted in accordance with the principle of an open market economy with free competition."

²¹ For data and documentation see European Social Survey (2008, 2012, 2014, 2016).

²² See Figure 9, specification 2. Data is from 1999/2000. The 24 countries included were Australia, Brazil, Canada, Chile, Cyprus, Czech Republic, Denmark, France, Germany, Hungary, Ireland, Japan, Latvia, New Zealand, Norway, Philippines, Poland, Portugal, Russia, Slovenia, Spain, Sweden, Switzerland, and USA.

4.4.3. Segmented political debate and advisory markets

A striking feature of the recent financial crisis is the national segmentation of the political, scientific and public debates about common economic policy issues in Europe. German newspapers tend to rely on the views of German economists while French economists fill the pages of their newspapers. At first glance this may seem natural since language barriers may call for such a division of labor. However a national segmentation of debates among scientific experts risks the emergence of persistently different and sometimes also politically tinted world views.

In 2012 a group of 172 economists from “German speaking countries“ published a letter²³ addressed to their “fellow citizens”, warning against adverse consequences of a European banking union. The text of this manifesto makes clear that it was mainly motivated by the will to protect Austrian and German taxpayers. According to those economists who argued in favor of a banking union, its main advantage is that it helps to break the link between state and bank finances.²⁴ This reason for the enterprise played no role whatsoever in the German economists’ letter. It is also worth noting that many of the 172 signatories had little or no specific expertise in banking or financial markets. In 2016, a similarly impressive number of 138 French economists argued in favor of ending austerity policies and letting Europe exit from what they call “l’impasse néolibérale”²⁵. It would be quite difficult to find a similar number of German economists who share their view.

Any bias in the views of a country’s scientific experts is likely to affect the views of their politicians. Since 2014, the Frankfurter Allgemeine Zeitung publishes an annual ranking of influential economists (see Table 13). This ranking is based on three dimensions, one of which is economists’ influence in the political sphere. This sub-ranking is constructed as follows. Several German politicians were asked: “Who are the economists whose opinion matters most to you.” This is an open question which does not exclude non-German economists. The overall outcome reflects a considerable home bias in favor of German economists since 18 out of the top 20 economists are German (Table 11). Many of these 18 economists have an undergraduate degree and a PhD from a German speaking university. Thus, the home bias also concerns the advisors’ scientific socialization. A pro-French bias is visible in the France’s Conseil d’Analyse Economique (Table 14). Of course, a home bias need not be associated with a minor quality of advice. There are many decent French and German universities. However, a home bias may imply that policymakers disregard important schools of thought that are more influential in other countries which in turn makes international political disagreements more likely.

4.5. OVERSHOOTING AND POLITICAL UNRAVELLING

Based on the E-I model, one can develop a fifth hypothesis for a decline in the support for European integration: Integration simply went beyond the equilibrium point. According to this a view, Europe’s political leaders “overdid it” when they introduced the common currency. The introduction of the currency union was a singular event that was not backed by a broad voter sentiment in all participating countries. The close outcome of the referendum on the Maastricht treaty that was held in France is one example. According to some observers, the Euro was part of a Franco-German political deal in the context of Germany’s reunification. Both the creation of the single currency and the following enlargement of the Union were not the subject of referenda in the member states. According to our theory, an overshooting beyond the equilibrium point (see Figure 10) must result in a long development of institutional unravelling. Obviously, little can or should be done if this was true.

²³The letter is available at <http://www.faz.net/aktuell/wirtschaft/protestaufruf-der-offene-brief-der-oekonomen-im-wortlaut-11810652.html>.

²⁴This is also the main argument that was put forward in the press release of the European Council from June 29, 2012: https://www.bankingsupervision.europa.eu/about/milestones/shared/pdf/2012-06-29_euro_area_summit_statement_en.pdf.

²⁵ See http://www.lepoint.fr/europe/138-economistes-veulent-sortir-l-ue-de-l-impasse-neolibérale-10-11-2016-2082320_2626.php.

Unfortunately, it is difficult to empirically evaluate the position of a group of countries within the E-I system. The discussion of policy measures that follows is merely based on the premise that unravelling shall be prevented but it does not shed any light on the question whether or not this is desirable from a welfare perspective.²⁶

5. POLICY MEASURES: FIVE PILLARS

5.1. PILLAR I: TAILOR COMMON POLICIES TO VOTER PREFERENCES

5.1.1. Compensate insider workers through capital taxation

Growth-enhancing policy reforms can become quite unpopular if costs and benefits are distributed very unevenly. The European Union can contribute to better balance the distributional consequences of policy reforms in member countries (for details see Grüner, 2013). Ideally, the European Commission should collect data regarding actual and perceived consequences of reforms and about preferences for political reforms. This data can be used to tailor country specific recommendations to the policy situation of a country. Many reforms that have been undertaken since the beginning of the European debt crisis have created a burden for insider employees and for those who are retired or expect to retire in the near future. Such policies find little acceptance if they are not accompanied by effective compensatory measures. European institutions that push for reforms are likely to suffer a loss in popularity in the respective countries if they do not take distributional effects of their policy proposals into account.

Compensatory measures for reforms that hurt insider workers can draw on increasing revenues from capitalists. The corresponding measures should increase the effective tax rate on the gross return for capital. Various policy measures can fulfil this task. In this context, the co-ordination of capital taxation is particularly helpful and the closure of Europe's tax loopholes is of the essence. Survey data clearly shows that this is a policy that would enjoy widespread support across member countries. In the Spring 2015 Eurobarometer, 87 percent of the respondents support tougher rules on tax avoidance and tax havens (QC3).

A major difficulty arises when the actual aggregate or distributional consequences of growth enhancing reforms are uncertain. In such cases a clear commitment to an appropriate compensation of reform losers may be helpful. For this purpose, it may be useful to develop a medium term target for distributional measures such as a net labor income share.

5.1.2. European risk sharing

Many observers argue that the establishment of a European risk sharing scheme is likely to enhance the popularity of EU policies. Such a scheme can in principle serve two distinct purposes: it can insure countries and citizens against (i) adverse effects of common (specifically pro-market) policies and (ii) adverse idiosyncratic risk that is not policy related.

The case for an insurance against consequences of common policies can be made as follows. A characteristic feature of the European integration project is that it is supposed to enhance competition

²⁶ Independently of such a welfare judgement, the model permits to identify various policy measures that increase or stabilize the political support for a high level of integration. It is important to note that some of these measures can be welfare enhancing even if one sticks to the negative welfare interpretation. Consider e.g. policies that improve the efficiency of policymaking. They shift the $I(E)$ curve to the right in both version of our model. In both cases, the good equilibrium is associated with a higher welfare level.

on free markets (Art. 3 TFEU) and popular support for this principle is mixed among member states. Political support for a system that is based on economic competition benefits from complementary social protection.²⁷ Currently, social protection is mostly provided on the national level (Alesina, Angeloni and Schuknecht, 2001) and the EU budget is far too small to provide notable additional support. This can be problematic in a heterogeneous union where a market oriented policies have varying and differential effects due to technological, cultural and institutional differences. The support for integration in countries or specific national sectors that are adversely affected by - say - a new external trade agreement could therefore benefit from a European mechanism of individual or collective insurance. This speaks in favor of establishing an EU fiscal capacity that enables the union to insure countries against idiosyncratic adverse effects of market oriented policies.²⁸ However, and independently of the motive for insurance, risk sharing schemes create moral hazard. This is why it is worth to consider the possible alternatives.

A first option is to rely more on the individuals' insurance against country specific risks. Individuals can to some extent insure themselves against adverse common policy or national macroeconomic shocks through an internationally diversified portfolio. One important factor that prevents this in practice is the home bias in individual investment activity, another one is the unequal distribution of wealth. Thus, one complementary measure would be to make more citizens less dependent upon labor income.²⁹ Another measure is to reduce the individual investors' exposure to national risk via a reduction of the national exposure of their banks. The banking union is one important step in this direction, but it is still incomplete since there is no real agreement about the size and role of a possible fiscal backstop for the recovery and resolution of banks. Regulatory measures to reduce banks' exposure to national government debt and a strategy for the establishment of pan-European financial institutions are a useful additional steps that should follow.^{30 31}

A second alternative to cross-border public insurance is national intertemporal consumption smoothing. Ideally, a country with access to international capital markets should be able to implement policies that provide automatic stabilization and use debt instruments for their financing. In their theoretical model Fahri and Werning (2012) show that cross country insurance is still useful when prices are sticky.³² Thus, cross country insurance and price- and wage flexibility can be considered as two alternative ways to deal efficiently with asymmetric developments within a currency union.

²⁷ A related point has been made in Part IV of Rajan and Zingales, 2003, who argue that competition finds more support when there is risk sharing. Related to the EU the complementarity is discussed in Buti and Pichelmann, 2017.

²⁸ Since Europeans seem to care more about unemployment than about sustainable public finances (Eurobarometer, QA3a), such a scheme would be likely to make the EU more attractive to many citizens.

²⁹ Spreading the gains from economic integration via more dispersed capital ownership helps to make integration attractive for more individuals. Policies that foster a more equal wealth distribution are the provision of savings incentives, "soft"-paternalistic policies, policies that generally improve the financial infrastructure as well as outright redistribution of capital or capital returns.

³⁰ Risk sharing that mainly relies on the interbank market may lead to a breakdown of the system exactly when it is needed most. Fecht, Grüner and Hartmann (2007) provide a theoretical analysis of the role of different forms of international financial risk sharing and show that international merges of financial institutions may provide a more efficient risk sharing between nations than contracting on the interbank market. See also recent empirical work by Faia, Ottaviano and Sanchez Arjona (2016).

³¹ Brunnermeier et al (2012) propose to go beyond the regulatory approach and advocate to collectively create a safe European asset by bundling government debt.

³² Their key assumption is that monopolists fix prices before uncertainty realizes.

Considering the political moral hazard problem that is associated with insurance, enhancing price flexibility seems to be the more attractive option.

5.1.3. Cross country compensation for reforms

Cross border insurance is not always a suitable tool to overcome resistance to market oriented reforms. To see why, consider the case where risk is shared via a European social security system and where one country considers a labor market reform that reduces both unemployment and labor income. The common unemployment insurance scheme does not compensate the reform country for the latter effect. Instead, it would pay out less to this country exactly when the country needs money to compensate the losers from the reform. Thus, internationally incentivizing a labor market reform requires a different instrument such as a reward that is tied to the unit labor cost. A policy of privatization would instead benefit from sector specific EU-insurance. Therefore, any reform-related international insurance would have to be designed on a case by case basis.³³

5.2. PILLAR II: POLICY PROCESSES MUST BECOME MORE EFFICIENT

5.2.1. Improve information flows and decision processes

It is difficult to restrict and structure information flows between policymakers. This holds specifically for the coordination and information exchange process between heads of sovereign states. One can regularly observe that ad hoc structures of interaction emerge such as the 2016 meeting of the heads of Mediterranean states or the 2016 meeting of the heads of states along the Balkan-route. Those ad hoc structures do not have permanent character, which is why substantial delay in decision making may be the result when new problems arise. We have already seen that sometimes it is difficult for heads of state to communicate in a timely manner. This is why it may be useful to establish a baseline procedure for situations in which it is important to come up with timely policy responses to an emerging situation. One way to achieve this would be to develop common guidelines for the way in which Europe's political leadership should deal with important events that require timely decisions. A communication protocol can serve as a coordination device, providing at least a focal point for internal communication.³⁴ Those guidelines may help to avoid unnecessary duplication or delay in information exchange. One interesting option is to group decision makers with correlated positions. Within each group, one policymaker could collect information about policy proposals or preferences. This position could rotate. The president of the Council could then collect information from the various speakers of groups of states.

5.2.2. Improve respect for common rules

Improving the enforcement of the common European rules is one of the most difficult tasks to achieve. The top down approach would be to wait for policymakers to actively coordinate on a better enforcement of the rules - by pure insight into the efficiency of such an arrangement. This approach

³³ A detailed analysis of ways to organize the process of rewarding reforms can be found in Grüner (2013).

³⁴ Mukhopadhyaya (2003) shows that without any pre-determined structure, decentralized information acquisition may lead to duplication or to underprovision. A similar form of coordination failure may arise in the context of group communication. Consider a group that needs to collect information in the absence of any predetermined communication structure. When communication acts have to be performed sequentially and when preferences are perfectly aligned, it is easy to see that there are multiple efficient equilibria. However, some coordination is needed in practice to arrive at one of these efficient equilibria.

does not seem to have worked very well in the recent past. The alternative, a bottom up approach, takes more time. It would consist of improving the knowledge about the common rules in the population and the establishment of a cross country debate on common policy issues. Details about how this can be achieved will be discussed below (Pillar IV).

5.3. PILLAR III: IMPROVE SIGNAL EXTRACTION

In order to improve citizens' capacity to properly evaluate the level or origin (national or supranational) of policy failures, several measures could be adopted. First, the knowledge about the functioning of EU institutions could be improved beyond the current - very low - level. A better coordination of national curricula in secondary civic education would be most useful in this respect. A second approach would be to make the results of European semester more widely known to the general public. This process could include the development of a set of common indicators of policy quality on the EU level. Third, information about national policy failures flows better if there is a truly European political debate - an issue that we deal with in more detail in the following section.

5.4. PILLAR IV: STRENGTHEN COHERENCE AND RESILIENCE

A common European identity can strengthen the support for a coordinated policy approach (Hooghe and Marks, 2004). Recent research by Masella (2013) and Aspachs-Bracons, Clots-Figueras, Costa-Font and Masella (2008) show that the language of education is a key determinant of the formation of a regional or national identity. Their empirical analysis of identity formation uses data from Catalonia and the Basque country, where the education system became bilingual in 1983. Masella (2013) compares survey responses of citizens who received a bilingual education for a different period of time (due to different birth cohorts). It turns out "that respondents who have been exposed for a longer time period to teaching in Catalan have stronger Catalan feelings." In the context of the recent migration into Europe it is also interesting to note that "the effect also appears to be present among individuals whose parents do not have Catalan origins; in addition the reform affects political preferences and attitudes towards the organization of the state." In Catalonia, bilingual education became compulsory whereas in the Basque country parents could choose the language of school education for their children. While the optional scheme had no significant effect on identity measures (presumably because parents avoided Spanish as a training language), the compulsory scheme had a significant impact.

According to Clots-Figueras and Masella (2013) ethnic diversity is not an obstacle to the emergence of identification with a nation. Thus, the emergency of a European identity is not ruled out per se and it would benefit from compulsory bilingual education in a commonly spoken language (for the status quo see table 15).

A major step in this direction would be to establish a European language agreement with the objective that every European leaving school should speak at least one second language fluently. Ideally, this should be the same language and (despite Brexit) English is the obvious choice. There is also evidence that cultural mobility programs such as the Erasmus program can contribute to the formation of a common identity (Demirkol, 2013). The member countries can also agree on common standards for treatment of EU institutions in national school curricula. Standards can be set collectively and teaching material could be provided centrally (ideally in the same language for all countries).

A completely different approach to enhance the formation of a European identity is to first create common institutions and to then wait for the identity of Europeans to follow. However, there is evidence that institutional integration does not necessarily foster the formation of a common European

identity. This is the result of a recent study by Müller and Page (2016), who show that the Euro did not lead to a stronger identification with the European Union. Hence, one should not expect that European sentiment simply follows institutional developments.

In recent experimental research, Müller, Bruschka and Page (2016) show that a common social identity enhances the support for redistribution. This indicates that the formation of a stronger common European identity could increase the support for a common insurance scheme. However, considering separatist tendencies in economically divided countries, there is little reason to expect that a common identity would be the consequence of such an insurance scheme.

The scope for identification with the EU is limited if there is substantial disagreement of Europeans of different nationality about fundamental aspects of the Union. Therefore, progress towards more coherence can also be expected from a more integrated political debate that also includes the exchange of scientific policy advice. Looking at the fragmentation of the advisory market that we documented, a radical approach would be to introduce quotas for foreign nationals in political and scientific advisory bodies. Similarly, the human resource management of state owned media could take the aspect of national diversity into account. Foreign correspondents of state owned media are often citizens of the home country - not the foreign country. One simple way to enrich the public debate would be to change this on a broad scale. A bolder vision would be to establish a common European public media source which could in principle be internet based. As a positive side effect it could also serve as an insurance against recent trends towards autocracy in some member countries.³⁵

5.5. PILLAR V: BASE DEEPENING AND ENLARGEMENT ON EU-WIDE REFERENDA

Our fifth hypothesis was that the (politically initiated) deepening and enlargement of the European went beyond what most voters want. Our theoretical analysis shows that any such move must backfire in the long run. A way to prevent this from happening is to firmly base the choice of the degree of further integration on broad popular support. However, basing decisions to deepen the union on the outcome of referenda in all member states would prevent any efficient progress within the Union. An alternative would be to introduce the instrument of an EU-wide referendum on significant changes of the common political system. Such a referendum could also be used in decisions about the accession of new member countries. The instrument of an EU wide referendum has the potential to shift major political debates to the European level.

³⁵ According to an empirical analysis of Van Spanje and de Vreese (2014) "the more positive the evaluations of the EU a voter is exposed to, the less likely she or he is to cast a vote for a Eurosceptic party. (In) countries where political parties have markedly different views on EU issues, the more a voter is exposed to framing of the EU in terms of benefits derived from membership in these countries, the less likely she or he is to cast a Eurosceptic vote."

6. HOW TO SAVE THE ACQUIS COMMUNAUTAIRE

It has frequently been argued that Europe has the choice between further institutional deepening and unravelling. Holders of this "either much more or far less" view of European integration consider the status quo as unstable and expect an unravelling if no further progress is made. The model that was developed in this paper leads to a more differentiated view of the present situation. Accordingly, further integration could backfire if it is not backed by the proper functioning of the political system and a strong enough common identity. Moreover, the current level of integration may become sustainable if it is backed by a strengthening of both components. Based on this view, those who want to save the *acquis communautaire* should give priority to improving the functioning of the present system instead of adding additional components to the system. This paper has discussed numerous ways to strengthen the support for political integration along these lines. This includes (i) an improvement of political outcomes, (ii) an improvement of political procedures, (iii) an improvement of citizens' ability to understand union politics, (iv) fostering a common European political debate and advisory structure and (v) a more democratic foundation of European integration. Between some of these measures there exist considerable synergies. Thus, a broad approach that addresses all fields seems to be the most promising way to avoid an unravelling of political and economic integration.

REFERENCES

- Alesina, Alberto and Allan Drazen (1989) "Why are Stabilizations Delayed?," *American Economic Review*, 79, 1170-1189.
- Alesina, Alberto und Dani Rodrik (1991) "Distributive Politics and Economic Growth," NBER working paper No. 3668.
- Alesina, Alberto, Rafael Di Tella, Robert MacCulloch (2004) Inequality and happiness: are Europeans and Americans different? *Journal of Public Economics*, 88, 2009--2042.
- Alesina, Alberto, Ignazio Angeloni and Ludger Schuknecht (2001) What Does the European Union Do? NBER Working Paper No. 8647.
- Alesina Alberto and George-Marios Angeletos (2005) "Fairness and Redistribution: US vs. Europe" *American Economic Review*, 95, 960-980.
- Arpaia, Alfonso, Esther Pérez and Karl Pichelmann (2009) "Understanding Labour Income Share Dynamics in Europe", *European Economy, Economic Papers* 379.
- Aspachs-Bracons, Oriol, Clots-Figueras, Irma, Costa-Font, Joan and Masella, Paolo (2008) Compulsory language educational policies and identity formation. *Journal of the European Economic Association*, 6, 434-444.
- Benabou, Richard and Jean Tirole (2006) "Belief In A Just World And Redistributive Politics," *Quarterly Journal of Economics*, 699-746.
- Bertelsmann Foundation (2016) <https://www.bertelsmann-stiftung.de/en/topics/aktuelle-meldungen/2016/april/in-deutschland-und-den-usa-waechst-die-skepsis-gegenueber-ttip/>
- Blanco, M., D. Engelmann, and H.-T. Normann (2011). "A Within-Subject Analysis of Other-Regarding Preferences." *Games and Economics Behavior* 72, 321--338.
- Bolton, G. E., and A. Ockenfels (2000). "ERC: A Theory of Equity, Reciprocity, and Competition." *American Economic Review* 90, 166--193.
- Braun, Daniela and Tausendpfund, Markus (2014) "The Impact of the Euro Crisis on Citizens Support for the European Union" *Journal of European Integration*, 36, 231-245.
- Brückner and Grüner (2010) "Economic Growth and the Rise of Political Extremism: Theory and Evidence", CEPR Discussion Paper No. 7723.
- Budzinski, O. and A. Christiansen (2005) "Competence Allocation in the EU Competition Policy System as an Interest Driven Process", *Journal of Public Policy*, 25, 313-337.
- Buti, M. and K. Pichelmann (2017), "European Integration & Populism: Addressing Dahrendorf's Quandary", LUISS School of European Political Economy, Policy Brief, January 30, 2017.
- Calmfors und Driffill (1988) "Bargaining Structure, Corporatism, and Macroeconomic Performance," *Economic Policy*, 6, 13-62.

- Charness G. and M. Rabin (2002). "Understanding Social Preferences with Simple Tests. " *Quarterly Journal of Economics* 117, 817--869.
- Clots-Figueras, Irma and Masella, Paolo (2013) Education, language and identity. *Economic Journal*, 123 (570).
- Corneo, Giacomo and Hans Peter Grüner (2000) "Social Limits to Redistribution", *American Economic Review*, 90, 2000, 1491-1507.
- Corneo, Giacomo and Hans Peter Grüner (2002) „Individual Preferences for Political Redistribution", *Journal of Public Economics*, 83, 2002, 83-107.
- Costa Lima, R. Moreira, H. and Verdier, T. (2012) "Centralized decision making against informed lobbying". CEPR Discussion paper No. 9199, 2-37.
- Dimitz, Maria Antoinette (2001) "Output gaps and technological progress in European Monetary Union", Bank of Finland, Research Department.
- Engelmann, D. and M. Strobel (2004) "Inequality Aversion, Efficiency and Maximin Preferences in Simple Distribution Experiments." *American Economic Review* 94, 857--869.
- Eurobarometer Standard 83, Spring 2015, Public Opinion in the European Union. European Social Survey Round 4 Data (2008). Data file edition 4.4. NSD - Norwegian Centre for Research Data, Norway – Data Archive and distributor of ESS data for ESS ERIC.
- European Social Survey Round 6 Data (2012). Data file edition 2.3. NSD - Norwegian Centre for Research Data, Norway – Data Archive and distributor of ESS data for ESS ERIC.
- European Social Survey Round 7 Data (2014). Data file edition 2.1. NSD - Norwegian Centre for Research Data, Norway – Data Archive and distributor of ESS data for ESS ERIC.
- European Social Survey (2016): ESS-7 2014 Documentation Report. Edition 3.1. Bergen, European Social Survey Data Archive, NSD - Norwegian Centre for Research Data for ESS ERIC.
- Faia, Ester, Gianmarco Ottaviano, Irene Sanchez Arjona (2017) "International Expansion and Riskiness of Banks", CEPR DP11951.
- Falk, Armin und Michael Kosfeld (2006) "The Hidden Costs of Control", *American Economic Review*, 96, 1611-1630.
- Fang, Hanming and Peter Norman (2005) "Overcoming Participation Constraints," Cowles Foundation Discussion Papers 1511, Yale University.
- Fang, Hanming and Peter Norman, (2008) "Optimal Provision of Multiple Excludable Public Goods," NBER Working Papers 13797.
- Fecht, Falko, Hans Peter Grüner and Philipp Hartmann (2007) "Welfare Effects of Cross-Border Financial Integration", CEPR Discussion paper 6311.
- Durante, Ruben and B Knight (2012) Partisan control, media bias, and viewer responses: Evidence from Berlusconi's Italy, *Journal of the European Economic Association* 10 (3), 451-481.

Fehr, E. and K.M. Schmidt (1999). "A Theory of Fairness, Competition, and Cooperation." *Quarterly Journal of Economics* 114, 817--868.

Fiori, Giuseppe. Giuseppe Nicoletti, Stefano Scarpetta, Fabio Schiantarelli (2012) "Employment Effects of Product and Labour Market Reforms: Are There Synergies?" *The Economic Journal*.

Frey, B. S., Felix Oberholzer-Gee, Reiner Eichenberger (1996): "The Old Lady Visits Your Backyard: A Tale of Morals and Markets" *The Journal of Political Economy*, 104, 1297-1313

Friedrichsen, Jana and Philipp Zahn (2014): "Political support in hard times: Do people care about national welfare?". In: *European Journal of Political Economy* 35, 23-37.

Gary, J. and J. Tilley (2009) "The Macroeconomic Factors Conditioning the Impact of Identity on Attitudes towards the EU", *European Union Politics*, 10, 361--379.

Gneezy, U., Meier, S. and Rey-Biel, P. (2011) "When and Why Incentives (Don't) Work to Modify Behavior". *Journal of Economic Perspectives* 25(4), 191-210.

Grüner, Hans Peter "Unemployment and Labor Market Reform: A Contract Theoretic Approach", *Scandinavian Journal of Economics*, 104, 2002, 641-656.

Grüner, Hans Peter „Demokratie, Reform und Wissenschaft", *Wirtschaftsdienst*, 2007, 87, 567-570.

Grüner, Hans Peter "Why EMU is not a Failure", *European Journal of Political Economy*, 2009, 26, 1-11.

Grüner, Hans Peter (2013) „The Political Economy of Fiscal Consolidation and Structural Reform Revisited", *European Economy, Economic Papers*.

Grüner, Hans Peter and Carsten Hefeker (1999) "How Will EMU Affect Inflation and Unemployment in Europe?", *Scandinavian Journal of Economics*, 101, 33-47.

Grüner, H. P. and Yukio K. (2012) "Public Goods, Participation Constraints, and Democracy: A Possibility Theorem". *Games and Economic Behavior* 75(1), 152-167.

Grüner, H. P. and D. Müller (2012) "Measuring Political Information Rents: Evidence from the European Agricultural Reform", mimeo, Universität Mannheim.

Güth, W. and Hellwig, M. (1986) "The Private Supply of a Public Good". *Journal of Economics* 5 (1), 121-159.

Hooghe, Liesbet and Marks, Gary (2004) "Does Identity or Economic Rationality Drive Public Opinion on European Integration?" *Political Science and Politics*, 37, 415-420.

Hooghe, Liesbet and Marks, Gary (2009) "A Postfunctionalist Theory of European Integration: From Permissive Consensus to Constraining Dissensus" *British Journal of Political Science*, 39, 1-23.

IMF 2011 Spain - Staff Report for the 2011 Article IV Consultation; Public Information Notice; Statement by the Staff Representative; and Statement by the Executive Director for Spain.

Isaksson, A.-S. and A. Lindskog (2009) "Preferences for redistribution - A country comparison of fairness judgements" *Journal of Economic Behavior & Organization*, 72, 884--902.

- Jackson, Matthew O. and Sonnenschein, Hugo F. (2007) "Overcoming Incentive Constraints by Linking Decisions" *Econometrica*, 1, 241-257.
- Junge, König, and Luig (2014) "Legislative Gridlock and Bureaucratic Politics in the European Union", *British Journal of Political Science*, 45, 777--797.
- König, T. (2016) "How Does Legislative Override Affect Judicial Behavior? The European Court of Justice and the Separation of Powers in the European Union", mimeo.
- Kuhn, Theresa et al. (2016) "An ever wider gap in an ever closer union: Rising inequalities and euroscepticism in 12 West European democracies, 1975-2009" *Socio-Economic Review*, 14, 27-45.
- Mailath, George J. and Andrew Postlewaite (1990) "Asymmetric Information Bargaining Problems with Many Agents," *Review of Economic Studies*, 57, 351-367.
- Masella, Paolo (2013) "National identity and ethnic diversity", *Journal of Population Economics*, 26, 437-454.
- Ministero dell'Economia e delle Finanze (2012) "Italy's Fiscal Consolidation and Structural Reforms" (November 2011 -- September 2012), available online.
- Müller, Daniel, Franz Bruschka and Lionel Page (2016): "Can a Common Currency Foster a Shared Social Identity? The Case of the Euro".
- Müller, Holger, Roman Inderst and Karl Wärneryd (2007) "Distributional Conflict in Organizations", *European Economic Review*.
- Persson Torsten and Guido Tabellini (2005) *The Economic Effects of Constitutions*, MIT Press.
- Rajan, Raghuram G. und Zingales, Luigi (2003), *Saving Capitalism from The Capitalists: Unleashing the Power of Financial Markets to Create Wealth and Spread Opportunity*, New York: Crown Business Press.
- Roose, J. (2010) "How European is European Identity? Extent and Structure of Continental Identification in Global Comparison Using SEM", FU Berlin, The transformative power of Europe discussion paper No. 19.
- Segal, Ilya and Michael Whinston (2011) "A Simple Status Quo that Ensures Participation (with Application to Efficient Bargaining)," *Theoretical Economics*, 6, 109-125.
- Solt, Frederick. 2016. "The Standardized World Income Inequality Database." *Social Science Quarterly* 97. SWIID Version 5.1, July 2016.
- Tabellini, Guido und Alberto Alesina (1990) "Voting on the Budget Deficit," *American Economic Review*, 80, 37-49.
- van Spanje, Joost and Claes de Vreese (2014) "Europhile Media and Eurosceptic Voting: Effects of News Media Coverage on Eurosceptic Voting in the 2009 European Parliamentary Elections", *Political Communication*, 31:2, 325-354.
- Waldinger, Fabian and Matthias Pary (2011) "Studying Abroad and the Effect on International Labour Market Mobility -- Evidence from the Introduction of ERASMUS", *The Economic Journal*, 121, 194-222.

ANNEX I

A microfoundation of the E-I-model

A microfoundation of the E-I-model

This appendix provides a microfoundation for the theoretical analysis in section 2. The microfoundation is based on a decision problem of firms that consider to engage in cross border activities. specifically, we assume that potential exporters have to make a fixed investment in order to be able to export their output. A firm only undertakes the investment if the cost is covered by expected revenues. Political integration reduces the cost of the investment. There are many good reasons to assume that this is the case. regulatory integration makes it easier to discover low cost products in the competing country. Integration of networks facilitates price discovery and transport. Therefore, integration makes more firms enter the export market. Which explains the macro-relationship $E(I)$.

On the other hand, more firms choosing to open themselves to trade makes integration more valuable for a welfare maximizing state. This explains why the benefit from integration grows with openness E .

Specifically, both relationships are modelled as follows. Consider two countries, $l = 1, 2$. There are two continua of goods that can be produced in both countries, $[0, 1]$ and $[1, 2]$. Each country has an expected cost advantage in the production of one continuum of goods. We call these goods the "home goods", and the other goods "foreign goods". Foreign goods can be produced at a fixed cost of 1. From now on, consider w.l.o.g. country 1 with its home goods $i \in [0, 1]$. Home good i is produced at a stochastic cost $c_i \in \{0, 1\}$ where the low value realizes with probability p . For simplicity, we assume that the demand for all goods in both countries is fixed and equal to one. A producer of home good i can choose to invest in a costly export option before his cost value realizes. The cost of establishing the export option is $k(i)$, with $k'(i) > 0$. Once the cost c_i has realized, exporting the good is feasible with probability I . We think of I as the degree of regulatory integration. There are gains from trade when the low cost value realizes. We assume that an exporting firm has bargaining power α . Therefore, when $c_i = 0$, the firm exports at a price of $\alpha \in [0, 1]$. Firm i is risk neutral and chooses the export option if

$$p \cdot \alpha \cdot I \geq k(i).$$

The marginal exporting firm is firm $k^{-1}(pI)$. Hence, the share of exporting firms is

$$E_l(I) := k^{-1}(p\alpha I).$$

$$\begin{aligned}
\alpha &= 1 \\
k^{-1}(0) &= 0 \\
I + \varepsilon &> k^{-1}(I) > I \text{ if } I \in (0, 0.5) \\
k^{-1}(0.5) &= 0.5 \\
k^{-1}(I) &< I \text{ if } I \in (0.5, 1) \\
k^{-1}(1) &= 1.
\end{aligned}$$

With this distribution function, the model has three equilibria that are associated with very different degrees of economic and political integration. These equilibria are $(E, I) = (0, 0)$, $(1/2, 1/2)$, and $(1, 1)$. The two low and high integration equilibria are locally stable whereas the middle one is locally unstable. Welfare is given by

$$\begin{aligned}
W(0, 0) &= 0. \\
W(0.5, 0.5) &= p \cdot \frac{1}{2} \cdot \frac{1}{2} - K\left(\frac{1}{2}\right) - a\frac{1^2}{2} = \frac{1}{8} - K\left(\frac{1}{2}\right). \\
W(1, 1) &= p - a - K(1) = \frac{1}{2} - K(1).
\end{aligned}$$

Letting ε converge to zero, we get $K\left(\frac{1}{2}\right) = 1/8$, so that $W(0.5) = 0$. Moreover, welfare is strictly higher than zero in the stable equilibrium at $E = I = 1$.

A macroeconomic E-I model with inefficient integration

Consider two countries that determine their degree of policy integration I , taking into account the cross border policy spillovers E . Specifically, assume that each country receives a direct linear economic benefit from integration I and has a cost of adjustment to integration of aI^2 . Finally, integration is needed to deal with negative externalities E , and uncovered negative externalities are costly. Overall, the country maximizes

$$W(E, I) := I - aI^2 - b \min\{E - I, 0\},$$

where a and b are given parameters. The optimal policy is given by

$$I(E) = \begin{cases} \frac{1}{2a} & \text{if } E \in [0, \frac{1}{2a}] \\ E & \text{if } E \in [\frac{1}{2a}, \frac{1+b}{2a}] \\ \frac{1+b}{2a} & \text{if } E \in [\frac{1+b}{2a}, 1] \end{cases}$$

In a next step we directly assume that integration leads to more externalities. Taking an upward sloping externality function $E(I)$ as given, multiple equilibria may arise. In this example, there are two stable equilibria at $(E, I) = (E_A, \frac{1}{2a})$, (E_B, I_B) , and $(E_C, \frac{1+b}{2a})$ with $E_A < \frac{1}{2a}$, $E_B = I_B$, and $E_C < \frac{1+b}{2a}$. In the two stable equilibria, welfare is given by

$$W\left(E_A, \frac{1}{2a}\right) := \frac{1}{2a} - a\left(\frac{1}{2a}\right)^2 = \frac{1}{4a}.$$

$$W\left(E_C, \frac{1+b}{2a}\right) := \frac{1+b}{2a} - a\left(\frac{1+b}{2a}\right)^2 = \frac{1+b}{4a}(2-1-b).$$

The equilibrium with $I = E = \frac{1}{2a}$ maximizes social welfare whereas the other stable equilibrium does not.

ANNEX II - Tables and Figures

TABLES

Table 1: **Image of the European Union in 2016. Source: Eurobarometer**

Country	Positive image of EU	Negative image	Positive/negative
EL	16	51	0,31
CV	27	41	0,66
CZ	26	34	0,76
UK	31	36	0,86
AT	32	37	0,86
DE	29	29	1,00
BE	35	31	1,13
NL	33	29	1,14
SK	30	26	1,15
IT	32	27	1,19
FR	36	29	1,24
ES	30	23	1,30
HU	33	25	1,32
SE	36	26	1,38
DK	34	23	1,48
FI	33	22	1,50
SI	32	20	1,60
LV	31	18	1,72
EE	33	17	1,94
HR	37	19	1,95
LU	45	22	2,05
PT	41	18	2,28
BG	51	17	3,00
RO	42	14	3,00
PL	47	15	3,13
MT	41	13	3,15
IE	58	14	4,14
LT	43	9	4,78

Table 2: **Number of European Council meetings and Euro summits since 1975**

		1980	3	1990	4	2000	4	2010	8
		1981	3	1991	3	2001	5	2011	11
		1982	3	1992	3	2002	4	2012	10
		1983	3	1993	3	2003	7	2013	7
		1984	3	1994	3	2004	4	2014	9
1975	3	1985	3	1995	3	2005	4	2015	10
1976	3	1986	2	1996	4	2006	4	2016	5
1977	3	1987	2	1997	4	2007	4		
1978	3	1988	3	1998	4	2008	8		
1979	3	1989	3	1999	6	2009	8		

Source: https://en.wikipedia.org/wiki/List_of_European_Council_meetings

Table 3: **Communication structure, September 2015**

Date	Sender	Receiver	Remark
September 4 noon	-	-	Refugees start to march North from Budapest
September 4 noon	German government spokesman Seibert	Press conference	Germany does not send back Syrian refugees who arrive but holds the view that Hungary is obliged to register them and to take care of them.
September 4	Hungarian PM	Austrian Chancellor	Attempt to talk – but Feymann wants to talk to Merkel first
September 4 evening	Austrian Chancellor	German Chancellor	Attempt to talk – but Merkel giving talk
September 4 evening	German Chancellor	Austrian Chancellor	Agree to let refugees pass. Ask their foreign secretaries to draft explanation for decision
September 4 about 21.00	Hungarian Ambassador to Germany	Head of Chancellery Peter Altmeyer	E-Mail message: Hungary cannot be handle registration anymore, lets them pass
21.00	German FS	Austrian FS	Meeting in Paris, draft explanation that never gets published
Later	Hungarian FS Péter Szijártó	Austrian FS	Ask him to ask Austrian Chancellor to talk to Orban
Later	Austrian Chancellor		Says that he will talk to Hungarian PM in the morning
Later	János Lázár	Media	Says that Fayman does not talk to Orban
About Midnight	Austrian Chancellor	Hungarian PM	Content not reported
During the night	German Chancellor	Austrian Chancellor	
September 5, 9.00	German Chancellor	Hungarian PM	

Source: <http://www.faz.net/aktuell/ein-jahr-fluechtlingskrise-ueberrollt-14418217.html>

Table 4: **Personal meetings between Hollande, Juncker and Merkel and EU heads of state in September 2016**

Juncker	Belgian PM
Juncker	German Chancellor
Merkel	Belgian PM
Merkel	PMs of Luxemburg and Romania
Merkel	Leaders of Lithuania, Malta, Poland and Lithuania
Hollande	PM Romania
Hollande	Renzi, Mediterranean leaders
Merkel	leaders of Greece, West Balkans
All	Bratislava Summit

Source: Various calendars.

Table 5: President Juncker's meetings with EU Prime Ministers, Presidents and other EU officials 2016

Date	Meeting with (name)	Date	Meeting with (name)
January		July	
15	Draghi	24	Hollande
29	Cameron		
		September	
February		1	Michel
9	Tusk	2	Merkel
16	Cameron	15	Fico
17	Tsipras	16	Bratislava Summit
18	Tusk		
		October	
April		5	Kern
16	Rutte	6	Marti
18,19	Council	21	Council
29	Presidents of EU's Outermost Regions	22	May
June		November	
1	Fico	24	EU -Ukraine Summit
13	Draghi		
20	Tsipras	December	
22	Kern	1	Rajoy
24	Rutte		
28	Cameron, Renzi, Sobotka, Council		

Source: https://ec.europa.eu/commission/commissioners/2014-2019/president_en#calendar

Table 6: **Meetings of the High Representative**

Participation of meetings of the High Representative of the Union for Foreign Affairs and Security Policy with EU Prime Ministers with Foreign Secretaries and high EU Officials in the first half of 2016

Date	Meeting
Feb. 5-6	All EU foreign ministers
Feb. 13-14	Munich security conference
March 13	Meeting on Syria in Paris
March 14	Foreign Affairs council
March 17-18	European council
April 18	Foreign Affairs council
April 19	Foreign Affairs council defense
	Rome Charlemagne prize
May 19	Ministerial Meeting F, D, UK, US
May 20	Nato foreign ministers
Juni 1	Bratislava, Slovakia, for an official bilateral visit.
June 2	Travels to Warsaw, Poland, for an official bilateral visit.
June 3	Participates in the International Conference on the Middle East, in Paris.
June 30-31	Travels to Bratislava, Slovakia, and participates in the Meeting of the European Commission with the Slovak Presidency of the Council (until 01/07).

Source: https://ec.europa.eu/commission/commissioners/2014-2019/mogherini_en#calendar

Table 7: **President Hollande's meetings with EU Prime Ministers and EU Officials, September 2016**

Date	Meeting
September 1	Déplacement à Evian pour les 25èmes rencontres franco-allemandes
September 9	Sommet des pays méditerranéens de l'Union européenne
September 13	Visite d'Etat en Roumanie
September 15	Entretien avec Mme Angela Merkel, chancelière de la République fédérale d'Allemagne
September 16	Sommet informel de l'Union européenne en Slovaquie
September 28	Entretien avec M. Nicos Anastasiades, président de la République de Chypre
September 28	Dîner avec Mme Angela Merkel, M. Jean-Claude Juncker et une délégation de l'ERT

Source: www.elysee.fr/chronologie

Table 8: Chancellor Merkel's meetings with EU Prime Ministers and EU Officials 2016

	January	February	March	April	May	June
1						
2						
3						
4		Supporting Syria/ London				
5		António Costa			Renzi	
6						
7		Schulz, Hollande	Meeting with Turkey	Hollande		
8						
9						
10						
11						
12		Szydło		Schulz, Juncker		
13						
14						
15	Draghi					
16		Tusk				Fico
17			Council			
18		Council	Council			
19		Council				
20						Schulz
21						
22						Szydło
23				Tusk		Kern
24						
25				Hollande, Cameron, Renzi		
26						
27				G7-Summit		Tusk
28	Mogherini			Hollande		Council
29	Renzi			Kučinski		Council
30						
31						

July	August	September	October	November	December
1					
2		Juncker			
3					
4	West-Balkan Conference				
5					
6					
7					
8	Nato-Summit				
9		Iohannis, Michel, Bettel			
10					
		Grybauskaitė, Anastasiades, Costa, Muscat, Kučinskis			
11					
12					
13					
14					
15		Hollande Informal meeting of group 27			
16					
17					
18	Donald Tusk,				
19					
20	May		Council		
21			Council		
22	Renzi, Hollande				
23					
24	Rõivas	West-Balkans- Meeting			
25	Zeman				
26	PMs NL, SWE, FIN, DK,...				
27					
28		Juncker, Hollande			
29					
30					
31					

Source: https://www.bundeskanzlerin.de/Webs/BKin/DE/AngelaMerkel/Terminkalender/kalender_node.html

Table 9: **The Lithuanian Prime Minister Algirdas Butkevičius' meetings with EU Prime Ministers and EU Officials July-December 2016 according to <http://ministraspirmininkas.lrv.lt/en/news?page=1>**

No meetings

Table 10: **The Lithuanian Prime Minister Algirdas Butkevičius' congratulations (selection)**

Date	Meeting
27 August	Prime Minister congratulates Moldova on the Independence Day
1 September	Prime Minister congratulates Slovakia on Constitution Day
21 September	Prime Minister congratulates Malta on the Independence Day
8 October	Prime Minister congratulates Croatia on the Independence Day
12 October	Prime Minister's congratulations on the National Day of Spain
23 October	Prime Minister's greetings to Hungary celebrating its Republic Day

Source: <http://ministraspirmininkas.lrv.lt/en/news?page=1>;

Table 11: **Uninformed citizens
Special Eurobarometer 398QA21
How Informed do you feel about the causes of the financial crisis?
EU 27**

How informed	Percent
Very well	10
Fairly well	44
Not very well	35
Not at all	10

Table 12: **Positive view of free markets 2007**

Country	Percent positive view of free markets
Italy	73
UK	72
Spain	67
Germany	65
France	56

Source: <http://www.pewglobal.org/2007/10/04/world-publics-welcome-global-trade-but-not-immigration/>

Table 13: Ranking of the politically most influential economists (German politicians) with their Alma Mater

Rank	Name	Quotes	Undergraduate	Graduate studies
1	Clemens Fuest	110	Cologne	Munich
2	Hans-Werner Sinn	84	Münster	Mannheim
3	Marcel Fratzscher	51	Oxford	Florence
4	Lars Feld	33	Saarbrücken	St Gallen
5	Peter Bofinger	29	Saarbrücken	Saarbrücken
6	Achim Wambach	28	Cologne	Oxford
7	Gustav Horn	27	Bonn/Oxford	Berlin
8	Michael Hüther	16	Gießen/ U. East Aglia	Gießen
9	Rudolf Hickel	15	Tübingen	Tübingen
10	Folkhard Isermeyer	14	Göttingen	Göttingen
11	Christoph Spengel		Mannheim	Mannheim
12	Paul Krugman	13	Yale	MIT
13	Christoph Schmidt	12	Mannheim	Princeton
14	Martin Hellwig	11	Marburg, Heidelberg	MIT
15	Justus Haucap	10	Saarbrücken	Saarbrücken
16	Axel Börsch-Supan	10	München	MIT
17	Bernd Fitzenberger	10	Konstanz	Stanford
18	Joachim Ragnitz	10	Köln	Köln
19	Thomas Piketty	9	Paris	EHESS/LSE
20	Axel Ockenfels	9	Bonn	Magdeburg

Source: Frankfurter Allgemeine Zeitung and own internet research

Table 14 : Composition of the French Conseil d'analyse économique in 2016

Présidente: Agnès Bénassy-Quéré	Philippe Martin
David Thesmar	Pierre Mohnen
Jean Tirole	Guillaume Plantin
Lionel Fontagné	Corinne Prost
Pierre Cahuc	Xavier Ragot
Philippe Askenazy	Alain Trannoy
Antoine Bozio	Etienne Wasmer
Brigitte Dormont	Guntram Wolff
Cecilia Garcia-Penalosa	

Source: <http://www.cae-eco.fr/-Membres-du-conseil-60-.html>

Table 15: Languages spoken

EB 77.1 Feb-March 2012 (EB 64.3 Nov-Dec 2005)

D48T1 Languages you speak well enough in order to be able to have a conversation - EU 27

Country	2012	2005
English	38	38
French	12	14
German	11	14
Spanish	7	6
Russian	5	6

FIGURES

Figure 1: **Trust in EU Institutions**
(Eurobarometer QA16 and QA8a, Spring values only)

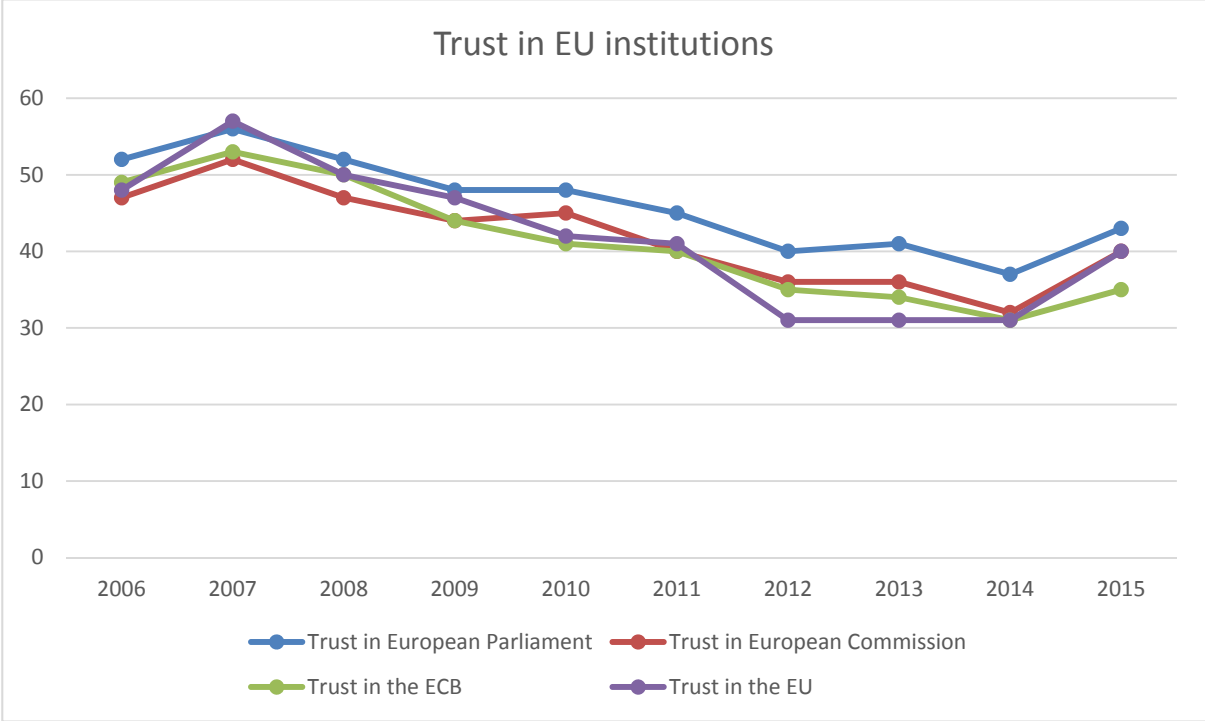


Figure 2: **Trust in national governments and European institutions**
(Eurobarometer QA8a, Spring values only)

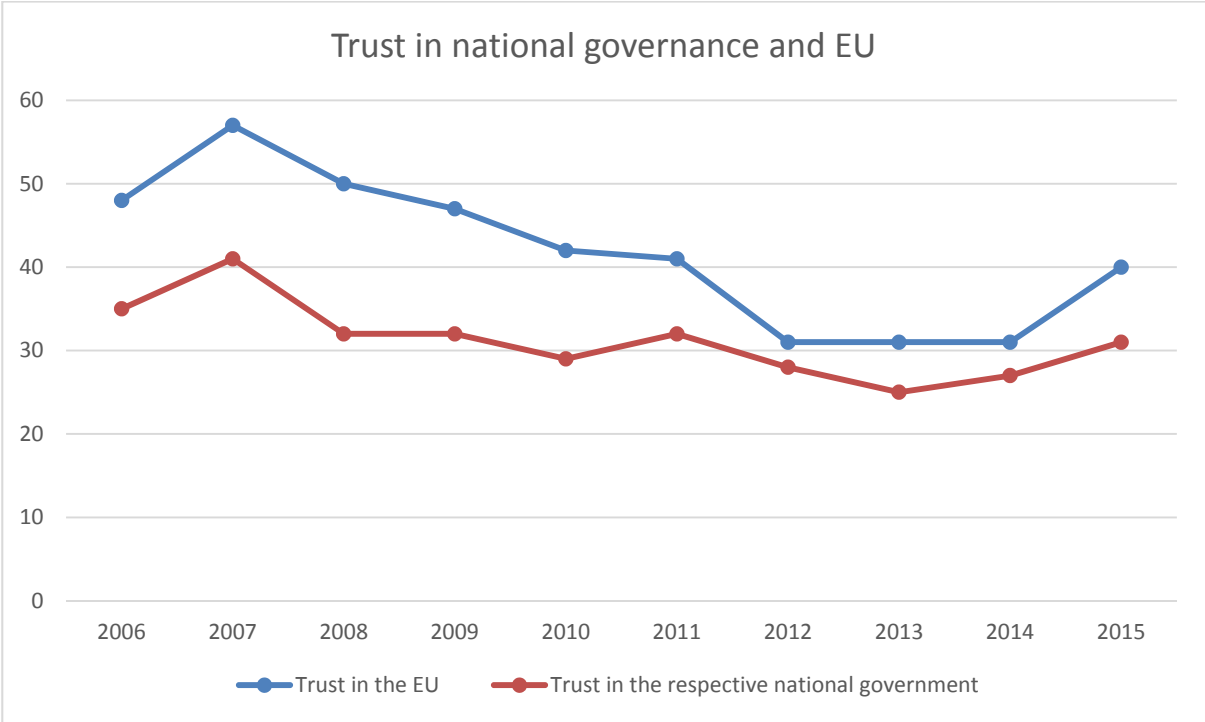
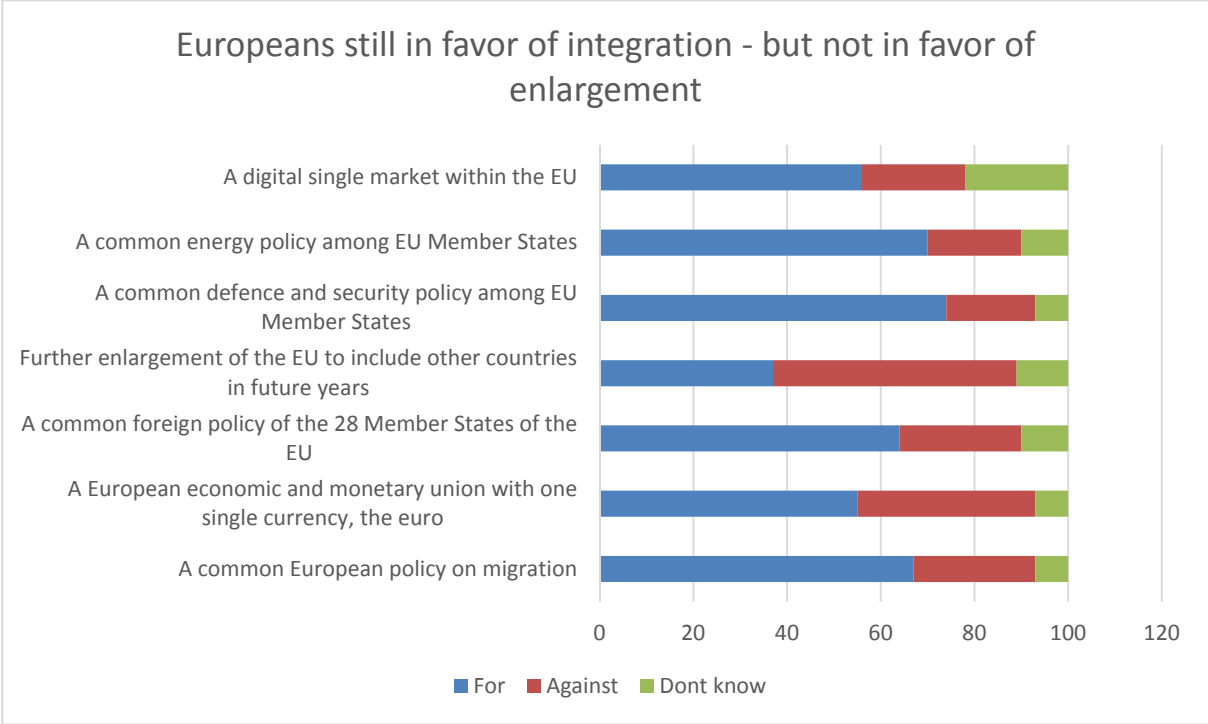


Figure 3: Preferences for a common policy approach in different policy areas, Fall 2016



Source: Eurobarometer 86.2, QA17

Figure 4: The I-E Model

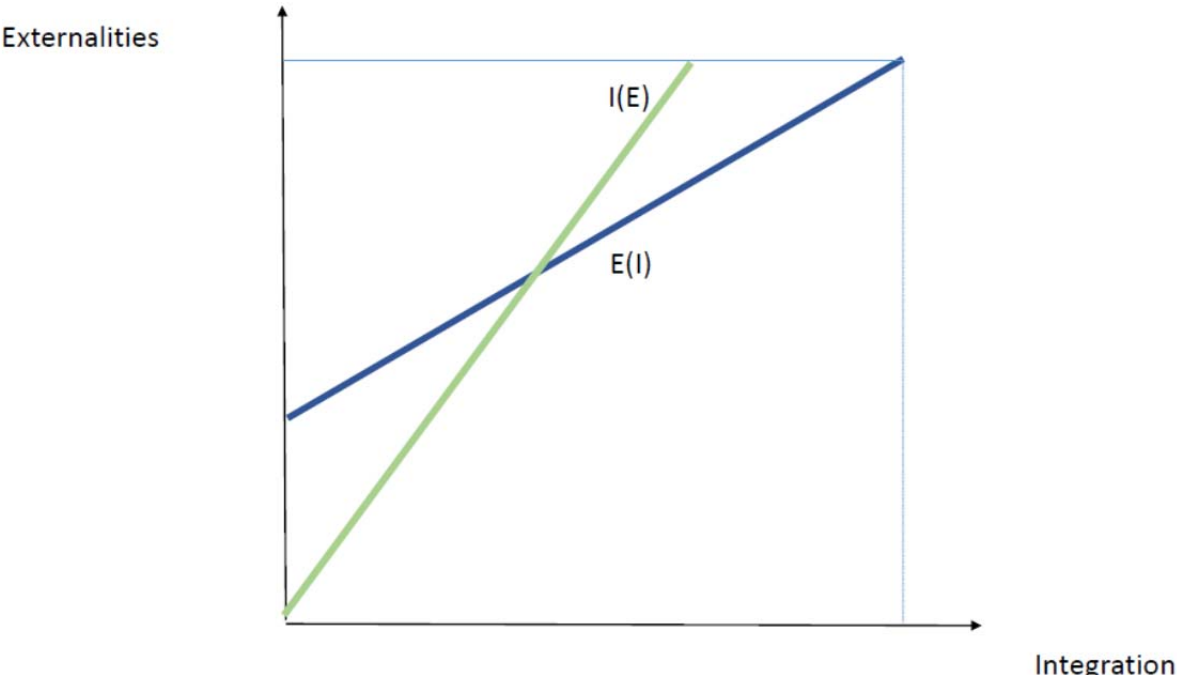


Figure 5: Deepening

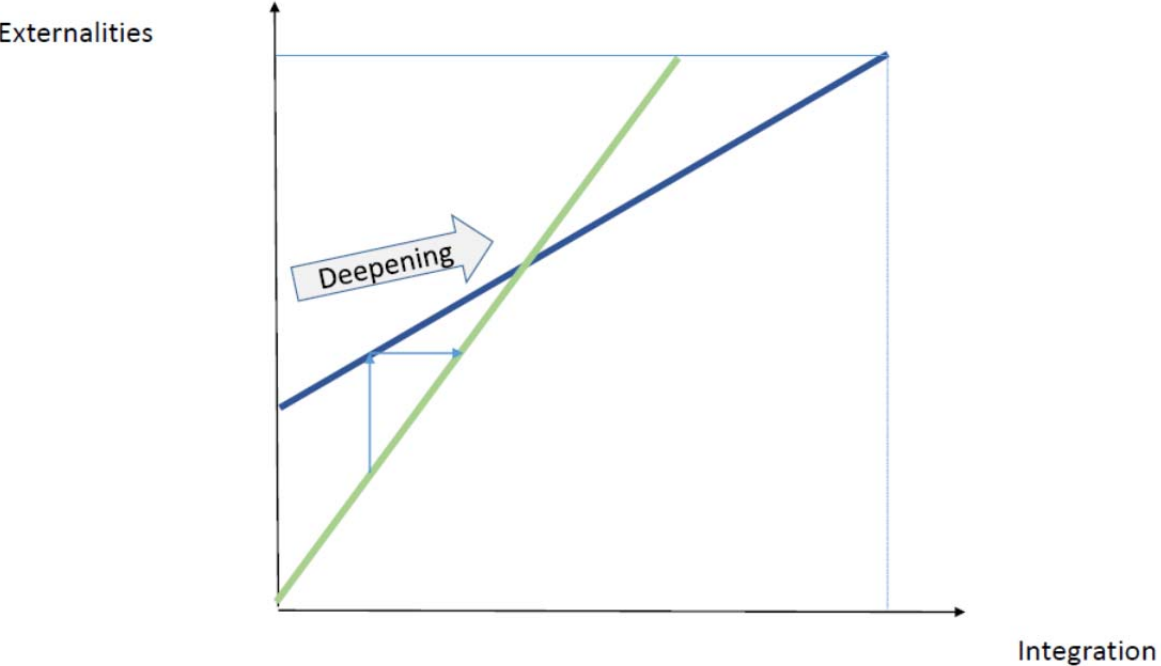


Figure 6: An exogenous increase of externalities

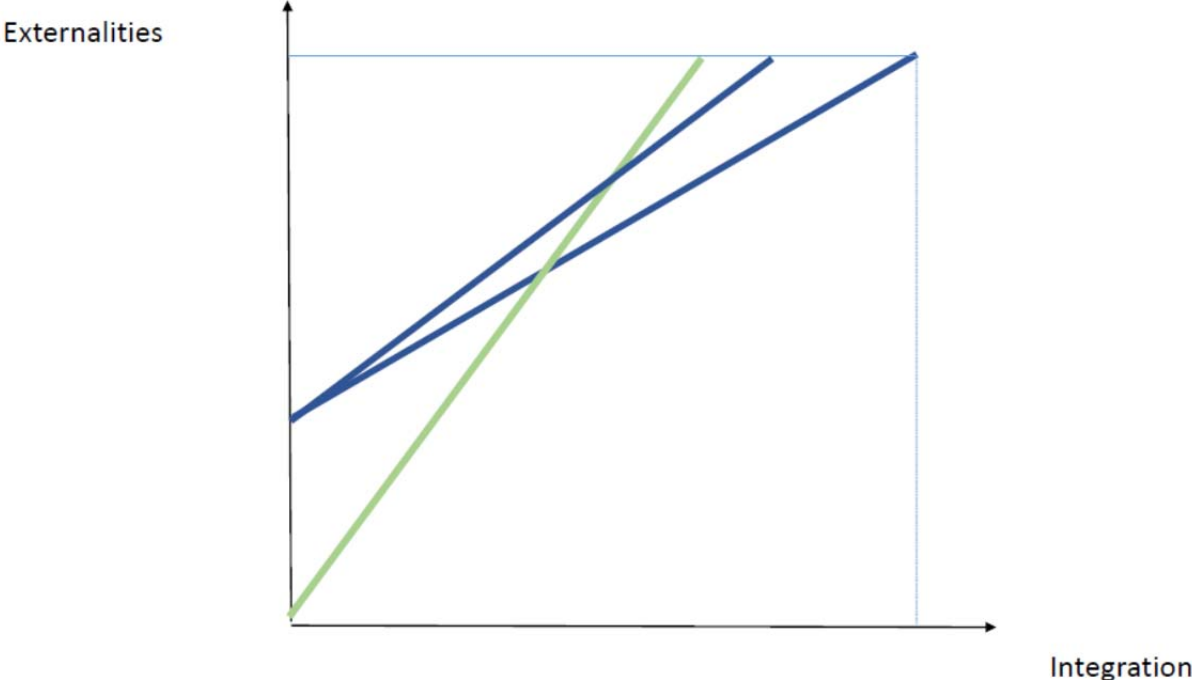


Figure 7: Equilibrium multiplicity

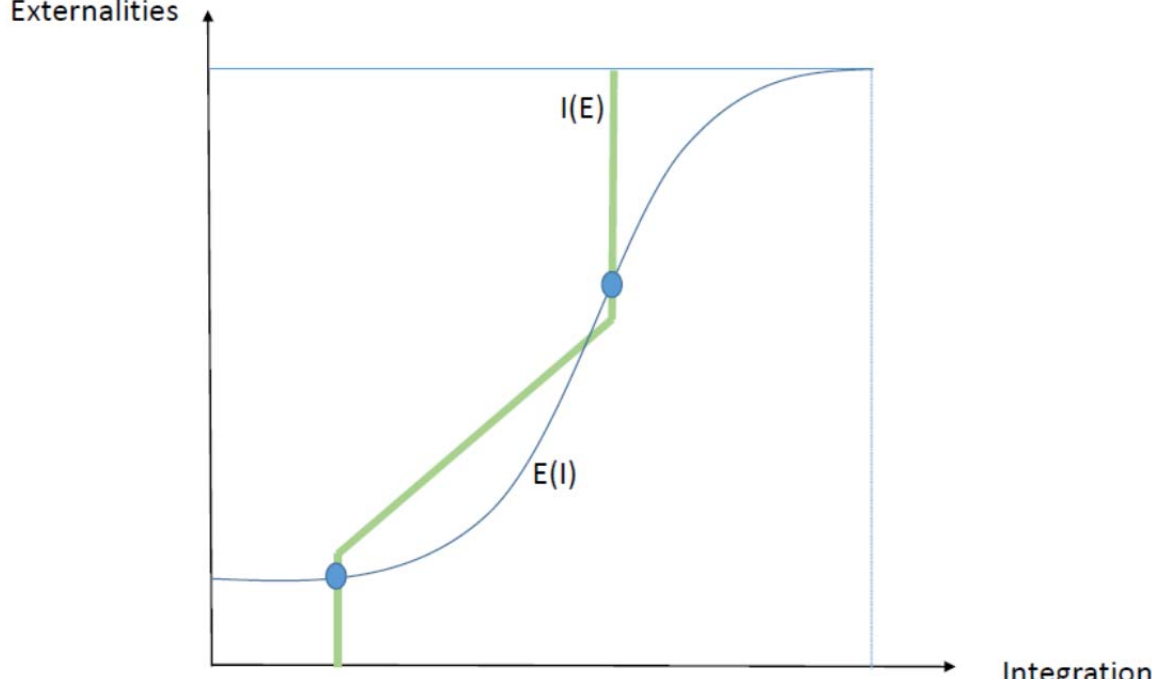


Figure 8: Unravelling due to a small shift in taste for integration

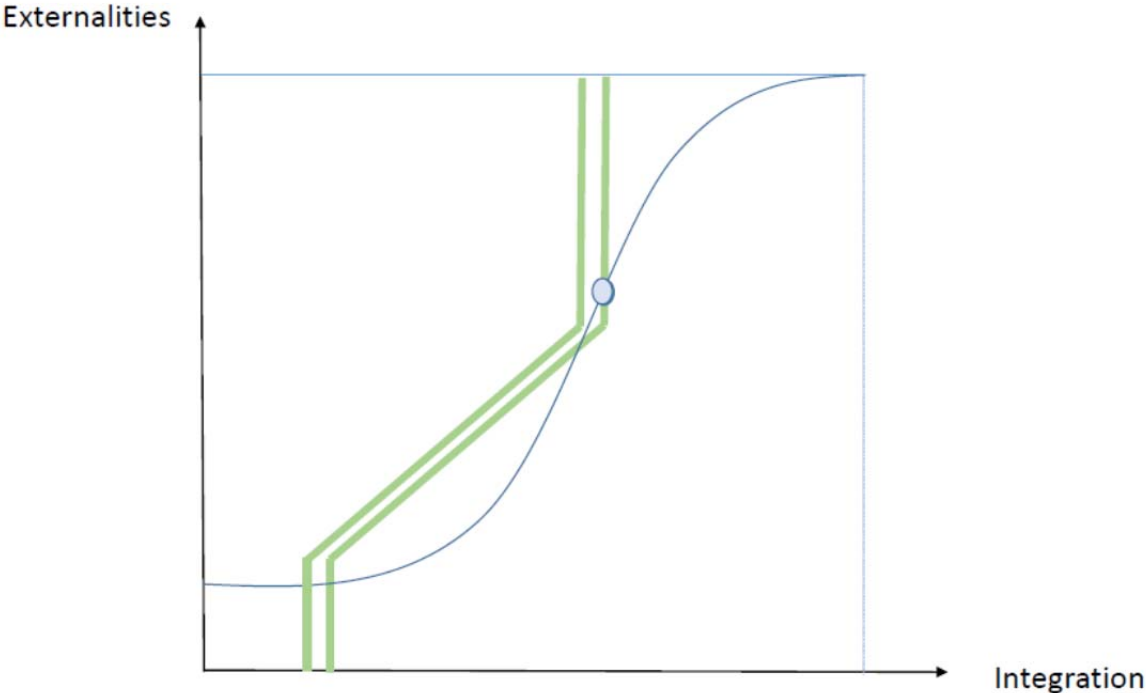


Figure 9: More externalities, less integration

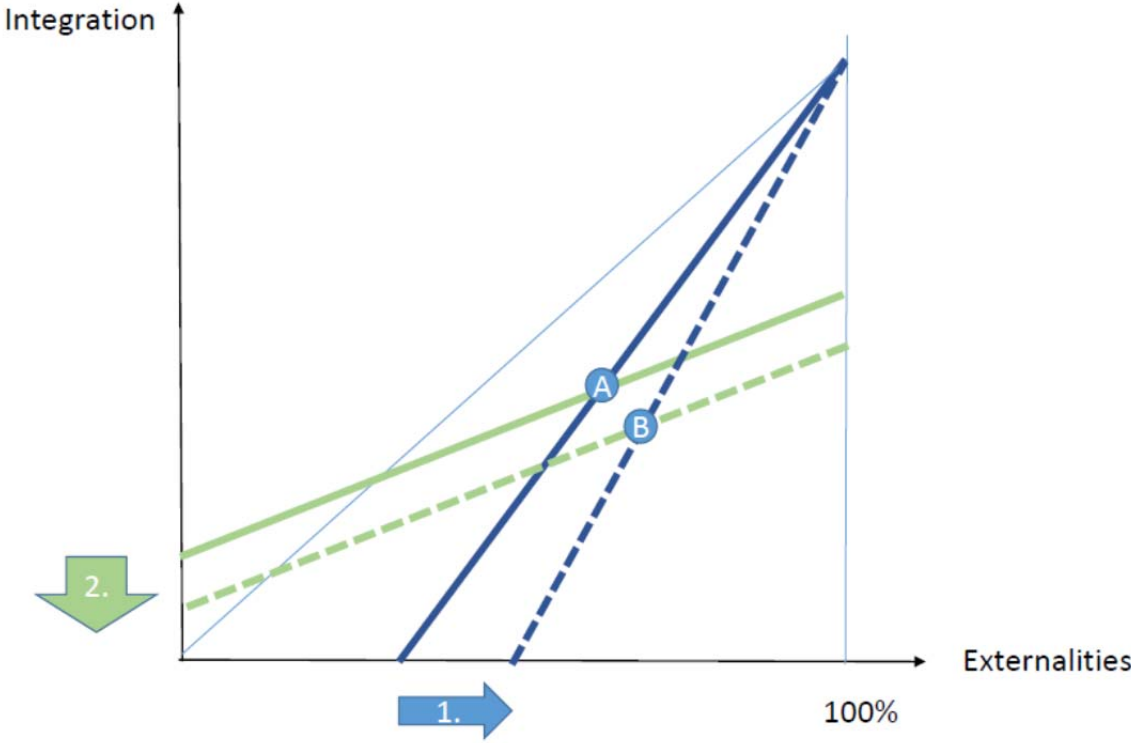


Figure 10: Overshooting

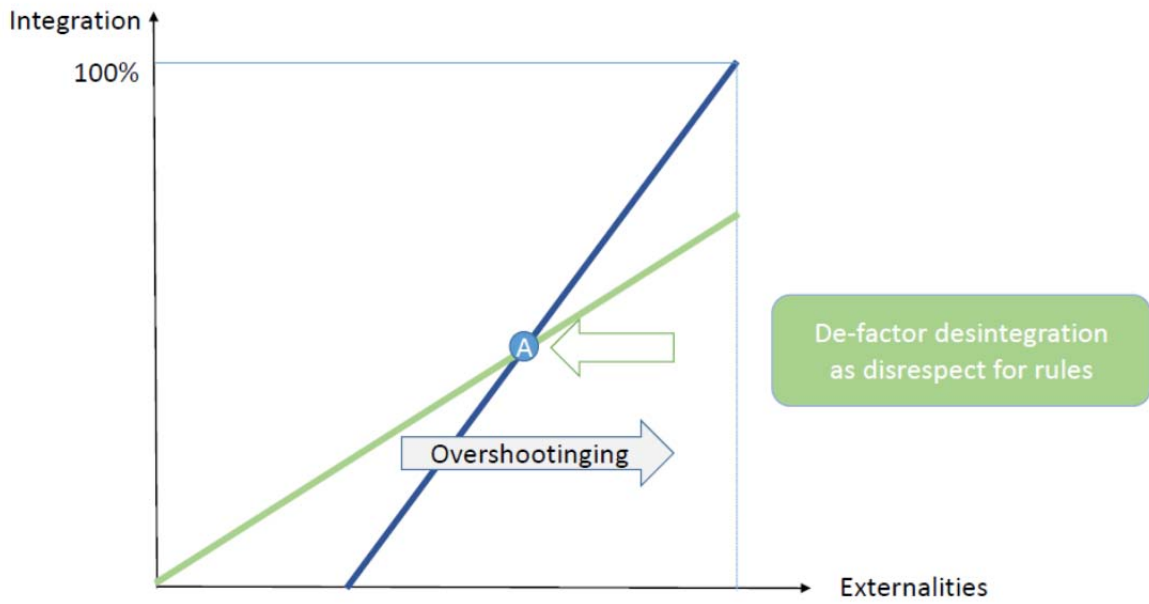


Figure 11: Support for EU deepening 2008 and 2014. Data Source ESS.

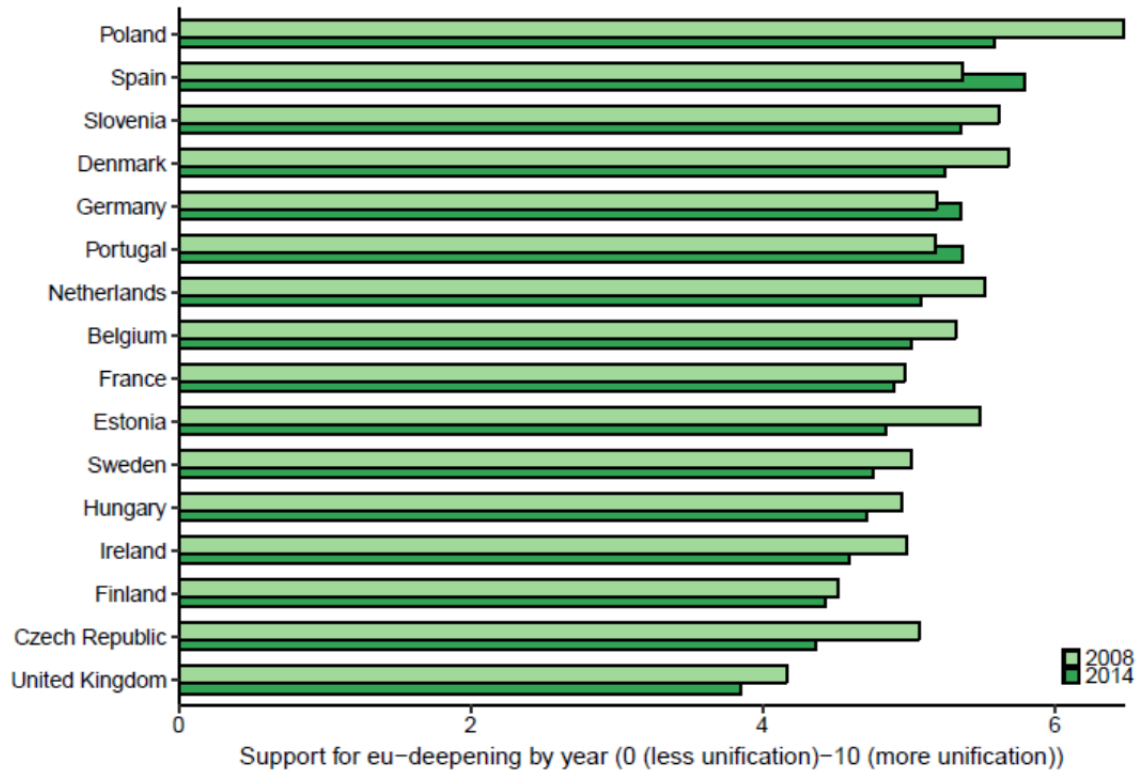


Figure 12: Support for EU deepening. Difference of averages from 2014 and 2008. Original statements range from 1 to 10. A positive difference means that average support has increased. Data Source ESS. Countries with above average Euro-area debt/GDP ratio in Q3/2016 in lighter color.

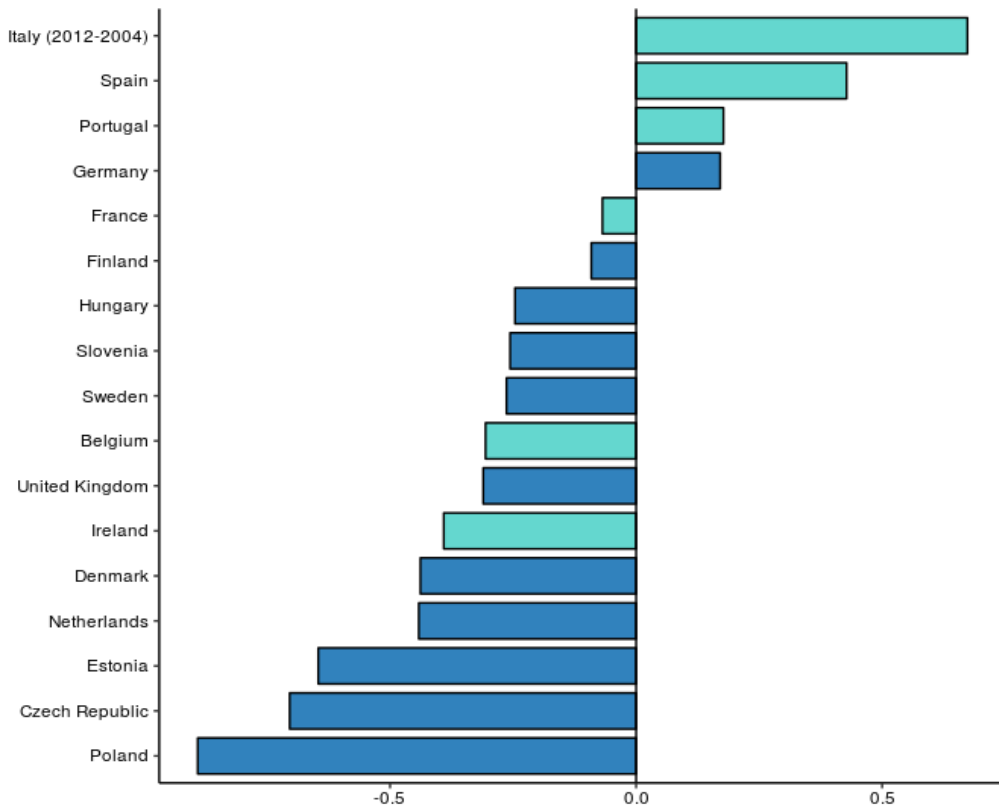


Figure 13: Support for EU deepening. Development of shares of different responses, 10 indication strongest support for deepening and 1 strongest support for the view that deepening has gone too far. Data Source ESS.

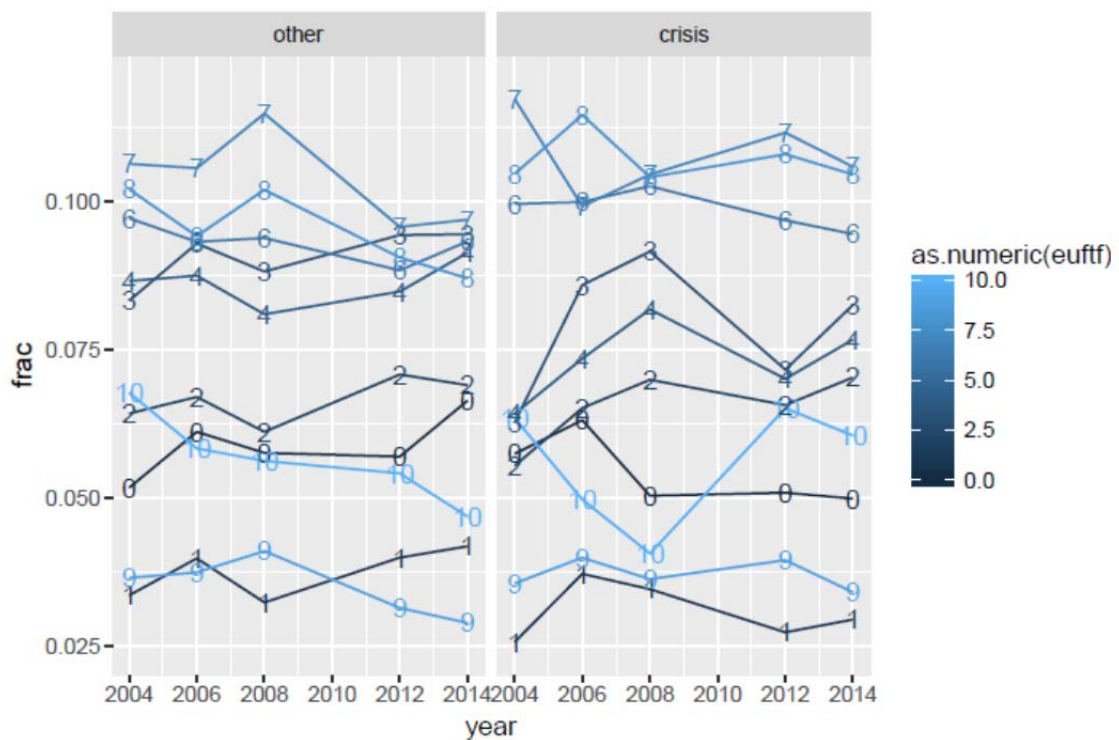


Figure 14: Joint development of the debt to GDP ratio and the average support for EU deepening. Sources ESS and Eurostat.

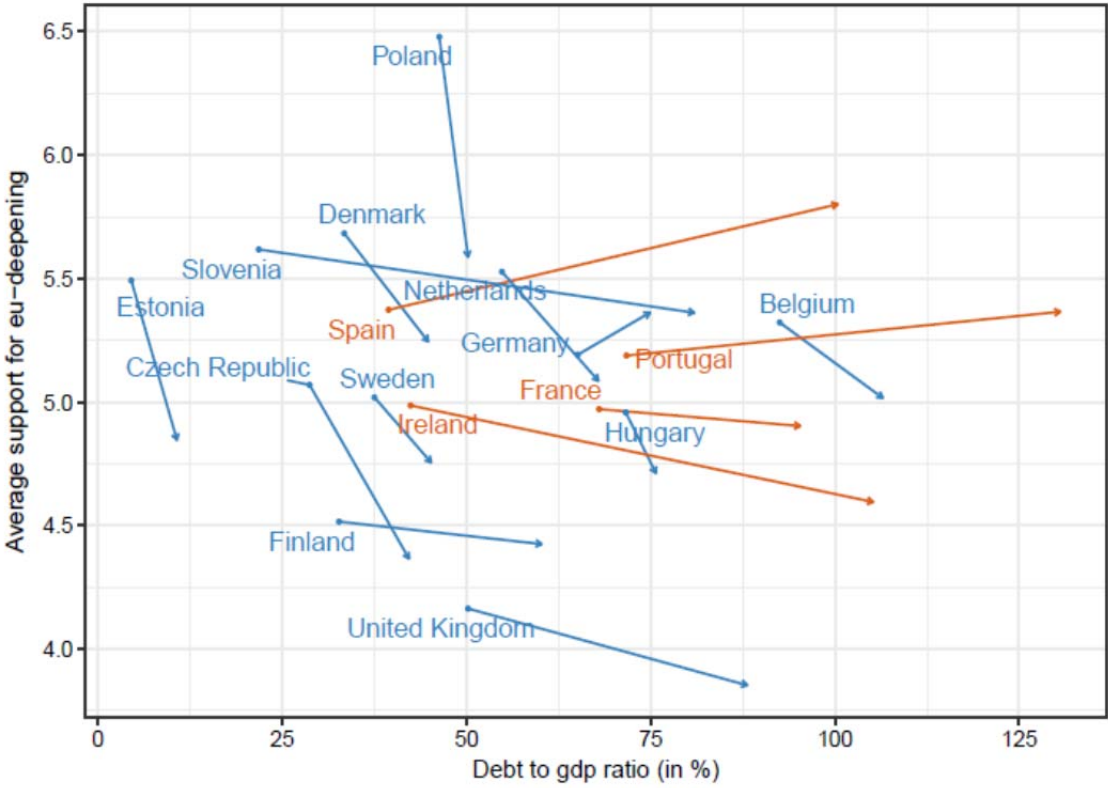


Figure 15: Development of Inequality. Gini coefficient for EU countries 2008 and 2014.

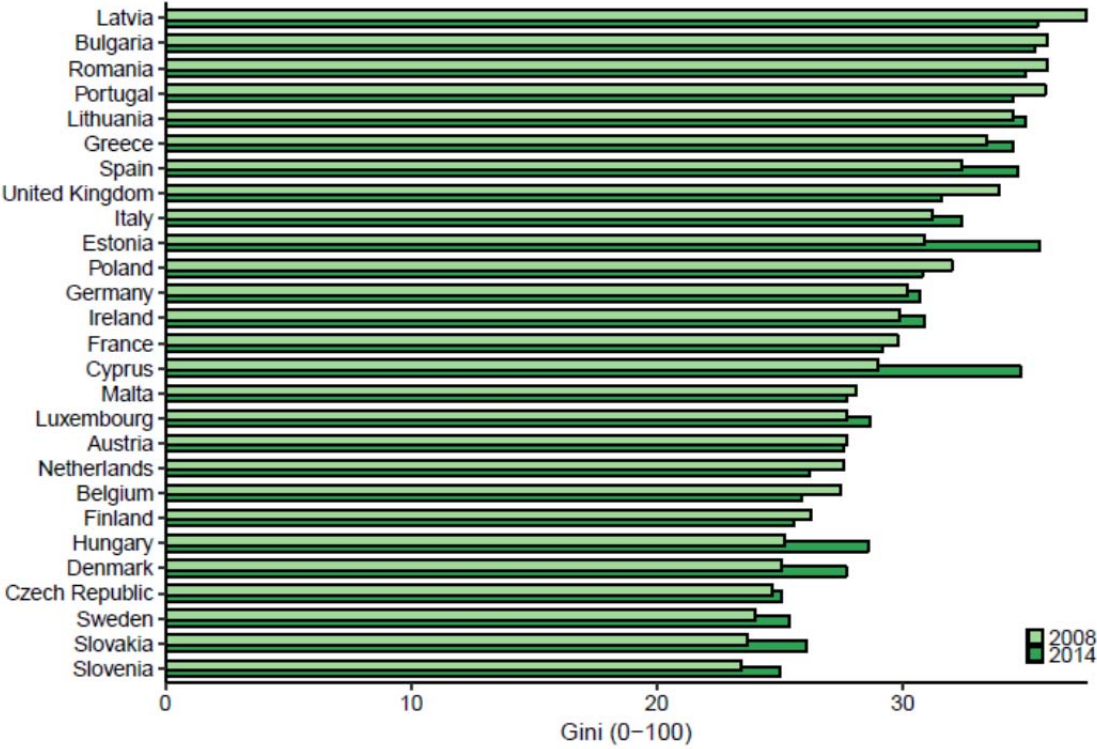


Figure 16: Development of Inequality. Change of the Gini coefficient (ranging from 0 to 100) for EU countries from 2008 to 2014. Countries with above average Euro-area debt/GDP ratio in Q3/2016 in lighter color.

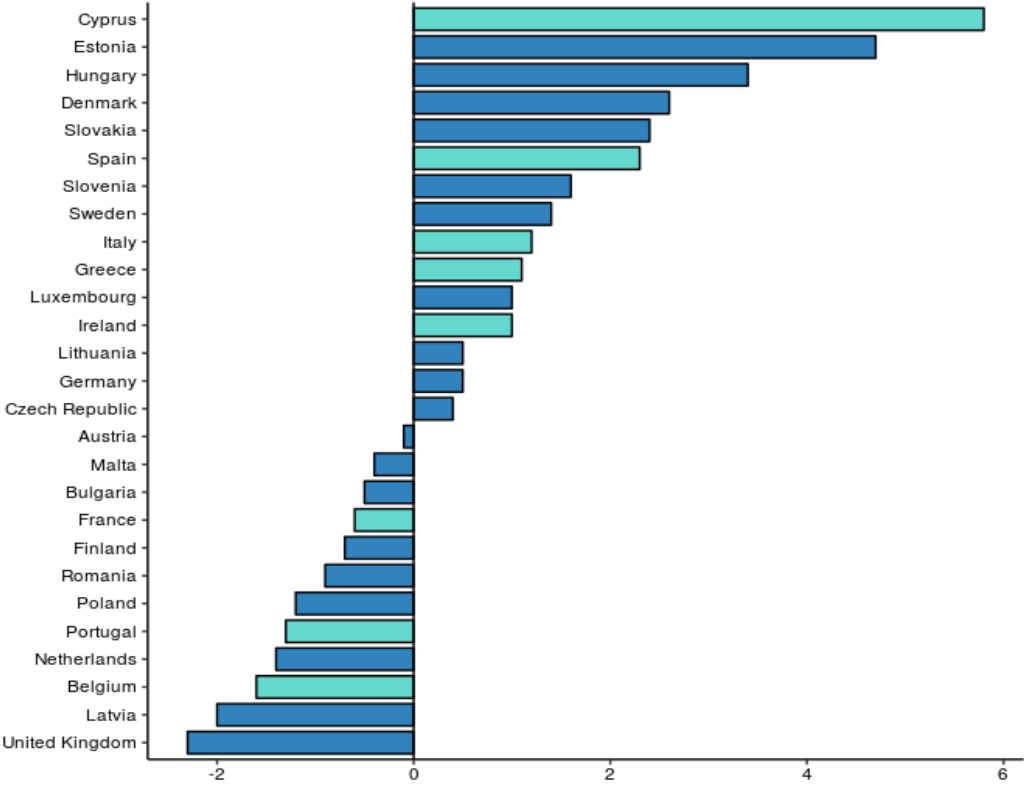


Figure 17: Joint development of inequality and the average support for EU deepening. Sources ESS and Eurostat.

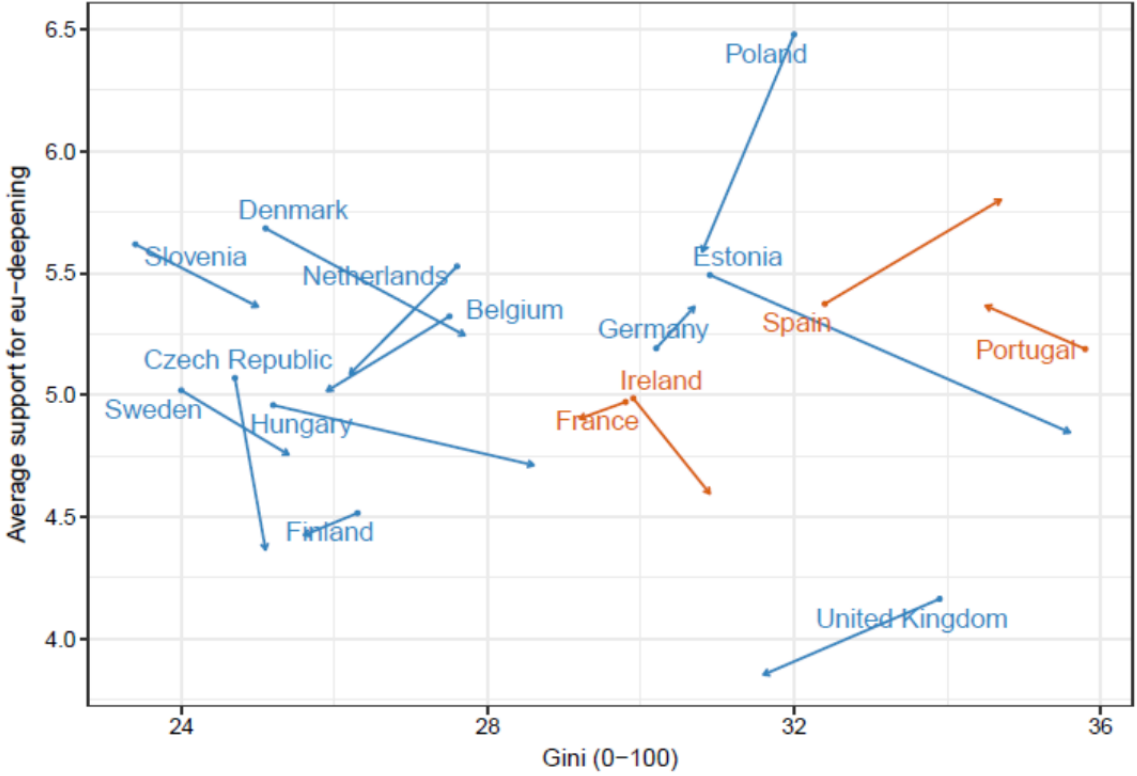


Figure 18: Support for redistribution 2014-2008. Values are average responses to ESS question gincdif, rescaled from 0 to 4 with 4 expressing strong support for redistribution. Countries with above average Euro-area debt/GDP ratio in Q3/2016 in lighter color.

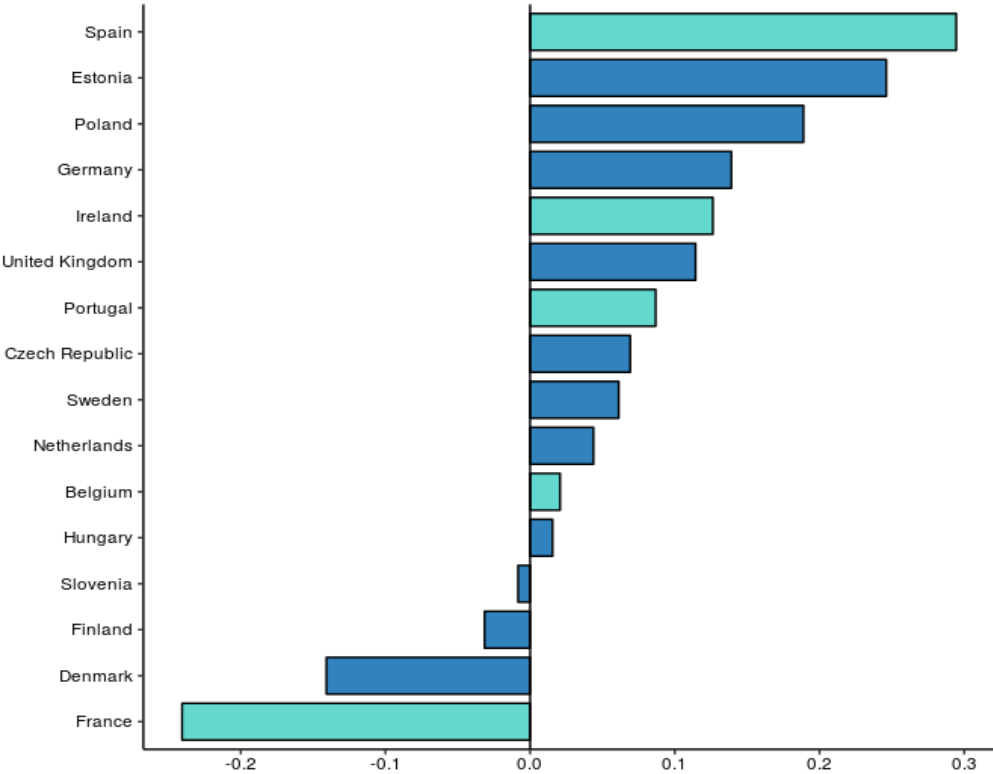


Figure 19: Support for redistribution 2008 and 2014. Values are average responses to ESS question gincdif, rescaled from 0 to 4 with 4 expressing strong support for redistribution.

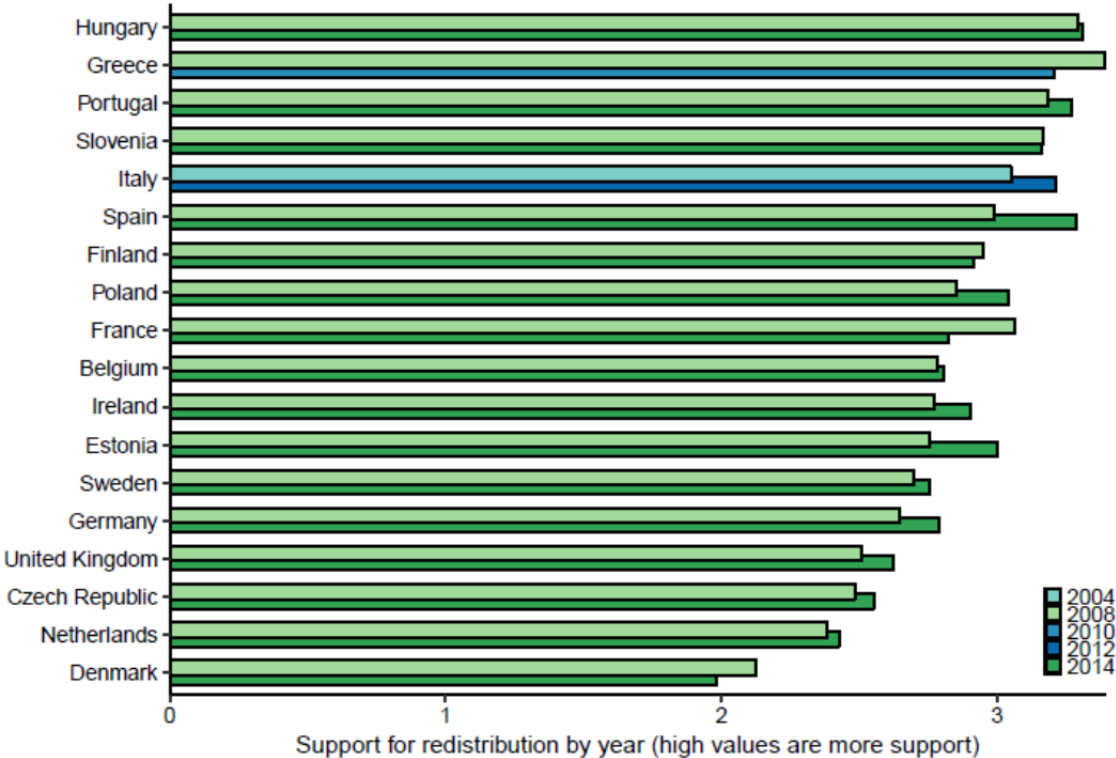


Figure 20: Illustration of meeting structure September 2016

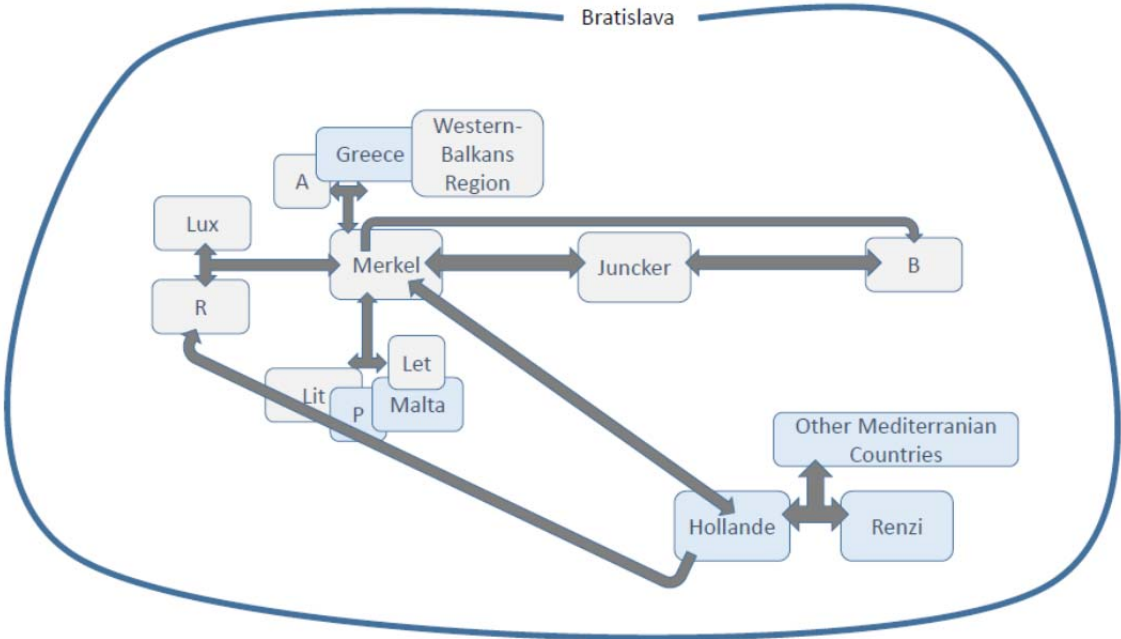
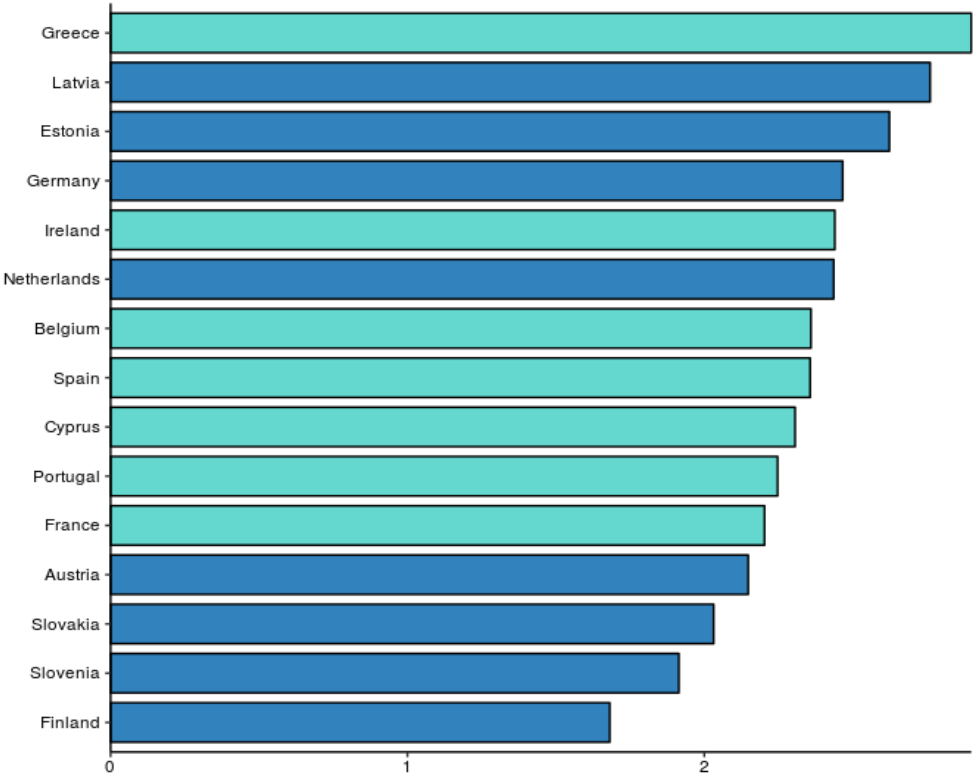


Figure 21: Acceptance of income differences due to talent and effort: country averages with individual responses ranging from 0 to 4. Countries with above average Euro-area debt/GDP ratio in Q3/2016 in lighter color.



EUROPEAN ECONOMY DISCUSSION PAPERS

European Economy Discussion Papers can be accessed and downloaded free of charge from the following address:

[https://ec.europa.eu/info/publications/economic-and-financial-affairs-publications_en?field_eurovoc_taxonomy_target_id_selective=All&field_core_nal_countries_tid_selective=All&field_core_date_published_value\[value\]\[year\]=All&field_core_tags_tid_i18n=22617](https://ec.europa.eu/info/publications/economic-and-financial-affairs-publications_en?field_eurovoc_taxonomy_target_id_selective=All&field_core_nal_countries_tid_selective=All&field_core_date_published_value[value][year]=All&field_core_tags_tid_i18n=22617)

Titles published before July 2015 under the Economic Papers series can be accessed and downloaded free of charge from:

http://ec.europa.eu/economy_finance/publications/economic_paper/index_en.htm

Alternatively, hard copies may be ordered via the “Print-on-demand” service offered by the EU Bookshop: <http://publications.europa.eu/bookshop>.

HOW TO OBTAIN EU PUBLICATIONS

Free publications:

- one copy:
via EU Bookshop (<http://publications.europa.eu/bookshop>);
- more than one copy or posters/maps:
 - from the European Union's representations (http://ec.europa.eu/represent_en.htm);
 - from the delegations in non-EU countries (https://eeas.europa.eu/headquarters/headquarters-homepage/area/geo_en);
 - by contacting the Europe Direct service (http://europa.eu/europedirect/index_en.htm) or calling 00 800 6 7 8 9 10 11 (freephone number from anywhere in the EU) (*).

(*) The information given is free, as are most calls (though some operators, phone boxes or hotels may charge you).

Priced publications:

- via EU Bookshop (<http://publications.europa.eu/bookshop>).

