Building Trust between Suspicious Minds

2.1 INTRODUCTION

The modern international system is constructed on the principle of the sovereign nation-state whose citizens have taken their destiny into their own hands. But the actions of nation-states clearly have consequences that go beyond national boundaries. Their economic success or failure impacts conditions elsewhere; they may set positive or negative policy examples; and they may deliberately seek to impose costs on other countries. Coordination between nation-states can clearly create a public good. But to what extent is that element of coordination compatible with the philosophy of the nation-state, and the choices made by citizens in the national context?

Most coordination institutions have states as their members and are owned by states. There is the United Nations Organization, built on lessons learnt from the experience of the League of Nations. The European Union is also built around the same principle, and gives micro-states like Cyprus, Luxembourg, and Malta a formally equivalent voice to France, Germany, or Italy in many institutional settings (including the European Central Bank, ECB). Given global and regional links, in what sense is the nation-state the appropriate setting for thinking about public goods and the general welfare of its citizens?

How is interaction within and between nation-states shaped? Trust is one of the most important elements that hold societies together. Trust is the basis of confidence: indeed the etymological root of 'confidence' is the Latin *confidere*: trusting together. Trust enables economic, social, and political interactions both within countries and internationally. It is also instrumental in forging common social identities. It is strengthened when there is contractual security in a relationship; but it is also created by the simple existence of repeated and continuing interactions between people. There is a spiral of interaction: trust allows good rules to be formulated, and good rules make for more trust. But conversely, the absence of rules increases distrust and makes it hard to establish a secure contractual framework.

The project of building a functional collaborative European community of nations is in many ways a unique experiment (Kohli, 2000). It crucially depends on trust in different ways and on a multitude of levels. Trust between people (individuals) of different nationalities impacts social cohesion within Europe and the eventual forming of an ambiguous and blurry European identity as part of the multi-dimensional identities of people in Europe. Trust between economic entities is essential for fostering close international business relationships and creating successful multi-national business networks across Europe.

Mutual trust has also developed as a key legal concept in Europe, with a common judicial space, known as the Area of Freedom, Security, and Justice, created by the Treaty of Amsterdam of 1997, whereby member states are committed to mutual recognition, in other words to give full recognition to judicial decisions taken in other jurisdictions across the European Union. This concept depends on mutual trust that similar standards are applied. Generally, since nation-states play the key role in European politics, trust between European states is critical for fostering the spirit of cooperation in Europe. In the words of the well-known Elvis Presley song, "We can't go on together / With suspicious minds / And we can't build our dreams / On suspicious minds." But trust appears to have been weakened in the aftermath of the financial crisis (Dustmann et al., 2017).

In this chapter we discuss the origins of nation-states and their functionality, before analysing trust in the European context between people, in business transactions and internationally. We then talk about whether trust or distrust in national institutions influences attitudes towards European integration and institutions (as well as international order). We conclude by commenting on the trade-offs inherent in one of the most significant European policy tools to-date, namely EU enlargements. Subsequent chapters in this report examine whether plural closer or larger arrangements between states ('clubs') make the task of coordination easier (Chapter 3); and whether the European Union has produced a convergence that may increase levels of trust (Chapter 4). Has enlargement created significant problems of trust, and reduced Europe's ability to confide or *confidere*?

2.2 HISTORY

Nation-states originated at different times in different parts of Europe. By the later Middle Ages, and certainly in early modern Europe, France, England and then the Netherlands were identifiably states with a fiscal capacity and a strongly developed sense of identity, often defined by geography. As Shakespeare eulogised in his play *Richard II*:

> "This royal throne of kings, this scepter'd isle,
> This earth of majesty, this seat of Mars,

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his other Eden, demi-paradise,
This fortress built by Nature for herself
Against infection and the hand of war,
This happy breed of men, this little world."

Further east and south, the nation-state was fundamentally a nineteenth century development. Namely, many peoples of Central, Eastern and South Eastern Europe were, for centuries, ruled by multi-national Austro-Hungarian and Ottoman empires. On the other hand, Germany and Italy emerged as united nation-states at roughly the same time, namely in the third quarter of the nineteenth century and following wars of unification. The later nation-state was partly the product of a new belief in the importance of linguistic identity as a shaper of political community – articulated above all in Johann Gottfried Herder's path-breaking *On the Origins of Language*. But by the mid-nineteenth century, especially in Germany and Italy, this linguistic definition was coupled with another insight: that the nation was an ideal geographic space for economic development and the management of shared resources. Individual German principalities and city states ('Kleinstaaterei') could not deal with the problems of poverty and migration in the impoverished circumstances of the first half of the nineteenth century. They could not construct the railroad systems needed to link natural resources, above all iron ore and coal. In 1868, on the eve of German unification, the influential journalist August Ludwig von Rochau spoke of unity as not being, "A matter of the heart; for Germans, it is fundamentally a purely commercial business" (von Rochau, 1868). There is an obvious parallel between nineteenth century economically-driven state- and nation-building and the late twentieth century process of European integration, where a search for a framework and a rationale for larger markets drove a process of building new institutions, but also of forging a new identity. There was a hope that common symbols – flags, coins, banknotes – would strengthen a new sense of identity.

Identity is also built by pooling resources. However, when resources are transferred in the absence of a powerful belief in coherence and a sufficiently high level of trust, they may be widely perceived as a painful and destructive extraction of resources. Thus, pooling resources can help to build, but also potentially erode common identity. Nation-states initially developed a fiscal capacity primarily for military purposes, but by the second half of the nineteenth century increasingly for the provision of a broader range of public goods, including the education of national citizens, and subsequently for welfare and transfer provisions, too. In the late nineteenth century the German economist Adolph Wagner formulated a 'law' of increasing state activity (Wagner, 1892). The redistributive functions of states expanded greatly in the twentieth century, along with their democratisation.

At the same time as states moved towards economic interventionism and expanded their activity, the locus of economic activity shifted to a much larger geographic basis. Raw materials, foods, metal ores, and other commodities from outside Europe played an increasingly important role. Some commentators began to argue that the age of the classic nation-state had passed, and that the future belonged to just a few colonial empires. Between them, these empires – the British, French, German, and perhaps also the latecomers like the United States, Russia, and even Japan – would rule the world.

There was thus a fundamental paradox: states were just the right size for social protection, but the wrong size for economic activity. That paradox emerges more clearly with the growing globalisation of economic activity.[1] This phenomenon became particularly apparent at both the beginning and the end of the twentieth century, and much less visible in the interwar era as globalisation retreated and a backlash set in. Small states began to feel more vulnerable on their own, and under pressure to collaborate in order to 'manage' globalisation in their best interests.

In multi-national empires, peoples were restive and craved liberation and the creation of their own nation-states. Smaller nation-states in Europe developed a strong sense of identity in the face of the challenges from imperial systems. In cases where the neighbours were highly threatening, as was Germany in the Nazi period, for example, the external threat facilitated the construction of a social compromise. Building social solidarity through redistributive systems that would include farmers and workers became the core of a new and highly successful example of how democratic consensus politics could be built, above all in smaller states, in Scandinavia and in Switzerland.

So nation-states had – in what economic historians now call the first era of globalisation – two options: they could develop into empires (and Belgium could follow the Netherlands in this regard), or they could develop protective mechanisms for cushioning their citizens from the shocks of globalisation. The first option was bound to create international conflict, while the second was moulded by the threat of conflict.

After 1945, the Western European empires (in which coordination was imposed by a single political authority) quickly disintegrated – often violently as in the cases of Algeria, Kenya, and Vietnam. That left the successful small state model based on social solidarity as a European political ideal, but it also meant that the problem of coordination – with countries making trade-offs involving losses in some areas and gains in others – would be the central issue of European politics.

Trust tends to be higher in small states and communities, and larger states tend to require more rules in the absence of trust. Small states are necessarily more open to global interconnections,

[1] For a discussion of the size of nations see Alesina and Spolaore (2003).

and particularly to trade; they have larger social safety nets, transfer mechanisms, and government spending ratios. These can be seen as an ideal defence or compensation mechanism in the face of globalisation (Rodrik, 2011). On the other hand, states that are bigger and more diverse are less inclined to redistribute (Alesina, Glaeser, and Sacerdote, 2001). They are also less open to trade flows. Rather than compensating for globalisation in the small state mode, they try to use power to shape globalisation in a way that fits in with their domestic balance of interests. These differing mechanisms by which small and large states cope with openness and globalisation largely describe adjustments to the development of trade and to trade shocks.

There is another way in which openness impacts the political process, namely through levels of trust. Globalisation creates greater diversity, but may also create bigger shocks and can leave some people feeling like victims of discrimination. As a result, people may become less likely to build or endorse social support networks that are based on trust (Alesina and La Ferrara, 2002). Transfer payments are less popular when citizens suspect others of cheating or being undeserving. That mistrust increases with ethnic or racial diversity. So globalisation, if coupled with increased migration flows, rubs against the trust established in states and undermines the economic and political foundations that make it possible.

As in the past when nineteenth century nation-building created new units and new sizes of political entities, in times of increasing globalisation the question of coordination arises. National political existence is challenged by internationalised economic behaviour. Modern globalisation, even more than earlier instances, binds national fortunes together. Whereas trade globalisation in the nineteenth century mainly referred to the exchange of manufactured goods for commodities, the new variant of globalisation that has emerged by the end of the twentieth century and in the new millennium involves complex global value chains, in which product specialisation means that goods are shipped back and forth in the course of production and assembly (Baldwin, 2017). The worldwide supply chains that complex products like modern jet aircraft require constitute a new form of global integration. The IT revolution marks a potentially even more radical disruption to the old order of things, and to the very notion of a national economy. Participants from all over the world are increasingly finding their place in the global market with rapidly declining search costs (e.g. without having to move in search of a job). This new type of globalisation provides major growth opportunities. At the same time, it is also an important source of vulnerability for national economies. For smaller economies in particular, finding and maintaining their place within global business networks often requires sacrificing full independence in matters of national economic policy. More specifically, the needs of cross-national business networks often contradict the demands for extensive social protection on which people in many European countries have learned to depend. As more jobs go virtual, this is bound to add to the pressure, creating serious strains in the fabric of society.

2.3 REFORM INITIATIVES AND INTERNATIONAL ORDER

Reforms – whether fiscal adjustment or micro-economic changes to labour market institutions – are initially painful and unpopular. Voters may penalise governments that undertake reforms. Politicians who foresee voter defection may be reluctant to implement measures that will later cost them votes and perhaps their office. As a result, reform packages are typically only adopted once a situation has spun out of control and when muddling through becomes impossible. The major phases of economic crises in Europe have always been associated with some sort of coordinated reform exercise.

The 1970s were widely supposed to have discredited fiscal Keynesianism. Smaller economies in Europe – notably in Scandinavia and Austria – abandoned the very high rates of corporate tax that had developed as part of the interwar compromise, because they feared the loss ("exit" in the terminology of Hirschman, 1970) of large corporations. The 1990s saw another wave of crisis, and another wave of fiscal retrenchment in the wake of housing market and bank collapses in Scandinavia. The global financial crisis produced yet another wave of adjustments. An independent fiscal council with advisory functions was seen as one way of countering the pressure of interest groups on governments and parliaments. After the financial crisis, some European countries instituted such councils: Sweden in 2007, Hungary in 2009, and the United Kingdom in 2010. These bodies have been characterised by a high degree of independence, and a willingness to offer critical assessments of government forecasts and policy. However, they have also led to conflict with governments, and the Orban government in Hungary even ended up replacing its fiscal council. The task of establishing national fiscal councils as an instrument of European cooperation was written into the Six Pack of EU reform measures in 2010.

Some reform initiatives may involve an attempt to free ride, to extract advantages for one national collective at the expense of other collectives. That motivation is especially evident in times of economic hardship, and distributing the costs of a crisis outside the national unit is a very appealing option for politicians. Tax policy or bank secrecy are both often cited as examples of this sort of activity. Smaller European countries may introduce lower rates of capital taxation in the hope of attracting enterprises or of incentivising

multinational enterprises to declare their profits in the country, rather than in another jurisdiction.

Hence, there is a demand for externally managed coordination. In the context of European monetary integration, the European mechanism was often presented as a necessary external compulsion to induce reforms for which there would otherwise be no domestic constituency. The European Monetary System was used to enhance policy credibility, as it functioned as a mechanism for "tying hands" (in the phrase of Giavazzi and Pagano, 1988). The introduction of the euro and the process of following the Maastricht convergence criteria was a way of creating incentives, particularly by lowering the cost of government borrowing, and at the same time of setting up restraint mechanisms to establish credibility.

This may be adequate motivation for a one-off reform or belt-tightening exercise, but is very likely to run into reform fatigue. In the language of international institutions, externally imposed programmes are vulnerable because they lack ownership.

2.4 TRUST AMONG EUROPEANS

It is intuitively clear that the extent to which one can integrate Europe into a functional community of nations (no matter what particular form such a community may take) is greatly influenced by how different European nations view themselves and each other. Various European surveys and opinion polls try to get a handle on this issue. Before presenting the evidence, we would like to highlight that it is primarily generated by surveys where respondents answer questions about their attitudes towards European institutions and/or towards various people in Europe. It goes without saying that asking people questions regarding their feeling of trust in theirs and other nationalities is potentially touchy. For this reason, apparently, these questions were not asked in more recent European surveys. Be that as it may, these kinds of surveys say something about stated preferences of Europeans. Unfortunately, we could not find evidence about revealed preferences of Europeans (for example, the extent to which they intermarry and how that changes over time). Genna (2003) argues that the probability of gaining support for the European integration project crucially hinges on the positive view that people have about other nations with whom they are supposed to integrate. Using the results of the Eurobarometer surveys for the first 12 member states, for the years 1986 to 1994, he finds that support for European integration is far stronger for those individuals that express trust in people from Southern European countries. The same is true for people that hold a favourable view of the two most dominant nations in the Union, namely Germany and France.

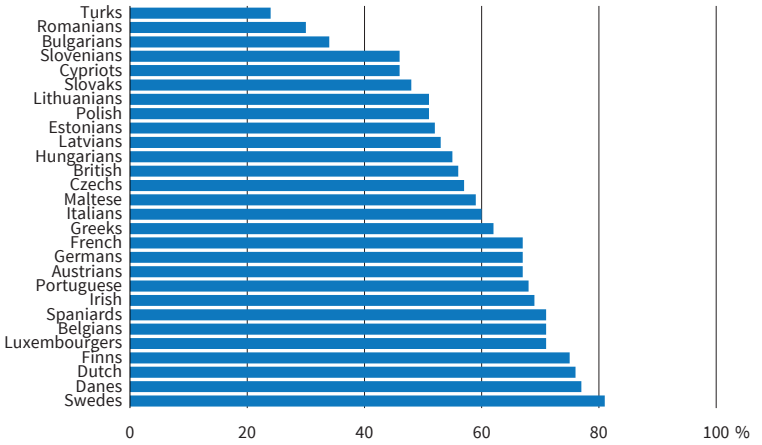
Delhey (2007) discusses how successive waves of European expansion have impacted social cohesion in Europe. He posits that the effect of enlargement on cohesion depends upon how much the existing members differ from the new entrants. The most important differentiating factors are the level of modernisation (including the quality of institutions), cultural proximity (in terms of language and religious proximity) and whether a newcomer is large enough to be perceived as a potential threat. Using Eurobarometer surveys from 1976 to 1997 he finds empirical support for these claims. Moreover, he argues that enlargements towards Northern Europe did not lower social cohesion in the Union. By contrast, expansion towards Southern Europe has done so since these countries differed more both in the quality of their institutions and their cultures from earlier entrants. He goes on to predict that the same would be the case with expansion into Eastern Europe (but this wave of expansion happened in years not included in his sample).

Gerritsen and Lubbers (2010) provide perhaps the most complete and up-to-date study of the factors influencing the trust that EU citizens have both in their fellow co-nationals as well as in members of other European nations. The study is based on over 400,000 trust evaluations made by the European Election Study in 2004. Importantly, and in contrast to previously mentioned studies, this study also includes several Eastern European countries both as trust-givers (a total of 20 countries is included in that sense) and as trust-receivers.

In line with previous studies, citizens of northern countries are trusted the most by other Europeans (see Figure 2.1). Citizens of large European countries like Germans and French are trusted less than those

Figure 2.1

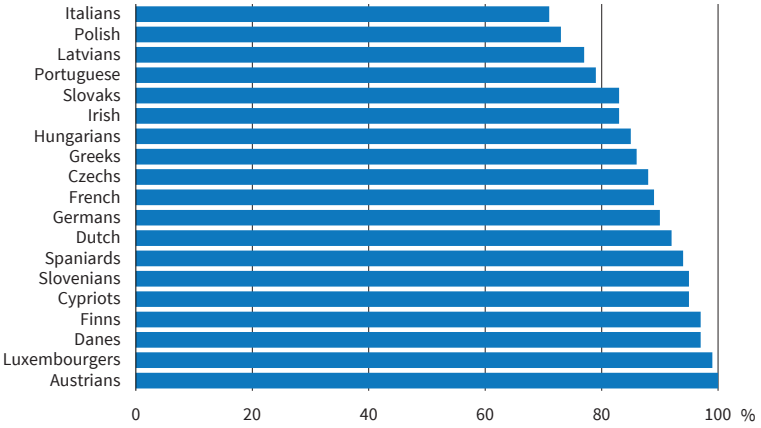
Percentage of People Trusted by Respondents from Other European States



Source: Adapted from Table 1 in Gerritsen and Lubbers (2010).

Figure 2.2

Percentage of People Expressing Trust in Own Population



Source: Adapted from Table 1 in Gerritsen and Lubbers (2010). © CESifo

of Nordic countries and almost to the same degree as Southern Europeans. Below them, in terms of levels of trust by other Europeans, rank Eastern and Central Europeans who had just joined the club in 2004 when the survey was conducted. At the bottom of cross national trust scale were three countries that, at the time of the survey, were not yet members of the EU: Bulgaria, Romania, and Turkey.

It is also interesting to see how much trust various countries place in their fellow countrymen (see Figure 2.2). It is worth noting that Northern Europeans, and especially Austrians, expressed a very high level of trust in their compatriots whereas Italians and several Eastern European nations (and the Irish) seem less inclined to trust each other. But it is also striking that levels of trust vary significantly within individual countries: in the case of Italy, Guiso, Sapienza, and Zingales (2016) argue that the differences in trust levels go back to the medieval experiences of self-governing city-states with high trust in Northern Italy and feudal rule, often with foreign rulers, in the Mezzogiorno.

A related question is the extent to which citizens of various countries trust their own people more than they trust other nations. One tentative way to try to get a handle on that could be to divide the fraction of people that expressed trust in other nations by the fraction of people that expressed trust in their compatriots. We can refer to this measure as relative trust. The smaller the ratio shown in Figure 2.3, the more, in terms of trust, a nation 'discriminates' against other nationalities in relative terms.

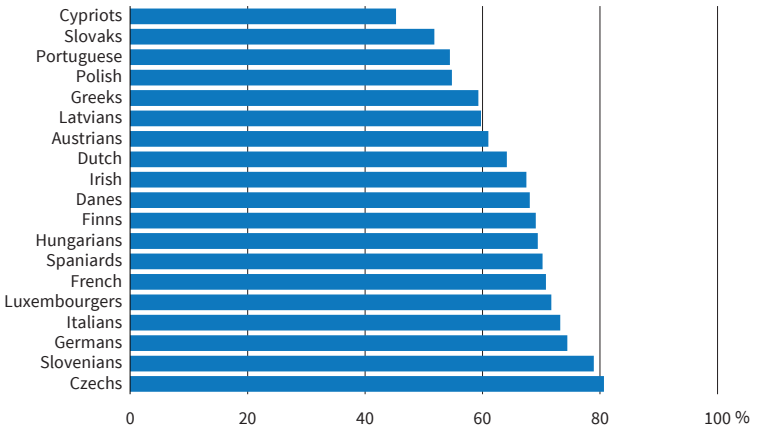
It is worth noting that the citizens of large European nations (Germans, French, and Italians) together with those of smaller states like the Czechs, Slovenians, and Luxembourgers are far less discriminating in relative terms than some Southern and Eastern European nations. There is also a significant difference in the relative evaluation of foreigners by Germans and Austrians, as well as by Czechs and Slovaks. This is curioussince,atfirstglance,nations in each of the two pairs of states are fairly similar to each other.

So, what are the factors that might explain how much Europeans trust their fellow countrymen, as well as other Europeans? When it comes to trust in their own populations, Gerritsen and Lubbers (2010) arrive at a result that contradicts the widely held view that ethnic diversity, either in form of fragmentation (a lot of different nationalities living within a country) or polarity (few significantly represented nationalities in a country) leads to the loss of social capital and, therefore, to greater distrust in fellow countrymen (see Putnam, 2007). In fact, Gerritsen and Lubbers (2010) find that cross-national differences in trust in their own population can be explained primarily by the level of income inequality (they find all other potential explanatory variables to be insignificant).

When it comes to trust in other nationalities, they argue, like Delhey (2007), that cultural proximity (and particularly, similarity of languages and dominant religion proximity) and the quality and prestige of institutions in the target country are significant predictors for cross-country differences in trust. In contrast to Putnam's hypothesis of diversity breeding distrust, ethnic diversity in the trust-giving country may actually have a positive effect on its citizens' perception of other nations. This conclusion holds using various measures of diversity. Importantly, the authors

Figure 2.3

Percentage of Other People Trusted Relative to Trust in Own Population



Source: Adapted from Table 1 in Gerritsen and Lubbers (2010). © CESifo

claim support for the 'unknown is unloved' hypothesis. Namely, the negative effect of cultural distance between nations is partly mediated by the level of familiarity with a particular population. Higher levels of education among survey participants also reduce this negative effect. The authors find that the initially low levels of trust can be somewhat overcome when people become more familiar with other populations and get accustomed to living together either within their own countries or, more broadly, within the European Union.

The familiarisation effect is consistent with the observation that countries that are longer in the European Union are also more trusted than those that have not yet joined or were members for a short period of time only. While, obviously, there can be alternative explanations for this effect, one way to think about it is that when a country joins the European Union, personal, cultural and business interactions with other Europeans increase and, gradually, trust accumulates. If this argument holds, it is certainly an important validation of the freedom of movement of people rule encoded in the Four Freedoms.

It is important to note that the familiarisation and increase in trust do not depend on identification with a set of values. An insightful contribution by Alesina, Tabellini, and Trebbi (2017) show that there is a substantial cultural heterogeneity in the European Union, but that this heterogeneity is less than within countries like the United States or the United Kingdom, or even within individual continental European states. Their conclusion is that "between 1980 and 2009 Europeans became slightly more different in their attitudes toward trust, values such as appreciation of hard work or obedience, gender roles, sexual morality, religiosity, ideology, the state's role in the economy, and related economic issues." But there is similar diversity in the United States, and more strikingly, even greater diversity within individual EU member states. So the central issue becomes the capacity to create trust both with cultural divides and across political boundaries.

2.4.1 The Impact of Trust on International Trade and Economic Integration

Trust is a critical component of establishing business relationships both within a country, and particularly in fostering international business relationships. This is due to the fact that the level of trust significantly impacts search and contracting costs, costs related to information gathering about product or service quality and potential partner reliability, monitoring and other 'soft' types of transaction costs. When such costs are too high, Pareto-improving trading does not materialise, leaving potential partners worse off. On the global level, a 'missing trade', i.e. international trade significantly below the levels predicted by neo-classical theory, is well documented (Trefler, 1995).

European rules and regulations, as well as European institutions, aim to create mechanisms that would reduce part of the transaction costs in inter-European business not only by abolishing direct trading costs such as tariffs, but also, at least in theory, by helping to increase indirect trust (i.e. by lowering legal uncertainty, protecting the right of equal access, etc.). However, the fact remains that, as we have seen above, Europeans trust their fellow countrymen more than foreigners. This indirect (dis)trust may lead to a home bias in business strategies and to a reduction of potential trading gains and other cross-national business activities.

In their 2003 working paper, den Butter and Mosch study the impact of both direct and indirect trust on international trading costs. They construct a gravity model for 25 developed economies, including many European ones. They use the proximity of the legal systems as the key determinant of the level of direct trust. If two countries belong to the same or a similar legal tradition, corresponding firms may have an easier time agreeing on how to draft an appropriate contract including, for example, how detailed the contract needs to be in specifying contingencies. While reducing direct costs is shown to potentially contribute to reducing transaction costs and, thus, to improving international trade, it is indirect trust that has been shown to have even stronger effects. As a proxy for informal trust they use a Eurobarometer survey question on trust between countries (i.e. trust between populations) and find that an increase in informal trust by one standard deviation may lead to an increase in bilateral trade flows of between 90 and 150% (den Butter and Mosch, 2003).

Combining this with the results of the previous subsection, one could conclude that for European Common Market policy to have a maximum impact, economic integration is not enough. Encouraging much closer contacts between citizens of Europe may simultaneously reduce negative stereotyping as well as help indirectly reduce potential hidden barriers to economic and other cooperation. Top universities, international scientific collaborations, or leading multinational companies provide great examples of what can be achieved when people cooperate irrespective of their national origin, cultural, or political differences.

2.4.2 Trust in Relationships between States

In the current institutional setup (and for the foreseeable future) national governments and their leaders play pivotal roles in the European project. For any institutional arrangement to be workable in the long run, one of the crucial issues is therefore the extent to which European countries (and their political leaders) can trust each other.

But what is trust between states? According to the political scientist Aaron Hoffman, trust between states implies a willingness to take risks on the

behaviour of partner countries under the assumption that the partners will "do what is right" (Hoffman, 2002). Thus, the concept of trust involves both the willingness to take risk by forming an expectation about the behaviour of others and, importantly, a belief in "fiduciary" responsibility in a relationship of trust. In a trusting relationship one state would enact policies that delegate partial control over its interests to the partner state or states. This can only happen if a relatively strong belief exists that the other side(s) are going to behave in a trustworthy manner. Examples of trusting relationships are the abolition of border defence between Canada and the United States and the border controls between most EU countries. By the same token, as trust in Europe weakened as a result of the protracted financial and economic crisis and, later, a large influx of refugees, some forms of border control re-emerged between Schengen countries.

Clearly, there is no absolute and unconditional trust between states. The level of trust between states may change over the years both in scope (i.e. in which areas the other parties are trusted), as well as in the intensity or degree of trust. We now briefly summarise some of the tools that can be used to assess or measure the scope and intensity of trust between countries.

Trust between Country Leaders

Negotiations between states are typically carried out by their representatives. This makes the degree of trust that exists between their leaders a very important predictor of trust. It is well known, for example, that the former German Chancellor Helmut Kohl had close relationships not only with the leaders of France and several other Western European countries; but also, to a large degree, with Mikhail Gorbachev, the last President of the USSR. This was instrumental in allowing Kohl to spearhead the reunification of Germany, and in the creation of the European Union. Trust between the leaders helps negotiate measures that grant other states discretion over outcomes previously controlled by others, with a clear expectation that the partners would "do what is right". On the flip side, a betrayal may be taken personally and can lead to a serious damage in a relationship. Note that private statements of leaders in their diaries or private letters are a far more valuable guide than public statements as to the true nature of personal relationships between country leaders.

Oversight Mechanisms

After identifying the discretion-granting policies negotiated by leaders, the next step in determining the scope and depth of trust is to consider mechanisms used to oversee the exercise of that discretion. Even if leaders trust each other implicitly (which is rarely the case), oversight mechanisms are needed for several reasons. The first is to allay the fears and concerns of people not involved in direct decision-making that agreements will actually be followed. Secondly, in most democracies leaders change on a regular basis and with no guarantee of any kind that the new leaders will understand each other as well as previous ones did.

There are two basic types of oversight mechanisms (Hoffman, 2002) (and many shades of grey in between). One is before-the-fact oversight, which takes place before decisions are implemented. In its full form it can be thought of as intensive policing before a crime (i.e. a violation of good behaviour) has been committed. The International Atomic Energy Association, for example, actively polices countries that are potential violators of the non-proliferation of nuclear weapons. It does not wait for the country to actually violate the rules before it starts meddling into its affairs. Obviously, the degree of intrusiveness is determined by the level of (dis)trust between the parties. Europe's attempt to manage fiscal rules before the financial crisis failed spectacularly, with many states (including France and Germany) breaking the rules and the President of the Commission calling the agreement on fiscal rules "stupid". Another type of oversight is after-the-fact oversight, which takes place after decisions are implemented and can be likened to a fire alarm in case of trouble. One example of such oversight is reports by whistle blowers on human rights violations.

Let us now consider the austerity measures implemented in several heavily-indebted European countries after the outbreak of the global financial and the subsequent government bond crisis in the Eurozone. Clearly, these measures are intrusive. They are also imposed after countries have already violated the spirit of 'good behaviour'. In hindsight, it seems clear that the absence of serious policing of fiscal violations *before* these violations were made (or, rather, before they got out of control) was partly responsible for subsequent problems. On the other hand, the degree to which countries allow themselves to be preventively policed is determined endogenously in the process of treaty negotiation. The more a country is willing to commit to an ex-ante oversight, the more it can be trusted not to violate the rules in the future (and vice versa). The degree of such commitment also depends on its trust in partners that such preventive measures are not going to be abused.

Types of Agreements

While some international agreements are oral,[2] most are written on paper. One may be tempted to conclude that written agreements result primarily from a lack of trust, but this is not necessarily the case. For written agreements are a necessity in a very typical situation when third parties (for example, parliaments) need to approve the agreements. Moreover, written agreements are essential if one is to preserve them for times when those who did the negotiations are no longer in office.

[2] One such oral agreement between the USSR and the West apparently stated that NATO should not spread eastwards upon German unification. Violation of an oral agreement may have equally as grave consequences towards building of trust as a violation of a written agreement.

There are two basic types of agreements that states conclude with each other: the first is a *framework-oriented* agreement type dominated by constitutive rules that specify the basic structure, institutional forms, procedures and rights, but do not cover specific implementation details. By contrast, *statute-oriented* agreements are dominated by codes that try to quite specifically spell out the behaviour of parties under sets of potential circumstances. Framework agreements are more indicative of a trusting relationship, *ceteris paribus*. The *ceteris paribus* caveat is important since parties sometimes simply do not want to commit to a more specific agreement type and the framework agreement then appears as the only viable solution if any agreement is to be reached.

To summarise, when analysing trust in relationships between countries, including members of the European Union, it is useful to consider all three of the dimensions described above and, whenever possible, to start with the first (trust between the negotiating parties), followed by a consideration of oversight mechanisms, and finally of the type of agreement in question.

2.5 COORDINATION

Coordination mechanisms can be thought of as a way of managing the redesign of institutions in accordance with long-term needs, but without the pain associated with crisis measures and exceptional adjustments in difficult circumstances. They deal mostly with the establishment of a framework, but not with specific enforcement.

Logically, coordination can be carried out in a number of ways. The first, most important and most successful way in the European setting, is through competition policy: with rules outlawing cartel formation, and the abuse of market dominance. The idea behind this type of coordination is that the market – and not the state – can deliver good outcomes, but only when the state has established a framework of rules. Some of the impetus behind this mechanism came from German sources: the insight about competition facilitated by a state-given framework or order was at the heart of the Freiburg school of *Ordo-Liberalismus*. But it largely came from the model of the United States, where the second New Deal, in the later 1930s, turned competition policy into the state's key weapon against the abuse of corporate power. In the case of competition policy management, there is a clear enforcement mechanism on a European level.

The second form of coordination drew on an important lesson from the interwar period, when the big losers from the globalisation wave were farmers, threatened by competition from outside Europe and by price declines that led to over-indebtedness and bankruptcy. They became politically radicalised, and formed a core support for radical populist parties, mostly on the right (although in some countries, notably Spain, there were also radical left-wing peasants' organisations). Most of the budgetary resources of the European Economic Community and its successor organisations (including to date the European Union) were devoted to the operation of the Common Agricultural Policy (CAP), designed precisely to compensate for losses, stop rural impoverishment and block political radicalisation.

The third coordination exercise was much more problematic. Both fiscal and monetary policy can produce spill-overs. Inconsistent monetary policy, with exchange rate alterations, threatened the complicated system of subsidies calculated under the CAP. That problem, along with concerns over inconstancy in US monetary policy, pushed Europe to try to coordinate monetary policy more closely from the late 1960s onwards, through a move towards a currency union (first laid out as a plan in the 1970 Werner Report). The inflation of the 1970s, with different European countries taking very different stances, frustrated the move towards monetary integration. In the late 1970s, however, in response to a rapid depreciation of the US dollar that strained European exchange rates as the Deutschemark (and the Swiss franc) appreciated against other currencies, including the French franc and the Italian lira, European countries adopted the European Monetary System, with fixed but adjustable exchange rates. Since a great deal of competition occurs in prices, the manipulation of exchange rates can create advantages. In order to prevent a game of competitive devaluation, agreements on exchange rates – or indeed a complete renunciation of the exchange rate as in the case of the European Economic and Monetary Union (EMU) – can be implemented. However, since internal costs may develop differently, real exchange rates can be badly misaligned in the case of a fixed rate system or a currency union, and may give rise to fresh accusations of exchange rate manipulation.

Unsustainable fiscal states create both domestic and international challenges. Burdened states grow less. Furthermore, given European and global interconnections, fiscally irresponsible behaviour by one country creates negative externalities for other countries in the network, especially if they have the same currency. Markets react by putting pressure on such players (e.g. by increasing interest rates and, if they have their own currency, by devaluing the corresponding currencies). But even these market moves create externalities on other network members. The obvious answer to these problems – domestic reform – is unpopular and hard to implement in a democracy.

Discussions at the time of the Delors Report of 1989 raised the question of fiscal discipline in a monetary union, with many central bankers arguing that market discipline alone would not be enough. This resulted in the devising of a set of convergence criteria for monetary union (the Maastricht criteria) that would later remain the central elements of the Growth and Stability Pact. The two central features were a limitation of public

deficits to 3% of GDP, and public debt levels to 60% of GDP. At the time, these limits were widely criticised by academics as arbitrary. It later emerged that, in the face of a severe recession, setting fiscal criteria expressed primarily as a proportion of GDP was problematical, as collapsing GDP would require further fiscal tightening in order to achieve targets. This became an issue in discussions of the so-called troika of European Commission, ECB, and International Monetary Fund (IMF) with program countries in the financial crisis. The IMF's fiscal criteria were initially expressed in terms of numerical targets for deficits, while the Commission thought in terms of share of GDP.

Surveillance by European institutions, but also by international organisations like the OECD or the IMF, was ineffective, and has been subject to a great deal of retrospective criticism. Eurostat did not detect or report wrong national reporting. International institutions were too keen to believe that the EMU was an intensely political project, with an enormous amount of political capital invested, and that surveillance should thus be left primarily to national governments and the European Commission. They were also too eager to accept national assurances that all was well.

A fourth coordination alternative depends on what is usually termed 'soft law', the establishment of norms and benchmarks, and the publication of comparative data, but without any formal enforcement mechanism apart from peer pressure or naming or shaming. In Europe, this approach was developed with regard to employment policy in the late 1990s, at the same time as the move to a monetary union, in an attempt to establish a parallel mechanism of convergence. It was formalised as the Open Method of Coordination at the Lisbon summit in 2000, and then extended to other areas including social inclusion, and later culture and health. It is – and needs to be – tolerant of differences in national approaches. In some ways it is little more than the employment of government resources to make comparisons and draw lessons, a function that may equally be performed by think tanks, academics, and media commentators. The sensitive issue of differences in house prices and affordability, for instance, which is a central issue for social coherence, has been left largely to academics. More recently, international organisations like the Bank for International Settlements and the IMF have started to collect and distribute data on this topic.

2.6 ATTITUDES TOWARDS A MULTI-LEVELLED EUROPEAN POLITICAL ENTITY

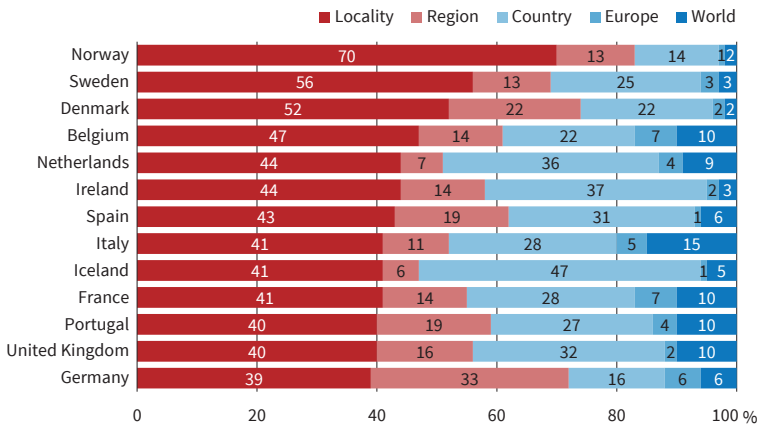
Contemporary Europeans live in a complex political reality. For centuries, people residing in this part of the world have had their local, regional, and national attachments or identities. Now there is a new layer, namely that of a unified Europe. In the political science literature it is often assumed that support for the European project must go hand-in-hand with the establishment of a unifying European identity. Kohli (2000) argues that social identities are dynamic and often conflicting. The predominance of an European identity is by no means a prerequisite for a partial European integration either, but may be necessary to create a federal Europe.

In 1990, citizens of several developed European countries were asked to state whether they primarily identify with their locality (city), region, country, Europe, or the world. Figure 2.4 reveals that most people primarily identified with the local area in which they live, followed by their country or region. By far the smallest fraction viewed themselves primarily as Europeans. On the surface, this is very bad news for European integrationists. Part of the reason for such a low number of 'primarily Europeans' is that those who are globally minded think overwhelmingly of themselves as the citizens of the world. For them, Europe is too narrow a construct. But this result also shows that nation-states do not primarily define the identity of Europeans either. This is especially true in Germany, where people more readily identified with their local place of residence (39%) and Länder (33%) than with Germany as a whole (16%). 6% of Germans and 7% of French also primarily identified with Europe, more than in most other polled nations. Norway, where 70% of the people primarily identified with the local community and just 1% of the people primarily thought of themselves as Europeans, is an extreme case in point.

These results argue for a more nuanced approach towards identity. It makes little sense to force people to choose just one dimension of their social identity (not to mention that geography-based identities may not be very relevant to many contemporary members of our modern global society). As Kohli (2000) shows, when

Figure 2.4

Primary Identifications of Europeans



Source: European Value Study 1990, adapted from Table 1 in Kohli (2000).

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people were asked whether they would include Europe as part of their identity, over 50% agreed. Thus, people may not primarily view themselves as Europeans, but are including Europe as a component of their more complex social identity.

In Europe, decisions are made at different levels of government. Obviously, most people have a better understanding of local, regional, or national politics than they do of the European political process. For this reason, what happens on the national level may be used to evaluate European institutions and the European integration process in general. In the literature (see, for example, Armingeon and Ceka, 2014), one can roughly classify the different types of trust at a national and European level as follows:

- The 'escapist'; distrusts national government and puts all hopes in the EU.
- The 'nationalist'; trusts national government, but distrusts the EU.
- The 'trusting' citizen; trusts both levels of government.
- The 'detached' citizen; trusts nobody.

In 2007, support for European integration was comparably high in newcomer states and less so in the richest countries of the Union (Figure 2.5, horizontal axis). The global financial crisis followed by the Eurozone debt crisis significantly eroded support for the European Union in many countries by 2011 (Figure 2.5, vertical axis). Unsurprisingly, support dropped the most in those countries that were hardest hit by the crisis (particularly in Greece). On the other hand, in some countries (Finland and Sweden) support for the EU even grew with respect to 2007, although coming from lower initial levels.

An interesting question is the extent to which this drop in support is a result of unfavourable attitudes towards their own government; and to what extent it is a direct reflection of dissatisfaction with the EU austerity policy. Another key consideration is whether more people are switching to 'nationalism' as a result of the crisis? In Figure 2.6 we present how the distribution between the four types of people (in terms of trust placed in their national government and in the European Union) has changed between 2007 and 2011. We do so for those countries that were subject to special IMF measures (crisis countries), those countries that were not in crisis, as well as for the entire EU-27 block.

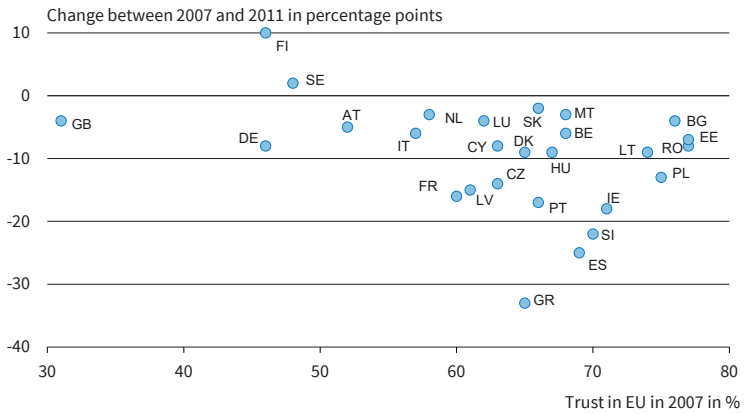
We see that the fraction of people in crisis countries that believed in their government and not in the European Union (the 'nationalists) was quite low before the crisis, and remained low afterwards (it increased from 3 to 4% of the total population). On the other hand, the number of those citizens that trusted everybody dropped from 28 to 21%, while the share of those that did not trust anybody grew very significantly (from 30 to 45%). At the same time, the number of people putting their whole trust in the European Union dropped from 39 to 30%. Thus, before the crisis many people put overwhelming trust in the European Union, while others expressed disappointment in all levels of government.

In countries without IMF conditionality in 2011, by contrast, there were initially more 'nationalists' than in countries without IMF conditionality, and this share remained almost unchanged after the crisis hit (it grew from 9 to 10% of the population). While trust waned across the board, it did so less in countries without IMF conditionality.

In order to better understand the relation between support for national and European institutions, Munoz, Torcal, and Bonet (2011) compare support for national and European parliaments. They study whether political confidence in institutions spills over between the two levels (national and European); or whether citizens compare and compensate by placing more confidence in one level of government when they mistrust another. They find that, in the case of parliamentary trust, both arguments partially hold. At the individual level, levels of trust in national and European parliaments are closely related. However, in countries with better institutions the frame of reference for approval of the parliament's work is set higher. In such countries, support for the European parliament is lower. In countries where national institutions function more poorly, by contrast, approval of the European parliament is higher, *ceteris paribus*. Support for the European institutions is therefore not formed independently of support for national institutions.

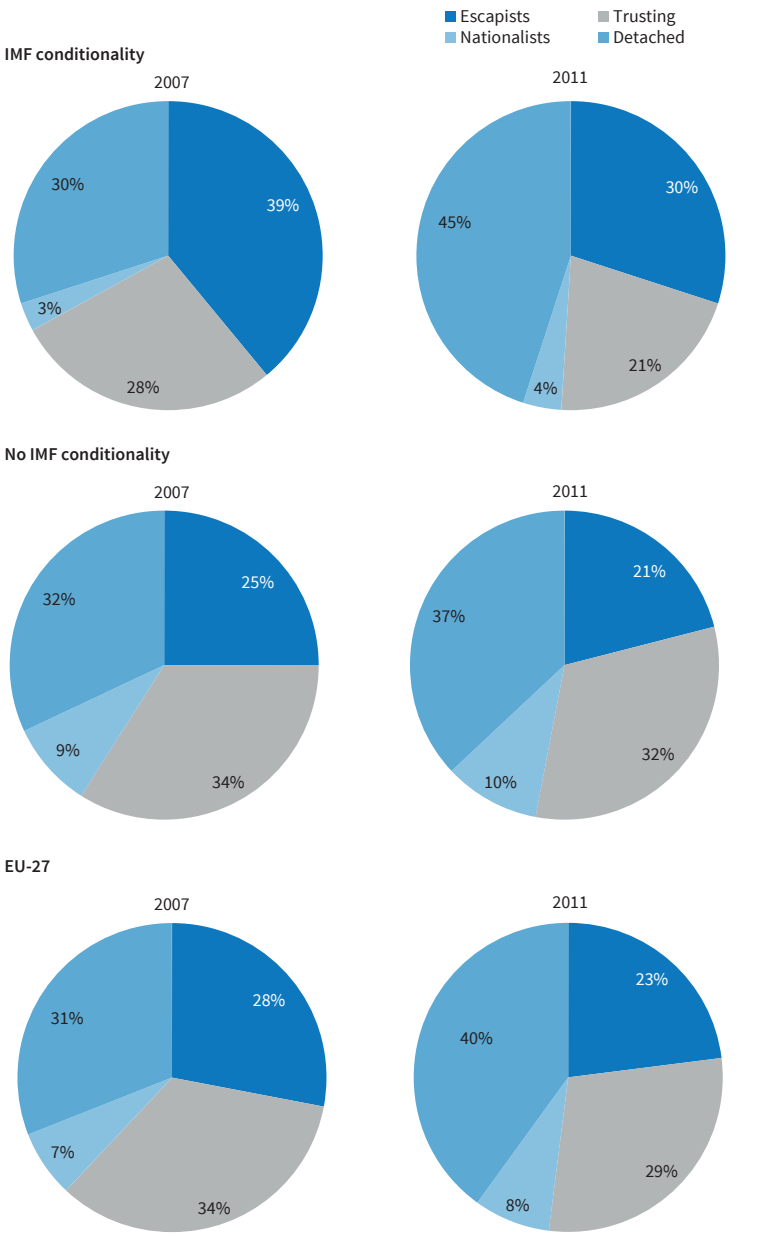
Figure 2.5

Percentage of People Expressing Trust in the European Union in 2007 versus the Difference in That Trust between 2011 and 2007



Source: Eurobarometer survey (2007), adapted from Table 1 in Armingeon and Ceka (2014). © CESifo

Figure 2.6
Trust in EU and National Governments



Source: Eurobarometer survey (2007), adapted from Table 1 in Armingeon and Ceka (2014). © CESifo

2.7 THE ENLARGEMENT PROCESS

We conclude this introduction by briefly commenting on the trade-offs inherent in the European enlargement process. Each political entity has its horizontal and vertical scope (see Genna, 2003). The enlargement process has been a critical strategic tool for the creation of an economically and politically (partially) unified Europe. It ultimately determines the horizontal scope or the boundaries of the European Union.

Imagine the Union without the enlargement. It would consist of three relatively large and three small European countries. Some would argue that a union of just these six countries may well had been more cohesive than is currently the case, and might have advanced further on a notional road to political union. Others, however, would counter that even these six countries are significantly diverse in terms of culture, language, economic prosperity or religion. Part of the attraction of inviting others into the European club of nations has been to try to bring potential allies and/or dilute the influence of other powerful nations. Its primary goal, however, was to extend the common market. One thing is certain: without enlargement, the club would be far less relevant not only in the world, but also in Europe. Germany would probably not have been allowed to unify in such a setup either. Without the prospect of joining democratic and prosperous European nations, it may also be much harder to achieve transitions in both the East and the South East of Europe. Enlargement is driven by the logic of expanding a stabilising mechanism.

On the other hand, a rapid expansion has, as we have seen, increased diversity and suspicion, while reducing social cohesion in the Union. There are growing doubts about the application of the principle of mutual recognition in criminal law. This mistrust, in turn, may have repercussions on the ability of the Union to achieve further integration. Thus, the horizontal scope impacts the vertical one (and vice versa). It is worth noting that in order to have clearly defined and defensible EU borders, as well as for several strategic reasons, it seems clear that sooner or later another expansion may be necessary, namely one that would eventually incorporate the Western Balkan countries (see EEAG, 2016). These countries are already integrated with Europe financially. In addition, European and global business networks are increasingly expanding their production and distribution networks into the region (via companies like Siemens, Fiat, Bosch, etc.). Failure to integrate the Western Balkans into the European Union would open the doors even wider for other nations (China, Russia, Turkey) to exert strong outside influence in the region, of which only China's influence would be primarily economic in nature (the New Silk Road initiative passes squarely through the region).

We have seen that cultural differences and the quality of institutions are significant predictors of people's attitudes towards other nations in Europe (and towards the integration process). On the other hand, the longer countries are together in the Union, the more people get to know each other, and the more relaxed, on average, they start to feel about other European nationalities. A major success of the Erasmus programme has been to demonstrate to young people across Europe that they are all part of something bigger than just their own country, that there is a whole wide world out there inhabited by people just like themselves. One can argue that the cultural differences between people from South Eastern Europe with, say, Austrians, Germans, or even Scandinavians are certainly not insurmountable. This is demonstrated by the ease with which most people from these countries integrate into Western Europe or Scandinavia (and vice versa, albeit in much smaller numbers). Moreover, the evolving global technological revolution is reducing the de-facto distance between cultures as time passes, since most young people today seem to inhabit a similar virtual world.

With the exception of fear of Islamic radicalism and a wider scepticism about Islam, most Europeans do not attach overwhelming importance to practicing religion. Thus, religious differences can hardly be a true impediment to a mutual understanding between most Europeans. One important objective barrier to easier European integration, namely the issue of different languages spoken across the continent, can be overcome over time if at least two foreign European languages (from different major language groups) are studied in schools across Europe. It may also be that machine or automatic translation (both of written and spoken texts) may quickly remove the barrier between people who do not share the same language. In addition, the process of European accession, while difficult, requires improvements in the quality of institutions in those parts of Europe in which they are lagging behind.

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